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Capital Market Financing for SMEs: A Growing Need in Emerging Asia

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ADB Working Paper Series on Regional Economic Integration



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Shigehiro Shinozaki

No. 121 | January 2014



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Abstract

Asia's bank-centered financial systems require the reduced supply-demand gap in lending as a core policy pillar to improve small and medium-sized enterprise (SME) access to finance. Meanwhile, the diversification of financing modalities beyond conventional bank lending is another key policy pillar to better serve various financing needs of SMEs and expand their financial accessibility. The rapid growth of emerging Asia is generating SMEs' long-term funding needs and requires robust capital markets as an alternative channel for providing their growth capital. The G20 Leaders also addressed the importance of promoting long-term financing for SMEs in the context of investment. The development of capital markets that SMEs can tap is one of the policy challenges under the pillar of diversified financing modalities, which requires more sophisticated and innovative institutional arrangements in order to respond effectively to their real needs. This paper explores the potential of capital market financing for SMEs in emerging Asia, reviewing the challenges of existing SME capital markets and assessing demands on SMEs, regulators, policy makers, market organizers, securities firms, and investors for developing an SME market, based on the findings from intensive surveys. Given the responses to the national growth strategies and the cross-cutting issues of global policy agendas such as climate change, energy efficiency, and green finance, the potential for developing the exercise equity market and the social capital market in Asia is also explored in this paper.

Keywords: Financial inclusion, innovative financing, long-term financing, SME capital markets, SME finance

JEL Classification: F36, G28, G29

1. Introduction

Small and medium-sized enterprises (SMEs) are a backbone of the resilient national economy in every country due to their nature of stimulating domestic demand through job creation, innovation, and competition. Meanwhile, SMEs involved in the global supply chain have the potential to encourage international trade and to mobilize domestic demand. Prioritizing SME development is therefore critical for promoting inclusive economic growth in Asia.

Given the global economic uncertainty, adequate and stable access to finance is crucial for SMEs to survive and grow. In Asia, however, most SMEs have been suffering poor access to finance, which is one of the core factors impeding SME development. There is a perceived supply-demand gap in SME finance. The International Finance Corporation (IFC) and McKinsey & Company estimated the value of the gap in formal SME credit in 2010 at US\$700 billion–US\$850 billion, which is equivalent to 21%–26% of the total formal SME credit outstanding in the developing world. If informal SMEs and microenterprises are included, the total gap in developing countries in terms of unmet financing demand exceeds US\$2 trillion.

Such a supply–demand gap suggests the limitations of bank lending for enterprises in raising sustainable and safe funds for business, especially for SMEs. Once unexpected events such as a financial crisis occur, the banking sector will naturally respond to such events and take actions to mitigate associated risks, which will cause a credit crunch in the banking sector and seriously affect SME access to finance. Moreover, Basel III might have a risk accelerating this trend in banks by further restricted financing for SMEs. The root causes of financial crises change as global financial systems become more advanced. Well-established SME finance policies will alleviate credit contraction, but cannot remove it entirely. To supplement the limitations of bank lending for SMEs amid the complex global financial environment, the diversification of financing modalities, with flexibility and innovation, is indispensable.

Capital market financing for SMEs is one of the policy challenges under the pillar of diversified financing modalities, which requires more sophisticated and innovative institutional arrangements in order to respond effectively to their real needs. Long-term financing for investment, including SMEs, is key for sustainable growth and job creation as stated at the G20 Finance Ministers and Central Bank Governors Meeting in Moscow in July 2013. On the occasion of the Saint Petersburg Summit in September 2013, the G20 Leaders also addressed the importance of promoting long-term financing for SMEs in the context of investment.

SMEs are a large mass of enterprises different from sector to sector and size by size, which include sole proprietorships and slower growing or zero-growth firms but those are not a group for tapping capital markets. High-end SMEs, a group of firms that seek to raise growth capital for business with innovative mind, are central to the ability of an economy as a whole to create jobs, and a major group seeking long-term funding and appropriate for tapping capital markets.

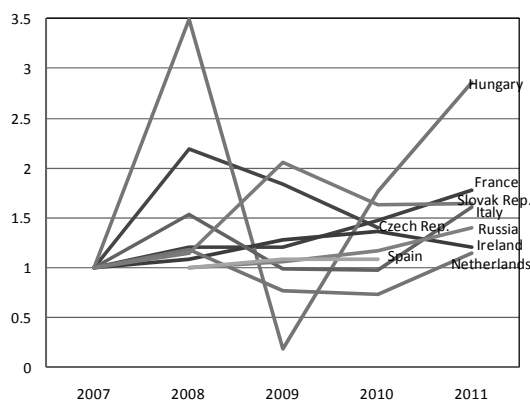
On the whole, SMEs, especially start-ups, tend to have a lower probability of survival than larger firms, which creates a general pattern of simultaneous high rates of SME market entry and exit across virtually all economic sectors and encourages financial institutions to regard them as being inherently riskier loan prospects than larger firms. Hence, banks' hesitation to provide long-term financing owing to uncertain economic circumstances is seriously affecting SMEs' growth capital funding.

Bank-centered financial systems in Asia require robust capital markets as an alternative channel for providing growth capital. The development of long-term financing instruments for high-end SMEs and proper regulatory frameworks for new instruments will be a key growth agenda among policy makers and regulators, which should be incorporated into a comprehensive menu of policy options on SME finance.

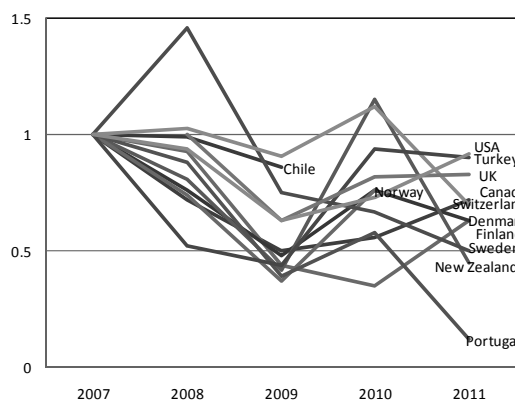
Capital markets are typically susceptible to changing external economic conditions, especially during a financial crisis. In OECD countries, most economies were severely impacted by the 2008/09 global financial crisis (GFC), with the level of equity investments in 2011 still below pre-crisis levels in several countries (Figure 1). SME capital markets should be well designed to mitigate risks arising from the external environment, which requires a sophisticated institutional mechanism supporting SMEs in direct finance as well as managing any possible risks.

Figure 1. Growth Capital Investment in OECD Areas

A. Countries Where Growth Capital Investment Increases



B. Countries Where Growth Capital Investment Declines



OECD = Organization for Economic Co-operation and Development; UK = United Kingdom; USA = United States of America.

Note: 2008 (base year) = 1 for Russian Federation, Spain, and the United Kingdom; 2007 = 1 for other countries.

Source: OECD. 2013. *Financing SMEs and Entrepreneurs 2013 – An OECD Scoreboard*. p.34.

This paper explores the potential of capital market financing for SMEs in emerging Asia, reviewing the challenges of existing SME capital markets and assessing demands on SMEs, regulators, policy makers, market organizers, securities firms, and investors for developing an SME market, based on the findings from intensive surveys. Given the

responses to the national growth strategies and the cross-cutting issues of global policy agendas such as climate change, energy efficiency, and green finance, the potential for developing the exercise equity market and the social capital market in Asia is also explored in this paper.

2. Landscape of SME Capital Markets in Asia

2.1 Type of SME Capital Markets

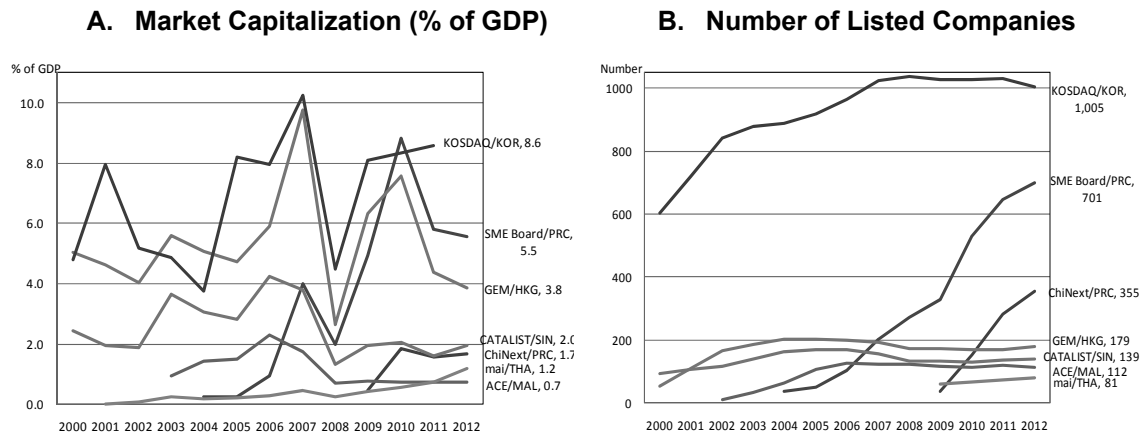
SME capital markets are still in the early stages of development in Asia that bank-centered financial systems have penetrated. Some countries have pursued a trial-and-error approach for creating a well-functioning direct financing venue for growth-oriented SMEs. This can be roughly classified into two types, an (i) exchange market and (ii) organized over-the-counter (OTC) market. For the exchange market, besides a typical SME Board under the stock exchange, a sponsor-driven alternative investment market (AIM) modeled on the United Kingdom's AIM (UK-AIM) has been established in some emerging Asian countries such as Malaysia, Singapore, and Thailand. As for the organized OTC market, self-regulatory organizations (SROs), such as the Korea Financial Investment Association (KOFIA) and the Japan Securities Dealers Association (JSDA), have operated a trading venue for unlisted SME stocks that is separate from the exchange market.

2.2 SME Equity Markets

In emerging Asia, equity financing venues for SMEs have been mostly created under stock exchange operations. In the People's Republic of China (PRC), the Shenzhen Stock Exchange (SZSE) has developed a three-tier market venue comprising the Main Board, SME Board (May 2004), and ChiNext (October 2009; high-tech venture board), in line with national economic development strategies. Hong Kong, China's Growth Enterprise Market (GEM) is an alternative stock market for high-growth enterprises, operated by the Stock Exchange of Hong Kong Ltd. India has recently developed dedicated stock exchanges for SMEs, following the recommendation of the Prime Minister's Task Force in June 2010. The Bombay Stock Exchange (BSE) launched the SME Exchange in March 2012 and it has 41 listed SMEs as of 19 November 2013. The National Stock Exchange (NSE) has also launched the SME platform named Emerge, with 3 listed SMEs. KOSDAQ is the largest organized market for SMEs and venture businesses in the Republic of Korea and is operated by the Korea Exchange (KRX). As KOSDAQ is becoming a funding venue for high-end larger enterprises, a new market designed for SMEs named KONEX was launched under KRX in July 2013. MESDAQ under Bursa Malaysia was re-launched as the ACE (Access, Certainty, Efficiency) market in August 2009, a sponsor-driven alternative market. Catalist in Singapore is a Singapore Exchange (SGX)-regulated but sponsor-supervised market for rapidly growing enterprises, modeled on the UK-AIM (December 2007). The Securities Exchange of Thailand (SET) has operated the market for alternative investment (mai) since June 1999, targeting SMEs as potential issuers.

Equity markets for SMEs in emerging Asia are typically small in scale, with market capitalization equal to less than 10% of GDP and market performances that significantly vary by country. In the PRC, both SME Board and ChiNext have been sharply expanding in terms of size and the number of listed companies, with more than 1,000 listed companies in both markets combined, although their growth rates have slowed recently. KOSDAQ and Hong Kong, China’s GEM enjoyed V-shape recoveries from the GFC, but the growth of these markets tends to be slowing with little new listings. The market size of Catalist Singapore, ACE Malaysia, and mai Thailand has not expanded well like similar markets in the PRC and the Republic of Korea, and their listed companies are not increasing at a sufficient pace. This suggests that equity markets in Asia, except for those in the PRC and the Republic of Korea, have not yet become a financing venue for SMEs. Extensive national policies and strategies for improved SME access to capital markets are needed.

Figure 2. SME Equity Markets in Emerging Asia



GDP = gross domestic product; SME = small and medium-sized enterprise.

Note: Emerging Asia comprises the People’s Republic of China; Hong Kong, China; the Republic of Korea; Malaysia, Singapore, and Thailand.

Sources: Various statistics from respective stock exchange websites.

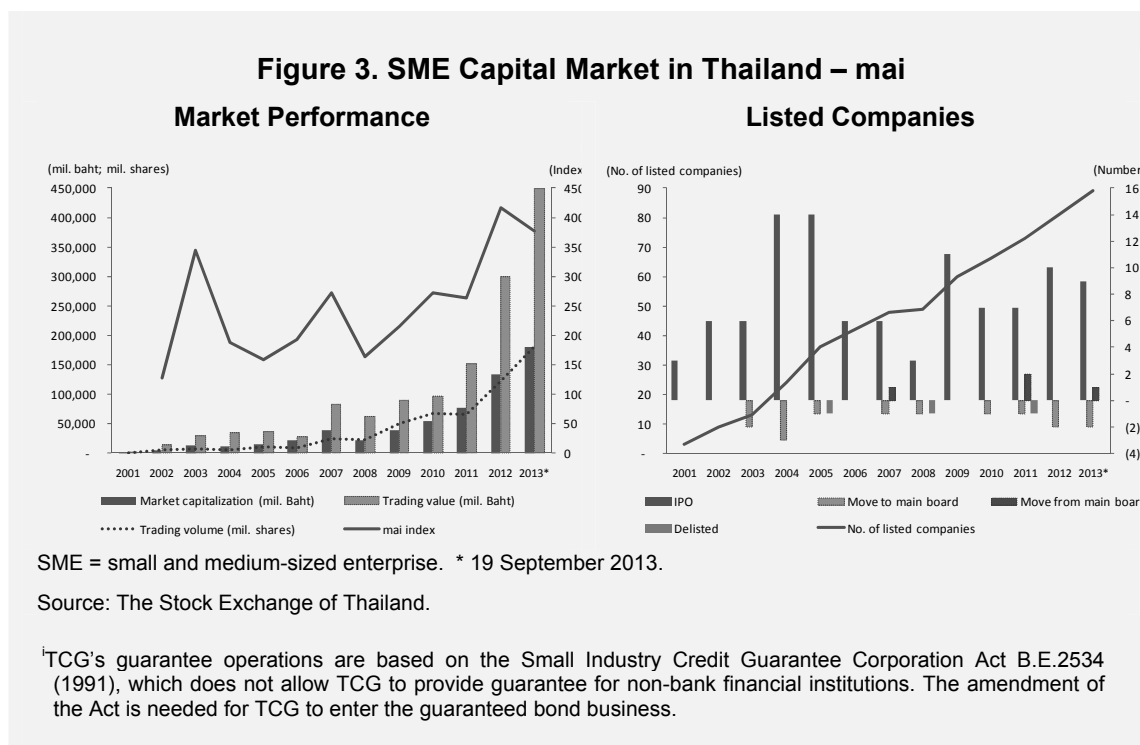
Box A. Challenges to Developing SME Capital Markets in Thailand

The Market for Alternative Investment (mai) was established under the Stock Exchange of Thailand (SET) in 1998, whose main mission is to provide opportunities for entrepreneurs and SMEs to tap long-term growth capital. Since the first listed company appeared in 2001, the mai market has been growing. As of 19 September 2013, mai holds 89 listed companies with total market capitalization of THB 180 billion and total turnover value of THB 448 billion. So far, 14 companies have successfully moved from mai to the main board of SET since the establishment. The Thai government initially introduced a tax incentive scheme for newly listed companies in mai, i.e., corporate tax reduction from 30% to 20% for five accounting periods, which boosted the number of listed companies in 2004 and 2005. This tax privilege is no longer available as the government has uniformly reduced corporate tax for all firms.

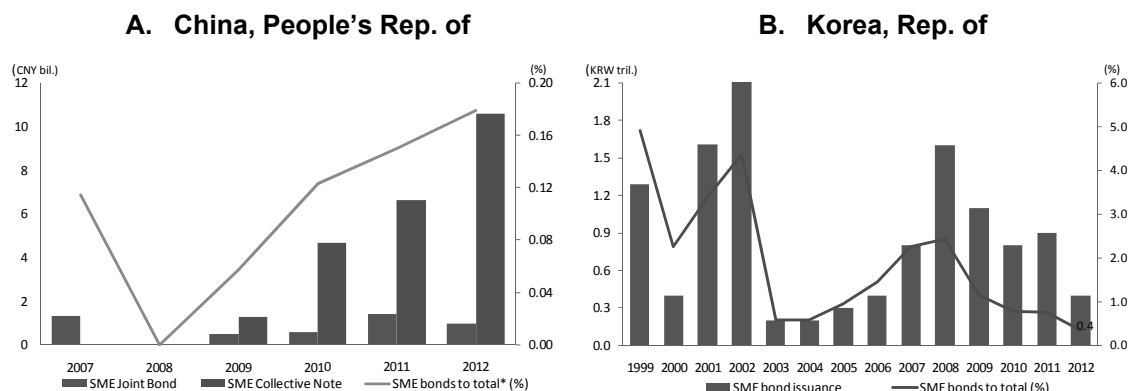
The listing requirements on mai have been relaxed as compared to the main board. For instance, the issuer must continuously operate at least for 2 years (3 years in the main board) and hold paid-up capital of no less than THB 20 million after public offering (THB 300 million in the main board). Minority shareholders should be no less than 300 persons (1,000 persons in the main board). The mai copes with only equity products (common stock and warrant) and no bond issuance and trading. At present, Securities and Exchange Commission (SEC) has brainstormed the development of SME bond market, together with Thai Credit Guarantee Corporation (TCG) for the potential guaranteed SME bonds¹.

The active issuers in mai are manufacturing and service industries, most of which are family-run businesses operating for 5-20 years. The technology sector is the potential segment of mai issuers in the future. The main investors in mai stocks are domestic individuals and institutions (97% of trading in 2012). Foreign investors' participation in mai accounted for only 1.6% of trading in 2012. There is the Thai Venture Capital Association (TVCA) that comprises 14 members. The Thai government has supported to establish several venture capital funds such as the SME Venture Capital Fund that amounted to THB 1 billion since 2000, but the venture capital industry is still quite small in scale in Thailand.

SEC is responsible for regulating and supervising Thai capital markets including the SET and the mai. Although still in the trial-and-error stage, SEC is taking several initiatives to develop SME capital markets in Thailand, which mainly comprises three programs. First is the program to promote SME bond issuance through educating SMEs (free seminar on issuing bonds) and creating incentive schemes for them to tap bond market (concessional rating fees, bond application fee exemption, and registration fee exemption in the Thai Bond Market Association). Second is the program named "IPO, Pride of the Province" to facilitate growth potential local firms to raise funds from capital markets through the provision of free training courses, consultations, and listing fee exemption. Third is the program to allow accredited investors (institutional investors and high net worth individuals) to invest in riskier products such as unrated bonds. Enhancing capital market literacy for the traditionally underserved or SMEs is a common approach across those programs.

Box A. Continued**2.3 SME Bond Markets**

There is a new movement for creating an SME bond market in countries such as the PRC and the Republic of Korea. In the latter, a qualified institutional buyer (QIB) system was established for SME bond trading in May 2012. However, SME bond transactions under the QIB system are quite limited and not attractive to individual and institutional investors due to the existence of low investment grade bonds (BB or below). The PRC has developed three types of SME bond instruments: (i) SME Collective Note, (ii) SME Joint Bond, and (iii) SME Private Placement Bond. The SME Collective Note market is an inter-bank market regulated by the People's Bank of China (PBOC) and the National Association of Financial Market Institutional Investors (NAFMII). It is growing rapidly, with annual issuance of CNY10.6 billion in 2012. An SME Collective Note is issued on behalf of between two and 10 SMEs and generally guaranteed by a government guarantee institution. SME Joint Bonds are traded in the inter-bank and exchange markets, which are regulated by the National Development and Reform Commission (NDRC), but the issuance volume is quite limited at CNY0.98 billion in 2012. SME Private Placement Bonds are regulated by the China Securities Regulatory Commission (CSRC). The plural regulators are involved in the SME bond markets in the PRC.

Figure 4. SME Bond Markets in Emerging Asia

SME = small and medium-sized enterprise. * SME bonds = SME Joint Bond issuance + SME Collective Note issuance.

Sources: The First ADB-OECD Workshop on Enhancing Financial Accessibility for SMEs. March 2013. Conference materials. China, People's Rep. of: Jiang 2013. Korea, Rep. of: Jeong 2013. ADB Asia Bond Online.

2.4 Regulatory Structure

Table 1 highlights the regulatory structure for capital markets that SMEs can tap in selected Asian countries. Although the observed markets do not always target only SMEs, this paper uses the term “SME markets” for convenience sake because they are part of the target issuers in such concessional markets. On the whole, the baseline laws and regulations show no differences between the general and SME markets in the observed countries. Under the control of uniform capital market laws and regulations, the responsible regulator (e.g., Securities Commission), stock exchange, or the operating SRO generally provides special rules, guidelines, and regulations on SME markets. The listing criteria and the disclosure requirements for SME markets are widely lightened as compared with the main board of the stock exchange.

However, there are some limitations to reducing the requirements for listing and maintaining stocks in such concessional markets. SME markets have mainly been created under a stock exchange or regulated SRO. Given the no stand-alone and specialized legislation that is separate from the general set of capital market laws, direct financing venues may be inflexible to SME funding needs, particularly in size matters. For instance, the minimum number of shareholders in a stock offering and the maintenance of stocks stipulated under the baseline laws may not fit the funding needs of those who want to raise small funds from limited investors. The regulatory framework for SME capital markets should be flexibly examined upon necessity.

Table 1. Regulatory Structure for SME Capital Markets in Asia

Economy	Regulators	Laws and Regulations	SME Markets	Market Type
China, People's Rep of	China Securities Regulatory Commission (CSRC)	<ul style="list-style-type: none"> • Law on Funds for Investment in Securities (2005) • Law on securities (2005) • Regulation on the Administration of Futures Trading (2007) • Securities Investment Fund Law (2012) 	SME Board/Shenzhen Stock Exchange (SZSE) ChiNext (venture board)/SZSE SME Private Placement Bond market	Equity/exchange market Equity/exchange market Bond/OTC market
	People's Bank of China (PBOC) National Association of Financial Market Institutional Investors (NAFMI)	—	SME Collective Note market	Bond/inter-bank market
	National Development and Reform Commission (NDRC)	—	SME Joint Bond market	Bond/inter-bank and exchange market
Hong Kong, China	Securities and Futures Commission (SFC)	<ul style="list-style-type: none"> • Securities and Futures Ordinance • Companies Ordinance 	Growth Enterprise Market (GEM)/Stock Exchange of Hong Kong (SEHK)	Equity/exchange market (AIM)
India	Securities and Exchange Board of India (SEBI)	<ul style="list-style-type: none"> • Securities Laws Ordinance (2013) • Depositories Act (1996) • SEBI Act (1992) and Regulations • Securities Contracts Act (1956) 	SME Exchange/Bombay Stock Exchange (BSE) Emerge/National Stock Exchange of India (NSE)	Equity/exchange market Equity/exchange market
Korea, Rep. of	Financial Services Commission (FSC) Financial Supervisory Service (FSS)	<ul style="list-style-type: none"> • Financial Investment Service and Capital Markets Act (2011) • Act on External Audit of Stock Companies (2010) • Certified Public Accountant Act (2011) • Secured Bond Trust Act (2011) • Registration of Bonds and Debentures Act (2011) • Asset-Backed Securitization Act (2011) 	KOSDAQ/Korea Exchange (KRX) KONEX/KRX	Equity/exchange market Equity/exchange market (AIM)
Malaysia	Securities Commission Malaysia (SCM)	<ul style="list-style-type: none"> • Capital Markets and Services Act (2007) and Amendments (2010, 2011, 2012) 	Free Board/Korea Financial Investment Association (KOFIA) Free bond/KOFIA	Equity/OTC market Bond/OTC market (qualified institutional buyer [QIB] system)
Singapore	Monetary Authority of Singapore (MAS)	<ul style="list-style-type: none"> • Securities Industry Act (1973) 	ACE Market/Bursa Malaysia	Equity/exchange market (AIM)
Thailand	Securities and Exchange Commission (SEC)	<ul style="list-style-type: none"> • Securities and Exchange Act (1992) and Amendments (1999, 2003, 2008) • Securities Exchange of Thailand Act and Regulations 	MyJULM (online trading platform) [concept launched in May 2013] Catalist/Singapore Exchange (SGX) Market for Alternative Investment (mai)/Securities Exchange of Thailand (SET)	Unlisted securities/OTC market (not yet established) Equity/exchange market (AIM) Equity/exchange market (AIM)

SME = small and medium-sized enterprise.

Source: Authors' compilation from various laws and regulations, and stock exchange websites.

3. Potential for Developing SME Capital Markets

Provided that increasing bankability is a traditional policy priority in SME finance, policy makers in Asia had not considered the development of SME capital markets significant for a long time due to the following reasons: (i) bank-centered financial system established, (ii) capital markets yet underdeveloped, (iii) fragile internal control systems of SMEs, (iv) no demands on SMEs and investors for capital market financing, and (v) cost and size matters for establishing and operating SME capital markets. However, such preconceptions are not proved with clear evidence, and advanced technology may make possible the creation of SME capital markets with reasonable costs. Besides, less coordination among multiple policy makers responsible for SME sector development and finance may have hindered the policy formulation of capital market financing for SMEs. This section assesses the real intention of supply-side (regulators, policy makers, market organizers, securities firms, and investors) and demand-side (SMEs) for developing an SME market, based on the findings from intensive surveys, and explores possible directions on increasing long-term financing opportunities for SMEs.

3.1. Methodology

Three-tier approach is used to assess the potential of capital market financing for SMEs: (i) online and paper-based surveys for the supply- and demand-sides of growth capital, (ii) study meetings on the development of SME capital markets, and (iii) interviews with the supply- and demand-sides. Study countries selected are the PRC, India, the Republic of Korea, and Malaysia. These countries have a unique path for developing an SME market as mentioned earlier. Two types of online and paper-based surveys were conducted from April through July 2013 in corporation with partner institutions in respective countries.¹ The supply-side survey aimed to review regulatory and policy stance, business and investment needs, and critical factors for developing SME capital markets. Meanwhile, the demand-side survey aimed to investigate funding needs of SMEs, barriers to accessing finance, and critical factors for establishing an SME-friendly market. The latter targeted SMEs under the respective national definitions and covered all types of industries. The survey used a set of questionnaires specially designed to ascertain real needs of the supply- and demand-sides for the development of SME capital markets, which comprised five-scale, check-box, and fill-in style questions. In parallel with that, half-day study meetings, followed by intensive interviews with the supply- and demand-sides, were organized in order to supplement the survey findings in India, the Republic of Korea, and Malaysia.² As a result, a total of 105 completed

¹ Partner institutions: (i) The PRC: National Association of Financial Market Institutional Investors (NAFMII) and China Association of Small and Medium Enterprises (CASME); (ii) India: BSE, Indian Private Equity and Venture Capital Association (IVCA), Association of National Exchanges Members of India (ANMI), Federation of Indian Micro, Small and Medium Enterprises (FISME), Chamber of Indian Micro, Small & Medium Enterprises (CIMSME), and the Associated Chambers of Commerce and Industry of India (ASSOCHAM); (iii) the Republic of Korea: KRX, Korea Venture Capital Association (KVCA), and Small & medium Business Corporation (SBC); and (iv) Malaysia: Bursa Malaysia, Malaysian Venture Capital Association (MVCA), and SME Corporation.

² Study meetings: (i) the Republic of Korea: Seoul on 8 April 2013 in cooperation with KRX, (ii) India: Mumbai on 29 April 2013 in cooperation with BSE, and (iii) Malaysia: Kuala Lumpur on 27 May 2013 in cooperation with Securities Commission Malaysia.

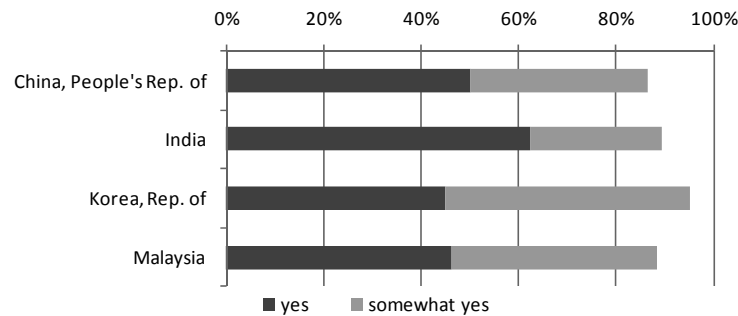
questionnaires in the supply-side and 431 valid samples in the demand-side were collected from four study countries combined (see Box B and C for details).

3.2. Supply-Side Analysis

3.2.1 Policy Stance on SME Capital Markets

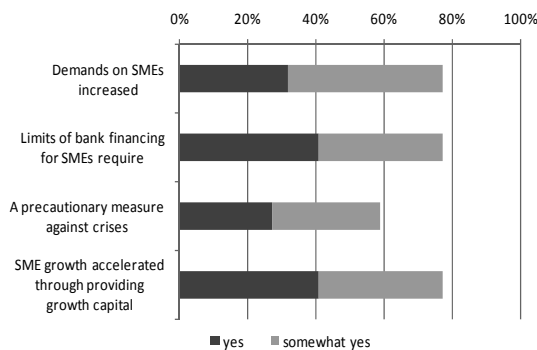
More than 80% of the supply-side respondents in respective study countries have recognized that developing an SME capital market is a policy priority at the national level (Figure 5). There were three dimensions of perception behind their answers: (i) awareness of the underserved segment, i.e., SMEs, in the capital market space; (ii) increased roles of capital markets as part of national growth strategies; and (iii) limitations of traditional bank-centered financial systems. Around 80% of the respondents in each country answered that potential demands on SMEs for long-term financing increase as Asia’s growth is continuously driving the global economy and that SME growth is accelerated further through directly providing growth capital for SMEs, which contributes to resilient national economies. Moreover, they identified that the limitations of bank financing for SMEs require diverse financing modalities for them, which is an SME capital market. Their answers for the development of SME markets are likely to be constructed from a long-term strategic point of view.

Figure 5. Is Developing Capital Markets for SMEs a Policy Priority?



(Reasons)

A. China, People’s Rep. of



B. India

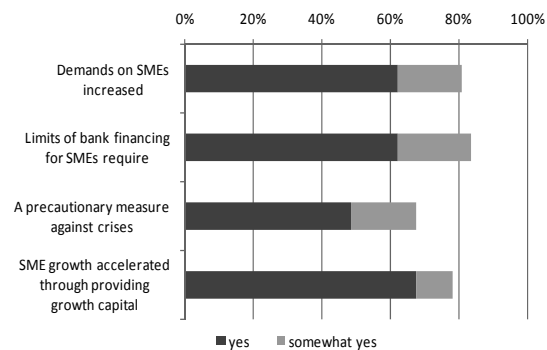
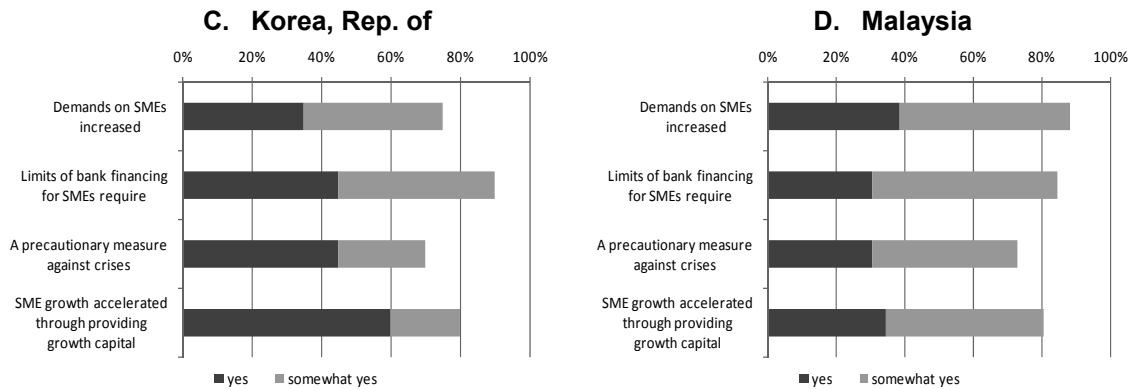


Figure 5. Continued



SME = small and medium-sized enterprise.

Note: Valid samples: the People’s Republic of China: 22; India: 37; the Republic of Korea: 20; and Malaysia: 26.

Source: Authors’ compilation.

3.2.2 Policy Actions to be Taken

There are several policy options and approaches to stimulate SME capital markets at the national level. The respondents ranked necessary measures to develop an SME market, with different priorities from country to country. On the whole, however, all study countries considered a comprehensive policy framework for SME access to capital markets needed; especially policy measures to develop investor base for an SME market and promoting market literacy for SMEs and investors are the most important actions to be taken by the government to realize a functional market. In the PRC, the establishment of SME financial and non-financial database, including an SME Whitepaper, ranked top as a necessary policy support area for SME markets with transparency. In India, policy measures to build the base of professionals that support SMEs in capital markets, e.g., disclosure support by consultants and certified public accountants (CPAs), ranked first as needed actions for active SME markets.

Figure 6. Actions Necessary to Develop SME Capital Markets

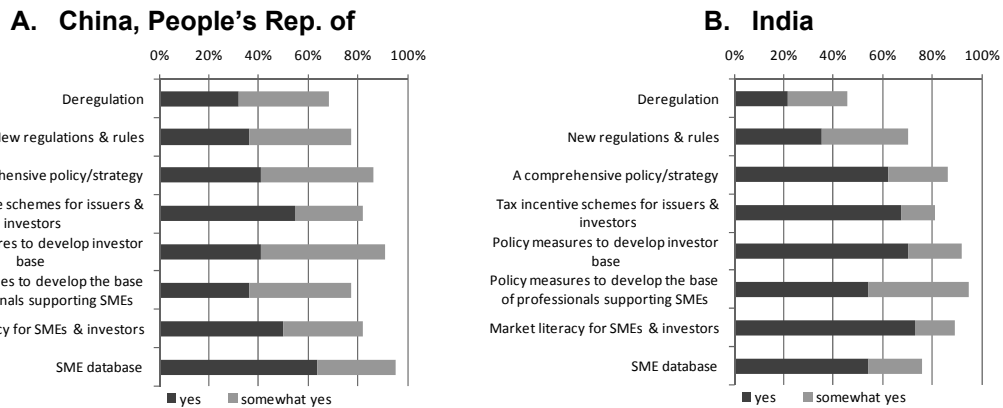
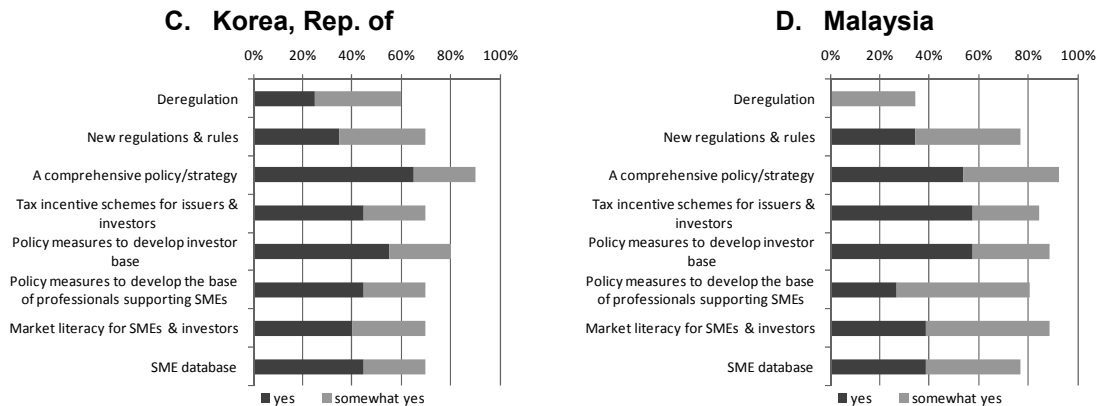


Figure 6. Continued



SME = small and medium-sized enterprise.

Note: Valid samples: the People’s Republic of China: 22; India: 37; the Republic of Korea: 20; and Malaysia: 26.

Source: Authors’ compilation.

3.2.3 Performance of SME Capital Markets

Answers from four countries on the growth potential of SME markets somewhat corresponded to the actual performance of existing SME markets, respectively. While the PRC respondents believed continuous growth of SME markets (SME Board and ChiNext/SZSE) due to SMEs’ strong appetite for growth capital, Malaysia had a discreet view of existing capital market that SMEs could tap (ACE/Bursa Malaysia) due to unpopularity of the market with market information not well disseminated among SMEs. The Republic of Korea also tended to be discreet for SME markets, still concerned about the aftermath of GFC and possible economic shocks. India had a neutral stance for the growth potential of existing SME platforms (BSE and NSE) due to their markets relatively newly launched and economic uncertainty.

Figure 7. Existing SME Capital Markets Growing?

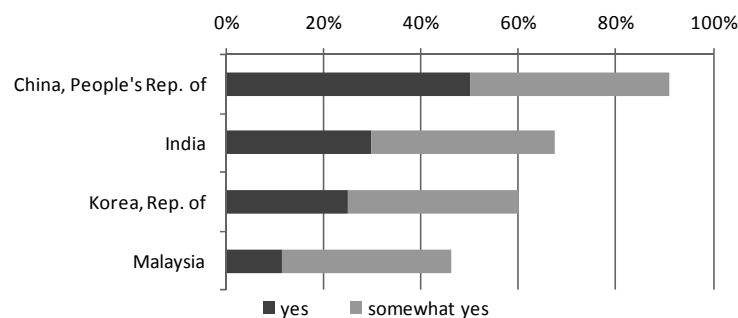
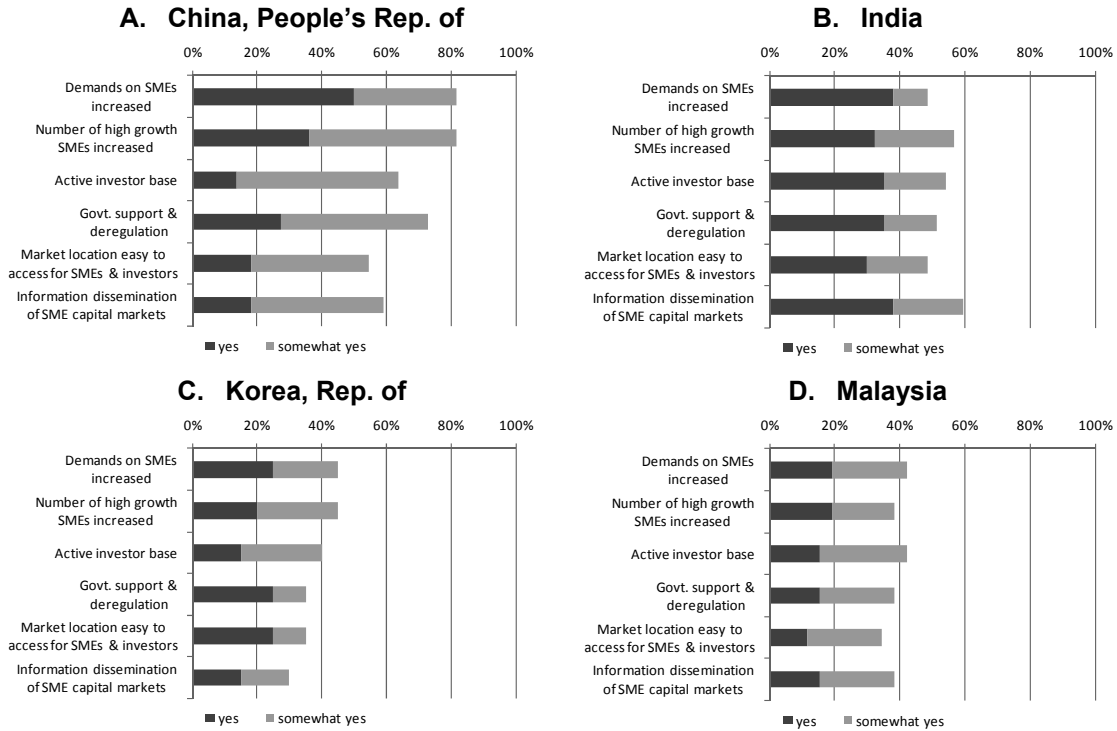
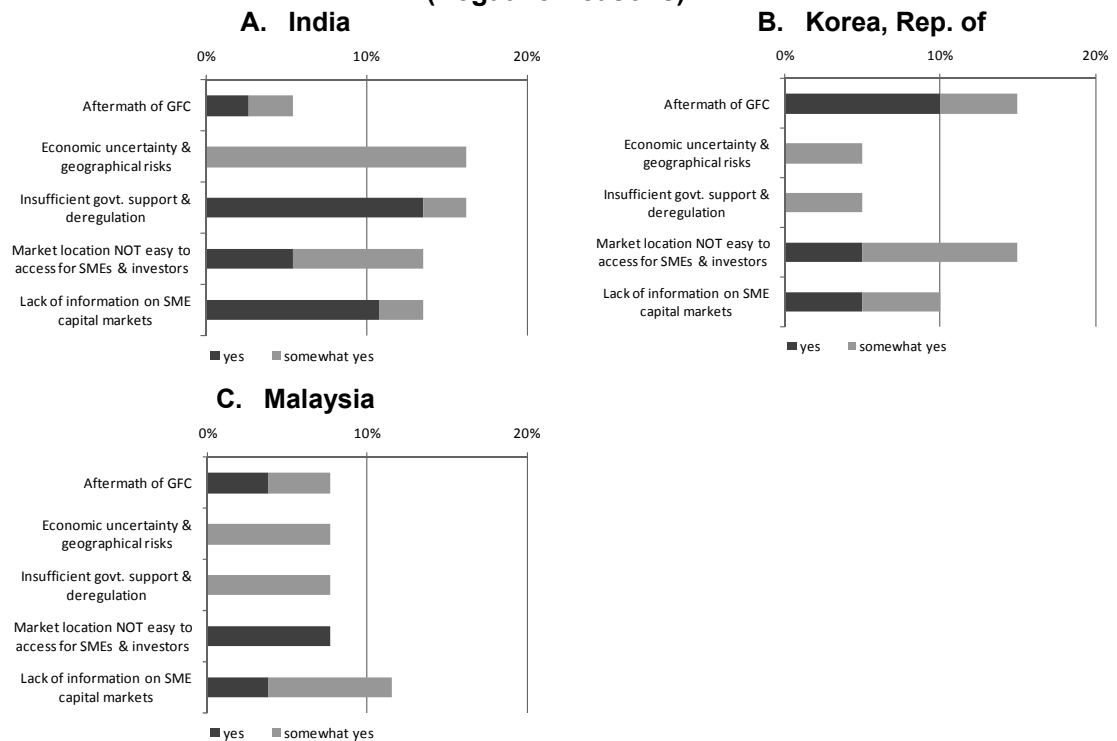


Figure 7. Continued

(Positive Reasons)



(Negative Reasons)



SME = small and medium-sized enterprise.

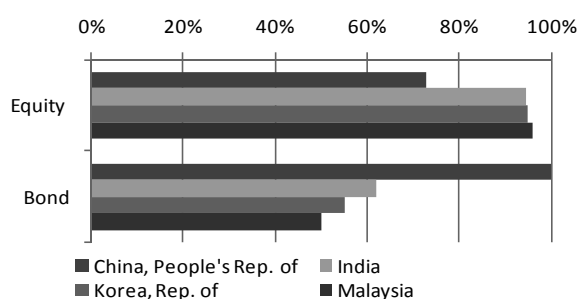
Note: Valid samples: the People's Republic of China: 22; India: 37; the Republic of Korea: 20; and Malaysia: 26.

Source: Authors' compilation.

3.2.4 Product Type and Market Modality

The supply-side respondents preferred to develop equity products rather than corporate bonds and debentures for SMEs in India, the Republic of Korea, and Malaysia, whose preference was reversed in the PRC. In emerging Asia, corporate bond maturity of between five and ten years tends to be popular, but bond instruments are part of debt financing and their relatively high yields can be considered still constraints for SME issuers. In the PRC, high-yield bonds can be incorporated in wealth management products (WMP) and traded among shadow banking system for infrastructure investments. This might be behind the preference of SME bonds in the PRC.

Figure 8. What Type of Product Appropriate for SMEs?



SME = small and medium-sized enterprise.

Note: Valid samples: the People's Republic of China: 22; India: 37; the Republic of Korea: 20; and Malaysia: 26.

Source: Authors' compilation.

In order to explore what type of market would be appropriate for SMEs, four market modalities under two large categories can be extracted from the current SME market structures: (i) exchange market – (a) domestic market and (b) AIM/international market for professional investors; and (ii) non-exchange market – (c) organized OTC market operated by SRO and (d) market for unlisted SME shares operated by non-SRO. Also, the recently developed special market venue for socially-oriented firms called a social capital market (see the section 4), which could be classified in either exchange or non-exchange market, was added in this brainstorming.

There were two-split opinions among country respondents (Table 2). In the PRC, India, and the Republic of Korea, around 70% of the respondents preferred the development of a domestic exchange market as an appropriate capital market venue for SMEs, while around 30%–40% indicated non-exchange market represented by a non-SRO operated market, and a specialized market for socially-oriented firms, as an inappropriate market venue for SMEs. They generally evaluated that the exchange market has a cost-efficient structure due to already established trading platforms to be utilized for SMEs under stock exchange and a relatively well-organized risk conscious mechanism with transparency backed by laws and regulations, while they had concerns about no potential investor base for the non-SRO operated SME market outside of stock exchange's control and the social capital market.

Table 2. Type of SME Capital Markets**A. Market Type Appropriate for SMEs**

	Exchange Market		Non-Exchange Market		Social Capital Market
	Domestic Market	AIM/Intl. Market for Professional Investors	Organized OTC (SRO-Operated)	Market for Unlisted SME Shares (Non-SRO-Operated)	
China, People's Rep. of	72.7%	50.0%	63.6%	45.5%	31.8%
India	67.6%	40.5%	24.3%	32.4%	24.3%
Korea, Rep. of	75.0%	45.0%	45.0%	50.0%	25.0%
Malaysia	50.0%	53.8%	42.3%	65.4%	23.1%

Why Your Selected Market(s) Appropriate for SMEs ?

	Amendment of existing laws and regulations possible	Cost efficient market structure	Risk control easy	Appropriate as a preparatory market for SMEs before tapping regular markets	Contribute to social welfare enhancement
China, People's Rep. of	59.1%	54.5%	77.3%	27.3%	22.7%
India	67.6%	70.3%	43.2%	40.5%	24.3%
Korea, Rep. of	50.0%	35.0%	70.0%	55.0%	10.0%
Malaysia	50.0%	61.5%	53.8%	69.2%	26.9%

B. Market Type NOT Appropriate for SMEs

	Exchange Market		Non-Exchange Market		Social Capital Market
	Domestic Market	AIM/Intl. Market for Professional Investors	Organized OTC (SRO-Operated)	Market for Unlisted SME Shares (Non-SRO-Operated)	
China, People's Rep. of	22.7%	13.6%	9.1%	18.2%	31.8%
India	16.2%	21.6%	32.4%	45.9%	35.1%
Korea, Rep. of	20.0%	25.0%	25.0%	30.0%	40.0%
Malaysia	34.6%	15.4%	15.4%	11.5%	26.9%

Why Your Selected Market(s) NOT Appropriate for SMEs ?

	Still lack of SMEs' ability to tap capital market	No profitable business for underwriter/broker/dealer	No potential SME issuers	No potential investor base	No professionals for supporting SMEs	Establishment of new market costly
China, People's Rep. of	22.7%	4.5%	9.1%	36.4%	27.3%	18.2%
India	29.7%	29.7%	29.7%	70.3%	40.5%	35.1%
Korea, Rep. of	25.0%	30.0%	5.0%	60.0%	20.0%	5.0%
Malaysia	42.3%	30.8%	19.2%	42.3%	23.1%	26.9%

SME = small and medium-sized enterprise.

Note: Valid samples: the People's Republic of China: 22; India: 37; the Republic of Korea: 20; and Malaysia: 26.

Source: Authors' calculation.

On the contrary, around 65% of the respondents in Malaysia preferred the development of a non-exchange and non-SRO operated market for SMEs, while the remains indicated the domestic exchange market as inappropriate for them. They mainly expected the non-SRO operated market for unlisted SMEs as a preparatory market before their tapping the regular market of stock exchange. In Malaysia, the ACE market under Bursa Malaysia is not indicating a good performance for a long time in terms of market capitalization and the number of listed companies. In May 2013, the Securities Commission Malaysia (SCM) announced the plan for creating a new trading venue for start-ups and SMEs, separate from exchange market, named MyULM (Malaysia Unlisted Market) that is a private-led market supervised by SCM. The respondents in Malaysia considered that even if the exchange market provides preferential measures for SMEs such as lowering listing criteria and fees, the lack of SMEs' ability to tap capital markets, especially in complying with disclosure requirements, is still a critical hurdle for

establishing an SME market. They also considered that a private-led preparatory market is needed to foster the base of potential SMEs that eventually move to the exchange market.

3.2.5 Critical Factors to Create an SME Market

Figure 9 shows the comparison of critical factors to create an SME market between the supply- and demand-sides. In every study country, there was the gap between both sides in priority actions to establish a functional SME market. In the PRC, the supply-side, mainly comprising securities firms and venture capital firms, indicated that top three priorities to be taken are (i) a well-established regulatory and supervisory framework, (ii) a mechanism that supports SMEs in preparing disclosure documents, and (iii) simplified listing procedures. These actions ranked eighth, sixth and third in the demand-side. SMEs pointed out (i) raising funds speedily, (ii) small amount funding available, and (iii) simplified listing procedures as top three priorities, while these ranked eighth, fifth, and third in the supply-side. Only the third priority was shared between both sides.

In India, top three priorities in the supply-side were (i) raising funds speedily for SMEs, (ii) simplified listing procedures, and (iii) information dissemination of SME capital markets, while these ranked fourth, third, and tenth in the demand-side. The top three in the demand-side were (i) simplified disclosure requirements, (ii) low cost for listing and maintenance, and (iii) simplified listing procedures, while these ranked tenth, fifth, and second in the supply-side. The item of simplified listing procedures was shared between both sides among top three issues.

In the Republic of Korea, top three priorities in the supply-side were (i) simplified listing procedures, (ii) low cost for listing and maintenance for SMEs, and (iii) low cost for establishing and operating an SME market, while these top two issues ranked sixth and fifth in the demand-side. The top three in the demand-side were (i) a well-established regulatory and supervisory framework, (ii) tax incentive schemes for issuers and investors, and (iii) simplified disclosure requirements, while these ranked sixth, seventh, and ninth in the supply-side.

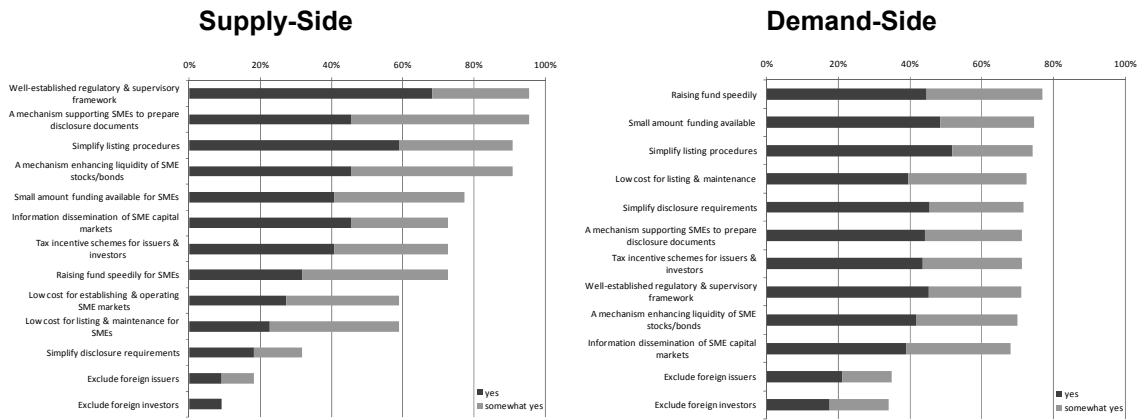
In Malaysia, top three priorities in the supply-side were (i) tax incentive schemes for issuers and investors, (ii) low cost for establishing and operating an SME market, and (iii) raising funds speedily for SMEs, while such the first and the third issues ranked fifth and fourth in the demand-side. The top three in the demand-side were (i) simplified listing procedures, (ii) simplified disclosure requirements, and (iii) low cost for listing and maintenance, while these ranked ninth, eleventh, and seventh in the supply-side.

The critical factors to create an SME market vary among countries due to different circumstances of SME financing and capital markets. However, these findings suggest a common issue in priority actions between the supply- and demand-sides: i.e., actions to reduce cost burden for SMEs to tap capital markets. The cost issue is often touched upon when establishing an SME market because the market size is anticipated to be typically small in scale. As indicated in Table 2, on the whole, country respondents tended not to see the establishment cost as a critical barrier for a new market if it is needed. However, the cost issue is yet crucial for creating a sustainable market venue

for SMEs. Given that the government regards an SME market as part of national growth strategies, it may be a public infrastructure, meaning that low cost structure of SME market for both SMEs and market organizers is indispensable for a sustainable long-term financing venue for SMEs.

Figure 9. Critical Factors to Create an SME Market

A. China, People's Rep. of



B. India

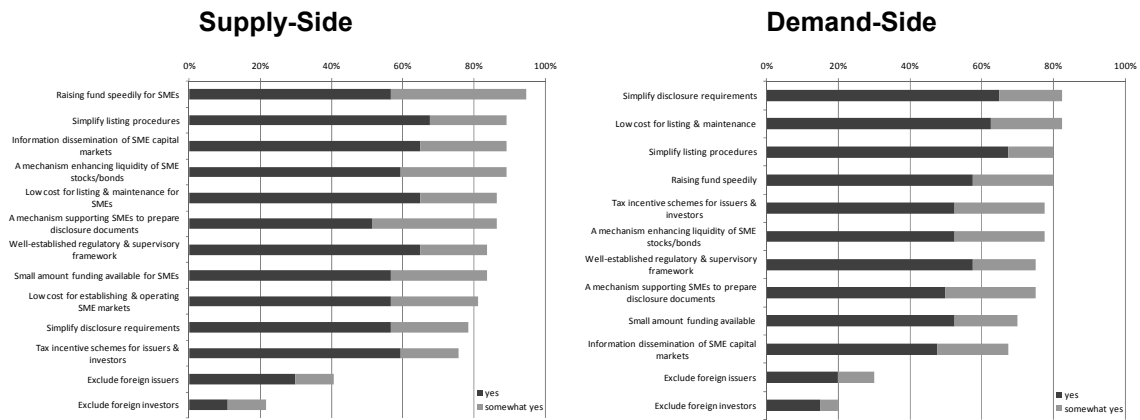
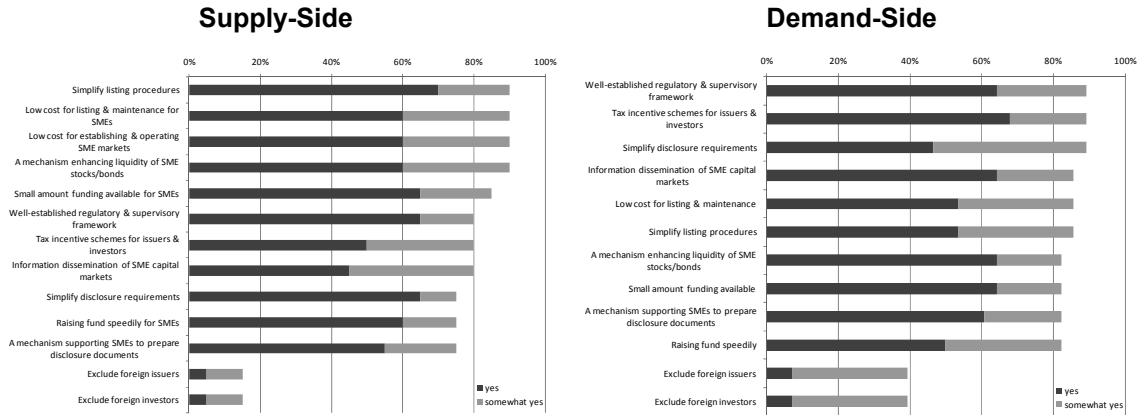
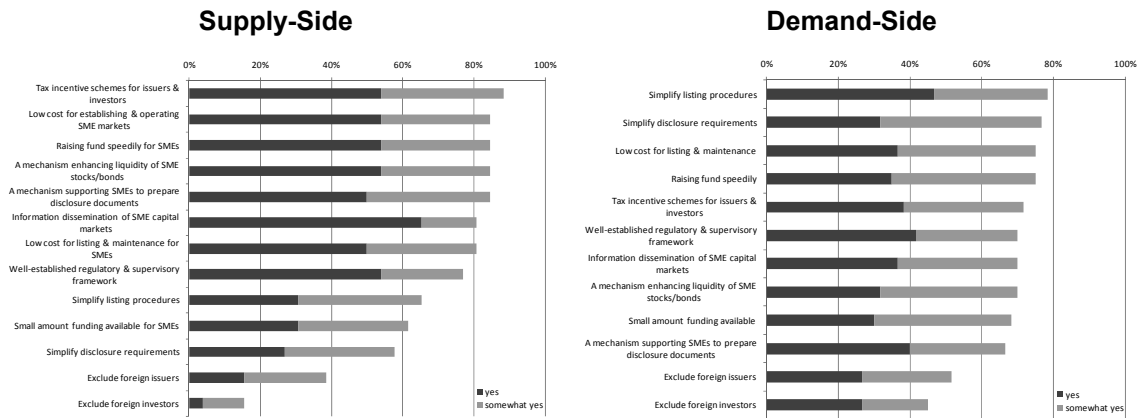


Figure 9. Continued

C. Korea, Rep. of



D. Malaysia



SME = small and medium-sized enterprise.

Note: Valid samples: the People's Republic of China: 22; India: 37; the Republic of Korea: 20; and Malaysia: 26.

Source: Authors' compilation.

Box B. Composition of Supply-Side Organizations Surveyed

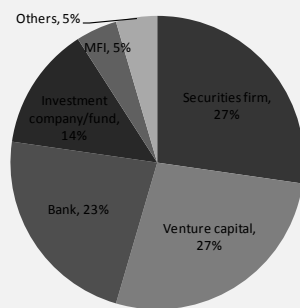
The supply-side survey was conducted on the online and paper-based manner in the People’s Republic of China (PRC), India, the Republic of Korea, and Malaysia throughout April-July 2013 in cooperation with; (i) the National Association of Financial Market Institutional Investors (NAFMII) in the PRC; (ii) the Bombay Stock Exchange (BSE), Indian Private Equity and Venture Capital Association (IVCA), and Association of National Exchanges Members of India (ANMI); (iii) the Korea Exchange (KRX) and the Korea Venture Capital Association (KVCA); and (iv) Bursa Malaysia and the Malaysian Venture Capital Association (MVCA).

A total of 105 completed questionnaires were collected from the supply-side that comprises 22, 37, 20, and 26 samples in the PRC, India, the Republic of Korea, and Malaysia, respectively. In the PRC, the supply-side mainly consists of securities firms (27% of total samples), venture capital companies (27%), banks (23%), and investment companies and funds (14%). In India, securities firms and venture capital companies accounted for the majority of samples at 35% and 14%, respectively. In the Republic of Korea, the combined number of market organizers (stock exchange and SROs) and securities firms accounted for 80% of the samples. In Malaysia, investment companies and funds, and banks, counted 23% and 19% of the total, respectively. The supply-side in India, the Republic of Korea, and Malaysia included regulators and policy makers responsible for SME sector development and access to finance.

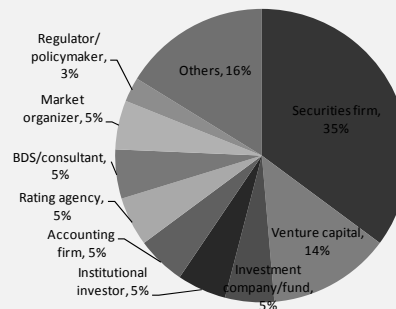
The questionnaire for the supply-side was designed to investigate policy stance and actions to be taken, business strategies, existing market performance, product type, market modality, and critical factors to develop an SME market, with five-scale, check-box, and fill-in style questions. In this survey, special questions for securities firms and investors were prepared to identify their business stance in the SME market, but sufficient numbers of valid samples were not obtained this time. The small sample size is an issue to be improved.

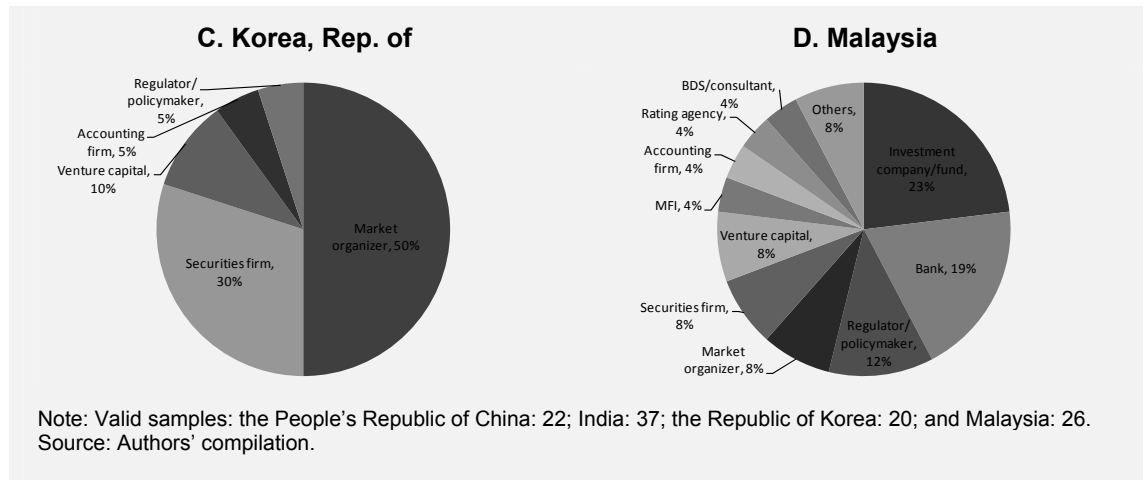
Figure 10. Composition of Supply-Side Organizations Surveyed

A. China, People’s Rep. of



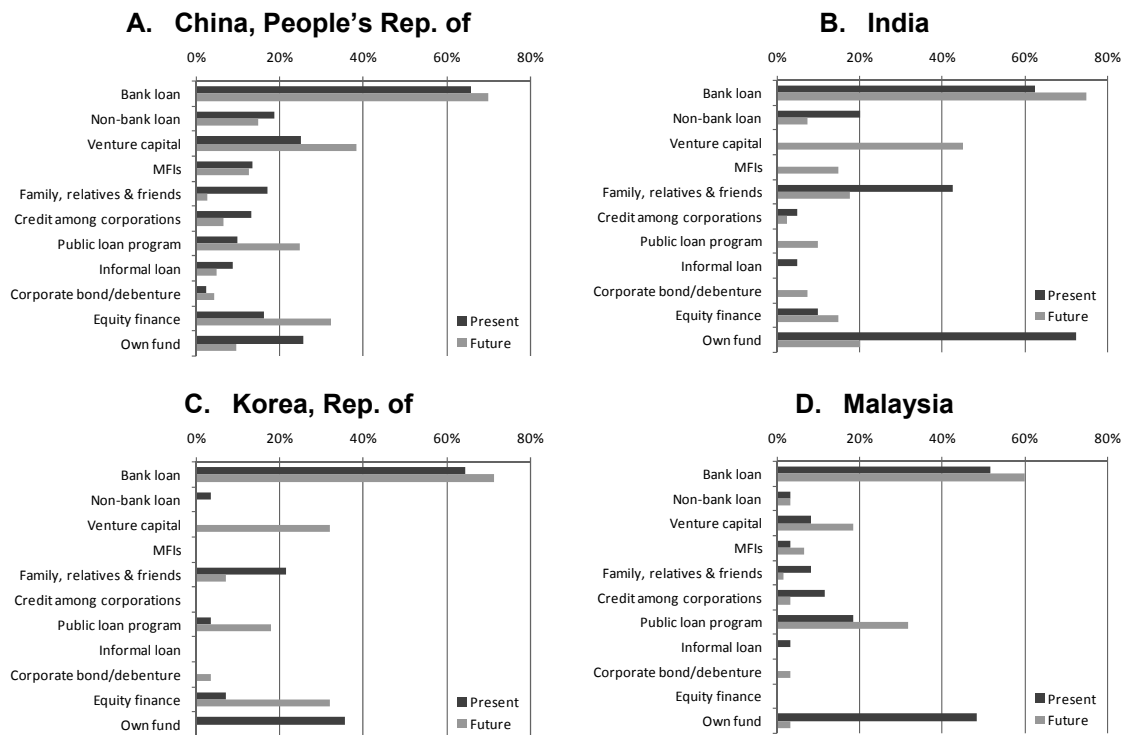
B. India



Box B. Continued**3.3. Demand-Side Analysis****3.3.1 Funding Instruments**

The findings from the demand-side survey indicate that more than half of the samples accessed banks for finance in the PRC, India, the Republic of Korea, and Malaysia (Figure 11). Only around 30% of SMEs sampled in the PRC and the Republic of Korea relied on their own capital for business, while around half or more samples in India and Malaysia had a dependence on their own funds besides bank credit. Only the small number of samples (around 20% or less) in the PRC, the Republic of Korea, and Malaysia utilized the funds borrowed from family, relatives, and friends for business (informal finance), while 43% of SMEs surveyed in India still relied on informal finance. For future funding, the SMEs surveyed desired further access to formal financial institutions such as banks and venture capital companies in four countries, especially with between 60% and 75% of the samples willing to access banks further. Instead, SMEs wished to sharply reduce dependence on both their own capital and informal individual borrowing for business. The results also indicated that the demands for public loan programs and direct finance instruments—such as equity finance and corporate bond issuance—are likely to increase in the future in four countries. The survey findings suggest that the majority of SMEs surveyed are seeking growth through safe money from formal finance while wishing to diminish the use of informal instruments.

Figure 11. Funding Instruments: Present and Future

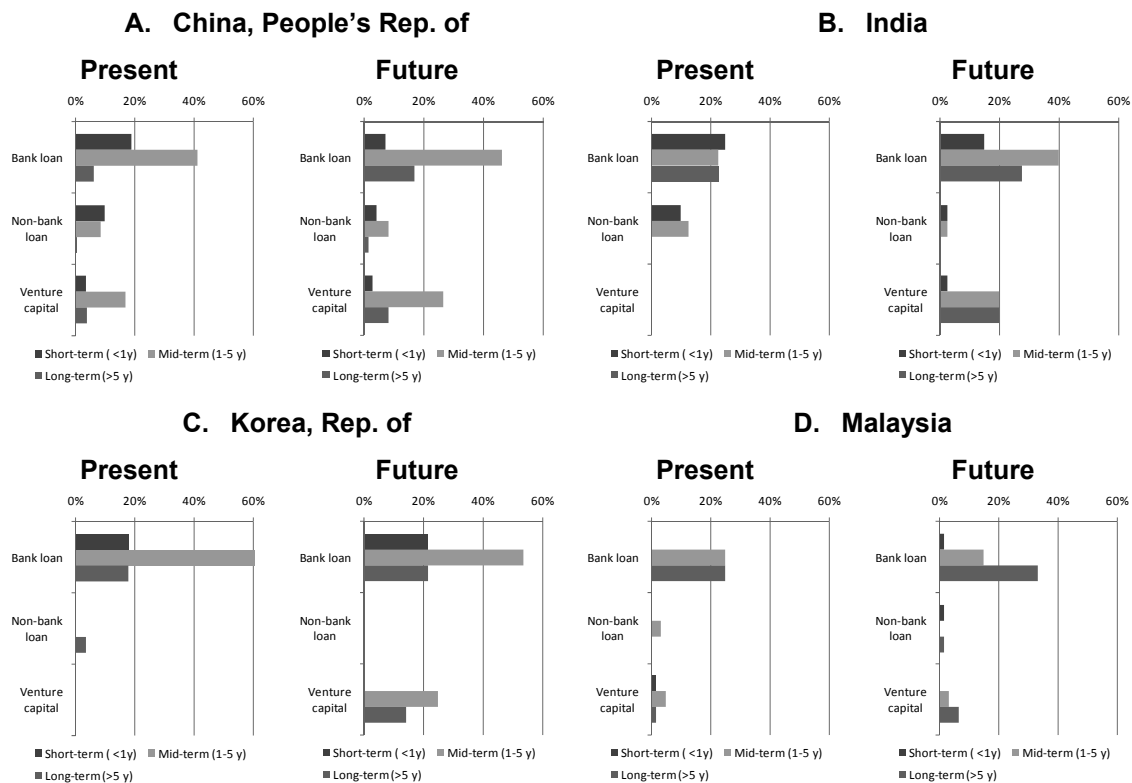


Notes: Present = funding instruments accessed, Future = funding instruments desired in the future.
 Valid samples: the People's Republic of China: 303; India: 40; the Republic of Korea: 28; and Malaysia: 60.
 Source: Authors' compilation.

The survey results also highlighted the supply–demand gap of SME finance in study countries. In the PRC, around 40% of the surveyed SMEs had access to mid-term (1 year–5 years) credit and only 6% had received long-term credit (more than 5 years) from banks (Figure 12). Meanwhile, SME demands for mid-term and long-term funding are likely to increase in the future, respectively with 46% and 17% in bank credit and 26% and 8% in venture capital finance. Also in India, SME demands for mid-term and long-term funding tend to increase in the future, respectively with 40% and 28% in bank credit and both 20% in venture capital finance.

In the Republic of Korea, 61% of the SME respondents enjoyed mid-term funding, while they are likely to wish to access venture capital companies for further mid-term and long-term funding in the future (25% and 14%, respectively). In Malaysia, 25% of the surveyed SMEs were content with mid-term and long-term bank credit, while 33% of those desiring long-term credit from banks. SMEs' long-term funding needs will increase as they grow further. However, it is hard for financial institutions to satisfy their funding demands due to information asymmetry.

Figure 12. Loan Term: Present and Future



Notes: "Present" refers to provided loans; "Future" refers to desired loans.

Valid samples: the People's Republic of China: 303; India: 40; the Republic of Korea: 28; and Malaysia: 60.

Source: Authors' compilation.

SMEs surveyed in four countries had strong funding appetite for expanding their business. Table 3 showed that cumulative funds raised from external sources per firm in the sampled SMEs were US\$ 3.29 million, US\$ 0.96 million, US\$ 1.87 million, and US\$ 0.64 million on average in the PRC, India, the Republic of Korea, and Malaysia, respectively. SMEs' desired amounts are likely to increase with US\$ 14.69 million, US\$ 0.99 million, US\$ 2.05 million, and US\$ 2.54 million on average in the PRC, India, the Republic of Korea, and Malaysia, respectively. In particular, the surveyed SMEs in the PRC raised relatively large funds on average, which was mainly backed by large investment needs in the construction and real estate sectors.

The profile of surveyed SMEs in the PRC indicated that 34% of the samples belonged to start-ups or early-stage firms willing to actively access growth capital. In India, service, manufacturing, and retail and wholesale trade sectors accounted for the majority of the samples, and more than 80% of them were willing to raise funds for business expansion and working capital, with 50% being firms living to five years or less. In the Republic of Korea, 71% of the surveyed SMEs belonged to the manufacturing sector, and more than half of them had funding needs for business expansion, working capital, and capital

investment. In Malaysia, also 71% of the samples belonged to service or agriculture sector, with 42% being firms surviving for over 11 years and 72% being those having 50 or less employees; 50% and 30% of them were willing to raise funds for business expansion and working capital, respectively.

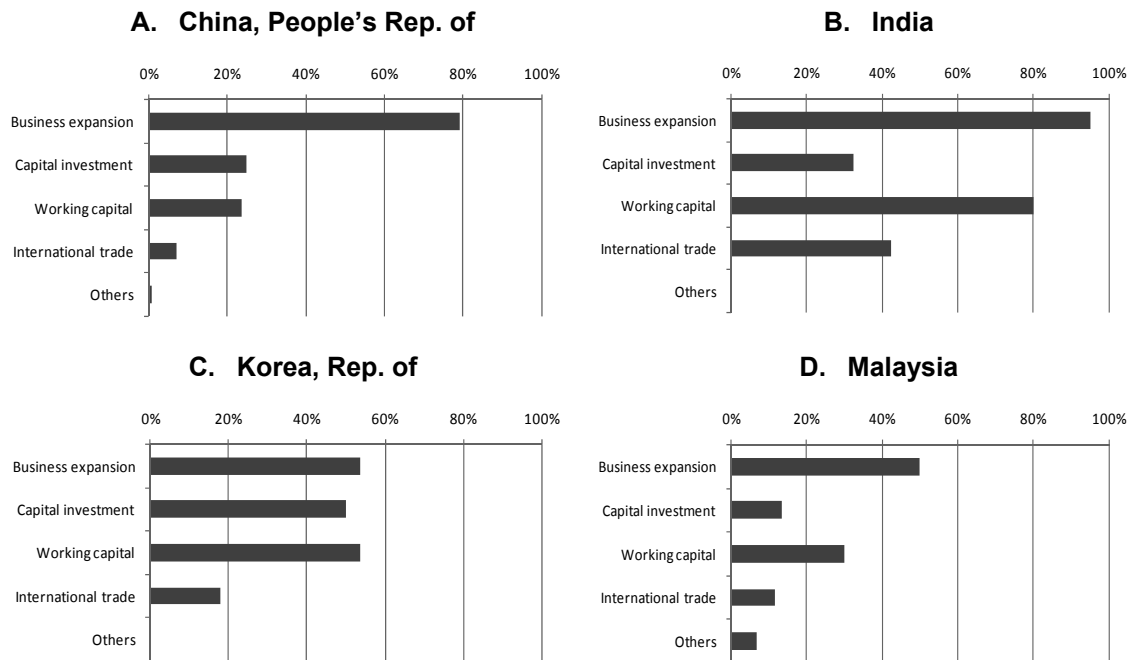
Table 3. Average Funding Amounts per Firm

	Funds Raised So Far (\$ million)	Funds Desired (\$ million)
China, People's rep. of	3.29	14.69
India	0.96	0.99
Korea, Rep. of	1.87	2.05
Malaysia	0.64	2.54

Notes:

- Valid samples: the People's Republic of China (except for firms with over 101 employees): 175 (funds raised so far) and 205 (funds desired); India: 40; the Republic of Korea: 28; Malaysia: 60.
- Author's calculation based on ADB Key Indicators 2013. Exchange rates: the PRC: CNY6.31/\$; India: Rs53.44/\$; the Republic of Korea: W1126.47/\$; Malaysia: RM3.09/\$ (data in 2012).

Figure 13. Purpose of Funds Desired



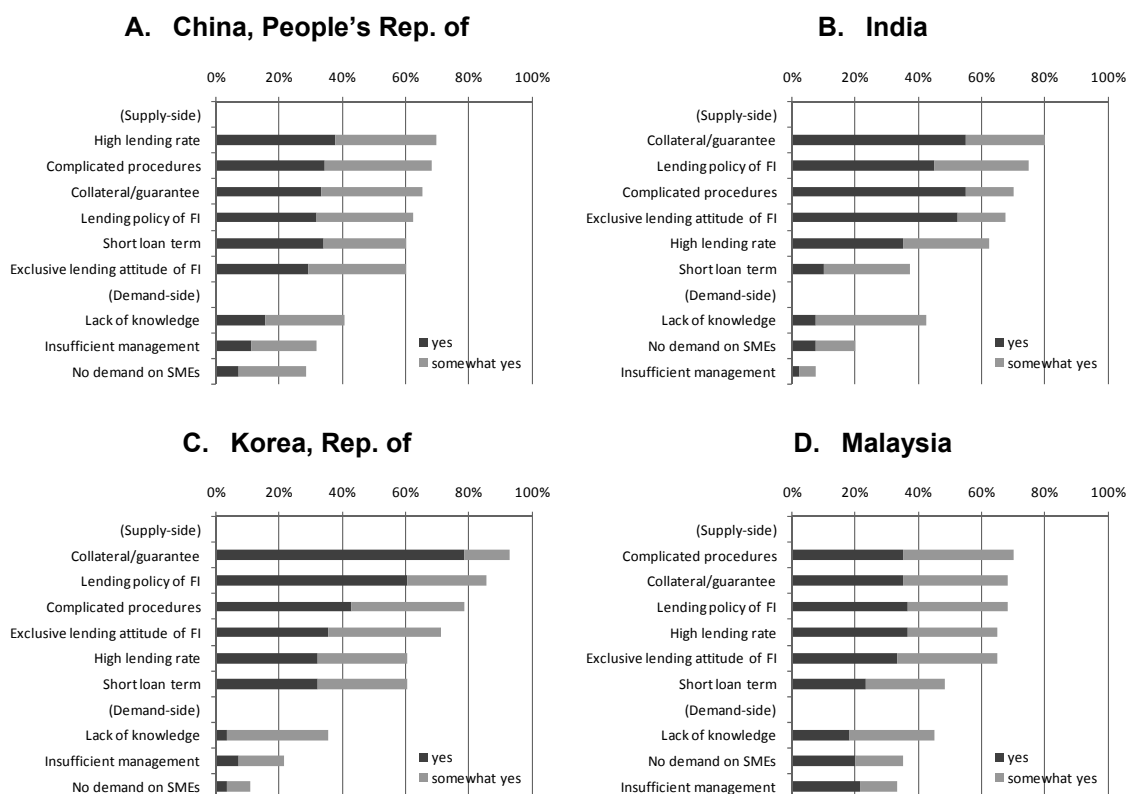
Note: Valid samples: the People's Republic of China: 303; India: 40; the Republic of Korea: 28; and Malaysia: 60.

Source: Authors' compilation.

3.3.2 Barriers to Accessing Financial Institutions

Poor access to finance is a chronic event for average SMEs, which several factors underlie in both the supply- and demand-sides. Figure 14 illustrates the barriers for SMEs in accessing formal financial institutions in study countries. The surveyed SMEs in four countries identified that major constraints arising from the supply-side for their access to finance were (i) collateral and guarantees as prerequisites for loans, (ii) complicated procedures to borrow money, (iii) a strict lending policy of financial institutions, and (iv) high lending rates. Meanwhile, they recognized the lack of knowledge of financial products as the most serious barrier in the demand-side to accessing finance. The findings suggest that collateral and guarantee requirements, together with somewhat complex documentation process and high lending rates being imposed on SME borrowers, still make a hurdle for them to raise necessary growth capital, but strengthening financial literacy is likely to generate positive effects to improve their financial accessibility. This also implies that capital market literacy is needed to involve growth potential SMEs in formal financial markets, which will be attributed to good market and government responses to their potential long-term funding needs.

Figure 14. Barriers to Accessing Financial Institutions



Note: Valid samples: the People's Republic of China: 303; India: 40; the Republic of Korea: 28; and Malaysia: 60.

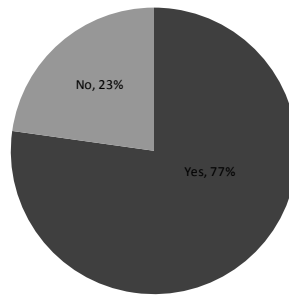
Source: Authors' compilation.

3.3.3 Willingness to Access an SME Capital Market

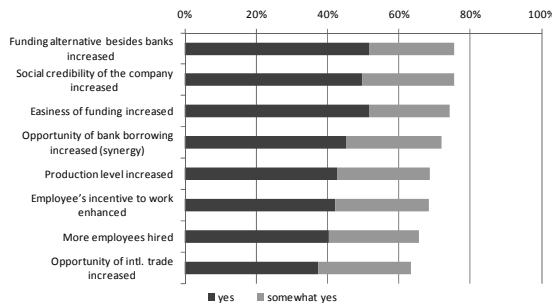
There is the discussion of whether a special equity financing and bond issuance venue for SMEs, regardless of stock exchange market, is needed for creating the base of high-quality SMEs that drive sustainable economic growth and pro-poor growth at the national level. The demand-side survey assessed their willingness to access an SME capital market. On the whole, the SME respondents in study countries are likely to utilize such a specialized market venue for their future funding if established, with positive answers (combined yes and somewhat yes) of 77%, 83%, 82%, and 54% in the PRC, India (for equity), the Republic of Korea (for equity), and Malaysia (for equity), respectively. In the latter three countries, they relatively preferred to access an equity market rather than a bond market. The major reasons of their preference to access an SME market commonly explained among four countries (i) increased easiness of funding overall, (ii) funding alternative besides banks, and (iii) increased social credibility of the company expected. Meanwhile, they commonly indicated that the major constraints to access an SME market were (i) procedures to issue stocks complicated and (ii) issuing stocks costly such as listing fees and maintenance of their listed stocks, addressing equity finance. This suggests that simple procedures and low cost structure are key for designing a functional SME capital market, given the potential demands on SMEs.

Figure 15. Willingness to Access an SME Capital Market

A. China, People's Rep. of
Companies Willing to Utilize a Specialized Equity/Bond Market



Expected Benefits



Reasons for Hesitating to Access

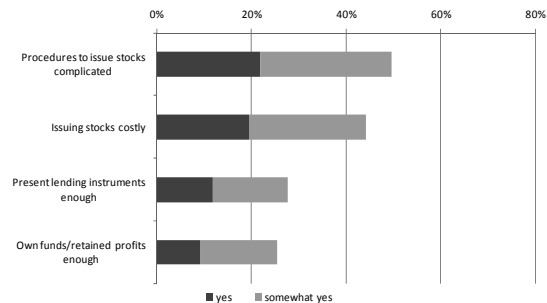
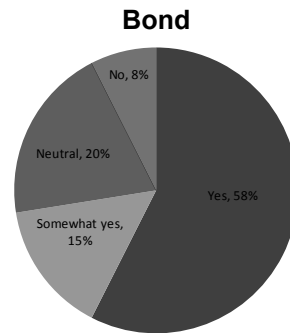
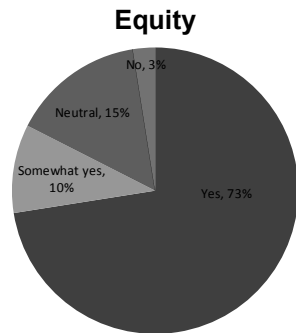


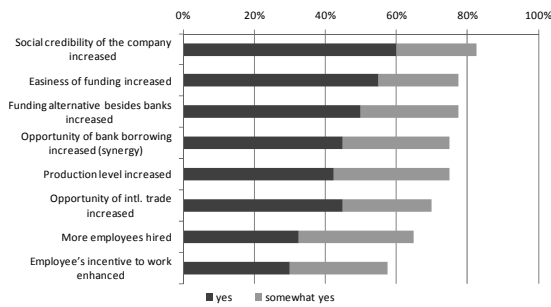
Figure 15. Continued

B. India

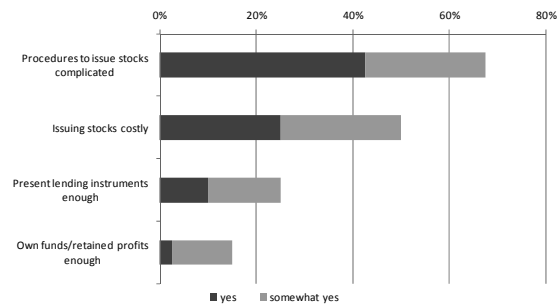
Companies Willing to Utilize a Specialized Equity/Bond Market



Expected Benefits

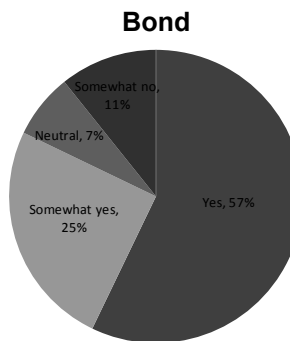
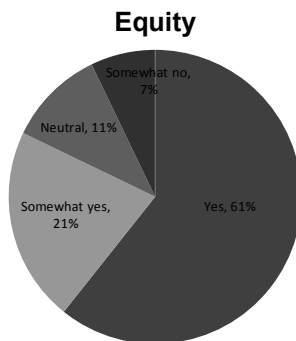


Reasons for Hesitating to Access

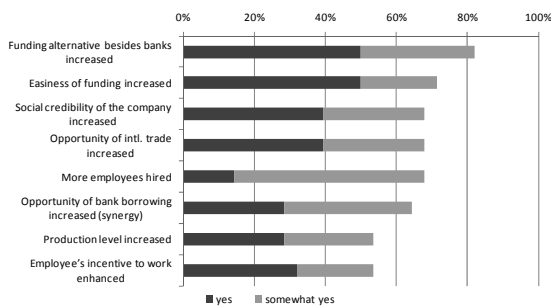


C. Korea, Rep. of

Companies Willing to Utilize a Specialized Equity/Bond Market



Expected Benefits



Reasons for Hesitating to Access

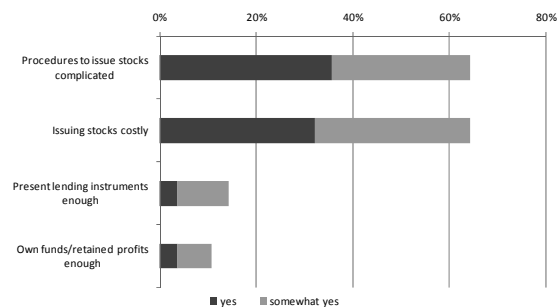
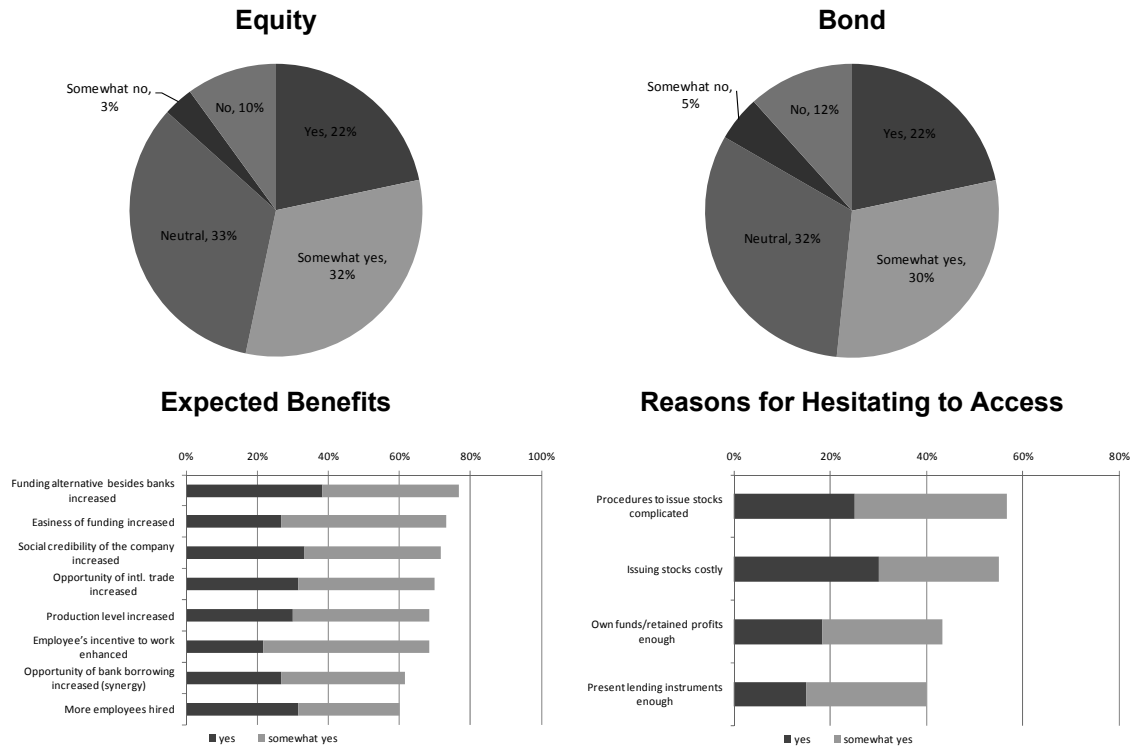


Figure 15. Continued

D. Malaysia

Companies Willing to Utilize a Specialized Equity/Bond Market



Note: Valid samples: the People's Republic of China: 303; India: 40; the Republic of Korea: 28; and Malaysia: 60.

Source: Authors' compilation.

Box C. Profile of SMEs Surveyed

The demand-side survey was conducted on the online and paper-based manner in the People's Republic of China (PRC), India, the Republic of Korea, and Malaysia throughout April-July 2013 in cooperation with; (i) China Association of Small and Medium Enterprises (CASME); (ii) Federation of Indian Micro, Small and Medium Enterprises (FISME), Chamber of Indian Micro, Small & Medium Enterprises (CIMSME), and the Associated Chambers of Commerce and Industry of India (ASSOCHAM); (iii) the Korea Venture Capital Association (KVCA) and Small & medium Business Corporation (SBC); and (iv) SME Corporation in Malaysia. In the PRC, the survey was conducted in cooperation with CASME at the China SME Investment & Financing Expo (SME IEFX) held in Beijing on 13-15 July 2013. A total of 431 completed questionnaires were collected from the demand-side that comprises 303, 40, 28, and 60 samples in the PRC, India, the Republic of Korea, and Malaysia, respectively.

The survey referred to the national definition of SMEs in each country. In the PRC, SMEs surveyed mainly consist of service (47% of total samples), manufacturing (15%), construction and real estate (12%), trade (10%), agriculture (7%), and transportation and telecommunication (4%) by sector. 45% of the sampled SMEs were located in capital city (Beijing); 50% were firms operating for 10 years or less; and 54% were firms having employees of 100 or less.

In India, SMEs surveyed mainly consist of service (38% of total samples), manufacturing (30%), trade (10%), transportation and telecommunication (5%), construction and real estate (3%), and agriculture (3%) by sector. 73% of the sampled SMEs were located outside of large cities (New Delhi and Mumbai); 73% were firms operating for 10 years or less; and 93% were firms having employees of 100 or less.

In the Republic of Korea, SMEs surveyed mainly consist of manufacturing (71% of total samples), service (11%), transportation and telecommunication (7%), and construction and real estate (4%) by sector. 86% of the sampled SMEs were located outside of capital city (Seoul); 61% were firms operating for 10 years or less; and 93% were firms having employees of 100 or less.

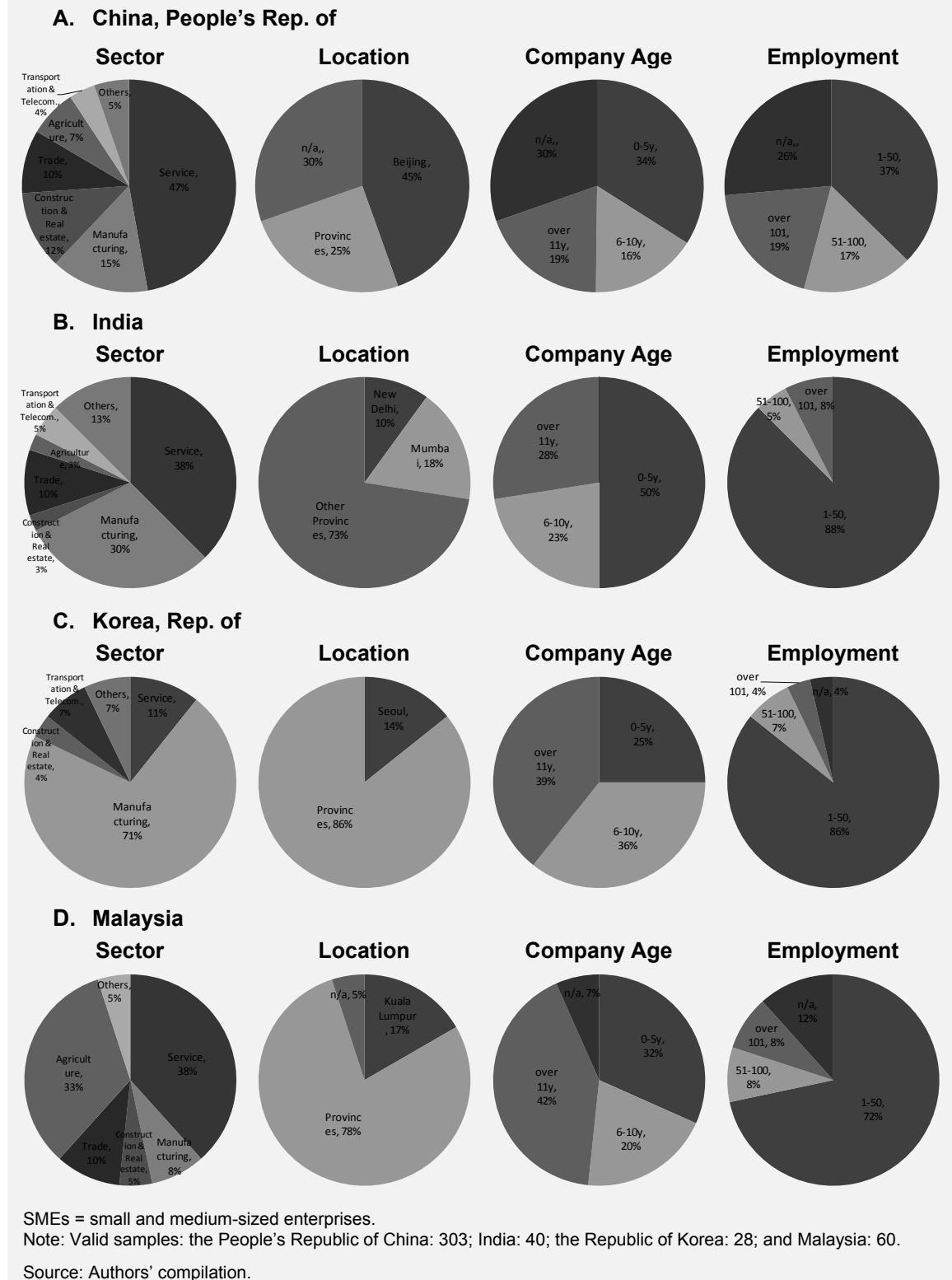
In Malaysia, SMEs surveyed mainly consist of service (38% of total samples), agriculture (33%), trade (10%), manufacturing (8%), and construction and real estate (5%) by sector. 78% of the sampled SMEs were located outside of capital city (Kuala Lumpur); 52% were firms operating for 10 years or less; and 80% were firms having employees of 100 or less.

At the time of surveys, business conditions of SMEs surveyed were generally good as compared to six months ago in study countries. In the PRC, India, and Malaysia, the majority of sampled SMEs expanded their business as compared to six months ago.

The questionnaire for the demand-side was designed to investigate business conditions, funding instruments, obstacles to accessing finance, demands on capital market financing, and critical factors to develop an SME market, with five-scale, check-box, and fill-in style questions. Similar to the supply-side survey, the small sample size is an issue to be improved.

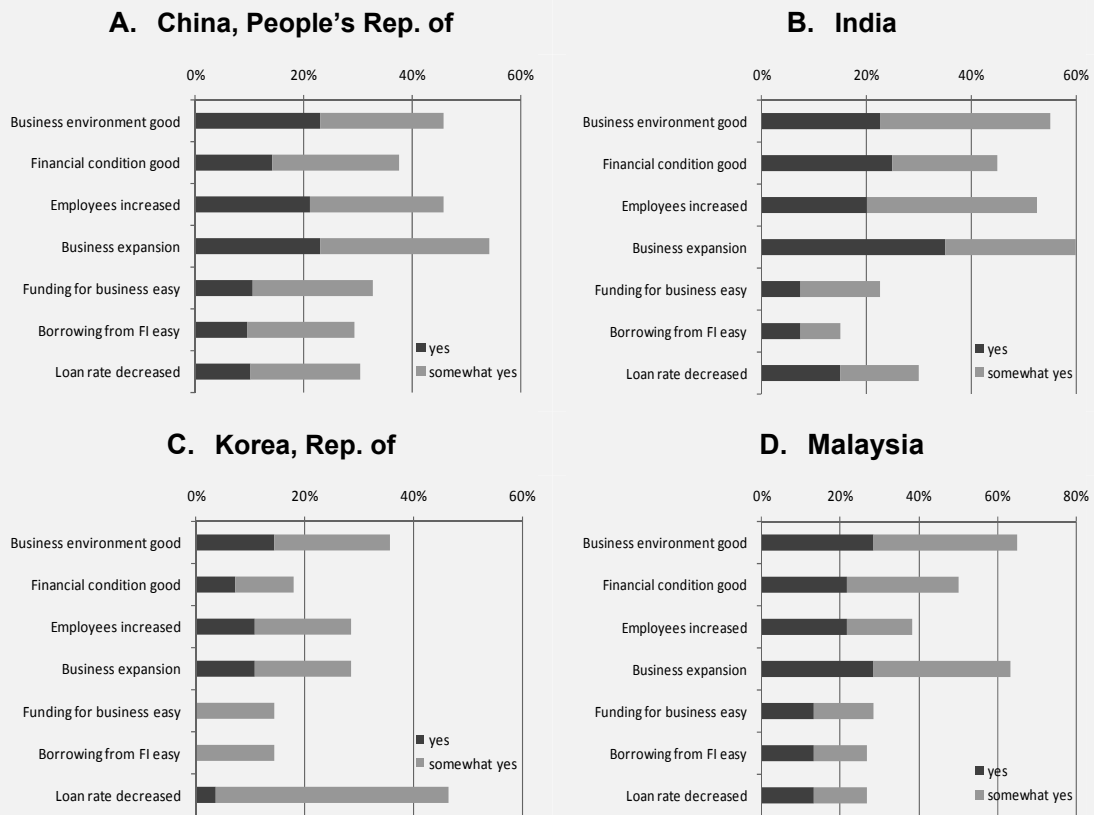
Box C. Continued

Figure 16. Profile of SMEs Surveyed



Box C. Continued

Figure 17. Business Conditions of SMEs Surveyed



SMEs = small and medium-sized enterprises; FI = financial institution.

Note: Valid samples: the People's Republic of China: 303; India: 40; the Republic of Korea: 28; and Malaysia: 60.

Source: Authors' compilation.

4. New Modalities of SME Capital Markets

The previous discussions threw plenty of challenges to establishing a venue of direct growth capital financing for SMEs in relief. Looking at the issues on developing an SME capital market from different angles, two types of specialized market infrastructure are worth exploring:

- Exercise equity market for SMEs (non-exchange market)
- Social capital market (exchange and non-exchange markets)

4.1 Exercise Equity Market for SMEs

The creation of an exercise equity market for SMEs, separate from the exchange market, can be beneficial, especially in lower middle income Asian countries.³ The concept is to create a preparatory market for “smaller but growing” firms that will eventually tap the regular market of stock exchange. This market will provide a chance for SMEs to learn more market rules and obligations such as disclosure before tapping the organized market, and to improve corporate culture through learning the importance of increased corporate value for growth. The exercise market has a comprehensive mechanism for supporting SMEs in equity finance from various angles, which is combined with (i) fostering the venture capital industry as an initial risk capital provider for SMEs; (ii) developing the base of professionals supporting the SME disclosure process, such as CPA networks; and (iii) designing government policy support measures such as tax incentives for SME issuers and investors.

Developing SME capital markets presents a two-fold challenge: (i) demand creation and (ii) market sustainability. To this end, a well-organized investor base and supporting professionals with government preferential measures are prerequisite to stimulating demand for an SME market. Meanwhile, with low cost operations, liquidity enhancement mechanisms—such as market making and obligatory shareholder allotment—are indispensable to making the SME market sustainable.

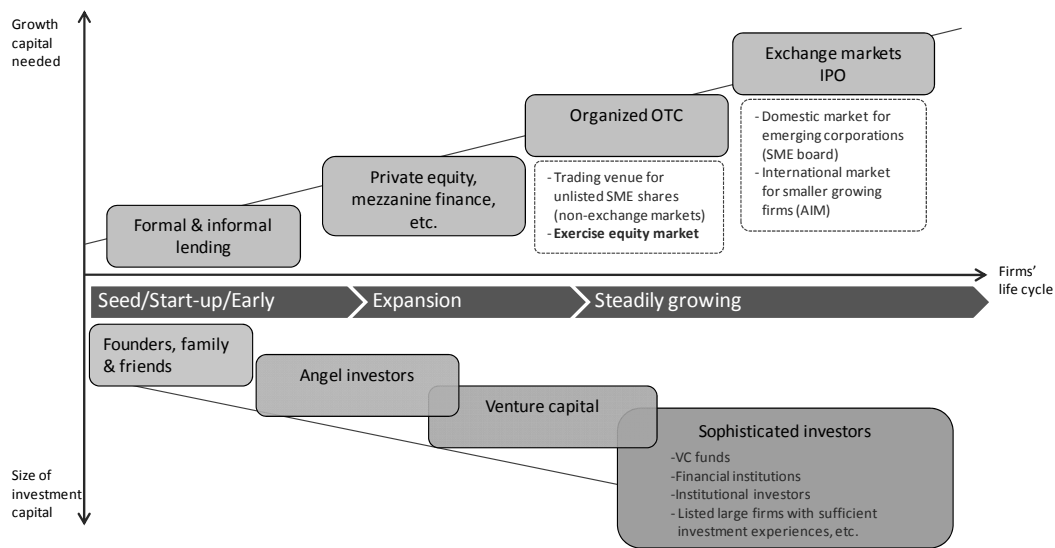
Figure 18 shows the conceptual combination of SME funding sources and risk capital providers in the growth cycle of enterprises. The financing needs of firms are dependent on their stage of growth. For instance, growing SMEs tend to seek access to long-term funding instruments for further growth of their business, which creates increased demands on SMEs for capital market financing. However, most SMEs have little ability to tap the regular stock exchange market because of relatively strict listing requirements and, more importantly, a lack of basic knowledge of capital market financing. Therefore, the creation of a venue for learning market rules, obligations, and benefits through the experience of issuing and trading stocks within the established system, yet separate from the regular market, is potentially useful for growth-oriented SMEs. The creation of investor and professional bases that support SMEs in equity financing is needed to

³ The concept was discussed in Indonesia as part of the JICA Capital Market Project (2008–10). The “exercise equity market” is a coined phrase developed from a stream of discussions on SME capital market in Indonesia.

implement this concept. In this regard, extensive national policies and strategies for SME access to capital markets, with appropriate regulatory backing, are key to realizing the preparatory market concept.

As a concern, unless stand-alone regulations are established through separate legislation from the general capital market laws, the exercise market may conflict with such general laws. For instance, if the number of shareholders for a stock offering and maintaining stocks in the non-exchange market exceeds the statutory minimum number stipulated in the general capital market laws, SMEs listed in such a market will be regarded as public companies under the general laws, which means that they cannot enjoy preferential treatment even if they are listed in the special market. In other words, their funding will be limited to small-scale fund raising from a limited investor base.

Figure 18. Growth Capital Funding and Risk Capital Providers



Source: Authors' illustration.

4.2 Social Capital Market

The social capital market is also a promising venue for SMEs as a place where social enterprises can link up with impact investors. Social enterprises are defined as business-oriented not-for-profits, or mission-oriented for-profits, having a social and/or environmental mission at the core of their work while seeking to operate in a financially sustainable manner (ADB 2011). This category includes microfinance institutions (MFIs) and innovative SMEs in the education, energy, health, and agro-business sectors. Impact investors are defined as investors seeking to make investments that create a positive social and environmental impact beyond financial return (JP Morgan 2010), including social venture capital funds, microfinance investment vehicles, pension funds, mutual fund managers, institutional fund managers, sovereign wealth funds, endowments, and family foundations. JP Morgan (2010) estimated that the impact

investment market has the potential to absorb between US\$400 billion–US\$1 trillion over the next decade, particularly in the areas of housing, rural water delivery, maternal health, primary education, and financial services. An ADB survey (2011) indicated that 74% of investors in the sample who were not currently impact investing would consider transacting on a social stock exchange.

There are two social stock exchanges operating in the world: (i) the Impact Exchange and (ii) the UK Social Stock Exchange. Both platforms were established in June 2013. The Impact Exchange, located in Mauritius, is operated by the Stock Exchange of Mauritius and supervised by the Singapore-based Impact Investment Exchange Asia (IIX), targeting Asian and African social enterprises. The IIX also established an online platform named Impact Partners in March 2011 that provides a dedicated matching service for social enterprises and impact investors. The UK Social Stock Exchange, with 11 listed social enterprises at present, was launched by the London Stock Exchange Group as part of the national strategies for fostering social impact businesses in the United Kingdom. The recent survey conducted by JP Morgan and the Global Impact Investing Network showed that impact investors plan to commit US\$9 billion in 2013, up from US\$8 billion in 2012.

A social stock exchange has similar functions as the regular market of stock exchange, where social enterprises can raise capital through offerings of shares, bonds, or other financial instruments. It seems that trial-and-error efforts were made to decide the trading platform in the present social stock exchanges. The IIX initially planned to launch a stand-alone trading platform for Asian social enterprises as Asia's first private-led social exchange, but ultimately decided to use the existing exchange market for operations probably due to potential barriers to sustainable operations in a new platform. The use of an existing platform brings several benefits to a new market: (i) cost efficiency, (ii) transparency and credibility, and (iii) standardized operations and management. These are challenges to be overcome in creating an independent market, with a possible solution being the creation of exchange market or partial collaboration with the existing stock exchange. At the same time, however, such arrangements could prove inflexible for the particular funding needs of different issuers given that market operations would be explicitly controlled by general capital market laws and regulations.

5. Conclusion

Asia's largely bank-centered financial systems require the reduced supply-demand gap in lending as a core policy pillar to improve SME access to finance. Meanwhile, the diversification of financing modalities is another core policy pillar to better serve various financing needs of SMEs and expand their financial accessibility, which includes the development of capital market financing for SMEs as a venue for providing long-term growth capital.

The demand-side survey identified SMEs' long-term funding needs. They are seeking to access formal finance and diversify long-term funding instruments for stable growth of business while wishing to diminish the dependency on their own capital and informal finance. However, there are the limitations of indirect financing—such as bank lending—to

satisfy such SMEs' long-term funding demands due to information asymmetry. SMEs are looking at supply-side barriers—such as collateral requirements, complex procedures for loan applications, lending policy of financial institutions, and high lending rates— as causes of poor access to finance while recognizing the lack of knowledge of financial products as another serious barrier generating low financial accessibility. This implies that strengthening financial literacy supports SMEs in improving their financial access, which can be applied to their access to capital markets as well. The preference of access to an SME capital market, especially equity financing, was identified among SMEs surveyed, where they expected to be released from poor funding environment and grow further with their increased social credibility while having concerns about high-costs and complex procedures to access it. This suggests that simple procedures and low cost structure for SMEs are key for creating a functional SME capital market.

The supply-side survey identified that developing an SME capital market is a policy priority toward the sustainable economic growth, considering the underserved segments in the capital market space (i.e., SMEs) and the limitations of bank-centered financial systems. The supply-side generally recognized that a comprehensive policy framework for SME access to capital markets is needed; with policy measures to develop investor base and promote market literacy. However, the lacklustre performance of existing SME capital markets is generating a discreet stance for developing an SME market among the supply-side.

Referring to the existing market structures, capital markets that SMEs can tap are classified into four modalities under two categories: (i) exchange market comprising (a) domestic market and (b) professional market; and (ii) non-exchange market comprising (c) SRO-operated and (d) non-SRO-operated OTC market. The market type appropriate for supporting SME growth at the national level is dependent on the country context. Two-split opinions were extracted from the supply-side survey. The country that supports the development of domestic exchange market for SMEs stressed the cost efficient structure of existing market due to already established trading platforms to be utilized for an SME market and the risk conscious mechanism backed by existing regulations, while having a concern about the lack of potential investors in non-exchange market. On the other hand, the country that supports the development of non-exchange market for SMEs indicated the necessity of a preparatory market before their tapping the regular exchange market in order to create the base of high-quality potential issuers for higher segment of the market, while considering SMEs still lack the ability to tap exchange market.

Although the priority factors to develop an SME market is different by country in details, the supply-side and demand-side surveys suggest a key issue to move forward: i.e., actions to reduce cost burden for SMEs to tap capital markets. The cost issue should be overcome to create a sustainable long-term financing venue for SMEs, which requires more sophisticated and innovative institutional arrangements well serving their real needs. This will also result in the establishment of a robust capital market that supplements the limitations of traditional bank lending at the national level.

Two-fold development path can be considered in the SME capital market: (i) private initiative linked to the private sector development (business-oriented) and (ii) public

initiative under the financial inclusion policy and the national growth strategies (social-oriented). In such two tracks, exchange market and non-exchange market can be organized. Accordingly, three types of costs come out: (i) infrastructure cost, (ii) regulatory cost, and (iii) policy cost (Table 4). For the infrastructure cost, the expected cost size will be different between exchange and non-exchange markets, depending on the usage of existing exchange platform, but not be different between private and public initiatives. The establishment costs for trading platform in the organized OTC market arise but will not be so expensive due to the small scale market. For the regulatory cost, the expected cost size will not be so different between exchange and non-exchange markets because the base of regulations and rules already exist and small costs may arise for amendments, but be different between private and public initiatives because the regulatory coordination between the capital market regulator and line Ministries responsible for SME sector development and access to finance is needed in exchange market under public initiative. For the policy cost, the expected cost size will be different between private and public initiatives because the latter needs sophisticated institutional arrangements to well serve the demands on both SME issuers and investors, and accordingly additional costs will arise from; e.g., (i) policy coordination between the capital market regulator and line Ministries; (ii) policy support measures—such as tax incentive schemes for SME issuers and investors, and subsidies for application and listing fees; (iii) socialization or dissemination of market literacy, and training for potential SME issuers and investors; and (iv) supporting infrastructure development—such as increased CPAs, outsourcing to SMEs for disclosure support, and fostering the sophisticated investor base and the venture capital industry. The cost and benefits should be well examined to design the SME market with which type of market modality and initiative being chosen.

The cost issue is a big burden for developing an SME market, given the public initiative selected, which is mostly generated from policy measures for attracting SME issuers and investors. To create demands on potential SMEs and investors, solutions from different angles are worth exploring: e.g., exercise equity market for SMEs and social capital market. The exercise market is not a simple funding venue but a learning venue for SMEs about benefits and obligations of capital market financing, which stimulates a growth cycle of enterprises as a response to the national growth strategies, and a comprehensive policy support framework is needed. The social capital market targets specialized segments of issuers and investors; i.e., social enterprises mostly comprising innovative SMEs, and impact investors with interest in contributing to social welfare. It can also respond to the cross-cutting issues of global policy agendas—such as climate change, energy efficiency, and green finance— and requires a comprehensive policy support framework as well.

The discussions in this paper suggest five core elements to develop an SME capital market: (i) demand creation focusing on target segments such as social enterprises and women-led SMEs, with designing a low cost structure for SME access to capital markets; (ii) establishment of investor base that provides initial risk capital for potential growth-oriented SMEs, with fostering the venture capital industry; (iii) strengthening market literacy for potential SME issuers and investors; (iv) investor protection mechanisms backed by proper laws and regulations; and (v) facilitation measures for access to an SME market backed by a comprehensive policy support framework with

well-organized policy coordination among regulators and line Ministries responsible for SME sector development and access to finance.

Table 4. Cost Structure of SME Market

	SME Capital Market			
	A. Private Initiative		B. Public Initiative	
	Private Sector Development (Business Aspect)		Financial Inclusion National Growth Strategies (Social Aspect)	
	Exchange market	Non-exchange market (OTC)	Exchange market	Non-exchange market (OTC)
Infrastructure Cost	S Existing exchange platform to be utilized	M Newly created trading platform but small scale	S Existing exchange platform to be utilized	M Newly created trading platform but small scale
Regulatory Cost	S Existing capital market regulations and amendments	S Self-regulatory rules and amendments	M ✓ Existing capital market regulations and amendments ✓ Regulatory coordination between the capital market regulator and line Ministries	S Self-regulatory rules and amendments
Policy Cost	-	-	L ✓ Policy coordination between the capital market regulator and line Ministries ✓ Tax incentive schemes for SME issuers and investors ✓ Subsidies for application and listing fees ✓ Socialization/market literacy/training for potential SME issuers and investors ✓ Supporting infrastructure: e.g., increased CPAs, outsourcing to SMEs for disclosure support ✓ Fostering sophisticated investor base and venture capital industry	L

SME = small and medium-sized enterprise.

Notes: S = expected small costs, M = expected medium costs, L = expected large costs.

Source: Authors' compilation.

Figure 19. Core Elements to Develop an SME Market



SME = small and medium-sized enterprise.

Source: Authors' illustration.

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Capital Market Financing for SMEs

A Growing Need in Emerging Asia

Broadening financing modalities beyond conventional bank lending is a key policy concern to better serve various financing needs of SMEs and expand their financial accessibility. The rapid growth of emerging Asia is generating SMEs' long-term funding needs and requires robust capital markets as an alternative channel for their growth capital. This paper explores the potential of capital market financing for SMEs in emerging Asia, reviewing the challenges of existing SME markets and assessing demands on SMEs and market players for developing a feasible SME market, based on the survey findings.

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