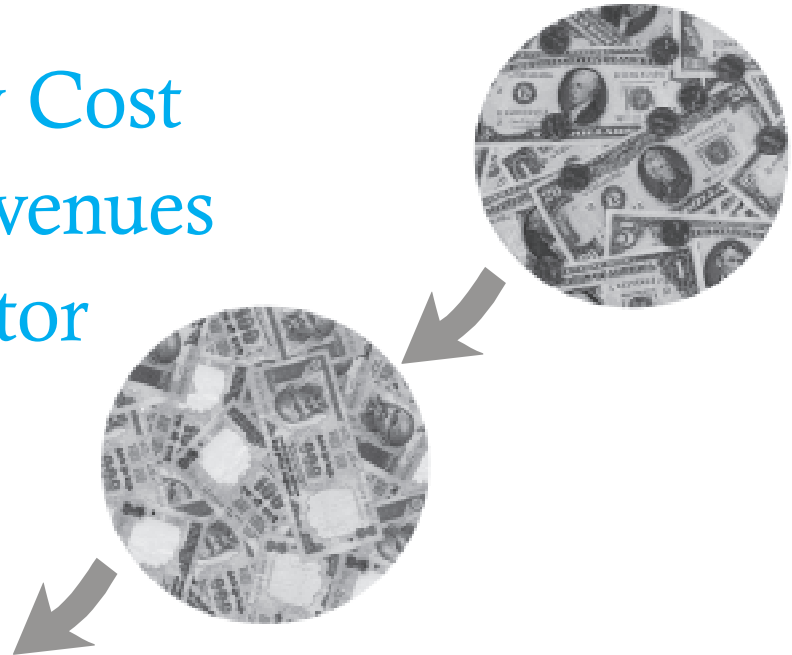
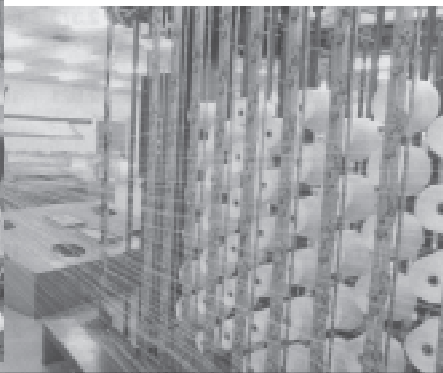
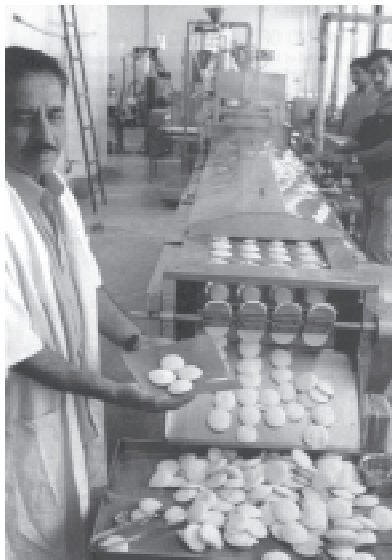


Alternative Low Cost Fund Raising Avenues for the SME sector

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Even though the Government of India has recently announced a few policy initiatives to enhance the credit flow to SME sector to help it grow at a higher pace, the SME sector is still confronted with a lot of constraints in resource mobilization. The SMEs are neither in a position to go to the public to mobilize resources nor able to convince the

financing agencies about their strength. This sector genuinely needs low cost funds not only to reduce the cost of production to be viable but also to compete with the large industries as well as upcoming MNCs.

The present domestic market conditions do not provide enough opportunities for the SME sector for raising low cost funds. With safety of loans being a major criteria, banks tend to give preference to lending funds to the "A" category corporate borrowers over the SMEs who do not have sufficient wherewithal to provide securities to the lending banks. Even in the bond market, a five year rupee bond would be in the range of 9.5% to 10% depending on rating. For unrated bonds, the rates would work out to be much costlier. In such a scenario, borrowing through the foreign currency route, either in the domestic or overseas market, provides an alternative viable option.

Of late, Small and Medium Enterprises (SMEs) sector has been identified as an 'Engine of Growth' in our country both in terms of employment generation and improving production. The small scale industries (SSI) produce about 8000 products, contribute 40% of the industrial output and offer the largest employment after agriculture. The sector, therefore, presents an opportunity to the nation to harness local competitive advantages for achieving global dominance.

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Domestic Foreign Currency Borrowings

Banks in India are providing low cost funds to the SME sector by way of foreign currency lending as term loans, working capital loans as well as export credit in foreign currency. Commercial banks who have large non-resident deposit funds are deploying such funds by way of foreign currency loans to their corporate clients for their working capital and term loan requirements. Even SIDBI has been raising funds from international lending agencies like World Bank, Asian Development Bank and onlending low cost funds to SME sector either directly or through various commercial banks. The SME sector has been increasingly taking benefit of such facilities extended by the banks. Such loans are generally extended by banks at a margin over the bench mark LIBOR in the corresponding foreign currency.

Export Finance in Foreign Currency

Exporter clients have been availing of low cost export finance in foreign currency (PCFC) disbursed by various commercial banks. The banks generally utilize their excess foreign currency deposit funds for this purpose. They have also been allowed to borrow low cost, short term foreign currency funds from various overseas banks, either through short term credits or standing lines of credit, for onward lending in foreign currency to their exporter clients. The maximum lending rate in case of PCFC is 100 basis points (bps) over corresponding LIBOR. The SME sector's exporter-borrowers have largely benefited by such borrowings.

Overseas Foreign Currency Borrowings

External Commercial Borrowing (ECB) : ECB generally refers to commercial loans by way of bank loans, buyers credit, suppliers credit, securitised instruments such as, floating rate notes and fixed rate bonds like FCCB availed from non-resident lenders with minimum average maturity of 3 years. The maximum all-in-cost, which includes rate of interest, other fees and expenses in foreign currency except commitment fee, pre-payment fee and fees payable in Indian rupees, for an ECB under the automatic/ approval route is 200 bps over 6 months LIBOR for average maturity period of 3 to 5 years and 350 bps over 6 months LIBOR (for the respective currency of borrowing or applicable benchmark) for more than 5 years average maturity period. The payment of withholding tax in Indian rupees is excluded for calculating the all-in-cost. Such loans are, however, raised for bigger amounts by big corporates, generally, through loan syndication route at a margin of less than 100 bps over LIBOR. The SME clients will find it difficult to raise funds through this route as small amounts attract higher margins over Libor thereby making it cost-ineffective proposition for them.

Trade Credits : Trade credits refer to credits extended for imports directly by the overseas supplier, bank and financial institution for maturity of less than three years. Depending on the source of finance, such trade credits include suppliers credit or buyers credit. Suppliers credit relates to credit for imports into India extended by the overseas supplier, while buyers credit refers to loans for payment of imports into India arranged by the importer from a bank or financial institution outside India for maturity of less than three years.

The maximum permissible all-in-cost which include arranger fee, upfront fee, management fee, handling/ processing charges, out of pocket and legal expenses, if any, are 50 bps over 6 month Libor for maturity up to one year period and 125 bps over Libor for a tenor of more than one year but less than three years. For example, SBI, Tokyo extends buyers credit to an Indian corporate with a view to facilitating import of raw materials, machinery, spare parts, etc. for a period up to 180 days, generally, at a low rate of 50 bps over LIBOR in USD, Euro or Japanese Yen. SBI, Tokyo also arranges suppliers credit for imports of machinery/ stocks covered by letters of credits for up to 180 days. They offer special arrangement facility by discounting exporter's bills and pay them at sight against usance bills under letter of credits issued by Indian branches of SBI/ Associate Banks/ reputed private and foreign banks in India.

Foreign Currency Convertible Bond (FCCB) : The external commercial borrowings are made in foreign currency and, with cost of forex cover included, often do not work out to be as less costly as perceived, unless the borrower is willing to look at some cost reduction derivative deals. As a result, many borrowers have been turning to the FCCB route. In fact, more number of recent SME overseas funding has been happening via the FCCB route where the funding comes by way of convertible debt. This is basically a play on the client's equity story.

A typical convertible bond is issued in a currency different from the issuer's domestic currency. It is a mix between a debt and equity instrument. While it acts like a bond by making regular coupon and principal payments, it also gives the bond holder the option to convert the bond into stock. These types of bonds are attractive both to investors and issuers. The foreign investors receive the safety of guaranteed payment on the bond and are also able to take advantage of any large price appreciation in the company's stock by activating the warrants attached to the bonds when the company's stock price reaches a certain point. Due to the equity side of the bond, which adds value, the bond coupon is kept lower, thereby, reducing the company's debt financing costs.

Careful Selection of Currency of Loan : While various avenues for raising low cost funds, especially in foreign currency, are available to the SME sector, what is important for the clients is the selection of the best available product, keeping in view the cost of funds and the risks involved in such transactions. For this, one has to know the various components of the total cost involved in such borrowings and look out for ways to reduce the cost of whichever component possible to ensure reduction in the overall cost of funds.

The costs in overseas borrowings (which are generally floating rate loans) include bench mark rate (say LIBOR), margin over LIBOR, out of pocket expenses like arranger's fee, lawyer's fee, etc. The all-in cost is exclusive of withholding tax (approx 15% p.a. on the interest) which is deposited with the tax authorities at the time of payment of interest to overseas lender. While the SME client generally takes utmost care to bargain for the margin over LIBOR as well as for the out of pocket expenses, what they tend, often, to ignore is the importance of withholding tax factor in the overall costing of the loan. For example, in case of a foreign currency loan in USD, where the interest cost is say 6.50% (6 month USD LIBOR is say 5.50 %, margin over LIBOR is 100 bps) the withholding tax, at 15% p.a. comes to 0.975%. In contrast to this, in case of a loan in Japanese Yen where the interest cost is, say, 1.5% (6 months Yen LIBOR is, say, 0.5% and Margin of 100 bps) the withholding tax will come to 0.225%. From the following table it can be observed:

It is worth noting that in the above case, if the loan amount is equivalent USD 10 million, the net savings to the borrower will be to the tune of USD 75000 (approximately Rs. 35 lakh) at the rate of 0.75% in case of Yen borrowing as against USD borrowing. Even on a fully hedged basis, the ECB in Yen vis-à-vis USD can give an arbitrage benefit to the borrower to the tune of differential in withholding tax, which may go above 0.5% p.a.

Hedging / Cost reduction Techniques : The borrowings, raised in foreign currency and utilized in domestic currency after conversion, have inherent risk of fluctuation in the exchange rate between the two currencies as well as variation in the interest rates applicable to both the currencies. Therefore, while going for such foreign currency loans, one should take care to appropriately hedge the currency risk as well as the interest rate risk by way of various hedging tools like currency swaps.

As regards short term foreign currency loans (FCL), the exporter clients need not hedge their currency risks as they enjoy a natural hedge against currency risks by way of their export receivables. For long term loans, (FCTL) they can convert their floating rate loans into fixed rate loans in case of a rising interest rate scenario. In a falling interest rate scenario, they can try to substitute their existing loans with new low cost borrowings.

Further, banks have been offering various derivative structures aimed at reduction in the cost of borrowing by swapping

	USD Borrowing	Yen Borrowing
LIBOR 6 months	5.50	0.50
Margin	1.00	1.00
Total Interest	6.50	1.50
Withholding Tax @ 15%	0.975	0.225
Conversion Cost Yen/USD	NIL	5.00 @
Conversion Cost USD/INR *	1.00	1.00
Total Cost	8.475	7.725

* The conversion cost is subject to market fluctuation but will remain the same for both the foreign currencies.

@ The Yen/USD conversion cost generally is equivalent to the difference in the respective LIBOR.

the loans in high cost currency like US Dollar to low cost currencies like Japanese Yen. Such structures, of course, have inherent currency risks as the loan amount is to be reconverted to the original currency at maturity. Such risks are, often, hedged by way of various option-structures embedded with the original swap structure. However, only savvy customers should venture into such ventures as these structured deals have inherent down side risk and are not fully risk free.

Institutional Support from EXIM Bank

The Indian SME sector, notwithstanding its prominent role in sustenance of the national economic growth as well as creating new entrepreneurship in the country, suffers from inadequate business advisory services to enhance their international competitiveness in the highly competitive financial market. Consultants of international repute are generally focused on the high-end corporates and are

unaffordable by the SMEs. Here is where the EXIM Bank has been endeavoring to provide a suite of services to the SME clients. It provides business leads, handholding during the process of winning an export contract and thus, assisting in the generation of export business, information dissemination, capacity building in areas like export marketing and financial advisory services such as, loan syndication. It also provides financial help by way of term loans, pre-shipment / post-shipment export credit, overseas buyer's credit, bulk import finance, guarantees, etc. The vision and mission of Indian corporates are to go and be global. The SMEs will be playing a vital role in achieving this objective. The commercial banks and financial institutions should, therefore, make efforts to make them vibrant players by not only helping in reduction of their borrowing cost but also by providing them with appropriate business advisory services in possible ways. ■

SMEs tapping the overseas markets for external commercial borrowings (ECBs) are pleasantly surprised to find many foreign parties interested in partnering with them for equities as well. This interest is more than welcome given that ECBs are often a boon to SMEs making export earnings. But SMEs that do not earn significant revenue from overseas markets need to be more cautious and weigh the cost and benefits carefully before setting out to raise ECBs. SMEs, of late, have been raising ECBs, a far cry from the days when the banks were skeptical about lending to small enterprises. Things are looking bright for SMEs as they managed to win over lenders not only at home, but also abroad. They are also managing to get much better rates than what they used to get earlier.

According to a recent study on finances of 2210 firms published by the RBI, 960 companies with a paid up capital of Rs. 515 crore recorded a growth over 50% in their net profits in 2005-06, compared with around 20% growth posted by large corporates. Though interest costs have gone up for SMEs, as compared to large corporates, the costs as a percentage of their sales were curtailed by at least 30 basis points during 2006 from the previous year's levels.

The strong performance by SMEs has helped improve their credit worthiness both at home and abroad. The focus on exports is proving to be an added advantage to firms who earn bulk of their revenue through exports as they have a natural hedge against foreign exchange risks. Borrowers end up having a net gain of upto 2% by resorting to ECBs. At times, even those SMEs focused on domestic market end up making gains from overseas borrowings. Cost of raising ECBs works out to around 10% for a 3-5 year loan. The post hedge cost works out to 0.5-0.75%. some companies are willing to keep their positions open so that they get a cost benefit of 2% at the time of contracting.

However, bankers warn that SMEs who do not earn significant revenue from the overseas markets should be more cautious on tapping the ECBs and weigh the cost and benefits carefully. Loans to SMEs have grown 15-20% annually, while SMEs account for around 10% of the \$ 10 billion odd ECBs raised by the Indian companies. With the increasing thrust on exports by the Indian companies, in general and by SMEs in particular, their appetite for ECBs, given its cost advantage, is expected to grow further. This will help SMEs bring down their costs and further improve their balance sheets.

(Source: The Economic Times dated September 29, 2006)