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Overcoming barriers by SMEs when accessing financial support from banks: a case study from Ethekwini Metro, KwaZulu-Natal

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Abstract

Small and medium sized enterprises (SMEs) have played a key role in achieving sustained economic growth in South Africa, and their success going forward will assist with driving growth. However, SMEs face hurdles hindering their growth, and a major restraint to growth is access to finance.

This article unpacks the financial obstacles that SMEs face in terms of accessing finance from banks, and how these obstacles might be resolved. The study was qualitative and was conducted among specialists at financial institutions in the Ethekwini Metro who dealt with the financing needs of SMEs in the region. Data were collected from one-on-one interviews with specialists - and were analysed using NVivo, a qualitative data-analysis programme.

The main obstacles to the access of finance in the Ethekwini Metro were: basic education, mentoring, passion, training, screening prospective entrepreneurs, the scoring system, and backing for collateral. Therefore, when applying for finance to financial institutions – entrepreneurs should attend training courses on basic education, mentoring, passion, training, screening prospective entrepreneurs, the scoring system and backing for collateral – as indicated by the financial specialists.

Key phrases

Accessing finance; entrepreneurs, financial specialists and loans

1. INTRODUCTION

Sustainable economic growth is important for the wellbeing of all South Africans. To achieve this objective, SMEs need to thrive, create wealth, and provide jobs. The South African government has taken an active role in assisting SMEs to flourish through their SME funding institutions – like the IDC (Industrial Development Corporation), Seda (Small Enterprise Development Agency), Sefa (Small Enterprise Finance Agency) and the NEF (National Empowerment Fund). Abor and Quartey (2010:218-228) mentioned that most of the formal business entities in South Africa are SMEs, and that these SMEs contributed 52–57% to GDP and provide about 61% of employment.

However, SMEs face many challenges which cause them to fail or remain small in size. Access to finance is a major obstacle that SMEs face. This particular obstacle is a hurdle that often constrains SME growth and sustainability. This hinders South Africa's economic growth, reduces prosperity, and impacts negatively on poverty alleviation. It is therefore critical for the development of South Africa that SMEs are offered support so that they can be successful and sustainable – thereby contributing to the wellbeing of our nation. Thus, the objective of the study is to explore ways to overcome the financial challenges faced by the SMEs in Ethekwini Metro, KwaZulu-Natal.

1.1 Definition of SMEs

There are various definitions of SMEs. For this research, Micro, Very Small, Small and Medium Sized businesses were considered according to the National Small Business Act of 1996, as amended by the National Small Business Amendment Act no 29 of 2004 (Government Gazette 2004:Internet):

Micro: The firm employs less than five employees, has an annual turnover of less than R150 000, and its gross assets, excluding fixed property, are less than R100 000.

Very small: The firm employs six to 20 employees depending on the industry it operates in. The firm's annual turnover is from R150 000 to less than R500 000 depending on the industry it operates in, while its fixed assets (excluding fixed property) are valued from R100 000 to less than R500 000 depending on the industry it operates in.

Small: The firm employs 21 to 50 employees, has an annual turnover of R500 000 to less than R25 million depending on the industry it operates in, and has assets (excluding fixed property) of R500 000 to less than R4.5 million depending on the industry it operates in.

Medium: The firm employs 51 to 200 employees depending on the industry it operates in. The firm's annual turnover is R25 million to R50 million depending on the industry it operates in, and has assets (excluding fixed property) of R4.5 million to R18 million depending on the industry it operates in.

1.2 The size of SMEs

The size of SMEs plays an important role in a SME's ability to raise finance. According to Kuntchev, Ramalho, Rodríguez-Meza and Yang (2014: Internet), the larger a firm becomes, the easier it is for it to secure finance. Cui, Zha and Zhang (2010:119) add that when a firm starts the owner funds it using internal equity financing, but as it grows external financing becomes more accessible due to the early success of the firm and improved future growth potential for investors – whose perception that the firm might fail is altered.

Mach, Carter and Slattery (2014:Internet) highlight that, at inception, the owner funds the firm using their own resources. During the early growth phase internal funding is key – with retained profits being a significant part of funding. In the maturity phase, financial institutions are likely to fund with several additional alternatives like hire purchase, leasing, overdrafts, and traditional bank loans.

Pal, Johnsen and McMahon (2005:160-177) found that SME size and industry are related to access to finance, where one industry is given preference over another. This suggests that financing institutions focus on specific industries, which they find to be more profitable and therefore less risky in terms of providing financial support to SMEs. Banking behaviour has changed due to the subprime crises (Paulet, Parnaudeau & Abdessemed 2014:36-45). This has made obtaining finance for SMEs more challenging – as banks view SMEs as being less profitable and the risk associated with SME loans is thus higher than for larger firms.

Irwin and Scott (2010:245-259) also highlighted the discrimination of banks in relation to the financing of SMEs, as their proposals in several cases were not considered 'bankable' – as

SMEs did not fit the target market of mainstream banking institutions, given they were unprofitable. Additional reasons why banks have been averse to loaning SMEs money include race, gender and education.

Van Niekerk (2014:Internet) points out that for a loan to be viable, the financing institution must consider the cost of doing a 'due diligence' for each loan. The cost of doing the investigation is the same for a small loan as it is for a large loan. Therefore, the larger loan is more profitable due to economies of scale – and larger firms are more stable and therefore less risky than SMEs. Financing institutions also must consider their shareholders who want the highest possible return.

There is strong evidence from the literature that SMEs face constraints when approaching banks for finance – due to their small size and low profitability. Banks are profit driven businesses and want to maximise their profits for their shareholders. However, they play an important role in offering finance to SMEs in South Africa.

1.3 Factors contributing to unsuccessful loan applications

Funding institutions often assess SME loan approvals or rejections by considering the personality of the SME owner. Haron, Said, Jayaraman and Ismail (2013:185) mention that a person's personality reflects 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 bank growth and profitability. Abdulsaleh and Worthington (2013:36-54) and Irwin and Scott (2010:245-259) 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 of the owner by financial institutions is a key factor used when offering or declining a loan to a SME.

SME credit risk from a bank's perspective varies. However, banks commonly view SME risk as being higher than large corporations – as they do not have the same level of security as their larger counterparts. According to Silburt (2012:Internet), credit risk is a view a bank takes of a SME – regarding whether the SME will be able to pay back the loan. The servicing of the loan is seen by banks as being risky for SMEs, because they often operate in highly competitive environments where profitability is low. Banks scrutinise an SME's ability to repay the loan by investigating their industry and the prospects of the industry. Assessments are also made of the ‘willingness ‘of the SME to repay the loan. This includes payment history from creditors, previous loans, and even payment of taxes (World Bank 2015:117-162).

Available collateral for many SMEs is insufficient for securing loans from banks. This hampers the firm’s ability to grow, and often SME owners must pledge their own assets as collateral so that their firm can obtain bank financing. According to the OECD (2015:Internet) SMEs face increased pressure to provide additional collateral for loans, as the region is undergoing economic hardship and SMEs pose a greater risk to lending institutions. Banks took a view that the assets used for collateral were overvalued – hence the increase in the collateral required. Abdulsaleh and Worthington (2013:36-54) reported that SMEs with a greater variety of fixed assets can obtain financing at lower interest rates, and have more chance of having their loans approved as they have greater financial leverage

2. METHODOLOGY

2.1 Research design

According to Sekaran and Bougie (2013:240-241) the research design is used 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 measurements while qualitative research uses data, not in the form of numbers, but rather in words. In this study, qualitative research was used to explore the financial specialist’s personal experiences and views relating to the funding of SMEs.

2.2 Location and study participants

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 Nedbank and FNB agreed to be interviewed for the study.

The participants targeted for the study were senior financial business managers who dealt with SMEs at these financial institutions. 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. The interviews were conducted at their regional offices 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 could 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. The interviews were all recorded for later analysis.

2.4 Ethical considerations

An ethical clearance certificate was obtained from the University of KwaZulu-Natal's Ethics Committee. Gate-keeper letters were obtained from each of the financial institutions before the interviews were conducted. The researcher undertook to ensure the 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

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, and then re-read them and highlighted similarities and differences. The similarities were given code names and were 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 following themes emerged from the interviews with the financial specialists from three banks in the Ethekwini Metro – concerning overcoming hurdles to receiving finance by SMEs. The main findings are illustrated in figure 1. Poor basic education, mentoring, passion, training, screening prospective entrepreneurs, the scoring system, and backing for collateral were all factors hindering the receipt of finance.

These findings are presented in Figure 1 and discussed further below:

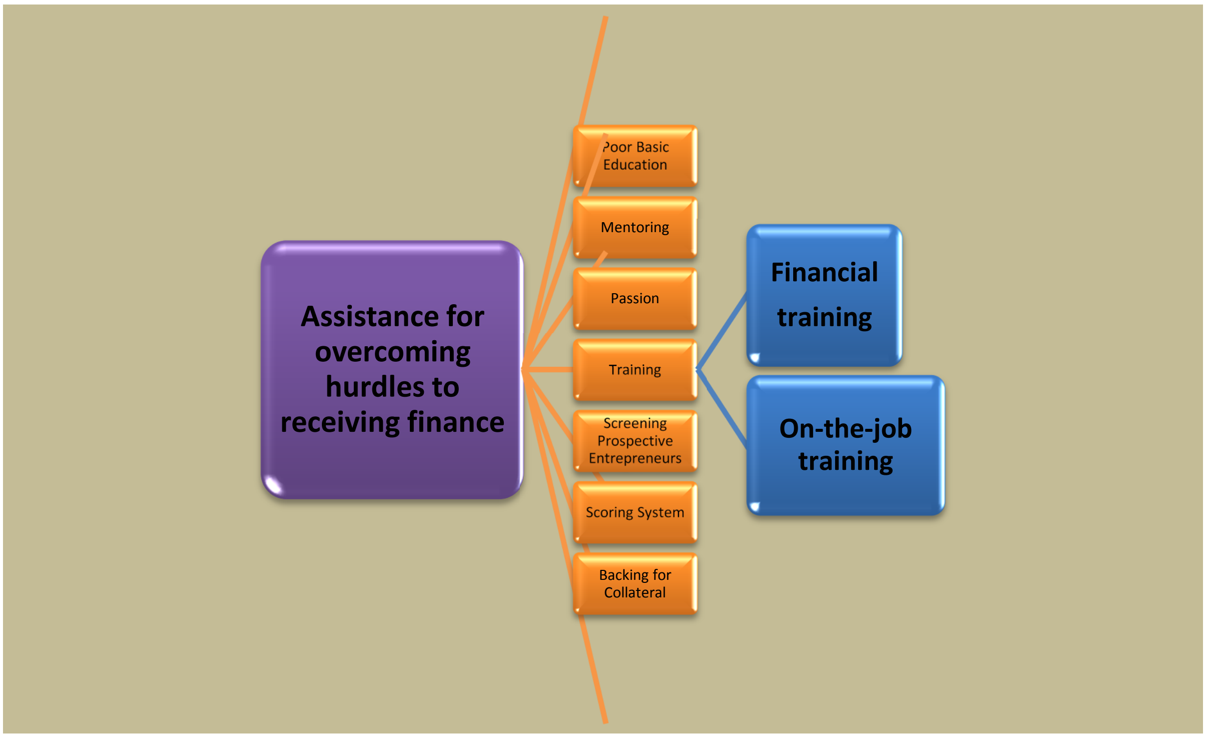

FIGURE 1: Forms of assistance required for overcoming hurdles to the receipt of finance by SMEs

Source: The present study

3.1 Poor basic education

The education system in South Africa currently (and in the past) has not focused on developing entrepreneurial thinking, and this has stifled innovation. The first specialist at Sefa commented:

"So, I think going forward, that government needs to spend more time making sure the education system is of a high quality and standard, and that resources and infrastructure are provided in those areas – so that people have basic needs covered and that they have the crucial basics from an education point of view. This is because knowledge is power."

The points highlighted the need for improving education so that students can learn the basics. Government has the potential to create an education system, over time, that meets the need to provide quality literacy and numeracy skills in students.

Kolstad and Wiig (2015:783-796) showed that there is a formal link between education and entrepreneurship, with literacy and numeracy being key in terms of entrepreneurial skills. Olawale and Garwe (2010:729-738) highlight the poor standard of managerial skills in South Africa. South Africa's education system has failed to generate a large pool of innovative entrepreneurs with managerial skills – to help create and grow SMEs that will be sustainable. SMEs fail due to insufficient management training and work experience.

3.2 Mentoring

Mentoring has the potential to overcome skills shortages through guiding entrepreneurs, and teaching them new methods for improving the way they manage their businesses. The FNB specialist commented:

"Mentorship programmes are important. I know that the Shanduka Black, Black Umbrella take people through their mentorship programmes, upskilling them in different categories of business, and then, once they pass – they're running a dual strategy. You're running your business, and also applying the different mentorship programmes – and at the end of the day this is on how to obtain new business. So at that stage, you'll be at a different level."

The points raised were that mentoring upskills entrepreneurs and helps them to manage their firms at a higher level. The second specialist at Nedbank commented:

"From a franchise perspective a franchisor would keep them under their wing – obviously so they would do that. We won't get involved in the day-to-day running of the

business – from that aspect, they would need to get additional training or whatever elsewhere. The bank won't take them on and hold their hands through the whole process."

This highlighted that banks don't want to become involved in the details of helping SMEs to manage their firms. However, where franchisors are involved – there would be support and training.

Brien and Hamburg (2014:61) note that mentoring helps SMEs to learn new ways of doing business and provides practical ways of implementing the changes which improve the sustainability of businesses.

3.3 Passion

Entrepreneurs who had passion for their business and what they do, are a motivating factor for financial institutions when loan applications are assessed. The first specialist from Sefa commented*:*

"Applicants must have that passion, that drive – because we're not just assessing businesses, we are also assessing the applicant: their background, knowledge, experience and qualifications. If we can see the passion and drive from these applicants and they understand if we ask them questions, and they understand the industry and we are content with that – that also motivates us to proceed with the application."

The second specialist at Nedbank supported this by commenting: *"It's so important that people go into this with passion. They must have passion for what they are doing and not just be doing it to make money."*

The specialists highlighted that entrepreneurs are assessed and need passion, with experience and an understanding of the industry they are involved in. Passion and experience were discussed previously – where a lack of passion hinders funding. Passion is a key factor which is assessed, because, as Murnieks, Mosakowski and Cardon (2011:2) state, passion is a strong desire that drives successful entrepreneurs to achieve success and to overcome obstacles. Galbraith, McKinney, DeNoble and Ehrlich (2013:222-248) showed that higher levels of passion from entrepreneurs resulted in more positive results when applying for grants. These studies confirm what the specialists pointed out above.

3.4 Training

Training entrepreneurs helps them to learn new skills and ways of managing their firms. An entrepreneur who does an MBA will understand different aspects of their business and will therefore manage the business more proficiently. The first specialist at Sefa commented:

"I think that more training is needed. I know that Seda gets involved in many training initiatives in certain industries."

The government – through agencies like Seda – actively trains entrepreneurs so that they will be more successful and that our country will benefit as a whole. Sanchez (2011:239-254) showed that entrepreneurship training increased the skill level of students and enhanced their motivation to start their own businesses. Boukamcha (2015:593-616) highlighted that entrepreneurial training increased the desire of students to go into business and to create new firms. Jones, Beynon, Pickernell and Packham (2013: 56-81) found that SME training needs to be specific to the industry they operate in, in order to be more effective, and stressed that trainers need to meet the needs of their market.

3.4.1 Financial training

Financial training for entrepreneurs will be beneficial, as they will understand how to manage their cash flow and how to compile and analyse financial documents. This will assist their firms when applying for debt finance. The second specialist at Sefa commented:

"The challenge is that they can't put down the financial information in terms of budgeting – to show us how are they going to sustain themselves. This new department of small business will look at that – create a structure that will help the client looking for finance in terms of preparing the loans and packaging the application properly."

The specialist highlighted that there is a need to train entrepreneurs to put together financial information when applying for finance. Many entrepreneurs are not competent in managing this process, and once they are competent their access to finance through an increased loan-application acceptance will promote their firm's growth and prosperity. Nyamboga, Nyamweya, Abdi, Njeru and George (2014:181-192) highlight the need to provide financial literacy training for entrepreneurs – to increase their financial management skills. The government needs to help SME owners in terms of financial management training and with the funding of their businesses. Fatoki (2014:151-158) supports this – as financial literacy is key to decision-making for entrepreneurs, as they understand financial information and how to manage their firm's financial management.

3.4.2 On-the-job training

On-the-job training is one of the primary methods for teaching new skills in SMEs. Entrepreneurs have the opportunity to learn from skilled workers – which the Ithala specialist highlighted. The specialist elaborated with the following comments:

"If they want to be in the said industry, I suggest they get some experience in the industry. For example, if a man working at a supermarket wants to produce blocks – go and get a job at a block yard. Go and understand, inter alia, the cost and formulae and the recipes. At least know how to make a block before you buy or start a business that makes blocks. You need to understand what it takes to make the blocks: more experience in the specific industry. That's the biggest challenge – entrepreneurs lack knowledge of the industry they want to go into."

The specialist pointed out that experience can be gained by learning on-the-job – which gives entrepreneurs an understanding of the industry they wish to target. Jacobs and Bu-Rahmah (2012:75-84) found that on-the-job training was beneficial, as there was a reduction in the development time for learning new skills – and confidence increased with the skills of new employees.

Swedberg, Michélsen, Hammar Chiriac and Hylander (2015:369-378) supported these findings and found that on-the-job training improved staff performance and competence. The experience gained by entrepreneurs who received on-the-job training in the industries they wish to do business in, will help entrepreneurs when applying for debt finance, as they will understand the industry.

3.5 Screening prospective entrepreneurs

Screening prospective entrepreneurs and their ideas may not seem helpful in terms of assisting them to be granted debt finance. However, it guides the financial institution to judge the potential of the applicant and their business. This was highlighted by the second specialist from Sefa, who commented:

“Before the guy comes for a loan – sit down with him and take them through the process. Check whether their business idea makes sense and then once we have screened those with potential, we take them to the next level.”

The specialist pointed out that it is worthwhile finding out what the entrepreneur’s idea is about – and whether the idea is worth supporting. If the idea is viable, the specialist suggested they would help develop the concept with the entrepreneur. This saves time in processing a loan application that might be viable or in rejecting an idea that is not viable. The second specialist at Nedbank was aligned to this thinking, and mentioned:

“Because we do the interview, we assess you and get a feel for your business acumen and what knowledge you've got – because we are backing the jockey.”

This highlighted that entrepreneurs are assessed according to their business management skills and their understanding of how to run a business. The financial institution assesses the entrepreneur’s ability regarding whether they will be successful.

De la Torre, Pería and Schmukler (2010:2280-2293) mention that banks screen out poor applicants, so that when the loan applications are sent to their head offices, the loans have a higher chance of being approved. Certhoux and Perrin (2013) suggest that the financial backers of SMEs first meet the entrepreneurs and learn about their idea or business, and then screen out the best opportunities and progress with them, while rejecting poor ideas – so saving time and money for both parties.

3.6 Scoring system

Rating SMEs and applying a score has the potential to assess the loan-application process in a fair and equitable manner. The second specialist at Sefa highlighted this, by commenting:

"They need to develop tool like that. Collaborate with universities and academics to develop a user-friendly tool, which makes it easier for these people to give the information – and then perhaps the system can score them."

Hasumi and Hirata (2014:555-568) suggest that scoring systems sift out window-dressing problems and bias in relation to financial statements. De la Torre *et al.* (2010:2280-2293) show that banks are more inclined to offer loans to SMEs as a result of technology advancements and standardised risk-assessment scoring tools. Scoring tools, however, are standardised, and there needs to be a soft approach which includes the people involved and the benefits of what the SMEs will do in respect of, for instance, job creation and community upliftment.

3.7 Backing for collateral

Financial institutions aim to manage their exposure to risk. Therefore, SMEs with assets which could be used for collateral when applying for debt finance are well on their way to achieving a positive outcome – as long as their proposal is viable. The first specialist at Nedbank highlighted this, by commenting:

"Collateral is always there because it is risk. Because you can always go and get into Khula (meaning money increases or grow using interest, in this case the company that lends money) where we have agreements to secure it. But the business has to have shown that it is strong and viable – before we can even start to get into that."

He was supported by the second specialist at Nedbank, who said:

"When I am thinking with my bank hat on, banks are always for security and assets in the background – and a lot of people don't have these, especially in the BEE market.

So yes, it's very difficult. We always lend against security and lend based on the jockey – so inevitably for us the person must have some assets."

The specialists both pointed out that collateral is a necessary requirement for finance. The business proposal also needs to be valid and strong. SMEs lacking collateral do, however, have the option of securing a guarantee using Khula to offer surety.

Abdulsaleh and Worthington (2013:39-44) found that the relationship of the SME owner with the financial institution is also key – as individuals with positive relationships and good track records had fewer hurdles to overcome when applying for finance. SMEs with fewer tangible assets found it was more difficult to obtain finance. Moro, Lucas and Kodwani (2012:57-79) contrasted this by showing that collateral was more important in the loan-application process for receiving finance, than having a positive relationship with their financial institution.

4. RECOMMENDATIONS

The research highlighted several practical ideas, which have the potential to overcome the difficulties that SMEs face when sourcing debt financing. The followings are recommended:

1. *One of the reason for failing to access finance was that entrepreneur education was found to be lacking in terms of literacy and numeracy. Therefore, the Department of Education should focus on increasing the standard of basic education – focusing on these two aspects.*
2. *Higher education institutions should offer certificate courses on business management skills, which financial institutions should encourage SME owners and entrepreneurs to be enrolled in – as a requirement for applying for a business loan.*
3. *Mentoring of entrepreneurs who lack skills relating to the management and growth of their businesses, would be useful. This is because mentors would be able to teach entrepreneurs practical ways of doing business and be able to train them in the finer details of financial management, marketing and sales, operations, and supply chain management which are key aspects of business management.*

4. *Government-led schemes, such as Khula, for backing SMEs who lack collateral, could be expanded to include backing for 100% of loans for entrepreneurs who are willing to first undertake training courses, as mentioned I n (2) above. This would encourage entrepreneurs to go on training courses and to overcome the impediment of lacking collateral.*

5. CONCLUSION

The potential for SME's to overcome the hurdles to receiving finance is a great opportunity for our country as a whole, 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. This study reviewed how to overcome barriers when applying for SME loans at financial institutions. Since this study looked at this from a banking perspective, SME owners and entrepreneurs should consider the above recommendations when applying for funding from financial institutions.

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