

SMALL BUT LOUD



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THE RECORD IS UNLIKELY TO BE REPEATED

TRENDS IN THE SME LENDING MARKET

- **SME lending experienced record growth in 2022.** The size of the portfolio of loans provided by small and medium-sized enterprises grew by almost 30% (by RUB 2.2 tln to RUB 9.6 tln) amid disbursements growing by 7.5% (the total amount of loans provided was RUB 11.4 tln). These indicators outperformed the dynamics of lending to other non-financial companies, where a decrease in the volume of loans was recorded (from RUB 75 tln in 2021 to RUB 54.5 tln), and portfolio growth amounted to 16.9%.
- **SME lending was unevenly distributed among sectors.** The best results in terms of increasing the loan portfolio were demonstrated by construction companies, which are often classified as SMEs only in terms of formal criteria. At the same time, the loan portfolio of wholesale companies, which accounts for over 30% of all SME loan issuances, declined in 2022.
- **ACRA notes that the government has strengthened its support for SMEs, however the impact of these programs on overall growth in the loan portfolio remains limited.** Amid the worsening macroeconomic situation, the state began allocating a more significant amount of funds to support the SME lending segment. However, ACRA notes that the share of loans with government support in the total volume of loans remains moderate at less than 15%. Consequently, further growth in SME lending will depend more on banks' appetite for risk than government support measures.
- **The quality of the SME loan portfolio continues to be stable.** In 2022, the analyzed segment saw a decrease in the volume of overdue debt and its share in the total portfolio (from 8.2% to 5.6%). Portfolio quality was partly supported by major restructuring — in 2022 around 18% of the portfolio was restructured. However, ACRA assumes that materialization of deferred credit risks in the SME segment is more likely than for other non-financial companies. Due to this, the Agency expects the share of non-performing loans to grow by 1–1.5% year-on-year in 2023.
- **It is unlikely that record growth of SME lending will be repeated in 2023.** The operating environment continues to be unfavorable for growing investment lending. Besides this, SMEs continue to prefer to independently finance investment projects, and banks are not ready to soften their requirements for borrowers. Growth may be supported by SMEs' participation in the government's programs to structurally transform the economy, including development of import substitution. Taking into account all the factors, ACRA expects the SME portfolio to grow by 10–15% in 2023.

2022 WAS A YEAR OF RECORD GROWTH

Despite the problems in the Russian economy, the SME segment recorded record growth of the loan portfolio in 2022, which increased by RUB 2.2 tln (approximately 30% year-on-year). This growth was driven by the continued issuance of new loans (growth of 7.5% compared to 2021), the volume of which exceeded RUB 11 tln.

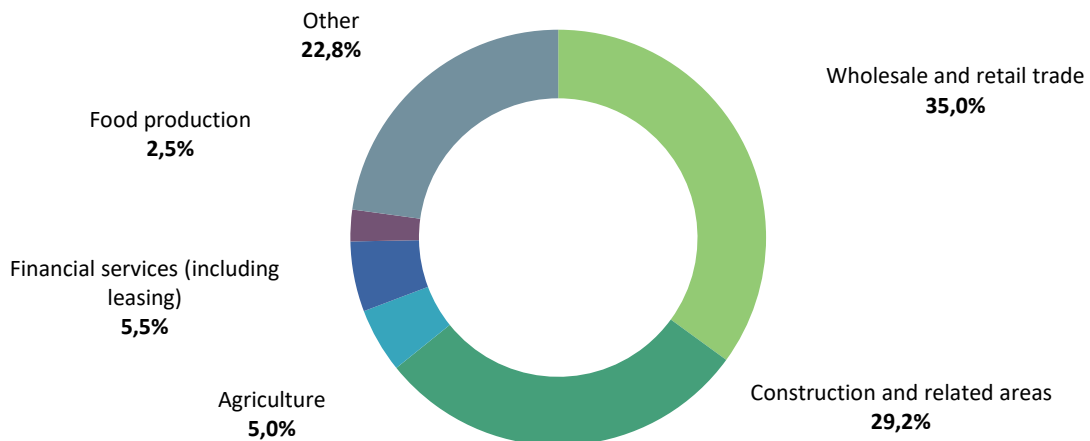
Although this trend was largely due to the specifics of classifying certain companies as SMEs (excluding large loans and loans provided to developers, the Bank of Russia estimates the growth of the loan portfolio at 14.6%), last year's results indicate that the activity of borrowers in the SME segment exceeds the total activity of lending to legal entities, where 16.9% growth of the portfolio was recorded with a decrease in issuances by 27.4%.

The increase of the number of borrowers also evidences the active growth of lending in the analyzed segment — the number of SMEs that had a loan in 2022 increased by more than 60,000, or 14.7% year-on-year. To a large extent, this is due to the activity of micro-sized enterprises, primarily those that are run by sole proprietors.

Despite the rather high indicators for the SME segment as a whole, the dynamics of lending in its separate areas were uneven. ACRA notes that around 50% of new loans are usually provided to companies specializing in construction and real estate transactions. These are the areas that account for almost half of the growth of the SME loan portfolio.

The trend of accelerated growth in lending to the construction sector is due to the high activity of developers, which, in turn, is supported by preferential mortgage programs.

Figure 1. Breakdown of new loans by type of economic activity



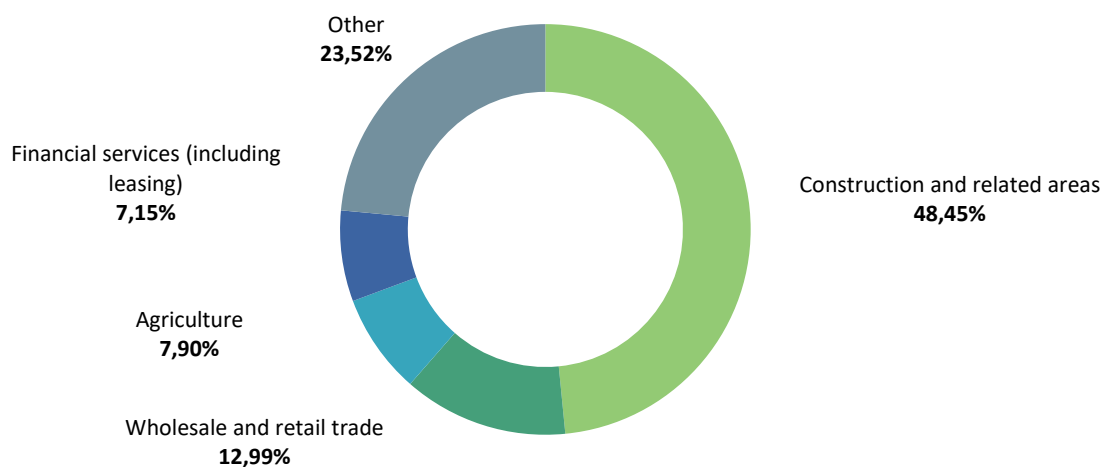
Sources: Bank of Russia, ACRA

ACRA shares the Bank of Russia's position that representatives of the construction industry can only conditionally be classified as SMEs (such companies, in particular, include a large number of specialized developers). Nevertheless, residential construction is related to many areas of the economy, and therefore lending to companies of this segment has a positive impact on SME lending in general.

On the other hand, the wholesale trade loan portfolio — the largest in terms of the volume of loans issued in the SME lending sector (more than 30% of new loans) — declined by 8.6% year-on-year in 2022. This was worse than the pandemic year of 2020 (-1.8%) and was the consequence of a decline in retail trade turnover. Total growth of

receivables from SMEs in this area amounted to 7% in 2022, while disbursement rates were mainly affected by the decline in working capital lending.

Figure 2. Loan portfolio structure by area of economic activity



Sources: Bank of Russia, ACRA

Fast growth of the SME loan portfolio allowed the share of this segment to increase to almost 19% in the total volume of loans issued to legal entities. At the same time, it should be taken into account that the growth in corporate lending in 2022 was largely driven by the replacement of foreign lending to legal entities by loans from Russian banks, while the growth of SME loans was generated by new issuances.

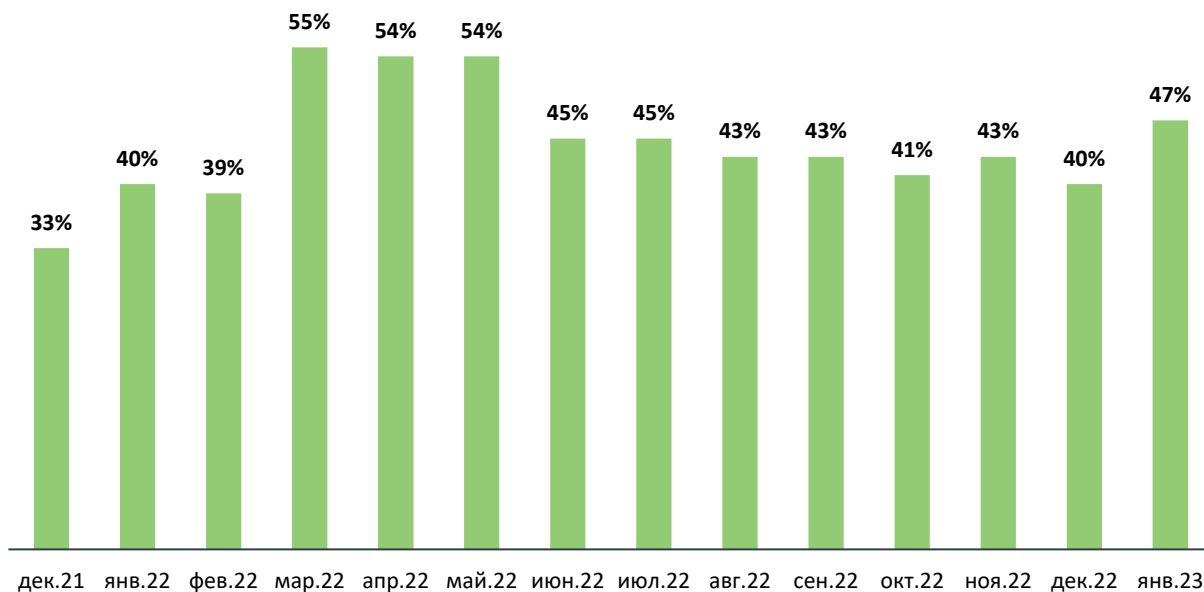
LENDING CONDITIONS: STRONGER GOVERNMENT SUPPORT AND STABLE RISK APPETITE AMONG BANKS

In Q1 2022, credit institutions' interest in working with SMEs did not decline as dramatically as in the segment for lending to big business and retail. Despite a generally noticeable increase in the number of refusals of banks to issue new loans, the volume of issuances to SMEs in March 2022 only declined by 15% compared to February (and the portfolio grew by RUB 320 bln), while issuances of other loans to legal entities fell by almost 30%.

The Agency used the results of joint research carried out by Promsvyazbank PJSC¹, non-governmental organization Opora Russia, and MAGRAM Market Research to assess banks' readiness to lend to SMEs. According to it, the share of loan rejections out of the number of loan applications was 39% in February 2022 and then increased to 55% in March, which was the maximum in 2022. The share of rejections stabilized at just above 40% in the subsequent months of last year, thereby approaching the indicators of 2021. This January, the share of rejections grew to 47%, however, ACRA notes that this situation is typical for the start of the year, and banks' interest in lending to SMEs will be relatively stable in 2023.

¹ ACRA rating AA+(RU), outlook Stable

Figure 3. Share of loan rejections



Source: Index Opora RSBI

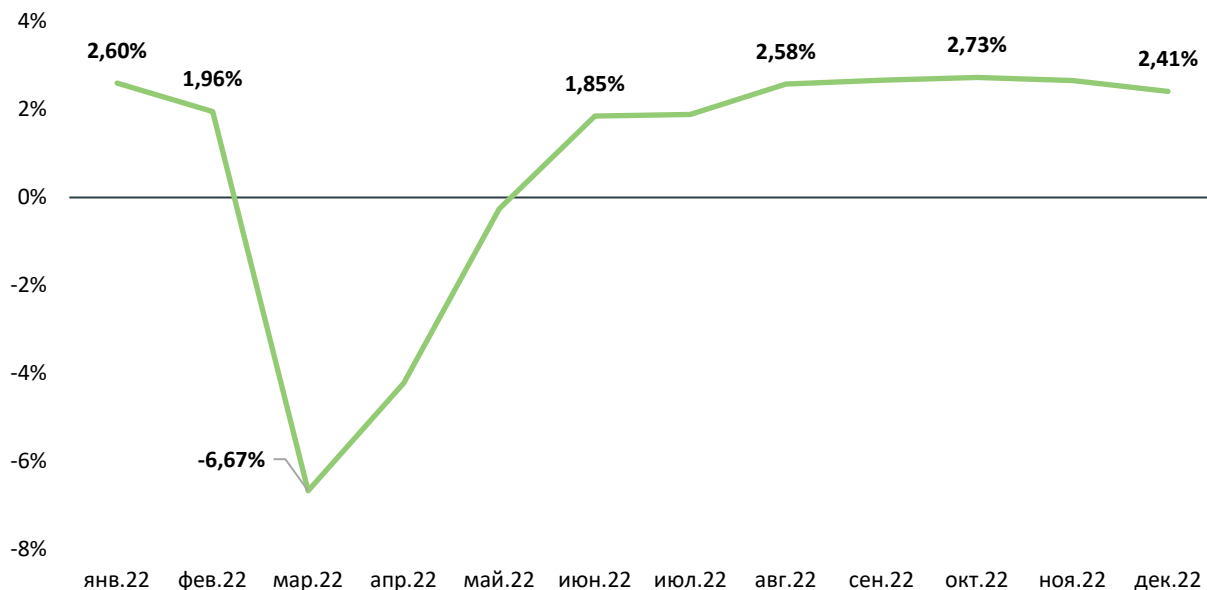
The interest of banks in lending to SMEs is also evidenced by the decrease in the weighted average interest rate for loans in this segment, which continued in Q4 2022, despite the stabilization of the Bank of Russia's key rate. Banks' interest in working with SMEs is a reflection of the overall trend of their operations with the corporate sector — the spread between the weighted average rate for SME loans and the rate for loans to other non-financial companies has stabilized. At the same time, the spread between the weighted average rate for SME loans provided for up to a year and the Bank of Russia's key rate is at the same level that was observed in February 2022, which confirms that the credit risk premium has declined.

Banks' willingness to finance SMEs can be partly explained by the expansion of the government's programs to support this segment. Back in March 2022, in response to a credit crunch amid higher rates and lower risk appetite of banks, the key organizers of the support programs — the Ministry for Economic Development, Bank of Russia and Federal SME Corporation² — substantially increased limits, which enabled SMEs to receive loans under preferential terms. The SME Lending Stimulation Program (LSP) of the Bank and Russia and Federal SME Corporation was increased by RUB 500 bln and reached RUB 675 bln. In addition, the limit for subsidizing rates under the 1764 Program of the Ministry for Economic Development was increased by almost RUB 15 bln.

Over the following months of 2022, this set of programs was expanded by combining the investment area of the LSP and the 1764 Program, thanks to which borrowers gained the option of receiving investment loans at interest rates below the key rate. The use of guarantee support provided by Federal SME Corporation, regional guarantee organizations, etc. has also become actively spread.

² ACRA rating AAA(RU), outlook Stable

Figure 4. Spread between the weighted average rate for SME loans provided for up to a year and the Bank of Russia's key rate



Source: Bank of Russia

Measures to support lending to SMEs have had a positive impact on this segment, confirming the state's readiness to assist it in a period of economic instability. However, the real role of such programs in terms of increasing the loan portfolio of SMEs is not so clear.

First of all, as ACRA notes, the volume of loans provided under preferential programs is incomparable to the total volume of disbursements (according to ACRA's estimates, such loans account for less than 15% of disbursements). In addition, preferential programs ensure the supply of financial resources, but cannot fully form demand for loans. So, if the limit on current loans of the LSP (RUB 340 bln) was almost completely provided already in July 2022, then investment lending turned out to be less popular (disbursements since the start of the program stand at RUB 112.3 bln). Disbursements under the combined LSP and 1764 programs amounted to RUB 38 bln vs. an expected RUB 50 bln.

The impact of guarantees provided for loans is also heterogeneous, since it depends, among other things, on economic activity in the region where the borrower operates. For example, in Moscow, last year the volume of loans granted under guarantees of the Small Business Lending Assistance Fund grew by more than 42% year-on-year (with a total volume of such loans at RUB 49.5 bln), while in the Samara Region growth was only 2% (total amount of issuance under guarantees was RUB 2.4 bln).

In 2023, increased limits on lending support to SMEs are expected to remain in place, but their impact on the risk appetite of banks and lending volumes will be limited. It should be taken into account that the requirements for the quality of borrowers who can receive preferential loans remain quite strict, so that the expansion of concessional lending, although it may satisfy demand, only has a limited impact on the emergence of quality borrowers.

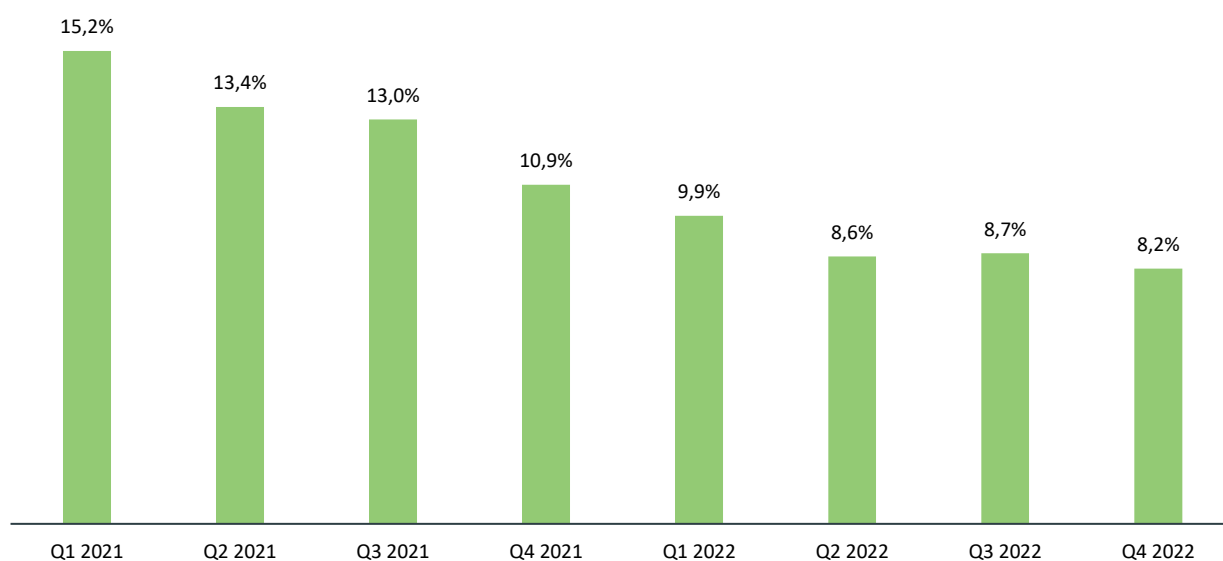
Given the factors described above, SME lending trends in 2023 will primarily depend on the risk appetite of banks, which in turn will be influenced by the state of the operating environment.

THE SHARE OF OVERDUE LOANS HAS DECLINED, BUT...

Similar to other lending segments, the quality of the SME loan portfolio remains stable. According to the Bank of Russia, at the end of 2022, the share of overdue loans was 5.6% vs. 8.2% a year earlier, and the total amount of overdue loans decreased by RUB 72 bln in 2022. The Bank of Russia's information on category IV and V loans confirms the stability of the portfolio's quality: the share of such loans was 8.2% in 2022 compared to 10.9% a year earlier. At the same time, the Bank of Russia observed a moderate increase in the volume of non-performing loans, which allows us to conclude that the improvement of the quality of the portfolio is due, among other things, to its rapid growth.

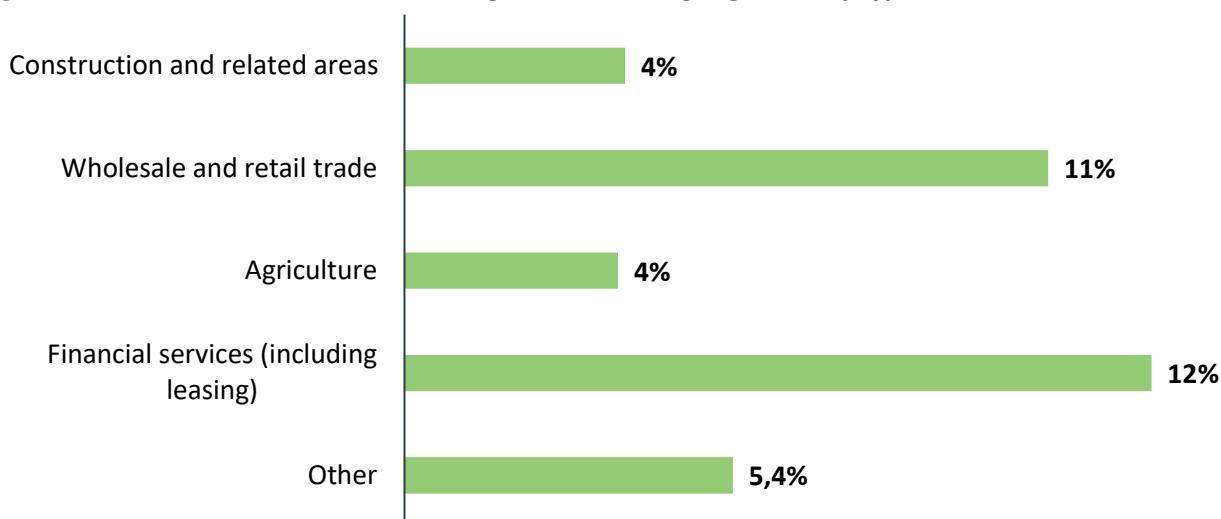
The Bank of Russia notes that the share of category IV and V loans (excluding loans to developers who belong to SMEs only on formal grounds) was 11% at the end of 2022. Since H2 2019, there has been a steady downward trend in the share of overdue loans in the SME loan portfolio, which is partly due to the high quality of loans granted to construction and real estate companies (the share of such companies in the portfolio is continuously growing). At the same time, it should be noted that the share of overdue loans is not increasing in most other industry segments.

Figure 5. Share of SME loans in quality categories IV and V



Source: Bank of Russia

ACRA's analysis of loan portfolios of banks focused on lending to SMEs also confirms their stable creditworthiness. In part, this may be explained by a shortage of funds, which encourages medium-sized and small banks to select the highest quality borrowers (that are resistant to operating environment risks) in order to benefit more from preferential lending programs, etc.

Figure 6. Share of overdue loans in the largest SME lending segments by type of business

Source: Bank of Russia

Like in the entire corporate lending segment, a significant volume of loan restructurings was recorded in the SME sector in 2022: according to the Bank of Russia, their total amount exceeded RUB 1.7 bln. This is 18% of the portfolio, which is less than the share of restructured loans of other non-financial organizations. ACRA does not exclude that the materialization of deferred risks in the SME lending segment may affect the portfolio quality much more than that of other non-financial borrowers.

In particular, ACRA notes that a significant number of the debt restructurings of large borrowers could be due to change in the loan currency. In general, the share of foreign currency loans in the corporate loan portfolio exceeded 15% as of February 1, 2022. By January 1, 2023, the volume of these loans had decreased by 30%, while the share of foreign currency loans had decreased from 15.6% to 9.5%.

In the SME sector, the share of foreign currency loans was 4% at the beginning of 2022 and it decreased to 2% during the year, while the total volume of foreign currency loans decreased by 20% in ruble terms.

Such differences in the SME sector allow us to suppose that most of the restructurings were caused by the deteriorating solvency of borrowers. According to the Bank of Russia, a third of the restructurings were initiated by large developers; however, the remaining volume (over RUB 1.1 tln) is a significant amount that exceeds the total volume of category IV and V loans at the end of 2022.

How SME loan portfolio quality changes in 2023 will depend on the outcome of completed restructurings, as well as the extent to which the sector's companies adapt to the challenging economic conditions.

Like other lending segments, in 2021, the SME sector avoided deferred growth of credit risks, which was characteristic of the portfolio quality after the crises of 2008 and 2014 (in 2014, overdue debt grew from 7% as of January 1, 2014 to 15.3% as of May 1, 2016). Nevertheless, ACRA believes that this sector may be more susceptible to deferred risks than loans granted to other non-financial companies. With this in mind, ACRA expects a gradual movement of the share of overdue loans to the values observed in late 2021 — early 2022. By the end of this year, average overdue debt in the SME sector may amount to 6.5–7%.

POSSIBILITIES, BUT NOT FOR EVERYONE?

SME lending activity is still determined not only by the borrower's industry, but the characteristics of banks operating in this sector as well. In this regard, ACRA notes the continued limited capacity of small and medium-sized banks to increase the volume of issued loans, despite increased demand.

According to the Agency's estimates, the majority of small and medium-sized banks rated by ACRA had a corporate loan portfolio that was either shrinking or showing near-zero growth in 2022.

Even if we set aside the fact that the overall growth of SME lending in 2022 was largely supported by the provision of large loans to developers (a segment in which the positions of small banks have never been strong), the ability of such banks to maintain lending activity is still negatively affected by the competitive advantages that industry leaders possess largely due to the relatively low funding costs. Historically, higher SME lending risk costs, as well as the increased administrative costs of such loans, lead to the fact that large banks, including those with access to almost cost-free funding in the form of demand accounts of individuals, offer potential borrowers more attractive terms.

Government support measures allow, to a certain extent, small banks to participate more actively in lending to SMEs, since some programs give opportunities to attract resources on entirely competitive terms. Nevertheless, ACRA notes that the existing distribution framework of limits on the use of funds aimed at supporting lending to SMEs actually freezes the situation where industry leaders benefit from their competitive positions — large banks take most of the allocated funds, while the abilities of small banks are limited to one-off disbursements.

In addition, even if there are guarantees from Federal SME Corporation, the credit risk assumed by small and medium-sized banks in SME lending remains significant relative to disposable capital.

The lending incentive program for 2023 provides for the limit of RUB 30 bln earmarked for small banks (including banks with a basic license), which may be used to provide loans to companies engaged in excisable businesses/mining. However, this volume of support will not change the overall situation, and small and medium-sized banks will not be able to become full-fledged beneficiaries of the growth.

On the other hand, large banks' focus on offering standard products is a barrier for the entry of new SMEs into the borrowing market. Therefore, many SMEs prefer to rely on their own resources when expanding business.

THE RECORD IS UNLIKELY TO BE REPEATED

As for the development prospects of the SME lending segment in 2023, ACRA believes that it will be hard to maintain the achieved growth rates.

In general, the growth opportunities in this segment are largely based on significant expansion of government programs aimed at the structural transformation of the economy and import substitution.

The Agency notes that the situation in 2022 has created not only risks, but also opportunities for the development of SMEs, for example, in segments vacated by foreign companies. In addition, it is the SME sector that can play a decisive role in the development of mechanisms that compensate for the economic losses from the disruption of logistics chains that push down the supply of imported products to the

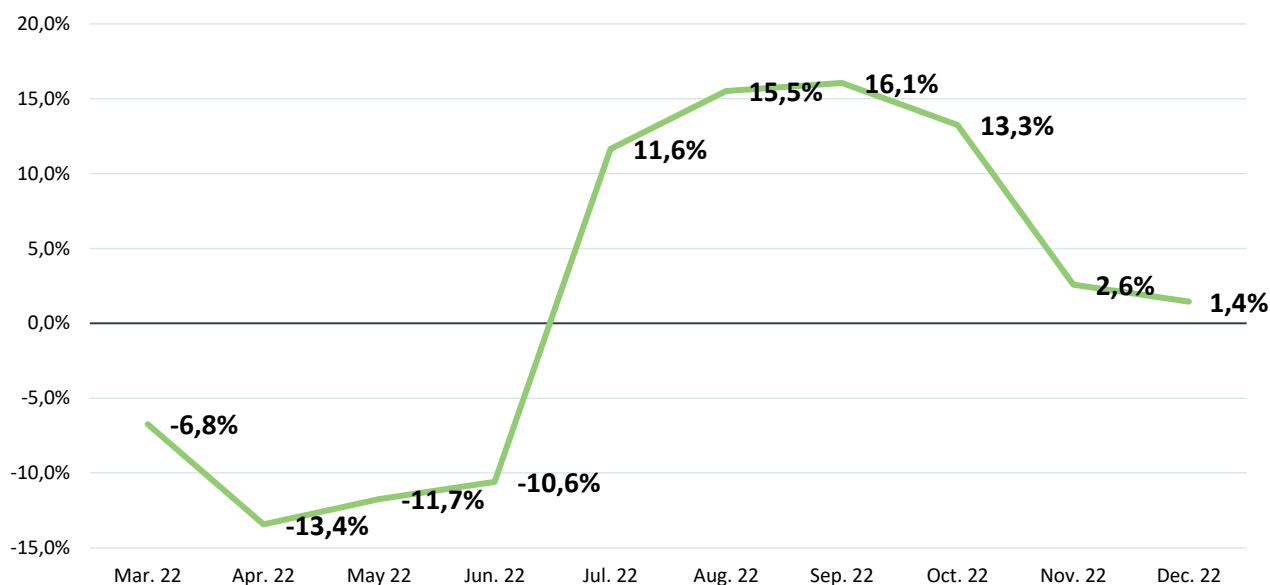
Russian market (including through parallel imports). These and a number of other factors can support demand for borrowed funds.

The banking sector, in turn, has retained significant capacities to increase lending to SMEs, and they are expanding due to, among other things, an increase in government support programs. ACRA expects the government to continue to encourage the development of the SME sector, including through the further creation of favorable lending conditions. In particular, at the beginning of 2023, the Bank of Russia issued a roadmap for the development of SME sector financing that contains a number of measures aimed at more active involvement of credit institutions in this segment.

However, on the 12-month horizon, in ACRA's opinion, there are major risks capable of slowing down the growth of lending to SMEs.

In particular, regardless of the fact that in H2 2022, the volume of disbursements exceeded the figures of the same period in 2021, in December 2022, the increase in disbursements was as low as 1.4% year-on-year. This may indicate saturation of SMEs' demand for loans.

Figure 7. Monthly dynamics of new loans in 2022, year-on-year



Source: Bank of Russia

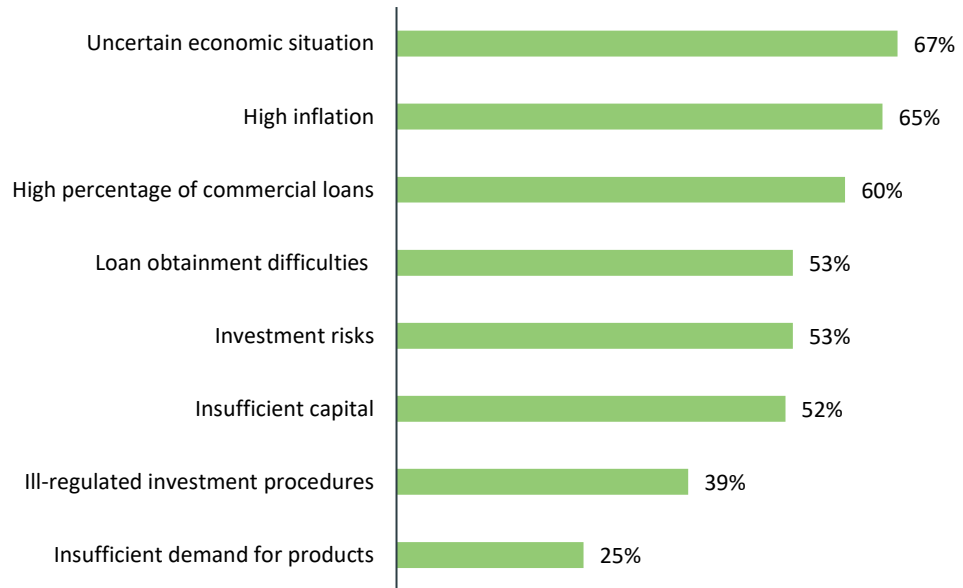
ACRA expects that this trend may be observed in 2023 as well. The activity of companies in the SME sector depends more on the situation in the economy (for example, according to Rosstat, in 2021, up to 67% of SMEs considered economic uncertainty to be the main constrictor of investment activity) than on the activity of their larger competitors. At the same time, despite the existing discrepancies in estimated GDP growth prospects for 2023, general expectations suggest that a significant increase in economic activity (and even more so, a recovery to the level of 2021) is unlikely.

It should be noted that according to the previously mentioned studies conducted by Promsvyazbank PJSC, NGO OPORA RUSSIA, and MAGRAM Market Research, 70% of companies that plan to invest in Q1 2023 will rely on their own resources first of all. For comparison, in April 2021, this indicator was 59%.

Relatively low demand for debt financing from SMEs in general is characteristic of this sector. Thus, the share of borrowed funds in the total volume of investments in fixed assets of medium-sized companies decreased from 46.9% to 30.8% in 2019–2021. Bank loans formed only 18% of the resource base of the SME sector in 2021.

Another important factor that negatively affects SMEs' interest in borrowed resources is their cost. A steady reduction in rates is unlikely if the current monetary policy of the Bank of Russia is maintained, while it is hardly possible that it will soften in the face of existing risks. High interest rates are directly related to increased inflation expectations, which are among the factors constricting the investment activity of the sector's entities. All in all, we can say that the general conditions for the development of SME lending in 2023 will remain far from the most favorable.

Figure 8. SMEs' opinion on investment-restricting factors



Source: Bank of Russia

Continued limited business activity in certain sectors of the economy is among the factors that can restrain the growth of lending to SMEs in 2023. For example, despite the abovementioned uncertainty in the categorization of residential developers as SMEs, the overall impact of construction industry trends on SME lending dynamics can be considered positive (including due to the business impact of industry segments associated with construction companies).

ACRA notes that, thanks to growing lending to construction companies backed by the preferential mortgage programs introduced since 2020, the portfolio of SME loans grew by more than 20% annually. This trend allows us to conclude that the aggregate growth of SME lending directly depends on the continued positive impact of preferential mortgage programs. Despite the fact that the floor area commissioned in 2022 generally corresponded to that of 2021, the persistence of residential construction growth rates remain questionable, as evidenced, in particular, by surveys of developers conducted by JSC "DOM.RF"³. According to these surveys, almost half of the respondents expect their construction portfolios to shrink in the next 12 months. The residential construction growth slowdown is likely to result in a decrease in demand for investment loans and, in general, for loans in the group of business types related to construction (it forms up to 50% of the SME loan portfolio).

Given the sanctions regime and the withdrawal of a number of suppliers from the Russian market, the prospects for investment lending aimed at purchasing new machinery and equipment and as one of the largest segments of capital investments of SMEs remain unclear.

³ ACRA rating AAA(RU), outlook Stable

Summing up all these factors, ACRA expects that growth of the SME loan portfolio in 2023 will slow down significantly and amount to 10–15%, depending on changes in the operating environment. On the other hand, continued business optimism and stronger government support may ensure faster growth of the portfolio of SMEs loans compared to lending to other non-financial companies.

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