SME SENTIMENT INDEX 1H 2023

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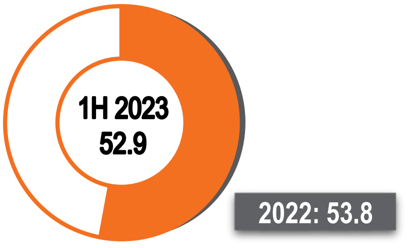
SME Bank has conducted its second SME Sentiment Index survey between January and May 2023 after a remarkable success of its inaugural survey last year. The survey managed to garner a total number of respondents above 700 from various sectors and sizes of Micro, Small and Medium-sized Enterprises (MSMEs). A leading economic indicator, this Index serves to **gauge MSMEs' view of the business environment which can be the yardstick in measuring how the overall economy is expected to behave.**



The Index has continued to show **a positive reading of 52.9**, suggesting that the overall MSMEs **remain healthy** in which business owners are **still optimistic, resilient and adaptive, albeit slightly lower than 2022** (53.8). A score above 50 reflects optimism/positive sentiment and vice versa.

The 1H 2023 SME Sentiment Index reading of 52.9 is **in line with the country's economic slowdown foreseen this year** where SME Bank as well as official sources - Ministry of Finance (MOF) and Bank Negara Malaysia (BNM) - expects Malaysia's gross domestic product (GDP) to continue growing between a range of 4.0% YoY to 5.0% YoY, moderating from 8.7% YoY in 2022. This expectation is supported by our findings where **most of the MSMEs (45%) foresee the economy to slow down** over the next 6 to 12 months, **predominantly the micro and small enterprises**. On the other hand, 44% of the medium and large size businesses, respectively, anticipate further expansion in the economic activities compared to 40% who expect it to be dimmer and 16% at status quo.

Figure 1: 45% of MSMEs expect the economy to slow down over the next 6 to 12 months…

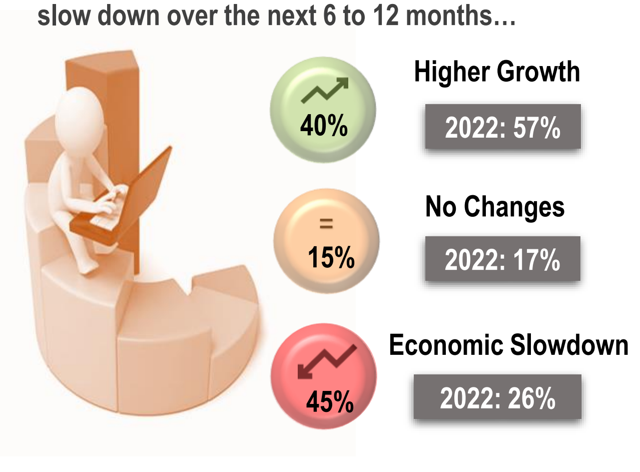
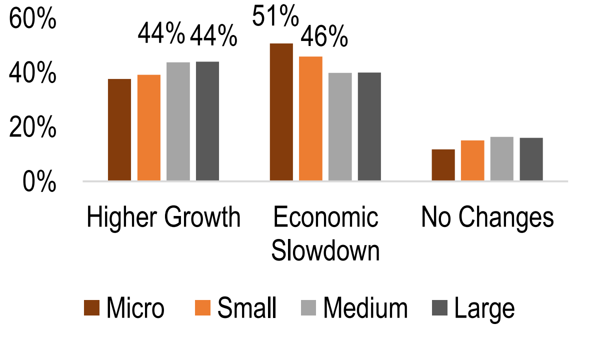


Figure 2: … however most of the large and medium sized businesses anticipate higher growth



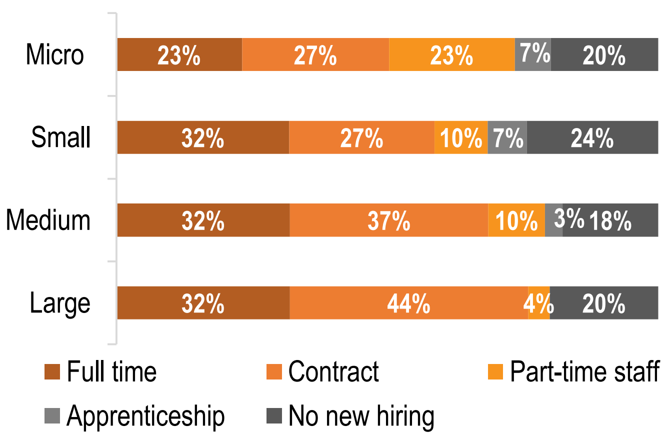
By sector, the moderation comes mostly from several services sub-sectors such as **electricity, gas, steam and air conditioning supply (60%), real estate (60%) and retail (55%)** as well as **manufacturing sector (55%)** in line with **high cost of living which may limit purchases** especially in discretionary/ big ticket items (e.g. houses, automotive, electronics, fashion and entertainment). Meanwhile, respondents in the **mining sector (86%) are the most upbeat on brighter economic prospects/ business environment** as Brent oil price remain above its long-term trend, spurred by further recovery in travel and tourism. As such, respondents from the **transportation sector (45%)** are also foreseeing further growth in the overall economy. SME Bank and BNM expect Brent oil price to average at the range of USD80 – USD90 per barrel (YTD 2023: USD81; 2015-2019 average: USD57).

Education (54%) is another sector where most of its respondents have brighter economic outlook as it continues to recover from the pandemic. Rising affluency, brand awareness, preference towards holistic education as well as industry requirement particularly of technical and vocational education and training (TVET) could be some of the contributing factors.

Figure 3: Top 3 sectors that expect an increase in cost are:

- **Accommodation** 100%
- **Food & Beverage** 94%
- **Human Health** 94%

Figure 4: Most of the MSMEs prefer hiring contract workers to have more flexibility



Apart from waning pent-up demand, the economy is expected to cool down this year in the face of elevated inflation and higher interest rate environment. **87%** (2022: 95%) of the respondents **foresee cost of doing business to go up** in the next 6 to 12 months**. To cope, most firms opt to cut costs (80%)** by reducing labour costs or seek for cheaper supplier, among others. This is reflective of **MSMEs' preference (close to 50%) in hiring contract and part-time workers as well as apprentices** as it can be **cost effective** and offers **greater flexibility**. In fact, the tendency to hire non-full-time employees is greater than last year (44%). This could partly be attributed to the increase in minimum wage and discussion on raising employers' contribution to EPF up to 20%. While the preference to recruit non-permanent employees is expected to save cost (e.g. mandatory social security/health insurance, paid time off, overtime payment), overall **salary package still needs to be attractive** in order to entice and retain talent amid **a still tight labour market** where the ratio of vacancies to unemployment in Feb 2023 compared to pre-pandemic levels suggests that there are nearly two job openings for every unemployed individual looking for a job. (*More details on MSMEs' labour analysis on the next page.)*

In keeping up with Industrial 4.0 and a dynamic economy, considerable number of respondents (75%) intend to **upskill and reskill** their employees by sending them for training. Moreover, **58%** of the respondents are willing to **invest in automation** (e.g. machine adoption & software/hardware upgrades) in order to sustain their businesses. This is because **two thirds of respondents** have indicated that **digital transformation is impactful to their business performance**, in which more than 50% cited it to be significantly important. Our result is similar to World Bank's Malaysia Economic Monitor publication in Feb 2023 where half of the SMEs that have increased the usage of digital platforms and current digital adoption consider digital transformation a permanent feature as only a tiny fraction (2% - 5% of businesses) would revert to pre-pandemic manual systems.

Figure 5: MSMEs voted cost cutting as their preferred measure to sustain their business

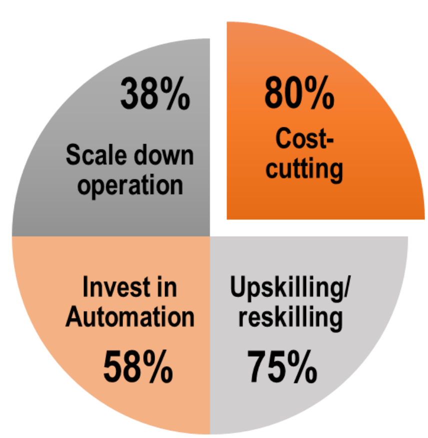
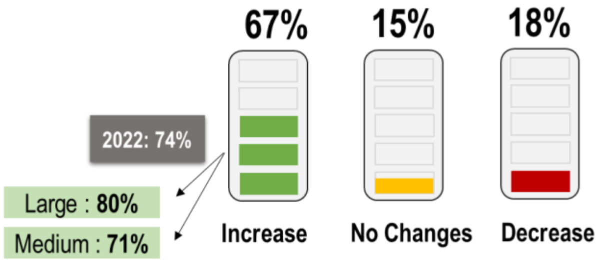


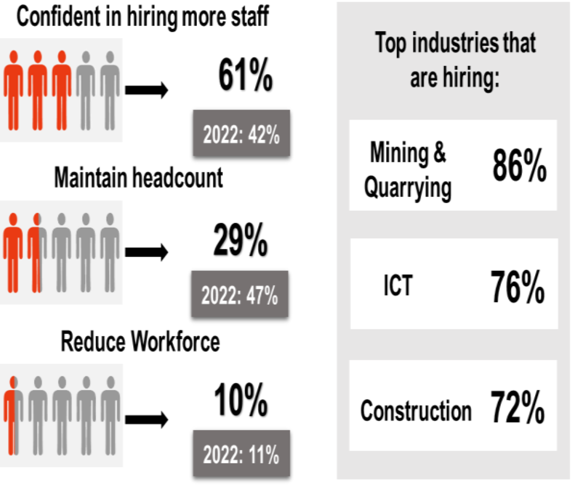
Figure 6: Majority of MSMEs (67%) expect an increase in their sales performance, albeit easing from last year



Regardless of the less exciting economic outlook, **firms across all sizes remain upbeat on their sales and profitability though less optimistic compared to last year**. Majority of MSMEs expect an increase in sales performance where **mining and quarrying (86%) being the most bullish**, followed by financial services (75%) and construction (74%). Although higher revenue doesn't always result in better profit, 60% of MSMEs anticipate an **increase in profit,** led by respondents from the **education (75%) sector**, followed by financial services (71%) and ICT (67%).

Nonetheless, as MSMEs continue to recover from the pandemic, reliance on human capital is still strong despite ongoing digitalisation. The majority plans to **increase hiring** (61% vs 42.2% in 2022) in order **to meet growing demand**. As MSMEs account for almost 50% of total employment in the country, our finding is consistent with the national level's labour market performance where employment continued growing steadily with latest growth unchanged at 2.9% in Mar 2023 while unemployment rate returned to full employment condition of below 4%, currently at 3.5% in Mar 2023. By firm size, **higher hiring** expectation is **concentrated in the micro enterprises** (40%) followed by medium (30%), small (25%) and large (5%). COVID-19-induced retrenchment was likely more prevalent in the smaller firms compared to the large ones hence the need for the former to rehire at a faster pace in order to keep up with the improving demand for their products and services as the pandemic subsides.

Figure 7: 61% of MSMEs plan to increase hiring to meet growing demand due to economic recovery



The hiring expectation among MSMEs is **broadly positive across sectors with mining** (86% of respondents) and construction (72%) **chalking among the highest demand** as the duo has considerable room to grow since they have yet to fully recover from pre-pandemic levels. GDP of mining and construction sectors in 2022 are still below 2019's level, at 6.5% and 19.6%, respectively. Moreover, labour shortage issue is still prevalent in the construction sector, albeit easing, where the current employment during 4Q 2022 stood at 95% of the level seen in 2019.

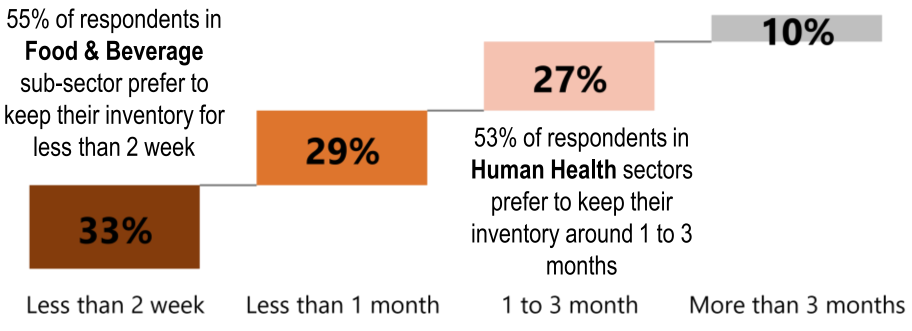
Deep diving into services sector which accounted for 63.2% of total MSMEs employment in 2021, hiring prospects in the ICT sub-sector (76% of respondents) were among the highest, followed by financial services (75%), and electricity, gas, steam, and air conditioning supply (71%). **Rapid digitalisation** especially those using advanced technologies such as artificial intelligence, cloud computing and cyber security **require new skill sets** hence demand for more talent. This is in line with evidence from the Malaysia's Critical Occupations List (COL) which suggests that demand for advanced digital skills have been rapidly rising more than its supply where a wider range of related occupations (e.g. professionals in animation & visual effects, digital games & eSports and web & multimedia developers) have been added to the critical list.

On the other hand, MSMEs in the accommodation sector is relatively cautious in expanding their labour force where majority (56%) prefers to maintain their workforce at the current level. Limited cash reserve below 6 months (50% of the respondents) and unison expectation on the higher cost of doing business (100%) are seen as factors hindering MSMEs in the accommodation sector from hiring. Furthermore, the full return of Chinese tourists to Malaysia may not happen immediately as travelers may favour domestic trips first amid abrupt reopening of the economy, lingering fears of COVID-19 as well as other concerns such as pricey airline tickets and slow visa approvals. In fact, Tourism, Arts and Culture Ministry (MOTAC) targets 16.1 mil foreign tourists this year which is just 62% of 2019's total arrival, suggesting a rather gradual return of Chinese tourists. Alternatively, **automation can also be a reason for limited hiring prospects** in the accommodation sector, along with F&B services and transportation and storage. This is reflected by their high focus (73% to 90% of the respondents) on digital transformation over the next 6 to 12 months which may include the use of robots, self-check-in systems and radio frequency identification (RFID) scan.

While MSMEs are steadily picking themselves up during this economic recovery phase, business climate remains challenging which affects their progress to a certain extent. **Inflation** was cited as the **top impactful factor** (87% of the respondents) to MSMEs' business performance, followed by changes in government and its policies (70%) and digital transformation (68%). Environmental change and implementation of targeted subsidies are voted to have the least impact to MSMEs probably because climate change, flood, landslide and pollution are quite localised and may not be a major concern to them at this point in time. Likewise, **most of the existing subsidies/ incentives are supportive of MSMEs**. For instance, lower voltage non-domestic users MSMEs are being excluded from the electricity tariff surcharge of 20 sen/kWj for the period of January 1 to June 30, 2023 while the implementation of targeted fuel subsidy is likely to only happen next year.

One-third (33%) of businesses prefer to **restock their inventory in less than 2 weeks**. This is **predominantly true for F&B services** (55% of the respondents) as their stocks are mostly perishable items. Likewise, retail sub-sector is less keen to keep their inventory above 1 month which may also signal softer future demand for their products hence they avoid stocking up for too long to reduce risk and costs. These **retailers' behaviour correspond with their expectation (55% of the respondents) for the economy to cool down in the 6 to 12 months ahead.** In contrast, other services sub-sectors such as human health and ICT as well as the mining sector expect to stock up their inventories longer, more than 1 month, mainly due to the durability of their inputs.

Figure 8: More than half of MSMEs (62%) prefer to keep their stocks less than a month



Recognising the importance of good marketing for their businesses amid a highly competitive environment, **most of the MSMEs (87%)** want to focus on **increasing or improving their marketing strategies as well as branding** over the next 6 to 12 months. This include getting frequent feedbacks from the customers and reward programmes which can strengthen relationship and boost customers' loyalty. Reward programmes are a win-win situation where customers can earn prizes while firms can use collected information to send targeted marketing offers to customers which ultimately helps attract returning customers and contribute to more sales. Besides that, restructuring and reinvention (83%) is also one of the top focus areas for the MSMEs where they plan to review and make necessary changes to their business strategies from time to time to remain agile, adaptive and improve efficiency and productivity. Strategies may include managing operational costs, exploring new revenue streams, diversifying their customer base and employing new pricing strategies to stay competitive.

Figure 9: Focus on increasing marketing strategy, particularly in the education, accommodation and real estate sectors

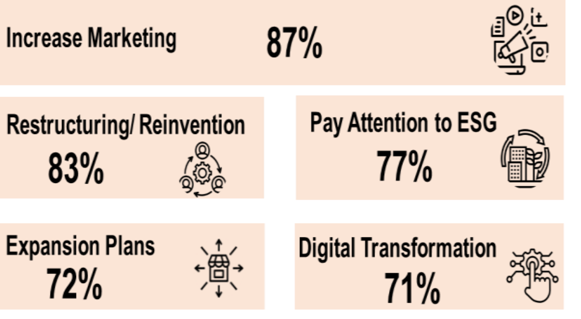
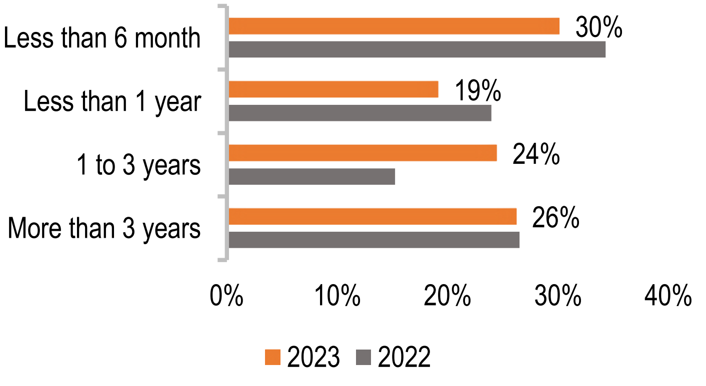


Figure 10: A third of MSMEs are more vulnerable to shocks due to low cash reserves



Although some improvements were seen in terms of liquidity and cashflow management of MSMEs, where the majority of the respondents (70%) have enough cash reserve for more than 6 months (2022: 66%), **almost a third of all businesses have less than 6 months cash buffer except agriculture. Accommodation sub-sector is the most vulnerable,** where 50% of respondents can only sustain financially up to 6 months. As generally expected, micro (36%) and small (34%) sized firms have the lowest cash reserve (less than 6 months).

While we believe vulnerable MSMEs with less than 6 months of cash buffer would require monetary aid to sustain their cashflow, **majority of accommodation providers (44%) are not seeking for additional financing**. Nevertheless, **close to 80% (similar to 2022) of MSMEs have indicated the need for cash assistance** via financing, despite the rising interest rate environment. 48% of respondents are **looking for additional financing** to manage their working capital or operating expenditure, **largely in ICT (79%)** and financial (63%) services. Meanwhile, financing for purchases of machinery and equipment are mainly required by respondents from the transportation (44%) and mining (43%) sectors. Those who don't require any additional financing mostly come from education and accommodation sectors.

The financing appetite shown by the survey is in line with SME financing performance at the national level where it has continued to grow with the latest figure of 2.2% YoY in 1Q 2023 (4Q 2022: 4.2%). **By sector, the highest annual growth of financing was recorded for the ICT** (29.2% vs 28.0% in 4Q 2022) sub-sector, followed by administrative and support service activity (15.6% vs 10.2%) and financial and insurance/takaful activity (14.5% vs 18.2%). In contrast, financing for the accommodation and F&B services as well as education and health declined during the quarter. Disbursement in these services sub-sectors are still positive, albeit lower than the repayment rate.

While the 1H 2023 SME Sentiment Index score of 52.9 still portrays a somewhat optimistic outlook, it actually eased from last year's 53.8, hence **we remain cautious** on the developments on both domestic and external front. The tighter global monetary policy environment, mounting geopolitical tensions, elevated inflation and risk of recession in certain advanced economies could have **spillover effects to the domestic economy** and may derail our recovery trajectory. Some key macroeconomic indicators have started to show signs of weaknesses. For instance, Malaysia's exports declined (-17.4% YoY) for the second consecutive month in April 2023 and experienced the steepest drop since May 2020 attributed to weakening global demand, among others. Likewise, Malaysia's manufacturing PMI stood at 48.8 in April 2023, the eighth straight contraction in the sector.

Nonetheless, we are confident that **MSMEs are resilient enough to adapt and adjust better** in this post-pandemic recovery phase where they **can leverage on technology and modernisation to identify new pockets of opportunities** to capitalise on the evolving nature of doing business to remain competitive. Businesses also need to be **mindful of consumers' spending pattern** as it could be influenced by various factors beyond just interest rate, such as income levels, consumer confidence as well as economic conditions. As such, decision to pass on costs to consumers need to be **prudently executed without causing a major drawback to the businesses** in terms of competitiveness, market share and profitability. There are many funding options as well as trainings provided on the related matter. Some programmes offered by SME Bank, such as Lestari Bumi Financing (LBF), IBS Promotion Fund 2.0 (IBS 2.0), Young Entrepreneur Fund 2.0 (YEF 2.0), SME Recapitalisation Fund and the newly launched, Social Enterprise Financing Scheme (SEFS), Juara Lestari Scheme and ESG Sustainability Accelerator Programme as well as other collaborative programmes such as Penjana Tourism Financing, and Bumiputera Supply Chain (BSC), could be of interest to businesses.

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