

The Outlook for Ultra-Micro Financing amid Pandemic

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PEFINDO views the outlook of the ultra-micro financing segment as stable in the near to medium term, underpinned by its potentially strong demand from non-bankable debtors and limited lenders typically focusing on larger financing of the ticket size, such as banks and multi-finance companies. This segment is also characterized by a business model seeking a high margin to compensate for high operational expenses. For the lenders, it is essential to continuously reign in the acceptable level of credit risks and manage the efficiency by controlling operational expenses, allowing lenders to obtain the desired margin in the labor-intensive business.

We have revised the ultra-micro financing industry risk profile to moderately high from previously considered as high, following the trend of gradual business recovery from severe impact of the outbreak of the pandemic in 2020. The amount of average monthly collection receivable has returned to 70%-80% in 2021 from below 50% in 2020, due to the social restriction has eased during 2021 which enabled collectors to meet their customers since the ultra-micro financing collection model mostly relies on direct interaction and mass gathering to meet its group (consists of 5-10 woman). On the other hand, as the customers majority coming from low-middle income and non-fixed income earner, this segment is very vulnerable to the changes of macroeconomic situation.

The new disbursement also increased in 2021 by around 80%, after many companies stopped their new booking due to low revenue generation amid low collection receivable in previous year. We also noted significantly lower number of restructuring in 2021 both given to debtors or obtained from the lenders.

The government commitment to support ultra-micro financing industry

During these two years of pandemic, PEFINDO views that the government has strong commitment to support ultra-micro as well as micro, small-medium enterprises (MSME) segment. The government through Bank Indonesia has issued a new regulation, PBI No. 23/13/PBI/2021, enforcing the banks to provide loans to MSME segment which the contribution gradually increases until 30% in 2024. In the banking industry, the MSME segment contributed only 18.6% of the total loan as of September 30, 2021 (9M2021), a low standard when compared to neighboring countries, such as Singapore (39%), Malaysia (50%), and Thailand (above 50%), calling for a concerted government effort to raise its contribution. In developed countries, its contribution is even higher, such as Japan around 60% and South Korea around 80%. To support the mission, the government also continue allocating the state budget to provide Kredit Usaha Rakyat (KUR, with credit facility up to IDR100 million) program. The KUR portion has increased to IDR285 trillion in 2021 from IDR190 trillion in 2020, with interest rate subsidy of around 3% in 2021.

The government also allocated substantial funds around IDR123.5 trillion as part of National Economy Recovery (Pemulihan Ekonomi Nasional, PEN) to MSME segment, including interest rate subsidy IDR35.3 trillion, placement of fund for restructuring of IDR78.8 trillion, guarantee fee of IDR5 trillion, final tax burdened by government of IDR2.4 trillion, working capital loan of IDR1 trillion and investment loan through Lembaga Pengelola Dana Bergulir (LPDB) of IDR1 trillion. Besides those government assistances, the government also extended the restructuring program in banks and other financial institutions to March 2023, in order to alleviate financial burden of the MSME entrepreneurs.

The government's commitment to developing the micro, small-medium enterprises (MSME) segment is also reflected in the establishment of the ultra-micro holding led by PT Bank Rakyat Indonesia (Persero) Tbk (BRI, rated *idAAA/stable*) with PT Pegadaian (Pegadaian, rated *idAAA/stable*) and PT Permodalan Nasional Madani (PNM, rated *idAA/stable*) being its subsidiaries. PNM and Pegadaian, as the front-line companies to reach the non-bankable customers, will gain access to lower-cost funding sources through strengthened synergy with BRI. In addition, both PNM and Pegadaian may expand their networks through BRI's vast office channels, strengthening its overall market presence. Moreover, leveraging the co-location among the

three companies will enhance their operational efficiencies, which may be passed on to end users, resulting in a more competitive lending rate.

PNM, through its Mekaar product, reached 10.6 million customers as of 9M2021 and extended loans amounting to Rp37.2 trillion since the program's establishment in 2015. The Government has set the growth target for PNM, reaching 12 million customers by 2024. Pegadaian also has a sizeable customer base serving 18.8 million customers as of 9M2021, disbursing Rp120.5 trillion through its pawn and non-pawn businesses.

In addition, the government also established the Ultra Micro Financing (UMi) program in 2017, a continuation of the social assistance program with the funding allocated from the state budget. UMi financing amounted to Rp17.9 trillion which distributed to around 5.4 million debtors, since its establishment to December 2021 through three government-related institutions, namely PNM, PT Pegadaian, and PT Bahana Artha Ventura, a subsidiary of PT Bahana Pembinaan Usaha Indonesia (Persero) (BPUI).

Growth prospect of ultra-micro segment

The government aims to continue developing the MSME segment as it is projected to be the backbone of the Indonesian economy. As the number of MSME entrepreneurs increased, financial institutions such as banks or non-bank financial institutions are starting to enter this segment. In a survey conducted by OJK in 2019, the third National Survey on Financial Literacy and Inclusion (SNLIK), the findings showed improvements in the financial literacy and inclusion indices to 38.0% and 76.2%, respectively, from 29.7% and 67.8%, respectively, in 2016. The government's support has played a pivotal role in boosting the micro-loan growth in the past few years before the pandemic hit, compared to other segments. However, the micro loan growth contracted by 15.6% year-on-year (yoy) in 2020 due to the pandemic since this segment is very vulnerable to the changes of macroeconomic conditions. Although banks exercise more caution in their underwriting approach to the micro segment, the MSME segment grew by 2.7% yoy in 9M2021. As the infection cases contained following the progress of the vaccination program in Indonesia, we view that the economy will gradually recover, including the micro-loan segment.

Table 1. Growth of MSME Loan in Banking Industry

	9M21	FY20	FY19	FY18	FY17	FY16
Micro	-17.1%	-15.6%	13.1%	14.1%	13.6%	10.9%
Small	18.0%	3.5%	10.5%	10.7%	11.5%	11.8%
Medium	2.0%	1.6%	2.8%	7.1%	7.5%	5.2%
Total	2.7%	-2.2%	7.7%	9.9%	10.1%	8.4%

Source: OJK, processed by PEFINDO

In addition, based on the data from the Minister of Cooperatives and SME, among 62 million MSME entrepreneurs, around 50% have gained access to the banking sector, while the remainder failed in meeting the banks' selection process, mainly due to inadequacy of financial reporting to convince the banks on their repayment capacities and insufficient fixed assets for collaterals. Given MSME's constraint in accessing funding, it remains challenging to improve the pre-welfare population, accounting for 30% of 275 million people as of March 2021 (Balai Pusat Statistik or BPS). It shows substantial potential market exists in the next few years.

Manageable asset quality but high operational expenses and limited access to funds

In PEFINDO's assessment, the asset quality of companies engaged in the ultra-micro financing sector is above average despite the pandemic, bolstered by a joint-responsibility scheme in a group and intensive collection system on a weekly basis, which is quite effective in preventing late payments. To maintain a conservative approach in managing credit risks, financing companies typically withhold up to five installments as cash collateral before disbursing loans to their customers. Such a method has, to some extent, managed to mitigate the debtors' high credit risks, stemming from their low and vulnerable income

to the unfavorable macroeconomic conditions, weakening their repayment capacity. The above- average asset quality is indicated by the non-performing receivable (NPR) overdue 90 days within a 1-3% range as of 9M2021, lower than the non-performing loan (NPL) ratio of MSME in the banking sector at 4.3% at the same period.

Given the high credit risk and operational expenses, the lenders tend to charge higher lending rates; yet, are acceptable to the debtors due to the limited access to funding and the less price-sensitive nature of low-ticket size financing. Such a business model also involves labor-intensive work to collect installments, including those domiciling in remote areas. Of the several companies we examine, finance companies engaged in the ultra-micro financing segment earn an average margin of 20-30%, higher than multi-finance company of 10-15%. The challenge for these players is to enhance operational efficiency by both scaling up operations and application of technology, thereby increasing profitability.

These lenders' capacity in obtaining funding sources is generally also limited. For the largest players, their funding sources widely vary from large state-owned enterprises (SOE) banks to issuing their debt instruments. However, for the smaller players, their access to funding is very limited, mainly relying on equity-funded operations. Given the uncollateralized ultra-micro lending business, PEFINDO views that their access to funding is limited, either from banks or the capital market. However, due to the high yield and growing interest to promote social values the ultra-micro financing may also attract foreign interests once they reach economies of scale.

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