

TIME FOR MARKETPLACE LENDING

ADDRESSING INDONESIA'S MISSING MIDDLE



A photograph of a man with dark hair and glasses, wearing a red button-down shirt, smiling at the camera. He is standing in a workshop or store filled with various items on shelves. The image is partially overlaid by a blue geometric shape on the left side.

AUTHORS

Jason Ekberg, Partner of Oliver Wyman
Ritwik Ghosh, Principal of Oliver Wyman
Iwan Kurniawan, Chief Operating Officer of Modalku

EXECUTIVE SUMMARY

Indonesia has more than 57 million micro-enterprises, but only around 1% of these businesses manage to grow to the size of a sustainable Small or Medium Enterprise (SME). Most micro-enterprises have limited capacity to scale their business, and may also lack the ambition to do so. Moreover, even those with the potential and will to grow are often held back by their lack of access to credit. We refer to this segment – businesses with monthly revenue of between 10 and 100 million Indonesia Rupiah (IDR) – as the “missing middle”. We estimate that limited access to credit for these companies reduces Indonesia’s GDP by approximately US\$130 billion, equating to 14% of total GDP¹ (according to 2015 figures). Marketplace lending can play a major role in facilitating this goal by providing improved access to credit for a broader range of Micro and SME businesses (MSMEs).

While this issue is particularly apparent in Indonesia, it is also evident in other markets. A considerable number of Fintech companies have emerged to take advantage of this opportunity across developed countries (such as United States and United Kingdom) and developing markets (such as China).

China is a case in point. Structural imbalances created huge gaps (estimated to be more than US\$700 billion) in MSME financing, and also led to surplus demand for return-seeking investable assets (estimated to be in excess of US\$2.3 trillion). Marketplace lending platforms have rapidly come to the fore to exploit this opening. They have already attained a market size of US\$150 billion², and are growing by more than 60% per annum.

We see a parallel in Indonesia, with a significant market opportunity generated by MSME – financing gap of US\$54 billion by 2020, and by affluent and mass affluent return-seeking investable assets of US\$210 billion in the same time-frame. We believe marketplace lending can be a similarly transformative force in Indonesia. However, fintechs, banks and regulators will have to come together and focus on getting three things right:

- **Fintechs** should focus on sustainable lending practices, as opposed to a single-minded pursuit of growth. Raising customer awareness and adding value to businesses beyond lending alone will be vital for the long-term future of the nascent industry.
- **Banks** should both collaborate and compete with fintechs, leveraging many core advantages (such as low-cost funding), rather than creating entry barriers and asymmetric advantages.
- **Regulators** should equip the industry with protective mechanisms before it grows too big, and maintain comprehensive vigilance while also keeping regulatory compliance costs down.

¹ Based on Oliver Wyman analysis

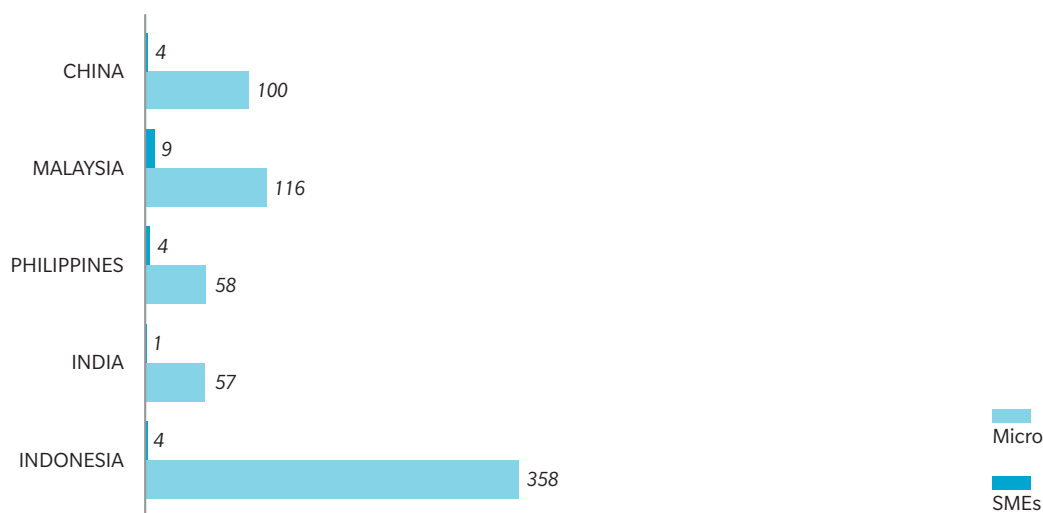
² WIND

INDONESIA'S MISSING MIDDLE

Indonesia has an unusually large micro-enterprise segment relative to its peer emerging countries, but a smaller than average SME segment. Indonesia has more than 57 million MSMEs¹, of which 99% are micro-enterprises. This translates to 358 micro enterprises, but only 4.4 SMEs, per 1,000 adults. In contrast, Malaysia has fewer than a third of Indonesia's micro-enterprises per 1,000 adults, but twice the proportion of SMEs.

Exhibit 1: Comparison of number of micro, small and medium enterprises across emerging Asian countries

NO. OF MICRO & SMEs PER 1,000 ADULT POPULATION
2014 ESTIMATES



Source: The World Bank, IFC, Oliver Wyman analysis

Only approximately 1% of Indonesian micro-enterprises manage to grow to a sustainable SME size at any stage. Most of these enterprises (more than 90% of them) have limited capacity and/or ambition to scale their business. The remainder is held back for various reasons, with the lack of access to credit being the most important. A nationwide survey we conducted in 2014 revealed that 44% of the larger or transitioning micro-enterprises², located in rural Indonesia³, do not currently have a loan. Of those who do not possess a loan, 35% indicated that they needed a loan today but do not have access to one, while another 30% indicated that they are likely to need to borrow in the foreseeable future.




1 Ministry of Cooperatives & SMEs, 2013

2 Monthly revenue of IDR 10 to 100 million

3 Refers to rural Kabupaten, regions with a population of fewer than 500,000 and where less than 70% of population is classified as rural by the Indonesia Bureau of Statistics

This is also easily inferred from a brief inspection of supplier-side dynamics for MSME credit in Indonesia. There are various institutions, including micro-finance institutions (such as MBK Ventura), rural banks (such as BPR), and leading domestic banks (such as BRI and Bank Mandiri), which specialise in providing micro-enterprise credit to the smallest micro-enterprises. At the same time, all leading banks focus on providing SME credit (primarily in a term loan structure), with a loan size range of IDR 1-20 billion. However, a missing middle (businesses with monthly revenue of IDR 10-100 million) of fast-growing micro-enterprises – with needs for working capital loans, or bridge financing, or loans to mitigate cash flow volatility – are not specifically targeted by either of these groups of credit providers.

This segment represents a diverse group of emerging businesses which often need financing to support growth and/or transformation of their business.

SEGMENT	WHO THEY ARE
<p>Startups</p> 	<p>Typically young entrepreneurs (aged 21 to 35) seeking to build enterprises through innovative business models, especially those which use technology. Some estimates suggest there are more than 2,000 startups^{*1} that have been formally registered over the last five years alone.</p> <p>Example: Entrepreneur for e-commerce portals, such as HijUp or Gorry Gourmet.</p>
<p>Second generation business owners</p> 	<p>Entrepreneurs typically taking over the control of a business from their elderly parents, with the ambition and ability to grow the business beyond its existing scope.</p> <p>Example: Middle-aged son of elderly parents taking over control of a small noodle shop.</p>
<p>Businesses in growth hot spots</p> 	<p>Parts of the Indonesian economy are growing even faster than the country average. Established (but small) businesses in these sectors and geographies are often looking for growth capital to expand their franchise.</p> <p>Example: Small pharmacy which intends to open a second store, or a carpet trader serving the growing renovation needs of offices.</p>

*1 TechnAsia report “Indonesia’s startup landscape in 2015 – Tech in Asia”

Lack of access to credit in this segment triggers a significant cost to the broader Indonesian economy. This represents a lost opportunity worth around US\$130 billion⁴, amounting to approximately 14% of GDP⁵.

4 Calculated based on the number of micro enterprises in transition and the revenue gap to become an SME

5 Based on 2014 GDP of US\$888.5 billion

WE NEED A FRESH START: DIGITAL CAN HELP

The missing middle’s lack of access to credit from traditional banks is in fact a case of market failure. These businesses do not meet banks’ expectations of their borrowers. Meanwhile, the banks themselves also fail to meet the expectations of these businesses, given the type of credit they actually need. This market failure is explained in the table below.

Exhibit 2: Market failure for missing middle credit due to bank’s expectations and typical offer structure

<i>“Missing middle” do not meet bank’s expectation</i>		Banks deliver	“Missing middle” need	<i>Banks do not meet “missing middle’s” expectation</i>
Banks require	“Missing middle” status	Long tenor loans	Most dominant need is for working capital finance (short term credit line) rather than term loans (2-5 years)	
Collateral	Limited/no fixed assets given the stage of the business; particularly in high growth services sectors		about 2 months turn around time	Frustrating to an agile owner keen to push his business ahead; views credit process as an errand rather than core to his work
Financial reports	Audited financial statements are a rarity given these businesses are owner run and in most cases do not have a professional finance manager		micro-treatment	They do not need on-site repayment collection (like wet market sellers) but value other services (e.g. business networking opportunities)
History of bank loans	Many businesses are young and have no loan history; others may have small loans not reflective of their current need			

This situation may be more prevalent in Indonesia relative to other peer countries, but is by no means unique. A broad range of fintechs have emerged to take advantage of this opportunity across developed countries (such as the United States) and developing markets (such as China). We can classify these fintechs into four categories:

1. **Balance sheet lenders** (such as OnDeck or Kabbage)

This is a traditional lending model adapted to a digital platform. Funded internally, it principally offers working capital and cash flow volatility management loans via an online platform, with an underwriting model that takes into account various new data sources (such as online sales data), in addition to frequently used banking data. These players have been more prevalent in developed markets (such as the United States and United Kingdom) often targeting customers who are not well served by banks.

2. **Marketplace – MSME-focused** (such as Dianrong or Yooli)

These are on-line or off-line platforms focused on extending credit to MSME clients largely for operational use (such as working capital loans). This has been a dominant trend in the digital financing space in China (which we explore in more detail in the following section). These players do not hold assets on their own balance sheet, and add value simply by being the matchmaker and by facilitating risk assessment. They increasingly differentiate themselves by offering value-added services (such as supply-chain solutions).

3. **Marketplace – Consumer-focused** (such as Lending Club or Prosper)

This is similar to the previous category, but distinct in its focus on individuals and consumers. The underlying risk analytics are therefore quite different, and the scope of the value-added solution focuses on cross-selling of personal banking services. These players have been more prevalent in developed economies with a mature consumer credit market, but many of the former leading lenders have withdrawn from parts of this consumer segment due to the level of risk involved.

4. **Aggregators** (such as Fundera or LendingTree)

These players follow a relatively well-established digital business model which centres on aggregation, price comparison and giving the borrower careful and detailed support throughout the process. For some of the leading non-financial services players traditionally serving SMEs in a different capacity (such as H&R Block, the tax consultants), being active in this category has permitted a value-added services plus diversification approach.

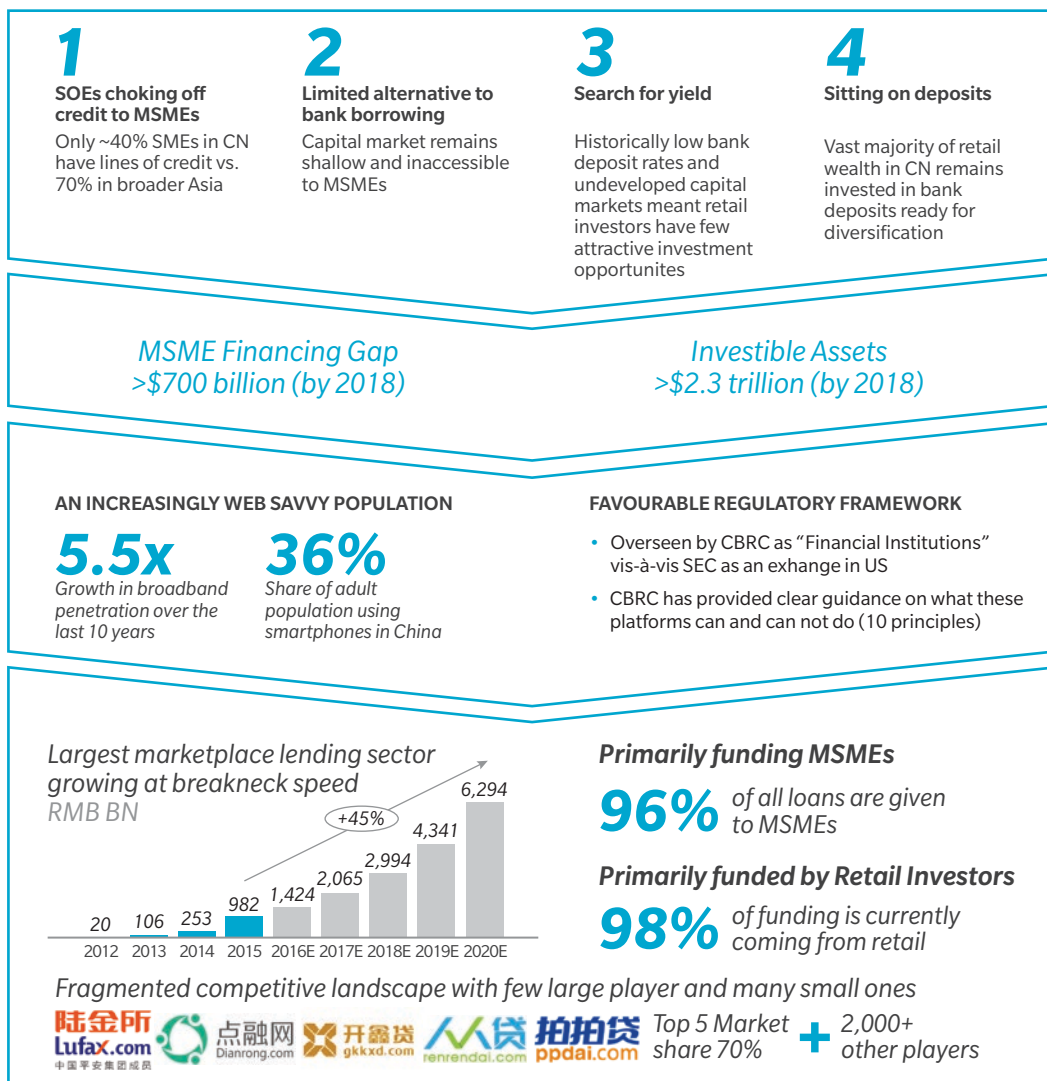
Exhibit 3: Selected examples of these players across developed and developing markets

<p>BALANCE SHEET LENDERS</p>  <p>CAPITAL FLOAT OnDeck Kabbage LENDINGKART CAN CAPITAL</p>	<p>AGGREGATORS</p>  <p>Deal4Loans lendio lendingtree smartbiz SBA loans made easy fundera expert market</p>
<p>MARKET PLACE – MSME FOCUSED</p>  <p>点融网 开鑫贷 陆金所 Dianrong.com gkkxd.com Lufax.com 中国平安集团成员 人人贷 MODALKU Funding Circle renrendai.com Bersama Berdayakan UKM</p>	
<p>MARKET PLACE – INDIVIDUAL FOCUSED</p>  <p>拍拍贷 zopa WeLab ppdai.com democratizing finance FAIRCENT.com PROSPER LendingClub EVERY % COUNTS</p>	

WILL CHINA MARKETPLACE LENDING REPEAT ITSELF?

China is a particularly interesting example where a number of structural imbalances created a huge gap in MSME credit (estimated to be more than US\$ 700 billion), and surplus demand for return-seeking investable assets (estimated to be more than US\$2 trillion). A large number of marketplace lending platforms have emerged to fill this space, using a combination of on-line and off-line models. As a result, China's marketplace lending market is already by far the largest in the world (more than six times the size of the US market) and can continue to grow to ten times its current size over the next decade. The exhibit below displays the dynamics of marketplace lending in China.

Exhibit 4: Marketplace lending dynamics in China



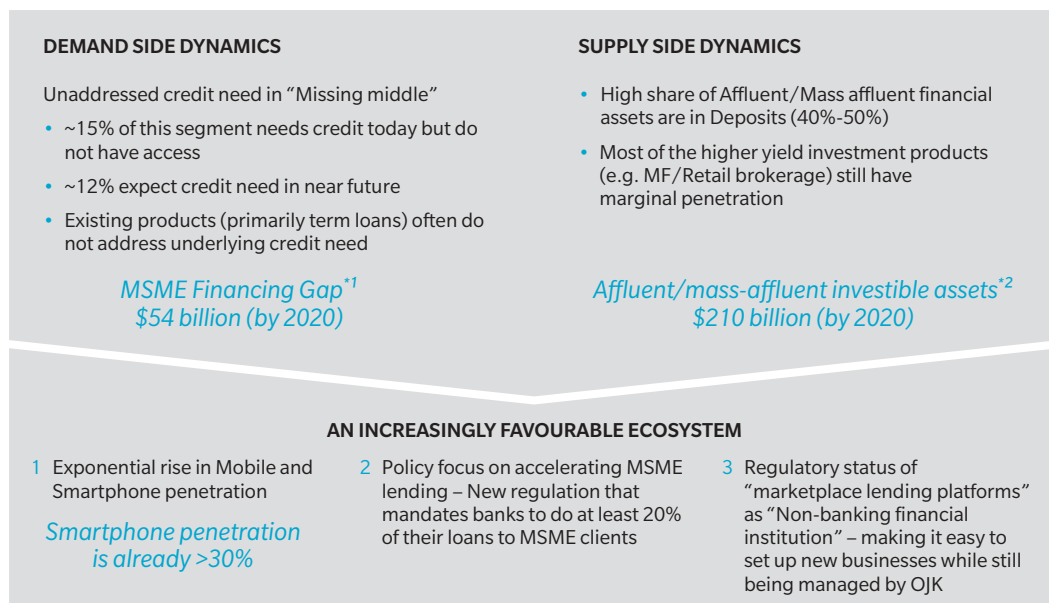
Fragmented competitive landscape with few large player and many small ones

Top 5 Market share 70% + 2,000+ other players

Source: Oliver Wyman analysis

There are significant parallels between China and Indonesia in their structural factors and key enablers. The following exhibit highlights some of these factors, and highlights our estimate of the market opportunity based on a gap analysis of the demand and supply side.

Exhibit 5: Marketplace lending outlook in Indonesia



*1 We estimate 20% of the “MSME Financing Gap” is in the “Missing middle” segment

*2 Investible assets include all on shore assets excluding deposits; a share of these assets can be mobilized by marketplace lending

Source: Oliver Wyman analysis

While there are many parallels between China and Indonesia, we also expect some important differences in the development of Indonesia’s marketplace lending in comparison to the China experience:

- Due to the increasing regulatory pressure on them to focus on financial inclusion, and their growing appetite for digital initiatives, banks are likely to take more interest in the marketplace lending opportunity in Indonesia than they initially did in China. This should aid the industry’s development, as bank interest may open up lower-cost acquisition channels for the lending platforms and allow lower-cost funding sources.
- Market development may be slower at first, as most of the Indonesian players are likely to be new businesses. This stands in contrast to the vast number of mid-sized shadow banking outfits that came within the remit of the formal financial sector in China when marketplace lending became a recognized institutional structure.
- Finally, the development of China’s e-commerce ecosystem preceded marketplace lending development, helping to form online transaction habits for a very wide cross-section of Chinese consumers. Although similar e-commerce transformation has started in Indonesia, it is still very urban-focused and lacks the muscle of home-grown Chinese players (such as Alibaba). Once again, this may mean that the opportunity takes more time to evolve than it did in China.

WHERE WE GO FROM HERE

In conclusion, we believe marketplace lending is a genuine opportunity in Indonesia, and can provide a significant boost to Indonesia's economy by supplying credit to the missing middle.

However, to realize this opportunity, three groups of stakeholders need to come together and pursue a coherent agenda of self-interest alongside industry development.

Fintechs

- Build brand and credibility both as a partner to the industry and viable investment option for investors. Indonesian customers are still new to digital finance and any failures or payment delays from newly-launched businesses can have a significant adverse impact on the reputation and long-term future of this nascent industry.
- Continue to invest in improving customer experience, underwriting capabilities, identifying new sources of risk related data and enhancing anti-fraud analytics – this will be the basis of competitive differentiation in the long run.
- Invest upfront in front-line staff training (e.g. loan officers) and incentives alignment – they are critical in fraud prevention, credit risk assessment and customer education.

Banks

- Collaborate (rather than just compete) with Fintech players in enhancing industry practices – e.g. data sharing in fraud prevention, access to credit line and quality reporting via credit bureaus and use of new data sources in enhancing quality of risk decisions.
- Identify opportunities to leverage market place lending as part of overall business strategy – e.g. referral arrangements with Fintechs, innovative products to support marketplace lending growth (e.g. credit insurance), risk innovation via use of new data sources.

Regulator

- Foster industry growth through focused regulation that addresses typical industry specific issues – digital account opening via online KYC processes, encouraging P2P investments via its inclusion as investible asset class for pension funds and potentially favourable tax treatment.
- Proactively define industry standards on transparency of performance of different platforms (e.g. standardizing NPL definition and mandating NPL reporting) and investor appropriateness (e.g. standardized disclosures on risk – return trade off).
- Push for improvements in credit data infrastructure via reporting of marketplace lending credit lines to existing credit bureaus, creation of new credit bureaus who may specialize in synthesis of new data sources (e.g. online footprint).



Oliver Wyman is a global leader in management consulting that combines deep industry knowledge with specialized expertise in strategy, operations, risk management, and organization transformation.

For more information please contact the marketing department by email at info-FS@oliverwyman.com or by phone at one of the following locations:

ASIA PACIFIC
+65 6510 9700

EMEA
+44 20 7333 8333

AMERICAS
+1 212 541 8100

www.oliverwyman.com



Modalku is a registered trademark from PT Mitrausaha Indonesia Grup, a registered company in the Republic of Indonesia, with a mission to support the business growth of SMEs through its peer-to-peer lending service. Modalku is committed to be a thought leader in the peer-to-peer lending business, especially for SME entrepreneurs, the government, and lenders.

For more information please visit our website www.modalku.co.id or by email at info@modalku.co.id.

AUTHORS' CONTACT INFO

Jason Ekberg

Partner, Corporate and Institutional Banking Practice
+62 21 2975 8051
jason.ekberg@oliverwyman.com

Ritwik Ghosh

Principal, Retail and Business Banking Practice
+65 6510 9700
ritwik.ghosh@oliverwyman.com

Iwan Kurniawan

Chief Operating Officer of Modalku
+62 21 2252 1344
iwan.kurniawan@modalku.co.id

Copyright © 2016 Oliver Wyman and Modalku

All rights reserved. This report may not be reproduced or redistributed, in whole or in part, without the written permission of Oliver Wyman and Modalku, and Oliver Wyman and Modalku accepts no liability whatsoever for the actions of third parties in this respect.

The information and opinions in this report were prepared by Oliver Wyman and Modalku. This report is not investment advice and should not be relied on for such advice or as a substitute for consultation with professional accountants, tax, legal or financial advisors. Oliver Wyman and Modalku has made every effort to use reliable, up-to-date and comprehensive information and analysis, but all information is provided without warranty of any kind, express or implied. Oliver Wyman and Modalku disclaims any responsibility to update the information or conclusions in this report. Oliver Wyman and Modalku accepts no liability for any loss arising from any action taken or refrained from as a result of information contained in this report or any reports or sources of information referred to herein, or for any consequential, special or similar damages even if advised of the possibility of such damages. The report is not an offer to buy or sell securities or a solicitation of an offer to buy or sell securities. This report may not be sold without the written consent of Oliver Wyman and Modalku.

