

# MAPPING SME UNDERSTANDING OF BANKING AND NON-BANKING PRODUCTS

REPORT

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# **MAPPING SME UNDERSTANDING OF BANKING AND NON-BANKING REQUIREMENTS**

REPORT  
FINAL

USAID ECONOMIC PROSPERITY INITIATIVE (EPI)

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DELOITTE CONSULTING LLP

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# DATA

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# ABSTRACT

The crucial role of SMEs' development in the economy is well described in number of publications, books, articles, papers etc. SMEs play a vital role in the economic growth of developing countries, typically accounting for over 90% of business establishments and about half or more of output and export shares. However, in Georgia only 40% of Labor Force is working in SMEs. Despite the importance of SME development majority of companies are facing significant constraints for their development: internal and external. SMEs in Georgia are facing similar problems to those that are companies in other countries: lack of managerial resources, inability to hire experienced or professional staff, low marketing resources as well as high barriers to access to capital: high interest rates, collateral requirements, reluctance of Banks to work with SMEs especially in agricultural industries.

# ABBREVIATIONS

ABG	Association of Banks of Georgia
AmCham	American Chamber of Commerce
EBRD	European Bank for Reconstruction and Development
EUGBC	EU – Georgia Business Council
GNIA	Georgina National Investment Agency
GSMEA	Georgian Small and Medium Enterprises Association
ICC	International Chamber of Commerce
IFC	International Finance Corporation
FIs	Financial Institutions
IFIs	International Financial Institutions
KfW	German Development Cooperation
MFI	Microfinance Institution
NBG	National Bank of Georgia
USAID	U.S. Agency for International Development

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# EXECUTIVE SUMMARY

SMEs in Georgia are still at the beginning stages of development. Global statistics show that SMEs account for up to 90% of jobs in a given country; however, in Georgia, SMEs made up only 42.4% of jobs created in 2009. Currently, SMEs face problems common to those in other developing countries (including Eastern Europe): undercapitalization, high barriers to financing, poor corporate governance practices, high interest rates and excessive collateral requirements from financial institutions. Although there are many real, significant barriers that prevent SMEs from accessing financing, some exist due to erroneous preconceptions held by SME owners/managers.

Based on the survey responses, there are several conclusions about the barriers to SMEs ability to access financing through the Georgian commercial banking and non-banking financial institutions. The perception-related issues that are barriers for SME borrowers can be summarized as follows:

For larger SMEs that already have previously established relationships with commercial banks in Georgia, the variety of banking products and level of service are more or less satisfactory. However, even representatives of these companies noted that the main barriers to financing are the currently high interest rates and the perception that commercial banks are risk adverse.

SMEs believe that commercial banks make decisions based on collateral requirements (where the average required collateral ratio equals 1.3 times liquidation value to a loan amount) rather than a cash flow analysis. Because of this collateral issue, many SMEs do not qualify for credit at commercial banks.

Another issue that is challenging for SMEs is the transparency of banks' commissions, as a loan's effective interest rate is unknown until the final stage of the process, when a borrower signs the loan agreement.

Due to real and perceived bank requirements, many SMEs are limited to personal loans, self-financing or MFI loans or simply opt out of taking a bank loan.

Below is a summary of the SMEs perception of banking and non-banking lending requirements:

- High interest rates for banking loans.
- High collateral requirements.
- Difficult bureaucracy and lengthy procedures for new customers.
- Lack of information (in Georgian) on getting financing, business development and relevant legislation, such as the Tax Code of Georgia.
- Banks have limited experience in financing projects/loans for agriculture .

- Availability of information on non-banking financial institutions (i.e. leasing) is limited.



# METHODOLOGY

EPI has identified the development of the SME business sector in Georgia as one of its main priorities and is in process of developing several initiatives to stimulate further growth in this sector. Specifically, one of EPI's goals is to eliminate barriers for SMEs in accessing capital resources to finance operations and expansion initiatives. While some existing barriers to capital relate to the existing lending requirements and procedures, there are also barriers related to perception. These perception barriers center on the SMEs sector's understanding of what banking and non-banking requirements are regarding access to capital.

The goal of this analysis is to address not only the perceptions and understanding of SMEs related to the various procedural, accounting and asset requirements of commercial banks in Georgia, but also to review the various sources of non-bank financing resources available to SMEs and the perceptions that relate to the ability of SMEs to access these capital sources.

Furthermore, this analysis will identify gaps where SMEs may qualify for currently available financing sources but do not secure financing for various reasons. These reasons include, but are not limited to, misunderstanding of lending requirements, miscommunication by banks and the lack of awareness of financing resources available.

## METHOD AND INSTRUMENTS

To obtain a qualitatively representative measurement of the SME sector's understanding of banking and non-banking requirements related to financing, it was essential for the EPI consultant to construct a survey that could identify a respondent's specific level of understanding of banking and non-banking financing requirements, while also allowing the respondent to identify individual challenges and, subsequently, to discuss what the causes of these challenges might be.

To execute this survey, the consultant conducted interviews with individual SME owners/managers, business associations, commercial banks, development banks and development agencies to develop a multidimensional, objective view of SME understanding of banking and non-banking financing.

In the execution of the survey and the subsequent analysis, the consultant relied on the following analytical methods:

- Desk Review (see Annex B – Resources Used)
  - Available industry reports
  - Published and online data
  - Government statistical information

- In-Depth Interviews of Industry Experts (see Annex A – Interviews Conducted)
  - The consultant conducted 45 in-depth, face-to-face interviews of approximately 30-60 minutes each.

- Respondents included in the survey had to be qualified as one of the following:
  - Representatives of IFIs or donor organizations with programs to support SME development in Georgia (including on-lending programs for local banks or other capacity building activities)
  - Representatives of SMEs working within the sectors identified as priority sectors in the “EPI Sector Assessment Analysis”
  - Representative of business associations that represent the interests of SMEs in Georgia or whose membership includes SME companies
  - Commercial banks and other non-bank financial institutions that provide services to SMEs
  - Industry and development experts in the SME sector.

In order to construct an appropriate survey and to select a correspondingly suitable list of survey participants, the consultant developed conducted an analysis of the economic context, which SMEs in Georgia operate. Data related to this economic context included employment statistics, output factors, and current bank lending statistics.

## **SPECIFIC CHALLENGE TO ANALYSIS**

As this analysis focused specifically on the SME sector’s access to financing in Georgia, it was vital for the consultant to choose an appropriate definition of what characteristics define a company that is classified as an SME. Due to the existence of conflicting SME definitions established by the government authorities, development partners and financial institutions, the consultant reviewed these definitions to determine the most appropriate working definition for this analysis. The various SME definitions include:

- Georgian Tax Code <sup>1</sup>
  - Registered micro businesses are those with an annual turnover below GEL 30,000. Registered small businesses are those with a turnover below GEL 100,000.
  - There is no definition of medium businesses.
- GeoStat, the National Statistics Office <sup>2</sup>
  - Small enterprises – 20 employees and annual turnover is less than GEL 500,000.
  - Medium enterprises – 100 employees and annual turnover is less than GEL 1,500,000.
  - Large enterprises – more than 100 employees and annual turnover exceeds GEL 1,500,000
- Commercial Banks
  - SME definitions vary from bank to bank, and some banks do not have an established definition.

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<sup>1</sup> Ministry of Finance of Georgia. “Georgia Pocket Tax Book 2011”.

<sup>2</sup> GeoStat. “Entrepreneurship in Georgia, 2010”.

- Example: TBC Bank
- SMEs are companies have an annual turnover up to GEL 8 million and liabilities up to USD 1.5 million.
- Development Partners
  - SME definitions vary by organization, and there is no consensus definition.
  - Example: IFC
    - Small Enterprises
      - 10 < Employees < 50
      - USD100 000 < Total Assets < USD 3 million
      - USD 100 000 < Total Annual Sales < USD 3 million
    - Medium Enterprises
      - 50 < Employees < 300
      - USD 3 million < Total Assets < USD 15 million
      - USD 3 million < Total Annual Sales < USD 15 million

Despite these differing classification systems for the definition of an SME business, the consultant used only the GeoStat definition as the working definition for this analysis due to its widespread use in reporting statistics.

# ECONOMIC CONTEXT

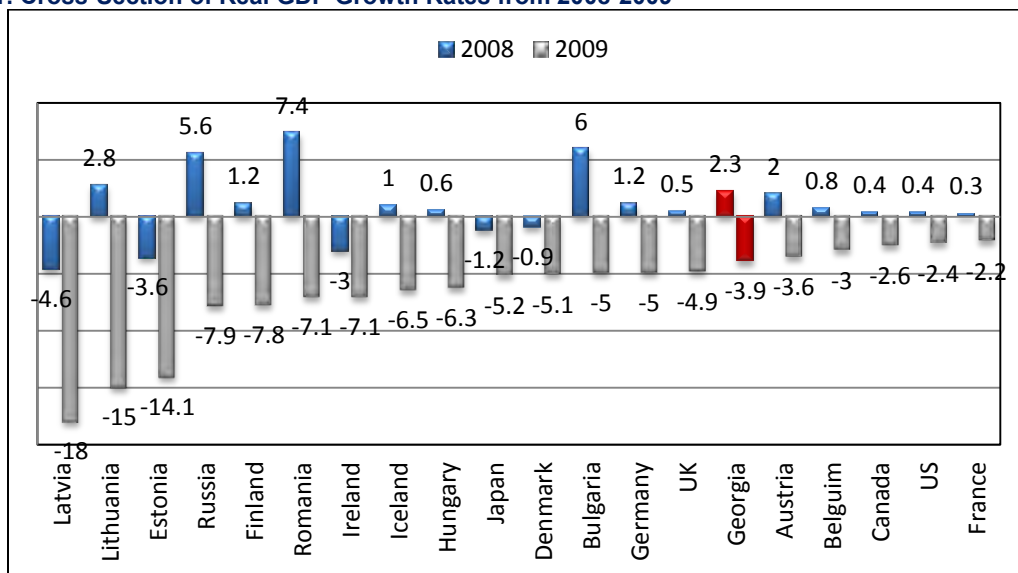
As the main growth driver among many national economies, SMEs are vital to overall economic growth, industry development, job creation, poverty reduction, innovation, and maintenance of a competitive and efficient marketplace. However, the role of the SME sector in Georgia as a growth driver remains unclear. Despite strong macroeconomic performance since 2003, there are still many barriers to SME sector development.

## MACROECONOMIC PERFORMANCE

From 2003 until 2007, Georgia experienced a 40% cumulative increase in real GDP, which was stimulated by far-reaching structural reforms, foreign direct investment, and strong credit growth. In 2007, before the global financial crisis impacted the Georgian economy, foreign direct investment was more than USD 2 billion.

Due to the extensive efforts of the Georgian Government and its international partners, a nominal GDP only contracted by 3.9% in 2009, which was significantly better than many leading economies.

Figure 1: Cross-Section of Real GDP Growth Rates from 2008-2009



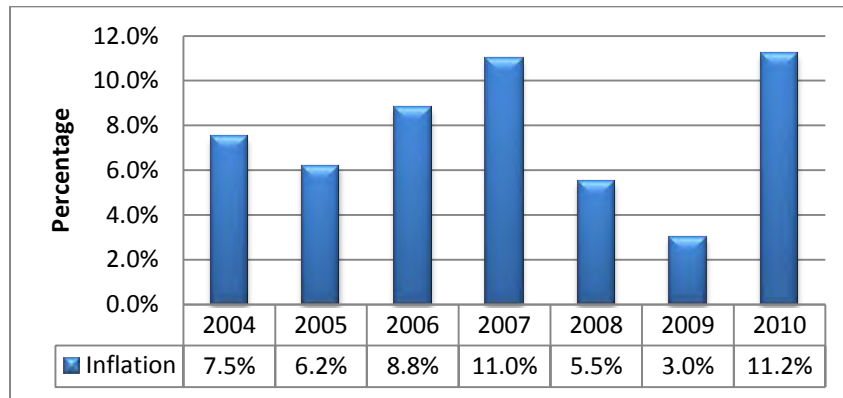
Source: International Monetary Fund

The economy demonstrated the first signs of recovery in the first quarter of 2010, and GDP has expanded significantly. The International Monetary Fund has projected real GDP growth in Georgia to be 5.5% for 2010 and 4% for 2011<sup>3</sup>, while the latest forecasts from the Georgian Ministry of Finance predict 6-6.3% GDP growth in 2011.

<sup>3</sup>International Monetary Fund. "World Economic Outlook". October 2010.

As an obstacle to development, inflation puts pressure on SMEs in particular by increasing the costs of input factors, such as raw materials, labor and energy. Since 2004, inflation in Georgia has been erratic, averaging 7.6% annually, with a low of 3.0% in 2009 and a high of 11.2% in 2010.

**Figure 2: Annual Inflation Rate in Georgia**



Source: Geostat

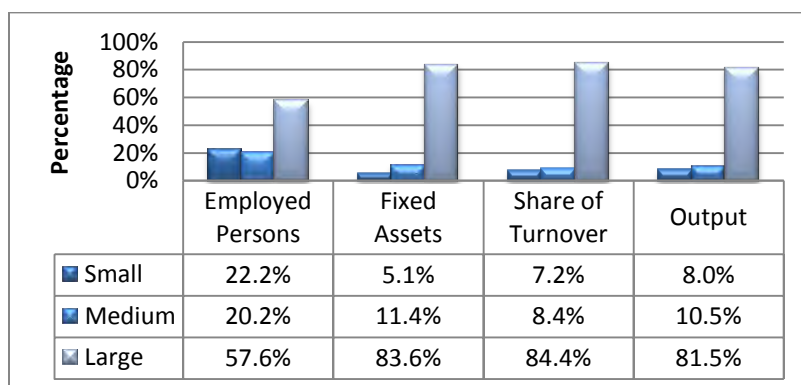
## ECONOMIC CHARACTERISTICS SMEs IN GEORGIA

In Georgia, despite a successful development agenda and strong economic growth, SMEs do not produce a significant percentage of national output, employ significant numbers of employees, hold large amounts of fixed assets or generate substantial turnover.

As demonstrated in the chart below, SMEs:

- Provide 42.2% of jobs;
- Hold only 16.5% of fixed assets;
- Generate 15.6% of overall turnover;
- Produce 18.5% of national output.

**Figure 3: Snapshot of Georgian Companies – 2009**

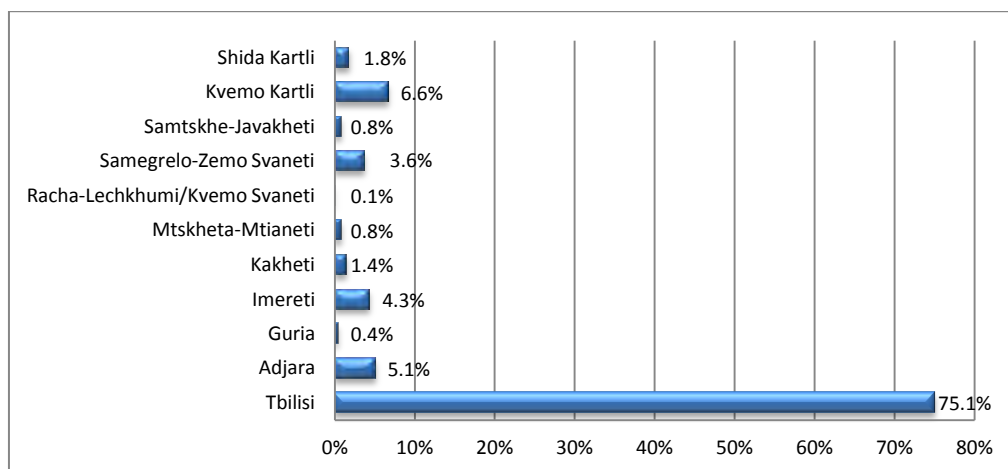


Source: GeoStat

These numbers are significant in that they indicate a lack of diversification within the overall economy, with a significant concentration of assets and output – and therefore, financing – held by corporations rather than SMEs, which are generally more flexible to changing market conditions.

Furthermore, SMEs outside of Tbilisi, the capital city, face additional barriers to growth due to the fact that businesses in Tbilisi generate 75.1% of the national turnover, as demonstrated in the chart below:

**Figure 4: Breakdown of National Turnover - 2009 (by Region)**



Source: GeoStat

## TRENDS IN COMMERCIAL BANKS

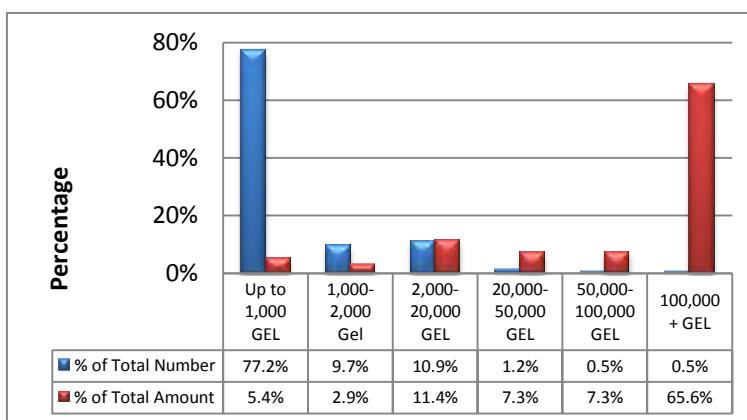
According to the NBG, the National Loan Portfolio of commercial banks rose to GEL 6.3 billion as of the end of FY2010 from GEL 5.2 billion in 2009, representing an increase of 20%. The initial analysis revealed that 77.2% of all loans were for GEL 1,000 or less and 97.8% were for GEL 20,000 or less. Even after allowing for consideration of individual retail loans, this still suggests that a larger percentage of loans disbursed by

commercial banks are in the amounts often utilized by SMEs. Furthermore, the largest borrowers (with loans in amounts larger than GEL 100,000) make up only 0.5% of the total number of loans.

However, further analysis of the actual amount of these loans reveals that only a small portion of the national loan portfolio is directed towards small and medium sized borrowers. In fact, only 5.4% of the national loan portfolio’s value was for loans for GEL 1,000 or less and only 19.8% were for GEL 20,000 or less. Conversely, 65.5% of the national loan portfolio’s value went to only 0.5% of all approved loans. These loans were for more than GEL 100,000, which is not typical for SME borrowings.

These numbers indicate that, while small and medium borrowers represent the majority of all loans disbursed, only a small percentage of the value of commercial lending is accessed by this market segment.

**Figure 5: Breakdown of National Loan Portfolio (by Size)**



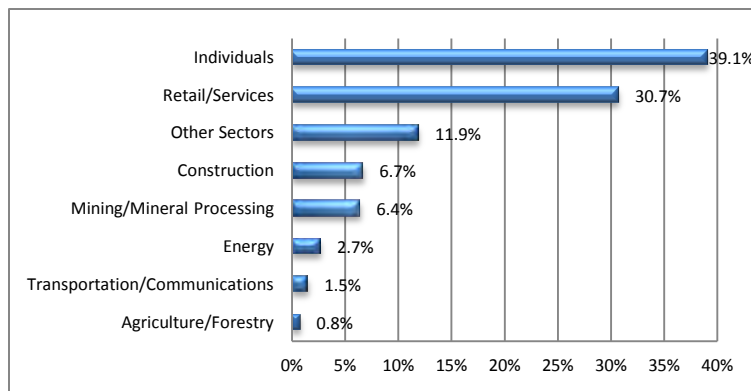
Source: National Bank of Georgia

By reviewing a breakdown of the national loan portfolio by sector, one can see that it is highly concentrated in certain sectors, with 69.8% of loans being disbursed to individuals and companies within the retail/services sector. However, the data also reveals that there are several sectors that make up a very small portion of the portfolio, including energy, transportation/telecommunications, and agriculture/forestry, which together make up only 5.0% of the national loan portfolio.

Combining this analysis with that in Figure 5 suggests that it is very difficult for SME borrowers in lowly-served industries to obtain loans from commercial banks.

**Figure 6: Breakdown of National Loan Portfolio (by Sector)**

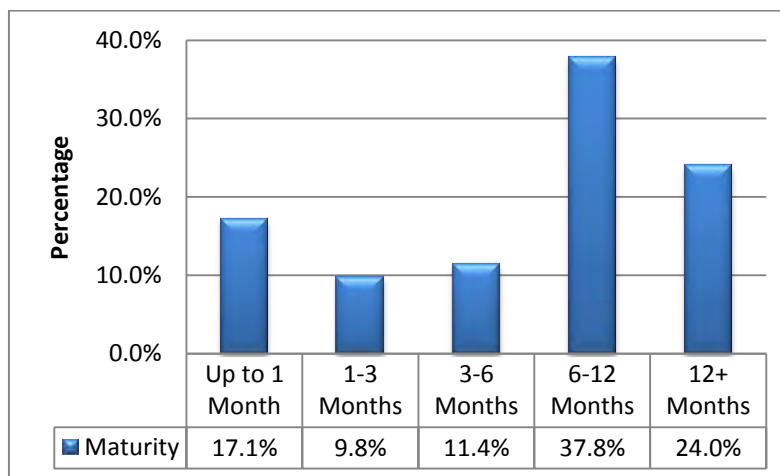




Source: National Bank of Georgia<sup>4</sup>

Additional analysis into the length of loans disbursed by commercial banks indicates that the vast majority (76%) of all loans are for 12 months or less, with the majority being for 6-12 months. This analysis implies that potentially 24% of the national loan portfolio is dedicated to a long-term credit, which suggests that opportunities for long-term financing through commercial banks are limited. This seems to be a significant barrier to overall economic growth, especially when considering that firms of all sizes need access to long-term credit to finance capital expenditures and to capitalize on growth opportunities.

Figure 7: Breakdown of National Loan Portfolio (by Maturity)



Source: National Bank of Georgia

## NON-BANKING INDUSTRY OVERVIEW

Compared to the regular credit instruments and guarantees offered by commercial banks, there are a limited number of non-bank financing options for SMEs to utilize.

<sup>4</sup> It is important to note that many SME owners take individual loans from banks to finance their business ventures; therefore some individual loans included in National Loan Portfolio could potentially be reclassified into business loans.

MFIs offer unsecured loans, but with annual interest rates at around 30-35%, which impedes a company's ability to expand while servicing the debt. Institutional equity funds, such as MCC's Georgian Regional Development Fund, offer alternative financing structures, but have strict investment policies that restrict an SME's ability to qualify for these funds.

Leasing services developed rapidly in 2007-2008; however, since the war in August 2008, the industry has been in stagnation. Despite this condition, leasing remains a viable option for SMEs that need to purchase equipment and machinery with fewer collateral requirements than commercials; however, the related fees and interest can be high.

Insurance companies also offer guarantees, which allow SMEs to receive prepayments; however, these guarantees still require company and/or personal assets to be collateralized.

Until recently, no insurance company has been active in providing insurance to companies in the agriculture sector. However, recently three major insurance companies launched agriculture insurance packages. These firms are Aldagi-BCI, Imedi-L and GPIH.

Below is a table representing the structure of the insurance market in Georgia (2010, Q3):

#	Class of Insurance	Written Premium (GEL)	Market Share
1	Life	6,419,488	2.10%
2	Travel	1,663,343	0.55%
3	Personal Accident	2,334,142	0.77%
4	Medical (Health)	216,776,211	71.06%
5	Road Transport Means	21,232,089	6.96%
6	Motor Third Party Liability	2,537,527	0.83%
7	Aviation Transport Means (Hull)	5,203,241	1.71%
8	Aviation Third Party Liability	2,034,779	0.67%
9	Marine Transport Means (Hull)	230,178	0.08%
10	Cargo	2,386,217	0.78%
11	Property	26,027,372	8.53%
12	Financial Risks	824,206	0.27%
13	Surety ships	10,942,005	3.59%
14	Credit	7,086	0.00%
15	Third Party Liability	6,457,035	2.12%
16	Legal Expenses	1,176	0.00%
	Total	305,076,094	100%

Source: National Bank of Georgia

## DIRECT INDUSTRY ASSISTANCE

Currently in Georgia, there is a limited number of programs available to support development and growth of the SME sector, by providing grants, loans or subsidies to SMEs. The main institutional players that provide financial assistance to the SME sector include:

- EBRD
- IFC
- EU
- KfW

However, the above-mentioned IFs provide their resources through senior loans to commercial loans. In addition to credit lines, EBRD also offers to SMEs Business Advisory Services (BAS). In order to make consulting services (generally, hardly affordable for SMEs), EBRD finances 50% of a project (i.e. developing a business plan, market assessment)

To further promote development of the SME sector and advocate its interests with the Government, AmCham, key associations in Georgia including ICC, EU-Georgia Business Council, and Georgian Business Association founded the Georgian Small and Medium Enterprises Association (GSMEA). The GSMEA provides general consultations to its members (i.e. regarding tax issues), and organizes workshops and seminars.

# SURVEY RESULTS

## SECTION 1 – SME PERCEPTION

The following survey of SME Industry Experts was conducted by the consultant over a three-week period during March 5 – March 28, 2011. The survey participants represent a range of perspectives, including those of SME owners/managers, business associations, commercial banks, development banks and development agencies operating in Georgia.

The main topics discussed during the interviews with the industry experts and the corresponding responses are provided below. The responses are divided into two sections, with those of the SME owners and managers in the first section and those of other industry experts in the second.

Notably, according to the information obtained during the interviews, the approval rates of credit applications (presented for the credit committee) vary from 80-92% from bank to bank. Moreover, within the current competitive environment, Georgian banks are keen to simplify the loan approval process.

However, due to poor bookkeeping standards (or absence of standards) in most SMEs, bank representatives stated that an average loan approval process (for a new SME client) may take two or three weeks, depending on the quality of data and financial statements presented by a potential borrower.

### SOURCES OF CAPITAL CURRENTLY AVAILABLE AS ALTERNATIVES TO GEORGIAN COMMERCIAL BANKING

It is worth mentioning that for most SMEs, a bank loan is still a primary source of financing their project for business expansion. Moreover, very few of the respondents were aware about other financial services, for example, leasing.

### MAIN SOURCE OF FINANCING START-UP BUSINESSES IN GEORGIA

For most businesses in Georgia, personal savings or private loans (including friends and family members) are the main source of financing business, especially start-ups.

*“It does not make sense to go to a bank for a loan when you start your business, they don’t care how good your project is if it’s a start-up.”,  
Business Owner, 45 years old.*

*“We have started our business 9 years ago. Started” from scratch”: we have rented a cheap office, brought chairs and tables from homes, did renovations ourselves and worked as private consultants to support our office for the first two years. Those were very difficult and rewarding years. Now we are one of the leading companies in our industry. Only after*

*several years of operations we were able to get banking financing and even though we have proven credit history it's still complicated for us to get a loan on favorable terms.” Partner/Managing Director, 39 years old*

## EASE OF DEALING WITH A BANK (NEW CLIENT)

For SME owners, it is complicated to start a relationship with commercial banks since often they do not understand all the requirements or procedures. This applies, especially, for the companies or farms in rural regions.

*“The very first experience with a bank was not that great. We had no idea how to talk to the bank, what to tell them. I guess we looked funny to loan officers back then. Since we did not have any financial background it was very difficult for us to understand what the banks were asking. Finally, we asked one of our friends to help us out with the bank (he is a finance guy). It worked and we got the loan.” Owner, 30 years old*

## COMMUNICATION WITH A BANK

For respondents, commercial banking staff can seem to be superficial, and it is not easy to explain to them the main points of a project. Some of the respondents stated that communications with banking staff is very complicated since information provided at the first meetings is not complete. However, many respondents were very happy with the level of service provided by the banking staff and indicated that most of credit officers would even visit their place of business while working on the project.

*“First time I went to a bank I had a feeling that we were from different planets. The guy rejected my loan application even without explaining why” Manager, 35 years old*

*“Our first visit to the bank was very successful, the credit officer was very attentive. She has listened carefully and asked the appropriate questions. She actually helped us with completing the application; our book-keeping and the bank's requirements did not match, so she helped with that too.” CEO, 38*

## LOAN APPROVAL PROCESS

According to some respondents, despite advertisements on television or in newspapers, most of the banks do not disburse business loans in a week or so, especially in the case of a new client.

*“I had to wait for the bank's decision for a month (and this is when I am their client with 100% turnover in the Bank). We were on a wait list for Real Estate Appraisers for two weeks. Every week they had new questions or requirements. Interestingly, even though it took them to*

*process the application a month, the credit officer has not visited our company office even once.” Owner, 40 years old*

## PRODUCTS OFFERED BY BANKS

Most SMEs owners/managers are aware of basic bank products: loans, deposits, current accounts, at least at the beginning stage of their cooperation with the commercial banks. However, more experienced clients indicated that banks offer basic services with strict terms, which are not customized to the needs of SMEs (i.e. seasonality, grace period and etc.).

*“I have called all the leading banks and none of them offered factoring services. They even do not offer credit lines for USD 50000”. CFO, 36 years old.*

## COLLATERAL REQUIREMENTS

Many companies find it difficult to get a loan from a bank due to collateral requirements, especially those in service and trade industries that suffer from undercapitalization and excessive collateral requirements. For SMEs, commercial banks make decisions based on collateral rather than on cash flows and income statement.

*“Our company is in consulting business; our main assets are human capital. Unfortunately, we don’t own big real estate properties. Actually, we were going to buy an office building recently however we could not convince any of the Banks to approve a loan. This is despite of our good credit history and cash flow.” CEO, 38 years old.*

*“Banks’ requirements are ridiculous! I have presented two contracts: one with a supplier and another with a buyer, all documents to prove historical transactions with both parties (including account statements from the same bank), I still had to pledge two apartments.” CEO, 34 years*

## BANKING STAFF EXPERTISE

Generally, banking staff is considered to be very professional. Commercial banks have gained significant expertise in financing companies in the service and trade industries. There are frequent cases when loan officers are offered CFO positions at client companies. However, with agriculture loans, the situation is different. Since the banks have limited experience in agriculture lending there are few loan officers with a deep knowledge and understanding of agriculture business processes.

*“It is very difficult to explain to credit officers specifics of farming. Most of them have never seen a farm. And they have one standard approach to everything. This approach is not going to work, at least, for agriculture. Every single farm has its own specifications” Farmer, 50 years old*

*“We were so happy with our loan officer that we offered him a CFO position in our company. During all our relationship with the Bank he made*

*it so easy to understand banking procedures and requirements. In two years we were working with the Bank he became an expert in our industry. So, offering him a position in our company was a natural choice. And now our relations with the Bank are even smoother.” CEO, 40 years old.*

## TRANSPARENCY OF BANKING FEES

For new bank clients, it could be a surprise to discover that at the end of the loan approval process there are additional fees to pay. Specifically, high pre-payment penalties prevent business owners from refinancing their loans at lower rates. Currently, pre-payment penalties vary from 5% to 8%. In some cases, banks have the authority to modify the annual interest rate on a loan without prior negotiations with a client during credit maturity.

*“When I read TBC’s loan agreement I was amazed about the bank’s rights and my obligations...and how much I was going to pay instead of the advertised rate. But we were so short in time we had no choice but to sign the contract” CFO, 28 years old.*

## BANKS AS PARTNERS

Generally, large companies see commercial banks as partners. However, with recent corporate restructurings with borrowers that resulted in bank ownership, many companies, of all sizes, have become more conservative in their borrowing practices. Conversely, in most cases SMEs do not perceive banks as partners, especially those who have been approved and later learned that the banks had reversed its decision to disburse the loan. Such decision reversals hurt the clients’ businesses, personal finances and trust in the banking system as a whole.

*“Our bank is the best partner for us. They were there for us during 2008 war. Despite uncertainty they still kept working and immediately after the war, in September they disbursed the loan which saved our company. ” Owner, 50*

*“Our bank got us in such a trouble! They approved us a loan, we did everything according to schedule: renovated the store, bought equipment, hired and trained staff and at the very last stage when they were supposed to disburse the last tranche for inventory...they have refused!!! No explanation...nothing. I understand that we are not the biggest clients but we managed to partner with an international brand and we had our obligations too. Long story short, we had to look for an alternative source of financing: friend and etc.” Owner, 35*

## LEASING

For all of the respondents, private loans, bank loans and MFI loans are the primary sources of financing. Most have never applied for leasing services and have very little or no information on leasing opportunities.

## INSURANCE

Most companies would use insurance services to insure company cars, shipments and property. Often, many companies only insure their property as a result of a bank's requirements.

*"We bought some equipment and had to insure because the bank required us to." CFO, 29 years old.*

## EASE OF WORKING WITH INSURANCE COMPANIES

Recently companies that are participating in Government tenders started using Letter of Guarantees. Apparently, insurance companies provide much faster service than the banks. However, SME owners/managers have had very negative experiences when trying to collect on a filed claim, accusing the insurance companies of misleading their clients.

*"We needed a letter of guarantee to sign one of our contracts with the GoG. We presented the contracts we have had with the bank, they checked the account statements. However, we were told that it would take two weeks to approve a letter of credit. Moreover, we had to have on the account amount equal to contract's value plus collateral. So we applied for a Letter of Guarantee to Imedi L. In two days we had a signed letter of guarantee. What is even better, we were not even asked for any collateral." Managing Director, 34 years old*

*"I have insured our storage facility in one of the insurance companies against most of natural disasters. However, when last year a very strong wind took off the roof and we claimed for compensations it came up that the wind was not strong enough. In fact, in the contract the insurance company indicated the minimum speed (when they were going to pay us) of wind which has never been indicated in Georgia! Their conditions and exclusions make it almost impossible to get compensations. "*  
*Farmer, 55 years old*

## INSURANCE FEES

Insurance fees are considered as being generally high by SME owners/managers; however, for one-time transactions or short-term coverage periods, SMEs are willing to pay these prices. For long-term solutions, SMEs try to find alternative arrangements.



## SECTION 2 – PERCEPTIONS OF SME PERFORMANCE HELD BY OTHER INDUSTRY EXPERTS

### GENERAL PROBLEMS THAT BANKS ARE FACING WHEN FINANCING SME CLIENTS

During the survey, the consultant held meetings with representatives of major commercial banks to better understand banking credit policies, procedures and, more importantly, their approach to SME financing. Additionally, the consultant met with development agencies and development banks that operate programs for SMEs to identify current challenges and to determine appropriate solutions.

The following are the main barriers that banks face when financing SME clients. The same reasons were stated by other industry experts as barriers for SMEs development in Georgia. Based upon meetings with these industry experts, the most common reasons for declining a loan application would be (1) a low debt service ratio, (2) undercapitalization and (3) failure to satisfy collateral requirements.

#### LACK OF RESOURCES

##### Undercapitalization

*Most SMEs have problems with adequate levels of capitalization. It is important to note that the current low levels of capitalization among SMEs also contribute to the commercial banks' need for strict collateral requirements.*

##### Lack of Human Resources

*Generally, SMEs are unable to hire a sufficient number of employees, and good professionals, due to lack of funds. Additionally, SMEs often cannot afford to hire a consultant to write their business plan or forecast financials.*

##### Technological Challenges

*Many SMEs, especially those in rural areas do not have a clear understanding of, or the ability to implement, new technologies. Furthermore, most SMEs are not able to purchase equipment or machinery necessary to increase productivity.*

#### LACK OF EXPERTISE AND BUSINESS ADMINISTRATION SKILLS

##### Financial Illiteracy and/or Tax Illiteracy

*Generally, most SME owners/managers have little to no qualified tax or financial management training. Not only does this position the SMEs at a*

*disadvantage, but it also causes the banks to exercise additional caution when lending to SMEs. The banks interviewed identified a substantial “tax risk” as one of the most prominent risks associated with SME lending.*

### Management-Related Issues

*Many SME owners/managers are highly qualified in their fields of expertise; however, a level of business administration acumen is very limited. A significant challenge to qualifying for credit is the implementation of core management practices and business plan development. Another area of weakness is that SMEs rarely have a comprehensive marketing strategy to diversify revenues and reduce operational risks.*

### Poor Financial Management Standards

*Often, SMEs are unable to hire experienced accountants and managers handle the companies’ financial management processes; therefore, the overall quality of book keeping and financial reporting among SMEs is very low. Many potential borrowers do not provide financial records or basic financial statements to the banks. Furthermore, many borrowers do not have a recorded banking or credit history, so it is difficult to demonstrate a credible history of healthy cash flows. Due to this poor financial management among SMEs, credit officers in banks regularly work with SME borrowers to construct the financial statements based on informal records.*

# MAIN CONCLUSIONS

Based on the survey responses, there are several conclusions about the barriers to SMEs ability to access financing through the Georgian commercial banking and non-banking financial institutions. The perception-related issues that are barriers for SME borrowers can be summarized as follows:

*For larger SMEs that already have previously established relationships with commercial banks in Georgia, the variety of banking products and level of service are more or less satisfactory. However, they also noted that the main barriers to financing are the current high interest rates and the perception that commercial banks are risk adverse.*

*SMEs believe that commercial banks make decisions based on collateral requirements (where the average required collateral ratio equals 1.3 times liquidation value to loan amount) rather than a cash flow analysis. Because of this collateral issue, many SMEs do not qualify for credit at commercial banks.*

*Another issue that is challenging for SMEs is the transparency of banking and insurance commissions, as a loan's effective interest rate is unknown until the final stage of the process, when a borrower signs the loan agreement.*

*Due to real and perceived bank requirements, many SMEs are limited to personal loans, self-financing or MFI loans or simply opt out of taking a bank loan.*

Furthermore, SMEs owners/managers and other industry experts identified several areas that represent barriers or obstacles to SMEs obtaining banking and non-banking credit. These include:

- Limited Supply of Alternatives to Commercial Bank Loans
- Limited supply of capital market instruments, such as private equity funds
- Venture capital is not a developed sector in Georgia
- The Angel Investor sector is not developed
- Obstacles and Barriers Related to Banking and non-banking Financing
- High interest rates and excessive collateral requirements for the loans, insurance and leasing services.
- Government Guarantee Scheme does not exist.

- Loan approvals are overly biased towards satisfying collateral requirements rather than focusing on projected and current cash flow or performance analysis.
- Benefits of insurance services are still not clear for SMEs, and these services are considered as a highly priced.
- Needed Improvements in SME Operations
- Most SMEs do not have comprehensive financial management systems or even bookkeeping records and reporting systems.
- Many SMEs are not able to attract professional staff.
- Most SMEs do not demonstrate sound business and financial planning skills.
- Various Levels of Options and Services Create Confusion
- Existence s of many SME definitions within various banking and non-banking financial institutions, creates confusion among SMEs as to what services are actually available to them.
- Some SMEs receive high levels of services at one bank while others receive lower levels of services.
- Commercial banks are not uniform in their application of the SME classification as some preferred SME clients are categorized as corporations in some banks and received much higher service quality levels and preferred terms on credit.

# RECOMMENDATIONS

To stimulate improvements in the understanding and perceptions of SME owners/managers, the consultant recommends the following actionable steps to directly address the challenges and barriers identified by both the SME owners/managers and the other industry experts.

PROBLEM	POSSIBLE SOLUTION
Financial Illiteracy	<p data-bbox="623 590 1159 617">Public Education and Outreach Programs</p> <ul data-bbox="574 642 1425 888" style="list-style-type: none"> <li data-bbox="574 642 1425 737">• Develop relationships with relevant educational organizations including high schools, universities as well as NGOs that work on financial literacy.</li> <li data-bbox="574 762 1425 888">• Design and implement outreach and education initiatives for SME owners/managers on financial and taxation issues. (e.g. educational outreach efforts to promote economic literacy, etc.).</li> </ul> <p data-bbox="623 913 1357 940">Facilitating and Supporting Business Advisory Programs</p> <ul data-bbox="574 966 1425 1140" style="list-style-type: none"> <li data-bbox="574 966 1425 1024">• Select partner consulting companies working for SMEs on business development.</li> <li data-bbox="574 1050 1425 1140">• Design a customized grant programs to co-finance advisory services projects for SMEs. Therefore, SMEs will be able to receive professional services at an affordable price.</li> </ul>
Lack of information on banking and non-banking services or requirements, alternatives or donor-sponsored programs	<p data-bbox="623 1199 980 1226">Information Portal for SMEs</p> <p data-bbox="623 1234 1425 1293">Create a information web-portal for SMEs to provide them with the information on:</p> <ul data-bbox="574 1318 1425 1854" style="list-style-type: none"> <li data-bbox="574 1318 1425 1346">• Available banking/non-banking products and requirements;</li> <li data-bbox="574 1371 1425 1461">• Templates for financial statements (balance sheet, income statement, cash flow), business plan, marketing plan, employment contracts and etc.;</li> <li data-bbox="574 1486 1425 1514">• Available donor programs supporting SMEs;</li> <li data-bbox="574 1539 1425 1598">• Research papers, articles, publications on different business activities/industries;</li> <li data-bbox="574 1623 1425 1682">• Information on available donor-sponsored projects, grants, etc.</li> <li data-bbox="574 1707 1425 1766">• Tutorials for companies oriented on export, (e.g. ISO and HACCP certifications).</li> <li data-bbox="574 1791 1425 1854">• Database of consulting companies providing business advisory services and training centers.</li> </ul>

- |   |  |
|---|--|
| Undercapitalization   | <ul style="list-style-type: none"> <li>• Facilitate development of a legislative framework that will safeguard and promote venture capital financing and the angel investor segments.</li> <li>• Advocate the GoG to develop SME Credit Guarantee Schemes, especially for agricultural production and agribusiness.</li> <li>• Promote the use of international lending practices (1) to move to industry-based assessment of a project instead of simply a risk-based (risk adverse) assessment and (2) to develop alternative banking products for SME financing.</li> </ul> |
| Limited Industry-Specific Expertise in Banking Staff            | <ul style="list-style-type: none"> <li>• Help to increase industry expertise both in FIs and SMEs by (1) providing industry reports and analyses and (2) providing technical assistance to banks to organize industry-specific groups within SME lending department.</li> <li>• Provide technical assistance to banks to create a classification system to break out SME banking activities from corporate banking activities.</li> </ul>  |
| Unclear definition of SMEs, absence of common approach to SMEs. | <p style="text-align: center;">Create a unified definition of “SME”:</p> <ul style="list-style-type: none"> <li>• To better coordinate the multiple national, international, governmental and commercial initiatives to develop the SME sector in Georgia, it is recommended to consider a unified definition and classification system of SME businesses.</li> </ul>  |
| Irresponsible finance (bank and non-bank services)              | <ul style="list-style-type: none"> <li>• Advocate responsible finance principles, i.e. to make services of banks and non-bank institutions (including insurance companies) more transparent and accountable to clients.</li> </ul>   |

## ADDITIONAL RECOMMENDATIONS

In order to ensure the success and sustainability of the aforementioned recommendations, the consultant recommends advocating the GoG to develop a framework by which SMEs can receive ongoing training and business educational opportunities. This especially true for SMEs that experience a significant growth, as the managers will need additional training on more complex financial and management issues as they encounter fresh challenges in their firms’ life cycles.

This framework could be formed as a public-private partnership, where the GoG and donor organizations can coordinate their programming efforts, alongside private sector consulting firms or business development firms, to establish ongoing training and educational centers throughout Georgia. Some examples of organizations that can serve as models for this effort are:

- U.S. Small Business Administration
  - Since 1953, the U.S. Small Business Administration has delivered millions of loans, loan guarantees, contracts, counseling sessions and other forms of assistance to small businesses. SBA provides assistances primarily through its four programmatic functions:
    - Access to Capital
    - Entrepreneurial Development
    - Government Contracting
    - Advocacy
- The JEREMIE Initiative
  - Developed in cooperation with the European Commission, the JEREMIE Initiative offers EU Member States, the opportunity to finance SMEs through a revolving Holding Fund acting as an umbrella fund. The JEREMIE Holding Fund can provide to selected financial intermediaries SME-focused financial instruments including guarantees, co-guarantees and counter-guarantees, equity guarantees, (micro) loans, export credit insurance, securitization, venture capital, Business Angel Matching Funds and investments in Technology Transfer funds.
- SPRING Singapore
  - SPRING Singapore is the enterprise development agency responsible for assisting Singapore enterprises. The agency works with partners to help enterprises in financing, capability and management development, technology and innovation, and accessing new markets.

# ANNEX A: INTERVIEWS/MEETINGS CONDUCTED

1	Devi Khechinashvili	Georgian Insurance Company Association
2	ZurabGvasalia	Association of Banks of Georgia
3	Thea Gigiberia	IFC, Country Representative
4	AyetyKukava	Alliance Holding
5	Irakli Mekvabishvili	EBRD, Principal Banker
6	Liza Koiava	EBRD, Agriculture component
7	Giorgi Kiziria	Asian Development Bank
8	Levan Kalandadze	Georgian Small and Medium Enterprises Association
9	Kakha Kokhreidze	Georgian Small and Medium Enterprises Association
10	FadyAsly	International Chamber of Commerce
11	Tamar Khuntsaria	European Union Business Council
12	George Chiladze	Bank of Georgia
13	Nana Mikashavidze	TBC Leasing
14	TinatinRukhadze	ACT Research
15	RusudanTelia	ACT Research
16	Alexander Mchedlishvili	Silknet
17	EleneZakareishvili	TBC Bank
18	Giorgi Shagidze	Business Association of Georgia
19	David Liparteliani	Dorani
20	Tamar Zhizhilashvili	TBC Bank
21	Tea Lortkipanidze	TBC Bank
22	KetevanBurduli	Procreditbank
23	Anna Botkina	Fortis Trading Co
24	Steve Johnson	American Chamber of Commerce/Hotel Betsy's
25	Lasha Gogiberidze	BGI
26	Mike Cowgil	Georgian American University
27	Steve Pipe	Bertling Georgia
28		Hotel Ambassadori
29		Hotel Varazi
30	Stephanie Komsa	Independent Advisor
31	CarstenKilian	KfW
32	Nino Shanidze	KfW
33	ResoOrmotsadze	USAID
34	Levan Beriashvili	Tserovani
35	ZurabKakhleadze	Ioli
36	Giorgi Imnadze	SentaPetroleum
37	Tata Sakhelashvili	Georgian Trading Center
38	Beso Jikurauli	Bank Republic



39	Kote Chanturia	Bank Republic
40	Patrick Jung	DWVG
41	Uta Beyer	DWVG
42	Goga Simonishvili	Agrokartli
43	Malkhaz Jakeli	Jakeli Wines
44		
45		

# ANNEX B: RESOURCES USED

1	Business Association of Georgia	<a href="http://www.bag.ge">www.bag.ge</a>
2	GSMEA	<a href="http://www.gsmea.ge">www.gsmea.ge</a>
3	Georgian Chamber of Commerce	<a href="http://www.gcci.ge">www.gcci.ge</a>
4	International Chamber of Commerce	<a href="http://www.icc.ge">www.icc.ge</a>
5	EU Business Council	<a href="http://www.eugbc.ge">www.eugbc.ge</a>
6	French Business Council	<a href="http://www.fbc.ge">www.fbc.ge</a>
7	German Business Council	<a href="http://www.dwvq.ge">www.dwvq.ge</a>
8	International Finance Corporation	<a href="http://www.ifc.ge">www.ifc.ge</a>
9	EBRD	<a href="http://www.ebrd.com">www.ebrd.com</a>
10	Geostat	<a href="http://www.geostat.ge">www.geostat.ge</a>
11	USAID	<a href="http://www.usaid.gov">www.usaid.gov</a>
12	Ministry of Finance of Georgia	<a href="http://www.mof.ge">www.mof.ge</a>
13	OECD	<a href="http://www.oecd.org">www.oecd.org</a>
14	World Bank	<a href="http://www.worldbank.org">www.worldbank.org</a>
15	SMEinfo	<a href="http://www.smeinfo.com.my">www.smeinfo.com.my</a>
16	National Bank of Georgia	<a href="http://www.nbg.ge">www.nbg.ge</a>
17	Ministry of Finance	<a href="http://www.mof.ge">www.mof.ge</a>
18	UNDP	<a href="http://www.undp.org">www.undp.org</a>
19	SPRING Singapore	<a href="http://www.spring.gov.sg">www.spring.gov.sg</a>
20	US Small Business Administration	<a href="http://www.sba.gov">www.sba.gov</a>

# ANNEX C: SAMPLE SME DEFINITIONS

The European Union defines SMEs as firms with between 10 and 250 employees

Firm Size	Employees	Annual Sales
<b>Micro</b>	<10	<€2 million
<b>Small</b>	<50	<€10 million
<b>Medium</b>	<250	<€50 million

Source: Recommendation 96/280/CE, with the May 2003 update

Malaysia SMIDEC defines SMEs differently depending industry

Firm Size	Manufacturing, Agro-based industries	Service, ICT, or Primary Agriculture
<b>Micro</b>	<5 employees or <\$66, 000 in sales	<5 employees or <\$53, 000 in sales
<b>Small</b>	<50 employees or <\$2 million in sales	<19 employees or <\$200,000 in sales
<b>Medium</b>	<150 employees or <\$6.6 million in sales	<50 employees or <\$1 million in sales

Source: MSIDEC – Small and Medium Industries Development Corporation

Definition may vary within a country

Country	Employees	Annual Sales
<b>United States</b>	<500 for most manufacturing and mining	<\$7 million for most nonmanufacturing, but ranges up to \$35.5 million
<b>Thailand</b>	<200 in labor-intensive industries and <100 in capital-intensive industries	
<b>Turkey</b>	10 to 250	

Source: IFC, US Small Business Administration

# ANNEX D: GEOGRAPHICAL COVERAGE OF LEADING BANKS

City	Republic	Cartu Bank	TBC Bank	Bank of Georgia	Procreditbank	Basis Bank
Tbilisi	X	X	X	X	X	X
Akhalkalaki	-	-	-	X	-	-
Akhaltzikhe	-	-	-	X	-	-
Bakuriani	-	-	-	X	-	-
Batumi	X	X	X	X	X	X
Bolnisi	-	-	-	X	-	-
Borjomi	-	-	X	X	X	-
Chiatura	-	-	-	X	-	-
Gardabani	-	-	-	X	-	-
Gori	X	X	X	X	X	-
Gurjaani	-	-	-	X	-	-
Kaspi	-	-	-	X	-	-
Keda	-	-	-	X	-	-
Khashuri	-	-	-	X	X	-
Khulo	-	-	-	X	-	-
Kobuleti	-	-	-	X	X	-
Kutaisi	X	X	X	X	X	-
Kvareli	X	-	-	X	-	-
Lanchkhuti	-	-	-	X	-	-
Marneuli	-	-	-	X	X	-
Mtskheta	-	-	-	X	-	-
Ozurgeti	-	-	-	X	X	-
Poti	X	-	X	X	X	-
Rustavi	X	-	X	X	X	-
Sachkhere	-	-	-	X	-	-
Sadakhlo	-	-	-	-	X	-
Sagarejo	-	-	-	X	-	-
Samtredia	X	-	-	X	-	-
Senaki	-	-	-	X	-	-
Shuakhevi	-	-	-	X	-	-
Signagi	-	-	X	X	-	-

City	Republic	Cartu Bank	TBC Bank	Bank of Georgia	Procreditbank	Basis Bank
Telavi	X	X	X	X	X	X
Terjola	-	-	-	X	-	-
Tetrtskaro	-	-	-	X	-	-
Tkibuli	-	-	-	X	-	-
Tsalka	-	-	-	X	-	-
Tskaltubo	-	-	-	X	-	-
Tsknti	-	-	-	X	-	-
Tsnori	-	-	-	-	X	-
Zestaponi	X	-	-	X	X	-
Zugdidi	X	-	X	X	X	-

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