OBSTACLES TO ACCESSING FINANCE BY SMALL BUSINESS OPERATORS IN THE BUFFALO CITY METROPOLITAN MUNICIPALITY

Tendai Chimucheka
Department of Business Management, University of Fort Hare
University of Fort Hare, Alice, P.B. X1314, Eastern Cape, 5700, South Africa
Tel: +27 (0) 73 504 1856; Email: 200705925@ufh.ac.za , tenchims@gmail.com

Ellen C Rungani
Department of Business Management, University of Fort Hare
University of Fort Hare, Alice, P.B. X1314, Eastern Cape, 5700, South Africa
Tel: +27 (0) 40 602 2504; Email: erungani@ufh.ac.za

Abstract

The study investigated the obstacles to accessing finance by small business operators in the Buffalo City Metropolitan Municipality. The objectives of the study were to identify the causes of inaccessibility to finance by small business operators, to investigate the role of government agencies in supporting small business operators, to assess the extent to which banks support SMMEs and to suggest solutions to ease the challenge of inaccessibility of finance by small business operators. Triangulation research design was used in this study. SMME owners and managers in the Buffalo City Metropolitan Municipality were the target population. Simple random sampling technique was used to select respondents. In-depth interviews were conducted to collect qualitative data. Quantitative data was analysed using descriptive statistics, Chi-square test and factor analysis. Qualitative data was analysed using content analysis. Obstacles to accessing finance were identified and discussed. Lack of collateral security, poor business plans, lack of knowledge and lack of financial deposit are some of the main factors identified. The banks, government and government agencies are urged to support the SMME sector for it remains the economic engine of many African countries. This sector also helps in reducing the impact of socio-economic challenges like unemployment and poverty.

Key words: small business, SMMEs, obstacles, finance, access

Introduction

The Small, Medium and Micro Enterprises (SMMEs) sector is globally regarded as the driving force in economic growth and job creation. SMMEs play an important role in creating jobs and wealth. Central to the growth of any economy is the development of a vibrant SMME sector which is the key to resolving many societal challenges, including unemployment (Entrepreneur SA, 2005:3).

The SMMEs sector forms the backbone of South Africa's economy, not just in terms of their contribution to national Gross Domestic Product, but especially in terms of employment. According to 2009 estimates, about 74% of South Africans active in the economy are employed by SMMEs (The Business Place, 2009:1). They are often the first to be offering new products in the market and they are more flexible than large organisations (Boone and Kurtz, 2006:125).This therefore means that SMMEs can meet and satisfy the population's needs better than bigger businesses that lack flexibility.

According to Visagie (1997), in most areas in South Africa, where active population is too small to justify large enterprises, the only source of economic activity is that provided by SMMEs. This justifies why this sector has received much attention from the government in recent years.

Despite support provided by the South African government, SMMEs still face challenges. The main problem faced by owners and operators of SMMEs, is the inaccessibility of bank finances. The lack or inaccessibility of bank finances is a serious constraint during the formation of new ventures as well as at later stages as business requires additional inflows of capital to support expansion and growth (Nieuwenhuizen and Groenewald, 2004:9).

It is important to note that the concept of small business is diverse and depends on the level of each country's economic development. In South Africa, the act that provides the regulatory and support framework for SMMEs, the National Small

Business Act 102 of 1996, defines an SMME as a “separate and distinct business entity, including cooperative enterprises and non governmental organisations, managed by one owner or more which including its branches or subsidiaries, if any, predominantly carried on in any sector or subsector of the economy”. In this study small businesses and, SMMEs will be used interchangeably.

Problem statement

In South Africa an unacceptable and disappointingly high number of SMMEs fail during the first few years of operation (Nieman and Nieuwenhuizen, 2009:35). They face various challenges. Inaccessibility of bank finance is one of the major challenges that South African SMMEs face among others. According to Nieman and Nieuwenhuizen (2009), the largest percentage of SMMEs fails during the first two years of their existence due to cash flow problems that arise because they could not manage growth. Cash flow problems can occur as a result of inaccessibility of bank finances.

Unemployment in the Eastern Cape Province and South Africa at large is a challenge faced by the nation and SMMEs can play a major role in curbing this problem. SMMEs need to be supported and they also need to be able to access resources they need to survive and grow. Inaccessibility of bank finance is a real challenge faced by SMMEs and the causes of this challenge needs to be investigated so as to come up with relevant solutions that can contribute to the success of South African SMMEs.

Objectives

The objectives of the study were to:

- identify the causes of inaccessibility to finance by small, micro and medium enterprises (SMMEs),
- to investigate the role of government agencies in supporting small business operators,
- to assess the extent to which banks support SMMEs and,

- to suggest solutions to ease the challenge of inaccessibility of finance by SMMEs.

Hypothesis

$H_{0:}$ SMMEs in Buffalo City Municipality, South Africa find it difficult to access bank finance.

Research questions

- What are the obstacles to accessing finance by small business operators?
- How can government agencies support small business operators effectively?
- What can be done to ease the challenge of inaccessibility of finance by small business operators?

Significance of the study

This study is useful for the development of the small business sector of South Africa. If obstacles to accessing finance by these small ventures are identified, relevant solutions can be implemented; hence their success rate will be improved. The more the small businesses survive and succeed in business, the better the welfare of people in the society. The small business sector helps in reducing poverty, creating employment and also in wealth creation. The study is also useful for banks and other financial institutions in developing products that will best suit the owners and operators of the small business sector.

Literature review

Fatoki and Garwe (2010) noted that inaccessibility of finance is the second most reported contributor to low firm creation and failure, after education and training in South Africa. Herrington et al*.,* (2009) also pointed out that access to finance is the major problem for South African SMMEs. Cassar (2004) makes it clear that inaccessibility of finance can be a constraint on SMME growth and success. A research conducted by Naude and Havenga (2004) proved that most entrepreneurs, specifically SMMEs struggled with accessing finances from banks due to excessive red tape and administrative burden. They argued that financial institutions rarely finance start up businesses because they are bureaucratic, lack knowledge or understanding of the owners or operators of SMMEs (entrepreneurs), are not willing to assist and are wary in providing finance to people who do not have a business record.

Access to finance is not the only challenge faced by SMMEs, Rogerson (2006) in the study conducted in the Free State province identified access to finance, inadequate premises, lack of equipment and tools, inadequate markets and marketing, theft, registering and transport challenges as attributes to failure rate in that province. It is also important to note that the impact of most of these challenges can be reduced if the challenge of inaccessibility of finance is addressed. From the findings of Rogerson (2006), inaccessibility to finance is the primary challenge and all other challenges can be said to be as a result of this challenge.

Mutezo (2005) revealed that conventional financing mechanisms do not allow for cost effective provision of finance to large numbers of entrepreneurs or SMMEs seeking small quantities of finance. He argued that poverty and lack of assets indicate that many people do not have the collateral needed to access formal financing. According to Mutezo (2005), entrepreneurial activity is hampered by lack of access to finance.

Mutezo (2005) asserts that the key factor militating against increased investment in SMME sector is the structure of the financial sector. He argued that the financial sector is composed of concentrated banking sector targeting corporate accounts and competing with smaller niche banks. He added that there is a strong dearth of strong alternative financial institutions providing credit to self-employed for productive purposes. A larger portion of the SMME sector is said to have no access to adequate and appropriate forms of credit and equity or financial services.

The study by Bbenkele (2007) revealed that SMMEs especially those from rural areas have a poor understanding of the services that banks offer and they also lack understanding of the bank loan procedures. Bbenkele (2007) argues that this lack of information and knowledge leads to SMMEs' weak bargaining position in terms of interest paid, asset and liability disclosure, misuse of loan funds and generally bad preparedness when applying for business loans.

Christianson (2005) supports that SMMEs face problems in accessing finances. He asserts that SMMEs in South Africa are often quoted as not being able to access money from banks to grow their businesses. Inaccessibility of bank finance is seen as the biggest inhibitor of growth. The main problem facing the development of SMMEs in both developed and developing countries is access to finance and this has also been supported by the work of Bosa (1969), Levy (1993) and Keasey and Watson (1994).

Other commentators have however refuted this fact and feel that the problem is not really inaccessibility of bank finance but how SMMEs apply for finances. South Africa is included in this predicament as a developing country and the government has tried different options to improve accessibility of finance. Despite various government initiatives, many SMMEs still have difficulties in accessing finance in South Africa.

Fin Mark Trust (2006), finds that only 2% of new SMMEs in South Africa are able to access bank loans. According to Foxcroft et al*.,* (2002), 75% of applications for bank credit by new SMMEs in South Africa are rejected. This suggests that SMMEs without finance may not be able to survive and grow. According to Phillips and Wade (2008), SMMEs without access to finance may find it difficult to purchase necessary technology.

The problem of information asymmetry

The problem of small business operators failing to access funds can also be attributed to the problem of information asymmetry. It is also known that when lending to small business operators, the major task of lenders will be that in reducing and avoiding credit risk is to overcome the challenge of asymmetric information. This problem occurs when one party to a contract knows relevant information which has a material effect on the contract, but which is not known by the other contracting party (Agyapong et al., 2011:132). When small business operators approach banks for loans, they always have an information advantage over the bankers. This in some cases can lead small business operators to overstate the viability of their businesses in relation to the finances sought (Storey, 1994).

It is because of information asymmetry that banks usually end up making unprofitable loans. Another factor is that the activities of most of these small scale business operators who borrow from banks are rarely monitored and are not directly observable by banks. According to Agyapong et al., (2011:132), the fact that these borrowers can use the funds for other purposes other than those stipulated in the loan agreement. This then means that banks should not only investigate the credit worthiness of the small business borrowers but should also monitor their activities once they have obtained the loans (Agyapong et al., 2011:132).

Factors considered by banks when granting credit

Agyapong, Agyapong and Darfor (2011), noted that the small business sector is now an increasingly important source of profitability for the financial institutions, particularly banks. It is therefore necessary for small business operators when borrowing to develop an understanding of the decision criteria used by financial institutions in order to increase the probability of getting their loan applications accepted by adequately fulfilling the required criteria. A study by Agyapong, Agyapong and Darfor (2011:132) found that when loan managers are deciding on whether to accept or reject a loan application from small business operators, the intended purpose of the loan, repayment records or previous loans, repayment schedule, type of business activity, size of loan relative to the size of a business and also the availability of collateral are ranked high on the criteria list. It is also crucial to note the fact that lenders take particular interest in risk when dealing with small business operators.

Traditionally, the assessment of credit worthiness of small business borrowers was based on the experience and skills of bankers in applying basic lending principles such as the 5Cs approach or the CAMPARI approach (Agyapong et al., 2011:133). The 5Cs approach considers the character of the borrower, the capacity, capital, collateral and conditions. The CAMPARI approach involves the assessment of the character of the borrower, ability, margin, purpose, amount, repayment and insurance.

It however has to be noted that the criteria used by banks to assess credit or loan applications differ from one bank to the other. Factors considered by banks to accept or reject loan applications by small business operators include collateral, guarantee, maturity and schedule of repayment (Ulrich and Arlow, 1981); collateral, credit history, initial capital, managerial experience and the bank policy (Jones, 1982); security, financial strength, business ability and honesty (Fertuck, 1982); profitability, financial stability, and liquidity (Berry et al.,1993); trading experience, equity stake, gearing and profitability (Deakins & Hussain, 1994; Fletcher, 1995), and quality of management and risk of default (Rosli, 1995).

Berger and Udell (2002) assert that small business lending focuses on three major categories, namely, the financial statement, asset base and the relationships. Financial statement lending emphasises on evaluating information from the financial statements, and the decision to lend is basically based on the strength of these statements. Under asset base, decision to lend will be based on the availability and quality of the collateral security. In relationship landing, the bankers focus their decisions in substantial part of proprietary information about the borrowers through a variety of contacts over time.

Methodology

Triangulation, a research design that applies both quantitative and qualitative research techniques was used in this study to obtain both quantitative and qualitative information. This also allowed the researchers to obtain the opinions of SMME operators in issues pertaining to accessing bank finance. SMME owners and managers in the Buffalo City Metropolitan Municipality were the target population. A sampling frame was constructed using the lists of SMMEs obtained from the municipality and also from the SMME associations in the Buffalo City Municipality. To avoid bias of selection, simple random sampling technique was used to select the respondents. The sample size was calculated using a Raosoft sample size calculator. The total population was two hundred (200). The sample size calculated was one hundred and thirty two (132) elements. In calculating the sample size the researcher used 95% confidence level, response distribution of 50% and the margin of error of 5%. Data was collected by the researcher moving from one business to another. A structured questionnaire was used to collect quantitative data while in-depth interviews were conducted to collect qualitative data. Quantitative data was analysed using descriptive statistics, Chi-square test and factor analysis. Qualitative data was analysed using content analysis. The Chi-Square test for independence was used to test for association, cross tabulation was also used to determine the distribution of respondents. Chi-square is used most frequently to test the statistical significance of results reported in tables (Barreira,2004:64). According to Barreira (2004), chi-square allows for decisions about whether there is a relationship between two or more variables; if the null hypothesis is rejected, one can conclude that there is a statistically significant relationship between the variables.

Results

Response rate

In total, 132 questionnaires were distributed and 109 questionnaires were completed. The analysis of data was based on 109 completed questionnaires. The response rate was 83% which is high enough to guarantee accurate results.

Population characteristics

Only business owners and managers were selected as respondents. 55% of respondents were owners and 45% were managers. Two thirds of questionnaires were completed in township areas while a third in the CBD area of East London. 62%

percent of respondents were male while their female counterparts only constituted 38%. 51%) of respondents were owners or managers of small enterprises, 9% for medium enterprises and 40% owned or managed micro enterprises. Only 28% of SMMEs had business plans. 79 out of 109 (73%) of the SMMEs once applied for bank finance but only 8 (10%) managed to access it. 30 out of 109 SMMEs (28%) never applied for bank finance.

Reasons for not applying for bank finance

Table 1 below shows the summarised results from respondents on reasons why they did not apply for bank finances.

Table 1: Reasons why some SMMES did not apply for bank finance

Reasons	Frequency	Percentage
Don’t know procedures	16	53
Don’t know sources of finance available	7	23
High interest is high cost	2	7
Had enough capital to start and run business	5	17

SMMEs (28%) that never applied for bank finances gave four main reasons. The majority (16 out of 30), 53% pointed out that they did not know the procedures. Another 23% (7 out of 30) lacked knowledge on the sources of finance available at banks. Only 7% were discouraged by high interest charged by banks. The remaining 17% had enough capital to start and run their businesses.

Reasons why SMMEs applications for finance were unsuccessful at banks

Table 2 shows responses from SMMEs that did apply for bank finance but their applications were unsuccessful. It is surprising that others (25%) never got any response from the banks.

Table 2: Responses SMMEs got from banks

Reason	Frequency	Percentage
Never got response from bank	18	25
Lack of financial deposit	12	17
Poor business plan	5	7
Lack of collateral	26	37
Business idea not viable	6	8
No loans for foreigners	4	6
Lack of financial management knowledge	0	0

25% of SMMEs that failed to access bank finance never got any response from banks clarifying why they could not offer them the much needed loans. Lack of financial deposit affected 17% of SMMEs that failed to access funds. It is lack of collateral security which proved to be the greatest obstacle in accessing finance by SMMEs, contributing 37%. Only 7% failed to access bank finance because they had poor business plans. The other reason why other SMMEs were not funded by banks was that their business ideas were said to be not viable. The other reason is that there are no loans for foreigners since Khula does not guarantee loans given to non-South African citizens. Six percent (6%) of SMMEs that failed to access bank finance were foreign owned and that was a reason enough for them not to access finance.

Results from in-depth interviews confirmed that Lack of collateral security, poor business plans, lack of knowledge and lack of financial deposit are some of the main obstacles to accessing finance by small business operators. This is also supported by Mutezo (2005), Bbenkele (2007) and Agyapong et al., (2011) who also identified these factors as main obstacles to accessing bank finance. Most small business operators confirmed that they do not know the criteria used by banks when granting loans.

The other factors that were raised as obstacles by respondents include:

- unavailability of proper financial records as a result of lack of financial management knowledge of lack of bookkeeping skills. It is surprising that some small business operators expect to obtain bank loans even if they do not have any business records.
- lack of collateral security due to poverty. Commercial banks expect collateral security from the loan applicants (for risk), it is however unfortunate that the majority of small business operators lack assets that can be accepted by banks as collateral. To the majority of small business operators, this is as a result of poverty.
- lack of connections as a result of inability to network. It was clear that small business operators who do not belong to any association had serious challenges in accessing finance and their businesses were being impacted negatively.
- banks do not see the viability of business ventures. Banks were also accused of suspecting that all small businesses fail. In some cases, banks do not see the viability of some entrepreneurial ventures and as a result, they fail to access loans. To small business operators, banks do not just agree to fund any type of business for they treat small businesses with caution when it comes to granting credit.
- misinterpretation of the business plan. This challenge can be as a result of the business owner or manager failing to interpret his/her own business plan, or the bank officials failing to do so the way the owner does. Some small business operators confessed that they couldn't interpret the business plans that were drawn by consultants on their behalf, this reduced their ability to negotiate for loans with banks.
- banks do not agree to the amount applied for. Although some small business operators have a tendency of overstating the amount needed in their projects or businesses, banks also do not necessarily agree to the amount applied for.

Testing of hypothesis.

$H_{0:}$ SMMEs in Buffalo City Municipality, South Africa find it difficult to access bank finance

A *p-value* (probability level) of 1.0 obtained from the test of association using the chi-square distribution is greater than 0.05 (5%) which means that we do not reject the null hypothesis (H_o).

These results are also supported by the Pearson Product Moment Correlation (r), which is a very insignificant number showing that there is no relationship between applying for finance and accessing it. This means that SMMEs do apply for finance but it is not guaranteed that they will get it. In actual fact, if one cannot access finance through applying for it, it is very unlikely that there is another way of accessing finance as it will be really difficult for SMMEs to access it.

The results therefore show that SMMEs in Buffalo City Municipality, Eastern Cape South Africa find it difficult to access finance. These findings are in line with the findings of Fin Mark Trust (2006) who said that only 2% (a very small number) of new SMMEs in South Africa are able to access bank loans. Foxcroft et al., (2002) also pointed out that the majority (75%) of applications for bank credit by SMMEs in South Africa are rejected. Christianson (2005) also supports that SMMEs face problems in accessing finances. Research conducted by Naude and Havenga (2004) similarly indicated that most SMMEs struggled with accessing finance from banks due to excessive red tape and administrative burden. Herrington et al., (2009) also pointed out that access to finance is a major problem to South African SMMEs.

Conclusion and Recommendations

The findings of this study support that small business operators find it difficult to access bank finance and it is as a result of a various factors. Financial institutions, government and government agencies are urged to support the small business sector for it remains the economic engine of many African countries. This sector also helps in reducing the impact of socio-economic challenges like unemployment and poverty.

Financial institutions should develop products that that are best suited for small business operators. This will not only benefit small business operators but the nation at large and also the banks themselves in terms of profitability and customer base.

Small business operators should not only depend on bank finance. They should explore other financing options. Money from friends, family and personal savings can be cultivated profitably in the business. Trade credit and contributions from associations can be other financing options. Small business operators should be responsible and act ethically if they are to be trusted not only by bank officials, but also by their customers.

The government and government agencies such as Khula Enterprise Finance, Small Enterprise Development Agency (SEDA), and Eastern Cape Development Corporation (ECDC) should strive to support small businesses in a more sustainable way, in a way that will not promote a spirit of dependency, but that of independency and creativity. They should create an enabling environment for small business operators to source funds without totally depending on the government or government agencies.

References

Agyapong D, Agyapong GKQ and Darfor KN (2011) Criteria for assessing Small and Medium Enterprises' Borrowers in Ghana. International Business Research, 4 (4):132-138.

Barreira JCD (2004) The Influence of Business Knowledge and work experience as antecedents to entrepreneurial success. Thesis. University of Pretoria

Bbenkele EK (2007) *African journal of accounting, economics, finance and banking research,* 1(1)

Berger AN and Udell GF (2002) Small business credit availability and relationship lending: The importance of bank organizational structure. The Economic Journal, 112, 32-53.

Berry A, Von Blottnitz M, Cassim R, Kesper A, Rajaratnam B and Von Seventer DE (2002) *The Economics of SMMES in South Africa.* [On- line]. Available at :<http://www.tips.afrihostcom/research/papers/pdfs/506pdf> [Accessed on 7 June 2010].

Boone LE and Kurtz DL (2006) *Contemporary Business*. South West Publishers

Bosa G (1969) *The financing of small enterprises in Uganda*, Oxford University Press: Nairobi, Kenya

Cassar G (2004) *The Financing of Business Start Ups*. Journal of Business Venturing, 19: 191-214.

Christianson (2005) *Micro Enterprise Alliance*. (Online). Available: http//www.mea.org.za [Accessed 03 May 2010]

Cooper DR and Schindler PS (2006) *Business Research Methods*. New York McGraw-Hill.

Deakins D and á Hussain G (1994). Risk assessment with asymmetric information. International Journal of Bank Marketing, 12(1), 24-31.

Entrepreneur SA (2005) *South Africa's leading monthly on entrepreneurship*: A profile. Nubia Media and Publishing. Randburg.

Fatoki O and Garwe D (2010) *Obstacles to the growth of new SMEs in South Africa: A principal Component analysis approach*. African Journal of Business Management, 4 (5): 729-738.

Fertuck L (1982) Survey of small business lending practices. Journal of Small Business Management, October, 33-41.

Finmark Trust (2006) *Fin Scope Small Business Survey Report*. (Online). Available: http://www.finmarktrust.org.za [Accessed 3 April 2010)

Fletcher M (1995) Decision making by Scottish bank managers. Int. J. of Entrepreneur Behaviour and Research, 1(2), 37-53. Available at: www.emeraldinsight.com/journals.htm?articleid=872001&show

Foxcroft M, Wood W, Kew K, Herrington M and Segal N (2002) *Global Entrepreneurship Monitor South African Report* (Online). Available: http://www.gbs.nct.ac.za/gbswebb/userfiles/gemsouthafrica2000pdf. [Accessed 17 May 2010].

Herrington M, Kew J and Kew P (2009) Global Entrepreneurship Monitor, South Africa Report. (Online). Available: http://www.gbs.nct.ac.za/gbswebb/userfiles/gemsouthafrica2000pdf. [Accessed 17 May 2010]

Keasey K and Watson G (1994) *The bank financing of small firms in the UK: Issues and evidence*. Small business economics, 6: 349-362

Levy B (1993) *Obstacles to developing small and medium sized enterprises*: An empirical assessment. World Bank Economic Review, 7 (1): 65-83.

Mutezo AT (2005) *Obstacles in the access to SMME finance: an empirical perspective on Tshwane.* Unpublished MCom Thesis. University of South Africa.

Naude WA and Havenga JJD (2004) *An overview of African entrepreneurship and small business research*: Journal of small business and entrepreneurship, 18 (1).

Nieman G and Neuwenhuizen C (2009) *Entrepreneurship: A South African Perspective*. Pretoria: Van Schaik.

Nieuwenhuizen C and Groenewold D (2004) *Key issues for improvement of entrepreneurial activity in South Africa*: Unisa. SAIMS Conference.

Phillips PA and Wade MA (2008) *Performance Implications of Capital Structure; Evidence from Quoted UK Organisations with Hotel Interests Service Industries*. 24. (5):31-51.

Rogerson CM (2006) Developing SMMEs in Peripheral spaces: The experience of Free State Province, South Africa: South African Geographical Journal 88 (1): 66-78.

Rosli M (1995) Bankers credit evaluation of small businesses. Bankers Journal of Malaysia, 89, 26-32.

Storey DJ (1994) New firms growth and bank financing. Small Business Economics, 6, 139-150.

The Business Place (2009) *Fact Sheet*, University of Stellenbosch. (Online) Available: http://www.reciprocity.co.za/documents/Reciprocity_BoP-FactSheet_BusinessPlace.pdf [Accessed 09 April 2010]

Ulrich TA and Arlow P (1981) A multivariate analysis of commercial bank lending to small business. American Journal of Small Business, 6, 47-57.

Visagie JC (1997) *SMME's Challenges in Reconstructing South Africa*. Management Decisions. 35: 656-663.