

Sergei Safonov

Partner, EY



Small and Medium Entrepreneurship in Russia

Roundtable discussion

SME financing in ENCA

Luxembourg, 12 March 2014



Contents

- ▶ The role of SME sector in the Russian economy and the government attention to SME sector development
- ▶ The Russian SME sector structure, financing instruments and growth potential
- ▶ Financing needs of the SME sector and the role of development institutions – both Russian and international – in financing markets development

Summary

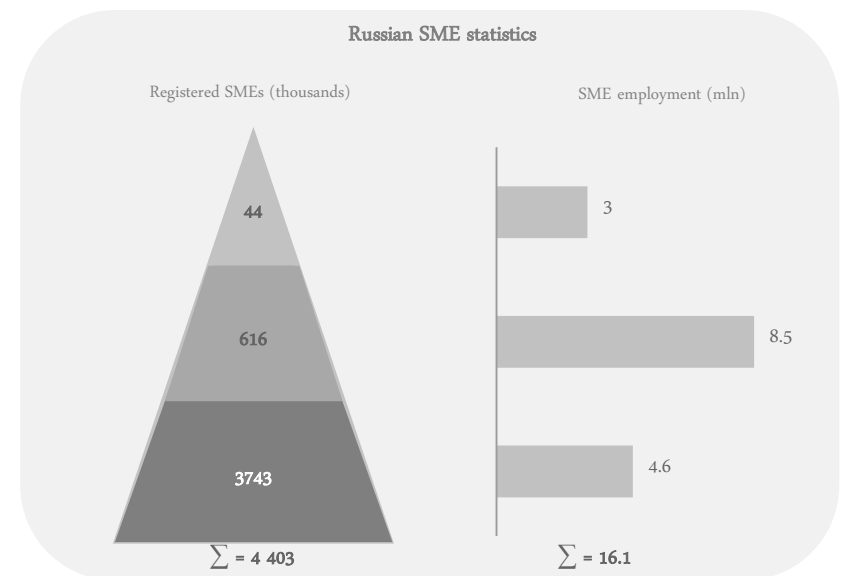
- ▶ Development institutions can make a considerable impact on the Russian SME sector as SME financing markets are still in developing or emerging stage
- ▶ The SME sector in Russia has been steadily growing in recent years, both in terms of SME number and turnover
- ▶ Despite high growth rates, an international comparison shows strong potential for further growth of SME sector in Russia
- ▶ Low availability of banking and nonbanking financing for SMEs is among main constraints for the development of the sector
- ▶ SME financing markets demonstrate sustainable growth with emerging markets (factoring and microfinance) showing the highest growth rates
- ▶ The Russian government is active in shaping the business environment for SMEs – both through legislative improvements and by providing direct financial support, e.g. from state-owned SME Bank (VEB Group)
- ▶ The government support for SMEs is primarily focused non-trade and non-resource sectors as well as on emerging SME activities across all industries
- ▶ SME financing markets attract various players including commercial and development banks – key strength of development banks is funding tenor, while funding rates at commercial banks are still quite competitive

Key components of SME classification in Russia are similar to those used in EU

For the purposes of state support, legal entities, individual entrepreneurs and agricultural producers are considered as small or medium businesses if they meet three criteria, according to Law 209-FZ:

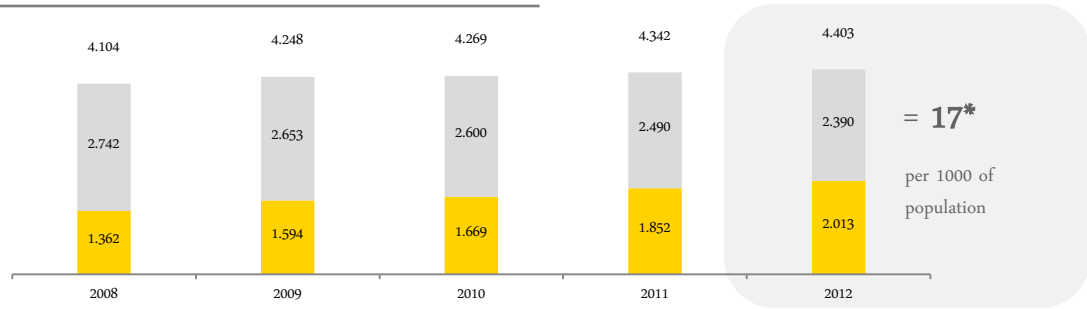
- 1 Ownership structure:** SME's **stake** held by one or several legal entities, which are not small or medium businesses, should not exceed **25%**
- 2 Workforce:** Number of employees should not exceed **250 people**
- 3 Volume of revenue:** Annual turnover should not exceed **25 euro mln.**

	SME Segmentation			
	Russia		EU	
	Revenue (eur mln)	Number of employees	Revenue (eur mln)	Number of employees
Medium	10-25	101-250	10-50	50-250
Small	1.5-10	15-100	2-10	10-50
Micro	<1.5	<15	<2	<10



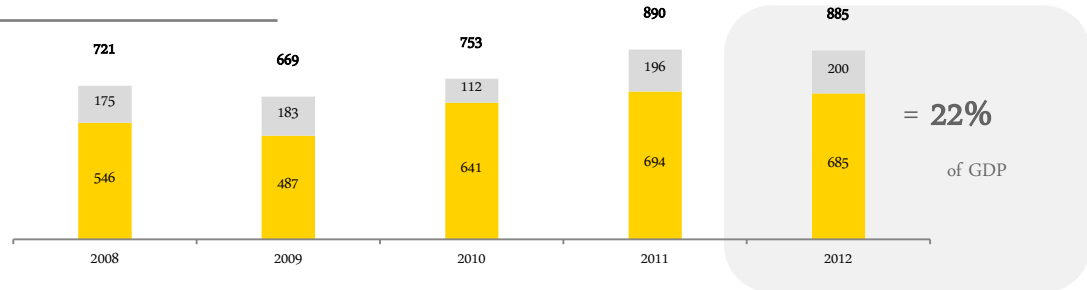
SME sector in Russia has been steadily growing both in terms of SME number and turnover

Number of registered SMEs, in thousands



Starting from 2008 the total number of small and medium enterprises has grown by 7% and reached 4.4 mln.

SME turnover, EUR bln

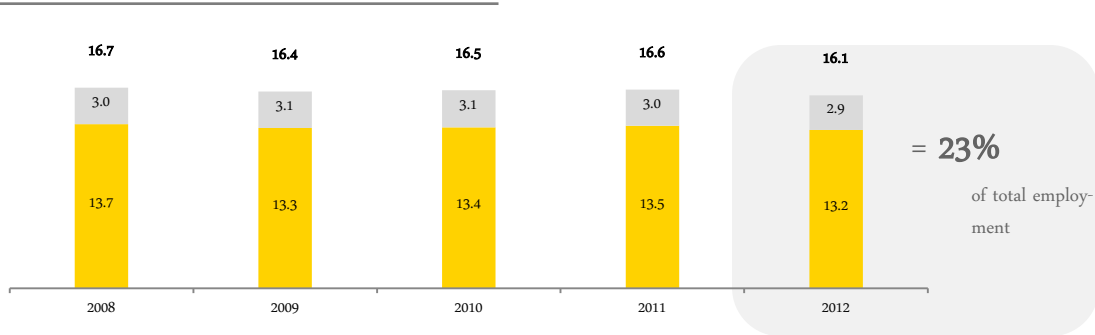


Turnover of small and medium enterprises has steadily grown during after-crisis period (starting from 2009) and in 2012 reached EUR 885 bln.

Average turnover per SME, EUR thousand, 2012



Employment in SME, millions of people



Total employment in Russian SMEs remained stable since 2008 and in 2012 is 16.1 mln. people.

Average employees per SME, 2012

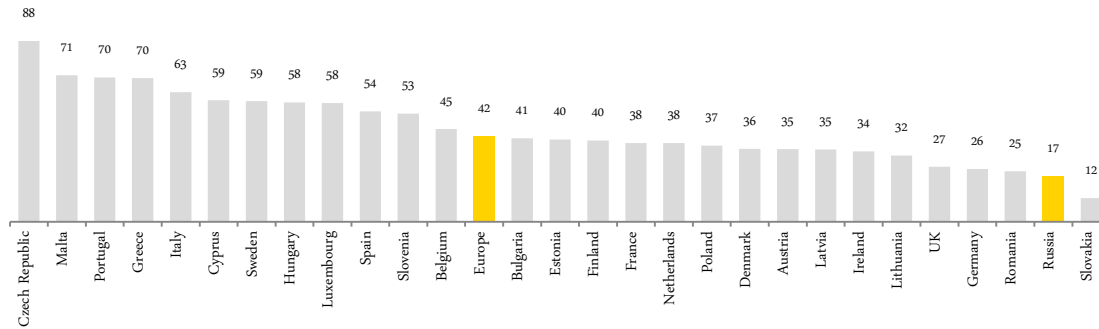


* Number of active SMEs

Legal entities (LE)
Individual entrepreneurs (IE)

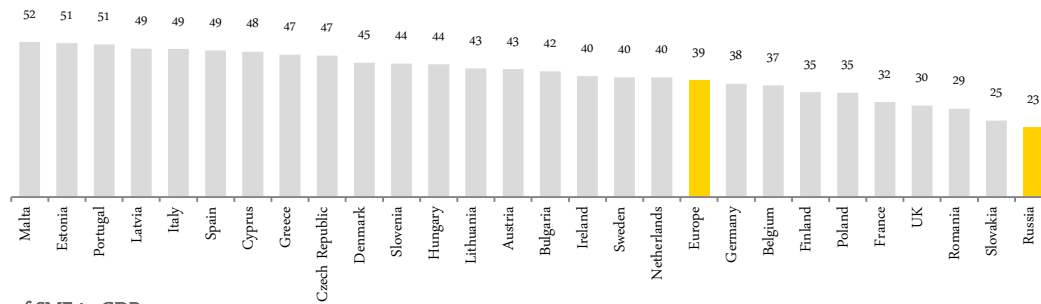
Despite recent growth, in international comparison there is still considerable potential for further growth in SME sector in Russia

Number of active SMEs per 1 000 of population (2011*)



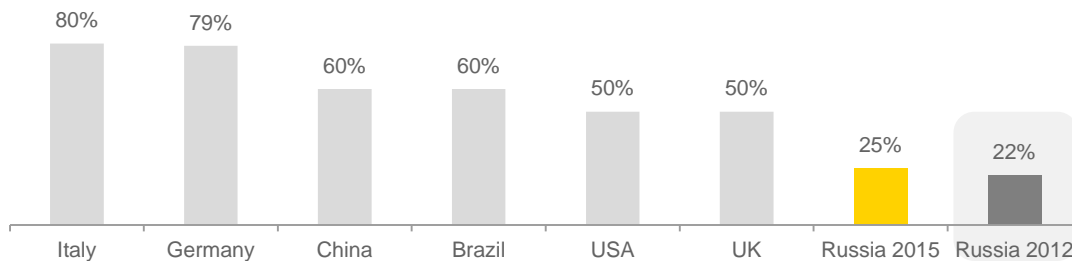
The number of SMEs per unit of population is 2 times lower than on average in EU

Employment in SME (% of total employment, 2011*)



Employment in SME segment is 1.7 times lower than on average in EU

Share of SME in GDP



In 2015 SME will produce quarter of Russian GDP which is still significantly lower than in other developed and developing countries

* Russian figures are for 2012

State support to SME sector takes different forms (financial support, special tax regime etc.) with the focus on innovative SMEs

LEGISLATION

DESCRIPTION

Federal Laws

- 1 ▶ *Law No. 88-FZ on State Support for Small Business in the Russian Federation (adopted in 1995)*
- 2 ▶ *Federal Law No. 209-FZ on Developing Small and Medium Scale Entrepreneurship in the Russian Federation (2008)*
- 3 ▶ *Federal Law No. 82-FZ on "Development Bank" (2007)*

Sets the framework for state support to small business, objectives, forms and methods of state stimulation and regulation of small business activity, definition and criteria for enterprises to be considered small-sized companies.

Replaced the previous 88-FZ. Introduced the terms "medium entrepreneurship", "microenterprises" and "infrastructure for support to SME". Defined methods of support for various forms of SME.

Defines objectives and functions of the development bank, in particular states SME support as one of the main functions.

Government measures

- 1 ▶ *State's finance program on SME support – Russian Government (2005)*
- 2 ▶ *President's Decree No. 956 on "Long-term state economic policy" (2012, May)*
- 3 ▶ *The Ministry of Economic development - decree No. 143 on "Selection criteria for Russian medium entities and their investment projects" (2013)*

Declares the goals such as the increase of the volume of support of the innovative SMEs, medium enterprises, leasing development, grant support of the beginner entrepreneurs, creation of SME support centers etc.

Sets measures and directions for improvement of entrepreneurship conditions, in particular through creation of mechanism of state's guarantees to secure medium-sized companies investment projects.

Sets criterias for mid-sized entities (investment projects) selection for VEB guarantee support.

- ▶ State support of SME sector is **focused on manufacturing sector with particular emphasis on innovative and technology intensive SMEs**
- ▶ According to the definition, innovations include modernization and energy efficiency

The Russian government is actively involved in shaping the business environment to intensify SME development

Leaders of the rating 2014 (top-20)

1. Singapore	8. Georgia	15. Ireland
2. Hong Kong SAR, China	9. Norway	16. Taiwan, China
3. New Zealand	10. United Kingdom	17. Lithuania
4. United States	11. Australia	18. Thailand
5. Denmark	12. Finland	19. Canada
6. Malaysia	13. Iceland	20. Mauritius
7. Korea, Rep.	14. Sweden	

Top-5 economies improving the most*

Country	2013	2014	Improvement
Philippines	138	108	▲ 30
Ukraine	137	112	▲ 25
Russian Federation	112	92	▲ 20
Rwanda	52	32	▲ 20
Kosovo	98	86	▲ 12

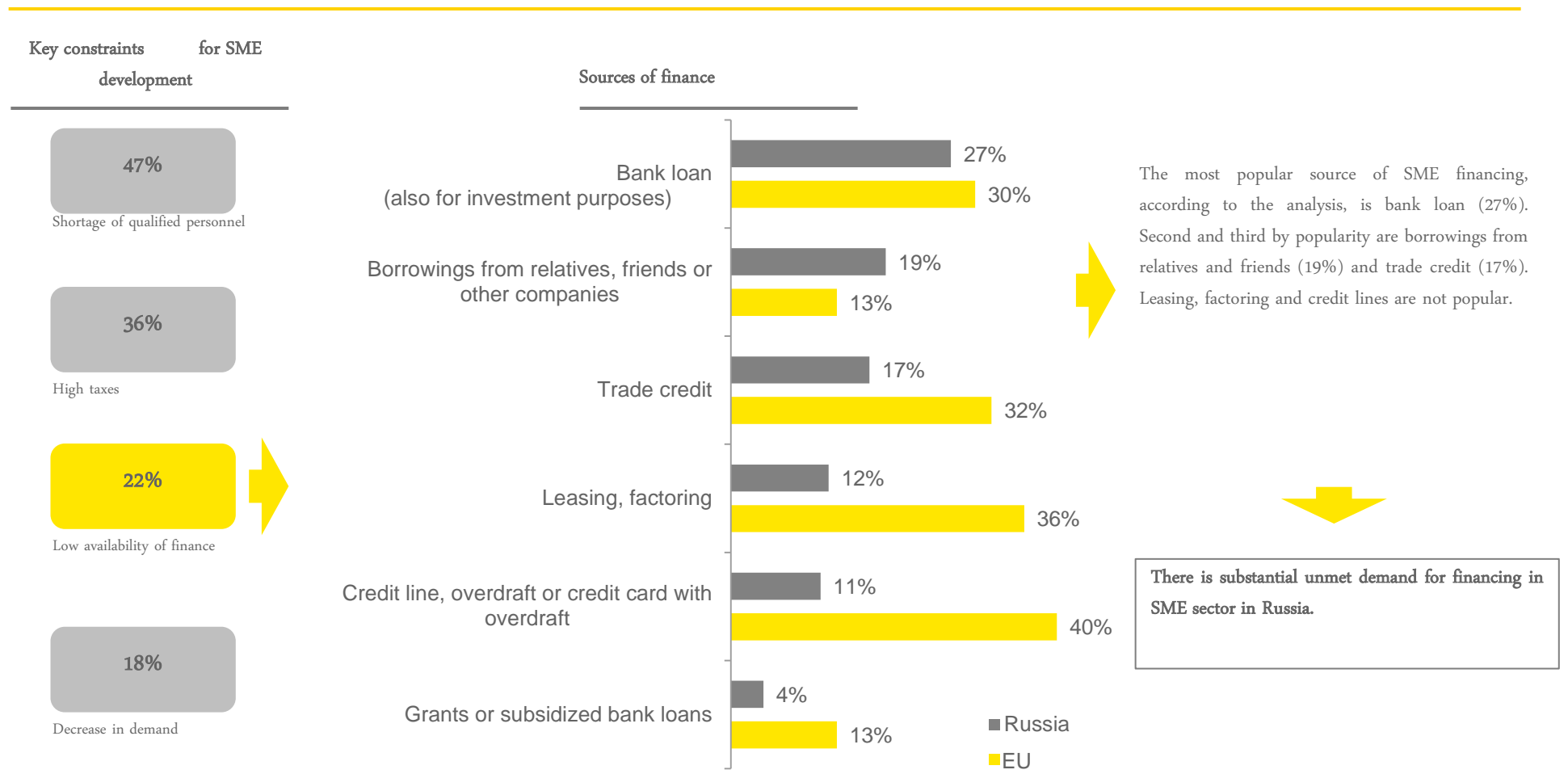
Russian Federation rating components*

Components	2013	2014
Starting a Business	100	88 (▲ 12)
Dealing with Construction Permits	180	178(▲ 2)
Getting Electricity	188	117(▲ 71)
Registering Property	46	17 (▲ 29)
Getting Credit	105	109 (▼ 4)
Protecting Investors	113	115 (▼ 2)
Paying Taxes	63	56 (▲ 7)
Trading Across Borders	162	157 (▲ 5)
Enforcing Contracts	10	10 (0)
Resolving Insolvency	53	55 (▼ 2)

- ▶ Doing business report was chosen by the government as an indicator of SME sector development
- ▶ Government measures implemented in 2012-2013 helped Russian Federation to move up 20 positions being amongst the top-5 countries improving the most in the year 2013. The goal set by the government is to reach top-20 by the year 2018.
- ▶ “Getting credit” is one of the key areas for improvement in the medium-term perspective

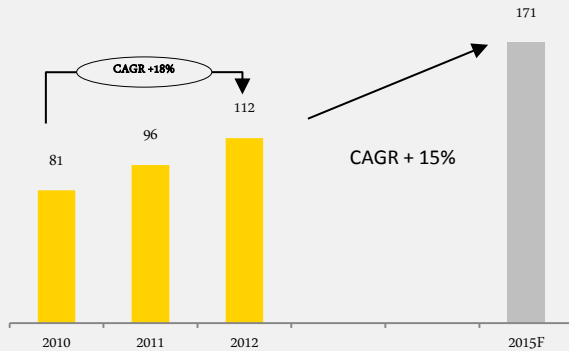
Source: World Bank Doing Business Report

More than 20% of Russian SMEs outline low availability of finance as a constraint for SME sector development



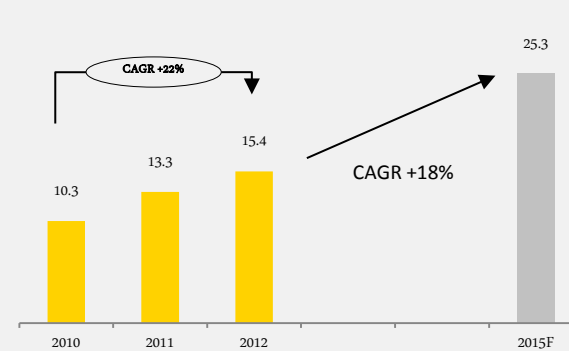
The markets of SME financing demonstrate sustainable growth with emerging markets (factoring and microfinance) showing the highest growth rates

SME lending market, EUR bln



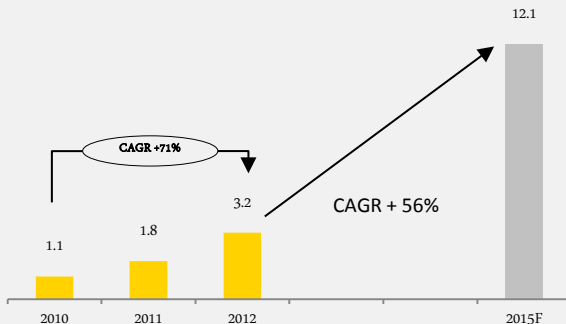
In 2012 the loan portfolio of Russian banks in the SME segment is RUB4.5 trln (EUR112.4 bln). The growth rate in 2012 (17%) is lower than in 2011 (19%) and in 2010 (22%).

SME leasing market, EUR bln



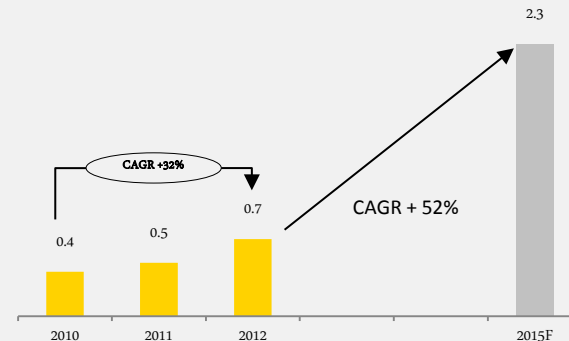
The SME segment accounts for about 35% of the total leasing market in Russia. In 2012 the SME share of total leasing market grew by more than 6%, reflecting the desire of leasing companies to diversify their portfolios.

SME factoring market, EUR bln



The factoring market is the fastest growing financial market in Russia. In 2012 its share of GDP grew to 2.3% (from 1.6% in 2011). The share of the SME segment in new deals (2012) is approximately 40%.

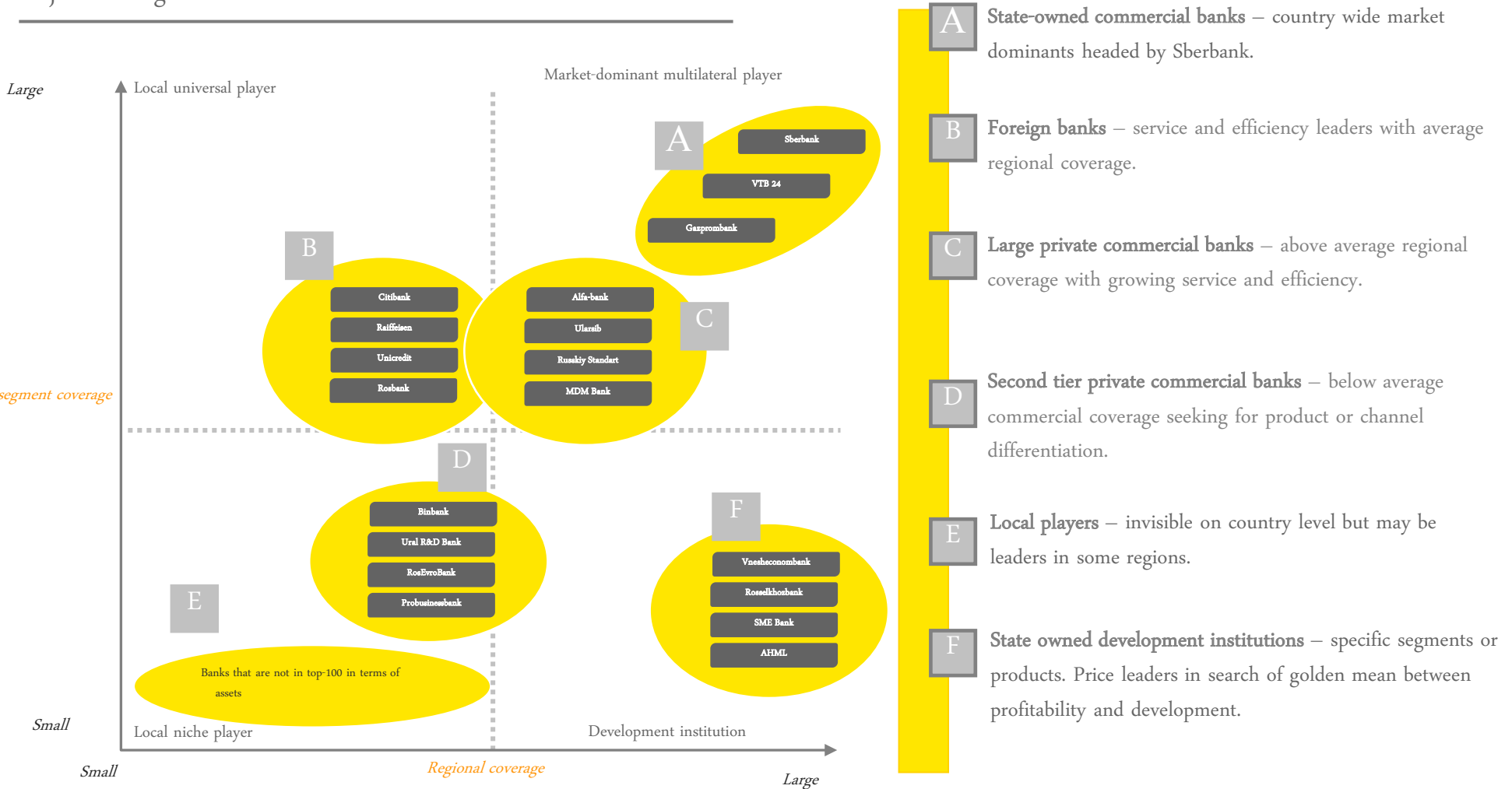
SME microfinance market, EUR bln



In 2012 the total portfolio of microfinance organizations (MFOs) was about RUB48 bln (EUR1.2 bln) with annual growth of 30%. The share of SME segment in portfolio is 54% with RUB26 bln (EUR0.65 bln) in absolute terms.

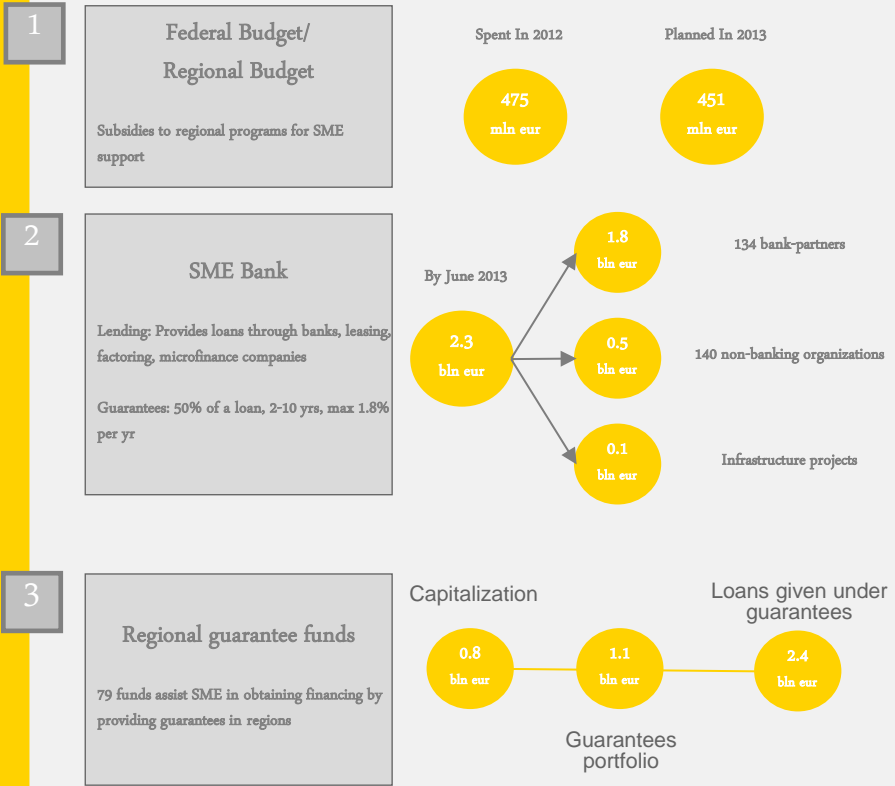
Actually there are six main groups of players on Russian banking market

Major banking clusters on Russian market

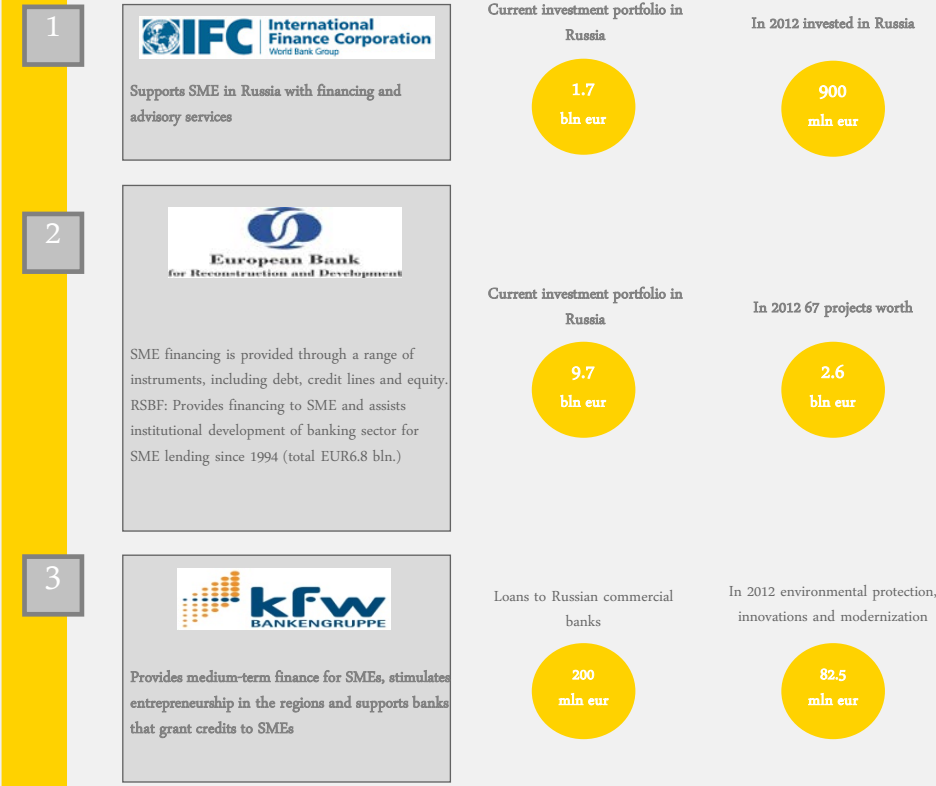


Government and International Development Banks (IDB) are active in the market of SME financing

Top3 government sources

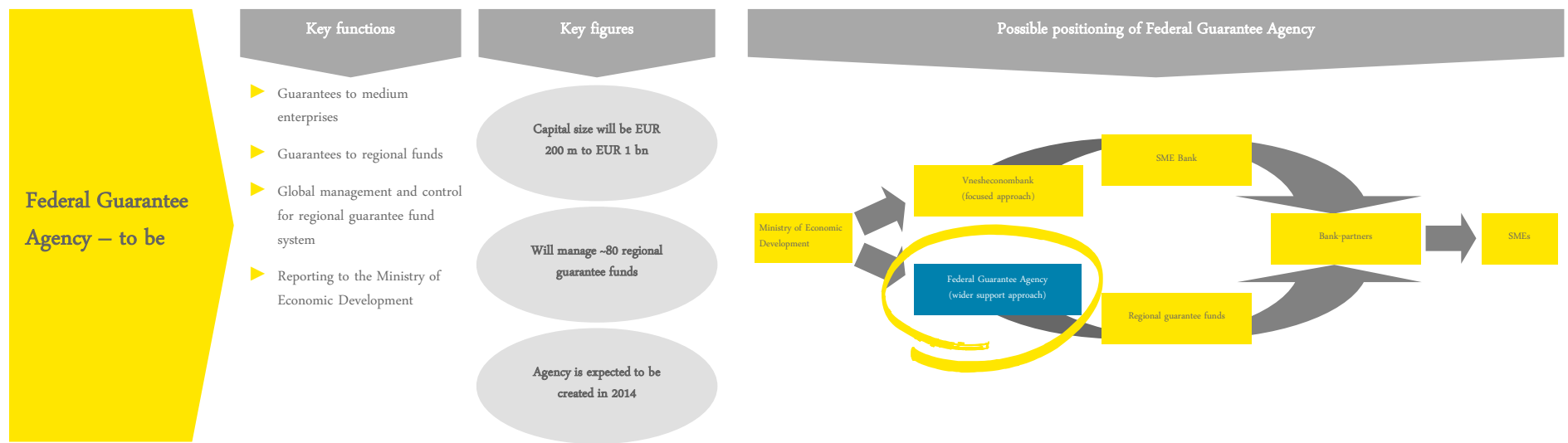
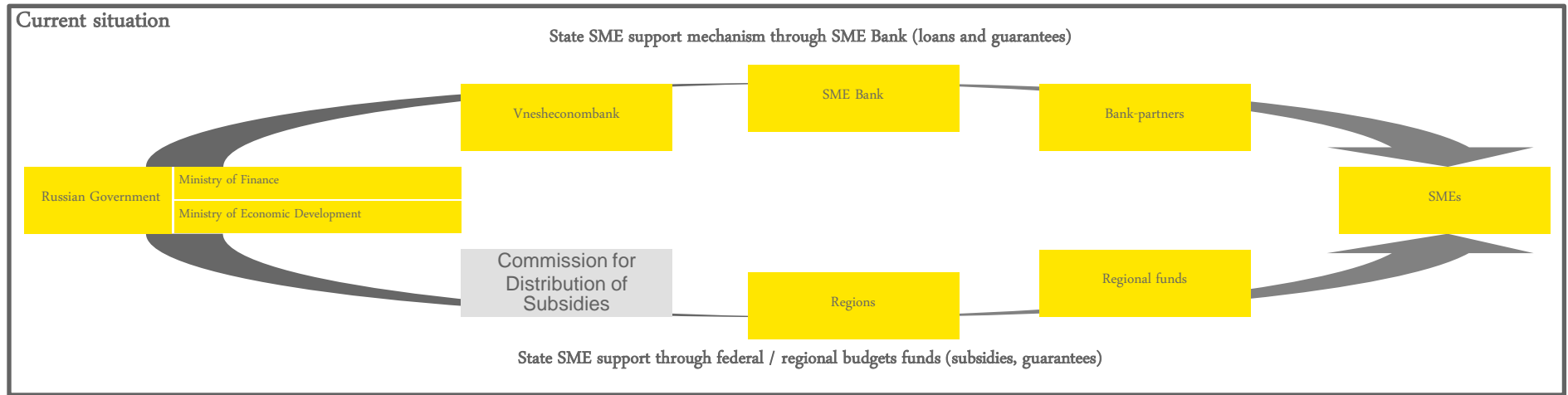


Top3 IDB players in Russia

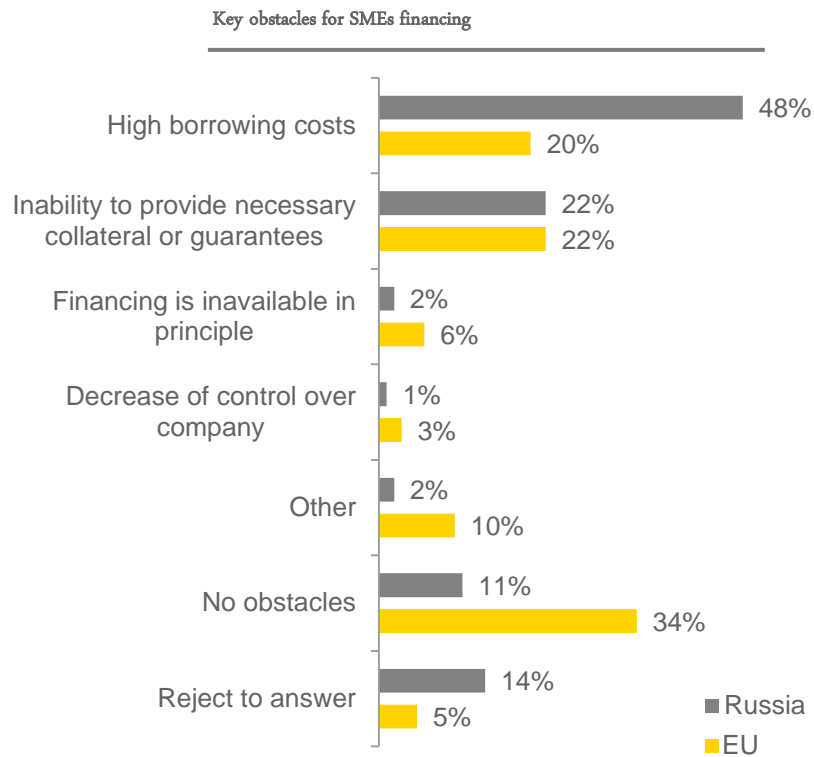


While government pays attention to SME segment, SME supporting policies and laws and funding sources are not unified and synchronous. Which leaves a lot of space for IDBs which are already consistently expanding their presence in SME financing market.

Most recent Russian government initiative in SME support is to create Federal Guarantee Agency



High borrowing costs are cited as the main obstacle for availability of SME financing



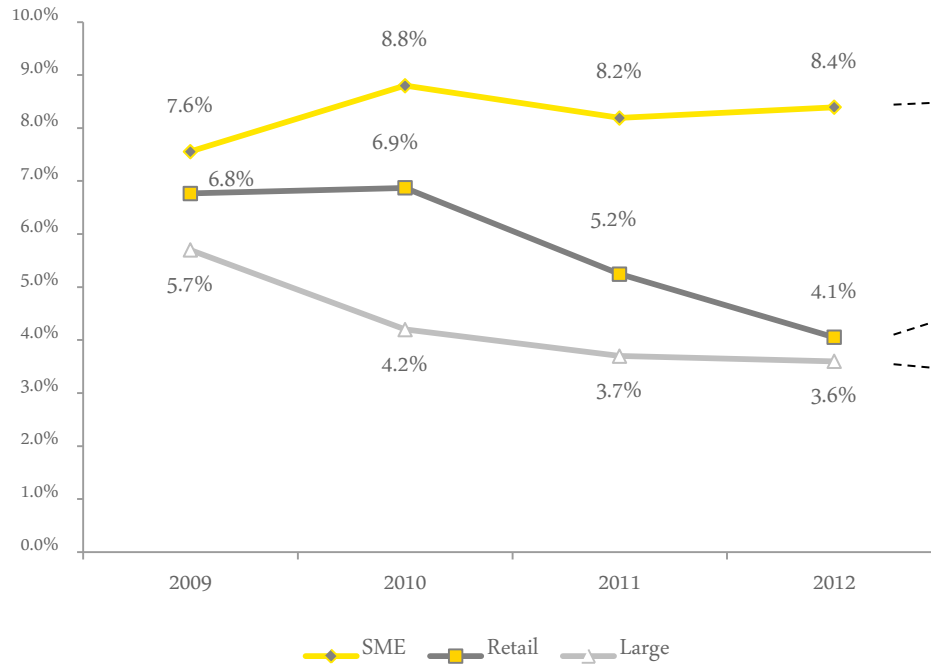
High borrowing costs is the major obstacle for obtaining financing in the SME segment (48%). The next significant obstacle is the **inability to provide collateral** (22%)



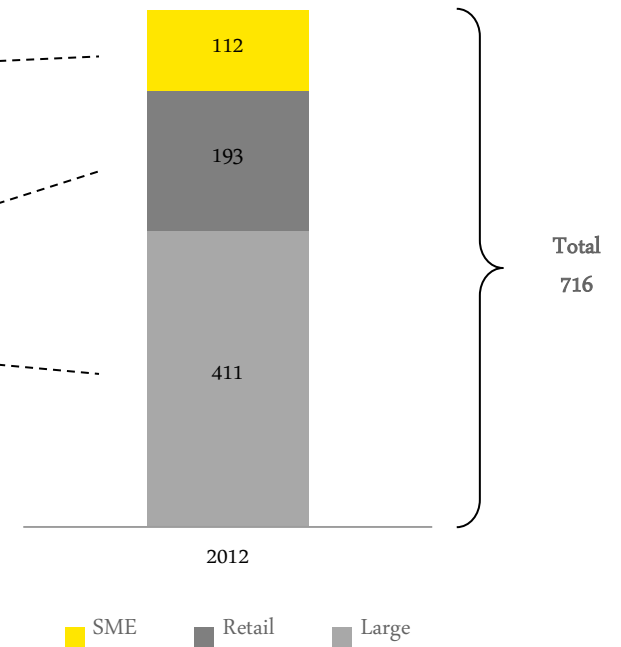
Bank loan is the main source of financing but there is a room for growth due to considerable share of financing received from relatives and friends

Key reason for high borrowing costs on SME financing market is high level of non-performing loans

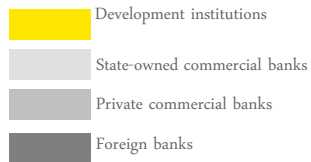
Non-performing loans in different segments



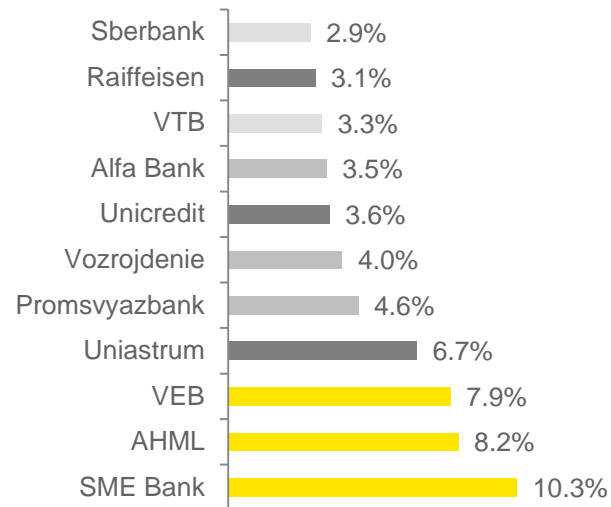
Loan portfolios of banks, EUR bln*



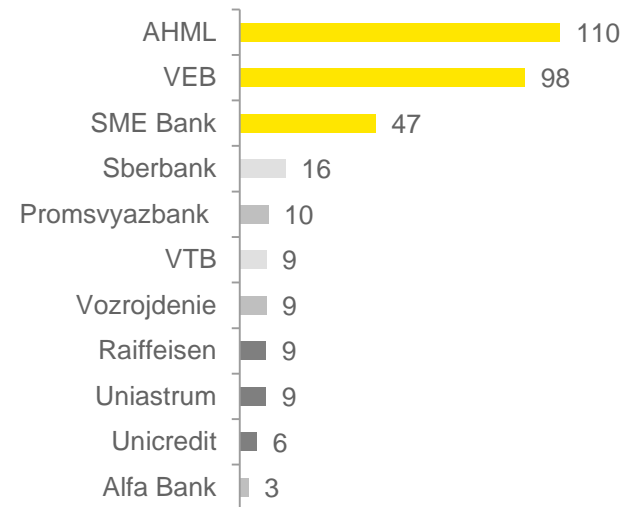
Local development institutions have about 10 times higher average funding tenor than commercial banks, while funding rates of commercial banks are significantly lower



Average funding rate (“blended”), %



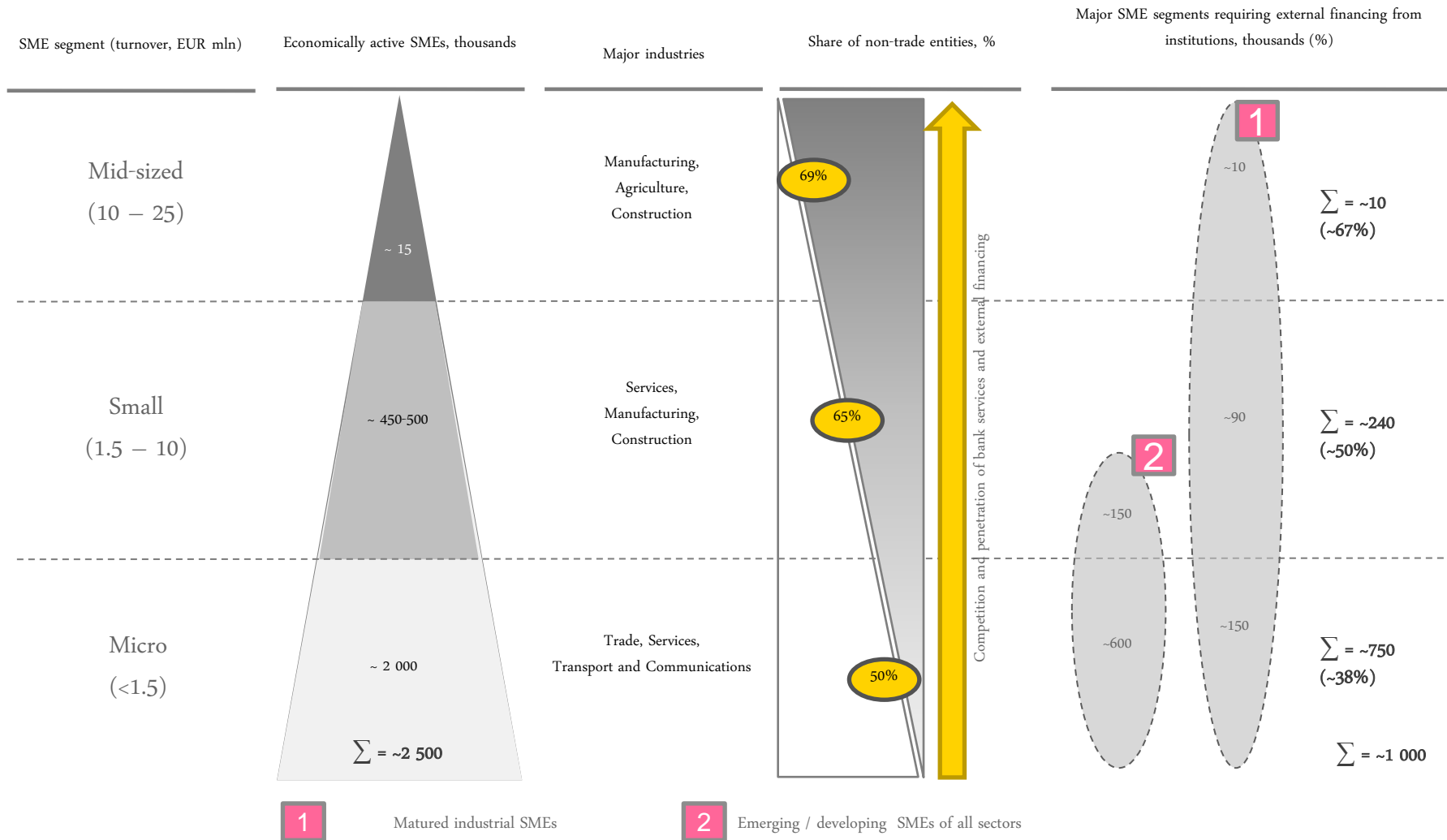
Average funding tenor, months



Development institutions don't have access to funding sources available to Commercial banks (e.g. deposit portfolio, current accounts), which affects both average funding rate and funding tenor.

* Rates are based on the average bond coupon rate. Source: cbonds.ru

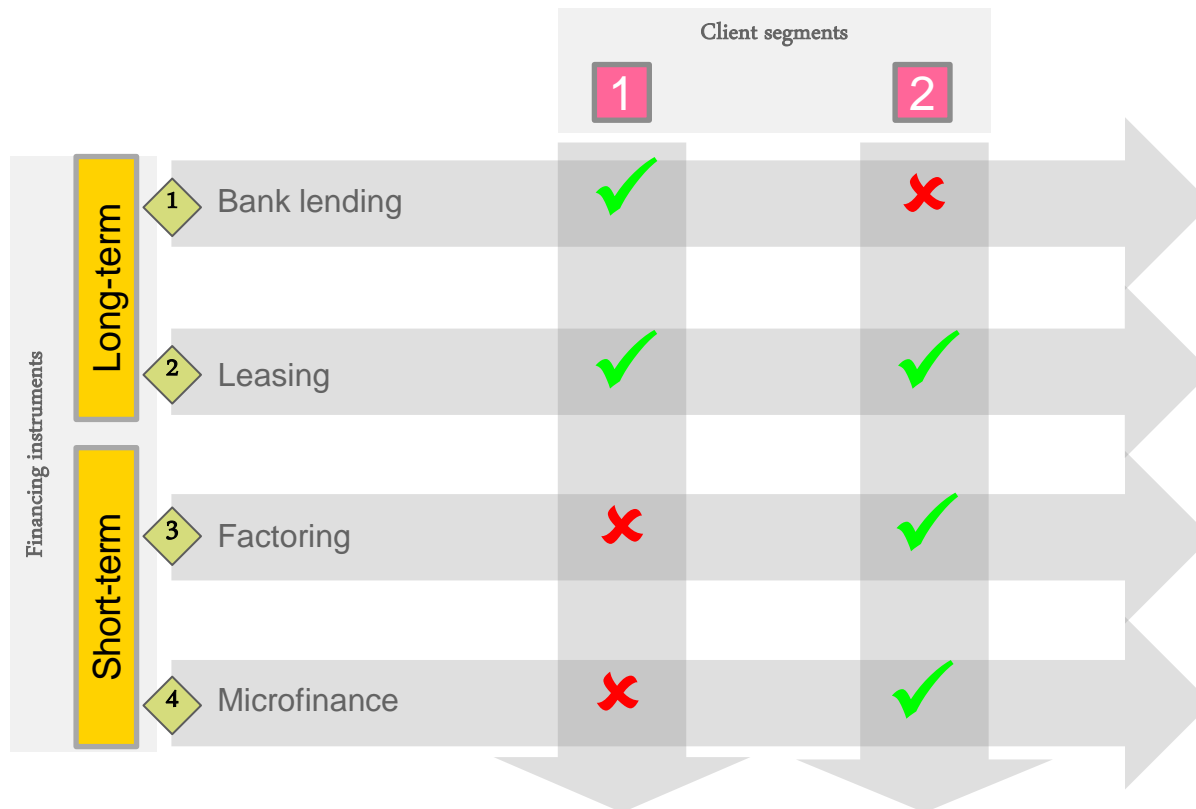
According to our estimations, about 1 million SMEs currently require external financing



Each group of SME requiring financial support should be addressed with proper instruments of financing (either long-term or short-term)

KEY DEVELOPMENT OPPORTUNITIES:

- 1** **Matured industrial SMEs** – Boostering long-term financing
- 2** **Emerging/ developing SME (all sectors)** – Providing short-term financing opportunities



The majority of SME financing markets in Russia is in the developing or emerging stage, and there is potential for EIB to make a considerable impact on the SME sector

Scenario = (1) product + (2) appropriate distribution technology				
(1) Product for ultimate clients (SMEs)	(2) Distribution technology			
	Three-level financing*	Two-level financing**	Guarantee	Securitization
Short term loans	✓	✓	✓	n/a
Long term loans	✓	✓	✓	✓
Long term loans to non-trade segment	✓	✓	✓	✓
Long term loans to innovative segment	✓	✓	✓	n/a
Leasing to SMEs	✓	✓	n/a	n/a
Leasing w/o railway and passenger cars	✓	✓	n/a	n/a
Factoring	✓	n/a	n/a	n/a
Microfinancing	✓	✓	n/a	n/a
Equity	✓	✓	n/a	n/a

Level of technology complexity and risk exposure	Low	Moderate	High	High
Technology capacity	Very High	High	Low	Low



Impact assessment		
Market maturity level	Potential market size	Potential impact
Developed	Very large	Low
Developing	Very large	High
Emerging	Large	Very High
Emerging	Large	Very High
Developing	Medium	High
Emerging	Medium	Very High
Emerging	Small	Moderate
Emerging	Small	Moderate
Developing	Large	Moderate

***Three-level financing** implies work with local development institutions (e.g., VEB and its subsidiary SME Bank) which will supply financing to commercial banks (2nd level) and after that commercial banks provide loans to SMEs (3rd level). This option will give EIB the access to a broad client network without establishing direct relations with commercial banks and will significantly reduce cost and risk. This option, however, will lead to lower level of control and will limit the ability for direct SME market impact.

**** Two-level financing** implies work with Russian commercial banks (including State-owned, privately- owned and international banks) which will provide loans to their ultimate clients (SMEs).

Conclusions

- ▶ The development of the SME sector is very important for the Russian economy
 - ▶ Diversification from the current concentration on large companies and on natural resources
 - ▶ Creation of new workplaces while one-quarter of the employable population already works in SME sector
 - ▶ SME sector potentially is a considerable taxpayer – a diversified income base for state budget
- ▶ SMEs output demonstrated high growth rates in recent years, about 19% p.a., and is expected to remain double digit in mid-term perspective
- ▶ The Russian government is making efforts on providing support to SME sector by improving business environment and financing activities but the system of state support is still fragmented and not fully transparent
- ▶ Many SME financing markets and financing instruments in Russia are in developing or emerging stage, e.g. long-term financing, financing of emerging businesses, securitization, etc.
- ▶ There is potential for development institutions to make a considerable impact on the Russian economy through enhancement of financial services for the SME sector

Appendix

Decrease of the growth rates, consolidation, and focus on retail sector – are the main trends in Russian banking sector

Expected changes in Russian banking sector:

Market size and growth

- In 2013 the volume of total banking assets in Russia is expected to reach
- EUR 1 250 bln (at current exchange rate at year end)
- Market will continue to grow but with decreased growth rates of about 10 - 12%
- Retail banking sector growth rates are expected to slow down

Market structure

- Market consolidation will continue, the total number of banks will continue to decrease
- A tendency of the growing pressure of the large state-owned banks will preserve
- Privately owned banks will focus mainly on retail, SME and MidCap segments as local LargeCap is predominantly covered by state-owned banks

Future success factors

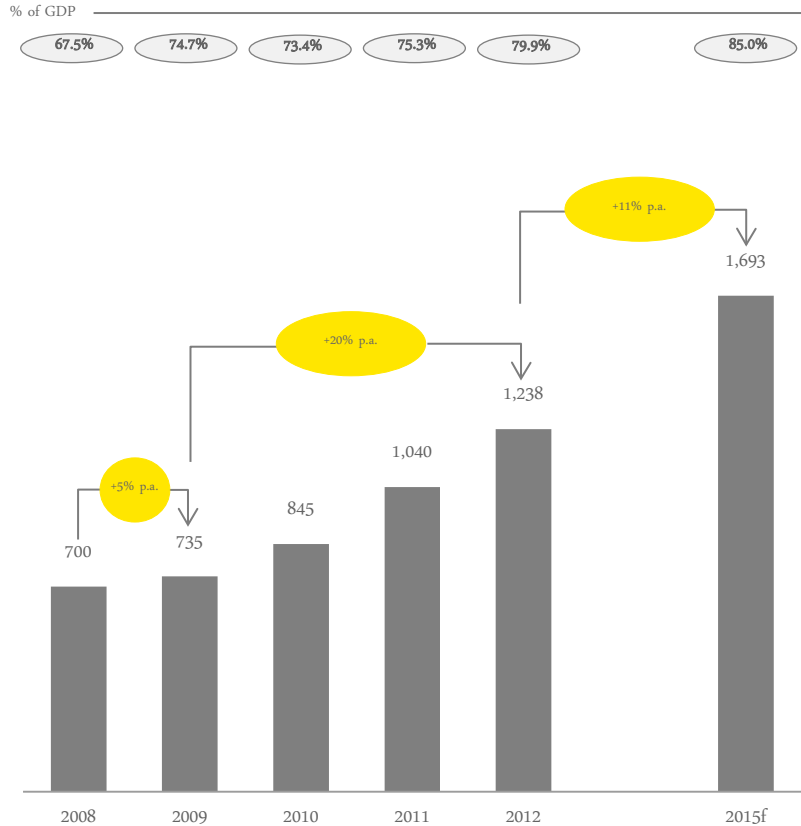
- Business scale, capital size and funding
- Innovative and technological business-models
- Network efficiency, right choice of product line and speed of entry in new market segments

Small players without a clear focus will be squeezing out of the market

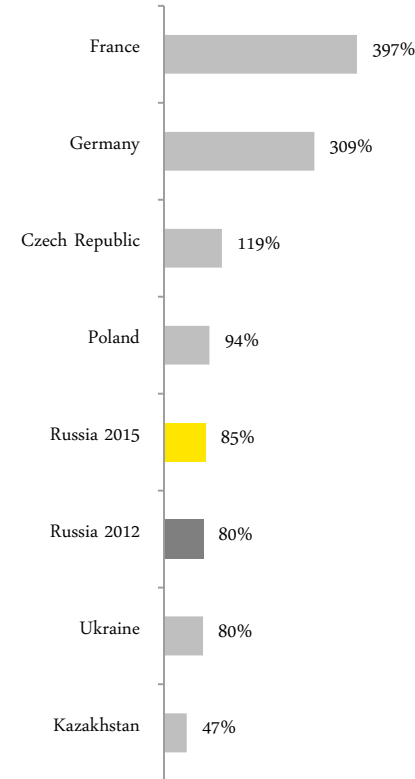
Bank assets growth rate will substantially slowdown, the volume of banking assets will reach 1 693 EUR bln by 2015

Total bank assets in Russia:

Assets, EUR bln.



Assets % of GDP, 2012 f.



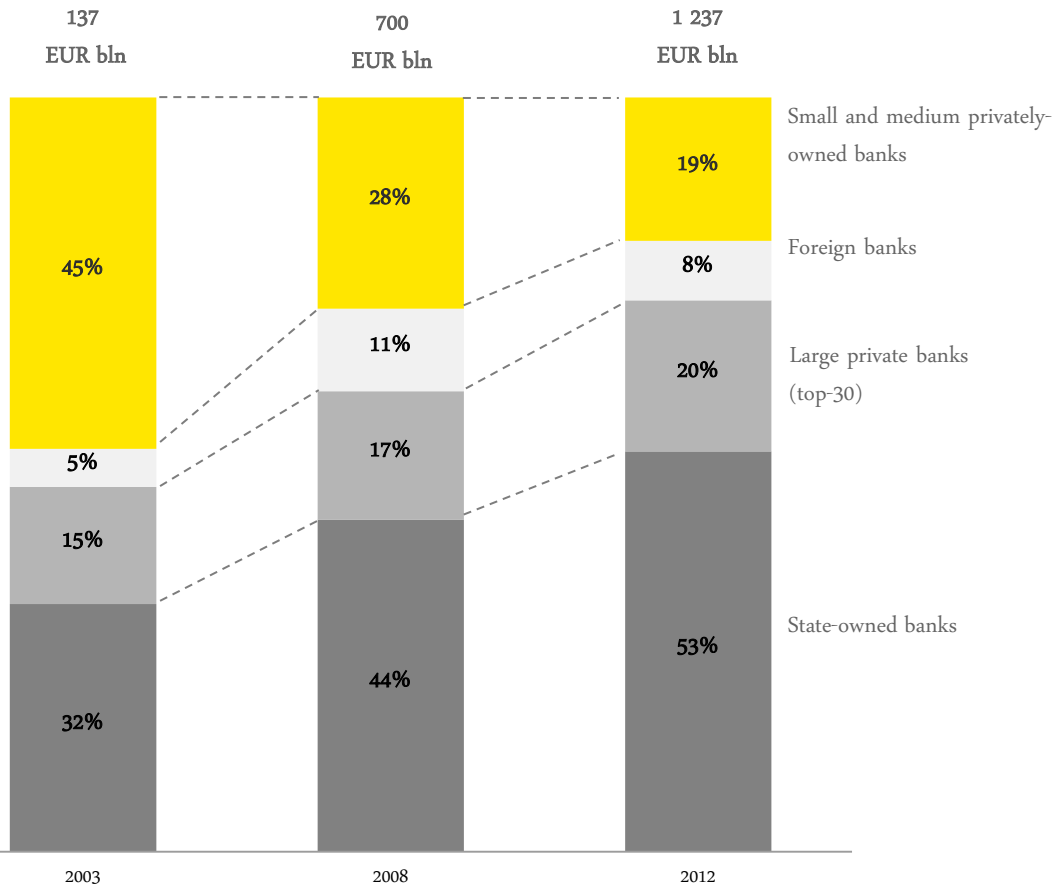
Comments

- In the next years it is expected that the current trend of GDP growth rate slowdown will preserve
- The bank assets to GDP ratio will continue to grow, however it's growth rate will slowdown
- Bank assets to GDP ratio is expected to be 85% by 2015
- Average growth rate of Bank assets in Russia will amount to 11% by 2015

Sources: EY, Bank of Russia

For many small banks without distinct positioning a survival question arises

Bank assets share in banking sector by types, %



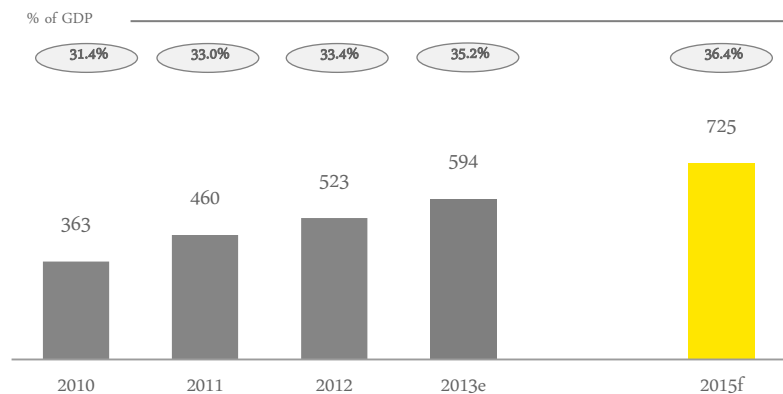
Comments

- ▶ The structure dynamics of the banking sector indicate that state-owned banks are strengthening
- ▶ In particular it is connected with state-owned banks being preferred by consumers as their financial services providers
- ▶ This trend will increase in case of economic decline
- ▶ Foreign bank's share in Russian banking assets decreased due to the problems at their domestic markets
- ▶ A substantial decrease of Russian small banks share is observed

Sources: EY, CEE Banking Sector Report

Forecasted population income increase will assure the growth of retail sector share in credit portfolio

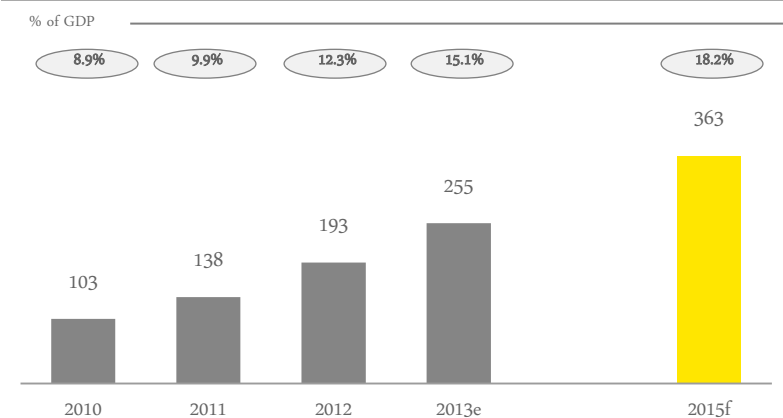
Credits to legal entities, EUR bln



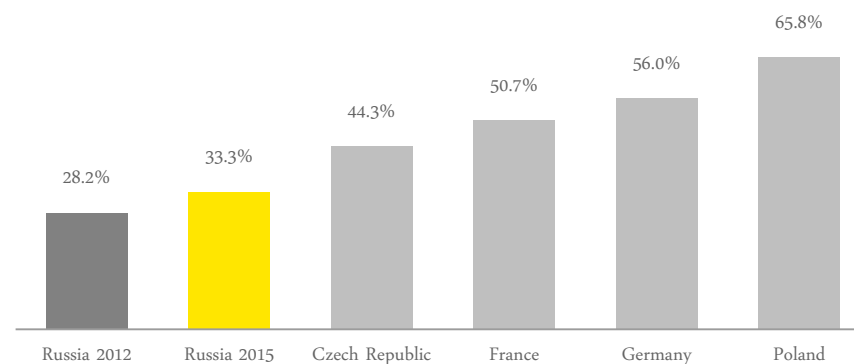
Comments

- ▶ Traditionally corporate lending significantly exceeded retail lending in Russia
- ▶ In the past years a significant growth of retail lending is observed, whereupon credit portfolio changes gradually approaching the indicators of the developed markets
- ▶ A further increase of retail credits share of 33.3% is expected by the end of 2015

Credits to individuals, EUR bln



Share of retail loan portfolio in total loan portfolio, %



Sources: EY, CEE Banking Sector Report, European Central Bank