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Transformation of Fundraising for SMEs and Startups

JAPAN

Startup Investments in Japan
Satoshi Takeshita / Nomura Institute of Capital Markets Research

INDONESIA

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FOREWORD

Small and medium-sized enterprises (SMEs) including micro enterprises account for more than 60% of total employment and approximately 30 to 60% of GDP in most of the Association of Southeast Asian Nations (ASEAN) countries. While SMEs are drivers of the sustainable economic development in these countries, they face a variety of managerial challenges among which the ability to raise sufficient funds is the key to achieving sound growth.

Banks play an important role in financing SMEs in ASEAN countries. However, banks are generally reluctant to provide loans to SMEs. The main reasons include their inability to provide adequate collateral to banks, unstable cash flows, and poor credit information. In some countries, the governments mandate banks to allocate a certain percentage of loans to SMEs, but lending to SMEs is not still sufficient in general. Under these circumstances, the governments in this region support SMEs' fundraising by several initiatives including providing loans at preferential interest rates and developing credit information platforms.

In recent years, there has been growing interest in utilizing technology to promote financing of SMEs in the ASEAN region. Peer-to-peer (P2P) lending that matches borrowers and lenders via internet is considered promising among other schemes. Financing SMEs through P2P lending platforms is on the rise in some countries, especially in Indonesia. Equity crowdfunding (ECF) that matches fast-growing startups with equity investors via the internet is another example that is gradually drawing attention in this region. Venture capital firms have been major investors in startups until now, but more types of investors including individual accredited investors have started to participate as equity investors through ECF platforms. Other recent developments include the establishment of a new board for startups with relaxed listing requirements on some stock exchanges. This led to the emergence of startups that successfully raised funds through initial public offerings.

Recently, business environments for many industries have worsened due to the COVID-19 pandemic in the ASEAN region. As a result, an increasing number of SMEs and startups are having difficulties in fundraising, and various efforts are being made to improve the financing environments for them in each country.

This issue of Nomura Journal of Asian Capital Markets features articles that discuss the current status, challenges, and future prospects for fundraising by SMEs and startups in ASEAN countries.

SATOSHI TAKESHITA

Nomura Institute of Capital Markets Research

Startup Investments in Japan

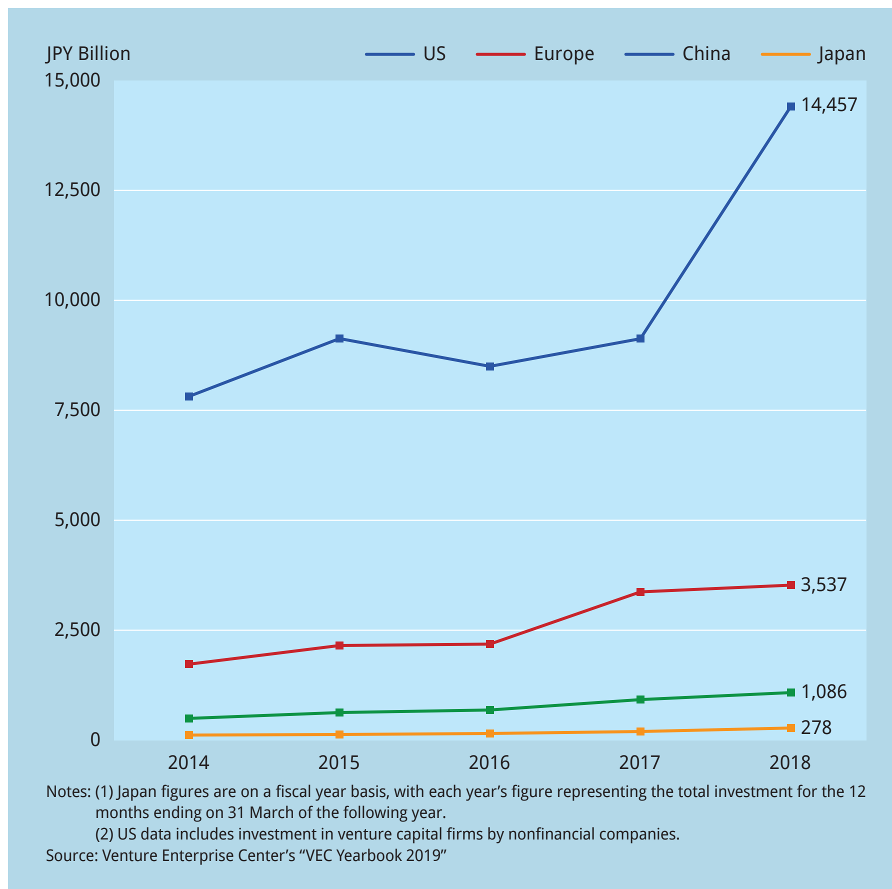
Japan's Startup Investment Small Relative to Economy's Scale

The Japanese government's Growth Strategy 2018, announced in June 2018, established a number of key performance indicators (KPIs), one of which is to create 20 unlisted (unicorn) or listed venture companies with an enterprise value or market capitalization of USD 1 billion or more by 2023. According to CB Insights, a US research enterprise, as of end-April 2020 the United States had 223 unicorns (unlisted ventures with an estimated value of USD 1 billion or more) and China had 119. Japan, however, had only three, an extremely small number relative to the scale of the country's economy based on GDP and other indicators.

One reason for the small number of unicorns in Japan is the level of investment in startups in Japan. In Japan, total investment in startups is only about one-fiftieth of that in the US and one-tenth that in China (Figure 1). Looking at the total amount of investments in startups relative to a country's GDP, Japan ranks 19th among OECD member countries. Japan's startup investment to GDP ratio is just 0.03%, compared with 0.4% for the US, which tops this ranking.*[1]

However, investment in startups in Japan has been increasing in recent years, and changes can be seen in Japan's startup ecosystem.

Figure 1: Comparison of Countries' Total Investment in Startups



Notes: (1) Japan figures are on a fiscal year basis, with each year's figure representing the total investment for the 12 months ending on 31 March of the following year.
(2) US data includes investment in venture capital firms by nonfinancial companies.
Source: Venture Enterprise Center's "VEC Yearbook 2019"

Special Characteristics of Startup Investments in Japan

Looking at the trend in startup investments (including corporate acquisitions and investments to make a venture a subsidiary) in Japan since 2010 reveals these investments have been rising sharply since 2014 (Figure 2). Total annual startup investment quadrupled from 2013 to 2018. Generally speaking, this increase was fueled by financial deregulation from 2014 paving the way for large sums of money to be invested in startups and by the Japanese government implementing a series of measures to support startups as part of its Japan Revitalization Strategy.

In 2019, startup investment was led by venture capital firms (VCs), accounting for 46% of the total amount invested, followed by nonfinancial companies, at 30%. Nonfinancial companies' investment in startups in 2018 was more than five times greater than in 2013. Moreover, as will be discussed later, nonfinancial companies make up about one-third of the investors in VCs. Accordingly, large corporations have been driving the growth in startup investment in Japan.

Startup investment by large corporations

Startup investment by nonfinancial companies, especially large corporations, includes investment by the companies themselves as well as investment by corporate venture capital firms (CVCs) set up by these companies. The establishment of these CVCs has increased as nonfinancial companies have expanded their investments in startups. Close to 90 CVCs were established from 2014 to end-2019.*[2]

Asked what the purpose of establishing a CVC firm is, more than 80% of the establishing nonfinancial companies cited "business synergies", with 24% citing "business synergies only", 45% saying "business synergies are the main purpose, but financial returns also are expected", and another 13% saying that "financial returns are the main purpose, but business synergies also are expected". This investment in CVCs seems to indicate that Japanese companies, which to date have accumulated core technologies and other strengths on their own, are beset by a growing sense of crisis that they are unable to keep up with rapidly changing times. A growing awareness that it is difficult to create innovative new businesses under existing corporate organizations and frameworks has led companies to establish CVCs as units that complement R&D organizations in the effort to create new businesses through an open innovation approach.

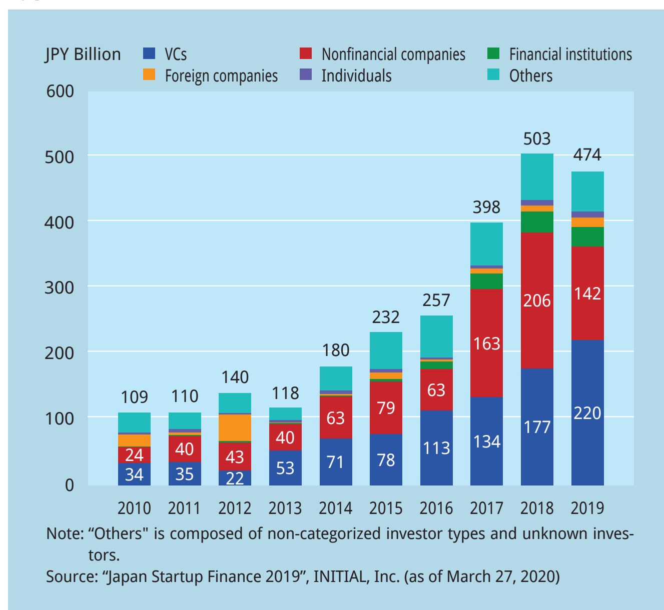
Venture capital firms (VCs)

In all countries, venture capital plays the major role in startup investments. In Japan, the term "venture business" has been used for companies that invest venture capital in startups. Japan's first private-sector VC firm was established in 1972. Since then, the number and size of VCs have both expanded. During fiscal 2018, 51 VCs were established, with a total value of JPY 237.5 billion. As of May 2020, the Japan Venture Capital Association counts more than 100 VCs among its members. A large number of independent VCs is crucial for supporting diversity among startups.

In fiscal 2018, 37% of the investment in VCs was by nonfinancial companies (Figure 3). This is a major feature of venture capital in Japan. If nonfinancial companies' motive for investing in VCs is primarily business synergies rather than financial returns, as is the case with their establishment of CVCs, the nature of VCs' investment could be affected.

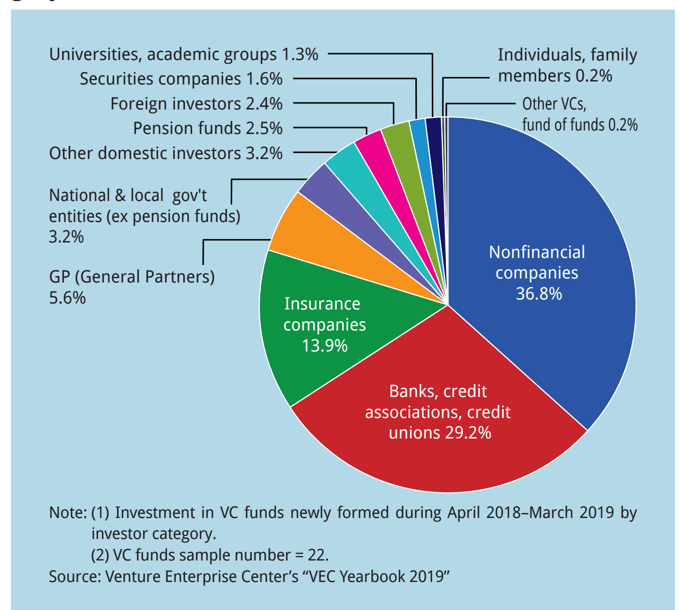
Meanwhile, pension funds accounted for just 2.5% of VCs' funding. In the US, the development and advancement of VCs and startups is considered to have been greatly promoted by the relaxation of the prudent-man rule set forth in ERISA (Employee Retirement Income Security Act of 1974) in 1979, because it led to large inflows of pension and other funds into VCs. Today, pension funds are one of the main investors in VCs in the US. How to attract funds from pension funds and other in-

Figure 2: Startup Investment Trend in Japan (by Investor Type)



Note: "Others" is composed of non-categorized investor types and unknown investors.
Source: "Japan Startup Finance 2019", INITIAL, Inc. (as of March 27, 2020)

Figure 3: Composition of VCs' Funding, by Investor Category



Note: (1) Investment in VC funds newly formed during April 2018–March 2019 by investor category.
(2) VC funds sample number = 22.
Source: Venture Enterprise Center's "VEC Yearbook 2019"

stitutional investors has become a major issue for Japan's venture capital industry.

Public-private fund

Amid the chilly investment environment during the global financial crisis triggered by the collapse of Lehman Brothers in 2008, investment in startups was supported by the establishment of the Innovation Network Corporation of Japan (INCJ). The INCJ was created in 2009 under the Act on Special Measures Concerning Industrial Revitalization and Innovation of Industrial Activities as a temporary 15-year public-private partnership with the government providing 90% of its capital and the remainder coming from 26 private-sector companies, including Toyota Motor Corporation and Hitachi, Ltd. The INCJ invested a total of JPY 270.9 billion in 110 startups from fiscal 2011 to fiscal 2018. During the global financial crisis that occurred after the collapse of Lehman Brothers, INCJ supported Japanese startup investment by providing 25% of the capital invested in new startups in 2009-2013.

Foreign investors

One reason for the small amount of investment from overseas is the relatively small size of startup investments in Japan.

In recent years, US mutual funds have included unlisted Japanese companies among the targets for their investments in startups. For example, in August 2018, Fidelity Investments (Japan) Limited invested in Raksul Inc., a startup company that provides printing and offline advertising services via the internet and was subsequently listed on the Tokyo Stock Exchange's Mothers market in May 2018. Another example is the T. Rowe Price Japan Fund's December 2018 investment in Sansan, Inc., a provider of cloud-based business card management services that listed on the TSE Mothers market in June 2019.

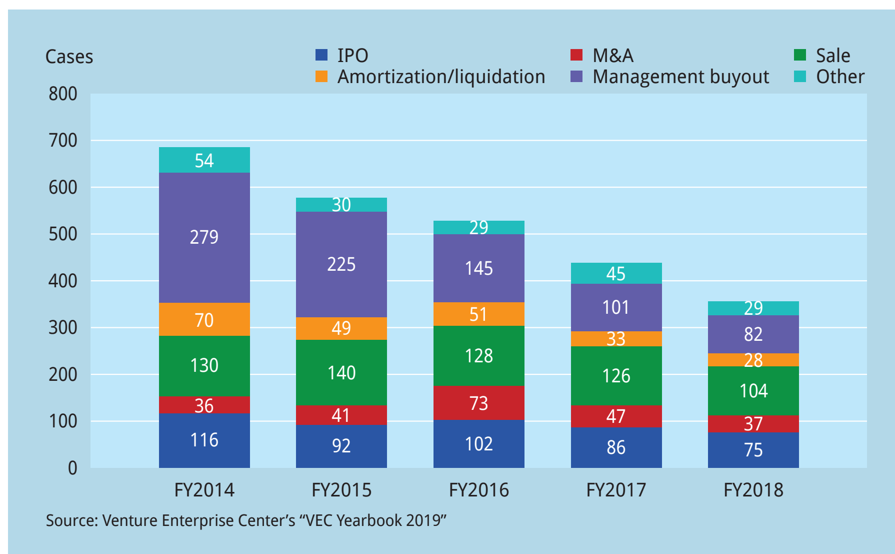
In the Startup Ecosystem Rankings that rank the world's cities based on their startup ecosystem activity level, Tokyo was ranked 14th in 2019, up 15 places from the previous year's rankings.*3 However, the report noted that "Japan will probably not be able to climb the ranks much further without a noticeable increase in English proficiency among local entrepreneurs." Japanese startups therefore need to better communicate their message to investors around the world.

Startup exits

In the US, M&As are overwhelmingly the most commonly used exit route from startup investments. In 2018, there were 779 M&As involving startup ventures compared to just 85 IPOs. In Japan, however, IPOs are more popular than M&As. In 2018, IPOs accounted for 21% of all VC exits from startup investments, as opposed to just 10% for M&As (Figure 4).

Exits from startup investments in Japan have declined each year since 2014 for three main reasons. (1) Strategic investments, especially by CVCs, have increased, resulting in more cases where the investor continues to hold its equity stake in the startup rather than exiting. (2) An expansion in investment targets has increased the number of startups requiring larger amounts of capital and time to build their businesses. (3) Startups seeking to be unicorns are not in a hurry to get to the exit stage.

Figure 4: Trend in Startup Exits in Japan



Source: Venture Enterprise Center's "VEC Yearbook 2019"

US Crossover Investments

Investments in unlisted companies by mutual funds and hedge funds, which mainly invest in listed companies, are called "crossover investments" in the sense that they cross the boundary between investing in listed and unlisted companies. An overview of US crossover investments may provide some insights into the future for startup investments in Japan.

In recent years, mutual funds and hedge funds have joined VCs as major investors in unlisted companies in the United States. For example, 55 mutual funds invested in Uber Technologies Inc. before its IPO.

Mutual funds recent aggressive stance on investing in startups is generally thought to be motivated by two major reasons. The first is that investors who wait for an IPO may miss out on an important stage in a company's growth cycle. The second is that, because startups often bring about innovation and creative destruction, an accurate understanding of a company's competitive position requires the investor to look at all players in that company's field, including listed companies and startups.

However, because unlisted companies' stocks are not priced on a stock exchange, one must evaluate the prices assigned to investment targets by each investment company. Startups (unlisted companies) are not subjected to the same information disclosure requirements that apply to listed companies. Interested mutual fund management companies must therefore independently collect information about startup investment candidates. As a result, they generally need more time to monitor a startup's business conditions and determine a valuation for the company's equity than is needed for listed companies. Crossover investments therefore are generally better suited for large funds that have an abundance of analytical resources.

The merits of crossover investments for startups

Having a major mutual fund listed as a shareholder before its IPO enables a startup to appeal to the broader equity market that its company management and

information disclosures have reached a certain level.

Being able to remain an unlisted company for a long period of time after securing necessary funding is a huge advantage for a startup's management team. The flip side of this coin, however, is that VCs that invested in the startup in its early stages must wait longer for an exit, while the company's employee shareholders also must wait longer for an opportunity to sell their shares on the open market. To secure and keep talented staff while also reducing pressure from employees for an IPO, some startups allow employees to sell their shares under certain conditions. On the other hand, institutional investors are keen to invest in the equity of startups, and especially in unicorns, that are expected to achieve strong growth.

The sale of holdings by existing shareholders (including company directors, employees, VCs, and others) before an IPO is called a "secondary sale". The scale of such transactions is expanding as the assumed market capitalization of unicorn companies increases. This is leading some major investors to form consortiums that make tender offers to acquire large numbers of shares held by existing shareholders.

The roles played by mutual funds' investments in unlisted companies

Mutual funds that have become crossover investors have become major players in the startup ecosystem. These mutual funds have become a major source of large financings conducted in a startup's ultra-late stage before an IPO. They also provide liquidity to a startup's initial investors, including its employees. Mutual funds will, in some cases, act as lead investors for a startup's financing, but unlike hedge funds, the other type of crossover investor, they do not get directly involved in the management of the unlisted companies by dispatching directors to the company. Nonetheless, by providing the equity capital that startups need to grow, they can promote the pre-IPO growth of unlisted companies and enhance their own funds' return. In addition, they are providing individual investors invested in mutual funds with an indirect opportunity to invest in unlisted companies.

As noted earlier, US mutual funds are already investing in unlisted companies in Japan. Going forward, the promotion of crossover investment will probably be important for promoting innovation and enhancing support for venture firms in Japan.

The Road Ahead

Going forward, the following two factors are expected to support the expansion of startup investments in Japan.

Initiatives to realize crossover investments

Investors in Japan are beginning to see the need for greater crossover investment. The "Ito Review 2.0 – Biomedical Edition" published by the Ministry of Economy, Trade and Industry (METI) in April 2018 emphasized that one of the challenges faced by Japanese drug discovery ventures seeking finance is the lack of crossover investors in Japan and the lack of VCs' support for IPOs. In addition, METI's Study Group for Risk Capital Supply for the Fourth Industrial Revolution pointed out that classification of companies as listed or unlisted has resulted in a very small group of providers of risk capital money and business knowledge to companies in the narrow space made up of companies that have just listed their shares on a stock exchange. The study group concludes that the lack of professional investors active in this zone may be a bottleneck for creating new industries.

Pension funds can play an important investment role as crossover investors who invest before an IPO and continue to hold the company's shares after the IPO. In the United States, pension funds have been a key provider of venture capital through their investment in VCs, but in recent years the pension funds have been shifting to in-house investment to improve their investment performance.

Japan too should consider initiatives to support more proactive crossover investment by institutional investors and especially pension funds. If institutional funds such as pension funds, which make long-term investments not bound by the typical investment fund's fixed period, become more active in venture investment, the pool of risk capital available to startup companies will become much deeper.

Platform for pre-IPO equity sales

In Japan, startups have been buying back stock allocated to their employees in preparation for an IPO. Some startups think they need to move quickly to the IPO stage in order to prevent an exodus of talented staff. It therefore is necessary to consider creating opportunities for a startup's original shareholders, such as employees and VCs, to cash in their shares.

For that purpose, Japan needs to follow the US example and create a platform for mediating sales of unlisted stock. However, rather than broadly targeting individual investors, this platform should seek to accelerate the process by limiting investment to pension funds and other institutional investors that can be expected to be hold shares for a long period of time and relaxing the information disclosure and other regulations usually required for public stock sales.

To increase the size of startups in Japan, an environment that enables startups to procure necessary funding must be established. In other words, investors willing and able to provide the necessary funding are needed. Funding provided by investments from domestic VCs is insufficient. Japan's startup ecosystem needs to be enhanced by measures that will encourage crossover investment from suppliers of risk capital and increase the liquidity of unlisted stocks.

Notes

*1 OECD, "Entrepreneurship at a Glance 2018 Highlights."

*2 INITIAL, "Japan Startup Finance 2019."

*3 Startup Blink, "Startup Ecosystem Rankings 2019."

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The Capital Market as a Viable Alternative Funding Source for Small and Medium-Sized Enterprises in Indonesia

Introduction

Micro, Small, and Medium Enterprises (MSMEs) play a significant role in Indonesia's economy, providing a substantial backbone to total national employment and gross domestic product (GDP). A report by the Ministry of Cooperatives and Small and Medium Enterprises (SMEs) of the Republic of Indonesia (2019) stated that in 2017 MSMEs, which include 62.9 million businesses, contributed 60% of GDP and 99% of total employment. These figures are relatively high compared to the merely 1% of total employment and 40% of GDP contributed by large enterprises. MSMEs also play a significant role in increasing workforce absorption in Indonesia. Notably, workforce absorption increased by 21% from 96 million in 2010 to 116 million in 2017 (Ministry of Cooperatives and SMEs of the Republic of Indonesia, 2010-2017), indicating the strategic role MSMEs play in stimulating national labor demand and, indirectly, in alleviating poverty.

In 2018, 54.9% of Indonesian adults aged 18 – 64 perceived the opportunity to start a business in the area where they live and 11.8% of that age group also already owned established business. These numbers are generally higher than the average in Southeast Asia (Global Entrepreneurship Monitor, 2018) and indicate that the entrepreneurial climate in Indonesia is slightly better compared to the region as a whole. As entrepreneurial activities invariably create new jobs and stimulate innovation and growth, Indonesian MSMEs undoubtedly are a key driver of the resilient national economy. Therefore, promoting programs to support MSMEs is critical, and in particular programs supporting access to financial services are crucial to encourage more scale-ups.

Startup & SME Financing: Current Landscape & Challenges

Law Number 20 of 2008 concerning Micro, Small, and Medium Enterprises categorizes Indonesian businesses into three categories:

1) Micro-enterprises, with net assets*[1] ≤ IDR 50 million, or revenue*[2] ≤ IDR 300 million.

2) Small enterprises, with IDR 50 million < net asset ≤ IDR 500 million, or IDR 300 million < revenue ≤ IDR 2.5 billion.

3) Medium-sized enterprises, IDR 500 million < net asset ≤ IDR 10 billion, or IDR 2.5 billion < revenue ≤ IDR 50 billion.

Indonesia has a very high density of micro-enterprise. In 2017, 98.7% of Indonesian MSMEs fell into the micro category, 1.2% fell into the small category and 0.1% fell into the medium-sized category.

As of September 2018, less than 20% of outstanding bank loans in Indonesia were to MSMEs, and the majority of those loans were to medium-sized enterprises which represented 43.5% of total loans to MSMEs (Bank Indonesia, 2019). Indonesia's MSMEs have a total of 16 million credit accounts; assuming each account is owned by one business unit means that less than 30% of all MSMEs in Indonesia have access to bank credit suggests that the majority of MSMEs are unbanked.

In 2019, the Ministry of Cooperatives and SMEs of the Republic of Indonesia issued programs and directives on cooperatives - MSME development for the years 2020 – 2024. The program suggests that the government will encourage more MSME scale-ups, more export-oriented SMEs, and more large scale cooperatives. The ministry projected that, assuming only 10% of MSMEs can scale up their business, national economic growth

would increase by more than 7% (Ministry of Cooperatives and SMEs of the Republic of Indonesia, 2019).

The government has been actively promoting programs to support MSMEs in several ways. In terms of funding, most of the programs are aimed at micro- and small enterprises. One of those programs is Kredit Usaha Rakyat (KUR), a government-backed loan with interest subsidy. KUR is the most extensive funding program for small and microenterprises in Indonesia.

The government also has been actively providing leniency for the MSME sector by lowering the KUR rate from 22% in 2014 to 7% in 2018, lowering the final corporate income tax rate for MSMEs and cooperatives*[3] from 1% to 0.5% in 2018, and establishing synergy with Indonesia Eximbank to promote more export-oriented SMEs (Ministry of Cooperatives and SMEs of the Republic of Indonesia, 2019). For those enterprises that do not qualify for KUR, the government also provides a loan-based revolving fund managed by the Revolving Fund Management Agency (LPDB) of the Ministry of Cooperatives and SMEs of the Republic of Indonesia.

Despite government efforts to create a more supportive and business-friendly environment, early-stage startups and SMEs in Indonesia still face several challenges in developing and scaling up their businesses. Indeed, putting startups and SMEs together on the same table is practically like comparing apples to oranges. They are different by nature, especially in their risk profiles and business goals, but they do have similar sets of problems.

The results of an Indonesia Digital Creative Industry Community (MIKTI) survey of 992 Indonesian startups in 2018 identified several main problems for startups including facilities, regulations, human resources, capital, and markets. Importantly, 39% of the total surveyed said that the major challenge is lack of capital and difficulty for raising funds because funding is crucial for running daily operations, improving technology, and launching a comprehensive marketing strategy to increase market awareness about the product (Indonesia Digital Creative Industry Community, 2018).

This finding is also similar to the results of a study conducted by the International Finance Corporation (International Finance Corporation, 2016), which concluded that the lack of financing options during the early stage of business is the major challenge for SMEs. Lack of financial products beyond standard working capital and investment loans will hamper growth, and this could be a significant barrier for SMEs to get off the ground. Banks also generally focus more on traditional collateral-based financing (immovables), and current KUR products are less focused on new clients. Current KUR products focus on interest rate subsidies rather than credit guarantees, which could be of assistance to first-time borrowers (ILO, 2019).

Alternative loan-based financing

Peer-to-peer (P2P) lending has risen significantly in Indonesia over the past few years. Data from Indonesia's Financial Services Authority (OJK) show that loans distributed by P2P lending services in Indonesia grew 260% from December 2018 to December 2019 (OJK, 2020). This growth is driven by a credit market gap of IDR 800 trillion (Gunadi, 2017) that can be served by P2P lending. This gap is around 15% the size of the IDR 5,295 trillion served by commercial banks in 2018. A survey conducted by the Indonesian Internet Providers Association in 2019 also shows that 64.8% of Indonesia's population of 264 million was already connected to the internet in 2018. OJK in 2016 issued Regulation No. 77/POJK.01/2016 covering information technology-based money lending services. All these factors have created a more friendly ecosystem for P2P lending.

However, as of December 2019, only around IDR 81.5 trillion (OJK, 2020) in loans had been distributed by P2P lending services in Indonesia, a relatively small amount of lending compared to the credit-based financing industry overall. Even so, the rise of P2P lending is playing a significant role in driving the banking industry to issue more innovative products, such as the niche invoice financing market that the P2P lending sector is currently leading.

Equity-based financing

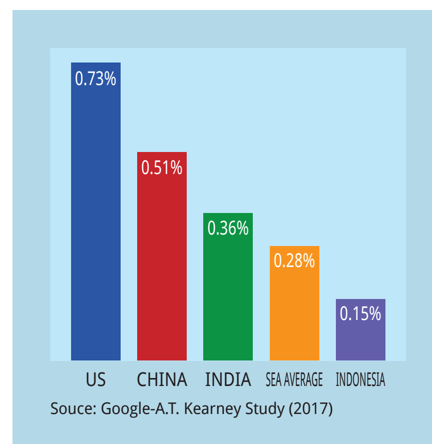
Companies tend to mix debt and equity financing to optimize their capital structure. Even though the cost of issuing equity is relatively higher compared to debt (Myers & Majluf, 1984), equity financing provides distinct advantages for early-stage startups and SMEs. Equity financing requires no repayment and provides extra working capital, which can be used to drive business growth. Most Indonesian entrepreneurs started their business by raising equity from family and friends; other than that entrepreneurs may access private equity financing through Angel Investors, Venture Capital (VC), and Private Equity, or the capital market through Equity Crowdfunding or by conducting Initial Public Offerings to raise capital.

- **Private placement financing**

Investments in startups in Indonesia have grown 68 times over the past five years. Although meager compared to total investment in Asia, almost 20% of investment in the ASEAN (Association of Southeast Asian Nations) region was invested in Indonesia, reaching nearly USD 3 billion in the first eight months of 2017, or double the previous year's total*[4] (Google-A.T. Kearney Study, 2017). Research also shows that most of the VC investments in Indonesia are still in the seed or early stages, but late-stage VC investments are generating most of the value. Most VC investors fell into two categories: local investors (54% of total capital) that primarily participate in early-stage deals and foreign investors (46% of total capital) that primarily participate in late-stage rounds. The largest funding rounds are led by e-commerce (42% of total deals) and related transport companies (31% of total deals).

Research also indicates that investors are generally optimistic about the outlook for the Indonesian market, even compared with other Asian markets, including the Southeast Asia (SEA) average*[5]. The reason for the positivity is that Indonesia has favorable demographics and a strong macro-economic foundation. Investors also believe that Indonesia is still under-tracking its peers in VC investment, which indicates much room for growth (Figure 1).

Figure 1: Country Comparison of VC Investments as a Share of GDP (2016)



Souce: Google-A.T. Kearney Study (2017)

Looking at the recent local player landscape, as of March 2020, 61 conventional VC firms have been licensed by the OJK. In terms of the operations of these 61 firms, 78% of their investments were made through profit- or revenue-sharing methods, compared to the mere 4% placed through convertible bonds and 18% through equity shares (Financial Services Authority - OJK, 2020). VC activity in Indonesia is not limited to startups as the OJK requires VC investors to allocate at least 5% of their funds to MSMEs.*6

Venture capitalists financed startups and SMEs with interest in generating a return through their eventual exit strategy. The two best ways for a VC to exit are, first, through merger and acquisition and second, if the company does well, by selling their shares through an initial public offering.

- **Public equity financing**

Initial Public Offering (IPO): Indonesia's capital market is still in an early stage of development. As of 2019, total market capitalization of listed domestic companies in Indonesia was only 46.8% of GDP, compared to 110.8% in Malaysia, 73.1% in the Philippines, 187.4% in Singapore and 104.7% in Thailand.*7 Despite its stage of development, Indonesia's market capitalization of USD 439.38 billion is the third highest in the region, behind Singapore with USD 645.79 billion and Thailand with USD 463.09 billion.*8 Still relatively modest in size compared to the major world exchanges, Indonesia's capital market has considerable room for growth.

The definition of SMEs by the capital market differs from the definition of MSMEs stated in Law Number 20 of 2008 concerning MSMEs under the Ministry of Cooperatives and SMEs of the Republic of Indonesia. In 2017, OJK issued Regulations No. 53/POJK.04/2017 and No. 54/POJK.04/2017 covering the public offering process of SMEs. These regulations also define small and medium-sized issuers as follows:

1) The issuer is categorized as small-asset issuer if their asset value *9 is ≤ IDR 50 billion

2) The issuer is categorized as medium-asset issuer if their asset value is IDR 50 – 250 billion

3) Neither category of issuer may be controlled (whether directly or indirectly) by a company that is a controller of an issuer or public company that is not a small or medium-asset issuer or has assets of more than IDR 250 billion.

The regulations also provide for some leniency in public offerings by SMEs.

Equity Crowdfunding (ECF): For startups and SMEs with assets less than IDR 10 billion and aiming to raise under IDR 10 billion, there is another public funding alternative called ECF. The ECF regulation (OJK Regulation No. 37/POJK.04/2018) defines the operational boundaries for ECF platforms, investors, and states the limitation on the amount of money that can be raised from the platform. ECF can be positioned as one step before an IPO. The platform shall help businesses and projects that do not qualify to conduct an IPO to raise funds through the crowdfunding mechanism. Those who participate as investors will receive shares in the company.

As of March 2020, three ECF platforms have obtained a license from OJK: Santara, Bizhare, and CrowdDana. Nevertheless, since the amount of money that can be raised by ECF is limited to under IDR 10 billion, startups and SMEs willing to get more than IDR 10 billion in funding from the public may consider an IPO as a feasible funding option.

Indonesia Stock Exchange (IDX) Initiatives to Support Startups and SMEs

IDX committed to facilitate startups and SMEs in obtaining funds through public offerings. However, to optimize the public funding that can be raised by Indonesian SMEs, IDX must be able to create a public equity financing ecosystem that will suit their needs. For the one level of funding below IPOs, IDX developed the IDX Incubator. Furthermore, IDX launched the Acceleration Board for IPO Initiatives.

IDX Incubator

IDX launched the IDX incubator in 2017 to support digital-based startups in scaling up their businesses. In addition, since 2019, IDX Incubator has a new incubation program focused on helping startups and SMEs in all sectors, not only digital-based startups, in preparing for the IPO process. The curriculum of the new program, called the "Road-to-IPO" Program, is shown in Table 1.

IDX Incubator also offers other facilities for startups and SMEs that become members, such as cloud services, meeting rooms, multipurpose training rooms, and co-working spaces with high-speed internet access.

IDX Incubator has offices in Jakarta, Bandung, and Surabaya, with 110 members. Nevertheless, only 41 startups and SMEs have joined Road-to-IPO Program. In 2018, 2019, and 2020, 3 IDX Incubator members successfully became listed companies on IDX. They are: PT Yelooo Integra Datanet Tbk. (YELO), PT Tourindo Guide Indonesia Tbk. (PGJO) and PT Cashlez Worldwide Indonesia Tbk. (CASH).

Table 1: Road-to-IPO Program IDX Incubator

Topics	Sub Topics	Trainer
OJK regulations	OJK regulations related to IPOs	OJK
IDX regulations	IDX listing regulations	IDX
Public offerings structure	Valuation	Investment bank
	Financial statement projection	Investment bank
	Roadshow process and IPO timeline	Investment bank
Preparation for meeting with anchor investor	Creating a company profile - Milestone - Business model - Business plan - Competitor and competitive advantage	Investment bank
Legal aspects of the company	VC funding term-sheet	Law firm
	Preparation for legal audit	Law firm
Accounting matters	Accounting bookkeeping services	Accounting firm

Source: IDX

Acceleration Board

Following the issuance of OJK regulations on the public offering by startups and SMEs (no.53/POJK.04/2017 and No. 54/POJK.04/2017)*[10], in 2019, IDX issued Rule number I-V Concerning Specific Provisions for the Listing of Shares (Stock) and Equity-Type Securities Other Than Stock on The Acceleration Board Issued by The Listed Company. The new board has introduced lower listing requirements than the general listing requirements on the Main Board and Development Board under Rule I-A Concerning The Listing Of Shares (Stock) And Equity-Type Securities Other Than Stock Issued By The Listed Company (Table 2).

As of the end of April 2020, two companies had listed on the Acceleration Board. Both were members of the IDX Incubator, PGJO and CASH.

A company listed on the Acceleration Board is expected to grow rapidly and soon be promoted to the Development Board or the Main Board. The Acceleration Board is designed for a company with a future

Table 2: IDX Equity Listing Requirements

Criterion	Listing Board		
	Main Board	Development Board	Acceleration Board
Independent commissioner	Required	Required	•Six-month grace period for medium-asset issuers •One-year grace period for small-asset issuers
Corporate secretary	Required	Required	•Six-month grace period for medium asset issuers •One-year grace period for small asset issuers
Audit Committee and unit of internal audit	Required	Required	•Six-month grace period for medium asset issuers •One-year grace period for small asset issuers
Operating period	36 months	12 months	Since booked operating revenue
Operating profit	Minimum 1 year	May experience loss, but should have operating and net profit in 2 years based on projection	May experience loss, but should have operating profit by 6th year, based on projection
Audited financial report	Minimum 3 years, unqualified opinion	Minimum 12 months with an unqualified opinion	•Minimum 1 year or since establishment if established less than one year •Unqualified opinion
Capital requirement	Net tangible assets*: minimum IDR 100 billion	a) Net tangible asset minimum Rp5 billion; or b) Net profit minimum IDR 1 billion and market capitalization minimum IDR 100 billion; or c) Revenue minimum of IDR 40 billion and market capitalization minimum IDR 200 billion	N/A
Number of shares owned by non-controlling and non-majority shareholders	Minimum 300 million shares and: •20% of total shares, for equity <IDR 500 •5% of total shares, for equity IDR 500 billion – IDR 2 trillion •10% of total shares, for equity >IDR 2 trillion	Minimum 150 million shares and: •20% of total shares, for equity <IDR 500 billion •15% of total shares, for equity IDR 500 billion – IDR 2 trillion •10% of total shares, for equity>IDR 2 trillion	Minimum 20% of total shares
Minimum offering price	IDR 100	IDR 100	IDR 50
Number of shareholders	≥1000 parties	≥500 parties	≥300 parties
Underwriting scheme	Full commitment	Full commitment	Best effort
Lock-up for controlling shareholders	N/A	N/A	6 months

Note: *Net tangible assets (total assets – intangible assets – deferred tax assets – total liabilities – non-controlling interest).
Source: IDX

potential of robust growth, so the most suitable investor type for this board is a growth-focused investor.

Even though the IDX has just launched the Acceleration Board on 2019, 90*11 small and medium-asset companies were listed on IDX in the period 2006 – June 2020 (Figure 2), based on the definition of small and medium-asset companies in OJK Regulation No. 53. The data indicate that even before the inception of the Acceleration Bboard, IDX was open to small and medium-asset companies.

IDX's data indicates that beside their large counterparts, SMEs also have been increasingly active in utilizing public offerings as one of their financing alternatives. The compound annual growth rate (CAGR) of SME IPO activity was higher than that of all IPOs in general, especially since 2016. IPO activity on IDX has been increasing significantly, with 36% CAGR for total IPOs and 48% CAGR for small-medium IPOs. As a matter of fact, in 2019, IDX ranked 7th highest in the world for the number of IPOs, accounting for 7.7% of global IPO activity (EY, 2020).

In addition to the business incubation program and the Acceleration Board, since 2016 the IDX also has assigned a special task force commissioned to give advisory assistance to potential listed companies. This task force also bridges companies with underwriters and any other capital market supporting institutions/professionals and conducts marketing and branding strategy to familiarize them with the IPO process in Indonesia.

Conclusion

Startup and SME financing through the capital market is not entirely new in Indonesia, as SME IPO activity has been going for the last couple of years. However, to keep up with the development of the industry that continues to transform rapidly, it is evident that more product innovation and leniency on regulations are needed to increase capital market inclusivity in Indonesia. So far, Indonesia's capital market has been focused more on SME equity financing compared to debt financing, but now efforts to foster more equity financing must continue alongside attempts to explore debt financing products for SMEs. To enhance collaboration within the ecosystem is also essential, as platforms or products that can serve as a bridge to the IPO level are still crucial to be offered to the public.

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Disclaimer:
The views expressed in this article do not necessarily reflect those of the authors' affiliation. Responsibility for any errors lies with the authors.

Note

*1 Total assets (excluding land and property) – total liabilities

*2 Annual revenue (net)

*3 This policy is applicable to any MSME or co-operative which booked operating revenue less than IDR 4.8 billion per year.

*4 From 2012 to 2017, 244 companies completed 381 VC investment deals.

*5 SEA consists of Singapore, Malaysia, Indonesia, Vietnam, Philippines, Thailand, Cambodia, Laos, Myanmar, and Brunei.

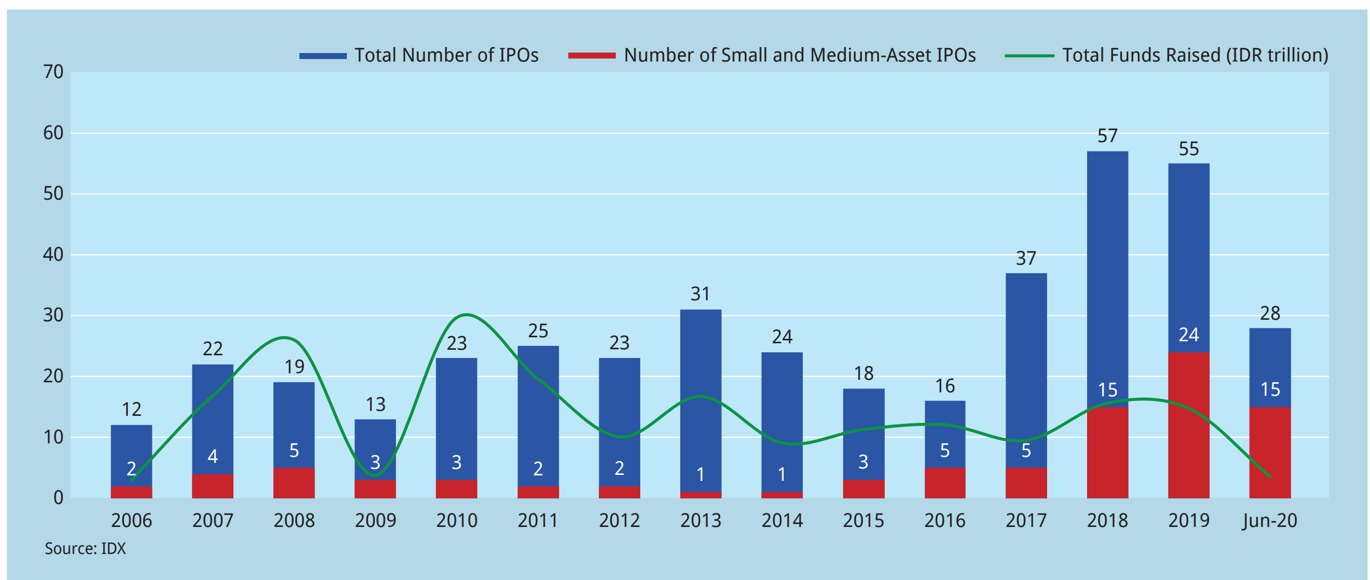
*6 OJK Regulation Number 35/POJK 05/2015

*7 World Federation of Exchanges database (2019)

*8 IDX (2020)

*9 Asset value is based on the financial statements used in the submission of the registration statement to the OJK.

Figure 2: Total Number of IPOs and Small and Medium-Asset IPOs



Source: IDX

*10 Regular public offering can also be conducted by following OJK regulation No. 7/ POJK.04/2017 and No. 8/POJK.04/2017 for non-startup/SME companies.

*11 88 companies initially listed on the Development Board and 2 on the Acceleration Board

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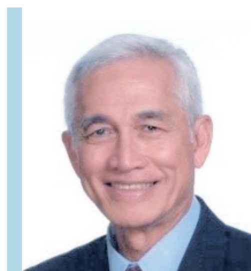

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MSME Financing in the Philippines: Status, Challenges and Opportunities

Introduction

Micro, Small, and Medium Enterprises (MSMEs) are catalysts for inclusive growth and development in the Philippines. In 2018, they accounted for 35.7% of the national economy and contributed 25% to total export revenue. Around 60% of MSMEs are exporters. Due to their sheer number and the millions of jobs they generate, the World Bank (2019) described MSMEs as the "bedrock of private sector and entrepreneurship" in the Philippines.

Despite this economic contribution and potential, the growth and development of MSMEs in the Philippines are constrained by the lack of access to finance (Maningo, 2016; Aldaba, 2012). Even the MSME Development Plan 2017-2022 recognized financing as a major challenge for MSMEs. Velasco et al. (2017) cited the difficulty in securing financing to fund business operations as one of the main reasons for the prevalence of business closures among MSMEs.

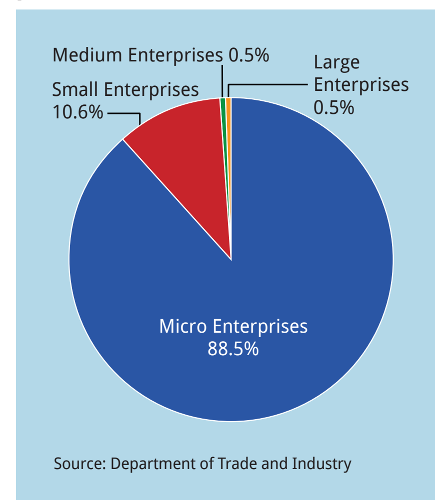
The accessibility of funds can determine the ability of MSMEs to compete for market share, innovate, expand operations, and withstand shocks (Khor et al., 2015). Thus, it is crucial to bridge this financing gap to maximize the potential of MSMEs to the economy.

MSMEs in the Philippines

MSMEs in the Philippines are defined using two criteria: (1) asset size based on the Magna Carta for MSMEs, and (2) employment size as used by the Philippine Statistics Authority (Table 1). The definition from the Magna Carta covers all types of business structure such as sole proprietorship, cooperative, partnership, and corporation.

As of end-2018, there are 1,003,111 business enterprises in the Philippines. Around 99.5% (998,342) of these firms are MSMEs (Figure 1). Broken down, micro-enterprises accounted for 88.5% (887,272 firms), followed by small enterprises with 10.6% (106,175 firms), and medium-sized

Figure 1: Establishments in the Philippines



Source: Department of Trade and Industry

Table 1: MSME Classification in the Philippines

Enterprise Classification	Asset Size	Employment Size
Micro	Not more than PHP 3,000,000	1-9
Small	PHP 3,000,001 – PHP 15,000,000	10-99
Medium	PHP 15,000,001 – PHP 100,000,000	100-199

Source: Magna Carta for MSMEs; Philippine Statistics Authority

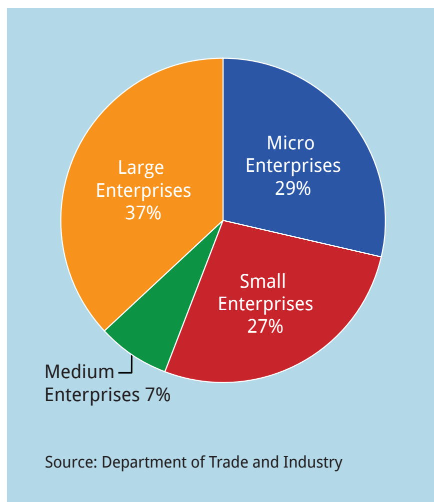
enterprises with 0.5% (4,895 firms).

MSMEs also created over 5.7 million jobs, accounting for 63% of total employment in the Philippines (Figure 2). Among MSMEs, micro-sized firms generated the largest number of jobs at 2.6 million or 28.9% of the total. Small enterprises have a workforce of 2.4 million (27% of total employment) while medium-sized enterprises have manpower of 658,930 (7.3%).

By industry segment, most MSMEs (461,765 firms) in the Philippines are engaged in Wholesale and Retail Trade, Repair of Motor Vehicles, and Motorcycles (Figure 3). Other major sectors include Accommodation and Food Service Activities with 144,535 firms; Manufacturing with 116,335 firms; Other Service Activities with 66,162 firms; and Financial and Insurance Activities with 46,033 firms. These five industry segments account for 83.6% of all MSME firms and generate 73.4% of total MSME employment.

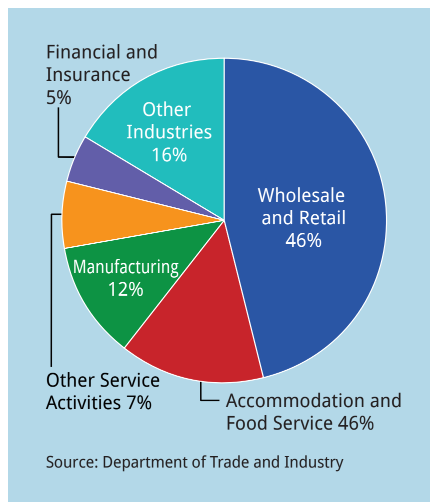
The majority of MSMEs are concentrated in six geographical regions led by National Capital Region which hosts 203,312 firms (Figure 4). This is followed by Region IV-A (CALABARZON) with 148,196 firms; Region III (Central Luzon) with 116,073; Region VII (Central Visayas) with 70,395; and Region VI (Western Visayas) with 61,590; and Region XI (Davao Region) with 58,459. These six regions host 66% of all MSME firms and 72.3% of all MSME jobs. Consequently, they are also the six biggest regional economies in the Philippines, registering a combined 78% share of the country's Gross Domestic Product (GDP).

Figure 2: Employment Share of Philippine Establishments by Enterprise Category



Source: Department of Trade and Industry

Figure 3: Number of MSME Firms by Industry Segment



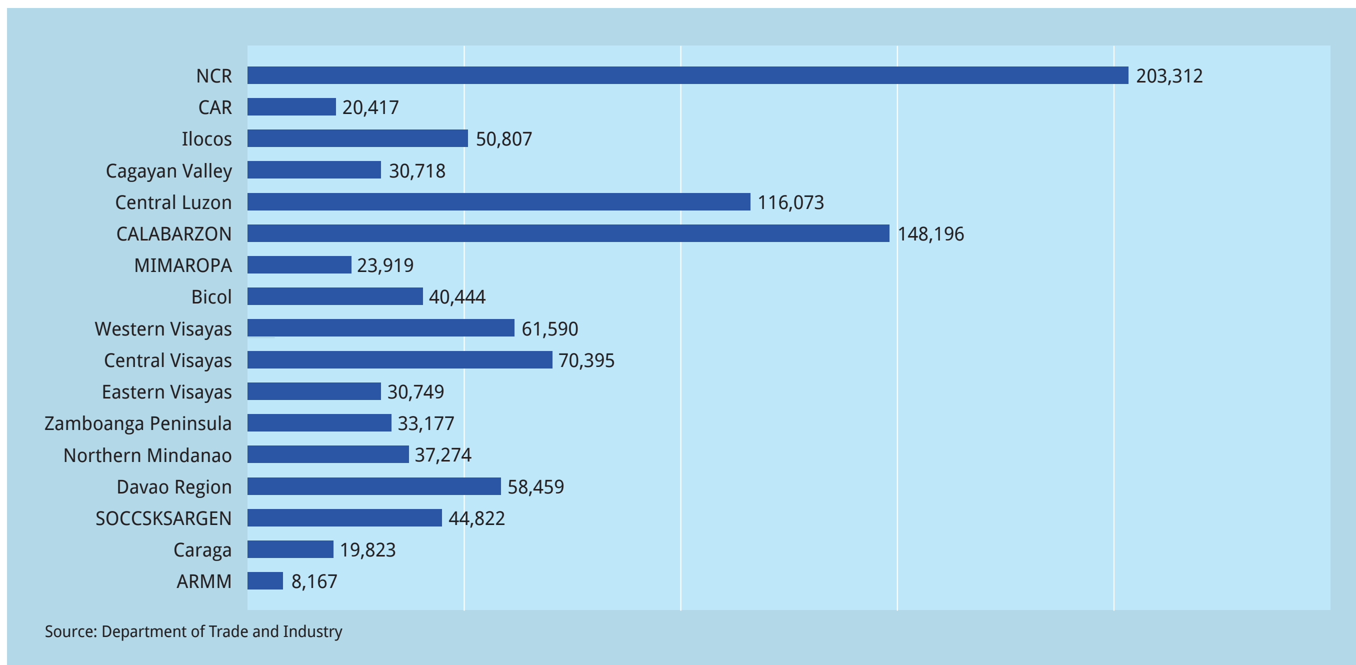
Source: Department of Trade and Industry

Policy Governing MSMEs in the Philippines

The Republic Act (RA) 6977 signed in 1991 and known as the Magna Carta for MSMEs, provides the national policy framework for the governance of MSMEs in the Philippines, with the Department of Trade and Industry (DTI) being the primary government agency responsible for their development.

This law was widely regarded as the most crucial piece of Small and Medium Enterprise (SME) legislation in the country as it consolidated all existing policies and programs geared at promoting the development of SMEs (OECD/ERIA, 2018; Aldaba, 2012). RA 6977 triggered the creation of two entities: (1) Small and Medium

Figure 4: Regional Distribution of MSMEs



Source: Department of Trade and Industry

Enterprise Development Council, an inter-agency council responsible for crafting policies for the growth and development of MSMEs; and (2) Small Business Guarantee and Finance Corporation, a body in charge of guaranteeing loans to qualified MSMEs.

The law also initially set a mandatory credit allocation by all lending institutions to MSMEs at 5% in the first year of implementation and 10% in the succeeding years until the end of the fifth year. After six years, the Magna Carta for MSMEs was amended by RA 8289. It reduced the mandatory credit allocation to 8%. Of which, 6% is allocated to small firms and 2% to medium-sized firms.

In 2001, the Small Business Guarantee and Finance Corporation was merged with the Guarantee Fund for Small and Medium Enterprises, a guarantee fund operated by the Livelihood Corporation under the Office of the President. This merger, through Executive Order 28, resulted in the creation of the Small Business Corporation (SBC).

In 2008, the Magna Carta for MSMEs was amended again through RA 9501. One of the significant amendments which stands until today is the increase in the mandatory allocation to MSMEs by lending institutions to 10%, with 8% allotted to micro and small-sized firms and the remaining 2% to medium-sized companies.

RA 9501 also institutionalized the SBC as the financing arm of the government for MSMEs. Moreover, it renamed the Small and Medium Enterprise Development Council as the Micro, Small and Medium Enterprise Development (MSMED) Council.

The law also mandated the DTI to craft a six-year MSME Development Plan to serve as the blueprint for the advancement of the MSME sector. Currently, the government is implementing the MSME Development Plan 2017-2022 which is targeting to increase employment in MSMEs from 4.7 million in 2017 to 8.2 million in 2022 and increase the number of registered MSMEs by 20%. One of the key focus areas of the MSME Development 2017-2022 Plan is maximizing access to finance.

Access to Finance: A Pressing Challenge

Financial inclusion remains a challenge in the Philippines. Data from the 2017 World Bank Findex showed that only 34.5% of the 70 million Filipinos aged 15 years old and above have access to a formal account (Demirguc-Kunt et al., 2018). This is lower than the 70.6% average for East Asia and the Pacific and the 57.8% average among lower-middle income economies. Even the 2017 Financial Inclusion Survey of the Bangko Sentral ng Pilipinas (BSP) showed a bleak picture. Only 23% of adult Filipinos, or 15.8 million people, have a formal account.

Expectedly, more Filipinos rely on informal lending schemes than on financial institutions. In 2017, around 41.2% of Filipinos borrowed from family or friends, much higher than the 29.6% average for the East Asia and Pacific region or the 30.4% average for lower-middle income countries (Demirguc-Kunt et al., 2018). Only 10.7% of Filipinos borrowed from a financial institution. In the BSP survey, about 40% of adults acquired loans from informal sources such as family and friends.

The same financing gap can be observed among MSMEs. Data from the 2015 World Bank Enterprise Survey showed that 12.9% of medium-sized firms and 10.2% of small-sized firms in the country cited access to finance as the biggest obstacle to their development, the third most pressing issue cited behind practices of informal sector and tax rates. In a recent survey, 78% of start-up founders considered funding as a major challenge in the next 12 months (Isla Lipana & Co., 2020). An estimate by the International Finance Corporation (2017) showed that MSMEs in the Philippines are facing a financing gap of USD 221.8 billion. This figure is equivalent to 76% of the country's GDP, the largest gap among the 128 countries surveyed in the IFC report (Figure 5).

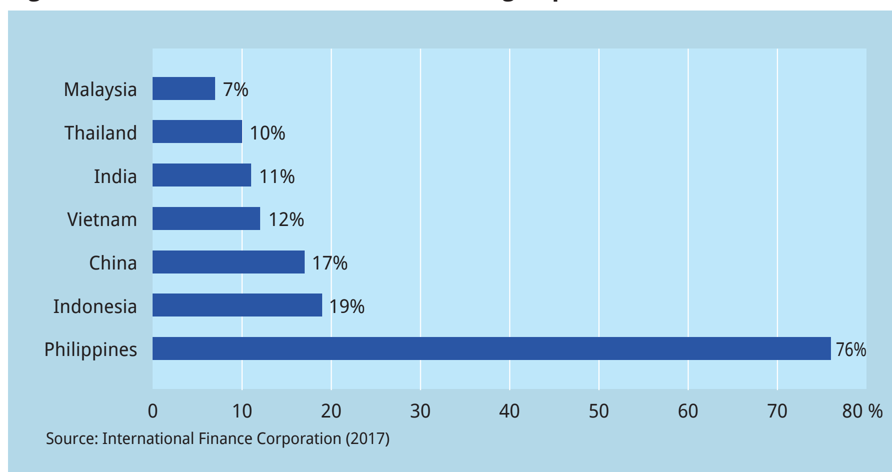
One study showed that around 42% of small-sized firms and 33% of medium-sized firms from a sample of 480 firms in Metro Manila and CALABARZON regions are classified as credit-constrained (Flaminiano & Francisco, 2019). Credit-constrained means that an MSME attempted to take out a loan but was denied; received a loan but the amount was not enough; or did not apply for a loan at all.

Due to the difficulty of accessing bank loans, MSMEs in the Philippines are borrowing from informal sources such as the so-called 5-6 money lending scheme. According to an estimate, 5-6 money lending is now a PHP 30 billion industry in the Philippines (Pimentel, 2019). These lenders charge at least 20% monthly interest rate, well above the 2.5% rate of the government's MSME credit program. The same study by Flaminiano and Francisco (2019) showed that 47% of small and medium-sized enterprises in their sample obtained loans from informal sources.

Government Programs to Improve Access to Finance

Bridging the financing gap is an integral part of the government's 7Ms strategic framework to facilitate the growth and development of MSMEs. The 7Ms are seven key factors identified as crucial for the suc-

Figure 5: Selected Asian Countries: Financing Gap as % of GDP



Source: International Finance Corporation (2017)

cess and empowerment of MSMEs: mindset, mastery, mentoring, market, money, machines, and models. Under 'money', the DTI seeks to expand access of MSMEs to finance through formal schemes and lessen their dependence on informal lending such as the 5-6 lenders. There are currently five main programs to improve access to finance.

Mandatory allocation of credit resources to MSMEs

The Magna Carta for MSMEs required all lending institutions to set aside 8% of their loan portfolio for micro- and small-sized firms, and another 2% for medium-sized enterprises. Based on Circular 625, series of 2008, of the BSP, lending institutions can extend loans through direct means (e.g., actual extension of loans) and alternative means (e.g., paid subscription or purchase of liability instruments or preferred shares of stocks of the SBC).

Financial institutions which fail to meet the credit allocation are slapped with penalties depending on the degree of non-compliance. Banks that fail to comply at all are fined PHP 500,000. Meanwhile, banks that fail to reach the required loan share are fined PHP 400,000 for every percentage point of under-compliance for micro and small enterprises, and PHP 100,000 for every percentage point of under-compliance for medium enterprises. Non-submission or delayed submission of compliance reports is also levied with corresponding, though smaller, penalty: PHP 1,200 per day of delay for universal and commercial banks; PHP 600 for thrift banks; and PHP 180 for rural banks and cooperatives.

Pondo sa pagbabago at pag-asenso (P3) program

Launched in 2017, the P3 program of the SBC is the flagship initiative of the government to provide an alternative source of financing with lower interest rates and no collateral requirement for MSMEs. Each MSME can avail of loans as small as PHP 5,000 up to as large as PHP 200,000, subject to 2.5% interest rate and service charges. The loan amount depends on the size and ability to pay of the borrowing enterprise. The P3 program was initially implemented across the country's 30 poorest provinces but has now expanded to cover 80 provinces. To expand the reach of the program, the SBC has partnered with around 400 microfinancing institutions nationwide through which the funds are being channeled. As of January 2020, the SBC has released PHP 5.1 billion worth of loans to over 124,374 beneficiaries. Today, the P3 program is also utilized as a means of providing loan facility to MSMEs affected by Covid-19.

Access of small entrepreneurs to sound lending opportunities (ASENSO) program

The ASENSO Program is a lending initiative of several government financial institutions (GFIs) like the Landbank of the Philippines (LBP) to provide short- and long-term funds for MSMEs. Before its relaunch in 2012, it was known as the SME Unified Lending Opportunities for National Growth (SULONG) program which originally started in 2003. The program targets all MSMEs except firms that are engaged in the trading of imported goods, liquor, and cigarettes, as well as extractive industries. Under the program, MSMEs can borrow up to a maximum of PHP 5 million and use it for: (1) export financing or temporary working capital (short-term) and (2) buying equipment, lot and inventories, and building construction (long-term). The interest rate varies every quarter.

Loans are secured with collateral such as a real estate mortgage, chattel on machinery and equipment, a deed of assignment on inventory and receivables (Briones, 2016). While it is not a policy of GFIs to decline a loan because of inadequate collateral, the borrower still needs to mortgage any available business and personal collateral to secure the borrowing. From 2004 to 2014, at least PHP 340 billion of loans were released to MSMEs under this program (Asian Development Bank, 2015).

Credit surety fund (CSF) program

The CSF program is an initiative of the BSP designed to increase the credit worthiness of MSMEs which are facing difficulties in securing loans due to lack of collateral, credit knowledge, and credit track record. First launched in the province of Cavite, the program is being implemented at the local level to allow flexible and efficient administration and to make it more accessible to beneficiaries (Maningo, 2016). The CSF program was institutionalized in 2015 following the passage of the Credit Surety Fund Cooperative Act (RA 10744).

The program allows MSMEs to borrow from banks using CSF surety cover as a guarantee for the loan even in the absence of acceptable collateral. It provides up to 80% surety cover for bank loans, that may increase to 90% if 30% of the loan has been repaid. Aside from this, the CSF also involves capacity-building among MSMEs to increase their knowledge on credit sources and business loans (Maningo, 2016).

The CSF is sourced from the pooled investments of cooperatives, non-government organizations (NGOs), local government units, and GFIs such as LBP and Development Bank of the Philippines. Only well-capitalized and well-managed cooperatives or NGOs with adjusted capital of not less than PHP 1 million, adjusted capital to assets ratio of at least 15%, and ability to contribute a minimum of PHP 100,000 can participate. Cooperatives or NGOs which contributed to the fund, including their MSME members can apply for the CSF program.

The CSF cooperative, which is a local government-partnered cooperative comprised of contributors or investors of the CSF, is responsible for administering the fund. As of end-2018, there are 54 CSF cooperatives, comprised of 791 members, across 33 provinces and 20 cities in the Philippines. The program has released total loans worth PHP 5.4 billion, benefiting around 18,000 MSMEs.

Digital payments

Through the National Retail Payment System (NRPS) of the BSP, MSMEs are encouraged to adopt digital payment schemes in order to widen their customer reach and increase access to credit. Launched in 2015, the NRPS is a regulatory framework that sets direction and standards for the creation of a reliable and efficient digital payments system in the country.

One of the platforms under NRPS is InstaPay which allows consumers and businesses, including MSMEs, to send and receive funds up to PHP 50,000 in real-time through mobile apps and internet banking facilities by participating banks and e-money issuers. As of March 31, there are 45 participating institutions in InstaPay.

Issues in MSME Financing in the Philippines

Banks are failing to meet the required mandatory allocation for micro and small enterprises

While loans extended by banks to micro and small enterprises increased over the past decade, the share of these loans in their total loan portfolio continued to de-

cline (Figure 6). In fact, banks have fallen short of the 8% mandatory credit allocation for micro and small enterprises for nine consecutive years since 2011. From 8.5% of banks' total loan portfolio in 2010, the compliance rate for micro and small-sized firms declined consistently over the years until it reached only 2.8% in 2019.

In particular, universal and commercial banks extended only 2.3% of their loan portfolio to micro and small firms in 2019, while thrift banks provided 4.5%. Only rural and cooperative banks complied with the provision, with 24.3% of their loan portfolios allotted to loans for small businesses.

Meanwhile, every category of bank has far exceeded the 2% required credit allocation for medium-sized firms over the past 10 years (Figure 7). In fact, the banking sector has been allotting a larger percentage of its loan portfolio to medium-sized firms than to micro and small enterprises since 2012. In 2019, banks provided 4.3% of their total loan portfolio to medium enterprises.

Despite the mandatory allocation, micro and small enterprises clearly still have difficulty accessing loans from lending institutions. As described by Khor et al. (2015), the problem is not the availability of funds itself, but the capacity of MSMEs to access the funds. There are four main reasons why MSMEs fail to secure loans from banks:

- **Collateral**
  One factor that makes it hard for MSMEs to secure loans from banks

Figure 6: Bank Lending to Micro and Small Enterprises

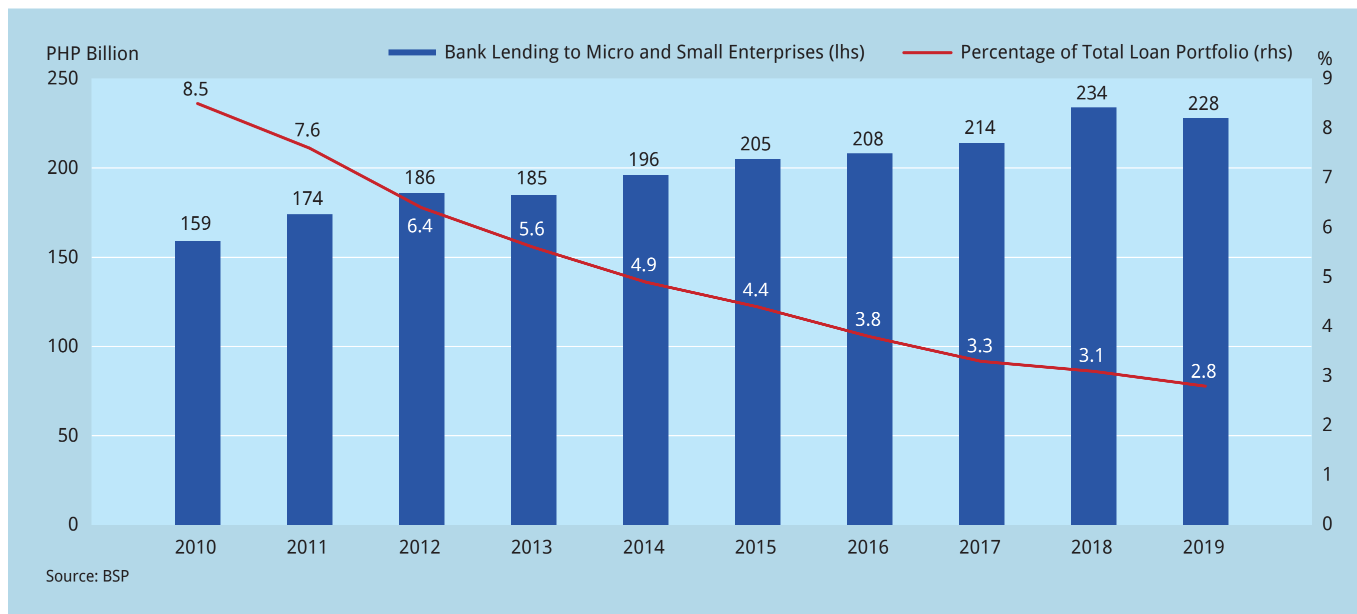
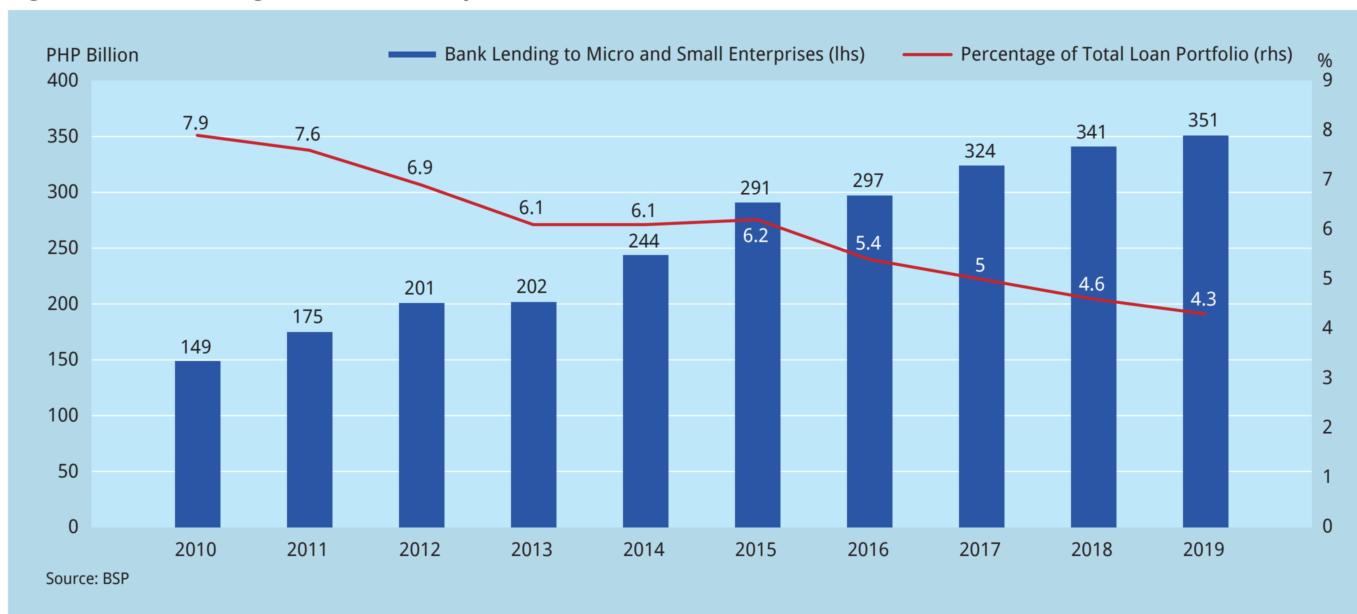


Figure 7: Bank Lending to Medium Enterprises



is the overemphasis on collateral (Aldaba, 2012). Banks often require immovable assets as collateral such as land or real estate which most MSMEs do not have.

- **Creditworthiness**
  Another problem is that banks face difficulties in assessing the creditworthiness of MSMEs globally due to lack of publicly available information (Abraham & Schmukler, 2017). Aside from lack of public information, Lagua (2014) also cited inconsistent financial statements and audits, lack of third-party information providers in the marketplace, and higher cost of obtaining credit information as factors that hinder banks in evaluating credit risk of MSMEs. Due to the risks arising from information asymmetries, banks often ask for higher fees and stricter requirements for collateral or, worse, decline to extend a loan at all.

- **Cost**
  Small-sized loans to MSMEs also involve a higher unit cost of transaction, thereby making it unprofitable (Lagua, 2014). This is because banks still follow the same process of credit appraisal and monitoring regardless of loan size. Banks usually transfer these added costs to MSMEs through interest rates and collateral requirements, increasing the cost of a loan for the borrower (OECD/ERIA, 2018).

- **High mortality rate**
  There is also an inherent risk in lending to MSMEs particularly due to their vulnerability to market changes, limited or inadequate management capabilities, and high death rates (Lagua, 2014). Based on a study, the Philippines has the highest rate of failure or business discontinuance in ASEAN at 12.2% (Velasco et al., 2017). Banks will be reluctant to extend credit to risky businesses that are prone to loan default.

Limited financial literacy among MSMEs also hinders their opportunity to access financing

MSMEs are hesitant to reach out to banks due to limited business capacity and financial management skills to meet the loan requirements, as well as limited knowledge of alternative modes of financing (Diokno, 2019). The tedious process of applying and approving loans is also discouraging MSMEs to secure funding from lending institutions. Some MSMEs possess limited information on the sources of funds and how to access them (MSMED, 2011).

Credit infrastructure reforms still in progress

The poor credit infrastructure of the Philippines hinders lending institutions from fully assessing the risks of MSMEs. In the 2020 Doing Business report of the World Bank, the Philippines ranked 132nd out of 190 countries in terms of the strength of credit reporting systems. While the country registered a high score on depth of credit information (7 out of 8) and accessibility of credit information, it performed poorly on the strength of legal rights (1 out of 12) and the extent to which collateral laws protect the rights of borrowers and lenders. It also registered a low score on credit bureau coverage, wherein firms and individuals registered under the largest credit bureau represent only 13.5% of the adult population. This is lower than the 23.8% average in East Asia and the Pacific.

Protection from economic shocks like pandemics

Today, the need to assist MSMEs has never been more important, particularly with the massive economic and social disruption brought by the coronavirus (COVID-19) pandemic. COVID-19 has paralyzed the operations of the business sector, including MSMEs, and displaced thousands of workers in the Philippines following the lockdown policy in major urban areas nationwide. Around 53% of MSMEs in the Philippines have temporarily shut down while 12% have been operating on a limited capacity since March (Lopez, 2020). The biggest challenge during this pandemic is ensuring that the distribution of assistance is executed as quickly as possible to all affected businesses.

Conclusion and Policy Recommendations

Given their immense contribution to the economy and employment, supporting the development of MSMEs bodes well for the attainment of inclusive growth for the Philippines. It is crucial for the government to create a viable and business-friendly environment where even micro-sized firms can thrive. To do that, there is a pressing need to solve the longstanding challenge of limited access to finance among MSMEs. Bridging this finance gap could unleash the growth potential of MSMEs in the Philippines. In light of the challenges that MSMEs continue to face in accessing finance, the following policy recommendations are made:

Revisit mandatory credit allocation by banks for MSMEs

The provision on the mandatory allocation of credit resources by banks under the Magna Carta expired in June 2018. Several bills seeking its extension are currently lodged in Congress.

This is the most opportune time for the government to explore the option of either eliminating the distinction between small/micro and medium loans or outright removing the mandatory MSME lending threshold among banks. In ASEAN, only Indonesia and the Philippines have implemented mandatory lending programs, but evidence suggests that their impact has been limited (OECD/ERIA, 2018).

According to Aldaba (2012), banks prefer to pay fines instead of allotting non-income generating funds to MSMEs. In some cases, funds are channeled to large enterprises that have understated their assets to be classified as medium-sized firms. Rural banks are also finding it hard to comply due to the lack of medium-sized enterprises locally. Instead of mandatory allocation, the focus should be shifted toward building the capacity of MSMEs and expanding alternative modes of financing.

Re-channel bank penalties to improve capacity of MSMEs

From 2011 to 2016, the BSP has remitted PHP 196 million to the Bureau of Treasury from the penalties collected from banks for non-compliance to MSME Loans (Makati Business Club, 2018). Around 90% of this amount was channeled to the MSMED Council in accordance with the Magna Carta on MSMEs. The MSMED should consider allocating a good portion of these funds to technology-enabling initiatives for MSMEs to adapt and sustain operations under the current pandemic.

Raising funds through public listing

In 2018, the Philippines had a market capitalization to GDP ratio of 78%, lagging some peers in ASEAN like Singapore (188.7%), Malaysia (111%), and Thailand (99.2%). To help MSMEs, raise capital to

finance expansion, they should be encouraged and incentivized to list in the Small, Medium, and Emerging (SME) Board of the Philippine Stock Exchange (PSE). Only four companies are listed so far in the SME Board.

Presently, eligible enterprises on the SME Board need to have a minimum authorized capital of PHP 100 million, of which at least 25% is subscribed and fully paid. The government should also explore providing incentives for newly listed SMEs to entice them to make initial public offerings. For instance, Thailand reduced its corporate income tax for listed SMEs from 30% to 20% (Shinozaki, 2014). It is also crucial to relax the requirements and assist SMEs with the procedures and requirements for public listing. For instance, the SME Board requires a track record of profitable operations for the past 3 years. This requirement, however, already excludes start-up companies from joining the Board because of the absence of any track record (Mariano, 2017).

Institutionalize the P3 Program

Currently, there are bills filed in Congress seeking to institutionalize the P3 Program of the DTI and allot greater funding up to PHP 30 billion per year. Enacting the program will ensure that it receives the needed funding every year and allow continuity of the program beyond the current administration. The government can also expand the program and put more focus on bridging the financing gap of MSMEs in the Visayas and Mindanao.

Expand financing schemes to the informal sector

The government needs to ramp up the implementation of the Barangay Micro-Business Enterprise (BMBE) Law to expand financing schemes even to micro-enterprises in the informal sector. Signed in 2002, the BMBE Law has been encouraging micro-sized firms in the informal sector to register and integrate into the mainstream economy through incentives such as priority access to a special credit window for financing. Aside from conducting a wide-scale information drive, the government should also assist micro enterprises in complying with the requirements of financial institutions.

Leverage on fintech and support the industry

Harnessing financial technology (fintech) is a game-changer for expanding access to finance among MSMEs (World Economic Forum, 2015). It provides an alternative source of financing from traditional financial institutions such as banks. The Philippines is also experiencing the disruption brought by fintech. Schellhase and Garcia (2019) explained that the fintech sector in the Philippines is maturing and attracting an increasing number of users and investments in recent years.

According to DTI, the fintech sector in the Philippines has been growing by 16% per year (Mercurio, 2020). As of February 2020, there are 136 fintech companies operating in the country. Data from Startup Genome showed that the value of the fintech market in the Philippines amounted to USD 5.7 billion in 2018 and is expected to reach USD 10.5 billion by 2022.

Based on *The Philippines Fintech Report 2018*, the two most dominant fintech segments in the country are payments and alternative finance, accounting for 33% and 30% of all fintech companies, respectively (Fintechnews Singapore, 2018). These segments are followed by blockchain (16%), remittance (8%), and investments (6%).

- **Digital payments**
  The DTI should also provide technical assistance for MSMEs in adopting technological tools such as digital payments in their operations. MSMEs can increase their creditworthiness by participating actively in the digital payment ecosystem. Online transactions such as sales and payments activity can be used as alternative data that lenders can analyze to assess the ability of the firm to repay a loan (Creehan, 2019).

- **Peer-to-peer (P2P) lending**
  A P2P lending platform creates an online marketplace where investors provide loans to borrowers without going through traditional banks (Nemoto et al., 2019). Compared to banks, P2P provides more accessible funding due to simpler requirements and faster processing. In one P2P platform, MSMEs in the Philippines can get a loan within 1-3 days ranging from PHP 50,000 to PHP 2 million, subject to a 2-3% interest rate.

- **Equity-based crowdfunding**
  In equity-based crowdfunding, a company sells shares to investors who provide funding through an online platform (ASEAN Secretariat, 2017). In the Philippines, the Securities and Exchange Commission limited the amount that can be raised through crowdfunding. An issuer can sell up to PHP 10 million of securities a year to any investor, and up to PHP 50 million to qualified investors or those that are well-versed about investing.

- **Distributed ledger technologies (DLTs)**
  DLTs like blockchain involve "recording and sharing of data across multiple data stores called ledgers, which are collectively maintained and controlled by a distributed network of computer services called nodes" (World Bank, 2017). In blockchain, the ledger is created by "combining blocks of valid transactions into a chain of blocks that is shared by the entire network" (Yoshino & Taghizadeh-Hesary, 2019).
  DLTs can address financing issues of MSMEs by facilitating transparent and secure transactions even across national borders. For instance, Yoshino and Taghizadeh-Hesary (2019) argued that DLTs can expand the investor pool of the Hometown Investment Trust Fund (HITF) in Japan. The HITF is a social funding scheme which allows local investors to connect and invest with local risky projects such as energy, agriculture, fisheries, and start-ups. They argue that DLTs could make it possible for investors in other countries to extend funding to start-ups in Japan by allowing them to trace their funds and track where it is invested (Yoshino & Taghizadeh-Hesary, 2019).

A good number of fintech entities have been providing alternative finance especially under the pandemic today. Resources and loans to mobilize can also be a challenge for these entities. Currently, most government loan assistance programs are channeled through GFIs and BSP accredited financial institutions. Government should also explore a means to support the fintech entities that are providing alternative finance by possibly establishing a special fund that fintech entities can tap on to continue lending to MSMEs.

Financial and technological literacy campaign

The government needs to embark on a coordinated national campaign, with the help of *Go Negosyo Centers*, focusing on two areas: (1) financial literacy and man-

agement; and (2) technological literacy with a focus on adopting digital tools such as cloud-based systems and online payment applications.

More than access to finance, MSMEs also need to learn how to efficiently allocate funds for their day-to-day expenses and expansion plans. The financial literacy campaign should also cover existing alternative financing schemes and their application processes. Currently, the government is enhancing its financial literacy program for beneficiaries of the *Pantawid Pamilyang Pilipino* Program (4Ps), the government's conditional cash transfer program.

Strengthen credit infrastructure

The government needs to fast-track the full implementation of its credit infrastructure reforms for MSMEs to help lending institutions lessen their dependence on real property as collateral. Both the creation of a central repository of credit information and central repository for movable assets held as collateral can facilitate alternative lending for MSMEs. These repositories can complement the risk management tools of financial institutions and increase their confidence in lending by empowering them to make more informed decisions. MSMEs can bank on both good credit history and movable assets to access alternative finance. More specifically, the full operationalization of the Personal Property Security Act can open up more options for MSME financing like wide utilization of receivables financing and even intellectual property as collateral.

Another game changer that hopefully will find its way in the legislative priorities is the Warehouse Receipts bill. This bill seeks to modernize the current Warehouse Receipts law of 1912. The passage of this bill can raise integrity and confidence in warehouse receipts financing so that farmers or MSMEs can use warehouse receipts as collateral. Warehouse receipts will be vouched for by an accredited warehouse that can attest to the quality and quantity of goods stored in their warehouses. The updated law can increase the confidence of financial institutions to take on warehouse receipts as collateral. This bill is a much-needed law that can address the many challenges posed by the pandemic like food security, farm to market logistics and access to finance. Currently, the bill is in Congress for deliberation.

Protecting MSMEs during pandemics

The government is preparing different interventions that would provide financial and technical assistance to MSMEs amid the COVID-19 outbreak. These include the extension of at least PHP 1.2 billion worth of loans and livelihood assistance to affected MSMEs and creation of a PHP 51 billion wage subsidy program. The BSP also allowed banks to recognize MSME loans as part of their compliance with the reserve requirement ratios, thereby freeing as much as PHP 360 billion for lending (Agcaoili, 2020). This measure will be applied from April 24, 2020 to December 30, 2021.

What is most crucial, however, is to remove as much bureaucratic red tape as possible in accessing and disbursing the loans and subsidies, and to target the most affected sectors of MSMEs, including those that are critical in the supply chain for basic necessities. Improving businesses processes is crucial to increase reach in MSMEs, and this can be done through technology. For example, as simple as providing an option for online submission of requirements should be prioritized. Furthermore, the government needs to ensure nationwide dissemination of information on government assistance programs and how to access them to ensure that it reaches even the remote areas in the country.

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Margarito "Gary" Teves is an economist who served as the Philippine Secretary of Finance from 2005 to 2010. He was awarded "2009 Finance Minister of the Year for Asia" by the London-based The Banker Magazine. Previously, he was the President and CEO of the Land Bank of the Philippines (2000-2005) and served three consecutive terms (1987-1998) as Congressman of the 3rd District of Negros Oriental in the Philippine House of Representatives. He is currently the Managing Director of the Wallace Business Forum and recently served as a consultant to the International Finance Corporation's financial inclusion projects in the Philippines.

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Gay held various positions in the World Bank Group for over 25 years. She worked in Investment and Portfolio Management and Credit Operations, Operational Risks and Advisory Services. She conceptualized and designed IT systems as well and authored the Operational Procedures of the International Finance Corporation of the World Bank Group. In her last role at the International Finance Corporation (IFC), Gay was a Senior Financial Sector Specialist and led the Financial Infrastructure/Inclusion program of the IFC of the World Bank Group in the Philippines. She led the engagement with the Government and private sector on the Secured Transactions Reform and the passage of the Republic Act 11057 - the Personal Property Security Act (a law that seeks to broaden the use of movable assets as collateral for MSMEs) which was passed in August 2018. This was among the fastest moving bills in the Philippines' legislative history.

As a financial inclusion advocate, Gay wears many hats today. Gay is currently the Executive Director of Fintech AlliancePH, Chair of the Financial Inclusion Committee of the Financial Executives Institute of the Philippines and Trustee of the Institution for Growth, National Integration, Transformation and Empowerment (IGNITE). She also provides technical advice to developmental projects like enhancing/developing the financial literacy program of the Pantawid Pamilyang Pilipino Program (Conditional Cash Transfer Program of the Philippines and MSME Access to Finance on USAID projects through Chemonics International) and serves as Senior Advisor for a number of fintech entities. She holds a Master's degree in Business Administration from the Johns Hopkins University, a Certificate in Internal Audit from George Mason University and Six Sigma Certificate from George Washington University.

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An Ecosystem Approach to Financing SMEs in Singapore

Introduction

In today's challenging times, especially for a small and open economy like Singapore, an article looking at how the financing needs of small and medium-sized enterprises (SMEs) will change over their business life cycles is timely. As a start, we will paint the landscape of why SMEs matter to Singapore's growth, not just over the past decades, but even more so, going forward. In addition, we will examine what some of the key post-pandemic challenges faced by many of the SMEs are before proceeding to identify the common financing options currently adopted by SMEs. In the recent five years, both capital availability and financing options have taken many forms, ranging from venture investment, private equity and buyouts to peer-to-peer lending to ensure that SMEs are not handicapped in their ability to seek growth capital. In fact, the way forward is getting even more exciting, with SMEs having access not just to private capital and government financing but also via the set-up of private exchange and alternative family business-based sources of financing with mentoring.

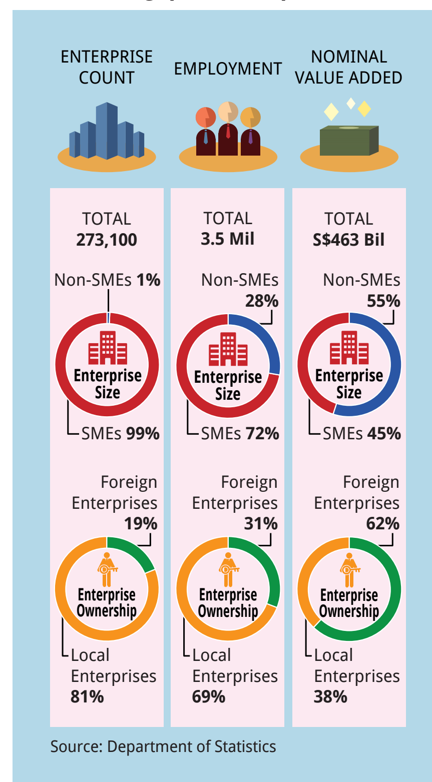
A Brief Overview of the SME Landscape and Challenges

The early history of Singapore growth was powered predominantly by an export-led strategy driven by large multinational companies (MNCs). In the 1970s and 1980s, through creating clusters in industries such as electronics, transport and machinery, the government promoted inter-firm linkages, and SMEs played a supporting role to MNCs as subcontractors. In 1987, SMEs contributed 90% of the total number of establishments, generated 44% of employment and contributed to 24% of value added (SME Master Plan, 1989).

The first active push to entrepreneurship and small enterprises in policy making came with the publication of the Economic Review Committee (ERC) report in 2003 in the aftermath of the Asian financial crisis. The report called for developing Singapore into a creative entrepreneurial nation where locally competitive SMEs co-exist with larger MNCs. This was followed by the Economic Strategies Committee (ESC) report in 2010 and the report of the Committee on the Future Economy (CFE) in 2017, urging the economy to move further towards knowledge-based and innovation-driven activities.

Fast forward to today when 99% of 273,100 Singapore enterprises are SMEs, and they contributed nearly half of nominal value added while employing 72% of the workforce in 2019 (Figure 1). In 2014,

Figure 1: Number, Employment and Value Added of Singapore Enterprises in 2019



the Ministry of Trade and Industry (MTI) updated the definition of an SME to include enterprises having at least 30% local shareholding, in addition to having annual sales turnover under SGD 100 million and employing fewer than 200 employees.

Key Challenges Faced by SMEs Post COVID-19 Pandemic

Many studies and reports have identified the challenges faced by SMEs over the economic cycles that Singapore experienced in the past 55 years of the country's independence. However, the authors believe that those challenges pale in comparison to what the SMEs are currently facing post-pandemic. While the impact of Covid-19 is felt across the full range of SMEs, like in the United States, smaller businesses and businesses that rely especially on retail foot traffic have been disproportionately affected. In addition, Singapore, being relatively open to trade and tourism, is finding that SMEs which are heavily dependent on the travel and hospitality industry are struggling to survive, let alone thrive. Current challenges include the following:

Finance-related problems

Poor management of financial and human resources was often the main source of the problem in many troubled SMEs in the past. Now, with the wider choices of SMEs in Singapore (both online and off-line) than previously, customers have become more discerning, resulting in stiffer competition. These customers often stockpile debts with the smaller SMEs in particular and threaten to end their patronage if the business should insist on repayment. Under such conditions, many small businesses find it impossible to meet their obligations with their suppliers and as a result, undesired friction and broken business relationships arise. As such, cash flow management has become an important imperative for survival, and, as we discuss later, choices such as supply chain financing or invoice financing have taken on greater utility and attractiveness.

Labor inadequacy and rising operating costs

Like other national markets, manpower appears to be in short supply in Singapore. Coupled with higher rentals and rising wage demands, SMEs often have to bear the brunt. For the past 20 years, many jobs in the food and beverage, construction and retail sectors have been manned by foreign labor. Covid-19 is a good wake up call for many SMEs, and beyond short term cost management, their medium to long term challenge is to leverage more on technology and reduce dependence on foreign labor.

Absence of an entrepreneurial mindset (in general) and failure to embrace technology

Many of the SMEs in Singapore appear to be living in the past, following archaic business models and able to keep afloat because there is growth all around the region. While the rest of the world is going digital at a fast pace, many SMEs in Singapore have retained business as usual practices or lagged behind in terms of technology adoption to help their trade. With the digitization of business, failure to embrace technology and its accompanying tools is considered entrepreneurial suicide. Many SMEs in Singapore that are culpable have complained of the lack of resources and manpower required to sustain, not to mention grow, their businesses. Interestingly, Covid-19 may have accelerated a change in mindset, and we are seeing some attempts to change business models, adopt technology, diversify demand, including target markets and leverage on partnerships to stay afloat. We discuss one such encouraging case in a later section of the article.

Stiff competition

SMEs are considered the driving force of the Singapore economy. The Singapore government has introduced targeted policies to support SMEs. However, many of the policies are also aimed at helping startups grow and thrive, especially in the fintech area, including incubating foreign ones. These startups are becoming even more rampant, and many of the new entries have the singular objective to dislodge existing competitors using distinct strategies and have a more regional outlook than traditional, incumbent players. With the dawn of the digital era, a myriad of options is now opened to consumers, leaving many small (and traditional) businesses struggling to survive.

Economic downturn and pandemic impact

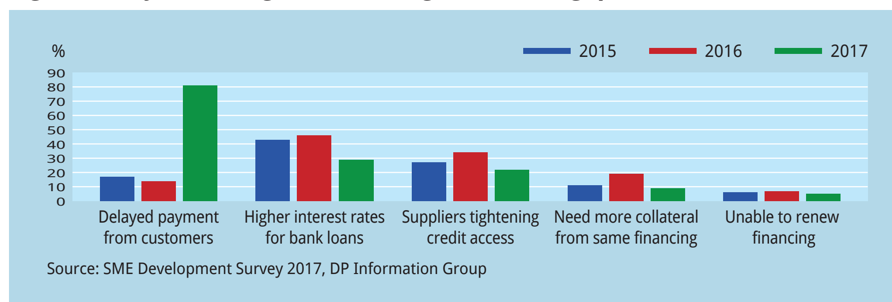
One of the expected repercussions of the impending economic downturn is the dwindling cash flow available to SMEs in the wake of the pandemic. To stay afloat under such crippling conditions, small and medium-sized businesses will have to think outside the box to get ahead of the pack. Although this article is about financing options available to SMEs, other enabling drivers beyond financing are needed to help SMEs thrive and become the engine of growth they are meant to be for the Singapore economy.

Traditional Financing Options Available to SMEs

Having reliable cash flow and working capital is crucial to sustain financially strapped SMEs. The small size of SMEs often implies that they are unable to benefit from economies of scale to reduce both their operational and compliance costs. SMEs not only face difficulty in raising funds, they also have limited ability to pass on these costs to their customers.

The SME Development Survey 2017 found that 35% of companies surveyed faced financing issues, up 13% year-on-year, and at the highest level since the survey began tracking this challenge in 2011. Among the financing issues SMEs faced, all categories showed improving trends with the exception of delayed payment from customers, which increased nearly six times from 14% in 2016 to 81% in 2017 (Figure 2).

Figure 2: Key Financing Issues Facing SMEs in Singapore



Source: SME Development Survey 2017, DP Information Group

Delayed payments can create ripple effects affecting the cash flow position of the SME community; when a debtor company delays payment, the creditor company may also slow down its payments to other companies in the supply chain. The proportion of SMEs making losses has also increased to 21%. Of the profitable SMEs, 42% have thin margins of 0 to 5%. We believe the financing situation worsened for many SMEs in the first six months of the Covid-19 pandemic since the start of 2020.

Bank financing

As such, it is not surprising that when asked about their sources of financing, only 6 in 10 SMEs in Singapore answer they are financed by bank loans and facilities. The remaining 4 in 10 do not have banking support. SMEs are not well established and may not have a stable outlook. As a result, given their lower risk appetite, financial institutions are less willing to lend to SMEs and support small business lending. In fact, the lack of SME cash flow visibility and credit information for small and medium-sized businesses increases the cost of credit risk assessment by financial institutions and makes it less attractive for them to service certain segments of the SME market. As a result, financial institutions are placing more emphasis on collateral requirements when assessing SME credit risk. However, SMEs are often unable to supply such collateral, leading to rejection of their loan applications. Therefore, SMEs have to resort to alternative funding options when they are unable to secure financing from banks. The government in Singapore has made a number of grants available for SMEs through different government agencies. We will showcase several such schemes in the section that follows and include a case study of one SME tapping on the government ecosystem for holistic support.

The Singapore government has launched a series of financial schemes to aid SMEs with their finances and these are administered by Enterprise Singapore (ESG). Here is a summary of the various loan-related schemes:

- **Temporary Bridging Loan Programme**
  - Introduced in 2020 to help SMEs deal with Covid-19's impact
  - Maximum funding of up to SGD 5 million
  - Repayment period up to 5 years
- **SME Working Capital Loan**
  - For local SMEs with group turnover less than SGD 100 million or group employment under 200
  - Maximum funding up to SGD 300,000
  - Repayment period up to 5 years
- **SME Equipment and Factory Loans**
  - For automating or upgrading equipment or purchasing government premises
  - Maximum funding up to SGD 15 million
- **Loan Insurance Scheme (LIS)**
  - Credit insurance for SMEs to obtain trade finance facilities from financial institutions
  - A portion of the credit insurance is supported by Enterprise Singapore
  - Financing of inventory, receivables discounting and pre-delivery working capital

What matters to many SMEs is not just the availability of government financing options, but rather grants which can help them cushion costs of innovation and investing in training or help SMEs transform over the life cycle of the business. We describe the case of Commune Lifestyle as an example:

The Singapore Furniture Industries Council (SFIC) in March 2018 unveiled its 2021 Furniture Industry Roadmap which outlined strategic directions for the sector's competitiveness and long-term growth. The new roadmap sought to transform the industry by encouraging local companies to adopt new business models that leverage on technology, innovation and design to broaden their knowledge, skillsets and value chains instead of relying on traditional business concepts and supply chains. One of the goals was for Singapore to become the Asian hub to influence tomorrow's urban living by 2021 (2021 Singapore Furniture Industry Roadmap Press Release, 2018).

A company which rose to this challenge was Commune Lifestyle Pte Ltd. Commune is Singapore's home-grown furniture design and lifestyle company and aspires to become more than just a furniture showroom. Commune is in many ways a forerunner in transforming the landscape of furniture design. Commune was born out of a design thinking project funded by SPRING Singapore (an agency under the Ministry of Trade and Industry responsible for helping Singapore enterprises grow and building trust in Singapore products and services).

Commune had been proactive in tapping government funding in various forms to constantly innovate its business models and to support its overseas expansion. Some of the projects that Commune has undertaken with government funding include:

- **Franchise Development Programme (funded by SPRING under Capability Development Grant (CDG))**
  Together with the help of consultants to develop a franchising package, Commune was able to scale its business internationally using the franchise model.
- **Customer Centric Initiative (funded by SPRING under the Customer-Centric Initiative)**
  Working closely with the consultants, Commune was able to understand how to create better experiences for its customers.
- **3D Floorplanner/ VR Project (funded by SPRING under CDG)**
  Working with another government agency, A*Star and its startup, Commune co-developed this solution to provide its customers with a first-of-its-kind experience through better visualization of their living space to support customer confidence in decision making.
- **E-Learning Project (funded by SPRING under CDG)**
  Commune was able to provide training more effectively across its network of stores through the development of an E-Learning Programme for employees.
- **Omni-Channel Project (funded by ESG under Enterprise Development Grant)**
  An omni-channel platform that linked Commune's online and in-store systems for a seamless customer journey was developed. Using an AR app, customers are able to view Commune's products in their living spaces on a mobile device. An iPad-based point-of-sale system that was developed, allows its in-store sales team to access a customer's in-

formation from online shopping or to apply in-store shopping information to online purchases.

- **New market expansion (funded by International Enterprise/ ESG under International Marketing Activities Programme/ Market Readiness Assistance)**
  The funding supported Commune's participation in international trade fairs and business missions and its engagement of consultants for market research.

Not letting Covid-19 hamper its business, Commune promptly identified gaps in its customers' digital experience and is currently revamping its online store to include more content. As e-commerce alone would not be the main form of business due to Commune's price point, a good online platform will help customers decide whether a trip to the physical store is necessary.

The example of Commune illustrates how SMEs can utilize a variety of government grants to help them innovate and scale beside tapping on government financing to meet their cash flow needs. Moreover, SMEs should keep in mind that government financing is often part of the total finances needed. In addition to bank loans and government financing, two other funding options which have gained some traction in recent years are invoice financing and crowdfunding. We will include these together with other examples of how SMEs are using various non-traditional options like Platform-based "Marketplace" or Specialized SME Exchange (like CapBridge Financial), and Business Ecosystem funding, to seek additional financing and unlock their cash flows.

Alternative Financing Options to Unlock Cash Flows

The lack of access to affordable and available funding can lead to more credit erosion for SMEs, trapping them in a downward spiral. Fortunately, SMEs can turn to various alternative funding options when they are unable to secure financing from banks. In order to remain sustainable during times when it is challenging to obtain bank financing, alternative channels of financing and funding, including those which are tech- or platform-related, have emerged in the last few years to address this demand. These alternative funding options include the following:

Invoice financing (including e-invoice financing)

Invoice financing, also known as invoice trading, is a short-term alternative solution which allows firms to draw down cash against outstanding receipts due from customers. By allowing SMEs to get an advance on funds for which they have already invoiced their customers, this funding option helps the SMEs improve their cash flow so that they can continue to cover their business expenses and pay suppliers and employees. In general, an SME pays a percentage of the invoice amount to the lender as a borrowing fee and can access 70% to 90% of the funds due upfront. Invoice financing appeals particularly to SMEs which do not have a long credit history or substantial assets to serve as collateral for traditional financing through a bank. What's more, it can take months to get the credit assessments and loan approvals for bank financing.

Ecosystem platform-based "marketplace" financing

Closely related to the invoice financing model is the channel by which online marketplaces such as Lazada and Zeemart capitalise on E-invoicing processes to arrange financing through tie-ups with their banking and venture funding partners. As E-invoicing enhances transparency and efficiency of the invoice processing, it removes manual invoice processing costs, decreases the time needed to send and receive transaction information, and reduces exposure to risks historically associated with manual processes, such as fraud. Hence, this platform technology has allowed factoring and reverse factoring businesses to dramatically decrease approval and processing times, a key benefit for SMEs with imminent liquidity needs. As a result of the reduction in transaction costs, digital invoice financiers are able to serve SMEs which are typically deemed too small and unprofitable for traditional factoring entities. Overall, invoice and E-invoice financing can potentially solve problems associated with overdue payments by customers and difficulties in obtaining other types of business credit. In addition, this source of alternative funding can definitely help businesses improve their cash flow.

Dedicated investment platforms have also been established in the last few years, tying up with banks (including digital ones) to help SMEs and larger corporate firms raise private capital via their investment platforms or affiliated private exchanges, e.g., 1exchange (1X). Such online capital raising platforms enable investors to efficiently access promising private companies, while providing orderly and transparent exit options (other than the traditional Initial Public Offering) for investors in these private companies. CapBridge Financial's ecosystem exchange fund-raising model is an illustrative case of this funding option:

CapBridge Financial

CapBridge Financial (CapBridge) provides private market solutions that help companies and investors unlock value via a uniquely integrated primary syndication and secondary trading approach. Based in global financial hub Singapore, CapBridge is regulated by the Monetary Authority of Singapore. The CapBridge primary syndication online platform holds a Capital Markets Services Licence (CMSL), while Singapore's first regulated private securities exchange, 1X, holds a Recognised Market Operator licence to facilitate secondary trading.

CapBridge works with late-stage growth or pre-Initial Public Offering private companies seeking growth or expansion capital. The online platform intelligently seeks and matches companies with private capital and facilitates the entire capital raising process with technology. Private investors on CapBridge gain access to institutional grade private opportunities, previously limited to large institutional investors. CapBridge also deploys the lead and co-lead business model to ensure institutional grade transactions. With CapBridge, companies and investors interact in a seamless, safe, and secure online environment.

CapBridge also owns Singapore's first regulated private securities exchange 1X. Widely regarded as the third board in Singapore, 1X is a "light- touch", cost- effective, and fully digital private securities exchange designed specifically for family owned businesses, growth and pre-IPO businesses. 1X is built on the blockchain and features state of the art security and robust online processes, providing a secure online trading experience for all participants. Market-oriented solutions such as direct private listings and trading of employee share options are facilitated via

fully online processes, providing growth companies, founders, and business owners optimal options for partial exits while retaining flexibility and control. Private equity investors on 1X can securely and freely trade in and out of their private positions to achieve liquidity anytime, anywhere via fully online trading functions.

CapBridge is backed by Singapore Exchange, South Korea-based Hanwha Investment and Securities Co., Singapore government-owned SGInnovate, and HKSAR government-backed Hong Kong Cyberport (Figure 3).

Crowdfunding

Crowdfunding is a form of alternative financing that pools small amounts of capital from many individuals to fund a project or business venture. Entrepreneurs can pitch their business ideas on crowdfunding forums or platforms, and investors will then chip in a small amount to ideas which sparked their interest. Success depends on a sound creative idea and also a thorough understanding of online campaigns. While the advantages of raising money through crowdfunding are obvious – the outside possibility of obtaining full financing, complete control of these finances in most cases, using it to supplement existing financing, little or no money required to float a crowdfunding programme – it is also a very uncertain method of raising finance. The number of required investors tends to be large and funding amounts skewed towards the low end for many campaigns.

Peer-to-Peer lending platform

Another method of crowdfunding is peer-to-peer lending which is a relatively new online lending concept. Peer-to-peer lending platforms are online sites where individuals or small businesses can lend to one another. The advantage for the investor is a potentially higher return on savings and for the SME a lower interest rate. Interestingly, Funding Societies, an SME digital financing platform in South East Asia ended 2019 by crossing the SGD 1 billion mark in SME loans across its three markets in Singapore, Malaysia and Indonesia. They attributed the growth in SME loans with Funding Societies as reflective of the increasing openness amongst businesses towards new generation funding options.

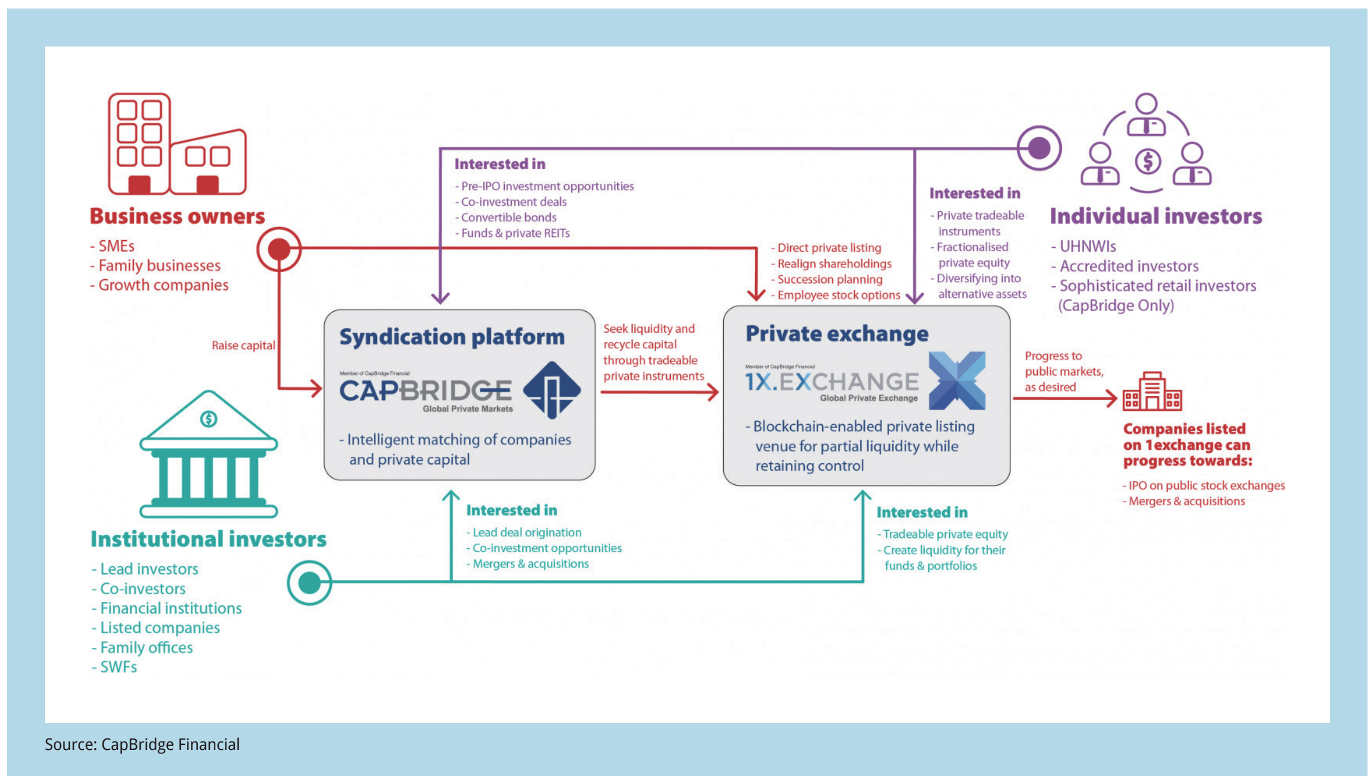
Business ecosystem funding

The business models of some investment funds, conglomerates and family businesses have continued to evolve with the times. Some funds and conglomerates like the global trading houses (e.g., Cargill), Temasek and GIC, have been investing or financing venture companies and SMEs in their supply-demand chain ecosystem as well. They often invest in their suppliers or provide supply-chain financing as these entities constitute an integral part of their business eco-system, while at the same time, often provide growth and diversification opportunities as well. These funds, conglomerates, and family businesses, especially, have also started to invest in SMEs and start-up companies with new products, technologies, or business processes that would add value to their existing businesses. Funding the SMEs in their business ecosystem helps ensure the sustainability and resilience of their own core businesses as well.

Conclusion and the Way Forward

The main aim of this article is to provide readers with a comprehensive view and

Figure 3: Value Proposition of CapBridge Financial Private Markets Integrated Ecosystem



Source: CapBridge Financial

understanding of the financing and funding landscape for SMEs in Singapore. In particular, we showcase those options which are closely aligned to the government's initiatives and objectives to enhance Singapore's status as a financial and economic hub. Very often in association with private sector partners with industry-specific target markets in mind, some of these financing and funding channels are innovative in helping transform SME business models and industry sectors, going beyond the normal "one size fits all" SME financing approach.

We have observed that these funding mechanisms are meant not merely to support and help SMEs in managing their sustainability and liquidity risks but are often tied to the government's objectives in industry transformation, innovation and internationalisation, so that the focus is also to motivate positive change. In addition, we hope we have provided some useful insights into how the approach to financing SMEs in Singapore will continue to evolve in a more innovative fashion. In fact, more change is expected going forward with the impending announcement of five digital banking licenses to be awarded towards the end of 2020. We believe this ecosystem approach to SME financing will be the catalyst in helping our SMEs transform their businesses, leveraging on trust forged with government and partners, embracing technology to build greater efficiency and transparency and garnering talent to build resilience and sustainability. The SME financing space in Singapore is definitely well worth watching.

Acknowledgements

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BUSINESS FAMILIES INSTITUTE @ SINGAPORE MANAGEMENT UNIVERSITY

Since 2010, the Singapore Management University (SMU) has recognised the emergence of Asian business families and discerned that they require specifically contextualised thought leadership and applied knowledge. In response to the growing needs of business families in Asia, SMU established the Business Families Institute (BFI) in August 2012. BFI@SMU collaborates with various partners, academic or practice, to be a leader in Asian business family-related knowledge. The Institute also encourages business families to Think Generations, Think Growth, Think Giving and Think Global. In doing so, BFI@SMU addresses business family-specific issues such as succession, family governance, entrepreneurship and wealth management. The mission of BFI@SMU is to enable business family members to be engaged and responsible stewards of their families, businesses and communities, through education, research and ecosystem support.

MONGKON LEELATHAM

Government Savings Bank

Raising of Growth Capital by SMEs and Startups in Thailand

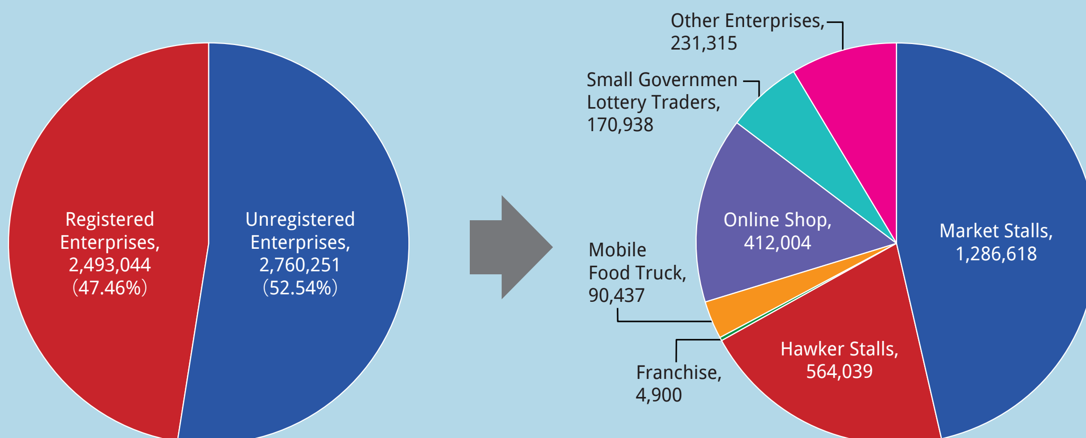
Overview of SMEs in Thailand

Based on data from the Office of Small and Medium Enterprises Promotion (OSMEP), the total number of Small and Medium Enterprises (SMEs) in Thailand at the end of 2018 was 3,077,822. Of these, 23.03% or 708,883 enterprises were classified as Juristic Persons, 2.70% or 83,208 were Community Enterprises, and 74.26% or 2,285,731 were classified as Persons/Others.

Classified by industry, the trade sector accounts for 41.57% or 1,279,557, the service sector accounts for 39.79% or 1,206,763, manufacturing accounts for 17.14% or 527,485 and agri-business accounts for 1.5% or 46,217.

A joint survey conducted by the SME Development Bank (SME Bank) and the Thai Chamber of Commerce University (UTCC) found 5,253,295 Thai SMEs, including both registered and unregistered enterprises. The difference between OSMEP and UTCC is OSMEP only includes SMES with a physical location however UTCC includes services and a lot of the informal sector such as taxis. Figure 1 shows the distribution by type of enterprise.

Figure 1: Number of SMEs by UTCC Survey



Source: The Center of Economic and Business Forecasting, UTCC Published on June 29, 2018

Financing of SMEs

The problem of financial access for Thai SMEs is the financial gap, or the difference between the demand for funds by SMEs and the supply of funds in the financial market. Access to finance is frequently identified as a critical barrier to their growth. Fiscal Policy Office data indicate 1.5 million SMEs cannot access credit (Figure 2) and the UTCC survey data cited above indicated 2.7 million SMEs are unregistered.

The financial gap for SMEs is attributed to a number of factors including their inadequate collateral, strict government rules and regulations, their lack of business experience and understanding of modern business management, their unreliable accounting systems, and their low technological capabilities.

To alleviate the financial constraints facing SMEs, the government provides various support programs including encouraging banks to provide more SME lending via soft loans, providing more financial assistance and offering entrepreneurship development guidelines. Figure 3 summarizes the government's promotional programs and entrepreneurship development guidelines.

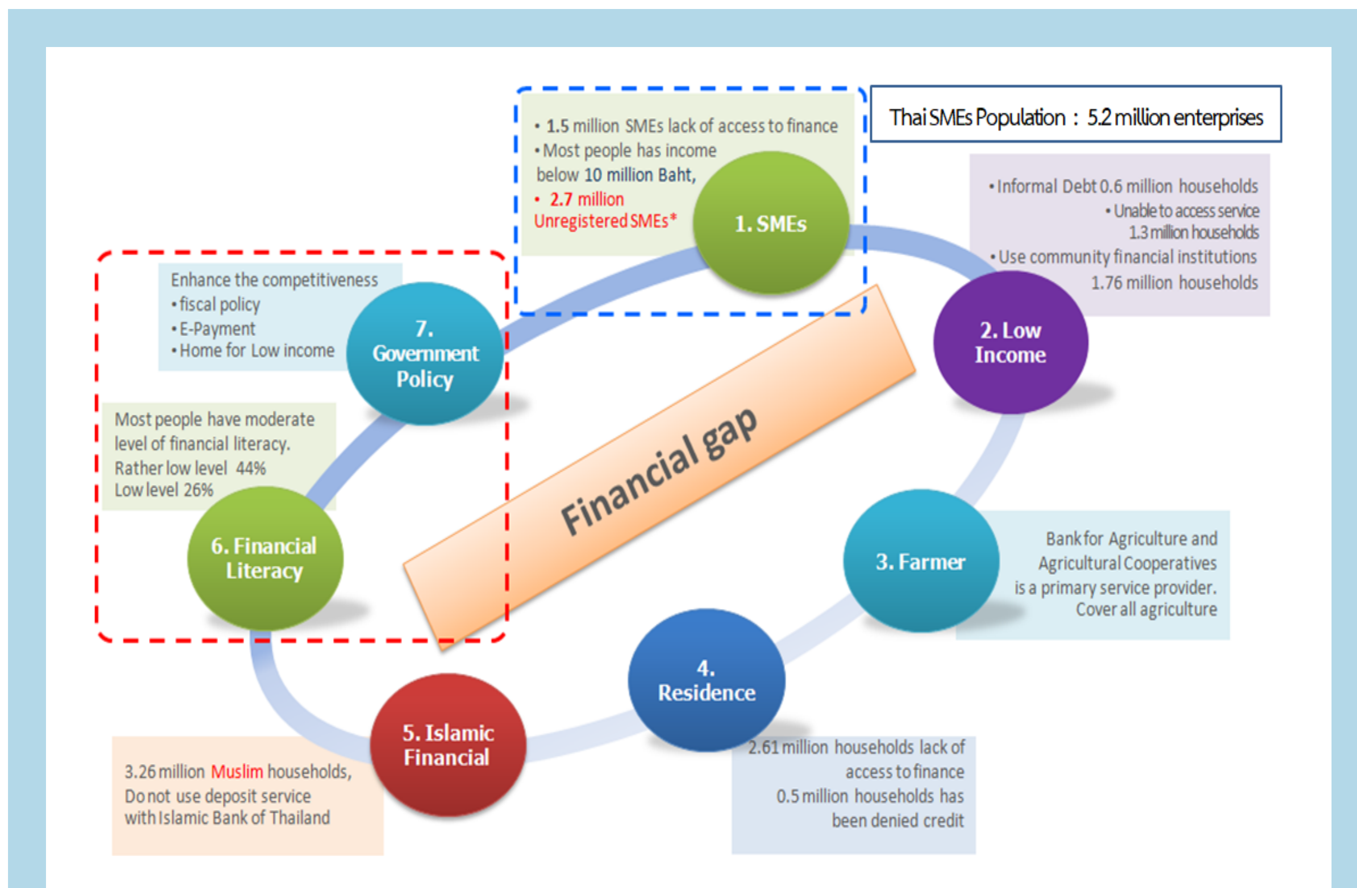
Role of the Government in Promoting Financial Access for SMEs

The government has played an important supporting role in the development of SMEs from the past up to the present day by adopting policies and measures to promote and support small and medium-sized businesses. These policies address almost all aspects of their operations from finance to marketing, technology, innovation, management, and adjustment of laws and taxes based on cooperation between the state and the private sector.

SME development policies

Before 2000, Thailand did not have a basic law on SMEs that could give coordinated and explicit guidelines for their promotion and long-term development. Since the financial crisis in 1997, SMEs have become one of the main engines for sustainable economic growth. Between 1999 and 2000, the government enacted the Small and Medium Enterprises Promotion Act 2000 and established a Board of SME Promotion, a Market for Alternative Investment (MAI) to create new fund-raising opportunities for SMEs, and an SME Venture Capital Fund as well as recapitalized the

Figure 2: Financial Gap for Thai SMEs



Source : Fiscal Policy Office (FPO)

Small Industry Credit Guarantee Corporation. Over the next four years, the government established the OSMEP, the SME Bank, the Assets Capitalization Bureau and more venture capital funds. It also brainstormed strategies for SME development, set and implemented a national plan for SMEs Promotion (2002-2006), and took steps to create an entrepreneur society and to solve existing problems and expand the roles of several government agencies. Since 2004, the Thai government has focused on medium to long term plans, promoting sustainable development, gradually shifted from an authoritative to a more supportive role, and emphasized coordination between businesses and clustering systems especially for strategic sectors.

Financial assistance programs

Over the past three decades the government has introduced a variety of financing initiatives targeted to specific needs of SMEs. To solve their credit access problem it 1) set up (2002) the SME Bank as a specialized financial institution to provide financial support and promote new SMEs; 2) set up (1991) the Small Business Credit Guarantee Corporation (SBCG) to provide credit insurance to SMEs with business potential and inadequate or no collateral and to extend cooperation with commercial banks; and 3) established the Central Credit Information Service Company and the Thai Credit Bureau Company to collect information and facilitate information sharing for SMEs. To address the need for equity funding the government undertook two main initiatives: establishing the MAI in 1999 to provide an alternative for investors as well as funding for SMEs and set up the Venture Capital Fund (THB5 billion, USD12 million) in 2003 to look for investors to take a share in potential SMEs and help improve their capability and efficiency.

In 2017 under the Startup Policy, the government classified startups as distinct from SMEs. Startups are technology-driven businesses and as such they need a comprehensive ecosystem to transform their unique ideas into operating businesses. After only three years of development, startups have been proliferating and the government acknowledges that it is essential to push them to develop further to achieve the country's mission to be the startup hub of Asia.

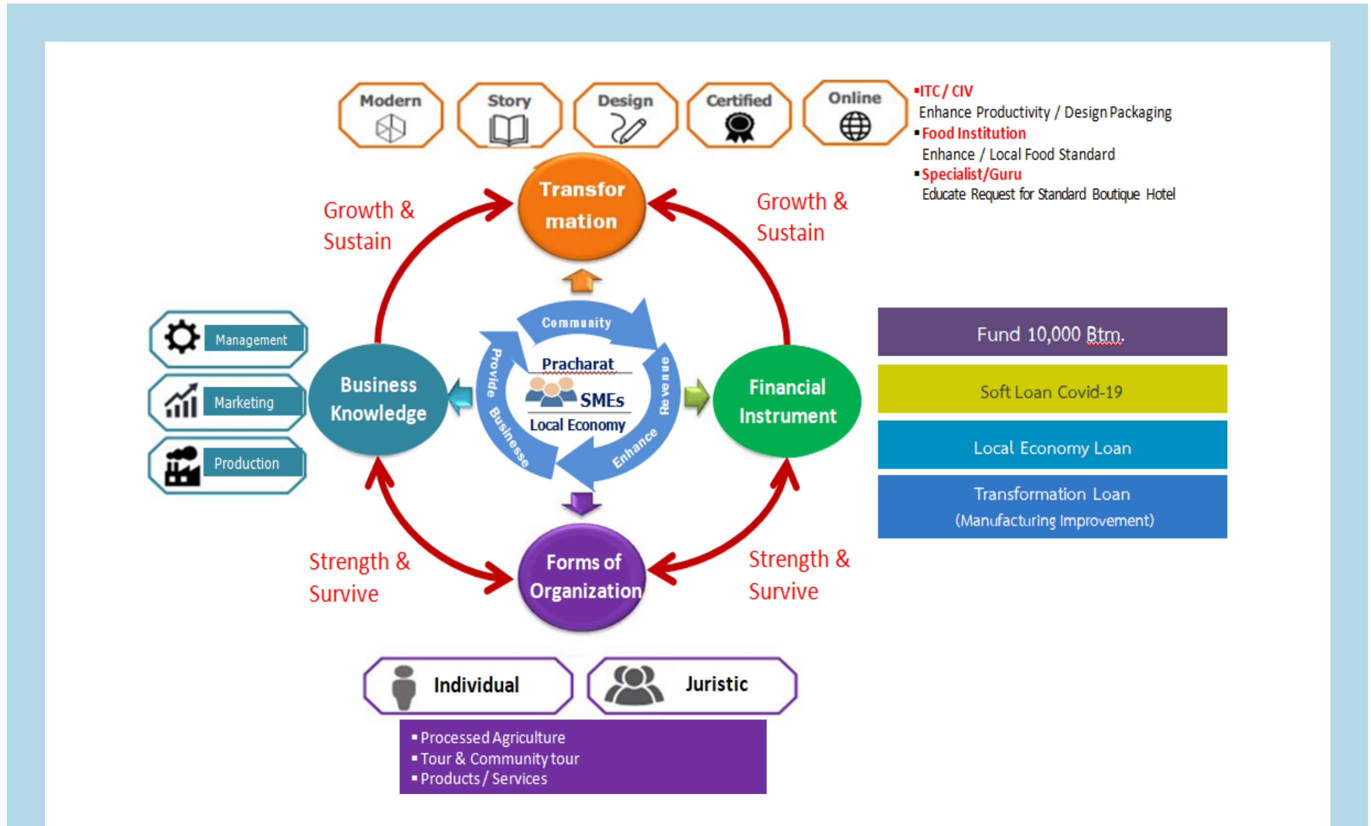
Alternative Finance

Financial access is essential for the growth of SMEs and startups. Alternative financing can fill the financial gap for small and new enterprises that are not able to access loans from commercial banks. With the operations of SMEs and startups depending on a diverse range of knowledge, innovation and networking, the demand is increasing for new sources of funding that meet the requirements of their current business models.

Venture Capital (VC)

VC is a form of private financing provided by VC firms or funds to startup,

Figure 3: Government Programs and Entrepreneurship Development Guidelines Promoting SMEs



Source: Created by the author with various sources

early-stage, and emerging companies with high potential or demonstrated growth in exchange for equity or an ownership stake. Typically, VC investors exit through initial public offerings (IPOs) or mergers and acquisitions.

Venture capitalists take on the risk of financing startups in hopes that some will become successful, but, because startups are commonly centered around innovation and new technology they face high uncertainty, and VC investments have high rates of failure. For SMEs, VC financing offers the opportunity for expansion, valuable guidance and expertise, help in building networks and connections, and no repayment obligations. On the other hand, with VC financing the entrepreneur's ownership and control are diluted, the business might require a high return on investment, and it might be undervalued.

In Thailand, there are generally four types of VC: investors, venture companies (VC Funds), venture capital management companies and SMEs.

VC financing was introduced in Thailand in 1987 when Business Venture Promotion Co., Ltd. was formed by a joint venture between six commercial banks and the United States Agency for International Development (USAID). Its purpose is to provide an alternative source of funding to support the expansion of SMEs and to encourage them to become the foundation of Thailand's economy.

Since its introduction, VC financing has not received adequate attention from entrepreneurs or SMEs due to the lack of awareness and the stigma behind bank funding. In addition, the regulations on VC are inflexible, making investing in startup businesses difficult. Venture capitalists refrained from investing in startups due to their small size, unattractive return on investment and high risk, and they mostly invested in growing businesses that already had a track record and required accelerated growth.

Aware of the potential growth in VC-financed businesses and wanting to support SMEs lacking financing, the Ministry of Finance advocated establishing VC funds. A cabinet resolution approved the establishment of the SME Venture Capital Fund (SMEVC), the Thailand Equity Fund (TEF), the Thai Recovery Fund (TRF), the Tsunami Thailand Recovery Fund, and the VC Fund by SME Development Bank (SME Bank).

Corporate venture capital (CVC) in Thailand started in 2012 and has developed in three stages. It started with companies in the telecommunications industry, such as InVent, Dtac Accelerate and True Ventures, which are in the innovative fields of technology and digital business. In the second stage, starting in 2016 as technology played a greater role in financial businesses, financial companies began to set up corporate VC arms primarily focused on investing in FinTech startups. These ventures included Digital Ventures (by Siam Commercial Bank, SCB), Beacon VC (by Kasikorn Bank), Bualuang Ventures (by Bangkok Bank) and Krungsri Finovate (by Bank of Ayudhya). The third stage of CVC evolution began during 2017 when several non-financial businesses became more interested in investing in startups. Such companies as Siam Cement Group (SCG), in construction materials, Sansiri and Ananda, in real estate, PTT, in the energy sector, and MithrPhol, in sugar production, focus on investing and advancing innovations. Some companies also invest in other businesses for self-interest.

Overall, these CVCs are more diverse and have more monetary resources. Digital Ventures of SCB has already invested USD100 million (about THB3.3 billion). On September 8, 2015, the Cabinet approved measures to support startups through a joint investment/venture fund of THB2 billion with Government Savings Banks (GSB), SME Bank and Krung Thai Bank Public Company Limited (KTB). Altogether the fund had a total of THB6 billion to invest in high potential startups that would significantly contribute to the nation's economic growth. At the end of 2019, the GSB has jointly invested THB429.9 million in 20 SMEs and between 2015 and 2019, SME Bank invested a total of THB219 million in 10 SMEs.

VC investors often face a number of problems and obstacles including a lack of business potential, a lack of knowledge about VC financing, and the failure of SMEs to comply with the agreement especially in the preparation of financial statements and the adjustment of accounting standards.

In the funding process, there are also several domestic and international private equity firms in the public and private sector that provide funds to SMEs. A lack of strict accounting standards and few auditors affect the due diligence process.

Startup businesses

Over the six years from 2011 to 2017 more than 90 startups in Thailand received VC funds with a combined value of USD305 million. In 2017, Thailand had 12 VC firms compared with only three firms in 2016. The rise of startups has created the image of Thailand as "Startup Universe" and helped Bangkok's selection as the best city for startups in Asia and the world's seventh-best city for startups. Thailand has 30 startup networks active in 25 countries. The National Innovation Agency (NIA) is a state system integrator for startups. Under phase 2 of the national master plan for startup development for the years 2018-2021, NIA outlined the so-called 3I strategic plans to help the country achieve a place among the world's top 20 startup nations. The 3I strategies stand for innovation, investment and international.

The year 2019 was a challenge for entrepreneurs, investors, and various sponsors in Thailand's startup scene, but investment the country's startup ecosystem has grown. According to TechSauce's *Thailand Tech Startup Ecosystem Report*, in 2019 the total investment in startups amounted to USD 97.55 million from 35 deals. Even though the investment figure is not record-breaking, it did increase from the 2018 level of USD 61.25 million (Figure 4).

In 2019, CVCs were still the main source of investment for startups in both the growth and seed stages. Many strategic partnerships were made directly with companies or through CVC events, including profit-based relationships. Traditional VCs still played a significant role in funding startups at the pre-seed stage to Series A. The government continues to support the startup ecosystem creating various platforms. Every department within the government aims to develop itself. The Thai government has generated a good foundation and structure for supporting the ecosystem (Figure 4).

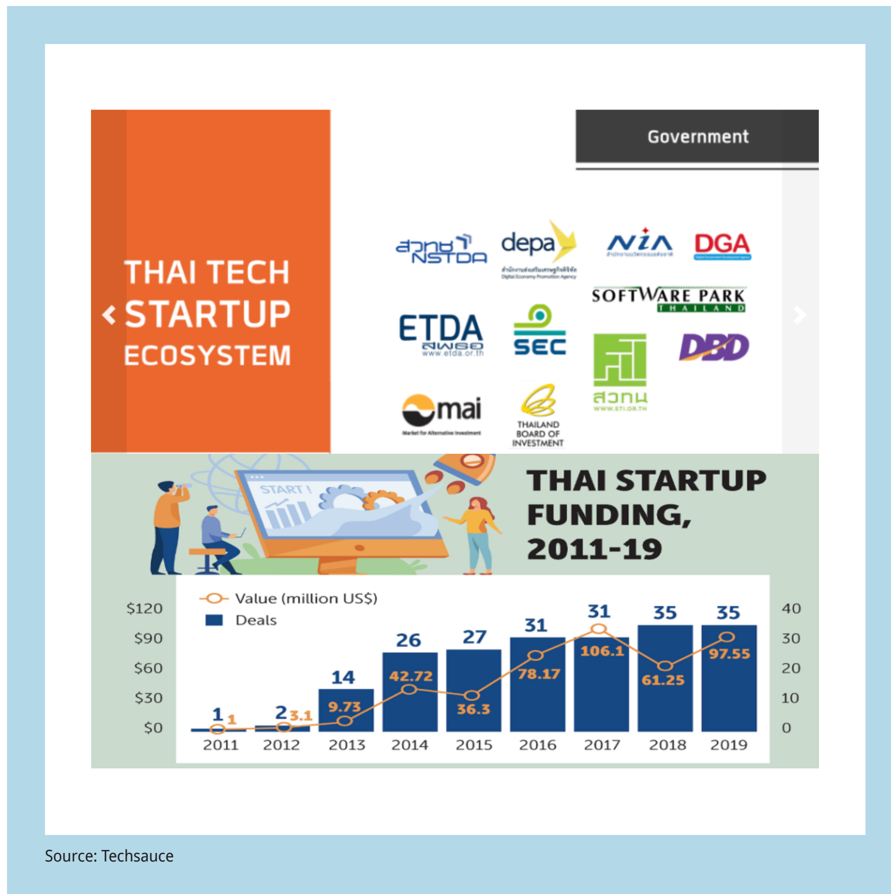
The public sector can support startups in two ways: reducing regulatory risks by amending laws and launching programs for areas that need support. The government can also use startup products and services. In terms of incubating innovation, no country in the world introduces regulation before innovation. The government should aim to relax regulation in areas that do not pose much risk so that there is space for growth and future opportunities that create benefits for consumers and producers.

Crowdfunding

Crowdfunding is another new option available to small businesses and startups seeking injections of financing.

Crowdfunding is a form of fundraising forms using digital platforms to provide businesses with financial access. The crowdfunding process is conducted through an intermediary website or platform; an operator seeking to raise funds

Figure 4: Startup Ecosystem and Funding 2011-2019



Source: Techsauce

will propose a project or business via the platform and interested investors can provide the capital by transferring resources or funds to the business.

Generally speaking, there are four categories of crowdfunding. With donation-based crowdfunding, funds are provided to projects by a community of donors who do not expect tangible returns. Often, this type of crowdfunding is used to fund social causes, non-profit organizations, films, and artistic endeavors. Rewards-based crowdfunding is typically used to raise funds for a new startup or organization that offers a product or service. Peer-to-Peer lending, also known as debt crowdfunding, is the practice of lending money to individuals or businesses through online services that match lenders with borrowers. Finally, with equity-based crowdfunding, also called investment crowdfunding, entrepreneurs sell part of their company to outside investors in exchange for capital, making the investor a shareholder in the business.

Peer-to-Peer (P2P) lending

Among the categories of crowdfunding, P2P lending, whereby money is lent to individuals or business on the expectation of regular interest payments, is expected to transform the lending business and reduce funding gaps for small businesses in the Thai market. Furthermore, P2P offers the potential for firms to take out micro-loans and it will enable savers to benefit by lending their savings in a greater variety of ways. A P2P loan is a person-to-person agreement made through online channels with a platform to match and provide a contract between the borrower and the lender (matchmaker).

To regulate and facilitate P2P lending, which is still in the early stages of development, the Bank of Thailand (BOT) announced regulations in September 2018 that became effective in January 2019. The regulations highlight the boundaries within which operators are to function. They define a P2P platform provider as a person or entity that delivers an electronic system or network for lending between peers and define a lender as an individual or juristic person that offers a loan via an electronic system or network. BOT regulations stipulate that a P2P platform provider must: not be a financial institution (including banks, although subsidiaries of banks are permitted); be a private company or public company incorporated in Thailand; have paid-in capital of at least THB 5 million; and have at least 75% of its total shares held by Thais.

For individuals and businesses, P2P lending provides another fast and convenient funding option via an online platform with a ceiling interest rate of 15% a year, while for lenders it offers another option to invest, in smaller amounts, and earn an appropriate return. The risks with P2P lending are that borrowers create excessive debt and that loans are not repaid.

Recently, P2P lending is become more popular due to affordable pricing. Borrowers can find cheap funding while lenders or investors have the potential to gain higher returns. Examples of the emergence of P2P lending in Thailand include PeerPower, which focuses on creating a platform for borrowers and lenders of SMEs, JFin Coin, which is well known as the first initial coin offering (ICO) created by Jaymart Group, and Daingern.com, an online platform in the car for cash loan market, offering low interest rates for borrowing while lenders can get a higher return.

Conclusion

Together, the Thai government and banks are creating a supportive environment that stimulates entrepreneurship, startups and innovation by making financial resources and funding accessible for all. Throughout the decades, the government and banks have and will continue to raise awareness over resources and make them accessible to support the success of startups. Various strategies such as government-subsidized banks, VC funds, and alternative financing have been employed to develop SMEs. These actions have enabled Thailand to succeeded in growing SMEs.

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MONGKON LEELATHAM

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Mongkon Leelatham was president of SME Development Bank from 2016 to 2019. Prior to that he was a member of the board of executive directors as well as deputy vice president of Thai PBS from 2012 to 2015. He has also been a member the advisory committee of The Federation of Thai SME (2017-2019) and director of the board of the National Credit Bureau NCB (2010 – 2012). He was also a member of the subcommittee on the Economy and Driven, National Legislative Assembly of Thailand (2017-2018). In addition, he was the president of Thai Investors Association (2011-2016) and the chairman of the Board of Executive Directors for the Thai Credit Retail Bank, Plc (2007-2012). He is a former Deputy Vice President and Committee Member of the Federation of Thai Capital Market Organizations (FETCO).

He currently serves as chairman of the board of executive directors and member of the expert committee for Small and Medium Enterprises Promotion; member of the expert committee of the board for the Promotion and Preservation of Cultural Heritage (Ministry of Culture); chairman of the project team to integrate the rubber solution of Thailand (Rubber Authority of Thailand); director and executive committee of MFC Asset Management, Plc; member of a board committee of Puay Ungphakorn School of Development Studies at Thammasat University; director on the board of the Marketing Organization for Farmers (Ministry of Agriculture and Cooperatives); and director and chairman of the board of executive directors for Information Technology and Board of Executive Directors for Government Savings Bank.

He earned a Masters of Development Economics and a high vocational certificate in development economics from the National Institute of Development Administration. He earned a Bachelor of Commerce and Accountancy at Thammasat University and a Bachelor of Economics at Ramkhamhaeng University.

He was awarded the title 'Banker of the Year' in 2018 by DOKBIA THURAKIJ Magazine.

MOHAMMAD RIDZUAN ABDUL AZIZ

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Capital Raising for Growth by SMEs and Startups

Background

Impact of Covid-19 on Malaysia & ASEAN

Malaysia has almost 1 million small and medium-sized enterprises (SMEs) that cut across various sectors, sizes and levels of maturity and SMEs make up approximately 96% of businesses across ASEAN.*[1] In 2018, SMEs collectively contributed USD 126.3 billion (38%) to Malaysia's Gross Domestic Product (GDP) and 66% to employment. As in many developing nations, SMEs play a vital socio-economic role in driving Malaysia's growth.

Prior to the Covid-19 pandemic, the growth of SMEs was largely driven by conventional business practices, such as face-to-face interactions, physical verification, cash-based transactions (despite a high internet banking rate) as well as seminars, conventions and exhibition approaches to promote brand and narrative awareness.

Since mid-March 2020, the pandemic has accelerated deployment of digital technology by businesses and government agencies – largely due to social distancing requirements and concerns about the infection risk. Many SMEs resorted to digital technology in fulfilling the new value-chain and adapting to the 'new norm' of Low-Touch, High-Tech (LTHT).

This new norm has also fuelled a number of new startups, especially in financial technology (fintech) and digitally enabled businesses such as e-commerce, digital banking and alternative financing. In addition to the new norm, Malaysia already has a solid foundation in a high internet banking penetration, nation-wide 4G coverage and government policies that facilitate growth in this area.

Given this situation, various types of investors - including, but not limited to, crowdfunding platforms (equity and loan), venture capitalists, private equity firms, high net worth individuals and family offices (hereafter identified as "potential strategic investors") - are seeking specific opportunities to invest in the potential growth of certain SMEs and startups that are benefiting from customers' specific behavioural changes and the new norm based on the LTHT concept.

This article discusses the factors affecting fund-raising attractiveness from the perspective of potential strategic investors, with an in-depth look into certain elements based on specific business cases.

Factors Impacting Fund-Raising Attractiveness

It is natural for any business founder to focus on day-to-day matters during the startup stage. As the business matures, there are a variety of compelling needs to shift attention to strategic aspects in order to facilitate viable growth, wealth optimization and relevancy of the business's unique value proposition for the foreseeable future.

This article focuses on four key factors that independently and collectively impact the attractiveness of any fund-raising specific for a growth campaign, particularly since Covid-19 and in light of several recent corporate scandals. These factors are discussed from the perspective of potential strategic investors, focusing on the following aspects that are commonly scrutinized prior to investing for the growth phase:

1) Customer Value Proposition

2) Breadth and Depth of Talent

3) Governance, Risk Management and Compliance Competency

4) Technology as Enabler

Customer Value Proposition (CVP)

Establishing a compelling and relevant CVP is key for businesses to be attractive and viable. CVP refers to the ability to articulate clearly to prospects why they should do business with a business rather than its competitors and how the attributes of its product or service address their key issues and needs.

For prospective investors, this is one of the first factors that that they would be looking for, as a compelling CVP would enable the revenue to command higher value and, to a certain extent, generate repeat transactions or brand loyalty. For instance, the company Grab*[2] has demonstrated the ability to solve various last-mile connection issues concerning supply and demand for transportation, food & beverages, and other household needs via its digital platforms. Despite not yet being profitable, Grab is worth USD 6 billion*[3] and has managed to attract ten rounds of funding worth USD 4.997 billion to fuel its future growth. The company continues to enhance its CVP by expanding its network of riders, drivers and merchants on its digital platform to serve up to 660 million potential customers in ASEAN.

From the perspective of investors, this is a compelling CVP as Grab is in the business to solve basic issues that incumbent businesses have failed to solve for years. In addition, the solutions offered by Grab are seamless and convenient, delivered via mobile devices and right to the consumer's doorstep.

Another interesting aspect is Grab's transparency in acknowledging that it is not yet profitable because the cost to develop, maintain and continuously enhance its features requires a huge amount of investment. Such candor is rather new and may not be understood by certain conservative investors but it has proven to be compelling to entities such as Softbank Group,*[4] Vertex Ventures SEA,*[5] China Investment Corporation*[6] and Booking Holdings (formerly Priceline.com).*[7]

CVP fails

Establishing, maintaining and enhancing a compelling CVP is an extremely vital focus for any business, especially for an SME. However, we found many businesses struggle to capitalize on their CVP as they failed to either identify their target customers' key issues or were unable to produce workable solutions to address them. The following are some of the causes.

- **Poorly defined customer segment**
  A good value proposition hinges on a clearly defined, specific customer. Many businesses are keeping their customer definition broad, thinking that this would increase their revenue potential. However, this is wrong as marketing efforts to a broad audience will confuse customers, and as a result the business will suffer without a clearly defined customer segment.

- **Ambiguous narrative and branding**
  Many businesses identify key words to summarize and communicate the value they offer. Customers are missing the context and meaning of the company's culture which results in confusion, ambiguity and misunderstanding as well as declining relevance from the customer's view.

- **Too common CVP**
  A compelling CVP should be able to answer this question: "How is your product or service or company different from the competition?" If there is no difference, customers will not care.

From the perspective of potential strategic investors, a compelling CVP is a 'must-have' factor with almost no room for negotiation. It has to be precise, relevant and compelling always, period.

Breadth and Depth of Talent

The approach of potential strategic investors to evaluating an opportunity to drive growth can be described by a horse-racing analogy. Investors look at three aspects: the Jockey (i.e., founder and senior management), the Horse (i.e., the business model) and the Race Course (i.e., the vertical industry).

Potential investors tend to prioritise the breadth and depth of talent among the founder and senior management to fuel and drive the next business growth, and in many cases, the founders believed that they would remain relevant for the foreseeable future. However, we noticed that this is not necessarily the case, as the growth phase requires different skill sets and mindsets, and thus, different approaches from those needed to found a business.

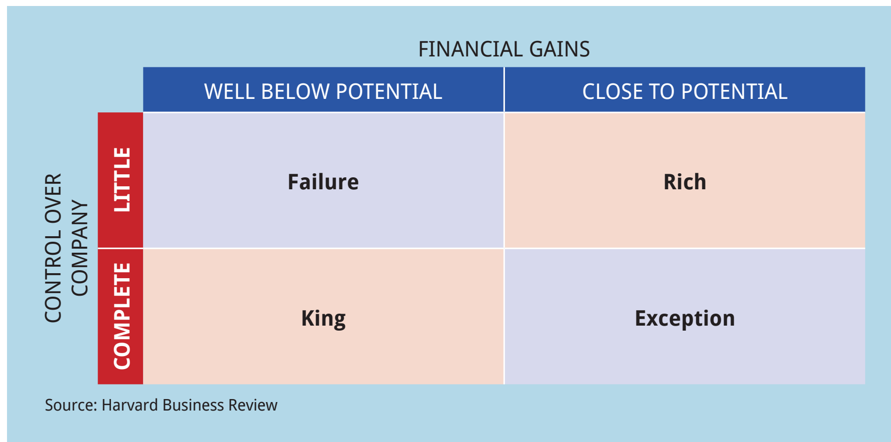
A key consideration that 'the Jockey' needs to understand is the impact of the transition of a business from startup to growth phase. It is a dream of every founder to be a Bill Gates or an Anna Roddick, each of whom founded a large company and led it for many years. However, in reality, versatile founders are a very rare breed as most of them surrendered management control especially when the business transitioned to the growth phase.

According to an article in the *Harvard Business Review*,*[8] by the time a business is 3 years old, 50% of founders are no longer the CEO, a year later only 40% remain at the top and less than 25% lead their business to initial public offerings. The general assumption is that founders would facilitate any initiatives that would increase the chance to make more money and grow. However, many studies have shown that founders made less money in the startup phase and hence were reluctant to handover management control as they would suffer financially once the business transitioned to the growth phase. Many investors discovered that founders made business decisions that conflicted with wealth-maximizing principles, especially if the business focused on solving social issues (e.g., financial inclusion), leading fundamental changes (e.g., filling the unserved and underserved gap for financial services), or competing against long-standing issues (e.g., digital KYC as a utility platform). Figure 1 summarizes the options facing the founder regarding control and financial gain.

Potential investors are looking for a founder, a Jockey, who is rational and mature enough to adapt to the needs of the business. This is their key concern since founders often believe that only they can effectively lead the business irrespective of its performance and trajectory.

Potential strategic investors searching for growth opportunity definitely do not want to consider having to manage a rebel Jockey (founder and senior management) who would potentially ride in the opposite direction and risk losing the race, no matter how noble, inspirational and passionate the Horse would be.

Figure 1: The Trade-off Entrepreneurs Make



Source: Harvard Business Review

Governance, Risk Management and Compliance (GRC) Competency

YES Bank and Wirecard are technology-enabled and fintech companies with reputable institutional investors that have been funding their growth and global expansion from startup until recently. These companies have policy statements, a GRC mission, but they have failed in these aspects of their business.

In reality, the GRC aspect of a business is often considered to be less important by potential strategic investors and most entrepreneurs, especially in relation to business growth of SMEs and startups. The GRC aspect is often seen as a hindrance to growth due to its emphasis on 'what-if' circumstances and risk assumptions. The two cases discussed below show the importance of GRC competency for business success.

Case #1 – Yes Bank

A licensed private bank in India, Yes Bank was put under moratorium by the financial regulator as a result of its poor response to the central bank's asset quality reviews in 2017 and 2018. Unfortunately, despite knowing the weaknesses highlighted, Yes Bank's senior management continued to under-report its non-performing assets during 2018 to 2019. It also continuously provided false assurances to the financial regulator that it was restructuring its business model to improve the quality of its balance sheet and liquidity management, while in actual fact, there were no serious efforts being made. Yes Bank continued its reckless lending practises based on unrealistic grounds such as accepting 'personal guarantee' from certain tycoons as collateral for huge loans which clearly violated the prudential requirements of the financial regulator.

As a result, potential strategic investors were uninterested in Yes Bank's purported business restructuring plan despite its being the 5th largest private bank in India with total assets that once stood at USD 36 billion. The rogue nature and approach of the founder and Managing Director, Rana Kapoor, who compromised GRC across the business, was a sign that Yes Bank's growth plan was not aligned with many investment tenets. According to *The Financial Times*, Yes Bank's Managing Director (MD) "took to the extreme the lending and accounting practices rife in India's banking sector." This blatant misbehaviour is apparent in Figure 2 which compares non-performing assets ratios at private banks in India during 2018 and 2019.

The Reserve Bank of India dismissed and arrested Rana Kapoor in late 2018, and the new management raised USD 270 million in an effort to revive Yes Bank, but it was too late as the repercussions from the previous blatant disregard of GRC standards had dented its reputation too deeply and shaken the confidence of potential strategic investors.

Case #2 – Wirecard

The recently discovered extent of accounting and misrepresentation at Wirecard has a different twist as it started from 2008 and unearthed both structural and reckless elements at the heart of the scandal. Wirecard is neither a startup nor an SME; it is listed in Germany on the prestigious DAX 30 with market capitalisation of USD 25 billion and with global operations spanning from its Berlin headquarters to Dubai and Singapore.

The extent of the alleged accounting scandal took a turn for the worse in October 2019 upon the publication of a *Financial Times* article with a subheading stating that certain "internal documents from the payment company point to a concerted effort to fraudulently inflate sales and profits." *9 The then CEO, Markus Braun, dismissed this allegation and stated that "a dozen measures to improve compliance, including the appointment of a new chairman of the supervisory board in 2020" were being taken to address all concerns raised above. More recently, it was discovered and confirmed that USD 2 billion purportedly safely kept the Philippines is unaccounted for and allegedly held at an obscure location instead of in the banks as claimed. In several key ways, Wirecard went against the GRC fundamentals including:

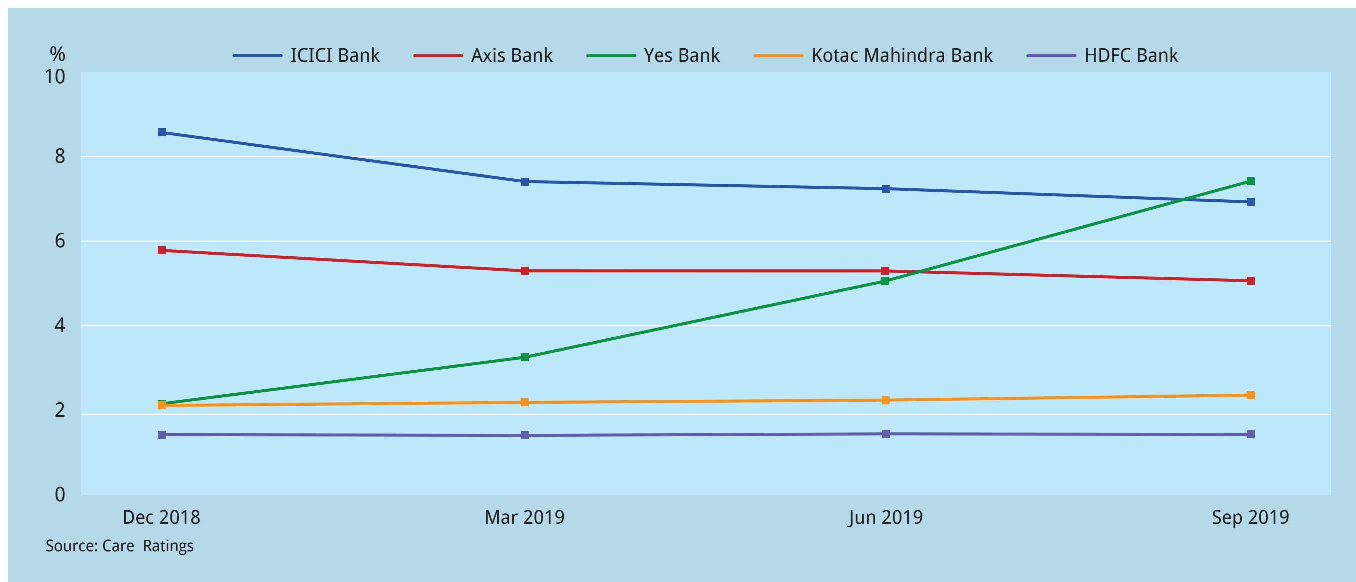
- Failure of the external financial auditor to receive and verify Wirecard's bank statements since 2017;
- Poorly explained business relationship that has no economic rationale and attributes: a foreign entity, e.g., a partnership with a Dubai-registered "3rd party acquirer" called Al-Alam that allegedly contributed half of Wirecard's profit in 2016;
- Dismissal of concerns about inflated sales and profit numbers of numerous subsidiaries across Asia that resulted in multiple raids of its Asia regional headquarters by Singapore's Police commercial crime unit.

The Wirecard scandal is a repeat of the Enron scandal in which the senior executives recklessly dismissed numerous concerns and brushed them aside in pursuit of growth and financial gains. Fortunately, despite being dismissed repeatedly and investigated for alleged insider information collusion for short-selling, The Financial Times steadfastly pursued the Wirecard case for five years as it has similar traits to prior accounting scandals such as Enron and WorldCom.

Lesson learned

Potential strategic investors are not able to identify early a business's weakness in GRC competency, as it is subjective, complex and largely dependent on the risk appetite of each investor. For fiascos in-

Figure 2: Non-Performing Assets Ratios at Indian Private Banks



Source: Care Ratings

volving Yes Bank and Wirecard, the extent of both scandals could only be quantified after the fact and no investor would claim that they managed to avoid huge losses by not 'investing' in these companies because they knew what was going on or would happen. This is the one area that has no early-warning signs for potential strategic investors in managing or mitigating the risk impact when it materialises.

Technology as Enabler

Technology as enabler is a relatively new factor that seasoned potential strategic investors need to relearn given the involvement with technology by many businesses–either by leveraging technology to pivot the business or by using technology as a key component within the original product or service. An example of the first type is the 169-year-old Western Union company which in 2006 leveraged technology to pivot from telecommunications to money services, focusing on money remittance and currency exchange businesses. An example of the second type of technology driven company is PayPal, which has undergone many permutations since 1999 yet retains its nature as a payments company.

In Malaysia, almost 40% of demand for growth funds came from SMEs and startups related to vertical payments such as payment gateway, open-loop e-wallet, non-bank mobile-money issuers, and money services business (i.e., currency exchange and international remittance). One company that has successfully embraced technology for growth is Merchantrade, which was founded in 1996 as a brick and mortar currency exchange and remittance provider and has evolved as one of the most innovative entities with digital offerings for payment services, money services business and mobile services.

Merchantrade's founder, Ramasamy K. Veeran, expedited growth with funds from strategic institutional investors in 2009 (Sumitomo Corporation) and 2014 (Axiata). A large portion of the funds received was invested into technology and business process automation that have increased speed, security and brand trustworthiness, from customers' perspective.

Despite the success of Merchantrade in deploying technology as a key growth enabler, the majority of payment businesses have been unable to emulate this path for growth largely due to the founder's reluctance to pivot their approach and seek alternative funding sources away from the traditional incumbent financial institutions and government funding agencies.

From the perspective of prospective strategic investors, the founder's aspiration and vision to invest in technology, and where needed to pivot the business, is a must-have ingredient for future growth. Among interactions with approximately 200 licensed money services business in Malaysia, a majority expressed unwillingness to dilute their management control in exchange for funds to invest in technology or a business pivot, as well as a complacency due to the steady stream of revenue from their loyal customers.

Emphasis by prospective investors

The author also spoke to crowdfunding platforms (equity and loan), venture capitalists, private equity firms, high net worth individuals and family offices to understand their views and expectations, in particular regarding investing for growth via technology deployment. The following are the findings:

- The majority expects their investee companies to invest in business process automation that would drive revenue, cost reduction, data-related technology (i.e., acquisition, behaviour, analytics) and efficiency.
- More than 50% expect improvement to be made in the capability to cross- and up-sell existing products or services leading to revenue optimization via repeat transactions, i.e., improved brand loyalty and stickiness.
- About 60% expect new business development and expansion of existing horizons via inorganic approaches (e.g., mergers, partnerships) for faster revenue growth and improved cost effectiveness.

Disclaimer
This article offers the author's personal opinion based on observations during 22 years of direct and indirect involvement as a financial regulator, banker, head of compliance, entrepreneur and fintech industry advocate in Malaysia and the Asia-Pacific region.
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Conclusion

This article highlighted pertinent expectations of prospective strategic investors about investing for the growth of SMEs and startups. The expectations are as follows:

- Growth must be driven by a CVP that is clear, well-articulated and unique.
- The founder and senior management's breadth and depth of talent need to be aligned with that of investor's who are willing to fund growth according to the business CVP. This usually requires the founder and senior management to allow certain dilution of management control in order to accommodate new perspectives and facilitate gains in sustainable growth.
- Willingness to invest depends on GRC competency to ensure constant checks and balances.
- Deployment of technology as growth enabler is expected to improve the synergy of products and services and horizontal expansion.

Notes

*1 Asian Development Bank

*2 https://www.grab.com/my/

*3 Grab's valuation as quoted by Forbes

*4 https://www.softbank.jp/en/corp/

*5 https://www.vertexventures.sg/

*6 http://www.china-inv.cn/en/

*7 https://en.wikipedia.org/wiki/Booking_Holdings

*8 The Founder's Dilemma

*9 Financial Times article dated 15 October 2019

MOHAMMAD RIDZUAN ABDUL AZIZ

President, FinTech Association of Malaysia

Mohammad Ridzuan Abdul Aziz (Ridzuan) has over 20 years of regulatory, compliance and technology experience in the Asia-Pacific region. He provides business-oriented regulatory advice, solutions and consultancy to banks, remittance companies, fund management entities, broker dealers (equity and derivatives) on regulatory requirements, compliance risk management, licensing, business viability and implementation of fintech and regulatory technology (RegTech). Ridzuan is currently WorldRemit's Country Director for Malaysia and Head of ASEAN Business. WorldRemit is one of the fastest growing global online-only remittance providers headquartered in the UK, operating in over 50 countries and servicing more than 5,000 corridors.

As the current president of the FinTech Association of Malaysia he is particularly focused on promoting the combination of onshore, Labuan mid-shore and Islamic talents for various stakeholders and the Malaysia digital economy.

Ridzuan is a member of the international advisory panel of the Labuan Financial Services Authority and the Malaysia Innovation Policy Council. Both roles provide him a unique perspective on onshore and mid-shore optimization of Malaysia's competitive advantage in the fintech eco-system.

Ridzuan founded RHT Compliance Solutions in 2013 and CS Technology Solutions Sdn Bhd in 2016. Both firms provide RegTech advisory consultancy for established fintech firms seeking assistance on regulatory matters in Malaysia, Singapore, Indonesia and Hong Kong.

In 2017, Ridzuan was CEO of Sedania As Salam Capital Sdn Bhd, a patented fintech solution provider that utilizes mobile airtime as the commodity for Tawarruq Contract for Shariah compliance financing provided by 40 financial institutions in Malaysia.

Ridzuan was Head of Compliance at Macquarie Capital Securities Malaysia from 2005 to 2009 and at Nomura Securities Malaysia from 2009 to 2013. His last designation was Executive Director for Asia (ex-Japan), responsible for regulatory compliance, transaction monitoring and supervision for 11 markets in APAC (ex-Japan)

He was a regulator with the Kuala Lumpur Stock Exchange (1998) during the Asia financial crisis, at the Securities Commission (2001) and then redeployed to a joint task force between the Securities Commission and Bank Negara Malaysia during the formation of the investment bank (2002).

Ridzuan graduated from University of Wales, Aberyswyth (1997) with a BSc in Economics, majoring in Accounting and Finance. He obtained his MBA, specializing in Management Information Systems from the International Islamic University Malaysia (2005).

Introducing Nomura Foundation

Nomura Foundation (the Foundation) is a public interest incorporated foundation formed in 2010 from the combined resources of three existing foundations established by Nomura Group, Japan's largest securities company. The Foundation aims to support a dynamic and sustainable economy and society by promoting the social science disciplines, enhancing international understanding, and fostering young academic and artistic talent. It focuses on four program areas: Social Sciences, Foreign Student Scholarships, Arts and Culture, and the World Economy.

The World Economy program supports research, conferences, and publications related to the macro economy and capital markets.

In the macro economy area, the Foundation has organized conferences together with experts from the Brookings Institution (US), Chatham House (UK), the Development Research Center of the State Council (China), and Bruegel (Belgium) as well as Nomura Securities and Nomura Institute of Capital Markets Research to share research on such topics as monetary and financial institutions, fiscal stability, and demographic change and sustainability.

In the area of capital markets, the Foundation has organized conferences

Panel Discussion at the 2015 Forum

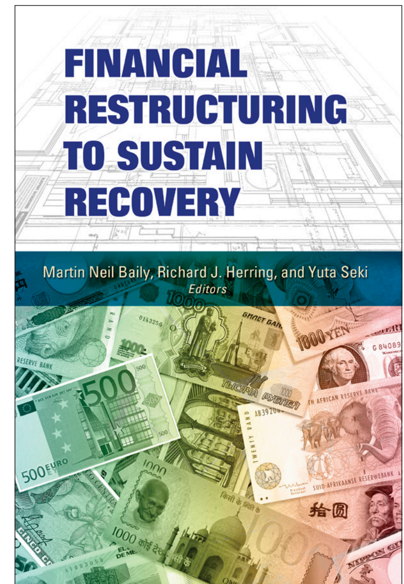
and roundtable discussions in conjunction with the Brookings Institution, the Wharton School, the Development Research Center of the State Council (China), China's Center for International Knowledge on Development and Nomura Institute of Capital Markets Research. It has also provided financial backing for several conference volumes published by the Brookings Institution, *Capital Markets in India* published by Sage, Inc., and the quarterly Japanese-language journal *Chinese Capital Markets Research*.

Research papers and presentations prepared for conferences and the content of print publications are available on the Foundation's website http://nomurafoundation.or.jp/en.

With the expanding importance of Asia in the 21st century global economy, the Foundation has been increasing its support of intellectual interactions among experts at think tanks, universities and government agencies in the region. As part of this effort and recognizing the importance of capital market development in promoting economic growth and prosperity in Asian countries, the Foundation started publishing *Nomura Journal of Asian Capital Markets* in 2016.

Cover of *Chinese Capital Markets Research*

Lord Mervyn King at the 2015 Forum



Cover of *Financial Restructuring to Sustain Recovery*

Introducing Nomura Institute of Capital Markets Research

Nomura Institute of Capital Markets Research (NICMR) was established in April 2004 as a subsidiary of Nomura Holdings to build on a tradition begun in 1965 of studying financial and capital markets as well as financial systems, structure, and trends. NICMR develops original research and policy proposals by specialists based upon knowledge of actual business practice.

NICMR publishes some of its research output in Japanese in *Nomura Capital Markets Quarterly*, and posts some items in Japanese, English, and Chinese on its website.

NICMR's core mission is to contribute to reform of Japan's financial system and securities market in order to foster establishment of a market-structured financial system. Structural changes, particularly population aging, are having a major impact on Japan's economy and society. Addressing the challenges created by these changes calls for reforming social security, tax, and public finance systems. One of Japan's most valuable resources is the JPY1,800 trillion in financial assets held by households. Establishing a market mechanism-driven money-flow that makes efficient, effective use of these assets is critical to the country's future.

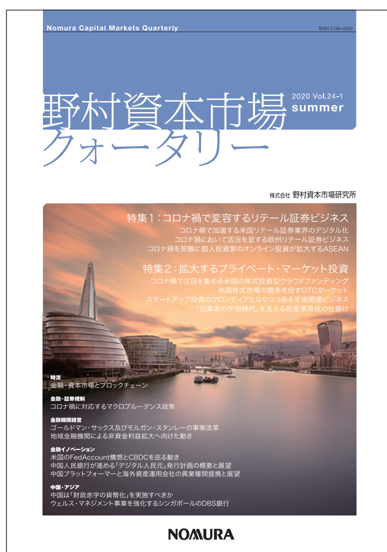
NICMR's research focus extends well beyond Japan to encompass current issues in capital markets around the world. In addition to research offices in New York, London and Beijing, NICMR established a research office in Singapore in 2015 to strengthen its Asian research platform.

The continued growth of Asian economies including China is generating huge funding needs for infrastructure and creating an urgent need for indirect financing systems and robust capital markets in the region. Promoting the development of Asian capital markets is a key for the future of Asian financial systems and economies. Moreover, it is important that Asian perspectives and regional differences are recognized in the post-global financial crisis environment of closer cooperation among financial regulators making rules and global standards.

NICMR's recommendations for developing financial and capital markets in Asia are based on analyses of past experience in developed economies. In particular, Japan offers useful lessons on the importance of direct finance for supporting new businesses and of investment services to cater to the needs of a growing middle class.

NICMR has also been working to strengthen its sustainability initiatives. To this end, it established the Nomura Research Center of Sustainability in December 2019. This research center focuses on objective and practical research into areas of sustainability closely related to the financial and capital markets in major regions including Asia.

As a member of the Nomura Group, a global financial group based in Asia, NICMR strives to contribute to the development of financial and capital markets in Japan and the rest of Asia through fundamental research and experience-based policy recommendations.



Cover of *Nomura Capital Markets Quarterly*

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