The Elephant is Trumpeting; where are the Babies?

by *Sundar Sankaran*[1]

The Indian economy is expected to grow at 7.75% during 2009-10 - a scorching pace against the backdrop of a world coming out of a recession. The elephant is truly trumpeting.

Inflation, driven by food and fuel, is a worry. However, the government faces little pressure on this count - no major election is scheduled over the next 12 months. The pressure will be on the economically weak. I recall an old RK Laxman cartoon in The Times of India that depicts a conversation between two people who live in the foot-path. One reads out from the newspaper – 'The economy is doing very well'. RK Laxman's cartoons can be so timeless.

This piece is however, not on economically weak people, but on economically weak businesses. Large sections of the Small & Medium Enterprises in the country fall in this category. They are the babies, many of whom fail. Some of them grow well - a select few, like Infosys, grow into elephantine corporations. A combination of core country strengths (Advantage-India) and an emerging eco-system of Venture Capital (VC) & Private Equity (PE) funding have helped quite a few Indian companies to make their mark over the last decade.

Businesses can be either of two kinds – (1) Businesses built on the VC-PE buzzwords of revenue model, scalability and "professional" management. Let us call them *valuation-based businesses.* (2) Businesses built on the sweat of promoters, who personally run it, and believe small is beautiful. The businesses often get carried forward from generation to generation. Your friendly neighbourhood grocer is a good example. In retail jargon, we call them mum & pop shops. Such businesses are not restricted to retail. Let us call them *income-based businesses.*

The failure rate for *valuation based businesses* is significantly higher because:

- VC-PE expectations push the organisation on a path, where, for several years there is need for successive rounds of financing. If the financing does not come, for any reason, the business cannot meet liabilities. The only option is to close down.
- Unlike the hereditary nature of the *income based businesses*, the exit barriers for the promoters of *valuation-based businesses* are a lot lesser.

The returns for the investor in a *valuation-based business* that succeeds, can be quite high. This, more than makes up, for the failed businesses in the portfolio of a VC-PE investor. The risk-return economics having now been established, the VC-PE eco-system will keep growing, and supporting *valuation-based businesses.*

The concern is the *income-based businesses*. They also grow. Your friendly neighbourhood grocer expands his product range, buys the next shop etc. Traditionally, he had two sources of money to support his expansion – (1) the parallel cash economy (2) bank loans.

Over the last decade, the government has been on an overdrive against the informal economy at the grass root level – PAN cards, income tax returns, cash deposit limits ... While the ultra-rich keep swelling their Swiss bank accounts, the environment is becoming more and more difficult for the *income-based businesses* to avail of the support of the parallel economy.

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It is not my case that the parallel economy should be promoted. But, for the *income-based businesses,* the formal economy ought to make up for the weakening of the support of the informal economy. Instead, things have gone into reverse gear.

Let us look at financing of small businesses. Banks are happy investing in Government Securities and Mutual Fund schemes. Non-food credit from the banking sector is going down. Economists would like to believe that this is a reflection of disintermediation viz. companies are avoiding the banks, and directly accessing the market for funds. This may be true for large corporations – but for most others, such direct access is impossible.

Valuation-based businesses have the VC-PE sources of finance – and on the back of that, banks are prepared to offer the traditional funding lines. *Income-based businesses* are however being strangled. For the owners of such businesses, over the last decade, credit cards were the only easily accessible financial product. Thus, economic, liberal, credit quality based bank financing for the business, has been replaced by exorbitant, restricted, revolving credit based promoter funding. The heartless income tax authorities will no doubt add to the misery by disallowing this expense in the tax assessments.

Higher rental costs, compounded by service tax on the rent; weaker financial support, from both the formal and informal sector – one would have thought the cup of woes is complete. But two significant challenges are in the horizon:

- On climate change, one can expect the government to enforce mitigation steps, with a disproportionate burden on the small businesses.
- A larger concern is the mindset of the government. Consider the Direct Tax Code (DTC) proposals regarding Minimum Alternate Tax (MAT). For the uninitiated, MAT is a minimum tax, which is payable on book profits, even if taxable profits are lower. The DTC proposes to charge MAT as a percentage of assets deployed in the business. MAT, as a concept, is in any case regressive – linking it to asset efficiency is even more regressive. The government will charge a tax on profits that do no even exist in the books! Worse is the justification that has been offered by the government – *businesses need to be efficient, and earn a minimum percentage of the assets deployed.*

  Economies of scale are one of the largest sources of efficiencies. This is obviously not available to *small is beautiful* businesses. Imposition of economic costs that are linked to asset efficiency, will end up killing many of these small businesses, which are a large contributory to employment and economic output of the country. These businesses can withstand market forces, which tend to be supportive of larger enterprises – but not a government, which wants to hammer them down.

The environment is killing many hereditary *income-based businesses.* The children are finding it more remunerative to take up jobs, instead of joining the family business. Attractive real estate value is making it easier to shut down the business and encash the space value – instead of trying to create business value in a hostile environment. Thus, an entire chain of entrepreneurial blood is in danger of joining the ranks of salary earners. Potential *job creaters* will become *job seekers.* Both, the entrerpreneurial climate and the job market climate will be adversely affected.

The earlier the government realises the fallacy in its fundamental thinking, the better it would be for the economy – and the small businesses. Let us applaud the trumpeting elephant, and the elephantine Indian corporations that are making their mark in the global lists of *Forbes* and *Fortune*. But let us also protect the babies – else, the next generation will not see any new Indian entrants in those lists.