Credit Preference of Micro and Small Enterprises of Assam (India)

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ABSTRACT

The study aimed at finding out the credit preference of Micro and Small Enterprises in Assam, India. The sampling technique was judgmental, as only those enterprise which had borrowed from banks were considered for the study. 101 Micro and 51 Small enterprises were covered. 75% respondents used their own fund for initial investment, while 93% stated using bank loans. 69% respondents used both debt and equity for initial investment. 94 enterprises preferred cash credit facility offered by banks, 36 had utilised working capital loan, and 43 had opted for term loan. 88 sought credit to start the business, 83 for operational needs, and 5 for repaying off earlier debt. 78% respondents stated that the bank officials explained the credit proposals to them. It appears that banks do not go out to woo this segment of customers. 88% were satisfied with the credit facilities offered. Majority of the respondents (61%) stated that it took longer than the stipulated time for the credit to be sanctioned. Overall the Micro and Small enterprises in Assam are funded by the nationalised banks and they use debt and equity in almost the same proportion.

Keywords: Micro enterprise, Small Enterprise, Credit preference, India

1. Introduction

It is those small businesses, along with big businesses, that keep the economy moving in a country as diverse as India as well as in most parts of the world. Studies have been done in different parts of the world focussing on different aspects of Small and Medium Enterprises (SMEs). Assam, as most Assamese would like to believe, lacks in entrepreneurial activities. Most of the entrepreneurial activities that happen in Assam are trading activities.

In accordance with the provision of Micro, Small & Medium Enterprises Development (MSMED) Act, 2006 the Micro, Small and Medium Enterprises (MSME) are classified in two classes, as per Government of India norms.[i]

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[i] http://www.dcmsme.gov.in/ssiindia/defination_msme.htm

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(a) **Manufacturing Enterprises**- The enterprises engaged in the manufacture or production of goods pertaining to any industry specified in the first schedule to the Industries (Development and regulation) Act 1951, or employing plant and machinery in the process of value addition to the final product having a distinct name or character or use. The Manufacturing Enterprises are **defined in terms of investment in Plant & Machinery.** For Micro enterprise, the maximum investment is Rs. 25 lakhs; while for Small enterprise the Lower limit is more than Rs. 25 lakhs and the upper limit is Rs. 5 crores.

(b) **Service Enterprises**: The enterprises engaged in providing or rendering of services and are **defined in terms of investment in equipment**. A Micro enterprise investment should not exceed Rs. 10 lakhs; for the Small enterprise the lower limit is more than Rs. 10 lakhs and the upper limit is Rs. 2 crores.[ii]

1.1 Literature Review:

Literature review revealed that few studies relating to credit preference of Small and Medium Enterprises have been done and they are placed in Table 1.

Table 1: Some SME related credit preference studies done across the world

STUDY	AREA	SAMPLE SIZE
Financing preferences of ethnic minority owner/managers in the UK	United Kingdom	36
An Empirical Approach to the Financial Behaviour of Small and Medium Sized Companies	Spain	461
Small and Medium Size Enterprise Financing: A Note on Some of the Empirical Implications of a Pecking Order	United Kingdom	626
Objectives and constraints of entrepreneurs: evidence from small and medium size enterprises in Russia and Bulgaria	Russia and Bulgaria	216 + 221
The financing preferences and capital structure of micro, small and medium sized firm owners in forest products industry in Turkey	Turkey	851
Finance for Small and Medium-Sized	United Kingdom	2500

[ii] 10 lakhs = 1 million 1 crore = 10 million

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Enterprises *A Report on the 2004 UK Survey of SME Finances*		
Capital Structure in Small and Medium-sized Enterprises: The Case of Vietnam	Vietnam	558
Preferences of micro, small and medium scale enterprises to financial products in Nigeria	Nigeria	100

Nguyen and Ramachandran, (2006) did a study on SMEs of Vietnam. In Vietnam SMEs are defined as those organizations with less than 300 employees and/or registered capital of less than 10 million Vietnam Dong (VND). Among other things studied, this study found out that on an average Vietnamese SMEs have a debt ratio of 43.9 percent. Short term liabilities, including sourced from networks, account for a significant proportion of the capital structure while long-term debts are rarely employed.

Hussain and Matlay, (2007) investigated the financing preferences of owner/managers in small ethnic minority businesses in the UK and examined their access to both formal and informal finance as well as the use of personal funding networks. A number of important results have emerged from this qualitative research study on the financing preferences of small business owner/managers in the UK. It appears that family and close associate networks are very important for the support of ethnic minority owner/managers and their businesses. In terms of finance, the businesses required loans from banks and other financial institutions, both at the start-up stage and in subsequent years. For the vast majority of ethnic minority businesses in the sample, the initial importance of financial institutions declined over the five years. Personal sources of finance proved significant for ethnic minority owner/managers at the start-up stage but its importance declined during the subsequent five years. They exhibited an awareness of venture capital as a strategy for medium- to long-term financial planning. Importantly, however, owner/managers in the research sample showed a preference for less intrusive and more “user friendly” financing options that allow them to remain in full control of their businesses.

Lopez-Gracias and Aybar-Arias, (2000) conducted a study on financing behaviour of small and medium size companies in the Spanish regional state of Valencia. Their sample comprised of Micro (sales < $ 0.5m), Small (sales between $ 0.5m to $ 2.5m) and Medium (sales between $2.5m to $ 16m) sized companies. They found that large companies showed a higher index of self-finance. On the other hand, small and micro size companies showed precarious financial behaviour because they depended

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on short term financing.

Pissarides, Singer and Svejnar, (2003) studied objectives and constraints of entrepreneurs of small and medium enterprises in Russia and Bulgaria. SMEs in these two economies are recently created and privately owned firms that are characterized by concentrated ownership. The two most important objectives of the CEOs of these start-ups are achieving the highest possible profit and output growth. The five constraints that they cite most frequently as being most important in both countries are: suppliers are often not ready to deliver; the firm is facing financing problems that hinder expanding production; in obtaining financing, the firm is facing high level of interest rates; the firm is facing constraints on getting land, office space and buildings; and other production constraints. This finding suggests that the nature of issues confronting SMEs and the policies that may be formulated to assist them are similar across the transition economies. Only about a third of the surveyed firms reported receiving a loan from a financial institution over the previous three years and this indicates that SMEs obtain only a limited amount of credit from external sources. SMEs used internal finance to fund investment projects, and the constraints on external financing limited their ability to expand production.

Akyuz et al, (2006) investigated into the financing preferences and capital structure of micro, small and medium size (MSMS) enterprises, involved in forest products, in Turkey. Credit constraints constitute one of the main obstacles to growth of MSMS firms in the forest products industry. These credit constraints operate in a variety of different ways. An underdeveloped capital market forces entrepreneurs to rely on self-financing or borrowing from friends and relatives. Lack of the equity capital and lack of access to long term credits (5 years and more) for new and MSMS firms means that MSMS firms are forced to rely on high cost short term finance (1 year and less). Financial barriers which affect new firms include the high cost of credit, relatively high bank charges and fees. 75% of total investments in the forest industry sector is financed by the owners. This situation led to increases in the cost of capital as long as the external financing is at the most minimum level. Large and mature firms have the advantage of using external sources compared with the small and new firms. The ownership ratio in total assets decreases and debt ratio increases with time. Especially, long term debt ratio is at a minimum level in total debt (22%) in all MSMS firms. Short-term debt ratio is nearly 48% in all debt burden.

In a study conducted on *Finance for Small and Medium-Sized Enterprises: A Report on the 2004 UK Survey of SME Finances,* Fraser(2004) reported the following :

- 80% of SMEs have used one or more external sources of finance in the last 3 years.
- Use of external finance increases with the number of employees and turnover. It varies from 75% (no employees) to 98% (50-249 employees).

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- There are no significant differences in the likelihood of using external finance between male and female owned businesses or between white and ethnic minority owned businesses.
- Just under 2 million businesses (53% of SMEs) use an overdraft.
- Approximately 900,000 businesses use term loans (24%).
- A similar number (27%) use leasing and/or hire-purchase (asset finance).
- About 6% of SMEs report using loans or equity finance from friends and family.
- Personal savings were the principal source of finance for 2 in every 3 start-ups.
- 1 in 10 relied mainly on a bank loan.
- Less than 1 in 20 entrepreneurs relied mainly on a mortgage on their home.

Evbuomwan et al (2012) set out to determine the preferences of MSMEs to financial products in Nigeria so as to adequately target them. Survey results indicated that 75.7% of the respondents relied mostly on own funds to finance their businesses, the frequency analysis indicated that inadequate fund/working capital was the most mentioned problem with a percentage share of 60.7%, followed by the problem of poor power supply/inadequate infrastructure which took 55.7%. However, 64.7% would prefer loan so they can be in full control of their businesses, while only 15.7% preferred equity.

2. Objective of the study:

- To find out the credit preference of Micro and Small Enterprises in Assam, India.

  The research questions are:

  What is the amount of investment and sales turnover?

  What is their preferred choice of finance and why?

  Are they satisfied with the existing facility or do they want more?

2.1 Methodology:

The sampling technique was judgemental as only those enterprise which had borrowed from banks were considered for the study. The sample comprised 152 responses drawn across the state of Assam, trying it to make it as representative as possible. The responses came from Upper Assam (45), Guwahati – the capital city of Assam (80) and Central Assam (27). A questionnaire was used for collecting responses and analysis done using SPSS software.

3. Findings:

3.1 Demographic Profile

101 Micro and 51 Small enterprises were covered. The number of female owners was only 16. The year of establishment ranges from 1901 to 2013, with 8 establishments

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from pre-independence era (prior to 1947) and majority from post liberalisation period (after 1990). 8 were purely manufacturing enterprise, and 5 had retail activity along with manufacturing. 105 were retailers. 24 were service enterprises, and 8 had retail activities along with their service enterprise. The other 2 could not be slotted in any of the above category.

Table 2: Type of firm according to establishment year

	Micro	Small	Total
Before 1947	7	1	8
1948 to 1990	11	1	12
1991 to 2013	99	33	132
Total	117	35	152

3.2 Investment and Sales Turnover

Majority (74%) had an initial investment of less than Rs. Ten Lakhs. 75% respondents used their own fund for initial investment, while 93% stated using bank loans. 69% respondents used both debt and equity for initial investment.

Table 3: Initial Investment

	Less than Rs. 10 Lakhs	Rs. 10 lakhs to Rs. 25 lakhs	> Rs. 25 lakhs and < Rs. 1 crore	Total
Micro	113	4	0	117
Small	0	27	8	35
Total	113	31	8	152

The sales turnover of the sample is shown in Table 4.

Table 4: Sales Turnover

	Micro	Small	Total
Low	34	7	41
Medium	49	13	62
High	34	15	49
Total	117	35	152

3.3 Credit Details

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In terms of source of funding, 114 respondents used their own funds in the business. 142 used bank finance in their business. Only 19 respondents used family funds in the business and 2 depended on external financers, leaving aside banks. 94 enterprises preferred cash credit facility offered by banks, 36 had utilised working capital loan, and 43 had opted for term loan. In other words 62% had shown strong preference for cash credit facility. The reasons for preferring cash credit are listed below.

- Can be returned at convenience
- Limit can be increased any time
- Interest is charged on drawn amount and not on sanctioned limit
- Easily available
- Easy terms of credit
- Reasonable interest rate
- When less amount is required for short term
- For sudden requirement of funds
- Can withdraw as required
- Monthly repayment system
- New schemes available during festive season

The reasons for opting for a term loan are as follows:

- To commence business
- Low risk factor
- Easy to get
- Less burden
- With constant income, repayment can be done easily
- Preferred choice for buying fixed assets
- Suggested by bank
- Flexible repayment system

88 sought credit to start the business, 83 for operational needs, and 5 for repaying off earlier debt.

The respondents had association with the following banks. State Bank of India, the largest and oldest nationalised bank of India appeared to be the favourite, funded 46 enterprises. This was followed by UCO Bank (15) , Union Bank of India (17), Allahabad Bank (8), Punjab National Bank (8), and United Bank of India (8).

It was tried to understand whether the bank officials were involved in explaining the credit proposals to the borrowers. 78% respondents stated that the bank officials explained the proposals to them.

It appears that banks do not go out to woo this segment of customers. Only 30%

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respondents stated that they were approached by other banks and offered credit facilities. Whether the firm was approached or not appears to be dependent on the sales turnover, as seen from Table 5a and 5b. Firms having high sales turnover are more likely to be approached by other banks.

Table 5a: Approached by other banks

		Yes	No
Sales Turn over	Low	29	12
	Medium	53	9
	High	26	23
	Total	108	44

Table 5b: Chi-Square Tests

	Value	df	Asymp. Sig. (2-sided)
Pearson Chi-Square	13.991a	2	0.001
Likelihood Ratio	14.23	2	0.001
N of Valid Cases	152		

a. 0 cells (.0%) have expected count less than 5. The minimum expected count is 11.87.

From Table 6a and 6b, it can be inferred that whether the enterprises were approached by the banks was independent of the type.

Table 6a: Approached by other banks

	Not approached by other banks	Approached by other banks	Total
Micro	81	36	117
Small	27	8	35
Total	108	44	152

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Table 6 b: Chi-square test

	Value	df	Asymp. Sig. (2-sided)
Pearson Chi-Square	.820a	1	0.365
Continuity Correctionb	0.48	1	0.488
Likelihood Ratio	0.848	1	0.357
N of Valid Cases	152		

a. 0 cells (.0%) have expected count less than 5. The minimum expected count is 10.13.

3.4 Satisfaction Level

From Table 7a, it can be seen that 88 % were satisfied with the credit facilities offered; the remaining 12% were either unsatisfied or had no comment on this issue. It is surprising that although only 39% received their credit facility within or less than the stipulated time, yet majority appeared to be happy with the facilities.

Table 7a: Sanction Time for Loan

	Less than stipulated time	Within stipulated time	More than stipulated time	
Not satisfied with existing credit facilities	3	0	16	19
No comment	4	4	15	23
Satisfied with existing credit facilities	29	19	62	110
Total	36	23	93	152

Table 7b: Sanction Time for loan

	Less than stipulated time	Within stipulated time	More than stipulated time	Total
Micro	32	16	69	117
Small	4	7	24	35
Total	36	23	93	152

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It can be seen from Table 7b that irrespective of the type of enterprise, majority of the respondents (61%) stated that it took longer than the stipulated time for the credit to be sanctioned.

A couple of respondents had faced rejection from banks while applying for credit. Improper documentation (9%), non-compliance of ‘Know Your Customer’(KYC) norms (6%) and lack of business experience (3%) were the top reasons for a credit request being turned down by banks.

The satisfaction level is attributed to the following reasons:

1. The clients could completely avail the facility they wanted.
2. They had good relations with the Manager of the concerned bank.
3. They did not have to bribe to get the loan.
4. The interest rates were reasonable.
5. Repeat loans were sanctioned at a lower interest rate.
6. Less collaterals and less documentation.

3.5 Comparison:

It is seen here that the Micro and Small enterprises prefer short term cash credit option over long term loans or working capital. This has also been found in the studies done in Vietnam, Spain, Turkey and also the United Kingdom. 53% of SMEs in the UK preferred overdraft, while 62% of the Micro and Small enterprises in Assam preferred cash credit. The reasons for preferring short term financing and not long term finance was the need to remain in control of their business (Hussain and Matlay 2007), credit constraints (Pissarides, Singer and Svejnar, 2003), and lack of access to long term credit (Akyuz et al, 2006). In this study the reason for preferring short term credit arises out of benefits associated with it viz. convenience, interest charged on drawn amount, reasonable interest rate, flexibility of enhancing credit limit etc. It must also be kept in mind that this sample had more of non-manufacturing units and very few manufacturing units. This is likely to affect their choice of credit. In UK personal savings were the principal source of finance for 2 in every 3 start-ups (Fraser, 2004), in Nigeria 75.7% depended on equity (Evbuomwan et al, 2012) while in Assam it was seen that 93% had debt and 79% had equity in their capital structure.

4. Conclusion:

The survey reveals the following:

i. 142 used debt and 114 used their own fund in the business; thus the sample has a debt-equity ratio of 1.2:1

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ii. 27% reported low sales turnover.
iii. 62% prefer cash credit facility of banks.
iv. Banks are not making effort to woo this segment of clients.
v. An overwhelming majority are satisfied with credit facility received.
vi. Sanctioning of the credit, on an average, took a long time.
vii. Most bank officials explained about terms and conditions of the credit facility.
viii. State Bank of India funded 30% of the enterprises.
ix. A total of 31 banks figured in the sample, of which 24 were nationalised banks, 5 were private banks and 2 were rural/cooperative banks.

The Micro and Small enterprises would like to see the following changes in credit sanction process. It happens that a client is interacting with the bank manager for a loan and then in a few days the manager is transferred to another branch. In this case the client has to initiate the process all over again. The customers would benefit if the interaction was documented in some form so that the process does not have to begin from the scratch. Clients are bothered by the rude, uncooperative behaviour of bank employees and the suggestion is that the bank employees are given adequate behavioural training. Most of the clients do not have the time to visit the bank and therefore they miss out new or seasonal schemes that are being floated. They would prefer that the bank takes initiative to inform them about promotional offers over phone.

Overall the Micro and Small enterprises in Assam are funded by the nationalised banks and they use debt and equity in almost the same proportion. The most preferred choice of credit is cash credit. The sales turnover on an average is fair. The average sanction time for a credit is high and yet the respondents appeared to be satisfied.

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