SME Financing Needs, Knowledge, Access & Satisfaction

Punjab, Pakistan

Turn Potential into Profit

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Executive Summary

SME sector plays a significantly important role in Pakistan's economy and constitutes more than 90% of all the economic establishments operating across the country. SMEs employ 80% of the non-agricultural labor force and their share in the annual GDP is 40%, approximately; generate 25% of export earnings. In Pakistan, an enterprise is defined as 'SME' if it consists of up to 250 full-time employees, paid up capital of up to PKR 25 million and generates annual sales of up to PKR 250 million.

SMEs in Pakistan have immense potential, which can be further tapped to generate higher economic and inclusive growth levels as the sector is currently not operating at full capacity because SMEs continue to face several bottlenecks to their growth. Access to finance is the most frequently cited challenge faced by the SMEs in Pakistan. The overall lending to the SME sector remains at a small share of credit available for the private sector and tends to be provided at significantly higher financing costs.

Given that one of the most critical determinants of SME success in the long-run is their ability to meet their financing needs; this particular study is aimed to assess the current financing needs, knowledge, access and satisfaction from the perspective of local SMEs in the Province of Punjab. The prime drive here is to identify the major hurdles faced by SMEs in access to finance and formulate recommendations aimed at increasing the number of SMEs borrowing from formal financial institutions. The primary data was collected through survey questionnaires. The questions were designed to identify how SMEs meet their short and long-term financing needs, mainly including 'Working Capital', 'Medium- and Long-Term Financing', 'Leasing' and 'Equity Financing'.

A total number of 78 entrepreneurs / SME owners through convenience sampling methodology were approached for this quantitative survey. Around 69% of the respondents fall in the age bracket of 18 ~ 44 years followed by 25% who were 45 years old or older. Majority of the respondents (i.e. 58%) were classified under the legal ownership status of sole-proprietorship. 49% of the respondent SMEs were operating in the manufacturing sector whereas 29% were in services and 17% in retail / trade sectors. The participating entrepreneurs were fairly experienced in managing a business; with more than 57 % having an experience of running their present business for at least 6 years.

According to survey responses, below are certain key findings;

I. Overall taxation was among the most significant obstacles for local SMEs (37%) followed by getting additional finance (34%).

II. The financing requests of SMEs was between Rs. 5 ~ 10 million, with a vast majority (48%) did not apply for any form of external financing.

III. Almost all the applicants were required to provide any form of physical asset as collateral while processing the loan applications.

IV. The use of cash books was the most popular method that SMEs (34%) used to maintain their business accounts followed by formal accounting method (23%). Furthermore, 23% of the respondent SMEs did not maintain any type of formal accounting records whatsoever.

V. The main motivation to apply for medium-to-long term financing was need to expand their existing capacity and to scale the size of business operations.

VI. The common reasons for lease finance requests were attractive financial conditions offered and ease of application process.

VII. Equity sharing remains one of the least utilized sources of external finance among SMEs, as vast majority did not want to share ownership with an external investor.

VIII. Those SMEs which did not maintain formal records of their business accounts or lacked documented records of their credit or financial history were least likely to have a loan request approved by banks. Such firms were most reliant on equity share financing when looking to gain access to credit from an external source.

IX. The number of working capital and medium-/ long-term loans granted to Manufacturing SMEs was disproportional to the number of applications made by firms operating in the sector.

X. The highest percentage of SMEs that were sharing more than 50% of their current equity structure consisted of those firms which were established between 3 to 5 years ago.

Based on the findings of this study and review of previous researches on the subject, it is a proven fact that access to formal financing for SMEs is one of the major hurdles in their business progression, especially in developing countries like Pakistan.

In order to address the identified issue and to improve the current situation of SME financing in Pakistan, the following recommendation / suggestions may potentially be useful:

I. The strategy to expand and upgrade existing capital assets is a critical determinant of success for manufacturing-based SMEs. As the amount of capital investment determines competitiveness, it is recommended that sector specific financing products should be introduced to meet the specific needs of manufacturing sector SMEs.

II. Businesses that were established less than 5 years ago need access to more capital in order to accelerate their growth and size often face difficulties acquiring financing from banks but often have access to equity financing as investors are attracted to their potential for growth. To maximize benefits from equity finance, the decision to choose an external investor should be based on their similarity in perspective on the future direction of the SME and considering how they could contribute in the rapid growth of the firm.

III. SMEs that wish to access formal financing must ensure that they document their business accounts in a regular and professional manner as well-maintained financial records help reduce the bank's perception of risk an SME poses when considering a loan application.

IV. The need for SMEs to put up some form of physical asset as collateral in order to secure formal financing from banks tends to discourage many firms from applying for a loan. The introduction of other acceptable forms of collateral may therefore help encourage higher level of Interest from the SME sector.

V. Lease financing may be promoted especially among those SMEs that have a high fixed cost and capital-intensive structure. Capital leasing allows SMEs to utilize an asset as part of its manufacturing process without having to out rightly buy the asset.

VI. The SMEs that are legally registered as sole proprietorships have the highest propensity of not to document their business accounts as well as resistance to external equity finance. Such firms need to change their practices and perspectives if they wish to secure relevant financing to grow their businesses as currently their options are very limited.

VII. Entrepreneurs having more than 11 years of experience exhibited high ambivalence to equity financing and generally had access to wider formal financing options to choose from. Such enterprises may consider the benefits of sharing equity with an external investor not just for financing needs but also as a strategic growth tool whereby the new business partner can use resources to open new markets for the business.

VIII. A significant number of SMEs did not apply for financing and loans from banks due to religious reasons. It is therefore recommended that tailored products be offered for such SMEs in order to encourage higher borrowing from the sector.

1 Introduction to SMEDA

The Small and Medium Enterprises Development Authority (SMEDA), a premier institution of the Government of Pakistan, was established in 1998 with an objective to provide fresh impetus to the economy of Pakistan through the development and facilitation of SMEs. The organizations mission is "to assist in employment generation and value addition to the national income, through the development of the SME sector by helping increase the number, scale and competitiveness of SMEs".

SMEDA offers a broad spectrum of business development services to SMEs which include development of prefeasibility studies, identification of experts and consultants, delivery of need-based capacity building programs in addition to business guidance through help desk services. Steering SME / Entrepreneurial focused research has historically been one of the hallmarks of the organization's professional accomplishments. In order to meet its objectives, SMEDA has carried out 'sectoral research' to identify policy recommendations aimed at SME development in areas such as improving access to credit and financing, business development services, strategic initiatives, institutional collaboration and networking initiatives.

2 Significance of SMEs in Global Perspective

Small and Medium Size Enterprises (SMEs) are organizations that are distinctly characterized by the limited size of their revenues, assets and/ or employees which must be below a certain pre-defined institutional threshold – with different countries around the world each having their own set of criteria to determine what constitutes an SME (Lukács, 2005). The role played by SMEs is pivotal to the commercial activity in both developed and developing countries alike and is considered to form the backbone of the economy in almost every global economy (Nwakoby, 2014).

SMEs are viewed particularly significant in promoting inclusive economic development particularly in low-income countries. They play a crucial role in facilitating the transformation of the economy through creation and diversification of commercial activity by providing new sources of employment and raising citizens' per capita income. For instance, research focusing on developing countries have shown that SMEs operating in various sectors employ up to 80% of a nation's non-agricultural workforce. Furthermore, SMEs actively promote industrialization in underdeveloped regions by developing infrastructure in rural areas and create commercial as well as trade linkages which enable and facilitate the growth in economic activity among businesses located in different areas throughout the country and its wider region (World Bank, 2017).

The sector also plays an important role in improving the external trade balance of a country by locally producing the necessary components and parts used by large manufacturing enterprises in their production processes as well as providing various consumer goods and services providing consumers with more choice. Furthermore, the sector also provides a valuable source of foreign exchange by generating export revenues from overseas sales thereby facilitating a more balanced trade balance for the host economy.

SMEs also help foster an entrepreneurial mindset and culture amongst its population which rewards and incentivizes start-up initiatives at a mass scale (Ayyagari et al, 2014; Beck et al, 2005). SMEs provide the opportunity for entrepreneurs to become self-employed and focus their attention in order to help create value and generate higher economic returns and disposable income for both shareholders as well as their respective employees. Furthermore, studies have shown that SMEs are more resilient during periods of economic downturns and exogenous shocks which provides the economy with an important source of stability despite the high level of uncertainty characteristic during periods of recession and rapidly changing dynamics in global trade preferences.

3 SME Sector in Pakistan

In the context of Pakistan, the SME sector plays a dominant role in its economy and constitutes more than 90% of all the economic establishments operating across the country. It is estimated that SME's contribute approximately 40% to Pakistan's annual GDP, generate 25% of its export earnings and employ up to 80% of its non-agricultural labor force (SMEDA, 2019). Furthermore, their share in Pakistan's total manufacturing value addition is estimated to be around 40%.

The country has a number of institutions and state authorities working in collaboration with SMEs for the development of the sector - with each having their own set criteria that defines what constitutes a small or medium sized enterprise reflect organizational objectives. The table below provides the various definitions used to define SMEs in Pakistan.

Table 1: SME Definitions by Various Institutions in Pakistan

Institution	Small Enterprise	Medium Enterprise
State Bank of Pakistan	• Up to 20 employees • Annual Sales Turnover up to PKR 75 million	• Employees between 21 to 250 • Annual Sales Turnover of PKR 75 million to PKR 400 million
SMEDA	• Up to 250 Full-time employees • Paid up capital up to PKR 25 million • Annual Sales up to PKR250 million	
SME Bank	• Employees up to 50 • Annual Sales Turnover up to PKR 150 million	• Employees between 51 to 250 • Annual Sales Turnover of PKR 150 million to PKR 800 million
Punjab Small Industries Corporation	• Fixed assets with PKR 10 million excluding cost of land and building	
Pakistan Bureau of Statistics	• Up to 10 employees	

3.1 Major Issues and Problems of SMEs in Pakistan

The SME sector of Pakistan has immense potential for development which can be tapped to generate higher level of economic growth. The sector therefore demands a resolute and consistent level of government support to fully utilize the potential of the sector as a catalyst for economic growth and development (Khan & Ali Qureshi, 2007). Despite the significant increase in recent initiatives and programs initiated to promote the sector by various government institutions and international development organizations – enterprises in the SME sector of Pakistan continue to face significant challenges and issues which limit their growth, productivity, competitiveness and financial performance. The key issues and challenges faced by the local SMEs mainly comprise of the following:

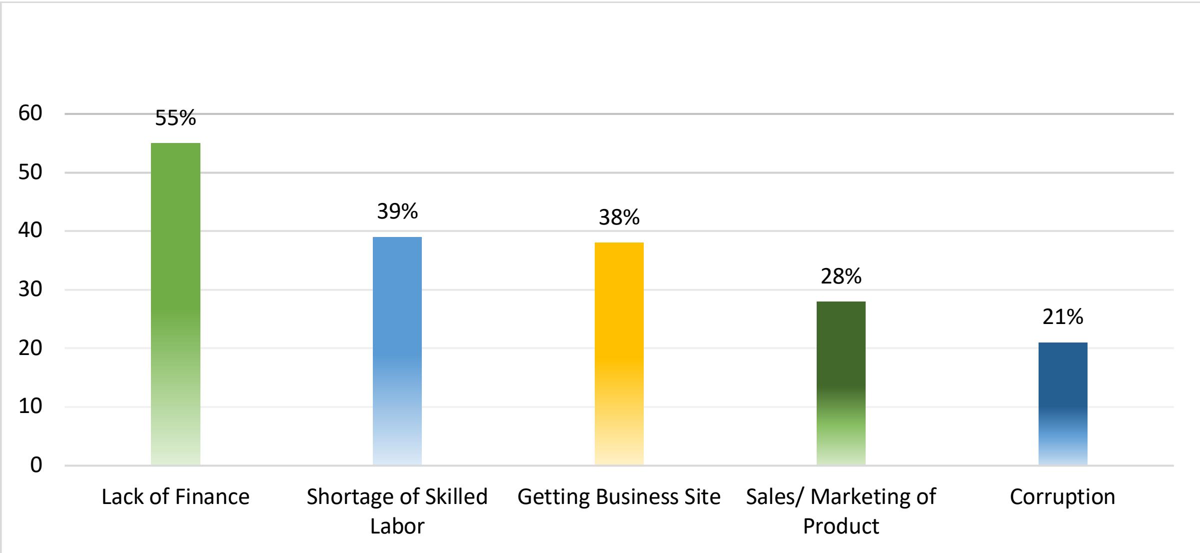
- Low Technology Base
- Lack of Access to Finance
- Lack of Labour Skill Competencies and Limited Human Resource Development
- Regulatory Procedure and Government Rules

- Low Level of Value Addition and Product Diversification
- Lack of Market Information

SMEs in the country in particular have had to face significant and persistent challenges with respect to gaining access to resources and confront various types bottlenecks to their growth such as little technical support, limited supply of skilled human resource, imperfect knowledge and information of employers, and constraints in gaining access to financing. The latter remains one of the biggest historical predicaments faced by the sector and continues to limit SME growth.

According to World Bank Survey, the top most challenges highlighted by the local SMEs as the greatest barriers to their growth are exhibited in the graph below.

Figure 1: Major Challenges Highlighted by SMEs in Pakistan



Source: World bank Survey

4 SME Financing in Pakistan

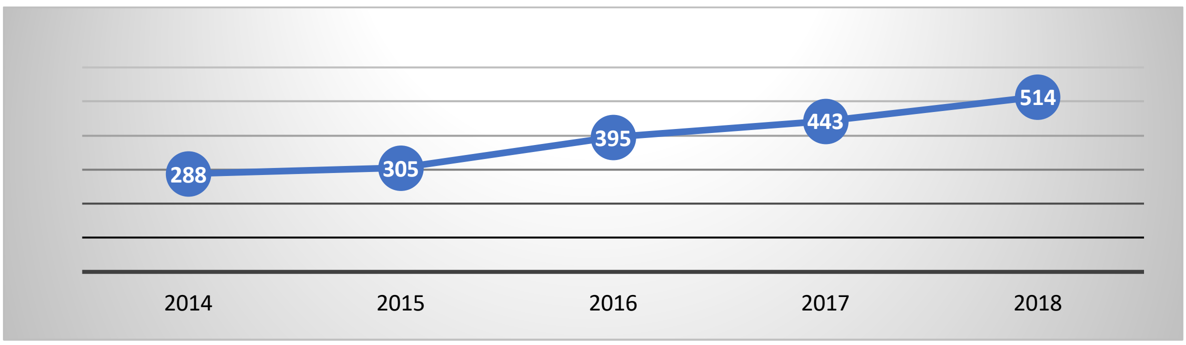
SME financing refers to means by which firms acquire the necessary finance to meet its short term and long term business requirements. Once an organization's internal sources of funding are exhausted it typically needs to approach an external source in order to secure the necessary funds in order to ensure its smooth operations and long-term investments. For instance, it is estimated that almost 90% of SMEs require external financing for long-term investments. Furthermore, 91% of SMEs require short-term financing from external sources for purchasing raw material, while 87% require medium to long term financing for acquiring new machinery and equipment (World Bank, 2009).

In Pakistan, the current status of financial inclusion is limited among its population with only 18% of its citizens holding an account with a financial institution therefore greatly limiting their access to vital services such as saving, borrowing and insurance (World Bank, 2017). Similar to individual trends, SMEs in Pakistan also have limited financial inclusion as only 6% of them avail loans from banks despite up to 40% of SMEs having a relationship with at least one bank (SBP, 2018). Experts have identified various demand side issues to account for the poor level of financial inclusion for SMEs such as low financial literacy among SME management, lack of collateral to put up for SMEs, not maintaining proper accounts, incomplete documentation and complicated loan procedures. In an effort to promote higher financial inclusion of SMEs, the State Bank of Pakistan aims to increase the number of loans to SMEs from the current level of 180,000 to 500,000 SMEs by the year 2020.

4.1 Current Scenario of SME Financing

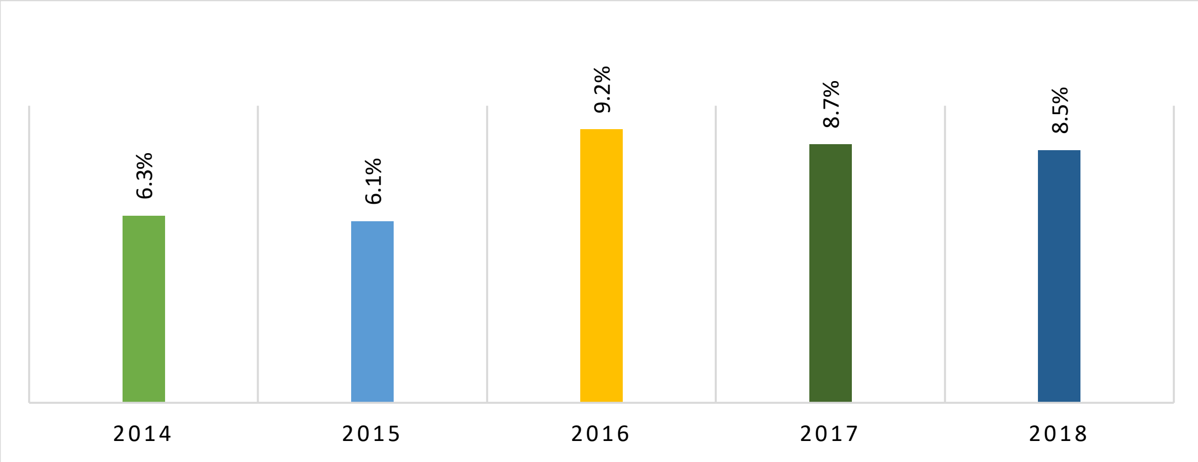
The total amount of SME financing provided by banks in Pakistan during 2018 was estimated at PKR 514 billion which grew by 16% compared to the previous year and was the first time SME financing crossed the PKR 500 billion mark in the country's history. The increase is the result of continued focus by the Government and State Bank of Pakistan to facilitate SMEs in accessing formal sources of financing. During the five year period between 2014 to 2018, SME financing increased at a CAGR of 15.6% whereas share of SME financing as a share of total private sector financing increased from 6.3% to 8.5%.

Figure 2: SME Financing by Banks in Pakistan – Last 5 Years (in PKR Billions)



Source: State Bank of Pakistan (SBP)

Figure 3: SME Finance as Percentage of Total Private Sector Financing (5 Year Period)



Source: State Bank of Pakistan (SBP)

The increase in SME financing can be attributed to the implementation of the new policy which puts additional focus on the promotion of SME finance by the SBP implemented towards the end 2017. The SME policy ensures the provision of an enabling regulatory environment for SME finance by prescribing SME financing targets for banks/DFIs, sensitizing banks to adopt SME financing as a viable business proposition, advising banks to provide non-financial advisory services for making SMEs bankable, simplifying procedures for SME financing and introduction of new SBP schemes for SMEs through Banks.

With respect to the sectoral distribution of SME financing, the manufacturing sector received the largest share of the total finance at PKR 213 billion during 2018, followed by the trading and services sector which received PKR 161 billion and PKR 140 billion respectively. It is worth noting; however, that the share of the services sector as a total percentage of SME financing has increased substantially from 17% in 2014 to 27% in 2018.

Table 2: Sector-Wise Distribution of SME Financing (PKR Billion)

SME Category	2014	2015	2016	2017	2018
Manufacturing	123	107	174	186	213
Services	49	85	89	101	140
Trading	116	113	132	156	161
Total	**288**	**305**	**395**	**443**	**514**

Source: State Bank of Pakistan

The major motivation for SME borrowing was to meet their working capital needs and represented 66% of all loans given to SMEs during the year 2018 followed by fixed investment and trade finance which represented 24% and 31% of SME financing respectively.

Table 3: Facility-Wise Composition of SME Financing (PKR Billion)

Financing Category	2014	2015	2016	2017	2018
Fixed Investment	38	71	89	99	123

Working Capital Finance	213	206	263	304	341
Trade Finance	38	28	132	156	161
Total	**289**	**305**	**395**	**443**	**514**

Source: State Bank of Pakistan

4.2 Problems of SMEs in Access to Finance

Access to finance is one of the most significant challenges for SMEs in Pakistan. SMEs in the country get a comparatively smaller share of credit available for the private sector and that too at significantly higher financing costs. Obtaining finance at a high cost necessitates earning higher profit margins to cover the interest cost, which inevitably increases product prices, making SME products less competitive. Some of the major reasons that SMEs identified to explain the general aversion to approaching banks for financing include high rate on interest charged by lenders, the loan application process being very complex and requiring a lot of paper work, long time to process loan applications, the collateral requirements of banks and having to disclose information about their tax returns.

For instance, a research study which surveyed 600 SME organizations in Pakistan showed that only 40% of SMEs ask for loans and monetary aid from banks/ financial institutions with the remaining 60% met their needs from personal saving and family borrowing. Furthermore, the survey highlights that only 16% and 19% try to gain financing for their long term and short term needs respectively.

The following are some of the major reasons which hinder SMEs access to finance in Pakistan are as follows:

- Banks still predominantly treat SMEs as large corporates or low-volume relationship models.
- Limited specialization in SME lending, and 50% of banks lack SME tailored asset and liability products
- Procedures and policies for SMEs remain complex, time consuming and costly
- Organisation and delivery structures are not conducive for efficient SME banking operations
- Heavy reliance on collateral rather than business-based lending
- Poor record keeping by SMEs, particularly accounting information and other business documentation.
- Problems with packaging bankable loan requests by SMEs.
- Limited knowledge of financing options for SMEs.
- Lengthy and cumbersome application procedures, which discourage both SMEs and Banks.
- High transaction costs owing to size of transaction, vis-à-vis volume of transactions which discourage banks.
- Lack of skills in banks for identifying needs and structuring the delivery of financial assistance to SMEs.
- Lack of expertise in banks for appraising/structuring SME Projects.
- General risk aversion tendency / approach by banks.

5 Study Background and Objectives

5.1 Objectives of the Study

Over the years, SMEDA has carried out and pioneered various SME focused researches pertaining to policy recommendations, strategic and institution reforms, access to finance, trade analysis and challenges to SME sector etc. Keeping in view the same institutional objective, this particular study is aimed to assess the current financing needs, knowledge, access and satisfaction from the perspective of local SMEs. The prime drive here is to probe SMEs perceptions on SME financing and to take conversant actions. The key objectives of the study include:

- To explore and understand the various types of financing needs of the Pakistani SMEs
- To identify the nature of relationships between SMEs and financial institutions
- To measure the extent to which SMEs realistically have access to and rely on formal financing to meet their financing needs
- To highlight SME perceptions and knowledge of the existing formal financing structure in Pakistan
- To identify the most significant problems faced by SMEs in access to financing and formulate recommendations to increase the number of SMEs borrowing from formal financial institutions.

SMEDA foresees this particular study, acquiring entrepreneurs' insight, as a step forward in construing a body of knowledge regarding SME financing in the province of Punjab, which is anticipated to expand in future with similar kind of studies in other provinces and regional jurisdictions.

5.2 Scope of Work

The purpose of the research is to discover and explore the financing needs of SMEs in the province of Punjab and how these needs are met.

- The extent to which SMEs are reliant on financial institutions to meet their financing needs and suggest measures for bridging the gap between SMEs and financial institutions.
- Understanding the dynamics of relationship between the SMEs and formal financial sector.
- Identifying the major requirement of SMEs of external financing and how these influence the type of financing arrangements.
- To comprehend the existing equity financing arrangements utilized by SMEs in order to satisfy their business and financial objectives.
- Understanding the reasons behind why SMEs are reluctant to borrow from formal institutions by carrying out primary research with SMEs to gain direct and documented access to information in an objective manner.

The findings of the study will provide a holistic understanding about SME financing both from demand (i.e. SME sector) and supply sides (i.e. Financing Institutions). The empirical findings help to identify the specific capacity building and operational changes formal institutions must implement to promote higher borrowing from SMEs.

5.3 Methodology

The total sample size of the study consisted of 78 small and medium sized enterprises located in the different cities of Punjab. The primary data was collected through the distribution of a questionnaire which was filled by the owners of the SMEs. The questions were designed to identify how SMEs gain access to the necessary financing for their short term and long term financing needs.

The data was collected from respondents (i.e. SME Owners) through administered survey questionnaire by SMEDA team based at Provincial Office Punjab as well as its Regional Business Centers (RBCs) located in major industrial cities of Punjab; including Lahore, Faisalabad, Gujranwala, Gujrat, Sialkot, Rawalpindi and Multan. The SMEDA Provincial Office Team / RBCs personally visited the SMEs to collect the data. The respondents were free to record their responses while maintaining the confidentiality. However, SMEDA representatives were available to guide and facilitate the respondents. All entries were analyzed by using the SPSS software. Secondary data used in the study came from a variety of published reports and literature provided in the bibliography section of this report.

The limitations of our research methodology are the standard set of limitations of primary research data collection associated with questionnaires. This includes that answers may not be based on actual experiences but rather the respondent’s own biases and perceptions. Secondly, the questions are designed to limit the respondents’ answers in order to extract the precise information the research is interested in acquiring; thus, limiting a more holistic perspective which would be provided if the questions were designed in an open manner in order to allow the respondent to answer the question based on the individual respondent’s interpretation.

6 Study Findings and Recommendations

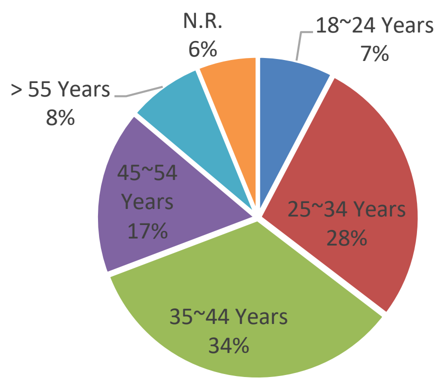
6.1 Personal and Business Profile of Respondent SMEs

The following section provides demographic information on the business and banking practice profiles of all 78 Small and Medium Enterprises included in our research sample as well demographics of the entreprneurs managing them. This provides insight into the underlying context and environment on the basis of which responses were collected and analysed.

Entrepreneur's Age Group

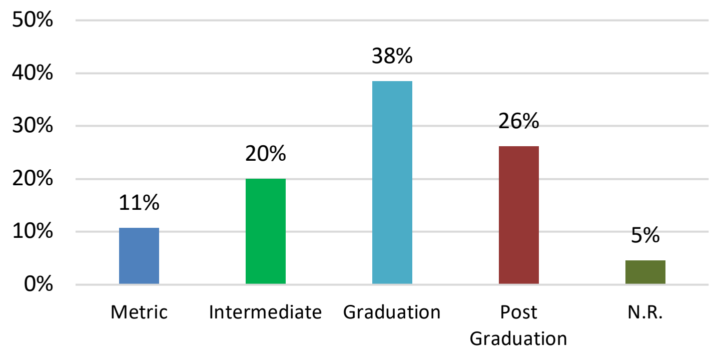
The majority of entrepreneurs who managed the small and medium enterprises in our sample size were at least 25 years old.

The most common age bracket of entrepreneurs was between 35 to 44 years with 34% of respondents being part of this range. This was followed by 25 to 34 years and 45 to 54 years age brackets which represented 28% and 17% of the respondents respectively.



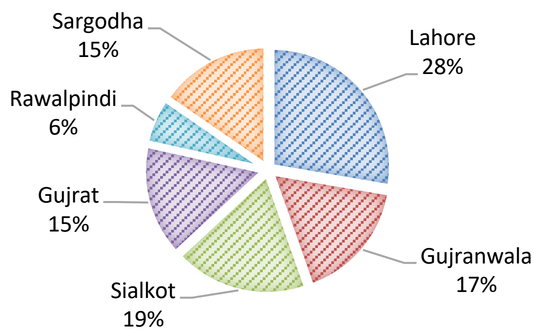
Level of Education

64% of the entrepreneurs from the participating SMEs successfully completed. their education up to university level. This was followed by Intermediate and Metric level of education which represented 20% and 11% of respondents respectively.



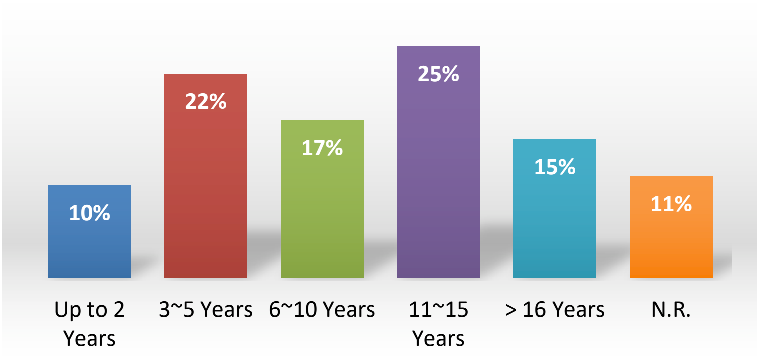
Location of Respondent SMEs

Lahore was home to 28% of the respondents among the SMEs part of our sample. This was followed by Sialkot and Gujranwala at 19% and 17% respectively.



Years of Business Management Experience, Present Business

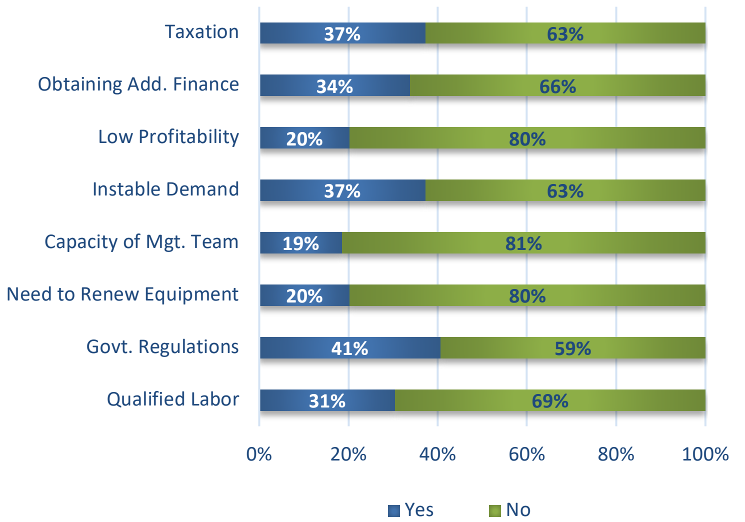
Out of all respondents, 25% of SME owners had the experience of managing their businesses between 11 to 15 years whereas more than 15% had been managing their business for more than 16 years. 22% of respondents had 3 to 5 years of managing experience whereas 10% of respondents had less than 2 years management experience.



Biggest Obstacle to Business Growth

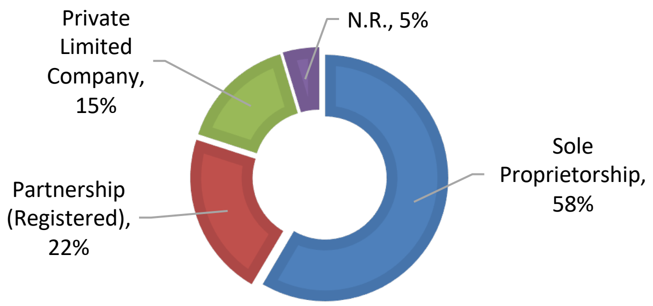
The most significant obstacle identified by SME respondents was government regulations with 41% of the respondents citing it as a barrier to their enterprise growth.

Other major obstacles faced by SMEs enterprise growth were identified as taxation, inconsistent market demand and obtaining additional finance with response rates of 37%, 37% and 34% respectively.



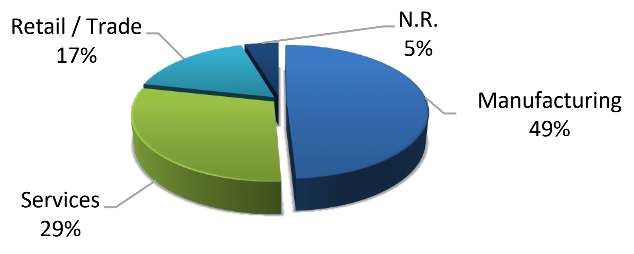
Legal Ownership Status of Business

58% of the respondent SMEs had a Sole Proprietorship ownership structure. Partnerships were identified as the second most popular ownership type with 22% of response rate followed by 15% of SMEs who identified as being Private Limited Companies.



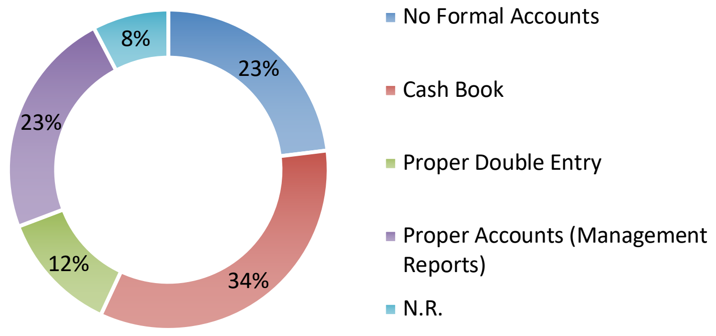
Business Type

The number of SMEs involved in manufacturing represented 49% of all respondents followed by 29% in Services and 17% in Retail or Trade.



Type of Business Accounts

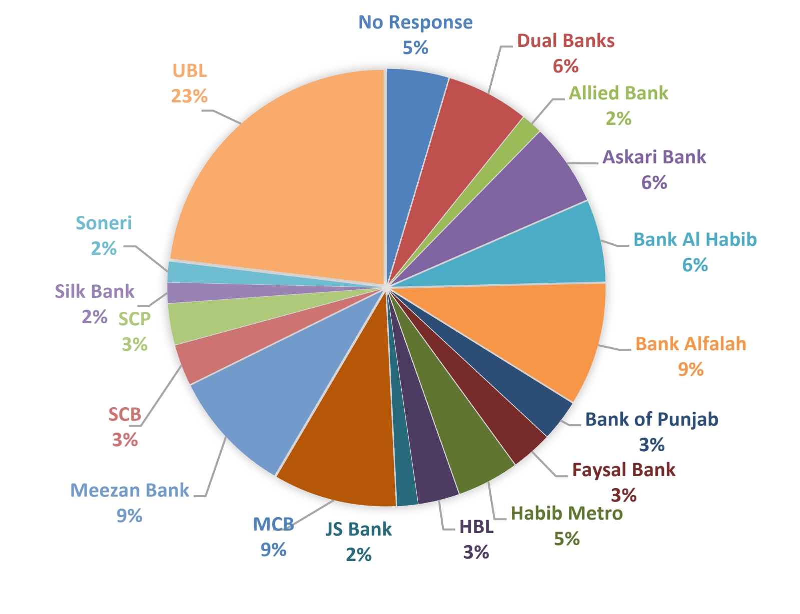
The most common way the respondent SMEs kept record of their business accounts was cash book (34%) followed by 23% of respondents who managed accounts properly with management reports. Furthermore, 23% of our surveyed SMEs kept no formal records of their business accounts.



Main Banks for Business Operations of Respondent SMEs

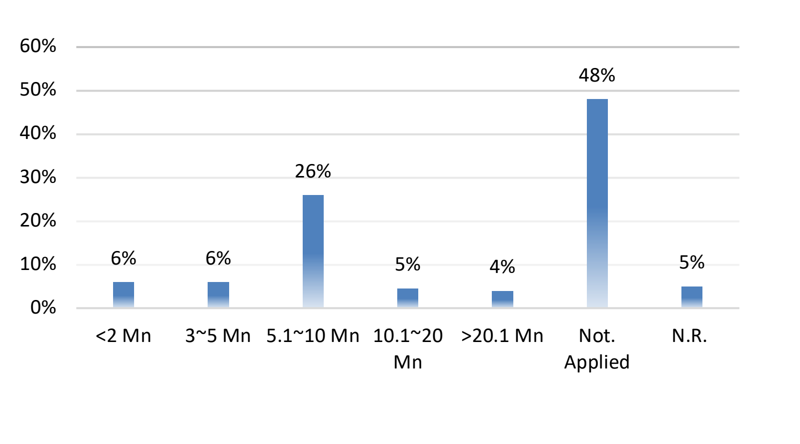
The most popular bank was UBL with 23% of respondent SMEs preferring the bank for their business operations.

This was followed by Meezan Bank, Bank Al Falah, and Muslim Commercial Bank (9% respondents for each).



Amount of Loan Required / Applied

The majority of SMEs either did not require or did not apply for a loan which represented 48% of our sample size. 26% of respondents applied for a loan amount between PKR 5.1 to 10 million whereas 12% applied for an amount below 5.1 million and 9% applied for a loan above PKR 10 million.

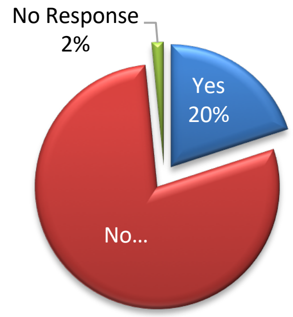


6.2 Working Capital Finance

The following section presents the survey findings related to how SMEs in the country meet their working capital requirements. The results presented in the following section shed light on what key needs do SMEs have with respect to working capital financing, how these needs are met and their knowledge of different financing sources. Furthermore, it shows the extent to which various organizational specific dimensions of SMEs impact their access to securing working capital financing from formal institutions and their overall satisfaction levels related to external working capital financing.

Request for Working Capital Loan

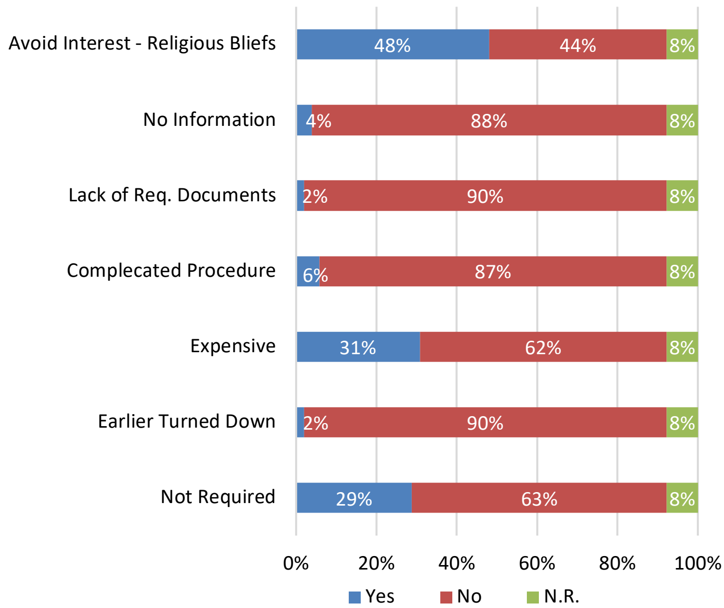
The majority of SMEs indicated they did not rely on banks to meet their short-term needs. Only 20% of respondents had made a request for a working capital loan compared to 78% that had not ever applied for short term finance.



Reasons for Not Obtaining Working Capital Loan

The most frequently cited reason for not obtaining a loan for working capital needs was due to the business ownership viewing any interest related financing as a practice against their religious beliefs with 48% respondents citing this reason.

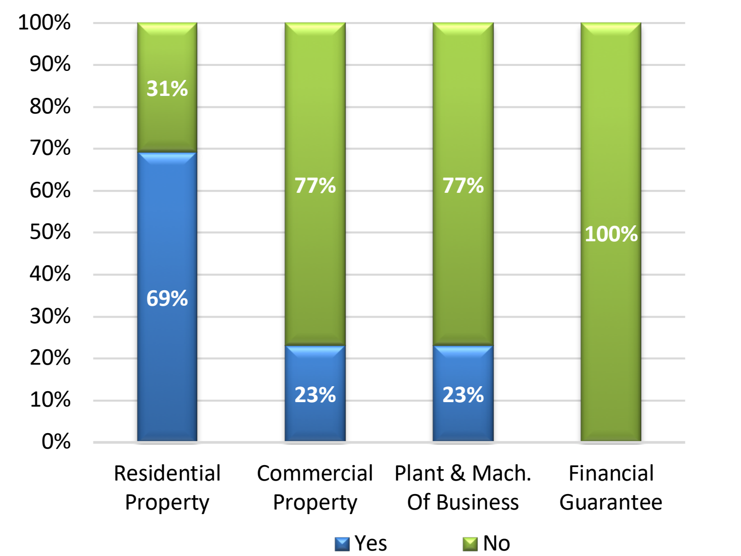
The second most significant reason for not obtaining external finance was that it was deemed to be too expensive an option by 31% of the sample size. Finally, 29% of respondents answered that they did not require such a facility to meet their short-term financing needs.



Type of Collateral Offered

SMEs requiring a working capital loan need to offer some form of collateral as security against their borrowed amount by banks. Out of sample size, 69% of the respondents had put up residential property as collateral.

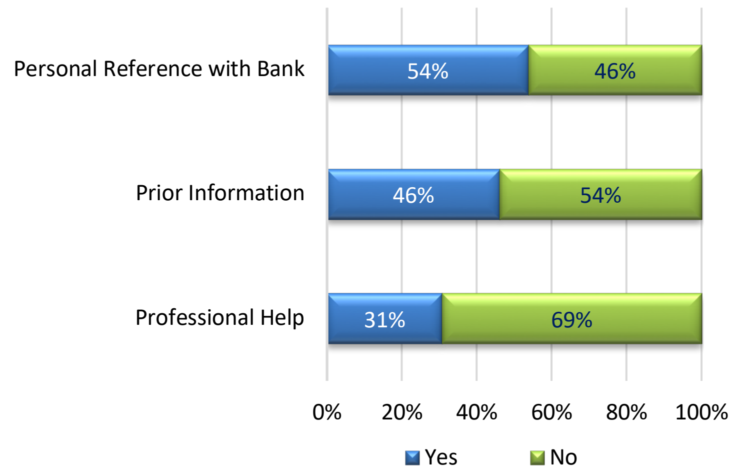
This was followed by 23% of respondents using commercial property and another 23% stated using capital equipment as collateral. Finally, a financial guarantee was not a sufficient collateral to obtain a loan in almost all cases. This indicates an informal need to have a physical asset for SMEs in order to obtain working capital finance.



Help Received in Application Process

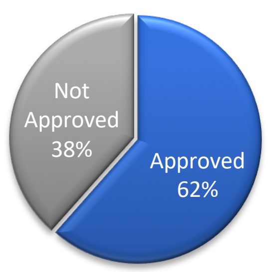
As part of their application process SMEs can access help from various sources in an effort to maximize their chances of having their loan request accepted by the bank. Out of all respondents, 54% received help using a personal reference with the bank.

Another 46% gathered prior information before initiating the application process and 31% decided to acquire professional help for obtaining a working capital loan from their respective bank.



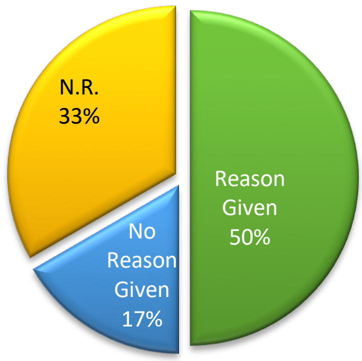
Status of WC Loan Application

Out of those SMEs in our sample size that did make an application for a working capital loan, only 62% were approved by banks whereas 38% did not have their loan request approved.



Did Bank Provide a Reason for Refusal

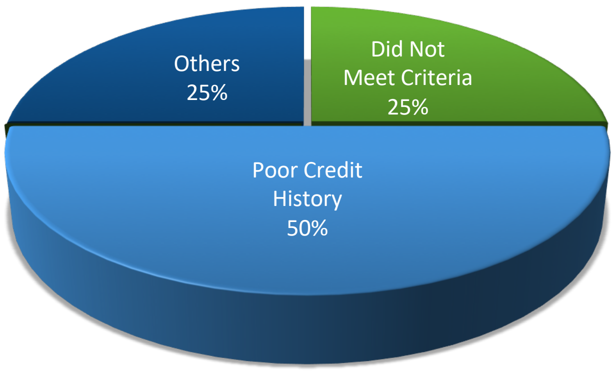
Out of the 38% of SMEs who did not have their loan request approved, at least 50% were given an adequate reason for refusal while 17% did not get any reasonable reason for refusal. Finally, 33% of our respondents did not provide us with a response to this question.



Reasons for Refusal

The most frequent reason banks gave for refusing a loan application was poor credit history of the applicant SMEs with 50% of our respondents citing this as the main reason given to them for refusal.

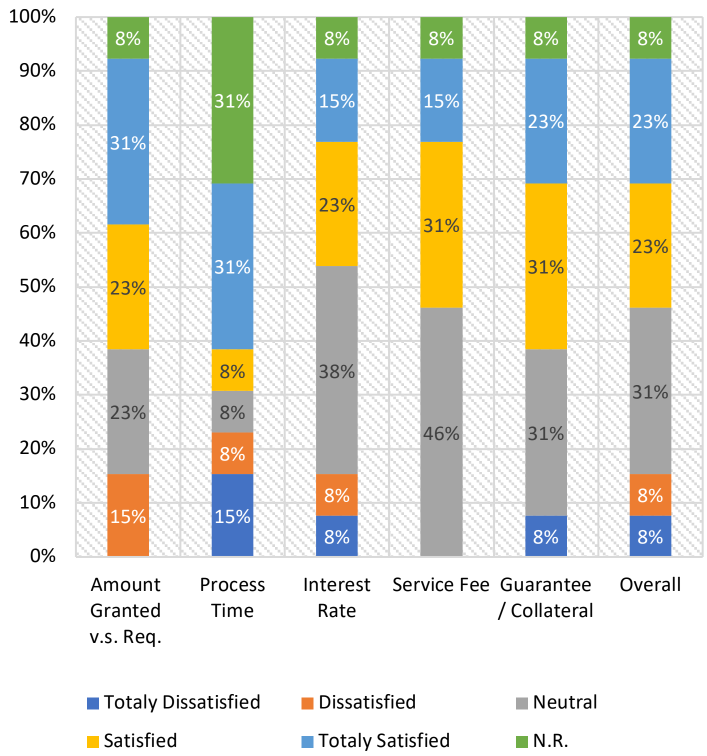
Another 25% were refused due to not meeting the banks' criteria for financing whereas another 25% of our respondents were provided with a variety of other reasons.



Level of Satisfaction for WC Financing

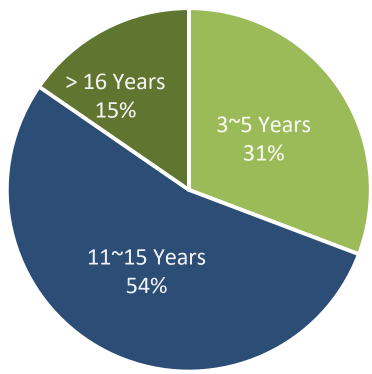
When considering the application process stage, at least 31% of respondents were totally satisfied with the processing time for their loan request. At least 46% of the respondents were either satisfied or totally satisfied with the service fee charged by the bank during the processing stage whereas 46% held a neutral view. Most respondents were satisfied or totally satisfied with the amount they were granted by the loan vis-à-vis their request with 31% being totally satisfied.

However, when it came to evaluating their satisfaction about the rate of interest they charged on their loan amount, almost 38% were neither satisfied nor dissatisfied in relation to the amount. Furthermore, out of all metrics the processing time showed the least percentage of satisfied respondents when compared to the four other metrics.



Working Capital Loan Request and Years of Exp. Present Business

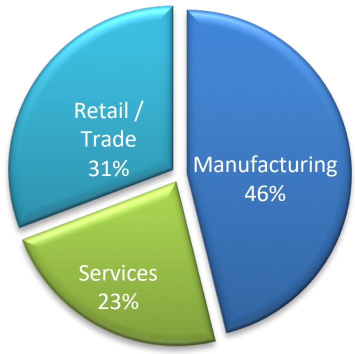
The highest amount of WC loan requests came from business establishments that were established between 11 to 15 years ago with 54% of respondents belonging to this category. 31% of respondents had been established between 3 to 5 years whereas 16% of WC loan requests came from respondents with SMEs which had been established for more than 16 years.



Working Capital Loan Request and Nature of Business

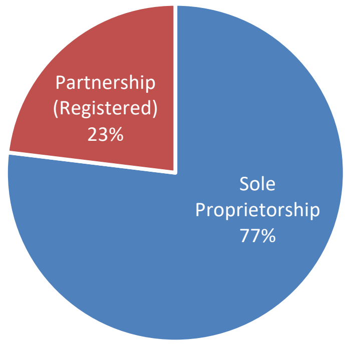
The highest WC loan requests were made by businesses engaged in the manufacturing industry and accounted for 46% of responses.

Retail/ Trade businesses accounted for 31% of WC requests and Services based SMEs accounted for 23% of loan requests amongst the sample size.



Working Capital Loan Request and Legal Status of Business

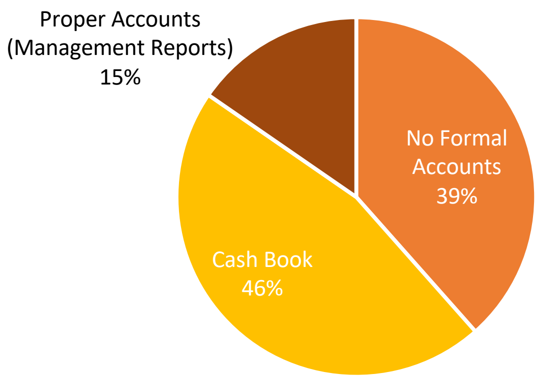
Sole Proprietorships accounted for 77% of WC loan requests compared to partnerships which accounted for 23%.



Working Capital Loan Request and Type of Business Accounts

Out of all SMEs in our sample size who made a WC loan request, 46% of respondent firms managed their accounts using a cash book while 39% held no formal accounting practices at all.

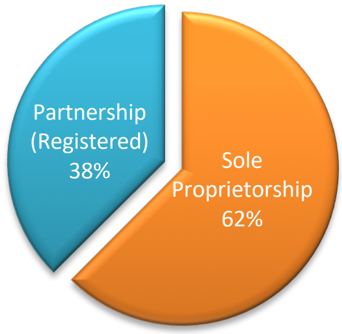
Only 15% of applicants managed their business accounts in a proper manner with detailed management reports being generated.



WC Loan Request Approved and Legal Status of Business

Our data indicated that those businesses registered as Sole Proprietorship accounted for 77% of WC loan requests but only 62% of them had their requests approved.

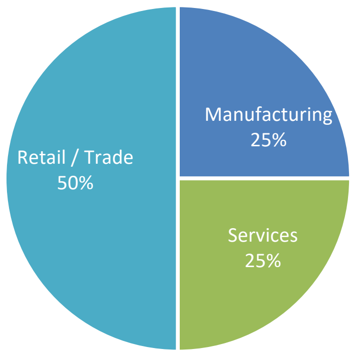
Comparatively, while partnerships represented a smaller share of total WC loan applications they were more likely to have their requests approved as 38% of total WC approvals were given to partnerships.



WC Loan Request Approved and Nature of Business

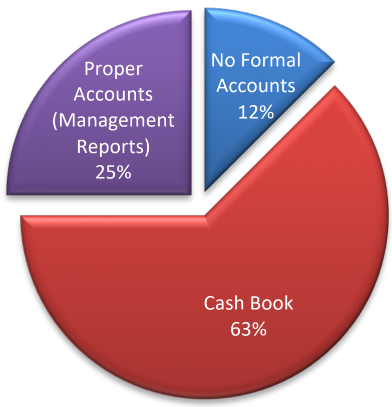
Despite the bulk of WC loan requests coming from businesses engaged in manufacturing, SME respondents from the sector only constituted 25% of overall requests approved.

Businesses engaged in Retail and Trade were most likely to have their applications approved with 50% of all loan approvals being secured by SMEs operating in the sector.



WC Loan Request Approved and Type of Business Accounts

WC loan requests from those businesses that maintained their business accounts in a well-documented manner were more likely to have their requests approved with applicants using a cash book or proper accounts having 88% of total requests approved. Those with no formal accounts only accounted for 12% of total loan request approvals.



6.2.1 Key Findings and Recommendations – Working Capital Finance

i. Those SMEs which failed to incorporate formal documentation records of their business accounting practices were least likely to be granted a loan whereas those incorporating professional accounting management standards were most likely to have their requests granted. SMEs that wish to acquire working capital loans must therefore manage their accounting records in a documented and formal manner as this reduces information uncertainty for banks in relation to the applicant firm and allows them to determine their ability to successfully payback the loan amount as per the financing agreement.

ii. All SMEs to put up some form of physical land or asset as collateral in their working capital loan applications. The access to working capital loan financing is therefore limited to only those SMEs that can provide a valuable source of physical asset as security to the bank. In order to incentivize more SMEs to approach for working capital loans, some other form of collateral other than physical assets must therefore be encouraged as the requirement severely limits the pool of loan applicants.

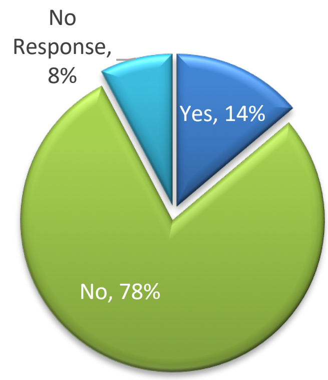
iii. The highest percentage of WC loan applications were made by SMEs in the manufacturing sector however the greatest percentage of approved loans consisted of SMEs operating in the retail and trading sector. Given that 40% of the country's value addition in manufacturing comes from SMEs the current scenario is not ideal for the growth of Pakistan's industrial output and therefore it is recommended that banks also divert capital towards the sector.

6.3 Medium- or Long-Term Financing

The following section presents the survey findings related to how SMEs in the country meet their medium to long term financing requirements. The results presented in the following section shed light on what key needs do SMEs have with respect to medium to long term financing, how these needs are met given and their knowledge of different financing sources. Furthermore, it shows the extent to which various organizational specific dimensions of SMEs impact their access to securing medium to long term financing from formal institutions and their overall satisfaction levels related to external medium to long term financing.

Request for Medium- or Long-Term (M/L- T) Loan

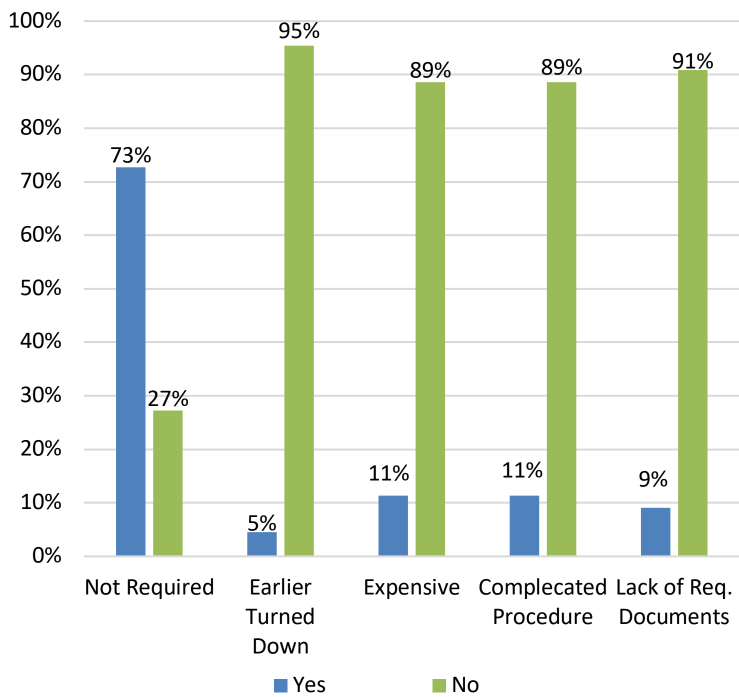
The majority of SMEs represented by 78% of all responses did not request for any formal medium- or long-term financing. The total percentage of respondents who had made the decision to request for this mode of financing represented 14% of the sample size.



Reason for Not Obtaining Medium- or Long-Term Finance

The most common reason cited by 73% of the respondents for not obtaining medium- or long-term finance was due to them not needing such external financing to meet their business needs. For 11% of our respondents, the cost of such financing was too expensive to meet their needs making it an unattractive source of financing.

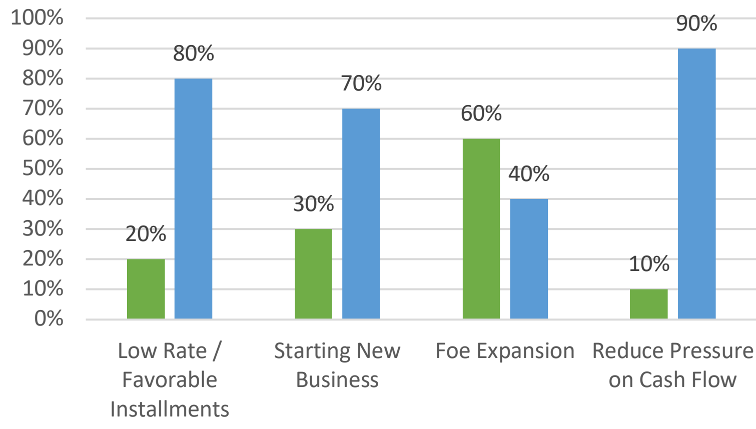
Furthermore, given that limited knowledge and resources are common problems which affect SME ownership and management another 11% and 9% of respondents cited the complicated procedure and lack of necessary documents respectively as key motivations for not to pursue this mode of financing.



Reason for Applying Medium- or Long-Term Finance

Among SME respondents who opted to apply for this mode of financing – the most frequently cited reason given by 60% of the respondents was need for expansion of their existing business capacity.

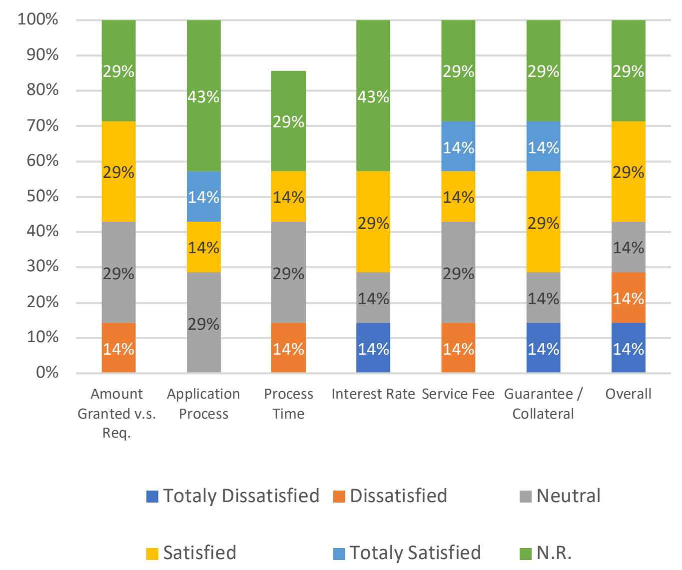
In addition to expansion requirements, 30% of respondents cited starting a new business, 20% cited favourable payment plans and 10% identified effect of financing on reducing pressure on cash flow as motivations behind applying for long term financing.



Level of Satisfaction for M/LT Loan

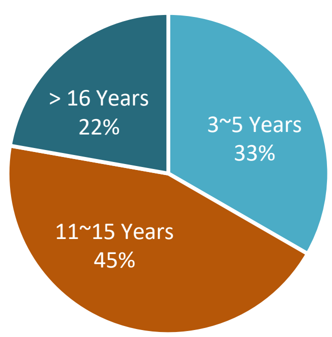
The level of satisfaction for M/LT loans was difficult to gauge primarily due to a significant percentage of respondents choosing not to offer a response to various satisfaction metrics related to M/LT loans.

After aggregating the results from all five dimensions, overall 29% of the respondents termed themselves satisfied with the using M/LT as a means of financing. 14% of the respondents held a neutral view whereas 14% each described the mode of financing as being dissatisfied and totally dissatisfied with the process. Another, 29% of the respondents did not provide any response.



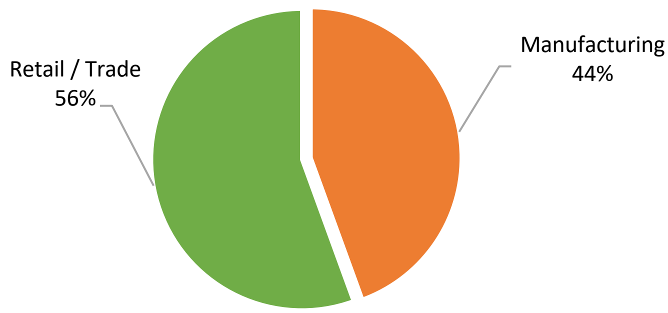
M/L T Loan Request and Years of Experience Present Business

The highest amount of loan requests came from business establishments owners having experience between 11 to 15 years with 45% of respondents belonging to this category. 33% of respondents had established business between 3 to 5 years whereas 22% of loan requests came from respondents with SMEs which had experience of more than 16 years.



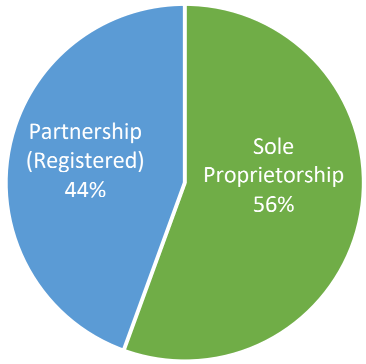
M/LT Loan Request and Nature of Business

Those businesses that operate in the retail or trade sector of Pakistan represented 56% of total loan requests to access M/ LT financing while the other 44% were businesses engaged in manufacturing.



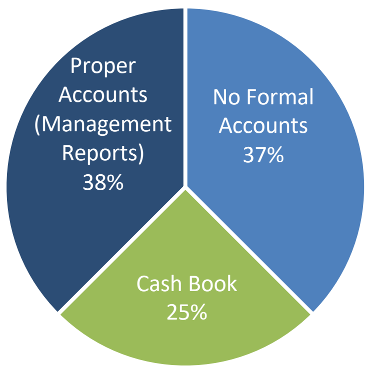
M/LT Loan Request and Legal Status of Business

Sole Proprietorships accounted for 56% of requests for M/LT loan compared to partnerships (registered) which accounted for 44%.



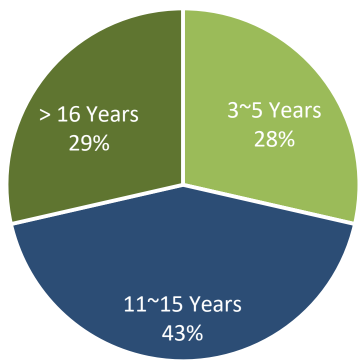
M/L T Loan Request Applied and Type of Business Accounts

Out of all SMEs in our sample size who applied for this form of financing, 25% of respondent firms managed their accounts through a cash book while 37% held no formal accounting accounts. 38% of applicants managed their business accounts properly which was significantly higher compared to businesses applying for short-term loans.



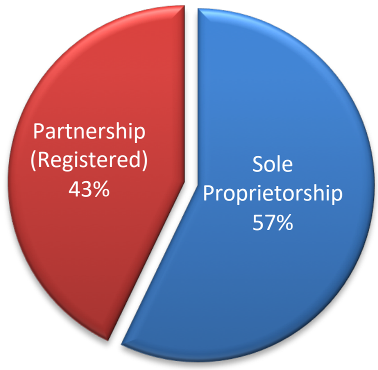
M/L T Loan Request Accepted and Years of Exp. Present Business

The highest success rates for loan requests came from business establishments that were established between 11 to 15 years ago with 43% of respondents belonging to this category.



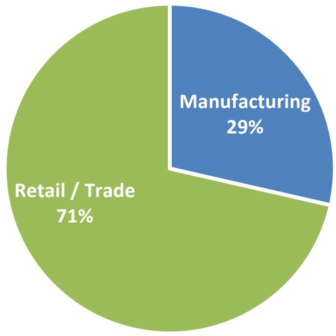
Loan Request Approved and Legal Status of Business

Sole Proprietorships accounted for 57% of all loan approvals for M/L T financing requests compared to partnerships (registered) which accounted for 43%.



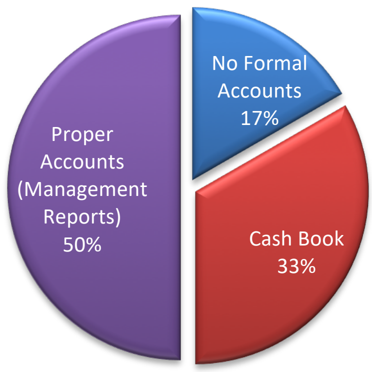
M/L T Loan Acceptance and Nature of Business

Those businesses operating in the retail or trade sector had 71% share among those firms granted M/L T financing compared to businesses in manufacturing which had 29% share despite making 44% of the applications for M/L T loans among our research sample.



M/L T Loan Request Approved and Type of Business Accounts

Loan requests from those businesses that maintained their business accounts in a well-documented manner were more likely to have their requests approved with respondents using a proper accounts and cashbooks having a share of 50% and 33% respectively of total loan approvals.



6.3.1 Key Findings and Recommendations – M/L Term Finace

i. The most commonly cited reason for requesting a medium and/ or long-term loan among SMEs was the need to utilize the funds in order to expand the production capacity and scale of their business. The need to expand and upgrade the capital assets of an enterprise is considered to be an essential determinant of whether a business will continue to grow over the long-term and remain competitive. This is particularly true for manufacturing SMEs as they need to be able to manufacture goods for consumers using latest production techniques in order to improve on both dimensions of price and quality. Similar to the demand for WC loans, the share of M/LT loans requested by SMEs in the manufacturing sector was disproportionate to loans granted. Given the importance of capital expenditures it is recommended that the industry is given a higher priority with respect to gaining access to long-term capital.

ii. This mode of financing was most popular among those SMEs that were established and have been operating for at least 11 years. This is consistent with the fact that those enterprises who manage to remain in business for a sustained period of time can witness a period of stagnation whereby their sales and revenues could grow at a slower pace or not grow at all. Finding itself in a new position with changing competitive and industry dynamics, such enterprises often aim to secure external source of financing which they aim to utilize in long-term investments. For instance, long-term financing can be used to expand the firms' retail operations and increase revenue by attempting to capture consumer demand in new geographical and regional markets.

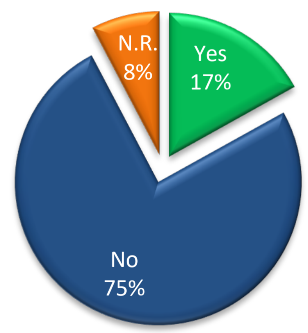
iii. SMEs which fail to maintain formal accounts are at a substantial disadvantage vis-à-vis SMEs that have a proper accounting management reporting system. It is therefore necessary for SMEs to follow appropriate accounting mechanisms in order to reduce the risk for banks when evaluating the credit worthiness of an enterprise.

6.4 Lease Financing

The following section presents the survey findings related to how SMEs in the country meet their lease financing requirements. The results presented in the following section shed light on what key needs do SMEs have with respect to lease financing, how these needs are met and their knowledge of different financing sources. Furthermore, it shows the extent to which various organizational specific dimensions of SMEs impact their access to securing lease financing from formal institutions and their overall satisfaction levels related to external lease financing.

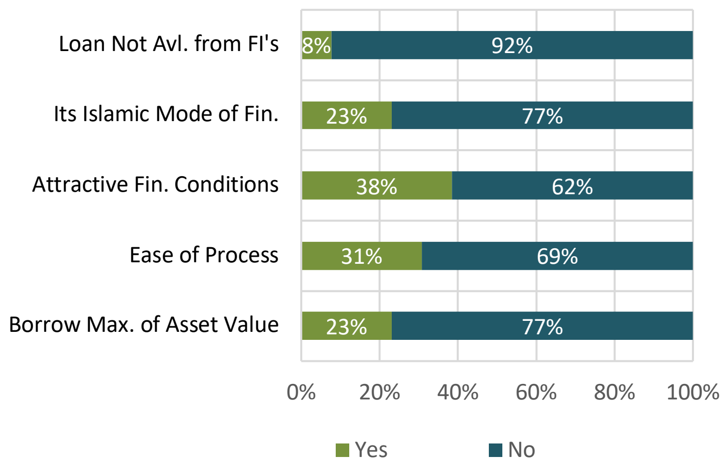
Request for Lease Finance

Out of all SMEs in our sample size, 75% did not apply for lease financing compared to 17% that did request for this mode of finance.



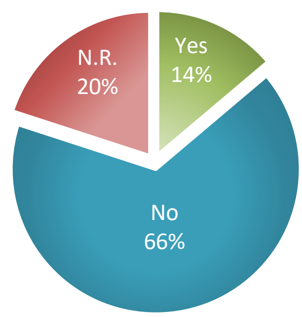
Reason for Opting Lease Finance

The most cited reason given by 38% of respondents was the attractive financial conditions of lease finance followed by ease of process with 31%. Respondents also identified its status as an Islamic mode of financing and to borrow maximum of the asset value as motivations with each having a response rate of 23% respectively.



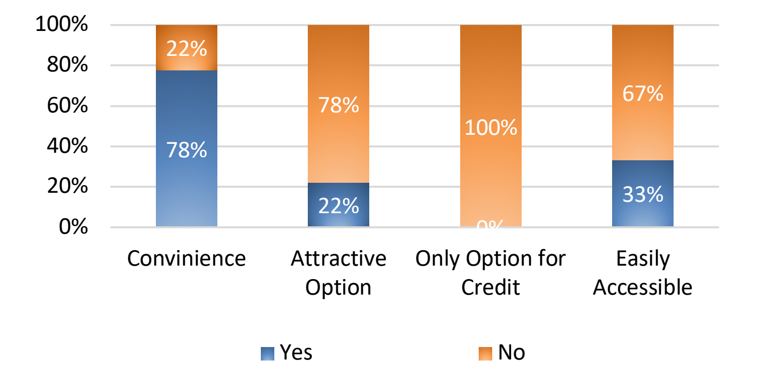
Use of Credit Card for Business Finance Needs

Credit cards are frequently used by businesses as medium for easy access to finance. Out of all SMEs in our sample size, only 14% reported using this medium for their financing needs.



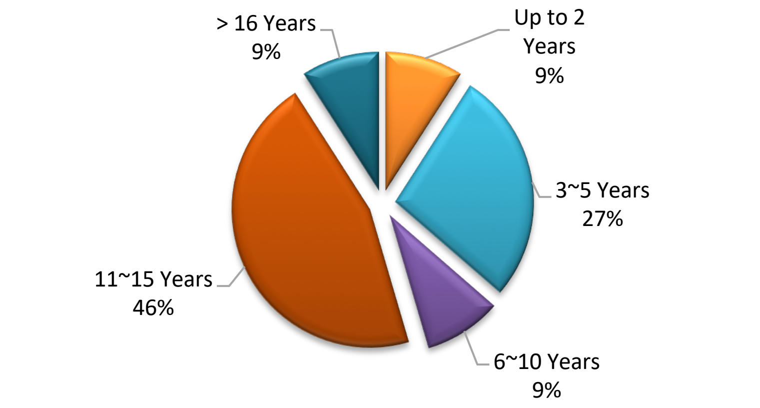
Reason for Credit Card Use

The convenience offered by credit cards was cited by 78% of the respondents as the main motivation behind credit card use. Other reasons for usage included easy accessibility and attractive financing conditions reported by 33% and 22% of SMEs respectively.



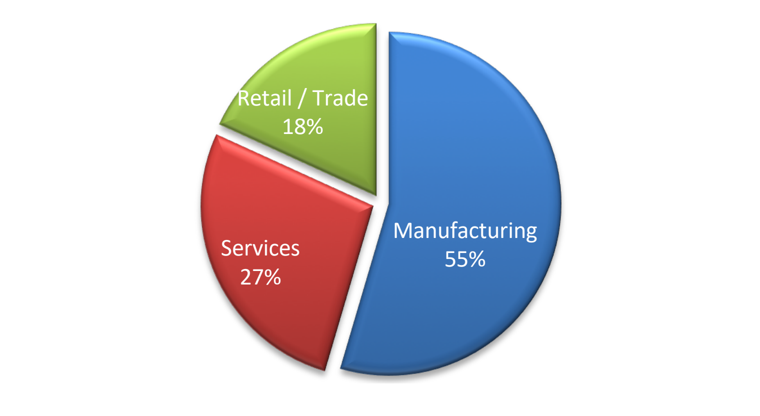
Lease Finance Request and Years of Exp. Present Business

46% of respondent SMEs that applied for lease financing were between 11 to 15 years old whereas 27% were between 3 to 5 years. Those businesses that had been operational for less than 2 years, between 6 to 10 years and over 16 years each represented 9% of total lease finance requests.



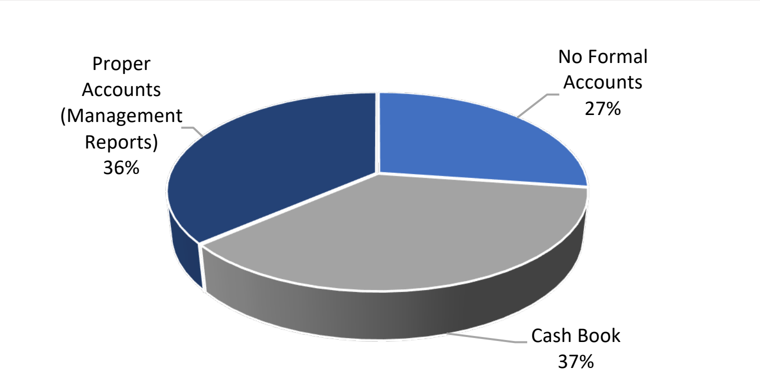
Lease Finance Request and Nature of Business

Businesses engaged in the manufacturing sector represented 55% of all requests for lease financing followed by 27% in services and 18% in retail/ trade.



Lease Finance Request and Type of Business Accounts

Among the SMEs that requested lease financing at least 71% of them had business accounts which were documented in one form or another while 27% of the respondents had no formal accounts.



6.4.1 Key Findings and Recommendations – Lease Finance

i. The most commonly cited reason behind why SMEs opt for lease financing was the attractive financial conditions offered by the lenders as well as the ease of application process, the latter reason being the most pre-dominant motivation behind the use of credit cards by SMEs. Lease financing allows the prospective applicant SME to obtain the necessary capital goods it needs to ensure the success of its business model without actually having to purchase an asset; thereby easing its cash flow, not having to incur significant depreciation costs and saving equipment maintenance costs.

ii. SMEs which fail to maintain formal accounts are at a substantial disadvantage vis-à-vis SMEs that have a proper accounting management reporting system. It is therefore necessary for SMEs to follow appropriate accounting mechanisms in order to reduce the risk for banks when evaluating the credit worthiness of an enterprise to maximize their chances to successfully secure lease financing from an external formal financial institution.

iii. The highest percentage of applications for lease financing came from SMEs engaged in the manufacturing sector. Our findings are consistent with global trends given the fact that lease financing is most attractive to manufacturing enterprises given the higher cost of capital required for them to operate compared to retail/ trading and services sector businesses. Lease financing is particularly attractive to facilitate those SMEs involved in the manufacturing sector as it facilitates them in the acquisition of a necessary capital asset required in the production of goods without actually having to purchase the asset as well as not incurring any costs related to depreciation of the asset. It is therefore recommended that lease financing should be further promoted for manufacturing based SMEs given the sector has the potential to reap the most substantial benefits from this mode of formal financing.

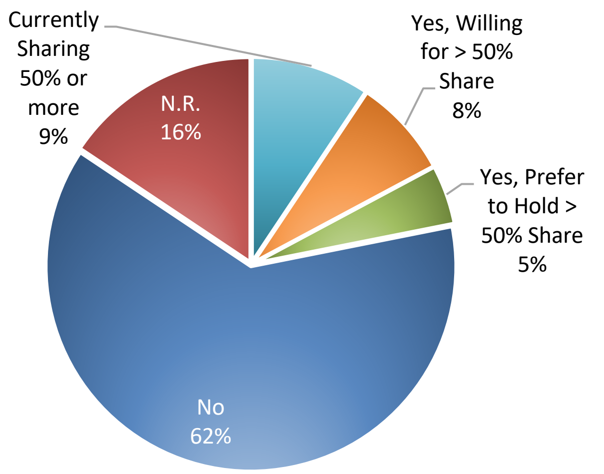
6.5 Equity Finance

The following section presents the survey findings related to how SMEs in the country meet their financing requirements from equity share finance. The results presented in the following section shed light on what key needs and preferences SMEs have with respect to equity share financing, how these needs are met given and their knowledge of different financing sources. Furthermore, it shows the extent to which various organizational specific dimensions of SMEs impact their access to securing equity share financing from investors and their overall satisfaction levels related to equity share financing.

Willingness to Share Equity

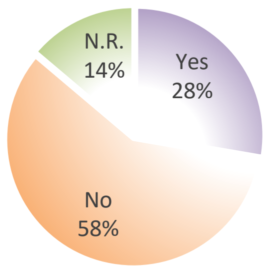
There was a lack of willingness shared by SME owners with respect to sharing equity as seen among 62% of the respondents. Among those who were willing to share:

- 9% of respondents were currently sharing 50% more of their equity.
- 8% were willing to share more than 50% equity
- 5% were willing to share equity as long as it was less than 50%



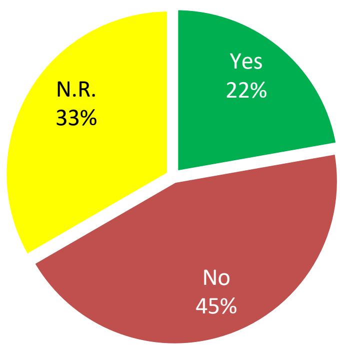
Approached to Private Investor (in Last 5 Years)

Out of our sample size, 58% of SMEs did not approach a private investor compared to 28% who had in the last 5 years.



Status of Request to Private Investor

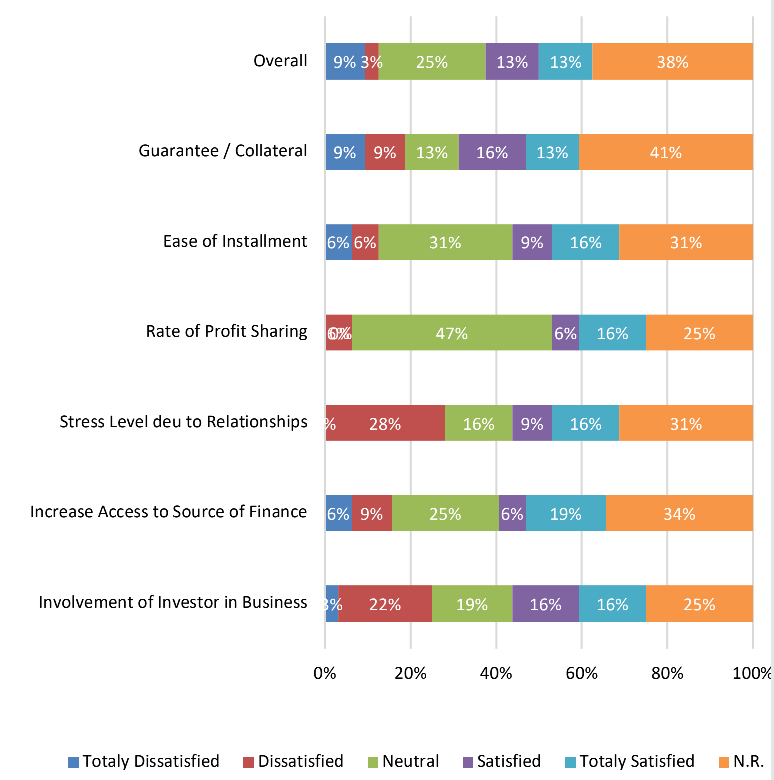
45% of the respondents said no compared to 22% who said yes. The other 33% did not provide any response.



Level of Satisfaction for Equity Finance

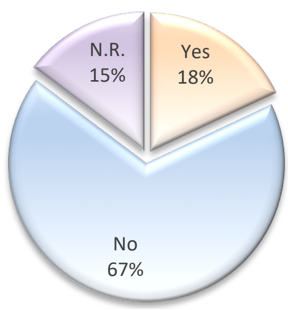
The overall satisfaction level was low with only 12% exhibiting satisfaction with equity finance compared to 26% who were dissatisfied. Furthermore, 25% had neutral opinion. The highest rates of satisfaction stemmed from involvement of new investors resulting from accepting equity financing. However, in contrast highest dissatisfaction came as a result of stress increase when it came to managing these new relationships.

The result points towards the possibility that new investors can bring something new to the business in terms of skills or knowledge. However, the existing management of the business could find it difficult with respect to the changing interpersonal power dynamics resulting from the new investors involvement in the business.



Loan Request from Informal Finances / Source

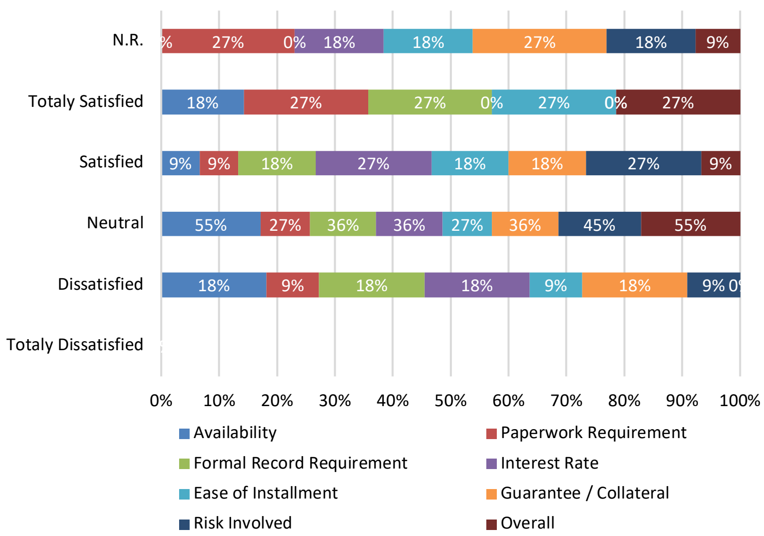
Out of all the respondents, 67% did not make a loan request from an informal source compared to 18% that had requested for such financing. A total of 15% did not provide any response.



Level of Satisfaction - Informal Finance / Source

The level of satisfaction for informal finance was difficult to gauge primarily due to a significant percentage of respondents choosing not to offer a response to various satisfaction metrics related to this particular source of financing.

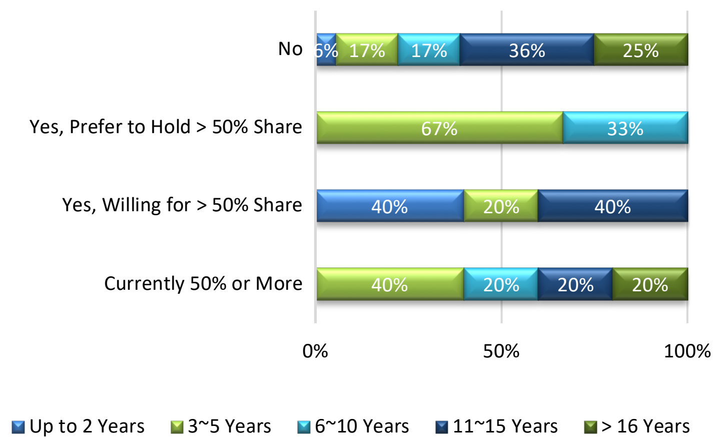
After aggregating the results from all eight dimensions, the most cited reasons behind SME preference for this particular financing was the limited requirements related to submitting formal records and paperwork to obtain informal finance vis-



à-vis formal channels of financing. Overall a total of 27% of respondents were totally satisfied with informal financing while 55% had a neutral perspective when aggregating the results of all seven dimensions.

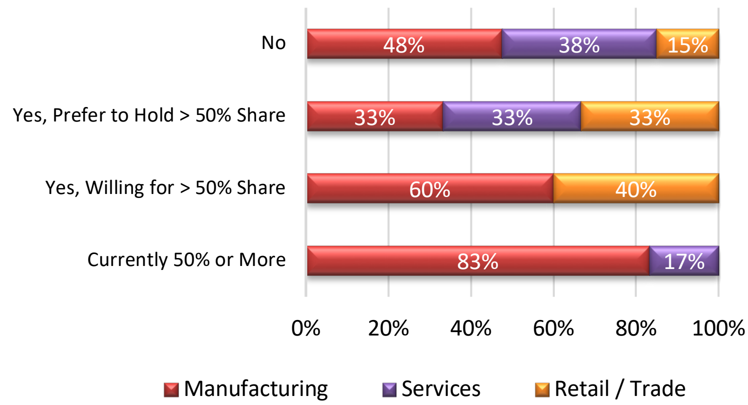
Sharing Equity in Firm and Years of Exp. Present Business

Among those businesses with no existing form of sharing equity, the majority of SMEs consisted of firms with at least 11 years of experience. Comparatively, business owners operating between 3 to 5 years had the highest percentage of equity shares with almost 40% of respondents having more than 50% share equity. Interestingly, businesses between 3 to 5 years also wished to hold more than 50% of their equity and up to 67% of responses reflecting this.



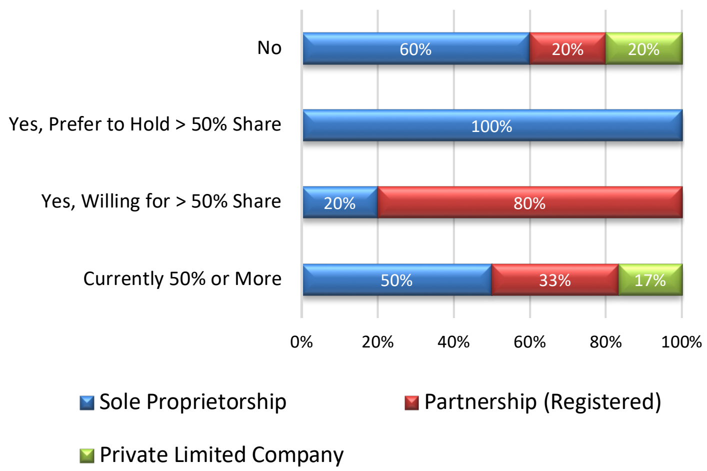
Sharing Equity in Firm and Years of Exp. Present Business

Given the high capital expenditures involved in manufacturing, the sector had the most need for equity capital and comparatively was willing to give up more control or already had given up control to secure this mode of finance. In contrast, the highest resistance came from services sector respondents.



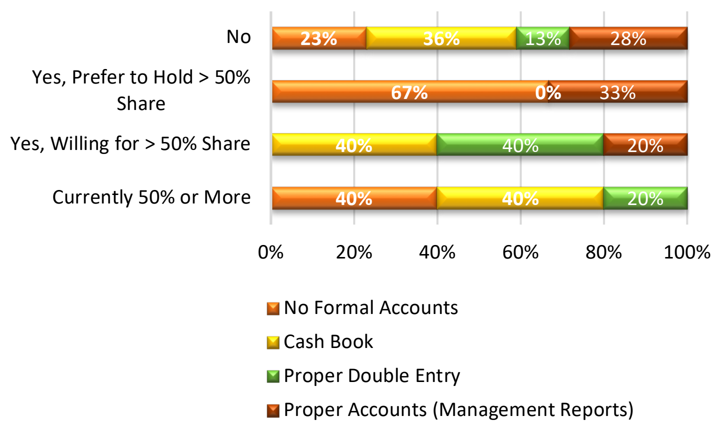
Sharing Equity in Firm and Legal Status of Business

The responses received were in line with common global standards with respect to equity sharing in relation to the legal status of a business. Sole proprietorships were most opposed to giving up control given that owners prefer to have complete control in their enterprises and are highly suspicious to equity capital and external interference in business operations.



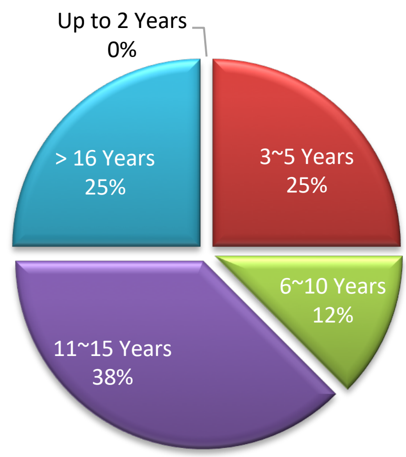
Sharing Equity in Firm and Type of Business Accounts

The responses show that despite those businesses where accounting processes are not formally documented or use a cashbook show a high degree preference for not wanting to give up control. Despite, this resistance they are more likely to accept this mode of finance due to their limited ability to obtain external or formal financing from financial institutions.



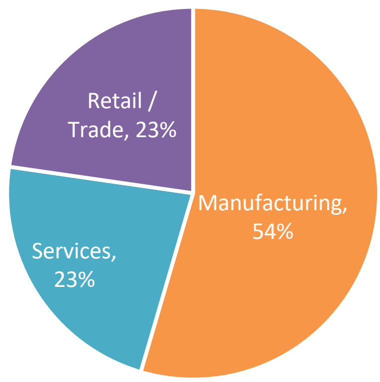
Request to FF for Finance Approved and Years of Exp. Present Business

Out of the SMEs that applied for formal financing, those businesses having 11 to 15 years of experience represented 38% of all approved loans. This was followed by businesses having between 3 to 5 years as well as more than 16 years experience each having a 25% share respectively.



Request to FF for Finance Approved and Nature of Business

Businesses operating in the manufacturing sector had the highest share with respect to having their requests for finance approved and constituted 54% of the total approvals in this category while other two sectors constituted 23% each.



6.5.1 Key Findings and Recommendations – Equity Finance

i. Equity sharing remains one of the least utilized sources of external finance among the SMEs in Pakistan. Given that most of the SMEs in Pakistan are family-owned businesses, SME owners are very cautious about sharing both control and context of their businesses. This is evident as the majority of SME respondents in our sample did not have any willingness to share equity and had not approached a private investor. One interesting finding relates to those SMEs that were legally classified as sole proprietorships and those SMEs that did not manage and hold formal accounting records of their business were most likely to be sharing more than 50% of their equity. This is despite the fact that they have the highest level of resistance to equity share financing as both types of businesses tend to have a very protective attitude to external influence in their businesses which naturally makes them suspicious of equity sharing. However, given both types of businesses generally are least likely to have their request for formal financing accepted, their decision to opt for equity financing is likely to be driven due to necessity and lack of options.

ii. When attempting to gauge the level of satisfaction with equity financing, the respondents cited the involvement of the new investor in the business as one of the most satisfactory effects after sharing equity. However, in contrast respondents cited the stress of having to manage relationships as the greatest source of dissatisfaction among all dimensions measured related to evaluation of equity financing. The finding points towards an interesting paradox where despite SMEs benefiting from external investor involvement they tend to be highly stressed when it comes to managing relationships with them as the new equity partner can often have competing aims and objectives vis-à-vis the old business owners especially given their latter enjoying absolute control over the business decisions prior to sharing equity. In order for SMEs to truly maximize the benefits of equity sharing agreements they should ideally select an investor who shares similar business objectives as well as personality traits with the SMEs existing ownership. Furthermore, owners could reduce stress levels by accurately forecasting that equity sharing is likely to lead to minor conflicts and prepare themselves adequately in advance.

iii. An interesting relationship was witnessed in the results in relation to the perceptions and existing patterns of equity finance sharing among the SME respondents when compared to their years of experience and operations. Those enterprises which were older than at least 11 years generally had the highest ambivalence to equity sharing finance which could be the result of them having a wider variety of formal financing alternatives available. In contrast, those enterprises which were established less than 3 years ago had the highest preference for equity sharing as it would benefit from external capital during its survival and growth stages while simultaneously reducing their risk.

iv. Finally, SMEs with 3 to 5 years of experience were most likely to be sharing more than 50% of their equity despite being most opposed to equity share financing amongst the respondents. This is due to the fact that businesses in this category have already managed to get past the survival phase and often have strong potential for growth especially if they are provided with additional capital to help them expand and increase existing capacity. As these businesses are already successful, the owners would like to keep equity but given the necessity to gain external financing along with the limited access to formal financing, they have to rely on equity share financing. In order to ensure their future success, decision to choose an external investor should be made based on their similarity to the company’s vision and their potential to help the firm grow aggressively in the future.

7 Conclusion

SME sector in Pakistan is confronted with numerous challenges among which the access to finance remains a significant problem towards their growth and development. This study therefore aimed to shed deeper light on the financing needs of SMEs in Punjab, to comprehend the extent of their knowledge regarding different financing options, and identifying and evaluating their access and level of satisfaction for each of the different financing options.

In particular, our focus was on identifying the demand side dynamics and challenges from the perspective of SMEs based in the province of Punjab. Our research and findings correlated with previous research on the topic thus reaffirming the view that SMEs face significant hurdles in accessing different types of formal financing in Punjab. The majority of SMEs did not rely or prefer to engage formal institutions such as banks to meet their financing needs.

Out of those respondents that had approached a formal financing option, we focused on identifying specific characteristics and profiles of SMEs that had applied for working capital finance, medium- to long-term financing, lease financing and equity share financing. For instance, those SMEs who maintained formal accounting records and documentation or had been operational for a longer period of time were more likely to be granted financing from banks compared to equity share financing. Finally, we provided various recommendations that would enable a more financially inclusive environment for SMEs that would aid them in gaining access to finance as well as focusing on recommendations that would enable SMEs to maximize gain from different financing options.

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