PERSPECTIVE MARCH 2020

IS THE MSME BANKING STRUGGLE IN SOUTHEAST ASIA OVER FOR TRADITIONAL BANKS?

by Stefano Sorrentino, Cesare Zanotti, Aljo De Ungria, Pedro Milanez

VALUE PARTNERS

CONTENTS

EXECUTIVE SUMMARY

Southeast Asia (SEA) is one of the fastest growing markets in the world, and its growth is mainly supported by micro, small, and medium-sized enterprises (MSMEs). MSMEs' contribution to Southeast Asian countries' GDP is significant, ranging from 37% to 59% depending on the country. However, the disparity between MSMEs' contribution to GDP and their share of total credit issued still exists in all SEA countries. This financing gap remains an issue in SEA since traditional banks have been historically unable to serve the segment due to onerous documentary requirements, stringent credit policies, conservative risk attitudes, high cost structures, misaligned skillsets, and service models and service levels that do not fit with what MSMEs need.

To grab a piece of this underserved pie, traditional banks need to drastically change their business models by building and strengthening their MSME teams, creating dedicated salesforces, expanding distribution channels, developing customized products and services, launching tailored advertising and marketing activities, relaxing documentary requirements and credit policies, changing their risk attitudes, automating back-end processes, and employing a test-and-learn approach. Implementing these changes is not at all easy – banks have been trying for decades without much success.

This inertia is mainly due to the influence of banks' legacy systems and focus on maintaining their existing customer bases. In fact, global or even regional MSME banking best practices do not seem to exist.

By contrast, fintech firms have proliferated as they do business so efficiently that they can bear relatively more credit losses. Among these players are payment providers, peer-to-peer lenders, and even companies whose core businesses are not in finance (e.g. Grab). However, fintech firms still account for a small market share of the total lending market, as they lend with small loan ticket sizes, usually ranging from USD 100 to 500, so they require a larger number of customers to be sustainable. Also, their reach, though potentially unlimited (being digital), must cope with high competition, low differentiation, weak brand awareness and potentially low customer loyalty.

At present, an opportunity to combine the traditional banks' strengths (i.e. brand, branches, customer's trust, big balance sheets, investment capacity, etc.) with the innovations provided by the fintech world (i.e. data analytics, efficiency, online or digital presence, agile business model, customer orientation, etc.) is on the table.

The mix of these features, if properly combined, can be the key to success in the MSME banking sector. Therefore, one of the fastest and most cost-efficient ways for traditional banks to grow in the MSME lending space is to develop partnerships with fintech firms. Acquiring - or partnering with - a fintech company, allows a bank to reduce costs and shorten the time-to-market required to develop its own MSME business, as well as accelerate the build-up of the required capabilities. On the other hand, this approach is not risk-free, given the substantial peculiarities and remarkable differences that characterize the two parties involved.

Value Partners has completed numerous engagements with financial institutions and fintech companies in the MSME segment in SEA, and is uniquely positioned to support banks and other financial institutions in developing and executing successful partnership strategies, and ultimately capturing a greater share of customer value in the MSME segment.

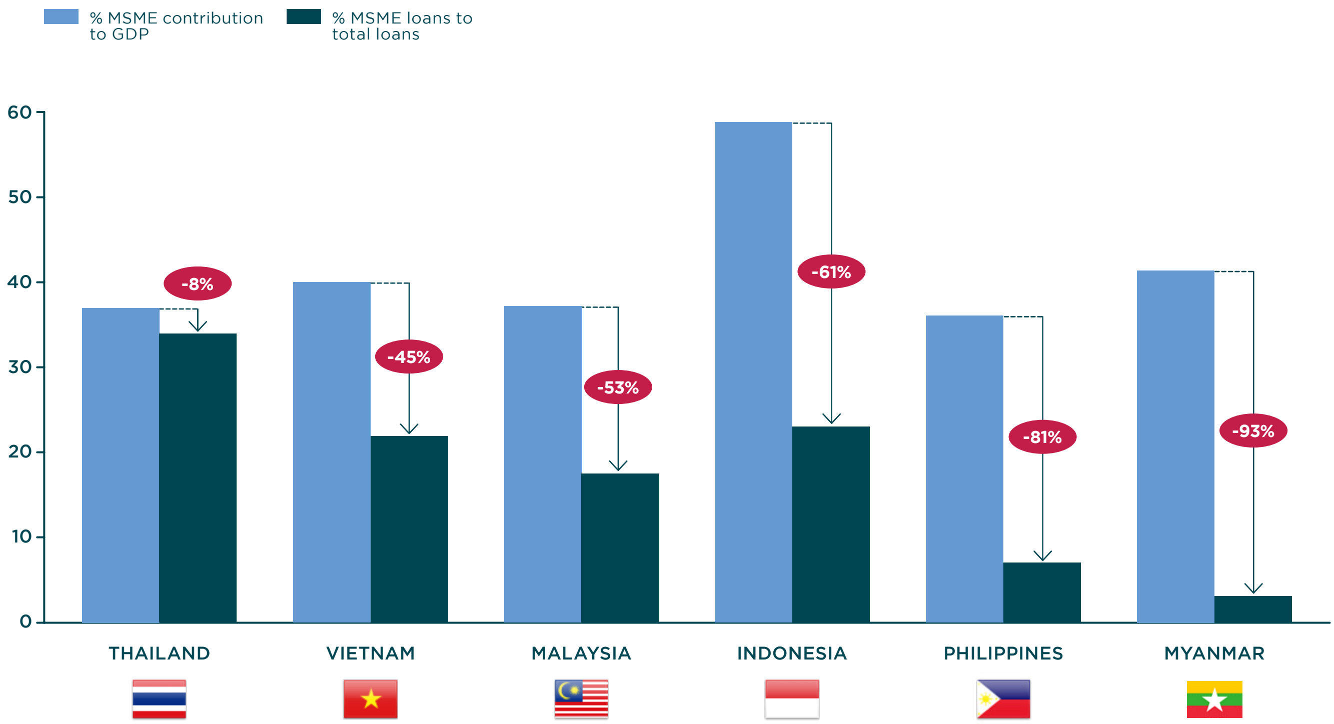
To achieve success in the MSME segment in SEA, a traditional bank should build an entirely new business (including people, products, processes, and tools), which requires a shift in legacy mindsets and attitudes, especially towards risk.

THE MSME SEGMENT IN SOUTHEAST ASIA — EXISTING PLAYERS AND THEIR STRUGGLES

The definition of micro, small, and medium-sized enterprises (MSMEs) varies by country and by bank (e.g. based on employees, assets, revenues, ownership, existing relationship with the bank, etc.). Notwithstanding the classification, arguably MSMEs' contribution to GDP in Southeast Asia (SEA) is significant, ranging from 37% to 59%.

However, the disparity between MSMEs' contribution to GDP and their share of total credit issued still exists in all SEA countries (see Exhibit 1), with the biggest gap observed in Myanmar and Philippines.

EXHIBIT 1
MSME share to country GDP and total loans in selected ASEAN countries



Source: OECD, Bangko Sentral ng Pilipinas, Bank of Thailand, Bank Indonesia, Ministry of Industry (Myanmar), Bank Negara Malaysia, Value Partners analysis.

The MSME lending market is huge, and a substantial portion of it remains unserved by existing financial institutions, especially in the Philippines and Indonesia (see Exhibit 2).

The financing gap still exists as traditional banks have been historically unable to serve the segment as their lending models are misaligned with the characteristics and needs of the MSME segment (see Exhibit 3).

EXHIBIT 2
Potential MSME loans market size and gap (USD Bn) in selected ASEAN countries

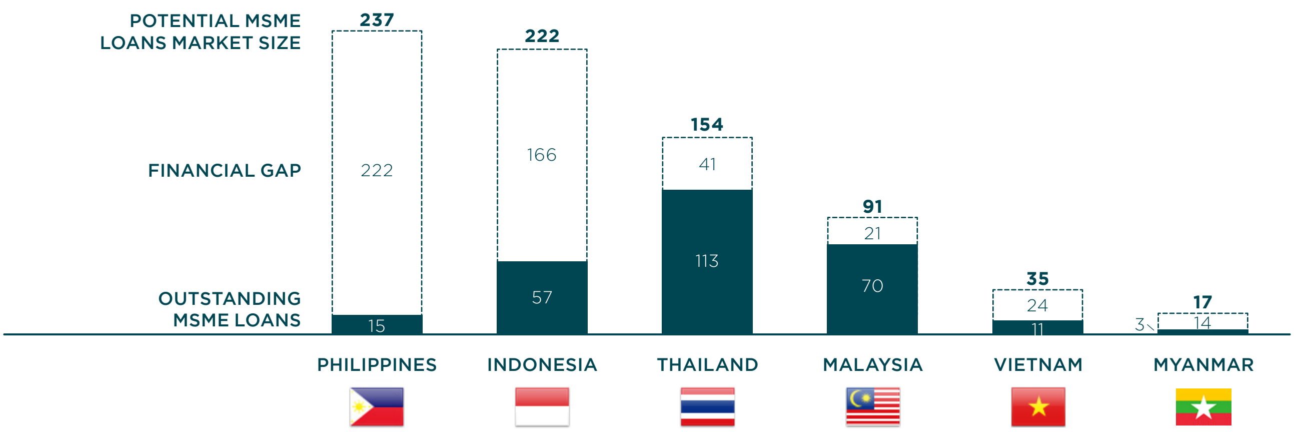


EXHIBIT 3
Traditional bank's lending model vs. general MSME segment needs / characteristics

	TRADITIONAL BANKS		MSMES
DOCUMENTS REQUIRED	Require proof of income such as financial statements and tax returns	X	Do not have formal accounting records and / or are not registered businesses
CREDIT POLICY	Feature a long approval process, approve lower loan amount and require collateral	X	Need funds almost immediately and cannot provide collateral
RISK ATTITUDE	Charge relatively lower interest rates and maintain low levels of non-performing loans	X	Pay for high interest rates, have higher default incidences than larger companies
COST STRUCTURE	Incur high compensation and physical asset costs, with increasing digitalization costs	X	Spread across a country, even in rural areas, and have heavy usage of mobile phones
SKILLSETS	Train salespeople to serve either individual accounts or corporate clients	X	Require different sales and service approach (e.g. need knowledge of SME business and owner's character)
SERVICE MODEL AND LEVEL	Require in-person interaction, submission of physical documents, mostly through a single channel	X	Heavy use of internet and social media, lack the time to leave the business operations

Source: IFC, SME Finance Forum, Company websites, Value Partners analysis.

By contrast, fintech firms can conduct their business more efficiently, and hence can afford to bear relatively more credit losses.

Fintech firms have been growing faster than traditional banks both in terms of the number of players and their loan portfolio sizes. In the Philippines, the number of fintech players in the MSME lending segment more than doubled in the past 5 years (see Exhibit 4). In Indonesia, peer-to-peer lending almost doubled in value in only 5 months from December 2018 to May 2019 (see Exhibit 5).

Moreover, other technology players without core lending businesses have entered the MSME lending segment.

Grab, whose main business is transportation services, has started lending to SMEs in Singapore and plans to boost its SME financing by launching pilots in the Philippines and Thailand.

However, despite their proliferation, fintech firms still have limited individual market shares in the credit sector, as they lend with small loan ticket sizes, usually ranging from USD 100 to 500, and therefore require a large number of customers to be sustainable. In addition, despite their potentially unlimited customer reach due to their digital service model and delivery channels, fintech firms must cope with high competition, low differentiation, weak brand awareness, and potentially low customer loyalty. As a result, most of them are not yet profitable.

EXHIBIT 4
Growth of fintech lenders in the Philippines

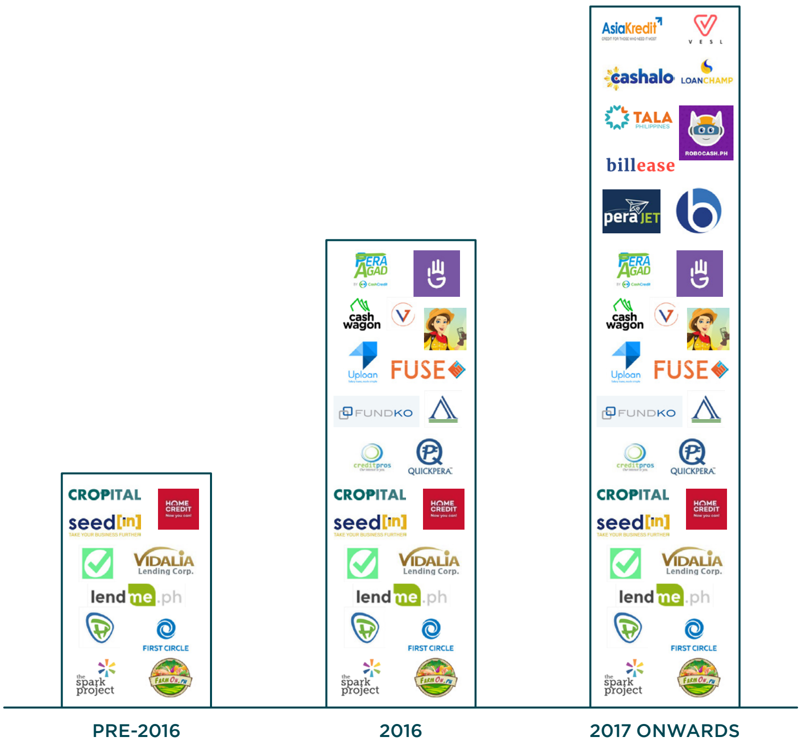
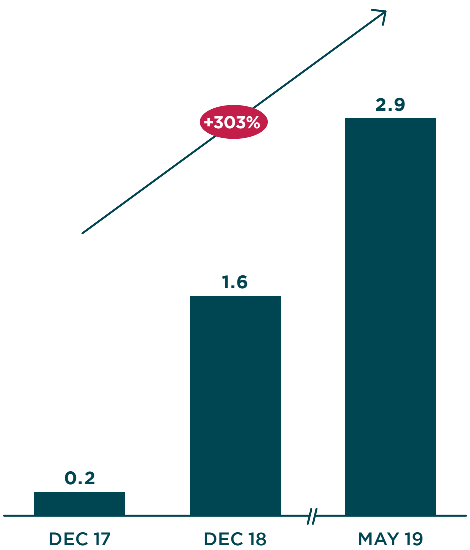


EXHIBIT 5
Total P2P Lending in Indonesia (USD Bn)



Source: Company websites, Fintech news, Asian Development Bank.

TO CREATE A SUCCESSFUL MSME LENDING BUSINESS IS A PAINSTAKING PROCESS FOR A BANK

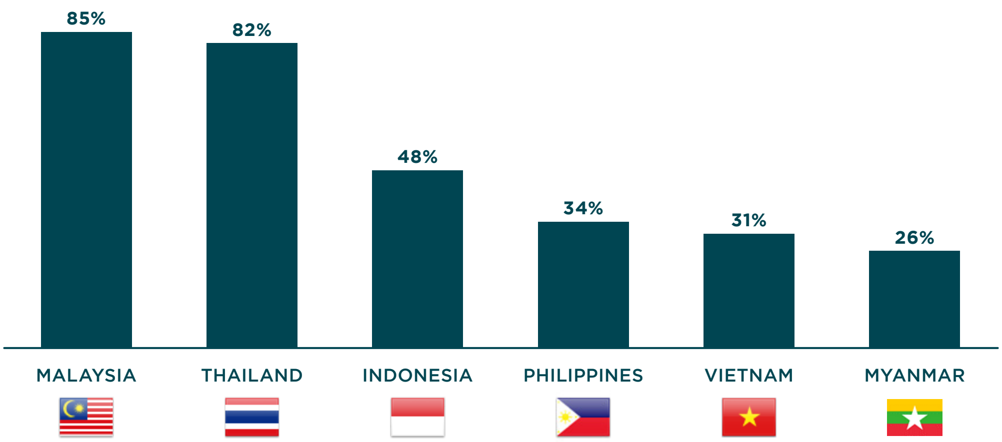
To achieve success in the MSME segment in SEA, a traditional bank should build an entirely new business (including people, products, processes, and tools), which requires a shift in legacy mindsets and attitudes, especially towards risk. The list of required changes is substantially long, as illustrated in the following paragraphs.

Make it nimble. Separating the MSME unit from the rest of the bank will result in management decisions that are less influenced by legacy mindsets and systems, and more accurate profitability measurement, avoiding penalizing overhead allocations. In addition, reducing internal levels of approval will allow adaptations in the business model to be implemented quickly.

Know your segment. While most banks categorize MSME as "small corporates", the truth is that these enterprises differ greatly from large corporates, and resemble retail customers more. MSMEs' attitudes, behaviours, needs, and expectations towards a financial service provider are mostly unknown to traditional banks, and hence a deep and comprehensive study of the segment characteristics is required before making any other business decision.

Change your risk attitude. When lending to MSMEs, banks should look at the overall profitability of the business (i.e. risk-adjusted margin) rather than just monitoring non-performing loans (NPLs). In fact, although MSMEs show less disciplined repayment behaviours, they are generally also willing to pay higher interest rates to access credit facilities (within a short timeframe).

EXHIBIT 6
Adult population with bank account by selected Southeast Asian country



Source: World Bank, Hootsuite, WeAreSocial.

Reduce bureaucracy & relax rules. Banks' credit policies need to consider the segment characteristics while coping with regulatory requirements. For example, Exhibit 6 (previous page) shows that the percentage of the adult population with a bank account in Indonesia, Philippines, Vietnam, and Myanmar is below 50% and thus, bank statements as a loan application requirement may not fit the business model for the MSME segment, especially for the micro and small businesses.

Bring in new minds. To serve a new segment, companies typically need new capabilities.

For banks, the best way to set up an MSME team is to deploy a mix of internal and external hires, from different backgrounds (retail, corporate, sales, analytics, etc.). In addition, the management needs to evolve their understanding of the MSMEs by conducting field work and gathering first-hand knowledge of their business operations, and by attending related forums and events.

Be dedicated. The MSME segment has specific needs that are different from other segments and thus, requires the banks to assign a dedicated salesforce team(s) with proper knowledge and tools (see Exhibit 7).

EXHIBIT 7
Building and gearing MSME salesforce teams

	TAILORED TRAINING	DIGITAL TOOLS
MICRO-ENTERPRISE SALES TEAM	• Characteristics of micro businesses • Financial literacy	• CRM tools
SMALL ENTERPRISE SALES TEAM	• Characteristics of small businesses • Product and services preference	• Mobile and online loan application
MEDIUM ENTERPRISE SALES TEAM	• Characteristics of medium businesses • Maintaining relationships with management and owners	• Sales analytics tool

In addition, the bank's salespeople should adopt a proactive approach, be specialized and tech savvy, and not necessarily equipped with a strong banking background (Exhibit 8).

Extend your reach. Considering MSMEs' geographical presence (semi-urban and rural areas), size, age (all ages, including youth), lifestyles (open to innovation), banks need to expand their sales channels through technology, agents, referrals, and third-party providers (see Exhibit 9).

EXHIBIT 8
Ideal skillset of a salesperson in the MSME segment

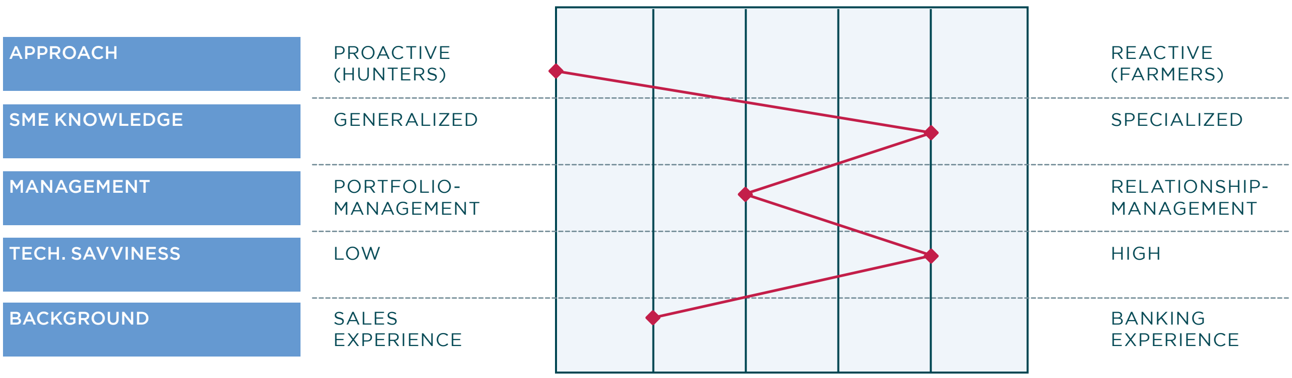


EXHIBIT 9
Expanding sales and distribution channels

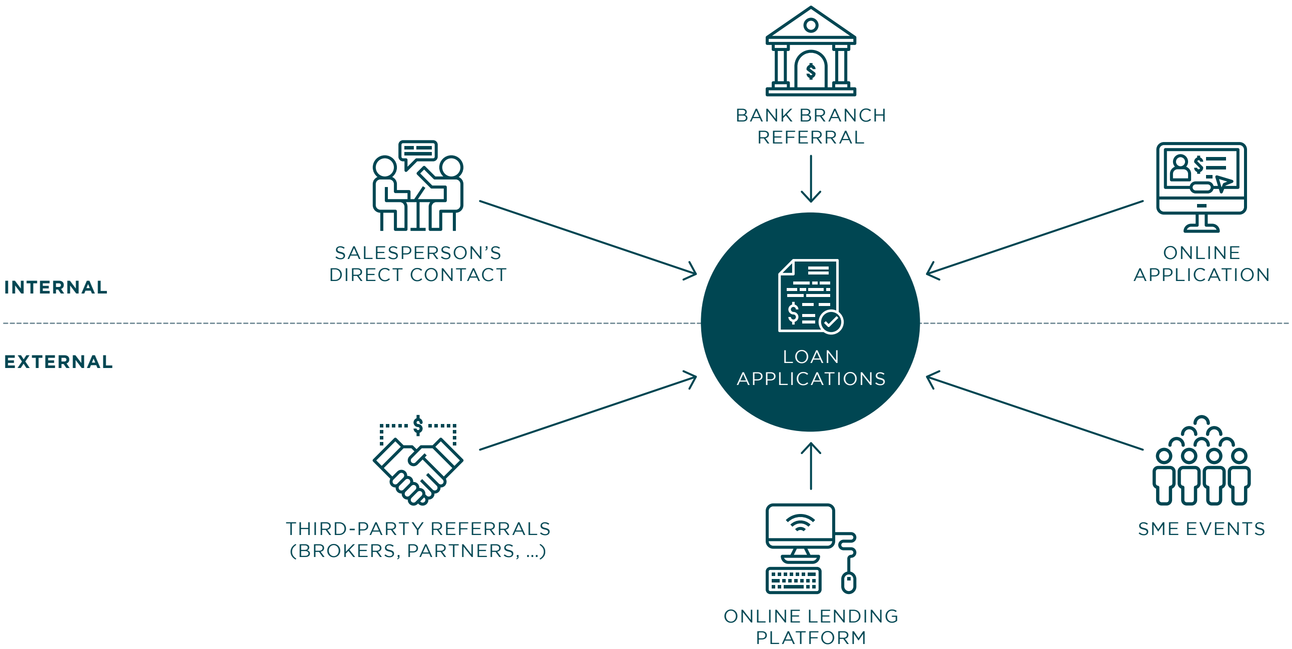


EXHIBIT 10
Illustration of automated loan product recommendation

EXAMPLE OF SMALL LOAN PRODUCT RECOMMENDATION TOOL

- **RECOMMENDED PRODUCT**: FRANCHISING LOAN
- **ANNUAL INTEREST RATE***: 8% - 12%
- **APPROVAL TIME***: 3 – 5 WORKING DAYS

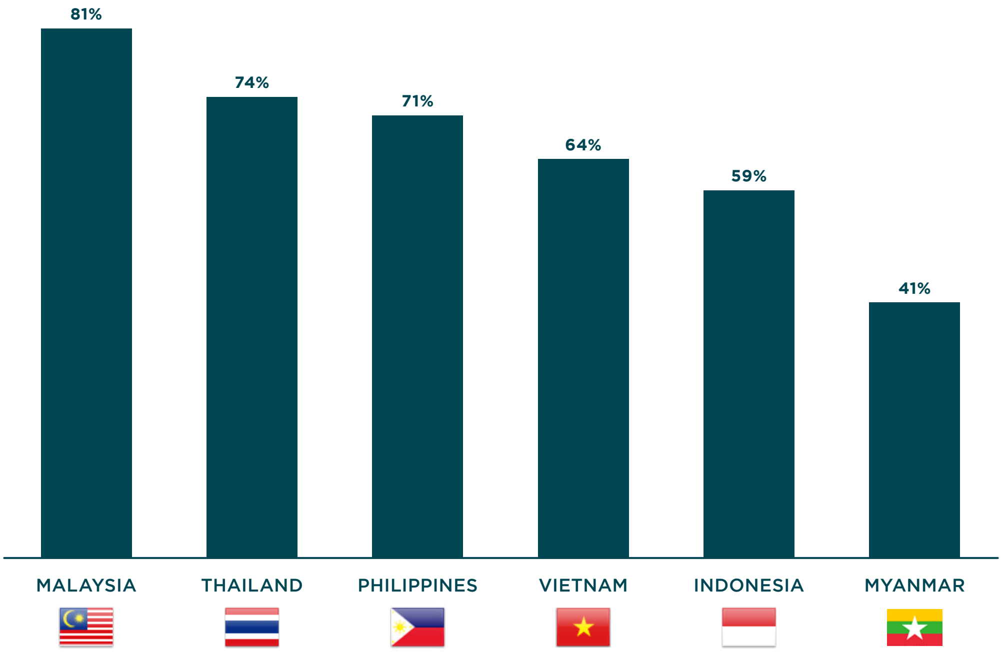
Note: (*) subject to further credit assessment.

Customize your offer. As is the case for large corporates, several factors need to be considered when developing a value proposition for MSMEs. Examples of factors to consider include MSMEs' business' life cycle (e.g. loans for start-ups, loans for micro-entrepreneurs who have business at expansion stage, etc.), loan purpose (e.g. franchise loan, asset acquisition loan, machinery funding, etc.), and industry (e.g. tailored loan products for restaurants, pharmacies, etc.).

Subsequently, each customer sub-segments should be offered a specific, seemingly tailor-made loan product (see Exhibit 10 on previous page).

Leverage social media. Especially with MSMEs, banks should leverage the power of social media, for both marketing and credit scoring purposes. Exhibit 11 shows that it is worth investing in social media advertising in Malaysia, Thailand, Philippines, Vietnam, and Indonesia.

EXHIBIT 11
Active social media user penetration rate by selected Southeast Asian country



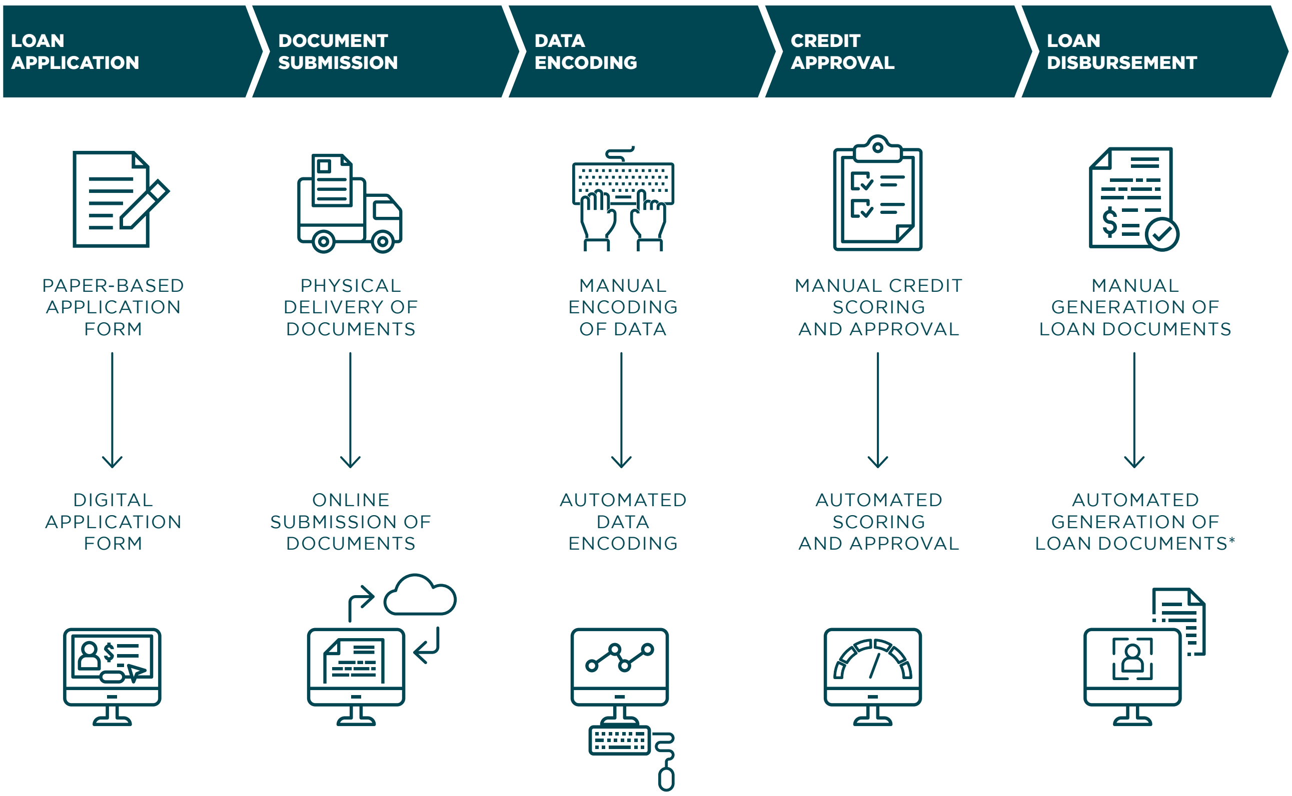
Source: Hootsuite, WeAreSocial.

Automate and digitize. In the MSME segment, banks compete with fintech firms, that can approve and disburse loans within a few days, or sometimes hours. To achieve fast loan processing times, banks have no option but to automate and digitalize their end-to-end processes (see Exhibit 12).

Test and learn. The test-and-learn approach is a crucial factor in achieving success in the MSME segment, as illustrated in Exhibit 13 next page.

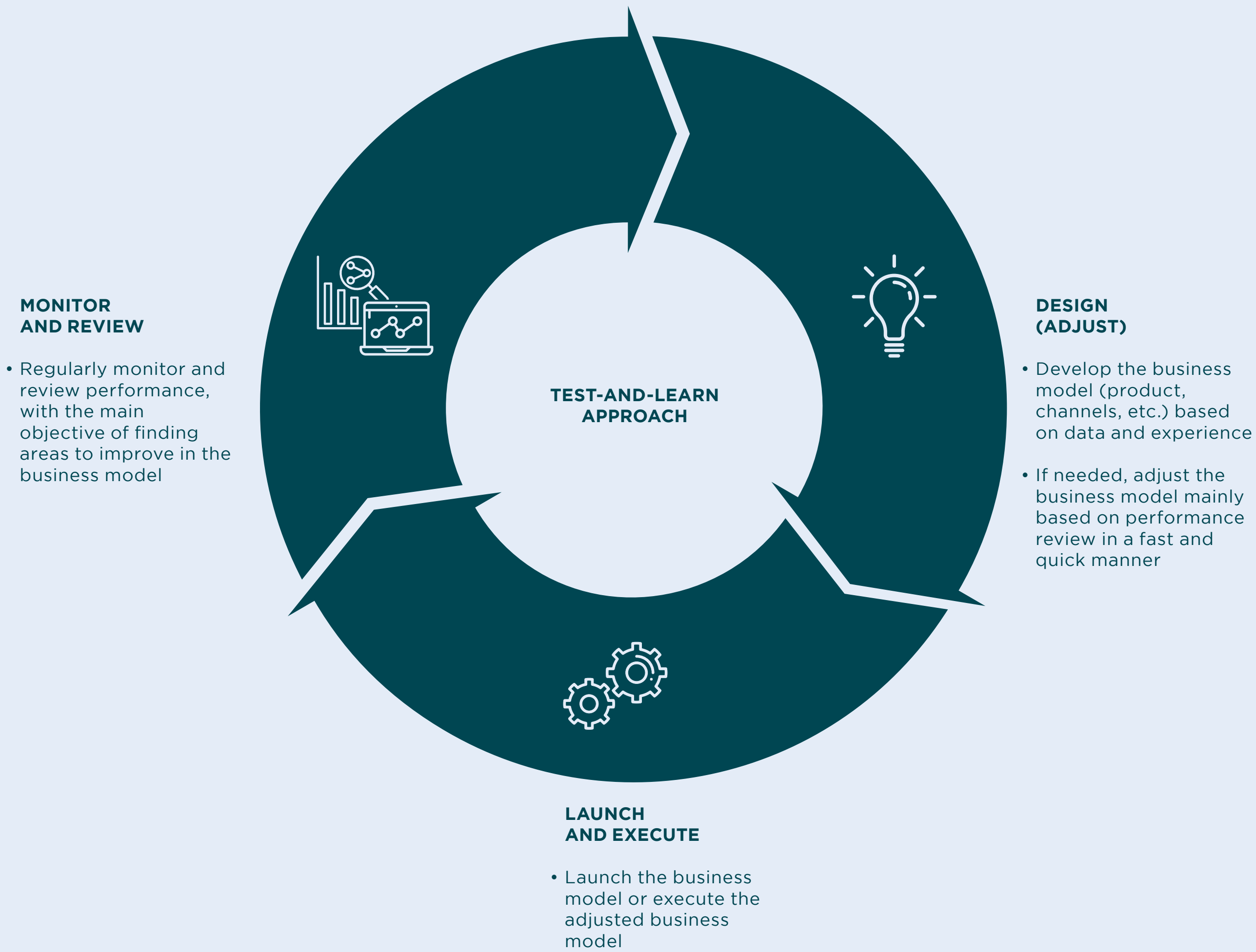
Implementing all these changes is everything but easy. Banks around the developing world have been trying for decades and have mostly failed or given up. In fact, global or even regional developing market MSME banking best practices do not seem to exist at all.

EXHIBIT 12
Automation of loan application processes



Note: (*) e.g. with facial recognition, fingerprint, ...

EXHIBIT 13
Illustration of test-and-learn approach



A POSSIBLE SHORTCUT: PARTNERING WITH FINTECHS

At present, an opportunity to combine the traditional banks' strengths with the innovations provided by the fintech world is on the table.

The mix of these features, if properly combined, can be the key to success in the MSME banking sector (see Exhibit 14).

Therefore, one of the fastest and most cost-efficient ways of getting ahead of the market in the MSME lending space is to develop partnerships with fintech firms. Acquiring - or partnering with - a fintech company, allows a bank to reduce costs and shorten the time-to-market required to develop its own MSME business, as well as accelerate the build-up of its required capabilities.

EXHIBIT 14
Combining the strengths of a bank and a fintech firm

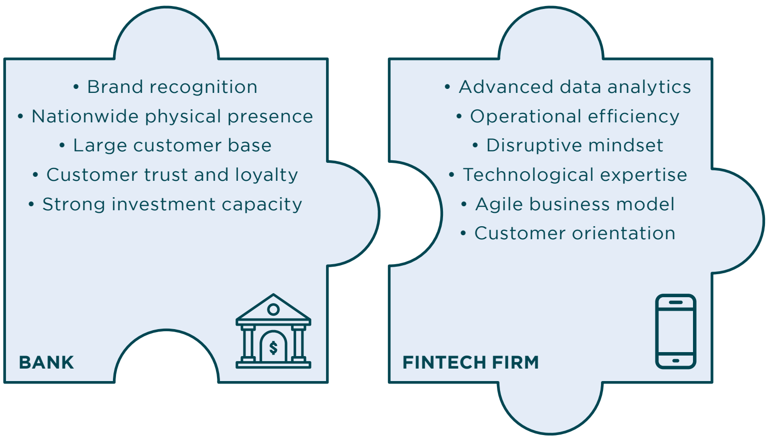


EXHIBIT 15
Assessment of options to build an MSME business by a traditional bank

OPTIONS TO IMPLEMENT BUSINESS MODEL CHANGES		TIME-TO-MARKET	COSTS	CAPABILITY BUILD-UP
DEVELOP INTERNALLY	Banks to develop internal capabilities on its own	LONG	LOW	SLOW
BUY SOLUTIONS	Banks to buy needed technology or capabilities	MEDIUM	MEDIUM	FAST
PARTNER WITH A FINTECH	Banks to partner with fintech firms	SHORT	LOW	FAST

Depending on the strengths and weaknesses of the bank, different types and levels of partnership could be formed. Exhibit 16 below shows examples of partnerships already established in Southeast Asia.

The scope of partnerships may also vary, and include lead generation, distribution channel expansion, new product introduction (peer-to-peer lending, receivables financing, etc.), credit scoring improvement, and payment channel diversification, to name a few (see Exhibit 17 next page).

Despite the "best of both worlds" combination resulting from the partnership between banks and fintech firms, banks need to consider the potential risks of this endeavour, such as:

- Lack of clear goals and scope of a partnership (e.g. to fill skill gaps, to test a new model, to push for internal improvements, to challenge the status quo, etc.)
- Failure to define a shared timeline and medium-term view, including the effort to be deployed and the time needed to see the expected results
- Tendency by one or both parties to pursue its own growth and development agenda, reducing the synergies and the upselling opportunities
- Technological incompatibility of different information systems and technological frameworks adopted by the parties
- Cultural divide between the parties and lack of a common understanding of the opportunities and risks, leading to frustration and discontent.

EXHIBIT 16
Illustration of types of partnerships that could be formed with fintech firms

UTILIZING FINTECH'S PRODUCTS AND PLATFORM	LEVERAGING FINTECH'S CUSTOMERS AND DATABASE
Rizal Commercial Banking Corporation (RCBC) / **Acudeen**	**Kasikorn Bank (KBank)** / **Grab**
RCBC launched USD 2 billion fund for Acudeen to **offer receivable financing to the MSME segment through its online platform**	KBank aims to **launch the GrabPay electronic wallet** and to get **access to Grab's data** to formulate loan product proposals to drivers and merchants
OFFERING PRODUCTS THROUGH FINTECH'S PLATFORM	**LEVERAGING FINTECH'S BLOCKCHAIN EXPERTISE**
Siam Commercial Bank (SCB) / **GoJek and GET, GoJek's subsidiary**	**Unionbank of the Philippines (UnionBank) and UBx** / **OneConnect Financial Technology (OneConnect)**
SCB aims to **offer total financial solutions** (loans, payments, etc.) to **GET drivers, merchants and end consumers** through the GET mobile application	OneConnect partnered with UnionBank's fintech subsidiary UBX to co-create Philippines' first **blockchain-enabled platform for MSMEs**

Source: Company websites, news articles, Value Partners analysis.

EXHIBIT 17
Mapping of potential fintech's and possible scope of partnership (not-exhaustive)

POTENTIAL FINTECH PARTNERS IN THE SEA BANKING LANDSCAPE

LEAD GENERATION	DISTRIBUTION CHANNEL EXPANSION	NEW PRODUCT INTRODUCTION	CREDIT SCORING IMPROVEMENT	PAYMENT CHANNEL DIVERSIFICATION
TigerData	eCompareMo.com	First Circle	Lenddo	GrabPay
2C2P	lendme.ph	BIMA	trustingsocial	dragonpay
midtrans	TheBank	AKTIVAKU	CredoLab	ipay88
FullSuite	KreditGoGo	ammana	KayaCredit	PayPal
OLIVIA				GCash
QWIKWIRE				

Source: Company websites, Value Partners analysis.

CONCLUSION

A huge financing gap still exists in the Southeast Asian MSME segment, that both traditional banks and fintech players have been struggling to fill. So far, they have not fully realized that the combination of each other's strengths and assets could lead to winning propositions.

One of the fastest and most cost-efficient ways of getting ahead of the market in the MSME lending space is to develop partnerships with fintech firms. Acquiring – or partnering with – a fintech company, allows a bank to reduce costs and shorten the time-to-market required to develop its own MSME business, as well as accelerate the build-up of its required capabilities.

Given that hundreds of fintech firms are born every year in Southeast Asia, banks need to carefully identify the type of partnerships they need in order to achieve leadership in the MSME segment. There is no one-size-fits all solution as fintech firms also have their own strengths, weaknesses, and goals.

Value Partners has completed numerous engagements with financial institutions and fintech companies in the MSME segment in SEA. Given this experience, Value Partners is uniquely positioned to support banks and other financial institutions in developing and executing successful partnership strategies and ultimately capturing greater share of customer value in the MSME segment.

AUTHORS

STEFANO SORRENTINO
Partner
Hong Kong office

Stefano.Sorrentino@valuepartners.com

CESARE ZANOTTI
Senior Engagement Manager
Hong Kong office

Cesare.Zanotti@valuepartners.com

ALJO DE UNGRIA
Associate
Hong Kong office

Aljo.DeUngria@valuepartners.com

PEDRO MILANEZ
Business Analyst
Hong Kong office

Pedro.Milanez@valuepartners.com

VALUE PARTNERS

ABOUT VALUE PARTNERS

Value Partners, founded in Milan in 1993, is a global management consulting firm with a proven track record across the financial services and telecommunications industries. Over a quarter of our projects are on behalf of financial institutions, covering micro-finance, retail and business banking, payments and digital services. We also possess one of the largest TMT practices worldwide, as we collaborate with the leading Telecom, Media and Content players globally, on projects that span the full universe of telecom & media technologies – fixed, wireless, broadband, satellite, broadcast –, and range from customer segmentation, to product launch, market entry, strategic alliances, and M&A.

An area of focus in developing countries across the Middle East, Asia and South America is also "financial inclusion", helping universal banks and other industry players to target the unbanked population at the bottom of the pyramid, through mobile financial services or more traditional community lending business models. Members of our team have played a primary role in advancing financial inclusion by building lending businesses for microenterprises and Small Medium Enterprises (SME) in multiple Asian countries. In this context, we help our clients adapt their business models in an increasingly complex and rapidly evolving business environment, to maximize impact and returns in the financial services industry.

We serve our client worldwide from our offices in Milan, Turin, London, Rio de Janeiro, Shanghai, Hong Kong.

For more information on the issues raised in this note please contact the authors.

Find all the contact details on valuepartners.com

Is the MSME banking struggle in Southeast Asia over for traditional banks?

Published by
Value Partners
Management Consulting
1402, 14/F, Harcourt House
39 Gloucester Road
Wan Chai
Hong Kong

March 2020

Written and edited by:
Stefano Sorrentino
Cesare Zanotti
Aljo De Ungria
Pedro Milanez

If you would like to subscribe or to be removed from our mailing list please write to: subscription@valuepartners.com