



SMES' ROLE IN INDIA'S MANUFACTURING SECTOR

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EXECUTIVE SUMMARY

The Small and Medium Enterprises (SMEs) are of key importance to the Indian economy. They contributed 17 per cent to the nation's GDP during FY11 and employed 60 million people, the second largest workforce in the country after the agricultural sector. The MSME (Micro, Small and Medium Enterprise) units are growing swiftly and strengthening their role in the economic growth. The SME units are more concentrated in manufacturing sector compared to service sector.

The importance of SMEs in manufacturing sector is mainly due to the quantum of units that fall in this category, forming 90 per cent of the total industrial units in the country. Further, SMEs account for 45 per cent of the nation's industrial output and 40 per cent of total exports. This significant contribution of SMEs to the economy is a result of increasing focus of industrial bodies, associations and policymakers towards the development of SMEs

Today, SME units are flourishing in an organised way. Cluster-based operations have become a high growth channel among these units, given the inherent advantages of such collective strategies. Some of the nation's manufacturing clusters have become leading producers in their respective industries; many others account for a large share in exports.

With healthy growth and favourable outlook ahead, SME's are being increasingly viewed by banks as important business destinations. Several Indian Banks have joined hands for the formation of SME Rating Agency of India (SMERA) in August 2005, to facilitate the process of lending to SMEs. The rating is adding to the competitiveness of these units for business at national as well as international levels. Increasing awareness about their own ratings is fostering self-improvement among these units which will contribute to their development in the long-run.

Apart from self-development, government is also encouraging the SMEs to innovate and grow through various schemes. These schemes are launched by National Manufacturing Competitiveness Council (NMCC) and are aiding overall development of the SMEs as it facilitates improvement at all the steps of value addition in the manufacturing activity.

1. SMEs ARE THE BACKBONE OF INDIAN ECONOMY

Small and Medium Enterprises (SMEs) have played a vital role in India's economic growth. With over 30 million units, SMEs accounted for 17 per cent of the country's GDP in 2011. Small & Medium Business Development Chamber of India projects the share of SMEs in the expansion of the Indian economy to increase to 22 per cent of the GDP in 2012. The estimate is backed by its assumption of 12 million additional people joining the SME sector over the period 2012-14); SME units currently employ 60 million people.

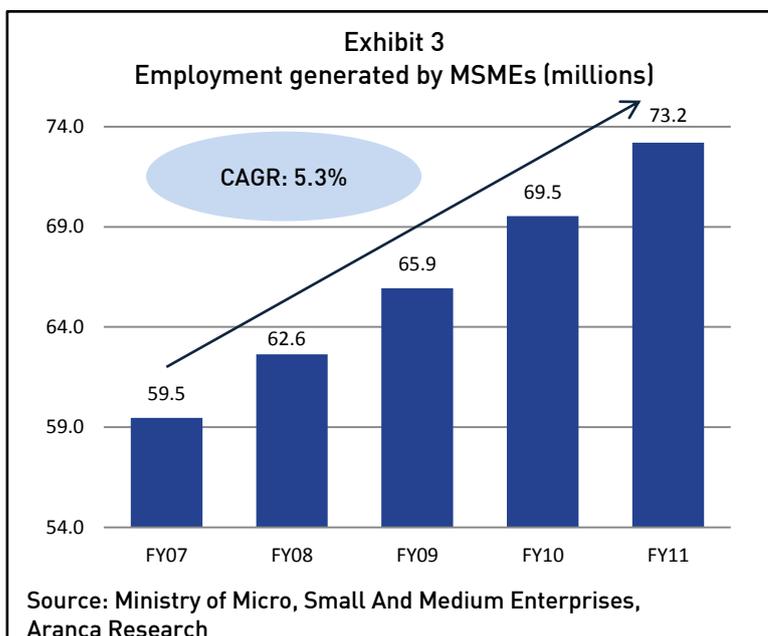
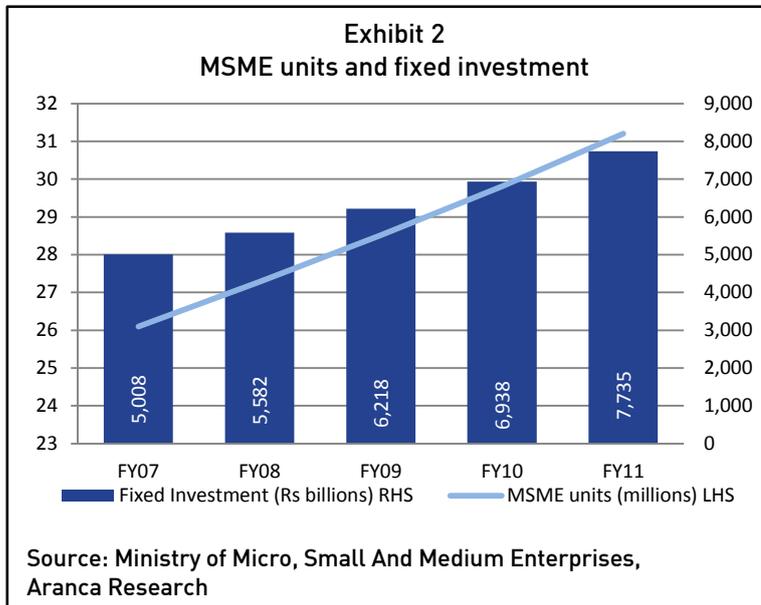
The units in India are classified under the MSME (Micro, Small and Medium Enterprise) category on the basis of their investment size. Manufacturing enterprises are classified with respect to their investment in plant and machinery, while the classification of service enterprises is based on investment in equipment.

Exhibit 1 Definition of MSME units in India		
Description	Manufacturing Enterprises	Service Enterprises
Micro Enterprises	Up to USD62,500	Up to USD25,000
Small Enterprises	Above USD62,500 and up to USD1.25 million	Above USD25,000 and up to USD0.5 million
Medium Enterprises	Above USD1.25 million and up to USD2.5 million	Above USD0.5 million and up to USD1.5 million

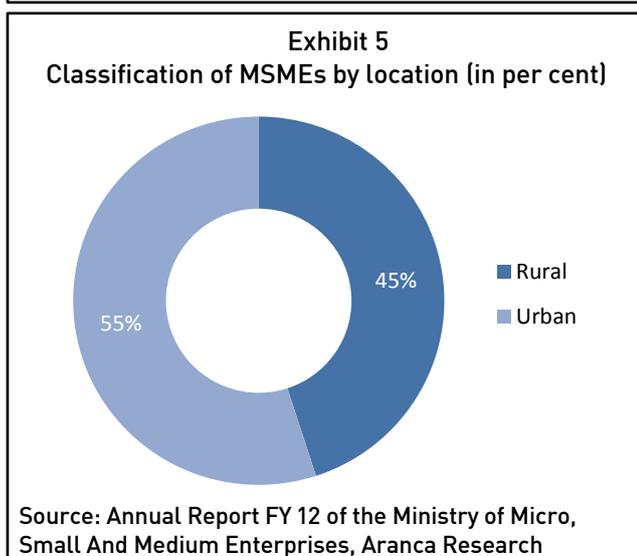
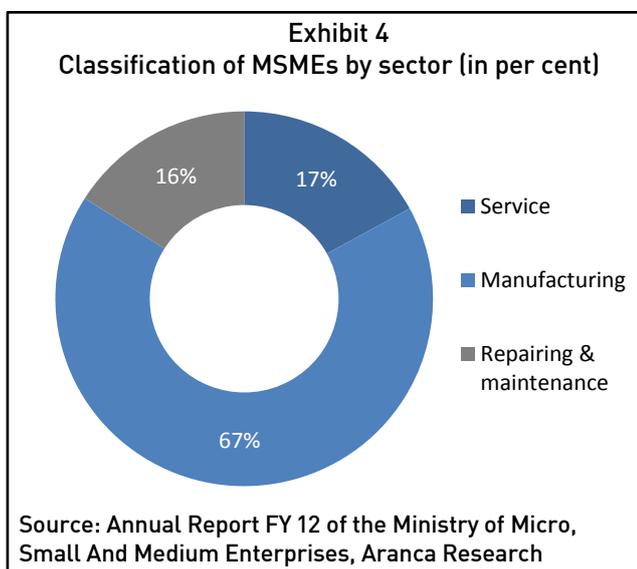
Source: Small & Medium Business Development Chamber of India, Aranca Research

1.1 SMEs trends

According to the Ministry Of Micro, Small and Medium Enterprises, the number of MSME units in India has grown at a CAGR of 4.5 per cent during FY07 – FY11, and stood at 31.2 million at the end of FY11. The cumulative investments in these units rose at a CAGR of 11.5 per cent during the same period. Strong growth in total investments in MSMEs indicates towards their expanding footprint and growing importance. The MSMEs are increasingly contributing towards employment generation in India. The number of people employed by MSME has grown to 73.2 million during FY11 recording a CAGR of 5.3 per cent since FY07.



As per the fourth All-India Census of MSMEs (2006-07), 94 per cent of the enterprises are in the unorganised sector. The MSMEs are not concentrated in terms of rural versus urban origin. Rural areas account for 45 per cent of all MSMEs, while the remaining 55 per cent are located in urban areas. On the other hand if classified with respect to sector of operation, 67 per cent are involved in manufacturing activities and the remaining 33 per cent units are distributed in the service sector (17 per cent) and repairing and maintenance sector (16.1 per cent), respectively.



2. SMEs IN THE MANUFACTURING SECTOR

The burgeoning importance of SMEs in the manufacturing sector is due to their significant contribution to the key factors of the growing Indian economy. According to Small & Medium Business Development Chamber of India, SMEs currently¹ contribute 45 per cent of the nation's industrial output as well as 40 per cent of the total exports. SMEs form 95 per cent of the total industrial units in the country and manufacture around 8,000 quality products for the Indian as well as international markets.

¹ Annual Report FY12 of Ministry Of Micro, Small And Medium Enterprises

2.1 Growth opportunities for SMEs

Clusters leading firms to long-term sustainable growth

According to the United Nations Industrial Development Organization (UNIDO), clusters are agglomerations of interconnected companies and associated institutions. Enterprises operating as part of the cluster manufacture related or similar products and are located in spatial proximity.

These enterprises enjoy benefits such as:

- External economies that might be related to specialised raw material supplier, sector-specific labour skills
- Emergence of customised services for the enterprises; for instance, financial services
- A platform for building cooperation at the inter-firm level, and local public and private institutions that eventually fosters production and innovation
- Support from related business associations and technical assistance providers

Indian manufacturing clusters have positioned themselves with a strong footprint in the economy. These clusters account for 40 per cent of the nation's industrial output and 35 per cent of direct exports. Some of the prominent clusters in the manufacturing activity are² –

- Panipat cluster, which produces 75 per cent of the country's blankets
- Tirpur cluster, which produces cotton hosiery and accounts for 80 per cent of the product's exports
- Agra footwear cluster, which includes 800 registered and 6,000 unregistered enterprises with a cumulative capacity of approximately 150,000 pairs of shoes per day, contributing USD60 million of exports
- Ludhiana, which has developed multiple product clusters and produces 95 per cent of the country's woollen knitwear, 60 per cent of the total bicycle and bicycle parts and 85 per cent of the sewing machines

Credit rating fostering business growth in MSMEs

SME Rating Agency of India Limited (SMERA) is India's first and the only rating agency focussed on the MSMEs. SMERA is a joint project of Small Industries Development Bank of India (SIDBI), Dun & Bradstreet Information Services India Private Limited (D&B), and nation's many leading banks. The main objective of SMERA's establishment was to design a system to facilitate the banking sector in providing credit to these units. Thus, MSMEs with rating from SMERA are able to seek easy and timely credit on favourable terms. MSMEs are also witnessing growth in business due to the following benefits of credit rating –

² Source: UNIDO (United Nations Industrial Development Organization)

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- The business units that avail SMERA rating are assigned a unique 9 digit D&B D-U-N-S[®] number which acts as an international identification for these units. The D&B D-U-N-S[®] number is recognized, recommended and sometimes required by more than 500 global trade associations for internal purpose and thus supports growth in export business.
 - Enables large corporate units build confidence in the MSMSE units when the latter is seeking to form part of vendor base of the former.
 - Strengthens the position of MSME among peers for the one bearing credit rating and also allows easy comparison.
 - Allows MSMEs to explore opportunities internationally as rating provides a platform for trade partnerships with global players.

2.2 Enabling SMEs to contribute more to the economic growth

The key to ensure that SMEs are able to grow in tandem with the economy in this age of increasing globalisation is to reckon the issues faced by most of them. The government recognises the importance of SMEs for the overall development of the country, and already has measures in place to harness the erupting issues associated with them.

Financing

The major hindrance in the expansion of SMEs is the unavailability of sufficient and timely funds to finance their growth plans. Measures proposed by the government would ensure availability of adequate funds to MSMEs to power their growth. Small Industries Development Bank of India (SIDBI), the country's apex development bank, has targeted 18–20 per cent YoY growth in disbursement of credit to microfinance institutions (MFIs); with this, the total credit disbursed during FY11 would total INR10 billion. In order to garner more funds for MSMEs, the government is drawing the attention of private equity (PE) firms and venture capitalists (VC) towards these units. The Ministry of Micro, Small and Medium Enterprises (MSME) has plans to network major PEs through informal meetings to invest in MSMEs. Furthermore, in July 2011, the secretary of Department of Industrial Policy and Promotion (DIPP) announced plans to offer incentives to VCs on their investments in SMEs.

Also, SMEs will now have greater exposure to public funds given the recent launch of an SME exchange at the Bombay Stock Exchange (BSE). The BSE SME Exchange commenced operations in March 2012 and senior BSE officials expect about 100 companies on its trading platform by mid-FY13. The exchange is set to be a key source of low cost equity capital for SMEs to aid their growth and expansion plans.

Infrastructure issues

Policy focus on infrastructure will be instrumental in boosting growth in SMEs manufacturing activities as it brings markets closer. Government infrastructure spending is set to touch USD1 trillion under the 12th Five-Year Plan (2012–17), up from USD514 billion in 11th Five-Year Plan (2007–12). Much of this investment will be directed at the development of roads, bridges, ports, power, railways, airports and urban infrastructure, among others. Apart from spending from its own coffers, the government is keen to engage the private sector as well. Successful implementation of numerous infrastructure projects through the Public-Private Partnership (PPP) model has encouraged the government.

Empowering SMEs to facilitate growth

The main barrier in the growth of SMEs is the lack of resources. SMEs require support from government and industry bodies to overcome the limitations. In line with this, the National Manufacturing Competitiveness Council (NMCC) has announced 10 schemes for developing global competitiveness of the Indian MSMEs in the sector. These schemes cover most of the key areas related to the manufacturing activity –

- **Lean Manufacturing Competitiveness Scheme:** Implemented under the Public Private Partnership (PPP) mode with 42 Lean Consultants, the project aims to reduce manufacturing waste, and increase productivity and competitiveness.
- **Design Clinic Scheme:** This is a platform to enable MSMEs to avail expert advice and cost-effective solutions for real-time design issues. The scheme includes two projects, namely Design Awareness and Design Project Funding.
- **Marketing Assistance and Technology Upgradation:** The scheme focuses on upgrading technology for increasing competitiveness in marketing. Activities include technology upgradation for packaging, competition studies and development of marketing techniques.
- **Technology and Quality Upgradation:** The scheme aims to encourage MSMEs to adopt global standards for improving the quality of goods.
- **Promotion of Information and Communication Tools (ICT):** The scheme focuses on encouraging the adoption of ICT technology by SME clusters, which have been delivering world-class products and, therefore, have potential for growth in exports. The scheme covers building E-readiness infrastructure³ and web portals and linking it to national level portals for reaching global markets, training MSME personnel for ICT applications, and the development of software solutions for efficient management of production at clusters, among other measures.

³ E-readiness infrastructure implies developing the physical infrastructure of a firm/organisation up to a state that enables the usage of information and communication tools and technologies

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- **Tolling and Training Centres:** This includes incorporation of tool rooms and training centres as a facility to MSMEs.
 - **Improving Quality in Products:** In order to improve the product quality of the MSE (Micro and Small Enterprise) sector, this scheme covers various activities such as – 1) Introduction of appropriate modules for technical institutions, 2) Organising awareness campaigns, 3) Organising competition watch (C-Watch), 4) Implementing quality management standards and quality technology tools in selected MSEs, 5) Monitoring international study missions, and 6) Impact studies of the initiatives.
 - **Awareness on Intellectual Property Rights (IPR):** The scheme aims to foster Indian MSMEs to attain leading positions globally, and seeks to empower these units with the IPR tools to protect their innovations.
 - **Barcode Certification:** The certification enables higher export price realisation. The adoption of Barcode certification is being encouraged among MSMEs under this scheme by reimbursing 75 per cent of the annual certification fee (recurring) in the initial three years.
 - **Nurturing Innovative Business Ideas:** The 'Support for Entrepreneurial and Managerial Development of MSMEs through Incubators' scheme is aimed at nurturing the innovative idea of an entrepreneur by providing technical assistance through various institutions. Funds up to INR 625,000 are offered per idea as assistance to commercialise the innovation and establish the enterprise through guidance by relevant associations. Currently, 76 business incubators have enabled the approval of 190 business ideas.

Few more schemes have been designed to boost the growth of MSMEs:

- **Cluster Development Programme for Enhancing Productivity:** The Ministry of MSMEs announced this programme, which aims at increasing the productivity, competitiveness and capacity of MSEs. Clusters are provided financial assistance for the preparation of Diagnostic Study Report and infrastructure development of the Common Facility Centre. This programme has proved beneficial for the clusters. For instance, the Brass and German Silver Utensils Cluster registered a three-fold growth in revenues.
- **Prime Minister's Employment Generation Programme (PMEGP):** Considering the importance of MSMEs in the nation's employment generation, a national level credit-linked subsidy scheme was announced by the Khadi and Village Industries Commission (KVIC). The programme had a total outlay of INR44.85 billion during the last four years (2008–09 to 2011–12) of the 11th Five-Year plan. This scheme covers financial assistance for setting up of microenterprises. The Ministry of MSME is also contributing to this initiative of the KVIC. The programme is estimated to have enabled the generation of 442,000 jobs.

2.3 Success stories from global manufacturing SMEs

Although SMEs in India are yet to prove their mettle globally, instances from some developed countries indicate that the sector is heading in the right direction. Successful SMEs in Germany and Italy were beneficiaries of focussed support from the government and industry bodies. It helped them to emerge as the backbone of their economy and gain a leading position in the global marketplace.

Germany SMEs - key growth contributor to economy

German SME's, locally known as Mittelstand companies, are small-and medium-sized enterprises which are mainly family-owned. These units have less than 500 employees and an annual revenue below EUR50 million. The importance of these units can be reckoned by the quantum of their contribution to the economy; Mittelstand companies account for nearly 50 per cent of the country's GDP employing approximately 70 per cent of the nation's workforce. Their success is noteworthy, mainly because they constitute 99.7 per cent of the companies in Germany, and have enabled the country to emerge as the world's second largest exporter of manufactured goods in spite of a strong euro and with one of the world's largest wage pay scales.

The success of Germany's Mittelstand strategy can be illustrated in the case of pencil manufacturers Staedtler and Faber-Castell. These two companies operating in the low-technology industry have been able to maintain leading position globally in the high-end pencil market for more than 175 years despite the high wages prevalent in the country. The common factors contributing to the long-held leading position are constant technical innovation, ploughing back of profits rather than dependence on bank credits and cordial relations with employees.

Mittelstand emerged under the German government's strategy to ensure industries in Germany enjoyed a competitive edge over those in the UK and France. The strategy linked regional educational institutes with nearby industries. Students pursuing post-secondary education were required to execute a project in these units in order to complete their course and receive a degree. This enabled the manufacturing units to achieve lean production by applying concepts from vocational training colleges, polytechnics and universities, and local industries. This also enabled in creating a well-trained workforce for the manufacturing units.

While Mittelstand companies have been subject to limited access or high cost capital, they have been innovating on a constant basis that has helped them develop niche businesses. They backed their business growth with aggressive marketing, which eventually resulted in 80 per cent of their products being exported. These units also provide intensive after-sales service to help them understand customer needs better and constantly improve their products.

Eventually, Germans developed the technology-intensive area of machines, machine tools and precision instruments as their forte. This is illustrated by the fact that Germany is the biggest exporter of machines to China, which is considered as the factory to the world.

The Mittelstand development capitalized on the quality, durability of their product which was a result of flat structures that permit quicker rollout of products from innovations, financial prudence and holding skilled workforce. The business model has been successful in spite of restricted capital sources and high labour costs in these units.

Italy's SME clusters strengthening economy

According to the president of Federazione dei Distretti Italiani (Association of Italian Clusters), SMEs concentrated in clusters have played a major role in helping Italy to overcome the economic crisis of 2008.

As per Osservatorio della Federazione Distretti, the cluster observatory, Italian exports from these units grew 10.5 per cent during January–September 2011 compared to the same period last year. Notably, the industrial clusters grew at a slightly faster pace of over 16 per cent compared to non-clusters (15.6 per cent) – a trend seen after many years in Italy's industrial history. Furthermore, most of the clusters envisage a rise in exports during 2011; a meagre 4.9 per cent of these units projected a decline in exports during this period.

The clusters have achieved this success mainly due to the modification of organisational strategy by the SME units when the economic crisis was at its peak. The change in the business model was named as "triple A", which stood for "adattativo, affidabile, alternative" (adaptable, reliable, alternative). The adaptation of this model meant capitalising on the changing trend in market demand, innovating with the product or the manufacturing process and carrying business with an increasingly flexible local cooperation network. The key drivers for the evolution of this business model are innovation and network.

Innovation was possible through the efforts carried by the industry association, which established tie ups with universities and research centres to make them accessible to SMEs. This allowed the entrepreneurs with ideas to improve further, and test and innovate through resources at these centres. This enabled innovation in these manufacturing units, either with new products or at various levels of value addition.

The SMEs formed clusters to gain synergies from working together as it ensured better use of existing knowledge. They created "network companies" and led to "network contracts" that have been legalised in Italy.

This enabled sectors such as engineering, apparel, furnishings, textiles, leather and pottery to restore their export business, and thus contribute to the country's economy.

3. CONCLUSION

The growing importance of SMEs, which account for about one-sixth of India's total GDP, is manifesting itself in various quarters of the economy. Government is trying to push it forward with a number of plans to foster technology, innovation and quality in SMEs. Banks have joined hands with private players to create a rating agency focused on SMEs in order to improve the credit disbursal to them.

Indian SMEs are increasingly organising themselves in clusters, which improve their access to business associations and technical assistance providers. It also helps in building inter-firm cooperation that adds to productivity and innovation. The clusters already account for 40 per cent of the nation's industrial output and 35 per cent of direct exports. The efficacy of clustering in SME space will further increase in future as clusters continue to leverage benefits of spatial proximity.

Globally, successful instances of SMEs have been witnessed in Germany and Italy. Germany's SME units, called Mittelstand companies, emerged as the key contributor to the economy due to the government initiative of bringing together the companies and education institutions. This policy worked as a win-win situation for both companies who adopted concepts towards lean manufacturing and also the students enabling them to improve their technical skills from hands-on experience.

India's manufacturing SME sector is well equipped to grow, and the fundamental drivers are in the right place. Continued empowerment of SMEs will enable them to attain high and sustainable growth in the long-run.

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