SME SENTIMENT INDEX 2H 2023

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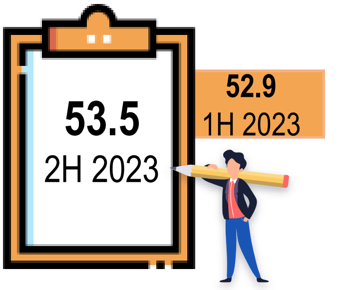
SME Bank has conducted SME Sentiment Index survey for the 2H 2023 between July and October 2023 which managed to garner 423 respondents from various sectors and sizes of businesses. As a leading economic indicator, this Index serves to **gauge Micro, Small and Medium-sized Enterprises (MSMEs)'s view of the business environment which can be the yardstick in measuring how the overall economy is expected to behave.**

The index **inched up to 53.5 in 2H** from 52.9 in the 1H – a score above 50 reflects optimism/positive sentiment and vice versa. It suggests that **overall MSMEs remain healthy in which business owners continue to be optimistic, resilient, and adaptive**. The reading is also aligned with SME Bank's as well as official (Ministry of Finance)'s economic growth projection for next year at 4.0% YoY to 5.0% YoY (2023e: official: 4.0%; SME Bank: 4.0% - 5.0%).



Nonetheless, **more than 50% of respondents think that the economy will continue growing albeit at a softer pace** over the next 6 to 12 months, partially **driven by mounting external headwinds**. This applies to **all business sizes, except large** ones where their view of the economic outlook is balanced between slowdown (46%) and higher growth (46%). By sector, expectations of an economic slowdown came mainly from the agriculture (75%), ICT (72%) and Wholesale (69%) sectors.

Figure 1: 54% of MSMEs expect the economy to slow down over the next 6 to 12 months…

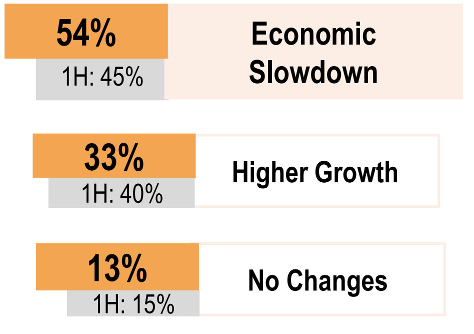


Figure 2: …mostly coming from small and micro businesses

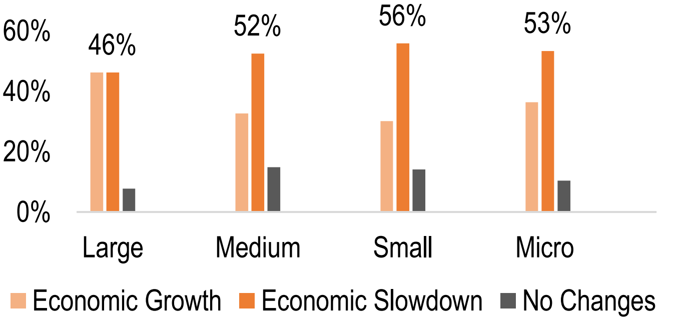
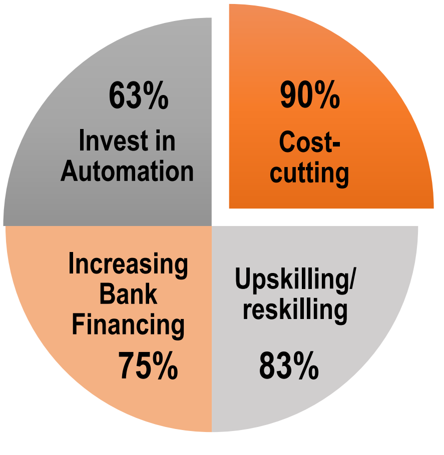


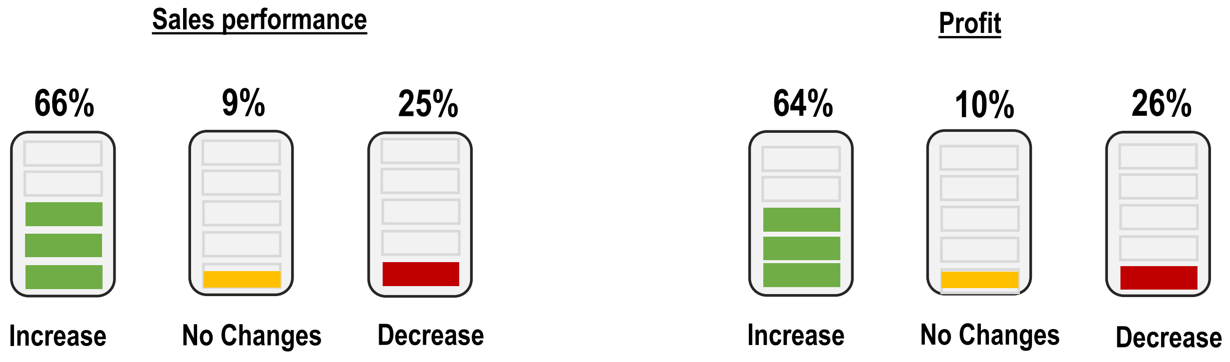
Figure 3: Business Mitigation Plan During Economic Slowdown



More than two-thirds of respondents prioritise cost-cutting to sustain their businesses amid a slowing economy, which may include sourcing for cheaper supplies, reducing office space, cutting marketing expenses or even downsizing. However, as **rehiring after downsizing can pose many challenges and costs** especially if economic conditions improve faster than expected, businesses prefer to retain and retrain their employees to diversify their talent and increase their productivity which eventually could help to sail through hitches. This was reflected by a substantial share of respondents **(83%) opting to upskilling and reskilling their workforce**, second to the cost-cutting measure. Meanwhile, to apply or increase financing (75%) and to invest in automation (63%) seem not to be a priority during an economic slowdown although respondents acknowledge that these two measures have their own benefits.

Regardless of the less sanguine economic outlook expected by MSMEs, **business confidence remains intact** as reflected by more than half of the respondents foreseeing their **revenue (66%) and profit (64%) to increase** in the next 6 to 12 months. This is particularly **evident in the services subsectors such as financial (91%) and education (78%)** which are in line with their anticipation of a better economic outlook for next year.

Figure 4: Majority of MSMEs expect an increase in their sales performance (66%) and profit (64%)



The education sector is likely to benefit from greater demand driven by improving household standards of living, higher interest of foreign students to pursue studies in Malaysia as well as continuous focus given to Technical and Vocational Education and Training (TVET). In line, latest data on foreign students' application for higher studies (certificate to PhD) in 2Q 2023 showed that it surged by 33% YoY to 12,665 persons. To note, higher education is dominated by private institutions (72% of total in 2022). Better prospects in the education sector also explained why **100% of the respondents** in the sector **plan to increase their manpower, with preference given to full-timers.**

Figure 5: Top sectors that expect an increase in sales are:

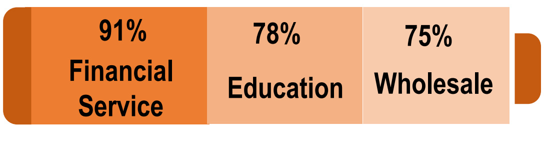
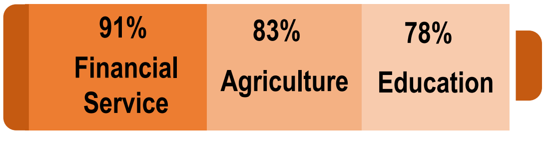


Figure 6: Top sectors that expect an increase in profit are:



By size of business, **large companies (85%) are the most optimistic about their sales and profits** in the next 6 to 12 months. The expectation is better than the 1H 2023 (sales: 80%; profit: 67%) which also holds for **micro business sizes where the sales (67%) and profit (68%) foreseen are higher than in the 1H** (sales: 61%; profit: 58%). Large businesses may have more capacity in being agile and adaptive by exploring more opportunities to remain profitable while micro businesses are probably being sheltered by various government assistance and subsidies on top of running at relatively low operating costs compared to other business sizes. This is supported by further findings on expectations of the **cost of doing business going up mostly in large (92%) and medium-sized (92%) businesses.**

More than half of the respondents (72%) received their order less than a month in advance. Similarly, most of them (54%) keep their input inventory for less than a month. This is predominantly true for micro-sized businesses as they are mostly in F&B services which need to deal with perishable items.

Figure 7: 88% of respondent expect business cost to increase…

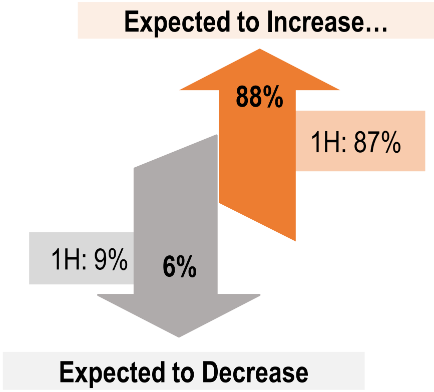
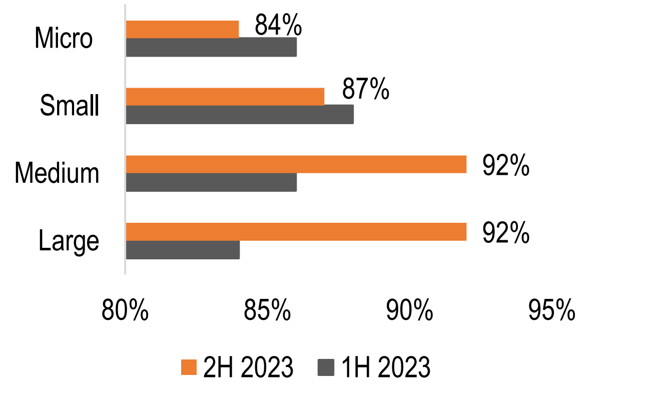


Figure 8: …with large and medium businesses expressing the highest concern



High-cost environment will continue to pose challenges to MSMEs as reflected in **majority of them expecting costs to increase next year** (2H: 88%; 1H: 87%) led by services subsectors such as ICT (93%), utilities (93%) and food and beverages (93%). The expectation could **be augmented by the higher and broader service tax, diesel subsidies rationalisation and implementation of luxury goods tax** that were announced in Budget 2024. While **e-invoicing** will be made mandatory to large firms (revenue/profit above RM100 mil) for the start, MSMEs which are integrated **within the supply chain may also be indirectly obligated** to adopt it concurrently to meet requirements as vendor or suppliers. Adopting e-invoicing may incur cost as it requires upfront investment in technology and adjustments to firms' existing systems unless they opt for MyInvois Portal which involves no cost.

In line with the anticipated increase in the cost of doing business, almost all respondents **(98%) recognised inflation's profound impact on their business performance** particularly 100% of respondents in **retail services, construction and food processing manufacturing** sectors. The inflationary pressures could stem from various factors mentioned above along with **Ringgit depreciation** against major currencies which makes imported goods, particularly **raw materials, more expensive.**

For the YTD average until November 2023, Ringgit has depreciated against USD, SGD, THB, and IDR, among others. However, the Ringgit also appreciated against some key partners' currencies such as CNY, JPY, INR and AUD. China together with Japan, Australia and India account for about one-third of Malaysia's total imports for the first 10 months of the year. For next year, SME Bank forecast Ringgit to strengthen against the USD at a range between RM4.45 – RM4.55 (2023e: RM4.50 – RM4.60) on the back of potential end of interest rate hike cycle in the US.

Second to inflation, most respondents (88%) also feel that **changes in government policies are another impactful factor** toward business performance. This includes the implementation of targeted subsidies, political uncertainty as well as regulatory requirements such as Environmental, social, and corporate governance (ESG) adherence, tax compliance and labour laws.

Figure 9: Almost all MSMEs feel that inflation is affecting their business performance

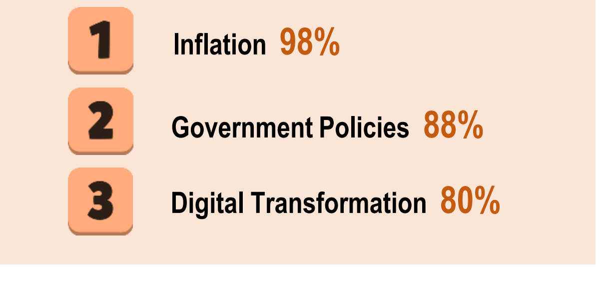


Figure 10: Top 3 sectors impacted by inflation

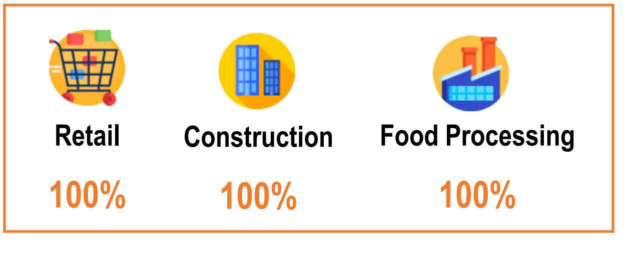
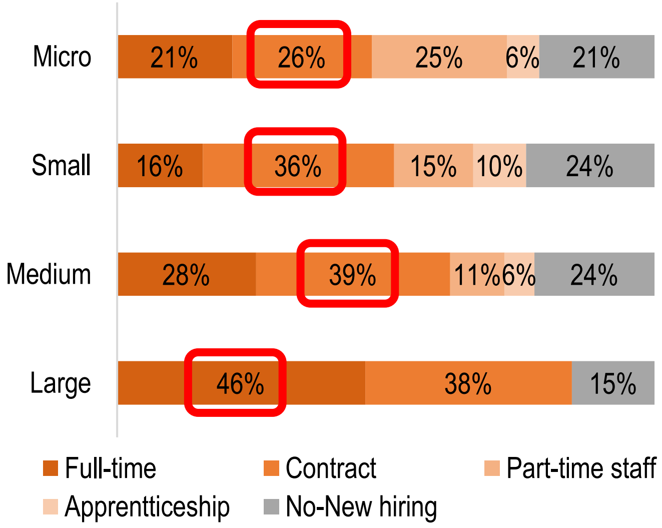


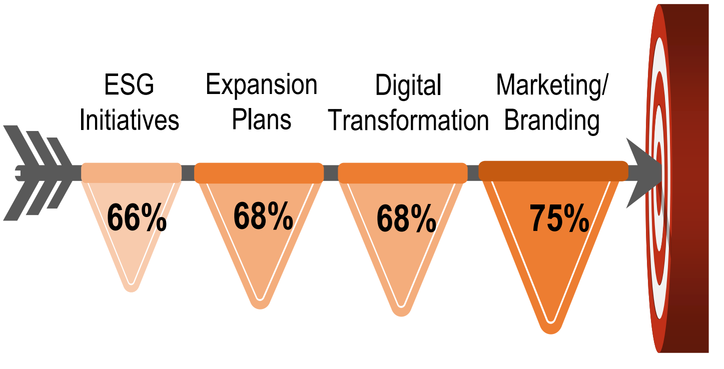
Figure 11: All business sizes but large prefer hiring non-full-timers due to its flexibility.



In terms of hiring, most **MSMEs (67%) plan to expand their workforce** in the next 6 to 12 months which was better than 61% recorded in 1H 2023, despite the high-cost environment but aligns with higher expectations of sales and profit. Nonetheless, **all business sizes but large prefer hiring non-full-timers** probably due to its flexibility which allows businesses to swiftly adapt to changing market conditions. The tendency to hire non-permanent employees (57%) is also greater than 1H (49%) as businesses may save some costs (e.g. mandatory social security/ health insurance). However, the overall salary package still needs to be attractive to entice and retain talent amid a still tight labour market. Almost all the sectors are looking to hire with the **top three being education (100%), financial services (90%) and chemicals and pharmaceuticals manufacturing (83%).**

Most of the respondents (75%), albeit lower than 1H (87%), continue to **focus on marketing and branding**, which includes feedback, rewards, and loyalty programmes, for the next 6 to 12 months amid a highly competitive environment. With transition toward digital marketing in tandem with high penetration rate of internet among household (2022: 96.4%; 2019: 90.3%) and smartphone access (2022: 96.7%; 2019: 93.5%), businesses could leverage the social media platform to maintain a good relationship with clients.

Figure 12: Majority of respondents (75%) wish to focus on improving branding as well as marketing strategies..



However, **large and medium-sized businesses are focusing more on expansion plan** (92% of large-sized businesses) **and digital transformation** (72% of medium-sized businesses), respectively. This explains 80% of medium-sized businesses who indicated that digital transformation is impactful to their business performance as well as the 85% of large businesses who are most optimistic about their sales and profit.

Figure 13: ...however large and medium businesses focus more on expansion and digital transformation, respectively.

Business Size/ Focus	**Large**	**Medium**	**Small**	**Micro**
Business Expansion	**92%**	68%	67%	67%
Digital Transformation	75%	**72%**	64%	71%
Marketing/ Branding	83%	71%	**75%**	**77%**

While the majority (66%) still have cash reserves for more than 6 months, the trend is shifting whereby the **share of respondents (36%) having cash buffer more than a year has been drastically reduced**, compared to 1H (50%). Moreover, one-third of respondents (1H: 30%) have less than 6 months of cash reserves hence vulnerable to shocks. Adequate cash reserves are crucial as it helps to protect businesses in the event of unexpected expenses or revenue drops. On the other hand, lower cash reserves can also mean that companies are actively investing and making more profit elsewhere in a diversified portfolio.

Figure 14: 1/3 of MSMEs have low cash reserves hence more vulnerable to shocks.

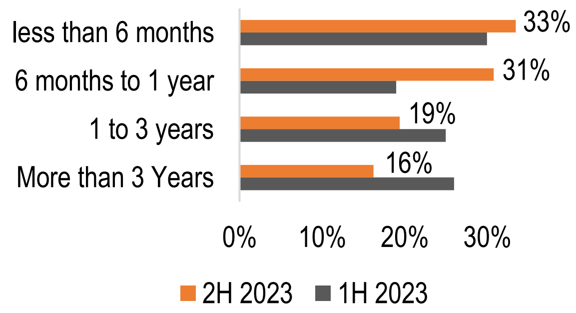


Figure 15: Top Sectors that have high and low cash reserve

High Cash Reserve (>6 Months)		Low Cash Reserve (<6 Months)	
Private Education	100%	Food Processing	50%
Agriculture	83%	Chemicals & Pharmaceuticals	50%
Transportation & Storage	77%	Human Health activities	50%

By sector, **education (100%), agriculture (83%) and transportation and storage (77%)** have the highest share of respondents having **cash reserves above 6 months** while human health (50%), chemicals and pharmaceuticals manufacturing (50%) and food processing manufacturing (50%) are on the opposite. As generally expected, micro (42%) businesses have the lowest cash reserves (less than 6 months) while large (92%) have the highest.

Despite more businesses having less cash reserves, **only 44% of respondents are seeking alternative financing options which were reduced by half compared to 1H** (80%). In fact, sectors which have low cash reserves as mentioned above are considering other alternative options than financing, such as **exploring partnerships or collaborations as well as negotiating payment terms with suppliers** to share or cut costs. The lower appetite for financing could be due to factors such as a high interest rate environment or that businesses have successfully secured the necessary financing previously. Overnight Policy Rate was last raised by 25bps to 3.00% in May 2023 which has almost returned to pre-pandemic level of 3.25%. SME Bank expects OPR to stay at the current level for next year.

At national level however, MSMEs portray a still strong demand for financing as reflected by applications which soared 26.3% YoY in 3Q 2023 (2Q: 7.6%). Likewise, disbursement increased at a faster pace of 5.7% YoY (2Q: 2.6%). Additionally, MSMEs seem to be capable of serving their debt as repayment rose 4.4% YoY (2Q: -1.1%).

While some respondents acknowledge that additional financing could be a helping hand, they are also afraid to commit as considerable economic uncertainties remain on air. Some **downside risks** to domestic economy include **1) slow recovery in China** (key trading partner), **2) geopolitical tensions** including US – China trade skirmishes and potential exacerbation of Middle East conflicts, and **3) rising cost for businesses** from potential fuel subsidy removal, climate change and rising protectionism.

Nonetheless, **expansionary Budget 2024, upbeat foreign & domestic direct investment** as well as **faster rationalisation of infrastructure projects are supportive** of the overall economy as well as MSMEs. Cash assistance such as *Sumbangan Tunai Rahmah, Sumbangan Asas Rahmah* and incentives to civil servants and pensioners announced in Budget 2024 are likely to increase household disposable income which may spur consumer spending. However, businesses also need to be **mindful of consumers' spending pattern** which could be influenced by various factors such as income level, lifestyles, preferences, and perceptions. As such, any business decision needs to be **prudently executed without causing a major drawback** in terms of competitiveness, market share and profitability.

We are confident that **MSMEs will continue to be resilient in navigating through the evolving nature of doing business** by continuously reviewing their business operations and adjusting accordingly to current suitability and needs. Some approaches may include good management practices, human resource development, optimising capital savings and new business methods such as digitalisation, automation and e-commerce. There are many funding options as well as training provided on the related matter. Some programmes offered by SME Bank, such as BizCashPlus. Social Enterprise Financing Scheme (SEFS), SME Recapitalization Fund, IBS Promotion Fund 2.0 (IBS 2.0), PEMERKASA Matching Grant Financing Structure (PMG), Lestari Bumi Financing (LBF), SME Technology Transformation Fund (STTF), Jaguh Serantau (JS), Contract Financing (CF), Skim Juara Lestari as well as other collaborative programmes such as Penjana Tourism Financing could be of interest to businesses.