# State Bank of Pakistan

# SME Financial Review

*(Second Quarter 2007)*

## Small and Medium Enterprises Department

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# 1. Overview

The development of economies globally testifies that SME sector plays an important role in the ameliorated uplift of the socio-economic fabric of both the first and second world countries. The latent potential of SME sector in creation of employment, alleviation of poverty, promotion of economic growth and formation of forward and backward linkages place it in a highly important transformative position across the globe. The peculiar economic and social characteristics associated with this sector such as promotion of entrepreneurial ability, quick adaption to market dynamics, innovative orientation towards market economy provides it with the right set of features to serve as the backbone of the economy. A review of economies like USA, Germany, UK, Canada, Japan, China, Malaysia, Korea, Thailand, Hong Kong and India etc. reflects that Small & Medium Enterprises sector has provided the essential impetus in achieving the goals of economic and social development in these nations **(See Figure 1.1,1.2)**[1].

Figure-1.1:-Share of SME sector in formal employment (%)

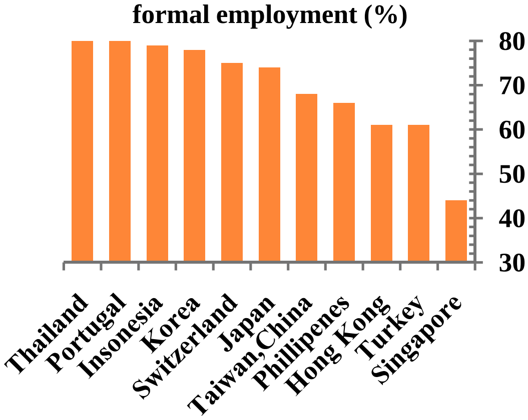
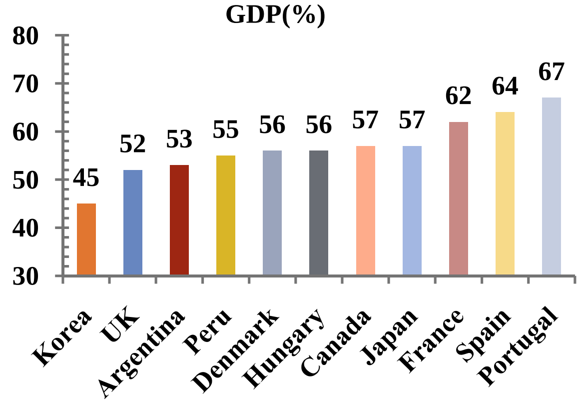



Figure -1.2:- Share of SME sector in GDP(%)




In Pakistan, there are 3.2 million Economic Establishments[2], 44% in rural areas and 56% in the urban areas. Out of these, a total of 99.06% employed 1—10 persons, clearly indicating that these establishments fall under the definition of SMEs. Similarly, individuals own about 97% of such establishments, where 53% of the establishments belong to wholesale & retail trade and Restaurant & Hotel sectors, 20% are part of the manufacturing sector and 22% fall in Community, Social and Personnel services sector. Almost 68% of the manufacturing establishments in the households were engaged in

[1] SMEs across the Globe: A New Database by Meghana Ayyagari, Thorsten Beck and Asli Demirgüç-Kunt World Bank Review on Small Business Activities 2003.

[2] Economic Census of Pakistan-National Report May 2005(www.statpak.gov.pk)

Textile wearing, apparel and leather industries. Sialkot, Gujranwala, Lahore, Karachi, Rawalpindi and Peshawar are the major clusters of small enterprises in the country. The contribution of SMEs towards GDP is over 30%, export earnings share of 25% besides contributing 35% in the manufacturing value addition. It also generates 78% of non-agricultural employment[3].

## 2. Current SME Profile Scenario

SME sector is the second largest sector, in terms of banks exposure, after corporate sector, constituting about 15.4% of the total bank loans at the end of second quarter of 2007. At the end of CY06, in absolute terms exposure to the SME sector had reached Rs. 408 Billion, increasing by Rs.47 billion or an increase of 13% over the previous year. However, during the first quarter of the current year, the exposure to the SME sector decreased by Rs.21 billion, to Rs.387 billion, with consequent reduction in its share from 17% to 16.3% of the total loan portfolio of the commercial banks. This downward trend prevailed during the second quarter of CY07 and the absolute amount further reduced to Rs.382.9 billion. The data reflects that SME loan portfolio of commercial banks for the period Mar07-June07 declined by 1.09%. A glance at the nature of break-up in SME financing facilities shows that a major chunk of loans availed by the

**Figure-2.1:- Loans to SME sector**

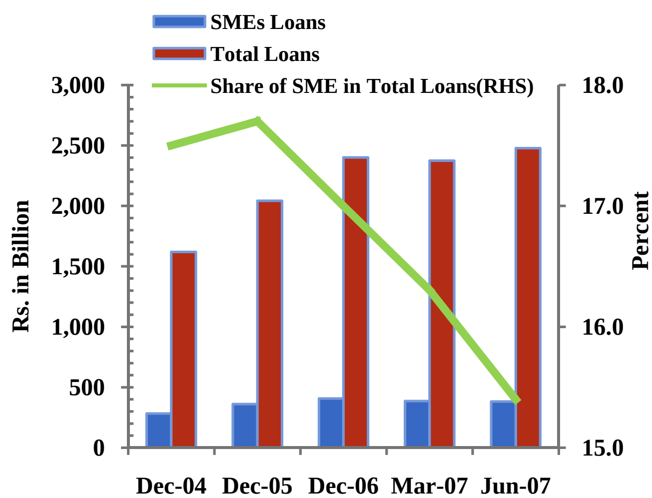
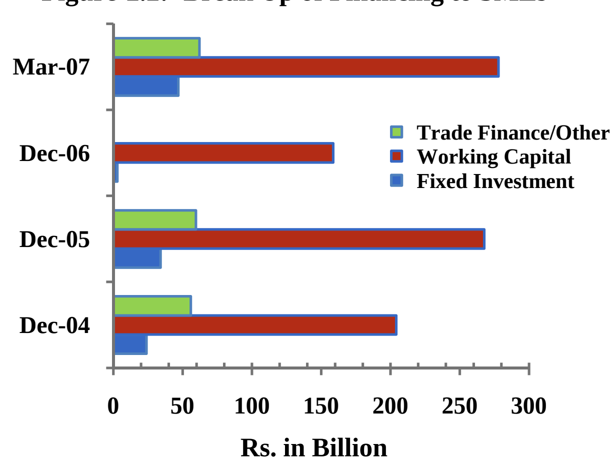



**Figure-2.2:- Break Up of Financing to SMEs**




[3] Economic Survey of Pakistan 2003-04

SMEs is directed to Working Capital Finance followed by fixed investment and Trade Finance respectively **(See Figure 2.2)**. A significant share of 72.68% of the total financing facilities provided to SMEs is utilized toward working capital finance, while 15.69% and 11.6% is accounted for by fixed investment and Trade finance needs of the SMEs.

During the second quarter of Year 2007, fixed investment and Trade finance facility witnessed a negative growth of 5.3% and 3.3% respectively, while the working capital finance recorded a nominal growth of 0.1%. This scenario clearly corroborates the overall position of declining a SME loan portfolio during the period. At the end of second quarter Rs. 278 billion were disbursed under working capital finance, while fixed investment and Trade finance received Rs. 44 billion and Rs. 60 billion.

Over the recent past, however, one of the important aspects of the banking industry's contribution in financing the SME sector is the significant enhancement in outreach reflecting itself in increased number of borrowers. The number of borrowers increased from 67,000 in CY02 to 168,000 in CY06 (increase of 149.2%). However, in the first quarter of CY07, number of SME borrowers first reduced from 168,000 to 164,000 and then went down to 162,000 in the second quarter of CY07 **(See Figure 2.3)**. The net change in the second quarter turned out to be -1.1%. Though it is quite encouraging that the outreach of SME finance has increased substantially over the past few years, the erosion in the first two quarter of the current year shall not go unheeded. Keeping in view the number of SME establishments in the country it can safely be stated that there is still huge potential for the banking industry to further enhance its outreach in this sector.

The quality of SME loan portfolio has improved over the years. The total

**Figure-2.3:- No. of Borrowers of SME Sector**

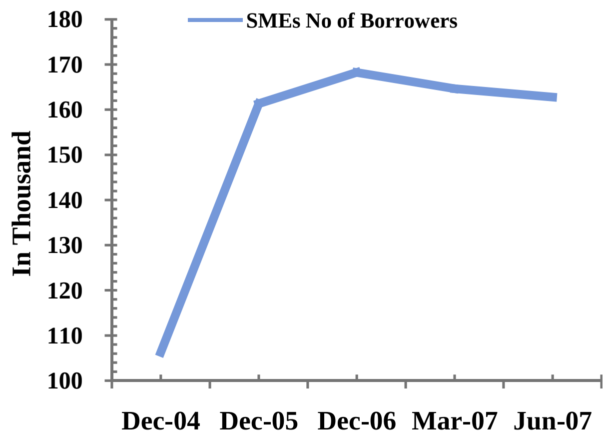
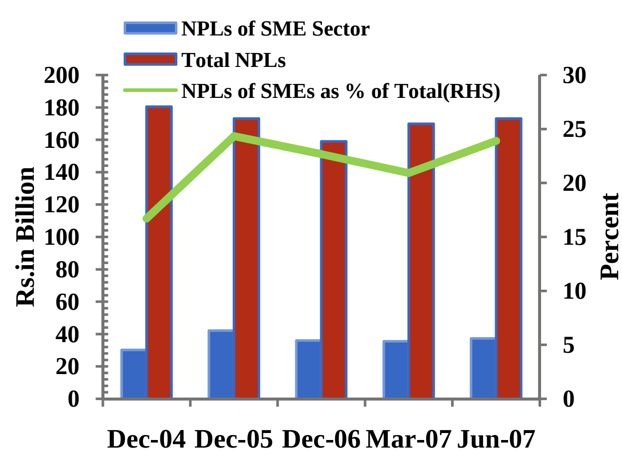



**Figure-2.4:- Loans to SME Sector**

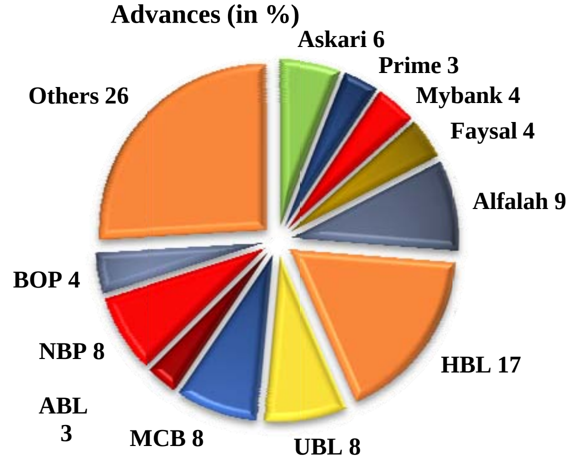


amount of NPLs of SME sector declined from Rs. 42 billion in CY05 to Rs. 36 billion in CY06. In the first quarter CY07 the total absolute outstanding NPLs of SME sector further reduced to Rs.35.5 billion but in the second quarter increased to Rs.37.3 billion. However, the share of SME sector NPLs in the aggregate NPLs remained at about 24% during the second quarter of CY07 **(See Figure 2.4)**.

While SME finance performance in the banking industry has been quite encouraging during the past few years; this sector has not been fully tapped. The currently extended financing facilities do not meet the needs of the SME sector, keeping in view the large size of the SME sector and the share of SME finance in total loan portfolio of the banking industry. Ready access to affordable finance is the need of this sector, to foster its growth for underlying imperative contribution to national economy. A number of issues pertaining to demand and supply side of SME finance are hindering the smooth flow of finance to the sector. To count a few, lack of reliable information and documentation, cumbersome lending procedure and process, non-aggressive lending strategies of commercial banks, human resources constraints, dependence on collateral based lending, lack of awareness programs for SMEs, reluctance to disclose financial position and many other issues need to be resolved for providing easy access by the finance to SME sector.

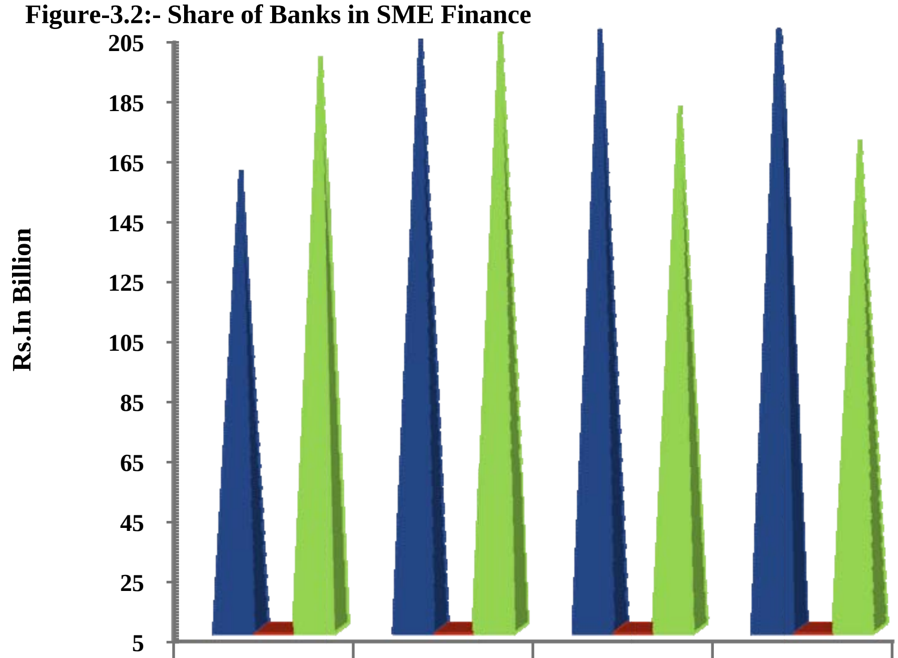
## 3. Banks SME Finance Profile

**Figure-3.1:- Share of Banks in Total SME Advances (in %)**




The Bank wise share of SME finance reflects that almost 43.1% of total SME related advances are being made by the big five banks while the remaining institutions have a combined contribution of only 56.1% towards SME advances. The individual share of the larger banks shows that HBL carries the largest share of 17.2%, followed by MCB & UBL with 8% each; NBP & Allied Bank with 7.6% and 3.1% respectively **(See Figure 3.1)**. In absolute terms, the five big banks disbursed loans of Rs. 168 billion at the end of second quarter of CY 07 while only Rs. 214 billion were extended by all other banks. HBL had the highest disbursement figure of Rs. 66 billion as of end of June-07. Among other banks, Bank Al-falah had disbursed about Rs.34 billion followed by Askari Commercial Bank with Rs.22.5 billion of total banking sector exposure towards SME sector at the end of second quarter of CY07.

**Figure-3.2:- Share of Banks in SME Finance**



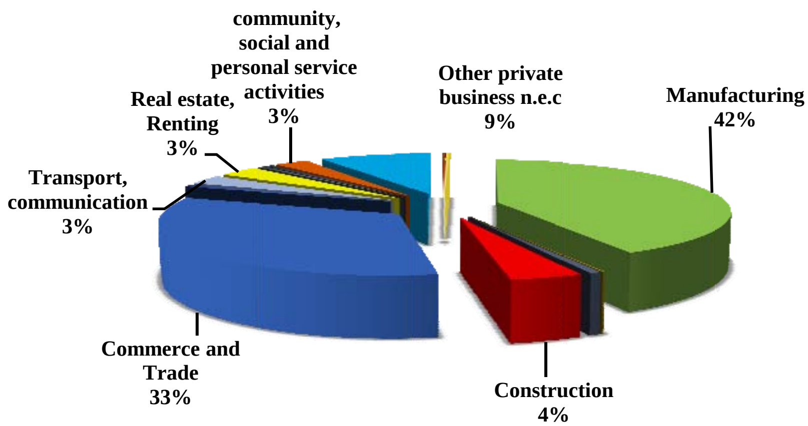

| | Dec-05 | Dec-06 | Mar-07 | Jun-07 |
|---|---|---|---|---|
| Local Banks exclud.5 Big Banks | 158 | 202 | 205 | 213 |
| Foreign Banks | 3 | 2 | 2 | 2 |
| 5 Big Banks | 196 | 205 | 180 | 168 |

Analysis of the banks' exposure to SME sector reflects that the share of big five banks in SME finance which was 54.2% in Dec-05 declined to 50.1% in Dec-06, and further slipped to 43.9% as at the end of second quarter of CY07. However, it is encouraging to note that the share of local banks excluding five big banks increased from 45% to 55.6% of the total SME finance during the period Dec05-June07. This also reflects the fact that due to expanded branch network, smaller banks are now well positioned to exploit the potential of SME sector and compete with the larger banks. In absolute terms, the exposure of other local banks stands at Rs. 212 Billion at the end of June-07 **(See Figure 3.2)**. From March07 the share of SME finance of other local banks excluding 5 big banks, has increased by 2.6 % during second quarter. Traditionally the share of foreign banks in SME finance has been meager constituting 0.5% of the total SME exposure of the banking sector at the end of second quarter.

Further, a major portion is accounted for by of Al-Baraka Islamic Bank which contributes around 0.3% of the total foreign banks SME exposure, the share of other foreign banks being negligible. At the end of the second quarter of CY07, the total SME exposure of the foreign banks stood at around Rs. 2 Billion.

## 4. Sectoral Analysis of SME Finance

**Figure-4.1:- Sectoral Distribution of SME Finance**

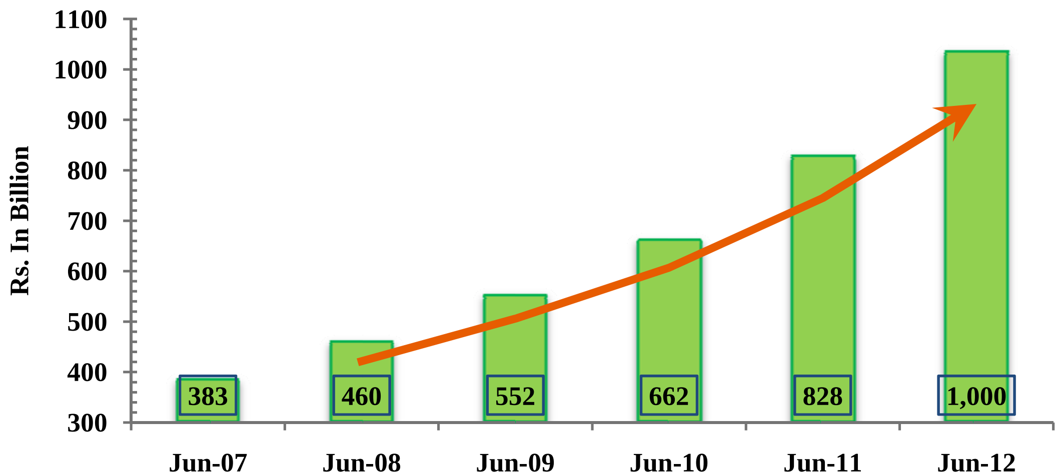



The sectoral distribution of SME finance reflects that the major share of SME finance is going towards Manufacturing, Commerce and Trade sectors. Collectively these sectors have received about 75% of the total SME finance channelized to all sectors, at the end of second quarter. A split of this major share reveals that 42% of the total SME credit is availed by the manufacturing sector while 33% availed by Commerce and Trade sector. The Construction, Real estate, Transport and Communication accounts for 9% of the total sectoral finance distribution **(See Figure 4.1)**. In absolute terms, Rs. 285 billion was disbursed to Manufacturing, Commerce and Trade sector and Rs. 41 billion to Real estate, Transport and Communication sectors. However, manufacturing sector recorded a negative growth of 4.97% during the quarter under review, while Commerce and Trade sector displayed a positive growth of 0.51% for the quarter ending June07.Likewise the Transport and Communication sector showed growth of 15.43% followed by Construction sector which witnessed a growth of 10.46% during the second quarter of CY07. The real estate, renting and business activities displayed a negative growth of 3% during the second quarter of CY07. A glance at the sectoral distribution reveals no major shift in terms of SME finance allocation, over the last few years. SME finance is mostly concentrated in two or three sectors. The share of other sectors in SME finance has been: Fishing (0.23%), Mining and Quarrying (0.21%), Ship breaking ((0.14%), Education (0.44%) and Electricity, gas (0.68%) etc. The rationale behind the current availment pattern of greater share of SME finance in Manufacturing, Commerce and Trade sectors is the relatively established and organized status, better entrepreneurship practices and to some extent their relatively bigger size within the SME sector

## 5. Future Outlook

The promotion of SMEs through adequate availability of needed financing is one of the important objectives of SBP's policy initiatives. Towards this end market driven support programs are important to attain sustainability, maximize potential for cooperation with the private sector, and to minimize distortions in the economy. A close assessment of the historical trends, capacity of financial institutions and the potential of SMEs, indicate that the credit from the banking sector for SMEs needs to increase from Rs.382.9 billion as of June 2007 to about 1,000 billion by the end of June 2012, to achieve projected economic growth, employment and other macro-economic targets **(See Figure 5.1)**.

**Figure-5.1:- Proposed Targets-Overall SME Credit**




In order to provide financing to the sector to the projected scale, annual growth in provision of credit of around 20% for the next three years would be needed. Concurrently a more evolved mechanism in terms of SME designated/SME-focused branches, trained SME staff and new cash-flow based SME lending products put in place and fully operational, would support the expected 25% average growth in SME credit from formal sector in the fourth & fifth years.