International Journal of Management, IT & Engineering
Vol. 8 Issue 11, November 2018,
ISSN: 2249-0558
Impact Factor: 7.119Journal Homepage: http://www.ijmra.us, Email: editorijmie@gmail.com
Double-Blind Peer Reviewed Refereed Open Access International Journal - Included in the International Serial Directories Indexed & Listed at: Ulrich's Periodicals Directory ©, U.S.A., Open J-Gate as well as in Cabell's Directories of Publishing Opportunities, U.S.A

Pharmaceutical MSMEs in India: Financing Choices and Challenges

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Abstract

The government's emphasis on 'Make in India' is aimed at giving MSMEs (Micro, small, and medium enterprises) a competitive advantage in today's globalised environment. Simultaneously, with the implementation of the Companies Act 2013 and the SEBI (Listing obligations and disclosure requirements) Regulations, 2015, significant changes are taking place in the corporate sector. MSMEs must be viewed as a harbinger of economic growth in the current era, as they provide jobs, increase manufacturing activity, and innovate, among other things. However, MSMEs face many challenges, the most significant of which is obtaining financing.

Equity financing appears to be a low-cost option for meeting the finance challenge, according to most experts. However, listing becomes necessary to obtain equity. The new Companies Act places a greater emphasis on corporate governance, and SEBI has tightened its listing agreement.

Keywords:

MSME, Globalization, Private Equity, Listing, SME platform, Credit Rating.

Introduction

In the last three decades, there have been exceptional developments in the field of corporate governance all over the world. It can be traced back to international efforts to increase liberalisation, privatisation, and globalisation in various countries as a panacea to bring about a turnaround in the ailing economies. A series of corporate failures and frauds in some of the world's most renowned companies necessitated developments in corporate governance. These developments shook stock exchanges and led to a drop in investor sentiment; India is no exception. Various initiatives have been undertaken by the industry (ICC Code of Corporate Governance in 1998), SEBI (Kumarmanglam Birla Committee Report, enactment of clause 49, and Narayan Murthy Committee), and the Ministry of Company Affairs (Irani Committee Report in 2004). The Companies Act of 2013 contains numerous provisions aimed at improving corporate governance and corporate social responsibility. The SEBI has also issued the Securities and Exchange Board of India (Listing Obligations and Disclosure Requirements) Regulations, 2015, which go into effect on September 2, 2015.

Corporate governance has been defined in a variety of ways by various authors and authorities. The OECD defines Corporate Governance as "a set of relationships between a company's management and its board of directors, as well as the relationships among various participants in determining the direction and performance of the corporation." According to Sir Adrian Cadbury, "Corporate Governance is concerned with maintaining a balance between economic and social goals, as well as between individual and communal goals." According to J. Wolfensohn, corporate governance is about promoting corporate "fairness, transparency, and accountability," and while Marc Goergen (2012) believes it "deals with conflicts of interest between providers of finance and managers," Shiefler and Vishny (1997) believe it "deals with the way suppliers of finance assure themselves of receiving a return on their investment." ICC, CalPERS, and the Corporate Library limit it to a "relationship" between shareholders, directors, and management.

Corporate Governance is thus both a structure and a well-defined system of relationships that provides direction and may lead to corporate excellence. The Board of Directors, which serves as a bridge between the aspirations of stakeholders and management, is at the heart of Corporate Governance.

Just as the twentieth century was dubbed the "age of management," the twenty-first century could be dubbed the "age of governance" due to the increased emphasis placed on it around the world. The corporate structure is recognised as a growth engine that propels the private sector. Corporate governance is critical for competitive performance. Recent global economic developments, particularly deregulation and technological advancements, have exposed businesses to the need for more capital. Increased competition necessitates increased spending on R&D and capacity enhancement. This increases the pressure on managers to improve economic performance. At the same time, governance issues have grown in importance as various E&Y surveys show that capital suppliers are willing to pay a premium for better-governed firms. According to James E Post (2009), "sound corporate governance acts as a brake on the extreme impulses of entrepreneurial leaders by imposing standards of accountability and transparency." When governance is undermined, accountability suffers, and leaders are free to run amok, incurring more risk, defying disclosures, ignoring legal requirements, and putting personal agendas ahead of the organization's interests."

Review of Literature:

Muneer Mohamed Saeed Al Mubarak and Allam Mohammed MousaHamdan (2016) examined how corporate governance and market capitalization are related using the Agency Theory. The sample consisted of 36 firms listed on the Bahrain Stock Exchange. The study took place between 2009 and 2013. The study used econometric techniques to establish relationships between various aspects of corporate governance and market valuation.N. M. Leepsa and Brahmadev Panda (2017). The purpose of this article was to investigate agency theory using theoretical and empirical evidence. The paper discusses various concepts and issues concerning the conflict between ownership and management.In his study, Jaswal (2014) contends that for MSMEs to overcome the challenges presented by the current economic situation, the government must be supportive while also making MSMEs aware of the various measures taken by the government.In his paper, Mahmood, Shahnawaz (2013) discusses the challenges that SMEs face in developing countries, particularly in South Asia, as well as the importance of embracing corporate governance and ethical business practices. He believes that an incentive-based system for encouraging SMEs to adopt good governance practices is more likely to succeed. He also presents a market-based solution for engaging closely with SMEs through the formation of venture services companies.Ntim, Lindop, and Thomas (2013) investigate whether the quality of firm-level Corporate Governance has any effect on the quality and extent of corporate risk disclosures (CRD) in South Africa, with a focus on the pre and post-global financial crisis periods. CRD has been discovered to be large' non-financial,' 'historical,' 'good news,' and 'qualitative.'Mande, Young, and Mungsoo (2012) investigate whether corporate governance influences the choice of financing (equity versus debt). They have worked on the hypothesis that increasing the level of Corporate Governance leads to a decrease in agency costs, resulting in more equity financing. The findings suggest that measures of Corporate Governance effectiveness have a positive impact on the likelihood of choosing Equity over Debt.Al Shabibi, Badar, and Ramesh (2011) conducted an empirical study in the United Kingdom in 2007 on the

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impact of Corporate Governance factors and firm-level factors on the Dividend Policy of non-financial companies. According to the findings, firm characteristics have also influenced dividend policy.According to Hajiheydari, Dastgir, and Sultani (2011), R&D is an important component in the success of pharmaceutical companies, but the cost of R&D is exorbitant, so many managers regard it as wasteful. The paper contends that there is a strong and positive relationship between R&D costs and pharmaceutical company profitability.Leng and Ding (2011) seek to investigate the impact of Corporate Governance Structure on Internal Control Disclosure. For 2010, a sample of 1309 Chinese listed non-financial companies was taken. According to the paper, the degree of ownership concentration, the board size, proposal of independent directors, and size of Board of Supervisors are not significantly related to internal control.The paper by Buysse (2010) investigated the impact of the global recession on medicine consumption, as well as pharmaceutical expenditure and prices. IMS Health data for 84 countries were obtained from the first quarter of 2007 to the fourth quarter of 2009. Lee and Kohler (2010) investigate the growing trend among pharmaceutical companies to benchmark their Corporate Social Responsibility performance and its impact on increasing access to medicines. The article demonstrates the importance of benchmarking and transparency in fostering inter-business competition, as well as the translation of these responses into actual access to medical practices.Dima et al. (2008) attempted to understand the interrelationship between Corporate Governance and Corporate Social Responsibility both theoretically and empirically. A sample of 8 Lebanon-based corporations was studied, with findings indicating that the majority of managers regard Corporate Governance as a necessary pillar for long-term Corporate Social Responsibility.Chander and Aggarwal (2007) studied 50 pharmaceutical companies. This industry was chosen because it is one of the most important industries in India, with tremendous growth. The data spans ten years, from 1995-1996 to 2004-05. The findings show that size, advertising expenditure, age, efficiency ratio, profitability, and research and development are statistically significant in determining the growth of firms in the drugs and pharmaceutical industry.Patibandla (2006) elaborates on the argument that large outside investors can reduce agency costs by monitoring and disciplining managers more effectively than a large number of small dispersed investors. The empirical results show that the growing presence of foreign institutional investors has a positive effect on corporate profitability. Firms that rely on governmental financial institutions have seen a drop in performance.

The significance of the study and its goals

The increased interest in Corporate Governance over the last two decades can be attributed primarily to two factors: (1) the growing integration and globalisation of markets, and (2) the spate of scandals that have gripped the business world.

In response to these developments, various codes have emerged all over the world in an attempt to improve the level of Corporate Governance and thus protect investors in particular and various stakeholders in general.

Because of the widespread interest in this topic, researchers have attempted to study it from various angles, but the majority of the literature is limited to the United States and the United Kingdom. Some cross-national studies have also been conducted, but studies on industry-specific problems in the Indian context have been few and far between. It is widely acknowledged that a 'one-size-fits-all' mechanism cannot be developed in the Corporate Governance sphere. As a result, Corporate Governance structures and mechanisms must evolve in response to a country's economic, cultural, and political dynamics. Similarly, each industry has its own set of problems and challenges that draw attention to various variables. As in the pharmaceutical industry, there is a need to understand the impact of R&D spending and the placement of scientific personnel, innovation, national and international regulatory compliance, and so on Corporate Governance levels, and vice versa.

Corporate Governance is an ever-changing field. In India, SEBI implemented the revised clause 49 specifying mandatory and non-mandatory/recommendatory guidelines for listed companies in January 2006, which was later modified in 2008. Later, in 2009, the Ministry of Corporate Affairs issued "Corporate Governance Voluntary Guidelines," which were followed in 2011 by "National Voluntary Guidelines on Social, Environmental, and Economic Responsibilities of Business." As a result, there are three types of guidelines: mandatory, non-mandatory/recommendatory, and voluntary.

The Companies Act 2013, which recently came into effect, focuses on Corporate Governance and introduces new concepts and definitions. SEBI (LODR) was introduced by the Indian regulator SEBI in 2015 to improve the effectiveness of corporate governance. The MSME sector could be a sign of future growth in the Indian economy. However, governance issues must also be considered. As a result, understanding the dynamics of MSMEs' corporate governance becomes critical.

The study would attempt to assess the various Corporate Governance challenges faced by MSMEs in India.

The study will be based on secondary sources of information, such as books, government publications, journals, annual reports of companies, and other publicly available information. The methodology used is content analysis.

With 45 per cent of manufacturing output, 95 per cent of industrial units, and 40 per cent of exports, the MSME sector dominates the Indian economy. This sector employs 60 million people, making it the second-largest source of employment after agriculture. Thus, the development of this sector is critical to inclusive growth and India's future. (Grant Thornton Vision 2020: Implications for MSMEs)

Significantly, the MSME sector has maintained a higher growth rate than the overall industrial sector over the last decade. According to a survey, despite rising raw material costs, sluggish global demand, and stiff international competition, exports from these businesses are on the rise. Today, the sector manufactures a wide range of products, from simple consumer goods to high-precision, sophisticated finished goods. It has emerged as a major supplier of mass-consumption goods, as well as a manufacturer of electronic and electrical equipment, drugs, and pharmaceuticals. A boost to the sector is likely to have a multiplier effect on economic growth.

The Most Important Financing Challenges Facing India's MSMEs

According to Grant Thornton Vision 2020: Implications for MSMEs, the following are the major challenges confronting MSMEs in India at the moment:

a. Economical availability of finance
b. Easy access to stock exchanges
c. Technological and Environmental considerations
d. Overcoming challenges of infrastructural bottlenecks
e. Compliance issues

Access to finance is the most critical of the various challenges. Because of the current market conditions in the country, the MSME sector is finding it difficult to raise low-cost funds. There is an urgent need to recognise MSMEs' reliance on working capital financing from public sector banks. However, because the cost of credit in India is higher when compared to international levels, and because public sector banks have strict norms, credit is difficult to come by for this sector. To make funds available to the MSME sector, the following reforms procedure is proposed.

a. A visible credit rating system.
b. A simple documentation procedure to obtain funds.
c. Making provision for interest rate subsidies to the sector.

The most significant impediment to growth, however, is the timely and adequate availability of finance to MSMEs. According to the Prime Minister's Task Force on MSME report, while bank

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credit to the sector has increased significantly from Rs. 70,787 crore in March 2000 to Rs. 2,69,153crores in March 2009, access to the credit needs to increase further given the size of the MSME sector.

During this time, the MSME sector's share of Net Bank Credit (NBC) fell from 22.3 per cent to 15.9 per cent. The government is taking proactive steps to improve credit access. Bank lending to the sector will increase by 20% year on year, with a 10% annual increase in the number of micro-enterprise accounts, with micro-enterprises accounting for 60% of MSME credit. These and other similar measures will ensure adequate credit flow to the sector, particularly to micro and small businesses. Despite such measures, banks are hesitant to lend to MSMEs due to their higher risk profile as a result of zero collateral or a limited number of years of operation.

According to a recent FICCI study, large Indian firms (those that are larger than the MSME threshold by the official definition) received approximately 47% of their total funding from internal sources, 19% from banks and financial institutions (FIs), and 5% from capital markets. The remaining 29% came from other sources. Only 15% of MSMEs' funding came from internal sources, 25% from banks and FIs, and 10% from capital markets. Around 50% of the funding has come from alternative sources such as friends and family, trade credit, and so on. Alternative sources are typically far more expensive, are dependent on current market conditions, and are rarely a guaranteed source. This implies that MSMEs face extremely high-interest costs as a result of a lack of adequate credit. This can be effectively countered by the methodical induction of equity capital.

Equity as a Source of Financing for Micro, Small, and Medium-Sized Enterprises

Traditionally, MSMEs in India have not looked into equity as a source of funding. However, there is a need to promote equity as a means of financing for several reasons. Private equity is known to encourage entrepreneurship. The funds can be used to gain expertise in their field and to implement best practices. It will also result in improved corporate governance, which will result in increased transparency and reporting. The company's customer base is expected to grow as well.

We can learn from the London Stock Exchange, which has a specialised wing called the Alternative Investment Market. This wing only serves MSMEs. This is necessary because the cost of compliance may be prohibitively expensive for such firms, and the AIM has less stringent rules. The Market, which opened in 1995, contributed approximately 21 billion pounds and supported 5,70,000 full-time jobs.

In India, the BSE and NSE have recently established their SME Platforms following the SEBI rules and regulations. The BSE SME Platform provides an entrepreneur- and investor-friendly environment for the listing of SMEs from India's unorganised sector into a regulated and organised sector.

The listed SMEs will cross the SME Platform's threshold and enter the world of finance for further growth and development. These platforms help these SMEs raise equity capital for growth and expansion, allowing them to grow into full-fledged businesses. They will be able to migrate to the BSE's Main Board in due course, under the existing rules and regulations.

The exchanges benefit entrepreneurs by allowing them to raise equity capital for the growth and expansion of their businesses in a cost-effective manner. Simultaneously, investors gain opportunities to identify and invest in good companies at an early stage, as well as a long-term capital gain tax benefit and an exit route. To date, 191 companies have been listed on the SME platform, with a total of Rs 1498.12 crores raised. To date, the market capitalisation of companies listed on this platform has exceeded Rs 17657.54 crores.

Corporate Governance and Private Equity

The Private Equity route to financing necessitates listing, which necessitates compliance with various corporate governance norms. The time and money required to establish a rigid governance framework with a slew of policies, charters, and new executive appointments to run a small corporate entity appear to be prohibitively burdensome in many cases. For many SMEs and start-ups, the upfront financial contribution toward building a strong governance framework is also a significant task, especially when there is no legal consequence or financial deterrent for noncompliance.

Having said that, we are seeing the implementation of penalty systems for non-compliance with corporate governance measures on a global scale. These measures are primarily aimed at encouraging greater accountability and shareholder protection for corporate entities, particularly in the aftermath of the global financial crisis. Financial penalties and penalising individual directors who violate corporate registrars have, in some jurisdictions, acted as sufficient encouragement for the development of sound corporate governance practises being implemented at the SME and start-up levels. Many jurisdictions and economies strike a delicate balance between over-regulating start-ups and smaller businesses and ensuring adequate shareholder protection measures are in place.

A strong governance framework has several significant advantages, including:

a. Improving investment credentials and creditworthiness
b. Capability to protect against significant and damaging financial crime affecting the business.
c. Being well-prepared and positioned for anticipated legislative change.

In recent years, there has been an increase in and implementation of stricter corporate governance requirements in many jurisdictions around the world. As a result, we've seen many SMEs reconsider their internal governance strategies. With increasing demands from stakeholders, particularly institutional investors and debt financiers, for strong and well-maintained corporate entities with significant and defined governance standards, corporate governance and the building blocks and drivers that underpin the concept are undoubtedly here to stay. While the challenges of implementing and maintaining such measures are significant, the benefits for many SMEs and start-ups are in the bottom line and future success.

Conclusion

The Indian economy is on the verge of breaking new ground, and the importance of MSMEs in this successful storey cannot be overstated. MSMEs play an important role in this development, but one of the most significant challenges they face is finance. Private equity is one of the methods recommended by experts for obtaining low-cost financing. Private equity, on the other hand, necessitates listing and strict adherence to Corporate Governance standards. MSMEs can take advantage of the recent formation of SME platforms by the BSE and NSE to gain access to private equity. This industry needs to be made aware of the difficulties in obtaining financing as well as the available options. However, the issue of corporate governance and the protection of stakeholders' interests must not be overlooked.

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