

Understanding Financing through the Lens of Small and Medium Enterprises (SMEs)

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Introduction

Small and medium enterprises (SMEs)¹ play a critical role in generating income, employment, innovation, and facilitating social cohesion. With about one million establishments² in the country, SMEs contribute 37.1% of the Malaysian GDP, 66% of employment and 17.3% of exports.³ The positive linkage between entrepreneurship and growth is well established⁴, but a growing body of research focusing on the importance of finance in supporting SME development shows that firms with access to loans grow at a faster rate than those without such access.⁵

As part of the Bank's functions to promote a sound, progressive and inclusive financial sector, efforts have been directed towards developing a holistic SME financing ecosystem. This includes addressing information asymmetry and market imperfections, which are key barriers to finance. There have been significant strides made in the areas of credit information; credit guarantees; specialised funds; advisory services; redress and debt resolution arrangements. Financing to SMEs now constitute 48.7% of total financing outstanding by financial institutions to businesses (2010: 37.6%) and 17.5% of total financing outstanding (2010: 14.4%).

In 2018, as part of ongoing efforts by the Bank to promote continued access to financing for SMEs, a demand-side SME Finance Survey (the Survey) was conducted to obtain a better understanding of the financing needs and behaviour of SMEs. This article presents the Survey findings, which provide insights on the following:

1. Key characteristics and financing behaviour of Malaysian SMEs;
2. Underlying challenges in financing; and
3. Policy implications moving forward.

Survey Scope and Methodology

A total of 1,529 formal⁶ SME businesses participated in the Survey, which covered firm and entrepreneur characteristics, business performance and challenges, as well as access to finance and usage of financial services. A stratified sampling approach was deployed to ensure representativeness of the national distribution. In addition, a sample of 223 informal businesses was also surveyed to understand their unique financing needs and concerns.

Profile of SMEs

The majority of Malaysian SMEs are microenterprises (77%) and the bulk of these businesses are concentrated in the services sector (89%).⁷ In terms of legal set-up, SMEs mostly operate as sole proprietors (61%, Diagram 1).

Insights from the Survey Findings

1. Key Characteristics and Financing Behaviour of Malaysian SMEs

The Survey showed that more than 90% of the SMEs served the domestic market, with 7% exporting their products and services. About 83% of SMEs reported utilising Information and Communications Technology (ICT) in their business operations (Diagram 2), with 22% that have their own website and 14% that operate online stores. More than half of the respondents (53%) used professional services including auditors, accountants or financial advisors to manage their financial accounts.

¹ Includes microenterprises.

² Based on the 2018 estimates by the Department of Statistics, Malaysia.

³ 2017 data on GDP, employment and exports sourced from the Department of Statistics, Malaysia.

⁴ Beck, Demiurgic-Kunt, Levine, 2005. SMEs, Growth and Poverty, National Bureau of Economic Research (NBER) working paper series.

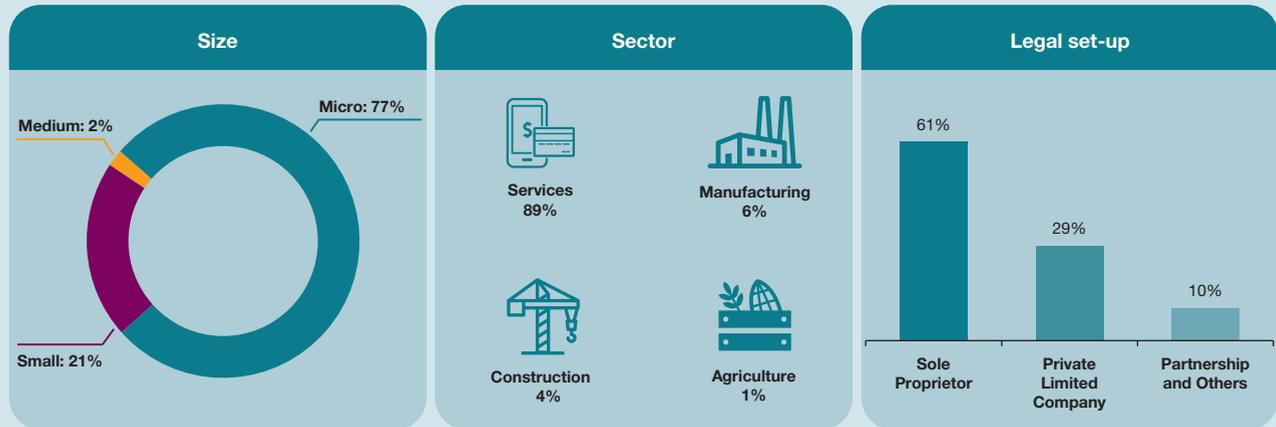
⁵ Ayyagari, Juarros, et al. 2016. Access to Finance and Job Creation; Firm Level Evidence across Developing Countries, World Bank Group.

⁶ Registered with the Companies Commission of Malaysia (SSM).

⁷ Based on the 2016 Economic Census, Department of Statistics, Malaysia.

Diagram 1

Profile of SMEs by Size, Sector and Legal Set-up



Source: Department of Statistics, Malaysia

Diagram 2

Characteristics of Malaysian SMEs

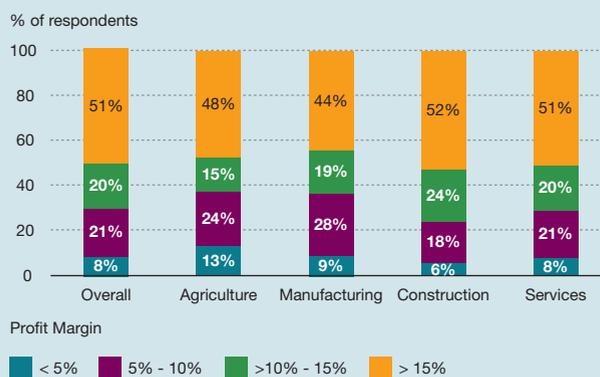


* Less than 3 years in operation

Source: Bank Negara Malaysia

Despite the challenging business environment in the first quarter of 2018, a majority of SMEs (71%) recorded profit margins of above 10% (Chart 1) and were able to maintain positive cash flows. Manufacturing firms reported higher levels of productivity and paid higher wages for new graduate hires compared to other sectors.

Chart 1: Profit Margin of SMEs by Sector

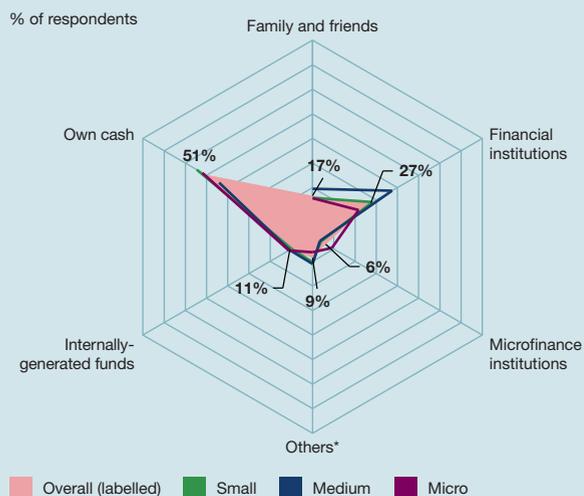


Source: Bank Negara Malaysia

On financing, respondents reported utilising funds from a variety of sources, both internal and external, with own cash contributions being the main source. Among other funding sources, about 27% of the respondents had facilities with financial institutions, followed by family and friends, internally-generated funds and microfinance institutions (Chart 2). In the microenterprise segment, 22% had financing facilities with financial institutions, including 9% of respondents who secured financing under the *Pembiayaan Mikro*⁸ facility.

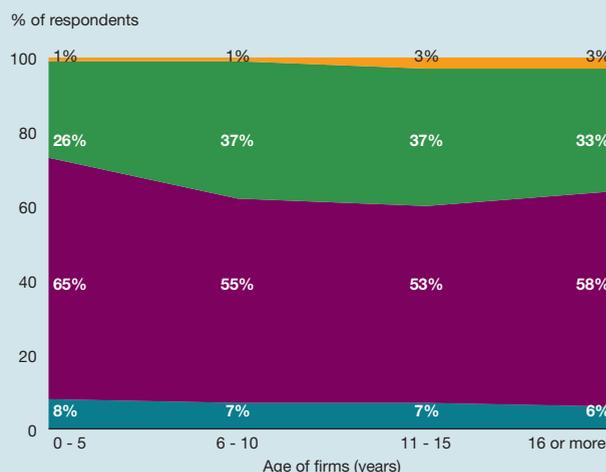
Sources of financing also vary through the business lifecycle. At the initial stage, young firms tend to rely on their own cash and informal sources such as family and friends. This is consistent with most research findings, which attribute such behaviour typical of young firms to information opacity; lack of collateral, track record and financial skills; as well as high transactional costs.⁹ As businesses mature (typically after five years in operation), they tend to rely more on external financing in the form of both debt and equity, including bank financing (Chart 3).

Chart 2: Sources of Financing by Firm Size



* Others include alternative finance and Government grants
 Note: Figures labelled refer to % of total firms. Firms can provide multiple answers
 Source: Bank Negara Malaysia

Chart 3: Sources of Financing by Age of Firms



Source: Bank Negara Malaysia

Among the SMEs that had applied for financing, most indicated that they were able to secure financing. About 22% of the respondents had applied for financing in the six months prior to the Survey, with the majority (94%) of their applications being approved.

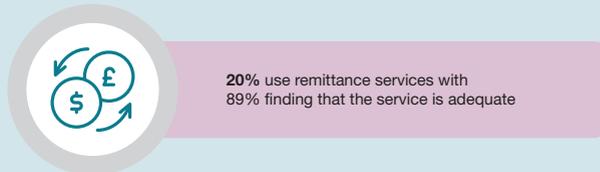
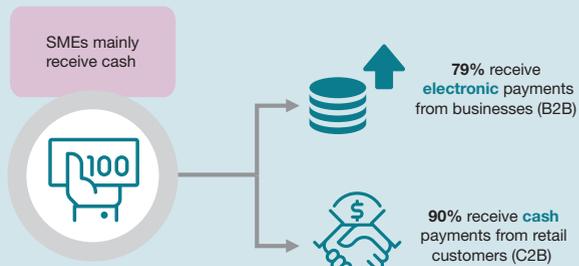
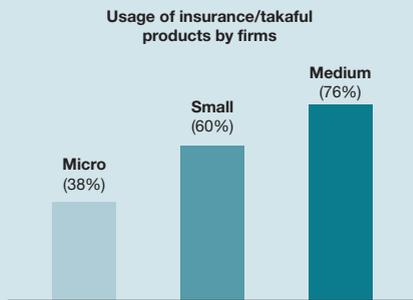
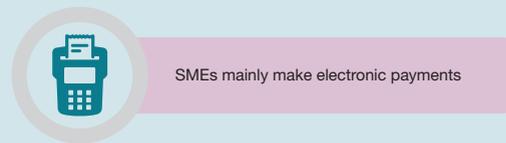
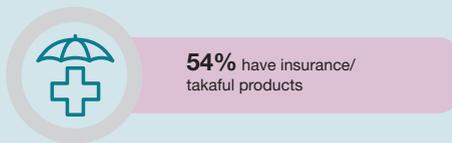
- About 13% applied to financial institutions with 91% of their total financing applications approved, while the remaining 9% applied to other sources,¹⁰ with a 99% approval rate.
- Women-owned firms reported higher demand for financing (33% of women-owned firms applied versus 22% for all respondents), but experienced a lower approval rate of 83% (overall: 94%) mainly due to the lack of track record and insufficient documentation. Most of these firms obtained unsecured financing from microfinance institutions, banking institutions and development financial institutions.
- About 44% of the respondents were first-time borrowers.
- The main purposes of the financing applications were for the purchase of assets (building, property, machinery and equipment: 23%), working capital (22%) and starting a new business (19%).
- On average, the majority of the applications (89%) was approved within one month and the funds were disbursed within the subsequent month (87%).

⁸ A specialised microfinance scheme that is non-collateralised for business financing of up to RM50,000.
⁹ Berger, Udell, 1998. The Economics of Small Business Finance: The Roles of Private Equity and Debt Markets in the Financial Growth Cycle; Organisation for Economic Co-operation and Development (OECD), 2015. New Approaches to SME and Entrepreneurship Financing: Broadening the Range of Instruments.
¹⁰ The main providers of other sources were Amanah Ikhtiar Malaysia (AIM) and TEKUN.

The Survey also provided insights on SMEs' usage of other financial services, such as insurance, takaful and e-payments (Diagram 3). More than half of the respondents have insurance or takaful products, although this was less prevalent among microenterprises. While the current take-up has been low, potential future demand for insurance and takaful by SMEs is significant for all products across the board, with emerging interest particularly in securing protection for risks associated with cyber security, professional indemnity, payment default and damages in crops. SMEs mainly made electronic payments, but preferred cash in receiving payments from customers. It was also observed that cheques remained popular for payments to suppliers and other B2B (business to business) transactions.

Diagram 3

SMEs' Usage of Other Financial Services



Note: Firms can provide multiple answers

Source: Bank Negara Malaysia

2. Underlying Challenges in Financing

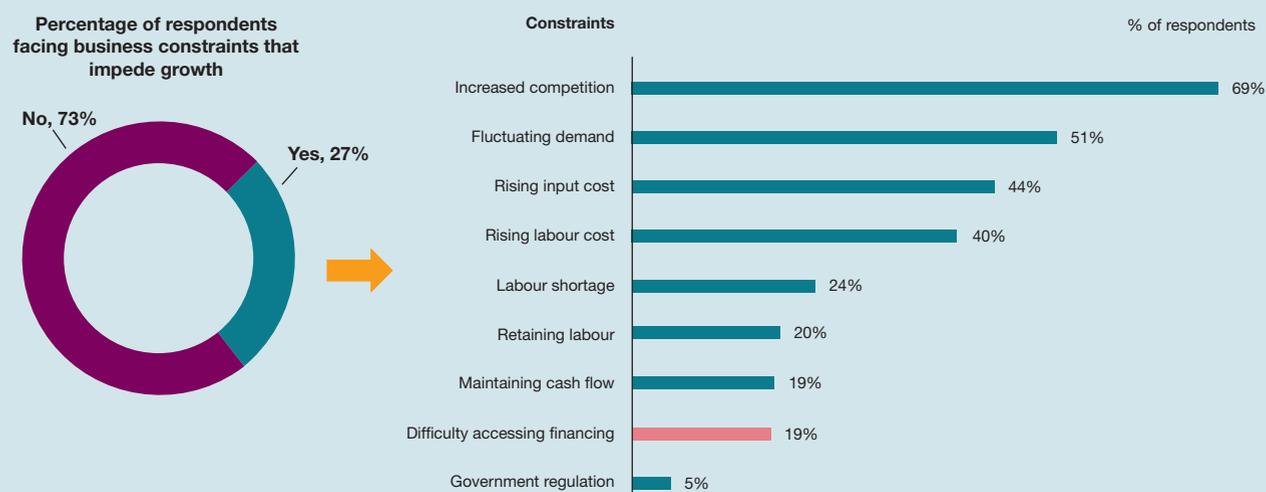
a) Financing barriers mainly relate to documentation, costs and business viability

Among the key constraints to business growth, difficulty in accessing sufficient financing was ranked low, second to last out of the nine constraints identified by SMEs (Chart 4). Nevertheless, the findings from the Survey revealed some financing barriers faced by SMEs:

- SMEs that experienced rejections of their financing applications cited insufficient documentation, insufficient cash flow to meet repayments and non-viable business plans as the main reasons for rejection.
- SMEs involved in automation, innovation, manufactures of goods, and exports experienced higher rejection rates compared to the overall SMEs (Chart 5). Firms that automated stated insufficient collateral and projects perceived to be of higher risk as key reasons for rejection. The rejected applications were mainly for the purchase of machinery and equipment and ICT tools, as well as undertaking research and development (R&D). These projects could be deemed to be higher risk as they may involve moveable and intangible assets with low salvage value in the event of commercial failure, and involve the use of new and untested processes with high uncertainty on returns.¹¹ Innovative firms cited insufficient documentation as a key factor for rejection. Exporting and manufacturing firms that faced greater difficulty obtaining financing were mainly firms that were newly established with limited repayment track records.
- Businesses that needed financing but did not apply (41%) were either cautious in taking on debt, unsure of their repayment capacity, or found the application process too difficult.
- About 46% of the respondents stated that the financing products offered by financial institutions did not meet their business needs due to high financing costs (50%), insufficient financing amount (42%) and onerous documentation requirements (29%). The average financing rate that respondents were willing to pay was 3.88%, well below the average lending rates to SMEs of 6.18% at the time of the Survey (second quarter 2018).

The challenges raised by businesses in the Survey point to opportunities for improvements in the on-boarding process of financial institutions (including documentation requirements) and financial management capabilities of SMEs to enhance their creditworthiness. New approaches to credit assessments by leveraging on technology and big data also present opportunities to increase access to financing for SMEs.

Chart 4: Business Constraints Faced by SMEs

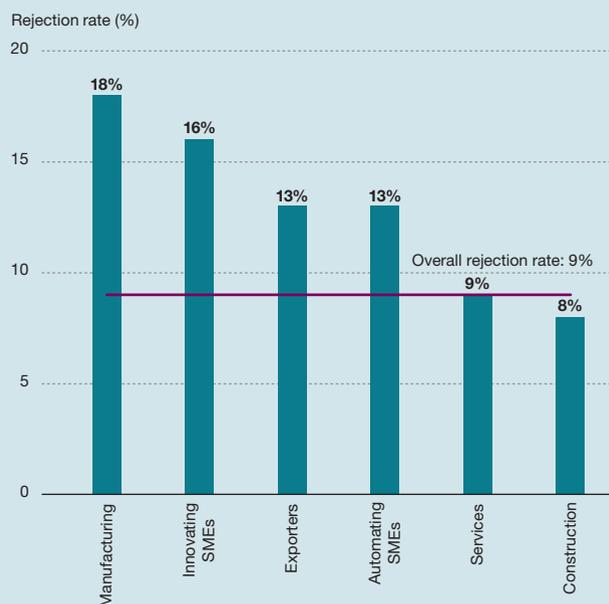


Note: Firms can provide multiple answers

Source: Bank Negara Malaysia

¹¹ OECD, 2004. Financing Innovative SMEs in a Global Economy.

Chart 5: Rejection Rate of Financial Institutions for Key Segments



Source: Bank Negara Malaysia

b) Funding is the most sought after form of government assistance

The Survey indicated that the main constraints to SME growth were factors associated with operating and business conditions, namely increasing competition (69% of respondents), fluctuating demand (51%), rising input costs (44%) and rising labour costs (40%). However, when asked which form of government assistance would be most useful, financial assistance (e.g. grants, soft loans, guarantees) was consistently preferred by a significant majority of SMEs as being most useful (Chart 6). This could suggest that SMEs lacked awareness on other forms of government assistance which could be better suited to address specific challenges faced, including capacity building support, regulatory responses or access to new markets.

Findings from the Survey further suggest that certain factors such as the level of education, membership in trade associations, and ICT usage are positively linked with higher awareness (Chart 7). These factors can be leveraged upon in the development of future awareness programmes to ensure more effective outreach.

c) Higher demand for financing for automation and technology

About 19% of the respondents indicated that they have automated their operations, 15% actively leveraged on technology to innovate or introduced new products and processes, while some 17% (especially medium-sized firms) were preparing for Industry 4.0.¹² Businesses that had automated their operations (mainly in the wholesale trade, computer and IT-related services, and machinery and engineering equipment manufacturing) reported higher revenue per worker on average by about 90%, compared to those that did not automate. The move to automate therefore holds significant potential for enhancing the growth and contribution of SMEs to the economy, for which financing will be a key enabler.

Firms using technology¹³ generally had higher demand for financing compared to the overall respondents (Chart 8), but also faced higher rejection rates. In particular, for automating firms the purpose of financing was mainly to

¹² Industry 4.0 or Fourth Industrial Revolution is a name given to the current trend of automation and data exchange in manufacturing technologies. It includes amongst others cyberphysical systems, the Internet of things, cloud computing, cognitive computing, big data and autonomous robot.

¹³ Refers to firms that automate and enhance productivity as well as innovate.

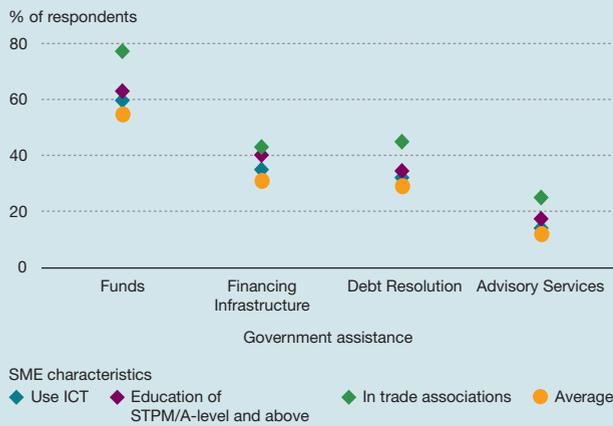
Chart 6: Government Assistance Deemed Most Useful by SMEs versus the Key Constraints Faced



Note: Firms can provide multiple answers
Source: Bank Negara Malaysia

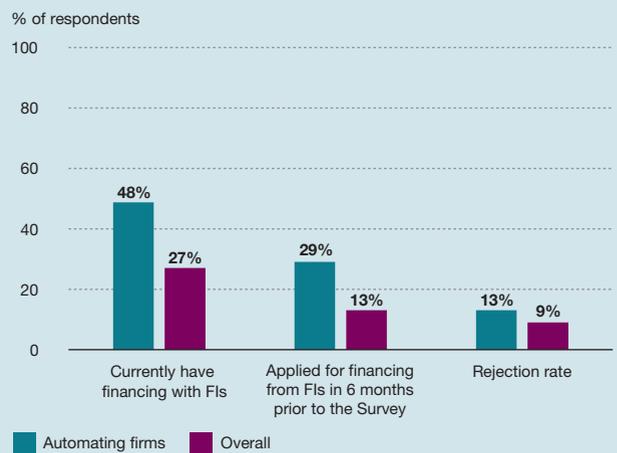
purchase machinery and equipment and ICT tools including hardware and software, as well as to undertake R&D activities. Such financing can involve higher risks associated with uncertain values and security attached to intangible or movable assets, including their ability to generate cash flows, hence resulting in the higher rejection rate. A further reason may be a lack of customised products in the market for financing automation due to inadequate experience in evaluating innovative technologies and pricing the associated risks.¹⁴

Chart 7: SME Awareness on Government Assistance



Note: Firms can provide multiple answers
Source: Bank Negara Malaysia

Chart 8: Financing Behaviour of Automating Firms



Source: Bank Negara Malaysia

¹⁴ Shroder, 2017. The Challenges of Industry 4.0 for Small and Medium-sized Enterprises.

At the same time, the Survey revealed that automating firms were open and willing to share information with financial service providers. They also have higher ownership of assets (three times higher than those not automating). Therefore there are opportunities to better understand the distinct profile and financing needs of automating firms, enhance and customise product offerings for automation, as well as review collateral policies and the supporting infrastructure to tap into movable assets and intangibles as acceptable collateral.

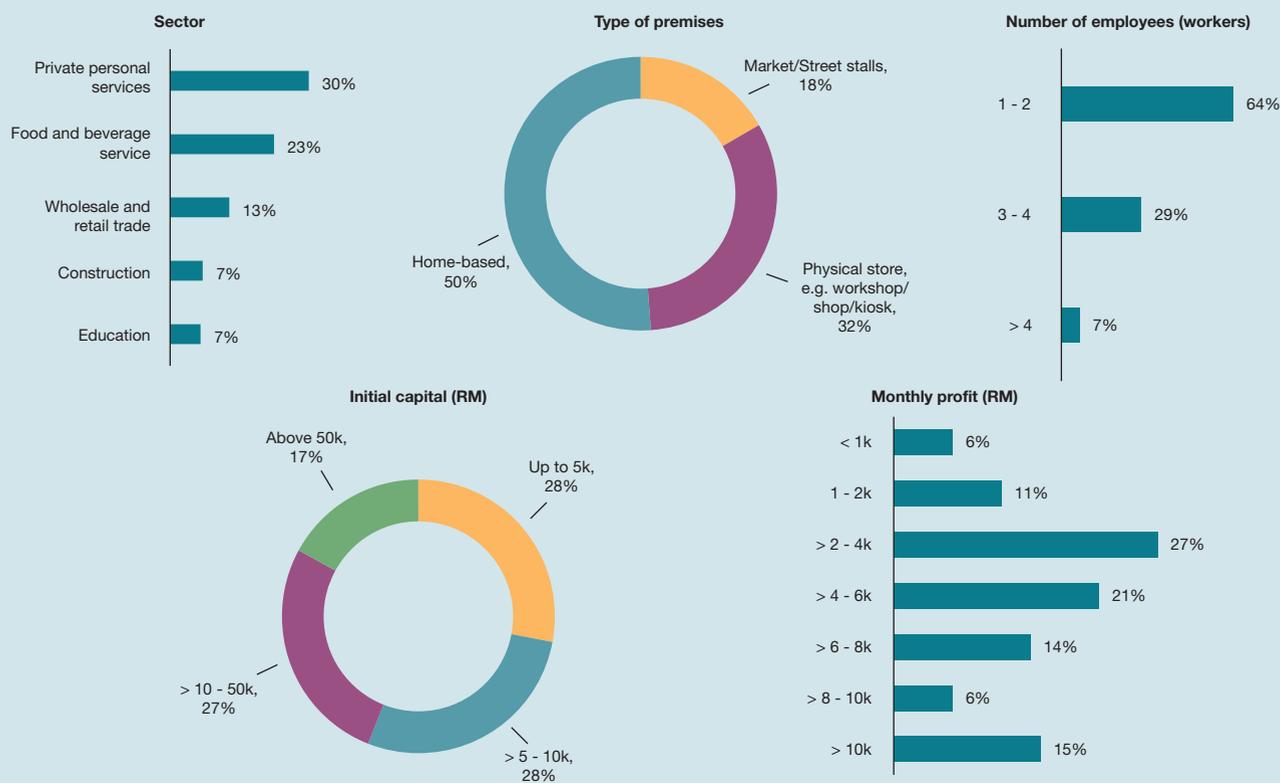
d) Persistence of informal businesses further limits access to finance

The Survey also revealed that unregistered firms¹⁵ generally recorded higher profitability averaging at 17.7%, compared to 16.1% by formal SMEs. These firms rely heavily on funds from family and friends and own cash at the initial stage, and continue to depend on family and friends, and internally-generated funds even as their business expands, with low access to external financing. The lack of access to critical resources and assistance could limit their scope for growth.¹⁶

Only 6% of the owners of unregistered firms indicated that they intended to formalise their business in the next two years. The World Bank Enterprise Surveys indicated that common reasons for firms not registering include the lack of information on how to register, time taken to register, taxes to be paid, and the lack of perceived benefits from formalisation. Other studies have also highlighted high entry costs, strict labour regulations, lack of access to resources and a complicated registration process as being deterrents to formalisation.¹⁷ These factors, potentially also relevant in the case of Malaysia, could be further examined through future surveys to encourage greater formalisation of businesses.

Diagram 4

Key Characteristics of Informal SMEs



Note: As % of respondents, k denotes thousand

Source: Bank Negara Malaysia

¹⁵ Businesses not registered with the Companies Commission of Malaysia (SSM). However, 36% of these firms have been registered with other authorities such as local authorities, ministries, societies and associations.

¹⁶ International Finance Corporation (IFC), 2013. Closing the Credit Gap for Formal and Informal Micro, Small, and Medium Enterprises.

¹⁷ Ibid.

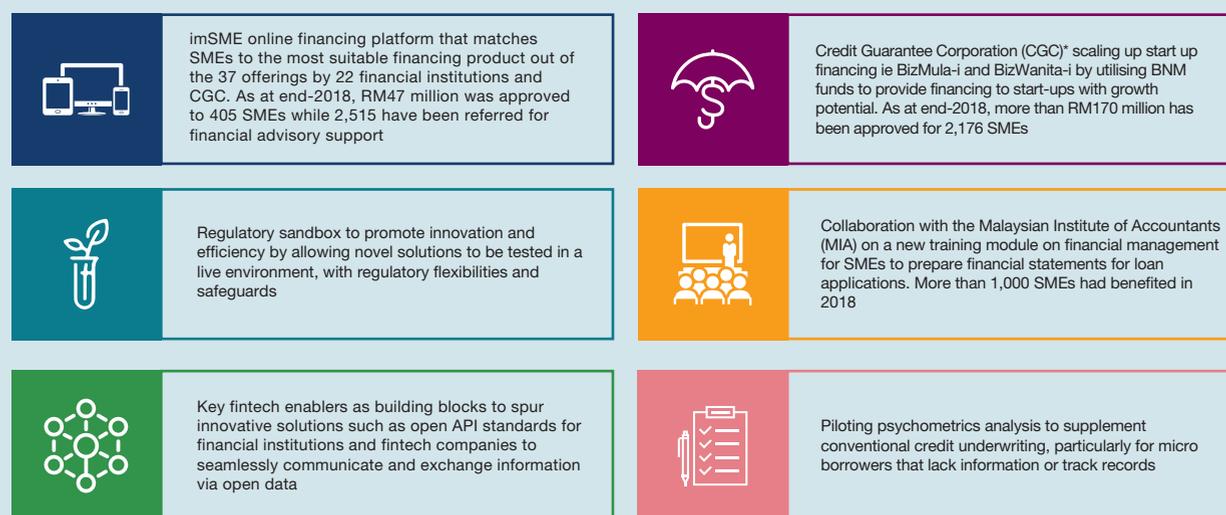
3. Policy Implications

The Survey findings affirm that existing policy priorities, which are directed at encouraging greater innovation by financial institutions, enhancing the efficiency of financing processes, credit enhancement products for SMEs and strengthening the financial management capabilities of SMEs remain relevant in light of barriers to financing that still exist among pockets of SMEs. Recent initiatives by the Bank in collaboration with key stakeholders are described in Diagram 5. In addition, areas for further development to address new and emerging needs of SMEs for financing include:

- a) **Establishment of a secured transaction framework:** The on-going effort to establish a modern and unified movable property security interest legislation, and a centralised collateral registry for movable assets in Malaysia marks an important step in improving the infrastructure for access to finance particularly for SMEs. Currently, unincorporated firms that make up close to 70% of SMEs do not have a legal framework to use movable assets as collateral. The new framework would broaden the range of assets that SMEs can use to borrow (e.g. machinery and equipment, intellectual property, inventories, agriculture products) in addition to more conventional collateral in the form of building or property.¹⁸ A World Bank study¹⁹ has shown that secured transactions increased access to bank finance by 8 percentage points and lowered the cost of financing by 3 percentage points.
- b) **Formalisation to enhance access to finance:** Given that the informal segment is estimated to account for about 29.6% of Gross National Income in Malaysia,²⁰ well designed incentives for businesses to formalise will further expand access to financing for such businesses to grow. This should be accompanied by measures to identify and address the key reasons for businesses choosing not to formalise. Impact studies²¹ in other countries have shown that just addressing business registration processes and costs alone proved to have little effect on encouraging firms to formalise, but when combined with monetary incentives (e.g. grants) or market access opportunities (e.g. criteria to bid for public procurements), they provide stronger inducements for firms to register.

Diagram 5

Recent Initiatives to Enhance SME Financing



* CGC Malaysia assists marginal but potentially viable SMEs, particularly those with inadequate collateral and track record to obtain financing from financial institutions, via guarantee schemes.

Source: Bank Negara Malaysia

¹⁸ Statistics from United Nations Commission on International Trade Law (UNCITRAL) indicated that 78% of capital stock worldwide is in movable assets.

¹⁹ Across 73 countries in 2013.

²⁰ Estimate by Friedrich Schneider in 2012 in 'The Shadow Economy and the Work in the Shadow: What Do We (Not) Know?'

²¹ IFC, 2013. Closing the Credit Gap for Formal and Informal Micro, Small, and Medium Enterprises.

Studies²² have also shown that access to benefits such as social protection schemes, commercial finance services and business development services as well as facilitative tax administration (increasing the threshold for taxation) have contributed to the formalisation of firms. Such incentives should be balanced with better enforcement, which may include stiffer penalties for non-compliance with business regulations, to reap the full benefits of policy interventions.

c) Promote alternative finance: A well-diversified financial landscape is necessary for SMEs to have access to a wide range of financing options best suited to meet their specific needs and for different stages of their business life-cycle. Moving forward, alternative finance is expected to play a bigger role in complementing bank financing to bridge the “financing gap” in catering to firms that are ill-suited to financing by deposit-funded banks. Amongst these include technology-based start-ups and innovative firms. High asymmetries in information and sparse financial information, reliance on intangibles, high uncertainty on returns, as well as informal governance and management arrangements that tend to be characteristics of such firms, especially in their early stages, pose particular challenges to traditional bank lending, and can disproportionately increase the risk of losses to depositors.²³ Currently, alternative finance, which includes venture capital, equity crowdfunding, angel investments, leasing, factoring and peer-to-peer financing, accounts for less than 3%²⁴ of total SME financing in Malaysia and is fragmented with numerous players. A more holistic approach to its development with greater coordination among relevant authorities would serve to build an enabling ecosystem with appropriate regulations, incentive systems and supporting infrastructure to foster and accelerate the growth of alternative finance in supporting SMEs.

²² International Labour Organisation (ILO), 2016. Policies, Strategies and Practices for the Formalisation of Micro and Small Enterprises.

²³ OECD, 2016. New Approaches to SME and Entrepreneurship Financing: Broadening the Range of Instruments; Bravo-Biosca, 2013. Access to Finance for Innovation: Rationales and Risk of Public Intervention.

²⁴ Compiled from data sourced from Bank Negara Malaysia, Securities Commission, SME Corporation Malaysia and various authorities. In comparison, alternative finance accounts for over 20% share of SME finance in the United States.