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Assessment of financing needs of SMEs in the Western Balkans countries

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Country report: Montenegro

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List of Acronyms

BEEPS	Business Environment and Enterprise Performance Survey
BFC	Business & Finance Consulting
CAR	Capital Adequacy Ratio
CPI	Consumer Price Index
DEG	Deutsche Investitions- und Entwicklungsgesellschaft
EBRD	European Bank for Reconstruction and Development
EFSE	European Fund For Southeast Europe
EIB	European Investment Bank
EU	European Union
EUR	Euro currency
FDI	Foreign Direct Investment
FI	Financial Institution
GDP	Gross Domestic Product
GGF	Green for Growth Fund
GVA	Gross Value Added
IDF	Investment and Development Fund of Montenegro
KfW	German Development Bank
MCI	Micro-credit Institutions
MFI	Micro-finance Institution
MIDAS	Montenegro Institutional Development and Agriculture Strengthening
MSME	Micro, Small and Medium Enterprises
NACE	Statistical classification of economic activities in the European Community
NASME	Directorate for Development of Small and Medium Enterprise
NPL	Non-performing Loan
OECD	Organization for Economic Co-operation and Development
PE	Private Equity
PPP	Purchasing Power Parity
SME	Small and Medium Enterprises
SOE	State-owned Enterprises
TA	Technical Assistance
VAT	Value Added Tax
VC	Venture Capital

About this report

This report is one of a series of reports produced by Business & Finance Consulting GmbH (BFC) for European Investment Bank (EIB) as part of the project "Assessment of financing needs of SMEs in Western Balkans countries." The series of reports includes individual reports on Albania, Bosnia and Herzegovina, Kosovo, Macedonia, Montenegro, and Serbia as well as a synthesis report which considers the results of all six reports. The purpose of the project is to assess the financing needs of SMEs in the Western Balkans and identify market failures that prevent SME access to finance.

The project was carried out from October 2015 to April 2016 by a team of three experts from BFC. Onsite visits were conducted for each country in order to meet with representatives from financial institutions, development institutions, government organizations, and other relevant experts who can provide insights into the SME sector.

The visit to Montenegro took place from January 19–27, 2016, during which time meetings were held with representatives from 19 organizations, including 9 local financial institutions, 4 international development institutions, the Central Bank, one municipal government, 3 SMEs, and one business association.

The authors take full responsibility for the contents of this report. The opinions expressed do not necessarily reflect the view of the European Investment Bank.

1. Executive summary

Economy: In terms of economic development, Montenegro is ahead of its non-EU neighbors with a higher GDP per capita than Bosnia and Herzegovina, Serbia, and Albania. However, GDP growth was slow on average from 2011 to 2014 before showing signs of picking up in 2015. The service sector is by far the largest in Montenegro, led by a large and growing tourism industry. The manufacturing sector is very small and has limited participation from SMEs. Export activity is weak, especially from SMEs, contributing to a large trade deficit of 42% of GDP. The state is running very large budget deficits annually, although total public debt is still at a manageable level of GDP.

Demand: There are few large corporations in Montenegro, so the SME sector has an outsized contribution to the economy in comparison with EU averages. Demand for credit from SMEs has been generally stable in recent years but is trending upward starting from 2015, in line with higher economic growth. A sharp decline in interest rates over the last two years also provides incentives for SMEs to borrow. The regulatory and institutional environment for SMEs has been gradually improving over the past decade. It is relatively easy to establish a business, although survey results indicate that SMEs find tax rates and administration to be constraint to development, and the World Bank identifies getting electricity and getting construction permits to be problematic.

Supply: There are 24 financial institutions providing credit products to SMEs: 14 banks, 6 microfinance institutions, and 4 leasing companies. However, there are no funds providing equity finance, and the stock market has not proven to be an attractive option for SMEs to raise capital. Credit growth has been slow over the last five years but accelerated in 2015 and is likely to continue to accelerate in 2016 in the opinion of most industry observers. High NPLs, a legacy of the 2008–2010 crisis, has spurred many lenders to adopt conservative policies and strict eligibility requirements, although this tendency is party counteracted by high competition among banks for creditworthy clients. The regulatory framework for financial institutions is good overall and does not present any serious barriers to the provision of funding to SMEs.

Gaps: There is a moderate funding gap for loans, driven by conservative lending practices of banks and the informal practices of borrowers. Most SMEs can get a loan, but it may not be on terms (considering the amount, collateral requirements or maturity, for example) that are acceptable to the borrower. Although the demand for leases and equity products is low, there is a notable gap relative the size of demand due to the weak condition of the leasing sector and due to the absence of formal institutions providing equity finance. Agricultural enterprises, startup businesses, enterprises based in the northern part of the country, and informal enterprises all face challenges in access to funding. In addition, micro and small enterprises tend to be disadvantaged relative to medium enterprises. As the high level of NPLs in the banking sector declines and economic growth improves, a trend which has already taken hold in 2015, more SME should be able to access funding on reasonable terms, and the funding gap should decrease in size. The continued decline in NPL levels and improved economic growth observed in 2015 should encourage financial institutions to provide more financing to SMEs on more advantageous conditions in the coming year.

2. Macroeconomic environment

Key findings:

- *Economic growth has been weak on average in recent years, although the pace of growth improved in 2015 and is expected to be reasonably good in 2016*
- *The tourism sector has been a strong performer, contributing to a large service sector that makes up almost half of GDP. The manufacturing sector is particularly small, accounting for less than 5% of GDP*
- *Inflation has been low on average over the past five years, and 2014 saw deflation of 0.7%, which may have restrained household spending and contributed to weak revenue growth for SMEs*
- *Montenegro has a huge trade deficit (42% of GDP) highlighted by a poorly-performing export sector in which there is minimal participation of SMEs. The volume of FDI inflows is substantial, although most of it is targeted towards large enterprises*
- *The government has been running very large budget deficits in recent years, often more than 5% of GDP, although overall public debt is still at a manageable level*

Key macroeconomic indicators for the country are presented in Annex 1. The main source of data in this section is the *Statistical Yearbook* of the Montenegro Statistical Office. Unless otherwise noted, all data is taken from that source.

2.1 Economic development and growth

Montenegro's economic growth in the last five years (2011–2015) has varied greatly by year. The country dipped into recession in 2012, recording a 2.7% fall in real GDP, but rebounded with a reasonably strong 3.5% growth in 2013. Modest growth of 1.8% in 2014 was followed by a much improved 3.6% in the first three quarters of 2015. Although economic growth has been fairly broad-based across sectors, the tourism sector has performed particularly well. Foreign tourist arrivals rose by 27% from 2009 to 2013, encouraging the founding of many new small businesses engaged in food service and accommodation.

The GDP per capita of EUR 5,561 exceeds that of its neighbors Bosnia (EUR 3,642) and Serbia (EUR 4,524). High unemployment is a serious impediment to economic development as the country reported an official unemployment rate of 18.0% in 2014. Encouraging and enabling the unemployed to engage in entrepreneurial activity would be one path to reducing the unemployment rate. This average rate hides major discrepancies by region, however. The coastal part of the country, the main beneficiary of the tourism boom, enjoys a relatively low unemployment rate of 6.7%. The central region, which includes Podgorica, has a higher 13.4% rate while the northern region reports a very high 39.0% unemployment rate. Despite various government initiatives to boost investment in the northern region, it remains far behind the central and coastal regions in terms of economic development.

2.2 The structure of the economy

The service sector (excluding trade) is the largest in the country, accounting for 49.1% of 2014 gross value added (GVA). The trade sector follows at 14.2% of GVA. The increasing entry of international corporations in activities such as retail clothing trade has translated into fewer opportunities for SMEs, encouraging some of them to shift from trade into the service sector. As noted above, the strength of the tourism industry has attracted many small enterprises, further boosting the service sector. One interviewee estimates that tourism, when broadly defined, may account for as much as 20% of GVA.

The agriculture sector is small in Montenegro, contributing 10.0% of GVA and employing just 4.5% of the population, according to official figures. However, the actual contribution and employment may be significantly higher since a large share of agricultural output is produced by unregistered, micro-sized family farms. The contribution of SMEs (excluding these micro farms) to agricultural output is relatively small. Nevertheless, there are examples of entrepreneurs who have established successful, usually export-oriented commercial farms that would be classified as SMEs. There is reportedly good potential for small wineries, for example, as the country has few of these at present. Other agricultural activities with good potential are olive oil production, herbs, spices, honey, and mushroom harvesting.[1]

The manufacturing sector is particularly small and accounted for only 4.8% of GVA in 2014. Small enterprises have a relatively small role in manufacturing but a particularly high role in trade. Of the gross output of large enterprises, 49% comes from industry but just 12% is from trade. By contrast, industry makes up just 13% of gross output for small enterprises while trade makes up 27%. Medium enterprises are more balanced with an identical 26% of output coming from trade and industry. Manufacturing activities often require large capital investments which are not feasible for small entrepreneurs. Nevertheless, there are opportunities for SMEs in this sector as evidenced by their active participation in the wood processing industry. In the area of energy production, a number of interviewees cited good opportunities for the establishment of small hydro power plants in the north of the country.

State-owned enterprises are not believed to be a major contributor to economic output, although their exact contribution is unknown. The government's privatization program has been mostly successful, and only a few firms are left to be privatized.

2.3 Inflation and asset prices

The consumer price index has been variable in recent years but not especially high. In the five years from 2011 to 2015, it had a peak of 4.1% in 2012, and deflation of 0.7% was recorded in 2014. For the first nine months of 2015, average inflation was 1.6% compared to the first nine months of 2014. Overall, price inflation has not acted as a major barrier to the development of the SME sector since there have not been any sharp increases or decreases in recent years. However, the deflation in 2014 may have encouraged households to save rather than spend (as evidenced by a 10% jump in bank deposits that year), which would negatively affect SME revenues.

After a sharp decline from early 2008 to mid–2010, real estate prices were generally stable from 2010 to 2013. However, from mid–2013 to late 2014, a decreasing trend has been noticed. The average price per square meter of residential property in Podgorica fell from EUR 1,169 in March 2013 to EUR 950 in September 2014. In the country as a whole, a falling trend was also noted in each quarter of 2014 for newly constructed buildings. The Central Bank attributes the fall in real estate prices partly to reduced housing lending activity from banks.[2] For SMEs looking to acquire property, the fall in prices presents a good buying opportunity, but for those that already own real estate, a reduction in the value of potential collateral for loans could limit their ability to obtain funding.

[1] World Bank. *Project Paper: Montenegro Institutional Development and Strengthening Project*. November 25, 2015. Report No: PAD1427.
[2] Central Bank of Montenegro. *Financial Stability Report 2014*.

2.4 Balance of payments

Montenegro's balance of payments is characterized by a large trade deficit, equivalent to 19.8% of GDP in 2014. The value of exports equaled 40.1% of GDP in 2014 but most of this was generated by exports of services. Exports of goods only comprised 9.6% of GDP, down from 11.2% in 2013. Although no statistics are available, most export activity is reportedly generated by large corporations, with substantially less participation from SMEs, particularly small and micro enterprises. This is connected to the issue of low participation of SMEs in the manufacturing sector, as mentioned above, and the bifurcation of the agriculture sector between large enterprises that often do export and micro household farms that tend not to export.

FDI inflows make a substantial contribution to the economy, representing 10.8% of GDP in 2014. Most of the FDI is reportedly targeted towards large enterprises; there may be some investment in the upper end of the medium enterprises category, but the volume of investment rapidly declines as the size of the enterprise decreases. Overall FDI in 2014 was up from 10.0% in 2013 but down sharply from 15.1% in 2012.

2.5 The fiscal and political situation

The country's economy is heavily dependent on government spending, which represented 42.1% of GDP in 2014. The state is a key employer, with wages to government employees representing 27% of total government spending and 11.2% of GDP. The government has been running large budget deficits in recent years, exceeding 6% of GDP in 2012 and 2013. The deficit improved to 3.0% of GDP in 2014 partly as a result of improved VAT tax collection. Despite the deficits, the government is not yet heavily over-indebted – the ratio of public debt to GDP stood at 59.9% at the end of 2014. The government's planned investments in infrastructure – in particular, a major highway running across the country – make it likely that deficits will continue to remain significant in 2016 and coming years. The euro has been adopted as the national currency, so there is no need for the government to maintain a large currency reserve position.

The political situation has been stable in recent years, which has helped to support business confidence in spite of the tepid economic growth. The upcoming elections in 2016 introduce an element of uncertainty, but, overall, there are no major risks that would be relevant to the SME sector.

3. Demand analysis

Key findings:

- *The SME sector consists of 22,313 active non-agricultural enterprises and 48,824 family farms*
- *The contribution of SMEs to the economy is well above EU averages, with SME turnover at 77% and value added at 67% of the total*
- *There is a somewhat high concentration of enterprises in Podgorica, Budva and Bar municipalities while the northern region of the country is under-represented*
- *Based on survey data, SMEs identify a number of institutional and regulatory concerns that inhibit their development: tax rates and procedures, informal sector competition, and access to finance are generally rated as major constraints*
- *Total demand for loans is estimated to be EUR 560 million. Demand for credit has generally been stable in recent years, with a notable increase in 2015 as the economic environment improved*

3.1 Size and growth of the segment

3.1.1 Number of SMEs

According to Monstat, the official statistical agency of Montenegro, there were 22,351 active[3] non-agricultural enterprises in 2012 (the most recent available data), of which 22,313 (99.8%) were classified as SMEs. This proportion is the same as the EU average. [4]

Table 1. Number of active non-agricultural enterprises in 2012

Size	Definition	Number	Share
Small	0–49 employees	22,058	98.7%
Medium	50–249 employees	255	1.1%
Large	250+ employees	38	0.2%
TOTAL		**22,351**	**100.0%**
Total SMEs		22,313	99.8%

Source: Monstat

The categories are based on the EU standard definition of number of employees. These statistics exclude the agricultural sector, however, so farmers are not counted. According to the 2010 agricultural census, there were 48,824 “family agricultural holdings” (i.e. family farms). Although no breakdown by size categories is provided, it can be assumed that all of these family holdings would meet the definition of a small enterprise. Adding these agricultural enterprises to the non-agricultural enterprises gives a total number of SMEs of 71,137, raising the proportion of SMEs to 99.95%, well above the EU average. The number of large enterprises would likely be even lower if the EU definition of at least EUR 50 million in turnover were applied rather than only the number of employees. One interviewee suggested that there were just 5–10 companies in the country with turnover more than EUR 50 million. Another estimated that there were about 50 companies with more than EUR 5 million in turnover.

The latest available statistics on the number of enterprises are from 2012, so it is not possible to determine the growth rate since then. Most local experts interviewed for this study believe that there has been slow but steady growth in the number of registered enterprises in recent years. Enterprise growth has been restrained by Montenegro’s modest economic performance on the one hand but boosted by the increasing number of informal enterprises electing to register their business on the other hand.

[3] They were active in the sense that they had turnover, employed staff and were registered.
[4] European Commission. *Annual report on European SMEs 2014/2015.* November 2015.

3.1.2 Importance of the SME sector to the economy

SMEs, excluding the agriculture and financial sectors, accounted for 77% of turnover and 67% of gross value added in 2014, according to Monstat. The result for gross value added is much higher than the EU average of 58%.[5] The following table presents the contribution to turnover and gross value added by size category.

Table 2. Share of SMEs in turnover and gross value added

Size	Turnover	Gross value added
Small	50.1%	39.1%
Medium	26.5%	28.1%
Large	23.4%	32.8%
TOTAL	**100%**	**100%**
Total SME	76.6%	67.2%

Source: Monstat, Enterprise Operations, Year 2014

Although the contribution of SMEs to employment is not available, Monstat reports that SMEs accounted for 53% of total personnel expenses in the manufacturing sector, 98% in construction, 81% in trade, and 71% in services in 2014, further highlighting the importance of SMEs to the economy.[6]

Classifying the enterprises by turnover rather than number of employees would also be likely to boost the contribution of SMEs since many of the enterprises with more than 250 employees earn less than the threshold of EUR 50 million in turnover, as evidenced by the fact that the average reported turnover of the enterprises with more than 250 employees is only EUR 40 million.

3.2 Characteristics of SMEs

In the absence of data on SMEs in particular, the statistics in this section are given for enterprises of all sizes, including large enterprises. However, since the number of large enterprises only accounts for 0.2% of the total, these statistics represent a very close approximation of the SME population.

3.2.1 Registration type

The following table shows the most common types of registration in Montenegro by number of enterprises in 2012 and 2011 (the most recent available data)[7]. By far, the most common registration is limited liability company, followed by the category “entrepreneur”, which is a natural person authorized to run a business. There are several other registration categories not shown in the table that each make up less than 1% of the total. For example, there are 13 publicly-owned enterprises in the country, representing 0.1% of the total. There were also 97 state-owned enterprises, 0.4% of the total.

[5] European Commission. *Annual report on European SMEs 2014/2015.* November 2015.
[6] The contribution of SMEs to total employment is not available.
[7] These, and most other statistics in this section, are based on the total number of enterprises in the country, including large enterprises since a breakdown by enterprise size is not available. However, since there are so few large enterprises, these statistics should correspond very closely to the results for SMEs.

Table 3. Most common enterprise registration types

	2012	2011
Single member private limited company	61.3%	59.9%
Limited liability company	20.1%	21.4%
Entrepreneur	14.1%	13.9%
Cooperative society	1.3%	1.7%
Joint stock company	1.1%	1.0%

Source: Monstat[8]

Although exact data are unavailable, the entrepreneur registration type is likely to be comprised almost solely of microenterprises while joint stock companies are probably comprised primarily of large and medium enterprises.

3.2.2 Business activity

Services were the largest sector of the economy in 2012 by number of enterprises, comprising 42% of the total. Trading followed at 39% of the total. Manufacturing enterprises accounted for 8.8%, and construction stood at 9.1%. Registered agricultural enterprises were just 1.1% of the total; however, if the 48,824 farming households mentioned in Section 3.1 above (all of which are assumed to be unregistered) were included in the count, the proportion of agricultural enterprises would be 69.2%.[9] The following table shows the most common activities according to the EU's NACE classification system.

Table 4. Most common business activities

	2012	2011
Trade and vehicle repair	38.8%	42.0%
Accommodation and food service activities	11.3%	10.6%
Construction	9.1%	8.8%
Manufacturing	8.8%	8.1%
Professional, scientific and technical activities	8.3%	8.0%
Transportation and storage	7.2%	6.9%
Real estate activities	3.5%	3.7%
Administrative and support service activities	3.5%	3.0%
Other service activities	2.8%	2.7%
Information and communication	2.2%	2.1%

Source: Monstat

Within the service sector, accommodation and food services register the highest count at 11.3% of the total. The importance of this activity is connected to tourism, one of the key drivers of the Montenegrin economy. The decline in the proportion of enterprises in the trade sector in 2012 is consistent with anecdotal accounts that large foreign retailers are gradually putting smaller enterprises out of business.

3.2.3 Regional distribution

There is a somewhat high concentration of businesses in a few of Montenegro's 21 municipalities. Podgorica leads by a large margin with 31.7% of registered enterprises. Including Budva and Bar pushes the cumulative proportion for the top three municipalities to over 50%. Aside from Podgorica, most economic activity is concentrated in the coastal areas (Budva, Bar, Herceg Novi, Kotor, Ul-

[8] Monstat, "Analysis of the number of structure of business entities in Montenegro for the third and fourth quarter of 2012."
[9] The average family agricultural holding had 3.6 head of livestock and 6.0 hectares of total land, 4.3 hectares of which was utilized for agriculture. Almost a third (31.6%) of these holdings were very small in size with up to 0.5 hectares of land.

cinj, and Tivat) where tourism is highly developed. The northern part of the country[10], which is mountainous, is considered under-developed and accounts for a relatively small proportion of enterprises – 15.6% at the end of 2012.

The following table shows the concentration of businesses by municipality. The top ten of Montenegro's 21 municipalities are listed.

Table 5. Most common locations of enterprises by municipality

	2012	2011
Podgorica	31.7%	33.3%
Budva	11.2%	10.9%
Bar	10.2%	9.9%
Herceg Novi	7.8%	8.6%
Nikšić	7.1%	7.4%
Bijelo Polje	5.0%	5.1%
Kotor	4.6%	4.6%
Ulcinj	4.3%	4.3%
Tivat	3.3%	2.9%
Cetinje	2.6%	2.6%

Source: Monstat[11]

3.2.4 Gender

Women comprised just 9.6% of business owners in 2011[12], reportedly the lowest in the Balkan region. Interviewees suggested that traditional gender roles discourage women from starting businesses; many women are expected to stay home and care for the household and family. Partly as a result of the traditional gender roles, household assets are usually owned by male members of the household – as a result, female entrepreneurs have less flexibility in offering collateral to obtain a loan. Despite the gloomy picture, attitudes are changing for the better for female entrepreneurship over time. Organizations such as the Investment and Development Fund (see section 4.5) and various donor programs are supporting female-owned businesses and encouraging more women to consider entrepreneurship as a means of supporting themselves and their families.

3.3 Performance

The general consensus among the banking sector experts interviewed for this study is that the financial performance of SMEs was moderate in 2015 and slightly better than in 2014. Growth of turnover and assets is reportedly slow, and profitability is acceptable but not particularly strong. A small improvement in line with expectations of slightly improved economic growth is expected for 2016. According to Monstat's figures, the turnover of SMEs grew by a meagre 0.7% in 2014, although this was better than large enterprises, which experienced a decline of 0.9%.

Bank perception of SME performance is colored by the high degree of manipulation of SME official financial records. Tax avoidance – usually by means of understating revenues and profit – is widespread, leading banks to have a more negative image of SME performance than is actually the case. Nevertheless, mediocre economic conditions in recent years make it likely that SME performance has not been particularly good and that growth is weak on average.

[10] Consisting of the municipalities: Pluzine, Savnik, Kolasin, Andrijevica, Plav, Zabljak, Mojkovac, Pljevlja, Bijelo Polje, Berane and Rozaje

[11] Monstat, "Analysis of the number of structure of business entities in Montenegro for the third and fourth quarter of 2012."

[12] Monstat. "Owners of Business Entities in Montenegro in 2011 by Gender." March 2012.

3.4 Institutional and regulatory issues

Montenegro has a moderately good institutional and regulatory framework, but there are notable constraints that limit the development of the SME sector. The barriers that are most commonly mentioned by survey respondents include informal sector competition, tax rates and administration, access to finance, and access to electricity. Most experts interviewed for this study agree that the business environment is improving gradually over time.

According to the World Bank's Doing Business indicators for 2016, Montenegro has a reasonably good overall rank of 46 out of 189 economies, an improvement from 51 from 2013. The country is particularly strong in the areas of getting credit (rank: 7), protecting investors (36) and resolving insolvency (36). The weakest area by far is getting electricity (rank: 163), although dealing with construction permits (91) and registering property (79) also rank somewhat poorly. The full set of World Bank indicators, as well as the indicators for other studies mentioned below, can be found in Annex 2.

EBRD's BEEPS surveys[13] (carried out most recently in 2013) identify the top constraints to doing business as competition from the informal sector, access to finance, electricity, and tax administration.[14] A number of important issues such as corruption, business licensing, and customs and trade were rated very low as obstacles.

In the World Bank Enterprise Surveys, small enterprises identified tax rates, practices of the informal sector and access to finance as top constraints while medium enterprises identified labor regulations, political instability and crime as the top three. By contrast, most large enterprises stated that customs and trade regulations were the top obstacle.

The OECD's SME Policy Index, last conducted in 2012, scored Montenegro weakest in the areas of innovation policy (a score of 2.0 out of 5), SMEs in a green economy (2.3) and entrepreneurial learning and women's entrepreneurship (2.9). The highest scores were given in the regulatory framework for SME policy making (3.7), the operational environment for SMEs (3.6), and bankruptcy and second chance (3.6).

The Directorate for Development of Small and Medium Enterprise (NASME) is the government body responsible for defining strategies, proposing policies, and coordinating projects related to SME development. There is no specific law on development of SMEs, but NASME produced a strategy for SME development which covered the period of 2011–2015. Montenegro is trying to create SME policies in line with EU policies as part of the EU accession process.

3.5 Innovation

It is difficult to evaluate the degree of innovativeness in Montenegro's SME sector since the types of organizations and individuals that would typically identify and work with innovative companies, such as angel investors and venture capital funds, are absent. Banks generally report that there is a very low level of innovation among their clients; however, bankers tend to value stability over creativity among their clients and are less likely to notice or support innovative companies. Although a few municipal governments have opened incubators, the few that exist provide a limited scope of services to a relatively small number of enterprises. Overall, it is likely that there is a quite small group of innovative companies — most of them in the early stages of development, unprofitable, and op-

[13] Source: http://ebrd-beeps.com/countries/bosnia-and-herzegovina/

[14] Possible explanations for the good result for access to finance in Doing Business versus the poor result in BEEPS are given in Section 6.

erating on a limited scale. Such companies may have individuals who are very capable in terms of a particular area of knowledge but lack business skills such as financial planning and marketing. For this reason, it is arguably of particular importance that these companies receive support of some kind, either financial or technical, in order to create success stories that would inspire students and other entrepreneurs to engage in fields that have a high degree of innovation.

3.6 Demand for finance

3.6.1 Overview

Demand conditions have generally been stable in Montenegro as of early 2016. According to banks and MFIs, demand for credit from SMEs has grown over the last two years, albeit at a very slow rate. That trend is expected to continue in 2016 as well. The decrease in interest rates over the past two years (see section 4.2 for details) has provided incentives for SMEs to borrow, although this may have been partly counteracted by price deflation in 2014, which encouraged enterprises to save.

3.6.2 Estimate of demand

The demand for loans from registered MSMEs is estimated at about EUR 560 million, which is equivalent to 16.2% of 2014 GDP. The main steps in the calculation are shown in the following table.

Table 6. Calculation of demand for loans from MSMEs

Step in Calculation	Value	Source
A. Number of MSMEs	22,313	Monstat
B. Average loan size demanded (EUR)	47,519	BFC survey of local lenders
C. % of enterprises needing a loan	52.8%	World Bank Enterprise Surveys
D. Total demand (EUR millions)	**559.8**	**= A * B * C**

The number of registered MSMEs, based on government statistics, is multiplied by the average loan size demanded and the proportion of MSMEs that need a loan. The average disbursed MSME loan size for banks responding to a BFC questionnaire is used as a proxy for the amount demanded. To the extent that actual demanded loan size may be higher than the amount received due to lenders being overly conservative in their loan decisions, the demand estimate could be understated. The share of enterprises needing a loan is taken from the World Bank's Enterprise Surveys.[15]

The accuracy of the estimate may be somewhat compromised by the different definitions of MSMEs from the different sources. Monstat, the banks, and the World Bank all apply different definitions of MSMEs. In addition, the timing of the data differs — the number of enterprises is from 2012, loan size is from mid–2015, and the percent demanding a loan is from 2013. The resulting demand estimate is only intended to give a general sense of the scale of demand.

There is insufficient information available to estimate the demand for other product types such as equity or leases.

3.6.3 By type of SME

Enterprises engaging in tourism are demonstrating higher demand growth for credit than other sectors in recent years. In connection with tourism, the coastal areas of Montenegro have also seen higher demand growth. However, aside from tourism, managers of banks and MFIs interviewed for this study were not able to consistently identify any specific segments that are exhibiting unusually

[15] The World Bank reports the percentage of respondents that do not need a loan, so the rest are assumed to want a loan.

high or low demand growth. The stable, slow growth in credit demand that has been observed in recent years appears to be mostly broad-based.

3.6.4 By instrument

Aside from loan products, banks report that demand for guarantees is relatively strong while demand for letters of credit is weak due to a lack of awareness and familiarity with this product from the side of potential customers. The situation for leasing products is similar with demand restrained by lack of familiarity. Although entrepreneurs generally understand the basic mechanics of leasing, they often do not feel sufficiently comfortable with the details and contractual specifics, making them less likely to approach a leasing company. The limited branch networks of leasing companies also make leasing inconvenient for SMEs not based in the largest cities. The dynamics of demand for both loans and other products has been generally stable in recent years since economic growth has been mostly flat.

4. Supply analysis

Key findings:

- *Nearly all financial institutions in Montenegro work with SMEs since there are very few large corporate clients*
- *Credit growth has been slow in recent years but shows signs of picking up in 2015 with the exception of the leasing market, which has gone through a lengthy period of contraction*
- *High NPLs, a legacy of the earlier crisis period, has led banks to be conservative in their credit policies and decision-making, particularly with regards to collateral and setting loan amounts*
- *There are no venture capital funds or private equity funds that target the country, and the country's stock market is rarely used by SMEs as a way to raise capital*
- *The regulatory framework is good overall and does not present major constraints to the financing of SMEs*
- *The total supply of loans to SMEs is estimated to be around EUR 552 million, equivalent to 26.6% of the total bank and MFI loans and 16.0% of GDP*

4.1 Number and type of intermediaries

Despite Montenegro's small population, there are a reasonably high number of institutions providing financial services to SMEs. However, these institutions are heavily concentrated on the provision of credit products with almost no intermediaries providing equity financing. The following table shows the total number of financial intermediaries in the country by type.

Table 7. Number of financial intermediaries

	Q3 2015	2014	2013
Banks	14	12	11
Leasing companies	4	4	4
Micro-credit institutions	6	6	6
Stock markets	1	1	1
Government funds	1	1	1
Private equity/venture capital funds	0	0	0

Banks: There were 14 banks in Montenegro at the end of 2015, up from 12 at the end of 2014 (Zapad Bank and ZiraatBank received licenses in 2015). The number is likely to increase again as the Central Bank is reviewing the application of another bank at the time of this writing in early 2016. All 14 banks are engaged in lending to the SME sector – given the small size of the large corporate sector, they have little choice but to work with SMEs. The industry is not highly concentrated considering that there are 14 banks – the largest bank accounts for 17.2% of total banking assets and the top three for 43.9%.

Micro-credit institutions: There are six micro-credit institutions (MCIs) in Montenegro. They are all engaged in micro-lending to some extent but are not able to move up the scale to serve larger clients due to a regulatory restriction that limits their maximum total exposure to one borrower to EUR 30,000. Several of the MCIs are reportedly focusing on consumer lending and have relatively small portfolios of business loans. The industry is very highly concentrated with a single institution – Alter Modus – accounting for 67% of the total assets of all MCIs.

Leasing companies: There are four specialized leasing companies: S-Leasing, Porsche Leasing, NLB Leasing and Hypo Alpe Adria Leasing. In addition, two banks are engaged in leasing activities: Hypo Alpe Adria Bank (parent of Hypo Alpe Adria Leasing) and Prva Banka. Hypo Alpe Adria Leasing and

Prva Banka did not, however, issue any new leases in 2014 and only collected on older contracts.[16] All four of the leasing companies work with the SME sector.

Government: There is one fund established by the government, the Investment and Development Fund of Montenegro (IDF), which disburses loans directly to SMEs on advantageous terms. Although this fund was established by the government, all of its funding comes from international institutions. It is described in more detail in section 4.5 below. A few municipalities offer loans to SMEs, but the overall volume of such lending is very small in comparison with the IDF.

Guarantee funds: There are no guarantee funds at the national level in Montenegro. A few municipalities have established guarantee funds, providing guarantees directly to SMEs, but they are very small in scale and do not have a meaningful impact on the market as a whole.

Others: The financial sector also includes 11 insurance companies and one stock exchange, the Montenegro Stock Exchange. For reasons discussed in section 4.2 below, the stock exchange is not considered an important funding source for SMEs. There are no private equity or venture capital funds that are based in or focusing on Montenegro.

As the following table shows, banks account for 91.4% of financial sector assets with leasing companies and MCIs contributing 2.6% and 1.1%, respectively. The share of leasing companies' assets declined severely in 2014 as two companies halted the issuance of new lease contracts.

Table 8. Share of financial sector assets by type of intermediary

	2014	2013
Banks	91.4%	90.6%
Leasing companies	2.6%	3.6%
Micro-credit institutions	1.1%	1.1%
Insurance companies	5.0%	4.8%
TOTAL	**100.0%**	**100.0%**

4.2 Type of funding instruments

4.2.1 Loans

The business loan portfolio of banks has vacillated in recent years, declining in 2012 and 2014 but growing modestly in 2013 and the first nine months of 2015. In each of those periods, business loan growth lagged behind the overall credit portfolio growth of the banks. The weakness in business lending partly reflects that banks are writing off or selling troubled loans from the crisis period of 2008–2010.

The loan portfolio of MFIs has grown at a strong rate since the end of 2012 with further acceleration in 2015. However, this growth followed a massive decline in the MFI loan portfolio in the previous three years – MFI loan portfolios fell by 52% from the end of 2009 to the end of 2012.

[16] Central Bank of Montenegro, *Leasing Market in Montenegro: Briefing 2014.*

Table 9. Loan growth rates by year

	Jan–Sept 2015[17]	2014	2013	2012
Banks				
All loans	7.5%	–1.9%	3.1%	–0.7%
Business loans	2.1%	–2.9%	2.3%	–5.2%
MFIs	19.1%	7.0%	7.8%	–16.1%

Source: Central Bank of Montenegro

In terms of their lending policies, banks have been very conservative since the 2008–2010 crisis period as they struggle to deal with high NPL ratios. NPLs, defined as 90 days or more past due, stood at 16.8% at the end of 2014, an improvement from 18.4% at year-end 2013. The improvement in portfolio quality has encouraged banks to cautiously expand lending and to loosen credit policies somewhat in 2015. Portfolio quality is reportedly good for loans disbursed in recent years (i.e. after the crisis). However, business sector delinquency (including SME loans) is much higher than consumer NPLs (past due 30 or more days of 29.2% for business loans vs 14.2% for consumer loans at the end of 2014), giving incentives to banks to favor the consumer sector.[18]

Interest rates on loans have been falling sharply over the past two years. Bankers explain this trend as a result of the high liquidity of banks, falling cost of funding, and high competition for a relatively small pool of creditworthy customers. Most of the institutions interviewed for this study reported that they charge in the range of 6–9% on SME loans and that the average rate has fallen by almost 2% in the last 1–2 years. Earlier, rates of 10% or more were common. The average effective lending rate reported by the Central Bank fell from 9.4% at the end of 2013 to 8.9% as of Q3 2015.

Conservative credit policies are reflected in a number of areas: loan maturity, collateral requirements, eligibility requirements, and the setting of loan amounts relative to the borrower's financial capacity. Survey data indicate that the value of collateral needed for a loan in Montenegro is 243% of the loan value.[19] For the most part, bankers confirmed that they are taking a cautious approach in most areas of the credit process but that they have already started or plan to start making it easier for clients to access loans.

4.2.2 Leases

Leasing constitutes a small but important source of SME financing in Montenegro. There were 5,096 active leasing contracts in Montenegro at the end of 2014, a total of EUR 116.3 million, for an average of EUR 22,827 per contract. 1,084 new contracts were issued in 2014 for a total of EUR 15.0 million, with an average value of EUR 13,878. The leasing market has been contracting in recent years. Total assets of leasing companies fell from EUR 144 million in 2012 to EUR 88 million in 2014[20]. The number and value of contracts written also fell in 2013 and 2014. Although the overall size of the market is small and declining, roughly two thirds of the lease portfolio is disbursed to legal entities, most of which can be classified as SMEs.

The leasing market is heavily oriented towards vehicle financing with very little going to SMEs for the purpose of equipment financing. Passenger vehicles accounted for 88% of contracts written in 2014 with commercial vehicles representing another 9%. The vast majority of leases (90.6% in 2014) are structured as finance leases as opposed to operating leases. The leasing industry would benefit from a greater degree of variety both in the types of assets available and in the structure of the contracts.

[17] Figures are not annualized

[18] Central Bank of Montenegro. *Financial Stability Report 2014*.

[19] World Bank Enterprise Surveys, 2013.

[20] The total assets of leasing companies is less than the total outstanding balance of leasing contracts (EUR 116.3 million) because the latter includes the lease portfolios of banks.

4.2.3 Letters of credit and trade finance guarantees

Non-loan trade finance products such as guarantees and letters of credit are available to SMEs from most (but not all) banks in Montenegro. Usage of guarantees is reasonably high, but there is very little usage of letters of credit. Bankers argue that the low supply of letters of credit to SMEs is a consequence of low demand (as discussed in section 3 of this report) and does not reflect an unwillingness of financial institutions to provide these products on reasonable terms.

Among the four banks that provided data, the value of outstanding guarantees on behalf of SMEs totaled EUR 28.5 million, equivalent to 19% of their SME loan portfolio, whereas the total value of outstanding letters of credit was just EUR 55,000.

4.2.4 Risk capital

Although the supply of risk capital to SMEs cannot be quantified, interviewees consistently agreed that it is extremely low. The Montenegro Stock Exchange rarely serves as a means for raising equity for SMEs, and there are no PE or VC funds active in the market. There are no angel investor networks or similar platforms for entrepreneurs to connect with individual investors. Entrepreneurs wishing to attract equity investment must rely on their personal connections to find family members and friends willing to take part in their business.

The Montenegro Stock Exchange is generally not an appealing option for SMEs seeking equity capital mainly due to a low level of activity. The total turnover of equities in 2014 on the free market[21] amounted to EUR 12.3 million (excluding block trades) with about 9 trades occurring per day.[22]

4.3 Characteristics of funding recipients

Of the EUR 2.54 billion in total bank lending at Q3 2015, 37.6% was disbursed to private enterprises.

Table 10.

	Q3 2015		Q4 2011		Growth rate
	EUR	%	EUR	%	
Financial institutions	550,476	21.6%	364,819	15.5%	50.9%
State owned companies	35,479	1.4%	47,067	2.0%	−24.6%
Government	81,796	3.2%	116,903	5.0%	−30.0%
Private enterprises	956,941	37.6%	990,793	42.0%	−3.4%
Households	914,245	35.9%	833,730	35.3%	9.7%
Other	4,668	0.2%	5,845	0.2%	−20.1%
TOTAL	**2,543,605**		**2,359,157**		**7.8%**

Source: Central Bank of Montenegro

State-owned enterprises do not appear to be crowding out lending to private companies as bank loans to SOEs represented just 1.4% of total loans. Lending to the government and its agencies is also relatively modest. However, lending to financial institutions represents a substantial 21.6% of total lending. A comparison with the end of 2011 shows that both the share and total value of bank loans to private enterprises has declined at the expense of loans to households and financial institutions.

[21] The stock exchange consists of an "official market" where mostly large corporations are listed and the "free market" where medium-sized enterprises would be more likely to be found.
[22] Montenegro Stock Exchange. *Annual Report 2014*.

4.3.1 By sector

Based on a survey of four banks, the trading sector is the most popular destination of loans (35.0% of total SME loans) followed by the service sector (20.7%).

Table 11. SME lending of 4 banks by sector at June 2015 compared to share of 2014 GDP

Sector	4 banks	Share of GDP
Agriculture	2.8%	10.0%
Manufacturing/production	11.0%	4.8%
Services	20.7%	49.1%
Trade	35.0%	14.2%
Other	30.5%	21.9%
TOTAL	**100%**	**100%**

The analysis is complicated by the fact that some banks place sectors such as tourism and transportation, which would normally be considered services, in the "other" category. The actual volume of lending to the service sector is likely to be higher than the 20.7% indicated here.

SME lending to the manufacturing sector (11.0% of total loans) is notably higher than the sector's share of GDP. Several banks report that they favor manufacturing enterprises over other sectors for a variety of reasons including (as some banks perceive) average larger loan sizes, higher growth potential, and lower risk.

Very little bank lending goes to SMEs in the agriculture sector. This partly reflects the structure of the agriculture sector, which consists of several large corporations on the one side and many unregistered, micro-sized family farms on the other. Since the banks do not serve unregistered businesses, the vast majority of farmers are not part of banks' target market. In addition, some bankers consider the agriculture sector to be more risky and less profitable than other sectors, so, to an extent, there is a conscious decision to avoid the sector.

Although MFIs can and do work with unregistered enterprises, there is nevertheless a low penetration of the agriculture sector by MFIs. The largest MFI in the country reports that agricultural loans comprise about 10% of the total loan portfolio and that the organization does not consider agriculture to be one of its top priorities. One MFI that focuses on the agriculture sector was badly impacted by the financial crisis and cut back its overall scale of operations, leading to a sharp decrease in the supply of agricultural microloans. The total assets of this rural lending specialist fell from EUR 52.2 million in 2009 to just 8.6 million in 2014.

4.3.2 By region

The vast majority of lending goes to the central region (including Podgorica) and coastal region of the country. A comparatively small amount of lending activity takes place in the relatively underdeveloped northern region. Although precise figures are not available, it is likely that the coastal region is experiencing the greatest increase in lending in recent years, spurred by the tourism boom.

4.3.3 By purpose

Lending to finance working capital is the most common purpose for bank loans. Nevertheless, the financing of fixed asset purchases is a fairly high 34.1% (based on the average of four banks that provided data).

Table 12. SME lending by purpose for 4 banks

Sector	Share
Working capital	49.6%
Fixed assets	34.1%
Other	16.3%
TOTAL	**100%**

Source: BFC survey

The "other" category consists of purposes such as debt refinancing and consumer spending (by the owners of the SME).

4.4 Institutional and regulatory issues

The regulatory and supervisory environment for banks does not appear to pose any major impediments to the financing of SMEs. The banks interviewed for this study generally expressed satisfaction with the regulatory framework. There has reportedly been discussion in the government about the imposition of interest rate caps that would set the maximum rate based around the actual weighted average rate. However, several interviewees expressed doubt that this proposal will be approved.

The regulations for MFIs prohibit them from taking deposits, which is common in most countries in the region. MFIs cannot have an exposure to one client of more than EUR 30,000 (and only EUR 10,000 if it is a new client), which limits them to working with microenterprises only. Other than these important restrictions, the regulatory framework does not impose any other problematic barriers to micro-lending. MFIs are required to operate as for-profit companies and have a minimum capital requirement of EUR 100,000.

The leasing sector, like the banking sector, does not face serious regulatory constraints to the financing of SMEs. Unlike in some neighboring countries, leasing in Montenegro does not face any VAT disadvantages relative to lending, so leasing companies can, in theory, set pricing in line with banks (to the extent that they can access similarly-priced funding). Banks are also free to engage in leasing if they obtain a license.

4.5 Funding of intermediaries

Montenegrin banks have been in a process of deleveraging since the middle of the financial crisis. Total loan borrowings of banks stood at EUR 264 million at Q3 2015, less than half their value of EUR 697 million at year-end 2010. Each year from 2010 to 2014 has seen a notable decline, but the first nine months of 2015 saw a modest 5.5% increase, suggesting that the deleveraging process has ended and banks are poised to borrow more in coming periods. International development institutions are the primary source of borrowings followed by parent banks and government sources. For banks, the decline in borrowings has been offset but increased deposits in recent years with deposit growth of 5.9% in 2013, 10.0% in 2014 and 13.7% in the first nine months of 2015. Loans are fully covered by deposits as the system had a loan to deposit ratio of 96.9% as of September 30, 2015.

4.5.1 Government

The government provides funding to banks either directly or indirectly through four channels: the Ministry of Finance, the Directorate for Development of SMEs, the Investment and Development Fund of Montenegro, and the 1000+ Housing Scheme. The following table shows the total borrowings of commercial banks at the end of 2014 from these sources.

Table 13. Government and quasi-government loan financing to banks, end of 2014

	Amount (EUR 000s)	%	# of banks
Investment and Development Fund of Montenegro	36,113	86.3%	8
Ministry of Finance	2,699	6.5%	2
Directorate for Development of SMEs	1,673	4.0%	5
1000+ Housing Scheme	1,339	3.2%	1
TOTAL	**41,824**	**100.0%**	

Source: Banks' audit reports

The Investment and Development Fund of Montenegro (IDF) was established in 2009 by a special law for the purpose of encouraging economic development. Support to SMEs is a key component of the fund's activities along with infrastructure development and environmental protection. The fund has special lines dedicated to groups that traditionally have difficulty accessing credit, including startup businesses, businesses owned by young entrepreneurs, women-led businesses, and small farmers. Aside from these special projects, the fund lends to all other sectors of the economy but attempts to focus on fixed asset financing and the production sector. EIB, EBRD, and the World Bank support the IDF by providing funding – none of its funding comes directly from the government.

The fund both supports local banks by providing them with credit lines and acts as a competitor by disbursing loans directly to SMEs. For most types of enterprises, the minimum loan amount is EUR 10,000 and the interest rate to end borrowers is 6% annually, although the minimum amount can be ignored and interest rates can be lowered for certain vulnerable groups mentioned above. IDF finances up to 50% of the total investment, so the entrepreneur must contribute the remaining 50%. Banks accessing these lines pay a 3% interest rate to the fund, meaning that they earn a 3% margin on a typical loan with a 6% rate to the end borrower. There are 9 bank partners, although not all 9 are actively using the fund's resources.

In 2015, IDF funded 254 projects for total amount of EUR 115.6 million. Financing of disadvantaged groups (women, youth, startups, and small farmers) made up 2.3% of total financing (75 projects).

Funding from government sources increased by 61% in 2014, with most of the gain accounted for by the IDF.

4.5.2 Development finance institutions

EIB by far is the main provider of loan funding to local banks, accounting for 61% of loan funding by international institutions at the end of 2014. It should also be noted that several of these international institutions are financing the Investment and Development Fund of Montenegro which, in turn, provides loans to banks.

Table 14. Outstanding borrowings to Montenegrin banks from international institutions, end of 2014

	Amount (EUR 000s)	%	# of banks
EIB	62,319	60.6%	8
EBRD	27,545	26.8%	2
KfW	5,746	5.6%	3
DEG	3,500	3.4%	1
EFSE	3,147	3.1%	2
ResponsAbility	500	0.5%	1
TOTAL	**102,757**	**100.0%**	

Source: Banks' audit reports, 2014

Borrowings from international development institutions declined by 20% in 2014.

4.5.3 Parent banks

At the end of 2014, six of Montenegro's 12 banks had foreign parent banks. These parent banks accounted for EUR 86.8 million of total loan borrowings to their local subsidiaries, somewhat lower than the total funding from development institutions but substantially higher than other sources. Parent bank funding decreased by 42% in 2014. When considering the total exposure of local banks to their parent banks, including deposits and other liabilities, the decline is a similar 39% in 2014. In most cases, this reduced parent funding reflected reduced need from the local subsidiary rather than reduced capacity or willingness of the parent to lend. Nearly all the exposure of local banks to their parent banks is in the form of loan borrowings, with only a small volume of deposits.

4.5.4 Other sources

Montenegrin banks have not borrowed from any international commercial banks other than the development institutions mentioned above. However, borrowing and lending between local banks is common with 21% of total bank loans outstanding to other banks as of Q3 2015. Interbank lending is increasing in recent periods, rising by 20.4% over the 12-month period up to September 30, 2015.

4.6 Supply estimate

The total supply of MSME loans in mid–2015 is estimated to be EUR 552 million, equivalent to 26.6% of the total loans of banks and MFIs and 16.0% of 2014 GDP. MFIs contribute 5.1% to the total volume of MSME lending. For banks, the estimate is based on the weighted average share of loans of the four banks providing data. For MFIs, data from only one MFI is used; however, that MFI accounts for 67% of MFI sector assets, so the estimate is assumed to be a reasonable approximation for the MFI sector as a whole. The value of total loans for banks and MFIs is reported by the Central Bank.

Table 15. Estimate of MSME loan supply at June 30, 2015

	Banks	MFIs	Total
A. % of FIs offering SME loans	100%	100%	100%
B. MSME loans to total loans (survey)	25.8%	62.0%	26.6%
C. Total loans (EUR millions)	2,030.4	45.2	2,075.6
D. MSME loan supply estimate (=A*B*C)	523.8	28.0	551.8

Source: BFC survey, Central Bank of Montenegro

Based on data from one of the largest leasing companies, BFC estimates that roughly 62% of all leasing contracts are granted to SMEs. With a total lease portfolio (from all leasing companies) of EUR 116.3 million at the end of 2014, this would make the value of leases to SMEs EUR 72.1 million.[23] Adding this amount to the loan supply gives a total amount of SME financing of EUR 623.9 million or 18.0% of GDP.

The supply of venture capital funding is assumed to be close to zero, and, at most, consists of a few small investments from angel investors.

[23] Leases issued by banks are classified as loans in the Central Bank's reports and cannot be disaggregated. Therefore, some very small but unknown portion of total loans shown here are, in fact, leases.

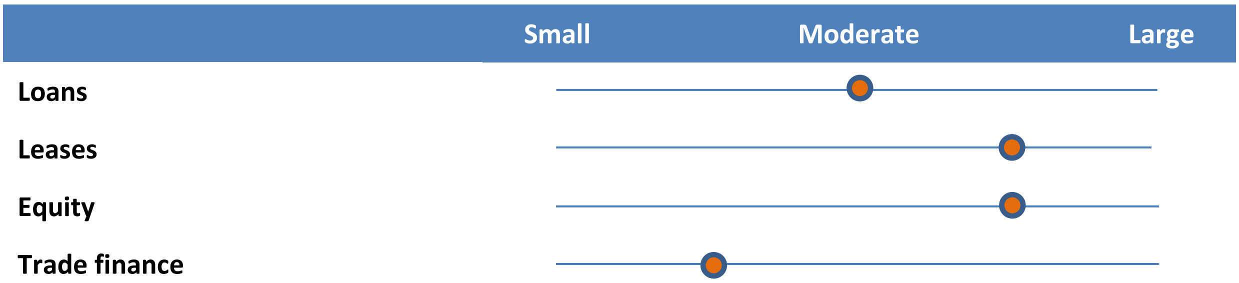
5. Gaps in private sector financing

Key findings:

- *There is a moderate funding gap for loans in Montenegro highlighted by an above-average rejection rate and conservative lending practices such as strict collateral requirements and financial ratios*
- *The gap is even higher for leases and equity products in relative terms since the leasing sector has scaled back its activities since the crisis and there are no dedicated equity funds*
- *By type of SME, agricultural enterprises and startup firms face especially high gaps in access to finance, and micro and small firms face higher gaps relative to medium-sized enterprises*
- *Enterprises in the north of the country are disadvantaged relative to their counterparts in the central and coastal areas*
- *Funding of financial intermediaries does not represent a constraint at the present time, partly as a result of strong deposit growth in recent periods; however, if lending activity picks up as anticipated in 2016, financial intermediaries will increasingly rely on loan funding from other sources*
- *International institutions are contributing to the development of the SME sector through funding and technical assistance programs, but there remain opportunities for new programs, especially in areas such as startup financing and agriculture*

5.1 Gaps by instrument

Summary of gaps by instrument



5.1.1 Loans

In terms of loans products, the overall financing gap is judged to be moderate in size and to disproportionately affect certain types of SMEs (as explained in the next section). On one hand, high competition among 14 banks in a relatively small market stimulates lending to SMEs. On the other hand, however, this is countered to some extent by conservative lending practices that are the consequence of high NPLs dating from the crisis period of 2008–2010. This conservatism is reflected in the results of the World Bank Enterprise Surveys: 11.6% of respondents were rejected for their most recent loan application[24] versus an 8.5% average rejection rate for the Eastern Europe and Central Asia region.

Even when SMEs are approved for a loan, the offer may not be on terms which the SME finds acceptable. Some aspects of the loan offer from lenders which SMEs tend to find unsatisfactory are loan amounts that are low compared to the requested amount and strict collateral requirements. Most commonly, collateral requirements are considered strict due to the amount of collateral which is required relative to the loan size. The Enterprise Surveys indicate that the value of collateral needed for a loan in Montenegro is 243% of the loan value, well above the Eastern Europe/Central Asia average. Furthermore, requirements for multiple co-signers and an insistence on using real estate

[24] These surveys were done in 2013 but are probably still a fair reflection of the situation in 2015/2016.

(as opposed to movable assets) as security, even for relatively small loans, can also be a barrier to credit access.

The approval of loan amounts lower than the requested amount is mainly a function of the conservatism of lenders and the intentional under-reporting of income by SMEs in their official accounting records. The weak capacity of lenders in financial analysis and inaccurate accounting of SMEs (unintentional errors, as opposed to tax avoidance) also contribute to this issue to a lesser degree.

5.1.2 Leases

The supply of leases has fallen dramatically in recent years, from EUR 31.3 million disbursed in 2011 to EUR 15.0 million in 2014, as several leasing companies have stopped issuing new lease contracts. It is unlikely that demand has fallen so sharply over the same timeframe; therefore, it is reasonable to conclude that there is a significant gap between the demand and supply of leases. Most leasing companies have a very limited branch network, so potential customers located far from Podgorica are less likely to have convenient access. The fact that leasing companies prefer to focus on automobile leasing (97% of the total lease portfolio) with a relatively small degree of equipment financing further highlights the weaknesses of the supply side in meeting demand.

Some SMEs can substitute loans for leases to meet their financing needs, so the severity of the gap may not be as serious as suggested by the drop in leasing volume. In addition, the decline in leasing supply is reported to be generated mostly by consumer leasing – the gap for legal entities may be less severe. Nevertheless, SMEs without sufficient collateral to offer for a loan are certainly negatively impacted by the decreased activity of leasing companies.

The leasing gap would be larger if enterprises had better financial literacy with regard to leasing products. Demand is limited by the fact that many enterprises do not have sufficient knowledge about leasing contracts and products, leading them to not consider leasing as an option.

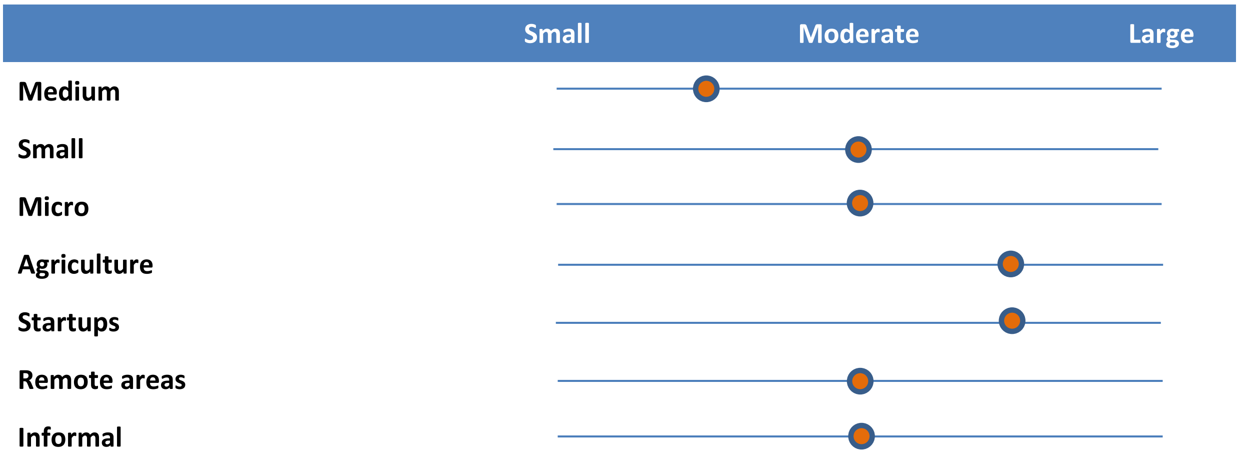
5.1.3 Equity investment

There is a large gap for equity investment in SMEs driven primarily by the absence of formal organizations providing equity funding. Entrepreneurs seeking equity are typically forced to rely on their own connections – friends and family members who have the capacity and desire to participate in the ownership of the company. While medium-sized enterprises have the option of being listed on the stock exchange, this has not proved to be an important funding source in practice. Given the low turnover on the stock exchange, many medium enterprises would not consider the effort and cost of listing to be justified.

Respondents in the World Bank Enterprise Surveys indicate that 9.7% of their investments are financed by equity or stocks sales, well above the 6.0% average for Eastern Europe and Central Asia. Due to the absence of dedicated equity funds and limited use of stock markets, it can be inferred that most or all of this equity financing is coming from family members, friends, and/or the personal savings.

5.2 Gaps by type of SME

Summary of gaps by SME type



5.2.1 Size

Access to finance tends to decrease as firm size decreases in Montenegro. Again referring to the World Bank Enterprise surveys, all of the firms that reported being rejected for their most recent application were in the smallest size category (5–19 employees) while none of the larger enterprises reported being rejected. Although lenders express an interest in working with very small enterprises, in practice, the speed and simplicity of the credit process does not differ greatly for larger and smaller SMEs, making the process less attractive to the smallest enterprises. The smallest microenterprises, which have less than 5 employees, are usually served by microfinance institutions and are less likely to qualify for a bank loan.

5.2.2 Agriculture

There is evidence of a moderate to severe funding gap for agricultural enterprises in Montenegro. The share of lending to agricultural enterprises among banks is very low, much lower than the share of agriculture in GDP. In other countries in the region, MFIs make a large contribution to agricultural finance, particularly in terms of outreach to small household farms. In neighboring Bosnia, for example, agricultural loans make up 37% of total MFI loans. In Montenegro, by contrast, the share of agricultural lending in the portfolio of MFIs is relatively small. Both banks and MFIs often dismiss agricultural enterprises as being too risky, too expensive to serve, and too complicated to analyze. Some institutions are making a genuine effort to reach out to farmers, and the Investment and Development Fund offers a special credit line for farmers, but, on the whole, the supply of agricultural finance appears to lag behind demand.

5.2.3 Startups

As mentioned above, there are no sources of equity financing for startups at present. Fortunately, the situation for startups is far from hopeless. Some banks and MFIs do make loans to startup companies, although they do so only in small amounts. The Investment and Development Fund has a special credit line for startup companies with a low interest rate. Startup funding is a particularly critical issue for Montenegro in light of the country's high unemployment rate. Overall, there is a moderate-to-high gap in financing for startups highlighted by the unavailability of equity financing from formal institutions.

5.2.4 Remote regions

The northern part of the country is economically under-developed in comparison to the central and coastal regions, as evidenced by a very high unemployment rate of almost 40%. Not surprisingly, this region gets less attention from financial institutions in terms of branch placement. Although the reduced activity of financial institutions in the north is partly justified by the lower degree of business activity (only 16% of registered enterprises are located in the north), anecdotal reports indicate that there may be some bias against applicants from this region and that financial institutions apply tougher criteria. Therefore, the gap for the northern region is judged to be moderate relative to the central and coastal regions.

5.2.5 Informal enterprises

Informality takes the form of both unregistered enterprises and registered enterprises that either under-report their income or, in other ways, avoid adhering to laws and regulations. Although unregistered enterprises generally cannot get bank loans unless they apply for a consumer loan, they can get loans from MFIs. Outside of the agriculture sector, the number of unregistered enterprises is declining in general, so this is not considered a critical gap.

The share of registered enterprises that practice tax avoidance and other means of circumventing regulations is, however, very high. Most banks indicate that they either do not consider unreported income at all or that they consider it at a subjective level but set the loan amount based primarily on reported income. Enterprises that do not fully report their income, therefore, face reduced access to credit. However, these enterprises have usually made the conscious decision to gain the advantages of informality at the price of reduced access to finance. In that sense, their difficulties in getting loans are not especially unfair, so this gap is, likewise, not considered to be of critical importance.

5.2.6 Other types of SMEs

Given the somewhat conservative lending policies of banks, SMEs that do not own real estate often have reduced access to finance unless they only require very small loan amounts. Enterprises with weak accounting and business planning tend to be looked on less favorably by banks, making it more difficult for them to get loans.

BFC did not find evidence of a financing gap for SMEs owned or managed by women. Although there is a gap in female entrepreneurship, with less than 10% of all enterprises owned by women, the nature of the problem seems to be connected to cultural and historical norms rather than financing. There is nothing to suggest that the staff of financial institutions are either intentionally or unintentionally discriminating against women in their lending practices. Nevertheless, financial institutions can attempt to play a role in promoting female entrepreneurship by offering special credit lines on advantageous terms. The IDF, for example, has recently introduced a product for female entrepreneurs with no minimum loan amount (most IDF lines have a EUR 10,000 minimum).

5.3 Gaps in funding of intermediaries

Gaps in the funding of intermediaries are not a key contributing factor to gaps in the financing of SMEs at the present time. Over the past two years, deposit growth has outpaced credit growth, leading to high liquidity and a reduced need for loan borrowings. Deposit growth was sufficient in 2014 to compensate banks for a reduction in funding from parent banks and international institutions. Although there are several small local banks that would benefit from increased funding, the overall impact of their funding struggles on the SME lending market as a whole is minimal. Until lenders loosen their somewhat conservative credit policies and SMEs demonstrate a higher appetite for loans, funding of intermediaries is not expected to be a major barrier to SME finance.

5.4 Potential and capability of IFIs to fill gaps

5.4.1 EBRD

EBRD actively supports SMEs in Montenegro through both indirect financing (through banks and MFIs) and technical assistance. At the end of 2014, EBRD had loans outstanding to two Montenegrin banks in a total amount of EUR 28 million. EBRD also supported the microfinance sector through a loan to Alter Modus in 2015. EBRD has not made any equity investments in SMEs but did provide equity financing to a large local retailer.

Through its Small Business Support program, EBRD provides technical assistance to about 35 companies per year in Montenegro, using mostly local consultants. Topics of technical assistance are varied and include marketing, business planning, and feasibility studies in particular industries or sectors. EBRD has also granted technical support to financial institutions on topics such as credit scoring and staff training for specific products.

EBRD contributes to the development of the financial sector policy and legal framework, for example, by providing input on the draft law on factoring. EBRD's cumulative total commitments in the country through all sectors amounted to EUR 445 million as of mid–2015.

5.4.2 World Bank

The World Bank's most relevant project for SME access to finance is MIDAS (Montenegro Institutional Development and Agriculture Strengthening), which started in 2009. This project disbursed grants totaling around EUR 6 million (as of September 2015) to small farmers for investment in agricultural assets such as machinery and livestock. The project also include a TA component for training farmers. A planned extension of this project from 2016 to 2018 is expected to add food processors as a beneficiary.

The World Bank group does not provide any direct financing to banks. The World Bank's support for the financial sector has been targeted to the macro and policy level through such efforts as strengthening systemic risk monitoring, enhancing the deposit insurance scheme, and improving the regulatory framework for banks as part of the Financial Sector Policy Based Guarantee project.

5.4.3 KfW

Since starting operations in Montenegro in 2001, KfW has disbursed roughly EUR 135 million to SMEs through local banks and MFIs. In addition to general credit lines for SMEs, KfW has set up specialized lines for energy efficiency and agricultural and rural lending. At the end of 2015, KfW had open lines to Erste Bank and Alter Modus. KfW is not currently providing TA to local banks since the banks already have sufficient capacity and expertise in terms of lending to SMEs. Outside of the financial sector, KfW is primarily focused on the energy sector, waste treatment and infrastructure.

Together with EIB, KfW is one of the founders of the Green for Growth Fund (GGF), which is planning to start its first disbursals in Montenegro in 2016. Since awareness of renewable energy and energy efficiency projects is low, the fund will be accompanied by TA for both financial institutions and SMEs.

5.4.4 European Fund for Southeast Europe (EFSE)

EFSE, represented in Montenegro by its fund advisor Finance in Motion GmbH, provides loans and technical assistance to banks and MFIs. Its credit lines tend to be direct towards the lower end of the market, micro and small enterprises, more so than medium-sized enterprises. The maximum loan size for sub-loans is EUR 100,000, and emphasis is given to amounts under EUR 20,000. EFSE has three partner lending institutions in Montenegro – two banks and one MFI. Its most recent loan was a EUR 5 million senior loan to NLB for housing finance. Technical assistance is delivered directly to partner lending institutions on a variety of topics that are customized for the needs of each institution. Those topics include strategy, product development, risk management, operational efficiency, internal audit and impact assessment. The average budget of a TA project is around EUR 45,000.

5.4.5 EIB Group

EIB is the single largest lender to banks in Montenegro and has a number of credit lines open with the country's largest banks. These usually take the form of senior loans in relatively large amounts for general (not sector-specific) SME lending. EIB has also given loan funding to the Investment and Development Fund (see section 4.5.1) for on-lending to SMEs. The European Investment Fund, which is part of the EIB Group, is providing a loan portfolio guarantee to one local bank (CKB) for the benefit of high-risk SMEs that traditionally cannot get credit from banks.[25] Aside from access to finance, EIB has made investments in the country's infrastructure, such as road projects.

Together with EBRD and the European Commission, EIB is also one of the founding partners of the Western Balkans Enterprise Development and Innovation Facility. This facility consists of an early-stage venture capital fund, the Enterprise Innovation Fund (ENIF), a growth-stage fund, the Enterprise Expansion Fund (ENEF), a loan guarantee facility, and a support services facility offering technical assistance directly to SMEs and other stakeholders. EDIF's venture capital funds and guarantee facility had not yet made any investments in Montenegro at the time of writing in April 2016.

5.5 Recommendations

Investment from IFIs is needed to mitigate the considerable gaps in access to finance described above. The types of funding and technical assistance that are judged to have the best potential to close these gaps are:

- Increase the volume of guarantee funds available through the creation of new funds or expansion of existing ones. Guarantee funds should be targeted to ease the creation of startup enterprises and provide collateral relief. Guarantees could also be used to spur increased lending to agricultural enterprises, particularly in circumstances where lenders primary concern is the risk of agricultural activities.
- Since there have been no known venture capital investments by formal institutions, it is critical to increase the availability of equity funding to SMEs, especially through creation of venture capital funds. Seed-stage, early stage, and growth stage investments are all needed.
- Substantial TA support is needed to develop the venture capital ecosystem. While there are a number of incubators, mostly established by local governments, the country would benefit from more private incubators and accelerators that have improved capacity to offer training and technical support to their companies. Invest in training programs for entrepreneurs focusing on core skills like accounting, financial management, marketing and human resources management, either as standalone programs or in cooperation with incubators.
- Invest in the microfinance sector, which is weak compared to some other countries in the region. A stronger microfinance sector can boost startup enterprises and help with the problem of youth unemployment, since young people starting enterprises often need the small amounts that microfinance institutions can offer. A combination of credit lines and guarantee instruments would be appropriate, and TA should focus on working with startup enterprises and upscaling to

[25] This is part of the European Commission's COSME (Competitiveness of Enterprises and Small and Medium-sized Enterprises) project, which EIF manages. CKB had previously received a similar guarantee under the predecessor program to COSME – the Competitiveness and Innovation Programme (CIP).

serve larger enterprises within the micro sector, since some MFIs focus mainly on the small end of the micro scale.

The synthesis report that accompanies this country report provides additional details about how such funding and TA support could be structured.

Annex 1: Macroeconomic indicators

Indicator	Q3 2015	2014	2013	2012	2011
GDP (nominal, EUR millions)	2,700	3,458	3,362	3,181	3,265
Population (thousands)	-	621.8	621.2	620.6	620.1
GDP (nominal) per capita (EUR)	-	5,561	5,412	5,126	5,265
Real GDP growth rate	3.6%[26]	1.8%	3.5%	–2.7%	3.2%
Inflation rate (CPI)	1.6%[27]	–0.7%	2.2%	4.1%	3.1%
Unemployment rate (official)	-	18.0%[28]	19.5%	19.7%	19.7%
Poverty rate ($1.90 per day, 2011 PPP)[29]	-	-	1.7%	1.3%	0.2%
Poverty rate (national definition)[30]	-	-	8.6%	11.3%	9.3%
Current account balance (% of GDP)	-	–15.3%	–14.6%	–17.7%	-
Trade balance (% of GDP)	-	–19.8%	–20.1%	–24.4%	–22.0%
Exports of goods (% of GDP)	-	40.1%	41.3%	43.7%	42.3%
Net FDI (% of GDP)	-	10.8%	10.0%	15.1%	12.3%
Public debt (% of GDP)	-	59.9%	57.8%	46.3%	45.4%
Fiscal balance (% of GDP)	-	–3.0%	–6.5%	–6.8%	–5.9%
Government expenditure (% of GDP)	-	42.1%	43.0%	41.9%	40.4%

Largest sectors (share of GDP)

Sector/activity	2014
Trade	14.2%
Agriculture	10.0%
Public administration and defense	9.0%
Accommodation and food service	8.2%
Real estate activities	8.0%
Financial services	5.8%
Education	5.4%

[26] Average of quarterly growth rates compared to the corresponding quarters of 2014
[27] Average monthly rates for first 9 months of 2015 compared to same period of 2014
[28] 6.7% in coastal region, 13.4% in central region, 39.0% in northern region
[29] Source: World Bank Development Indicators
[30] The national poverty line was set at EUR 186 per month in 2013.

Annex 2: Business environment indicators

World Bank *Doing Business* Indicators (2016)

Source: http://doingbusiness.org/data/exploreeconomies/bosnia-and-herzegovina

Indicator	Rank
Ease of doing business	46
Starting a business	59
Dealing with construction permits	91
Getting electricity	163
Registering property	79
Getting credit	7
Protecting investors	36
Paying taxes	64
Trading across borders	42
Enforcing contracts	43
Resolving insolvency	36

Getting credit indicators

Indicator	Value
Strength of legal rights index (0–12)	12
Depth of credit information index (0–8)	5
Public credit registry coverage (% of adults)	0.0%
Private credit registry coverage (% of adults)	26.4%

World Bank Enterprise Surveys

Source: http://enterprisesurveys.org

% of enterprises identifying the given constraint as a major constraint

Constraint	Small	Medium	Large
Corruption	27.1	26.5	19.6
Court system	5.9	8.5	26.4
Crime, theft and disorder	6.0	9.8	0.5
Access to finance	13.6	12.4	29.4
Practices of competitors in the informal sector	22.8	9.3	2.2
Electricity	8.7	9.4	27.3
Transportation	3.8	4.0	1.8
Tax rates	16.8	23.4	29.3
Tax administration	10.6	17.7	4.0
Business licensing and permits	8.9	7.8	7.8
Customs and trade regulations	8.6	2.2	4.2
Labor regulations	5.7	19.4	2.8
Inadequately educated workforce	5.0	8.9	17.2

OECD SME Policy Index (2012)

Source: OECD, et al. (2012), SME Policy Index: Western Balkans and Turkey 2012: Progress in the Implementation of the Small Business Act for Europe, OECD Publishing.

	Category	Score
1	Entrepreneurial learning and women's entrepreneurship	2.54
2	Bankruptcy and second chance for SMEs	3.64
3	Regulatory framework for SME policy making	3.75
4	Operational environment for SMEs	3.62
5a	Support services for SMEs and startups	2.94
5b	Public procurement	3.33
6	Access to finance for SMEs	3.07
7	Standards and technical regulations	2.81
8a	Enterprise skills	2.69
8b	Innovation policy for SMEs	2.02
9	SMEs in a green economy	2.29
10	Internationalization of SMEs	3.29

Annex 3: Financial sector indicators

Banking sector indicators

Indicator	Q3 2015	2014	2013
Structure of the sector			
Number of banks	14	12	11
Number of state-owned banks	0	0	0
5-bank concentration ratio	66.2%	68.4%	-
Financial indicators (EUR millions)			
Total assets	3,487.2	3,136.3	2,959.2
Total gross loans	2,543.6	2,367.2	2,414.0
Total net loans	2,378.6	2,356.2	2,225.0
Total deposits	2,623.9	2,308.1	2,097.7
Total equity	465.4	444.0	397.8
Total net profit	-	23.8	2.0
Financial ratios			
Capital adequacy:			
Total CAR	-	16.2%	14.4%
Equity to total assets	13.3%	14.2%	13.4%
Liquidity:			
Loans to deposits	96.9%	102.6%	115.1%
Growth rate of deposits	13.7%	10.0%	5.9%
Liquid assets to total assets	-	22.2%	20.0%
Profitability:			
Return on average assets	-	0.8%[31]	0.1%
Return on average equity	-	5.7%	0.5%
Net interest spread	-	4.9%	4.1%
Asset quality:			
Growth rate of loan portfolio	7.5%	–1.9%	3.1%
NPL ratio[32]	-	19.0%	20.7%
Restructured loans to total loans	-	19.4%	-
Others:			
Growth rate of total assets	11.2%	6.0%	5.4%
Bank assets to financial sector assets (%)	-	91.4%	90.6%
Average effective interest rate	8.9%	9.2%	9.4%
Average effective deposit rate	1.3%	1.8%	2.5%

[31] Ten banks were profitable; two had losses
[32] Defined as more than 90 days past due. Includes receivables aside from loans

Annex 4: The largest lending institutions

Banks by total assets at Sept 30, 2015

	Bank name	Website	Assets (EUR 000s)
1	Crnogorska Komercijalna Banka	http://ckb.me	599,219
2	NLB Montenegrobanka	http://nlb.me	493,307
3	Societe Generale	http://societegenerale.me	437,175
4	Hipotekarna Banka	http://hipotekarnabanka.com	416,686
5	ERSTE Bank	http://erstebank.me	361,746
6	Prva Banka Crne Gore	http://prvabankacg.com	310,295
7	Atlas Banka	http://atlasbanka.com	271,458
8	Hypo Alpe-Adria Bank	http://hypo-alpe-adria.co.me	238,620
9	Komercijalna Banka	http://kombankbd.com	124,796
10	Universal Capital Bank	http://ffbank.org	97,858
11	Invest Banka Montenegro	http://invest-banka.com	46,562
12	Lovćen Banka	http://lovcenbanka.me	44,346
13	Zapad Banka	http://zapadbanka.me	34,925
14	ZIRAAT Bank Montenegro	http://ziraat.com.tr	10,161

MFIs by total assets at Sept 30, 2015

	MFI name	Website	Assets (EUR 000s)
1	Alter Modus	http://altermodus.me	31,063
2	Monte Credit	http://agroinvest.rs	8,778
3	Montenegro Investments Cred-it		4,089
4	Klikloan		1,849
5	Ozmont		744
6	Kredit+		100

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