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Small and Medium-Sized Enterprises Financing

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Abstract: The operations of small and medium-sized enterprises (SMEs) occupy an admirable position in the economic landscape of most economies in the world, especially for developing countries. Based on literature review, this paper critically assesses the sources of finance available to SMEs and the difficulties they encounter in accessing these finances. The study identified bank loans, venture capital financing, business angels, trade credit, and government support as the key sources of finance available to SMEs. The study further shows that limited resources, personal characteristics of SMEs managers, and the nature of some SMEs are the common factors inhibiting SMEs access to finance.

Keywords: small and medium-sized enterprises, access to finance; bank loans; difficulties

1. Introduction

Small to Medium-Sized Companies sometimes also SMEs are considered an important component for the economic growth and development of every nation, especially for developing countries (Khan, 2015). Small and Medium Enterprises (SMEs) as defined by the European Union, are businesses with employees less than 250 and with annual turnover not more than 50 million Euros (Organisation for Economic Co-operation and Development, 2002). The sector contributes immensely to the gross domestic product (GDP) of a country and employs a reasonable percentage of a country's labour force (Gamage, 2015; Nitescu, 2015). It is estimated that more than 95% of enterprises across the world are SMEs and they account for approximately 60% of private sector employment (Ayyagari et al., 2011). A critical determinant of the growth and success of SMEs is access to finance (Abdulsaleh &Worthington, 2013). However, the difficulties for SMEs to raise finance to support their growth are widespread (Kumar & Rao, 2015). A number of studies have shown that financing is a great obstacle for SMEs than it is for large firms, particularly in the developing world, and that access to finance adversely affect the growth of the SME sector more than that of large companies (Schiffer & Weder, 2001; Beck et al., 2005; Beck et al., 2006). It is therefore, unsurprising that the international development community has listed SME access to finance as an important policy priority.

This paper surveys the literature on the financing of SMEs taking into consideration some of the various sources of finance available to SMEs, and at the same time examining the difficulties faced in raising finance by SMEs.

2. Sources of SMEs Finance

Brookfield (2001) identified twelve sources of finance available for SMEs and classified them as: initial owner financing, business angel financing, trade credit, leasing, factoring, venture capital, short-term bank loans, medium-term bank loans, mezzanine finance, private placements, public equity, and public debt. SMEs sources of finance can be broadly categorized into equity financing and debt financing, and the firm can decide to choose between these two sources, or combine the two based on the financing needs (Covas & Den Haan, 2012). Some of the sources of finance available for SMEs are discussed below.

First, bank finance serves as the main source of external finance for SMEs in most countries, especially where banking dominates the financial system (Carey & Flynn, 2005; Angela, 2011). Cosh and Hughes (2003) established that about 65% of small businesses in the UK are financed by bank loans. However, based on the UK Survey of SME Finances, Fraser (2004) estimated that out of 80% of external finance used by 2.9 million SMEs, only 10% was bank loan. Fraser's findings appeared different as claimed by Cosh and Hughes (2003). According to the Department for Business Innovation and Skills (2012), SMEs' access to bank finance has declined. The report explained that the decline results from the steps taking by SMEs to minimize their dependency on external debt finance. Research revealed that large firms have more access to bank finance compared to small firms (Angela, 2011). Gamage (2015) indicated that banks consider investment in SMEs as risky, and fail to advance credit to potential SMEs. They assume that investing in SMEs involves high cost of transaction and lower returns. Despite the financing difficulties and the expensive nature of bank finance, banks remain the ultimate supplier of finance as they provide SMEs with higher returns (Keasey & McGuinness, 1990; Boocock & Shariff, 2005).

Second, venture capital financing is another source of finance for SMEs. It is a form of equity finance provided by private individuals investing in start-ups with great potentials (Sahlman, 1990). Venture capitalists play a key role in financing SMEs. They bring a lot of experience to the new business and are usually concern with the business strategic objectives. A study by Sohl (2003) revealed that venture capital financing contributes greatly to SMEs' financing in the US. According to Sohl, the amount of venture investment increased from $15.1 billion in 1998 to $38.2 and $89.8 billion in 1999 and 2000 respectively. However, a different picture emerged in the UK in the sense that investment by venture capitalists has fallen since 2009. In 2008 venture investment was estimated at £1,200 million, which continue to decline since 2009 (British Business Bank Report, 2014). A major limitation of this source of finance

is that it can be quite expensive for a start-up firm as legal and accounting costs are necessary. Nevertheless, venture capital finance is more dominant among SMEs, especially in the UK (McLaney, 2009).

Also, business angel financing is another source of finance for SMEs which involves direct investment by individual investors in small businesses (Brookfield, 2001). The investment made by business angels is usually equity investment in the form of common stock (Abdulsaleh & Worthington, 2013). McLaney (2009) stated that there are about 40000 active business angels in the UK investing between £10,000 and £75,000 in small business. For many SMEs, angel investment is central to their growth especially at the early stage. Sohl (2003) indicated that about $30 billion is invested by angels every year in close to 50,000 ventures in the US. Sohl estimated that, in 2010, angel investment was $20.1 in the US representing a 14% increment over 2009. Fairchild (2011) claimed that in terms of financial value and the number of firms seeking finance, angels are preferred over venture capitalists. However, other studies indicated that angels do not contribute actively in financing SMEs compared to venture capitalists, and getting the right business angel can be time-consuming (Barry, 1994; Wall, 2007). Despite the limitations, there are still reasons why angel investment is appropriate. Notwithstanding the financial contributions, angels bring expertise to the firm and help businesses to overcome the difficulties in accessing funding (Macht & Robinson, 2009).

Moreover, trade credit serves as one of the most crucial sources of debt financing for SMEs. Trade credit is the credit granted by the supplier who does not demand instant payment for goods delivered (Elliehausen & Wolken, 1993). According to the European Commission (2014), one of the most used debt instruments is trade credit. A survey by the EU in 28 EU countries revealed that about 68% of SMEs used trade credit in their debt financing. Data gathered by Berger and Udell (2006) showed that 33% of the total debt used by SMEs in 1998 in the US was trade credit. Also, Cook (1999) stated that trade credit serves as a means by which SMEs easily get access to bank loans. In addition, Elliehausen and Wolken (1993) claimed that trade credit is used as a substitute for other sources of finance when these sources are difficult to raise. Other scholars criticized trade credit on the basis that, it sometimes (not in all cases) tends to be expensive and has a limited duration (Brookfield, 2001). Notwithstanding these limitations, the use of trade credit remains a vital source of finance for SMEs as argued by Nilsen (2002) and Berger and Udell (2006). They believe that during monetary contractions, SMEs can resort to trade credit.

Furthermore, government support and initiatives serve as another source of finance for SMEs. Government initiatives such as subsidized fees, factoring and credit guarantee schemes are major ways to ease SMEs' access to additional finance (Boocock & Shariff, 2005). The Small Firm Guarantee Scheme is one of the examples of government support programs. This was created in the UK in 1981 with the aim of enhancing access to finance by SMEs with feasible projects and serving as guarantors for small business loans (OECD, 2002). It was estimated that for the period 1998-1999, the scheme guaranteed about 4500

SMEs loans worth £189 million. The OECD report further stated that the scheme guaranteed about 4269 SMEs loan in 2001-2002 with about £255 million in value. However, a different case appeared in Croatia, where the government initiated a National SME Loan Scheme to facilitate the supply of funds for SMEs. The program in the first two years (2000 and 2001) failed to meet its objectives as fewer loans were approved with 5% in 2000 and 29% in 2001 (Cziraky, Tisma, & Pisarovic, 2005). Despite these contributions by national governments in facilitating SMEs' access to finance, government initiatives are usually associated with rules and regulations with regards to eligibility and how the funds should be used.

3. Challenges SMEs Face in Accessing Finance

In spite of the numerous sources of finance available for SMEs, they sometimes face difficulties in accessing these sources. The main causes of the difficulties are discussed below.

In the first place, personal characteristics of some SME managers such as gender, ethnicity, and education are believed to have an impact on SMEs' access to finance. According to some studies (for example Irwin & Scott 2010; Ram & Smallbone, 2001) the uneducated and ethnic minority businesses, especially Africans and Bangladeshis, have the most difficulty in accessing finance. Coleman (2007) established that female entrepreneurs face difficulties in raising bank credit, as they are being discriminated and are usually charged with higher interest rates. Irwin and Scott (2010) however showed the opposite. They stated that it is easier for women entrepreneurs to raise finance than men though in other studies, women are risky borrowers.
Also, the locations of most SMEs hinder their ability to raise external funding. Kira and He (2012) stated that SMEs located in the remote areas have difficulties in accessing external finance. Fatoki and Odeyemi (2010) added that firms located in the major cities get more access to external finance as they find it easy to establish greater relationships and networks with investors especially banks. In assessing the obstacles SMEs encounter in accessing funding in Fiji, Reddy (2007) explained that SMEs prefer to operate in the cities to avoid the rural factors that may affect their ability to raise finance. It is evidenced that SMEs' location has a positive relationship with their ability to raise external finance.

Moreover, lack of collateral obstructs SMEs' access to finance. The inability of SMEs to provide collateral subjects them to high intermediation costs (Berger & Udell, 1998). A study by Ono and Uesugi (2009) revealed that the use of collateral is positively correlated to borrower’s power, and firms without collateral face difficulties in accessing finance. This is consistent with the study by Odit and Gobardhun (2011) who found that SMEs with less tangible assets are likely to face complications in raising external finance because of their inability to present the collateral required.

In addition, business information is key to accessing finance. Lack of information about SMEs activities contributes to the difficulties in raising finance (OECD, 2002). Sarapaivanich

and Kotey (2006) argued that insufficient information brings about information asymmetry restricting SMEs' access to finance. According to Brookfield (2001), early-stage businesses especially SMEs lack track records compared to large businesses. Brookfield stated that large firms provide information with a high degree of certainty as their activities are being monitored, for example, auditing their accounts periodically. However, SMEs' activities are not monitored making it difficult to prove their worthiness to potential investors.

Furthermore, higher cost of borrowing impedes SMEs' access to finance. Higher interest rates charged by lenders make it extremely difficult to access bank credit. The European Commission (2014) argued that SMEs in countries like UK and Italy face higher interest rate in borrowing compared to countries like Germany and Belgium, which is indicative of the fact that SMEs borrowing conditions depends on the country's condition of interest rates. However, the Department for Business Innovation and Skills (2012) reports that SMEs in the UK pay lower interest in accessing finance as a result of the decline in the interest rate of the Bank of England. This is contrary to the survey presented by the European Commission (2014).

4. Conclusion

In conclusion, SMEs play a vital role in the development of a country's economy. However, due to limited resources, personal characteristics of SMEs managers, and the nature of some SMEs, they are usually faced with difficulties in accessing finance despite the wide range of financial sources (such as bank loans, venture capital, trade credit, etc.) available to them. In solving the problems of access to finance, there is a need for SMEs to form networks in order to organize financial resources together. Such an initiative could help SMEs to access funds with less or no cost of borrowing, and with no collateral. Furthermore, national governments should recognize the role SMEs play in developing their economies and establish or strengthen their support schemes for these firms.

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