Growing SME Capital Markets – An Opportunity of Wealth Creation

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Background

Micro Small and Medium Enterprises (MSMEs, also called generally as SMEs) are the backbone of any fast developing economy. And India is no exception! SMEs have been playing a vital role in growth of Indian economy. SME, as a segment, has been the fountain head for numerous products and innovations for the Indian and international markets.

SMEs in India contribute significantly to the GDP, exports and employment. As per Government statistics, MSMEs provide 45% of the manufactured output, and accounts for 40% of the Country's exports.

Contribution to GDP	17 %
Share of Industrial output	45 %
Share of Exports	40 %
Total Employment	69 million
Job creation every year	1.3 million

Source : Ministry of Micro, Small and Medium Enterprises, GOI

In order to bolster growth funding opportunities vital for next-level elevation of SME businesses, Prime Minister's Task Force (2010) recommended setting up dedicated exchanges for SMEs. Subsequently, in March 2012, SME Exchanges were launched by BSE and NSE. This was followed by newer platform of Institutional Trading Platform where companies can get listed without IPO. Recently, SEBI Board has approved a third platform for raising capital for IT, knowledge based and other start-up companies.

SME Exchange Platforms

SME exchanges or trading platforms are prevalent globally albeit known by different names, such as 'Alternate Investment Markets' or 'growth enterprises market', 'SME Board' etc. The global trend in recent times is towards creation of new forms of capital markets specifically designed to meet the funding needs of SMEs.

Globally, institutional trading platforms are prevalent, in various different avatars albeit. For instance, AIM (UK) permits listing without IPO on fulfillment of prescribed conditions. In the US, "Over the Counter Bulletin Board" (OTCBB) could be used by companies as a stepping stone before leaping into the larger exchanges and markets.

In India, SME Exchange platforms were launched by BSE and NSE for companies with paid up capital of up to Rs. 25 Crores. An 'SME Exchange' is a stock exchange dedicated for listing and trading of shares of SMEs which otherwise find difficult to get listed on the main exchanges. These SMEs can get listed on SME Exchanges through IPO route.

Key Regulatory Framework

SME IPO and listing eligibility criteria have been relaxed greatly so that the maximum number of emerging businesses can reap the benefit of capital markets. Small companies can now think big. A company as small as that having Rs. 3 crore of networth (paid up equity capital and reserves) can seek listing its shares on SME exchange. Besides, the company should also have :

1. Net Tangible assets of at least Rs. 3 crore
2. Distributable profits for two financial years out of three immediately preceding financial years or networth of at least Rs. 5 crores

Post-IPO, the paid up capital of the company should be at least Rs. 3 crore and the maximum paid up capital a company can have while being listed on SME Exchange is Rs. 25 crores.

Minimum 25% of the post-IPO shares is required to be offered to public through IPO and at lest 50 investors should subscribe to the IPO. The minimum application lot in an SME IPO is Rs. 1 lakh per application. Investors can apply for shares worth Rs. 1 lakh or in multiples of Rs. 1 lakh. Even shares can be traded post listing in the same lot size of Rs. 1 lakh unlike Main Board where shares can be traded in lots of 1 (one) share or more.

In order to facilitate liquidity to investors and boost trading of shares in SME segment, SEBI has mandated compulsory market making for a continuous period of 3 (three) years from the date of listing.

Currently, market maker has to compulsorily invest 5 per cent of the Issue Size and provide buy and sell quotes 75 per cent of the trading day time. Market Maker is required to provide two-way quotes for 75 per cent of trading time.

Unlocking Valuation

SME listing provides opportunity for unlocking business valuation. Unlisted businesses are typically benchmarked in the light of the net-worth, which is based on historic values. However, business valuation on a going concern basis could be significantly higher than the historic values. And that's the gap which can be typically bridged by capital marketplace through stock prices.

For any company to carry out an IPO valuation, it is essential to move beyond tax savings based valuation strategies to wealth creation strategies. For example, a 10 rupees of tax saved reduces a pre-tax profit of Rs. 30 (approximately, assuming 1/3rd of tax on profits earned). On the contrary, Rs. 30 of profits would turn out to be Rs. 20 post tax profits (per share of Rs. 10 face value each) which in turn would fetch a valuation of, say, Rs. 200/- (rupees two hundred) assuming the stock prices are based on a P/E multiple of 10.

The following table depicts as to how some of the companies have unlocked their valuation after listing on SME Exchanges :

	Si. Vi. Shipping	AIFL	Ultracab	Momai Apparels
A. Market Cap	**INR Crores**			
Pre Issue Net Worth	3.10	10.98	6.25	17.12
Issue Size	6.86	21.00	7.97	43.33
Market Capitalization	25.08	507.71	55.30	129.94
B. Price Pattern	**INR Per Share**			
Issue Price	25.00	40.00	36.00	78.00
*CMP (Face Value INR 10)	43.60	260.80	69.00	90.05

The current SEBI regulations are based on disclosure regime. There is no prescribed set of valuation norms. SEBI regulations specify disclosure norms and provide guidance on overall methodology for IPO valuation and pricing.

The following are the three methods which are mentioned under the SEBI guidelines and based on which pricing need to be disclosed in the offer document:

1. Net Asset Value or Book Value per share
2. Price Earnings Multiple per share
3. Comparable prices with peer companies

In simple terms, pricing as per the above methods needs to be disclosed in the offer document. Notably, IPO pricing is not as per discounted cash flow (DCF) method, which is based on future projections. Pricing is driven predominantly by the pricing earnings multiple (PE multiple). Price is derived as post tax earnings per share multiplied by an average multiple. The multiple is the average figure of comparable companies. Efficiently managed business with low capital and productive post tax profits provide better valuation and public issue pricing.

It is recommended that emerging companies draw their financials appropriately so that their proper valuation can be benchmarked and the same can be unlocked when companies approach SME exchanges. Since the base is typically small for an SME company, it is advisable to have well laid out financials and appropriate disclosures right from beginning which aid to long term business plan and valuation strategies.

The myth of savings more by aggressive planning of reduced post tax profits should be addressed. The choice is between two alternatives: save 1/3rd of pie or raise business valuation to, say, 10 times. The cost of tax planning could be phenomenal in terms of valuation foregone. Progressive businesses, who appreciate the wealth creation and business valuation, have been able to raise the valuation to desired levels without bothering incremental tax outgo. That has also benefitted the exchequer and the shareholders at large. This is a win-win for the business and its stakeholders.

Benefits of Listing on SME Exchanges

- **Operational Benefits**
  - **Access to capital and financing opportunities**: What can be attributed more as a benefit of listing than the enormous financing opportunities that it presents both in terms of raising equity and the beneficial treatment in terms of cost at which funds can be raised.

- **Currency Value**: Listing shares, having their value established in the market, act as currency. Listed shares can be used as collateral to raise funds. Listed securities act as a viable M&A currency and help avoid the cost and time involved in M&A transactions.
- **Reduced cost of borrowing**: Listing often leads to improvement in credit rating, which in turn enables raising of loans at a reduced rate of interest.
- **Stakeholders' Comfort** : Listing adds to the comfort of stakeholders such as customers / lenders/creditors of the company, which in turn, often, results in increased order book, better negotiated business terms like credit period, margin requirements, less-onerous contractual covenants etc.

Tax Benefits

- **No long term capital gains** : Under Income-tax Act, 1961, long term capital gains are exempt from tax on transfer of listed shares held for more than 12 months. Even, short term capital gains tax on listed shares is payable at a half rate of 15%.
- **No tax on equity infusion in the company** : As per the Finance Act, 2012, a company is liable to tax on equity infusion, if the equity shares are issued to an investor other than a registered venture fund at premium exceeding the fair price. Such a tax is not applicable in case the shares are listed.
- **No tax on distressed business purchase** : As per the Income-tax Act, there lies a tax liability on the investor if the shares of an unlisted company are bought below its book net-worth. Such a tax incidence is mitigated if the shares are listed.
- **No tax on buy-back of shares** : As per the amendments in the last year's Union Budget (2013), companies are subject to tax @ 20% on buy back of shares. Such a tax is not applicable if the shares are listed.

Other Benefits

- **Unlocking Value**: The value is often locked or not benchmarked for companies not on a trading platform. The companies listed on an exchange are in a position to unlock/ benchmark their fair value.
- **ESOPs - Talent retention tool** : ESOPs, typically, serve as a tool for retaining/ incentivizing the talent and also act as a wealth creator for employees. The benefits of listing can be attributed to unlocking the value of the company and making ESOPs effective, thus aiding to talent retention.
- **Visibility – Profile Building** : The companies listed in the stock exchange get recognition, as well as are followed by investors and analysts. Listing of a company provides a platform for recognition and visibility.
- **Corporate Governance – Internal Systems**: Though the listing requirements for a company listed on SME Exchange are simplified, but they are adequately drawn up to ensure internal control systems and corporate governance suiting to SMEs.

Migration from SME to Main Board

A company listed on SME platform can migrate to the Main Board after two years of listing on SME platform, if the paid up capital of the company Rs. 10 crore or more.

If the paid up capital of the company exceeds more than Rs. 25 crores, then the company is required to migrate to Main Board compulsorily. However, if the paid up capital of the company listed on SME platform is between Rs. 10 crores and Rs. 25 crores, the company has the option to continue on SME platform or get migrated to the Main Board. Option to migration can be exercised subject to the following conditions :

(a) Company can be migrated to Main Board any time after two years from the date of initial listing on SME platform;

(b) A special resolution is passed by shareholders (other than promoters) in favour of the proposal by at least two-third majority.

As per BSE norms, if the company's shareholders are 500 or more, on migration, the scrip gets included in 'B' category of Main Board, else in 'Trade to Trade' segment of Main Board. Whenever, the number of shareholders exceeds 500, the scrip is shifted from 'Trade to Trade' to 'B' category.

It is noteworthy that, the company is not subject to the eligibility norms prescribed under the SEBI Regulations for Main Board listing and as such, the conditions like minimum average operating profit of Rs. 15 crore p.a. for at least 3 years do not apply to SME listed companies for migration to Main Board. It is the only the norms of Exchange that need to be satisfied by the company, which are briefly captured above.

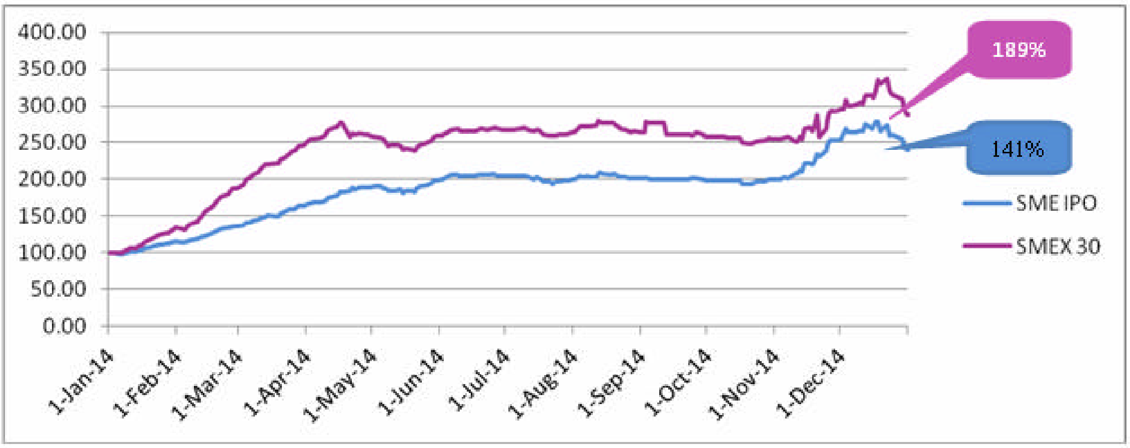
Even the companies listed on Main Board but having their paid-up capital less than Rs. 25 crores can reverse-migrate to SME platform. Though, there is no such instance of a main Board listed company getting migrated to SME platform.

However, There is no provision of migration for companies listed on Institutional Trading Platform (ITP). ITP listed companies can remain listed only for 10 years and after that they are compulsorily de-listed. Such companies cannot be migrated to SME platform and / or Main Board, and rightly so, because these companies are not subject to IPO due diligence and requirements. This is because companies get listed on ITP without any IPO and public participation.

Main Board migration facility incentivises promising SMEs to grow and achieve the threshold for graduating to next level. Main Board migration decision should however be based on relevant factors such as company's business life cycle, internal systems and controls. On SME platform, companies get benefits of simplified compliance regime and lesser disclosures. Upon migration, such relaxations no longer apply and companies become subject to all the listing compliances and disclosures including quarterly newspaper publication of financial results. On migration, however, companies no longer remain subject to the requirements of market making and minimum lot size (of Rs 1 lakh).

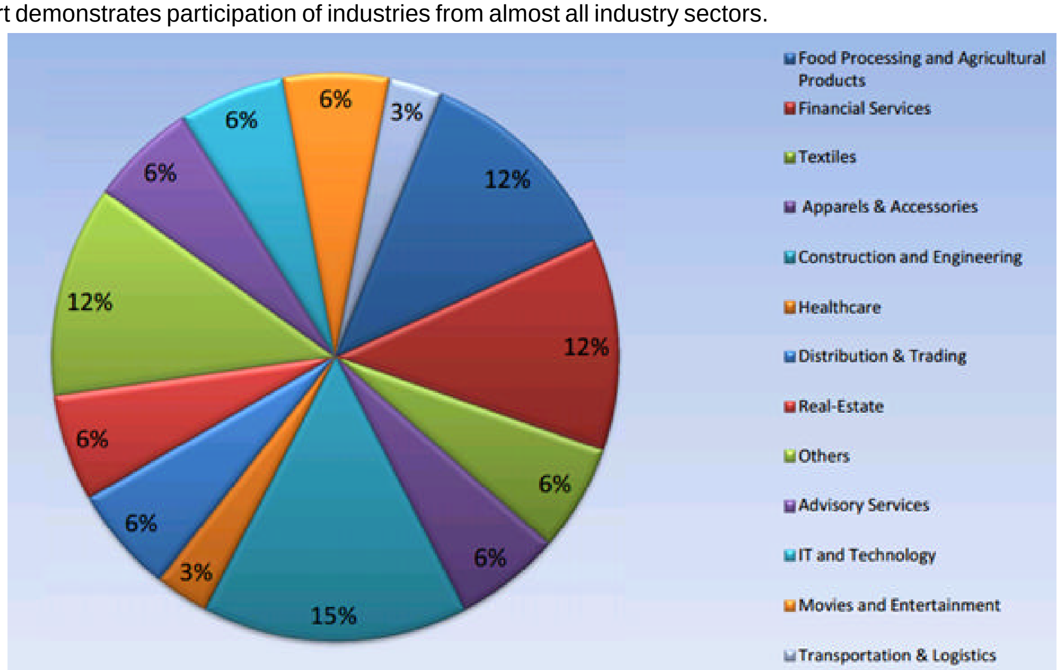
SME Capital Markets So Far

The SME Capital market in India has seen a flurry of activities in past 3 years. SME Platform has opened up immense opportunities not only for the small and medium enterprises to maximize wealth and gain visibility but also provides new investment opportunity to investors. Increasing number of companies are participating on SME Exchanges of BSE and NSE. In the year 2014, Pantomath SMEX-30 index has increased more than 180%.



So far, 94 companies have got listed on BSE SME Exchange and 7 on NSE Emerge. Further, several companies have filed their draft offer documents with these Exchanges. The total market capitalization of SME Exchanges has peaked over INR 10,000 Crores. Six companies listed on BSE SME platform and one on NSE Emerge have already got migrated to the Main Board of BSE and NSE respectively. Companies are motivated and excited about moving to the Main Board.

To talk of sectoral participation, companies from varied sectors have got listed on SME Exchanges. The following chart demonstrates participation of industries from almost all industry sectors.



(Source : BSE SME Platform presentation by BSE-Data 2013)

Concluding Remarks

These recent initiatives of capital markets aim at bridging the gap between SMEs and capital markets by providing an opportunity to SME entrepreneurs to raise growth capital and reap benefits of listed space. These SME capital market platforms are in evolutionary stages and perhaps would undergo changes as markets would be broad-based and newer practices developed. Regardless, SME entrepreneurs spot a ray of fresh light and hope for raising growth capital in economical and tax efficient manner and move up the ladder towards next-level growth. In the process, this opens up as a colossal opportunity for capital markets, market intermediaries and professionals.