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SME Access to Finance

Market Assessment for Malta

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1 Executive Summary

The present Small and Medium-sized Enterprises (SME) Access to Finance Market Assessment (AFMA) report for Malta has conducted a thorough analysis of the existing market environment for SMEs, including lessons learned from existing Financial Instruments (FIs) in the country and has implemented a methodological approach, aiming to define the existing gaps regarding SMEs and their access to finance. In order to draw conclusions reflecting the reality of the SME environment in Malta and to provide recommendations for the future Proposed Investment Strategy for Financial Instruments in the framework of the Operational Programme (OP) under the ESI Funds, financing gaps have been identified across different financial products and across three categories of SMEs according to their size, namely micro-enterprises (0 to 9 employees), small (10 to 49) and medium-sized enterprises (50 to 249).

The Maltese economy, driven by gaming, ICT and financial services, outperformed the Eurozone average since the country joined the Union in 2004 and has proved more resilient to the crisis than many of its European counterparts, partly thanks to the strong domestic SME population. In 2008, the Maltese GPD contracted by 2.5% percent (as compared with almost 4% for EU-28), and experienced a sharp recovery in 2010 (4%, 2 percentage points ahead of the EU-28 average) (Eurostat, 2014). This success is partly due to the recent regulatory adjustments and its attractiveness for Foreign Direct Investments (FDIs) from EU Member States (73.2% of total FDI in 2013) (NSO, 2014).

SMEs dominate the corporate landscape of Malta and are a key driver of its economy. SMEs represent almost the entire population of enterprises: 99.8% in 2012, in line with the EU-28 average (99.8%) (NSO, Eurostat, 2014). The population of active SMEs declined by 1.1% in 2011 and by 3.7% in 2012, mainly because of the implementation in 2011 of a new regulation exempting from VAT reporting SMEs with a turnover under EUR 7,000[1]. Among these SMEs, approximately 95% are micro-enterprises, i.e. 2.5 percentage points ahead of the EU-28 average. Small and medium-sized enterprises accounted respectively for 4% and 0.9% (NSO, Eurostat, 2014). SMEs weight 78.6% of national employment, a higher proportion than in the EU-28 (67.2%) (NSO, Eurostat, 2014). Between 2009 and 2012, the share of micro-enterprises in the employed population decreased by 2.4%, establishing at 32.3% in 2012 (almost 2 percentage points above the EU-28 average). In the same period, the share of small and medium-sized enterprises increased and reached, respectively, 22.1% and 24.2% in 2012 (NSO, Eurostat, 2014).

1 Value Added Tax Regulations, 2010 (Exemption from Registration), coming into force on 1 January 2011, as notified in the Legal Notice 524 of 2010.

Because of the dominance of the banking sector, the supply almost exclusively consists of bank loans, whereas equity and microcredit play a very marginal role in the financing of SMEs.

The Maltese banking sector appears to be in a good position to step-up lending, thanks to a strong capital basis and high levels of liquidities. Indeed, The World Economic Forum rated Malta's banking sector as the 12th soundest in the world out of 144 countries, and placed Malta at number 15 for financial market development (Malta Financial Services Authority, 2012). However, commercial banks apply interest rates and collateral requirements that are relatively higher than the rest of the Eurozone.

Taken together, young SMEs which often lack collateral and have no credit history can face difficulties in their access to finance: bank loans are unaffordable, whereas alternative products supply is not especially developed.

Bank-lending to private Non-Financial Corporations (NFCs) declined at a fast pace during 2013, falling by 4.9%, after a drop of 0.7% in 2012. Apart from subdued domestic private investment, this could be an indication of continuing tightness in credit standards. The reduction in loans to private sector NFCs was broad-based, but stemmed mainly from reduced borrowings by firms in the construction and wholesale and retail trade sectors. For the first time since the onset of the financial crisis, loans to private NFCs in Malta during the second half of 2013 contracted at a faster annual pace than in the Eurozone as a whole.

On the demand side, the three size categories of SMEs were analysed in order to provide insight into their needs. The findings are outlined in the following paragraphs:

Micro-enterprises represent the vast majority of companies in the country (95% of all SMEs). Micro-enterprises have financial needs for working capital and investment purposes, but are experiencing problems in accessing the banking system. Access to mainstream banking products tends to be limited to those micro-enterprises with a good credit history of the owner, larger turnovers and lower levels of debt financing and sufficient equity invested according to banks' standards. Micro-enterprises which cannot fulfil the bank's requirements seek financing from informal sources (family and friends) because they are not aware of the existing Financial Instruments providing guarantees and lack knowledge of banking procedures.

Small enterprises' share among all SMEs (4% of all enterprises) had been constantly increasing since 2009 signifying that companies are growing within the local market, in line with the growth in GDP. Small enterprises can rely on banking finance to a much larger extent than micro-enterprises. According to the findings presented in previous chapters, small companies have significant access to bank financing. They are perceived by banks as clients of interest and for the most part have the experience and knowledge to apply for loans. The majority of small enterprises indicated that they did not face obstacles when seeking finance; however, some indicated that costs of financing and other terms and conditions imposed by financial institutions are a growing cause of concern to them.

Medium-sized enterprises represent a very small but economically important segment of the SME population in Malta (0.9% of all enterprises). The financial crisis does not seem to have affected their prospects, leading to a nearly unchanged population of medium-sized enterprises. Their relatively robust asset base allows them easiest access to banking products for different uses and to diversify their types of financing. Short-term loans, overdrafts and credit lines are the most used products for this SME size. Medium-size enterprises are likely to be better educated on the suitability of different products and show for example the highest use of public guarantees.

In addition, the present report analysed **large companies'** access to finance. Results from the online survey indicated that only a small minority have insufficient access to loan products. Overall, large companies in Malta do not face any material difficulty accessing finance.

Following the description of Malta's economic and business context and the dynamics of supply and demand for SME financing, computations described in the report were able to quantify the supply and demand for specific financing products. The quantified total supply of each financial product has been estimated for each of the three categories of SME size. The quantification of the potential demand for finance from SMEs has been based on their future needs expressed in the online survey, and past use of Financial Instruments. The financing gaps have been computed, based on the potential total demand for various financial products across the SME population. However, in order to provide a better picture of the scale of unmet demand among viable companies, a second methodology was implemented to compute financing gaps based on the viable demand (referred to as Viable Financing Gaps or VFGs).

Following the computation methodologies, which will be described further on in the present report, the ranges of the potential and the viable financing gaps per annum for the total population of SMEs in the region are given in the table below. It has to be borne in mind that, against the background of an environment of imperfect information and uncertainty, there is no perfect solution to assess (*ex-ante*) SME finance market gaps, and the correct quantification of these gaps is impossible. According to the European Investment Fund's Guidelines for SME Access to Finance Market Assessments (GAFMA), which form the methodological guidance for this report, *"[t]he uncertainty and imperfect information refers not only to the "measurement" of existing gaps (assessment of status quo), but also to the forward looking elements as the market assessment has to consider the short and medium-term future (e.g. impact of current changes in bank lending behaviour on the future* *access to finance for SMEs)*"[2]. The quantification of financing gaps can only provide indications and is only one element of the analysis; it has to be considered in combination with the additional quantitative and qualitative assessments, performed throughout the present report.

Table 1: Potential financing gap and viable financing gap for loan products for the total SME population in Malta in 2014

	Potential financing gap range (mEUR)	**Viable financing gap range (mEUR)**
Short-term loans[3], bank overdrafts[4] and credit lines[5]	123 - 136	21- 23
Medium and long-term loans	148 - 164	37 - 41
Total	**272 - 300**	**58 - 64**

Source: PwC analysis, 2014.

As presented in the table above, the computations first provided the total financing gap based on the potential demand of loan products ranging from EUR 272m to EUR 300m in 2014. This gap represents a potential request for the whole year. But since SMEs tend to overestimate their needs, and the potential gap calculation is based on the responses of all SMEs and not only the *viable* ones, they should not be perceived by policy makers as amounts that should be covered in a single year or as gaps which have to be bridged by Financial Instruments. They are only an indication of financing needs in the regional economy, according to the methodologies described in the present report and market constraints experienced by SMEs. However, this indication confirms the need to apply Financial Instruments as public support mechanisms, particularly in order to catalyse further private financing for SMEs.

The estimated potential demand is based on the online survey answers provided by SME owners and is related to their knowledge of their respective markets and the perspective of their company. That is why the following points have to be taken into account when considering the financing gaps based on potential demand:

- Potential demand may not actually translate into action;
- Lack of previous investment due to the crisis;
- Limited knowledge of financing sources and products; and
- Uncertain economic environment.

[2] European Investment Fund (2014). Guidelines for SME Access to Finance Market Assessments (GAFMA). Working Paper 2014/22.

[3] Short-term loans are defined as loans to be repaid in less than one year and are most commonly used to finance working capital needs.

[4] Overdrafts are an extension of credit from a bank when an account reaches zero thus allowing a company to continue withdrawing money even if the account has no funds; also primarily used for working capital fluctuations.

[5] Credit lines are defined as maximum loan amounts approved by a bank to a company where interest is charged only to the used part of the loan.

The online survey conducted for the present report also allows an estimate of the SMEs that are considered viable (i.e. exhibiting growth) but have previously been unsuccessful in seeking loan financing: they represent circa 10.2% among micro-enterprises and none among small and medium-sized enterprises. The Viable Financing Gap (VFG) has been estimated at between EUR 58m and EUR 64m for all loans for the total SME population in Malta in 2014. This gap will have to be bridged partially by the financial system and partially by publicly supported Financial Instruments, i.e. in order to catalyse private financing for SMEs.

The analysis furthermore highlighted how EU-funded Financial Instruments (JEREMIE, JASMINE and CIP) have contributed, and keep contributing, to the improvement of SMEs' access to finance in Malta. These Financial Instruments partially cover the scope of current SMEs' needs (especially in terms of guarantees).

Overall, the existing Financial Instruments supported by public interventions have positively impacted the financing conditions and environment of the national market. They however allow room for improvement:

- Involvement of different financial intermediary to enhance competition of products and visibility among SMEs;
- Creation of sufficient impact to address the lack of equity and microfinance actors in the market.

The present AFMA report concludes that the impact of existing Financial Instruments could be increased with the use of ESI Funds into diversified existing or new Financial Instruments. This use would allow offering new products to better service SMEs' specific needs.

The following paragraphs summarise the findings and conclusions per financial product, and present high level recommendations for the formulation of a future investment strategy.

Microfinance

Demand for microfinance covers both existing SMEs and people currently unemployed and/or at risk of poverty who see themselves as potential business creators if their access to finance were facilitated (financial inclusion, leading to social inclusion).

There is practically no microfinance market in Malta. The few existing initiatives focus on supporting targeted populations, through charity rather than microfinance for business purposes.

In the case of Malta, the potential financing gap for existing micro-enterprises in 2014 ranges between EUR 108m and EUR 120m. Concerning microfinance for financial inclusion, a financing gap has been estimated around EUR 6m. The microfinance financing gap may be partly explained by:

- High demand from micro-enterprises (especially 0 employee) facing difficulties when seeking financing from financial institutions, notably commercial banks;
- The absence of microfinance in Malta;
- Difficulties for potential beneficiaries in identifying microfinance products.

The table below summarises the financing gap for microfinance.

Table 2: Potential financing gap for microfinance for micro-enterprises in 2014, including social inclusion

	Financing gap for existing micro-enterprises (mEUR)	Financing gap for social inclusion (mEUR)	Total financing gap for microfinance (mEUR)
Microfinance	**108 - 120**	**6**	**114 - 126**

Source: PwC analysis, 2014. See Boxes 1 and 2 for detailed descriptions of the methodology.

Demand for microfinance products will increase as the number of newly created 0 employee micro-enterprises is expected to continue increasing.

Short-term loans, overdrafts, credit lines

On the supply side, the analysis has highlighted that commercial banks do not face liquidity issues but still apply relatively high interest rates on SMEs' loans, due to their conservative approach toward financing SMEs leading. Local stakeholders believe that most of Maltese SMEs are under-capitalised when compared to their EU counter-parts.

On the demand side, the priority for SMEs of all sizes is to secure the financing of working capital in order to remain operational in the short-term.

The study reveals viable financing gaps for short-term loans for micro-enterprises, but not for small and medium-sized companies, as illustrated in the table below.

Table 3: Viable financing gaps for short-term loans, overdrafts and credit lines in 2014

	Viable financing gap for micro-enterprises (mEUR)	Viable financing gap for small and medium-sized enterprises (mEUR)	Viable financing gap for SMEs (mEUR)
Short-term loans, bank overdrafts and credit lines	21 - 23	-	**21 - 23**

Source: PwC analysis, 2014. See Boxes 1 and 2 for detailed descriptions of the methodology.

Medium- and long-term loans

All sizes of SMEs use medium and long-term debt financing in Malta. These loans are sought to finance equipment renewal as well as investment and business expansion. In the short run, micro-, small and medium-sized companies intend to continue investing in their equipment and machinery as well as launch new activities. According to the analysis, micro-enterprises have more difficulties to access collateralisation than small and medium-sized enterprises. Bridging these gaps would foster investment and job creation in the region.

Viable financing gaps were calculated and are presented in the table below.

Table 4: Viable financing gaps for medium and long-term loans in 2014

	Viable financing gap for micro-enterprises (mEUR)	Viable financing gap for small and medium-sized enterprises (mEUR)	Viable financing gap for SMEs (mEUR)
Medium and long-term loans	37 - 41	-	**37 - 41**

Source: PwC analysis, 2014. See Boxes 1 and 2 for detailed descriptions of the methodology.

Equity

A potential financing gap was calculated for equity financing for all SMEs in Malta, and needs to be read as indicative for reasons explained further in the present report. The table below presents the financing gap for 2014.

Table 5: Potential financing gap for equity financing for all SMEs in 2014

	Financing gap for equity financing (mEUR)
Equity financing	**35 - 174**

Source: PwC analysis, 2014. See Boxes 1 and 2 for detailed descriptions of the methodology.

The analysis highlighted that equity financing should be considered as key for the support of SMEs in their future access to finance in view of supporting their growth strategies. However, in the design of any FI, consideration needs to be given to the presence of a sufficient critical mass in demand from specific targets for equity investment, their attractiveness to private investors and the ability of the financial intermediary to leverage existing networks and stakeholders (incubators, Chamber of Commerce) to facilitate matchmaking and provide the required mentoring and support to the SMEs.

Recommendations

The use of Financial Instruments is relatively recent in Malta. In recent years some initiatives to implement FIs and support business enterprises through loan guarantees and direct loans have been introduced, primarily though Malta Enterprise and JEREMIE.

However, the specific nature of the Maltese economy and more specifically the dominance of the banking sector have created some limitations to the use of FIs that need to be overcome.

As an EU member state, Malta has for a number of years been benefiting from various EU funding programmes, particularly grants. The launch of the JEREMIE guarantee instrument in 2011 provided another dimension towards how EU funds could be used to support SMEs in Malta. Given the take-up to date, JEREMIE has been a relative success in Malta and is considered to be a best practice example amongst other member state regions. In going forward, the challenge for Malta will be to understand how EU and national funds can be combined to foster further support for SMEs through the use of FIs. The diversification of FIs beyond guarantees, the involvement of more intermediaries, and the launch of instruments in fields that are still non-existent in the country such as microfinance and equity have to be investigated.

The key recommendations from the analysis conducted in the present AFMA report are detailed below:

a. **Support and expand the implementation of JEREMIE**.

   The implementation of the JEREMIE guarantee instrument during the 2007-2013 programming period was successful and demand for the product will continue. It stands to reason that this instrument should be further supported during the upcoming EU programming period.

   The Managing Authority (MA) should consider expanding the allocation of EU funds for the next programming period towards this instrument, given that the new instrument would span the full duration of the programming period. The MA should consider expanding the allocation of EU funds and diversifying the available Financial Instruments beyond the current JEREMIE guarantee. This could be in the form of risk sharing facilities and/or equity instruments, subject to further investigation and the prerequisites mentioned in Recommendation e). Diversification should also allow JEREMIE to design Financial Instruments more dedicated to start-up or micro-enterprises.

   In implementing JEREMIE instruments going forward, it is also important to consider appointing more than one financial intermediary, recognising that a certain critical mass will be required for each, particularly for low-leverage instruments such as risk sharing loans or equity.

b. **Consider developing specific guarantee instruments or complementing the existing instruments to facilitate access to short-term debt for working capital purposes and long-term debt for investment purposes.**
The analysis has revealed that financing gaps exist for short-term and medium and long-term loans for micro-enterprises. Moreover, it was established that an increasing need for working capital financing is appearing in the market. The main barrier to debt financing for SMEs, especially micro-enterprises, is related to the collateral requirements imposed by commercial banks. Taking into account the lack of microfinance institutions in the country, Financial Instruments in the form of guarantees and other risk mitigation products to support micro-enterprises without collateral could be developed or could complement existing guarantee products.

c. **Considering the introduction of a risk sharing loan facility.**
Besides the need for guarantee schemes and collateral support, Maltese SMEs could also benefit from a Financial Instrument which would target a reduction in the cost of lending. It was highlighted in the analysis that interest rates, including bank charges and fees in Malta are high thus affecting the overall cost of financing. With the introduction of a risk sharing loan facility, for example, SMEs and especially small and medium-sized companies willing to expand, could benefit from reduced interest rates.

However, when designing and implementing FIs, several factors have to be taken into account, such as, the leverage effect and the capacity of the market to benefit from these FIs. In the case of Malta, the priority should be put on guarantees which are mostly needed by SMEs and have a higher leverage effect.

d. **Support the provision of microfinance for existing and potential entrepreneurs.**
The supply of microfinance in Malta is still very limited and is often provided in the form of standard bank loans. Micro-enterprises are exposed to excessive interest rates and bank charges and often rely on personal assets, such as their personal properties, as collateral. The promotion of a microfinance facility provided by a non-banking institution, to support existing and potential entrepreneurs should be considered. In lack of such a specialised institution, the provision of (collateral-free) microfinance through a risk sharing scheme with commercial banks could also be considered.

e. **Create the conditions for the development of an environment that will support equity financing and an active Business Angel community.**
The equity market and business angel environment in Malta have a very weak presence. Early-stage investments in the technology and knowledge-based sectors in Malta are scarcely financed. The investment gap is particularly apparent for companies in their start-up phase, where risk and uncertainty are at their highest.

A Financial Instrument could be used to cultivate a new business mentality and raise awareness among SMEs on the benefits of equity financing. Experience in other countries has shown that equity investments in SMEs through public assistance schemes tend to attract private investors and Business Angels. With the creation of a co-investment fund acting as a lead investor, for example, private investors could be encouraged to invest in companies, especially technology and knowledge-based start-up companies, and such a fund could ultimately encourage the creation of an organised private investment community in Malta.

However, in the design of any FI, priority should be given to develop an adequate business environment as an efficient equity market does not solely depend on sufficient supply – particularly given previous attempts in Malta which have created only limited impact in the market.

f. Consider an appropriate combination of grants and FIs for investment purposes or mentoring and training support to SMEs.

Malta has implemented several grant programmes in recent years that have proved successful. A combination of grants and FIs for investment purposes could help SMEs complement their financing with banking loans and facilitate the implementation of their business plans. A combination of grants and FIs could also be envisaged in initiatives to mentor SME owners. It has been mentioned in the analysis that SMEs do not have experience in negotiating with financial institutions and in preparing business plans. Mentoring initiatives would support SMEs in applying to banks but also to grant programmes. When setting up such initiatives it is vital to keep the balance between tailoring them to the needs of SMEs and maintaining a scope sufficiently broad to ensure a reasonable take-up. As illustrated by several unsuccessful grant schemes in the programming period 2007-2013 (e.g. on vocational training of farmers or development of new farming products), too specific a programme, however well-meaning, may be inefficient, with only a handful (if any) SMEs using it.