MORE THAN MEETS THE EVIL EYE

Business Practices and Constraints of SMEs in Turkey

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THE FLETCHER SCHOOL
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THE INSTITUTE FOR BUSINESS IN THE GLOBAL CONTEXT

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This report is the result of this innovative collaboration.

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EXECUTIVE SUMMARY

Turkey has a window of opportunity to facilitate progress and growth in established small and medium-sized enterprises (SMEs) and leverage their success to propel Turkey's economy.

As Turkey continues to define itself as an emerging market, negotiating its position between Europe and the Middle East, SMEs will prove to be a very important and strategic sector.

Having built its current growth story on domestic consumption and portfolio investment, Turkey has yet to sufficiently leverage its prolific SME segment for future growth. This issue is now incredibly significant, as recently elected President Recep Tayyip Erdogan and his ruling Justice and Development Party (AKP) have established ambitious goals aimed at dramatically improving Turkey's position in the global economy by the Republic's 100th Anniversary in 2023. With these goals in place, Turkey has a window of opportunity to facilitate progress and growth in established SMEs and leverage their success to propel Turkey's economy.

Turkish SMEs have the potential to make significant contributions to gross domestic product (GDP), to create jobs for an underutilized and growing labor force, and to nudge Turkey's current categorization as an efficiency-driven economy toward the next stage as an innovation-driven economy. However, in order for SMEs to play a greater role in the Turkish economy, some key constraints need to be overcome.

While financial service providers and public organizations have placed a greater emphasis on providing specialized products and services to the SME segment, businesses still face significant constraints in accessing finance, effectively utilizing human capital, and enhancing competitiveness.

Thus, these challenges prevent the existing "solutions" from truly unlocking the potential of SMEs to fuel Turkey's economic growth. More than 30 in-depth interviews with participating SMEs and 15 interviews with expert stakeholders and financial service providers illuminated the following key insights:

An overall lack of strategy and planning preclude many SMEs from thriving.

Despite various motivations for starting or running a business, owners and managers lacked formal business plans and/or well-devised strategies to help achieve business goals. Moreover, the family-run nature of many SMEs means most owners and managers do not have the necessary training or expertise to make strategic decisions in human capital and financial management, further inhibiting them from professionalizing.

The overall lack of strategy and planning implies a failure to properly allocate resources in terms of reaching target customers, hiring qualified human capital, and preparing for future challenges and opportunities, among other things. In order to effectively expand or enter new markets, Turkish SMEs will need to increase knowledge about and use of business plans and strategies.

The supply of qualified human capital and the ability for SMEs to attract talented employees is a significant challenge.

72% of respondents cited finding or hiring employees as one of their greatest challenges and many reported a gap between the skill levels currently available in the workforce and their employment needs.

Overall, business owners complained slightly more frequently about their ability to find skilled workers than with unskilled workers. Well-placed, qualified talent will be an important step in moving Turkish SMEs to the next level. For Turkey, this will primarily necessitate a convergence of the education system with employer needs. Additionally, more coordinated efforts to find and place employees are needed, and re-conceptualized retention strategies should orient the focus towards increased employee autonomy and improved working environments.

Capital is indeed available in the market, but gaining access to that capital is highly costly.

Business owners reported prohibitive loan terms, such as high interest rates and strict collateral requirements. A mismatch exists between bank and SME expectations, resulting in SMEs being perceived as high-risk investments and contributing to a distrustful relationship, ultimately harming both banks and businesses.

Moreover, cash flow management was another commonly cited challenge for business owners and managers who struggle to collect payments and to deal with the system of long check maturities. Increased access to capital, particularly to long term financing, could help SMEs invest in expansion and enhanced competitiveness, but access to capital will not likely improve until there are some gains in professionalization – thus, financing alone will not be the magic bullet to SME success.

Increased self-awareness about a given SME's position in the market, in addition to increased knowledge about how to export to new markets and invest in R&D and market research will help SMEs thrive.

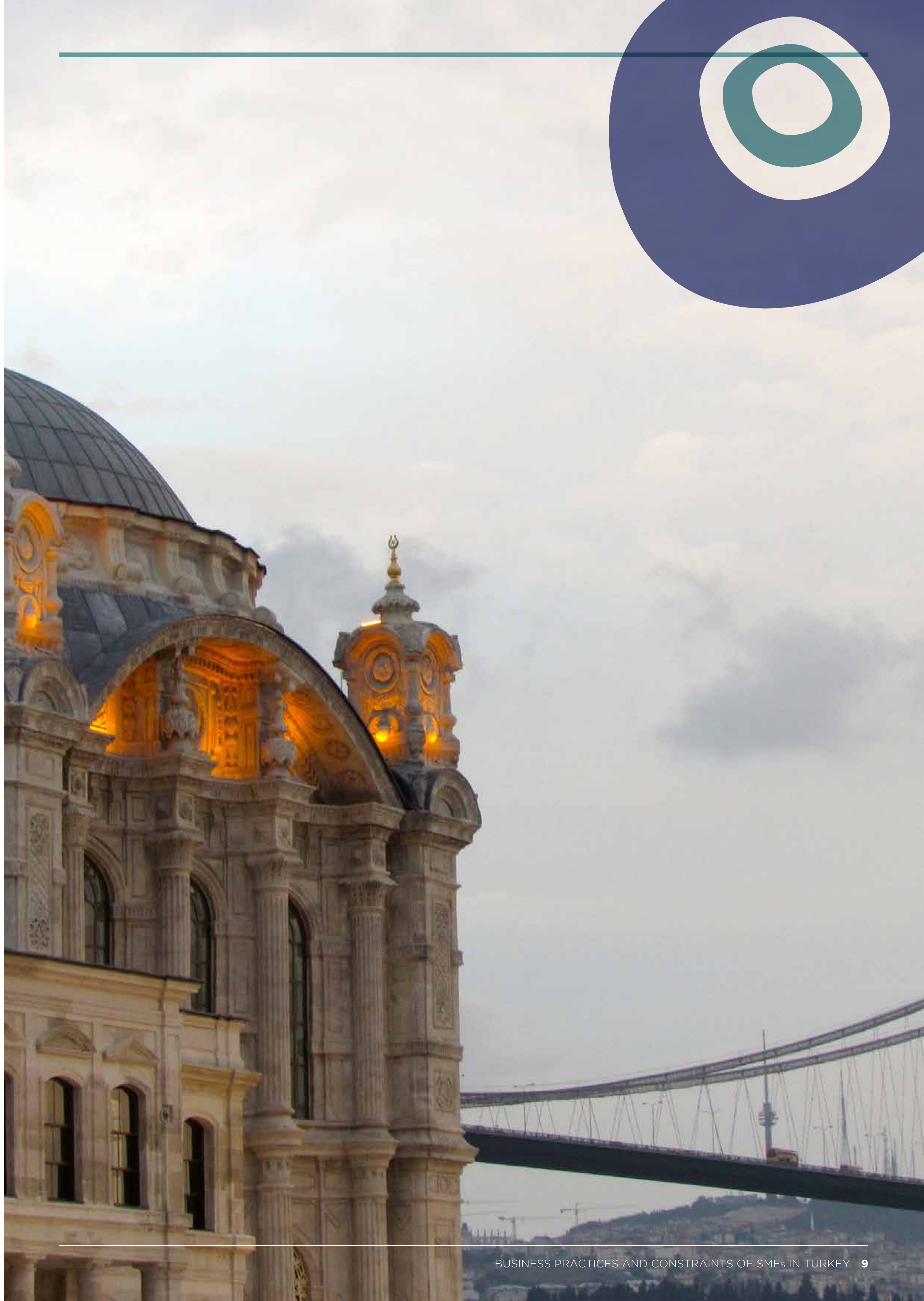
The majority of participants spoke vaguely about their competitors and their own position in the market and very few businesses reported investing in any market research or R&D for innovation.

On the other hand, SMEs currently contribute to 58% of Turkey's exports and a significant proportion of this sample were interested in expanding their role in international markets. Thus, there is great potential to increase the competitiveness of Turkish SMEs in order to move Turkey up the global value chain and into more international markets.

A variety of private and public sector solutions may help to push Turkey up the global value chain and towards its 2023 goals.

A necessary prerequisite for leveraging the full potential of Turkish SMEs is to improve professionalism, especially in managers and owners. For its part, the public sector can diminish institutional barriers obstructing cash flow, in addition to continuing, enhancing, and increasing awareness of public SME support institutions such as the state employment agency and the credit bureau. Financial service providers can provide more guidance and transparency to SMEs, potentially by expanding the role of relationship managers (RM), among other things.

Similarly, experienced business owners can mobilize forces to serve as "SME Ambassadors", acting as role models helping others tap into foreign markets, create business plans, expand their businesses, and more. Lastly, SMEs themselves can increase the autonomy, professional development, and career paths for employees to attract top talent and also consider hiring accountants and financial advisors. These and more solutions will be expounded upon in the Findings and Analysis section.



INTRODUCTION

Small and medium-sized enterprises (SMEs) are most commonly referred to as engines of economic growth as they create jobs, increase productivity, and foster innovation and forward thinking.[1]

Turkey, as an emerging market, benefits from a prolific SME segment, but has thus far based its growth story primarily on a steady level of domestic consumption and portfolio investment.

If leveraged successfully, SMEs have the potential to make huge contributions to Turkey's economy by increasing GDP, creating jobs for its underutilized and growing labor force, and mitigating income distribution differences. SMEs could even nudge Turkey's current categorization as an efficiency-driven economy toward the next stage as an innovation-driven economy.

Thus, our motivating research question was: What public- and private-sector driven solutions exist or would need to exist to stimulate the growth of key SME segments in Turkey? To answer this question, we took a fresh look at the challenges SMEs face, hoping to enable both public and private players to unlock the full potential of this segment.

While there are existing public and private initiatives aimed at assisting the SME segment, the relatively small part SMEs have played in Turkey's growth story indicates that they may be missing the mark.

Public organizations, motivated by the potential of SMEs to fuel Turkey's economic growth, and financial service providers, attracted to SMEs as a growing customer segment, have both placed a greater emphasis on providing specialized products and services to SMEs. However, businesses still face significant challenges in accessing finance, effectively finding and utilizing human capital, and enhancing competitiveness. Beyond simply offering more financial products to SMEs, increasing the capacity of business owners to effectively utilize financing, manage human capital, and invest in research and innovation may be required.

AMBIGUOUS POSITION IN THE GLOBAL MARKET

Turkey faces a variety of internal and external challenges which complicate its strategic position as an emerging market and compromise the ability of Turkish SMEs to thrive.

Erdogan's Victory

First, Recep Tayyip Erdogan declared victory on August 10, 2014 in Turkey's first-ever direct presidential election, turning his 12-year stint as prime minister into another five years as leader of both the Justice and Development Party (AKP) and the country. While Erdogan garnered nearly 52% of the votes in the presidential election, his vision for Turkey and many of the reforms passed in recent years have deeply divided the country.

His policy-making and the controversial handling of political issues have sparked large protests over issues such as rising political Islamism, suppression of political opposition, and censorship over free media. This domestic instability places particular stress on businesses as they attempt to make plans in the face of political uncertainty.

Regional Instability

Second, regional instability also contributes to the uncertainty of the Turkish economy. The ongoing civil war in Syria has damaged both political and economic relationships between the countries. In addition, as of August 2014, Turkey is hosting more than 800,000 Syrian refugees and another 150,000 people fleeing the recent Islamic State (IS) occupations arrived in late-September 2014.[2]

Also, since violence has erupted in Iraq, Turkish exports to the country—its second-largest foreign market—have dropped by 30%.[3] Considering Iraq and Syria have been the destination for more than 7% of the exports from Turkey, this is quite a blow to the existing current account deficit.

Deficit

Third, Turkey's current account deficit is unsustainably high, due primarily to a reliance on foreign natural resources. Moreover, the country has a low household savings rate of around 12%. Both contribute to higher pressure on the nation to finance its growth through foreign capital inflows. An over-dependence on those inflows is an unsustainable and risky growth model which could thwart Turkey's ambitious goals.[4]

Furthermore, being dependent on foreign capital means that Turkey also depends on foreign investors' confidence. In particular, Erdogan's aversion to high interest rates and the oft-criticized independence of the central bank could put Turkey in a vulnerable position. Certain structural weaknesses such as an overregulated labor market, high minimum wages, a large informal sector, low female participation rate, and a relatively weak education system significantly impact SMEs.[5]

Despite these significant challenges, Turkey is still well positioned as an emerging market in today's global economy. With its growing population and strategic geopolitical location, Turkey is often compared to Mexico, Indonesia, and South Korea – the next tier of emerging market powerhouses, also referred to as MIST countries. Foreign investors are attracted to these countries as they each contribute over 1% to nominal global GDP, have experienced rapid economic growth, and support a large domestic market powered by a young population.

Turkey in particular boasts a tight fiscal policy, low public debt, and enjoys close trade linkages to the EU, Middle East, and Russia. Moreover, with its EU customs agreement, low labor costs, and weak exchange rate, Turkey has become a hotspot for multinational corporations seeking a market to produce intermediary goods and is a major center for final production in the automotive sector.[6]

2013 GDP GROWTH **4.0%**

$65b CURRENT ACCOUNT DEFICIT
7.9% of GDP

EXPORTS 26.3% of GDP

31.5% of GDP IMPORTS

TOP 5 IMPORT ORIGINS GERMANY CHINA, RUSSIA, ITALY, USA

GERMANY IRAQ, IRAN, UK, UAE **TOP 5 EXPORT DESTINATIONS**

TOP FIVE IMPORTS

MINERAL FUEL OIL, MACHINES, PRECIOUS STONES AND METALS, IRON, STEEL, PLASTICS

TOP FIVE EXPORTS

KNITTED AND NON-KNITTED CLOTHING, FRUITS, IRON AND STEEL PRODUCTS, SALT, SULFUR STONES

SECTORS WITH HIGHEST SHARE OF GDP

58.4% SERVICES

26.9% INDUSTRY

9.2% AGRICULTURE 5.9% CONSTRUCTION

$12.918m FOREIGN DIRECT INVESTMENT

9-10% INFLATION RATE

SME FACT SHEET

Turkey officially uses the European Commission standards for differentiating business sizes between micro enterprises, SMEs, and large firms, yet each commercial bank has a unique SME segmentation. These definitions are based on number of employees and annual net sales revenue.

Turkey has approximately 3.5 million SMEs and about 3,000 large firms. 98.5% of all businesses are micro-enterprises, 0.9% are small, %0.5 are medium, and 0.1% are large enterprises.

SMEs account for 81% of total employment, 62% of investments, 59% of total value added and 56% of exports (a steep increase from around 10% in 2004).

The average SME in Turkey has been in business for 16 years.

SMEs come in last in terms of growth rates, as compared to rapidly growing microenterprises and top corporate firms.

Type of Enterprise	Number of Employees	Annual Revenue
Micro	*1 – 9*	*< 1 million TL*
Small	*10 –49*	*< 5 million TL*
Medium	*50 – 250*	*< 25 million TL*

GENDER GAP 120th OUT OF 136 COUNTRIES

77 MILLION POPULATION

AVERAGE AGE 29.6 YEARS

PRIMARY EDUCATION 23.5%

17.7% SECONDARY EDUCATION

TERTIARY EDUCATION 9.4%

HUMAN DEVELOPMENT INDEX 69th OUT OF 187 COUNTRIES

"Erdogan and the government have put a very high priority on taking Turkey from the world's 17th largest economy to the 10th largest by 2023, the 100th anniversary of the Republic. The growth of the SME market is an essential component to this.
- Arthur Scully, CEME Senior Fellow at The Fletcher School, Tufts University

SME'S COULD DECIDE TURKEY'S FUTURE

To propel Turkey even further, the governing AK Party has established a set of lofty goals aimed at making Turkey one of the world's 10 largest economies by 2023. This feat would require at least a 6-8% annual growth rate – an objective which has not been achieved since 2011.[7]

Turkey can use the 2023 goals as an opportunity to more effectively leverage its SME segment and to allow these businesses to play a greater role in the country's growth story. For example, Erdogan envisions an ambitious increase in annual Turkish exports from the current $151 billion to $500 billion and SMEs are important actors in increasing exports.

While Turkish SMEs already account for 60% of Turkey's total exports[8], increasing their contribution will push Turkey closer to its goals.

Having recognized the potential SMEs have to help Turkey realize its own goals, while also acknowledging the current constraints that many SMEs face, this research aims to identify solutions which can have a positive impact on those businesses and, in turn, on Turkey's economy.

The report is organized in the following way: the Methodology section (page 16) describes the key SME segments we studied; the Key Stakeholders section (page 20) identifies existing private and public actors which have been established to support SMEs. Then, the Findings and Analysis section (page 24) examines the current formal and informal practices of SMEs, their greatest needs and constraints, and highlights potential solutions.

METHODOLOGY

We began with a comprehensive literature review of the Turkish economy, which allowed us to assess the role of SMEs in Turkey's growth story and to understand the constraints SMEs face in emerging markets.

Upon our arrival in Turkey, we conducted preliminary key informant interviews with experts on the Turkish economy and SMEs in Turkey, and also representatives from financial service providers, including commercial banks and factoring and leasing companies. These conversations, in addition to the literature review, helped establish the parameters for choosing businesses to participate in the study and guided our decision to focus on three constraint categories (access to finance, human resources, and competitiveness) during interviews.

Over the course of the in-country study, we used the following qualitative research techniques:

- **Semi-structured interviews** with the business owner (85% of SME interviews), or with a manager when the owner was unavailable. These interviews gave us access to basic business indicators, the business' development, and their future goals, strategies, and most challenging constraints. After allowing the participant to express their own concerns and thoughts, the questions were narrowed to the three themes identified from the literature review and key informant interviews: access to capital, human resources, and elements of competitiveness. Interviews lasted between an hour and two hours and were conducted in whichever language the participant was most comfortable (Turkish or English), and sometimes a combination of both.
- **Key informant interviews** with experts working in the financial service industry and/or SME space. Interviews generally lasted an hour.
- **Observations**, including touring organized industrial zones, factories, and businesses.

PARTICIPANT AND REGION SELECTION

Since the research sought to discover the practices and growth potential of businesses taking on a certain level of professionalization, and since asking businesses for their annual revenues was difficult and inconsistent, participants were selected based on employee numbers. Thus, eligible businesses needed to have between 10 and 250 employees.

Moreover, this research focused on SMEs who had been established for at least three years, as opposed to start-up businesses.

Lastly, the literature and key informant interviews pointed to some strategic sectors to explore, namely manufacturing, automotive, textiles, construction, and food services. Thus, the size, duration, and sector were used as criteria for determining which businesses to enroll in the study.

Potential SMEs were found through personal networks and key informants, in addition to snowball sampling from participating SMEs. Businesses were first approached by the existing contact and, if they were willing to participate, we more clearly explained the goal of the research and established a time to meet the business' owner or a manager.

We focused on two regions within Turkey: the **Marmara** and **Southeastern** region. These two geographic areas were chosen to provide a rich comparison of business practices and constraints as they represent very different socioeconomic and cultural characteristics.

In the Marmara region, SMEs were interviewed in the cities of Istanbul, Edirne, and Gemlik. In the Southeastern region, all interviews were conducted in Gaziantep.

56

Average number of employees of the sample.

12 years

Average number of years participating businesses had been open.

Breakdown of sample:

- 9% operating for 1-3 years
- 18% operating 4-9 years
- 15% operating 10-14 years
- 21% 15-20 years
- 37% over 20 years

Percentages of sample from each sector:

- Manufacturing 24%
- Construction 24%
- Textile 15%
- Food 9%
- Other 27% (includes automotive, entertainment, advertising, paper products, catering, housing, and furniture)

CHALLENGES AND LIMITATIONS

Due to the semi-structured nature of the interviews, each participant was not interviewed for the same amount of time, nor were they all asked the same questions. The original research agenda incorporated repeat visits to each business so that trust could be built and more in-depth discussions established.

However, due to the time constraints on both businesses and research team, repeat visits were arranged only with particular participants based on their willingness to meet. This proved limiting because, as certain trends emerged and some information needed clarification, the research could have been enriched with repeat visits.

Additionally, the findings presented in this report are limited to the veracity of participant answers. Factors that may have affected interviewee answers were: misunderstood questions, open offices that may have led to self-censored answers, and distrust of the research aims.[9] Finally, due to the small size and potential selection bias[10], the information gathered cannot be generalized to all Turkish SMEs but rather can help illuminate trends and areas for improvement in Turkey.

STAKEHOLDERS IN THE TURKISH SME LANDSCAPE

This section offers an overview of the major players who provide services and products to SMEs in Turkey. An understanding of these actors is pertinent to our findings and analysis in the subsequent sections due to their capacity in offering existing solutions and in ways they could potentially improve their services to further aid SME development.

The Turkish government, in addition to financial service providers, has increased financial and non-financial services to SMEs since the mid-1990s, resulting in a complex web of public and private support institutions.

Among the spectrum of institutions, commercial banks today play a much larger role in providing a variety of offerings to SMEs than they have in the past. Nearly all 49 banks, including public, private, and international banks, operating in Turkey have established dedicated SME departments or units to provide customized financial services and capacity building to SMEs.

These banks are expected to play a major role in the growth and development of the economy through mobilization and deployment of financial resources. See Appendix 2 for an extensive list of services banks supposedly offer SMEs, as well as evidence of a segmentation-based approach to providing these products and services.[11]

Compulsory Organizations

The Union of Chambers and Commodity Exchanges of Turkey (TOBB)

- Highest legal entity in Turkey representing the private sector, with 365 members in the form of local chambers of commerce, industry, maritime commerce and commodity exchanges; represents 1.3 million businesses
- Aims at ensuring unity and solidarity between chambers and commodity exchanges, enhancing development of the professions in conformance with the general interest, facilitating professional works of members, and preserving professional discipline and ethics

Assembly of Export Associations (TiM)

- Established in 1993, the umbrella organization of exporting firms has around 52,000 members and represents 26 local unions of exporters
- Determines the issues related to exporting, conducts improvement studies, liaises between exporters and the highest competent authorities

Professional Associations

- Associations of all professionals who have graduated from the same faculty or department; 33 such associations exist
- Help provide technical and scientific studies, preparing standard contracts like licensing and training of future professionals; also collaborate with other professional associations and public authorities
- Example: Union of Chambers of Engineers and Architects

Voluntary Organizations

Interest Based Associations

- Appeal to business owners with similar world-views
- Conducts research, forms views, develops projects and activities in the context of accelerating international integration and interaction as well as regional and local development; liaises with the government, other states, international organizations through the media and other means
- Examples: Turkish Industry and Business Association (TUSIAD) and Independent Industrialists and Businessmen's Association (MUSIAD)

Sectoral/Regional Associations

- Express current sectoral problems to government authorities, collaborate with other NGOs, get media support to solve sectoral problems, inform members about upcoming regulations, organize and/or attend foreign and domestic seminars
- Examples: Poultry Meat Producer and Breeders Association; the Direct Marketing Association

Small and Medium Enterprises Development Organization (KOSGEB) and other public development organizations

- Government-sponsored organizations
- KOSGEB's mission is to increase SMEs' share in economic and social development by offering quality service and support towards developing SMEs' power of competition and spreading the culture of entrepreneurship
- Other organizations like the Thrace or Silk Road Development Agencies enhance collaboration between public sector, private sector and NGOs to dissolve regional inequality, to aid development, and to mobilize regional dynamics and human resources

Along with the commercial banks, international finance institutions (IFIs), government agencies, local administrations, and occupational organizations intervene in the credit markets via tools such as credit guarantee, interest subsidy, and regulative subsidies. Of the many organizations that provide this type of support to SMEs, the most prominent domestic actors include KOSGEB, Exim Bank, and regional development agencies. These actors compliment the work of EU actors, including the European Investment Fund and European Bank for Reconstruction and Development (EBRD).[12]

Aside from the professional organizations required for technical fields, all businesses who wish to be legal entities must register with TOBB. Beyond that, businesses can opt-in to the voluntary organizations, and most have at least registered with a sectoral/regional association and KOSGEB. Voluntary organizations are not limited and any group of three or so like-minded businesses can start one and then claim to represent the interests of other businesses, even lobbying the government at times. The chart to the left describes some of the most important organizations and associations—both compulsory and voluntary—who support SMEs through a variety of services and membership benefits.

Despite the plethora of organizations available, a stakeholder explained the system of support organizations as ineffective, saying Turkey suffers from "institutional inflation." Indeed, most businesses simply stated their registration with these institutions almost like they were obligatory tasks to check off when starting their business, even if they never participated or benefited from their services.

Approximately 18% of the sample participated in supporting organizations and associations such as the local Chamber of Commerce, voluntary associations such as the Association for Fasteners, Industrialists and Businessmen, the Poultry Meat Producer and Breeders Association, etc., and KOSGEB. When asked which sponsored activities the business participated in, there were a wide variety of answers, including attending seminars, yearly meetings, and expos, in addition to receiving information via bulletins, emails, and daily SMS messages. Three businesses reported that they had received support in advocating for or changing laws pertaining to their sector.

Overall, participants' opinions on these organizations' effectiveness were mixed, with 45% of participants reporting being satisfied with the organizations they have worked with and 36% expressing dissatisfaction.

Interestingly, a greater proportion of dissatisfied businesses were located in the Marmara region, while far more satisfied businesses were located in Gaziantep. However, in Gaziantep, there was also a higher percentage of businesses who had not even heard of specific programs offered by these supporting organizations. These findings may be a result of the general attitude of independence and self-reliance characteristic of Gaziantep businesses.

While positive comments mostly focused on the actual service being provided, such as the R&D support they received, wages paid for educated employers, low interest loans acquired, etc., the negative complaints centered on cumbersome processes and difficulty contacting the organization. KOSGEB in particular was pointed out as one of the most bureaucratic and difficult organizations to work with.[13]

Additionally, some businesses complained of nepotism as detailed in the authors' note below.

It is difficult to determine whether these organizations have a positive effect on Turkish SMEs due to the lack of publicly available information regarding the actual reach government and independent organizations. Still, many participants mentioned the desire to have representatives from these various institutions visit their business to provide specific advice. Some topics that businesses mentioned as desirable are how to prepare a business plan, how to get into exporting, what specific management tools are available, how to conduct a market analysis, etc.

Author's Note

We noted a high correlation between the positive comments, particularly about the local Chambers of Commerce, and some social connection between the business owner and an official at the Chamber. In some cases, the participant had previously been in a leadership position at the supporting organization and in others, the participant openly spoke about a close friendship with someone at the organization. These participants were also those who seemed to benefit significantly from the programming offered. Other participants insinuated that one's social capital is an important determinant to whether a business receives support.

FINDINGS AND ANALYSIS

Strategy and planning
Human capital
Financing
Competitiveness

Now, with the image of Turkey's economic and political landscape, in addition to the key actors involved in supporting Turkish SMEs, we can begin to understand the main challenges that businesses face and what types of solutions may help them overcome those challenges.

Interviews with business owners and managers largely reinforced what the literature review and key informant interviews indicated: the main constraints of SMEs in Turkey fall into three categories: access to finance, human capital, and enhancing competitiveness.

Thus, this section mostly discusses these constraints and the existing solutions intended to lessen them, as well as potential new solutions. However, first, we begin with the basics of how businesses emerge in Turkey and why professionalization matters for the overall health and longevity of an SME. Professionalization, or a lack thereof, is an important theme that ripples throughout our findings.

Detailed summaries of our most significant findings can be found in each sub-section. These findings are meant to highlight opportunities and to introduce important considerations for financial service providers and public actors alike.

Author's Notes and other boxes provide additional information regarding how current solutions can be improved upon, and statements based on observations and informal conversations. Finally, the ideas found in the potential solutions boxes were developed as a result of our own analysis and directly relate to the SME challenges we have identified. The solutions presented are by no means exhaustive; rather, they are meant to provide a starting point for further development and study.

STRATEGY AND PLANNING

The family-run nature of many SMEs means most owners and managers lack the necessary training and/or expertise to make strategic decisions in human capital and financial management, inhibiting a business from becoming professionalized.

Despite various motivations for starting or running a business, most business owners lacked a strategic plan from day one.

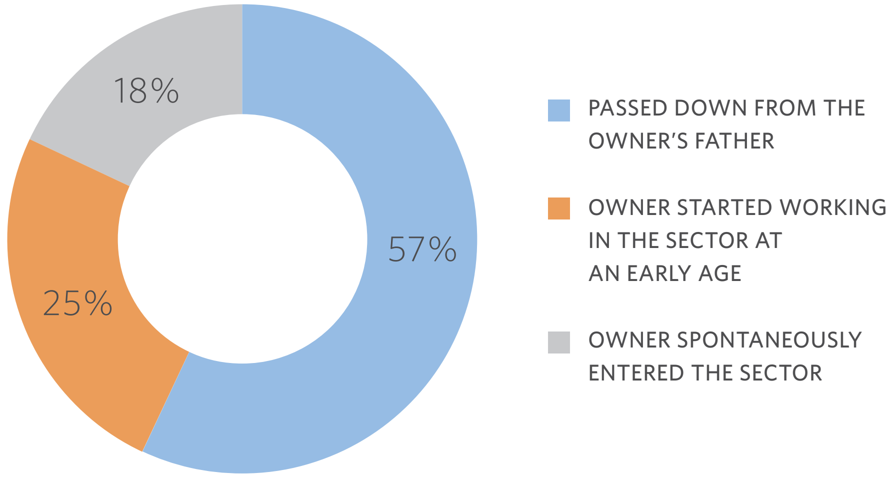
Considering only 10% of already established businesses in Turkey last longer than 3.5 years[14], it is important to understand the most common impetus for starting a business and what inhibits an SME from professionalizing.

Most participating businesses demonstrated an overall lack of formal strategy or planning and a lack of necessary skills or financial resources to conduct due diligence before entering a market.

This could imply a failure to properly allocate resources in terms of reaching target customers, hiring qualified human capital, and preparing for future challenges and opportunities, among other things. In order to effectively expand or enter new markets, SMEs will need to increase knowledge about and use of business plans and strategies.

Despite the various reasons participants gave as their impetus to start or run their business, the vast majority of the SMEs were family-owned, a fact which had significant impact on the extent to which their business had professionalized.

How Participating SMEs Got Started



Family-Run

The family-run nature of many Turkish SMEs impedes professionalization and progress.

In the context of this research, characteristics representing professionalization include established decision-making mechanisms, a governance structure, well-educated leaders and managers, and utilization of market analysis and a business plan.

As is common in many emerging markets, the lack of professionalization complicates the growth of Turkish SMEs in a multitude of ways, which was demonstrated by the in-depth interviews and has also been widely discussed in the literature and by Turkish experts. Participating businesses, not only lacked most of the characteristics comprising a professionalized company, but were generally very strongly managed by a Patron or family patriarch. Upwards of 90% of Turkish SMEs are family businesses which often means power to make any decision is almost always consolidated with the Patron or his sons.[15]

A business run by a Patron is categorized in stark contrast to a more westernized governance style where decisions are made through a hierarchical system of boards, executives, mid-level, and low-level management. The family is usually reluctant to hire professional managers and even if they do, the decision-making authority always rests with the family at the top.

Only 15% of businesses reported having an institutionalized decision-making structure where the boss does not necessarily need to be informed of all decisions. One manager expressed the urgency surrounding this problem: *"It's unclear what will happen when the Patron doesn't show up or dies. The boss makes all the decisions. If he's not there, what is the decision-making mechanism?" (Sales and Marketing Manager at Manufacturing Business, Istanbul).*

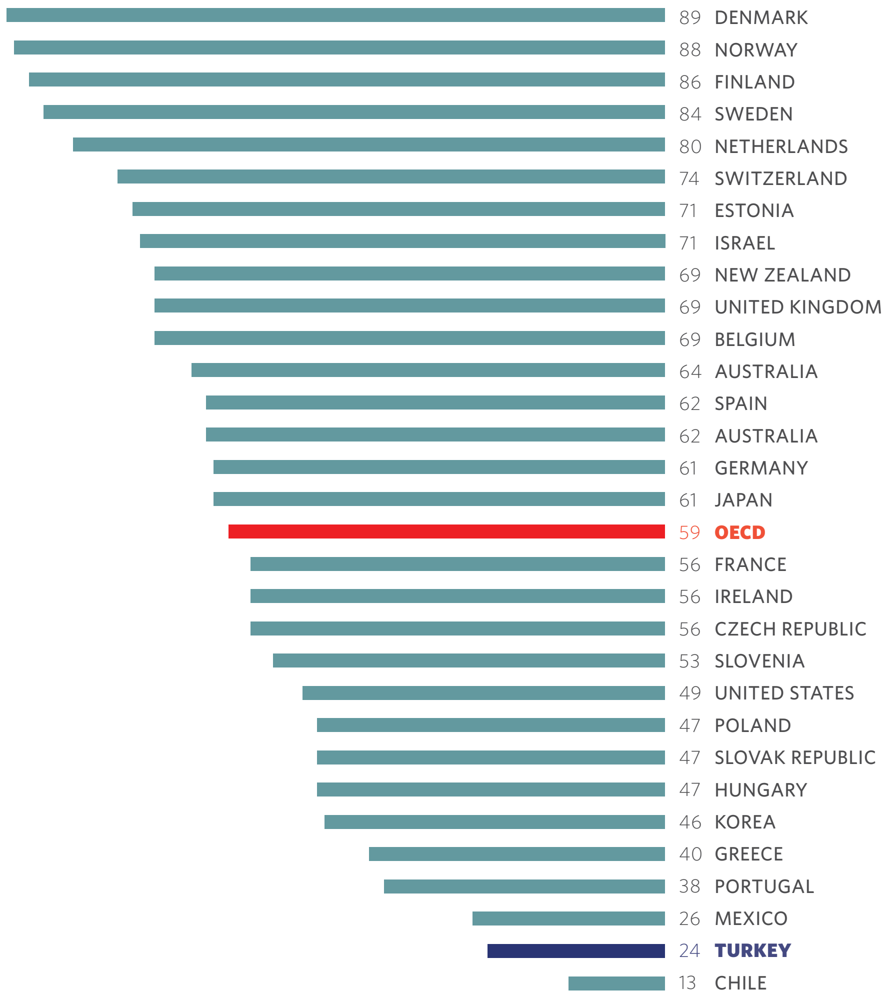
Based on our time spent in the country, we suspect that the reluctance to relinquish control likely stems from historic insecurity, cultural underpinnings, and also limited available resources. Given that nearly 60% of the businesses interviewed have been operating for over 15 years, those businesses have also seen two global economic crises that have left a lasting impression on Turkey's economy.

Additionally, Turkey simply has a less trusting population. In an OECD survey, when asked "Generally speaking would you say that most people can be trusted or that you need to be very careful in dealing with people," only about 24% of interviewees in Turkey expressed trust in others. As can be seen in the figure below, this was considerably below the OECD average.[16]

That, coupled with the fact that many of the participants in our study had invested everything they have into their business, helps explain why many hesitate to place control into the hands of another, particularly if they are not family. As one participant explained, *"Because I started the business from scratch, worked hard to get to where we are today, and was the lead decision maker as we grew, of course we have some issues with trust" (Owner of Furniture Business, Edirne).*

Besides trust issues, some businesses cited a lack of resources as the reason they have not been able to professionalize. One relatively new business owner stated, *"I am the R&D. I am the owner and financial director, everything. Because our company isn't too large...I am the only one in this company that has enough experience. So I am everything" (Owner of Manufacturing Business, Gemlik).*

Percentage of People Expressing a High Level of Trust in Others



Many businesses referenced a certain turning point at which they would be forced to professionalize, although pinpointing exactly what that juncture would look like proved difficult. Some used a certain level of turnover as a point of reference while some suggested that professional managers would be needed after hiring a certain number of employees.

Others simply had a phase of their business in mind; for example, one business owner stated, *"We have an industrial engineer [outside the family] working in the factory but we're responsible for management. When we grow big enough, when we start producing aluminum ourselves, we'll be forced to hire more employees outside the family and go corporate" (Owner of Manufacturing and Export Business, Gaziantep).*

Whether an SME feels forced to professionalize through expansion, or simply resists the process all together, the lack of professionalization seen amongst Turkish SMEs tends to be written off as a side effect of an underfinanced SME segment.

While this may be true, without knowledge of business administration, SME owners and managers may not understand or recognize the importance of professionalization, or of many other components such as how to invest in the business, what customer bases to target, what strategies to employ when expanding, etc.

This phenomenon will likely continue to produce short-lived businesses and prohibit many family-owned SMEs from strategically placing human and financial resources to fulfill both short and long-term goals.

Lack of Clear Strategy

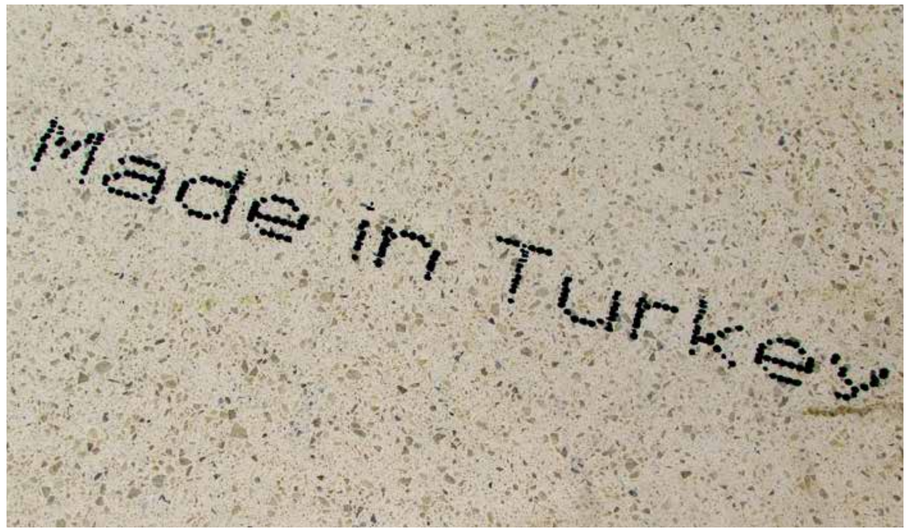
Most businesses lacked a business plan or clear strategy.

One area where the negative impacts of an under-professionalized SME segment became painfully clear is in the lack of business plans or strategy. Of the respondents asked, 53% stated that they had created a business plan.

However, based on the perplexed looks in response to the question, and a lack of details surrounding these ostensible business plans, the extent to which these were thorough, official business plans was much less certain. In fact, only one business showed us a physical business plan, which had been modeled after a KOSGEB business plan.

Despite the lack of evidence indicating creation or use of business plans, 73% of respondents could articulate business goals, which included, among others, increasing capacity (33%), expanding international business (27%), improving their position in their sector (21%), and simply surviving (12%). These goals demonstrate that, for the most part, participants aspired to grow and expand.

They are not necessarily satisfied with their current size and market share. However, strategy and planning will be crucial to pushing Turkish SMEs and the economy in general to the next level. After all, as one stakeholder put it, *"If business owners think in terms of 'as long as I buy a home and go on vacation', that's as far as they'll grow" (Neslihan Tombul, Board Member of Turcas Petrol, Expert in Banking and Finance)*



HUMAN CAPITAL

72% of respondents cited finding or hiring employees as one of their greatest challenges. However, the vast majority of those were comments from Gaziantep.

Participants reported a gap between the skill levels currently available in the workforce and their employment needs. This shortage appears to exist for both skilled and unskilled workers.

Many respondents struggle to recruit, retain, and fully utilize talented human capital, often as a result of the family-run nature of the business.

This section highlights the most pressing concerns related to finding, hiring, and retaining employees. As one of the most frequently cited challenges to SMEs in general, participants were asked whether they faced constraints in human capital, in addition to follow up questions about recruitment, training, and retention.

Most of the businesses that reported human capital as a primary constraint focused on the challenge of actually finding qualified employees. A qualified employee in this case means someone educated and/or trained for the level of work needed.

Overall, business owners complained slightly more frequently about their ability to find skilled workers as they did unskilled workers; although, even when pressed, the vast majority of business owners and managers struggled to articulate any unique challenges associated with those different groups.

Well-placed, qualified talent will be an important step in moving Turkish SMEs to the next level. For Turkey, this will necessitate a convergence of the education system with employer needs, more coordinated efforts to find and place employees, and re-conceptualized retention strategies focused on increased employee autonomy and improved working environments.

"Even though unemployment is quite high in Turkey, trying to find the skilled person that really meets your needs is an extreme challenge. What ends up happening, is you find someone from the university and you train them. This slows the whole process down."
- Branch Manager at Seker Bank, Gaziantep

Current Solution to Labor Shortages: Undocumented Workers

Participants reported that businesses are employing Syrian refugees and other undocumented laborers as it brings the advantage of saving on social security payments and other labor costs. The temptation is likely increased due to an influx of nearly one million Syrian refugees alone. Still, only a couple of businesses we spoke to openly admitted to employing undocumented Syrian workers:

"We are not content with our workers but we have felt relieved after started hiring Syrian refugees. Most of the sectors employ Syrian refugees. Hiring them is more appealing, when you consider the lower fees involved and no social insurance payment. The government overlooks the current circumstance" (Owner of Textile Business, Istanbul).

"The factory environment is really dusty, the job is physically difficult. They don't want to work here. It's not only a salary issue. Sometimes we hire Syrian workers, but it's illegal. Right now, we have 3-4 Syrians working who are talented and I will continue to work with them"(Owner and Production Manager of Construction Materials Business, Gaziantep).

Finding Talent

Finding and hiring qualified employees is the first challenge.

With an official unemployment rate of 8.8%, there are approximately 2,551,000 people in Turkey who are currently unemployed. An even more revealing statistic shows that Turkey's rate of people aged 15-29 who are neither employed nor in education or training (NEET) is 35%, which is the highest rate among OECD countries.[17] This means there is a significant number of youth who are not employed, nor enrolled in school.

With such a significant number of people out of work, we did not expect business owners to report such difficulties finding employees. On top of that, the significant influx of people fleeing regional conflicts has also increased the number of people seeking employment.

Despite what appears to be a large pool of potential employees, 72% of SME respondents still cited finding or hiring employees as one of their greatest challenges. Interviews revealed that the majority of businesses use informal recruitment strategies, such as leveraging personal networks and asking current employees to find new workers.

These strategies were most common in Edirne and Gaziantep, but were least prominent in SMEs located in Istanbul, where businesses were more likely to use formal channels such as an online site like Kariyer.net, newspaper advertisements, or hiring agencies.

Those businesses were also more likely to look at resumes for a candidate's education and number of years of experience. Over a quarter of the participants in Gaziantep reported using the Turkish Labor Agency's (ISKUR) employment service, while no businesses reported using that service in the Marmara region.

The use of informal recruitment strategies, while congruent with the culture of leveraging social networks, is most likely putting additional strain on SMEs as they could be focusing recruitment efforts on different strategies, regions, or demographics

Matching Skill Sets

A mismatch exists between the skill sets of potential workers and the needs of SMEs.

When labor shortages were discussed, they were in relation to both skilled and unskilled workers. Approximately 25% of the participants struggled to find even unskilled laborers. Recent legislation introduced by the AK Party may be perceived as exacerbating these supposed labor shortages of low-skill workers.

Commonly referred to as "4+4+4", the education legislation now extends compulsory education to 12 years. One business owner explained his theory on labor shortages: *"In the past, people started working through apprenticeship after graduating from primary school, at the age of 12. But now, people start working after graduating from high school, at the age of 18 or 19. We have either unqualified workers or engineers. No workers in the middle, no technicians" (Owner of Manufacturing Business, Gaziantep).*

Just short of 30% of the participants expressed a need for workers with the necessary technical knowledge to play a supervisory role and/or to perform highly specialized tasks. Other qualities sought after in a skilled worker were foreign languages or management skills. Speaking English is an increasingly important skill, given the growing amounts of exports and partnerships with foreign companies.

A small number of businesses did point out that they struggled most with mid-level managers – those with the technical skills of the specific sector who could also manage less skilled employees. According to a report

Author's Note

Out of 33 SME participants, we only spoke with two women, both managers in their respective businesses. Although we were told that more women are starting to own businesses, we could not manage to interview any of them.

Moreover, we specifically asked some business owners whether the family patriarch ever passed the business on to daughters as well as or instead of sons. Very few interviewees responded affirmatively, and we found no concrete examples of that practice.

> *"SMEs aren't the most sought-after employers. It's hard to attract the talent as SMEs are always in financial trouble. The talent prefers to join corporations, banks, and tech companies. The future career opportunities are not clear in SMEs and the business plans are pretty simple."*
> *- Head of SME Department at ING Bank*

POTENTIAL SOLUTIONS

ISKUR can act as a supplementary solution to in-house training and vocational schools.

Part of the government's vocational training plan is ISKUR, the Turkish Employment Agency which provides vocational training and other employment support services in order to upgrade the skills of job seekers and help them find productive employment. In 2012, ISKUR trained 464,000 people, most of whom had less work experience and were more educated than the average job seeker.

One of the SMEs interviewed had participated in an ISKUR program: *"We collaborated with ISKUR, the employment agency, in terms of giving technical education to 20 trainees. They arranged a 3-month long training period. But we needed at least 1-year long program. The agency required us to hire at least 50% of the trainees. We hired 19 out of 20" (Owner of Food Production Business, Gaziantep).*

Also, approximately 45% of the businesses specifically mentioned in-house training programs. The duration of training programs varied widely, from two weeks to a year to even five years. Overall, the duration depended on whether the employee needs rudimentary skills to complete his/her job or whether he/she needs higher-level skills to be considered a 'master'. While the vast majority of businesses did not offer any particular opinion about having to train new employees, some pointed out important challenges.

Both interviews with SME participants and supporting evidence such as a World Bank evaluation of ISKUR's vocational training programs indicate that the skills taught to potential employees need to be adjusted to the needs of employers. Specifically, Turkish employers value and desire tangible skills that could be better emphasized in vocational schools, colleges, and training programs.

Increased usage of ISKUR and other job search sites such as Kariyer.net would help match employees and employers. However, this is conditional on employers actually using services like ISKUR to find employees, which should not be taken as a given considering the perceived high labor costs in terms of minimum wage and benefits.

Women can help narrow the skills gap and expand the talent pool.

The female labor participation rate (FLPR) in Turkey sits at a mere 29% as compared to the OCED average of 61%, implying a massive missed opportunity. Including more women in the workforce is not simply about advancing human rights—it just makes economic sense. While increasing the number of working women may decrease wages in the short term[24], increasing the already low FLPR would also provide a significant boost in real GDP per capita. According to the Economic Policy Research Foundation of Turkey (TEPAV), if the AK party reaches its goal of a 38% FLPR by 2023, GDP per capita will grow by 5.6%. Furthermore, if the FLPR reaches 50%, real GDP per capita growth could soar by 12-17.5%.[25]

Both public and private actors should provide additional support to women who aspire to work in order to increase the available labor supply. Since 87% of girls have a secondary-level education and 32% have attended vocational and technical schools,[26] women have the ability to help fill the gap of skilled and mid-level employees. SME owners in Turkey operate in an increasingly diverse business environment. The SMEs who value their country's most talented people—regardless of their sex—will be the ones most likely to thrive.

However, this proposed solution is not likely to materialize without complications. Currently, a large majority of women exit the formal sector and are hired for lower wages without job insurance and social security. Institutional barriers such as a lack of child and elderly care services mean women, even highly educated ones, are not able to utilize their skills and participate in the workforce.[27]

Traditional gender roles and norms tend to act as barriers for females, which may be reason that SMEs in manufacturing have less than 14% female participation in their full-time workforce. These cultural barriers negatively affect the FLPR in more conservative areas, where a women's role is traditionally fulfilled at home, as a mother, wife, and caretaker. Targeted efforts to increase the FLPR are most needed in the conservative Southeastern region—where only 18% of full-time workers are female despite the high prevalence of SMEs in the region.[28]

Yet, rallying support for such targeted efforts may prove to be difficult. Uproar following President Erdogan's remarks on this issue suggest further complications for this proposed solution. Erdogan stated at a conference, *"you cannot bring women and men into equal positions. That is against nature, because their nature is different."*[29]

Erdogan and his ruling AK Party seem to be in disagreement with the basic principles of gender equality – both at home and in the workforce. This implies inadequate government-led attention to and support for the introduction of more women into the workforce.

published by one of Turkey's largest holdings, the education system at large does not generate graduates capable of mid-level positions.

While Turkey provides free education, with almost universal enrollment at the primary level, the country's standardized test scores indicate that the education system is still relatively weak.[18] Moreover, only approximately 30% of adults aged 25-64 have earned the equivalent of a high school degree, which is dramatically lower than the OECD average of 75%.[19]

The working age population with less than a basic education accounts for most of the jobless and informal workers.

While the previously discussed lack of formal recruitment strategies may be contributing to the difficulties in locating workers, overly theoretical degree programs, with insufficient focus on practical skills, were often cited as a reason for the skills gap. Specifically, participants focused more on the perceived ineffective vocational school system.

Turkey's education system consists of both a university track and a vocational track, including vocational and technical high schools and colleges. Out of the 10,955 formal education high schools, 58% of them are vocational and technical high schools and they teach approximately 50% of secondary students in the country. Following secondary school, students may choose to attend a two-year vocational college which prepares students for advanced technical and vocational positions through both theory and practice.[20]

Half of the respondents that mentioned vocational schools believed that there are not enough students graduating from them, particularly compared to the number of those graduating from university.

> *We have high quality people for Turkey's standards despite low wages. They work here because maybe they love the company, they are comfortable, feel safe. They are high quality people, but work here for personal reasons even though they work for lower wages. Employees stay for a long time. Emotions persuade them to stay. Not the money – we don't have the money to persuade them! We have hope.*
> *- Sales and Marketing Manager at Manufacturing Business, Istanbul*

A couple of business owners pointed out that there are either not enough schools or not enough students choosing to attend them. For example, one business owner stated, *"We need more vocational schools. I hire people from vocational schools that are more qualified than people who are foreign educated who don't fulfill our requirements. Vocational schools should supply businesses with human capital. Now there is not enough supply from vocational schools, but too much from the university"* (Owner of Textile Manufacturing Business, Gaziantep). Several other respondents unsatisfied with the vocational education system claimed that graduates were not of high enough quality.

These findings are supported by a survey conducted by the Union of Labor of Education and Science, which concluded that despite the increasing number of graduates from vocational high schools, 49.7% of enterprises do not see graduates of vocational high schools qualified for needs of the business world.[21]

71.3% of these graduates of vocational high schools quit their education paths right after high school, implying a large volume of workers who will not obtain further training and do not necessarily match the needs of many SMEs.

The study hypothesized that the problem results from poor physical infrastructure due to low investment (approximately 20% of the education budget), and from a lack of satisfactory collaboration between vocational schools and enterprises.[22]

Some of the AK Party's 2023 goals are explicitly geared towards solving this problem of lack of vocational skills. They have promised to allocate approximately 1.5 billion Turkish lira (6.6 million USD) and to give vocational training to 400,000 unemployed people each year.

Additionally, their Vision for 2023 document pledges to increase the number of standards required for vocational competence in order to meet world standards and to continue incentive programs to increase employment among women and the disabled.[23]

Talent Retention

Beyond hiring, SMEs struggle to retain and fully leverage talented employees.

While Turkey's unemployment rate has been increasing slightly since mid-2012, it is still at its lowest rate since 2001. This implies a relatively tight labor force where employers face steeper competition for talented employees – a fact that was confirmed in participant interviews.

On the one hand, this empowers employees who can put greater demands on employers for increased wages, more benefits, and improved workplace conditions.

Additionally, Turkey's workforce is young, which can imply a growing intolerance of discrimination, resistance to tight systems of control, and less loyalty to one employer.

On the other hand, the younger population has fewer skills and experience to use as leverage in hiring processes and wage negotiations. This context is important for SMEs to understand when managing their employees.

Approximately 25% of respondents said they use wages to retain employees. However, those business owners and managers whose only stated strategy for keeping employees was through their wage, were more likely to complain about their inability to keep workers.

Stealing qualified workers was also mentioned: *"It is impossible to find an available experienced worker. You must find them from your competitors. You ask the worker you would like to hire how much his wage is, and for example if it is 2000 TL, you offer him 2500 TL" (Owner of Construction Business, Gaziantep).*

Just over 30% of respondents believed other conditions were the reason employees chose to stay, the most common of which was the general work environment, including a friendly boss, working with nice people, and the existence of new machines. Other conditions stated included reasonable working hours and professional development.

From a potential employee's perspective, a business' level of professionalization may also be an important condition when deciding where to work. As mentioned in the Strategy and Planning section, most SMEs are strongly managed by Patrons, which is not necessarily a positive trait for prospective employees.

As one general manager of a pump manufacturing business explained,

POTENTIAL SOLUTIONS

Clearly delineated career paths and more flexibility may help retain talent.

Progress towards hiring professional managers and establishing a decentralized governing structure will contribute to overall better management of human capital, particularly if people trained in business administration and management are hired and given responsibility in the business.

Additionally, Turkish SMEs may be better able to recruit talent if they provide and emphasize career paths both for educated employees and also for those employees who start as apprentices. If an SME could initiate an institutionalized system of upward mobility, they may have an easier time recruiting and retaining talent while also mitigating some trust issues as the employee would be trained by their own hand and be well integrated into the family business.

SME owners and managers should also work to allow employees to use their talents and should demonstrate stable leadership qualities such as effective communication with employees. Moreover, work-life balance initiatives are becoming more prominent in retaining talented employees; these may include flexible working hours, time off, and childcare facilities.[30]

Finally, SMEs should consider their employer brand. By identifying their differentiator and then communicating or leveraging the brand through core messages and appropriate language, they can create a reputation which will in turn help attract quality employees.

"The best for professionals is to work for a company without a Patron. I've worked in those companies and it's nice because you don't know the Patron, there is no Patron, everyone is an employee in the end, even the general manager. So you're more comfortable. The general manager and the chairman of the board are all working for the company" (Sales and Marketing Manager at Manufacturing Business, Istanbul).

Another manager explained how the company retained talent:

"…even though we are a family-owned company, the workers don't feel it because our boss is only in contact with top management and he doesn't get into details. It is like a big company and has a corporate culture. We are also open in terms of costs, communication. Nothing is hidden from our employees or partners" (Deputy General Manager at Printing and Stationary Business, Istanbul).

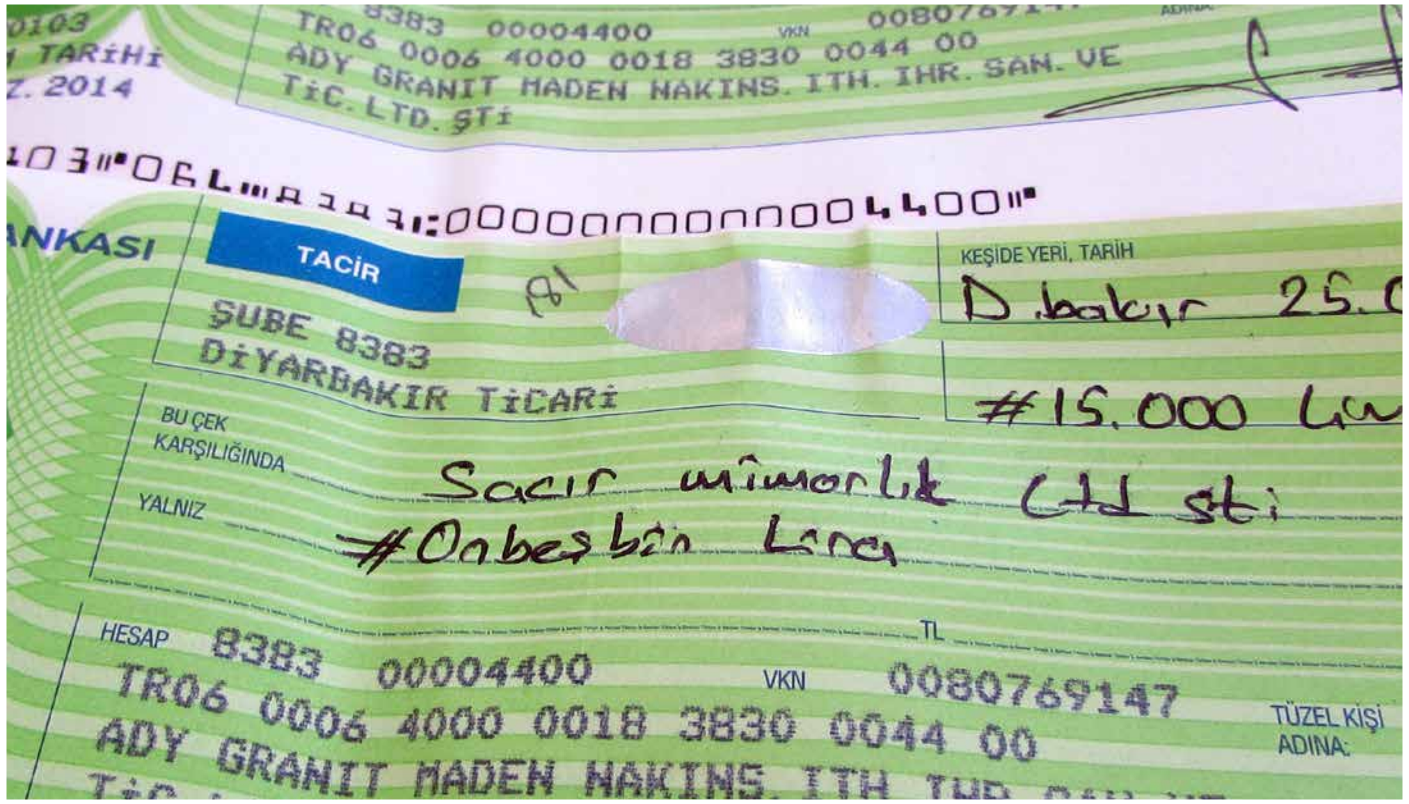
Patron-style management often precludes a sense of autonomy in decision-making. Studies show that, even more than wages, being given responsibility and being trusted to complete work at one's skill level contributes significantly to an employee's job satisfaction.

A commonly held perception of Turkish business owners is that "*they don't trust other people to actually manage to the extent that they can. They don't want to take on the risk and lose control" (Portfolio Manager at Yapi Kredi Leasing).* This attitude affects management style as people reportedly manage by seeing—by walking around their factory, or even using video cameras.

Professionalism is also important for managing human capital because it provides a sense of stability both in greater confidence that one will receive a paycheck consistently and on time, and it presents the possibility of a future career path.

Non-family employees may feel trapped in SMEs because there is no upward mobility; they are concerned about their career path and where a job will take them. Given the tight labor market, employees have their pick of jobs, so salaries themselves will not be a sustainable way to keep workers. There have to be other incentives to stay.

FINANCING



Abundant capital is indeed available in the market, but actually accessing that capital is the main problem faced by businesses who reported prohibitive borrowing conditions, such as high interest rates and strict collateral requirements.

SMEs are perceived as high-risk investments, particularly due to a lack of transparency.

A mismatch exists between bank and SME expectations, fueling distrust and ultimately harming both banks and businesses.

Cash flow management is also a challenge for business owners who struggle to collect payments and to deal with the system of long check maturities.

This section describes SMEs' challenges with financing their business, from start-up capital to operational expenses and long term investment financing. The literature indicates that both the availability of funds offered to SMEs and the ability of SMEs to actually access those funds present challenges to business owners.

In Turkey, however, there is an abundance of capital technically available to businesses; the main challenges reported by SME owners and managers were in accessing the capital and in managing cash flow. Interestingly, business owners and financial service providers disagree about the root causes of those challenges – the former blaming barriers mostly related to the banks, and the latter pointing to lack of professional management of most businesses' accounts and finances.

The implications of these findings are two-fold: (1) increased access to capital, particularly to long term financing, could help SMEs grow and expand, and invest in R&D to enhance competitiveness, but (2) access to capital will not likely improve until there are some gains in professionalization – thus, financing alone will not be the magic bullet to SME success.

Access to Capital

Business owners are banked and banks have money, but access to capital is a common complaint.

Banking penetration is high in Turkey, with 58% of the population having an account at a formal financial institution.[31] Of the Rapid Growth Markets (RGM), Turkey has the highest ratio of branches to people, with 18.3 branches per 100,000 adults.[32] Banks are increasingly loaning more money to SMEs. Compared to other OECD countries, such as Chile, France, Korea, Russia, and Switzerland, Turkey experienced the greatest expansion in SME lending over 2010-2011. The share of overall SME loans has increased from a mere 4% in 2004 to 37.5% in 2012.[33]

While the largest proportion of total business loans continues to be allocated to low-risk corporate borrowers, the growth of lending to consumers and SMEs has outpaced other categories since early 2010.[34]

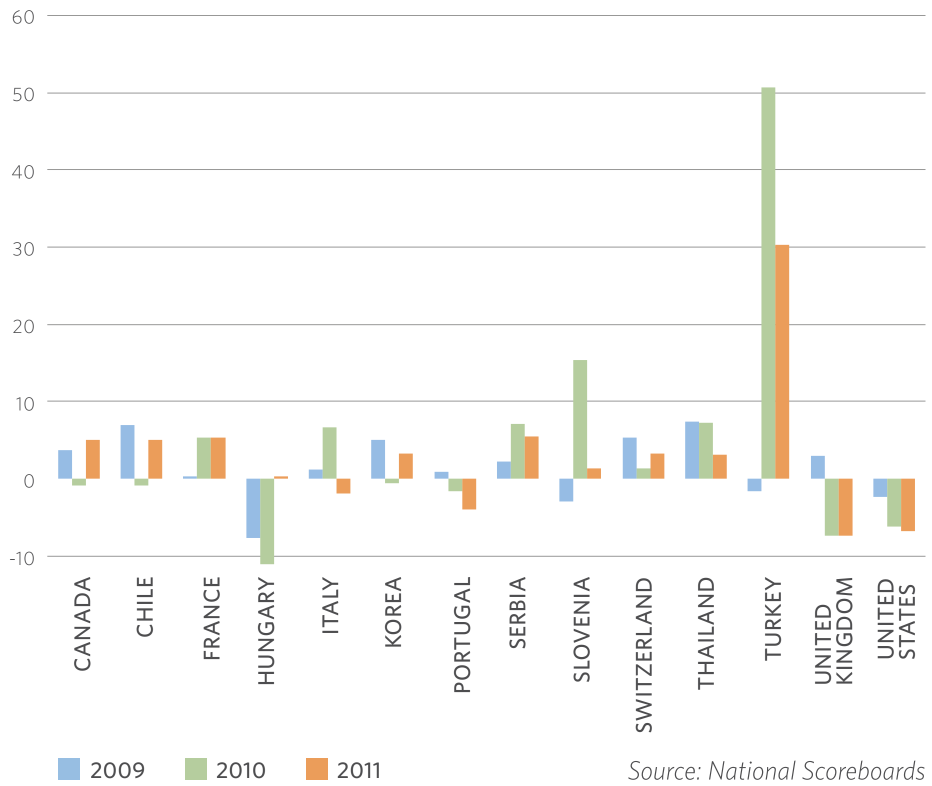
However, despite the increasing loan allocation to SMEs and the heightened attention on SMEs from government organizations, 42% of SMEs interviewed described access to capital as one of their most severe constraints.

Discussions surrounding this topic circled around a few pain points, namely: prohibitively high interest rates, difficulty finding sufficient collateral, and misperceptions between SMEs and banks.

Of the participants who described access to capital as one of their greatest challenges, 42% specifically cited high interest rates as the problem. A public website called The Bodrum Bulletin shows the interest rates of 14 main banks, none of which were above 9.6% as of the end of August 2014.[35]

When asked, participants generally reported that current rates range from around 10-15%. The discrepancy is not overall that shocking since the interest rates from The Bodrum Bulletin are those advertised by the banks themselves and the actual assignment of

Growth of SME Loans



Source: National Scoreboards

interest rates to businesses includes an individual risk assessment.

Strict collateral requirements were the second most cited barrier to accessing capital. Despite having a credit limit at a particular bank, 27% of respondents stated that a lack of appropriate collateral held them back from accessing capital. Interestingly, collateral requirements are actually more demanding for medium-sized enterprises in Turkey.

These firms typically have to provide more collateral as a percentage of loan value than small firms (104% for medium-sized enterprises versus 83% for small and large firms, respectively[36]). In terms of specific collateral types, banks were reported to demand physical assets in the form of real estate, such as land or homes, whereas businesses were most often prepared to use their machinery, factories, or personal assets as collateral.

One Istanbul business owner described his experience with non-flexible collateral requirements: *"We were able to get loans with good terms but as an SME who puts all of the money we earn back as an investment, it is kind of risky. Banks are so powerful in those situations. So, we tell them: We don't have any savings because we are reinvesting it in our company. Should we instead buy more homes to use as collateral or reinvest it in our company?" (Owner of Entertainment Business, Istanbul).*

The issue of interest rates and collateral is a common one in emerging markets as banks balance the huge potential of lending to SMEs while also considering their accompanying default risk. Turkey's sovereign risk profile, as highlighted in the introduction, results in overall higher

> *"Interest rates are maybe not as high as the past decades, but compared to current profit margins, it is really high. Your profit margin is 10%, you pay 50% of this to interest."*
> *- Owner of Textile Manufacturing Business, Gaziantep*

interest rates. Since mid-2013, the borrowing costs for Turkish business owners have increased, and according to Moody's, this spike in interest rates significantly affects SMEs and their ability to take new loans.[37]

Of the many institutions that intervene in the credit markets (see Key Stakeholders in the Turkish SME Landscape section on page 20) the Credit Guarantee Fund (KGF) is a tool that played a prominent role in our interviews with financial service providers and SMEs alike, yet none of the participating SMEs had actually benefited from this public intervention.

The KGF, in addition to Turkish institutions like KOSGEB, and The Turkish Tradesman and Craftsmen Credit and Guarantee Cooperatives' Union (TESKOMB), provide credit guarantee for SMEs to get access to credit in the domestic market, therefore addressing the common complaint that collateral requirements prohibit SME access to capital.

However, the KGF has yet to fully address the issue of collateral constraints, as banks are hesitant to participate due to bureaucratic delays in the payments of guarantees and overall cost issues. Only 52% of banks in Turkey accept KGF guarantees, and only 33% of applications are accepted by the KGF equity, further proving the barriers to access to credit in the Turkish market.[38]

Risk Perception

The lack of professionalism and transparency increase (perceived) risk of SMEs.

Financial service providers find lending to the SME segment risky. This is in part due to the fact that only 10% of already established businesses in Turkey last longer than 3.5 years.[39] The high rate of failure adds to the risk that financial service providers must bear when working with SMEs. *"Being small comes with the risk of bankruptcy," said a financial service provider in Istanbul, "Because the scale and production capacity of SMEs are lower than larger counterparts, the risk of bankruptcy is much higher for them."*

However, there are also micro level indicators which increase an individual SME's risk and, in turn, their interest rate and collateral requirements. As a representative of ING Bank explained, assigning the terms of a loan is an art, and pricing depends on a unique combination of criteria that gives a bank an estimated likelihood of default.

Criteria such as company and client assets, the duration of a company, a client's history with the bank and usage of other banks, and a client's knowledge of and experience in a particular industry are just a few components of the risk evaluation process. Several financial service providers said that businesses often failed to provide coherent invoices and transaction histories which are essential for banks to trust them as borrowers. This most likely stems from a lack of knowledgeable financial professionals working in most SMEs, an issue covered more thoroughly in the previous sections.

The financial documents provided to banks also cause concern as it is widely known that most Turkish businesses do not accurately represent all of their transactions. A representative at Finans Bank explained, *"Most businesses have two sets of financial metrics, official and unofficial. Maybe 80% of annual turnover is unofficial. That's why banks can't see anything and why some SMEs are unbanked—they can't prove they're doing a business. They are relying on family or personal loans."* This practice further complicates a financial service providers' ability to accurately evaluate the creditworthiness of potential SME clients.

Yet, from an SMEs' perspective, the loan application processes can seem opaque and cumbersome; as one construction chemicals producer said, *"I've had overall negative experiences with banks. Other than high interest rates, whenever we used bank loans in the past, we've had to jump through so many hoops" (Owner of Construction Chemical Manufacturing* Business, Istanbul).

In order to deal with the lack of transparency, two systems were put into place to help gather intelligence on potential clients.[40] These intelligence-gathering systems, Memzuç and the Credit Bureau (KKB), are outlined in the box above. From the financial service providers' perspective, these systems are seen as a new era in risk management. In fact, each customer available in KKB database is queried 10 times a year on average, allowing banks to make more accurate decisions about their clients.[41]

Prior to 2012, the KKB was only available to corporations, but is now open to individual consumers. According to the EBRD, however, the KKB still remains a work in progress, as it presents a number of inefficiencies in terms of processes, data quality, and consumer protection.[42]

Memzuç and KKB

Memzuç: Owned and operated by the central bank of Turkey, Memzuç is a credit bureau whereby financial institutions report monthly and gather information on a client's credit history. Reported information includes:

- Transaction history and payment performance of firm and its partner(s)
- Balance sheet and income statements, if they exist
- Market intelligence and references
- Sector and date of establishment

Credit Bureau (KKB): Turkey's first Credit Bureau, Kredi Kayıt Bürosu was founded on 1995 in partnership with 11 leading banks in the sector. KKB is widely used in allocation, monitoring and collection processes for credit risk management of the banks and other financial institutions.

Banks and Businesses

There is a discordant relationship between banks and businesses.

Banks and their SME customers suffer greatly from a lack of understanding and mutually understood expectations. First, businesses understand banks' value proposition quite differently than banks themselves. Most banks, based on interviews and also their websites, promote non-financial services as a unique value-add to SMEs, as well as a key strategy to differentiate from competitors.[43]

However, SME clients do not choose banks based on these non-financial services, but rather price is the top consideration. Surprisingly, when asked whether they had heard of non-financial service offerings from banks, almost none of the business owners had heard of nor taken advantage of non-financial services offered by banks.

Whereas banks portray themselves as allies looking for the best ways to maximize SME success, over a quarter (27%) of respondents discussed a lack of trust in financial service providers as a major constraint. Online advertisements, TV commercials, and billboards across Turkey proclaim that banks are open for the business of SMEs; yet, conversations with business owners generally revealed an overall lack of confidence in a financial service provider's ability to deliver the most appropriate services with fair conditions.

Consequently, 12% of SMEs interviewed actually admit to manipulating their financial statements and loan applications to get the best deal possible; this implies deliberate undermining of banks' risk assessment processes and of the transparency supposedly created by Memzuç and the KKB.

Business owners, particularly in the city of Edirne, claimed to shop around each season and employ a variety of strategies to obtain more favorable interest rates.

Whether the strategies involved shifting money from account to account to look less vulnerable, or simply using fast decision-making and timing to avoid paying higher interest rates, SME owners were aware of their overall inferior position vis-à-vis banks and, hence found clever techniques to increase their power.

Additionally, the lack of trust and level of manipulation means that most businesses use many banks, sometimes playing their offers against each other. Out of 33 businesses interviewed, not one business admitted to pledging allegiance to one individual bank.

More commonly, businesses worked with at least two banks, and sometimes utilized up to 10 banks; this tendency for SMEs to have a multi-bank portfolio is in stark contrast to banks' preferences where long-term and loyal relationships with customers are prioritized. Furthermore, it implies that banks will need to work harder to sell a full range of products to their SME customers.

In addition to the trust issues discussed in the Strategy and Planning section, businesses also fear what they call "callbacks," in which a bank will demand that a business immediately repay its debt. *"The banks often threaten us to return the money we have borrowed. When they give you a credit call, you must pay back the loan in full. This equates to a business going bankrupt" (Owner of Construction Chemical Manufacturing Business, Istanbul).*

This distrust was more pronounced in the southeast; while accessing capital seemed equally challenging for businesses in the Marmara region as in the Southeastern region, there was a noticeable difference in the sources of funding used and the attitudes towards using banks. To cover operational costs and business investments, 100% of all

> *"Erdoğan and the government have put a very high priority on taking Turkey from the world's 17th largest economy to the 10th largest by 2023, the 100th anniversary of the Republic. The growth of the SME market is an essential component to this.*
> *- Arthur Sculley, CEME Senior Fellow at The Fletcher School, Tufts University*

Author's Note

Based on evidence of an overly distrustful society (see OECD survey on page 28) and comments made to us by family-owned business owners in Gaziantep (approximately 60% of the regional sample), we hypothesize that family-owned businesses are less likely to accept outside financial help (i.e. sources that are not associated with family).

This may be due to an overall lack of trust in the banks, conservative values present in the region, and an overall fear of rapid business growth. As established in the Strategy and Planning section, expansion and growth generally lead to a business voluntarily or involuntarily professionalizing. This process of professionalizing entails giving up a certain portion of control over the business – a reality that did not seem to bode well with the Patrons we spoke to in Gaziantep.

POTENTIAL SOLUTIONS

Financial service providers and SMEs should work together for better access in the long term.

Banks should develop more innovative ways of profitably lending to SMEs, while the SMEs should also strive to make themselves more attractive to banks by improving their record keeping, financial acumen, and level of professionalization. Through our research, including conversations and discussions with each stakeholder group, we have devised four potential solutions to narrow the financing gap:

1. Financial Service Provider Solution

The role of relationship manager (RM), an already established channel of direct communication and knowledge sharing between banks and SMEs, should be enhanced to provide a greater breadth of services tailored to individual business needs.

Considering the various degrees of professionalization, the potential value that an RM brings cannot be approached as "one size fits all". RMs must be nimble and be able to provide the necessary guidance based on the financial and business acumen of that particular SME owner.

According to a recent study on SME banking done by Accenture, an RM's style is also important and nuanced.[44] Some SMEs may value an RM who "knows them personally", while others may prefer simply a "transactional RM", who knows the products well and can execute on their behalf.

SME owners could benefit from a heightened role of the RM, including more guidance on the loan application process and how to effectively monitor and predict their future cash flows. SMEs, in turn, will be better equipped to tackle the loan application process, access a wider spectrum of financial tools, and quite possibly, do a better job of representing themselves as a lower risk customer to banks.

2. Financial Service Provider Solution

Banks can do more to ensure transparent application processes and credit assessment. For example, banks could provide details on how a potential client will be evaluated based on specific loan criteria, how credit history will impact a bank's decisions, and provide feedback on all loan evaluations. With the new generation of SME-owners becoming more tech-savvy, these examples could eventually be put in place via online systems that allow for direct feedback.

3. Public Institution Solution

Local chambers of trade and commerce could institute a program using role models from local business communities; a role we coined "SME ambassadors." This solution manifested itself through interviews with SMEs, who often cited a lack of existing mentorship. SMEs ambassadors could be businessmen or women, who have been successful in either accessing outside public or private supports, have navigated foreign export markets, have a number of years of experience in a particular industry or sector, among other attributes.

4.SME Solution

As part of the professionalization process, SMEs should consider hiring experienced accountants and also financial advisors. While SMEs in Turkey often hire accountants to do internal audits and provide basic advice, more often than not, these positions are blended with a finance department and thus, important individual roles become blurred.

By opening separate finance and accounting departments, and recruiting professional managers, an SME has the potential to significantly boost its financial performance.

participants in and around Istanbul reported primarily utilizing loans, whereas 78% of respondents in Gaziantep reported primarily using retained profits.

Although 63% of Gaziantep participants also utilize bank loans in combination with retained profits and personal funds, their attitudes towards borrowing, as highlighted by one participant, were often negative: *"I started the business with 40 kilos of pistachios and I made it just fine. Why take the small profits that we earn just to give it back to the banks?" (Anonymous Participant).*

Although many businesses voiced strong opinions against using banks, virtually all of the businesses still used them. This, at least in part, is due to the fact that in order to even have the potential of taking out a loan, a business must first have a credit limit set with a bank. Another frequently used non-loan service is selling checks to the banks before they mature. Still, with a more positive and trusting relationship, businesses, particularly in the southeast, may be more apt to utilize more bank services.

The literature generally highlights lack of knowledge about financial services as one of the main barriers to SMEs' access to capital, primarily due to the fact that many business owners have no training in administration, finance, accounting, and human resources.

In the current study's sample, only 6% of SME owners had an MBA and few others had formal training in those categories, but the participating business owners were well informed on a limited spectrum of financial services offered by banks, such as loans, credit cards, and factoring and leasing services.

They do not, however, know the full range of services available such as lines of credit, cash management products, SME consultants, free trainings, investment products, etc. Many of the participants could greatly benefit from those types of services which begs the question: are the services actually accessible and how can utilization of them increase?

Despite misunderstandings between SMEs and banks, the two parties do agree on one point; high interest rates and collateral requirements present significant challenges for businesses. In order for progress to be made toward alleviating these constraints, bilateral changes will need to be made.

Serving SMEs effectively is central to the success of banks across Turkey; these customers constitute a valuable segment which is also a key driver of economic growth. For SMEs, better representing their business to financial service providers can lead to a smoother application process, more appropriate loan terms, and reduce the necessity of intervention by outside actors.

Cash Flow

Cash flow management is weakened by post-dated checks.

Access to capital, primarily through bank loans, was clearly a challenge for the participating SMEs and it is on the top of their minds; however, another topic which was usually brought up simultaneously was restricted cash flow due primarily to extended check maturities, but also due to difficulty collecting payments and long payment periods. Based on discussions with interviewees, long check maturities are sometimes the reason SMEs use – or overuse – short-term loans to cover daily operational expenses.

Despite no references to this form of payment in the literature review, post-dated checks are, unlike in other countries, legal, widely used, and represent a large constraint to an SME's overall financial health.[45] In other parts of the world, checks are a means of payment that can be readily cashed at any moment, yet in Turkey in 2011 alone, $150 billion in post-dated checks were issued.

A pump manufacturer described the common practice of checks with long maturities and the role factoring plays in SME financing: *"Customers give us checks and we use those to make money from those credits...The checks usually mature after four months. Then, we have an agreement with banks or private companies and if you give the checks to them, they give you the money, but of course they keep some of it. It's like factoring, but with a check, instead of your accounts receivable. Turks don't trust the invoice, so they factor on checks" (Manager at Manufacturing Business, Istanbul)*

Clearly, factoring plays a rather large role, especially considering factoring companies outnumber banks and leasing companies in Turkey, and total factoring receivables outnumber total bank loans.

Without prompting, just over a quarter of respondents said they accept checks as a form of payment and nearly the same amount, 24% of SME owners, reported actually selling these checks to banks or factoring companies.

Participants stated that the use of long maturities, in addition to the difficulty in collecting accounts receivables, leads to inadequate cash flow, which in turn compromises their sustainability by denying them the revenue stream needed to grow. It is important to note, however, that the participating SMEs themselves are likely use checks to make their own payments, thereby potentially balancing out their own cash flow problem.

Furthermore, 27% of participants stated that simply collecting accounts receivable is a significant challenge. The owner of a construction business in Gaziantep stated, *"The biggest problem is collecting receivables when trading in Turkey. It is not guaranteed that you are going to collect your money from your customers. With the average maturity in checks being around four months, business is harder for sellers."* Business owners reportedly wait for up to three months to receive payment in some sectors, which, with a long maturity added on to it, means that there is a potential financing gap of over a year. 21% of participants complained of this financing gap.

Moreover, bounced checks present a problem and recent legislation has actually softened the penalty for bad checks. Contrary to former legislation, the issuers of bounced checks will only be subject to an administrative fine rather than imprisonment.

The lack of strict punishment can in turn cause default cascades in check payment systems. In fact, according to Interbank Clearing House's data, the ratio and volume of bounced checks doubled in 2012 compared to 2011. By the end of 2013, the value of bounced checks was around USD 6.2 million.[46]

A representative from Turkey Economic Bank (TEB) described the new legislation as detrimental to the financial system, as there has been a decrease in the amount of trust afforded to checks: *"[The new law] means that people stopped caring about whether they were writing good checks. This is a problem for the banks as well because we take some of these checks as collateral for loans. We don't know which check to accept and which ones not to accept. This means quite a bit of overhead and it slows down the financial system."*

Current Solution: Factoring Companies Fill A Gap

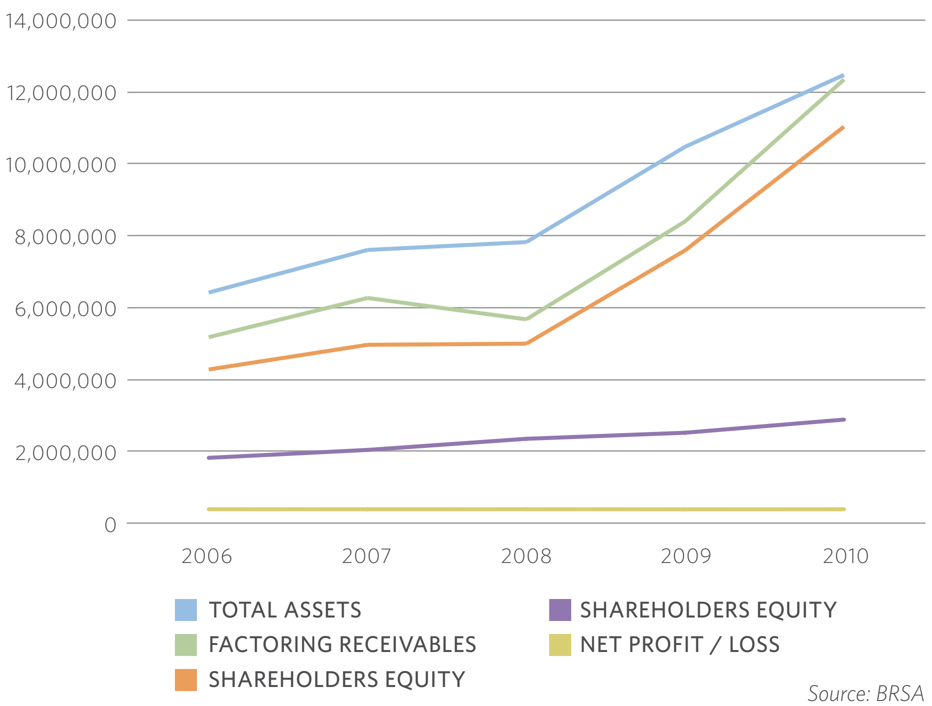
- Due to the large volume of post-dated checks in Turkey ($150 billion annually), factoring companies have positioned themselves to work with SME customers financing small ticket receivables.
- Factoring firms finance more than **50,000 SMEs in Turkey each year**. In recent years, factoring companies have increased their market share among non-bank financial institutions partly because **they have been successful in providing quick and practical solutions to SMEs' funding requirements**.

"Banks want to expand into SME credit business just because it's more profitable than other credits. However, banks, for years, have not been really successful at doing so... Banks are not as flexible as factoring companies when it comes to SME financing. They are not quick enough when it comes to reducing the credit limit of businesses that are slowing down. One other reason is that there is increasing competition in SME banking, which has resulted in reduced credit insurance time. One advantage of factoring businesses over banks is that they can give out loans much faster than banks"

"In addition to the banking industry in Turkey, factoring companies have also started playing a more crucial role in financing SMEs. As a result, the factoring industry has grown rapidly especially in the past 5 years. The factoring industry concentrates mainly on SMEs and micro-level businesses that are not capable of tapping resources at banks."

- Arda Tunca, CFO of Eko Factoring, Istanbul

Factoring Receivables and Use of Bank Loans



Source: BRSA

POTENTIAL SOLUTIONS

Carefully choosing customers – through improving the functionality of the Credit Bureau – can help SMEs overcome some cash flow issues

In light of Turkey's unique post-dated check system and the difficulty SMEs face when collecting accounts receivable, some participants found creative ways around this issue. When asked if the new trade law prompted him to be more careful about selecting his customers, a Gaziantep business owner responded that he simply could not find customers if he demanded collateral or a guarantee from them. His alternative strategy, rather, was to incentivize alternative payments by offering discounts for cash payments.

Another business owner in Gaziantep went as far as reducing payment installments, demanding different forms of payment, and even requesting payments in advance. Other businesses have adapted by simply choosing their customers based on certain criteria, such as credit history of a client or how "honest" they seem.

However, a business must have enough power – that is, demand for the good or service and lack of competition – to be able to choose customers, adjust the payment period, or require collateral. As one manager said, *"We can pick our customers. We work with firms that can pay us in cash and are honest to us. We reject ones that can't pay in cash. In other markets, SMEs don't have the luxury we enjoy since the market conditions differ... They have no option but to sell in any form of payments their customers demand. Consequently, they face issues with financing" (Manufacturing Business, Gaziantep).*

It is clear that there is no one silver bullet to solve the issue of post-dated checks, unless the government outlaws the use of them all together. It is also clear that the current legislation further exacerbates the problem as it implies impunity for bad checks and fails to protect SME owners from the vulnerabilities of bounced checks and engrained cultural practices of check writing.

What can be done, and is currently a work in progress, is improving the functionality and usage of the existing Credit Bureau (KKB) database for individual consumers and firms alike. (see page 41 for additional details). The ability for SMEs to select customers and suppliers based on a standardized credit score would revolutionize the way Turkey does business, and in a sense, give businesses the power to filter negligent suppliers and customers. Much like in developed economies, where anyone can access their own credit score, the adoption time of a similarly functioning system in Turkey makes this a long-term solution.

COMPETITIVENESS

Many respondents placed a strong emphasis on competition when asked how they interacted with other SMEs in their sectors. The value proposition many SMEs see themselves offering is honest, quality work which creates loyal customers.

A significant proportion of our sample was interested in expanding their role in international markets.

Investment in market research and R&D will need to significantly improve in order to make many SMEs competitive enough to move Turkey up the global value chain and to thrive in international markets.

As this report aspires to uncover what SMEs need to thrive in order to help drive Turkey's economy, it was important to discover not only the most frequently cited constraints, but also the elements which indicate where Turkish SMEs stand in the domestic and global value chain and how they can increase their competitiveness.

While this section is not necessarily a comprehensive representation of SME competitiveness, it does offer insights into the participants' perceived market position, their exporting goals, and their investment in R&D and market research.

The majority of participants spoke quite vaguely about their competitors and their own position in the market, demonstrating how a lack of knowledge and training in business management can ripple out to many parts of Turkish SMEs. Moreover, very few businesses reported investing in any market research or R&D for innovation.

These two activities have been demonstrated to be important factors contributing to a business' competitiveness and will need to be enhanced for Turkish SMEs to thrive, particularly if they are to help Turkey move up the global value chain by producing higher-end products, and to aid in increasing exports to $500 billion of exports by 2023.

Competitive Spirit

Many respondents emphasized competition over collaboration.

In order to find out where SMEs perceived and positioned themselves within their sector, they were asked a broad question about how they interact with other businesses. A slight majority of the SMEs interviewed (55%) immediately mentioned competition, while approximately 40% of them brought up ways in which they collaborate with other businesses; in some cases, businesses also collaborated with their competitors. There were some significant regional differences, with unfair competition featuring more prominently in the Marmara Region and a perception of being at the top of their sector being a more common belief in Gaziantep.

21% of participants expressed a lack of real concern about domestic competition. Out of those participants, 71% simply felt that their market position was so strong that they did not worry about much competition, while the remainder were more concerned about competition from abroad than domestic competitors.

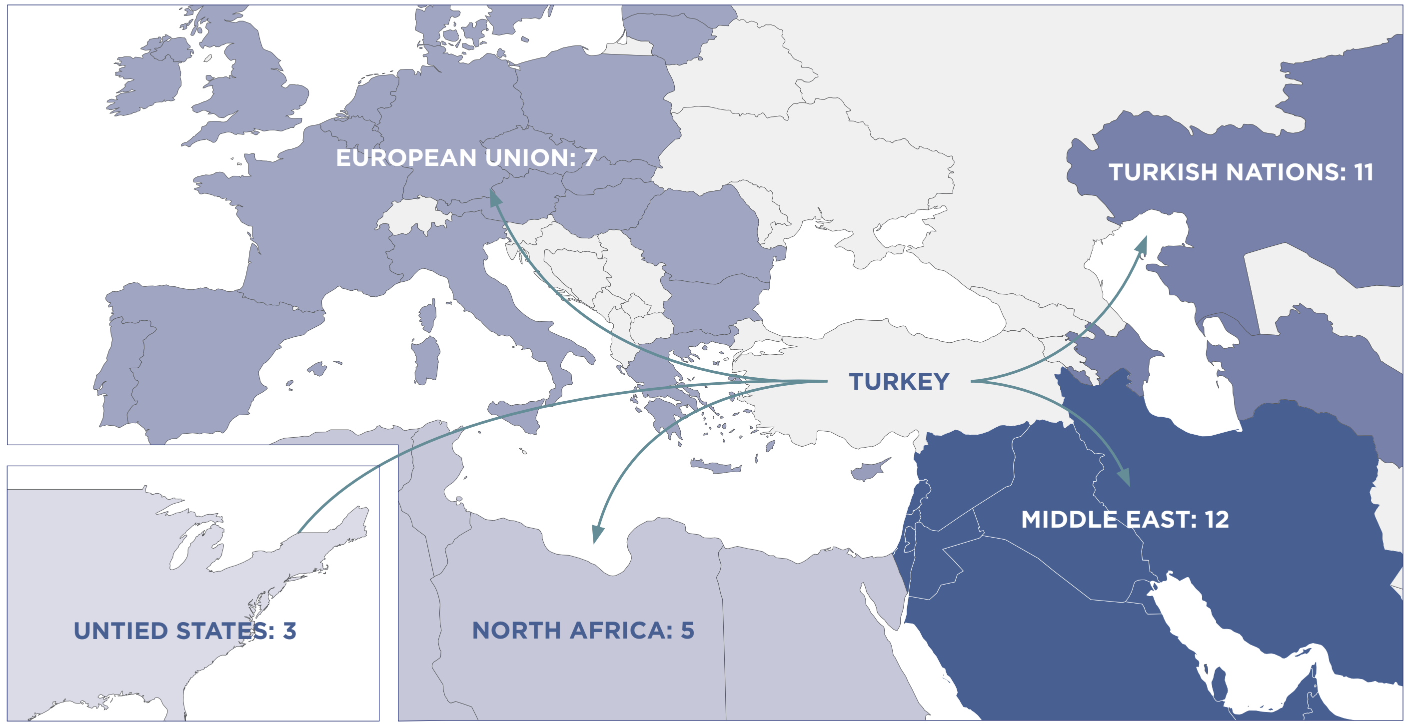
This lack of concern for competition may imply that a lack of knowledge or capacity in conducting market research and formulating a strategy. These weaknesses are likely a result of the previously discussed lack of professionalization in the SME segment.

European competition was, for the most part, a concern of businesses in Istanbul, although some Gaziantep SMEs also mentioned it. European competitors were particularly seen as having more resources – human capital, R&D investment, and physical space – which present a sizable challenge to many Turkish SMEs.

The flattening world, connected constantly by technology may also be a challenge for Turkish businesses, especially if they lack brand recognition; as one owner said, *"…there is global competition. In one project, there is a*

"European companies are our biggest competitors. Of course, local companies are our competitors in certain markets, but we are most afraid of the European competition because they have big opportunities to kill us. We are competing against global brands here in Turkey now – German and French companies. We are competing with Grundfos, one of the biggest pump companies in the world with more than 60 people here in Turkey. They have money, technology, and educated people like engineers, research centers in Europe…and we are here. We have 5 people."
- Sales and Marketing Manager at Manufacturing Business, Istanbul

Main Export Markets of Participating SMEs



company from US or from Europe. It is easy for a customer to find a company – they just have to Google it" (Manufacturing Business, Gemlik).

For 27% of participants, their primary market positioning strategy was superb customer relations, a fact congruent with Turkey's culture of strong social networks and hospitality. This strategy places great value on making existing, long-term customers happy and relying on them to spread your reputation.

Factors contributing to positive relations included providing high quality products, timely delivery of goods and/or services, and a trusting relationship. The Gaziantep construction business, Yukseller, stated, *"There are huge competitors in the region that can easily penetrate our customer base. We have always kept our word and finished our projects on time. Other companies give promises that cannot be kept. Our company now has a positive image as a fast and trustworthy business. Other SMEs don't like us."*

Turkey's focus on quality products served it well in the past decade, particularly after establishing the customs union with the EU in 1996. Even now, Turkey's international branding strategy is TURQUALITY which is an accreditation system initiated by, among others, the Ministry of Economy, Turkish Exporter's Assembly (TiM).

It is a project designed to elevate the brands of certain companies to the level of international standards and to create awareness of Turkish brands.[47] At the same time, according to the Secretary General of TiM, Turkey will now shift its national focus more towards increasing the quantity of Turkish goods in the international market by turning domestic surplus into exports.

Global Trade

SMEs, particularly in Gaziantep, aspire to expand global trade.

Currently, SMEs account for around 60% of total exports[48] and many of the participants in this study expressed a desire to enter new international markets. 27% of respondents mentioned either entering the international market or increasing existing international business as one of their goals. An overwhelming majority (78%) of those respondents were located in Gaziantep.

Among a handful of other countries, nearly half of respondents expressed interest in increasing their export volumes to the Middle East and to Turkic nations such as Azerbaijan, Turkmenistan, and Kazakhstan. These interests align with current Prime Minister Ahmet Davutoglu "zero problems with neighbors" policy, whereby Turkey is focused on diversifying its regional partners instead of relying so heavily on Europe.

However, regional instability hampers the ability to export to neighboring countries such as Iraq and Syria. Moreover, trade to Europe and the accompanying regulations and standards have in some ways helped to increase the quality produced in Turkey, which makes it overall more competitive.

For SMEs and other aspiring exporters, the Secretary General of TiM predicts a bright future: *"The current economic environment is very different from the past; Turkey used to have an economic crisis every seven years! Just the survivors were able to export."*

Now, he explained, Turkish exporters have evolved into two distinct groups. First, the firms who work with European brands in almost all sectors. Second, the companies who produce their own brands, marketing, and sales plans, and are in fact reaching the market on their own. *"This is growing day by day, and these companies are pushing for new markets,"* he said.

Today, Turkey has reached a very important position with increasing medium-tech industries, but the 2023 vision will require a new paradigm, particularly concerning exports. This implies a necessary jump for many SMEs that simply support European firms through the production of intermediate goods to graduate to the next level of developing national brands.

The Secretary General continued: *"Following this push for higher quality products, Turkey now needs to unlock the excess capacity within manufacturing sectors and the only way to move forward is through innovation, design, and branding."*

Furthermore, Turkey's relatively high labor costs and pressure from Asian rivals on its main exports – cars and textiles – will necessitate a greater effort from Turkey's SMEs to remain competitive on the world market.

Part of Turkey's plan for improving cooperation, innovation, and economies of scale, is its clustering policy, initiated in 2007, which established small industrial estates and organized industrial zones throughout the country.[49] In Gaziantep, we were able to repeatedly visit two of the five organized industrial sites which housed manufacturing and carpet businesses. 18% of participants reported sharing products, processes, or even customers with other SMEs in their sector.

The collaboration, at least partially inspired by their proximity to similar businesses, primarily resulted in business owners and managers being comfortable with walking a fine line between cooperation and competition amongst other firms.

POTENTIAL SOLUTIONS

Financial service providers should leverage clusters to increase penetration of financial and non-financial services .

Turkey's existing clustering policy provides a platform for banks to leverage as they segment the SME market. As evidenced by the SME Services Offered by Major Turkish Banks chart earlier in this report, most banks develop a multivariate segmentation strategy to widen their SME client base and ultimately earn greater profits from the SME segment. Under the assumption that customers have similar demand in one specific industry, the existing clustering of SMEs can enable financial service providers to target specific regional industries by financing the supply chain of a company, better understanding a particular industry's barriers to international trade, or even developing B2B (Business to Business) platforms for a given cluster.

In an International Finance Corporation (IFC) case study, the Indian bank ICICI is an example of industrial cluster-based client segmentation. By separating its customers by industry and business linkages, the bank was able to tailor its services to the specific needs of a cluster.

Services offered included checking accounts, transition, banking services, cash management services, and trade services which equated to a major increase in their total SME client base, only 5% of which were lending clients.[50]

For example, competitors may buy raw materials in bulk together, pass on smaller projects or delegate intermediate tasks to smaller firms. However, the clustering policy, at least in our sample, did not appear to necessarily inspire innovation. Only one Gaziantep business reported working with a competitor on R&D projects and another lamented the fact that he could not rally his colleagues in a similar direction.

Research + Development

There was no clear definition of R&D and market research amongst SMEs.

Although some evidence was collected on whether businesses engaged in market research and R&D, the results are inconclusive due to significant amounts of missing data and widely varied under-standings of what those two terms mean.

For example, when asked if the business allocates funds for market research, several interviewees began talking about their marketing techniques such as advertisements and sales teams. From the confusion and overall lack of concrete answers for both market research and R&D, it is clear that there is a lot of potential for growth in these categories.

Currently, the government runs a series of R&D and innovation programs, which include technology development zones, university-business collaboration, R&D centers, tax incentive schemes, R&D cooperation projects, and more. In fact, a recent report issued by the European Commission (EC) found that Turkey shows strengths in key technologies and in high-tech and medium-tech contributions to the trade balance, in addition to a growing commitment to investing in science, technology, and innovation.

The report also found that Turkey is benefiting from the EU budget through programs like the 7th Framework Program for Research and Development. Surprisingly, Turkey's research and innovation system is weaker than the EU average in many areas except in the percentage of SMEs introducing marketing or organizational innovations and in public expenditure on R&D.[51]

Moreover, key industries such as manufacturing and construction are moving towards more research intensive activities as shown by increases in the level of R&D expenditure as a percentage of value added.

This macro-level information provided by the EC study demonstrates significant differences to what was found in interviews with SME participants. Thus, taking into account sample size limitations, an increase in knowledge and awareness of existing programs, in addition to expanding the reach of those programs would likely increase participation.

However, for the majority of SME participants, the solution will not only be increasing knowledge and funds for market research and R&D; significant attitude change will be necessary for some SMEs to even see the value in these activities. This is closely related to the finding that a large portion of SMEs believe their market position to be so strong as to render competition irrelevant. For example, a chicken farm owner in Gaziantep stated, *"No, we have no marketing problems, our customers are loyal. Our demand and supply is also nearly the same, so no problem."*

Likewise, a construction business owner in Edirne stated, *"No. We don't do R&D either. I just close my eyes and bulldoze my way through. I don't pay for market research but I keep up with newspapers and look at some statistics."*

Indeed, it may just be that the most resourceful and ambitious SMEs tap into the programs and funds available for innovations of all types. An increasingly professionalized business culture, along with improvements in resource allocation and management, may be precursors to many SMEs investing in elements such as R&D and market research which will enhance their competitiveness.

Potential Solution: Market Research

One potential opportunity that can be expanded upon is for professional associations to assist with market research or to create specific funds for SMEs in their sector to conduct R&D.

One owner mentioned that his association, the Direct Marketing Association (DPID), provides him with pertinent information to help inform his decision-making: *"We don't allocate funds for market research. DPID does yearly studies that contain information about customer profiles, members' revenues, etc. Through this, we can better understand our position in the sector"*

(Owner of Public Relations and Advertising Business, Istanbul

CONCLUSION

Turkey's move from an efficiency-driven economy to an innovation-driven economy, and to one of the world's largest economies at that, will take improvements from every type of enterprise.

Currently, microenterprises make up the largest proportion of Turkey's economy and large enterprises generate the most profits. But SMEs occupy important spaces in manufacturing, textile, and construction sectors and are increasing exports to international markets.

Furthermore, as a sector, they have the potential to make significant contributions to Turkey's GDP while also creating jobs for an underutilized and growing labor force. Investing in SME growth is a much more stable and inclusive strategy than relying on foreign capital inflows and domestic consumption.

One underlying change, which will be a necessary prerequisite for leveraging the full potential of Turkish SMEs, is to increase the overall level of professionalization, especially in managers and owners. Relinquishing control and increasing knowledge of business administration will help usher in improvements in strategy and planning; finding, hiring, and managing human capital; organizing business accounts and finances; and investing in other important activities to enhance competitiveness.

Of course, not all problems can be solved by professionalization. SMEs can aspire to reach the next level through combined efforts between the public and private sectors.

The public sector can implement policies diminishing institutional barriers, such as mitigating long payment plans and enabling debt collection, in addition to continuing, enhancing, and increasing awareness of public SME support programs.

More of an emphasis should be placed on improving government employment agencies to not only foster and incentivize formal recruitment strategies, but also to help align the current mismatch that exists between what SMEs want – workers with a practical skill set – and vocational graduates with an overly theoretical knowledge base.

The private sector can contribute in a number of ways, through financial service providers and also through consultants, which, if they can gain the trust of business owners, can offer guidance on all areas delineated in this report, and more.

Relationship managers (RM), who already have an established level of trust with SME clients and, equally, act as a direct channel of communication, can be better leveraged to provide more value to SMEs seeking guidance. Banks can also attempt to provide a more transparent and seamless process for SMEs wishing to utilize the broad spectrum of financial tools offered.

SMEs themselves can play a greater role in their own story. Experienced business owners can mobilize forces to act as "SME Ambassadors", acting as role models helping others tap into foreign markets, create business plans, expand their businesses, and more. Lastly, considering the diverse business environment SMEs operate in today, SMEs cannot afford to ignore half of Turkey's working-age population. SMEs should attempt to better integrate women into their formal workforce, as this strategy not only makes economic sense but will likely aid in securing their future prosperity and competitiveness.

A combined and coordinated effort, along with its strong, aspirational vision, can propel Turkey into a more competitive and lucrative global position. Turkish SMEs simply need a boost to the next level. As one participant pointed out, *"This is a country of a lot of opportunities… If you do everything right—if you analyze competition right, if you launch the right products at the right price and right place, if you give the right tools to the sales team and customers – then it works" (Deputy General Manager of Printing and Stationary Business, Istanbul).*

APPENDIX 1:

INTERVIEW LIST

SME Participants

Cavit Alamut
General Manager, Owner
ALSO Catering

Seyit Ahmet
Owner
Senab Betaon Parke

Cengiz Israfil
Owner
Fil Finance and NY Steakhouse

Cavit Duvan
Owner
Duvanpen Yapi Marketi

Murat Demircan
Hakki Tutunculer
Managers
Alfen Machinery and Armature Industry Inc.

Levent Baloglu
Owner
Balo Ticaret Tourism

Taner Onen
Sales Manager
Balo Ticaret Tourism

Okan Biyik
Owner
Kontek Muh.

Yunus Kacar
Owner
Parantez Tonitim

Mustafa Aktas
Owner
SARAC End. Urunleri Yapi Kimyasallar

Berna Acar
Deputy General Manager
Umur

Oktay Karaman
Owner
Elit Matbaa Form & Etiket

Mehmet Boz
Owner
Boz Pa Tekstil

Ugur Sacir
Production Manager
Owner of Sadestone

Talat Tuzlu
Mehmet Tuzlu
Owners
MOST Metal

Mehmet Catioglu
Owner
Flas Makina

Ramazan Yuksel
Owner
Yukseller

Mehmet Calisici
Owner
Caliskan Makina

Hikmet Okutucu
Owner
Insaat Malzemesi ve Taahhut

Siddik Kayabas
Owner
Gunmak

Ismail Ilimbey
Feride Yucedag
Managers
Gunmak

Ahmet Goksular
Owner
Gumusmekik Hali

Metin Durak
Bulent Saraclar
Owners
Gaziantep Kargo

Murat Borin
Owner
Berrce Furniture

Murat Evyapan
Manager
Edacan Construction

Omer Can Bilecan
Owner
My Office

Cemgiz Yukseltam
Owner
Ufuk Construction

Ali Bozhuyuk
Owner
Tad Pilic

Nevzat Erkmen
Owner
Merkur Hali-Gumussuyu

Gokhan Gopuroglu
Owner
SHO Carpet

Omer Gullu
Owner
Baklavaci Gulluoglu

Four additional business owners chose to remain anonymous

Financial Service Providers

FINANSBANK

Liam Hardy
Marketing Assistant

Sulun Gurtin
Communications

Burcu Koyuturk
Manager for Middle Size Enterprise Marketing

Cemal Tevrizci
Assistant VP for SME Banking

EKO FACTORING

Arda Tunca
CFO

Serkan Ozer
Head of Credit

TURKISH ECONOMIC BANK

Turgut Boz
SME Banking Senior Assistant General Manager and Deputy CEO

Devrim Tavil
SME Banking Segment Mgt. and Business & Development Director

YAPI KREDI LEASING

Ugur Cem Bastimar
Portfolio Manager, Sales

ING BANK, TURKEY

Yucel Olcer
Head of SME Department

Erdogan Yilmaz
EVP of SME Banking

SEKERBANK

Omer Cakir
Gaziantep Branch Manager

Other Stakeholders

Arif Torun
SME and EEN Expert
Small and Medium Enterprises Development Organization

Mustafa Ilbeyli
Project Director
Republic of Turkey Prime Ministry Investment Support and Promotion Agency

Recept Zipkinkirt
President
Edirne Chamber of Commerce

Guliz Yardimci
EU and Foreign Relations
Edirne Chamber of Commerce

Eyup Bartik
President
Gaziantep Chamber of Commerce

Mustafa Mente
General Secretary
Turkish Exporters' Assembly

Ali Sökmen
Economic Studies
Economic Policy Research Foundation of Turkey (TEPAV)

Neslihan Tombul
Expert in Banking and Finance
Board Member
Turcas Petrol

Arthur Sculley
CEME Senior Fellow
Fletcher School, Tufts University

Steven Koltai
Managing Director
Koltai & Company

APPENDIX 2:

SME OFFERINGS BY MAJOR TURKISH BANKS

	SME Segmentation	Number of SME Customers	Formal Financial Services Provided	% of Loan Portfolio Allocated to SMEs	Non-Financial Services Provided
Turkish Economy Bank (TEB)	**Micro:** *< 1m USD* **Small:** *1m to 10m USD* **Medium:** *10m to 20m USD*	Approx. 155,000	• Cash Management • Loans with installments up to 3 years • Factoring and Leasing	45.33%	• TEB SME Academy • SME Consultants • TEB SME Club • TEB SME TV
Finansbank	**Micro & Small:** *<2mil TL annual revenue or Total credit risk below 1mil TL* **Medium:** *Between 2 to 20mil TL annual revenue or Total credit risk below 10mil TL*	4.5% market share in SME banking	• Cash management • Investment Loans Under EIF Guarantee • Spot Loans • Revolving Line of Credit • Foreign Currency Loans	25%	• SME Central • SME Cloud
ING Bank	*<15 mil TL annual turnover*	Over 100,000	• Loans in collaboration with KGF, KOSGEB, Exim bank, EIB and trade chambers • Factoring and Leasing • Cash management	32.6%	• SME academy, offering free "e-lessons"; working on online portal to help bank clients find customers both domestically and abroad
Yapi Kredi Bank	**SME Banking:** *<5m USD in annual revenue* **Medium:** *5- 20 mil TL annual revenue, total credit risk/banks below 10mil)*	911,000 10% market share in SME banking	• Commercial installment loans • Revolving loans • Flexible commercial accounts • POS and Merchant Services, • Agricultural Banking Products • Cash management products • Investment products • Commercial credit cards • Commercial purchasing cards leasing • Loans in collaboration with GAGF, EBRD, IFC, KOSGEB and KGF	13% (2009)	• At least one SME RM in every retail branch, including Remote Relationship Managers (RRMs) in 9 different regions of Turkey • SME internet portal www.kobiline.com • Brand and patent consultancy services
Garanti Bank	**SME:** *<10m TL annual revenue*		• Loans • Factoring and Leasing • Cash management • Credit cards • Insurance and retirement investment • Garanti POS (direct loans from POS machines) • Revolving Credits	30%	• KOSGEB Startup Support Package • SMEs Consultancy Call Center • Entrepreneur Magazine • Rentals • Informational guidelines for safety of work place

	SME Segmentation	Number of SME Customers	Formal Financial Services Provided	% of Loan Portfolio Allocated to SMEs	Non-Financial Services Provided
AK Bank	**SME:** *< 30 m TL in annual turnover*		• Loans • Cash management • Credit cards • Sector-based SMEs packages • Agreements with chambers and VESTEL distributors • Factoring and Leasing • Import-export advice	40% (2007)	• Improving Entrepreneurs Programme • Global University Student Competition • Investment programs
Is Bank	**SME:** *<250 employees and <40m TL annual revenue*		• Loans • Cash Management • Leasing • Company Credit Cards • Support Packages for Specific Sectors • Innovation Support • Credit Cards	27.5%	• SME consulting meetings • SME Website • SME Seminars
Halk Bank (Public)	**Micro:** *<10 employees and 1 m TL net income* **Small:** *<50 employees and <5 m TL net income* **Medium:** *<250 employees and <25 m TL*	369,414 13.5 % market share in SME banking	• Loans • Insurance • Leasing • Cards • Cash management • Investment support	36%	• Risk investigation reports • Entrepreneurship Academy, • Consultancy for M&A
Vakif Bank (Public)			• Loans • Sector-based credits • Cash management • Factoring and Leasing • Insurance • Agreements with chambers • Import-export advice	20.5% (2012)	• 1400 SME account managers and over 100 support staff in regional offices • Risk investigation reports
Turkiye Finans (Islamic Bank)	**Micro:** *<500,000 TL* **SME:** *500,000 to 15 m TL*	3.2% market share in SME banking (27.8% among participation banks)	*Commercial and Business cards* *Leasing* *Profit-Loss Partnership* *FX indexed Loans* *Insurance* *Cash Management*	44% (2013)	• KOSGEB and KGF cooperation • Advice on various incentives and grants • Agreements with trade chambers • 400+ staff dedicated to SME customers

APPENDIX 3:
ENDNOTES

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9. Some questions elicited vague or confused responses. For example, businesses were asked whether they developed a business plan and whether they funded and utilized market research and R&D. Another example is loan terms: how long is a long-term loan to us and to them? Although those concepts were accurately translated into Turkish and the participants understood the language when asked, the actual conceptualization of these terms may not be aligned between Western and Turkish business culture. The analysis thus takes into account the ambiguousness about exactly what "business plan", et al. meant to participants.
10. Many businesses were found using connections such as certified public accountants and bank representatives which may imply that businesses with a certain level of professionalism or certain social connections may be overrepresented.
11. The informational gaps in the chart demonstrate another finding. Despite interviews and extensive online research, we were unable to uncover basic information about SME coverage, what services are provided, and how that particular bank segments SMEs. All numbers are from 2013, unless otherwise noted.
12. For a detailed overview on SME-supporting organizations, see section III on Stakeholders
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