Financing Without Collateral to Small and Medium Enterprises in Klang Valley: A Study of the Firm Characteristic

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Received Date: 14 May 2020

Accepted Date: 20 July 2020

Available Online: 30 November 2020

ABSTRACT

This paper attempts to understand the characteristic of small and medium enterprise (SME) firms in Klang Valley that received financing without collateral from the commercial lenders. SME located in Federal Territory of Kuala Lumpur (FT) and Selangor were selected as the population of the study. The legal status of the business entity, business sector the firm involved, using external advisor in conducting business, preparing a business plan, age of the firm and number of the employee owned by the firms, will be analysed and tabulated accordingly. The study combined two sampling methodologies, i.e. convenience and purposive to collect the data and at its level best, covering all 10 districts available in Selangor and FT. Accompanied by the close-ended questionnaire, an interview with 109 owner-manager (OM) was conducted for eighteen months. The data then analyzed using descriptive analysis before a conclusion was made.

Keywords: *Financing without collateral, SME, Small business, Collateral, Financing*

INTRODUCTION.

Many studies have been conducted to address the linkage between collateral and access to formal lending by the SME. All of these studies are trying to understand the importance of collateral in lending sphere related to SME. The outcome of the study still indicates that collateral is playing a major role in access to formal lending by the SME. Malaysian SME had cited that collateral remains as their main obstacle in getting a loan as per latest study conducted by R. Haron & Ibrahim (2016). A survey conducted by SMECorp Malaysia, a body who supervise the development of SME in Malaysia, bring no surprise result as 90% loan approval to SME is required collateral as a back-up (National SME Development Council, 2015). It shows that collateral remains a major stumble block for SME to get a loan from commercial lenders (Ramlee & Berma, 2013).

Commercial lenders require collateral as back-up since SME is high-risk in nature (Mohd Harif & Md Zali, 2011; Nawai & Shariff, 2011). SME is generally more opaque than its larger brethren and hence, its imposed high-risk to the lender (Hamilton & Beck, 2016). Service sector and hi-tech company that require less fixed asset to operate even worst affected by the requirement of the collateral set by the commercial lenders (Abdullah & Ab Manan, 2011; Asian Development Bank, 2014). The commercial lenders need to see the availability of fixed asset in the business as it shows the stability and availability of the second way out in case of default (Chin & Nor, 2016; R. Haron & Ibrahim, 2016). Nonetheless, a study done by Alam (2010) indicates collateral is also required for the manufacturing firm to access formal lending despite the firm has many fixed assets in their balance sheet. A fixed asset such as machinery, plant, equipment or vehicle that offered by SME is hard to ascertain the value (Ramlee & Berma, 2013). Hence, commercial lenders avoid holding this type of collateral for lending and requesting liquid collateral such as mortgage and cash (National SME Development Council, 2015).

Nonetheless, to prolong the issue of collateral in access to financing brings no benefit to the SME. SME requires sufficient fund to flourish, but informal sources of capital such as personal savings or borrowing from relatives are not enough to support (Wu, Song, & Zeng, 2013). Commercial lenders are still their primary sources of fund to tap (Abdesamed & Abd Wahab, 2014; Ahmed, Beck, McDaniel, & Schropp, 2016). But the collateral requirement had jammed-up the smooth flow of fund from commercial lenders to SME. It is noted that less study has been conducted on financing without collateral to SME. A better understanding of this area is needed to reduce the dependability of SME on collateral for access to formal lending. Hence, this study attempts to deliberate the characteristic of small and medium enterprise (SME) firm that received financing without collateral from the commercial lenders, for greater understanding.

LITERATURE REVIEW

Small and medium enterprises (SME) is a major contributor to the national income for many countries, including Malaysia (Chhabra & Pattanayak, 2014; Mohamed Asmy & Mohammed, 2015). As evidence, SME in Malaysia contributes almost 50% output in GDP in the year 2015. Since SME is the major contributor to the income of any country, their role as poverty alleviator has been enhanced by the government of the day through various policies (Korutaro, Nkudabanyanga, Kasozi, Nalukenge, & Tauringana, 2014; Suraya Hanim Mokhtar, Zealand, & Gan, 2012). Hence, SME has been long recognised as an important entity for every country in this world for their significant contribution for GDP, and an effective tool for poverty alleviator.

Nonetheless, SME is facing various challenges. Their major problem is lack of access towards financing from formal lenders (H. Haron, Saniza Binti, Jayaraman, & Ishak, 2013; R. Haron & Ibrahim, 2016). Problem with access to financing from formal lending is a global issue, as many SMEs in various countries, raise the same concern. Formal lenders had responded by giving a reason on fragile establishment track record, mostly set-up under sole-proprietorship whereby successor is not clearly identified, SME mostly involved in the low value-added business sector, they are rarely seeking professional advice in conducting business which leads to unclear preparation of the business plan and a small number of staff which raise concern on the business sustainability.

Lenders tend to declined financing application from a small firm which mostly established under sole-proprietorship, compare to the private limited company due to existence of track record and visible financial muscle (Asia News Monitor, 2015; Mac an Bhaird et al., 2016). Therefore, the study includes the legal entity as one of the variables to be investigated in this study. The next variable to be investigated is the business sector. Sector such as ICT, services and high tech businesses reportedly received lesser attention from formal lenders as these sectors are highly volatile and carry very low tangible asset (Comeig, Fernández-blanco, & Ramírez, 2015; Hong & Zhou, 2013)

OM mostly branching out to others including the banker and an accountant, besides family members when they need advice related to their business. (Carey & Tanewski, 2016; Wells Fargo & Co, 2016; Williams & Donovan, 2015). Professional advice gets by the OM allow them to identify the risk and opportunity for their business to grow, simultaneously assist them in preparing a reliable and flexible business plan (Ferrari, Morone, & Tartiu, 2016).

Besides the above stated reason collateral also remains as a major stumbling block for SME to get access to financing from formal lenders. Many SME studies have been concentrating on collateral requirement when lending is a concern and hence, by tabulating the characteristic of the firms that received the financing without collateral, despite small in amount and short term in nature, it might enhance our understanding on this issue.

RESEARCH METHODOLOGY

Sampling

The study is concentrating on SME located in Federal Territory, Kuala Lumpur (FT) and Selangor as the main population. Based on statistic tabled in SMECorp Malaysia website accessed on 07/06/2017, Selangor has the highest number of SME operating within its boundary (125,904), followed by FT (84,679) at the second place. However, there is no ready sampling list on SME that enjoying financing without collateral as the data mostly under tight safe-keeping of the financial institution. To overcome the challenge, the study combines convenience and purposive sampling methodologies to collect data with application of non-probability sampling to determine the sample. Convenience allows the data to be collected from any agreed OM to participate in the study, and purposive allows only SME with financing without collateral to be included in the study.

The pilot study has been conducted earlier through Facebook posting and WhatsApp application to collect the data, but the response is low. Besides that, Facebook and WhatsApp are public domain, and it raises concern on the person answering the questionnaire. To mitigate the challenges, the study appointed six experienced interviewers to do a direct interview with the OM using a close-ended questionnaire. The study is at the level best, trying to cover all 10 districts available in FT and Selangor. Table A below shows the allocation of the area to be covered by each of the interviewer and the number of completed survey questionnaire gathered by them.

Table A: Coverage Area for Each Interviewer and Total Number of Completed Survey Questionnaire.

Selangor									**FT**	**Total**
IV1			IV2		IV3		IV4		IV5 & 6	
Gombak	H. Langat	H. Selangor	Klang	K. Langat	K. S'ngor	Petaling	S. Bernam	Sepang	FT	
11	5	4	5	0	17	32	3	0	32	109

IV = Interviewer

After 18 months of the data collection period, only 109 OMs are willing to participate. The main reason for the long time taken to gather the data is largely due to high resistance of OM to participate in the study and data collection was done on a part-time basis by the interviewer. Most of the interviewer is a banker, who had to attend their daily work first. Another reason is lack of financial resources and frequent rescheduling of an appointment made by the OM, which finally lead to unmaterialized meeting. After the data has been collected, to derive the conclusion, the data were analysed using descriptive analysis.

FINDINGS

The study is trying to tabulate the characteristic of the firms located in KL and Selangor who had received financing without collateral from the commercial lenders. Among the area that was assessed is includes the age of the firm, the legal status of the business entity, business sector the firm involved, using external advisor in conducting business, preparing business plan, and the number of the employee owned by the firms.

The Firm’s Age.

The age of the firm was grouped into four categories, i.e. below 5 years, 6 to 10 years, 11 to 15 years and 16 years and above. From 109 participants, 61% of the business was aged between 6 and 10 years, 17% between 11 to 15 years and 16 years and above come handy at 6%.

Table 1: Frequency Analysis for Age of the Firm

Items	Frequency	Percentage	Cumulative Percentage
5 years and below	18	16.5	16.5
6 to 10 years	66	60.6	77.1
11 to 15 years	19	17.4	94.5
16 and above	6	5.5	100
Total	109	100	

Majority of the correspondence (78%) is coming from the age segment between 6 to 15 years. The firm is considered stable if they managed to survive more than five years (six years and above) whereby 5 years and below recorded high wound-up case (Yeoh, 2014). Lenders are comfortable to give financing to a stable and matured company where the track record and business acumen are proven (Ezeoha, 2008; Ukaegbu & Oino, 2014). For the firm that has no track record and lack with collateral, Credit Guarantee Corporation (CGC) is available to assist any viable Malaysian company to get financing from the formal lenders (National SME Development Council, 2015). The outcome of the study is aligned with the existing research whereby the commercial lenders are preferred matured SME firm to grant financing. The requirement of matured firm is strengthen given financing to the firm is without the collateral.

Legal Status of the Firms

Only three classes of business legal entities had participated in this study. Limited liability partnership (LLP) is still new to the Malaysian entrepreneur, and none of them from this legal class. From table 2 below, 48% of the respondent form their business under private limited. Establishing a private limited company is much costly compared to the sole-prop business. Despite much expensive to form, business owner want to enjoy better privilege when creating private limited company such as clear ownership & directorship, tax benefit and for easy to identify the successor. The second highest business legal entity is sole-prop at 38% and followed by the partnership at 14%.

Table 2: Frequency Analysis for Legal Entity of the Firm.

Items	Frequency	Percentage	Cumulative Percentage
Sole-Prop	41	37.6	37.6
Partnership	16	14.7	52.3
Private Limited	52	47.7	100
Total	109	100	

The commercial lenders tend to decline financing application form small firms particularly sole-prop since this legal entity is imposing difficulty in replacing the business successor, small size, less capitalise and mostly managed by one person (Asia News Monitor, 2015; Mac an Bhaird, Lucey, & Vidal, 2016). Compared to the large businesses which mostly established under private limited company or public listed company, these companies are easy to get access to formal lending since they have strong track record, tangible asset visibility and less opaque as information on them are publicly available (Briozzo & Vigier, 2015; Cole, Goldberg, & White, 1999; H. Haron, Said, Jayaraman, & Ismail, 2013; Kim, 2004; Ramlee & Berma, 2013). The outcome of the study is able to reflect the risk appetite of the commercial lenders whereby it prioritises large and stable company, i.e. private limited in giving financing without collateral. It also explains why private limited company tend to have a high level of debt compare to the rest of the business legal entity (Hlavsa & Aulová, 2013; Zuoping, 2010).

The Business Sectors

SMECorp of Malaysia classified Malaysian SME into micro, small and medium enterprises based on sector and number of employees. Hence, to inline with the method adopted by SMECorp, the study categorised the sector that the respondent had involved in three groups, i.e. Manufacturing, Non-Manufacturing and Services. Table 3 below indicates, majority of the respondent is doing services (49%) and followed by non-manufacturing at 46%. Manufacturing only constituted 5% from the study since owner of the business really busy managing their plant and manufacturing processes. Due to lower cost to established and require a lesser fixed asset, the service business is gaining popularity among the entrepreneur (Abdesamed & Abd Wahab, 2014; Hong & Zhou, 2013; Tucker & Lean, 2010).

Table 3: Frequency Analysis for Business Sector of the Firm.

Items	Frequency	Percentage	Cumulative Percentage
Non-Manufacturing	50	45.9	45.9
Manufacturing	6	5.5	41.4
Services	53	48.6	100
Total	109	100	

The outcome of the survey quite contradict with the existing study where commercial lenders prefer a company that has a tangible asset compared to the business under services (Alabi, Lawal, & Chiogor, 2016). General trade, food processing and low-tech manufacturing, which mostly seated under the manufacturing sector, are the sector preferred by the lenders (Asian Development Bank, 2014). These companies have a fixed asset to surrender for loan securitisation (Ukaegbu & Oino, 2014). Mohd Shariff (2000) and Peou (2009) in their research had proven that the manufacturing company is playing a significant role in influencing the outcome.

Nonetheless, taking into consideration that the survey was conducted based on non-probability sampling, the outcome indicates commercial lenders are still grant financing without collateral to the service and non-manufacturing businesses. The commercial lenders are giving a ‘clean’ facility to the service sector and non-manufacturing company, which known to have a lesser fixed asset. The outcome is significant since the facility granted was on a clean basis, i.e. without collateral.

Use External Advisor in Conducting Business

Owner of small business always branching out to their family members, close friends, and professional advisors such as accountant, lawyers, and chairman of the business chamber, to seek advice, besides drawing their judgement, when conducting their business including raising funds activities (Wells Fargo & Co, 2016).

Table 4: Frequency Analysis for Sources of External Advice Seeking by OM.

Items	Frequency	Percent	Cumulative Percent
None	19	17.4	17.4
Relatives or friends	13	11.9	29.4
Bank Manager	56	51.4	80.7
Accountant	15	13.8	94.5
Chamber of Commerce	6	5.5	100.0
Total	109	100.0	

The outcome of the survey indicates 51% of the business owner branching out to the Bank Manager to seek business advice. It is vital for the business owner to connects with capable bankers who have in-depth knowledge of the industry when they apply financing with the commercial lenders (Rubens & Barton, 1988). This implies the importance of bankers as a touchpoint for small business to start the borrowing relationship since bankers mostly are well experienced in credit and have in-depth knowledge of the industry. Beside advising funding requirement of the company, the role of the banker is also to educate their borrower on financial mismanagement and current global financial crisis (Cutler, 2014).

The business owner also seeks business advice from an accountant. 14% of the respondent asks business advice from their accountant. Besides providing basic accounting services, an accounting firm also providing business advisers to their client (Gooderham, Tobiassen, Doving, & Nordhaug, 2016). The business owner also branching out to the accountant for tax-related matters. An accountant who can provide advisory on tax, business management and accounting services, could benefit small business owners greatly (Zimmerman, 2016). Since small business used their accountant for various purposes, accountant competency and quality of services provided by the firm, are the significant factors affecting the relationship tenure between small business and their accountant (Carey & Tanewski, 2016; Gooderham et al., 2016). Another popular way of seeking advice used by most OM is through an online platform where they seek advice from a peer that they never met before (Kuhn, Galloway, & Collins-Williams, 2016). The online platform becomes more popular with the breakthrough of internet, video calling and media social like Facebook, Instagram and others.

Preparation of the Business Plan

The outcome of the study shows that business owner is less preparing a business plan when they are establishing their business. Only 12.8% owner prepared the documents, while 87% is not prepared for the documents when they created their business. Since the interview session was conducted based on a close-ended questionnaire and the business owner is busy managing their business, the study did not provide the answer for the reason the business plan was not prepared.

Table 5: Frequency Analysis for Preparation of Business Plan.

Items	Frequency	Percentage	Cumulative Percentage
No	95	87.2	87.2
Yes	14	12.8	100.0
Total	109	100.0	

The business plan allows the business owner to assess business opportunities by differentiating between the ideas and the opportunity (Botha & Robertson, 2014). Hence, business opportunities actually can be formed from a clear and concise business plan. A business plan outlines the ways, means and goal of the business (Branch, 1991). The plan able to narrow down the uncertainty from relevant dimensions, of which inadequately addressed might jeopardise effort to solve the emerging problem and put the whole business at risk (Ferrari et al., 2016). Hence, a business plan provides a useful blueprint for the company to move forward, provide clear guidance to achieve their business objective, simultaneously avoiding costly mistake once emerging problem realised.

A business plan was frequently made to raise money or initial fund for the business (O'Connor, 2016). The documents communicate the ideas of the business owner to prospective investors, bankers or other interested parties, explaining the purpose of the money was raised. A carefully designed business plan has the capability to attract capital or provide the basis of loan proposal (Branch, 1991; O'Connor, 2016). In broad perspective, a business plan was tasked to explain to the willing investors, commercial lenders, family members, business "angels," or others as to why they should invest their money in the business (Branch, 1991; Sahlman, 1997).

The Number of the Employee

SMECorp Malaysia classified SME based on two categories, i.e. sector and the number of the employee. Sector consists of manufacturing, non-manufacturing and services, while number of employees determine either they are micro, small or medium enterprise. Hence, to in line with the classification methodology and to ease the analysis, the study divide the data into two categories, i.e.

manufacturing and non-manufacturing. Non-manufacturing and service sectors were combined together and classify under non-manufacturing.

a) Manufacturing.

Table 6.a: Frequency Analysis for Number of Employee for the Manufacturing Sector.

Items	Frequency	Percentage	Cumulative Percentage
Below than 5	2	33.3	33.3
5 to 75	4	66.7	100
Total	6	100	

Over 109 respondents, only 6 respondents fall under the manufacturing, and the balance falls under the non-manufacturing sector. 67% of the respondent who has financing without collateral has total number of employee between 5 to 75 employees. This considered as a medium-size firm from the SME perspective. None of the respondents has more than 75 staff, and only 2 respondents (33%) has employee below than 5. Manufacturing sector requires more people to operate as it involved value-added processes along the supply chain, and it justifies higher employee's absorption in this sector (Mohd Shariff, 2000).

b) Non-Manufacturing

Table 6.b: Frequency Distribution for Number of Employee for Non-Manufacturing.

Items	Frequency	Percentage	Cumulative Percentage
Below than 5	26	25.2	25.2
5 to 30	75	72.8	98.1
31 to 75	2	1.9	100
Total	103	100	

Majority of the non-manufacturing company that enjoy financing without collateral has 5 to 30 employees. This segment contribute almost 73% of the overall sampling. The company that maintain this size of employees is considered a stable firm from the lender's perspective. Lenders are interested in giving more financing to large firms compared to the small firms due to the economy of scale (Ramlee & Berma, 2013). Since the cost of credit can be directly transferred to the applicant, size of the firm which based on a number of employees will give much influence on the firms' cost of credit (Mohd Shariff, 2000). Hence, the outcome of the study confirming that a medium-size firm easily secured financing without collateral compare to the small firms.

The outcome between manufacturing and non-manufacturing sectors have one similarity, i.e. a medium-size firm, which is in this study measure through a number of employees, is easy to get outside capital compare to its small peers (Kartikasari & Merianti, 2016). Small firms not only face limited access to finance, but they also face more stringent financing conditions, higher pricing, shorter tenure & less flexible facility type (Gill & Biger, 2012; Mohd Shariff, 2000; Zecchini & Ventura, 2006). The outcome of this research is affirming the conclusion of the previous study, that firm size is positively related to the access to financing from the formal sources (Ozturk & Mrkaic, 2014).

CONCLUSION

The study had achieved its main objectives to analyse the features of the firms that received financing without collateral from the commercial lenders. The sample is withdrawn from SME located in FT and Selangor. Commercial lenders are keen to grant financing without collateral to the firm that aged 6 years and above as it shed some stability of the business. In term of legal business entity, majority of the firms that received the financing are the private limited company. The private limited company viewed more stable compare the rest of the legal business entity. The commercial lenders show some balance approach in giving financing based on sector. 46% respondent come from non-manufacturing sector and 48% from service sector. When connecting with the bank, business owner mostly prefers to talk to the bank manager, as final decision of the loan proposal normally in their hands. Bank manager also has intuitive capability to screening a pool of potential client before deciding to on-board the client into their books. Despite the importance of having a proper business plan, 87% of the business owner does not prepare the document. Due to the limited time of the interview session, the real reason for not preparing the business plan was not asked to the business owner. In term of number of employees, the commercial lenders are keen to finance manufacturing company that have 5 to 75 employees and non-manufacturing company that have 5 to 30 staffs. These companies are considered as stable and preferred by commercial lenders.

DISCUSSION

Collateral has been cited as one of the main reason SME fails to get financing from commercial lenders. Many studies have been conducted to explore the linkage, and the outcome still concludes the same conclusion. Nonetheless, this study provide evidence that SME in Malaysia actually has access to formal lending, albeit in a small amount. The commercial lenders still grant them small financing line in the form of personal loan, personal overdraft and credit card to the firms and to the business owner, which require no collateral for utilisation. The research provides a stark contrast outcome from the existing study, who continuously arguing that collateral is the main reason SME was denied from access to financing. Commercial lenders are granting SME formal financing on non-collateral basis, albeit on a small scale.

The other outcome worth to discuss is that commercial lenders are keen to grant financing to non-manufacturing and a service company. Hi-tech and non-manufacturing companies own less fixed asset and were cited as the party that mostly affected with the collateral requirement set by the commercial lenders. Nonetheless, this research provides evidence that commercial lenders are still keen to grant financing to these sectors, even without collateral. At the same time, despite business plan is important, commercial lenders are still give financing to the business that not prepare the document. The decision to lend might not totally depend on the document but credit scoring, CCRIS record and other decision tools used by the commercial lenders, might influence the overall approval process.

Although the study provides new evidence, it is best to reiterate that this research was conducted in two states only, i.e. FT and Selangor. The selection of two states only may create a sectoral or area bias whereby, for a record, SME is highly concentrating in these two states. Commercial lenders might favour to the highly concentrated business area and they are also likely to have more branches serving this area, compared to other state that has less business activity. This situation create high competition among the commercial lenders and hence push the lender to serve every single business available within the area, which includes SME as their target market segment. The study should expand more sample to generate a better result. Sampling bias may occurred in this study but looking at high level of resistance of business owner to participate in the study, getting 109 samplings within 18 months viewed as acceptable. Also noted that the study is only focused on the firm’s criteria and it should expand further to include variables such as the business owner variable, financing type variable and also to consider the type of commercial lenders institution that the firm dealt. These variables have been used in many research to address the linkage between collateral and access of financing by the SME.

IMPLICATIONS FOR FUTURE RESEARCH

The study had achieved its main objectives to analyse the features of the firms that received financing without collateral from the commercial lenders. However, as explained in the discussion part, this study is only concentrating on firm’s features, neglecting other variable including the business owner, type of financing received and other variables that typically used in SME’s studies such as relationship lending, type of commercial lenders, capital position of the company and other macro-level variables. Other suggestion for further study is to address the reason why the business owner is not preparing the business plan. Due to limited interview time and depending on close-ended questionnaire prepared earlier, this research does not provide clear answer for this area. The study also concentrating in two states only. More extensive coverage which is to include other states should be considered if resources permitted. This study does not provide insight into a particular industry or sector for specific understanding. Hence, this area shall be given attention for future study. In conclusion, the study had provide an evidence that SME is enjoying financing from formal lender on non-collateral basis. The commercial lenders are granting this type of facility to a matured and stable company, as evidenced by the outcome of the survey.

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