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Case Study

Leveraging the Potential of SME Capital Markets: Evidence from Small and Medium-Sized Enterprises in Jammu Region, India

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Received: 27 November 2021; **Revised:** 12 October 2022; **Accepted:** 15 October 2022

Abstract: The paper intends to explore the potential for developing Small and Medium-sized Enterprise (SME) capital markets in India by analyzing the business conditions of SMEs, the priority, reasons, necessary actions and critical factors needed for developing capital markets for SMEs, and to offer strategies for development of new SME capital market. Besides, the status of the SME capital market in India has also been analyzed. The study has been restricted to 114 non-financial firms consisting of 43 SMEs engaged in manufacturing activities and limited to five selected major industrial areas surrounding suburbs of Jammu city. The study covered 71 SMEs engaged in service activities and confined to hotel and restaurant, computer and electronics, offset printing, pharmaceutical distribution, wine trade, motor parts, gold jewelry, and wholesale general merchant in the commercial areas of Jammu city in Jammu and Kashmir. The study has used a life cycle approach to analyze the sources of finance in different stages of the SME. A simple descriptive technique has been used to analyze the data. The study reveals that there are various challenges to establish direct growth capital financing for SMEs. Looking at numerous viewpoints on the development of SME capital market, a specialized market infrastructure of non-exchange foundation equity market for SMEs can be developed. The establishment of a separate foundation equity market for SMEs from exchange market can be advantageous. There is a need to develop a preliminary market for growing SMEs. This should ultimately integrate into the regular SME stock exchange market. A preliminary market is expected to endow SMEs with a chance to understand clearly SME capital market rules and responsibilities linked to disclosures before integrating into the organized capital market. It will imbibe the corporate culture through knowledge regarding the significance of enhanced corporate value for the growth and development of firms. The foundation market should evolve into a robust system for carrying SMEs in equity finance from various dimensions. These dimensions can be the promotion of the venture capital market to provide initial risk capital for SMEs, the development of a strong base of capital market professionals to train and goad the SME disclosure process through a network of certified public accountants, and the development of a blueprint for government policy support measures including tax incentives for SME issuers and investors.

***Keywords*:** small and medium-sized enterprises, capital markets, strategies, policy implications, India

JEL Codes: E44, L22, L26, L53

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1. Introduction

Small and Medium-sized Enterprises (SMEs) drive economic growth (Ayyagari et al., 2016) in both developed and developing countries (Floyd & McManus, 2005; Naude & Chiweshe, 2017). SMEs account for the majority of firms and create more than three-fourths of net jobs in developed countries (OECD [Organisation for Economic Cooperation and Development], 2006). On average, SMEs contribute half of the Gross Domestic Product (GDP) and 60% of the employment worldwide (Gerlach-Kristen et al., 2015), 57% of the GDP and 61% of jobs in an individual country (Irene, 2017). In low-income economies, the contribution of SMEs to GDP stood at about one-fifth, while SMEs contribute more than half to GDP in high-income economies (Tadesse, 2009). In developing countries, SMEs contribute one-third to the GDP (IFC [International Finance Corporation], 2010). SMEs contribute substantially to value-added, economic diversification and inclusive economic development (Sommer, 2019). For instance, SMEs contribute more than half of value-added (OECD, 2019) and manufacturing employment (Ayyagari et al., 2007), above 60% of all employment in developed countries (Harwood & Konidaris, 2015), and less than half of employment in developing countries (IFC, 2010).

The firm's size, age, growth, ownership, and industry sector determine SMEs' access to finance (Mac an Bhaird & Lucey, 2010). A firm's size determines the access to finance and affects SME performance (Quartey et al., 2017). Small firms significantly contribute to the employment growth (Ayyagari et al., 2014). Informal firms generate more jobs but remain largely less productive than formal firms with high gross profits (Rand & Torm, 2012). When informal firms become larger, they become efficient like formal firms (Amin & Islam, 2015).

SMEs' access to finance improves their growth (Wang, 2016), employment creation, profitability, efficiency, exports, productivity and return on assets (IFC, 2010). SMEs rely more on informal financing due to informational opaque, high credit risks and bankruptcy, and lower profit margins. Young firms seek informal financing than formal financing (Beck et al., 2006). Old firms prefer internal capital to finance business operations (Hanedar et al., 2014). Asset-based financing refers to receiving funds by pledging a subset of the firm's assets as collateral (OECD, 2015). SMEs lack resources and collateral, experience volatile growth, profitability, cash flow and earnings. This can increase their default and insolvency risks due to the limited track record of credit (Hyytinen & Pajarinen, 2008). Credit refers to funds for the productive activities of a firm. It determines SMEs' access to financial resources. Formal lending to SMEs remains poor due to their intrinsic weaknesses (Beck & Demirguc-Kunt, 2006), legal constraints (Cull & Xu, 2005), deficient banking and financial system (Beck et al., 2006) and information asymmetry and other constraints (Klapper et al., 2006). All these constraints hinder firms' productivity, survival and profitability (Dong & Men, 2014).

Firms' financial constraints influence the investment costs of using internal and external finances. Internal financing refers to the firm's own capital including retained profits. External financing refers to funds from banks, investors, venture capital, and crowdfunding. Both internal and external financing boosts SMEs' growth (Pretorius & Shaw, 2004). SMEs face huge barriers to external financing due to inadequate collateral, poor cash flow, hurdle in credit rating, lack of credit history, lofty risk premiums, and substantial transaction costs (Wieneke & Gries, 2011). Other barriers include low domestic savings and information asymmetries and higher finance costs (Beck et al., 2006). All these barriers impact their growth performance (Cull & Xu, 2005; Klapper et al., 2006). Strong regulatory and institutional environments promote the growth of SMEs (Beck et al., 2006) and significantly promote market expansion and job growth (Troilo, 2011).

The financial position of firms determines their survival (Bartelsman et al., 2005), and growth and exit from the market (Bakhtiari, 2019). Besides financial constraints, the institutions and management skills (Beck & Demirguc-Kunt, 2006; Lee et al., 2012) directly determine the firms' dynamism (Gill & Biger, 2012). A better financial environment removes small firms' growth restrictions (Beck & Demirguc-Kunt, 2006). Credit and liquidity constraints hinder their growth and create entry deterrence in a less competitive credit market (Cetorelli & Strahan, 2006). The increasing market power of banks leads to higher credit constraints for SMEs (Love & Martínez Pería, 2015).

SMEs seek equity capital and debt financing. This differs in terms of sectors, business risk, asset structure, debt-to-equity ratio, growth stage, and profitability. Equity financing refers to money received from investors in exchange for an ownership share in the business. Debt financing refers to raising capital for business operations to be repaid over a specified period with interest (Horne, 2013). Debt financing includes both short-term and long-term debt with a credit guarantee to recuperate costs and retain profits (Damodaran, 2013). These can be used by new as well as established firms for business expansion and to overcome economic slowdown (Hussain, 2016). Equity financing is used by firms to finance business operations. Most SMEs prefer formal debt financing from financial institutions. Information asymmetries restrict debt financing from financial institutions (Nassr & Wehinger, 2016). SMEs under-served by capital markets and formal financial institutions depend on their own funds and informal financing for their survival and growth (Beck & Cull, 2014). Limited knowledge of the financial market and financial literacy hinder the access to SME financing. Therefore, understanding alternative sources of financing such as SME capital markets becomes relevant. Stock exchange listing can alleviate SMEs' financing constraints. But it involves difficulties due to admission requirements and disclosure regulations. This can lead to relaxing regulations for SMEs. It can reduce their greater reliance on lending banks. This can also remove the financial constraints for SMEs' growth and competitiveness. It can also reduce information asymmetry to improve their ability to access external market-based equity finance and reduce their failure. Against the above backdrop, the paper intends to explore the potential for developing SME capital markets in India by analyzing business conditions of SMEs, the priority, reasons, necessary actions and critical factors needed for developing capital markets for SMEs, and to offer strategies for the development of new SME capital market.

2. Theoretical underpinnings and empirical review

Firm value remains low which changes with novel financing decisions. However, the return on firm's equity increased with debt financing (Modigliani & Miller, 1958). The Trade-Off Theory (TOT), Pecking Order Theory (POT), Agency Cost Theory (ACT), and Market Timing Theory (MTT) have been advanced to explain firm financing. The TOT argues a trade-off between costs and benefits linked to debt (Kraus & Litzenberger, 1973). The POT advocates the preference for internal financing followed by debt and equity financing (Myers, 1984). The ACT emphasizes the agency problem linked to free cash flow, debt overhang and asset substitution (Jensen & Meckling, 1976). The MTT maintains the effect of market timing in the issuance of equity and debt (Baker & Wurgler, 2002). These theoretical contributions have led to numerous empirical studies on the determinants of capital structure (Bevan & Danbolt, 2002; Bancel & Mittoo, 2004).

Small and domestic banks provide significant financing to SMEs (Hassan et al., 2017). This can be due to the personalized contacts (Beck et al., 2011), networks and relationships with banks (Cenni et al., 2015). Networking reduces information symmetries between lenders and borrowers and enhances formal financing to SMEs (Safavian & Wimpey, 2007) irrespective of credit volume (Le & Nguyen, 2009). Credit relationship with a single bank ensures better accessibility to finance than does other firms (Bolton et al., 2016; Cenni et al., 2015). The duration of bank-firm relationships also determines access to bank finance (Agostino & Trivieri, 2017; Cenni et al., 2015).

Banks provide huge finance for SMEs in developed countries (Harrison & Baldock, 2015). However, most SMEs lack bank finance (Beck & Cull, 2014; Dong & Men, 2014) compared to large firms (Beck & Demirgüç-Kunt, 2006). This can be due to asymmetric information in capital markets, credit rationing by banks, high transaction costs (Ramalho et al., 2018), information asymmetry (Kersten et al., 2017) and collateral requirements (Beck & Cull, 2014; Dong & Men, 2014; Ramalho et al., 2018). Firms' capacity to repay and informality also compel the firms to rely on internal resources to finance business activities.

SMEs build up internal funds (Mateeva et al., 2013) from their own savings (Forte et al., 2013). The goal is to reduce the debt burden (Degryse et al., 2012) and meet expenses related to financial constraints (Beck et al., 2019). This can hamper the productivity of SMEs (Hsieh & Klenow, 2009). In the case of SMEs, equity is limited to the owner's capital. The main source of SME financing is debt. This is determined by asset structure and growth. Informal credit acts as a more common source of financing start-ups. Formal finances provide investment to more efficient SMEs (Hernández-Trillo et al., 2005). Informal financing builds SMEs' reputations and facilitates their subsequent access to formal finances (Hernández-Trillo et al., 2005).

The size and age of the firm determine financing constraints (Nikaido et al., 2015). Large firms possess larger tangible assets to be used as collateral to access financial markets (Almeida & Campello, 2007) compared to small firms (Carpenter & Petersen, 2002). This aggravates the financial constraints of SMEs due to a lack of internal finances. Therefore, access to finance influences the growth performance of a firm (Canton et al., 2013).

Innovative firms face more difficulty in bank finance due to the risk involved (Lee et al., 2015). Multiple owners lower information asymmetry and increase access to financing (Blumberg & Letterie, 2008). A high firm's profitability of firms positively influences access to bank finance due to a lower risk of default compared to low profitable firms (Quartey et al., 2017). SMEs in the service sector prefer short-term debt compared to manufacturing SMEs (Abor, 2007). Short-term debt makes SMEs more vulnerable to economic distress (Benkraiem & Gurau, 2013). Small firms become more financially vulnerable due to business slowdown (Cowling et al., 2015). This can delay additional investment (Cabral & Mata, 2003). However, manufacturing firms possess sufficient physical assets to pledge as collateral. This can facilitate bank finance compared to the service firms. High capital intensity positively influences the access to bank financing (Bhavani & Bhanumurthy, 2014). High asset tangibility lowers credit rationing and increases access to bank credit (Gou et al., 2018). Exporting SMEs access more bank loans (Quartey et al., 2017). High productivity positively influences access to external funds (Presbitero & Rabellotti, 2016). Firms' credible commitments including collateral and information provisioning also positively influence banks' loan decisions (Blumberg & Letterie, 2008).

Financial constraints pose an immense threat to the growth of firms. This is termed as the finance gap (Dong & Men, 2014) which refers to the divergence between supply and demand for capital due to market failure and information asymmetry (Abdullah & Manan, 2011). The funding gap for SMEs remains huge in developing countries (Dong & Men, 2014; OECD, 2006). This is due to a lack of collateral for long-term credits. Long-term financing refers to financing for a period of more than a year. Smaller and younger firms have larger financing gaps (IFC, 2016, 2012). Bank financing through loans, overdrafts and secured credits dominates external finance for SMEs (Esho & Verhoef, 2018). Trade credit, factoring and leasing or equity finance can be alternatives to bank lending (Ferrando & Mavrakis, 2017). Trade credit refers to a financing arrangement between buyer and seller wherein the seller allows delayed payment for the products as a substitute for cash payment. Trade credit meets short-term working capital needs of SMEs (OECD, 2006). The short-term financing refers to the fund with a maturity of one year or less. Working capital refers to excess of current assets over current liabilities. Trade credit significantly impacts a firm's growth (Demigurc-Kunt & Maksimovic, 2017). This facilitates firms by indirectly accessing credit from suppliers due to difficulty in accessing credit from financial markets (Rajan & Zingales, 2018). Factoring refers to the sale of accounts receivables by a company to a third party for immediate money and finance, which complements working capital finance for SMEs (Klapper, 2005). Leasing refers to a rental contract specifying the payment schedule for the borrower in exchange for the right to use the fixed asset bought by the lender. Specialized leasing institutions offer credit to a small proportion of SMEs (Bruhn et al., 2017). Equity financing enables firms to invest in fixed assets, and support increased debt needs. It provides financing to high-risk SMEs in early lifecycle stages (Nassr & Wehinger, 2016). Both debt and equity financing play a complementary role in a firm's growth. Therefore, the right balance between debt and equity financing is needed (OECD, 2006).

In recent decades, numerous SME public equity markets have been promoted. But they failed to attract sufficient SMEs for listing and trading activity. The main reasons are information asymmetry, high listing and maintenance costs, regulatory burdens, and inadequate management practices. Most empirical studies on SME financing remain confined to developed countries (Mac an Bhaird & Lucey, 2010) and support the POT (Mateeva et al., 2013). Earlier studies have paid inadequate attention to the substitutive or complementary applications of debt and equity instruments. Moritz et al. (2016) have used a holistic approach to analyze SME financing. SMEs suffer from institutional (Ramalho et al., 2018) and market failures to access finance (Beck, 2013), which hinder their growth (Kersten et al., 2017). Better institutions can increase the security of capital providers (Beck et al., 2008). However, research on complementary and substitutive applications of different financing instruments is lacking. Therefore, understanding alternative sources of financing such as SME capital markets becomes relevant in the context of developing countries like India and the present study is an attempt to fill this research gap.

3. Objectives and methodology

In India, SME capital markets remain underdeveloped. Equity financing for SMEs has been accomplished through stock exchange operations. India has developed dedicated stock exchanges for SMEs through their respective platforms. Capital market laws and regulations regulate the SME markets with relevant listing criteria and disclosure requirements. In India, SME finance has focused on the banking system. The development of SME capital markets has received little attention due to the perception of well-established bank-centered financial systems, high cost of establishing and operating SME capital markets. However, the application of cost-effective advanced technology and strong coordination among SME players can facilitate the development of SME capital markets. Little research exists on the potential for developing SME capital markets in India. Therefore, the present study aims to bridge this knowledge gap on SME financing. The study has focused on business conditions of SMEs, the priority, reasons, necessary actions and critical factors needed for developing capital markets for SMEs, and offered strategies for the development of new SME capital markets.

A demand survey of SMEs has been carried out to assess the potential for developing the SME capital market to increase long-term financing opportunities for SMEs. The demand survey mainly covers the following questions: (i) what are the business conditions of SMEs? (ii) Is developing capital markets for SMEs a policy priority? What are the reasons for developing capital markets for SMEs? What are the necessary actions needed to develop SME capital markets? What are the reasons for existing SME capital markets growing? What types of products are appropriate for SMEs' growth and development? What are the critical factors needed to create an SME market? What are the present and future funding instruments available to SMEs? What are the long-term sources of finance available to SMEs at present and expected in the future? What are the average funding amounts available and desired per firm? What are the purposes of funds desired by SMEs? What are the barriers faced by SMEs to access financial institutions? What is the willingness to access SME capital marke? What are the expected benefits and reasons for hesitating to access the SME capital market?

The data has been collected from the SMEs in Jammu city and its suburbs during May-July 2019 in cooperation with the Chamber of Commerce and Industries, Bari Brahmana Industries Association, Birpur Small Scale Industries Association, Jammu Small Scale Industries Association, Hotel and Lodges Association, Computer Dealers, Distributors Association, Offset Printers Association, Pharmaceutical Distributors Association, Jammu Hotel, Restaurant and Bar Association, Wine Traders Association, Motor Part Dealers Association, Sarafa Association, and Wholesale General Merchant Association.

The sample has been drawn using non-probabilistic judgmental sampling to collect the data from the SMEs having either savings or current bank account and registered in respective government authorities. The sample size was restricted to 114 non-financial firms. Of which, 43 SMEs were engaged in manufacturing activities. These SMEs were confined to five selected major industrial areas surrounding suburbs of Jammu city namely Small Industrial Development Corporation (SIDCO) Industrial Complex, Bari Brahamana; Small Scale Industries Development Corporation (SICOP) Complexes located in Birpur, Gangyal, Digiana, and Jammu Cantonment. Out of 114 firms, 71 SMEs were engaged in the service activities. These SMEs were confined to hotel and restaurant, computer and electronics, offset printing, pharmaceutical distribution, wine trade, motor parts, gold jewelry, and wholesale general merchant in the commercial areas of Jammu city in Jammu and Kashmir.

The study has used a life cycle approach to analyze the sources of finance in different stages of the SME. The SMEs were grouped into three types: start-up (<3 years of age), survival (3-6 years of age), and both the growth and sustenance (>6 years of age). SMEs in the start-up and survival stages were setting up the firm in the market. SMEs, which have transverse the initial two stages entered into the growth stage followed by the sustenance stage. Most of the sampled SMEs were in the sustenance stage followed by the growth stage and the survival stage. Table 1 reveals the sample size of selected SMEs engaged in manufacturing and services and their distribution according to the life cycle stage. A simple descriptive technique has been used to analyze the data.

Table 1. Sample size and distribution of SMEs

Sector	Start-up	Survival	Growth	Sustenance	Total	%
Manufacturing	4	5	11	23	43	38
Service	4	7	21	39	71	62
Total	8	12	32	62	114	100

4. Financial needs of SMEs in India and policy measures

Availability of finance remains one of the key factors that reduce the survival time of Indian high-tech startups. However, inadequate and timely access to finance remains the biggest challenge for MSME sector in India (IFC/Intellecap, 2018). Despite various initiatives, credit to MSME remains weak. This compels most firms to rely on informal financial sources. A small proportion of enterprises utilize the equity finance (RBI [Reserve Bank of India], 2019).

Financial needs of SMEs differ in terms of their life cycle development. Financial access positively influences SMEs' survival and growth. Robust entrepreneurial ecosystem positively influences growth of businesses (Bala Subrahmanya, 2018). In India, inadequate and timely access to finance poses the biggest constraints for SMEs' growth and development (IFC/Intellecap, 2018). This is truer for women owning SMEs (IFC, 2019). This can be due to investment risks and lack of equity buffers, high cost-to-serve barriers due to information asymmetry, and lender coverage issues (RBI, 2019).

The banking sector in India is small relative to the needs of SME sector. SMEs face immense challenges to access the required credit. Demand side reasons for SMEs financial access include information asymmetry, inadequate collateral, and limited equity base. Supply side reasons include high transaction costs and lower margins, low risk appetite, outdated underwriting process, and inadequate product innovation. In India's MSME sector, the estimated demand for debt and equity finance stood at ₹87.7 trillion (US$1.4 trillion) compared to viable and addressable debt demand at ₹36.7 trillion (US$565 billion in 2017). Therefore the credit gap stood at ₹51 trillion and informal sources finance 84% of total debt demand (IFC/Intellecap, 2018).

Government has implemented many policies to improve SMEs' access to finance. Recent financial measures to inject additional liquidity for MSMEs in India include (i) the Emergency Credit Line Guarantee Scheme (ECLG); (ii) provisioning of subordinate debt to stressed MSMEs; (iii) establishment of a Fund of Funds to directly invest in MSMEs and encourage them to list on the Indian stock exchanges; (iv) amending of the General Financial Rules 2017 with the rider of no 'global tenders enquiry' for government procurements up to ₹2000 million to benefit MSMEs; and (v) increased the minimum threshold for default from ₹0.1 million to ₹10 million to initiate corporate insolvency resolution (RBI, 2019).

Despite various policy support measures, India's SMEs face informality and are susceptible to structural and cyclical distresses. There exist broad SME finance programs in many developing countries (Quartey et al., 2017), but insignificantly affect profitability and wages (Kersten et al., 2017). Subsidies remain ineffective to boost the growth performance of SMEs. Innovative lending strategies can lead to better performance of firms' compared to traditional debt financing (Beck & Demirguc-Kunt, 2006). Therefore, besides access to finance, the type of finance also matters to SME's performance. In India, the enormous potential of SMEs needs to be harnessed. The financial landscape of the SME sector needs extensive evaluation. Data availability remains a major constraint and poses a challenge for research on SMEs' growth and development. Therefore, this paper has analyzed the potential for developing SME capital markets in India and derived strategies for the development of a new SME capital market to address financial scarcity of the SMEs.

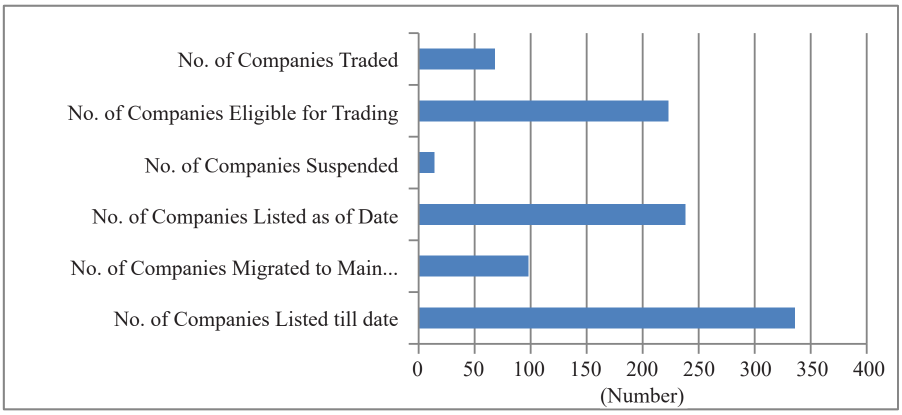
5. Status of SME capital market in India

SME development is a priority to realize inclusive economic growth in India. Adequate financial access is essential for SME's growth and development in the era of economic slowdown. However, most SMEs face inadequate financial access. The supply-demand gap in SME finance remains huge in India due to limited bank financing for SMEs. In the context of ongoing economic uncertainty, the priority of banking sector is to alleviate the related risks. The Basel III can also add fuel to the fire in the banking sector lending to SMEs. Therefore, there is a need for sound SME finance policies to ease credit reduction in an uncertain financial environment. This requires flexible, innovative and diversified financing strategies. Therefore, capital market financing through robust and innovative institutional mechanisms can address the financial requirements of SMEs in India.

In May 2010, the Government of India has recommended to establish a dedicated stock exchange for SMEs. SME

Exchange refers to a stock exchange for trading shares/securities of SMEs. In March 2012, the first SME Exchange was established in India. SME Exchange improves the visibility of the listed SMEs and attracts sufficient trading volumes. In India, SME Exchange is regulated by the Securities and Exchange Board of India (SEBI). A SME can be listed on the SME Exchange, if its post-issue paid-up capital is below ₹250 million. SME stock exchanges would allow SMEs to access capital markets easily, quickly and at lesser costs. It can provide equity financing for SMEs' growth, lower debt burden and financing costs. It can also improve their visibility, increase participation of venture capitalists, support innovation and entrepreneurial spirit, and transfer risk. SME listing provides many advantages such as funding convenience. The benefits to SMEs also include access to capital and financing opportunities, acquisition transaction, premium valuation, efficient risk distribution for investors, ready and easy entry and exit for strategic investors. Other benefits to SMEs include tax benefits besides no tax on long-term capital gains, fresh equity infusion, and distressed business purchases.

Figure 1 and Figure 2 show the latest market statistics of the Bombay Stock Exchange (BSE) SME platform and market capital of SME listed and money raised respectively. Figure 1 reveals that total number of companies listed on BSE SME was 336 up to April 2021, of which only 99 companies migrated to the main board, and 24 companies were suspended and the remaining companies stood at 237. The total number of companies eligible for trading was 212 and only 69 companies resorted to trading. Figure 2 reveals that the total market capital of companies listed on SME was ₹22,519.85 and the total amount of capital raised stood at ₹3,492.54



Source: Author's creation

Figure 1. Market statistics of BSE SME platform, 2021

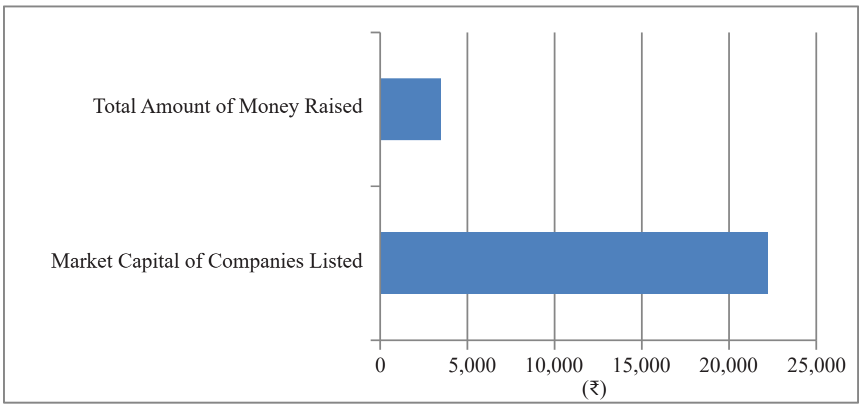


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Figure 2. Market capital of SME listed and money raised

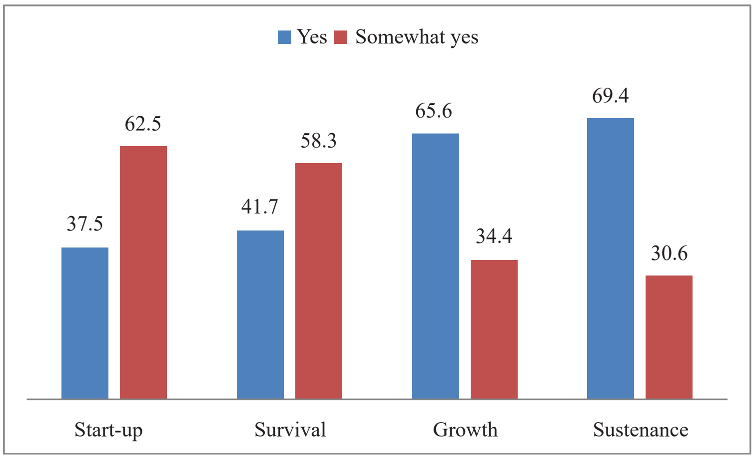
In India, the dependence of SMEs on capital markets is very meager. However, the desire to search for an innovative financial market to explore long-term funding for sustaining businesses is immense. Therefore, tapping capital markets can be one of the viable options. The life cycle growth determines SME's survival and their financial needs. For instance, the probability of survival of start-ups tends to be lower compared to the firms in the growth and sustenance stages. It can generate instantaneous high rates of entry and exit of early-stage firms from the SME market across sectors. They can become high-risk clients of the financial institutions than the firms in the growth and sustenance stages. Therefore, uncertain economic circumstances restrict the banks to provide long-term financing to new firms. This can affect SMEs' growth capital funding. This calls for the development of alternative financial channels of long-term financing instruments for high-end SMEs through strong capital markets to leverage growth capital based on robust regulatory frameworks to operationalize the new instruments.

Keeping in view the experience of vulnerability of the capital markets to economic uncertainties, well-designed SME capital markets based on robust institutional mechanisms should be promoted to mitigate such risks in India. The following section explores the potential of capital market financing for SMEs in India using the results of the demand survey confined to sampled SEMs in the manufacturing and service sectors in Jammu region of Jammu and Kashmir. All the sampled SMEs across the life cycle stage in both manufacturing and service sectors were formally registered with respective government agencies such as goods and services tax, sales tax, excise tax, the Shops and Establishments Act, etc. However, most SMEs were unaware of the legal and financial compliance and listing requirements across the life cycle stage. None of the SMEs were credit rated and listed. Therefore, credit rating and listing were not a priority for the sampled SMEs across life cycle stages.

6. Potential of SME capital market: Results of the study

6.1 *Business conditions and developing capital markets for SMEs*

Table 2 shows the business conditions of SMEs surveyed, which were generally good in terms of business environment, financial condition, employment, business expectation, finance, borrowing except the rate of interest. There are various policy alternatives to boost SME capital markets in India. Figure 3 shows that the sampled SMEs considered the development of a SME market as a priority for which a robust policy framework is required. Figure 4 shows the reasons for developing capital markets for SMEs, which include the increase in demand for financing, limits of bank financing to meet SMEs' requirements, and a precautionary measure against financial crises. Table 3 shows the necessary actions suggested by the sampled SMEs to develop SME capital markets. There is a need to develop policies and programmes focusing on increasing the investors' network and developing the database of financial professionals for a functional SME market in India.



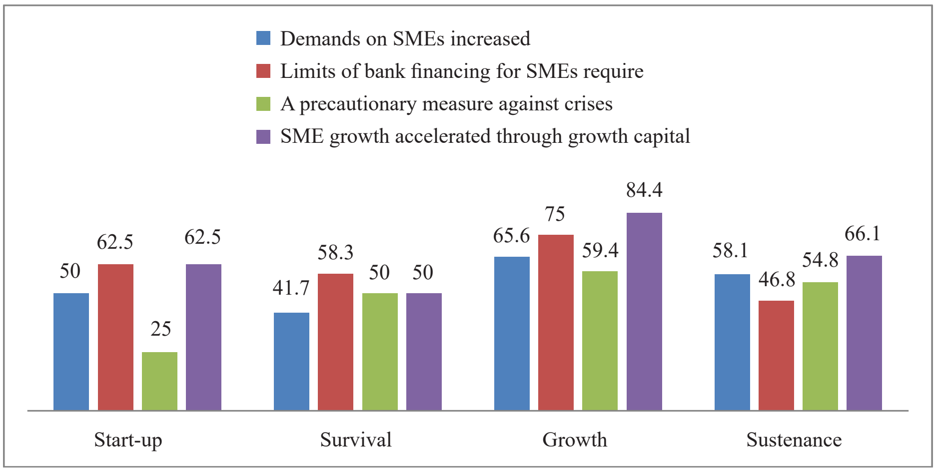
Source: Author's creation

Figure 3. Priority for developing capital markets for SMEs (%)

Table 2. Business conditions of SMEs (%)

Business conditions	Start-up	Survival	Growth	Sustenance
Business environment good	0.0	16.7	34.4	50
Financial condition good	25	33.3	40.1	35.5
Employees increased	50	33.3	53.1	22.6
Business expansion	37.5	41.7	43.8	43.5
Funding for business easy	25	25	28.1	21
Borrowing from FI easy	25	25	25	17.7
Loan rate decreased	0.0	0.0	3.1	11.3
Total	N = 8	N = 12	N = 32	N = 62

Source: Author's compilation



Source: Author's creation

Figure 4. Reasons for developing capital markets for SMEs a policy priority (%)

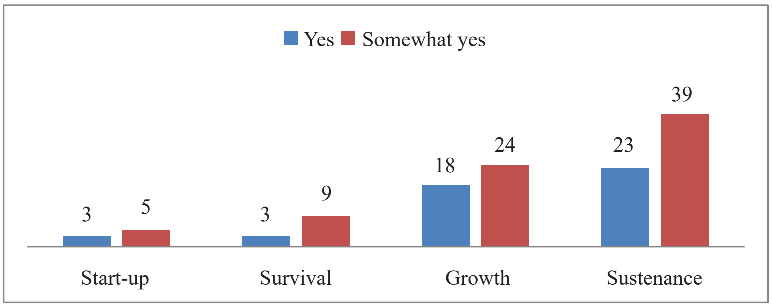
Table 3. Actions necessary to develop SME capital markets (%)

Action needed	Start-up	Survival	Growth	Sustenance
Deregulation	25	42.9	28.1	30.6
New regulations & rules	37.5	41.7	34.4	41.9
A comprehensive policy/strategy	62.5	58.3	65.6	43.5
Tax incentive schemes for issuers & investors	50	50	75	54.8
Tax incentive schemes for issuers & investors	62.5	50	59.3	46.8
Policy measures to develop investor base	62.5	66.7	62.5	50
Policy measures to develop professionals base	50	41.7	75	48.4
Market literacy for SMEs & investors	62.5	50	65.6	43.5
SME database	62.5	58.3	78.1	58.1
Total	N = 8	N = 12	N = 32	N = 62

Source: Author's compilation

6.2 *Performance of SME capital markets*

The growth potential of SME markets is linked to the actual performance of existing SME markets. Figure 5 shows the sampled SMEs' opinion on the performance of existing SME capital markets in India. The sampled SMEs expected incessant growth in SME market due to the substantial demand of SMEs for growth capital. Due to the recent existence of SME platforms and their vulnerability to economic uncertainty, their performance remained dismal. Table 4 shows both positive and negative reasons affecting the growth performance of the existing SME markets in India.



Source: Author's creation.

Figure 5. Performance of existing SME capital markets (%)

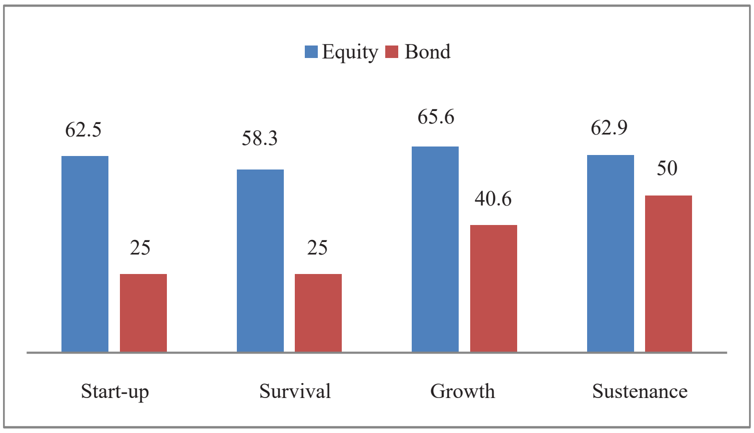
Table 4. Reasons for existing SME capital markets growing (%)

Reasons	Start-up	Survival	Growth	Sustenance
Positive reasons				
Demands on SMEs increased	25	33.3	25	35.5
Number of high-growth SMEs increased	37.5	33.3	28.1	30.6
Active investor base	25	41.7	7	38.7
Government support & deregulation	25	41.7	28.1	33.8
Easy market location	25	50	34.4	32.2
Information on SME capital markets	25	33.3	13	27.4
Negative reasons				
Aftermath of Global Financial Crisis (GFC)	37.5	50	10	29
Economic uncertainty & geographical risks	50	41.7	28.1	25.8
Insufficient government support & deregulation	50	41.7	34.4	33.9
No easy market location	50	33.3	37.5	30.6
Lack of information on SME capital markets	50	41.7	40.7	30.6
Total	N = 8	N = 12	N = 32	N = 62

Source: Author's compilation

6.3 *Product type and knowledge of type of SME capital market*

Figure 6 shows that the majority of the sampled SMEs preferred to develop equity products rather than bonds and debentures for SMEs in India. Table 5 shows the knowledge of sampled SMEs regarding the types of SME capital markets. There are two large categories of SME market structures namely exchange market and non-exchange market. The exchange market includes a domestic market and an international market for professional investors. The non-exchange market includes an organized over-the-counter market operated by a self-regulatory organization and a market for unlisted SME shares operated by a non-self-regulatory organization. The development of a domestic exchange market should be an appropriate capital market for SMEs. The exchange market should be cost-efficient and well-organized supported by robust laws and regulations.



Source: Author's creation

Figure 6. Type of product appropriate for SMEs (%)

Table 5. Knowledge of type of SME capital markets (%)

Knowledge of market type appropriate for SMEs	Start-up	Survival	Growth	Sustenance
Exchange market				
Domestic market	37.5	33.3	53.1	58.1
International market for potential investors	0.0	0.0	18.8	27.4
Non-exchange market				
Organized over-the-counter market	37.5	8.3	34.4	33.9
Market for unlisted SME shares	12.5	16.7	40.7	30.6
Total	N = 8	N = 12	N = 32	N = 62

Source: Author's compilation

6.4 *Critical factors needed to create an SME market*

The sampled SMEs contemplated that even if the SME exchange market offers superior measures for SMEs, such as lowering listing criteria and fees, their inadequate capability to tap the potential of capital markets such as compliance with disclosure obligations remains a critical challenge to establish a robust SME market. Table 6 shows the critical factors affecting the supply and demand sides for the establishment of a SME market. There remains a significant gap between the priority actions of both supply and demand sides for the establishment of a functional SME market. Three major supply-side priorities include speedily raising of finances for SMEs, existence of simplified listing procedures, and information dissemination of SME capital markets. Major demand-side priorities include simplified disclosure requirements, lower costs for listing and maintenance, and existence of simplified listing procedures. Therefore, there is a need to evolve priority actions striking a balance between the supply and demand sides to reduce the cost burden for SMEs to tap capital markets. Cost remains a critical factor for the establishment of a sustainable SME market. A low-cost SME market structure is central to promote the sustainable long-term financing for both SMEs and market organizers.

Table 6. Critical factors needed to create an SME market (%)

Critical factors	Start-up	Survival	Growth	Sustenance
Critical factors: Supply-side				
Raising fund speedily for SMEs	37.5	50	68.8	51.6
Simplify listing procedures	37.5	58.3	65.6	59.7
Information of SME capital markets	37.5	58.3	59.4	56.5
Enhancing liquidity of SME stocks/bonds	50	58.3	53.1	58.1
Low cost for listing & maintenance for SMEs	50	50	56.2	62.9
Supporting to prepare disclosure documents	50	41.7	65.6	62.9
Regulatory & supervisory framework	62.5	50	71.9	66.1
Small amount of funding available for SMEs	62.5	66.7	75	64.5
Establishing & operating markets	50	50	65.6	58.1
Simplify disclosure requirements	50	58.3	62.5	56.5
Tax incentive schemes for issuers & investors	62.5	66.7	53.1	59.7
Exclude foreign issuers	37.5	25	9.4	14.5
Exclude foreign investors	12.5	3	9.4	11.3
Critical factors: Demand-side				
Simplify disclosure requirements	50	66.7	65.6	54.8
Low cost for listing & maintenance	37.5	66.7	68.8	51.6
Simplify listing procedures	50	58.3	71.9	50
Raising fund speedily	62.5	66.7	62.5	46.8
Tax incentive schemes for issuers & investors	62.5	58.3	59.4	53.2
Enhancing liquidity of SME stocks/bonds	50	58.3	53.1	46.8
Regulatory & supervisory framework	37.5	50	50	53.2
Supporting to prepare disclosure documents	62.5	58.3	68.8	50
Small amount of funding available for SMEs	62.5	50	65.6	32.3
Information of SME capital markets	50	75	71.9	53.2
Exclude foreign issuers	25	33.3	25	17.8
Exclude foreign investors	12.5	25	18.8	11.3
Total	N = 8	N = 12	N = 32	N = 62

Source: Author's compilation

6.5 *Funding instruments used and expected*

Table 7 shows that a significantly very high proportion of sampled SMEs have accessed bank financing, besides their own capital, informal loans and equity finance compared to funds borrowed from family, relatives, and friends for business development. In the future, the sampled SMEs expected higher access to formal financial institutions such as venture capital companies, besides bank finance and desired to reduce their dependence on their own capital and informal financing. Direct finance instruments such as equity finance and corporate bond issuance are expected to surge in the future. Thus, it is evident that most of the sampled SMEs seek business development via secure finance from formal financial instruments and less dependence on informal instruments.

Table 7. Funding instruments: Present and future (%)

Funding instruments	Start-up	Survival	Growth	Sustenance
Funding instruments: Present				
Bank loan	87.5	75	84.4	62.9
Venture capital	0.0	0.0	9.4	9.7
Non-bank loan	37.5	33.3	25	33.9
Family, relatives & friends	62.5	25	25	30.6
Credit among corporations	0.0	0.0	0.0	3.2
Informal loan	75	41.7	43.8	35.5
Corporate bond/debenture	0.0	0.0	0.0	6.5
Equity finance	37.5	41.7	40.6	35.5
Own fund	75	10	71.9	69.4
Funding instruments: Future				
Bank loan	50	41.7	43.8	40.3
Venture capital	50	50	50	74.2
Non-bank loan	25	33.3	11	33.9
Family, relatives & friends	37.5	33.3	28.1	30.6
Credit among corporations	37.5	41.7	71.8	58.1
Informal loan	37.5	25	34.4	27.4
Corporate bond/debenture	25	41.7	59.4	43.54
Equity finance	50	58.3	65.6	59.7
Own fund	37.5	41.7	56.3	53.2
Total	N = 8	N = 12	N = 32	N = 62

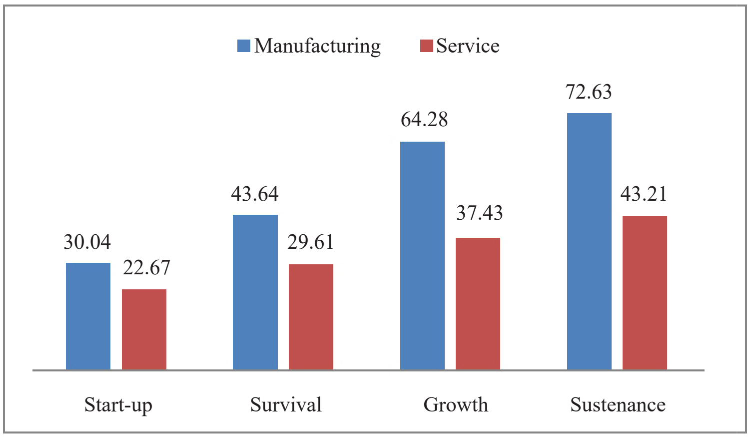
Source: Author's compilation

Table 8 shows the supply-demand gap of SME finance. A small proportion of sampled SMEs has used long-term and mid-term financial sources. However, SME demands for mid-term and long-term finance are expected to surge in the future. The dependence on non-bank finance and venture capital finance has been low and is expected to increase in the future. Information asymmetry remains a major hurdle for financial institutions to satisfy future finance demands. Figure 7 and Figure 8 show a substantial appetite for finance to increase businesses by the sampled SMEs. Average cumulative finance raised from external financial sources per SME stood higher for SMEs engaged in manufacturing compared to SMEs in the service sector. It is likely to remain so in the future but with a comparatively higher desired level of financing in both the manufacturing and service sector. Therefore, the unmet financial needs of the sampled SMEs remain substantial. Table 9 shows the purpose of funds desired by sampled SMEs. This includes business expansion, capital investment, working capital international trade besides other purposes. It varies considerably by the life cycle growth. Start-ups or early-stage firms were willing to actively access growth capital. Both SMEs engaged in the manufacturing and service sectors were willing to raise finances for business expansion and working capital.

Table 8. Supply-demand gap of SME finance: Present and future (%)

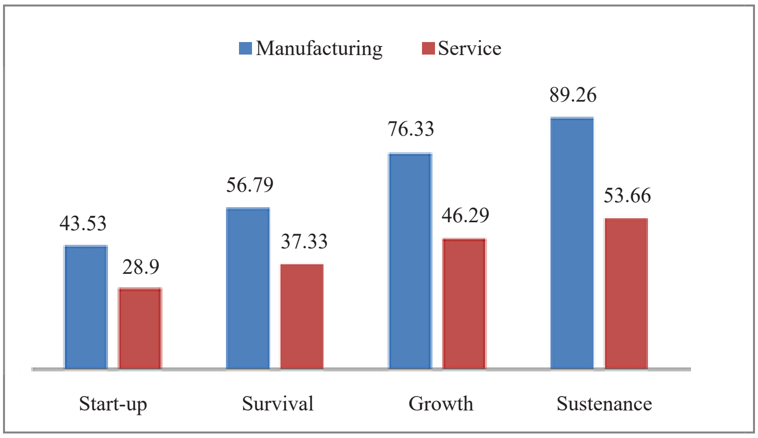
Supply-demand gap of SME finance	Start-up	Survival	Growth	Sustenance
Supply-demand gap: Present				
Bank loan				
Short-term (<1 year)	50	41.7	59.4	43.5
Mid-term (1-5 years)	37.5	25	18.8	9.7
Long-term (>5 years)	0	8.3	6.3	9.7
Nonbank loan				
Short-term (<1 years)	37.5	33.3	15.6	22.6
Mid-term (1-5 years)	0.0	0.0	9.4	6.5
Long-term (>5 years)	0.0	0.0	0.0	4.9
Venture capital				
Short-term (<1 year)	0.0	0.0	9.4	9.7
Mid-term (1-5 years)	0.0	0.0	0.0	0.0
Long-term (>5 years)	0.0	0.0	0.0	0.0
Supply-demand gap: Future				
Bank loan				
Short-term (<1 year)	25	25	12.5	16.1
Mid-term (1-5 years)	25	16.7	12.5	14.5
Long-term (>5 years)	0.0	0.0	9.4	9.7
Nonbank loan				
Short-term (<1 years)	25	16.7	18.8	11
Mid-term (1-5 years)	0.0	16.7	9.4	9.7
Long-term (>5 years)	0.0	0.0	6.3	6.5
Venture capital				
Short-term (<1 year)	37.5	33.3	25	17.7
Mid-term (1-5 years)	12.5	16.7	12.5	21.0
Long-term (>5 years)	0.0	0.0	12.5	35.5
Total	N = 8	N = 12	N = 32	N = 62

Source: Author's compilation



Note: Exchange rate for ₹69.87 = 1US$ on 19 June 2019
Source: Author's creation

Figure 7. Average funding amounts raised so far per firm (₹ million)



Note: Exchange rate for ₹69.87 = 1US$ on 19 June 2019
Source: Author's creation

Figure 8. Average funding amounts desired per firm (₹ million)

Table 9. Purpose of funds desired (%)

Purpose of desired fund	Start-up	Survival	Growth	Sustenance
Business expansion	75	66.7	81.2	69.4
Capital investment	25	25	18.8	17.7
Working capital	62.5	75	68.8	58.1
International trade	0.0	0.0	12.5	9.7
Others	0.0	16.7	15.6	11.3
Total	N = 8	N = 12	N = 32	N = 62

Source: Author's compilation

6.6 *Barriers to accessing financial institutions*

Table 10 shows that the inadequate access to finance remains a persistent problem for sampled SMEs across life cycle growth due to various factors on both the supply and demand sides. Sampled SMEs faced substantial barriers to access formal financial institutions. Sampled SMEs reported major supply-side constraints to access finance. This includes collateral and guarantees as a precondition for formal finance, cumbersome borrowing practices, harsh financial rules of lending institutions, and high-interest rates. The demand-side constraints include inadequate knowledge of financial instruments. The need for collateral and guarantee including intricate documentation processes and high-interest rates inflicted upon SME borrowers remained a major barrier to access growth capital. Therefore, improvement in financial literacy is expected to create significant positive effects to improve access to formal finance. Capital market literacy should be imparted to engage SMEs with growth potential in formal financial markets. This calls for the development of a robust SME capital market and strong government support to realize their potential long-term funding requirements.

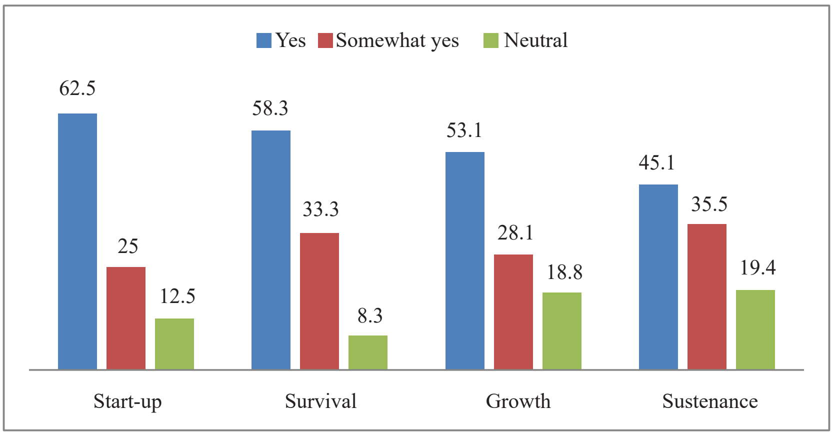
Table 10. Barriers to accessing financial institutions (%)

Barriers	Start-up	Survival	Growth	Sustenance
Barriers: Supply-side				
Collateral/guarantee	75	75	68.8	69.4
Lending policy of FI	37.5	41.7	28.1	17.7
Complicated procedures	37.5	50	34.4	24.2
Exclusive lending attitude of FI	25	41.7	31.3	33.9
High lending rate	62.5	41.7	34.4	35.5
Short loan term	25	33.3	59.4	33.9
Barriers: Demand-side				
Lack of knowledge	37.5	33.3	25	14.5
No demand on SMEs	37.5	25	21.9	17.7
Insufficient management	25	25	9.4	11.3
Total	N = 8	N = 12	N = 32	N = 62

Source: Author's compilation

6.7 *Willingness to access an SME capital market*

There are arguments that whether a special equity financing and bond issuance venue for SMEs is prime for generating high-growth SMEs for sustainable business development and economic growth irrespective of the stock exchange market. Figure 9 shows the willingness of sampled SMEs to access the SME capital market. Sampled SMEs are likely to utilize a specialized market venue for their future financing requirements if established with more preference for an equity market than a bond market. Table 11 shows the main reasons for their preference. This includes expected high ease of funding, alternative financing including bank lending, and high social credibility of SMEs. Table 12 shows the major hurdles in accessing an SME market. This includes complicated procedures to issue stocks, and high stock issuing costs like listing fees and maintenance. Therefore, there is a need to simplify the listing procedures and reduce the cost structure in the establishment of a well-functioning SME capital market to meet the potential demands of SMEs.



Source: Author's creation.

Figure 9. Willingness to access an SME capital market (%)

Table 11. Expected benefits of SME capital market (%)

Expected benefits	Start-up	Survival	Growth	Sustenance
Increased social credibility	87.5	41.7	56.3	69.3
Easiness of funding increased	75	33.3	40.1	61.3
Funding alternative increased	62.5	50	43.8	62.9
Bank borrowing increased	50	41.7	34.4	59.7
Production level increased	37.5	33.3	50	71
International trade increased	37.5	25	34.4	29.0
More employees hired	62.5	25	28.1	27.4
Incentive to work enhanced	50	41.7	68.8	30.6
Total	N = 8	N = 12	N = 32	N = 62

Source: Author's compilation

Table 12. Reasons for hesitating to access capital market (%)

Reasons	Start-up	Survival	Growth	Sustenance
Procedures to issue stocks complicated	50	58.3	65.6	71
Issuing stocks costly	37.5	41.7	40.1	59.7
Present lending instruments enough	37.5	33.3	59.4	53.2
Own funds/retained profits enough	50	50	34.4	33.9
Total	N = 8	N = 12	N = 32	N = 62

Source: Author's compilation

6.8 *Strategies for the development of new SME capital market*

It is evident that there are various challenges to establish direct growth capital financing for SMEs. Looking at numerous viewpoints on the development of the SME capital market, a specialized market infrastructure namely non-exchange foundation equity market for SMEs can be established. The establishment of a separate foundation equity market for SMEs from the exchange market can be advantageous. There is a need to develop a preliminary market for growing SMEs. This should ultimately integrate into the regular SME stock exchange market. A preliminary market is expected to endow SMEs with a chance to understand clearly SME capital market rules and responsibilities linked to disclosures before integrating into the organized capital market. This can imbibe the corporate culture through knowledge regarding the significance of enhanced corporate value for the growth and development of firms. The foundation market should evolve a thorough system for carrying SMEs in equity finance from various dimensions. This includes promotion of the venture capital market to provide initial risk capital for SMEs, development of a strong base of capital market professionals to train and goad the SME disclosure process through the network of certified public accountants. Besides, the development of a blueprint for government policy support measures including tax incentives for SME issuers and investors is needed.

The development of robust SME capital markets poses two major challenges: first, demand creation, and second market sustainability. There is a need to develop a well-organized investor base and evolve professionals' support for government preferential measures to promote demand for the SME market. There is also a need for developing low-cost operations and liquidity promotion instruments to make the SME market sustainable. It is evident that the financing requirement of SMEs depends on their stage of growth. The growing SMEs look for long-term financial instruments to boost their business. This creates a surge in demand from SMEs for capital market financing, also requires essential knowledge and skills in capital market financing to integrate into the regular stock exchange market. Therefore, there is a need to develop a venue for learning market rules, obligations, and advantages of issuing and trading stocks in an established system different from the regular market. This will benefit growth-oriented SMEs. This also requires the development of strong investor and professional bases to sustain SMEs in equity financing. Achieving the goal of the preliminary market cannot be realized without strong government regulation and support through robust policies and strategies for SME access to capital markets. There is a need for developing separate regulations different from the general capital market laws through objective legislation, because the foundation market may contradict existing general laws. The general capital market laws stipulate that if the shareholders for a stock offering and maintaining stocks in the non-exchange market surpass the statutory requirements, listed SMEs will be considered as public companies and as such cannot avail preferential treatment even if listed in the special market and their funding benefits and investor base will be limited.

7. Conclusion and policy implications

There is a need to reduce the supply-demand gap in formal financial lending to leverage SMEs' financial access in India. This calls for a diversified financing system to improve the financial accessibility of SMEs through the development of capital market financing to cater to the needs of long-term growth capital. SMEs seek greater access to formal finance through diversified long-term funding instruments for sustainable growth and development of businesses. At the same time, traditional lending faces the problem of information asymmetry, which constrained the long-term finance needs of SMEs. Besides, the supply-side barriers include collateral needs, cumbersome procedures, lending policies, high-interest rates, and inadequate financial literacy which hamper financial accessibility. Therefore, there is a need to improve the financial literacy of SMEs to enhance financial access and access to capital markets. Equity financing has been the preferred financial instrument by SMEs through the SME capital market. High-costs and complex procedures to access financing can be mitigated by simplified procedures and low-cost financing for SMEs through a functional SME capital market. Therefore, the development of a robust SME capital market should be a policy priority to achieve the goals of sustainable business growth. This requires a robust policy framework for SMEs' access to capital markets focusing on developing an investor base and promoting financial market literacy among the participants. However, the dreary performance of existing SME capital markets suggests the cautious development of an innovative and preliminary SME market.

Keeping in view the existing market structures, SMEs can integrate into the following models of capital markets. These include an exchange market consisting of a domestic market, and a professional market, a non-exchange market consisting of a self-regulatory organization's operated market, and a non-self-regulatory organization's operated over-the-counter market. The appropriate market to support SME growth should be based on cost-efficient existing markets supported by existing trading platforms and regulations. This is due to a lack of potential investors in non-exchange markets to support the development of a domestic exchange market for SMEs. There is a need to support the establishment of a non-exchange market for SMEs through the development of a preliminary market before integrating into the existing exchange market to generate a high-quality potential issuers base. This is essential due to the inability of SMEs to integrate into the higher segments of the exchange market.

There is a need to reduce costs for SMEs' integration into capital markets by establishing a sustainable long-term financing platform for SMEs through innovative institutions catering to the needs of SMEs. This will facilitate the establishment of a strong capital market to address the restrictions of traditional bank lending. The development of SME capital market should be based on private initiatives tied to business development and also public initiatives linked to financial inclusion strategies. Exchange markets and non-exchange markets should be developed through both private and public initiatives. This involves substantial expected costs for the development of infrastructure, regulation, and policy. The expected infrastructure cost will depend on the usage of existing exchange platforms. The expected development cost for trading platforms in the organized over-the-counter market will be low due to the small size of the market. The expected regulatory cost will be almost similar for both the exchange and non-exchange markets due to the existence of base regulations and rules and involve small costs for their amendments. However, the regulatory costs will be different for private and public initiatives. This is attributed to the management of capital market regulators and responsible government ministries for SME development and establishment of exchange markets through public initiatives. Like the regulatory cost, the expected policy cost will also be different for private and public initiatives. The public initiatives will require robust institutions to cater to the needs of both the SME issuers and investors and involve extra costs for policy coordination and support, knowledge dissemination and training of potential SME issuers and investors including infrastructure development. Therefore, cost constraint for developing the SME market is a prime concern. The foundation equity market for SMEs can be solution to create demand from potential SMEs and investors. Besides funding, the foundation market should provide a learning platform on the benefits and obligations of capital market financing to SMEs and stimulate their growth cycle through a robust policy framework.

Conflicts of interest

There are no conflicts of interest.

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