SME OWNERS AND DEBT FINANCING: MAJOR CHALLENGES FOR EMERGING MARKET

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Abstract

The purpose of this qualitative study was to unpack the different aspects of the financial obstacles that small medium entrepreneurs (SMEs) face in South Africa. Data were collected by conducting one on one interview's among four financial specialists from financial institution. The financial specialists reported risk was seen as a contributing factor for loans being declined. Other reasons to decline loan were not having business management skills, lack of financial management, experience in an industry and passion for what they do, poor credit record keeping, and lack of collateral. The opportunities leading from the study suggest that entrepreneurs have the potential to improve their chances of accessing finance by enrolling in entrepreneurial and business management studies, thereby learning to overcome poor financial management, and improve their business management skills.

Keywords: Business Growth, Collateral, Entrepreneurs, Financial Specialist, Management Skills, Receiving Finance

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1. INTRODUCTION

Small and Medium Enterprises (SME's) play a crucial role in economic development, especially in creating employment and wealth. SME's are key drivers of economic growth however they face challenges in achieving growth through difficulties in raising and obtaining finance (Ruis et al. 2009; Yon and Evans 2011). De la Torre, Pería and Schmukler (2010) add SME's face financing hurdles and therefore need special focus from financing institutions to assist them in gaining adequate finance to grow their firms. SME's are vital for a country's growth and prosperity as they create a large share of new jobs and are a large part of most economies in the world today.

South Africa faces many challenges with economic growth being a major hurdle that needs to be overcome (Abor and Quartey 2010). To achieve sustainable economic growth the South African government needs to create an environment in which business can flourish and create jobs. SME's are a key part of our economy and the success of SME's is vital for the countries success. SME's however face many challenges to survive and grow. There are many obstacles that they have to overcome to be sustainable such as marketing their products and services, managing their business efficiently and maintaining their cash flows to keep their firms operating.

A major challenge for SME's is the struggle to obtain finance to start or grow their businesses (Yon and Evans 2011). This results in a constraint to economic growth in South Africa and other countries around the world. The challenge of accessing finance to grow their businesses places a heavy burden on the shoulders of entrepreneurs. Increasing access to finance is therefore crucial for SME's to allow them to reach their full potential.

1.1. Definition of SME's

There are numerous definitions of SME's. But for this study, the researchers consider the South African definition as defined in Section 1 of the National Small Business Act of 1996 as amended by the National Small Business Amendment Acts of 2003 and 2004 (NSB Act) as:

"… a separate and distinct business entity, including co-operative enterprises and Non-governmental organisations, managed by one owner or more which, including its branches or subsidiaries, if any, is predominantly carried on in any sector or subsector of the economy…"

Table 1 below summarises the split of firms into SMME's using the number of employees, annual turnover, and Gross Assets, Excluding Fixed Property.

Table 1. Broad definitions of SMME's in the National Small Business Act

Firm size	*Number of employees*	*Annual turnover (SA. Rand)*	*Gross assets, excluding fixed property*
Medium	51 to 200, depending on industry	R25m to R50m depending on industry	R4.5m to R18m depending on industry
Small	21 to 50	R500k to > R25m depending on industry	R500k to > R4.5m depending on industry
Very Small	6 to 20 depending on industry	R150k to >R500k depending on industry	R100k to > R500k depending on industry
Micro	> 5	> R150k	> R100k

Source: Author adapted from Falkena (2015)

1.2. SME support from the banking sector

Globally banks play a key role in offering finance to SME's and banks have developed scoring systems to weed out poor prospects vs profitable prospects from amongst SME's, applying for finance. Banks specifically target SME's because they can be lucrative business for the banks if managed through their filtering systems in which high risk SME's are eliminated for loan approval (OECD 2006).

The four main banks in South Africa namely Nedbank, ABSA, FNB and Standard Bank, have increased their focus on SME's. The Banking Association of South Africa (N.D.) reports that South African banks should continue to assist our country's growth initiatives such as the National Development Plan (NDP) by supporting SME's. The loans they suggest are to be targeted at SME's involved in infrastructure development. The Banking Association also suggests that the South African government in turn should provide banks with guarantees for loans to SME's.

Standard Bank (N.D.) has recognised the importance of funding SME's and their research into SME's helped them understand that traditional SME's are often 'one man' operations in which financial statements are non-existent. Standard Bank created a unique solution for SME's in which collateral was not required, called 'SME Quick Loan.' The working of the loan agreement was, the quicker the loan was paid off the sooner the SME owner would be offered larger loans. In this way Standard Bank has kept their risk low and helped SME owners create a credit history for more traditional loans. According to Mahembe (2011) banks have focused on investing in micro businesses as they envisage that these customers will become profitable once their firms grow. Banks have opened their loan facilities to previously disadvantaged individuals (PDI) as part of their transformation process.

Hussain, Millman and Matlay (2006) point out the importance of the relationship between the owners of SME's with their banks. A positive relationship is key for the day to day financing and functioning of their firms plus it plays an important part for gaining longer term loans. They also mention that financing from banks plays a more important role in their firms as the firms grow. Initially financing for their firms was from owner's personal savings or family and friends. The European Investment Bank (EIB) (N.D.) reports that they have actively increased their support for SME's and continue to improve this going forward. They believe that finance for SME's should be encouraged and they believe in formulating packages for SME's according to the changing needs of the market. They also back SME's through banking guarantees and offer equity financing to SME's.

The World Bank's (N.D.) programme, 'Targeted Support for SME's',(TSME) has specifically been set up to channel funds to SME's via government funding agencies and assist where banking for SME's has been lacking. The World Bank does not traditional focus on SME's however this undertaking is playing an important role in supporting SME's.

1.3. Factors contributing to unsuccessful loan application

Funding institutions often assess SME's loan approval or rejection by considering the personality of the owner of the SME. Haron et al (2013) mention that a person's personality points to whether they will honour the loan agreement. They additionally point out that financial institutions are striving to build long term relationships with their customers as the market has become very competitive and retaining customers is key for the banks growth and profitability. Abdulsaleh and Worthington (2013) and Irwin and Scott (2010) adds further to support this by pointing out that because the owner of a SME plays a significant role in the company and is the main decision maker the assessment by the financial institution is of the owner is a key factor used when offering or declining a loan to a SME.

SME's credit risk from a banks perspective can vary however banks commonly view SME's risk as higher than large corporations as they do not have the same level of security as their larger counterparts. According to Silburt (2012) credit risk is a view a bank takes of a SME as to whether they will be able to pay back the loan or not. The servicing of the loan is seen by banks as risky for SME's because they often operate in highly competitive environments in which profitability is low. Banks scrutinize the SME's ability to repay the loan by investigating the industry they are in and the prospects of the industry. Assessments are also conducted into the 'willingness 'of the SME to repay the loan. This includes payment history from creditors, previous loans and even payment of taxes (World Bank 2014).

Available collateral for many SME's is insufficient for securing loans from banks. This hampers the firm's ability to grow and often SME owners have to pledge their own assets as collateral so that their firms can obtain financing from banks. According to OECD (2014) SME's faced increased pressure to provide additional collateral for loans as the region is undergoing economic hardship and SME's pose a greater risk to lending institutions. Banks took a view that the assets in general used for collateral were overvalued hence the increase in the collateral required. Abdulsaleh and Worthington (2013) reported that SME's with a greater variety of fixed assets are able to obtain financing at lower interest rates and have more chance of having their loans approved as they have greater financial leverage.

1.4. Problem statement

SME's are the engine of growth for the South African economy. Growth of our economy is important because through growth, jobs are created and unemployment is reduced. SME's however face a number of constraints to growth such as a lack of management skills, poor marketing capabilities and access to finance. Financial constraints caused by difficulties in accessing finance are therefore a major cause of limiting SME's growth and hindering South Africa's economic prosperity. SME's unlike larger firms rely heavily on debt finance and are vulnerable to failure as a result of not having sufficient funding. The challenge was therefore to gain an understanding of the challenges SME's went through in trying to access funding for growth. The study therefore explores the challenges faced by SME's in obtaining finance from the supplier's perspective.

2. METHODOLOGY

2.1. Research design

According to Sekaran and Bougie (2013:95,240-241) research design is to create a structure in which data are collected, measured and analysed using the research objectives as a base. Quantitative research uses data in the form of numbers or measurement and qualitative research uses data not in the form of numbers but rather in words (Punch 2013:3). In this study, the qualitative research method was used to explore the financial specialist's personal experiences and views relating to funding SMEs.

2.2. Location and participants of the study

The study was conducted in the Ethekwini Metro which incorporates the city of Durban. The researchers contacted Nedbank, Standard Bank, ABSA, First National Bank (FNB) and Ithala. But only Nedbank, FNB, and Ithala agreed to be interviewed for the study. The participants targeted for the study were senior financial business managers who dealt with SMEs at financial institutions in the Ethekwini Metro. These senior managers were purposefully selected based on their experience in dealing with SME finance. Two interviews were conducted with Nedbank, one with FNB, and one with Ithala – totaling four interviews. The interviews were conducted at their regional offices which were situated in Durban and in Umhlanga (FNB's regional office).

2.3. Data collection

The researcher used semi-structured interviews for the study, as they guided the interview using a specifically designed questionnaire focusing on SME finance issues. Each participant could give their specific views on the questions asked and share their answers freely using their own words. The interviews were conducted individually with the finance specialists at their premises, and lasted around 40 minutes each. The interviews were all recorded for later analysis. After a week of each interview, the researcher had similar interview with each of the participants again to see if the participants did not leave any important information. If there were any new information was provided in the second interview. No new information was provided by all the participants during the second interview. The researcher recorded all the interviews using audio recorder.

2.4. Ethical considerations

An ethical clearance certificate was obtained from the University of KwaZulu-Natal's Ethics Committee. Gate-keeper's letters were obtained from each of the financial institutions before the interviews were conducted. The researcher undertook to ensure that quality and integrity of the research and was given informed consent from each of the study subjects. The researcher respected the confidentiality and anonymity of all study subjects. Participation in the study was voluntary.

2.5. Data analysis

According to Woods (2011:5), the analysis of qualitative data includes the identifying, coding and categorising of themes and patterns in the data. Thematic analysis was used to identify and extract the themes and patterns from the data. The researchers read all the interview transcripts, then re-read them and highlighted similarities and differences. The similarities were given code names and arranged into themes. The transcripts were then imported into NVIVO and each was analysed line by line, and as further themes (Nodes) emerged the text relating to the themes was coded.

3. RESULTS AND DISCUSSION

The objective of the study was to explore the reasons for not approving finance to the SME owners when applying for finance from financing institutions. The following themes emerged from the interviews with the financial specialists from the banking sectors.

3.1. Risky business

SME's often do not receive finance because they are seen as a high risk by financial institutions. Risk for finance institutions has to be managed and is a key factor that is considering when approving or declining loan applications from SME's. The track record of SME's plays a significant role in assessing loan applications. The FNB specialist mentioned, "So I think generally banks have learnt from previous experiences and, and, and experiences and instances where people have failed us. There's a high failure rate in that section. So I…ja…like it's difficult. A lot of SME's I must say, most…the majority of them don't have a good track record."

This negative sentiment does not bode well for SME's and Silburt (2012) highlighted SME credit risk as to whether they will be able to pay back the loan or not. The risk was further heightened in Silburts view as SME's operate in highly competitive environments in which profitability is low. The World Bank (2014) elaborates further the high risk in loaning to SME's as banks have cut lending to SME's and driven SME's to acquire financing from other sources.

3.2. Lack of business management skills

Not having business management skills is another reason highlighted by the financial specialists for not having loans approved. This is a concern for our country as entrepreneurship is vital for growing our economy and creating employment. The FNB specialist mentioned,"They don't have the necessary experience. They have a good idea but they are not schooled in leadership. How to manage people. How to manage a business. What are the components of the financial leg of the business? So all of that. So those are some of the failures."

The issues highlighted of not having the experience, leadership skills and general business management skills is a major reason why business loans are declined. The Ithala specialist mirrored the above concerns using an analogy of a horse and jockey. A great horse with a poor jockey does not win races however an average horse with a great jockey does. The below comments by the Ithala specialist went as follows. "Because … look generally it also comes a bit with the management, the responsibility to run that business. Sometimes you might have the best business ever, it is like a jockey and a horse situation. You have got the best horse but if you don't have a good jockey, you are not going to win anything, you know. But if you have got an average horse but the best jockey, that guy knows how to … how to win a race. He knows how to overcome the challenges, how to pace himself, etcetera. So it is exactly the same thing as a business. The jockey sometimes is more crucial in the viability."

Abor and Quartey (2010) mention the shortage of management skills in SME's is a major factor hindering SME growth. SME's owners often are not qualified to manage their businesses and also struggle to attract qualified managers as large firms are able to pay higher salaries and offer career paths to qualified managers. Jyothi and Kamalanabhan (2010) add that there is a difference in the management skills of SME owners and the management skills they require to manage their firms. Entrepreneurs experience is often lacking. A Turkish study revealed that Turkish women entrepreneurs recognize managerial skill deficiencies and usefulness of prior work experiences significantly impact on their business to be successful (Welsh, Memili, and Kaciak, 2016).

3.3. Experience

Entrepreneurs who don't have experience in the industry that the go into struggle. This was highlighted by the second specialist at Nedbank who commented, "So, you must have your mind right and you must know why you are doing it. You must have going for the right reasons and that is why we always look whenever we do an application we ask for a CV of the potential client to make, to see what experience they have got. Not only in that industry, but also in terms of handling staff…

And it's for the right reasons. Ja. Also, if I think of a couple of my franchises that have gone belly up. One of the reasons was the client didn't have the right experience, he'd been in an office job and resigned and went into a DIY store and what does he know about DIY, you know, so we backed him, obviously we took security, but he didn't make it because he didn't have that knowledge to run a business."

The Ithala specialist backed this up by saying, "So we … ideally in a situation, we would like a guy from the industry, who has had experience in the industry that he wants to go into as a business." Olawale (2010) supported this by highlighting that SME's fail due to insufficient management training and work experience.

3.4. Poor financial management

Poor financial management is a reason why SME's fail to obtain finance from financial institutions. The FNB specialist commented, "They don't have the financial acumen… He doesn't have the financial acumen to back him up. Ja. There is…it is difficult." The second specialist at Nedbank supported this by saying, "You have to allow your business, at least a year, turn your profits back into the business before you start drawing an income otherwise, it's going to put too much pressure on the cash flow, and yes, it's not as glamorous as it seems. It's very, very hard and you've got to be very careful that you don't, once you see cash coming in, that you don't think, okay, I can start spending. No, you must put that away, build up the reserves, and then…". Jyothi and Kamalanabhan (2010) backs this up by highlighting that the lack of financial management often results in difficulties in securing finance and ends up in firms running out of funds to continue operations resulting in the business shutting down.

3.5. Poor credit records

Linked to poor financial management is poor credit record keeping. This also results in difficulties for SME's when applying for finance. The FNB specialist commented, "They either have a, an unhealthy credit record or credit history and now they're…the situation is here." This highlights the importance of managing creditors and ensuring that the firm's credit ratings are kept clean by paying bills and loan repayments on time. Ingilfsson (2011) supports this by adding that lending institutions asses SME's data such as financials, credit history and data about the SME's from credit bureaus. Silburt (2012) also points out that SME's have gaps in financial information due to poor record keeping practices. Poor financial management impacts negatively on the ability of firms to obtain finance and may result in business failure.

3.6. Poor business plan

A poorly written up business plan or one the entrepreneur does not understand hampers the funding process for SME's. Entrepreneurs in South Africa often do not have formal business training and do not have the capability to write up a business plan. They outsource their business plan to accountants or consultants and as a result do not understand the costs of running a business or understand the plan. The first specialist at Nedbank highlighted this by commenting, "I would say business plans not being theirs. So I mean there is a thousand templates out our website SimplyBiz.co.za has one, there, what happens is that people tend to have a generic business plan and generic ideas and it doesn't really talk to the heart of their business so you can't actually connect that when get into entrepreneurs."

The second specialist from FNB added to this by stating, "Let alone other factors that I've mentioned in terms of lack of skills and others, we find that the business proposal does not make sense."

The issue of not having business plans that are understood by entrepreneurs or plans that don't make sense lead to unsustainable businesses as capital depletes and cash flows run dry. Urban and Naidoo (2012) proposed that SME's lack operational skills in the manufacturing sector which is linked to not having comprehensive business plans including an operations plan with financial projections. Barbera and Hasso (2013) suggest that hiring an external accountant benefits the growth and sustainability of SME's. The external accountant fulfils the role of a business consultant bolstering the planning and assisting with compiling a formal business plan. This assists the SME management team in managing their business in a sustainable manner.

3.7. Lack of research

A lack of research and understanding the market, the customers and the competition has the potential to sink an application for finance as finance institutions want to know that SME's will be able to market and sell their products or services. The first specialist at Nedbank said, "As I say, it is a lack of research done. So there's lack of research and understanding of the business, understanding of the operations of the business. There is a lack of understanding the market that is the biggest weakness in most applicants." The second specialist at Sefa supported this by commenting, "The market is already, is not there or the entrepreneur cannot prove to us that there's a market. So the onus is on the entrepreneur to prove to us and justify that there's market for…for the business."

The points from the specialists highlighted that entrepreneurs need to do research and understand the market and operations (management) of their business. Thomas et al (2014) suggest that business plans and research is not going to guarantee success, as often these are made up of 'good guesses.' They propose that SME's rather use a business model canvas as a framework and work out the details as they progress. This is contrary to what the specialists said and could be viewed as an entrepreneurial approach which differs from the standard business plan approach used by financial institutions and accountants.

3.8. Not viable

Entrepreneurs have many ideas, however when tested the ideas may not be viable or don't make business sense. A business idea that is not viable, obviously will not be funded. The specialist from Ithala highlighted this by commenting, "The biggest reason is by lack of viability and affordability or sustainability. I mean if you get what I am saying, and that viability is always crucial, so those are the things that generally lead to us making a … declining an application. Mostly it plays with the viability." The second specialist from Sefa supported this by saying, "The main reason as I'm saying, the most of the businesses which come to us, we find that they are not viable. So when we look at the business proposal, there's nothing that shows that the business will be sustainable."

The importance of a business being viable was highlighted by the specialists. Viability from an operations point of view firstly, in that the business should be able to fund operations, pay back the loan and market a product or service successfully to generate cash flows to fund the operations and make a profit. The business should also be viable from a management point of view, does the entrepreneur have the skills and experience to manage the business. Resnik (2013) shows that leaders in SME's are key to the success of their firms. A leader or entrepreneur with leadership skills should have the ability to lead a firm and grow the firm.

3.9. Lack of collateral

A lack of collateral is a key reason for SME's failing to be granted finance. This was highlighted by the first specialist from Nedbank who commented, "Collateral is always going to be one and then I think a lot of factors around understanding the market and the competitors in that so if they start to do a swat analyses they tend to be very strong around what their skills are, what they bring to the table."

Collateral reduces the risk of the financial institutions as SME's often do not flourish but fail and are unable to pay back their debt financing. SME's do not always have assets that they are able to offer as collateral which hampers their funding drives. This is unfortunate as there are government agencies such as Khula that offer financial institutions backing for SME loans in situations when entrepreneurs don't have sufficient collateral. Steijvers et al (2010) add the personal wealth of SME owners plays an important role in whether or not SME's are able to obtain finance from banks. The owners often have to use their own assets as collateral as their firms do not have sufficient assets to secure loans. This places an additional burden on SME owners as they may lose their business and their personal assets should the business fail. According to Abdulsaleh and Worthington (2013) SME's with fewer tangible assets found it was more difficult to obtain finance. Researchers also concluded that combining with other variables such as sector and technology, business size is an important condition for firm to survive. There must be a relationship between incubators and other factors to ensure firm survival (Mas-Verdú, Ribeiro-Soriano, and Roig-Tierno, 2015).

3.10. Lack of passion

Entrepreneurs who lack passion for what they do may add a hurdle to receiving finance as has been highlighted by the second specialist at Nedbank who commented, "Possibly because as I say we back the jockey, so if it's somebody that's being, say for instance, being say a doctor's wife, for instance, that has been at home all her life, but now he's buying her a fish and chip shop. She doesn't really know much about fish and chips, she doesn't really know much about, about running a business, so for us it's so important that people go into this thing with a passion. They must have passion for what they doing and not just that they are there to make money. It is, it's not easy, hey. I always say, I admire the person that can go into business for themselves. You've got to have nerves of steel and you've got to have passion and you've got to have the willingness to work not just 09:00 to 05:00, but 7 days a week."

The specialist highlighted entrepreneurs need to have a passion for what they are doing. Entrepreneurs need to want to be involved in their business and to put in the hours needed to make their business successful.

Passion does not substitute experience however as a lack of business management experience can result in entrepreneurs not being able to cope with the finer details of managing a business. An entrepreneur may not manage stock levels or cash flow resulting in the business failing. Cardon et al (2013) suggests that passion is at the heart of entrepreneurship and the will to succeed. A lack of passion and experience may therefore result in a loan application being declined because financial institutions 'back the jockey'.

4. CONCLUSION

The results show that there are legitimate reason why financial institutions decline loan applications. Risk was seen as a contributing factor for loans being declined. Not having business management skills is another reason highlighted by the financial specialists for not having loans approved. The lack of financial management often results in difficulties in securing finance and ends up in firms running out of funds to continue operations resulting in the business shutting down. Experience in an industry and passion for what they do was also highlighted as a benefit for an entrepreneur as financial institutions look for experience and passion when assessing loan applications and experienced entrepreneurs stand a greater chance as 'the jockey' to have loan applications approved. Poor financial management came up strongly as a reason to decline loan applications. Linked to poor financial management is poor credit record keeping. This also results in difficulties for SME's when applying for finance. Banks often view SME's as poorly managed and find their applications for loans have gaps in financial information due to poor record keeping practices. Poor business plans were also highlighted as a concern by the financial institutions when entrepreneurs applied for finance. Further to this a lack of collateral is a key reason for SME's failing to be granted finance.

5. RECOMMENDATIONS

The research has highlighted a number of practical ideas that have the potential to overcome the difficulties that SME's face when sourcing debt financing. The followings are recommended:

- Entrepreneur's education was found to be lacking in both literacy and numeracy. Our department of education should focus in increasing the standard of basic education focusing on these two key aspects.
- Training courses for entrepreneurs who lack business management skills would assist in educating SME owners and help entrepreneurs become more successful. These training courses could be run at higher education institutions and entrepreneurs could be encouraged by financial institutions to be enrolled in the courses as a requirement for applying for a business loan.
- Mentoring of entrepreneurs who lack skills for managing and growing their businesses would be useful as mentors would be able to teach entrepreneurs practical ways of doing business and train them in the finer details of financial management, marketing and sales, operations and supply chain management, which are key aspects of business management.
- Government led schemes for backing SME's who lack collateral such as Khula could be expanded to include backing for 100% of loans for entrepreneurs who are willing to first go through training courses as mentioned in b) above. This would encourage entrepreneurs to go on training courses and overcome the hurdle of not having collateral.
- The recommendations for future studies are as follows: Factors in the macro environment could be explored in how they benefit or constrain SME growth. It would be interesting to investigate the level of success for SME's in relation to the level of education that the entrepreneurs have. Competitive advantage of SME's compared to larger firms could be investigated in relation to SME's decision making timespan.

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