ICMR
Institute for Capital Market Research Malaysia

Market-based Financing for SMEs in Malaysia:
Issues, Challenges, and Way Forward

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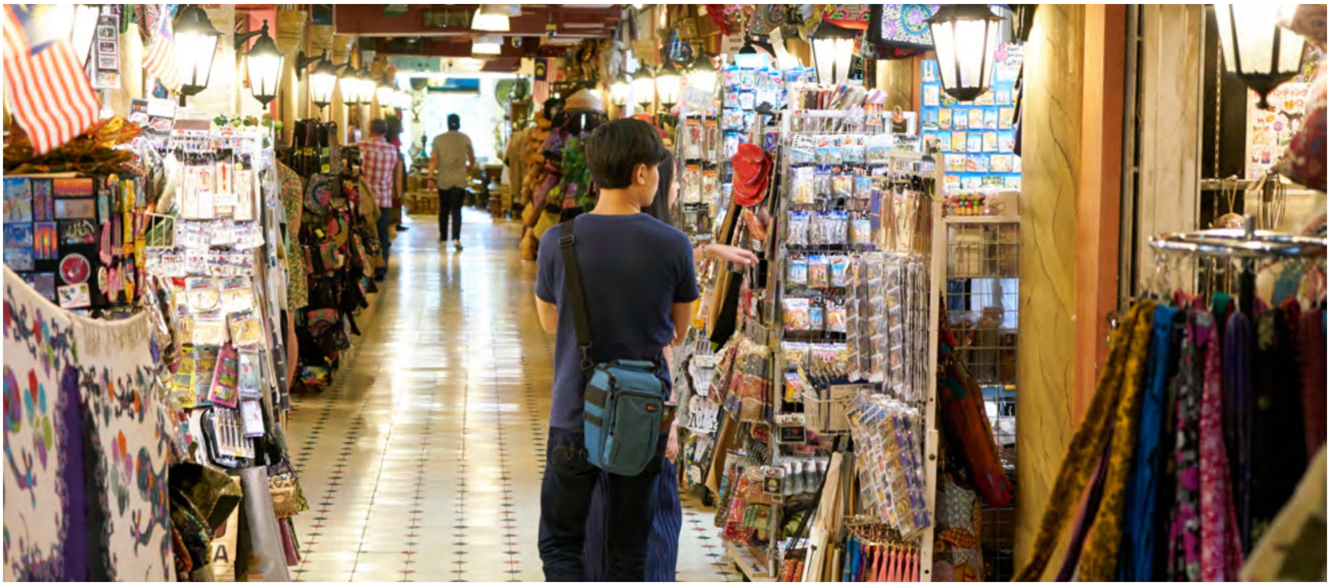
Executive Summary



In Malaysia's pursuit of economic reforms, the significance of Small and Medium Enterprises (SMEs) cannot be overstated. These enterprises serve as the backbone of the nation's economic growth, playing a pivotal role in driving innovation, creating employment opportunities, and fostering inclusive development. As the economic landscape evolves towards innovation-driven sectors, SMEs become central to this transformation, contributing to technological advancements and the overall resilience of Malaysia's economy. This is in line with the government's recent reform policies announced in 2023, such as Madani Economy, National Energy Transition Roadmap (NETR), and New Industrial Master Plan (NIMP) 2030.

To unlock the full potential of SMEs, it becomes imperative to establish a well-developed ecosystem where access to finance serves as a key enabler, connecting various other ecosystem enablers across distinct stages of a business's life cycle. Limited financing poses a substantial hurdle for SMEs to grow and has the potential to jeopardise the entire SME ecosystem's development. As such, the role of market-based financing in catalysing growth and innovation within SMEs has never been more critical. This study aims to offer insights into the current state of access to market-based financing for SMEs in Malaysia, alongside the challenges and opportunities presented.

Diversifying financing options is crucial to accommodate the evolving needs of SMEs at various stages in their business life cycle, meeting the increasing demand for funding. In Malaysia, regulatory bodies have been supportive of developing financial tools tailored to each SME's life cycle. However, this study reveals gaps in access to financing at different stages of a business's life cycle. Addressing these gaps is vital to ensure the success of SMEs.

To understand the financing challenges of SMEs in Malaysia, ICMR conducted an enterprise-level survey targeting key decision-makers in different types of SMEs, including startups, micro, small, and medium-sized enterprises (MSMEs), and mid-tier companies (MTCs). The survey, complemented by qualitative interviews and focus groups, provides a comprehensive overview of the financing landscape for SMEs, shedding light on the challenges and opportunities faced by startups, MSMEs, and MTCs. The key findings are:

- 64% of SMEs have experience in raising external finance, with most opting for funding from the banking sector, while market-based financing is the less utilised financing option. Market-based financing is primarily used for business expansion, while banking sector financing is more commonly used to meet their working capital needs.

- Among respondents with no experience in market-based financing, 61% were aware of its availability, while 39% remained unaware. This sentiment was echoed in interviews, particularly regarding crowdfunding platforms like Equity Crowdfunding (ECF), and Peer-to-peer (P2P) financing. Of those aware, 85% expressed a willingness to consider market-based financing, while only 15% ruled it out for future funding needs. This willingness is contingent on a better understanding of market-based financing, trust, ownership control, and concerns about exit strategies, underscoring nuanced considerations across different business sizes.

- Primary hurdles for SMEs adopting market-based financing included complex and lengthy procedures, stringent requirements, high funding costs, and a surprising lack of outreach by industry players. Based on interviews, these challenges were notably more pronounced outside urban areas such as the Klang Valley. Unlike banks, where information can be obtained by approaching a branch, SMEs reported unfamiliarity with where and how they can access market-based financing.

- Across all business sizes, networks play an important role for accessing information. Leveraging networks through government agencies and business associations was the top-preferred medium for obtaining information about market-based financing. Startups showed a greater inclination towards digital platforms and online sources. Therefore, regulators, Recognised Market Operators (RMOs), advisers, sponsors, and other intermediaries should strengthen their networks with business associations and government agencies to disseminate information on market-based financing offerings to SMEs.

- Digital technology adoption was embraced by 73% of SMEs, broadly but with varying motivations. MTCs prioritised digitalisation in financial management, while startups and SMEs focused primarily on marketing and sales. A positive impact from digitalisation was reported by 89% of SMEs, with a significant portion (72%) marketing their products on e-commerce platforms, which became a major revenue source for SMEs.

- Environmental, social, and corporate governance (ESG) practices were not universally adopted among SMEs, with only around half incorporating ESG principles. Notably, MTCs led with an impressive 68% adoption rate. The decision to incorporate ESG practices was primarily driven by external factors, particularly the growing demand from customers indicating its growing business imperative. For startups, the lack of government incentives was seen as a predominant barrier, while MSMEs faced challenges due to the complexity of ESG reporting. In contrast, MTCs identified the high cost of issuing ESG financing instruments as a significant hurdle.

- A higher percentage of companies leveraging market-based financing embraced both digitalisation and incorporated ESG practices, highlighting a potential synergy between market-based financing and ESG and sustainable business practices. The survey also indicated that SMEs conducting comprehensive business reviews, including financial, macro, digitalisation, and ESG considerations, tended to enjoy better access to external financing.

Additionally, insights from interviews with government agencies and intermediaries further described challenges and opportunities in the SME landscape. The key findings are:

- Knowledge gaps and talent shortages within the SME financing ecosystem, especially regarding market-based financing, were consistently highlighted during our interviews by various stakeholders. ESG as a growing business imperative augments this challenge. Addressing talent shortages and reducing knowledge gaps is considered a critical factor to ensure a robust financing ecosystem supporting SME development in Malaysia. These knowledge gaps and talent shortages underscore the need for more targeted interventions to support various stakeholders based on their specific needs.

- SMEs face a significant challenge due to the scarcity of data available to investors, financial institutions, and agencies providing grants and loans. Information asymmetries result in higher costs for monitoring and evaluating SMEs, exacerbating challenges in accessing financing.

- SME assistance should also facilitate the transition from SMEs to MTCs, enabling them to become larger corporations. However, government support predominantly focused on MSMEs may inadvertently create a certain unintended "comfort zone" for MSMEs to remain as they are. Support mechanisms and incentives should be growth-oriented to foster the growth of MSMEs to grow faster and larger.

- The current investment landscape is changing significantly, with investors, particularly venture capitalists (VCs), shifting focus from "growth at all costs" to considering revenue, profitability, and long-term sustainability of the businesses, as VCs grapple with rising funding costs (hurdle rates).

- There is a need to focus on the availability of effective and efficient exit strategies for SMEs, and investors. Companies exploring listing on the Leading Entrepreneur Accelerator Platform (LEAP) market face high issuance fees and a lack of vibrancy and liquidity constraints, which increase the financial burden for the issuer and limit the interest of investors. Likewise, merger and acquisitions (M&A) deals focusing on SMEs are limited and need to be further enhanced.

In light of the findings, this report presents a set of recommendations to effectively address the intricate funding requisites throughout the SME life cycle and fortify the overarching ecosystem. The recommendations are anchored from two main perspectives:

1. Addressing SME's life cycle funding needs:

The report focuses on narrowing funding gaps across the SME life cycle, categorised broadly into risk capital, growth capital, and late-stage capital stages.

- **Risk capital:** This pertains to capital formation for early-stage SMEs, where the government plays a pivotal role due to higher uncertainties and failure rates. Streamlining government assistance, broadening the role of fund-of-funds (FoF), and providing guarantee schemes to SMEs will increase private sector participation and enhance investor protection to finance early-stage SMEs.

- **Growth capital:** Recommendations focus on enhancing capital allocation to support SMEs' growth by diversifying financing options. This involves encouraging the offering of innovative funding structures using a blended financing approach and expanding the product offering for market-based financing. Encouraging more private capital participation is critical not only for providing capital but also for offering support beyond capital, such as access to markets, knowledge and talent development, and technological support. Areas like promoting corporate venture capital (CVC) in the private equity market are emphasised.

- **Late-stage capital:** The focus is on optimising exit strategies for SMEs through public equity capital and M&A structures. Recommendations concentrate on enhancing the role of the LEAP market by addressing issues related to the high cost of issuance and reshaping it into a specialised SME exchange that focuses on NETR and NIMP identified sectors. Regarding M&A, the report highlights the need to harness more M&A activities involving SMEs by targeting incentives and intervention programmes to attract Multinational Corporations (MNCs), Government Linked Companies (GLCs), and local corporates.

2. Strengthening SME ecosystem beyond pure financing:

The report emphasises the significance of leveraging FinTech, enhancing data infrastructure, focusing on the roles of Islamic finance and social finance, growing talent and financial education, as well as broadening market access and supporting the internationalisation of SMEs.

- **FinTech integration:** The role of FinTech in supporting SME financing needs is gaining traction due to its inclusive nature and the use of digital tools to broaden financial coverage. To further enhance the role of FinTech, the report suggests developing data infrastructure by leveraging the existing ImSME platform to improve data availability for assessing SME creditworthiness.

- **Islamic finance and social finance:** The report underscores the role of Islamic Finance and Social Finance in supporting SMEs, particularly those with impact-based goals, by leveraging both concessional and private capital.

  To encourage an entrepreneurial culture, the government could consider the "Entrepreneurship for All" programme, aiming to level the playing field for aspiring entrepreneurs, especially those from low-income households.

- **Growing talent and financial education:** The report emphasises various intervention measures to support SMEs, including building networks, providing effective incentives for capacity building, and addressing talent shortages. Specific actions recommended in this regard include enhancing accelerators and incubators programmes, strengthening University-Industry linkages, and fostering a risk-taking culture which allows for "creative destruction" for more innovation to flourish.

- **Market access and internationalisation:** Broadening market access and supporting internationalisation are critical for SME growth and competitiveness. The report highlights the need for SMEs to leverage bilateral, regional, and multilateral agreements signed by Malaysia, focusing on assisting SMEs in entering new markets. The Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP) and the Regional Comprehensive Economic Partnership (RCEP) are highlighted as major multilateral agreements for Malaysian SMEs to explore.

  Strengthening Malaysia's role within the Association of Southeast Asian Nations (ASEAN) region is also crucial, with the suggestion of positioning Malaysia as an ASEAN 'Test-Hub' due to its robust infrastructure and growing middle-class consumer base.

  Expanding the export of service sectors among SMEs is recommended, with support from agencies such as Malaysia External Trade Development Corporation (MATRADE), which has a proven, successful model under the Mid-Tier Companies Development Programme (MTCDP) to promote trade activities can be further scaled.

In conclusion:

The role of SMEs in Malaysia's economic development is indispensable. Recognising the heterogeneity among SMEs is crucial, particularly in identifying high-growth startups and scale-up SMEs driven by innovation, growth and investments, and network expansion. This group not only requires greater policy focus and government support but is also particularly suitable for market-based financing. While the role of market-based financing is gaining traction, the report highlights policy recommendations to further enhance its role in supporting innovative, high-growth SMEs.

It is important to recognise that focusing on financing alone does not solve all barriers faced by SMEs. Addressing challenges such as knowledge constraints, limited managerial skills, business acumen, financial management skills, access to technology and innovation assets, talent shortage, adaptation of digital technologies, and embedding sustainability principles within business organisations is equally important. One-size-fits-all solutions are insufficient, and policy interventions should target various levels, including specific SME categories, to tap into new growth areas with high potential. By strengthening the SME ecosystem, Malaysia aims to bolster its contributions to the economy, employment, technological advancements, and break away from the middle-income trap, becoming a resilient advanced economy with a greater focus on sustainability.

Chapter One

Introduction

1.1 Background

In recent months, the Malaysian government has unveiled a series of economic reforms and development policies aimed at revitalising economic growth, ensuring its robustness and sustainability for the future. A recurring theme in all of these policies is the imperative to strengthen the Small and Medium Enterprise (SME) ecosystem, as it plays a pivotal role in enhancing local business capabilities and competitiveness.

Micro, Small, and Medium Enterprises (MSMEs) and Mid-Tier Companies (MTCs) are critical components of Malaysia's growth engine, leading the way in job creation, promoting innovation, and fostering inclusive growth opportunities. For the purposes of this research, we will collectively refer to MSMEs, startups, and MTCs using the umbrella term "SMEs" to simplify the terminology, notwithstanding the need to recognise the heterogenous nature of the different types of SMEs.

While SMEs are often categorised based on size metrics such as employment and turnover, recognising their heterogeneity is vital. Factors like ownership background, industry focus, technological orientation, and organisational behaviour contribute to the diversified landscape within the SME. Micro and traditional SMEs prioritise maintaining their businesses, emphasising stability and continuity over scaling up operations. On the other hand, high-growth startups and scale up SMEs, fuelled by innovation and higher risk investments, may require more government support and capital allocation, especially in their early stages to realise their full potential. To unlock the full potential of SMEs, it is essential to establish a well-developed ecosystem where access to finance plays an important role, connecting various ecosystem enablers across different stages of the business life cycle. A lack of external financing poses a significant obstacle to SME growth and can potentially jeopardise the SME ecosystem (Beck and Demirguc-Kunt, 2006; Ardic et al., 2011; Gupta and Gregoriou, 2018).

Bank lending is the primary source of financing for SMEs, providing direct debt to fund their business operations, working capital, and expansion.

According to the Bank Negara Malaysia (BNM), the banking sector accounts for over 90% of the total financing requirements for SMEs in Malaysia.[1] To support SME development, bank lending not only comes directly from commercial banks, but is also complemented by various lending schemes administered by BNM, government agencies, and Development Financial Institutions (DFIs).

While bank lending remains a prevalent source of SME financing, relying solely on it is increasingly unsustainable (Shinozaki, 2014). Some middle-income countries faced a credit crunch in the aftermath of the 2008-09 financial crisis (World Bank, 2019) and credit tightening in the banking sector made SMEs' dependence on banks increasingly challenging. What is more, alternatives to traditional debt finance, such as venture capital, growth capital, and angel investing were affected even more severely by the financial crisis, thus penalising innovative SMEs in need of finance (OECD, 2020b).

During both the 2008-09 financial crisis as well as the more recent COVID-19 crisis, policy responses through the banking system either through expanded lending, special lending facilities or guarantee schemes and other credit measures became the main tool to support finance for SMEs. Generally, market-based financing such as equity instruments gained more attention in the post-crisis landscape, which marked a shifting focus, from cyclical issues to more longstanding structural issues in SME access to finance (OECD, 2020b).

Megatrends such as globalisation, digitalisation, and demographic changes will continue to reshape the landscape for businesses and policies on SME financing. Against this backdrop, financial markets have become more complex and interconnected than ever before. The role of the financial system, in its ability to support the creation and expansion of SMEs and entrepreneurs and to foster new sources of growth and value creation for the real economy have been called under question, especially since the 2008-09 financial crisis. As the banking sector continues to adjust to a stricter regulatory environment and tighter financial conditions, it is important that a more diversified set of options for SME financing is made available to reduce the vulnerability of SMEs to changes in the credit market.

Traditional capital market instruments, such as bond and equity markets have typically served larger corporations and have limited usage by the SMEs. However, with the evolution of the capital market landscape facilitated by the advancements of digital technology and changing investor preferences, the potential for alternative instruments in the capital markets such as the development of specialised markets or exchanges and crowdfunding models using digital platforms is increasingly being recognised as an important source of funding for SMEs. In addition, under the broader term "market-based financing", the role of venture capital, private equity, and angel investing has significantly increased providing new financing opportunities for innovative, high growth potential start-ups.

As the Malaysian economy seeks revitalisation with new growth sectors taking the lead, the role of market-based financing in accelerating innovation among SMEs has never been more crucial. Market-based financing plays a pivotal role, facilitating the allocation of capital that empowers SMEs to thrive and make significant contributions to Malaysia's socio-economic development.

The objective of this research is to provide insights into the current state of access to market-based financing for SMEs in Malaysia. The study will address the awareness, willingness, and challenges faced by SMEs in accessing market-based financing and explore potential solutions to expand the reach and depth of market-based financing in Malaysia. The findings will be valuable for policymakers, the entrepreneurial community, and investors seeking to better meet the funding needs of SMEs and entrepreneurs in Malaysia.

1 https://www.bnm.gov.my/sme-financing

1.2 Why this study is important

The uniqueness of this study lies in its exclusive focus on SMEs' access to market-based financing in Malaysia. Most existing research on SME financing has primarily revolved around the banking sector and other financial institutions, including Development Financial Institutions (DFIs), factoring, and leasing companies. While we acknowledge the pivotal role banks and other financial institutions play in SME financing, our research delves specifically into the distinct potential of market-based financing to provide diverse funding options to investors and business owners. This, in turn, fosters the growth of SMEs and contributes to a thriving SME ecosystem in Malaysia.

Malaysia has long aspired to break free from the middle-income trap and transition into a developed economy. The recently launched Madani Economy Framework has set key indicators for Malaysia to rank among the World's top 30 largest economies by 2030. In alignment with this vision, the role of SMEs is to develop local business capabilities and enhance international competitiveness. In developed countries like the United States, Germany, and Canada, SMEs have contributed nearly 90% of total employment and half of the Gross Domestic Product (GDP).

Under the National Entrepreneurial Policy (DKN) 2030, Malaysia aims to increase its SMEs' contribution to GDP from the current 38.4% to 50% by 2030, aligning with the average share of SMEs in Organisation for Economic Cooperation and Development (OECD) countries. However, it is crucial not only to emphasise increasing the share of contribution but, more importantly, to undergo a paradigm shift toward enhancing the quality of SMEs. This means focusing on producing higher value-added goods and services with international market reach and the ability to generate high-paying jobs.

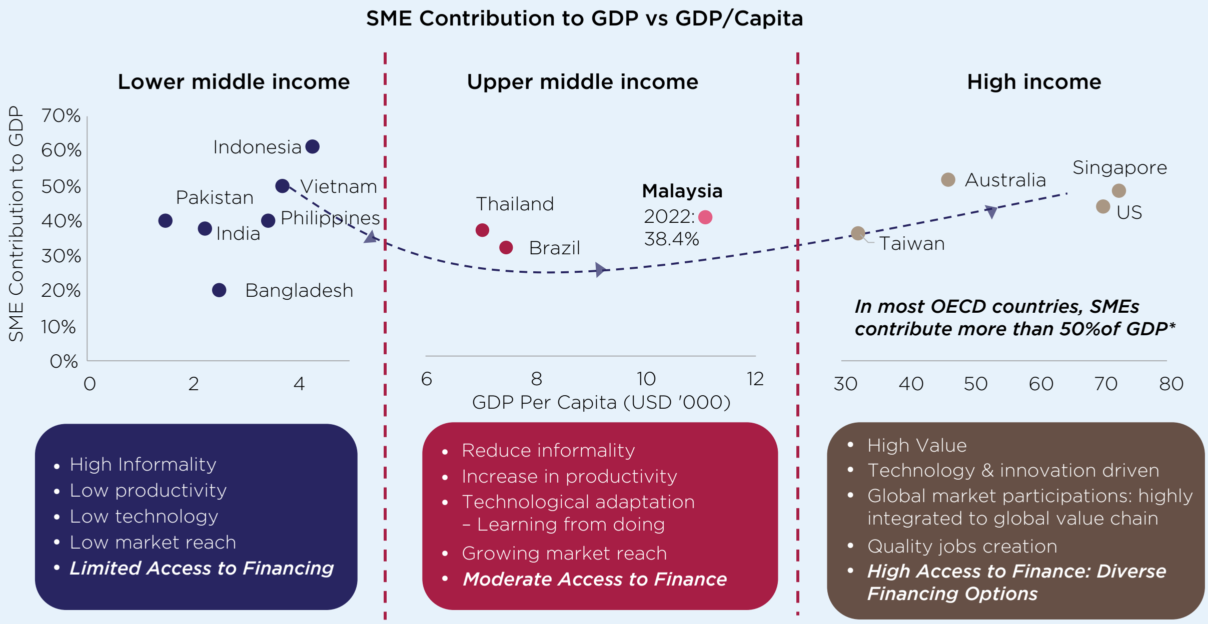
As the country progresses, SMEs become more formal and productive, with a focus on adopting new technologies and expanding their market reach (see Figure 1.1). In Malaysia's case, this shift is from an upper-middle-income economy to a high-income economy. To achieve this, SMEs require robust support for technological upgrading and innovation activities, enabling them to produce high value-added products and services while extending their reach to international markets. This will create greater opportunities for job creation, particularly in high-paying positions.

One critical determinant of SMEs' progress across various development stages is their ability to access financing. According to the International Finance Corporation (IFC), 40% of formal MSMEs in developing countries face an unmet financing need of US$5.2 trillion annually. Closing these financing gaps can be achieved through sustainable economic development, improved governance, and enhanced credit information (Fouejieu et al., 2020).

In developed economies, SMEs not only enjoy better access to financing but more significantly, they have a range of diverse financing options at their disposal. A cross-country study by the World Bank (2013) of 150 countries showed a clear pattern that as income grows, the entire financial sector which includes both the banking and the market-based sector grows. Given that SMEs often have complex and varied business models based on their life cycle stages, market-based financing can offer alternative funding solutions tailored to their needs. It matches their risk profiles and plays a complementary role alongside traditional bank financing. Furthermore, innovation is key to breaking free from the middle-income trap, and market-based financing is ideally positioned to support more risk-taking and innovation-led activities.

In alignment with the government's efforts to reform and revitalise the Malaysian economy, this research aims to explore the role and opportunities presented by market-based financing in supporting the growth of SMEs. This, in turn, will have a far-reaching impact on the broader economy. By focusing on the specific strengths and weaknesses within the current market-based financing ecosystem, our research aims to both recognise the limitations of market-based financing for SMEs as well as unlock the full potential benefits that market-based financing can bring to the growth and development of SMEs in Malaysia.

Figure 1.1:
Malaysia's SMEs transformation towards high-income journey



Source: Developed by author using various data sources

1.3 The evolving story: An increased role for market-based financing mechanisms

The role of market-based financing is becoming increasingly vital in the current geo-financing landscape. Given the shift in global macroconditions and the government's economic reform agenda as well as tighter regulations in the banking system, there is a growing need for a more diversified financing ecosystem. This is especially relevant for the SMEs which have always been disproportionately impacted by economic crises.

The current landscape for a market-based financing ecosystem in emerging markets, such as Malaysia is rapidly evolving from traditional capital markets such as equities and bond markets. To encourage innovation, capital markets in Malaysia today have broadened to offer more alternative sources of market-based financing including new platforms such as Equity Crowdfunding (ECF), and Peer-to-peer (P2P) for SMEs and entrepreneurs to seek funding.

Enabling factors which have increased the range of market-based financing options available to Malaysian SMEs today include capital market policy developments which broadly encourage innovation in Malaysia's capital markets, while at the same time, aimed at widening the investment opportunities for retail investors and addressing the lack of liquidity in our equity markets, specifically. In addition, external factors such as advancements in technology, the rise of platform business models, and the younger demographic preferences for low-cost convenient platforms have also contributed to these developments.

There is also an increased recognition that direct alternative financing platforms can offer certain benefits such as allowing for a lower amount of financing raised typically for SMEs, more flexible requirements with eased disclosure requirements and comparatively lower admission costs to better cater to SMEs. In addition, from an overall financial system perspective, the availability of broader financing options from **market-based financing mechanisms can help reduce risk concentration and improve the resilience of the financial system.**

Despite the varied policy initiatives established by the Securities Commission of Malaysia (SC) to offer a wide range of market-based financing instruments in Malaysia, our domestic financial system remains dominated by commercial banks. This gives an obvious advantage to large enterprises and government-related companies and limits access to financing for SMEs and new ventures.

However, today the vulnerability of the SMEs to shifting global macro conditions and the changing risk landscape has become more pronounced. Against this backdrop, **Malaysia's aspirations to move into a high-income economy will need to focus more on quality SMEs which rely on technological upgrading and innovation activities, enabling them to produce high value-added products and services while extending their reach into international markets.**

In particular, these newer, innovative, and fast-growing companies which have a higher risk-return profile will likely be less suited for debt financing offered by banks. Thus, the long-term success of these types of SMEs may also be dependent on the availability of a more diversified financing ecosystem which can respond to their different financing needs at different stages of their life cycle. Specifically, these SMEs will also likely face a multitude of challenges in a rapidly changing macro environment, including digitalisation and technology, climate change, the pursuit of Sustainable Development Goals (SDGs) and ESG disclosures, as well as evolving talent requirements among others. In this context, these types of

SME businesses may be more willing to explore market-based financing mechanisms which offer "knowledge capital" or "smart capital" alongside financial capital if it can better serve their firm-specific needs.

In the following section, we will delve further into the shifting structural factors above which rely on an increased role for more market-based financing mechanisms for SMEs.

1.3.1 Shifting global macroconditions

Even as the global health crisis from the pandemic gradually recedes, the aftershock on the global economy and the evolving geo-economic trends has led to higher levels of uncertainty. Global growth is decelerating, and there are mounting concerns about a global recession due to the collective tightening of monetary policy, which has raised the cost of capital for investment in productive economic activities. Geopolitical risks, xenophobia, and nationalism are influencing the flows of capital, labour, and goods. Economic sanctions, anti-migrant labour policies, and trade wars are challenging the fundamental principles of *Laissez-faire*, prompting policymakers and economists to reconsider new economic models.

While every crisis presents opportunities, the current geopolitical trends are opening up new economic prospects for developing countries like Malaysia. The transition from U.S. hegemony to a multipolar world is creating opportunities for non-aligned nations to attract Foreign Direct Investment (FDI) for reshoring and friend shoring. Malaysia's ability to offer an English and Chinese-speaking workforce will be a key comparative advantage, alongside our robust infrastructure network and various tax and non-tax incentives.

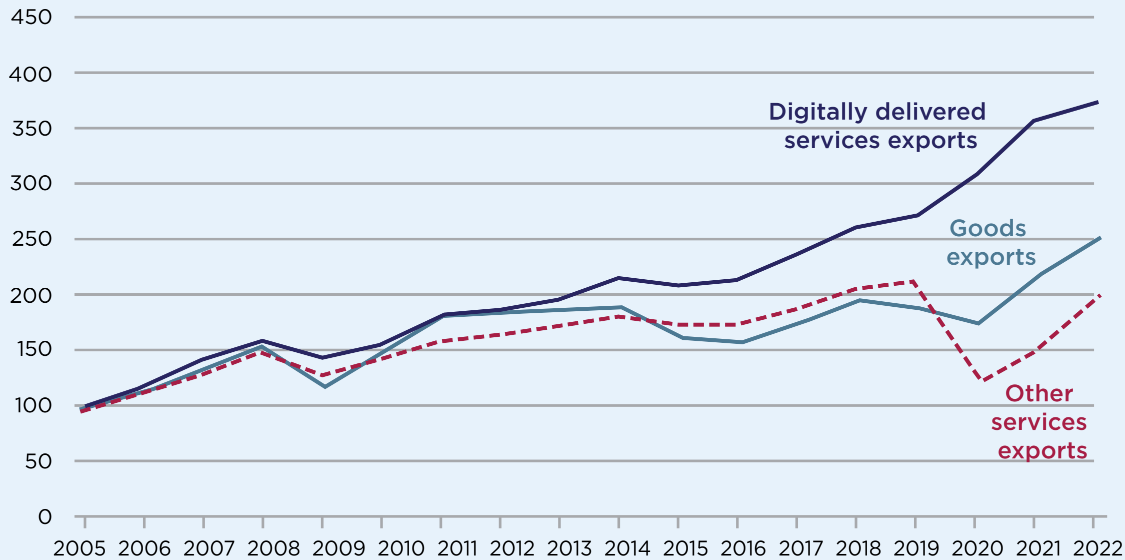
Establishing a strong value chain, especially in emerging economic sectors, will benefit the broader economy and, in particular, SMEs, by facilitating technology transfers and access to new markets.

In contrast to the growing threats to global trade, the development of digital technology, with a strong emphasis on open-source platforms, is accelerating the speed of knowledge transfer and altering the way goods reach markets. Generative Artificial Intelligence (AI) is bridging the knowledge gaps between advanced and developing countries by learning rapidly and effectively. The rapid acceleration of information flow is expected to expedite mass-market transformations, including the way global exports operate.

The services sector, particularly the export of computer services worldwide, has seen a remarkable 45% growth above pre-pandemic levels, driven by demand for software, cloud computing, machine learning, and cybersecurity.[2] Furthermore, digitally delivered services have experienced nearly a fourfold increase in value since 2005, surpassing the growth rates of goods exports and other service sectors (see Figure 1.2).

2 Based on Global Trade Outlook and statistics by WTO https://www.wto.org/english/res_e/booksp_e/trade_outlook23_e.pdf

Figure 1.2:
Fast-growing global exports of digitally delivered services



Source: World Trade Organization (WTO) estimates

Malaysia is well-positioned to capitalise on the increasing demand for digitally delivered services, thanks to its youthful, internet-savvy population, with internet usage exceeding 90%.[3] In 2022, SMEs accounted for 50.1% of total employment in the services sector. However, the services sector's share of total exports remains low at 2.0%.[4] The government has included the internationalisation of SMEs as a vital component of Malaysia's economic reforms under the Madani Economy Framework. Allocating capital for digitalisation, innovation, and technological upgrades can significantly expedite the transformation of SMEs. Both the government and the market can play pivotal roles in supporting these endeavours.

3 Department of Statistics Malaysia (DOSM) data on usage of ICT and E-Commerce establishment 2022 shows that internet usage in 2021 is at 90.6%

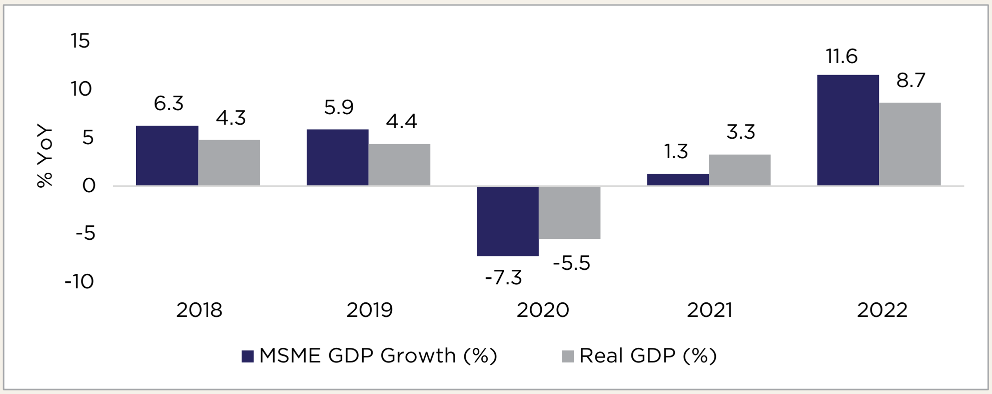
4 Micro, Small and Medium Enterprises (MSMEs) performance 2022 from DOSM

1.3.2 Facilitate Malaysia's economic reforms

MSMEs experienced a robust rebound in growth in 2022 after a sharp contraction in 2020 due to the COVID-19 pandemic, followed by a slow recovery in 2021 when MSME growth lagged the broader economy (see Figure 1.3). The government provided support to MSMEs through various incentive packages to ensure their survival during the challenging period of intermittent lockdowns. However, the circumstances have now evolved, and the support for MSMEs must transition from mere survival to fostering growth.

The recent unveiling of a multitude of economic reforms through initiatives such as the Madani Economy Framework, the NETR Phase I, the New Industrial Masterplan 2030, and the Mid-term review of the 12th Malaysian Plan has set the direction and laid the pathway for transforming Malaysia into a "Prosperous, Inclusive, and Sustainable" nation. These reforms have identified several key indicators, with the transformation of SMEs into new drivers of growth that can compete in international markets being a focal point. Under the National Entrepreneurial Policy (DKN) 2030, specific targets have been established to increase SME contributions to GDP, employment, and exports to 50%, 80%, and 30% respectively by 2030.

Figure 1.3:
MSMEs rebounded strongly in 2022 Malaysia's real GDP growth



Source: DOSM, CEIC

As the backbone of the Malaysian economy, the development of SMEs is a critical component of Malaysia's journey toward becoming a truly developed nation. To meet these ambitious targets, aspiration alone is inadequate and must be complemented by effective execution. The realisation of the DKN 2030 vision demands the cultivation of a robust SME ecosystem fuelled by technological advancements, an innovation-centric economic growth strategy, and robust institutional support. It envisions a substantial integration of Malaysian SMEs into global value chains, a goal further facilitated by initiatives like the CPTPP and RCEP, reinforcing the nation's commitment to fostering a competitive and interconnected SME landscape.

As such, addressing financing challenges emerges as a critical factor in fortifying the SME ecosystem. The SME Association of Malaysia has called on the government to allocate more capital to facilitate the transformation of SMEs in line with the industrial and digital revolution to ensure their competitiveness.[5] While the government has a pivotal role to play in supporting SME financing, it cannot solely meet the funding requirements for the transformation of SMEs and Malaysia's economy.

A combination of public, private, international capital, and philanthropic contributions is essential to achieve inclusive and sustainable progress. In this respect, market-based financing plays a special role in supporting innovation and SME transformation, a point emphasised in the Prime Minister's speech during the launch of Madani Economy. Market-based financing is vital for assisting startups, MSMEs, and MTCs by attracting investments from both domestic and foreign sources. Facilitating risk capital and growth capital for investments in the country's new growth strategy is crucial to ensure the success of the nation's economic reform agenda under the Madani Economy initiative.

1.3.3 Diversification in the financing ecosystem

Since the financial crisis of 2008/2009, Western economies' banking sectors have shifted their focus to deleverage and have imposed stricter regulatory capital requirements. The introduction of Basel III aims to restrict excessive leverage within the banking system to enhance overall bank stability. However, this has had repercussions on access to credit, especially for SMEs, which are often perceived as riskier compared to larger corporations and households. In response, international institutions like the OECD and the European Union (EU) have underscored the significance of market-based financing as a source of diversified funding, employing risk-sharing instruments to support various business sectors, particularly SMEs.

Among Southeast Asian economies, the average share of MSME loans to GDP from 2010 to 2021 stood at 14.2%, with non-banking financing to GDP for the same period at only 4.2%. Nevertheless, the growth in banking credit to national GDP contracted by 3.3% annually, whereas non-bank and market-based financing exhibited an increase of 13.4% annually during the same period. This highlights the increasing reliance of SMEs on non-bank and market-based financing, even though banking credit remains a major source of funding in the region.

In Malaysia, a similar process of bank deleveraging began much earlier, stemming from the 1997/98 financial crisis. Between 2000 and 2010, domestic credit to the private sector from banks declined from its peak of 152% of GDP in 1997 to below 100% of GDP in 2008. In response, corporate bonds and Sukuk, an instrument under market-based financing, emerged to bridge the credit gap left by the banking sector. The corporate bond market grew substantially, increasing from less than 1% of GDP in 2001 to 45% of GDP in 2020. This shift toward market-based financing was strategically planned in the Capital Market Masterplan I by SC, coinciding with banking sector consolidation under the Financial Market Master Plan I by BNM.

While there is evidence that the role of market-based financing for SMEs is gaining global traction, it is also important to note that market-based financing should not be viewed as a substitute for banking credit. Rather, the emphasis should be on understanding the need for a diversified financing ecosystem that can cater to businesses with varying risk profiles. Direct market-based investments can carry higher risks compared to traditional banking credit as market-based financing shifts the risk to investors, whereas excessive credit risk can be detrimental to public savings and lead to systemic economic failures.

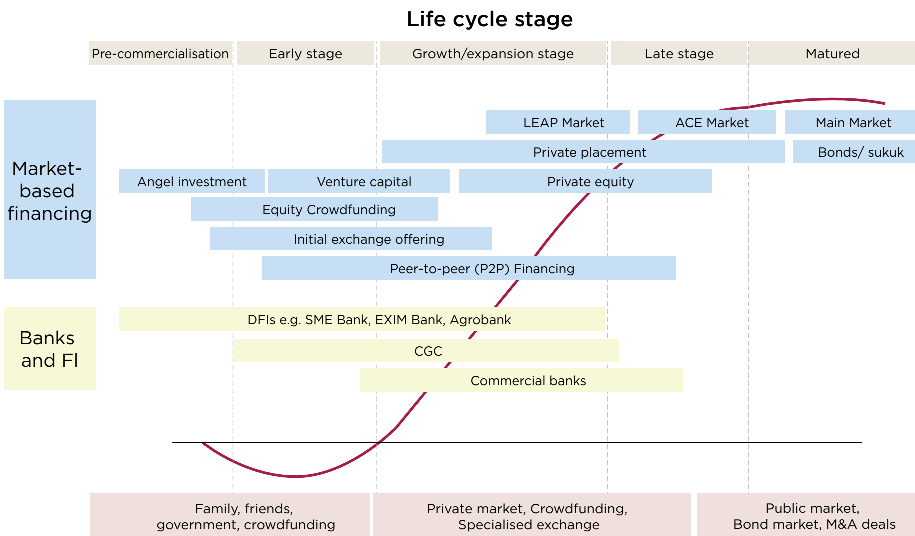
5 https://www.nst.com.my/news/nation/2023/07/935636/sme-malaysia-calls-government-support

A well-developed capital market can efficiently allocate capital to innovative and productive economic sectors. However, not all capital market instruments are suitable for SME fundraising, primarily due to the high cost of issuance, scalability, liquidity, and investor demand. **Market-based financing also requires regulations and policies which reduce risk and strengthen investor protection without eliminating the SMEs' contribution to long-term economic growth.**

This, however, requires an understanding of which types of market-based financing are conducive to economic growth and which ones can increase its fragility and the probability of more market failures. Given that each type of financing has its own merits and limitations, policy initiatives which have led to more innovative financing instruments are being introduced, including but not limited to, hybrid financing models where the banking sector and market-based financing can coexist and complement each other. Both banking sector and market-based financing institutions can collaborate to establish comprehensive guidelines and overarching policy strategies. This collaborative effort should aim to alleviate the burden on SMEs by simplifying complex compliance requirements, including those related to sustainability disclosures. For example, the Joint Committee on Climate Change (JC3), co-chaired by BNM and Securities Commission of Malaysia (SC) established collaborative actions for building climate resilience within the Malaysian financial sector, while Capital Markets Malaysia launched the Simplified ESG Disclosure Guide (SEDG) for SMEs in Supply Chains in October 2023.

Diversifying financing options is imperative to accommodate the evolving needs of SMEs at different stages in business life cycles, meeting the growing demand for funding (see Figure 1.4). Many SMEs encounter difficulties in accessing financing, especially in their early stages. As a result, they often resort to informal sources like self-financing or assistance from family and friends.[6] Early-stage businesses, with limited credit history and operating in high-risk environments without substantial tangible assets, find it challenging to secure traditional straight debt financing.

Figure 1.4:
SME financing across life cycle stages



Source: Adapted from BNM & SC

6 According to Bank Negara Malaysia survey in 2018, 51% of MSMEs relied on self-financing and 17.0% were funded by family and friends.

Similarly, emerging high-growth areas may entail higher risks, necessitating an innovation ecosystem that embraces the potential for failure—an aspect that may not align well with the risk-averse nature of traditional banking. This is where private capital plays a pivotal role in supporting entrepreneurs, from the inception of their ideas to commercialisation, and eventually, reaching mature stages suitable for the public market. Government intervention can encourage partnerships with private investors, fostering support for startups and technopreneurs, thus further promoting the growth of innovative sectors. Government grants can help facilitate innovation and further serve as a signal or validation for private capital to crowd-in investment in high-risk innovation activities.

Moreover, the increasing rate of internet penetration and digitalisation within both the public and business communities have created fertile ground for crowdfunding financing to flourish in Malaysia. People can now directly invest in businesses through platforms like ECF and P2P financing, offering businesses and investors direct access to meet their various financial needs. RMOs facilitate the flow of capital supply and demand, cultivating a dynamic market for financing SMEs and fostering a thriving entrepreneurial ecosystem.

Regulators are also exploring innovative ways to enhance access to market-based financing, recognising that not all capital market instruments are suitable for addressing SMEs' financing requirements. In 2017, Bursa Malaysia introduced a specialised SMEs market known as Leading Entrepreneur Accelerator Platform (LEAP), aimed at bringing together SMEs, sophisticated investors, intermediaries, and advisers onto a single platform to create a conducive marketplace for raising funds. The LEAP market is expected to offer transparent capital formation and price discovery mechanisms compared to private markets.

1.3.4 Support beyond financial capital

For SMEs, it is worth delving deeper into understanding the role of market-based financing mechanisms which involve investors and the intermediaries and their relationship with the SMEs or startups they fund. There are various financing sources, such as angel investments, Venture Capital (VC) funds, Corporate Venture Capitals (CVCs), LEAP market, ECF, and P2P lending which are characterised by different motivations, targets, scale, and operating models, but are highly complementary in the financing continuum, especially for early-stage firms. For instance, VC funds, private equity firms, and business angels provide more than just the provision of financial capital to SMEs. The structure of their financing arrangements includes their own equity stake in the SMEs or startups, which incentivises them to ensure the success of the businesses.

This inherently provides them with a motivation to extend support beyond financial capital to the startups or SMEs, which can include the sharing of expertise, financial planning, knowledge transfers, business guidance, enhancing market access, networking opportunities, assistance with business strategies, governance issues including ESG, and talent development and acquisition.

For example, let's consider a young entrepreneur with a brilliant idea for commercialisation but lacks the experience and knowledge to bring the product or service to the market. Venture capitalists, CVCs, and ECF platforms can step in to offer valuable support through direct engagement with the businesses or by providing capacity-building programmes through training, networking, and establishing strategic partnerships with industry leaders.

This mentorship and guidance empower SMEs to navigate the complexities of the market, develop effective branding strategies, efficiently manage their businesses, and attract the right talent needed for success.

Government grants, seed capital from angel investors, and backing from ECF platforms serve as crucial validations of a startup's credibility, rendering it more attractive for subsequent funding rounds as it grows. This recognition opens doors to additional capital, bolstering the startup's position for future success. Despite the fact that ECF platform as a business is not required to provide additional support to issuers after the post-ECF event, doing so demonstrates its quality and credibility. In line with Ordanini, Miceli, Pizzetti and Parasuraman (2011), the ECF platforms, on top of connecting the financiers and fundraisers, also act as a marketing platform for the ventures to introduce and promote their products and services. When the products or services offered meet their expectation, investors can also eventually become consumers. Thus, it helps to increase the number of customers, increase sales, and encourage performance.

Consider Dropbox, a cloud storage and file-sharing service that participated in the Y Combinator (YC) accelerator and funding programme. The programme not only provided capital in the form of funding but also offered intensive monitoring, business advice, and networking opportunities. The mentorship received from YC played a pivotal role in the early success of Dropbox, which has now become a well-known brand in the cloud storage platform industry. YC has since become a major player in Silicon Valley, contributing to the emergence of numerous companies valued at over $1 billion today, including Stripe, Airbnb, Instacart, and Coinbase.[7]

By combining financial support with knowledge-based capital or smart capital, market-based financing can play a central role in connecting the various enablers within the SME ecosystem, allowing it to flourish. It acts as a vital catalyst for fostering growth, innovation, and sustainable development for startups, MSMEs, and MTCs. Through this multifaceted approach, market-based financing can be a powerful enabler for the success of SMEs, propelling them towards realising their full potential and making a significant impact on the economy.

7 https://www.cnbc.com/2018/03/23/y-combinator-notched-its-first-ipo-with-dropbox.html

1.4 Objectives of the study

To make market-based financing a viable funding source for SMEs, this study will critically assess the challenges and willingness of SMEs to access market-based financing instruments in Malaysia. The policy recommendations arising from this study are expected to further strengthen the access to capital for SMEs using market-based financing, especially to support the new growth economic sectors as part of the structural reform under the Madani Economy, National Energy Transition Roadmap (NETR) and New Industrial Master Plan 2030 (NIMP) frameworks. The SMEs will continue to be the backbone of the Malaysian economic growth to become prosperous, inclusive, and sustainable.

The study aims to meet the following objectives:

1. To understand the role of market-based financing to support SME's financing needs in Malaysia.
2. To identify challenges and awareness surrounding market-based financing for SMEs
3. To identify solutions that could accelerate access to market-based financing and better serve the financing needs of the SMEs.
4. To identify the opportunities of market-based financing to strengthen the SME ecosystem in Malaysia.

By identifying the underlying issues and addressing the current financing challenges, the research aims to improve the financing landscape in Malaysia. The role of market-based financing goes beyond funding, also to ensure it is connected strongly with the success of the SME ecosystem in Malaysia.

1.5 Scope of the study

This study focuses on market-based financing, also known as capital market financing, which encompasses various instruments such as Initial Public Offerings (IPO) (which include listing of shares on the MAIN, ACE, and LEAP markets), Bond instruments (Debt securities), Venture Capital (VC), Private Equity (PE), ECF, and P2P financing.

To comprehend the capital needs, we have conducted an enterprise-level survey to assess the financing history of SMEs in Malaysia and gauge their awareness and interest in utilising market-based instruments for financing in the future. We will also investigate the impact of digitalisation initiatives and ESG practices at the firm level on accessing market-based financing. Furthermore, we interviewed MSMEs, startups, and MTCs to gather their feedback and identify potential solutions to address their financing issues.

On the supply side enablers, we conducted qualitative interviews with various key stakeholders within the SME ecosystem, including regulators, advisers, RMOs, government agencies, and investors, to obtain their perspectives on the issues and challenges related to financing SMEs. This will aid us in bridging the gaps between the supply and demand of capital for financing SMEs and identifying potential solutions to address these gaps.

Throughout this study, we performed quantitative and qualitative analysis by categorising the sample based on the following classifications: Start-ups, MSMEs, and MTCs. The categorisation of Startups, MSMEs, and MTCs will adhere to the official definitions provided by the respective government agencies, as depicted in Figure 1.5.

Figure 1.5:
Definition of MSMEs, Mid-tier Companies, and Startups

Manufacturing		Services and others
Annual revenue RM50 million ≤ RM500 million	MTC	Annual revenue RM20 million ≤ RM500 million
Annual sales turnover RM15 million ≤ RM50 million OR Number of employees 75 ≤ 200	Medium	Annual sales turnover RM3 million ≤ RM20 million OR Number of employees 30 ≤ 75
Annual sales RM300,000 < RM15 million OR Number of employees 5 < 75	Small	Annual sales turnover RM300,000 < RM3 million OR Number of employees 5 < 30
Annual sales turnover < RM300,000 OR Number of employees <5	Micro	Annual sales turnover < RM300,000 OR Number of employees < 5
Startup, as defined by MOSTI in 2021, is " a technology or innovation enabled business at an early stage, with a scalable business model and a high growth strategy.		

Source: SME Corp. Malaysia, MATRADE and MOSTI

1.6 Conclusion

In short, market-based financing plays a pivotal role in empowering SMEs to flourish in today's dynamic business landscape, characterised by the internet, innovation, knowledge, and technology. This financing approach offers a range of funding options, including listing opportunities (IPO), VC, PE, ECF, and P2P lending. By providing access to these diverse funding sources, market-based financing addresses the challenges posed by limited collateral and credit history, reducing reliance on a single funding channel and enhancing financial resilience.

However, the role of market-based financing extends beyond mere funding provision. It offers valuable support to SMEs in various ways, including mentorship, networking opportunities, access to markets, partnership building, validation, and fostering trust, especially for new startups. This comprehensive support ecosystem significantly contributes to the growth and success of entrepreneurs.

In addition, it is also important to recognise that market-based financing requires regulations and policies which reduce risk and strengthen investor protection without eliminating the SMEs' contribution to long-term economic growth. The role of policymakers and regulators is to tackle market failures which can increase market fragility. This is, however, fundamentally linked to understanding the different needs of different types of SMEs.

This study recognises that market-based financing covers a wide range of SMEs' business models and their life cycle stages, which necessitates different types of funding. For instance, not all SMEs have growth ambitions requiring equity funding. The World Bank (2013) identified that many SMEs fail within a few years of establishment, and many of the surviving SMEs do not grow much beyond their starting size, with only about 5 per cent considered "competitive SMEs" with high-growth prospects but which contribute disproportionately to overall economic performance.[8]

This study aims to address both common challenges and specific challenges based on the type of business, whether they are MSMEs, MTCs, or Startups. By encompassing this diverse array of business models and life cycle stages, the study seeks to gain comprehensive insights into the SME financing ecosystem. However, the diversity among SMEs may present challenges in drawing universal conclusions, as the needs and requirements of each type of business can vary significantly.

One limitation of this study is the lack of comprehensive data on the actual demand for market-based financing. Unlike the well-established banking sector, market-based financing is relatively new, especially in emerging markets such as Malaysia, and its demand is not adequately measured. Time series data is limited, particularly for instruments specifically tailored to MSMEs, such as the LEAP market, ECF and P2P financing, which are relatively recent additions to the Malaysian capital markets.

Nonetheless, we believe that the findings of this study remain crucial for policymakers, industry players, investors, and SMEs themselves, given that market-based financing continues to evolve and expand its reach among SMEs. It is poised to drive a new era of entrepreneurial success and strengthen the entrepreneurial ecosystem in Malaysia. This, in turn, is aimed at facilitating Malaysia toward becoming a developed nation in the years to come. The ongoing growth of market-based financing holds significant promise for fostering innovation, enabling sustainable growth, and driving economic progress as part of the economic reforms in Malaysia.

8 The report identified that by their seventh year, 60 per cent of firms have exited, around 20 per cent remain self-employment or single proprietor firms, 15 per cent are small and medium firms but with low or stagnating growth. The last segment accounting for less than 5 per cent of the cohort have a strong growth history and good growth prospects – and are a powerful engine of new growth and innovation.

Chapter Two

The Current Landscape of Market-based Financing in Malaysia

The landscape of SME financing in Malaysia has undergone substantial changes, especially in the aftermath of the 1997/98 Asian Financial Crisis. Key reform blueprints, such as the Capital Market Masterplan and the Financial Sector Masterplan, led by the SC and BNM respectively, have played pivotal roles as instrumental frameworks driving capital market and financial sector reforms in Malaysia. These masterplans have served as catalysts for implementing diverse structural changes, with a particular emphasis on expanding the array of financing instruments accessible to local businesses. Notably, a consistent theme throughout these masterplans is the persistent commitment to prioritising support for SMEs, acknowledging their vital role in the economic landscape.

In this chapter, our attention is to unveil the current landscape of market-based financing in Malaysia. This involves a comprehensive exploration of the diverse market-based financing instruments currently available in the Malaysian market. We delve into their performance, examining their effectiveness and impact on SMEs. Furthermore, our investigation extends beyond national borders as we draw comparisons between Malaysia and its regional peers, offering valuable insights into relative strengths and areas for improvement.

2.1 Overview of SMEs in Malaysia

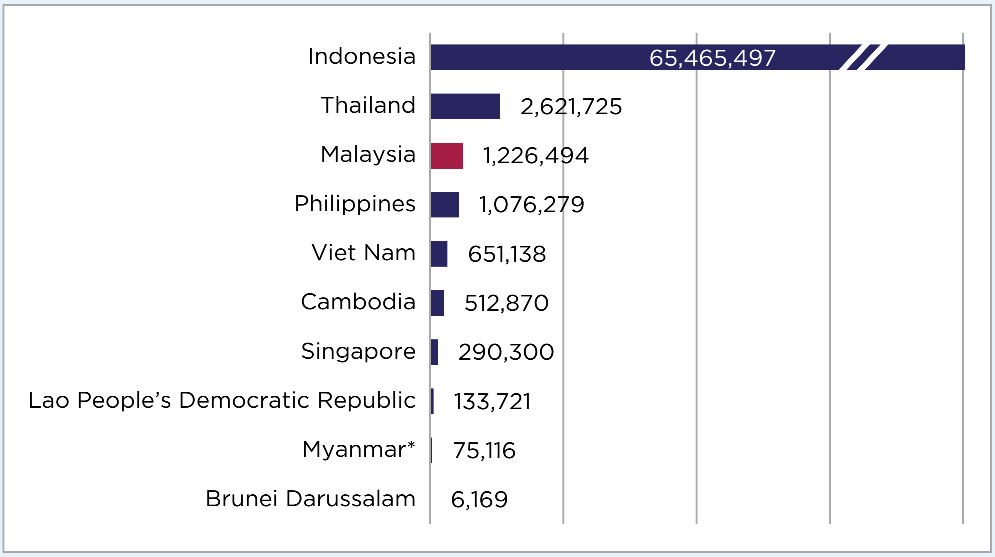
The SMEs are critical driver of economic development in the Association of Southeast Asian Nations (ASEAN) region. Currently, the region has over 72 million registered SMEs, with Indonesia alone accounting for a significant 91% of the total registered SMEs in ASEAN (refer to Figure 2.1). SMEs play a crucial role in contributing 44.8% to the GDP and providing employment for 85% of the workforce in the region.[9] Furthermore, SMEs constitute between 97% and 99% of all registered business establishments in the area.

Malaysia ranks just after Thailand with the third-highest number of registered SMEs in the region. In 2022, approximately 97.4% of business establishments in Malaysia fall under the SME category. The SMEs contribute 38.4% to Malaysia's GDP in 2022, reflecting a gradual increase from 37.0% in 2015. In the regional context, Indonesia leads with the highest SME contribution to GDP, followed by Singapore at 61% and 44% respectively.

While Thailand initially registered a higher SME contribution to GDP at 41% in 2015, this figure dropped significantly to 34.6% in 2021 following the challenges posed by the COVID-19 pandemic.

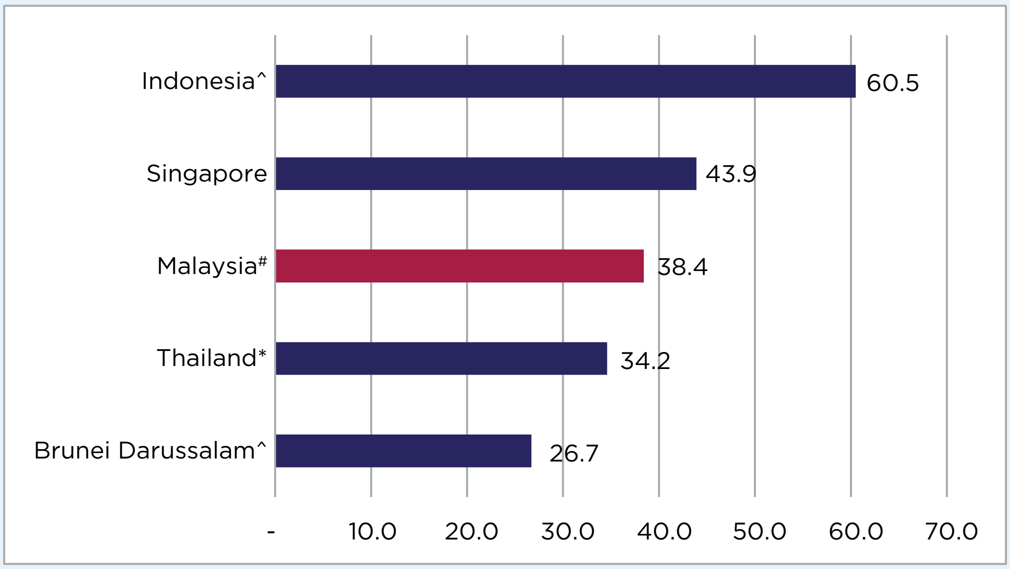
9 development of Micro, Small, and Medium Enterprises in ASEAN (MSME), ASEAN

Figure 2.1:
Number of SMEs in 2021



*Source: ADB Asia SME Monitor,[10] *Year 2020, ^Year 2019*

Figure 2.2:
Share of SMEs contribution to GDP (in %) in 2021



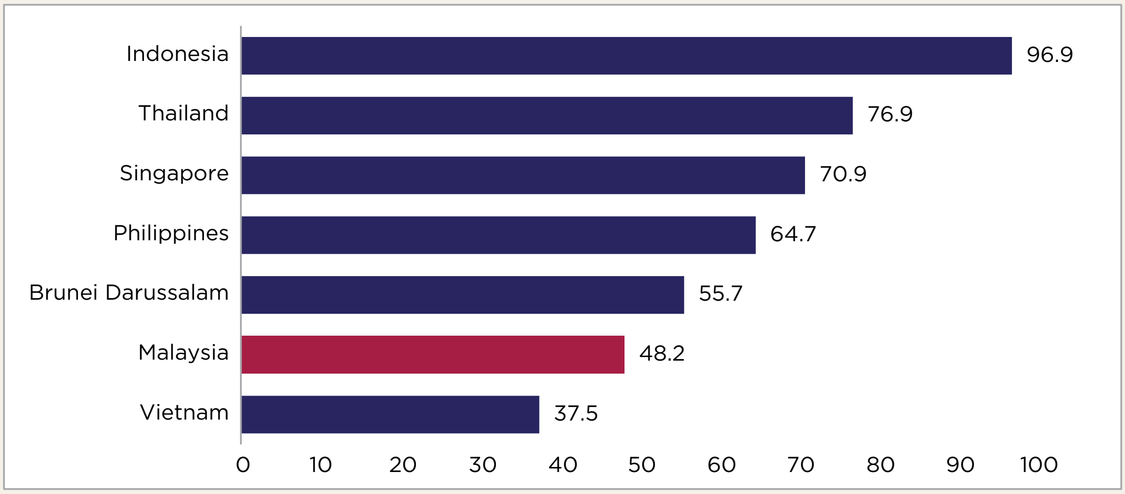
*Source: ADB Asia SME Monitor 2022. *Year 2020 ^Year 2019 # Malaysia 2022 data from DOSM*

10 Data from ADB Asia SME Monitor is provided based on definition of MSME categories

The services sector which encompasses mainly wholesale & retail activities, has consistently contributed more than 80% of all MSMEs throughout the span of 2015 to 2022 period. Zooming on to 2022 structure, services sector retained its position as the largest sector at 84.7% and construction sector at 7.9%. About 5.6% of MSMEs are concentrated in manufacturing sector, followed by 1.4% in agriculture sector while the remaining 0.4% in mining & quarrying sector. In terms of business size, microenterprises are the largest component of MSMEs, accounting for 78.7% of the total MSME establishments in 2022, small-sized firms comprised of 19.7% and medium-sized firms constituted the balance 1.6%.

Across most ASEAN countries, SMEs serve as the primary source of employment, ranging from as high as 96.9% in Indonesia to the lowest at 37.5% in Vietnam. In Malaysia, the employment share for SMEs stood at 48.2% in 2022, experiencing a marginal increase in contribution of less than 2% over the past seven years (from 46.6% in 2015). The majority of SME employment in Malaysia occurs in the services sector, followed by manufacturing and agriculture.

Figure 2.3:
Share of MSMEs contribution to employment (in %)



Source: ADB Asia SME Monitor 2022. Data for Malaysia is as of 2022; Philippines, Singapore, and Thailand as of 2021; Brunei, Indonesia, and Vietnam as of 2019

Non-MSME labour productivity has consistently remained 1.5 times higher than that of MSMEs since 2015. This disparity is attributed partly to the productivity gains of larger firms which have been supported by increased capital investment and a greater presence of highly skilled workers. The most significant labour productivity gap was observed in the mining & quarrying sector, standing at 12.3 times higher for non-MSMEs. Nonetheless, MSMEs in this sector achieved the highest productivity value, reaching RM137,490 per worker in 2022 while the construction sector reported the lowest productivity at RM39,080 per worker (SME Corp. Malaysia, 2024). The construction sector emerges as the least productive sector in SMEs in Malaysia, suggesting a potential need for sectoral reorganisation towards technology and capital-intensive approaches, reducing reliance on manual labour, especially from foreign workers.

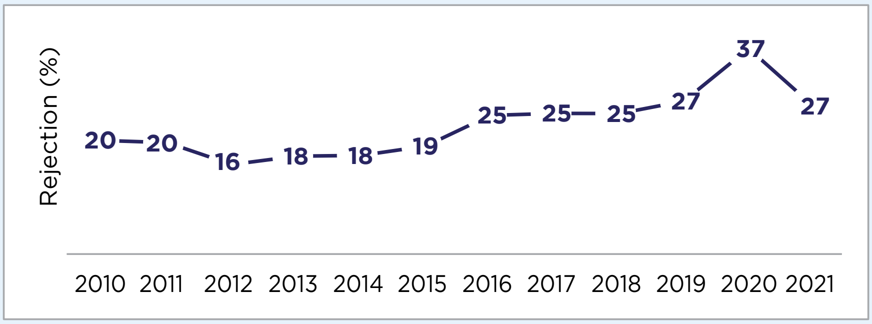
Despite the domestic focus, Malaysia's SMEs exhibit a declining share of exports, dropping from 17.7% in 2015 to 10.5% in 2022. Manufacturing services contribute the largest share at 8.3%, followed by services at 2.0%, and agriculture at 0.2%. Emphasising internationalisation becomes crucial to fostering growth and competitiveness in the global market. Facilitating integration with global value chains is imperative to internationalise SMEs in Malaysia effectively.

2.1.1 Financing SMEs in Malaysia

The role of the banking sector and non-bank financing institutions (NBFI) in supporting SME development varies across the region. Vietnam, Indonesia, and Malaysia heavily rely on bank financing, while Brunei primarily supports SMEs through finance companies and pawnbrokers. It is crucial to note that data representing NBFI collected from each country may differ based on how each country classifies NBFIs.

In Malaysia, SMEs remain highly dependent on bank financing, which contributes to more than 90% of total financing. Nevertheless, the share of SME financing relative to total bank loans has been decreasing over the past five years, predating the COVID-19 pandemic. The SME loan share declined from 18.3% in 2017 to 15.4% in 2021. Additionally, the rejection rate for SME loans has increased over the years, rising from 16% in 2012 to 37% in 2020 (refer to Figure 2.4). The majority of bank lending is directed towards financing the household sector, comprising 59% of total bank loans in 2022. While the banking sector continues to play a critical role in financing SMEs, it is important to diversify the financing opportunities available for SMEs in Malaysia.

Figure 2.4:
Rejection rate for SME loans

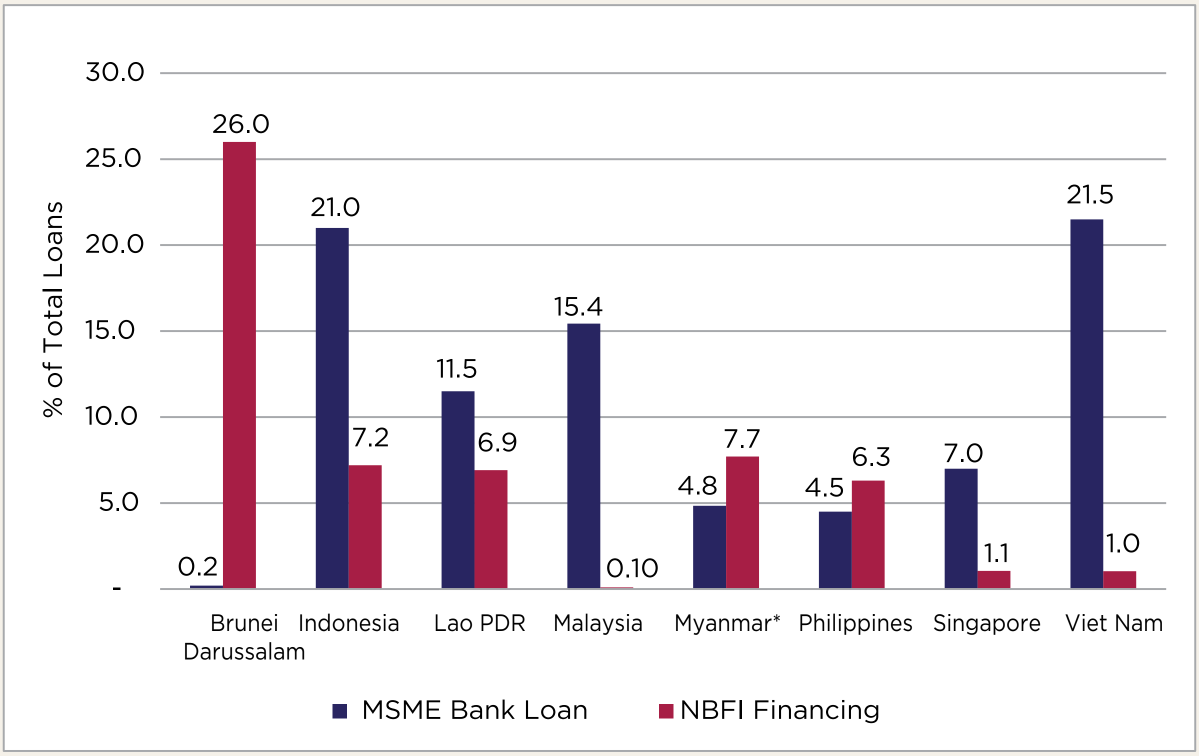


Source: ADB Asia SME Monitor

Despite various initiatives to diversify the sources of financing for SMEs, the share of NBFI to total loans in Malaysia is the lowest among regional peers (refer to Figure 2.5).[11] In Malaysia, NBFI data only includes private equity, venture capital, factoring, and leasing companies, omitting information on pawnshops and other money lending entities. This differentiation could be attributed to the fact that licensing for moneylending and pawn brokerage falls under the Ministry of Housing and Local Government, not the Ministry of Finance (MOF) or BNM. Additionally, post the 1997/98 financial crisis, many finance companies underwent consolidation and mergers to enhance the resilience of the banking sector in Malaysia (Cook, 2003). This may result in a lower contribution of financing companies to total loan in Malaysia.

11 However, it is key to recognise that the definition of NBFI is not uniform across the region, and data discrepancies may be a significant factor in the observed variations

Figure 2.5:
Share of bank loans and NBFI financing across ASEAN



Source: ADB Asia SME Monitor

*Notes: End-of-year data except * fiscal year data (ended 31 March in Myanmar). Brunei Darussalam: B$ million (finance companies and pawnbrokers); Indonesia: Rp billion (finance companies, microfinance institutions, and government pawnshops); Lao PDR: KN million (microfinance institutions, pawnshops, and leasing companies); Malaysia: RM million (private equity, venture capital, factoring, and leasing companies); Myanmar: MK million (microfinance institutions); Philippines: P million (credit unions and cooperatives [2015-2018], pawnshops [2009-2018], and nonstock savings and loans associations [NSSLAs; 2014-2020]); Singapore: S$ million (finance companies); Viet Nam: D million (People's Credit Funds and microfinance institutions).*

To ensure that SMEs can reach their growth potential, diversified access to financing is crucial, a point that will be continually emphasised in this report. In the following section, market-based financing options will be categorised into three classifications: public market, private market, and alternative financing. An analysis of selected instruments will be conducted, considering market size, liquidity, and Malaysia's position within the regional market. This will provide a comprehensive understanding of various financing options available in Malaysia and its challenges, facilitating the development of SMEs in Malaysia.

2.1.2 Public market

Public markets are financial markets where securities are traded on an exchange. Companies seeking additional capital may opt to be listed on the public market by undergoing an IPO. In Malaysia, there are three market options for IPO: the Main, ACE (Access, Certainty, Efficiency), and LEAP markets. In addition to being a broader source of capital for SMEs, the public market is also typically viewed as a means of strengthening a company's brand and profiling to enhance its credibility as well as an exit strategy or access to liquidity for the founders and/or investors of the SME. Being a listed company provides a level of confidence not only to potential investors, but also potential partners or consumers which helps to strengthen the SME's market presence.

Each market is unique in terms of listing criteria, target companies, and investor accessibility. The main characteristics of each market are:

i. Main Market is for established companies that meet Bursa Malaysia's quality, size, and operations standards for listing. A profit track record or minimum market capitalisation must be reached to list on the Main Market. The Main Market may be accessed by institutional and retail investors.
ii. ACE Market is a sponsor-driven market designed for companies with growth prospects. Sponsors must assess the suitability of the potential issuers, taking into consideration attributes such as business prospects, corporate conduct, and adequacy of internal control. Both institutional and retail investors can invest in ACE Market.
iii. LEAP Market is an adviser-driven market which aims to provide emerging companies, including SMEs with greater fundraising access and visibility via the capital market. It is accessible only to sophisticated investors.

As the LEAP is a specialised market catering more specifically to SMEs, this report will focus on analysing the LEAP market. This market plays a crucial role in providing financing options for SMEs and will contribute valuable insights to the report.

LEAP market

The LEAP market was launched in 2017, as a specialised market to provide fundraising access, mainly to SMEs via the capital market in Malaysia. The main advantage for LEAP compared to the private market is the role of the exchange to provide efficient and transparent capital formation and price discovery mechanisms. To ensure SMEs are able to access to the capital market, the listing requirements for the LEAP were made more flexible with facilitative rules and regulations as well as aiming for lower cost of compliance.

Bursa Malaysia has distinguished its LEAP market from its regional counterparts' SME exchanges through a notable feature: its less stringent approach to attract Malaysian SMEs. Unlike many SME exchanges in other jurisdictions that impose requirements such as profit-testing or basic capital assessments, the LEAP market is positioned for SMEs by adopting a more flexible stance (refer to Figure 2.6). This approach aligns with the OECD's perspective on SME exchanges, emphasising a focus on SMEs' risk and performance rather than merely firm size.[12]

12 In OECD's report of Opportunities and Constraints of Market-Based Financing for SMEs, Public equity markets, specifically SME Exchanges, can be perceived as natural platforms for equity financing of those SMEs that have important growth prospects, with a specific focus on the firms' risk and performance characteristics rather than on their size.

Figure 2.6:
Listing requirements of selected specialised SME exchanges

Stock exchange	With Profit-testing requirement
MAI, Thailand	At least **2 years of operating track record**, and minimum net profits from operations of **THB 10 million** over the latest year, there must be an accumulated net profit in the period prior to the filing of an application
SME, Philippines	Must have a cumulative **EBITDA** of at least Php 15 million **OR** cumulative operating revenue or sales of at least Php 150 million for the last 3 years
Stock exchange	**Other form of Capital requirements**
GEM, Hong Kong	Does not directly imply a need for profit-testing but requires a positive cashflow from **operating activities** of at least **HKD 20 million** in aggregate for the two years preceding the listing
Acceleration, Indonesia	**No profit-testing,** follow requirements of Small and Medium **Asset Sized** Company regulated by POJK 53: **Asset ≤ Rp250 billion**
Catalist, Singapore **(For high-growth, not specifically SMEs)**	**No profit-testing** but requires **base capital of SGD 250k**

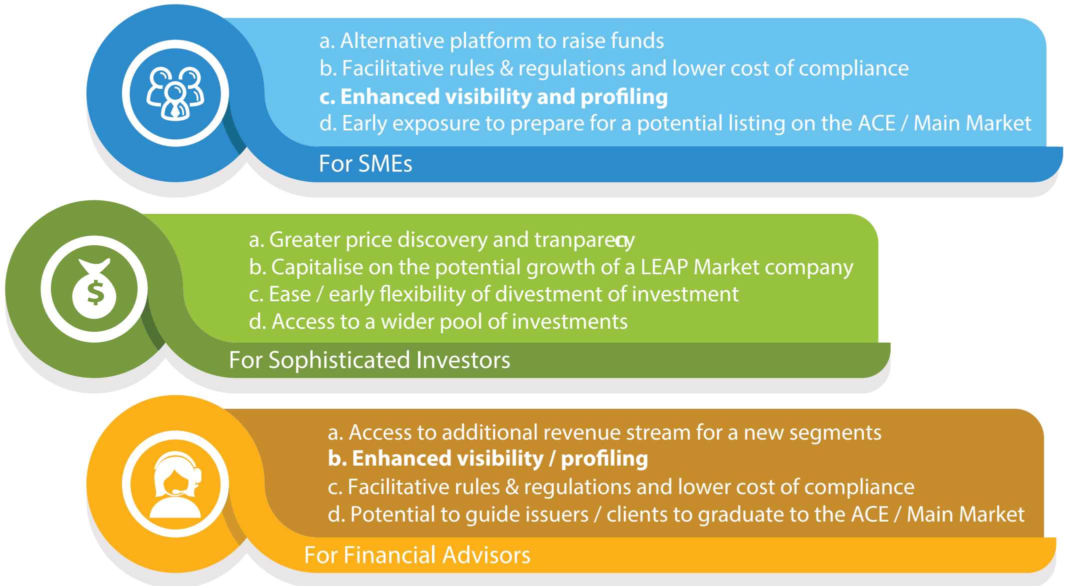
Source: Listing requirements from respective exchanges

The absence of profit-testing or basic capital requirements aims to facilitate a smoother listing process and specifically cater to the unique needs of Malaysian SMEs. With a focus on minimal documentation, the LEAP market promises a quick process of application to listing. In fact, Bursa Malaysia's official listing information suggests that this entire process can be completed in a mere three weeks.

The requirements for listing on the LEAP market include:

i. SMEs must be a public company incorporated in Malaysia.
ii. Has a clear identifiable core business.
iii. 10% public shareholding spread at the point of admission only.
iv. Meets the suitability assessment by an approved financial adviser.
v. Does not require a minimum profit or operation track record, nor is there any minimum market capital requirement.

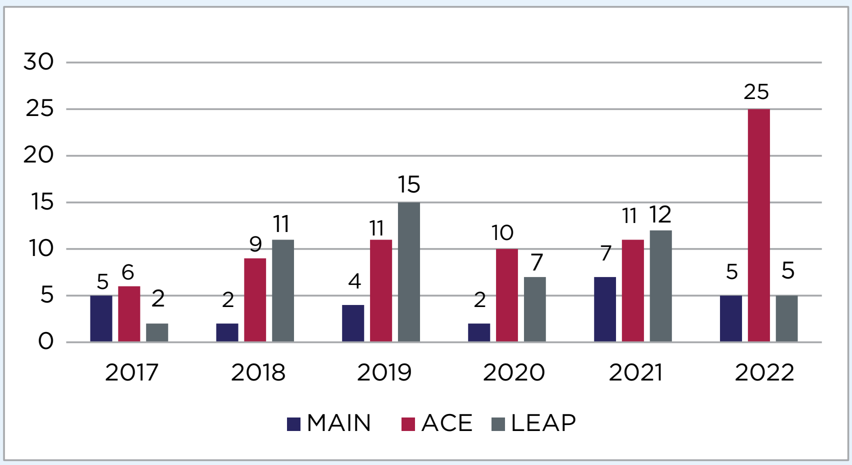
Figure 2.7:
LEAP market value proposition



Source: SME Corp. Malaysia, SME Annual Report 2016, Chapter 6, Access To Finance

The LEAP market in Malaysia provides a new investable asset class for sophisticated investors as well as open listing opportunities for SMEs. There are currently 47 companies listed in the LEAP market in Malaysia. Over the period from 2017-2022, LEAP has showcased considerable growth. LEAP has a listing of an average of 10 companies annually, securing an average funding of RM3.7 million per listing and the upward trajectory of the LEAP market is evident.

Figure 2.8:
Number of listings on Malaysia's MAIN, ACE & LEAP markets



Source: Bursa Malaysia

Since its inception in 2017, LEAP has registered a strong 55.6% compounded annual growth rate for the period 2018 to 2022, whereas ACE and the main market has registered 29.0% and 0.1% respectively for the same period. Nonetheless, the strong growth rate could be mainly attributed to the low base effect, where the LEAP was first introduced only in 2017. Within the region, number of companies listed and market capitalisation in LEAP is higher compared to some of the regional counterparts like the Philippines' SME Board and Indonesia's Acceleration Board, but still relatively smaller compared to other regional SME exchanges like Korea's KONEX, Thailand's MAI, and Singapore's Catalist.

Due to the higher risks associated with investing in SMEs, the LEAP market is only accessible to sophisticated investors. This restriction to a significantly smaller pool of investors created a low liquidity environment for companies listed on LEAP.[13] While no exact figures are available, in 2022 it was reported that many SMEs on LEAP had not experienced a single trade,[14] limiting their ability to use their listed status as a means of raising further funds.

Malaysia is not alone in recording limited liquidity on a specialised SME exchange. Trading on Thailand's MAI is 28 times lower than on the SET, Singapore's Catalist is 188 times lower than STI and Hong Kong's GEM is over 1,000 times lower than the HKEX.[15] In the instance of Hong Kong's GEM, the severely low liquidity environment eventually led to insider trading and market manipulation, which further reduced investor activity on the exchange. As a result, GEM had no new listings since 2021 as SMEs sought to list on foreign exchanges such as NASDAQ.[16]

Nevertheless, it is crucial to recognise that specialised exchanges differ across the region. Each exchange has its unique features tailored to address the specific requirements of domestic SMEs. While a direct comparison between these specialised exchanges may offer a general sense of where LEAP stands in relation to its regional peers, it may not fully capture the nuanced intricacies of each market across the region.

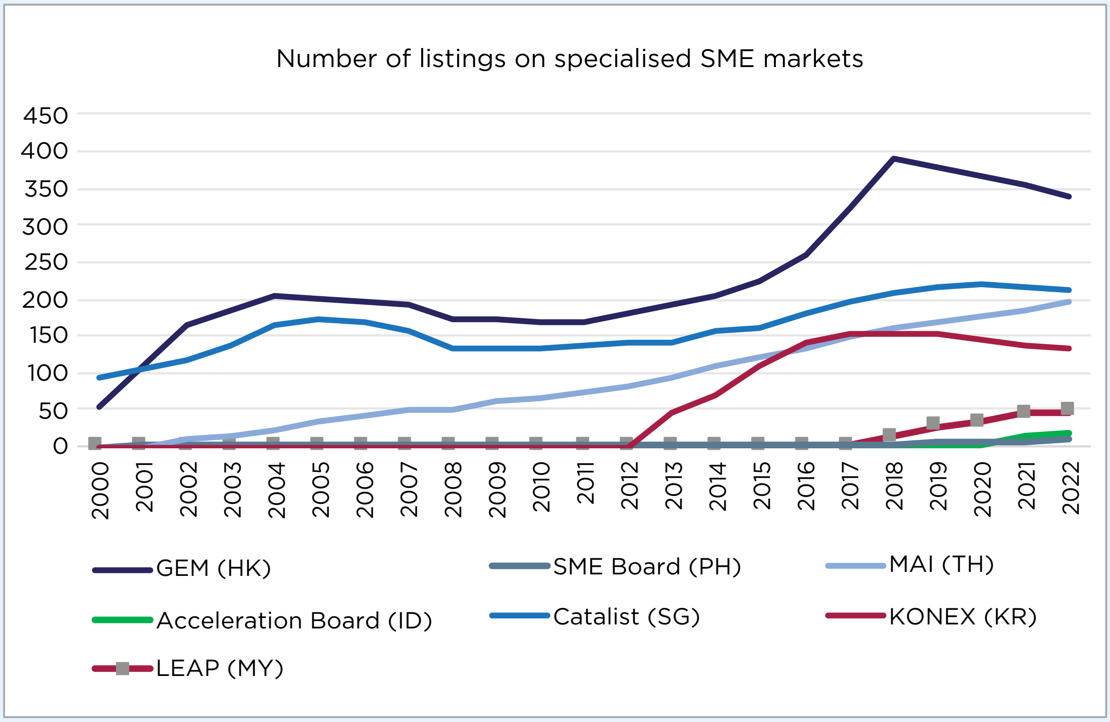
13 In 2022, Asas Advisory Services, in Rethinking the LEAP Market, identified lack of liquidity as the main reason for three of the five companies delisting from LEAP. The remaining two sought delisting to transfer to ACE. https://asasadv.com.my/rethinking-the-leap-market/

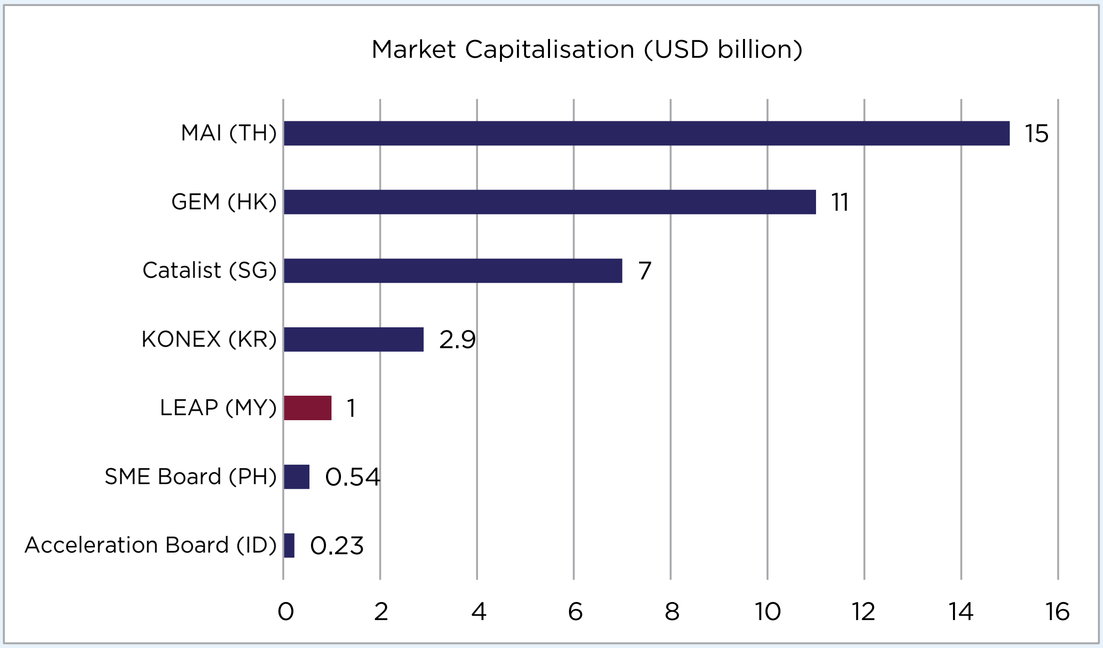
14 As reported by The Edge on 27 June 2022. https://theedgemalaysia.com/article/liberalising-leap-market

15 From Bloomberg, as of 13 December 2023. Trading is measured by the turnover/traded value for each of the exchanges relative to their main index

16 Hong Kong's small brokers push for new rules to revive IPOs | The Straits Times

Figure 2.9 & Figure 2.10:
Number of listings on specialised SME markets and their market caps





Source: Bloomberg, respective stock exchanges

2.1.3 Private market

Private markets refer to the investment in the capital of privately owned companies versus publicly traded companies.[17] This includes angel investment, venture capital, and private equity investment. The private market is characterised by its higher risk profile and limited access for investors.

Similar to the public market, private markets provide access to capital and branding support for SMEs. However, the private market offers additional support in the form of access to strategic advice and mentorship from industry professionals and access to additional markets and investors through the network effect.

Investee companies in the private market are generally within the early to growth stages of the business life cycle. Specifically in the early stage, companies are faced with large uncertainties such as market, financial, and operational challenges. Navigating these challenges requires expertise and financing that the entrepreneurs may not have. This is where the private market enters the picture. Due to the significantly higher risks undertaken by private market investors, only qualified sophisticated, and institutional investors may participate in investment activities. Limiting the access to private markets was conducted as a means of investor protection for retail investors. This is because retail investors do not have access to the same resources as more sophisticated investors, and thus are unable to bear the associated risks.

Angel investment

Generally, an angel investor can be defined as an individual investing their personal money into early-stage companies. The investment is either in the form of direct (investor as a direct shareholder) or indirect (investment via structured syndicate) investment.[18]

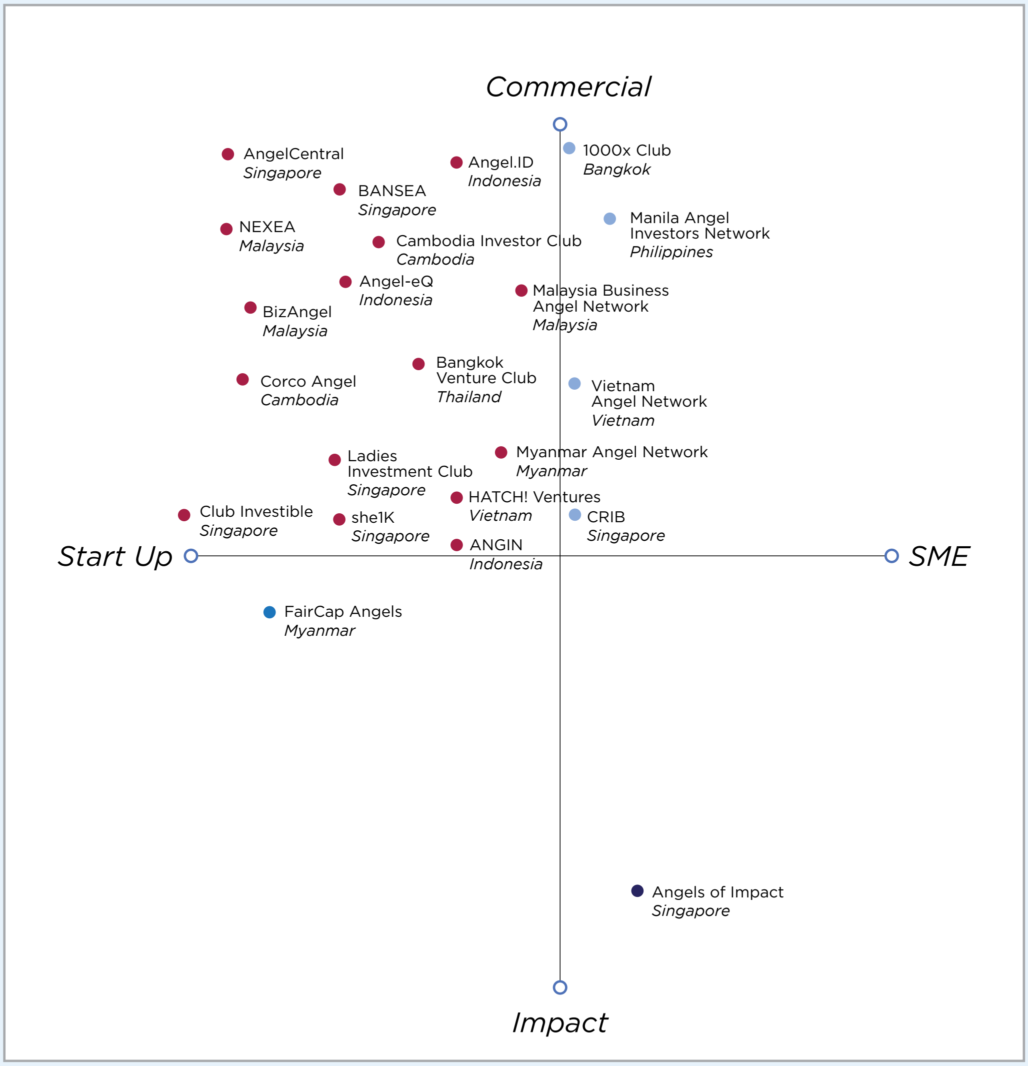
Within Southeast Asia, angel investment is largely driven by Angel Investment Networks (AINs). These networks not only play the pivotal role of convening trade deals, but also provide value added services such as due diligence, negotiation, and post-investment evaluation for investors.

Southeast Asian AINs mainly service commercial-driven startups, with only Singapore's Angels of Impact focusing on impact-driven SMEs (see Figure 2.11).

17 As defined by Russell Investments

18 Angel Behavior Survey Report 2023

Figure 2.11:
Mapping out Southeast Asian AINs



Source: The Emergence of Angel Investment Networks in Southeast Asia

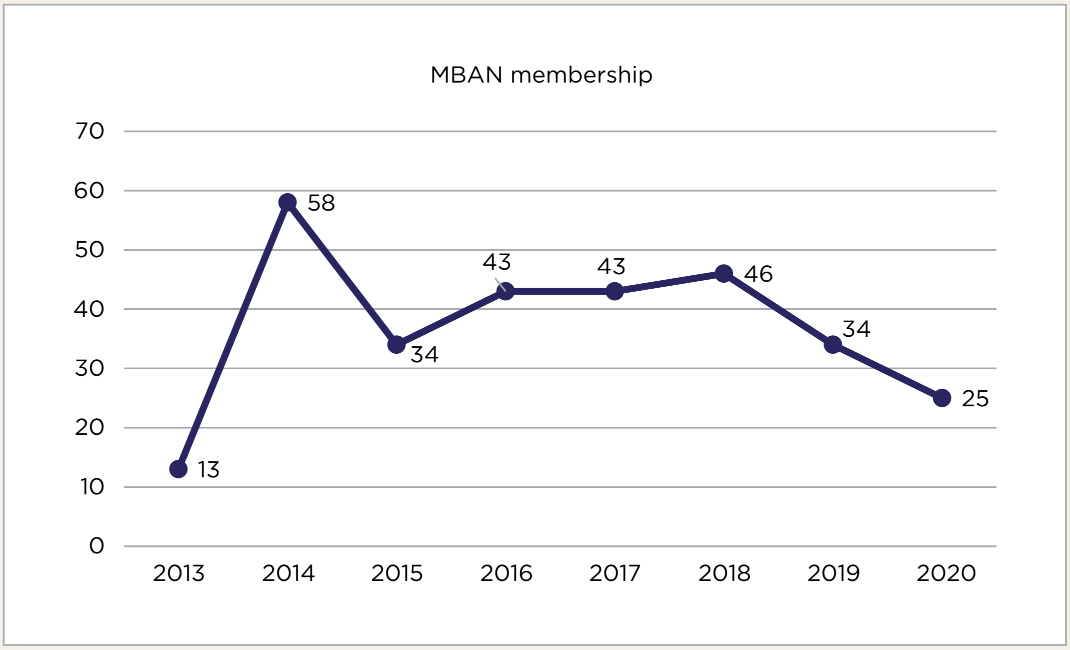
With the emergence of cross-border collaboration between the AINs such as through the ASEAN Angel Alliance, it may be in AINs' best interest to expand either their network (NEXEA Australia allows startups in Australia and New Zealand to seek funding within Southeast Asia) or their portfolio, by offering funding for more impact-based companies to continually attract new investors and entrepreneurs.

Within Malaysia, the angel ecosystem can be characterised by five identifiers; newly developed ecosystem, available investment opportunities, perceived weak investment ecosystem, difficulty in accessing high quality deal flow; and government involvement being both positive and negative. (Harrison, Scheela, Lai, & Vivekarajah, 2018). There is a reported lack of knowledge on angel investors from both the investor (who may not know they qualify as angels) and entrepreneur side (who may not know where to find angel investors). This knowledge gap then contributes to the underdevelopment of the ecosystem, making it harder for angel investors to seek quality deals. Entrepreneurs are also hesitant to share their business plans with investors. Coupling this with a lack of publicly available information affects investor confidence, leading to reduced investment disbursements.

To add to the current situation, all of Malaysia's AINs operate within the same focus area. As such, entrepreneurs who do not operate within the same focus areas may have a more difficult time in sourcing financing locally and are forced to turn to foreign investors. As a means of encouraging more active participation from angel investors, many countries, including Malaysia, offer some form of tax incentives to attract angel investors.

The introduction of tax incentives in the 2013 budget led to a spike in the growth of angel investors in Malaysia (Figure 2.12). However, preceding years have shown a slowdown in new memberships, suggesting that either tax incentives alone may not be sufficient to entice the registration of new angel investors, or that the local startup ecosystem lacks the vibrancy needed to grow the participation of angel investors. Moving into new growth areas with innovation at the centre of development is likely to attract angel investors, both locally and from abroad, to invest in Malaysian startups and scale up SMEs.

Figure 2.12:
New MBAN members



Source: MBAN Annual Report 2020 (latest available)

Venture Capital (VC) and Private Equity (PE)

VC and PE is one of the cornerstones in the global entrepreneurial ecosystem, with funding of successful companies contributing to new job creation, innovation, and overall economic growth. In addition to providing capital, VC and PE firms typically also act as mentors to entrepreneurs by providing strategic advice, guidance, and sharing of business expertise. Additionally, entrepreneurs are able to benefit from the network effects by developing partnerships through mutual connections made via the VC/PE firms. It is reported that around 60% of deals are either from a VC's former colleague or work acquaintance (30%), referrals from other investors (20%) or existing portfolio companies (8%).[19]

Globally both VC and PE recorded spikes in investment during the COVID pandemic, recording a year-on year (y-o-y) growth of over 30%.[20] This spike was largely due to the surge in demand for healthcare related investments during the period.[21] However, the growth spurt was short-lived as capital raised began to moderate post-COVID. This is especially evident within the VC sphere, where only $117 billion was raised as of September 2023.

Several factors were identified as contributing to the decline in funds raised, including global market uncertainties that emerged following post-COVID reopening, and the shortage of exit opportunities for VC-backed startups which led to constraints on funds being recycled back into the industry and increasing cost of capital due to monetary tightening across major central banks, globally.[22]

Figure 2.13:
Capital raised from global VC and PE activities

	Capital Raised ($ billion)				YoY Change (%)	
	2020	2021	2022	2023*	2020-2021	2021-2022
VC	253.9	354.2	301.4	117.3	39.5%	-14.9%
PE	463.9	613.8	535.8	367.0	32.3%	-12.7%

Source: Pitchbook. 2023 data is as at September 2023

The tumultuous market conditions also negatively affected VC and PE activity within ASEAN. PE deal value declined by 52% in 2022,[23] while Malaysia experienced the largest decline in VC funding in the region (Figure 2.14).

19 From survey conducted by Harvard Business Review. https://hbr.org/2021/03/how-venture-capitalists-make-decisions

20 Based on data from Pitchbook Q3 2023 Global Private Market Fundraising Report. Calculations are the authors' own

21 According to the KPMG Q3 '23 Venture Pulse Report, energy, health care devices & supplies, and health care services and systems recorded the highest growth in terms of total investment. These sectors continue to grow in importance relative to others, in spite of the overall slower pace of investment in recent years.

22 The Transient Era of Billion Dollar Funds

23 Southeast Asian private equity: Macro fundamentals remain robust

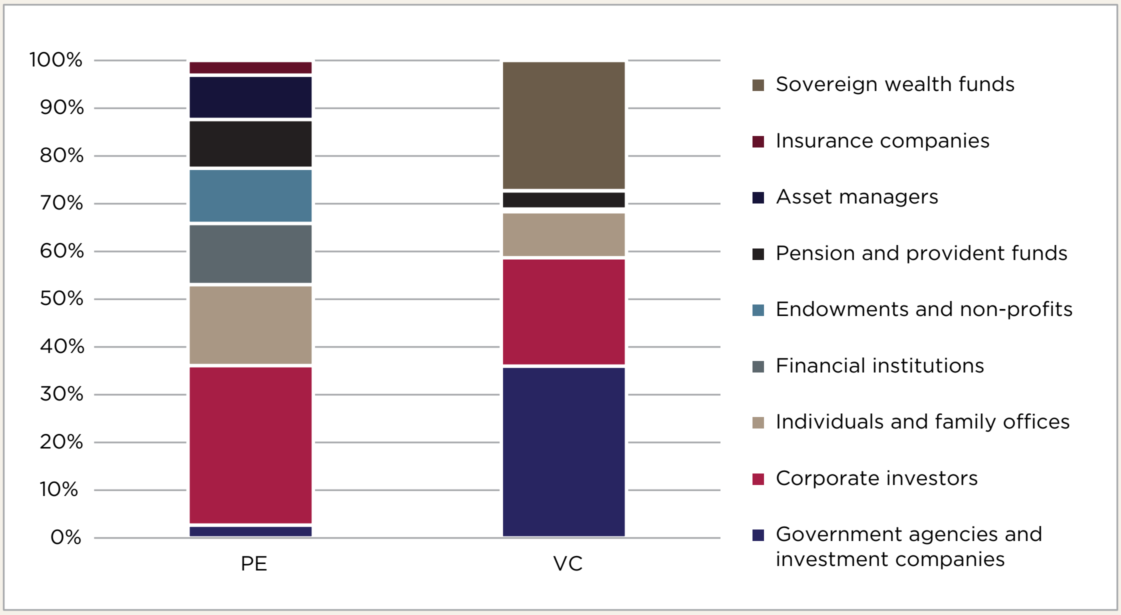
Figure 2.14:
Capital raised from ASEAN VC activities

	Capital Raised ($ billion)		YoY Change (%)
	9M 2022	9M 2023	
Singapore	8.5	4.3	-49%
Indonesia	2.9	1.2	-61%
Malaysia	0.6	0.1	-86%
Philippines	0.6	0.1	-79%
Thailand	0.5	0.6	13%
Vietnam	0.7	0.6	-7%

Source: Deal Street Asia

In Malaysia, early and growth stage investments represented the largest proportion of new VC and PE investments in 2022,[24] contributing to over 70% of total new investments for the year. VC and PE investments are sourced from a wide array of investors, ranging from government agencies, sovereign wealth funds, to insurance companies (Figure 2.15).

Figure 2.15:
Source of funds for VC and PE in Malaysia (2022)



Source: SC Annual Report 2022

24 From SC Annual Report, Growth stage investments

One of the main challenges faced in Malaysia is the high dependence on government for venture funds. Callagher, Smith, and Ruskoe (2015) identified that there are risks embedded with government involvement in venture funding. Among the risks identified include the perceived lack of understanding amongst government officials regarding venture capital. Another challenge lies within the mismatch of expectations between the government and public VCs, which affects their ability to operate efficiently.

This sentiment is shared by startups in Malaysia who have shared that there is a lack of expertise in assessing investment opportunities within government VCs. In addition to the lack of expertise, startups have also shared that there is a lack of coordination among the various ministries which leads to lost time in trying to identify the right contact for funding purposes. The difficulty in obtaining financing was also cited as one of the reasons Malaysian startups seek financing from foreign VCs.

As a means of promoting VC investment in the country, the Malaysian government introduced specific tax incentives for VC companies, VC management companies, and investors.

Figure 2.16:
VC tax incentives in Malaysia

Beneficiary	Incentive	Key requirements
Venture Capital Company ("VCC")	Tax exemption for registered VCC: • Exempt period of 5 years or remaining life of the fund (whichever shorter) • Exemption on all sources of statutory income (other than interest income arising from savings or fixed deposits and profits from Syariah-based deposits)	o VCC incorporated under Companies Act 2016 ("CA 2016") o VCC must be registered with SC no later than 31 Dec 2023 o At least 50% of funds must be invested in qualifying venture companies
Venture Capital Management Company ("VCMC")	Tax exemption for registered VCMC • Exempt period from YA2018 to YA2026 • Exemption on management fees, share of profits, carried interest, and performance fees derived from a tax-exempt VCC	o VCMC registered with SC o VCMC must meet substance tests (min. local spend and staffing requirements)
Investors (companies or individuals with business income)	Tax deduction on investment made into a venture company (whichever is lesser)	o Investment is in the form of the holding unlisted shares of the venture company (at the point of investment) o Investment must be held for at least 3 years from the date the investment
	Tax deduction on investments made in a qualified VCC, equal to the investment made into a VCC or up to RM20 million annually (whichever is lesser)	o VCC had maintained, on average over a 3-year period, at least 50% of invested funds in qualifying venture companies o Investment into the VCC must be held for at least 3 years from the date the investment

Source: SC website as at December 2023

Malaysia is not alone in introducing tax incentives for VCs. Various other countries have also introduced similar measures, as highlighted below.

Figure 2.17:
Selected countries' VC tax incentives

Country	Name of scheme	Tax relief on		
		investment	income received	disposal
Australia	Early-Stage Venture Capital Limited Partnership program	/	/	/
	Venture Capital Limited Partnership program	X	/	/
	Tax incentive for Early-Stage Investors	/	X	/
Germany	"INVEST -Venture Capital Grant"	/	/	X
Japan	Tax Incentives to Promote Venture Investment	X	X	/
	Angel Tax System	/	X	/
South Korea	Tax exemptions for venture capital companies	X	/	/
	Tax deductions and exemption from capital gains tax for individual investors in venture capital funds	X	/	/
United Kingdom	Enterprise Investment scheme	/	X	/
	Seed Enterprise Investment Scheme	/	X	/
	Venture Capital Trust	/	/	/
	Social Investment Tax Relief	/	X	/
	Private Placement Withholding Tax Exemption	X	/	X
	Business Property Relief	X	X	/
USA	Qualified small business stock (QSBS)	X	X	/
	Investment tax credits	/	X	X

Source: European Commission (2017)

2.2 Alternative financing

According to OECD (2020b), fostering alternative financing instrument, is one of the most important policy responses to narrow financing gaps across the ASEAN region. While OECD used a broader term of alternative financing as funding other than bank lending, in this report, we have used the term alternative financing to refer specifically to ECF and P2P Financing as part of the alternative marketplaces included in the Capital Market Masterplan 3.

At a global level, there was a great variety in ECF and P2P activity between 2019 and 2020 (Figure 2.18). The most notable were regulatory changes regarding non-bank lending in China, which effectively erased China's P2P industry. Within Asia Pacific, both ECF and P2P had positive growth for the period, with ECF's high growth mainly attributed to an increase in new issuers.[25]

Figure 2.18:
ECF and P2P volume by region, 2019 and 2020

	ECF			P2P		
Geography	**2019 ($ million)**	**2020 ($ million)**	**YoY Growth**	**2019 ($ million)**	**2020 ($ million)**	**YoY Growth**
APAC	219.4	333.5	52.0%	1,623.9	1,819.6	12.1%
China	0.1	0.0	-100.0%	13,434.6	0.3	-100.0%
Europe	224.1	279.7	24.8%	1,481.3	1,843.6	24.5%
Latin American & the Caribbean	10.3	12.6	22.3%	58.7	29.9	-49.1%
MENA	12.9	12.5	-3.1%	152.2	124.3	-18.3%
Sub Saharan Africa	10.3	1.2	-88.3%	15.6	13.7	-12.2%
UK	474.6	549.3	15.7%	2,537.9	3,262.2	28.5%
USA & Canada	141.9	331.5	133.6%	1,509.2	8,280.7	448.7%
Total	**1,093.7**	**1,520.4**	**39.0%**	**20,813.5**	**15,374.4**	**-26.1%**

Source: The 2nd Global Alternative Finance Market Benchmarking Report (2021)

25 The 2nd Global Alternative Finance Market Benchmarking Report

During this period, the Malaysian alternative financing industry grew in its significance within Asia Pacific, ranking third in both ECF and P2P in 2020. However, the total funds raised in Malaysia paled in comparison to Singapore and Indonesia (Figure 2.19). In this light, Malaysia is on the right track to grow its alternative finance models.

Figure 2.19:
Top three countries in Asia Pacific for ECF and P2P

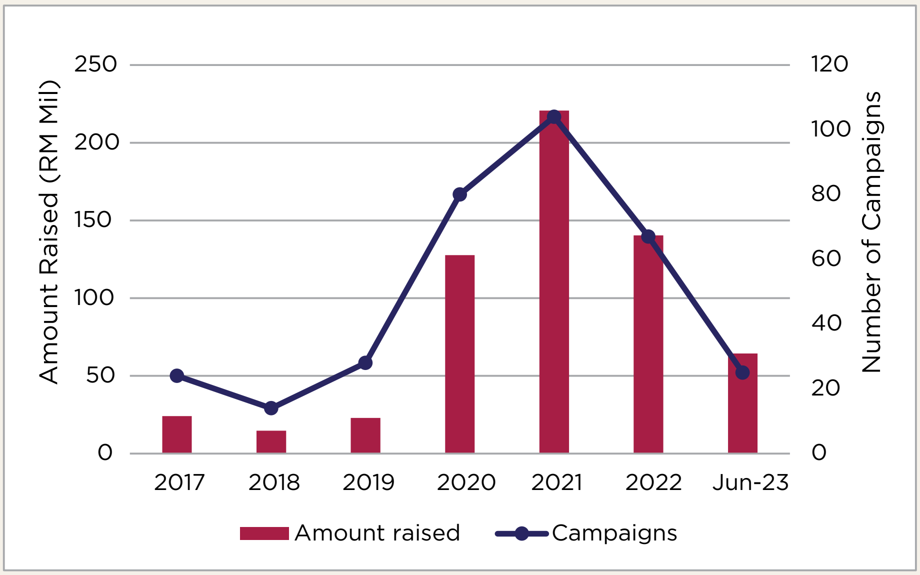
ECF		P2P	
Country	**$ million**	**Country**	**$ million**
Singapore	206.0	Indonesia	910.2
Australia	39.5	Japan	640.3
Malaysia	**20.0**	**Malaysia**	**67.8**

Source: The 2nd Global Alternative Finance Market Benchmarking Report (2021)

ECF in the Malaysian market

ECF in Malaysia has raised a total of RM560 million up to 2022 over 330 campaigns. The industry recorded a spike in investment in 2021, coinciding with the introduction of tax exemptions for individual investors that invest in ECF for a minimum of 2 years.

Figure 2.20:
ECF funds raised and number of campaigns in Malaysia (RM Million)



Source: SC website (as of December 2023)

ECF investment in Malaysia is accessible to all investors, subject to certain imposed limitations for retail and angel investors. In view of investor protection, retail investors are limited to a maximum single investment of RM5,000, and total investment cap of RM50,000, while angel investors are subject to a maximum of RM500,000 within a 12-month period.

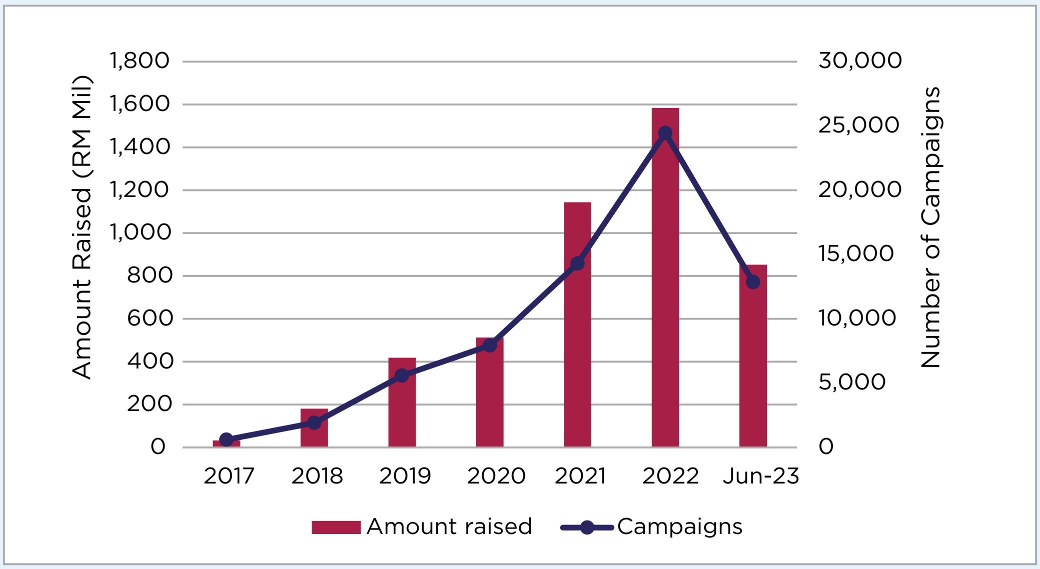
In an effort to support ECF in Malaysia, the Malaysia Co-Investment Fund (MyCIF) was introduced in 2019. The role of MyCIF is to co-invest on a 1:4 ratio basis, with MyCIF investing RM1 for each RM4 raised from private investors for a maximum investment of RM1 million. Since its inception, MyCIF invested a total of RM99 million into 241 ECF campaigns.[26]

P2P in the Malaysian market

P2P investing in Malaysia is available for all investor categories, subject to a suggested limit of RM50,000 total invested at any one time, while no limit is imposed on sophisticated and angel investors. For issuers, a campaign must raise a minimum of 80% of the target amount for funds to be kept. Any amount raised above 100% is returned to the investors. The amount that an issuer is eligible to raise depends on the risk assessment. To promote its use among SMEs, P2P financing is exempt from taxes for arrangements made between SMEs and investors from January 1, 2022 to December 31, 2026.

As of end of 2022, P2P financing raised RM3.9 billion over nearly 55,000 campaigns. The growth in P2P in Malaysia was in part supported by MyCIF, which also caters to P2P issuers. Operating under similar conditions, MyCIF invested RM541 million into 35,000 campaigns since its inception. Through its P2P scheme, MyCIF has invested 40% of its funds into non-Klang Valley issuers in 2022.[27]

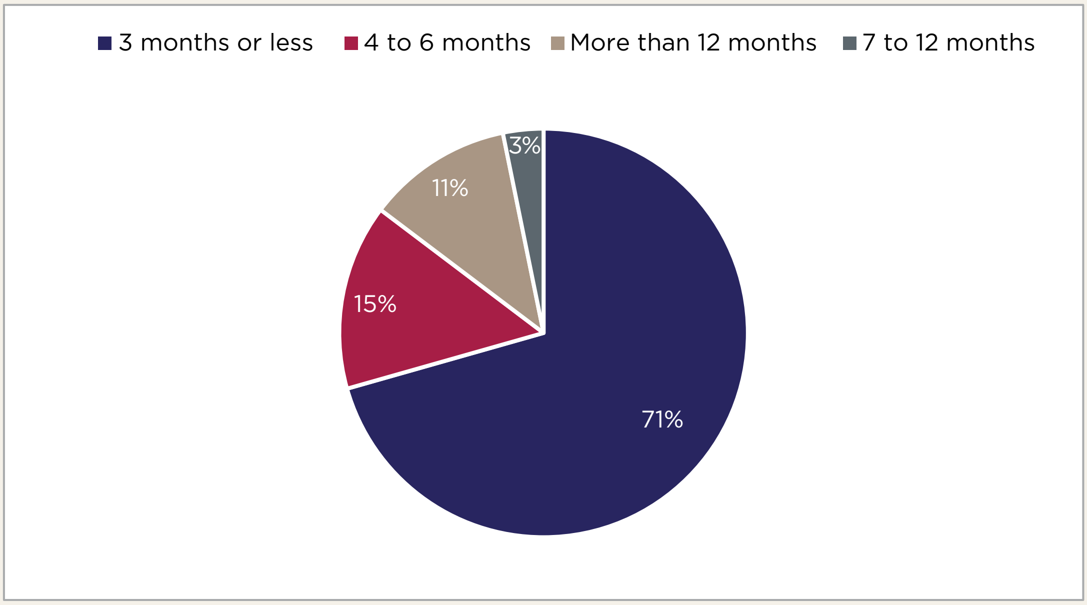
Figure 2.21:
P2P funds raised and number of campaigns in Malaysia (RM Million)

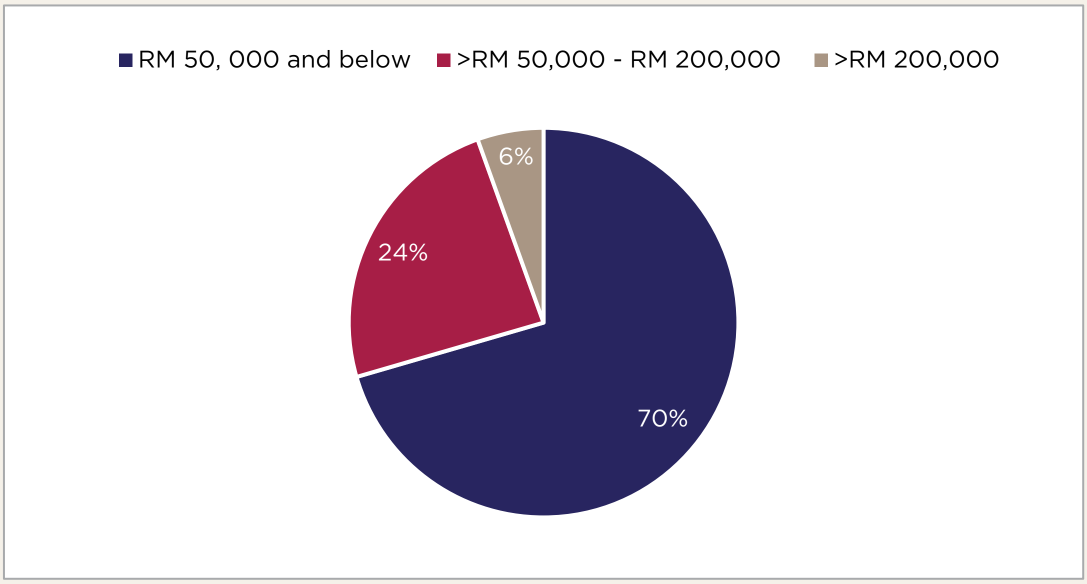


Source: SC website (as of December 2023)

26 MyCIF Annual Report 2022
27 MyCIF Annual Report 2022

Figure 2.22:
Breakdown of P2P loan tenure and amount in Malaysia





Source: SC website (as of December 2023)

In Malaysia, P2P financing is primarily used for short-term and smaller amounts of finance with around 70% of loans having a tenure of 3 months or less, and 70% of loans carrying a value or RM50,000 and below.

On the surface, the debt-based structure of P2P financing presents as a viable alternative to bank financing. Features such as fast access to funds, less stringent requirements, and financing flexibility make P2P an attractive option for SMEs. However, these features are not without their drawbacks.

P2P financing costs are relatively high in Malaysia, ranging from 10%-18% per annum, acting prohibitively towards SMEs in search of financing.

Figure 2.23:
P2P lending rates in ASEAN

Countries	Min	Max
Indonesia	12%	24%
Malaysia	10%	18%
Philippines	12%	36%
Singapore	8%	15%
Thailand	-	15%
Vietnam	10%	20%

Source: Various

As the number of issuers grows, so too does the risk of default. This has been the case in Indonesia where delinquency among P2P issuers has increased in recent years. In May 2023, the 90-day default level increased to 3.36%, the highest figure since the pandemic when the default rate was over 5%.[28] Therefore, regulators must be ready to step in and take the necessary action to prevent extreme events such as China's P2P collapse.

SC has taken a proactive approach in regulating P2P activities in Malaysia by elevating supervisory efforts to ensure regulatory compliance among operators. To foster future growth, the SC has also opened applications for operators with unique value propositions such as providing debt-based financing for MTCs and Shariah-compliant offerings.[29]

Conclusion

Overall, the Malaysian capital market has a wide range of financing options for SMEs to utilise and is on par with more developed countries. However, the reach of these financing options is limited, as illustrated by the small amount of fundraising within each of the instruments, and Malaysia's position amongst its regional peers.

There is a need to recognise that there is no one-size-fits-all approach to financing for SMEs. Factors such as the development stage, market conditions, and business models vary significantly. Additionally, the financial health and risk tolerance of individual SMEs differ, influencing the suitability of financing options. Simply having a variety of financing options for SMEs is insufficient in ensuring that their various needs are met. To this end, financing options need to be tailored to suit a broader range of SMEs and promote the long-term viability and sustainability of the Malaysian SME landscape.

Given the role of market-based financing within the SME ecosystem, identifying factors that may promote or hinder its use is crucial in fostering the growth of high-quality SMEs to achieve the national target of 50% SME contribution to GDP by 2030.

28 Debt trap: Millions of Jakartans owe trillions to online lending platforms. https://www.thestar.com.my/aseanplus/aseanplus-news/2023/07/09/debt-trap-millions-of-jakartans-owe-trillions-to-online-lending-platforms

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Chapter Three

Survey and Interview Insights

3.1 Background

This section will delve into the methodology and analysis employed in examining market-based financing for SMEs in Malaysia. Our research adopts a comprehensive approach, utilising both quantitative and qualitative analyses using enterprise-level surveys and interviews. Specifically, we focus on assessing the willingness and challenges faced by SMEs in raising funds through market-based financing. Additionally, we incorporate feedback from various stakeholders within the SME ecosystem to further strengthen our argument.

Chapter 1 highlighted existing studies on SME financing, which often focus on public sector financing and traditional financial institutions, with market-based financing considered an alternative funding source. In contrast, our study differentiates itself by placing market-based financing at the forefront of the discussion.

Recognising the limited information on how local SMEs perceive market-based financing, which is crucial for understanding the current challenges and opportunities, we identified the necessity for an enterprise-level survey in our research. The survey was exclusively designed for SMEs to gain a comprehensive understanding of their perspectives. Complemented by in-depth interviews with key stakeholders in the market-based financing ecosystem, this approach not only filled gaps in the survey data but also provided additional insights, enriching the depth of our study.

3.2 Research methodology

3.2.1 SME categories & demand and supply-side definition

In this section, we provide a contextual backdrop to our study by delving into the diverse landscape of SMEs in Malaysia. As highlighted in Chapter 1, the term "SME" serves as an umbrella for the purposes of this report only, encompassing three categories of enterprises within the Malaysian ecosystem, namely the MSMEs (national definition endorsed by the National Entrepreneur and SME Development Council (NESDC)), MTCs (defined by MATRADE) as a continuation from the MSME definition, and Startups (defined by MOSTI under their SUPER roadmap). The startup definition, which is solely based on the definition of whether an SME is a "technology- or innovation-enabled business at an early stage…." does not provide any quantitative criteria for us to ascertain the size of a company, but in the context of our study, we see start-up as a separate group of SME that are highly innovative and technology-driven, as opposed to the generic definition for MSMEs.

Throughout our study, we employed the terms "demand-side" and "supply-side" to delineate two crucial segments of our respondents and interviewees. The demand-side represents SMEs actively seeking financing (demand for capital), while the supply-side encompasses entities providing financing or facilitating the financing process, including regulators, agencies, intermediaries, platform providers, and other organisations (suppliers of capital). Having established this contextual foundation, we now proceed to detail the methodology and key findings of our study, shedding light on the financing challenges faced by these diverse SME categories in Malaysia.

3.2.2 Quantitative study: Survey

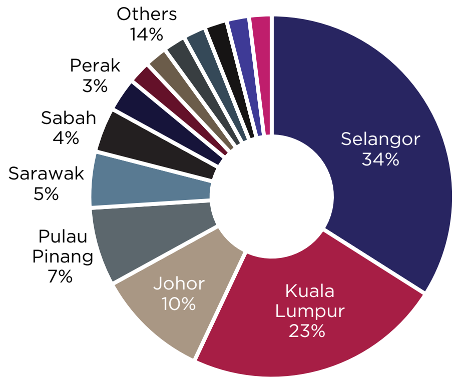
In order to gain insights into the financing challenges and issues encountered by start-ups, MSMEs, and MTCs, ICMR conducted a survey that was distributed to the key decision-makers from these entities, encompassing C-suite executives, Managing Directors, Proprietors, Business Owners, Company Owners, and Senior Managers. The questionnaire was distributed online using assistance from various parties, namely SME Corp. Malaysia, MATRADE, Malaysian Consortium of Mid-Tier Companies (MCMTC), Digital Penang, and Green Zebras. Hard recruitment quotas were implemented for start-ups, MSMEs, and MTCs to ensure a representative sample. With the aim of engaging only the intended respondents, screening questions were included at the beginning of the survey. Specifically, eligible respondents were categorised into the respective segments (start-ups, MSMEs, and MTCs) based on criteria such as revenue turnover, number of employees, and whether they identified as start-ups. As highlighted in Chapter 2, the definitions of the respective segments were adopted from established sources in Malaysia.

To recap, MSMEs are defined based on sales turnover and the number of full-time employees. In the manufacturing sector, MSMEs are firms with sales turnover not exceeding RM50 million or the number of full-time employees not exceeding 200. For services and other sectors, MSMEs are defined as firms with sales turnover not exceeding RM20 million or the number of full-time employees not exceeding 75.[30] Meanwhile, MATRADE defines MTCs in Malaysia as companies with annual revenues ranging from RM50 million to RM500 million in the manufacturing sector and RM20 million to RM500 million in other sectors. As for startups, the Ministry of Science, Technology, and Innovation (MOSTI) characterises a startup as a technology or innovation-enabled business at an early stage with a scalable business model.

Figure 3.1 illustrates the profile of survey respondents, encompassing a total of 401 company responses. Among these, 109 represent startups, 242 are from MSMEs, and 50 are from MTCs. The respondents are distributed across diverse geographical regions and sectors in Malaysia, with the highest concentration hailing from Selangor (34%) and the service sector (63%).

Figure 3.1:
Survey respondent profile

Geographical distribution



Sector and ownership distribution

Sector	Startups (109)	MSMEs (242)	MTCs (50)	Total (401)
Services	61%	65%	56%	**63%**
Manufacturing	19%	11%	28%	**15%**
Wholesale	8%	11%	4%	**9%**
Construction	6%	10%	8%	**9%**
Agriculture	5%	2%	0%	**3%**
Mining	1%	1%	4%	**1%**
Total	100%	100%	100%	**100%**

30 All SMEs must be entities registered with SSM or equivalent bodies. Exclusions comprise entities public-listed on the main board, subsidiaries of publicly-listed companies, multinational corporations (MNCs), government-linked companies (GLCs), Syarikat Menteri Kewangan Diperbadankan (MKDs), and state-owned enterprises.

This survey development process (see Figure 3.2) involved a thorough literature review, delving into existing knowledge on SME financing challenges. This informed the development of the draft questionnaire, ensuring alignment with current industry trends, emerging issues, and established best practices. To ensure alignment with regulatory perspectives, a dedicated feedback session was conducted with regulators. This engagement aimed to gather insights into the regulatory landscape, shaping the survey questions to capture information relevant to regulatory considerations and compliance within SME financing.

Subsequently, the draft questionnaire underwent a meticulous review by several experts in SME financing. Their invaluable insights and expertise played a pivotal role in refining the survey questions, enhancing clarity, relevance, and effectiveness in extracting meaningful data. Prior to the official distribution, a pilot test engaged a select group of representatives from each SME segment. This trial run identified potential ambiguities, redundancies, or challenges in the questionnaire, guiding refinements for optimal clarity, relevance, and respondent comprehension.

Figure 3.2:
Survey development process

The final survey was predominantly structured into five sections.

Section 1 was aimed at obtaining an understanding of the evolving business landscape, particularly within the post-COVID-19 environment. This section aimed to contextualise the challenges and adaptations faced by SMEs in response to the evolving economic scenario. This is especially important given the risk landscape for SMEs today are continuously being reshaped and most businesses are operating in a climate of higher uncertainty. The level of business acumen and strategic knowledge of the SMEs will also correspond to their financial knowledge for their business growth.

Moving to section 2, the survey delved into the external financing history of SMEs, with an aim to unearth insights into their past experiences with diverse financing methods. This exploration extended to understanding the primary purposes of finance for their businesses and their perceptions regarding the types of financing they have used.

Section 3 was strategically dedicated to assessing the awareness of SMEs regarding available market-based financing options. The focus here was to gauge the level of familiarity and knowledge within SMEs about the various avenues offered by market-based financing.

Transitioning to section 4, the survey took a deeper dive into SMEs' key considerations, explaining both the barriers and opportunities associated with market-based financing. This section aimed to uncover the factors influencing an SME's decision-making process with respect to its financing decisions and shed light on particular impediments as well as potential pathways for growth.

The final section, section 5, inquired about both the digitalisation efforts within SMEs and the integration of ESG-related activities by these firms. This exploration sought to reveal the extent of technological adoption within SMEs and their commitment to sustainable and responsible business practices. While not directly related to financing, digitalisation and ESG are now front and centre of policymakers' agendas for market-based financing. SMEs which are making strides in their digitalisation and ESG journey can also be seen as more prepared for business growth and innovation and are more resilient to economic shocks, both crucial for long-term market-based financing.

3.2.3 Qualitative study: Interview

In addition to the survey, ICMR conducted interviews and focus group sessions with both the supply-side and demand-side, a two-pronged approach to complement the data collection process. These qualitative methods offered deeper insights into the challenges and opportunities of market-based financing for companies in Malaysia. They allowed us to capture information not covered in the survey questions, providing a more nuanced understanding of the key challenges.

On the supply-side interview sessions, ICMR interviewed a total of 18 key stakeholders, including regulators, key agencies supporting SMEs, intermediaries, and VC players from the market-based financing ecosystem. The aim was to comprehensively understand the supply-side dynamics and their implications on the market-based financing landscape in Malaysia.

Simultaneously, ICMR conducted interviews with a total of 19 SMEs to gain insights into their financing difficulties and other challenges faced. These SMEs encompassed startups, MSMEs, and MTCs, representing various sectors such as Fintech, Logistics, Construction, Manufacturing, Engineering, Education, Medical, Tourism, Transportation, and more. Interviewees were recruited and screened internally by ICMR to ensure a diverse range of perspectives and experiences were captured. Prior to the interviews, an interview guide and a focus group discussion guide were developed, including open-ended questions that covered topics related to market-based financing, financing history, and business challenges.

All these interviews and focus group sessions were conducted in person and, when necessary, via virtual platforms to accommodate geographic dispersion. The interviews typically allowed participants to provide detailed responses and engage in constructive discussions. The qualitative findings were subsequently triangulated with the quantitative survey data to provide a comprehensive understanding of the financing landscape for SMEs in Malaysia. Throughout this report, verbatim quotes derived from the interviews have been integrated to provide direct perspectives from the participants. To maintain confidentiality and preserve interviewees' anonymity, pseudonyms have been used in place of their actual names.

3.3 What we found

3.3.1 Survey section 1: Post-COVID-19 environment

Business landscape in the context of the post-COVID-19

The survey findings underscored a pronounced negative impact of the COVID-19 pandemic on SMEs, with a staggering **71% of SMEs grappling with adverse effects.** Central to these challenges were the stringent lockdown measures and the imperative to secure funding for business sustenance during this challenging period. Notably, it was the **MSMEs that bore the brunt** of these challenges, while larger **MTCs demonstrated the anticipated resilience.** According to ADB Institute's working paper, MSMEs are more vulnerable to the pandemic's negative impact on their supply chain, labour supply, and final demand for goods and services than larger firms (Sonobe et al. 2021).

Figure 3.3:
Impact of the COVID-19 pandemic on SMEs

	Negative Impact	Positive Impact	No Impact	
Total SMEs	**71%**	**17%**	**12%**	100%
Startups	68%	21%	11%	100%
MSMEs	**75%**	13%	12%	100%
MTCs	56%	**30%***	**14%**	100%

**The survey revealed that MTCs were the most resilient whereas MSMEs were worst hit during the pandemic*

Further reinforcing these survey findings, a study conducted by the OECD (2020a) provides a global perspective on the impact of COVID-19 on SMEs. This comprehensive study, which compiled surveys from 41 SMEs worldwide, including countries such as China, the US, Finland, the UK, and Korea, aligns with ICMR survey's outcomes. The OECD study highlights how SMEs, given their limited resources and pre-existing obstacles in accessing capital, were disproportionately affected by the ongoing COVID-19 pandemic. This convergence of findings from the survey and the OECD study underscores the global nature of the challenges faced by SMEs and emphasises the urgent need for targeted support and resilience-building measures within this vital sector.

Within the cohort of negatively affected SMEs, a significant majority faced a substantial **revenue decline of at least 30% and had to delay or halt ongoing projects** due to the pandemic. This aligns with the broader findings from the OECD (2020a), which corroborate that more than half of SMEs globally faced severe losses in revenues. Our survey also shows that the **struggles of startups were further exacerbated, particularly in raising financing,** given that most stimulus packages announced during the pandemic primarily targeted the assistance of MSMEs.

This challenge was further compounded by the fact that most stimulus packages announced during the pandemic were primarily designed to assist

MSMEs. It is important to note that these stimulus initiatives, predominantly facilitated through banks, were strategically targeted at supporting MSMEs, making access to bank financing more accessible for this specific segment. Consequently, startups, which typically encounter difficulties in accessing traditional bank financing, found themselves with limited avenues for financial support through these packages.

Nevertheless, based on the interviews, there are some SMEs, especially those without collateral and credit history, similarly find it difficult to raise financing as most of the government assistance during pandemic were channelled through the banking sectors. For example, a construction company we interviewed shared their experience of being unable to raise financing during the COVID-19 pandemic, considering their business was deemed to be at high risk of default. This real-world example reinforces the challenges that some SMEs encountered during this period despite government intention to support SMEs during the pandemic.

Figure 3.4:
How SMEs were negatively impacted by COVID-19

Impacted aspects	Startups	MSMEs	MTCs
Revenue declined by more than 30%	70%	73%	86%
Delayed or halted projects	57%	57%	61%
Difficult to obtain financing	**47%***	33%	36%
Workforce reduced by more than 30%	22%	37%	25%

Business review

Within this section, a number of questions delved into the aspect of business reviews, exploring whether SMEs conducted such assessments within the last two years specifically due to the COVID-19 pandemic. This is important to ensure our SMEs are prepared to face post-pandemic challenges and able to shift gear from survival to growth mode. Hitt and Collins (2007) highlighted that firms that develop a decision-making process based on reliable and diverse knowledge are more likely to make high-quality strategic decisions, which will strongly determine the firm's performance. Additionally, there are also questions seeking to categorise the types of business reviews undertaken during this period, offering a nuanced perspective on the multifaceted approaches SMEs employ to navigate and adapt to the challenges posed by the pandemic.

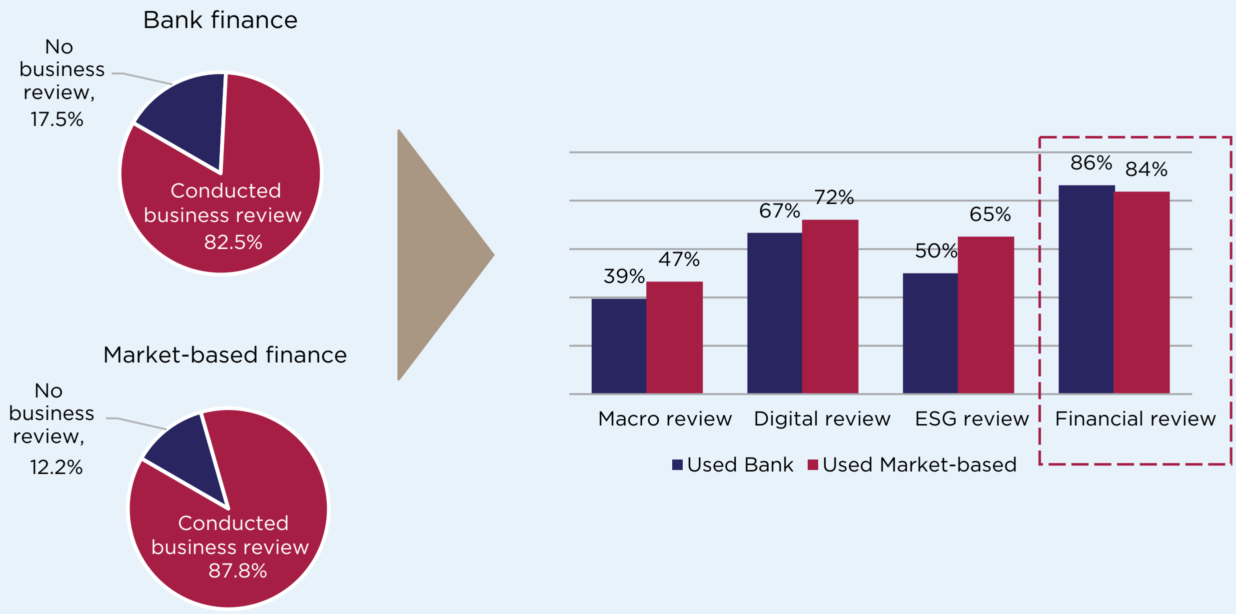
The survey revealed that the **majority (75%) of SMEs have conducted business reviews within the last 2 years post COVID-19 pandemic.** Notably, these reviews tend to concentrate more on internal factors such as financial and digital reviews, rather than external macroeconomic and ESG considerations. As such, SMEs appeared to be prioritising immediate controllable in response to the uncertainties brought about by the pandemic. Among the companies surveyed, **MTCs emerged as the segment conducting the most comprehensive review,** encompassing various facets of business operations. This suggests that larger enterprises recognise the multifaceted nature of their business operations and the interconnectedness of various aspects.

Figure 3.5:
Types of business review conducted

	Startups	MSMEs	MTCs
Financial	81%	76%	**84%**
Digital	52%	60%	**68%**
ESG	33%	41%	**70%**
Macro	25%	38%	**57%**

75% of the SMEs that have conducted business reviews, especially those encompassing financial aspects, had significantly higher access to external financing, both from traditional banking channels and market-based financing. This indicates a potential correlation between the inclination to conduct business reviews, particularly those focused on financial aspects, and enhanced access to external financing. Companies that invest time and resources in assessing their financial health and operational efficiency are positioned more favourably by both banks and market-based financing entities.

Figure 3.6:
Types of external financing and business reviews

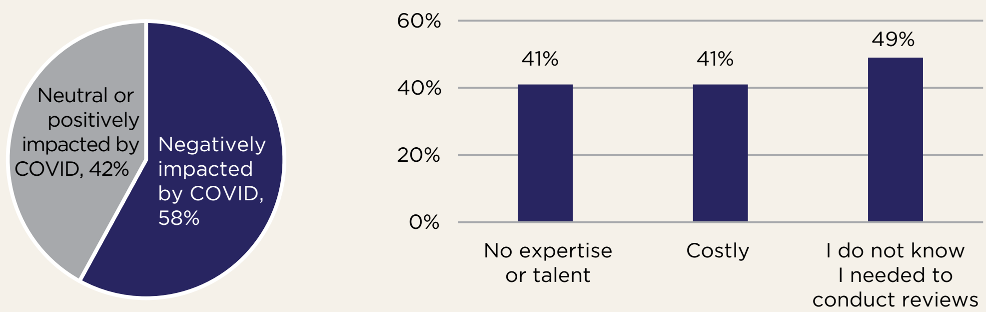


Interestingly, based on the feedback obtained from interviews with SMEs, when companies reviewed the financing options relevant to them, they were more willing and confident to approach new financing options. Some raised concerns about the lack of knowledge and understanding of a particular financing instrument, which lowered their confidence in adopting it. **This particular insight from SMEs underscores the practical implications of conducting business reviews and the role of financial literacy in making informed financing decisions.** It highlights the need for SMEs to not only assess their financial health but also invest in understanding various financing options to make well-informed choices in the ever-evolving financial landscape.

Of the 25% of SMEs that did not conduct any form of business review, 42% reported either neutral or positive impacts from COVID-19, while the remaining 58% experienced adverse effects due to the pandemic. Close to half of them cited a **lack of awareness about the necessity** for such evaluations. **Additionally, around 40% expressed concerns related to expertise and the associated costs involved in conducting comprehensive reviews. This underscores a substantial gap in the strategic management and adaptability of SMEs, emphasising the imperative for improved talent skillsets within this sector.** Lack of expertise and skills can impact the SMEs business acumen and limit their competitiveness and capacity to grow and innovate.

Figure 3.7:
Impacts from COVID-19 by respondents who did not conduct business reviews and reasons for not conducting business review

Proportion of respondents who did not conduct business reviews said:



3.3.2 Survey section 2: External financing history, purposes, and experience

External financing history

The question on external financing within the survey aims to provide a comprehensive understanding of the financial strategies employed by SMEs, with a focus on the sources they utilise beyond internal resources. This inquiry seeks to discern the prevalence of external financing adoption among SMEs, offering insights into the diverse funding avenues they explore.

The survey findings showed that a significant **64% of SMEs used external financing,** embracing a spectrum including banks, Development Financial Institutions (DFIs), government grants, non-bank credit, and market-based financing. Notably, among these options, **bank financing emerged as the most utilised, while market-based financing experienced lower adoption rates.** This is in line with a study by OECD (2015), which emphasises that bank lending remains the predominant external source of finance for many SMEs and entrepreneurs. The OECD findings, mirrored in our survey, reveal a consistent reliance on straight debt from banks to address a spectrum of financial needs, including startup funding, managing cash flow, and supporting crucial investments.

We delved into this finding further through more targeted questions during a focused-group interview session with startups. It was revealed that, when initiating a new business, their default financing choice was traditional banks due to its ease and commonality. However, these startups later found bank financing unavailable to them due to issues like business immaturity, difficulty in profit tracking, the need for collateral or guarantees and inadequate financial information. As a result, they turned to other sources such as grants or market-based financing as alternative funding sources. This highlights the evolving financing landscape for startups and the growing importance of market-based financing as a viable option for SMEs facing traditional financing constraints.

Decomposing the types of market-based financing preferred, **startups and MSMEs predominantly favour alternative and private market instruments such as ECF, P2P lending, VC, and PE.** This shows that startups and MSMEs often gravitate toward more agile and dynamic funding options. On the other hand, **MTCs, with a more established financial standing, show a preference for traditional market-based instruments like bonds and equities** which are also more accessible to bigger companies This nuanced instrument preference reflects diverse financing needs across different scales of enterprises.

These findings align with the framework outlined by BNM (2022) and SC (2021), which delineates funding sources for businesses at various stages of development. According to this framework, VC, PE, ECF, and P2P are earmarked for early and growth stages, while equity and bonds become more pertinent in the growth, late to matured stages. Additionally, insights from SC (2021) indicate that VC, PE, ECF, and P2P financing, although relatively small in size, have gained strong traction in catering to selected segments of MSMEs. This stands in contrast to MTCs, which, having outgrown existing financing avenues for MSMEs, exhibit a distinct financing landscape.

Figure 3.8:
External financing instruments used by respondents

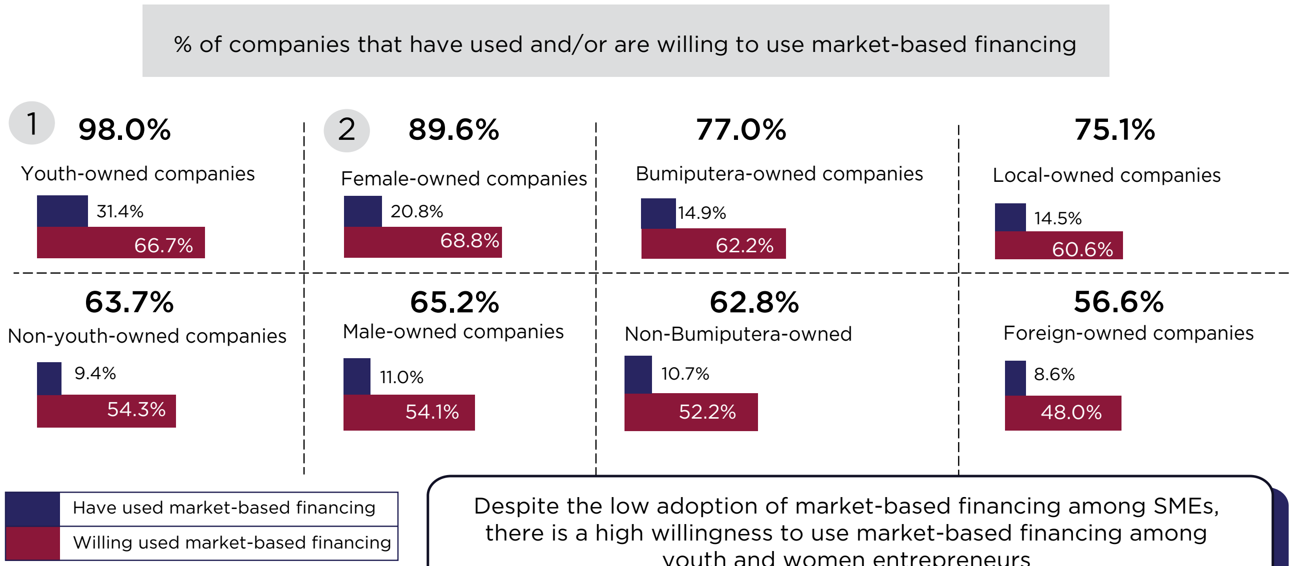
	Startups	MSMEs	MTCs
Bank	55%	68%	55%
DFI	31%	41%	55%
Government Grant	35%	37%	34%
Non-bank Credit	31%	29%	24%
Market-based financing	15%	18%	34%

For those who used market-based financing, they utilise more of:

	Startups	MSMEs	MTCs
Most used Instruments	Alternatives (ECP, P2P)	Private Markets (VC, PE)	Equities
	Private Markets (VC, PE)	Alternatives (ECP, P2P)	Bonds

Despite the relatively low adoption of market-based financing among SMEs, there was a **notable willingness among youth and women entrepreneurs to explore and use these market-based options.** This underscores a potential shift towards recognising the inclusivity and flexibility offered by market-based financing, particularly for historically underrepresented groups in the entrepreneurial landscape.

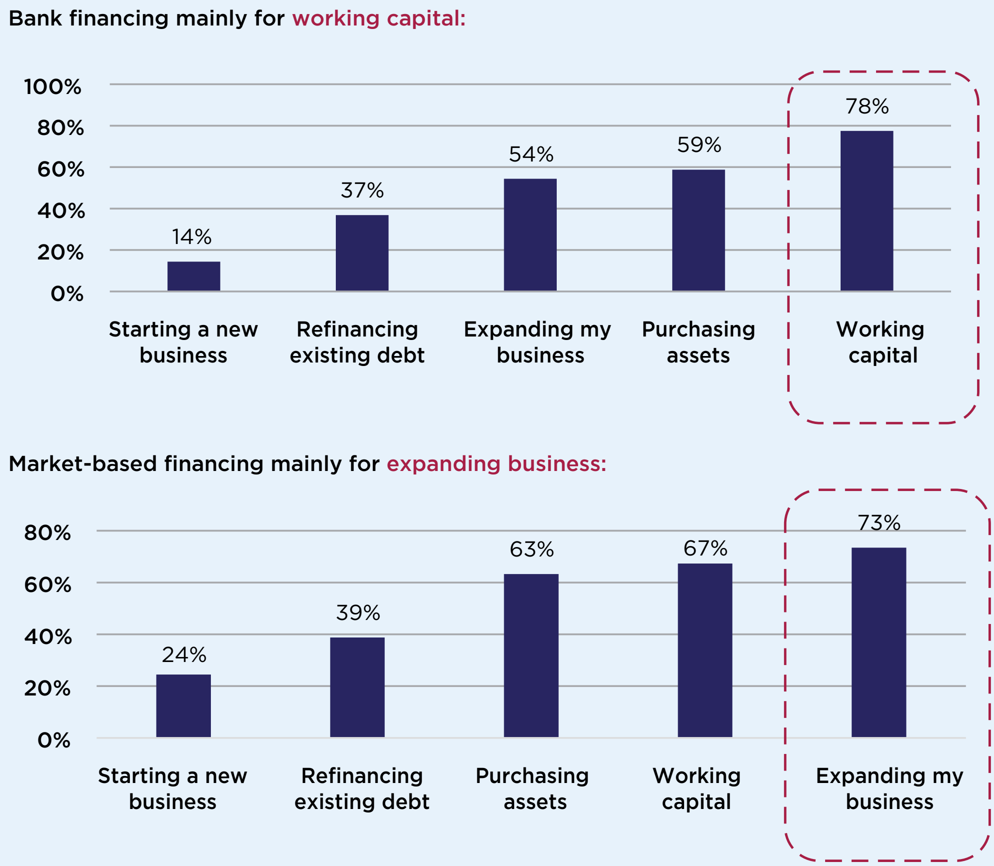
Figure 3.9:
Company ownership



Purpose of financing choice

In terms of the purpose of financing choice, this survey delved into the specific objectives for which SMEs opt for one type of financing over the other as this inquiry provides valuable insights into the strategic decision-making processes governing financial choices. The survey highlighted a **divergence in the purposes served by bank and market-based financing. Specifically, bank financing primarily catered to working capital** needs of the SMEs, covering essentials like inventory, salaries, raw materials, and rental expenses. In contrast, **market-based financing emerged as a preferred avenue for SMEs looking to embark on expansion initiatives,** signalling a distinct strategic focus toward a growth orientation. The findings illuminate not only the preferred financing methods for particular purposes but also a more nuanced preferences and considerations that guide SMEs in aligning their financial strategies with their specific business needs.

Figure 3.10:
Purposes of financing choice



Through our interactions with SMEs experienced in market-based financing, a broader perspective on its value emerged. Market-based financing is perceived not merely as a source of financial capital but also as a means to access strategic advice, expand professional networks, enhance market access, and leverage the knowledge and experience of investors.

Notably, publications from the Harvard Business Review (Ichii, 2018) and the World Economic Forum (2023) have similarly emphasised the vital role of investors, particularly venture capitalists, in providing guidance and mentorship to SMEs. **They underscore how early-stage funding extends beyond financial support, contributing to laying the foundations of a business and shaping its trajectory and strategies toward becoming an innovative and high-growth firm. This highlights the multi-faceted impact of investors in the growth and development of SMEs, extending well beyond the realm of a transactional financing approach.**

As for factors of which influence the adoption of their financing options, **flexibility and low financing costs emerged as the top two factors.** This underscores the importance of financial instruments and structures that provide adaptability and cost-effectiveness, influencing the overall financial health and sustainability of SMEs. Interestingly, the survey also revealed that **low awareness was not a significant barrier for those opting for bank financing to consider alternative financing** options, indicating it was more of an issue of willingness to consider non-bank financing options.

Figure 3.11:
Factors of choosing bank and market-based financing

Factors of choosing such financing	Bank	Market-based
Great flexibility	73%	55%
Low financing costs	69%	53%
Availability of government incentives	45%	47%
To improve the profile and credibility	39%	45%
Receive professional advice to grow business	32%	45%
Unaware of other financing options	8%*	NA

External financing experience

As shown in Figure 3.12 SMEs' experiences with the two financing sources revealed a mixed bag. **MSMEs and startups displayed a diverse experience with both bank and market-based financing,** while **MTCs, often positioned in a stronger financial stance, showcased positive perceptions for both financing.** This indicates that MTCs encounter relatively fewer challenges when seeking external financing. Their favourable experiences highlight the advantage of being more mature with a more robust financial position and established operational frameworks, allowing for smoother interactions with both traditional banks and market-based financing entities.

Conversely, **startups emerged with the least favourable experience in bank financing** when compared to both MSMEs and MTCs. As discussed earlier, this could be attributed to the inherent challenges faced by startups, such as limited operating history, perceived higher risk, and potentially stringent eligibility criteria imposed by banking institutions. This corresponds to other studies where financing constraints tend to be more acute for younger firms or for startups with limited track record to signal their ability to investors and financiers (OECD, 2015). This problem is exacerbated for SMEs whose business model is largely based on intangibles, as it is the case for sectors driven by knowledge-based capital investments, such as R&D and design (OECD, 2013).

> "We tried to get all sorts of financing, especially from bank, but we were not qualified because the company was less than 3 years and we were not profitable..."
>
> *- Startup in an advertising service*

> "The cost of hiring consultants and to maintain the reporting standard for listing is very expensive..."
>
> *- Logistic company preparing for listing*

Figure 3.12:
Experience with bank and market-based financing

Bank financing:	Startups	MSMEs	MTCs
Satisfied with bank financing	3.23	3.61	3.94
Sufficient support by government agencies	2.93	3.33	3.69
Sufficient support by bank	3.41	3.51	3.69
Sufficient support by regulators	3.16	3.51	3.81
Provide long-term financing for my business	3.73	3.86	4.13
Financing amount was sufficient	3.25	3.45	3.88
Market-based financing:	**Startups**	**MSMEs**	**MTCs**
Satisfied with market-based financing	3.50	3.44	3.90
Sufficient support by government agencies	3.83	3.74	3.90
Sufficient support by intermediaries/ advisers	3.50	3.78	3.90
Sufficient support by regulators	3.33	3.48	4.20
Sufficient support by RMOs	3.58	3.41	4.20
Provide long-term financing for my business	3.92	3.81	4.30
Financing amount was sufficient	3.67	3.41	3.80

Note: For numerical scores, a higher value indicates greater satisfaction in the respective category. Color-coding is used to signify the relative levels of satisfaction across the three business types. Green indicates the highest values, yellow suggests medium levels, and red represents the lowest values.

3.3.3 Survey section 3: Awareness of and willingness to consider market-based financing

Awareness of market-based financing

The survey also included a section to assess both the awareness and willingness of SMEs to embrace market-based financing.

Of those who have not used market-based financing before, **61% of respondents were aware** of market-based financing options, while a significant **39% were still unaware of the availability of market-based financing for SMEs.** The sentiment was echoed during interviews, specifically in relation to crowdfunding platforms such as ECF and P2P financing. Among those aware, **a significant 85% expressed a willingness to consider** market-based financing, contingent upon their specific needs being met.

Willingness to consider market-based financing

In particular, **startups expressed a willingness to embrace market-based financing, especially when faced with a lack of alternative funding sources such as internal funds or bank loans.** This reflects a pragmatic approach among startups, leveraging market-based options to fill crucial financial gaps. On the other hand, **MSMEs were more inclined to consider market-based financing if they could**

secure a sufficient financing amount. This emphasis on the adequacy of funds highlights the strategic importance of aligning financing options with the specific capital needs of MSMEs.

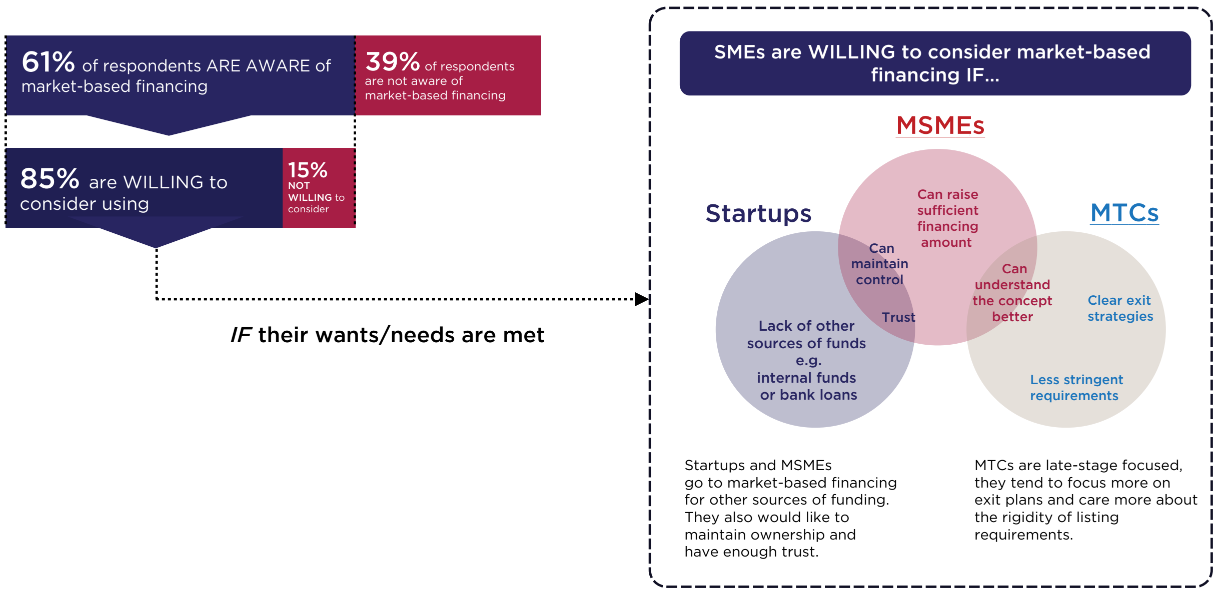
Both startups and MSMEs also shared a common ground in their willingness to explore market-based financing when two key conditions are met. The first condition, a foundation of trust, underscores the importance of establishing a secure and reliable relationship with chosen financing mechanisms. The second condition, the ability to maintain ownership, holds profound significance which goes beyond a mere desire for control. It reflects the strategic imperative for SMEs to avoid diluting their equity ownership through financing mechanisms like equity funding.

This strategic stance is grounded in the broader narrative of SMEs seeking financial support while carefully assessing the complexities of equity dynamics to retain control and autonomy in their business ventures. By prioritising the preservation of ownership, SMEs strategically position themselves to not only secure financial support but also to retain a firm grip on the direction and decision-making within their enterprises. Together, these conditions reveal SME's desire to balance financial support with the preservation of autonomy and trust in the chosen financing mechanisms.

MTCs, often at a later stage of development, exhibited a different focus. Their willingness to engage with market-based financing was intricately **tied to exit plans,** and they were particularly attuned to the **rigidity of listing requirements.** This reflects a strategic approach among MTCs, where considerations extend beyond immediate funding needs to long-term positioning and potential exits.

Another key finding of the survey was that the **willingness of both MSMEs and MTCs to explore market-based financing was contingent on a deeper understanding of the concept.** This underscores the importance of the need for a more comprehensive understanding, as compared to SMEs already having awareness of the market-based financing mechanisms. The findings revealed the necessity for targeted educational initiatives to empower MSMEs and MTCs with the knowledge required to leverage the potential benefits of market-based financing effectively. Efforts geared towards simplifying the intricacies of market-based financing mechanisms have the potential to pave the way for a more widespread acceptance and utilisation of market-based financing among MSMEs and MTCs.

Figure 3.13:
Awareness of and willingness to consider market-based financing



3.3.4 Survey section 4: Key barriers and opportunities for market-based financing

Key barriers and opportunities

The survey also brought to light both the obstacles and potential avenues for market-based financing adoption among SMEs. As shown in Figure 3.14, the primary hurdle faced by SMEs are the **complicated and lengthy procedures** associated with market-based financing. Application-related concerns, including stringent requirements, emerged as the top two reasons for the unwillingness to embrace market-based financing. This indicates a crucial area for improvement in streamlining processes by regulators and financiers to encourage wider adoption.

Alongside procedural challenges, **high funding costs** and **concerns regarding exit strategies** contributed to the reluctance to opt for market-based financing. Addressing these financial aspects and providing clearer and more efficient pathways for exits could potentially mitigate these concerns. Surprisingly, **not being approached** emerged as another significant barrier. This highlights a potential opportunity for financial institutions which offer market-based financing to proactively reach out and increase their engagement with SMEs and to demystify the process.

Figure 3.14:
Reasons for unwillingness to use market-based financing

Consistent with our interview findings, feedback from Startups, MSMEs, and MTCs highlights several challenges in the financing landscape:

1. **Funding for SMEs remains challenging:** Obtaining financing remains challenging, particularly for SMEs lacking sufficient credit history, profit track records, or collateral. While market-based financing instruments could cater to this group, there is often a lack of risk appetite from investors to finance high risk businesses, leading to risk capital gap for these early-stage SMEs.
2. **Restricted exit strategies:** Startups in Malaysia face constraints in terms of exit strategies, with IPOs being the primary route. However, some of the SMEs feel that there is a noticeable scarcity of M&A deals and opportunities in the Malaysian corporate landscape, compared to the growing

global trend toward trade sales as an exit strategy for private companies. A more diverse range of exit strategies is needed for SMEs seeking market-based financing.

3. **Knowledge deficits in market-based financing:** Generally, there is sufficient awareness of market-based financing options but the more detailed knowledge on where, how, and who to approach to obtain market-based financing is still low among SMEs. Many of those interviewed are not even familiar with the term market-based financing until we provide them with the definition and examples of what constitutes market-based financing. Product reachability remains an issue, especially in the P2P and ECF markets where these market-based offerings are still relatively unknown for many SMEs. Some startups, even after successfully securing VC/PE funding, admit to having a limited understanding of alternative market-based financing avenues. Separately, some startups in our interviews highlighted that local VCs lack the necessary skills and knowledge to evaluate their business effectively and in giving fair valuations. However, the flip side to the story is that some of the VCs addressed that startups often overvalue themselves by leveraging intangible assets such as innovative ideas and intellectual property, which are not commercially viable.

4. **Higher funding costs:** SMEs expressed concerns over the high cost of funding when utilising market-based financing, especially for P2P financing. Double-digit return expectations for short-term loans can impact SME profitability significantly. Nonetheless, our engagement with various stakeholders showed that ECF and P2P have high traction among Startups and MSMEs particularly due to digital convenience as well as the speed of disbursement. The lack of information and data to understand credit risks also leads to high pricing, which remains a concern and is one of the reasons why some SMEs shy away from using the digital financing platforms.

5. **Burdensome compliance and transition support:** Many market-based financing options are perceived as having onerous compliance processes, and the associated costs can be prohibitive for SMEs. Some interviewees also raised concerns about the high cost of listing for the Leading Entrepreneur Accelerator Platform (LEAP), which questions the economics and incentives for SMEs to list on the LEAP market.

Source of information

Given that SMEs face challenges in understanding market-based financing, identifying preferred mediums to disseminate information effectively is important, especially for policymakers and industry players. Respondents were also asked to indicate their top preferred medium to obtain more information about market-based financing. This question aims to discern the preferred channels through which SMEs seek information on market-based financing, providing insights into the most effective communication mediums for disseminating relevant knowledge and fostering awareness within the SME community.

The survey revealed that, **across all business sizes, leveraging networks through government agencies and business associations/chambers is the top-preferred medium for obtaining information about market-based financing.** This underscores the importance of established networks in disseminating information and signals an opportunity for collaboration between financial entities and these intermediary bodies. This is also aligned with research on successful entrepreneurial ecosystems which are characterised by being in an information-rich environment, both from organised and accidental networks in which there is a process for information-diffusion and tacit knowledge-sharing.

Notably, for **startups with a greater inclination towards digital platforms, online sources emerged as the preferred medium** for obtaining information about market-based financing. This emphasises the significance of tailored digital strategies to cater to the specific information-seeking behaviours of startups.

Figure 3.15:
Top 3 preferred medium to obtain information about market-based financing

	Startups	MSMEs	MTCs
Rank 1	Online Sources*	Business Associations/ Chambers	Government Agencies
Rank 2	Business Associations/ Chambers	Government Agencies	Business Association/ Chambers
Rank 3	Government Agencies	Networking and word of mouth	Trade shows and events

**Online sources include: Social media, articles, websites and advertisements*

Additionally, our interviews with SMEs also revealed that many of them face challenges in accessing information about market-based financing. They find that the information is scattered on different websites and fragmented, leading to additional resource costs due to issues like duplication of information and difficulty in access. Furthermore, awareness among SMEs regarding the availability of one-stop information centres like SMEinfo Portal needs further enhancement.

Specifically, the SMEinfo Portal by SME Corp. Malaysia serves as a centralised online information repository dedicated to meeting the diverse needs of MSMEs. This comprehensive platform is designed to provide SMEs with extensive information and resources to aid them in various aspects of their business operations. It covers a broad spectrum of topics, including financing, training, and various government initiatives and support programmes tailored for entrepreneurs and MSMEs.

The portal aggregates diverse information, encompassing business guides, detailed site maps outlining stages in business formation, strategies for growth and expansion, and guidelines for exiting a business. Additionally, it features sections for news and events, enabling MSMEs to upload their planned programmes. Published material covering policies, regulations, and publications like the SME Masterplan and various annual reports is also readily available on the portal.

These insights underscore the importance of streamlining and improving the accessibility of information sources to make them more user-friendly for SMEs, higher awareness of such platforms should also be raised to increase the outreach and effectiveness of the platform.

3.3.5 Survey section 5: Digitalisation and ESG

Digitalisation

The digitalisation trend accelerated strongly during the COVID-19 pandemic, when digital activities emerged as a fundamental condition for many firms to continue operating. Increasing the digital adoption rate is particularly relevant for SMEs, especially as they face a disproportionate impact during the periods of crises such as the recent pandemic.

Efforts to increase government support for digitalisation are aimed at levelling the playing field for SMEs. In Malaysia, the high broadband penetration rate[31] across the country is aimed at facilitating more online business, making it more viable, efficient, and cost effective for SMEs to access to markets. However, as technological advancements such as artificial intelligence (AI) continue to accelerate, there is a risk of a widening divide between SMEs which have made the digital leap and the others which struggle with digital transformation.

The questions on digitalisation in the survey further revealed the extent and nature of digital adoption within SMEs. Specifically, in the survey, digitalisation in the context of this study includes aspects such as:

- enterprise resource planning,
- big data,
- eCommerce,
- online advertisement, and
- marketplace

This section aims to provide a comprehensive understanding of how SMEs are leveraging digital tools and platforms in their operations. While not directly related to financing, digital adoption is now at the front and centre of policymakers' agendas for market-based financing.

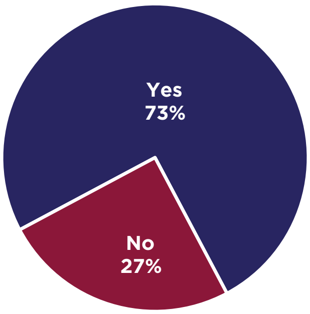
The survey illuminated the prevalent trends and impact of digital technology adoption among SMEs. Specifically, a notable **73% of SMEs have embraced digital technology** in their business operations. This signifies a substantial integration of digital tools and platforms within the SME sector, indicating a shift towards technologically driven business practices. Among the SMEs leveraging digital technology, **the top factor motivating digitalisation efforts was for them to gain access to new markets.** This underscores the pivotal role that digitalisation plays in helping expand market reach for SMEs to gain growth opportunities. According to OECD (2021), the pandemic opened up opportunities to new markets and products by upscaling their uptake of digital tools as well as cost-saving measures.

The survey further revealed distinct patterns in the areas where digitalisation is implemented. For **startups and MSMEs, the focus primarily lay in marketing and sales,** indicating a targeted effort to enhance visibility and customer engagement. In contrast, **MTCs prioritised digitalisation in financial management,** reflecting a strategic approach towards optimising their financial systems, again highlighting the different levels of sophistication of digital adoption as businesses mature.

In terms of the impact of digitalisation, an overwhelming **89% of SMEs reported a positive impact from digitalisation** on their overall operations. This widespread positive sentiment highlights the transformative role that digitalisation plays in reshaping the operational dynamics of SMEs. It shows that digital technology is not merely an auxiliary tool but a fundamental driver of enhanced efficiency, heightened competitiveness, and overall improved business performance within the SME sector. The findings suggest that SMEs, by embracing digitalisation, are experiencing a paradigm shift in their approach to operations, leveraging technology as a catalyst for growth and resilience in an increasingly digitised business environment.

Figure 3.16:
Digitalisation of SMEs in terms of adoption, factors, areas, and impact

How many have leveraged digital technology:



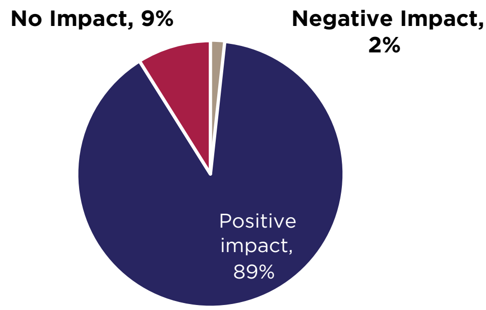
Of the 73% who leveraged:

Ranking	Factors of digitalisation
1	Access to new market
2	Customer expectation
3	Company's internal push
4	Better access to finance
5	Incentives from gov
6	Shareholder and investor push
7	Regulatory requirement

Areas where digitalisation is implemented:

	Startups	MSMEs	MTCs
Marketing & Sales	**76%**	**79%**	70%
Customer Relationship	64%	54%	70%
Financial Management	55%	60%	**75%**
Supply Chain Management	43%	39%	70%

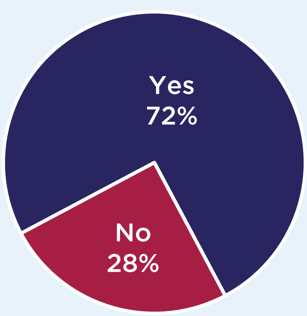
Impact of digitalisation on business:



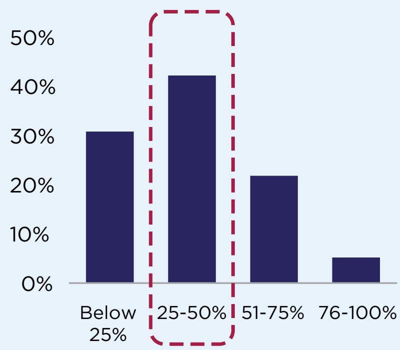
A significant 72% of SMEs marketed their products on e-commerce platforms, highlighting the increasing reliance on online channels for product promotion and sales. Most SMEs reported a substantial share of sales from e-commerce platforms, ranging from 25-50%. This reinforces the pivotal role of digital platforms in shaping the business landscape for SMEs.

Figure 3.17:
Use of e-commerce platforms for product marketing

How many market their products on e-commerce:



Share of sales from e-commerce platform:



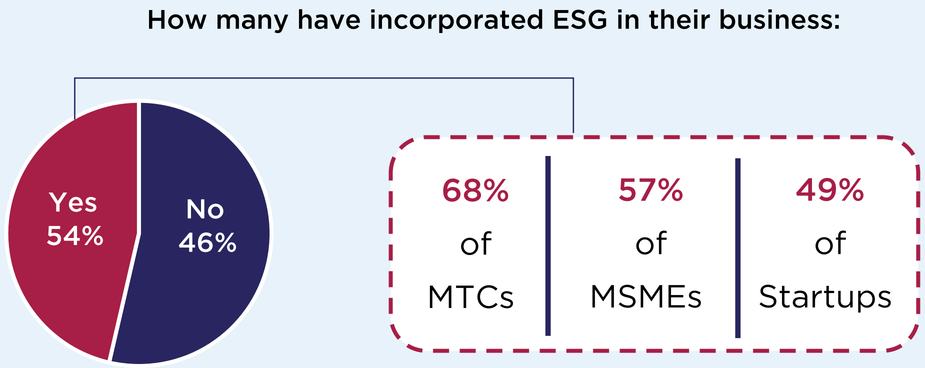
Environmental, Social, and Governance (ESG)

Integrating ESG principles into business practices is more crucial than ever. It is no longer merely a positive addition but is strongly tied to the resiliency and sustainability of a business. Furthermore, ESG should not only be prioritised by larger corporations; it is equally important for SMEs to consider ESG in order to meet the expectations of their customers, investors, and other stakeholders and is especially critical for SMEs which are a part of the global supply chain. ESG and digitalisation should be addressed in tandem to capitalise on synergies, as both are important for SMEs to adapt and future-proof their business models.

The survey showed that the incorporation of ESG practices was not yet universal, with **only half of the SMEs incorporating ESG** principles into their operations. Delving into the breakdown across different business sizes, a notable pattern emerged. **MTCs led the way with a commendable 68% adoption rate,** followed by 57% of MSMEs, and 49% of startups.

This variance suggests that larger enterprises, such as MTCs, may have a comparative advantage in dedicating talent, resources and capacity to ESG initiatives. In other words, the integration of ESG practices is potentially influenced by the scale and resources available to businesses. MTCs, with their larger size and resource base, seem to be at the forefront of embracing ESG principles, underscoring the potential correlation between organisational capacity and the ability to adopt sustainability and good governance practices. This insight not only highlights the current landscape of ESG adoption among SMEs but also prompts considerations about the scalability and resource implications of incorporating sustainable and responsible business practices within varying business sizes.

Figure 3.18:
Incorporation of ESG practices



The decision to incorporate **ESG practices was predominantly driven by external factors, with growing customer demand playing a central role.** Among the SMEs that have adopted ESG practices, the key factors included the increasing demand from customers or buyers, internal company policies, and the expectations of shareholders and investors. This strategic alignment with market forces and governance frameworks indicates a responsive approach to changing business landscapes.

Figure 3.19:
Key factors of ESG incorporation

Of the 54% who leveraged, the key factors are:

Ranking	Factors of ESG incorporation
1	**Growing demand from customers or buyers**
2	**Company's internal policy**
3	**Shareholders/investors**
4	Government incentives
5	Regulatory requirements
6	Suppliers
7	Employees
8	Lenders

"ESG disclosure is crucial, it will impact the financing prospects and it will become necessary for my future funding success..."

-An entrepreneur with 20 years of experience in managing multiple businesses.

"Our clients are mainly listed companies, so they ask us to be ESG compliant"

-A tech-based MTC which has been operating in Malaysia for more than 10 years

In the interviews with SMEs, we found that many are aware of the growing importance of ESG in the business landscape. However, some hold misconceptions about ESG, often perceiving it as solely related to environmental concerns, such as "being green." What is vital to grasp here is that ESG practices go beyond the environmental aspect; they encompass environmental and social impact, as well as governance elements, which significantly influence business strategies and financial prospects. This awareness highlights the need for a more comprehensive understanding of ESG and its broader implications on business operations and funding prospects.

The survey further elucidated key reasons for SMEs not incorporating ESG principles. **For startups, the lack of government incentives emerged as a**

predominant barrier, emphasising their reliance on external support. The current government assistance for startups may not emphasise the need to measure the impact of the grants on the environment and society, which can lead to the startups' view that government incentives are lacking for ESG integration into their business.

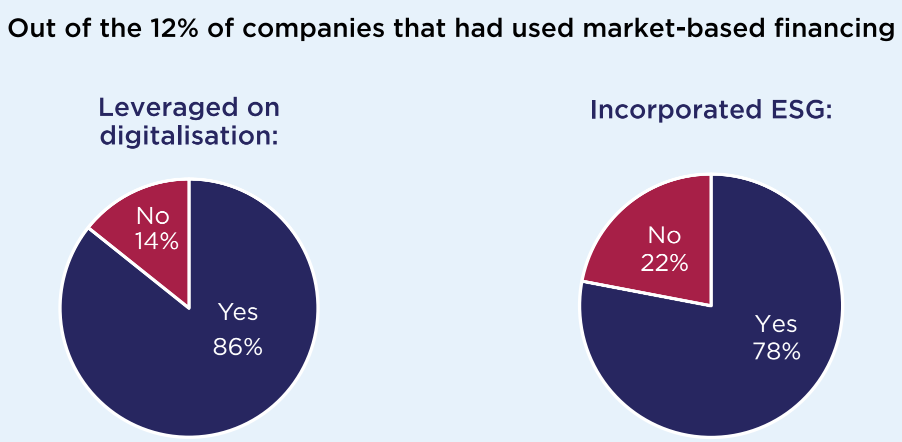
MSMEs cited the complexity of ESG reporting as the main hindrance. This highlights the need for streamlined and accessible reporting mechanisms. In contrast, **MTCs identify the high cost associated** with issuing ESG financing instruments as a barrier, pointing to the economic considerations influencing larger enterprises.

Figure 3.20:
Key reasons for not incorporating ESG

	Startups	MSMEs	MTCs
Rank 1	Lack of government incentives	ESG reporting is very complicated	High cost of issuing ESG financing instruments
Rank 2	High cost of issuing ESG financing instruments	High cost of issuing ESG financing instruments	ESG reporting is very complicated
Rank 3	ESG reporting is very complicated & it will increase the cost of production	Not relevant to my business	It will increase my cost of production

Notably, a **higher percentage of companies that have leveraged market-based financing have embraced both digitalisation and incorporated ESG practices.** Among companies that have leveraged market-based financing, a substantial **86% have also embraced digitalisation.** This synergy indicates a recognition of the interconnected and synergistic benefits of both sustainable practices and technological innovation in reshaping business strategies. Furthermore, **78% of these companies have incorporated ESG principles,** showcasing a dual commitment to sustainable business practices and the utilisation of alternative financing methods. This intersection reflects a strategic approach, where SMEs leverage both technological advancement and sustainable practices to enhance their market positioning and financial strategies.

Figure 3.21:
Market-based financing, digitalisation and ESG incorporation



3.3.6 Findings from interviews with government agencies and regulators

Interviews with agencies play a crucial role in gaining a comprehensive understanding of the SME ecosystem. These insights shed light on the challenges and opportunities faced by SMEs and provide valuable perspectives from organisations actively involved in supporting and monitoring these businesses. Aside from the interview insights that we have provided along with the survey findings in the earlier section, below are some of the key insights that we further summarised from the interviews with relevant agencies and regulators:

Lack of information and data on SMEs

One of the foremost challenges raised by government agencies is the scarcity of data and information that are available to the investors, financial institutions or agencies providing grants and loans. This information gap not only hinders SMEs' access to financing but also increases the cost of financing for them. Notably, the information asymmetries are particularly pronounced for micro to small-scale SMEs compared to larger enterprises, given the latter's obligation to produce audited financial statements and uphold more rigorous disclosure standards. The deficiency in SME information was highlighted in interviews, particularly concerning SMEs exploring listing options in the capital market, who encountered demanding information disclosure requirements. These information gaps faced by SMEs also amplify the monitoring and evaluation costs, a concern accentuated by the heterogeneity within the SME sector. As such, addressing information asymmetries emerges as a pivotal priority to enhance market transparency and efficacy for SMEs.

Transition challenges for SMEs

In the course of interviews with government agencies, Agency A raised a concern regarding the transition challenge. While MSMEs receive government assistance in the form of subsidised loans and other financial and non-financial programmes, this support can inadvertently disincentivise them from aspiring to grow beyond the SME level. According to agency A, "some informal businesses are hesitant to grow and would remain unregistered to retain their B40 status in order to continue to benefit from the subsidies provided by the Government". Additionally, it was also mentioned that there were companies started for the sole purpose of accessing SME grants, in which they do not create more value to their products or services provided. To encourage MSMEs to grow larger and faster, the support mechanisms and incentives provided should be designed to drive the growth of SMEs.

Shifting investment landscape

In-depth insights from interviews further illuminate a significant transformation in the investment landscape. Notably, investors, especially venture capitalists, are shifting their focus from "growth at all costs" to considering revenue, profitability, and long-term sustainability. This shift is partly driven by VC firms grappling with rising funding costs due to inflationary pressure and consolidated monetary tightening in major central banks globally (also known as the hurdle rates). Understanding this evolving landscape is vital for SMEs seeking investment and for managing their cash flows prudently to ensure continuity and survivability of the business.

Knowledge gaps and financial decisions

Insights gleaned from interviews, particularly with Agency B dedicated to early-stage startups, underscore the pervasive challenges that startups grapple with money management. The impact reverberates, affecting both their growth trajectory and their ability to secure crucial funding. Agency B emphasised the need for capacity-building programmes tailored to enhance entrepreneurs' fundamental business knowledge, with a specific focus on financial management encompassing basic accounting and cash flow management. As noted by Agency A, "some of the startups do not have basic accounting knowledge, hence they do not understand the importance of cash flow and account tracking…". This insight demonstrated the importance of fundamental business knowledge beyond just financing in any aspect of business management. Furthermore, startups often face uncertainty when identifying optimal funding avenues, leading them to select financing options that may not align with their business needs. Hence, addressing these knowledge gaps is essential to empower startups in making informed financial decisions, as the financing decision plays an important role on sculpting the business's future trajectory.

3.3.7 Findings from interview with the intermediaries

Intermediaries play a crucial role in connecting SMEs with investors and facilitating their access to various grants and funds available to them. Their insights are invaluable in comprehending the challenges and opportunities within the SME landscape. These intermediaries serve as the bridge between SMEs and investors, offering unique perspectives on the intricacies of business growth and financial transactions.

Talent mismatch and human capital challenges

As per insights from intermediaries in Malaysia's startup ecosystem, one significant challenge startups face is the struggle to identify and retain the right talent for their businesses. Getting their businesses off the ground is often hindered by the difficulty in locating individuals possessing the requisite skills to propel the business forward. The intermediaries provided examples, citing instances of startups with innovative ideas but lacking practical and technical knowledge to create prototypes. Another case highlighted a blockchain company's difficulties in securing an adequate number of programmers to develop their system. The talent challenge extends beyond recruitment, as retaining the skilled individuals proves to be another on-going concern.

Complexities in university-industry linkages

Insights from intermediaries further revealed a significant challenge – the complexities in the connections between universities and industries. While collaborations with academia hold promise for innovation, the practical implementation of innovative and new ideas encounters roadblocks, despite the strength of their underlying concepts. Establishing robust connections between universities and industries is crucial for tapping into the wealth of research and knowledge available within academic institutions. These linkages can drive innovation, help businesses leverage cutting-edge research, and foster a culture of learning and growth, ultimately contributing to the overall development of the business landscape. However, navigating the intricacies of these collaborations presents its own set of challenges, including issues surrounding intellectual property (IP) and the absence of structured arrangements for licensing. Addressing these complexities is pivotal in bridging the gap between theoretical research and real-world application, unlocking the full potential of these collaborations.

Barriers to entry for LEAP and ACE markets

Insights gathered from interviews shed light on another notable challenge faced by companies contemplating LEAP market listing. These companies exploring listing on the LEAP market face substantial issuance fees, which can place a significant financial burden on them when seeking for IPO as an exit strategy. Some entities seeking to list appear to be more motivated by the allure of brand recognition due to the benefits of obtaining preferable bank financing rates or bigger projects as a "listed company" rather than for the purpose of obtaining capital. Moreover, there is a mismatch between the listing requirement versus actual business practice, particularly concerning the profit-test for IPOs on LEAP. Overcoming these barriers is critical to fostering a thriving ecosystem for SMEs seeking to access these markets.

3.4 Conclusion

In conclusion, our survey and interview provided a comprehensive overview of the financing landscape for SMEs, shedding light on the challenges and opportunities faced by startups, MSMEs, and MTCs. The seismic impact of the COVID-19 pandemic was palpable, with a majority of SMEs navigating adverse effects, particularly pronounced among MSMEs. When considering external financing, SMEs exhibited a preference for bank financing while market-based financing experienced lower adoption rates. The willingness to explore market-based financing was influenced by factors such as trust, control, and specific business needs, emphasising the nuanced considerations across different business sizes. Moreover, the barriers to market-based financing ranged from complicated procedures to concerns about funding costs and exit strategies. Information-seeking behaviours, digitalisation trends, and the varying impact of ESG practices added further layers to the SME financing landscape.

Additionally, insights from interviews with government agencies and intermediaries further illuminated challenges and opportunities in the SME landscape. A critical hurdle was the lack of accessible data on SMEs, hindering financing access and elevating costs. Transitioning from SMEs to MTCs faced obstacles, potentially due to existing support structures. The evolving investment landscape, with increased focus on sustainable growth, demanded SME alignment with investor expectations. Knowledge gaps, talent mismatch, and complexities in academia-industry collaborations underscored the need for targeted interventions. Barriers to LEAP and ACE markets, like substantial fees, highlighted financial challenges. Integrating these insights emphasised the imperative for nuanced interventions, addressing information gaps, facilitating growth transitions, and navigating investment dynamics. In short, this chapter delved into the challenges and dynamics of SME financing based on the findings from surveys and interviews, presenting barriers and opportunities for informed interventions and policy considerations.

Chapter Four

Policy Recommendations

4.1 Market-based financing and the real economy

SMEs play an indispensable role in Malaysia's transition to a high-income economy (World Bank, 2021). The challenge lies not only in increasing their contribution to GDP to 50% by 2030 but also in facilitating their progress towards becoming more technologically driven, enhancing their competitiveness, and producing high-value-added goods and services for both domestic and international markets.

For Malaysia, there is a significant policy focus on the critical role SMEs play to achieve national policies i.e. Malaysia Madani Economy, NETR and NIMP 2030. Government policies on SME development are also evolving, with emerging focus on understanding better how it operates within the ecosystem and is connected to various other policies. Availability of finance is a critical feature of a successful SME ecosystem.

However, it must be complemented by a recognition that different types of SME businesses have different funding requirements. SMEs are often associated synonymously with innovation, growth, and entrepreneurship. But not all SMEs are prioritising growth and innovation. Many SMEs have neither the inclination nor the ability to grow, innovate or be involved in international markets. Some barriers could exist including scarce resources, low business acumen and strategic thinking and a strong desire to retain independence which might override the desire for growth, which is dependent on external funders giving advice (Curran and Blackburn, 1999).

According to the OECD (2023), intervention strategies to support the diverse needs of SMEs and entrepreneurship can be categorised into three key areas. These encompass 1. Targeting broad-based policies, such as those related to taxation, the labour market, trade, and infrastructure; 2. Targeting sector-specific policies, which involve targeted development efforts in sectors like renewable energy within the National Energy Transition Roadmap (NETR); and 3. Targeting policies to address unique challenges of specific SMEs and entrepreneurs, with a particular emphasis on those pursuing high growth and innovation-driven ventures. The implementation of these policies often spans across different government ministries and agencies and operates at various levels of government (federal, state, and local), exhibiting considerable diversity based on institutional arrangements and the extent of decentralisation.

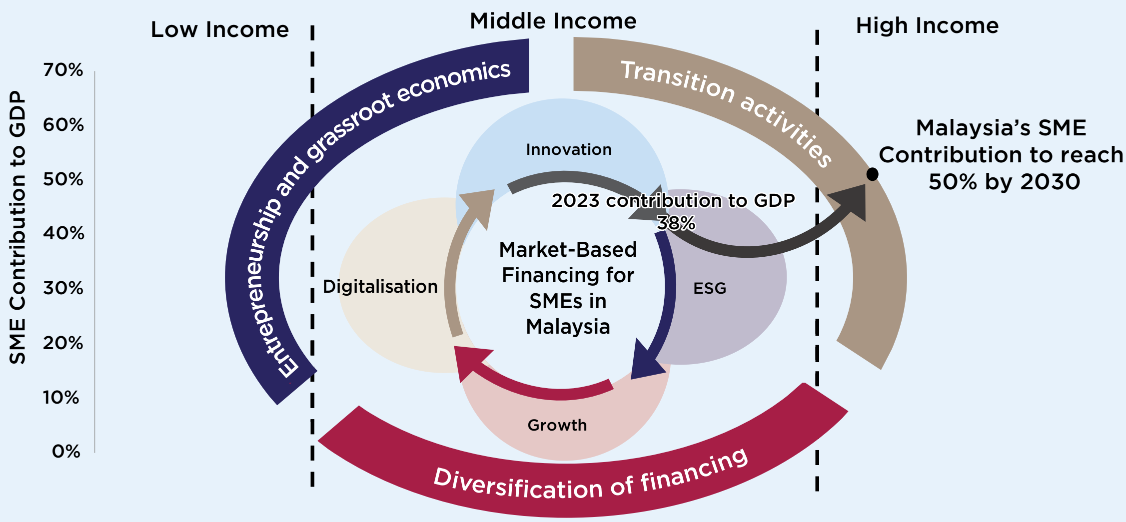
Focusing on policies aimed at specific SMEs and entrepreneurship is crucial, particularly when dealing with ventures entering new growth areas characterised by distinct challenges and high uncertainties. Despite the complexities involved, such ventures also hold the potential for economic profits (referred to as alpha) and the possibility of exponential growth, ultimately transforming into gazelles or even potential unicorns. Recognising the inadequacy of one-size-fits-all solutions, it is imperative to adopt an approach that emphasises policy interventions at multiple levels, aligning with the aforementioned categories of policies suggested by the OECD. This nuanced approach is better suited to effectively address the diverse and dynamic issues faced by SMEs, ensuring a more tailored and responsive policy framework.

The role of market-based financing is crucial in enabling the development of high-growth and quality SMEs needed for Malaysia to transition towards becoming a high-income nation, in particular by providing the necessary capital for financing the SMEs' growth and innovation.

Our survey revealed that SMEs prefer market-based financing as their primary means of capital raising to expand their businesses. This is in contrast to the SMEs which prefer bank-based financing mainly for working capital. These different preferences stem from the flexibility and diversity of financing options available for SMEs, in which market-based financing can play an important complementary role to bank-based financing. With a diversified financing option encompassing early to mature stages of financing, market-based financing provides a pool of capital from various sources and instruments tailored to specific needs and suitability, contributing to a 'funding escalator' and 'cocktails' of different funding sources (OECD, 2014).

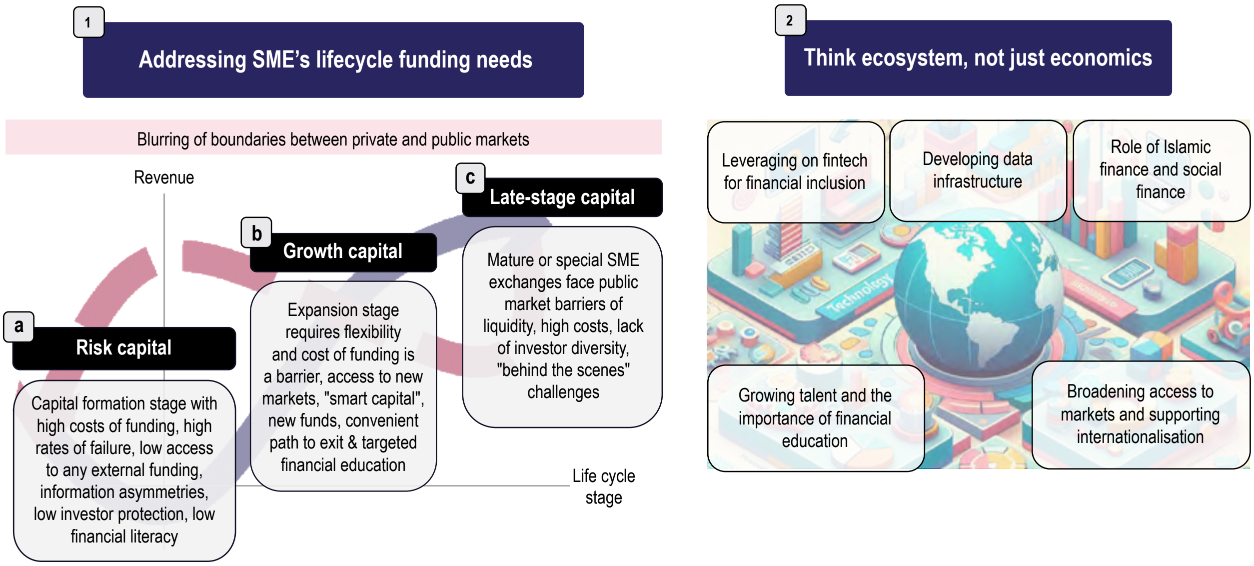
However, findings from the survey and subsequent interviews indicate that gaps exist in financing availability along the life cycle stages of the SME, with each cycle presenting its own unique challenges for policymakers and industry players to address. Likewise, promoting digitalisation and ESG principles in SMEs has a transformative impact on the economy. Market-based financing serves as a vital catalyst for SMEs seeking to transition towards embracing digitalisation and ESG principles for greater competitive strength. These two elements are intricately linked to market-based financing and structural reforms of the economy. Digital technologies enhance efficiency and open up opportunities for exploring new and innovative business models, while adherence to ESG principles, specifically driven by shareholders and regulators can drive SMEs to operate in a sustainable and socially responsible manner. Consequently, by providing financing support for the four core focus areas of innovation, growth, digitalisation, and ESG principles, market-based financing serves as a catalyst for transitioning Malaysia's SMEs into a modern, sustainable, and high-growth sector (see Figure 4.1).

Figure 4.1:
Market-based financing for SMEs in Malaysia



While the SMEs play a pivotal role in Malaysia's economy, contributing significantly to employment, innovation, and economic growth, it faces unique challenges that hinder their growth and development. These challenges can be broadly categorised into two main areas: addressing SMEs' life cycle funding needs and strengthening the overall SME ecosystem. In this chapter we will look into policy recommendations that could address the following changes and reduce financing gaps by SMEs, especially to finance the innovation activities (see Figure 4.2).

Figure 4.2:
Policy recommendation to strengthen SME ecosystem in Malaysia



Life cycle funding needs: A multifaceted challenge

Financing is a critical aspect of SME growth, and the availability of funding varies across different stages of the business life cycle. Each stage presents distinct challenges for SMEs, investors, industry, and policymakers to address in order to narrow the financing gaps.

Risk capital: Early-stage SMEs often struggle to secure funding due to the higher perceived risk. A key challenge at this stage is the difficulty in predicting early on which businesses have the highest growth potential. Not all SMEs can be considered as high-growth, competitive SMEs. World Bank (2013) identified that only a small subset of SMEs grow robustly after establishment but will contribute disproportionately to overall economic performance. These SMEs will often have needs and challenges that are easily addressed by a broad set of SME policies. For instance, they may have a relatively bigger need for finance at an early stage to undertake more risky activities, something traditional banks are wary to fund.

This early stage requires risk capital and innovative financing solutions that are more unlikely to be met by bank financing, such as angel investors, venture capital, and crowdfunding platforms. At the same time, the government plays a pivotal role in facilitating and attracting private funding for early-stage startups and high-growth and competitive SMEs. The primary role of the public sector is to reduce the risk and barriers for SMEs to grow by complementing and encouraging the development of the private capital industry. However, due to the unpredictable and high-risk nature of risk capital, policy design at this stage can be particularly complex and outcomes uncertain.

Growth capital: As SMEs transition from early to the mid-stages of their life cycle, innovation and growth activities become more crucial. Once they have successfully negotiated the start-up phase, these high-growth innovative SMEs become more market-driven and with increased revenue generating capacities which reduce the risk of full enterprise failure. However, challenges in accessing sufficient growth capital can limit their potential to "scale-up" and make a sizeable contribution to the national economy, in terms of innovation, employment, and overall productivity and income growth. This is also the critical stage where the SMEs can better respond to new business opportunities, absorb new technology and prioritise sustainability considerations such as ESG. Some SMEs will seek to access new markets through internationalisation and will be able to play an important complementary relationship with large firms. Policy attention focused on this complementary relationship can create a healthy ecosystem of firms, facilitating a process of 'entrepreneurial recycling' (Mason and Harrison, 2006).

At this stage, SMEs can use options such as private equity and specialised markets, such as the LEAP market, to raise financing. Digital tools such as P2P and ECF are also increasingly becoming preferred choices of financing for SMEs to meet their working capital needs and the expansion of business activities.

Late-stage capital: Mature SMEs seeking to expand into new markets or pursue mergers and acquisitions could raise financing from IPOs and bond markets. SMEs that have reached this mature stage will seek diverse financing options to optimise their capital allocation and facilitate transition activities such as changes in ownership and mergers and acquisitions (M&A) opportunities. For private SMEs, they will seek a viable exit strategy for their entrepreneurs and early-to-mid stage investors to realise their investment returns and grow the business further.

Policymakers must thus adopt a holistic approach that addresses both the life cycle funding needs of SMEs and the broader factors that influence their success. Encouraging the development of a diverse range of financing options tailored to the specific needs of SMEs at different stages of their life cycle provides options for SMEs to access financing that best suit their business and risk profile. This includes expanding access to complement traditional bank loans, developing alternative financing channels, creating mezzanine finance with options to convert debt to equity, and providing a clear path for an exit strategy. This will help to strengthen and thrive the SME ecosystem in Malaysia.

Strengthening the SME ecosystem: beyond financing

While financing is essential, it is not the sole determinant of an SME's success. For instance, fostering a culture of innovation and encouraging SMEs to adopt new technologies are equally important to enhance their competitiveness and productivity. This includes providing access to technology infrastructure, access to markets through internationalisation and public procurement (OECD, 2015), funding for research and development and other higher risk, innovative activities, and increased technology adoption which can collectively generate mutually reinforcing benefits. Therefore, a robust SME ecosystem encompasses factors beyond a specific set of interventions or a transactional financing approach but instead recognises a more systems-based form of support and policies to help Malaysian SMEs become globally competitive and resilient. In this report, we explore some areas which could further enable the market-based financing solutions for SMEs. These include:

Leveraging FinTech for financial inclusion: The role of FinTech is gaining traction, with innovation in financial technology and digitalisation facilitating the development of more inclusive financing tools. Alternative financing, such as P2P lending and ECF, plays a critical role in supporting SME financing, especially for those that traditional banking services may overlook. A commonly identified challenge of FinTech is its reach and distribution, as it may not always be accessible to different segments of the population of entrepreneurs and SMEs. Targeted thematic funding leveraging on FinTech can better serve specific groups requiring special attention, such as youth and women, increasing the likelikood of success of their businesses. Policies designed to enhance market-based financing for SMEs should aim to "level the playing field" for these underrepresented groups so that they do not unintentionally fall through the cracks of policy support and access to FinTech.

Developing data infrastructure: The ability to access financing and the high cost of financing for SMEs are often directly linked to the lack of data and information on SMEs. To tackle this challenge, the government can play a crucial role by developing data infrastructure and promoting the democratisation of data. The government could leverage the use of various existing public databases, such as CCRIS by BNM, SCORE by SME Corp. Malaysia and upcoming digital initiatives like digital ID and e-invoicing to enhance credit assessment. This would provide SMEs with diversified options for funding and help overcome the issues related to information asymmetry and transparency.

Role of Islamic and social finance: Malaysia has an unparalleled opportunity to tap on Islamic finance and social finance in supporting SME development in Malaysia. Leveraging Zakat and Waqf for capacity building and financing SMEs and social enterprises provides more opportunities for young and new entrepreneurs to start their businesses. By blending concessional and non-concessional sources of funds, Islamic and socially responsible investment instruments can be deployed to finance various business activities, particularly those with positive impact on the economy and society such as agropreneurship and halal industry to help economic activities in the rural area. Moreover, providing opportunities to become entrepreneurs to all levels of society will foster a greater entrepreneurial culture and help social mobility (Aparicio et al., 2022). At a broader level, Islamic finance also encourages the concept of "wealth circulation" so that wealth is not exclusively circulated among the rich in the society and ensures a fairer and more equitable mobilisation and distribution of resources, thus expanding financial inclusion.

Growing talent needs and the importance of financial education: Equipping SMEs with the necessary skills and knowledge for effective business management is essential for their long-term sustainability. Support and capacity building should aim at reducing SMEs' organisational inadequacies and improving business skills and can include training in areas such as financial management, marketing, technology adoption, and business strategy. Emphasising talent development for the market-based financing industries is also crucial to ensure that stakeholders have relevant knowledge and skillsets to offer support SMEs, particularly in emerging industries and high-tech sectors. Mentorship from corporate leaders help the young entrepreneurs to grow their business faster and safer.

Broadening access to markets and supporting internationalisation: Providing SMEs with access to domestic and international markets is critical for their growth. Initiatives such as promoting trade, networking opportunities, and export support can help SMEs expand their reach globally. This includes facilitating the implementation of trade agreements such as CPTPP and RCEP, providing access to export financing, and promoting SMEs in international markets. The government's strong promotion of SME internationalisation can be complemented by market-based financing, playing a critical role in providing necessary financial support, including value chain financing and factoring services.

Another form of support for access to markets for SMEs is through public procurement as governments themselves can provide an important marketplace for SMEs. Countries such as the United States, and other OECD countries such as Australia have made comprehensive efforts to increase the "share" which small firms obtain of government contracts and can provide market validation for the SMEs.

In summary, by understanding and addressing both the life cycle funding needs of the SMEs and strengthening the overall SME ecosystem, policymakers can create a more conducive environment for SMEs to thrive, fostering their ability to contribute significantly to Malaysia's economic growth and development.

4.2 Recommendation 1: Filling the risk capital gap for capital formation of SMEs

In the early stages of an SME's life cycle, entrepreneurs may have just initiated their business operations or be in a pre-operational phase, characterised by ideation or prototyping. During this period, the failure rates of SMEs are notably higher. Other than a few countries such as the United States, United Kingdom and Canada, private capital tends to steer clear of very early-stage financing and concentrate on growth and expansion stages due to higher investor risk aversion.

Most SMEs at very early stages tend to rely on internal financing in the form of a combination of self-financing, loans from family and friends and bootstrapping. The other major challenge is that the external funding cost of the early stage capital formation can be substantial. Limited information disclosures, higher failure rates coupled with persistent information asymmetry, increases the difficulty and costs to invest in the startups, as it requires higher-risk appetite from the investors.

The government's role in giving support, especially for early-stage SMEs, is pivotal for them to move out of "survival" phase where success or failure is highly uncertain. Research indicates that SMEs receiving both financial and non-financial assistance from the government exhibit a higher survival rate compared to those solely receiving either financial or non-financial aid, or none at all (Park, Lee & Kim, 2020). More recent literature has also started to challenge the role of government to move from producing policy simply for fixing explicit market failures toward a role which is involved in market-making and market-shaping. Indeed, markets themselves are outcomes of the interactions between both public and private actors, as well as actors from the third sector and from civil society (Mazzucato, 2016).

Our Malaysian government has demonstrated its strong commitment to supporting SMEs by providing various forms of financing facilities, including grants, loans, guarantees, and development programmes encompassing capacity building, training, and networking. Nevertheless, research based on an "ecosystem approach" (OECD, 2014) points toward the need for top-down initiatives to be complemented with bottom-up efforts which are not restricted to the quantity of SMEs but more importantly improving the quality of SMEs. Moreover, these bottom-up efforts should not be seen as the exclusive responsibility of government but one in which government agencies are better connected to other entrepreneurial actors.

In terms of expanding the role of government, three key findings from the analysis suggest that policy enhancements are needed in the government's SME development programmes. The enhancements would address areas of concern including efficiency and effectiveness of various government support measures targeted to SMEs by streamlining government programmes, collaboration and partnerships not only between ministries but also involving private investment through expanding the current fund-of-funds (FoF) structure to include a wider array of parties, and risk-related concerns that were raised throughout the survey and interviews through introduction of government guarantees for debt type market-based financing products.

4.2.1 Streamlining government programmes

Survey respondents and interviewees have consistently highlighted the necessity for an improved mechanism to access information about government programmes available to them. The lack of awareness and information poses a significant obstacle to the development of SMEs, particularly in their early stages. Establishing an effective communication channel is crucial to mitigating information asymmetry and expanding the reach of government programmes, thereby positively impacting SME performance in Malaysia (Shamsuddin et al., 2020). The information provided should be easily accessible, and the application process should be user-friendly.

A centralised gateway that consolidates all funding programmes provided by the government into a single portal can significantly boost SME participation in these programmes. For instance, the German Federal Ministry for Economic Affairs and Climate Action hosts a database of all funding programmes on its website. These programmes feature user-friendly interfaces, allowing searches based on target areas, funding organisations, and various filters for refining search results according to company size, eligible persons, and funding types.

Presently, the SMEinfo portal, which was developed by BNM in 2006 and handed over to SME Corp. Malaysia in 2008, serves as a centralised online information repository for SMEs, providing information on financing, training, government initiatives, and support programmes for entrepreneurs and SMEs. While the portal serves as a crucial information gateway for the SMEs, further enhancements, particularly focusing on improving user experience, will attract more SMEs to utilise the platform.

In August 2023, the government had announced the introduction of a single window initiative to further support the Malaysian startup ecosystem. The initiative aims to improve coordination and collaboration between agencies and has an ultimate target of creating 5,000 new startups by 2025.[32] This government effort is a step in the right direction towards developing a more successful entrepreneurial ecosystem by addressing various concerns surrounding financing, product innovation, marketing and specialised knowledge.[33] The single window initiative should expand its coverage beyond just focusing on government initiatives. It also should include private initiatives and international engagements in areas such as market access, fundings, online learning and other resources related to startup development. A similar approach was undertaken in India with the introduction of the Startup India initiative which was launched in 2016. Startup India is a flagship initiative to catalyse startup culture and build a strong and inclusive ecosystem and entrepreneurship in India. It focuses on three key pillars i.e. simplification and handholding, funding and incentives as well as incubation and industry academic partnership. The government can model the single window initiative in Malaysia by learning from the success of Startup India.

32 PM Anwar: Single window initiative will be implemented to strengthen startup company ecosystem Accessed on 11 December 2023. https://www.nst.com.my/news/nation/2023/08/948395/pm-anwar-single-window-initiative-will-be-implemented-strengthen-startup

33 Malaysia's single window initiative boosts startup ecosystem and digital identity. Accessed on 12 December 2023. https://commonwealthchamber.com/malaysias-single-window-initiative-boosts-startup-ecosystem-and-digital-identity/

4.2.2 Enhance public financing

There is growing concern regarding the insufficient availability of risk capital to support early-stage entrepreneurial and innovative activities. While various ministries and government agencies offer grants, seed investments, and matching funds to address funding gaps in this segment, the direct involvement of different government agencies in new venture investment poses a significant risk of fund misallocation or funding duplication. To address this challenge, there is a need for a centralised and consolidated pool of grants, seed investments, and matching funds to enhance the SME ecosystem.

In response to this need, the government established Penjana Kapital Sdn Bhd on July 1, 2020, with the goal of accelerating the development of a future innovation economy. This entity provides matching facilities under a FoF structure to attract private capital for investments in Malaysia's startups. As of July 2023, Penjana Kapital has successfully raised RM1.3 billion, with RM600 million from the government and the remaining RM770 million from local and foreign investors. However, recognising the importance of scale and international experience in building a competitive VC ecosystem, the government has announced the consolidation of venture capital agencies, combining Penjana Kapital and MAVCAP under Khazanah Nasional Berhad during the Budget 2024 announcement.

Khazanah Nasional, drawing on its own deal origination experience and partnerships with international VC players like Antler, Gobi Partners, and 500 Global, is expected to further strengthen the venture capital ecosystem. This consolidation aims to position Malaysia as a key player in the global venture capital space, fostering economic activities that enhance Malaysia's competitiveness and economic resiliency towards becoming a high-income economy.

In addition to consolidating VC agencies, there are particular benefits to further enhancing the coordination and consolidation of funding from various government agencies, a recommendation by ICMR (2019) but which was not fully captured under the previous establishment of Penjana Kapital due to different ministerial responsibilities. The recommendation was based on the FoF model implemented by Korea's Venture Investment Corporation (KVIC). The model is premised on a similar active role of the state and decides on the strategies and sets the milestones. However, not limited to a government matching fund (which is the model Penjana Kapital operates on), there is also a difference in the FoF structure where KVIC invests in different VC funds and sources its capital from limited partners (LPs) which includes multiple ministries such as Ministry of Education and Ministry of Environment which maintain separate accounts. The success of the Korea FoF (KFoF) in attracting both local and foreign VC companies is seen where, as of 2022, 57% of all venture funds operating in Korea are funded by KVIC. This provides a compelling example for Malaysia to improve its existing FoF structure.

To implement a similar approach in Malaysia, consolidating fragmented funding management across ministries and agencies to support the SME ecosystem could significantly improve the efficiency of public funding distribution. Khazanah, with its role in developing an FoF structure akin to KFoF, could potentially attract Development Financial Institutions (DFIs) and different ministries to become LPs and invest in the FoF structure managed by Khazanah. This pooling of capital would contribute to the economic growth of Malaysia by supporting high-growth innovative startups and SMEs, fostering the development of a competitive and resilient VC ecosystem.

4.2.3 De-risking investment

To enhance private participation in financing SMEs, the government's role in providing guarantees, grants, and co-investment structures is crucial. Current guarantees, primarily facilitated by Credit Guarantee Corporation (CGC), are predominantly distributed through traditional banking channels, as depicted in Figure 4.3. Although some P2P lending platforms have started incorporating CGC guarantees in their programmes, feedback from these platforms indicates that the cost of CGC guarantees is higher for P2P programmes compared to their counterparts in the banking sector. This higher cost translates to elevated borrowing expenses for SMEs participating in P2P funding.

While the guaranteed schemes enable increased participation from investors, particularly retail investors with a lower risk appetite, the elevated costs remain a hindrance to SMEs seeking P2P financing. To address this challenge, policymakers should consider measures to reduce the cost of guarantees specifically for P2P lending. By doing so, they can effectively lower the overall funding costs for SMEs participating in P2P programmes, fostering a more accessible and cost-effective financing landscape for small businesses.

Figure 4.3:
Guarantees provided by CGC

Conventional Schemes	Islamic Schemes	Government Funded Schemes
BizJamin Scheme (Malaysian-owned with at least 51% shareholding) – CGC guarantee coverage ranges between 30% to 90%	**BizJamin i-Scheme (Malaysian-owned with at least 51% shareholding) –** CGC guarantee coverage ranges between 30% to 90%	**Flexi Guarantee Scheme (FGS) –** Guarantee cover ranging from 30% - 80% as required by participating financial institutions.
BizJamin NRCC Scheme (Malaysian shareholder(s) must have a minimum 30% shareholding) - CGC guarantee coverage ranges between 50% to 70%	**BizJamin-I NRCC Scheme (Malaysian shareholder(s) must have a minimum 30% shareholding)** - CGC guarantee coverage ranges between 50% to 70%	**Franchise Financing Scheme (FFS) –** Unsecured portion will be covered 80% and 90% on the secured portion.
BizJamin Bumi Scheme (51% shareholding owned by Bumiputera) - The guarantee coverage ranges between 30% to 90% with multiple of 5%	**BizJamin Bumi i-Scheme (51% shareholding owned by Bumiputera)** - The guarantee coverage ranges between 30% to 90% with multiple of 5%	**Direct Financing** **Bumiputera Entrepreneur Project Fund-I (TPUB)** – Term and revolving financing for 100% Bumiputera companies up to RM 3 mil (5% per annum (on first application and RM 5 mil (BFR* Maybank Islamic +1% per annum) on subsequent application.

Source: CGC Malaysia official website

The Malaysia Co-investment Fund (MyCif) was established as part of Belanjawan 2019 with the aim of co-investing in SMEs and Social Enterprises alongside private investors through ECF and P2P platforms. With an allocated amount of RM230 million, MyCif has successfully co-invested in programmes worth RM638 million under the ECF and P2P platforms in 2022. This signifies that for every RM1 provided by MyCif, the fund has managed to attract RM2.28 from the private sector. This success demonstrates that MyCif has significantly benefited SMEs while concurrently attracting substantial private sector investment.

To build upon this success, the MyCif model could be expanded to include funding from other ministries, each with its specific Key Performance Indicators (KPIs). For example, Ministry of Women, Family and Community Development can allocate funds using a structure like MyCif to facilitate crowdfunding campaigns specifically to assist women entrepreneurs. This expansion would serve to increase access and provide additional options for SMEs seeking funding for their businesses. By broadening the scope of MyCif and involving multiple ministries, the government can further stimulate private sector participation in supporting the growth and development of SMEs in Malaysia.

Figure 4.4:
MyCif structure

For all MSMEs and startups that successfully raised funds from ECF and P2P platforms, MyCIF will invest in the following ratio:

<table>
<tr><th></th><th>Platform</th><th>Investment Ratio</th><th>Maximum Investment Platform</th></tr>
<tr><td>General MSME Scheme</td><td rowspan="2">ECF and P2P</td><td>1:4</td><td rowspan="3">RM1 million</td></tr>
<tr><td>Agriculture Scheme</td><td rowspan="2">1:2</td></tr>
<tr><td>Environmental, Social, Governance (ESG) Scheme</td><td>ECF Only</td></tr>
<tr><td>Social Enterprise Scheme</td><td>P2P Only</td><td>1:1</td><td>RM500,000</td></tr>
</table>

For instance, in case of 1:4 investment ratio, MyCIF will invest RM1 for every RM4 successfully raised from private investors on the participating platforms.

Source: SC – Malaysia Co-Investment Fund (MyCIF)

4.3 Recommendation 2: The "Missing Middle": Supporting growth capital needs

In this recommendation, we focus on the "Missing Middle", which refers to challenges faced by SMEs in accessing growth capital. This term encapsulates the difficulties encountered by SMEs seeking capital for business expansion, which includes initiatives such as broadening market access, expanding product ranges, and enhancing production processes to improve efficiency. The challenge is particularly pronounced for high-growth SMEs and startups that may lack the requisite collateral and credit history needed for traditional financing. However, these entities often possess valuable intangible assets, such as innovative ideas, intellectual property, and specialised expertise, which can serve as a foundation to support their funding needs.

Furthermore, when considering MTCs, they find themselves in a unique position. They are too large to qualify for SME-targeted government assistance or stimulus packages, yet they lack the scale and capabilities of larger listed corporations. Despite their potential for significant business growth, this group receives limited direct support from the government, predominantly through entities like MATRADE. MTCs are well-suited to raise financing from market-based sources, and our recommendations focus on enhancing market-based financing support specifically tailored to foster the development of MTCs.

Traditional bank loans have the scale to support mid-growth stage SMEs, but often lack the risk appetite, highlighting the crucial complementary role of market-based financing. This has been reflected in our survey findings where market-based financing is mostly used by SMEs to expand their business, compared to bank financing which is preferred for raising working capital. Nevertheless, at a certain stage of development it is common for these entities to use a combination of market-based financing and banking services to optimise their capital structure and meet specific financial needs. The choice between market-based financing and traditional banking depends on factors such as the company's growth stage, risk tolerance, capital requirements, and strategic objectives. This approach, encompassing a variety of alternative funding options, becomes a vital tool for SMEs looking to bridge the funding gap and unlock their growth potential.

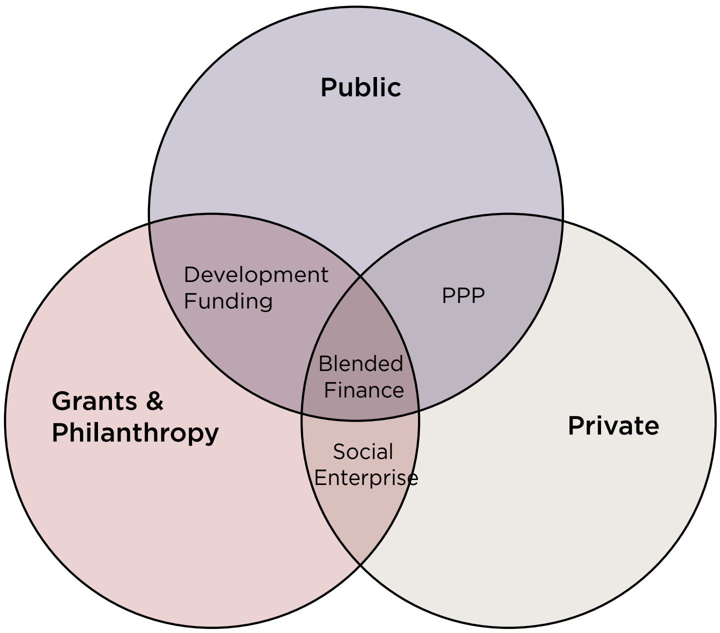
Market-based financing is better suited to tailor its approach to the specific needs of SMEs at different stages of development. For instance, private equity firms play a key role in providing growth capital to SMEs, particularly those involved in high-risk, innovative activities compared to angel investors who invest predominantly in seed or start-up companies. By offering funding in exchange for equity ownership or via a debt structure, the market-based financing empowers SMEs to expand operations, develop new products or services, and enter new markets. They provide a platform for SMEs to connect with a broader pool of investors, including venture capitalists, business angels, and institutional investors. Digital tools, such as P2P lending platforms and ECF platforms, have democratised access to finance for SMEs. These platforms offer alternative routes to traditional bank loans, enabling SMEs to finance working capital needs, expand business operations, or launch new ventures.

In this section, we will address the "Missing Middle" challenges and the need to fill the "emerging growth capital" gap needed for SMEs to accelerate their growth trajectory.

4.3.1 Encourage blended financing options

Blended financing is characterised by the strategic use of development finance to mobilise additional resources for sustainable development. This has emerged as a powerful tool in accelerating the transition to sustainable development solutions. Blended finance is a financial solution to enhance the role of public financing and facilitate crowding in from private investors by de-risking the investment. Figure 4.5 shows how blended financing can encourage catalytic capital from the public sector and philanthropic contributions to enhance investment attractiveness of sustainable initiatives while achieving the capital owner's investment objectives, i.e. financial and social returns. De-risking instruments from the public sector and philanthropic contributions help to accelerate private sector funding as project failure risk is distributed. Indeed, public sector financing is crucial in high-risk business cycle projects while the private sector could contribute to the same project at a lower risk.

Figure 4.5:
Blended financing



Source: Author

This approach has gained prominence in key development projects, especially related to energy transition and SDGs in many developing countries. For example, Indonesia has successfully used a blended financing approach to finance infrastructure development projects under the "SDG Indonesia One (SIO)" programme. In collaboration with the Asian Development Bank (ADB), SIO has been instrumental in partially funding green projects through a USD 150 million loan. This initiative supports infrastructure financing led by PT Sarana Multi Infrastructure, employing a mix of financing instruments from diverse public and private funding channels. The ADB's commitment to the SIO-Green Financial Facility (SIO-GFF) is pivotal, as it has approved a USD 150 million loan to finance a minimum of 10 projects, with at least 70% of the funding dedicated to green infrastructure. Beyond the direct financial support, ADB estimates that the SIO-GFF has catalysed up to 8 times the invested funds, fostering climate-friendly infrastructure and aiding Indonesia in transitioning its economy towards a sustainable trajectory.

In the case of Malaysia, the integration of blended financing within the Madani Economy Framework, NETR and NIMP holds significant promise for growth and sustainability, especially for SMEs. Blended financing is particularly suitable for SMEs, offering them a unique opportunity to access a mix of private investment and grants. At mid-growth stage, innovative and high growth SMEs are likely to attract private financing to supplement with grants from public sector. The provision of government grants serves as a validation of the potential innovation outcomes of a project. This validation not only boosts the credibility of the initiative but also acts as an incentive for private investors to assess the potential growth prospects stemming from the innovation. The alignment of government support signals confidence in the project's viability, encouraging private investors to consider the long-term growth potential of the SMEs. This synergy between public and private through blended financing support mechanisms creates a conducive environment for fostering innovation and sustainable growth within the SME sector, especially among the mid-growth stage SMEs.

As the government and key stakeholders actively pursue a balanced economic landscape, SMEs emerge as pivotal players in achieving these goals. Blended financing, with its combination of public and private funds, becomes a catalyst for SME growth in alignment with the broader national development policies. The following outline how SMEs can strategise to benefit from national development policies using blended financing:

1. **Catalysing SME growth through NIMP and NETR frameworks:** The NIMP and NETR frameworks, with their emphasis on specialty chemicals, CCUS solutions, and responsible transition scenarios, open avenues for SME involvement. Blended financing can mobilise funds to support SMEs engaged in these mission-based projects, fostering innovation and growth in sectors critical to Malaysia's sustainable development goals.

2. **DDIs driven by GLCs and GLICs:** With GLCs and GLICs steering Direct Domestic Investments (DDIs), SMEs can benefit from blended financing partnerships. These collaborations with larger mature companies can lead to positive spillover effects and create more opportunities for SMEs to participate in supply chains and value-added activities within strategic sectors such as E&E, the digital economy, and aerospace. Blended financing ensures that SMEs have access to diverse funding sources, fostering their integration into these key industries.

3. **Outcome-based tax incentives for high-impact activities:** The introduction of outcome-based tax incentives under the Madani Economy Framework provides SMEs engaged in high-impact activities with a unique opportunity. Blended financing mechanisms can help SMEs access additional capital, leveraging tax incentives to attract private investment. This approach not only stimulates SME growth but also aligns their activities with the strategic sectors identified in the Madani Economy Framework.

4. **Matching funds for startups:** Under the Madani Economy Framework, the Government and GLICs will invest RM1 billion of additional funds to match with private funds to boost local startups, SMEs and technopreneurs. Blended financing models facilitate the efficient channelling of these funds to SMEs, providing them with the capital needed to innovate, expand, and contribute to economic development. This approach encourages a vibrant entrepreneurial ecosystem and supports SMEs in emerging industries.

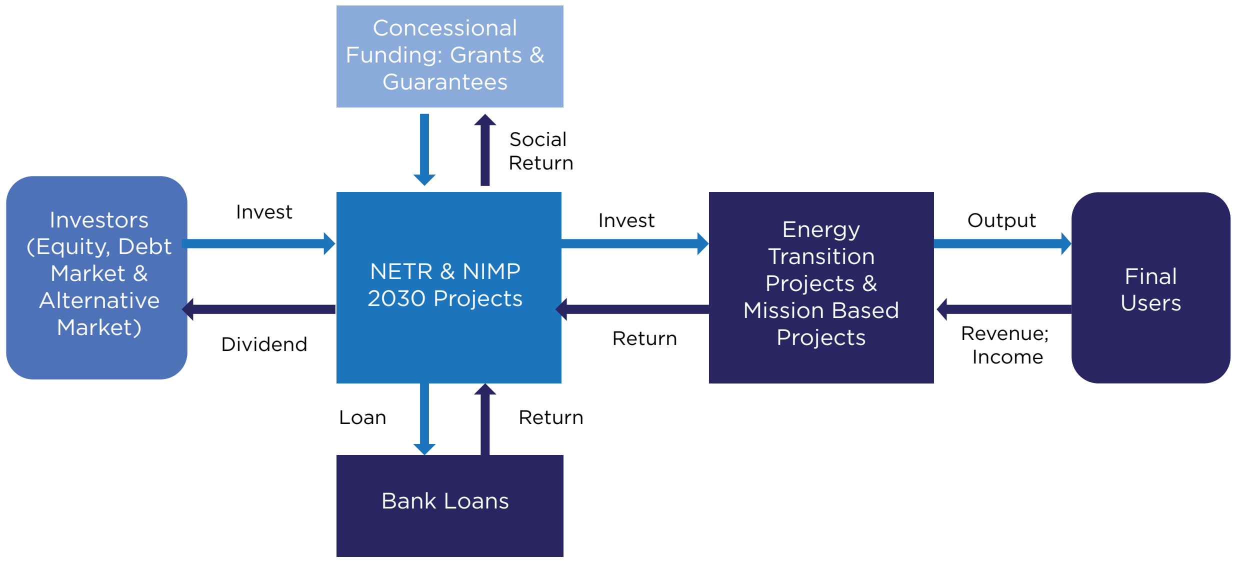
5. **Support for local food industry:** The allocation of RM200 million under Agrobank to enhance the Self-Sufficiency Level (SSL) and food security presents an opportunity for SMEs in the agricultural sector. Similar funding arrangements

using MyCif P2P funding approach can accelerate food production and address food security issues. Blended financing can amplify the impact of this support by attracting private investment, including young entrepreneurs into modern agricultural technology applications. This ensures that SMEs in the agro and food industries have the necessary resources to modernise and increase production.

6. **Wage increase policies for economic sharing:** The commitment to policies supporting an increase in wages relative to GDP aligns with the goal of inclusive economic growth. Blended financing can play a role in supporting SMEs to adapt to these policies by providing them with financial resources to invest in skills development, technological upgrades, and increased productivity. This in turn, contributes to the overall growth and competitiveness of SMEs.

7. **Leveraging technical assistance from international organisations:** To explore innovative blended financing tools to support SMEs, the regulators can work with international organisations such as United Nations Capital Development Fund (UNCDF) to develop a blended financing programme similar to the BUILD (Bamboo-UNCDF Initiative for the Least Developed) fund, which is a blended impact investment vehicle co-created by Bamboo Capital Partners and UNCDF to finance SME business in the least developed countries (LDCs). Malaysian regulators can leverage the BUILDER Technical Assistance (TA) Facility managed at arm's length by UNCDF to provide technical support on portfolio building and business advisory.[34]

Figure 4.6:
Blended financing approach to finance NETR and NIMP2030



Source: Author

34 See UNCDF https://www.un.org/ldcportal/tags/build-fund

The strategic integration of blended financing within Malaysia's development policies provides SMEs with a robust mechanism for growth, innovation, and sustainability. By aligning with the key initiatives outlined in the Madani Economy, NIMP, and NETR frameworks, blended financing becomes an enabler for SMEs to thrive, contributing significantly to Malaysia's economic development and resilience.

Blended financing is not only confined to large-scale projects but is also making a significant impact on inclusive financing initiatives. An exemplary case is iTEKAD, an initiative by BNM, collaborating with other cooperative parties leveraging Zakat and Waqf. The iTEKAD has gained attention from the financial sector and SMEs, encouraging exploration of new and innovative approach to provide inclusive funding avenues. This funding is aimed at meeting the needs of SMEs, providing seed capital, microfinancing, and structured training. The government has allocated RM25 million in Budget 2024 as matching grants to augment seed capital components. The focus is primarily on entrepreneurs from low-income households (asnaf/B40), aligning with the broader goal of fostering inclusivity in economic development. As of May 2023, this initiative has successfully supported 3,389 new entrepreneurs.

The P2P can also tap into similar structures like iTEKAD to increase their offerings by incorporating a blended financing approach focusing on financial inclusiveness to support SMEs from low-income households.

4.3.2 Reduce "growth capital" gaps

The current landscape in Malaysia poses significant challenges for SMEs seeking to raise bonds, hindering their access to vital growth capital. According to a World Bank (2020) report on the domestic bond market in Malaysia, bond market arrangers focus on larger issuances, giving preference to fundraising of above RM250 million. This is mainly due to tepid interest among the big institutional investors like the Employees Provident Fund (EPF) to subscribe to small debt issuances coupled with limits imposed by their investment mandates, which have resulted in subdued interest in smaller debt issuances. The preference for larger bond issuances further marginalises SMEs with more modest working capital or capital requirements. This disinterest in smaller debt issuances has repercussions, discouraging SMEs with limited capital needs from participating in the local bond market. The reluctance of investors to engage with smaller debt papers may also be compounded by an additional liquidity premium, making the issuance of debt more costly for SMEs, as noted by the World Bank.

In light of these challenges, it becomes imperative to explore alternative financing options and mechanisms that cater specifically to the unique needs of SMEs, promoting inclusivity in the financial market.

1. **Strategic development of SME bond market:** While the current Malaysian bond market is not the most conducive for fundraising by SMEs, a targeted approach could be explored through the development of SME Bond markets. Partnership with the Credit Guarantee Corporation (CGC) will add a layer of security, enticing investors to participate in financing SMEs by reducing its risks. Credit guarantees for SMEs are mostly distributed via DFIs and banks and often not for SMEs to directly raise funds from the bond market. This is not specific to Malaysia but is also seen as general practice in other jurisdictions. The direct bond fundraising by SMEs is generally associated with high risk and faces problems such as inefficient financial management, accounting standards, as well as issues related to governance, disclosures, transparency and performance.

   However, SME bonds remains relevant especially with government guarantee schemes, drawing lessons from Korea's Credit Guarantee Agency, the Chinese Government in the SME Private Placement Regulation and the enactment of civil and fiscal law in Italy.[35] To minimise the risk of failure and at the same time allow SMEs to tap into the bond markets, e.g. a SME CGC guaranteed bond targeted to medium-size enterprises that has a clear revenue stream could be offered via private placement method to institutional investors, including GLICs. The guaranteed programme for SMEs could also be extended to financing small to medium scale government infrastructure projects where the future revenue is predictable and safe. This will provide opportunities for investors to diversify investment portfolios while injecting much-needed capital into the growth endeavours of SMEs.

An alternative avenue to access the bond market for SME financing involves consolidating a substantial pool of SME assets for securitisation or issuing SME covered bonds. The asset-backed securities (ABS) and collateralised debt obligations (CDO) are commonly utilised instruments for SME securitisation (Nassr & Wehinger, 2015). In Malaysia, Cagamas has introduced an innovative programme to support SMEs in their greening initiatives. Instead of securitising the debt, Cagamas utilises the debt proceeds to acquire eligible noncarbon emitting industrial hire purchase receivables, focusing on SMEs actively contributing to environmental sustainability. The success of this approach is evident in the launch of the first ASEAN sustainability bond in October 2020, amounting to RM100 million. This initiative garnered significant investor interest, attracting a total order of RM240 million or book-to-cover ratio of 2.4 times and final price of 43 to 45 basis points above corresponding Malaysian Government Securities (MGS) rate. Hence, by aggregating SME risks, introducing innovative solutions and incorporating credit enhancements, such as guarantees, the bond market could continue to stand as a substantial source for SME financing in Malaysia.

2. **Positioning P2P financing for the mid-tier companies:** In the quest to reduce "growth capital" gaps, the role of P2P can be expanded to act as lending tools for a bigger financing and longer tenure needs of MTCs. Currently, the campaign size of the P2P segment is notably smaller, with 70% of the issuers raising RM50,000 or less, primarily targeting short-term working capital needs.[36] To enhance the role of P2P and provide diversity within the space, the Securities Commission Malaysia announced in 2022 that they would open new applications for the registration of new ECF and P2P market operators, focusing on offering debt-based financing for MTCs. In June 2023, Bursa Malaysia RAM Capital Sdn Bhd (BR Capital) received the approval-in-principle from SC Malaysia to operate as a new debt fundraising platform.

   BR capital will facilitate both listed and unlisted SMEs and MTCs tapping into a new pool of capital outside the traditional wholesale market with greater flexibility to these companies to raise funds. The platform caters for issuers that have financing requirements of at least RM5 million with minimum tenure of 1 year.

   While BR Capital opens up a new form of alternative funding for SMEs and MTCs, we foresee continued efforts to liberalise alternative market space to attract RMOs with specialised capabilities such as the blockchain technology and leveraging on innovative Islamic P2P lending platforms can revolutionise SME financing. With decentralised financing technology, P2P can bring transparency to transactions, instilling confidence in SMEs seeking growth capital.

35 Sakpunpanom, S., Budsayaplakorn, S., & Santipolvut, S. The Potential of SMEs Bond Issuance in Thailand.

36 See https://www.capitalmarketsmalaysia.com/digital-peer-to-peer-p2p-financing/

Simultaneously, Islamic P2P lending aligns with ethical principles, opening funding avenues for businesses committed to sustainable practices and use blended approach by tapping on concessional lending approach.

3. **Exploring Revenue-Based Financing (RBF):** Based on our interviews, the high-growth SMEs and startups have seen a shift in their business landscape especially with tighter financing conditions. The current landscape requires them to prioritise revenue sustainability over "growth-at-all-costs", when liquidity was cheaper.

   In this context, RBF model can potentially be considered as a strategic option. It has emerged as a valuable alternative for SMEs seeking flexible and non-dilutive capital to fuel their growth. Unlike traditional loans with fixed repayment schedule, the RBF repayments are directly aligned with business's revenue, embedding a counter-cyclical mechanism. This more flexible approach provides SMEs with an option for better risk management, especially during the economic downturns. On the other hand, for investor's with higher risk appetite, the RBF offers potential higher returns and can incentivise investors to identify and support companies with high growth prospects.

   Quick access to capital, no equity dilution, and no collateral requirements make RBF an attractive option for SMEs navigating the challenges of raising growth capital.

Figure 4.7:
Features and comparison of RBF

Benefits	Bank Loan	Venture Capital	Revenue Based Financing
Founder retains control	Yes, but banks may have some say in business decisions	Investors may have significant say in business decisions and take an equity stake in the company	Yes
Suitability of instrument	Difficult for early-stage businesses or those without collateral	Early stage & high growth	Best suited to early stage & high growth companies
Cost of capital	Mid (Lower than RBF, higher than VC)	Typically, the **lowest cost of capital,** but investors will expect a significant return on their capital	High (15%-30% p.a.)
Repayment schedule	Fixed (monthly or quarterly)	Flexible (tied to milestones or exit events)	Flexible
Collateral required	Yes, typically assets like property or equipment	No, but investors may take an equity stake in the company	No
Alignment of interests	Banks' interests are **not always aligned** with company interests as they may still want to be repaid even when company is struggling	Investors' interests are **aligned with company's long-term success,** as they expect the company to eventually go public or be acquired	Investors' interests are **aligned with company's success.** Investors are only paid if company generates revenue

Source: Various

The RBF financing option is growing at a fast pace, especially to finance SMEs with relatively strong and stable revenue streams. According to research on RBF, the global RBF market size was valued at $901.41 million in 2019 and is projected to reach $42 billion by 2027.[37] This substantial growth underscores the increasing prominence of RBF as an emerging financial tool for SMEs globally.

In Singapore, Choco Up and Jenfi already provide RBF financing options on their platforms. Choco Up is Asia's top revenue-based finance platform, where they provide financing for Singapore-based businesses with minimum six months in operation and have minimum monthly income of S$10,000. While the core advantage of RBF is flexibility in repayment based on revenue, the actual financing terms such as revenue ratios vary from platform-to-platform and are also assessed based on the risk of the programme.

The P2P platforms in Malaysia could consider offering the RBF schemes, especially for high growth sectors as well as a targeted investor segment of sophisticated investors. These will provide new financing options for SMEs as well as diversified investment options to investors.

Overall, policymakers should find innovative solutions to reduce "growth capital" gaps and foster sustainable growth for SMEs, contributing to the overall economic resilience of the nation.

37 Allied Market Research (2021). Revenue -Based Financing Market by Enterprise Size (Micro Enterprises, Small-Sized Enterprises, and Medium Size Enterprises), and Industry Vertical (IT & Telecom, Healthcare, Media & Entertainment, BFSI, Consumer Goods, Energy & Utilities, and others): Global Opportunity Analysis and Industry Forecast, 2020-2027.

4.4 Recommendation 3: Optimising exit strategies for SMEs through public equity capital and M&A

As businesses mature and expand their growth aspirations, their financing needs undergo a transformation. SMEs often require substantial capital from both public and private markets to support late-stage financing. Their needs also go beyond purely transactional forms of financing as they are also driven to achieve more growth, innovation, and to enhance their international competitiveness. At this stage of their life cycle, the SMEs will subsequently seek more exit opportunities for the founders and other key investors.

Beyond the high-risk survival phase, SMEs can secure financing through various avenues, including listing on specialised SME exchanges as well as facilitating mergers and acquisitions (M&A). However, our previous analysis clearly indicate that SMEs in Malaysia encounter numerous challenges when attempting to access late-stage capital. While some of these challenges are not unique to Malaysia and are also present globally, addressing them effectively is imperative.

The following recommendations aim to mitigate these challenges and enhance the availability of late-stage financing options for SMEs in Malaysia.

4.4.1 Recommendations for enhancing the LEAP market's appeal

Cost of listing consistently emerges as a critical factor when SMEs evaluate market-based financing options, despite the simplified listing procedure introduced to ensure ease for SMEs in the LEAP market. It is paramount to address the disproportionately high listing costs for SMEs listing in the LEAP market compared to the ACE and Main markets.

The average listing size in the LEAP market is about RM3 million to RM5 million, where the cost of listing can range from RM1 million to RM2 million, nearly one-third of the amount raised. This concern has been emphasised by SMEs in our interviews and is supported by publicly available documents produced by accounting and CF firms.[38] The majority of the fees go toward the payment of advisory services, with other charges, such as processing fees and initial listing fees, only costing around RM9,000 and RM3,000 respectively.

This is noteworthy, especially considering the guidelines provided by Bursa, where the initial admission fee of an adviser is fixed at RM20,000, and the annual fee is fixed at RM10,000.[39] Addressing this discrepancy is crucial for promoting a more accessible and equitable listing environment for SMEs in the LEAP market.

38 Overall estimated cost of listing for Main market, ACE market and LEAP market is above RM5 million, RM4 million to RM5 million and RM1 million to RM2 million, respectively : https://www.crowe.com/my/insights/listing-your-company-on-bursa-malaysia-

39 Fees and Charges for the LEAP Market (Bursa Malaysia) https://www.bursamalaysia.com/sites/5bb54be15f36ca0af339077a/assets/5c86103a39fba26bcc467dc1/LEAP_FeesandCharges_1September2018.pdf

Figure 4.8:
LEAP market admission fees

Fees paid for admission on LEAP market	Fees charged
Bursa Malaysia processing fee	RM9,000
SC's fee for lodgement of information memorandum *(to replace prospectus required for listing on MAIN and ACE market)*	RM500
Initial listing fee	RM3,000
Initial admission fee of Approved Adviser	**RM20,000**
Total fee:	**RM32,500**
Estimated Real-world Listing Costs* *(Including various professional fees to the regulators, consultants, advisers, and issuer)*	**RM1 mil – 2 mil**

*Source: Bursa Malaysia and Crowe, 2023** [40]

Based on our interviews with regulators and advisers, we found a significant factor that contributed to the high cost of listing is the notable gap between the official listing procedures required for the LEAP market and the actual business practice adopted by advisers and sponsors during the listing process. This discrepancy is evident in procedures such as profit-testing, due diligence, and compliance, adding layers of complexity and increasing the cost of listing for SMEs. Despite the LEAP market's intention to have flexible listing requirements and fewer barriers compared to the ACE and main markets, the observed practices have created unintended challenges.

It is essential to note that, although regulatory requirements do not explicitly detail these processes, they are often included as part of the listing process to ensure sufficient demand from investors for participation in the listing. Examining best practices across SME exchanges in the region reveals that these exchanges impose specific requirements for SMEs to tap into them (see chapter 2). These requirements may include setting a minimum threshold based on profitability, capital benchmarks, or evidence of positive cash flow. The rationale behind these measures is clear: while there is a push to lower listing barriers, advisers or sponsors still need some form of tangible financial assessments to fairly value a company's viability for listing and safeguard investor interests. Without reliable indicators, assessing a firm's potential becomes inherently challenging for advisers, especially those who come from a banking background with limited experience assessing the risk return profile of very early-stage SMEs.

Therefore, the LEAP market in Malaysia should adopt some measure of explicit financial assessment with a minimum threshold for listing. This step will ensure a standardised assessment fulfilled by SMEs seeking to list in the LEAP market, providing clarity to advisers and sponsors on how to evaluate SME listings. By establishing a clear framework, the assessment process becomes more transparent and efficient, facilitating a smoother and more streamlined approach to price discovery. Ultimately, this contributes to a more robust and accessible listing environment for SMEs, fostering confidence among stakeholders in the market.

Addressing the issues associated with the high cost of listing could be achieved by expanding the pool of Recognised Approved Advisers, thereby fostering

40 Crowe. (2023). *Listing your company on Bursa Malaysia- IPOs in 2022.* Crowe Malaysia IPO Booklet. Retrieved October 19, 2023, from https://www.crowe.com/my/-/media/crowe/firms/asia-pacific/my/crowemy/news/crowe-malaysia-ipo-booklet-2022.pdf?rev=ea7efccf75cc44668f02e918218227fb&hash=BFE11DE2D1172307708128B53C5EB921

innovation and promoting price competition in the market. In March of this year, SC introduced a new transfer of listing framework from LEAP to the ACE market. A key strategy under this framework involves expanding the pool of Sponsors/Advisers to include Recognised Approved Advisers. This expansion aims to diversify the participation of corporate finance professionals in the Malaysian capital market, moving beyond the dominance of the investment banking industry.

To further enhance competition and attract SMEs to list in the LEAP market, the inclusion of selected VC and PE players with relevant expertise and a Qualified Person as Recognised Approved Advisers for LEAP market listings should be considered. This aligns with the nature of the LEAP market, designed to facilitate high-growth and innovative SMEs in tapping the capital market, gaining recognition, and differentiating themselves as listed entities.

VC and PE players possess the expertise to fairly value companies with high growth, advanced technology, and innovative business structures, in contrast to investment bankers who may rely on standard measurements based on revenue models. Moreover, VC and PE players can continue to provide mentorship support for SMEs in the LEAP market, contributing to their ongoing growth. This approach also addresses concerns raised in our interviews regarding a lack of talent and the necessity to focus on capacity building to support the private market and the LEAP market.

To ensure the governance process of listing in LEAP is adequately addressed, VC and PE players recognised as approved advisers intending to list their investee companies in the LEAP market should undergo a mandatory moratorium on shares period that applies to promoters.[41]

In the interim, an immediate and impactful measure to address the issue of higher listing costs could be for the government to absorb some of these costs by offering listing grants to the issuers. This approach is not unprecedented, as the SC has already provided grants to offset up to 90% of external costs incurred for the issuance of Sustainable and Responsible Investment (SRI) Sukuk and Bonds. Likewise, in Singapore, the SMEs are offered support of up to 20% of eligible expenses, with a cap of S$300,000 for listing in the Singapore Catalist.

However, it is crucial to note that providing government grants for SMEs should be considered only after exhausting all options of market mechanisms for improving the efficiency of market-pricing mechanisms to reduce listing costs.

Moreover, the support provided through government grants should be accompanied by increased transparency in the listing fees for the LEAP market. Regulators could explore fixing the cost of advisory services, mirroring other professional fees, to establish a price ceiling and address the issue directly. This approach may bring about a more standardised and controlled pricing environment for advisory services related to SME listings, promoting fairness and transparency in the process.

41 Moratorium on share disposal for promoters in LEAP market for 12 months from the date of admission and subsequently, at least 45% must be retained for another 36 months.

4.4.2 Reshape LEAP market to become a niche/specialised SME market exchange

To bolster structural economic reforms in Malaysia, the government, under the Madani Economy Framework, has introduced the NETR and the NIMP. These initiatives aim to propel the Malaysian economy into a modern, high-income state by the end of the decade. In this transformative journey, SMEs play a pivotal role, and the LEAP market can be instrumental in facilitating fundraising exercises for these emerging growth-oriented, technologically advanced, and innovative SMEs.

The NETR and NIMP have identified key priority sectors that necessitate substantial capital allocation. However, the government alone may not have sufficient fiscal space to finance these ambitious plans. For instance, the NETR estimates a need for RM1.85 trillion by 2050, while NIMP 2030 is projected to require RM95 billion for the plan period. To bridge this financial gap, the LEAP market can serve as a strategic platform for SMEs to access funding, fostering economic growth and innovation in alignment with the national economic agenda.

Positioning the LEAP market to finance NIMP and NETR projects, with a specific focus on SMEs, can be a strategic move. Drawing inspiration from the Specialist Technology Company listing route in Hong Kong, tailored for tech companies, the LEAP market could adopt a similar approach for green enterprises. To make the LEAP market more attractive for investors and issuers in financing NIMP and NETR projects, the following changes could be considered:

1. **Special listing track:** Introduce a dedicated listing track for companies seeking financing for NIMP and NETR projects. This involves streamlining the application and review process, leveraging technology such as blockchain and Artificial Intelligence (AI) for documentation and licensing to enhance efficiency and transparency.

2. **Broadening investors category:** The LEAP market currently is only accessible to sophisticated investors. SC Malaysia plans to widen the sophisticated investors base by providing flexibilities within the calculation of high-net-worth individuals (HNWIs) threshold. SC is likely to expand the qualification of sophisticated investors to account for their knowledge and expertise as well as extend angel investors' participation.[42] While widening the sophisticated investors base will increase the investor pool, liberalising the LEAP market would allow retailers to benefit from economic opportunities coming from NIMP and NETR. Efforts should also be made to attract institutional investors, specifically the Government Linked Investment Companies (GLICs) to participate in LEAP, which is directly linked to NETR and NIMP related projects. The Co-investment Fund (CoSIF) under NIMP 2030 should be expanded to SMEs listed in the LEAP market and not restricted to only the main market or ACE market.

3. **Flexible weighted voting right structure:** Listed companies in the LEAP market should be allowed to adopt a weighted voting rights (WVR) structure, which allows the founders and management to maintain control of the company. This is important to address trust and control issues highlighted in the survey and interviews. Companies venturing in the new growth areas under NETR and NIMP may need to maintain control to preserve the entrepreneurial culture, technological drive and vision of the SMEs and startups. The WVR structure in Hong Kong, which specifically focuses on innovative companies and is reviewed on a case-by-case basis can be used as a basic structure for WVR

42 See https://www.thestar.com.my/business/business-news/2023/06/15/sc-to-widen-sophisticated-investors-base-says-md

implementation of the LEAP market for the NETR and NIMP companies.

4. **Dedicated grants:** Introduce a dedicated listing grant for SMEs directly engaged in NETR and NIMP projects. Subsidise or absorb listing costs to attract SMEs to list on the LEAP market.

5. **Tax incentives:** Offer tax breaks for companies involved in NETR and NIMP projects, encouraging more investors to list in this space.

With a re-evaluation of the LEAP market, focusing on niche areas to finance energy transition and new growth industries under NETR and NIMP, the goal of transforming SMEs to contribute 50% of GDP can be accelerated. This approach aligns with the broader economic vision and supports the government's efforts towards structural economic reforms.

4.4.3 Setting the stage for a more vibrant M&A environment

The presence of a viable exit strategy is a pivotal factor in late-stage financing for SMEs, particularly for VC and PE funds seeking potential investment returns. These funds typically derive returns from capital gains not only through listings but also M&A activities. Therefore, the broadening exit options for SMEs is a crucial and often understated element for market-based financing. According to ICMR's interviews with local startups and SMEs, there is a prevailing sentiment that the current LEAP market might not be their preferred exit route. Instead, they often find themselves having to wait for an exit via the IPO route, either through ACE or Bursa main market listing or alternatively look to list in a foreign market, due to various factors. A prolonged waiting period for founders and investors to realise their investments can also have spillover effects on the VC and PE industry in Malaysia.

Landström and Mason (2012) emphasised that difficulties in selling shares or the inability to engineer M&A deals hinder the expansion of VC & PE, limiting their capacity to invest in newer SMEs or startups. Additionally, Silicon Valley Bank reports that the majority of successful startup exits occur not through IPOs but through M&A deals.

European exit strategy data also reveals that only 0.2% of European companies exit via an IPO, further underscoring the crucial role M&A plays in SME and startup exits.

With greater liquidity in private markets, SMEs are increasingly more inclined towards M&A and trade sales opportunities, hoping to leverage other benefits such as enhanced market access, superior technology, or exclusive information from potential investors or acquirers. M&A can serve as a powerful growth catalyst for SMEs, enabling them to expand their customer base, acquire new technology, acquire talent, achieve economies of scale, and increase overall value through post-merger synergies. However, a common observation is that there is a scarcity of M&A deals in Malaysia, particularly among local SMEs and startups.

Unlike Singapore and Indonesia, where numerous unicorns engage in cross-border M&As to enhance scalability, Malaysian companies have been relatively lagging in this aspect. As of 2021, only one Malaysian unicorn engaged in M&A acquisition compared to 49 deals concluded by unicorns headquartered in Singapore.[43] Most M&As in

43 See ASEAN Investment Report (2022) Pandemic Recovery and Investment Facilitation : https://asean.org/wp-content/uploads/2022/10/AIR2022-Web-Online-Final-211022.pdf

Malaysia are focused on expanding market access and strengthening technological capabilities.

For SMEs to fully harness the potential of the business landscape and reposition themselves in a changing market, larger corporations and Multinational Companies (MNCs) play a critical role. Malaysia is able to leverage the presence of GLCs which can take the lead in building partnerships and providing support for smaller businesses. This is not merely about business growth; it is also about crafting a sustainable, collaborative ecosystem where businesses of all sizes thrive together. Although M&A deals may slow down during times of uncertainty, with a clear policy direction, M&A could present a unique opportunity to strengthen the SME ecosystem in Malaysia.

To achieve robust growth and encourage M&A activities involving SMEs, targeted incentives are crucial:

1. **FDI attraction incentives:** Investment incentives to attract FDI to Malaysia should extend beyond greenfield investments and also focus on attracting FDI through the M&A channel, with particular emphasis on SMEs. Encouraging SMEs to engage in M&A deals with MNCs looking to diversify their production base can be a strategic approach to expanding businesses quickly and integrating with the global value chain.

2. **Complex financing support:** Recognising the complexity of financing requirements for M&A compared to greenfield investments, the equity and bond markets should be leveraged to further strengthen the competitive landscape for financing M&A activities. Venture funds, through equity or debt financing, can play a role in co-financing SMEs engaged in M&A activities, fostering regional and global competitiveness.

3. **Government Linked Companies (GLCs) participation:** In response to SMEs expressing a desire for increased participation from Government Linked Companies (GLCs) in M&A activities, there should be efforts to establish a stronger link between GLCs and local SMEs. This collaboration should be a priority in GLCs' agendas, aligning with their reform objectives to support economic growth in Malaysia.

4. **Tailored incentives:** Capitalise on the attractiveness of tax and non-tax incentives for local and foreign companies engaging in M&A deals with local SMEs. This approach can be applied on a case-by-case basis, with a specific focus on new growth areas identified in NIMP 2030 and NETR.

5. **Corporate Venture Capital (CVC) incentives:** Introduce incentives for corporates and MNCs to take equity positions in SMEs and contribute to mentorship and capacity-building programmes. Revenue-generating corporates should be eligible for tax incentives to initiate offshoot startups or engage in recycling entrepreneurship through the acquisition of domestic startups. Encouraging CVC activities can facilitate the transition from family-owned businesses to more transparent business activities, enriching smaller businesses and providing corporates with fresh perspectives and potential innovation pathways.

6. **Exemption from Capital Gains Tax (CGT):** Considering the upcoming 10% Capital Gains Tax (CGT) effective from March 1, 2024, exemptions should be provided for SMEs engaging in M&A deals to further grow their business, with a specific focus on innovation and new growth areas within the NETR and NIMP sectors. This exemption can be subject to evaluation on a case-to-case basis, promoting a dynamic M&A ecosystem. While listed shares and venture capital are set to enjoy exemptions, extending this benefit to SMEs involved in M&A deals will mitigate potential challenges posed by the new tax regimen.

4.4.4 A renewed focus on driving corporate value via capital market reform

The Malaysian equity market has experienced lacklustre growth, with the main market growing at only a 1.7% annualised rate from 2012 to 2022. This can be attributed to both supply and demand issues. On the supply side, Malaysia needs more innovative and "investor-ready" SME firms to attract interest from domestic and foreign investors and improve market vibrancy. On the demand side, there is a need for revitalisation to attract both local and foreign investors.

Efforts toward revitalisation have been initiated, including the introduction of transfer frameworks such as the LEAP Market Transfer Framework and plans for automatic graduation from ACE to the Main market. Regulators have also announced measures like fractional shares trading to encourage more retail investor participation.

However, there are further areas of improvement that regulators can consider to revitalise the domestic equity market. Drawing inspiration from international benchmarks particularly in the context of ESG considerations, can enhance the intrinsic and perceived value of businesses. Here are some proposed approaches:

1. **Aligning with national policies:** Aligning the corporate sector growth strategy with national blueprints such as the NETR and NIMP 2030 is crucial. Malaysian businesses, including those listed on the LEAP market, can strategically position themselves to support these directives, actively participating in the green transition and upholding the objectives of these roadmaps. Our proposal to reshape the LEAP market by focusing on niche areas covering new growth sectors is an attempt to move our SMEs towards becoming high-growth SMEs.

2. **Drawing from international best practices:** Learning from Japan's transformative business model can provide significant insights. Their focus on capital management KPIs and corporate governance reforms, such as introducing a skills matrix for independent directors has driven value to their stock market. Malaysia can adapt and implement some of these strategies to reinvigorate our domestic capital market.

3. **Valuation focus:** Emulating the structural reforms by the Tokyo Stock Exchange, Malaysia can focus on companies' valuation to enhance shareholder value. Requiring companies with a price-to-book ratio (PBR) below 1 time to show improvement and disclose their plans can prompt proactive engagement from management teams. In the case of Malaysia, our analysis of the Bloomberg data show that 52%[44] of PLCs listed in main market are trading at below the book value. Requiring the management team to disclose their plans to increase shareholders' value and allowing investors to track those plans will reinvigorate interest of investors to invest in Malaysia's domestic equities.

44 Data as at 23rd November 2023. Calculation based on proportion of companies listed on Bursa Malaysia with a current price to book ratio less than 1. In total, 539 companies met this criteria of which 10 were constituents of the KLCI Index and a further 22 were constituents of the FBM70 Index.

Figure 4.9:
Tokyo Stock Exchange reforms

Three-tier Market Structure	Reforms focused on Valuation	Revised Japan's Corporate Governance Code	Other reforms
• Prime Market: Must have a market capitalisation of at least JPY 10 billion, total profits for the past two years of at least JPY 2.5 billion, and shareholder equity of at least JPY 5 billion. They must also have a board of directors with at least one-third independent directors. • Standard Market: must have a market capitalisation of at least JPY 1 billion and total profits for the past two years of at least JPY 1 billion. They must also have a board of directors with at least two independent directors. • Growth Market: must have a market capitalisation of at least JPY 500 million. They are not required to have a certain level of profitability or corporate governance.	• All companies listed in Prime and Standard to become more strongly aware of raising their corporate values • Companies with priceto-book ratio (PBR) below need to show improvement and disclose their plans. • JPX introduced Prime 150 Index where the selection based on 1. Top 75 based on PBR more than 1.0 times and 2. Top 75 based on estimated equity spread (difference between return on equity (ROE) and Cost of Equity. • Focus on valuation will make management team in Japan doing proactive role to create shareholders value.	• 1/3 of prime market board members as independent directors • Promote diversity in senior management e.g. more women, foreigners and midcareer professional to senior positions • Develop basic policy on sustainability • Succession plan for their CEO • Requiring companies to have a clear policy on executive compensation. This policy should be aligned with the company's long-term strategy and should be transparent to shareholders.	• TSE has made it easier for investors to access information about listed companies i.e. Japan Direct Market (JDM) program where foreigners can trade through their own broker without going through a Japanese broker • TSE launched JPX Investor Relations that provides detailed information about each company listed on the TSE. • Expansion of trading hours

Source: Japan Exchange Group[45]

45 Japan Exchange Group, Overview of Market Restructuring, refer to https://www.jpx.co.jp/english/equities/market-restructure/market-segments/index.html

4.5 Recommendation 4: Strengthening the SME ecosystem: beyond financing

In our commitment to enhance SMEs, we advocate for a holistic ecosystem approach that goes beyond merely focusing on traditional financing paradigms to support SME growth. The strategy emphasises integrating financial technology to enhance reach and improve the efficiency of capital allocation. Additionally, it aims to foster an entrepreneurial environment that is inclusive, addressing the shortage of human capital by focusing on talent and capacity development. Furthermore, the approach supports the imperative for internationalisation of SMEs, contributing to the resilient and sustainable growth of Malaysia's economy.

4.5.1 Leveraging on FinTech for financial inclusion

The FinTech landscape in Malaysia is still in its nascent stage. In April 2022, BNM announced the issuance of five digital banking licenses, with three consortiums operating under the Financial Service Act 2013 and two under the Islamic Financial Service Act 2013. Even before the advent of digital banks, SC introduced FinTech initiatives in various areas, encompassing Digital Investment Managers, RMOs, and Digital Asset Custodians. The FinTech industry is expected to enhance access to funding, bring innovation to financial services, and contribute to making financial services more inclusive through digital platforms.

Despite the impressive growth of FinTech in Malaysia, particularly with P2P and ECF registering annualised growth rates of 54.8% and 30.6% respectively, from 2018 to 2022, the country's performance in attracting FinTech funding still lags behind regional peers such as Singapore and Indonesia. These two countries accounted for 86% of total FinTech funding in the region, while Malaysia contributed only 4% during the same period.

Therefore, concerted efforts should be made to facilitate and promote FinTech growth in Malaysia, especially considering its potential to revolutionise the SME financing landscape. FinTech solutions offer innovative and accessible financing alternatives, expanding the reach of financial services to underserved and underbanked SMEs.

Policymakers and industry players should actively promote the adoption of FinTech by SMEs through initiatives such as:

1. **Raising awareness and education:** Our survey and interview findings have highlighted a notable lack of knowledge and awareness among SMEs regarding market-based financing. Interviews with SMEs revealed a surprising lack of awareness about P2P and ECF platforms, despite their existence since 2016. Moreover, the campaigns promoting crowdfunding activities have primarily focused on the Klang Valley region, resulting in limited reachability to areas such as Kelantan, Terengganu, Sabah, and Sarawak.

   To address this awareness gap, it is imperative for RMOs and regulators to actively promote ECF and P2P platforms. This can be achieved through online channels and by engaging with business chambers, government agencies, and state development agencies. Our survey indicates that SMEs prefer receiving information through these channels, emphasising the importance of targeted and strategic outreach efforts. By expanding the geographical reach of awareness campaigns and leveraging preferred information channels, regulators can contribute to increasing SME participation in market-based financing options.

2. **Facilitating partnerships between traditional financial institutions (FI) and FinTech companies:** Encouraging collaboration between traditional FIs and FinTech companies is crucial to leverage the expertise of both sectors and develop tailored FinTech solutions for SMEs. Notably, some digital banks in Malaysia have already partnered with FIs. In the realm of ECF and P2P RMOs, establishing partnerships with FIs can prove beneficial in areas such as data sharing, digital expertise, joint marketing initiatives, digital onboarding, and account management.

   This collaborative approach between FIs and FinTech entities can yield mutual benefits, offering SMEs increased accessibility and a wider array of financing options. The expertise of traditional financial institutions, coupled with the innovation and agility of FinTech companies, can result in the creation of specialised and effective solutions tailored to the unique needs of SMEs. By fostering such partnerships, the financial ecosystem can evolve to better serve SMEs, facilitating their growth and fostering a more inclusive and dynamic financial landscape.

3. **Targeted and thematic funds aligned with national policies:** To address specific financing needs and promote inclusive growth, the government should consider establishing thematic funds aligned with national priorities. These funds can be distributed by FinTech platforms to increase reachability and serve the financing needs of underserved groups. Government agencies and individual ministries can collaborate with P2P and ECF platforms, adopting a model similar to that used in MyCif. Ministries and government agencies can co-fund thematic programmes, setting their own targeted Key Performance Indicators (KPIs) to fulfil their ministerial mandates. Areas to focus on for thematic funds include:

   a. **Women and youth entrepreneurs funds**: Women and youth play a critical role in national economic development, but often encounter challenges in accessing financing. A study by Magoulios and Kydros (2011) found that women entrepreneurs around the world find it difficult to access finance, especially in the developing countries. The challenge of women accessing bank financing is more pronounced compared to other financial resources. Hence, developed economies such as the EU have created a specialised financial tool to support entrepreneurship among women.

      In Malaysia, establishing dedicated funds to provide access to capital and mentorship for women and youth-led businesses using market-based financing tools would foster female and youth entrepreneurship, encourage innovation, and promote economic empowerment. This focus is in line with survey findings that highlight the high preference of women and youth to use market-based financing to grow their businesses.

   b. **SME digitalisation funds:** Allocate funds to support SMEs in adopting digital technologies and enhancing their online presence. This initiative aims to drive digital transformation and enhance competitiveness among SMEs, ensuring they are well-positioned in the digital economy. This will complement the SME Automation and Digitalisation Facility (ADF) by BNM, which will be available until the full utilisation of RM1.5 billion facility to help SMEs accelerate digital adaptation.

   c. **Community-based funds:** Establish funds tailored to the needs of SMEs operating in underserved and rural communities, promoting regional development and economic inclusion. This includes supporting "Rural Industry" initiatives that have a positive impact on local communities by creating jobs for rural residents. Such community-focused funds can contribute to balanced economic growth and development across regions.

4.5.2 Data infrastructure to improve access to funding

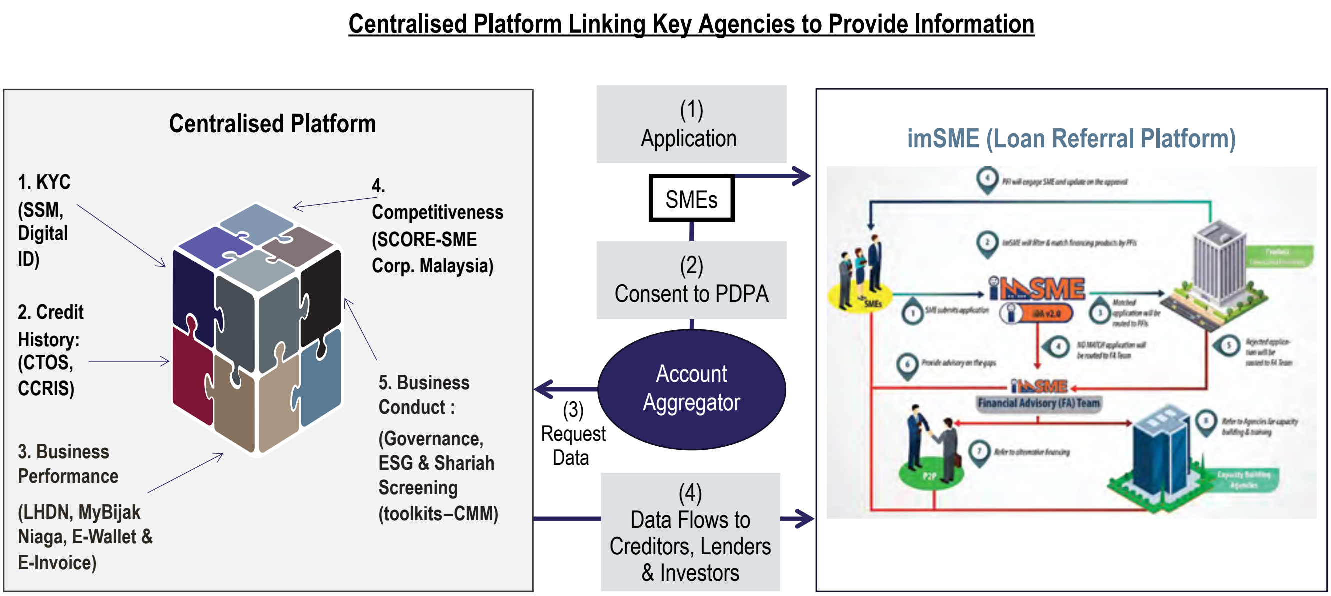
Traditional lenders often impose stringent credit requirements, creating challenges for SMEs seeking funding. In contrast, FinTech companies leverage alternative data sources and advanced analytics to assess creditworthiness, easing the process for SMEs to access essential funding. Despite these advancements, the cost of funding remains a significant hindrance for SMEs. Our interviews with RMOs reveal that the availability of information and data is a persistent challenge in assessing SME creditworthiness.

To address this, one potential solution is to facilitate the democratisation of data. Drawing inspiration from India's success with the India Stack, which operates the Open Credit Enablement Network (OCEN) to revolutionise SME financing, Malaysia can explore similar initiatives. In Malaysia, the ImSME platform by CGC Malaysia serves as the country's first online SME financing/loan referral platform, connecting SMEs with financiers and providing loan referral services. To enhance this platform, linking it with fragmented data sources available in the market can be a valuable step.

While creating a single-window credit assessment service by centralising all fragmented data is an ideal solution, it could be initially costly and complex. As a starting point, regulators and FinTech players can identify key data sources in existing public databases, such as SCORE from SME Corp. Malaysia and CCRIS from BNM, to improve credit assessment quality and provide funding at more efficient price levels. Additionally, upcoming government initiatives, such as digital ID and e-invoicing, could further enhance the database, providing a significant boost for the FinTech industry in Malaysia.

Expanding the ImSME platform to showcase all available funding options, including government funding and market-based financing, aligns with recommendations from the NIMP 2030, enhancing transparency and accessibility for SMEs seeking diverse funding avenues.

Figure 4.10:
Democratising access to financing



Source: Author, ImSME

The process of how the Centralised Platform operates is as follows:

1. Application from SMEs for funding through the ImSME portal
2. Consent under the Personal Data Protection Act (PDPA) for the funding institutions to access data related to the applicant
3. Setting up an Account Aggregator that become a single point for the funding institutions to deal with for information on the SMEs from various data provides linking to credit history, company performance, Know Your Customer (KYC) and Business Conduct
4. Data is analysed by funding institutions to offer funding options to the SMEs, where the SMEs can choose the best offer based on cost of funding, instruments and other criteria preferred by SMEs.

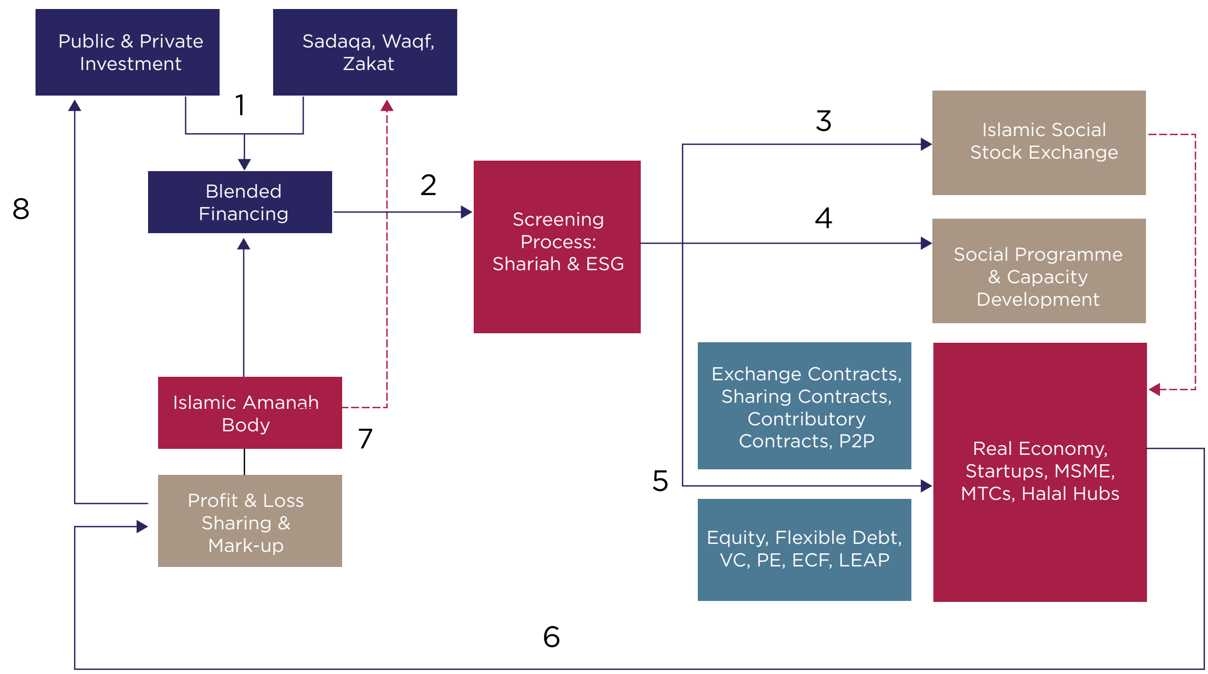
The democratisation of data via a centralised platform will not only enhance access to financing but also foster a proactive approach among SMEs in disclosing information, such as ESG metrics or participation in SCORE. The understanding that sharing such data can contribute to securing financing on more competitive terms is likely to motivate SMEs to engage more actively in this process.

4.5.3 Role of islamic and social finance

Malaysia, a global leader in Islamic finance, is strategically positioned to leverage its expertise to bolster support for SMEs. The government's current advocacy for "Halalan Tayyiban," incorporating both Halal and Tayyib principles, reinforces the role of Islamic finance in fostering sustainable development and ethical business practices within the SME sector. Embracing this framework opens avenues for innovative solutions, such as Islamic FinTech tailored for SMEs, sustainable financing practices, and educational initiatives to enhance SMEs' understanding of Sharia-compliant financial instruments. By aligning Islamic finance with the broader goals of responsible and sustainable business activities, Malaysia can further strengthen its SME ecosystem and contribute to global advancements in ethical finance. The following identifies areas of improvement and strategic initiatives where policymakers can focus on:

1. **Concessional capital for SMEs:** Concessional capital, offering more favourable terms than commercial sources, presents a unique opportunity for SME financing. Industry players and intermediaries can innovate by developing financing models that blend private capital with Zakat, Sadaqa, and Waqf. This innovative approach combines financial sustainability with social impact, providing a harmonious balance for investors, issuers, and the economy. Blended finance becomes an effective instrument to attract private sector investments, distributing and sharing risks among various stakeholders. The structure of this blended financing is outlined in Figure 4.11, showcasing a strategic framework to catalyse SME growth while addressing social and economic needs simultaneously.

Figure 4.11:
Islamic blended financing for financing SMEs and social impact programme



Source: Adopted from Khan (2020), Islamic Blended Finance for Impactful SMEs to achieve SDGs, The Singapore Economic Review.

The blended financing framework is explained as follows:

1. *Integrating public and private investment with Sadaqa, Waqf, and Zakat. The blended fund is use for financing in Islamic Social Stock Exchange, social programme, capacity development and financing SMEs.*
2. *All programmes will be subject to Shariah and ESG screening following "Halalan Tayyiban" principles.*
3. *Social enterprises can raise financing from Islamic Social Exchange to fund social entrepreneurs.*
4. *The blended finance also could be directly used for financing social programmes and capacity development programmes e.g. MyWakaf*
5. *Blended financing can be used directly to finance SMEs through exchange contracts, sharing contracts and contributory contracts using equity, Flexible Debt i.e. RBF, VC, PE, ECF & LEAP*
6. *Return from the economic activities funded under the blended financing instruments received as a Profit & Loss Sharing and Mark-Up*
7. *Formation of an Islamic Amanah Body to manage the return from investment and recycle the profit back to Waqf fund or continue as Sadaqa.*
8. *The public and private investors will receive a return on investment and satisfaction of providing social impact in the economy.*

Various types of blended financing can be developed, as outlined in Figure 4.12. However, the success of blended financing hinges on the efficacy of the application tools. A study by Tonkonogy et al. (2018) reveals that blended finance in the clean energy sector has witnessed considerable success, but subject to the need to bridge the gap between the types of instruments required and those available. Hence, the complexity and structure of blended financing offerings, tailored to market demand, are crucial factors in ensuring the effectiveness of blended financing instruments for SME financing. A thoughtful and market-responsive approach will be essential for maximising the impact of blended financing in supporting the growth of SMEs.

Figure 4.12:
Conventional Blended instruments (CB) and Islamic Blended instruments (IB)

CB blending instruments & structure	IB blending instruments	Market segment	Additional information
Grants	Waqf, Sadaqah, Zakat	Preparing, Pioneering	Religious-based philanthropic funds (Waqf, Sadaqah, Zakat) may be channelled to provide training for entrepreneurs or towards the development of social enterprises.
Repayable grants	Qard	Preparing, Pioneering, Facilitating	Qard is a form of collateral free loan that can be used to support startups and SMEs by providing working capital and growth capital.
Guarantees	Kafala (third party guarantee)	Pioneering, Facilitating, Anchoring	Kafalah is a guaranteed contract on assets, usufruct, and/or services provided by a guarantor. In the context of blended finance, Kafalah can be used to reduce risks of private investors by means of government funding.

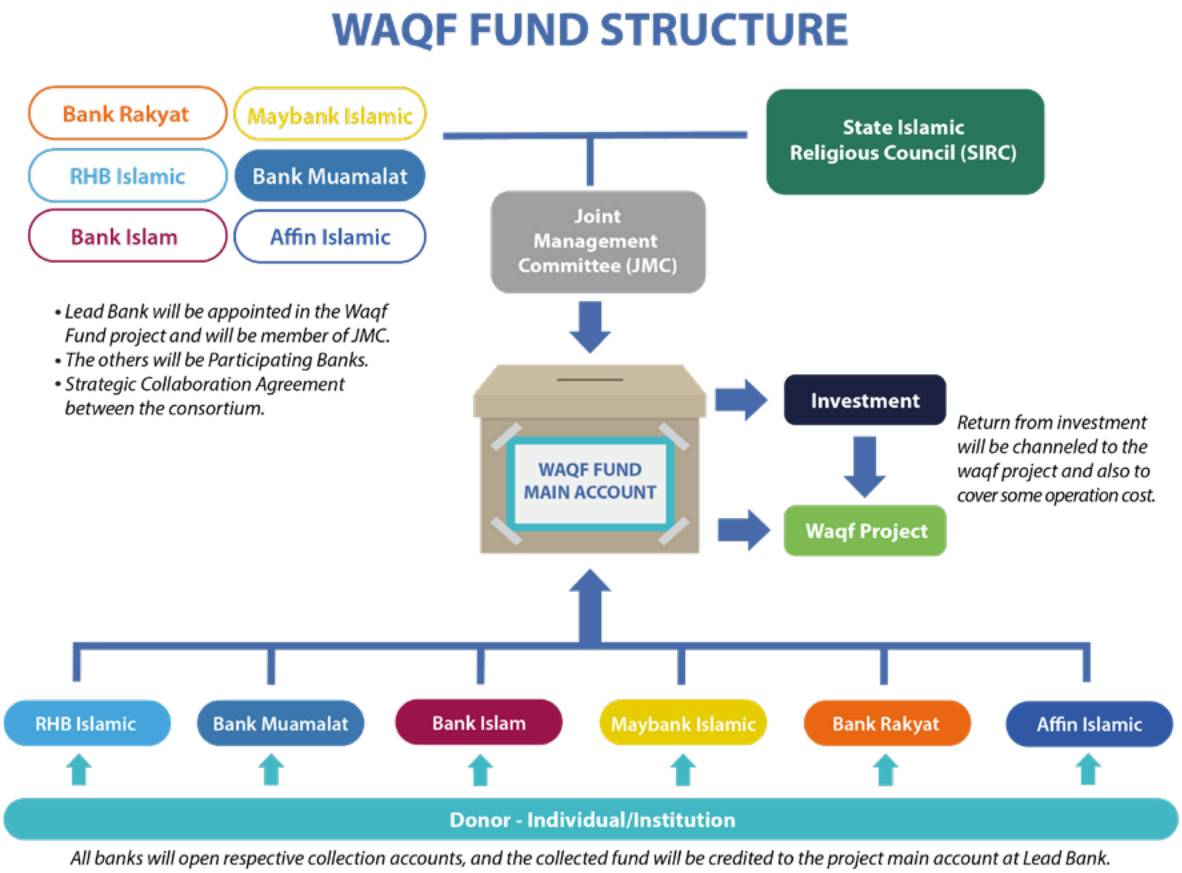
CB blending instruments & structure	IB blending instruments	Market segment	Additional information
Debt (concessional loans)	Murabahah line of credit, Sukuk, Salam, Istisna'	Preparing, Pioneering, Facilitating, Anchoring	Murabahah is cost plus financing, where the parties involved agree upon a markup on the credit line. Employing Murabahah for a concessional loan structure ensures a lower financing rate which is supportive of companies within the growth stage of the life cycle.
Debt (market rate)	Murabahah line of credit, Sukuk, Salam, Istisna'	Anchoring, Transitioning	Introducing different structures allows for better access to finance across a variety of SMEs. A market rate driven Murabahah is better suited to more mature SMEs.
Equity (first loss absorber /risk capital)	Unrestricted Mudarabah, Musharakah	Preparing, Pioneering	Mudarabah and Musharakah are collaborations or partnerships that follow a profit and loss sharing structure. Under the Mudarabah structure, the mudarib (manager) bears the risk of loss up to the amount of capital provided, whereas all parties under the musharakah contract share the risks based on their share of capital.
Market-based equity	Musharakah (diminishing), Mudarabah	Anchoring, Transitioning	Similar to the market rate driven Murabahah, this structure is more suited to mature SMEs.
Technical assistance	Waqf, Sadaqah, Zakat	All stages of the life cycle	Religious-based philanthropic funds may also be channelled to provide technical assistance to entrepreneurs in need

Source: Khan (2020)

2. **Leveraging on Waqf assets for financing SMEs:** The BNM and SC underscores a concerted effort to harness the potential of Waqf assets for economic and social progress in Malaysia. At the forefront of this initiative is myWakaf, a programme steered by six Islamic banks affiliated with the Association of Islamic Banking and Financial Institutions Malaysia (AIBIM). Operating under the oversight of the State Islamic Religious Council (SIRC), myWakaf employs economic instruments to foster financial inclusion and empower society.

Structured to address key areas such as education, healthcare, property investment, financial instruments, and community empowerment, myWakaf is a comprehensive initiative. Notably, it extends its support to startups and SMEs, exemplifying the versatility of Waqf funds in promoting economic sustainability. The structure of the Waqf fund within myWakaf is detailed in Figure 4.13, showcasing a strategic framework that aligns with national development priorities and enhances the societal impact of Waqf assets.

Figure 4.13:
myWakaf Framework



Source: myWakaf

To further amplify the societal impact of myWakaf, we propose an extension of myWakaf initiatives to include Shariah-compliant P2P and ECF RMOs. Given their extensive experience in managing crowdfunding and existing connections to the Malaysian crowdfunding market, integrating these platforms aligns seamlessly with myWakaf's objective of fostering inclusive development.

A particularly promising project within this expansion could involve the development of Cash Waqf-Linked Sukuk (CWSL) in Malaysia. A study by Sherin et al. (2023) has demonstrated the viability of CWSL in the Malaysian context. Indonesia's successful introduction of CWSL in 2020, supported by the National Waqf Movement, serves as a precedent for using waqf assets in social investments. CWSL in Indonesia has effectively addressed short-term financing needs for social infrastructure and impactful projects.

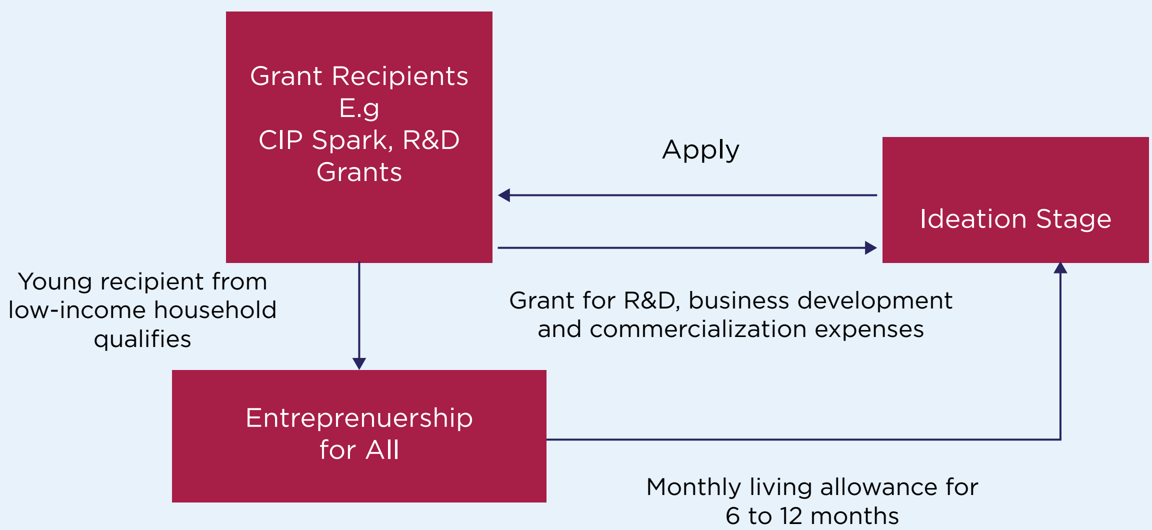
However, it is crucial to note that the current legal and regulatory framework in Malaysia presents challenges for the development of CWSL. The decentralised nature of Malaysia's Waqf legal and regulatory framework, administered at the state level, poses obstacles to scaling the structure and operations of CWSL. Reforms are imperative to establish a conducive environment for digital, retail, and institutional investors to participate in CWSL projects, unlocking its full potential for societal development in Malaysia.

3. **Entrepreneurship to all - fostering inclusivity in startup ecosystem:** The "Entrepreneurship to All" programme is envisioned to create a level playing field for aspiring entrepreneurs, particularly those from low-income households, providing them the opportunity to pursue their business ideas. Recognising the financial challenges faced by young startup founders during the ideation and early startup stages, the programme aims to support their basic needs through a monthly living allowance. Contrary to the notion that founders should independently sustain themselves during this phase, the reality is that early-stage startups often struggle to generate sufficient revenue.

   Based on insights gained from interviews with startup founders and funding agencies, it is evident that grants allocated for ideation and early startup phases may not cover the basic needs of founders. Young entrepreneurs, often backed by family and friends, face financial constraints that hinder their ability to focus on business growth. To address this, we propose that the government provides a basic living allowance for young entrepreneurs from low-income households who secure grants for ideation, such as the CIP Spark from Cradle or other R&D grants from government agencies (refer to Figure 4.14).

   This living allowance, extended for a duration of 6 to 12 months, aims to empower entrepreneurs to fully concentrate on expanding their businesses. Drawing inspiration from Finland's Starttiraha programme, where aspiring entrepreneurs receive a basic living allowance of approximately €750 euros a month for a maximum of 12 months, this support mechanism aims to encourage more young Malaysians, irrespective of their family economic background, to venture into business. By easing financial burdens, the "Entrepreneurship to All" programme seeks to nurture an entrepreneurial culture among the young generation, contributing to the vibrancy and diversity of Malaysia's startup ecosystem.

Figure 4.14:
Entrepreneurship for all framework



Source: Author

4.5.4 Growing talent and financial education

In light of the key challenges identified in Malaysia's current SME landscape, alongside the insights from surveys and interviews, it is evident that nurturing top-tier talent and enhancing financial education are pivotal for the enduring growth of the country's SME ecosystem. By addressing critical aspects of talent and capacity building as well as enhancing the role of university industry linkages, SMEs ecosystem in Malaysia could be strengthened further and provide a boost to our SMEs to be competitive. We propose the following recommendations to grow talent and financial development in Malaysia's SMEs:

1. **Building talent to strengthen SME ecosystem:** To reinforce Malaysia's SME ecosystem and tackle the prevalent talent shortage, a comprehensive strategy is essential. The IMD's World Talent Ranking highlights a significant disparity between Malaysia and Singapore in aligning education with the demands of a competitive economy. Addressing this gap necessitates collaborative efforts involving the Ministry of Education and universities to synchronise educational curricula with industry needs.

   Taking cues from successful models in Singapore, Switzerland, and South Korea, Malaysia should make consistent investments in vocational and higher education institutions. The unwavering commitment demonstrated by institutions like the National University of Singapore and Nanyang Technological University sets a benchmark for educational excellence. Additionally, valuable insights can be gleaned from the Swiss education system, which seamlessly integrates vocational training at the secondary school level with university education, cultivating a highly qualified workforce.

   By emulating these successful approaches, Malaysia can bridge the talent gap, ensuring that its education system is finely attuned to the needs of a rapidly evolving economy. This holistic talent strategy will not only empower SMEs with skilled professionals but also contribute to the overall economic resilience and competitiveness of the nation.

   The Malaysia Startup Ecosystem Roadmap provides a strategic framework, emphasising intensive programmes for graduates of Higher Education Institutions (HEIs) and Technical Vocational Education Training (TVET) students. Leveraging and expanding existing initiatives, such as the Digital Maker Programme and Digital Maker Hub, will contribute to tapping into a broader pool of tech talent, ensuring a robust supply of skilled individuals for the SME ecosystem.

   Learning from Singapore's success in attracting global talent through strategic immigration policies could help to address the local talent shortage in Malaysia. The government needs to streamline the visa approval processes for foreign tech talent in order to align seamlessly with the goals outlined in the Malaysia Startup Ecosystem Roadmap. This not only facilitates the rapid integration of global tech professionals but also positions Malaysia as an attractive and competitive destination for innovative and technologically skilled individuals.

   Enhancing existing programmes like the Malaysia Tech Entrepreneur Programme (MTEP) through a collaborative effort between public and private sectors is crucial. This programme, acting as a magnet for global tech talent, significantly contributes to fostering a diverse and dynamic ecosystem within the country.

   Recognising the urgency of upskilling and reskilling initiatives is essential. A collaborative framework involving government agencies, educational institutions, and private enterprises must be established. By drawing inspiration from successful models such as SkillsFuture in Singapore and the Future Skills Centre in Canada, Malaysia can implement targeted reskilling programmes that champion continuous learning. This national reskilling programme should offer opportunities for individuals to upgrade their skills at various career stages, ensuring a workforce equipped with the latest competencies demanded by evolving industries.

Additionally, a Malaysian adaptation of the talent development grant could strategically focus on cultivating skills and funnelling graduates into VCs. This approach would address the prevailing talent scarcity in Malaysia, fostering a more robust and informed financial ecosystem. Hence, adopting these strategies will not only bridge the talent gap but also fortify Malaysia's SME ecosystem, making it more resilient, competitive, and adaptable to the dynamic demands of the global market.

2. **Capacity building programmes:** Increase Quantity and Quality of Accelerators and Incubators. In tandem with workforce development, there should be a concerted effort to enhance the capacity-building programmes for SMEs. This involves a two-fold strategy:

    a. **Increase quantity of accelerator and incubator programmes via co-investment programmes:** Malaysia should focus on boosting the quantity of accelerator and incubator programmes, recognising their pivotal role in supporting high-growth ventures. Sustaining these programmes financially is challenging, making donor or government support crucial. Flexibility in support is essential, allowing accelerators to be responsive to evolving entrepreneurial needs. Incentivising the establishment of more accelerator operators onshore, as proven effective in Chile, can be a strategy. Co-investments between the government and private accelerators, along with direct financial support, attract global accelerators, enhancing access to formal funding. Returns on equity extracted from participating ventures, a proven strategy elsewhere, can promote financial sustainability and align the interests of accelerators with the success of supported ventures.

    Another strategic focus should extend to the active involvement of universities. Drawing inspiration from successful models like Seoul National University (SNU) in Korea, which established Seoul Techno Holdings, a company aimed at commercialising and supporting technology and startups affiliated with SNU, Malaysia can explore similar endeavours. Seoul Techno Holdings offers investment to technology-based startup companies and operates various funds, including a mother fund and a growth finance investment fund, to support these startups.[46] Founded in 2008 and based in Seoul, South Korea, Seoul Techno Holdings stands as a successful example of how a university can play a pivotal role in nurturing and investing in technology-driven ventures. Encouraging Malaysian universities to establish their accelerator programmes, complete with dedicated funds raised internally, would not only contribute to the expansion of high-quality programmes but also foster financial independence.

    b. **Improve quality of accelerator and incubator programmes:** Emphasis should not only be on quantity but also on the quality of accelerator and incubator programmes. A meticulous selection process, favouring independent companies led by internationally proven entrepreneurs and executives, is crucial. Incorporating high-quality accelerator programmes, akin to the Vigo programme in Finland or Y Combinator in the United States, can provide startups with invaluable

46 See CBInsights. (2023). Incubator/Accelerator: Seoul Techno Holding. https://www.cbinsights.com/investor/seoul-techno-holdings

mentorship and resources, propelling them toward sustainable growth and success in the global market.

In a concerted effort to drive innovation and propel Malaysia towards a dynamic future, Khazanah Nasional has forged a strategic partnership with Plug and Play, a global innovation platform headquartered in Silicon Valley. This collaboration marks the launch of Plug and Play's office in Kuala Lumpur, dedicated to supporting the "Future Malaysia Programme." This initiative signals a commitment to fostering innovation, creating a vibrant ecosystem that nurtures emerging technologies and startups. Through this partnership, Khazanah Nasional aims to leverage Plug and Play's global network and expertise to catalyse growth, positioning Malaysia at the forefront of innovation in the region.

To ensure the effectiveness and quality of entrepreneurial programmes, the implementation of a robust assessment tool is imperative. Taking inspiration from established models such as the Seed Accelerator Rankings Project (SARP) and the Global Accelerator Learning Initiative (GALI) can significantly enhance transparency and provide entrepreneurs with valuable, distilled guidance.

Models like SARP and GALI offer a framework for evaluating and benchmarking the impact of entrepreneurial programmes. By adopting similar assessment tools, Malaysia can systematically measure the success and effectiveness of its programmes, identifying areas for improvement and ensuring that entrepreneurs receive the most beneficial support. This commitment to assessment and improvement will contribute to the overall advancement and sustainability of Malaysia's entrepreneurial ecosystem.

a. **Reassessing existing SME development programmes**: A comprehensive reassessment of current SME development initiatives is imperative. Shifting from surface-level metrics to comprehensive impact assessments is crucial, evaluating long-term KPIs and policy outcomes such as business growth, job creation, and the sustainability of involved businesses which is divorced from the shortened political cycle. The reassessment should focus on the qualitative impact of these programmes on the skills, growth, and innovation capabilities of SMEs. Initiatives should be recalibrated to meet the specific needs of CEOs and business leaders, ensuring that learning and development programmes are not just nominal but truly effective.

Moreover, there is a pressing need to include education about market-based financing within these programmes. Addressing the significant knowledge gap among SMEs in understanding market-based financing will not only enhance awareness but also empower SMEs to leverage alternative financing avenues more effectively, contributing to a more robust and impactful entrepreneurial ecosystem in Malaysia.

b. **Skill development for strengthening SME ecosystem:** Skill development is a linchpin for the growth and success of SMEs, impacting all stakeholders within the ecosystem. A comprehensive skill enhancement strategy is essential not only for SMEs but also for government agencies, educational institutions, investors, accelerators, and incubators. This report places a particular emphasis on skill development within the context of capital market capacity building. Enhancing the competencies of human capital serving the Malaysian capital markets, including intermediaries, sponsors, and advisers, is pivotal. This ensures that they possess the knowledge necessary to understand and evaluate new growth companies and high-tech SMEs.

   To support talent development in capital market, various programme have been introduced such as InvestED initiative by SC Malaysia and Graduate Talent Programme by Bursa Malaysia. These programmes aim to provide on-the-job learning opportunities, networking opportunities, and leadership quality among young graduates in Malaysia. This will help to enhanced employability, build network and address talent issues in the capital market.

c. **Research talent development grant:** A scheme focused on nurturing and developing equity research talent in Malaysia. The government could provide matching grants to industry players to broaden and enhance the research coverage of Malaysian-listed entities. Under a matching scheme, industry players will co-invest in developing equity research talent in Malaysia, including broadening the coverage to include ACE and LEAP market.

   The programme to train industry players can be co-developed between the Securities Industry Development Corporation (SIDC) and international financial institution institutes such as CFA Society Malaysia (CFAM). This is also in line with the Memorandum of Understanding signed between SIDC and CFAM in 2021 to develop a strategic partnership centred on promoting professional excellence and investor education in Malaysia's capital market. Enhancing the quality and quantity of equity research talent will help strengthen the capital market ecosystem in Malaysia. This will contribute to greater vibrancy and growth of the equity market in Malaysia. Through research coverage, attraction and accessibility of platforms like the LEAP and ACE markets can be enhanced, creating a conducive environment for the sustainable growth of the Malaysian equity landscape.

3. **University-industry linkages:** Fostering robust university-industry linkages stands as a cornerstone for cultivating innovation culture and entrepreneurial mindsets, especially within the SME sector. To transform universities into vibrant hubs that not only disseminate knowledge but also instil the skills and mindset essential for entrepreneurship and innovation, Malaysia can draw inspiration from successful models like the National University of Singapore (NUS), recognised for producing thriving startup founders.

   To further support talent development within SMEs, Malaysia should prioritise robust collaborations between the government, academia, and the private sector. Leveraging the concept of universities as Centres of Excellence, inspired by the likes of the Small Business Innovation Research (SBIR) and Small Business Technology Transfer (STTR) Programme in the United States, can bridge the gap between Government-Academia-Industry. This collaborative model facilitates the commercialisation of innovations, contributing to the growth of a vibrant entrepreneurial ecosystem.

   Another successful model of university-industry collaboration is exemplified by Venture Kick in Switzerland. The organisation was established in 2007 with the express aim of doubling spin-offs from Swiss universities. Venture Kick offers direct contributions in the form of grants and convertible loans, as well as indirect contributions including coaching and promotion for the startups. To date, Venture Kick has supported over 1,000 startups, of which 700 are growing high-tech companies, and assisted in creating over 13,000 jobs.[47]

   Another critical aspect of fostering innovation is revisiting universities' Key Performance Indicators (KPIs) and incentive structures related to commercialisation and entrepreneurship. Learning from successful initiatives, such as substantial investments by institutions like the National University of Singapore (NUS)

47 See Venture Kick website and 2022 annual report https://www.venturekick.ch/index.cfm?page=136332

and Nanyang Technological University (NTU), Malaysia can adapt similar strategies. These investments act as catalysts for innovation, accelerating the transformation of academic research into viable commercial entities.

Furthermore, fortifying intellectual property (IP) and licensing rules is essential to create an environment conducive to innovation. Emulating the collaboration between NTU Singapore and NUS to develop a common IP licensing framework can significantly expedite the licensing and translation process for university technologies into spin-off companies. This strategic move reduces the period from the usual five months to just one month, fostering a more vibrant and dynamic innovation ecosystem in Malaysia.

4. **Fostering innovation and risk-taking culture:** Legal Reforms in Malaysia: Mitigating the fear of failure is crucial for cultivating an environment conducive to risk-taking and innovation within the entrepreneurial landscape. The recent amendments to the Insolvency Act, in effect from October 6, 2023, underscore the government's commitment to providing a second chance for bankrupt individuals. This legal reform plays a pivotal role in indirectly alleviating the fear of failure, fostering an environment where entrepreneurs are more inclined to take calculated risks without the spectre of lifelong financial repercussions.

   By offering a safety net for individuals facing financial challenges, these legal reforms contribute significantly to cultivating a culture where entrepreneurs feel empowered to venture into new endeavours. This shift not only promotes innovation but also encourages a more resilient and dynamic entrepreneurial ecosystem in Malaysia. Entrepreneurs, now assured of a second chance, are more likely to explore innovative ideas and undertake entrepreneurial ventures with greater confidence, ultimately contributing to the vibrancy and growth of Malaysia's business landscape.

   Mitigating the fear of failure is crucial for fostering innovation. Allowing failure not only facilitates creative destruction but also encourages the entry of new, innovative firms into the market. Capital allocation from both public and private sectors to SMEs should be growth-oriented, rather than aimed at safeguarding unproductive SMEs or larger corporations from failure. In fact, permitting the failure of larger firms opens up new opportunities for emerging SMEs. Daniel (2013) highlighted various examples demonstrating how the failure of large corporations facilitates the growth of new, innovative firms worldwide. For instance, in India, IBM decided to cease operations in the late 1970s after the government passed a law requiring foreign companies to transfer 60% ownership to local shareholders. This move led to thousands of IBM-trained executives in India venturing into business process outsourcing (BPO) services, and some even started their own software companies.

5. **Use of untapped resources:** The government should leverage untapped resources to provide necessary support to assist SMEs to grow. These untapped resources include professional bodies, civil society, retirees and volunteers to help SMEs and entrepreneurs with basic requirements for formalising their business, access to financing, access to market and capacity building on developing skills and competency of business acumen. The government could provide tax relief, grants, awards or recognitions to these group for their contributions to SME development in Malaysia. For example, the government can consider providing tax incentives for members of professional bodies such as MICPA (Malaysia Institute of Certified Public Accountant) and MACS (Malaysia Association of Company Secretaries), encouraging them to offer personalised mentoring and training to SMEs in areas such as business registration, documentation and disclosures, and basic accounting requirements. SME Corp. Malaysia can play a central role in coordinating this effort by building partners similar to the role played by Enterprise Singapore through their SME Centres.

4.5.5 Broadening access to markets and supporting internationalisation

Enhancing market access and supporting internationalisation activities are crucial for the development of SMEs in Malaysia. This is vital not only for ensuring the country's transition to a high-income economy but also for strengthening domestic business capabilities, with SMEs serving as a key pillar in this endeavour. However, the current export performance of SMEs is lacklustre and requires attention.

Despite the goals outlined in the SME Masterplan, the share of SMEs in overall exports remained low, accounting for only 13.5% in 2020. Alarmingly, this figure further declined to 10.5% in 2022, falling significantly short of the targeted 23% set for 2020. The primary contributing factor to this shortfall is the weakened linkage between Malaysia's SMEs and the global value chain (GVC).

To foster the internationalisation of SMEs and address this issue, several considerations should be taken into account:

1. **Leverage bilateral, regional and multilateral trade agreements:** Policymakers must formulate effective strategies to maximise the benefits derived from Malaysia's participation as a signatory in both bilateral and multilateral Free Trade Agreements (FTA). The primary focus should be on enhancing the export capabilities of our SMEs, particularly in light of the transformative impact of the CPTPP and the RCEP on the global FTA landscape.

   Given that the CPTPP and RCEP collectively contribute 15.2% and 28.33% of global trade, respectively, Malaysia, as a signatory nation, should strategically position its SMEs to leverage these markets. It is noteworthy that both multilateral agreements explicitly recognise the crucial role played by SMEs. For instance, CPTPP provides a great opportunity for SMEs to enjoy the benefit of zero tariffs and reduction in non-tariff barriers within CPTPP export markets. This will allow SMEs to expand their market with lower administration costs due to transparency in rules related to trade and investment under the CPTPP agreement.

   Within the RCEP framework, participating nations acknowledge the substantial contributions of SMEs to economic growth, employment, and innovation. As a result, there is a concerted effort to promote information sharing and cooperation to enhance the capacity of SMEs to exploit the opportunities arising from the RCEP Agreement. Chapter 14 of the RCEP agreement outlines specific obligations among the parties, with the aim of facilitating the sharing of RCEP-related information relevant to SMEs. This involves establishing and maintaining a publicly accessible information repository containing the full text of the RCEP Agreement, trade and investment-related laws and regulations pertinent to SMEs, and other business-related information crucial for SMEs to derive maximum benefit from the RCEP Agreement. Additionally, Chapter 14 also aims to strengthen cooperation in key areas such as e-commerce, intellectual property rights, access to markets, and innovation. Government agencies should take proactive measures to promote the benefits of Free Trade Agreements (FTAs) and assist SMEs in exploring trade opportunities.

   In order for SMEs to effectively capitalise on trade agreements, a robust support system is needed to provide guidance on updated information regarding changes in documentation requirements, trade regulations, and standards set forth by trading partners. The establishment of an information portal and the formation of a dedicated team to assist SMEs in navigating these aspects would prove highly beneficial.

2. **Leveraging Malaysia's position within ASEAN:** Malaysia's strategic position within the Association of Southeast Asian Nations (ASEAN)

provides unique advantages for supporting SMEs in their internationalisation efforts. Aligned with the goals of the ASEAN Economic Community (AEC), the priority is to strengthen integration within ASEAN by enhancing the mobility of goods and people to create a single competitive market. Various initiatives have been undertaken toward this objective, including the establishment of the ASEAN Single Window platform and the ASEAN Access Match platform.

The ASEAN Access platform serves as an online information portal that supports the internationalisation of SMEs in the region. Functioning as an information hub, it provides valuable insights into regional and international trade regulations, aiding SMEs in exploring new markets, particularly within ASEAN. The platform includes a database of distributors, business matchmakers, and other experts, facilitating cross-border trade among SMEs and helping overcome challenges in entering new markets.

To further support SMEs in Malaysia, government agencies and business chambers can play a vital role in assisting them to register and benefit from the ASEAN Access portal, granting them access to the broader ASEAN market. Registering Malaysian SMEs on this platform holds the potential to address connecting issues within ASEAN and foster increased intra-regional trade.

3. **Malaysia as an ASEAN "test hub":** Given its comparatively smaller domestic market size in comparison to countries like Indonesia, the Philippines, Thailand, and Vietnam, Malaysia with our robust infrastructure and burgeoning middle-class consumer base, can be strategically positioned as an ideal ASEAN "test hub." This role would enable SMEs from across the region to test and launch their products and services in the Malaysian market before considering further expansion. Malaysia has been a test hub for a various number of regional unicorns, such as Grab, Carsome, Airasia Digital, and Edotco. Even though some of them have chosen to relocate their regional headquarters outside of Malaysia, they initially started their operations and business growth journey in Malaysia. With effective incentives and a flexible immigration policy, positioning Malaysia as a regional "Test Hub" would likely attract high-tech and innovative entrepreneurs from across the region. The appeal of Malaysia as a testing hub could prompt entrepreneurs to launching their products and services, contributing to the country's development as a regional innovation and a test hub.

   Bilateral R&D incentive programmes could further enhance the role of Malaysia as a" Test Hub" of ASEAN region. The current structure of R&D incentives predominantly favours companies engaged in R&D activities within Malaysia. While this approach encourages domestic innovation, it may inadvertently discourage collaboration on R&D activities with firms outside of the country. The focus on local R&D could limit the potential benefits of regional and global collaboration and knowledge exchange. To optimise the effectiveness of R&D incentives, it might be worth considering a more inclusive approach that recognises and rewards collaborative efforts, both domestically and internationally. The government could introduce a Bilateral Research and Development (R&D) Incentives Programme, fostering collaboration between Malaysian SMEs and foreign companies or institutions for the co-development of new technological or the enhancement of existing technologies with commercialisation potential, thereby facilitating the internationalisation of SMEs. For example, the government can provide incentives of up to 50% of the approved R&D expenditure for Malaysian companies, with the remainder sourced from their foreign counterparts.

   Government incentinves exceeding 50% could be considered for companies operating under FTA partnering countries, with a specific emphasis on the ASEAN region. This approach is anticipated to expedite trade and technology adoption among SMEs, enabling them to scale up production, gain access to technological knowledge, and capture new markets. It is worth noting that a similar incentive has proven successful in Israel.[48]

4. **Focusing on exporting service sector SMEs:** Malaysia should prioritise the promotion of SMEs in the services sector, aligning with the sectorial distribution of SMEs that is heavily skewed towards services, retail, and wholesale sectors, constituting 84% of the total. In contrast, manufacturing accounts for only 6% of the distribution. Despite this, as of 2022, the export share of SMEs in services sector remains low, making up only 2.0% of Malaysia's total exports.

   A targeted strategy must be formulated to enable SMEs in the services sector to access markets beyond Malaysia and promote their services globally. While SMEs currently utilise e-commerce platforms for exporting goods beyond Malaysia, a comparable platform for delivering professional services such as education, healthcare, legal, architecture and designing across the region is quite limited. Hence, supporting private sectors in the development of a specialised e-commerce platform for this purpose could increase services sector exports of Malaysia.

   Government agencies, such as MATRADE, have demonstrated strong support through capacity-building initiatives, notably the Mid-Tier Companies Development Programme (MTCDP). Under this programme, 323 Mid-Tier Companies (MTCs) have been groomed, successfully registering RM34 billion in cumulative revenue, with 61% generated from exports. Moreover, the MTCDP has also benefited 9,000 MSMEs by appointing them as vendors and integrating them into the global supply chain.

   Taking the MTCDP as a successful model, the capacity-building programme can be extended to support MSMEs, particularly in the services sector, fostering their growth in the international export market. This approach can play a pivotal role in boosting the contribution of services sector SMEs to Malaysia's overall export landscape.

5. **Trade financing for SMEs:** The role of financing is pivotal for the internationalisation of SMEs, and the NIMP has underscored the importance of encouraging more supply chain facilities for SMEs to optimise working capital and address cash flow needs. The existing P2P campaign is already offering invoice financing facilities. Furthermore, specialised RMOs like Capbay are providing specific invoice factoring financing services to traders, particularly SMEs, through a crowdfunding facility.

   To further enhance support for SMEs and foster innovation in financing their internationalisation activities, it's crucial to consider the inclusion of more niche players in the financial landscape to provide innovative form of trade financing in Malaysia, particularly supporting the SMEs. These specialised entities can bring targeted solutions to address the unique challenges faced by SMEs in accessing the necessary funds for their global expansion. By encouraging the growth of such niche players, there is an opportunity to create a more diversified and responsive financial ecosystem, ultimately empowering SMEs in their internationalisation endeavours.

48 See https://innovationisrael.org.il/en/program/bilateral-programs-parallel-support

4.6 Conclusion

In conclusion, Malaysia's SMEs are pivotal drivers of employment, innovation, and economic growth, yet they grapple with unique challenges impeding their development. Two primary areas of concern revolve around addressing funding needs across SMEs' life cycle and fortifying the overall SME ecosystem. Financing challenges vary at different stages, necessitating innovative solutions and active government involvement to attract private capital for SME investments.

In the early stages, SMEs encounter difficulties securing funding due to perceived high risks. The government plays a crucial role in fostering a conducive environment for attracting private capital investment to finance SMEs. As SMEs progress, acquiring growth capital becomes imperative for market-driven activities, internationalisation, and sustainability efforts. In the more mature stage, facilitating SMEs' transition to the public market and broadening exit strategies for investors become paramount. Policymakers should adopt a comprehensive and an ecosystem-focused approach, promoting diverse financing options and addressing broader factors influencing SME success. Beyond financing, cultivating innovation culture, embracing new technologies, and enhancing competitiveness are vital for SME's success. A robust SME ecosystem necessitates support beyond transactional financing, encompassing internationalisation, technology adoption, and research and development. Fintech, including P2P lending and ECF, plays a crucial role, and policies should ensure accessibility across all segments, including youth and women. Islamic and social finance, emphasising Zakat and Waqf, can bolster SME development and foster fair resource distribution.

Equipping SMEs with skills and knowledge through financial education and talent development is essential for long-term sustainability. Broadening access to both domestic and international markets, including through regional market accessing platform, is pivotal for SME growth. This should be complemented by market-based financing to provide necessary support. By addressing financing gaps and strengthening the SME ecosystem, the path for SMEs to achieve high-growth, innovation, and greater international competitiveness becomes more tangible.

Chapter Five

Conclusion

The role of SMEs in Malaysia's economic development is indispensable. The aspiration to break away from being trapped in a middle-income economy will require the development of local capabilities, including enhancing the quality and quantity of our entrepreneurs and SMEs. While SMEs are commonly defined by their relative size compared to larger businesses, measured by factors such as employment, turnover, value of assets, or other metrics, it is also important to recognise the heterogeneity of SMEs based on other factors such as the background of their ownership, sectors, technology areas, and organisational behaviour (Raes, 2021).

Micro and traditional SMEs often focus on preserving their businesses, where stability and business continuity always take priority, and they do not aim to scale up their operations. This segment includes sole proprietorships and slower growing or zero-growth firms, but they are not necessarily a group suitable for tapping capital markets (Shinozaki, 2014). In contrast, high-growth startups and scale up SMEs are more driven by innovation, investment, and network expansion and may require greater support from the government and more capital allocation to enable them to explore their fullest potential. This is where market-based financing plays a particularly crucial role in allocating capital to support the growth of these types of SMEs.

It also aligns with our national target of increasing the share of SMEs in GDP from the current 38.4% to 50% by 2030, an average size of SME contribution seen in OECD countries. The increase in the SME share of GDP is also accompanied by a rise in employment opportunities, emphasising both the quality and quantity of job creation. Additionally, there is a focus on enhancing SMEs' capabilities to compete in the global market by internationalising these SMEs.

To ensure the achievement of this ambitious target, access to financing becomes a central focus of SME policies in Malaysia. Finance serves as a critical enabler for SMEs to initiate, expand, and grow their businesses. While gaining access to finance is crucial for SMEs, an equally important consideration is the provision of diversified financing options tailored to meet specific financing purposes. This approach is essential for addressing the diverse needs of SMEs at different stages of their business cycle and for mitigating financing risks, ensuring the resilience of SMEs in the face of potential future downturns.

The mapping of current financial instruments available to SMEs, presented in Chapter One of this report, illustrates that regulators have been facilitative in ensuring that SMEs have a variety of fundraising tools available, either through financial institutions or market-based financing, across different development stages. However, through our research, we identified gaps in access to financing at each business life cycle stage, which we address in the recommendation chapter 4. These gaps are influenced by various factors, including limitations within SMEs themselves and other challenges within the financing ecosystem, such as those related to investors, intermediaries, regulators, and government agencies.

For this study, we investigated the role of SMEs by conducting an enterprise-level survey and qualitative interviews to comprehend their experiences and willingness to raise financing using market-based instruments. It was observed that only a small percentage of SMEs have utilised market-based instruments for financing compared to other financial tools.

Among SMEs that are aware of market-based financing, their willingness to consider it is contingent upon addressing concerns related to the higher cost of capital, ownership control, and issues of trust. Meanwhile, for those unwilling to consider market-based financing, they attribute it to perceptions of complexity, high issuance costs, and the approachability of capital market intermediaries or RMOs. All this also points toward the need for more market literacy to provide SMEs with sufficient knowledge about market-based financing options and how they function in order to enable them to make more informed financing decisions. SMEs have found that financing-related information is scattered, relying mostly on information within their networks through business chambers and from various government agencies. For startups, online sources are equally important as a source of information. Consequently, regulators, intermediaries, and RMOs should build closer relationships with government agencies and business chambers nationwide to disseminate information regarding market-based financing instruments.

Additionally, enhancing existing single-window platforms for SMEs, such as the SMEinfo portal and ImSME, can help reduce information asymmetry. To improve credit assessment, financial institutions can leverage existing fragmented data collected from various government agencies and making it accessible for sharing through a single-window platform. Streamlining and centralising relevant data will enhance the efficiency and effectiveness of credit assessments for SMEs. This approach has been successfully implemented in countries like India to help SMEs access financing. Importantly, we encourage increased collaboration and credit data sharing for the mutual benefit of banking institutions and capital market development in Malaysia.

Strengthening support provided to SMEs, including business development and handholding programmes, can help SMEs better understand the process of fundraising activities, fostering confidence and trust in utilising market-based financing. To further incentivise support for SMEs, the government can consider providing tax incentives for members of professional bodies such as MICPA and Malaysia Association of Company Secretaries (MACS), encouraging them to offer basic support to SMEs in areas such as registration, documentation, and fulfilling basic accounting requirements.

A significant challenge faced by SMEs in Malaysia is the lack of internal capacity in areas such as access to managerial skills, talent shortages, and technology and innovation assets. Our survey findings and interviews with SMEs and stakeholders in the SME ecosystem have underscored this issue.

To address this, it is crucial to establish inter-firm linkages between SMEs and GLCs, MNCs, and the corporate sector, fostering knowledge transfer and technology spillover to support SME growth and internationalisation. Strengthening networks and cooperation through mentorship, accelerator programmes, access to markets, and linking SMEs to global value chains can facilitate this. The government can play an important role in facilitating inter-firm linkages by providing both tax and non-tax incentives. Simultaneously, market-based financing offers opportunities for equity investment and business partnerships with SMEs.

While market-based financing is gaining traction among SMEs, it is essential to recognise that close to 90% of SMEs still rely on bank-related straight-debt financing. Our survey indicates that most SMEs have experience with external financing from banking institutions and less so from market-based financing. This report does not position market-based financing as a competitor to bank financing but rather focuses on how both financing channels can complement each other. Both institutions, banks, and market-based financing entities can provide broad guidelines and cross-cutting policy strategies to ensure that SMEs are less burdened with complicated compliance requirements, such as sustainability disclosures. Sharing data and credit information will benefit both institutions and SMEs.

Our survey indicates that market-based financing has the potential to be more inclusive, particularly for attracting young entrepreneurs and underrepresented groups such as women entrepreneurs. This is attributed to the digital savviness of these groups and the challenges they face in raising financing through the traditional banking sector, especially if they lack credit history and collateral. In response, the government can consider diversifying its options for supporting SME financing by exploring market-based instruments for targeted thematic funds, such as those for women, youth, SME digitalisation, and community-based support.

While the MyCif structure is available to support crowdfunding financing, we encourage other government agencies to initiate similar programmes and disburse some of their SME-based funding through market-based financing channels. Beyond crowdfunding, an FoF structure can be considered, by partnering with entities like Penjana Capital to support the venture capital industry and promote innovation in Malaysia. Approximately 78% of the government's total allocation to SME development is directed towards financing SMEs, and this can be more effectively managed through collaboration using an FoF structure, particularly by partnering with venture capital firms with international experience.

It is crucial to note that the role of market-based financing extends beyond pure transactional capital raising but also includes business development support for business growth. Capital raised from market-based finance, often termed as "knowledge capital" or "smart capital", involves investors providing SMEs with capital and additional support such as mentorship, access to markets, and technology or knowledge spillovers. Our survey and interviews reveal that firms opting for market-based financing, like listing on the LEAP market or raising crowdfunding, do so not only for capital but also to achieve other purposes such as branding, accessing new markets, attracting talent, and facilitating ease of financing. This multifaceted value proposition should be a focal point for RMOs, advisers, and intermediaries to encourage market-based financing among issuers and investors.

In conclusion, the study emphasises the indispensable role of market-based financing in supporting SMEs in Malaysia, particularly those driven by high growth, innovation, digitalisation and ESG practises. Market-based financing not only provides capital for SMEs to grow but also offers support beyond mere financial assistance. However, the study also underscores that financing alone cannot address all limitations within the SME ecosystem. Policies to support SMEs should not solely focus on financing but should equally address other challenges faced by SMEs, including knowledge constraints, limited managerial skills and business acumen, lack of financial management skills, access to technology and innovation assets, talent shortage, and the adaptation of digital technologies, as well as embedding sustainability principles within business organisations.

According to the OECD (2023), policy responses to address the diversified needs of SMEs and entrepreneurship should be divided into three focus areas: broad-based policies (e.g., tax, labour market, trade, or infrastructure), sectorial policies (e.g., sectorial development such as renewable energy under the NETR), and targeting specific SMEs and entrepreneurs (e.g., high growth and innovation-driven ventures). These areas often cut across the boundaries of ministries and government agencies, as well as across levels of government (federal, state and local governments), with considerable variation depending on institutional arrangements and the degree of decentralisation.

Policy targeting specific SMEs and entrepreneurship is essential, especially for SMEs venturing into new growth areas where they face unique challenges and high uncertainties. Yet, these ventures also have the potential to enjoy economic profits (alpha) and grow exponentially, becoming gazelles or potential unicorns. One-size-fits-all solutions do not effectively address SMEs' problems; instead, the approach should focus on policy interventions at multiple levels, as recommended above.

Therefore, with the support of market-based financing and policy interventions addressing SMEs' needs at various levels, we are confident that SMEs in Malaysia can contribute towards the targets set under the National Entrepreneurship Policy 2030. This shift will play a crucial role in elevating the contribution of SMEs to the GDP, making it a key priority in Malaysia's development strategy. It is a fundamental step towards leading the country in breaking away from the middle-income trap and fostering our transformation into becoming a resilient and advanced economy with a focus on sustainability.

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