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Pakistan Microfinance Network
Achieving Together

Graduating Microenterprise Clients to SME Lending – Are We Really There Yet?

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INTRODUCTION

Despite the passage of seven years since microenterprise lending started in Pakistan, the sector has yet to reach its maximum potential and outreach remains low, especially when juxtaposed with the total microcredit portfolio. This MicroNote aims to explore the current landscape of microenterprises in Pakistan with regard to client graduation, their importance and contributions to the economy, growth, practices of client graduation, characteristics and whether there is a need for developing specialized financial products. It attempts to answer whether a typical microenterprise client can move on to higher loan cycles within the microenterprise loan category offered by microfinance banks (MFB) (i.e. PKR 150k to 1million), and eventually move to a higher loan category, i.e. Small and Medium Enterprise (SME) lending (beyond PKR 1 million), or are the needs of the current microfinance clients different from those who require larger loan amounts, and a new target market and products need to be sought? Additionally, it analyses whether a new target market for the higher microenterprise loan segment is needed.

Part 1 will set the context for the MSME landscape in Pakistan. Part 2 offers profiles and characteristics of microenterprises and small enterprises and their comparisons, borrowing from research conducted for two PMN studies carried out in 2018-2019. Part 3 discusses whether client diversification is needed in place of client graduation, and Part 4 summarizes the main findings and puts forward recommendations for the way forward.

PART 1: MSME LANDSCAPE IN PAKISTAN

Microfinance started gaining traction in Pakistan as a tool for poverty alleviation and social mobilization since the late 1990s and is now composed of 46 institutions and over 7 million active borrowers. Growing at an average rate of 32.5% per year, market estimations highlight that nearly 70% of the market for microfinance remains untapped. Within microfinance, Micro Small and Medium Enterprises (MSME) form an integral part. Access to finance is widely acknowledged as a major obstacle to growth for MSMEs worldwide. The State Bank allowed microenterprise lending in 2012, with loan limits capped at PKR 500k, which were then enhanced to PKR 1 million in 2017 [1] .

Growth in the MSME sector is closely associated with the growth of the country's economy and its contribution to the country's GDP and employment. In Pakistan, MSMEs account for 98% of all economic enterprises[2] . In December 2017, manufacturing MSMEs availed 46% of overall financing, followed by trading MSMEs (31%) and services MSMEs (23%).

1 C&MFD Circular No. 03 2017 - Enhancement of Maximum Loans Size for Microenterprises

2 Dawn (2019)

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Additionally, between 2012 and 2016, there was a sectoral shift in distribution of SME financing from trading sector to manufacturing and services sector, highlighting the increased importance of manufacturing MSMEs in the industry.

The MSME sector is heterogenous, dispersed, informal and mostly unorganized. Despite their large numbers, MSME financing as of December 2017 was only 8.73% of overall private sector credit. The lack of access to finance is exacerbated by a lack of granular information on the MSME universe. Pakistan falls into the 'cool' zone among the three country groups in which emerging MSME markets have been classified. A 'cool' zone has been defined as one in which the country has yet to 'create the conditions that will allow banks to fully capture the MSME opportunity' . Whereas a 'temperate' zone is one where the country has begun to create the said conditions, whereas a 'hot' zone is one where such conditions have been created.

Looking at microenterprise lending in Pakistan, there are 11 MFPs catering to MSME lending. As of 2019, there are 128,770 MSME borrowers, with the overall average loan size of PKR 190,643. The average loan size is well below the revised limit set by State Bank of Pakistan, which points towards the potential for growth for MFPs for lending to higher amounts. The total MSME GLP stands at PKR 19 billion. The total microenterprise portfolio represents 2% of total clients and 7.2% of the total Microfinance Portfolio of the industry as of June 2018. The table below shows details of the top players in MSME lending, their share of borrowers, average loan size and GLP.

Table 1 - MSME Players in Pakistan

Category	Name	MSME Borrowers	MSME GLP (PKR)	Avg. Size of Loan (PKR)
MFB	NRSP-B	40,825	2,437,642,388	59,710
MFB	KBL	23,671	3,445,810,357	145,571
MFB	FINCA	16,226	2,564,834,432	158,069
MFB	TMFB	11,117	2,742,417,464	246,687
MFB	FMFB	9,181	2,144,883,572	233,622
MFB	AMFB	8,744	2,995,107,893	342,533
MFI	SSSF	5,172	88,146,243	17,043
MFB	UBANK	4,689	1,182,400,677	252,165
MFB	ADVANS	3,787	686,204,596	181,200
MFB	MMFB	3,359	820,023,645	269,833
MFI	MOJAZ	1,999	156,322,694	78,200

3 SME Finance Annual Review - Infrastructure Housing & SME Finance Department State Bank of Pakistan (2016)
4 Chironga et al. (2012)

5 PMN MicroWatch(2019)

IMPORTANCE OF MSMES TO PAKISTAN'S ECONOMIC AND SOCIAL GROWTH

Research on the MSME financing gap in developing economies it is stipulates that access to finance remains the major constraint for MSMEs [6]. An IFC report states that there are 162 million formal MSMEs in developing countries and 141 million of these are microenterprises. The finance gap for formal enterprise is estimated at $5.2 trillion and for informal, the report estimates the potential demand at $2.9 trillion.

MSMEs alleviate poverty, enhance social inclusion, boost economic growth and help reduce trade deficits – which is why they comprise of 16% of all GDP in low income countries [7]. They can create a more inclusive society because of the employment opportunities they can provide for women, youth and minorities given their labour-intensive nature [8].

Within Pakistan, MSMEs together account for 30% of Pakistan's GDP [9]. They also contribute over 25% of earnings in export and employ 78% of the non-agricultural labour force in Pakistan [10]. It is imperative to develop products that meet the specific needs of microenterprise owners in a country that has an economy hampered by a current account deficit that has averaged -721.14 USD million from 1971 to 2019 [11]. Despite the centrality of MSMEs to the economic health of a country, their growth and, therefore, contribution is significantly hampered by lack of access to formal finance.

MICROENTERPRISE REGULATION

Recognizing the importance of this segment to Pakistan's socioeconomic growth, the State Bank of Pakistan revised loan limits in 2012 for MFBs, from PKR 150k to PKR 500k in order to promote enterprise lending [12]. It allowed MFBs to initiate microenterprise lending and extended the SME Guarantee Fund to MFBs willing to move up-market [13]. The process for MFBs of moving up market entails:

1) Submitting a business plan to the SBP showing readiness level for approval;
2) Getting permission from the SBP to launch a pilot;
3) Getting permission from the SBP for a full-scale launch;
4) Exposure to this market segment can only be up to 40 percent of the total loan portfolio to avoid mission drift and to mitigate risk to the MFB.

In 2017, the State Bank decided to enhance the loan size to Rs. 1.0 million for microenterprises employing up to 25 individuals (excluding seasonal labour). However, the existing limit of 40% on enterprise lending (as percentage of Gross Loan Portfolio) remained unchanged. The enhanced loan size was allowed for those MFBs which have graduated from pilot microenterprise lending programs

6 MSME Finance Gap: Assessment of the Shortfalls and Opportunities in Financing Micro, Small and Medium Enterprises in Emerging Markets, IFC, (2018)
7 Edinburg Group (2012)
8 Dalberg (2011)
9 Nenova and Niang(2009)
10 Afraz, Hussain, & Khan (2013)
11 Trading Economics (2019)
12 State Bank of Pakistan
13 Pakistan Microfinance Review (2018)

to commercial scale. MFBs will also require prior approvals from SBP's Agricultural Credit & Microfinance Department where requests are granted based on satisfactory assessment of the capital position and readiness level of the applicant. 6 MFPs have received approval so far.

Additional initiatives introduced by SBP to support SME financing include:

i) improving regulatory framework through revising prudential regulations, strengthening secured transactions framework and introduction of SME targets,
ii) market development through SME supportive subsidized refinance schemes, risk coverage scheme, Islamic SME financing, cluster surveys and non-financial advisory service and
iii) improving capacity building and awareness creation of bankers and SMEs.

There have been initiatives to encourage enterprise financing in the country, including the Credit Guarantee Schemes, Prime Minister Youth Business Loan Scheme and the Credit Guarantee Scheme for Women Entrepreneurs in Underserved Areas[14] , however, despite these efforts and the passage of seven years since microenterprise lending was allowed by the State Bank of Pakistan, lending to microenterprises has been low when compared to the entire microcredit portfolio and the sector is yet to reach its potential.

PART 2: PROFILING MICROENTERPRISES AND SMALL ENTERPRISES

While the microenterprise segment does not rely on commercial banks for access to finance, commercial banks are also more inclined to lend to those entities seeking larger loans and providing larger collateral. To look at why this is the case, we look the characteristics of a typical microenterprise and a small enterprise by analysing findings from two different studies conducted by PMN[15]. These studies covered various industries across Pakistan, including trading, services, manufacturing and others.

HOW ARE MICROENTERPRISES DIFFERENT FROM SMALL ENTERPRISES?

It can be ascertained that microenterprise loans have a longer tenor compared to microfinance loans, which makes it imperative for microfinance institutions to match liabilities. Primary research carried out during PMN's own studies highlighted thatclients graduating out of individual microloans need microenterprise loans that are issued for longer tenured liabilities for their funding needs to be adequately met.

14 Pakistan Microfinance Network (2018)

15 Microfinance and Enterprise Growth; Evidence from Pakistan 2018, and Graduating Clients Study, 2018

Box 1: Six Most Commonly Cited Obstacles by Firms

1. Electricity
2. Access to finance
3. Practices of the informal sector
4. Tax Rates
5. Political Instability
6. Corruption

Electricity and access to finance are the two most cited obstacles for businesses in developing countries, and access to finance affects small businesses much more than it does medium and large businesses.

Source: Micro, Small, and Medium Enterprises Around the World: How Many Are There, and What Affects the Count? – World Bank/IFC

However, it is not always possible for microenterprises to graduate to larger loan sizes, and eventually to SME-level lending due to the nature and scale of their businesses and their differing financing needs. Within the MSME sector, there is lack of segmentation at an overall level with separate needs for 'micro', 'small' and 'medium' enterprises. While there are also varying definitions of each of these segments by different national and international stakeholders, there is a need to further understand the differences with respect to industry needs and profiles of enterprises, which requires a more granular understanding of enterprises within each specific industry and segment. For instance, working capital as opposed to capital investment is a higher priority for microenterprises, while small enterprises require higher capital investments for business expansion, such as purchase of raw materials or machinery, and procurement of stock, etc.

Figure 1 - Profiles of Small and Micro Enterprises

PROFILING TYPICAL MICROENTERPRISE AND SMALL ENTERPRISE

MICROENTERPRISE		SMALL ENTERPRISE
2.4	Number of Employees	10
Less than a year	Loan Tenor	Less than a year
PKR 85,000	Average Loan Amount	PKR 3.1m
5 Years	Average Age of Enterprise	6-10 Years
PKR 1,998,510	Average Annual Revenue	PKR 9,980,476
Working Capital	Loan Usage	Business Expansion

Definitions

A microenterprise is characterized based specifically on the number of employees (between 1 to 10), while small enterprises are characterized based on number of employees (between 10 to 50), as well as total assets and total annual sales (between $100,000 to $3 million) [16].

Average Loan Tenor and Loan Amounts

Microenterprises and small enterprises typically have loan tenors of under one year, however the average loan amount varies significantly. The average loan amount for a microenterprise is PKR 85,000, while the average loan amount for a small enterprise is PKR 3.1 million. For microenterprise clients, 33% of the loans availed were bullet loans, 66% were equal monthly installment (EMI) loans and 1% were balloon repayment loans.

Average Age of enterprise

Approximately 62% of the microenterprises were 5 years old and 20% were between 3 to 5 years. 18% were relatively young enterprises, established in the past three years. On the other hand, 33% of small enterprises were between 6-10 years old, 31% were over 15 years old and 21% were between 11-15 years old. This highlights the differences in stability, financial planning and succession between micro and small enterprises and their differing financial needs.

Average Annual Revenue

The average annual revenue reported by microenterprises is PKR 1.9 million approximately, while for small enterprises the average annual revenue is 9 times that; PKR 9.9 million approximately.

Number of Employees

On average, a typical microenterprise employs 2.4 persons on a full-time basis. Specifically, 42% of microenterprises employed only one person, i.e. the entrepreneur him/herself. 20% hired one additional person whereas 32% of the businesses employed 3-5 people (including the owner). About 6% of the businesses had more than 5 full-time employees. On the other hand, on average, a typical small enterprise employs 10 people, with 53% of employees being on full-time payroll and 42% as daily wage workers.

Loan Usage

For microenterprises, 62.4% of the loans were availed for buying a business asset (for example equipment, machinery, furniture, etc.), 25.4% for buying business supplies (for example raw materials, tools, etc.) and 12.2% for consumption (for example groceries, medical expenses, etc.) While majority of small enterprises (65%) used loans for business expansion (new premises, employee bonuses, etc.), with using it for working capital (38%) and purchasing equipment (15%) following in as distant second and third options.

16 IFC -The SME banking knowledge guide. World Bank Group (2010)

PART 3: CLIENT GRADUATION OR CLIENT DIVERSIFICATION?

Academic discourse on graduating clients lends credence to the theory that the size of microloans can be too small to enhance firm performance, which is why it would make sense to procure a larger loan size, as this could help microenterprises grow. Globally, microenterprise lending is hindered by a range of constraints; operational, financial, regulatory etc.

NEED FOR MORE DIVERSIFICATION VERSUS CLIENT GRADUATION

Looking at the different characteristics and requirements of microenterprise and SMEs, there are varying opinions globally on the concept of 'client graduation'. One school of thought puts forward that after a limited number of loan cycles, the microfinance clients would no longer be needing credit. The other school of thought believes that poor clients can 'graduate' with enough wealth and confidence to become clients of commercial banks [18].

There are discussions around whether there is an overlap between existing microfinance clients and potential clients belonging to the 'missing middle', or whether this would be characterized as a new market segment. The literature recognizes that one of the motivations for MFPs of moving up-market is their 'desire to continue serving a small number of growing micro-clients, often their best' [19]. Our research identified that that some MFBs are already providing larger loans and encouraging their clients to graduate to higher loan ceilings, however MFIs who provide smaller loans would have to tap into a new segment as their existing clients are unlikely to graduate to loans of higher sizes. This is primarily due to their dynamics, the operational constraints, the informal sector in which they operate and the barriers in accessing finance. Additionally, there is also a capacity deficit; lack of skills, training, expertise and financial education which leads to inadequate business planning and marketing strategies.

While large and medium sized firms have increased access to finance, the micro and small firms struggle in this space; 90% of this segment is underserved [20] . This is primarily because MSMEs vary in their mode operations and performance, they are not homogenous and cannot be addressed by a blanket one-size-fits-all approach. Understanding the context of businesses, their sector, position in the value chain, governance structures and growth strategies are imperative for effective segmentation and customized products[21].

Research shows that it is necessary to bridge financing gaps faced by small and medium enterprises by creating specific financial products for different categories according to their needs, thus allowing them to graduate out of the loan cycle[22]. The needs of all microenterprises cannot be clumped together within the same category;it is important to analyze their future growth, potential for product innovation, profile of the entrepreneur and tolerance for market risk.Different MSMEs have different types of needs, which can be effectively addressed by segmenting them into multiple 'missing middles'.[23] This will allow more focus on scaling of suitable financial solutions rather than pushing not-yet-ready microenterprises to graduate to small-enterprise lending[24].

18 Wright (2007)
19 Glisovic& Martinez (2012)
20 Aslam (2013)
21 Edwards et. al (2010)
22 The Missing Middles: Segmenting Enterprises to Better Understand Their Financial Needs – CFF (2018)
23 Ibid
24 Jurgens (2018)

Box 2: Client Graduation: Examples from around the globe

Practices from **Egypt** highlight that clients graduate to higher segments of loans which are four times larger than their previous loans[25]. The conditionality for such microenterprise loans is that their employees should not be more than 15. The benefits of this graduation from individual microloans to microenterprise loans is it reduces administrative costs for the lender, injects capital into the business, expands the enterprise and boosts employment.

In **Kenya**, Chase Bank has started to offer tailor-made financial product offerings for microenterprises. What distinguishes Chase Bank from other enterprise lenders in the region is the development of appropriate strategies that enhance growth. The use of networks, strategic alliances, the legal and regulatory framework, innovation, diversification, market research and development are what aid the organization in successfully capturing the MSME segment and achieving high growth levels while also promoting inclusiveness and development.

In **India**, one of the significant steps taken by the government is to set up Micro Unit Development and Refinance Agency in 2014, which aims to fund the missing middle[26] . Loan amounts given by microfinance institutions in India are capped at INR 25,000, so the government encouraged institutions to set up separate financial products catering specifically to microenterprises, with loans of up to INR 300,000 with an interest rate of 12.75%. In 2015, the Reserve Bank of India set up a financing target of 7.5% for all commercial banks in order to fund micro and small enterprises, as per the mandate of the Prime Minister's Task Force on Micro, Small and Medium Enterprises[27]. The contention was that loan sizes are too small for those seeking to expand their businesses, and this was hampering the Indian economy.

In **Bangladesh**, it has been postulated that 20% of all microfinance clients can graduate to microenterprise level funding[28]. SAJIDA Foundation graduates capable microcredit borrowers into microenterprise borrowers, who are eligible for a larger loan. Moreover, Grameen Bank, which pioneered microcredit, offers larger loans called micro-enterprise loans, for its fast-growing members. There is no restriction on the loan size, though usually they amount to Tk 50,000.

In **Mexico,** lending specifically to entrepreneurs running microenterprises who have graduated from lower loan slabs has shown to have a plethora of benefits[29]. For instance, such lending supports consumption (everyday goods such as school fees, household goods etc.), income smoothening and to a limited extent, business growth. These groups receive a loan of about $500 on average, with an interest rate of 80 to 120% for up to six months.

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25 Bryan, Kabani and Karlan, Graduating Microenterprises to Larger Loans in Egypt (2015)
26 Inclusive Finance India Report (2018)
27 Indian MSMEs: Marching Ahead, Ministry of MSME, Government of India.
28 Diagnostic of microenterprise lending by MFIs in Bangladesh: Challenges and Opportunities, (2017)
29 Microenterprise Individual Lending in Mexico, Women's World Banking (2018)

Greater Segmentation to target potential market

There are various ways through which Microenterprise market can be segmented, based on business characteristics, owner-manager characteristics, strategic vision, expansion plans, etc.

- Increased segmentation makes for more targeted communication, deeper business-customer connections and effective customized products.

- Increased need-based segmentation can help facilitate different microenterprises and promote sustainability and growth in business.

- Tapping into the existing microfinance clients which can be graduated to larger loan sizes might be useful as an entry point for MFIs looking to tap into the micro and small segment. It will allow MFIs to retain clients who can be graduated and circumvent the difficulties in assessing risk and financial analysis of new clients.

- Loan officers typically have a good understanding about microenterprises which can be graduated to higher loan amounts. One example of this is TMFB, which piloted enterprises loans up to PKR 500,000 for clients who had dropped out of their programmes previously due to inadequate loan sizes[30].

- To address the financing needs of these microenterprises, various financing tools can be explored. Equity finance is especially relevant for firms with high risk-return profiles, while other equity instruments such as specialized platforms for SME public listing, can provide the required financial resources to growth-oriented SMEs.

Box 3: Challenges with graduating microfinance clients to microenterprise clients

- Lack of managerial capacity of microfinance clients – due to the lack of formal education and management training, microfinance clients are unable to grow their businesses.
- Lack of technical knowledge – there is a lack of formalization in the business in terms of bookkeeping practices, operations, market placement and growth and expansion strategies which can hinder this level of graduation.
- Lack of training and business development services – MFPs do not provide enough value-added services to microfinance clients to expand their businesses, resulting in lack of skill development and proper business expansion strategies.
- Lack of market linkages – microfinance clients often do not have access to the market and are unable to take advantage of market linkages and networks.
- Lack of opportunities to engage with commercial banks – given that commercial banks are not inclined to lend to this segment, MFIs also do not encourage any initiatives to help connect microbusinesses to commercial banks or formal financial institutions[31].

30 Pakistan Microfinance Network (2013)

31 Hasan, Islam, (2008)

In the case of Pakistan, there is a lack of comprehensive standardized credit data. In this case, financial instruments which are low risk can be attractive to investors. These can include asset-based finance, alternative forms of debt, hybrid tools and equity investments, however it is important to note that not all are suitable for all types of enterprises. Looking within the region, in India, Term Finance, Online Seller Finance, Pay Later, Merchant Cash Advance and Supply Chain Finance are some of the flexible credit products available to SMEs. In Kenya, banks are introducing innovative financial products, including business-specific accounts, digital banking systems and other value addition services such as memberships to business clubs and networking opportunities, which further facilitate the SMEs.

There is no “silver bullet” financing solution to addressing client graduation and financing gaps. What is needed is a diverse, robust ecosystem with multiple financial products suited to the needs of different microenterprise segments who are in different stages of growth and expansion.

Literature on the subject has identified four types of families that form divisions of segmentation network defined by The Collaborative for Frontier Finance; i) high-growth ventures, ii) niche ventures, iii) dynamic enterprises and iv) livelihood-sustaining enterprises[32]; this framework can be adapted to the Pakistan context by financial institutions to encourage lending to microenterprises based on the needs of these families in different phases of their growth journey. These families are differentiated based on their attitude towards external finance as well as their financing needs. They can face different gaps or ‘mismatches’ in the market between available financial tools, loan ceilings and solutions provided by either microfinance providers or commercial banks.

Global practices pertaining to microenterprise lending reveal that appropriate products need to be designed for clients with larger loan needs. First and foremost, products must be tailored to meet the needs of the target segment, namely micro-entrepreneurs. Loan sizes, interest rates and terms should be tailored to business cash flow and loan analysis, as well as consider the economics of the entire household unit. Collateral requirements need to be adapted to existing assets, and reasonable alternatives should be clearly identified for those that require flexibility.

32 Segmenting Enterprises to Better Understand Their Financial Needs - CFF

PART 4: CONCLUSION

The needs of both micro and small enterprise clients differ from each other, which is why it is imperative for them to be segmented into different categories, so that tailor-made financial products can be devised for each segment. We have not yet seen borrowing at the higher end of the revised lending limit spectrum (i.e. between PKR 0.5m and 1m), and given the growth in microenterprise lending and average loan amount of PKR 250,000, there is still a long way to go for these clients to graduate to commercial bank lending. While microenterprises have traditionally been underserved, an argument can be made that microenterprises are also not yet ready to graduate to higher loan amounts and eventually to SME lending. MFPs should continue to serve this segment, through leveraging networks, the legal and regulatory framework and using diversification and innovation of financial tools and products, capacity building of clients, complemented by market research to successfully capture this segment.

However, while some microfinanceclients may be able to graduate to SME lending and higher loan amounts. Hence MFPs should continue to serve their existing microenterprise clients as well as tapping into a previously untapped market segment and offer different loan products to, for example, tractor loans, tube well loans etc. that suit their needs. In the future, these clients may move up the ladder to SME lending.

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