Strategic investment decisions and deployability of funds in Indian small and medium enterprises (SMEs): Some observations.

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ABSTRACT

Policy liberalization and strong competition force Indian corporates to rethink organizational strategies. Rationalization of policy influencing cost, quality and delivery are continuously emphasized. Globalization of market has made competitive forces highly challenging for the small and medium enterprises (SMEs). These press the demand enhanced capability in SMEs, in manufacturing. Co-ordination with customers, bankers, suppliers and larger corporate require leveraging on information technology (IT). Job creation vs capital deployment ratio is low in SME than the large and mega enterprises (LME). Indian SMEs, many of which lack formal investment planning, need to respond urgently to changing demands focus to balanced funding for both debt and equity. SMEs are characterized by capital –labor dichotomy. Their labor-intensive nature is adoptable to the populated developing countries. The capital requirement of these industries is considerably low. Large industries require a large amount of capital for operation of competence.

Financial endurance of the promoter-owner-manager-entrepreneur is inbuilt into the business startup. The risk- bearing ability of the small entrepreneur is reflected to the extent he converts the fixed capital to working capital. Here, the quick-cycling of often over-drafted working capital defines the risk coverage. But, it may be kept in mind for both the provider and the user of the funds that, the period of debt-service-coverage in working capital (WC) is low in comparison to, fixed capital (FC). The fixed capital deployed in land, building, plant and machinery etc. do not get converted into revenue. Hence, FC does not have direct bearing on the aspiration for profit. The situation as described above is crystal clear, for the prospective entrepreneurs. Still, the apportionment of capital is ever uneven, resulting in scarcity of WC. This results in a rampant mismatch in the operating cycle. By this the availability of the finished product in the market, gets scare. As a result, earning and funds flow gets affected demanding further overdraft. E-market interventions are called for in the growth and development of SMEs. With lower capital formation in manufacturing in SME, back-up for financing working capital has become weak. It is weakening further due to increasing bankers risk and amassing of non-performing assets.

Introduction

Entrepreneurs views enterprise as a mind-set. They go for venturing, even without the extent of seed-money required for investment. They deploy funds from other's sources even they have no confirmed own funding support, to innovate and grow. They are the spark- plugs, bringing radical change in economic development. Van den Berg (2001) said, "Central to Schumpeter's process of creative destruction is the entrepreneur, the person who initiates the process of innovation. The entrepreneur is the one who sees the opportunities for introducing a new product, changing a firm's management organization, exploiting a new market, finding a new source of raw materials, cutting the costs of production, or motivating the labor force. Entrepreneurs are often more managers than inventors. They are the ones who see the economic potential of inventions. They need not themselves be "capitalists," that is, owners of capital: they may simply manage for those who provide the funds for the enterprise. But they have ideas, the ambition, and the confidence to bring projects to fruition."

Business transactions are segregated from personal transactions. For an SME entrepreneur, the dichotomy of capital utilization gets aggravated. Since, the personal investment encroaches the business sustenance. Further, in the context of the growth of the business, everything doesn't happen idealistic. Overdrafts are not invariably granted. As a consequence, when the entrepreneur seeks private funding as a "management by crisis" approach, this yields to financial sickness. To explain the process of working capital financing in SMEs, Hisrich and Peter (2004) said, "In spite of these potential problems, an entrepreneur at times needs some capital to finance growth, which would be too slow or nonexistent if internal sources of funds were used. Outside capital should only be sought after all possible internal sources of funds have been explored. And when outside funds are needed and obtained, the entrepreneur should not forget to stay intimately involved with the basics of the business."

Contrary to the thoughts quoted, Indian SMEs are more keen to deploy funds from other sources preferably public sector banks, where government is a major shareholder.

Entrepreneurs feel staked in risk to deploy their own funds. Non-timely payment of bills by the purchasers from SME and over-stayed inventory create working capital scarcity. In this context, several researches are conducted. One such study where Khanka (2001) said, "Working capital is that amount of funds which is required to carryon out the day-to-day operations of an enterprise- whether big or small. It may also be regarded as that portion of an enterprise's total capital which is employed in its short-term operations. These operations consist of primarily such items as raw materials, semi-processed goods, sundry debtors, finished products, short-term investments, etc. Thus, working capital also refers to all the short-term assets known as *current assets* used in day-to-day operations of an enterprise. Khanka further adds, "Capital/finance is regarded as life blood of any enterprise. Therefore, the significance of working capital in an enterprise lies in the fact that its circulation has to be properly regulated in the business. Because, any over-circulation or under-circulation may create problems just as improper blood circulation called high or low blood pressure, in the human body may create problems."

Debt / Equity and Working Capital:

Watch on the growth of business and the nature of funds circulation brings out the factors that creates the WC crunch in Indian SMEs. This had been the major cause of industrial sickness. Charantimath (2006) says, "The management of working capital has become an important activity. The proper management of capital ensures good health for business. It is also essential that an entrepreneur should make continuous cost analysis and try to minimize cost by evolving effective methods….Entrepreneurial efficiency to manage working capital is one of the darkest areas of management of small-scale enterprises. As a result, a large number of units fail to survive the initial enthusiasm. This is true for both in India and abroad."

Deciding financial structure for the business depends on the interests of entrepreneur, debtor and investor. Equity, of course holds the key to debt finance being the life-blood for business sustenance and growth. Kelly (1994) said, "Aside from issues related to 'loss of control', entrepreneurs are also reluctant to raise outside equity because the 'perceived cost' is too high relative to debt. Most entrepreneurs consider debt finance to be 'cheap'. After all, the return to debt holders is often 'fixed' for substantial periods of time and interest costs are a tax-deductible expense. Importantly, debt has an obvious 'control appeal' for entrepreneurs- they often perceive that they can obtain the necessary resources while retaining equity control."

The situation, above while complied for Indian SMEs, Padmanand and Jain further remark, "Any smart entrepreneur, in a manufacturing industry, should strive to reduce the working capital of his operations, either by looking for extended credit periods, by reducing the raw material to work-in-progress, to finished goods conversion period, by reducing the stocking period of inventories, viz., by manufacturing 'just-in-time', and by securing payments from buyers well in advance, or by reducing the period or incidence of credit sales. Working capital management goes haywire in the Indian environment. Managerial skills and expertise will not suffice, as business ethics, or at least market ethics, in many industrial sectors and segments is rather poor. And SSIs are the worst hit. They have empirical evidence, theory, and policy, directly or indirectly oriented against their survival."

On Capital-labor deployability in SME Little, Majumdar, Page Jr. (1998) said, "The supposed labor intensity of operations is explained partly by the inaccessibility or high cost of capital; and, second, that such inaccessibility or high cost is itself a market imperfection which should be removed or reduced (though, if the first hypothesis is valid, this would increase the capital intensity of the small firms but not necessarily that of the whole aggregate of firms." They further advocate, "Ninety percent of the start-up finance for units with less than 25 employees in Jamaica came from own savings, with friends and relatives providing another 6 percent. About 13 percent had applied for loans to commercial banks or government organizations, of which only 20 percent were successful. The more educated, and those in the towns, applied more often and were more successful. Lack of collateral was the main reason for refusal, and often also a reason for not applying (as everywhere)."

Industrial activities picked up in India w.e.f mid 80's as an effect of the implementation of the industrial policy reso9lution (IPR) 1960 by Govt. of India and the Small Industries policy 1991. Profuse funding by banks for FC or WC could hardly back the business survival in SMEs. Instead, market, management and policy framework not being properly watched, piled up non- performing assets in the SMEs. Many SMEs were closed. In the meanwhile, investment limit (investment in plant and machineries) were raised to 1 crore for SMEs with a provision to raise the limit, while they graduate to medium/large enterprises. Entrepreneurs are demanding further funding commensuration the resource crunch *ab initio*. Since almost every enterprise became more security than risk-driven. Investment in FC has increased the project cost but abundance of WC is always a question.

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