

RHODES UNIVERSITY

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**AN ANALYSIS OF THE AVAILABILITY OF AND ACCESS TO CREDIT
FROM THE FORMAL FINANCIAL SECTOR AND THE PERFORMANCE OF
SMEs**

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DEDICATION

This study is dedicated to God, my heavenly father, who gave me the strength and ability to start and complete the research. He says, “I am the Lord, the God of all mankind. Is anything too hard for me?” (32:27, NIV). And confidently, nothing is too hard to Him. Even this study was possible because of Him.

I also dedicate this study to my late mother, Bibiana Agie, my late uncles, Pa Joachim Achua and Pa Lucas Abia. Your guidance and prayers gave me strength and focus.

Furthermore, I dedicate this study to my father, Mr Fidelis Awah Asah and my siblings, all nieces, nephews and future children. I have set the pace. I trust you all will keep up the hard work and trust God in all you do.

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DECLARATION

I, the undersigned, Francis Tangwo Asah, hereby declare that this thesis is my own original work in design and execution and that it has not been submitted, nor will it be presented at any other University for the award of a similar or any other degree.

Signature.....

Date.....

ABSTRACT

As a developing nation, South Africa faces a high rate of poverty, high levels of inequality in terms of income and a high rate of unemployment. It is officially estimated that about 27.2% of the economically active population are unemployed. SMEs are expected to be an important vehicle to address the challenges of job creation, sustainable economic growth, equitable distribution of income and the overall stimulation of economic development. SMEs in South Africa constitute 99% of all businesses, contributing to employment, income inequality and poverty alleviation (Statistic South Africa, 2018). However, despite the remarkable contribution of SMEs to the economy of South Africa, the failure rate of SMEs (at 75%) is the highest of all the efficiency-driven economies sampled by the Global Entrepreneurship Monitor (GEM). The World Bank affirm that the availability of and access to credit from the formal financial sector is the primary cause of the high failure rate of SMEs. Contemporary literature advance that the future survival and performance of SMEs in South Africa is pegged onto the amount of financial capital available to address their capital needs. Thus, this study sought to analyse the availability of and access to credit from the formal financial sector and the performance of SMEs from the supply and demand-side.

In order to achieve the objectives of the study, a sequential exploratory mixed method research design, located in the pragmatic research paradigm, was used in a two phased approach. The qualitative data collection and analysis in Phase 1 informed the quantitative data collection and analysis Phase 2.

In Phase 1, in-depth face-to-face semi-structured interviews were conducted with 8 credit and 8 business managers representing the sampling unit of selected formal financial institutions. The qualitative data collected was analysed using the five-steps process of content analysis as illustrated by Terre Blanche *et al.* (2006:322-326). The main findings with regard to factors that impact on the willingness of the formal financial sector to provide credit to SMEs were collateral, annual business turnover, audited financial records, relationship with the bank, credit profile, nature of the business, economic climate, ethics, nationality, government policy, management team, valid Identity Document/permit, equity contribution, entrepreneurship education, product quality, and business intelligence. Assessing credit applications from SMEs, risk assessment, inspection of financial records, proper documentation and background checks were the different tasks performed by credit and business managers. In addition, the main challenges faced by the formal financial sector in assessing and approving credit in favour of

SMEs included the following: lack of investment capital; lack of collateral; lack of proper financial records; poor managerial knowledge; poor business plan; lack of industrial knowledge; and poor legal and credit laws. Lastly, contrary to the notion that formal financial institutions are not interested in investing in SMEs, on average, 70% of SMEs that applied for credit received such credit.

In Phase 2, a self-administered questionnaire was used to collect data from formal sector owner/managers of SMEs in the city of Johannesburg. Of the 702 questionnaires distributed, 300 were returned and useable. Data was analysed using the Statistical Package for the Social Sciences (version 24). A test for normality was performed using Shapiro–Wilks test. Reliability was tested using the Cronbach’s Alpha Coefficient. Exploratory factor analysis tested the validity of factors that prevent formal financial sector from granting credit to SMEs while Binary logistic regression was used to infer on the hypotheses. Spearman’s Rho correlation analysis was used to determine whether there was any significant relationship with factors that influence access to credit and SMEs performance.

The main findings revealed that access to bank finance was the only challenge that showed a significant correlation with performance. In addition, the study revealed that the South African Identity Document and collateral were the most important factors considered when applying for credit from formal financial institutions. With regard to the reasons why formal financial institutions may refuse to grant credit to SMEs, it was revealed that there was no significant positive relationship between lack of business networking and access to credit from the formal financial sector to SMEs. Conversely, the study also revealed a significant positive relationship between collateral, business information, managerial competency, business intelligence, business ethics, entrepreneurship education, legal system and macro-economy and access to credit from the formal financial sector to SMEs. Thus, it was established that there is a significant positive relationship between access to credit from the formal financial sector and the performance of SMEs.

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CHAPTER ONE

INTRODUCTION TO THE STUDY

“The stimulation of small and medium enterprises (SMEs) must be seen as part of an integrated strategy to take this economy onto a higher road - one in which our economy is diversified, poverty is reduced, productivity is enhanced, investment is stimulated and entrepreneurship flourishes” (Parliament of the Republic of South Africa, 2005).

1.1 INTRODUCTION

Globally, the relative and absolute importance of small and medium enterprises (SMEs) have been well documented in literature (European Commission, 2015; Organisation of Economic Cooperation and Development (OECD), 2016; United Nations, 2015; United Nations Development Programme (hereafter UNDP), 2016; World Bank, 2015). SMEs are crucial to the socio-economic development of South Africa. SMEs in South Africa constitute 99% of all businesses, contributing 77% of all private sector employment and 40% of the Gross Domestic Product (GDP) (National Planning Commission, 2015). Despite the remarkable contribution of SMEs to the economy of South Africa, the failure rate of SMEs (at 75%) is the highest of all efficiency-driven economies (Global Entrepreneurship Monitor, 2017). Furthermore, the availability of and access to finance from the formal financial sector is reported to be the primary challenge to the survival and performance of SMEs (GEM, 2014; Quartey, Turkson, Abor & Iddrisu, 2017:19). Therefore, analysing the availability of and access to credit from the formal financial sector and the performance of SMEs is fundamental to improving the availability of and access to credit from the formal financial sector and the performance of SMEs. The aim of this study was to analyse the availability of and access to credit from the formal financial sector and the performance of SMEs. Thus, this chapter provides the introduction to the study (undertaken in Gauteng Province, South Africa), an analysis of the availability of and access to credit from the formal financial sector and the performance of SMEs, the background of the study, the problem statement, objectives of the study, the research hypotheses and the significance of the study. The research methodology, ethical considerations, limitations of the study and the structure of the study are also discussed in this chapter.

1.2 BACKGROUND OF THE STUDY

Small and medium enterprises (SMEs) are increasingly acknowledged, worldwide, as playing a fundamental role in building strong economies through economic development (Global Entrepreneurship Monitor (hereafter referred to as GEM), 2014; Ikuomola & Zaaiman, 2014:374; Peprah, Mensah, & Akosah, 2016:26), poverty alleviation (Fatoki, 2014:185; Nieman & Nieuwenhuizen, 2014:13; Organisation of Economic Cooperation and Development, (hereafter OECD) 2015), employment (GEM, 2014; OECD, 2015; World Bank, 2015) and creating more opportunities for novel small businesses (Booyens, 2011:69; Garg & Phayane, 2014:60; OECD, 2015). Consequently, governments throughout the world emphasise the development of SMEs.

In the European Union (EU), in countries such as Germany and France, SMEs constitute 99% of all businesses and account for 66% of the total employment within the EU (Cowling, Liu & Ledger, 2012:781; European Commission, 2015; Katua, 2014:463; World Bank, 2015). Similarly, in the United States of America (USA), SMEs constitute 99.8% of all businesses, contributing about 68% of the total employment and 60% of GDP (OECD, 2015; Robb & Fairlie, 2008:1434). SMEs in Australia constitute 97% of all businesses and account for 57% of the total employment (Katua, 2014:464; Nicholas & Fruhmann, 2014:329).

In most African countries, SMEs constitute about 90% of all businesses and contribute more than 50% of the total employment and GDP. For instance, SMEs in Ghana constitute about 92% of all businesses, contributing 70% of GDP and 85% of all private sector employment (Quaye, Abrokwah, Sarbah & Osei, 2014:340), while in Kenya, SMEs contribute 53% of GDP and 60% of the total employment (Peprah *et al.*, 2016:26), and 50% of GDP and 50% of the total employment in Nigeria (Muritala, Awolaja & Bako, 2012:19; Onakoya, Fasanya & Abdulrahman, 2013:133).

In South Africa, SMEs constitute 99% of all businesses, contributing 77% of all private sector employment, which is important in the light of the decrease in formal employment (GEM, 2014). Additionally, SMEs also contribute 40% of GDP of the economy, compared to the one percent of large businesses that contribute about 60% to GDP and 46% to total employment (National Planning Commission, 2015). In spite of the high unemployment rate, estimated at 27.2% in 2018 (Statistics South Africa, 2018), the country also suffers from rural to urban

migration, causing the impoverishment of rural communities, and corporate restructuring, thus leading to the loss of jobs. The World Bank (2015) maintains one of the best ways to address the high unemployment challenge in developing countries (such as South Africa) is to leverage the employment creation potential of SMEs and promote the development of SMEs.

The National Planning Commission (2015) maintains the contributions of SMEs to the socio-economic development of South Africa can play an important role in achieving the Vision 2030 of the National Development Plan to reduce the unemployment rate to 6% through the creation of additional jobs in the SME sector. Former President Zuma (2014), in his state of the nation address, after his re-election for a second term in office, reiterated that to achieve the ambitious target of 6 million jobs before the end of his mandate (in 2019), to which the government had committed itself, the country needed serious investment in the development of the SMEs sector.

With regard to the challenges and weaknesses associated with the high failure rate of SMEs in South Africa and other developing countries, contemporary literature reveals that the non-availability of formal sector financing and lack of access to credit from the formal financial sector is the most important constraint to the development of SMEs (Brijlal, 2013; Fatoki & Smith, 2011:1414; GEM, 2014; Herrington & Kew, 2014; OECD, 2015; World Bank, 2015). In addition, these authors highlight that only 25% of SMEs in South Africa have access to formal sector finance. Brijlal (2013), Fatoki and Smith (2011:1414) and GEM (2014) moot that non-availability of and non-access to formal sector financing has been cited as the second most important constraint to the development of SMEs in South Africa. It has been asserted that lack of education and training is regarded as the most important constraint to the development of SMEs in South Africa (Brijlal, 2013; Fatoki & Smith, 2011:1414; GEM, 2014), however, Abor and Quartey (2010:221), Baltar and Icart (2013:203), OECD (2015) and the World Bank (2015) argue that non-availability and lack of access to formal sector finance is the primary constraint to the development of SMEs in most developing countries, such as South Africa. In addition, in most developing countries, national and local policy environments within which SMEs operate, race discrimination, and the legal system also play a fundamental role in determining the establishment and growth of SMEs (Gastrow, 2013:10; GEM, 2014; NPC, 2015; World Bank, 2015).

1.3 RESEARCH PROBLEM

GEM (2014), OECD (2015) and the World Bank (2015) state that the inability of SMEs to access formal sector finance is a combination of both demand and supply-side factors. From the demand-side, Claessens and Kose (2013) and Ramlee and Berma (2013:116) posit that the major challenges faced by SMEs with regard to access to credit from the formal financial sector can be classified as follows: *availability* (if credit is available and what quantity); *cost* (at what total price is credit available); *reliability* (if credit is readily available when needed); *convenience* (easy access); *continuity* (can credit be accessed repeatedly); and *flexibility* (are credits tailored to individual needs). Theoretical arguments advanced by Arena (2011:394) and La Rocca, La Rocca and Cariola (2011:109) reveal that information asymmetry, resulting from imperfect market conditions leading to credit rationing, low levels of accountability for credits, poor bookkeeping, lack of credible collateral, lack of transparency and market risks, are some of the reasons behind the low level of access to credit by SMEs from the formal financial sector. In addition, La Rocca *et al.* (2011:110) state that SMEs are not financially stable enough to participate in the formal financial sector given that they cannot afford market interest rates.

However, scholars (such as Adzido & Azila-Gbetteor, 2014:197; Gorodnichenko & Schnitzer, 2011; Odit & Gobardhun, 2011:113; Ramlee & Berma, 2013:118; Richard & Mori 2012:218) argue that some of the reasons why the formal financial sector does not lend to SMEs (supply-side) in developing nations include *cost-effectiveness of credits to SMEs, imperfections involved in SME lending, opaqueness of borrowers, high transaction costs, information economics* arising from imperfections involved in SME lending *and lending technologies to assess credit applications*.

While De la Torre, Peria and Schmukler (2008) argue that inadequate financing of SMEs in developing nations is influenced mainly by supply-side factors, SMEs, on their part, contend that they do not comprehend the reasons behind the high rejection rate of their credit applications, as the formal financial sector, most often, does not provide feedback as to why their credit applications were not successful (La Rocca *et al.*, 2011:112; Ramlee & Berma, 2013:116). Baltar and Icart (2013:204) and Fatoki (2014:186) assert that the formal financial sector in developing nations seems to be uninterested in financing SMEs and such phenomenon is referred to as the “*discrimination hypothesis*”. Padilla-Perez and Ontanon (2013:10) are of

the opinion that the formal financial sector is not interested in financing SMEs in developing nations.

Beck (2007:402) notes that the availability of and access to formal sector finance by SMEs in developing countries can also be influenced by both borrower-specific (internal factors) and systematic factors (external factors). Borrower-specific factors include *managerial competencies, quality of business information, availability of collateral, business networking, business ethics, business intelligence* and other factors largely controlled by the enterprise (Barbosa & Moraes, 2004; Beck, 2007:403; Cassar, 2004:265). Systematic factors include the *macro-economic environment, social factors (such as crime and corruption), regional balance, and the legislative environment* in which both the lender and borrower operate (Nieman & Nieuwenhuizen, 2014:26). These systematic factors are not only outside of the control of creditors, but neither can policy makers change them in the near future. Nevertheless, different aspects pertaining to internal and external factors will influence the demand and supply side and are relevant to both sides.

Given the limited availability of and access to formal sector finance (as indicated in the literature), majority of owners of SMEs in developing countries (such as South Africa) raise their start-up capital from personal or family savings, which are often inadequate for survival and growth (Akinboade, 2015:185; Baltar & Icart, 2013:202; Fatoki, 2014:184; Herrington & Kew, 2014). Some of the factors that providers of finance take into account are: the *performance of the business*; and its *financing structure*. From the balance sheet viewpoint, when an enterprise seeks funds to finance its operations, the enterprise has the choice of three basic forms of finance as follows: debt; equity; and/or retained earnings.

According to capital structure theories, enterprises should make use of debt in their capital structure for different reasons. While the Static Trade-Off Theory by Modigliani and Miller (1958, 1963) advocates that enterprises should take absolute advantage of the tax shield and aim for 100% debt in their capital structure (taking into consideration the assumptions of the Modigliani and Miller theory), the Pecking Order Theory advanced by Myers (1984) maintains that there is no well-defined optimal capital structure. According to Jensen and Meckling (1976), the Static Trade-Off theory (also referred to as the tax-based theory) suggests that the optimal capital structure of an enterprise is obtained when the net tax advantage of debt financing balances leverage related costs, such as financial distress and bankruptcy, while

holding the enterprise's assets and investment decisions constant. In light of the Static Trade-Off theory, issuing equity will mean moving away from the optimum capital structure, which is, in effect, considered to be a wrong decision.

Valsamis, Katsaiti and Petrakis (2011:77) state that the use of debt finance can be either positive or negative for the performance of the enterprise. The positive effect of debt means the enterprise is able to earn a return on assets that is higher than before tax interest rate on debt (Valsamis *et al.*, 2011:78). The South African Reserve Bank (2015) maintains positive leverage occurs when an enterprise operates under favourable conditions, sales and profit margins are high and the enterprise is able to generate a good return on assets. Negative leverage occurs when an enterprise faces difficult times and sales and profit margins are low. Baltar and Icart (2013:206) emphasise that SMEs with weak sales, low profitability and high operating leverage should use less debt finance in their capital structure since such enterprises are considered to be underperforming. Underperforming enterprises are enterprises that are unable to generate enough funds for working capital.

Investorwords (2016) defines enterprise performance as the activities of an enterprise or investment over a given period of time. For the purpose of this study, enterprise performance was measured over a period of three years. Enterprise performance can be measured in terms of enterprise growth and expansion (Akinboade, 2015:187; Marimuthu, Arokiasamy & Ismail, 2009:268; Valsamis *et al.*, 2011:79; Watson, 2011:9). According to Watson (2011:8), the definition of performance cannot be separated from the definition of business failure and it can thus, be inferred that, enterprises that have not failed (weak performance), are successful (high performance). Therefore, performance, in terms of failure may be linked to bankruptcy, discontinuance of ownership, the sale of an enterprise to minimise further losses and the discontinuance of business (Ihua, 2009:200). Fatoki and Garwe (2010:731) also define weak performance as the discontinuance of business for any reason and formal bankruptcy, or the winding down of an enterprise with subsequent losses to the owner(s).

According to the Business Dictionary (2016), financial measures of an enterprise's performance, can be referred to as the findings of the enterprise's operations in monetary terms. For the purpose of this study, enterprise financial performance was measured in terms of *sales growth, profitability growth, growth in cash flow, growth in revenue and turnover growth*. On the other hand, non-financial measures of performance of an enterprise are measures not found

in charts of accounts of the enterprise, and can be measured in terms of *employee growth*, *customer satisfaction*, *satisfaction with performance compared to competitors* and *overall satisfaction with the performance of the enterprise* (Marimuthu *et al.*, 2009:266). Both financial (objective) and non-financial (subjective) measures of performance were applied in this study.

The studies referred to in relation to challenges faced by SMEs in obtaining finance, focused on developing countries such as Malaysia, Ghana, Tanzania, Kenya and Nigeria. Though these studies have contributed substantially to the literature on SME financing, their findings cannot simply be applied in other countries, due to differences in economic and legal environments. While studies by Abor and Quartey (2010), Ayyagari, Demircuc-kunt and Maksimovic (2010), Baltar and Icart (2013), Brijlal (2013) and Nieuwenhuizen and Kroon (2003) focused on the sources of capital, capital structure and financing constraints faced by SMEs in accessing formal sector finance (demand-side) in South Africa, only Fatoki and Smith (2011) examined constraints of new SMEs in accessing finance from the supply-side in South Africa. In order to fully comprehend the challenges of access to formal sector financing by SMEs, Fatoki and Smith (2011:1415), GEM (2014) and the World Bank (2015) suggest that it is vital to study both the demand and supply-side. While the supply-side focuses on challenges affecting institutions involved in providing finance, the demand-side focuses on challenges that affect SMEs seeking financing from the formal financial sector. Studies focusing on both the ability of SMEs to borrow from the formal financial sector (demand-side) and the reasons why the formal financial sector does not lend to SMEs (supply-side) have not been conducted in developing countries such as South Africa. Consequently, this study seeks to investigate the relationship between the availability of and access to credit from the formal financial sector from both the supply and demand-sides in South Africa. This study, therefore, seeks to analyse the two sets of research questions for the supply-side and demand-side as stated in Sections 1.4.2 and 1.4.4.

1.4 AIM OF THE STUDY

The aim of this study was to analyse the availability of and access to credit from the formal financial sector and the performance of SMEs in Johannesburg, Gauteng Province, South Africa. To address the aim of this study, the following two sets of research objectives were

developed for the supply and demand sides of financing by the formal financial sector to facilitate the performance of SMEs.

1.4.1 First set of research objectives: Supply-side

Primary research objective

The primary research objective was to:

1. Investigate factors that impact on the willingness of the formal financial sector to provide credit to SMEs in South Africa.

Secondary research objectives

The secondary objectives were to:

2. Establish challenges faced by the formal financial sector in assessing and approving credit to SMEs in South Africa;
3. Determine how the formal financial sector assesses credit applications from SMEs in South Africa; and
4. Ascertain how the formal financial sector perceives investment in SMEs in South Africa.

1.4.2 First set of research questions: Supply-side

Primary research question

The primary research question was:

1. What are the factors that impact on the willingness of the formal financial sector to provide credit to SMEs in South Africa?

Secondary research questions

The secondary research questions were:

2. What are the challenges faced by the formal financial sector in assessing and approving credit to SMEs in South Africa?
3. How does the formal financial sector assess credit applications from SMEs in South Africa? and
4. How does the formal financial sector perceive investment in SMEs in South Africa?

1.4.3 Second set of research objectives: Demand-side

Primary research objectives

The primary research objective was to:

- 1) Investigate factors that impact on access to credit from the formal financial sector by SMEs in South Africa.

Secondary research objectives

The secondary research objectives were to:

- 2) Ascertain challenges faced by SMEs and their impact on the performance of SMEs in South Africa;
- 3) Investigate the financial needs of SMEs from the formal financial sector in South Africa; and
- 4) Examine the relationship between access to credit from the formal financial sector and the performance of SMEs.

1.4.4 Second set of research questions: Demand-side

Primary research question

The primary research question was:

1. What are the factors that impact on access to credit from the formal financial sector by SMEs in South Africa?

Secondary research questions

The secondary research questions were:

2. What are the challenges faced by SMEs and their impact on the performance of SME in South Africa?
3. What are the financial needs of SMEs from the formal financial sector in South Africa?
and
4. What is the relationship between access to credit from the formal financial sector and the performance of SMEs in South Africa?

1.5 RESEARCH HYPOTHESES

The following hypotheses were developed from the research objectives.

1.5.1 Primary hypothesis

Ha: There is a significant positive relationship between challenges faced by SMEs and access to credit from the formal financial sector in South Africa.

Ho: There is no significant positive relationship between challenges faced by SMEs and access to credit from the formal financial sector in South Africa.

To give effect to the primary hypothesis, the following sub-hypotheses were stated.

a) Collateral

Ha¹: There is a significant positive relationship between lack of collateral and access to credit from the formal financial sector to SMEs.

Ho¹: There is no significant positive relationship between lack of collateral and access to credit from the formal financial sector to SMEs.

b) Business information

Ha²: There is a significant positive relationship between lack of business information and access to credit from the formal financial sector to SMEs.

Ho²: There is no significant positive relationship between lack of business information and access to credit from the formal financial sector to SMEs.

c) Managerial competency

Ha³: There is a significant positive relationship between lack of managerial competency and access to credit from the formal financial sector to SMEs.

Ho³: There is no significant positive relationship between lack of managerial competency and access to credit from the formal financial sector to SMEs.

d) Business networking

Ha⁴: There is a significant positive relationship between lack of business networking and access to credit from the formal financial sector to SMEs.

Ho⁴: There is no significant positive relationship between lack of business networking and access to credit from the formal financial sector to SMEs.

e) Legal system

Ha⁵: There is a significant positive relationship between the inefficiency of the legal system and access to credit from the formal financial sector to SMEs.

Ho⁵: There is no significant positive relationship between the inefficiency of the legal system and access to credit from the formal financial sector to SMEs.

f) Macro-economy

Ha⁶: There is a significant positive relationship between a poor macro-economic environment and access to credit from the formal financial sector to SMEs.

Ho⁶: There is no significant positive relationship between a poor macro-economic environment and access to credit from the formal financial sector to SMEs.

g) Business intelligence

Ha⁷: There is a significant positive relationship between lack of business intelligence and access to credit from the formal financial sector to SMEs.

Ho⁷: There is no significant positive relationship between lack of business intelligence and access to credit from the formal financial sector to SMEs.

h) Entrepreneurship education

Ha⁸: There is a significant positive relationship between lack of entrepreneurship education and access to credit from the formal financial sector to SMEs.

Ho⁸: There is no significant positive relationship between lack of entrepreneurship education and access to credit from the formal financial sector to SMEs.

i) Business ethics

Ha⁹: There is a significant positive relationship between ethical awareness of SME owners/managers and access to credit from the formal financial sector to SMEs.

Ho⁹: There is no significant positive relationship between ethical awareness of SME owners/managers and access to credit from the formal financial sector to SMEs.

1.5.2 Secondary hypotheses

To give effect to the secondary hypotheses, the following sub-hypotheses were stated.

a) Challenges faced by SMEs and their impact on the performance of SME in South Africa

The different variables (challenges) investigated in this study were as follows: finding customers, regulations, book-keeping and accounting services, access to bank finance, competition, enterprise operates within a small margin, skilled and experienced managers, cost of production, and cost of labour. For the purpose of this study, secondary hypotheses were stated only for variables that showed significant positive relationship to performance. As such, the following hypothesis is stated.

Hs^{1a}: There is a significant positive relationship between access to bank finance and the performance of SMEs.

Hs^{1o}: There is no significant positive relationship between access to bank finance and the performance of SMEs.

b) The relationship between access to credit from the formal financial sector and the performance of SMEs in South Africa

Hs^{2a}: There is a significant positive relationship between access to credit from the formal financial sector and the performance of SMEs.

Hs^{2o}: There is no significant positive relationship between access to credit from the formal financial sector and the performance of SMEs.

1.6 CONTRIBUTION OF THE STUDY

This study is intended to add to the body of knowledge and scholarly understanding of the financing of SMEs with particular emphasis on the availability of and access to credit from the formal financial sector and the performance of SMEs in Johannesburg, Gauteng Province, South Africa. Additionally, this study will have significant implications to academicians, policy makers, educational and training institutions and government agencies involved in the financing of SMEs. Thus, the findings of this study would contribute to improving support programmes for SMEs by government, policy makers, educational and training institutions, novel entrepreneurs and government agencies. Using a mixed method research design (MMRD) located in the pragmatic research paradigm will further contribute, from a methodological perspective, to the literature on the financing of SMEs, which is predominantly presented from a quantitative perspective in both supply and demand sides. Refer to Chapter 8 Section 8.5 for detail contribution of this study.

1.7 RESEARCH DESIGN AND METHODOLOGY

In order to address the objectives of this study, the research questions were addressed and the stated hypotheses tested. Two main research approaches were adopted in the study as follows; firstly, a secondary study, which consisted of reviewing relevant literature on the constructs of SMEs finance to provide a theoretical foundation for the study; and secondly, a primary empirical study.

1.7.1 Approach 1: A secondary study

With regard to the literature review, SMEs were conceptualised, the importance of SMEs to development (economic development, economic growth, sustained economic growth, sustainable development and development of SMEs) reviewed, the failure of SMEs and the causes of such failures were examined. In addition, the literature review also focused on the theories of capital structure, the sources of equity and debt capital in order to determine if there is sufficient credit from the formal financial sector for SMEs in South Africa. The last part of the literature review focused on factors that impact on the availability of and access to credit from the formal financial sector and performance of SMEs. Secondary sources from related subject areas such as management, financial management and strategic management, were consulted. The information was accessed from search engines from both national and international databases. To this effect, Southern African Bibliography Information Network (SABINET) online search was employed to establish completed research studies on the availability of and access to finance from the formal financial sector and the performance of SMEs. The specific sources consulted included libraries of Rhodes University, university of Fort Hare, Nelson Mandela Metropolitan University, Wits University, University of Cape Town, University of Johannesburg and University of South Africa. Other libraries consulted included Nairobi University, University of Maryland, Australian Study Institute (East Africa), University of California, University of New Mexico and University of New Eastern Mexico. Other online search engines used to gather information for this study included Networked Digital of Thesis and Dissertations (NDLTD), Electronic Thesis and Dissertation Collection (ETD), Emerald Journals, Dissertation Abstracts and Business link. The most popular internet search engine, Google Scholar assisted in gaining access to universities such as University of Maryland, Australian Study Institute (East Africa), University of California, University of New Mexico and University of New Eastern Mexico, University of North Texas, British West Indies and University of Liverpool. From the many sources contacted, it is evident that bank financing

of SMEs and SMEs performance are two subjects that continue to gain attention from researchers, scholars and practitioners alike. It is important to acknowledge that the sources mentioned are not exhaustive in relation to bank financing of SMEs and SMEs performance.

Some key words used as guides in a search for information were “bank financing”, “SMEs financing”, “SMEs performance”, “SMEs”, “enterprise performance” “small business financing”, as derived from literature. A literature search of South African and international databases was made, leading to PhD thesis and master’s dissertation such as Brijlal (2013) and Rungani (2008) respectively. However, from the sources consulted, it is evident that there are no known studies that have been carried out on the analysis of the availability of and access to credit from the formal financial sector and the performance of SMEs in South Africa. The present study will contribute to the body of knowledge on the formal financial sector financing to SMEs and SMEs performance within the banking and SMEs industry.

1.7.2 Approach 2: Empirical studies

A mixed methods research design (MMRD) located in the pragmatic research paradigm was used to achieve the objectives of this study (Cameron, 2011:98; Glogowska, 2011:253). A mixed methods research design assists the researcher to better comprehend the research problem and objectives being investigated and also allows for more credible and dependable findings (Cameron, 2011:103; Creswell & Plano Clark, 2011:10). In this study, the adoption of pragmatism was driven by the research questions (Creswell, 2014). As such, using both qualitative and quantitative methods (Creswell, 2014; Mertens, Hesse & Biber, 2014:7) to address a real-life challenge was considered the most appropriate philosophical option for this study. The real-life challenge in this study was to analyse the relationship between the availability of and access to credit from the formal financial sector and the performance of SMEs in South Africa. As such, the pragmatic approach used in this study enabled the researcher not to rely on one philosophy and reality but to pursue what worked well in answering the research questions. A further explanation of pragmatism is provided in Chapter 5 Section 5.2.

In line with the pragmatic research paradigm, an exploratory sequential MMRD was adopted in this study, consisting of two phases of data collection as follows: qualitative data collection and analysis (Phase 1-supply-side) which, together with the literature review, provided the

basis for the design for the collection of quantitative data and analysis (phase 2 – demand-side). This design was considered appropriate for this study because both qualitative and quantitative data were required to achieve the objectives of the study.

1.7.2.1 Phase 1: Supply-side

The population of the study, sample frame and size, sampling techniques, data collection and data analysis are explained in this section.

a) Population, sample frame, and size and sampling techniques

For the purpose of this study, the population of the formal financial sector constitutes the 27 commercial banks (Banking Association of South Africa, 2018), while the unit of analysis comprised eight banks namely; Amalgamated Banks of South Africa (ABSA), Standard Bank, First Rand Bank, First National Bank (FNB), NEDCOR, Bidvest Bank, African Bank and CAPITEC Bank. These eight banks were selected because of their substantial contribution to commercial banking in South Africa, being responsible for about 91% of all assets and about 85% of all liabilities in the commercial banking sector. The sampling frame consisted of an estimated 106 business and credit managers of the eight selected banks in South Africa. These managers were responsible for credit evaluation, recommendations and approval within the selected banks. Credit managers approve credit applications from businesses, while business managers are responsible for evaluating and recommending applications of business credit. Purposive sampling was used in selecting the 8 business and 8 credit managers from the selected banks. The purposive sampling was largely based on the fact that these banks have their policies and guidelines in place for all managers to adhere to and also because the head offices are more informed in terms of their knowledge and experience in lending as they make the final lending decisions for other business and credit managers at the branch offices. Interviewing a business and credit manager at the head office would yield more insights than interviewing such manager at the branch office. Hence, taking into consideration regulations and guidelines governing credit lending in each bank, interviewing more than one credit and business manager from a single bank would normally lead to data saturation.

b) Data collection

In-depth, face-to-face semi-structured interviews were conducted with 8 credit and 8 business managers from the 8 banks selected for the study (representing the formal financial sector), as

described earlier in this chapter. The interview guide was designed based on the literature review (Chapters 2, 3 and 4) (see Annexure A and Chapter 5, Section 5.4.1.5).

c) Qualitative data analysis

Qualitative data collected for the study was analysed using the five-steps of content analysis as illustrated by Terre Blanche, Durrheim and Kelly (2006:322-326). The five steps include familiarisation and immersion, inducing themes, coding, elaboration, interpretation and checking. These steps are discussed in detail in the research design and methodology chapter (Chapter 5, Sections 5.4.3.1 – 5.4.3.5). Qualitative data analysis was evaluated against the qualitative research criteria, such as credibility, transferability, dependability and confirmability (Collins & Hussey, 2014). The qualitative research criteria are discussed in Chapter 5, Sections 5.4.2.1 – 5.4.2.4. With the support of a sound research design, a transparent description of the analysis considered to be credible, dependable and confirmable research findings were generated.

1.7.2.2 Phase 2: Demand-side

This section focuses on the population, sample frame and size, sampling techniques, data collection and data analysis.

a) Population, sampling unit and sampling techniques

In order to achieve the demand-side objectives of this study, an estimated number of registered SMEs in Johannesburg, South Africa was obtained from the Bureau for Economic Research (2016) commissioned by the Small Enterprise Development Agency. The population of this empirical phase consisted of an estimated 4,000 SMEs. For the purpose of this study, the city of Johannesburg was chosen because it is well-known as the largest economy of any metropolitan region in sub-Saharan Africa and is referred to as the “Little New York” (Grossberg & Nhemachena, 2015). Most of the banks also have their head office located within the city of Johannesburg. Furthermore, the Bureau for Economic Research (2016) commissioned by the Small Enterprise Development Agency confirm that approximately 49% of the total population of SMEs in the formal sector in South Africa operate in Gauteng Province (see Table 1.1). The study focused on SMEs in the formal sector because they are under government regulation. According to Cooper and Schindler (2011), a researcher is most likely to get credible findings from a sample obtained from a population that would reflect the

entire population than when the entire population is sampled and only a few respondents from the population participate in the research. Thus, the findings of this study can be generalised to the whole of Gauteng Province, South Africa.

Table 1.1: Provincial distribution of SMEs in the formal and informal sectors of South Africa

Province	Formal sector (2015) in %	Informal sector (2015) in %
Eastern Cape	05.2	13.4
Free State	03.2	06.6
Gauteng	48.6	24.6
KwaZulu Natal	13.0	18.8
Limpopo	02.7	14.3
Mpumalanga	04.1	07.7
North West	03.2	08.0
Northern Cape	01.2	00.7
Western Cape	19.0	05.9
TOTAL	100.0%	100.0%
Source: Adapted from the Bureau for Economic Research (2016)		

Based on Raosoft (2018), a sample size calculator was used in calculating the recommended sample size for the study, at a five percent margin of error, 95% confidence interval and a response distribution of 50%. Thus, the minimum recommended sample size for this study was 351. Due to the limitations associated with using questionnaires as a data collection tool, including non-response, the researcher doubled the minimum recommended sample size for the study. Thus, 702 questionnaires were distributed to selected SMEs in Johannesburg with the assistance of the Small Enterprise Development Agency. Simple random probability sampling was used to select SMEs that constituted the unit of analysis from the population of SMEs in Johannesburg. In probability sampling, each of the elements has a known, non-zero chance of being included in the unit of analysis (Williams, 2007:68). Simple random sampling was used to select SMEs from the sample frame to represent the sample for this study.

b) Data collection

A self-administered questionnaire was used to collect quantitative data for the study (Annexure B). The researcher was assisted by three research assistants who were compensated for their services. The questionnaire was developed based on the findings in Phase 1 of this study, relevant literature in Chapters 2, 3 and 4 and other research instruments as explained in Chapter 5, Section 5.5.1.5. The completed questionnaires were placed in sealed envelopes, which were later collected by the researcher and the three research assistants. After collecting the sealed envelopes from respondents, the completed questionnaires were then prepared for data cleansing, capturing and analysis.

c) Quantitative data analysis

Data was analysed based on the 300 completed questionnaires, representing a response rate of 42.735 %. Brijlal (2013), Abor and Quartey (2010), Fatoki (2014), Hair *et al.* (2008:4) and Cooper and Schindler (2011:72) agreed that a response rate greater than 40% is most common and acceptable in social science research. The Statistical Package for the Social Sciences (version 24) was used to analyse data. As highlighted by Coakes (2005:5), SPSS a software that is widely used for performing statistical procedures in the social sciences field. SPSS is a complete statistical package based on a point and click interface and has almost all statistical features available. It is widely used by researchers to perform quantitative analysis. The quantitative data collected was captured in Excel spreadsheet, checked, coded, cleaned and SPSS used for further analysis (Leech, Barrett, & Morgan, 2009). A descriptive statistical analysis of the data, such as means, standard deviations, frequencies and percentages was initially conducted, prior to inferential analysis. An exploratory factor analysis was used in this study to refine the research problem and enhance the validity of the study. Reliability was assessed using the Cronbach's Alpha Coefficient analysis (Tavakol & Dennick, 2011:53).

Tests for normality of data was done using Shapiro–Wilks test. Binary logistic regression was used to infer on the hypotheses. To establish if a significant relationship exists between access to bank finance, performance and other construct variables (hypothesised factors), a correlational analysis supplemented by binary logistic regression models was used. An independent sample T-test was performed to compare the performance between SMEs with debt finance in their capital structure and those without debt finance. The Mann-Whitney U means test was used to establish the mean differences between SMEs with access to bank finance and those without access to such finance. Binary logistic regression was used to test

access to bank finance and the reasons why formal financial institutions may refuse to grant credit to SMEs. A comprehensive explanation of the data analysis process is given in Chapter 5, Section 5.5.3.

1.8 ETHICAL CONSIDERATIONS

Research involving humans is essential for the improvement of knowledge in the sphere of humans and the society at large. Protecting the rights and dignity of humans involved in research is thus, of utmost importance (Cooper & Schindler, 2011:72; Kolb, 2008:13). The following ethical principles as highlighted in the Rhodes University Ethical Standards Committee Handbook (RUESCH) (2014) were considered in this study: participants were accorded the respect and dignity due to them, transparency and honesty, accountability and responsibility, and integrity and academic professionalism. This study thus, conformed to all ethical requirements as specified in RUESCH. Furthermore, the application for research ethics was approved by the Rhodes University Ethical Standards Committee for Humans prior to data collection (see Annexures C1 & C2).

1.9 LIMITATIONS OF THE STUDY

This study was limited solely to SMEs located in Johannesburg, Gauteng Province, South Africa. As a result, care should be exercised in the interpretation and application of the findings of this study and the generalisation of the findings to the whole of South Africa. The fact that the study involved a region and focused on the eight commercial banks in Johannesburg, Gauteng Province, South Africa (as highlighted in Chapter 5), further research could focus on the relationship between the availability of and access to bank finance from other sources of credit finances such as venture capital and angel capital.

1.10 DEFINITION OF KEY CONCEPTS

a) Formal financial sector

In general terms, the Banking Association of South Africa (2018) considers the formal financial sector as that category of the economy made up of institutions or firms that provide financial services to commercial and retail customers. This sector includes commercial banks, investment funds, insurance companies and real estate. For the purpose of this study, the formal financial sector refers to commercial banks.

b) Formal financial institutions

Formal financial institutions refer to the different commercial banks that provide financial services to commercial and retail customers. For the purpose of this study, formal financial institutions refer to the eight commercial banks selected for this study (see Section 1.7.2.1), from which qualitative data (Phase 1) was collected (Banking Association of South Africa, 2018).

c) Banks

Banks are formal financial institutions that provide financial services to commercial and retail customers. For the purpose of this study, banks and formal financial institutions are used interchangeably (Banking Association of South Africa, 2018).

d) Supply-side

The supply-side refers to providers or suppliers of credit, which, in this case, is the formal financial sector. In other words, they are also referred to as lenders.

e) Demand-side

The demand-side refers to consumers or users of credit, which, in this case, are SMEs. In other words, they are also referred to as borrowers.

f) Credit / debt finance

Credit refers to the funds or money borrowed from credit providers such as formal financial institutions which must be paid back with interest. Because it must be paid back, it is also known as debt in the literature of finance (Banking Association of South Africa, 2018). Thus, the term 'credit' used in this study is used interchangeably as debt finance.

1.11 STRUCTURE OF THE STUDY

This study is divided into eight chapters.

Chapter 1 – Introduction to the study: This chapter provides the background to the study, the problem statement and the aim of the study. The chapter also provides the objectives of the study, the research questions and research hypotheses. The contribution of the study, the

research design and methodology, ethical considerations and limitations of the study are also discussed in this chapter.

Chapter 2 – SMEs conceptualised: Chapter 2 provides a comprehensive literature review on SMEs, the importance of SMEs to development (economic development, economic growth, sustained economic growth, sustainable development and development of SMEs). The chapter also focuses on the concept of SME failure, the causes of such failure and challenges faced by SMEs in accessing finance from the formal financial sector. The performance of SMEs and measures of such performance are also discussed in this chapter. The definition of failure and the causes of such failure are also explained as well as the contributions and challenges faced by SMEs in South Africa.

Chapter 3 –financing of SMEs: Chapter 3 focuses on the financing needs of SMEs. SMEs need debt finance to invest in working capital, product development, preliminary losses and even the acquisition of fixed assets. Capital structure theories such as the static trade-off theory, the agency theory and the pecking order theory and their implication for SMEs are also discussed. The causes of the equity and debt gap for SMEs in South Africa and challenges faced by formal financial institutions in lending to SMEs are also examined.

Chapter 4 – Involvement of the formal financial sector in SMEs: supply and demand-side factors: This chapter focuses on the supply and demand-side factors that impact on the availability of and access to credit from the formal financial sector towards SMEs. The chapter also focuses on how demand-side factors might impact on the performance of SMEs. Supply-side factors include the cost of lending, information asymmetry, lending technologies, institutional structure and lenders' risk appetite. Demand-side factors include collateral, managerial competency, business information, business networking, legal and judicial system, macro-economic environment, business intelligence, entrepreneurship education and business ethics and how they can affect access to credit finance towards owners of SMEs.

Chapter 5 – Research design and methodology: This chapter focuses on the research design and methodology used in conducting this study such as the research paradigm, research design, the population of the study, the sample design, methods of data collection and data analysis.

Chapter 6 – Supply-side: findings and discussion from the qualitative data: This chapter focuses on phase 1 (qualitative data analysis and interpretation of findings as well as a discussion of the findings of the study).

Chapter 7 – Demand-side: quantitative data analysis: This chapter focuses on phase 2 (quantitative data analysis and interpretation of results and a discussion of the findings of the study).

Chapter 8 – Recommendations and conclusions: In this chapter, the researcher revisits the research problem and the objectives of the study. The conclusions drawn from the study, recommendations, limitations of the study and areas for further research are also discussed in this chapter.

CHAPTER TWO

SMALL AND MEDIUM ENTERPRISE (SMEs) CONCEPTUALISED

“If SMEs do not exist, it would be necessary to create them. They are the driving force in the creation of new jobs in every economy. Thus, a flourishing SMEs sector is critical to inclusive economic growth, poverty reduction and job creation” (Cosgrove, 2008).

2.1 INTRODUCTION

Scholars (such as Adams & Cuecuecha, 2010; Altenburg, Kulke, Hampel-Milagrosa, Peterskovsky & Reeg, 2016; Beine, Docquier & Rapoport, 2008; Todaro & Smith, 2012) have written about the problems of developing countries, outlining their characteristics as if it were one homogenous mass, despite the differences in income, values and culture from across borders. As a common characteristic, life in developing countries (Africa as a whole and South Africa in particular), is described in the most undignified conditions, portraying living conditions as insufferable. As a result, the importance of the level of development (economic development, economic growth, sustained economic growth, sustainable development and development of SMEs) in South Africa comes into play. Some of the fundamental development challenges faced by most developing countries such as South Africa include high and growing levels of poverty, income inequality and unemployment (OECD, 2015; World Bank, 2015). In addition, GEM (2016) highlight that an environment conducive for the development of SMEs is critical to solving the developmental challenges since SMEs are considered “*the engine for economic development*” (Altenburg *et al.*, 2016; Ikuomola & Zaaïman, 2014:374; Nieman & Nieuwenhuizen, 2014:27; Ramlee & Berma, 2013:116). Thus, this chapter provides a critical definition of SMEs (from an international and national perspective), the importance of SMEs to development, the failure of SME’s and challenges faced by SMEs in accessing finance. The chapter also focuses on the performance of SMEs and measures of their performance. In this chapter, effort is also given to achieving one of the objectives (to identify challenges faced by SMEs in accessing credit from the formal financial sector from a theoretical perspective).

2.2 DEFINING SMEs

Though SMEs are considered “*the engine for economic development*”, there is no clear consensus in the literature on the definition of SMEs in the field of business management (Berisha & Pula, 2015:22) and the definition is not uniform across countries (GEM, 2014;

National Credit Regulator, 2011; Nieman & Nieuwenhuizen, 2014). Despite this, a number of factors that correlate to a country's socio-economic surroundings influence the definition of SME. As such, most definitions include quantitative and qualitative factors. Quantitative factors include the number of employees, annual earnings (sales) and the total balance sheet. Meanwhile, qualitative factors require that a SME has a relatively small share of its market, be run by its owners and not be a subsidiary of a large organisation. Number of employees, annual turnover and maximum balance sheet are the fundamental criteria for defining SMEs in Australia, Europe, America and South Africa (Table 2.1).

Table 2.1: Definition of SMEs in Australia, Europe, America and South Africa

Firm size	Number of employees	Annual turnover	Maximum total balance sheet	Source
United States of America Small Business Administration standard for SMEs				
Small	Less than 250 depending on industry	Less than \$10m depending on industry	Less than \$7m depending on industry	Adapted from the United States Small Business Administration (2016)
Medium	Less than 500 depending on industry	\$10m - \$50m depending on industry	Less than \$25m depending on industry	
European Commission criteria for SMEs				
Small	More than 10 but less than 50	Less than 10m Euros	Less than 10m Euros	Adapted from the European Commission (2015)
Medium	More than 50 but less than 250	Less than 50m Euros	Less than 43m Euros	
Australia Bureau of statistics criteria for SMEs				
Small	More than 5 but less than 50	Less than \$10m	Less than \$9m	Swanepoel and Harrison (2015)
Medium	More than 50 but less than 199	Less than \$50m	Less than \$49m	
Schedule of size standards for the definition of SMEs in South Africa				
Small	Fewer than 50	R2m to R25m, depending on industry	R2m to R4.5m depending on industry	Small Enterprise Development Agency (SEDA) (2016)
Medium	Fewer than 200 depending on industry	R4m to R50m, depending on industry	R4.5m to R18m, depending on industry	

From Table 2.1, to qualify as a SME in Australia, Europe, America and South Africa, both the employee, the independence criteria (annual turnover or maximum balance sheet) must be satisfied. However, in Australia, the ranges of the employment size are based on “headcounts” rather than full time employment basis. From a comparative point of view, if the American definition for SMEs is adopted, all medium enterprises in Europe, Australia and South Africa would be considered as small enterprises. On the other hand, the definition of SME in Australia and South Africa are similar in terms of the number of employees’ criterion. The definition of SMEs as defined by the Small Enterprise Development Agency (SEDA) (2016) based on the National Small Business Act 102 of 1996 as amended in 2003 was adopted in this study. This Act defines SME as a separate and distinct entity, including cooperative enterprises and non-governmental organisations managed by one owner or more, including its branches or subsidiaries if any is predominantly carried out in any sector or sub-sector of the economy mentioned in the schedule of size standards, and can be classified as small by satisfying the criteria mentioned in the schedule of size standards in Table 2.1.

However, research suggests that a globally uniform definition of SMEs is crucial for the development of SMEs (Bergthaler, Kang, Liu & Monaghan, 2015; OECD, 2015; World Bank, 2015). Senderovitz and Philipsen (2008) argue that without a uniform definition for SMEs, it will be challenging to have a cross country comparison of the performance of SMEs. As a consequence, it will be difficult for international finance organisations such as the World Bank and the International Monetary Fund to put in place global support systems for the development of SMEs despite the fact that they are considered as the “*engine of economic growth, job creation and development*” (Nguyen, Alam, Perry & Prajogo, 2009:62; SEDA, 2016). Hence, SMEs are very essential to the economy of every country in both developed and developing nations.

2.3 IMPORTANCE OF SMEs

In their substantive roles, SMEs contribute towards job creation, often displacing existing large firms, that have ceased adequately to serve changing customer needs and are unable or unwilling to change, they are innovative in introducing new ideas and technologies and offer new choices to consumers, thereby changing patterns of consumption (Abdulsaleh & Worthington, 2013:37). SMEs are essential to the economy of South Africa, contributing 77% of all private sector employment, 40% of the GDP of the economy and 46% of the total

employment. Given the noted contributions, the GEM report of 2014 points out that the development of SMEs is one of the defining subjects of the 21st Century and is an essential, unavoidable and potentially beneficial component to the economic and social well-being of developed and developing countries such as South Africa. The development of SMEs plays a fundamental role in the evolution of any industry. Given that South Africa is confronted with a rising concern regarding unemployment, job creation, economic growth, and international competitiveness in global markets, scholars have responded to this concern with a new mandate to promote the development of SMEs. The development of SMEs is crucial for the development of every economy, especially economies with very low growth prospects such as that of South Africa (GEM, 2014; Industrial Development Corporation, 2015).

According to Williams (2003:37), the term “development” is a “puzzle”. In his study entitled “Studying development and explaining policies”, Williams (2003:38) asks simple but critical questions such as “*What is it that we are studying in development?*” “*What constitutes a problem as a development problem?*” “*What makes a policy a development policy?*” To add to the puzzle, the United Nations (2015) questions “*Why some countries are developed, and others less so?*” In simpler terms, *what is it that account for the difference in living standard across international borders?* The United Nations (2015) further expresses doubt whether developing countries will ever catch up with developed countries and, if possible, *how long will it take?* If not possible, *why not possible?*

The World Bank (2015) questioned why some countries are broadly classified as developed countries and others developing. According to the World Bank (2015), ‘developed country’ is the term used to describe countries with high levels of development according to standard criteria. These standard criteria include a high Human Development Index rating, a high level of industrialisation (countries in which the tertiary sector dominates the economy) and a high per capita gross domestic product (GDP) corrected for purchasing power parity. The GDP of a country is a measure of economic growth. Economic growth accompanied by a significant positive change in the general welfare of the people in the country such as improvements in the literacy rates, life expectancy, access to education and housing and health services is referred to as economic development (Todaro & Smith, 2012:18; UNDP, 2016).

From a policy point of view, economic development can be explained as efforts that seek to improve the economic well-being and the quality of life of a community by creating and/or

retaining jobs and supporting or growing incomes and the tax base (United Nations, 2015). The California Association for Local Economic Development (hereafter CALED) (2011), considers economic development as the allocation of limited resources - land, labour, capital and entrepreneurship in a way that has a positive effect on the level of business activity, employment, income distribution patterns and fiscal solvency. Economic development is a concerted effort on the part of a responsible governing body in a country to influence the direction of private sector (SMEs) investment towards opportunities that can lead to sustained economic growth. Sustainable economic growth can provide sufficient incomes for the labour force, profitable business opportunities for employers and tax revenues for maintaining infrastructure in order to support continuous growth (sustainable growth).

Altenburg *et al.* (2016), OECD (2016) and the United Nations Development Programme (hereafter UNDP) (2016) state that development is not only about economic growth but development also reduces deprivation and broadens choice. Deprivation represents a multi-dimensional view of poverty that includes hunger, illiteracy, illness and poor health, powerlessness, voicelessness, insecurity, humiliation and lack of access to basic infrastructure.

Development from the viewpoint of Todaro and Smith (2012:17) is a “multidimensional process”, involving major changes in social structures, popular attitudes and national institutions, as well as the reduction of inequality, the eradication of poverty and the acceleration of economic growth. With regard to whether South Africa is a developed or developing country, the World Bank (2016a) states that South Africa is a two-tiered economy that can be classified as a *First and Secondary economy*. As a *First economy*, the country is comparable to other developed countries with a per capita gross domestic product, corrected for purchasing power parity (PPP) at \$10,187 per annum, making the country one of the 50 wealthiest in the world. Even though South Africa experienced great recession between 2008 and 2018, using the PPP criteria, South Africa can still be classified as a developed country and is still among the top 100 wealthiest countries in the world (Nsiah, 2016:93). With regard to South Africa’s *Second economy*, with only basic infrastructure highly characterised by prominent poor social indicators such as very low level of human development index, the country ranks 115 out of 175 countries (GEM, 2014). Nsiah (2016:94) further moots that the human development index of South Africa has been on a decline over the past decades as the country’s life expectancy is among the worst 30 in the world. Projections of mortality suggest

that this measure might deteriorate further as deaths from the HIV/AIDS pandemic and crime increase (Crime Stats South Africa, 2018).

Despite being among the 100 wealthiest countries in the world, South Africa is one of the most unequal societies in the world with national policies discriminating vigorously against the majority of the country's population (Nsiah, 2016:94; OECD, 2015). Among other inequalities, people do not have access to the following: quality education; own property and accumulate assets; and the labour market.

Contemporary research on development have expanded the definition of development to include sustainable development (Nieman & Nieuwenhuizen, 2014:31; OECD, 2015; World Bank, 2016a). Khan and Khan (2012:23) posit that the development of a vibrant SMEs sector is acknowledged as a key condition in promoting equitable and sustainable economic development in Africa and South Africa in particular. As a result, sustainable development is gaining ground worldwide and is found on the agenda of most developing countries such as Brazil, Russia, India, China and South Africa.

Stoddart (2011) defines sustainable development as “development that meets the needs of the present without compromising the ability of future generations to meet their own needs”. Klapper, El-Zoghbi and Hess (2016) expand the definition of sustainable development to include, in order of importance: No poverty; Zero hunger; Good health and well-being; Quality education; Gender equality; Clean water and sanitation; Affordable and clean energy; Decent work and economic growth; Industry, innovation and infrastructure; Reduced inequalities; Sustainable cities and communities; Responsible consumption and production; Climate action; Life below water; Life on land; Peace, justice and strong institutions; and Partnership for the goals.

The very first sustainable development goal as listed by Klapper *et al.* (2016) “*ending extreme poverty*” explicitly emphasises the importance of access to financial support and services. Klapper *et al.* (2016) argue that when people are included in the financial system, they are better able to move out of poverty by investing in either business or education. Financial inclusion, according to Klapper *et al.* (2016), implies the formal financial sector is ready to make available services such as payment services, loans and insurance to consumers. In addition, the formal financial sector should also make sure that customers are actively and

effectively using these services to meet their specific needs. Klapper *et al.* (2016) conclude that the other sixteen sustainable development goals cannot be achieved if the number one goal of ending extreme poverty is not achieved.

Over the past decade, given that South Africa has been on the road to recovery, the government has recognised constraints, such as debt crises, underdevelopment in the country's rural areas and unsustainable economic environment and political relations as key priority focus areas if they are to turn the economy around. As a developing nation, the country is currently facing severe unemployment and poverty. According to Statistics South Africa (2018:14), 27.2% of the population are unemployed and 50% living below the poverty line. This has led to the proposition of policies by the government such as good governance, eradication of poverty, economic recovery, accountability, transparency and adequate attention to social services, with education the highest on the agenda, followed by health services, shelter, water and the provision of electricity for all South Africans.

Given the high unemployment rate, contemporary literature considers the development of SMEs to be the primary solution to South Africa's developmental challenges (Klapper *et al.* 2016; Nieman & Nieuwenhuizen, 2014:31; OECD, 2016; World Business Council for Sustainable Development, 2015). However, the very high failure rate of SMEs in South Africa is presently enthused by poor access to financial resources (Herrington, Kew & Kew, 2013:4). In addition, Kongolo (2010:2290) posits that self-employment is a risky venture and the poor and unemployed who are already financially and extremely vulnerable, find it impossible to contemplate taking on the additional risk associated with unemployment.

It is furthermore, asserted that the development of SMEs is the most important source of innovation in relations to introducing new products and develop new technologies (Fatoki & Patswawairi, 2012:138; Nkealah, 2011:121). SMEs are also capable of creating competitive pressure on established businesses and push businesses to improve their efficiency. These pressures arise as newly created SMEs pursue customisation and niche market strategies as a means of gaining market shares. In addition, Fatoki (2014:3) highlights that promoting the development of SMEs in South Africa will contribute to economic growth, as the benefits are likely to be in the form of new products, new jobs, more exports and increased taxation revenue. Thus, the development of SMEs can help South Africa meet its developmental challenges of poverty, unemployment and income inequality.

The Department of Trade and Industry (2017) argues that the creation of SMEs is of fundamental importance to the economic prosperity of South Africa and that the country risks economic stagnation without a high creation rate of SMEs. On the contrary, Hijzen, Upward and Wright (2010) disagree that the creation of SMEs significantly contributes to economic development given the very high failure rate of SMEs in South Africa. The high failure rate of SMEs in South Africa and other developed and developing countries is discussed in the next section.

2.4 FAILURE OF SMEs

Given the challenge of defining enterprise failure and the current lack of clarity surrounding the definition of SME failure, Walsh and Cunningham (2016:167) state that SME failure can be defined using objective and subjective criteria. Researchers (such as Coad, 2014:742; Jenkins & McKelvie, 2016:176; Walsh and Cunningham, 2016) use financial criteria to define enterprise failure as a result of poor performance from the broader concept of exit. However, this definition does not capture the variance in the performance of enterprise when they exit for other reasons than failure. For example, when entrepreneurs retire or they pursue alternative employment opportunities.

Researchers (Shepherd and Haynie, 2011:180; Shepherd, Wiklund and Haynie, 2009:136) who use subjective criteria to define enterprise failure focus on the entrepreneur's perception with regard to the performance of the enterprise relative to a benchmark or predetermined goal. For example, one of the most common and recent subjective definition of enterprise failure was proposed by Ucbasaran, Shepherd, Lockett and Lyon (2013:175) as "*the cessation of involvement in a venture because it has not met a minimum threshold for economic viability as stipulated by the entrepreneur*". According to Walsh and Cunningham (2016:167), the above subjective definition of business failure is inspired by Gimeno, Folta, Cooper and Woo's (1997) threshold performance theory, which states that the human capital of an entrepreneur influences the minimum performance level he or she is willing to accept. That is to say, if performance falls below the minimum level, the entrepreneur exits the business. This implies that, given the same level of performance, one entrepreneur may view the enterprise as being successful, while another entrepreneur may view the same enterprise as unsuccessful (Khelil, 2016:74). Therefore, using the subjective definition of defining enterprise failure, an entrepreneur who

exits an economically profitable business for an alternative option that appears more attractive, is considered as failing. The subjective definition of enterprise failure thus, confounds exit of a profitable enterprise that no longer meets the expectations of entrepreneurs with failure of an enterprise, which involves economic losses for the entrepreneur (Walsh & Cunningham, 2016:168).

Given the objective and subjective definition of enterprise failure, the researcher adopted a middle ground in defining enterprise failure. For the purpose of this study, enterprise failure is defined as *the closure of an enterprise, either for financially-related reasons or willingly (which in the latter case, can be due to the owners not achieving their expectations such as not enough current return on investment, no growth expectation, poor performance or not able to attract new debt or equity) in contrast to personal reasons such as retirement, relocation and family.*

Considering the definition of SMEs failure used for this study, the chances of SMEs growing and becoming an established large firm is very slim in developing countries compared to developed countries. Table 2.2 shows the failure rate of SMEs in some developing (South Africa, Mexico, Chile and Venezuela) and developed (Australia, New Zealand, UK and Japan) countries.

Table 2.2: Failure rates of SMEs in selected developing and developed countries

Developing countries	Failure rates of SMEs (%)	Developed countries	Failure rate of SMEs (%)
South Africa	75	Australia	30
Mexico	68	New Zealand	28
Chile	66	United Kingdom	28
Venezuela	48	Japan	24
Source: Adapted from OECD (2015)			

From Table 2.2, it can be inferred that the failure rate of SMEs in developing countries is higher compared to developed countries. This simply implies that the probability of a business to survive in a developing country is generally much lower compared to a developed country. In

addition, the failure rate of SMEs in South Africa is the highest among all the countries sampled by GEM (Baltar and Icart, 2013:203; Fatoki, 2014:924; Fatoki and Smith, 2011:1414).

GEM (2017) note that the high failure rate of SMEs is directly associated to the Total Early-Stage Entrepreneurial Activity (TEA) in the country. GEM (2017) TEA data reveals that South Africa's rate in 2015 (9.2) has dropped significantly by 30% within the years 2016 and 2017 (from 9.2 in 2015 to 6.9 in 2017) (GEM, 2017). This has widened the TEA gap between South Africans and their African counterparts (Egypt at 14.3, Cameroon at 27.6 and Burkina Faso at 33.5). The average TEA rates (17.6) in the Africa region as a whole are 2.5 times higher than for South Africa. South Africa also has one of the lowest TEA rates among the efficiency-driven economies (e.g. Egypt, Brazil, Poland), ranked 28th out of 32 efficiency-driven economies (GEM, 2017). The GEM (2017) report also concludes that South Africa's TEA is significantly lower than the average 15.6% for all middle to low income countries (such as Iran and India) and 11.7% for all efficiency driven (such as Egypt and Columbia) because most South Africans do not appreciate entrepreneurship as a career choice. Study by Asah, Fatoki and Rungani (2015) revealed that most South Africans are necessity entrepreneurs (push into entrepreneurship) as opposed to opportunity entrepreneurship (pull into entrepreneurship).

The low TEA, the low establish business rate and the high TEA to business discontinuance in South Africa as explained in the previous paragraph have drawn the attention of policy makers and research in the field of entrepreneurship to investigate and analyse the challenges and causes of SMEs failure (GEM, 2017; Gebre, Maharaj & Pillay, 2011:25; GEM, 2017; Jenkins & McKelvie, 2016:176; Kalitanyi & Visser, 2010; Khelil, 2016:74). Given that business failure is becoming a normal phenomenon to some SME owners/managers and a challenge to credit providers such as formal financial institutions, the above listed scholars advocate that a reliable analysis of the challenges and causes of SMEs failure should be comprehensive and take into consideration not only the causes as stipulated by SMEs owners/managers but also the views of other stakeholders such as formal financial institutions, who are the providers of credits to them.

The latest GEM report of 2017 shows that the probability of SMEs surviving beyond 42 months is less likely in South Africa than in any other country sampled by GEM (GEM, 2017). The high failure rate of SMEs in South Africa (at 75%) implies that government and policy makers should be very concerned about the state of entrepreneurship and the growth of SMEs.

According to Abdulsaleh and Worthington (2013:37), the high prevalence of failure of SMEs in South Africa and other developing countries is a serious waste of resources as not only economic resources are involved, but also human costs associated with failure. To better understand the failure of SMEs, the main causes of failure of SMEs are discussed in the next section.

2.4.1 Causes of failure of SMEs

Despite the importance of SMEs, as explained in Section 2.4, Jenkins and McKelvie (2016:176) suggest that the following are important causes that contribute significantly to the failure of SMEs: the liability of inadequate financial resources; lack of management experience; lack of functional skills (such as planning, organising, leading and controlling); poor staff training and development; and poor attitudes towards customers. In addition, Vandenberg, Chantapacdepong and Yoshino (2016:18) argue that the costs to develop export markets can be disheartening for SMEs, with considerable upfront costs (market development, market information and search for partners) and a high-risk discernment that the business may not even be successful after all. Vandenberg *et al.* (2016:19) also note that the inability of SMEs to expand to new markets makes them vulnerable to tight competition as they lack the essential resources to stay competitive within their market of operation.

According to Kambwale *et al.* (2015:85), another critical factor that also contributes to the failure of SMEs is the inability of its initial leadership to continue to meet new challenges as the SME grows. SMEs are often begun by an entrepreneur with a very specific marketable product or idea, who then brings together other founders and funding to manage and run the enterprise. As SMEs grow, it becomes paramount for the owners to augment their managerial capabilities. The growth of the SME presents changing leadership needs and a need for different managerial capabilities. At some point, owners of SMEs reach a limit where their inability to manage the enterprise becomes detrimental. In such circumstances, owners who fail to replace themselves with a professional manager, are more apt to fail (Kambwale *et al.*, 2015:85).

An empirical study by Holland (2008) revealed that about 90% of failures of SMEs in the United States of America (USA) are largely due to management mistakes. Some of the leading management mistakes that lead to failures are: going into business for the wrong reasons; the

owners of SMEs get worn-out and/or underestimate time requirements; family pressure on time and funds; pride; lack of market awareness; owners of SMEs falling in love with the product/business; lack of financial responsibility and awareness; and lack of a clear focus.

According to Boeker and Wiltbank (2005:127), the four most important factors that cause failure (in this order) are as follows: poor market conditions; poor capitalisation; poor management strategy; and incompetence of key people (incompetence of employees and managers). Boeker and Wiltbank (2005:127) further maintain funding providers, such as formal financial institutions, suggest the following four reasons as the primary causes of failure of (in this order) of SMEs: lack of management skills; poor product design; lack of technical skills; and inadequate capitalisation. Contemporary literature maintains inadequate capitalisation (lack of financial capital) is the primary cause of the failure of SMEs in developed and developing economies, while other causes are secondary (Amoros & Bosma, 2014:12; Coad, 2014:724; GEM, 2016; UNDP, 2016; Walsh & Cunningham, 2016:167; World Bank, 2016). Given the mixed result of the causes of the failure of SMEs, the question is whether the assessment by owners of SMEs and the suppliers of capital agree with each other. This difference in perceptions may affect which solutions are pursued when an SME starts to fail. As a result, owners of SMEs and fund providers could advocate different solutions based on their perceptions. Challenges faced by SMEs in accessing credit from the formal financial sector are discussed below.

2.5 CHALLENGES FACED BY SMEs IN ACCESSING CREDIT FROM THE FORMAL FINANCIAL SECTOR

In spite of the enormous contributions of SMEs to the economy of South Africa (as highlighted in Section 2.3), access to credit facilities from the formal financial sector has been one of the main challenges to the development of SMEs in South Africa (Baltar & Icart, 2013:203; Gastrow, 2013:10; GEM, 2016; Jenkins & McKelvie, 2016:176; Makomeke, Makomeke & Chitura, 2016:69; OECD, 2017). Adzido and Azila-Gbettor (2014:197) posit that there are various challenges that hinder SMEs from accessing credit from the formal financial sector in South Africa. These challenges are as follows: cost of finance; process of applying for credit; lack of collateral; managerial competency; and other challenges (such as lack of formal financial statements, no formal credit history of SMEs, time of processing, other costs and interest rate).

➤ **Cost of finance**

In accessing finance from the formal financial sector, the cost of finance is one of the critical challenges faced by SMEs (Levy, 2015:66). The OECD (2017) economic survey on SME Banking Assessment revealed that the average rate of interest for term loans charged by formal financial institutions in South Africa is between 12-20 percent, while working capital loans are granted at 13-18 percent. Conversely, other costs associated with the cost of finance include legal fees, valuation charges, and stamp duty, among others, which increase the cost of lending for SMEs. In addition, high interest rate, as highlighted by OECD (2017), seriously affect the performance, growth and competitiveness of SMEs. The cost of finance is further discussed in Chapter 4 (Section 4.2.1).

➤ **Process of applying for credit**

Adzido and Azila-Gbettor (2014:197) and Jenkins and McKelvie (2016:176) state that most successful owners/managers of SMEs who attempted to access credit from formal financial institutions maintained the process was one of the most time consuming, uncertain and frustrating activity in their entire business career. In spite of the glossy advertisements by most formal financial institutions offering SME finance in the media, the business reality is different as one has to be in their shoes to understand the dilemmas of SMEs each time they approach formal financial institutions for business credit.

➤ **Lack of collateral**

Within the South African perspective, Fatoki and Smith (2011:1414), Phaladi and Thwala (2008), World Bank (2016) argue that lack of collateral by SMEs, which can be used as leverage, are risky, thus further limiting access to credit from formal financial institutions. The formal financial sector, on the other hand, is also reluctant to make available credit for SMEs without any collateral as confirmed by the World Bank (2016). Furthermore, the World Bank (2016) states that only 10% of all formal SMEs in South Africa have access to credit from the formal financial sector. Consequently, SMEs in South Africa that rely on credit from the formal financial sector for growth and survival are exposed to undercapitalisation, which could result to failure. Collateral and lending is further discussed in Chapter 4 (Section 4.3.1).

➤ **Managerial competency**

Another serious challenge faced by owners/managers of SMEs when accessing finance from the formal financial sector is their managerial competency. Haven (2015) points out that though

owners/managers of SMEs understand the importance of managerial competency when seeking finance, they often pay little attention to it. When the enterprise is small in size, it is easier for owners/managers to successfully manage their own finances. However, as the enterprise grows and increases in size, most owners/managers develop false confidence and believe they can manage the finances (from credits obtained from formal financial institutions, to collections and settlement of creditors) (Fatoki, 2014:141). At this stage, SMEs run the risk of not being able to manage their own finances and access funds from formal financial institutions since they are not sure if such finances will be well-managed by the owners/managers (Brito & Sauan, 2016:4). The impact of managerial competency on lending is further discussed in Chapter 4 (Section 4.3.3).

➤ **Lack of networking**

Lack of networking between owners/managers of SMEs and branch offices of formal financing institutions, especially in rural areas, significantly limits SMEs' access to finance (Briere, Tremblay & Daou, 2015:714). In some instances, formal financial institutions do not have branches in rural areas (branches are located in capital cities and urban suburbs or areas). Owners/managers of SMEs found in rural areas complain that formal financial institutions do not recognise enterprises located in rural areas. Formal financial institutions also maintain they do not have sufficient knowledge about the performance of enterprises located in rural areas and, as a result, they are not in a good position to judge their credit risks sufficiently, resulting in limited financial facilities directed towards them (Makomeke *et al.*, 2016:69). The impact of business networking on lending is further discussed in Chapter 4 (Section 4.3.4).

➤ **Other challenges in accessing finance**

Baby and Joseph (2016:1) state that most owners/managers of SMEs usually approach formal financial institutions for credit to finance their working capital due to shortage in running capital, acquire a new business in order to expand their line of business activities, pursue a business opportunity in the market place, increase their line of production, acquire a new asset or better still, supply products in large orders. According to Adzido and Azila-Gbettor (2014:197) and Jenkins and McKelvie (2016:176), formal financial institutions do not share the sense of urgency and take their own time. Most owners/managers of SMEs maintain business and credit managers within formal financial institutions usually request additional documentation, delay in processing applications and provide non-committal responses, among others, despite having provided proof of confirmed business opportunity.

Levy (2015:68) moots that when SMEs require financing, they usually need it immediately because their management seldom plans operations in advance. Lack of strategic competence to plan for their operations in advance is a further reason why most formal financial institutions reject credit applications from owners/managers of SMEs (Makomeke *et al.*, 2016:69). In addition, the limited or no formal credit history of most SMEs, lack of formal financial statements, and the possession of few immovable assets also compound the process of granting credit to SMEs (Makomeke *et al.*, 2016:70). Notwithstanding, the macro-economic environment, business ethics, legal and judicial system, business intelligence and entrepreneurship education are other factors (discussed in Chapter 4) that might impact on access by SMEs to credit from the formal financial sector.

Given the challenges faced by SMEs in accessing credit from the formal financial sector, Quartey, Turkson, Abor and Iddrisu (2017:21) argue that there is incongruity regarding financial inaccessibility by SMEs. There is a significant difference in the manner in which access to finance is perceived by owners/managers of SMEs and credit providers (formal financial institutions). Owners/managers of SMEs claim that finance is a first challenge while formal financial institutions argue that unscrupulous management or lack of management skills is the main reason and, is in fact, the primary cause of the problem (the inability of SMEs to access finance from the formal financial sector) (Quartey *et al.*, 2017:14). It could, therefore, be concluded that finance may not be the real cause of the failure of business but a consequence of the problem.

2.6 PERFORMANCE OF SMEs AND PERFORMANCE MEASURES

Defining what constitutes the performance of an SME has always been a bone of contention due to its complexity and the wide variety of definitions proposed in the literature (Aminu & Shariff, 2015:157; Mackey & Barney, 2007:819; Richard, Devinney, Yip & Johnson, 2009:719; Santos & Brito, 2012:96). The definition of performance in the business literature cannot be separated from the definition of business failure (Aminu & Shariff, 2015:157) and it can thus, be inferred that, enterprises that have not failed are considered successful because they generate sufficient profit (high performance). Therefore, performance, in terms of failure may be linked to bankruptcy, discontinuance of ownership, the sale of an enterprise to minimise further losses and the discontinuance of business (Ihua, 2009:200). According to Santos and

Brito (2012:96) and Aminu and Shariff (2015:157), the success of every enterprise is basically explained by its performance over a certain period of time.

From a general perspective, Investopedia (2016) defines performance as a measure of how well an enterprise can use its assets from its primary mode of business and generate revenues. On the contrary, Investorwords (2016) defines performance as the result of the activities of an enterprise or investment over a given period of time. Meanwhile, the Business Dictionary (2016) defines performance as the accomplishment of specified business objectives measured against known standards, completeness and cost.

However, it is asserted that the stakeholder theory conflicts with the economic view of value maximisation in defining enterprise performance (Baltar and Icart, 2013:206; Fatoki and Garwe, 2010:731; Richard, *et al.*, 2009; Valsamis, Katsaiti, and Petrakis, 2011:70). The economic view of value maximisation explains that stock holders of a business are only interested in profit maximisation of the business because it affects the rate of return on capital investment (Valsamis *et al.*, 2011:70).

The definition of enterprise performance, according to the stakeholder theory by Freeman, is the most accepted approach in defining enterprise performance. The stakeholder theory considers enterprise performance as “*the sum of the utility created by a firm for its legitimate stakeholders*”. According to the stakeholder theory, an enterprise’s performance should consider all stakeholders internal (owners and employees) and external (customers, competitors and potential investors) in operating an enterprise. Critical to the stakeholder approach in defining and measuring enterprise performance, is the identification of stakeholders and defining the set of performance outcomes that measure their satisfaction in terms of the performance of the enterprise (Freeman in Santos & Brito, 2012:98).

Furthermore, the stakeholder approach emphasises that to better understand enterprise performance, both financial (objective) and non-financial (subjective) measures be used in measuring enterprise performance (Harrison, Freeman and Abreu (2015:859). These measures are discussed below.

2.6.1 Financial (objective) measures of performance

According to Freeman in Harrison *et al.* (2015:859), the financial measures of an enterprise is the art and science of managing an enterprise's finances given that successful financial performance in enterprises has a positive association with the capacity to manage financial issues effectively. Financial measures of the performance of an enterprise are referred to as objective measures of enterprise performance because they can be measured and verified. Likewise, the Business Dictionary (2016) states that financial measures can be expressed as the results of an enterprise's operations in financial or monetary terms and can be derived from the accounts of the enterprise or the balance sheet or in the enterprise's profit and loss statement (Correia, Flynn, Uliana & Wormald, 2011:5-17). The financial measures of an enterprise, as explained in the next section, includes return on equity, return on assets, profitability growth, sales growth, growth in cash flow and growth in turnover.

- **Return on Equity (ROE):** Watson (2011:860) states that the ROE of any enterprise should be the starting point of any systematic analysis of the enterprise performance. The ROE indirectly measures risk by indicating how much an enterprise earned for each Rand invested by its owners. The equation, as highlighted by Watson (2011:861), used to calculate ROE can be represented as:

$$\text{ROE} = \frac{\text{net income after tax}}{\text{total owners' equity}}$$

- **Return on Assets (ROA):** Correia *et al.* (2011:5-18) state that ROA is a very important measure of profitability of an enterprise given that it measures the profitability of an enterprise as a whole in relation to the total assets employed. In simple terms, ROA provides information about how much profit is generated by the enterprise, on average, by each unit of the assets of the enterprise. According to Correia *et al.* (2011:18), ROA is often measured using the following equation:

$$\text{ROA} = \frac{\text{earnings before interest but after tax (EBIAT)}}{\text{total assets}}$$

- **Profitability growth:** Correia *et al.* (2011:5-17) define profitability growth as the growth in the profits of an enterprise. It can also be described as the continuous increase in the financial profit or gain after all expenses have been deducted over a period of time. Profitability growth is considered as one of the objective measures of enterprise

performance as it shows that the enterprise is continuously improving in sales, revenue and profit margin (Correia *et al.*, 2011:17).

- **Sales growth:** Sales growth is an increase in sales over a definite period of time, usually but not always annually (Business Dictionary, 2016) and is regarded as one of the most prominent financial measure of the performance of SMEs (Abor & Quartey, 2010:219).
- **Growth in cash flow:** Growth in cash flow is an increase in the cash flow of an enterprise over a certain period of time, which can be as a result of increase in sales and customer base (Abor & Quartey, 2010:223).
- **Growth in turnover:** Fatoki and Garwe (2010:730) consider turnover as the net sales generated by a business over a period of time. Studies by Fatoki and Garwe (2010:730) and Brijlal (2013) reveal that most enterprises seek credit from the formal financial sector to increase either their working capital or stock due to the high demand for their product. Consistently, Abor and Quartey (2010:223) argue that owners/managers of SMEs may only risk to increase their turnover provided the demand for their products increase.

Kinyua (2014:6) argues that most owners/managers of SMEs are not: comfortable releasing information relating to the financial performance of their business; required to report and publish their financial records (Abor & Quartey, 2010:222; Brijlal, 2013; Fatoki & Garwe, 2010:730); and that it is difficult to obtain the financial figures on profitability and sales (Watson, 2011:6). According to Watson, this difficulty may be more severe in developing countries where very little is done in terms of follow-up on the performance of SMEs when granted credit. To overcome this difficulty (in obtaining financial-related information from SMEs in this study), a 7- point Likert scale in which the levels of satisfaction ranging from 1 to 7 were used rather than using a direct approach. Nonetheless, these measures should not be viewed in isolation given that they might increase as a result of some underlying factors such as price increases or sales promotions and not due to the improved performance of the enterprise or its products. Therefore, in order to fully measure performance, it is important to introduce non-financial measures of performance (hybrid measure of performance).

2.6.2 Non-financial (subjective) measures of performance

Non-financial measures of an enterprise's performance are also referred to as subjective performance measures. From a top management point of view, Likert-type scale questions can be used to measure subjective performance measures of an enterprise's performance (Channar, Talreja & Bai, 2015:232; Marimuthu *et al.*, 2009:266). Using subjective measures of performance to measure an enterprise's performance assists in supplementing financial measures and gives data on improvement relative to competitors or customer requirements and other non-financial objectives that may be essential in achieving profitability. Additionally, non-financial measures can provide indirect and quantitative indicators of an enterprise. The different non-financial measures of enterprise performance, discussed in the next section, includes customer satisfaction, employee growth, satisfaction with performance compared to competitors and overall satisfaction with performance.

- **Customer satisfaction:** Tse and Wilton (1988:204) define customer satisfaction as a process of a consumer's response to the evaluation of the perceived discrepancy between prior expectations and the actual performance of the product as perceived after its consumption. According to Ganiyu, Uche and Elizabeth (2012:15), the definition of customer satisfaction can be approached in two dimensions. The first dimension considers satisfaction as a final situation or as an end-state resulting from the consumption experience while the second dimension emphasises the perceptual, evaluative and psychological process that contributes to satisfaction. Tse and Wilton (1988:206) highlight that customer satisfaction is an important non-financial measure of enterprise performance as satisfied customers are likely to return for repeat purchases and spread positive words of mouth of the enterprise. Customers' referrals might lead to increase in the market share of the enterprise. Customer satisfaction is also considered to be the best indicator of an enterprise's future profit and competitiveness (Ganiyu, *et al.*, 2012:14-15).
- **Employee growth:** Employee growth, according to Beckman and Burton (2008:10) and Wiklund and Shepherd (2005:73), is an increase in the number of employees employed by an enterprise over a period of time. Beckman and Burton (2008:10) moot that an increase in the number of employees indicates an increase in the performance of the enterprise and vice-versa.

- **Satisfaction with performance compared to competitors:** Gerba and Viswanadham (2016:533) state that since most owners/managers of SMEs are hesitant to disclose direct figures of their sales or profits to outsiders (as they are not compelled to do so), such owners/managers prefer to make use of composite measures of performance such as comparing the overall satisfaction of their performance to that of their competitors using Likert Scales.
- **Overall satisfaction with performance:** Owners/managers of SMEs who are satisfied with the overall performance of their enterprise, perform better than those who are dissatisfied with the performance of their enterprise. Using Likert Scales, owners/managers of SMEs can measure their level of satisfaction of the overall performance of the enterprise (Gill & Biger, 2012:458).

It is recommended that both financial and non-financial measures be used together in order to obtain a true measure of an enterprise's performance and no one measure of performance should be considered in isolation of the others (Beckman & Burton, 2008; Brijlal, 2013; Fatoki & Garwe, 2010; Gerba & Viswanadham, 2016; Gill & Biger, 2012). The Business Dictionary (2016) also maintains that both financial and non-financial measures through indirect questions on growth in sales, profitability and overall satisfaction be used in order to obtain a better measure of enterprise performance. In order to achieve a better measure of enterprise performance, both financial and non-financial measures of performance were used in this study to measure enterprise performance as outlined in Sections 2.6.1 and 2.6.2 respectively.

2.7 SUMMARY OF CHAPTER

In this chapter, it was postulated that there is no universally acceptable definition of SMEs. The definition of SMEs as defined by the National Small Business Act 102 of South Africa (1996) as amended in 2003 was used in this study. SMEs were conceptualised with emphasis on the importance of SMEs to development, economic development and sustainable economic development. The development of SMEs significantly contributes to the economy of South Africa in terms of employment and GDP.

The failure of SMEs and the causes of such failure were also discussed. Some of the causes of the failure of SMEs include cost of finance, process of applying for credit, lack of collateral, managerial competency, factors attributed to owners/managers of SMEs (such as lack of formal

financial statements, no formal credit history of SMEs) and other challenges. The first secondary research objective (demand-side) which aimed at addressing the challenges faced by SMEs in accessing finance from the formal financial sector were also explained in this chapter. These challenges include lack of collateral, managerial competency, business networking, business information, cost of finance, cost of labour, process of applying for credit and other challenges in accessing finance. These factors are further researched and critically discussed in chapter four. While owners/managers of SMEs argue that access to finance is the most consistent reason that impede the growth and development of SMEs, credit providers (the formal financial sector) inconsistently argue that lack of managerial skills (which could also perpetuate lack of access to finance) is the major contributor to the failure of SMEs thus justifying the reason behind their inability to access finance in South Africa. The performance of SMEs and their measures of performance were also discussed. Both financial and non-financial measures of performance were used in this study as a measure of performance. Financial measures used included the following: ROE; ROA; sales growth; profitability growth; growth in cash flow; and growth in turnover. Non-financial measures of performance included the following: customer satisfaction; employee growth; satisfaction with performance compared to competitors; and overall satisfaction as measures of enterprise performance. The next chapter focuses on the financing of SMEs.

CHAPTER THREE

A REVIEW OF THE THEORIES OF FINANCE AND THE FINANCING OF SMALL AND MEDIUM ENTERPRISES

Finance, being the life-blood of every enterprise, no enterprise, irrespective of how well managed, can survive without adequate funds for working capital, fixed assets investment, employment of skilled employees and development of markets and new product (Hussain, Millman & Matlay 2008:587).

3.1 INTRODUCTION

The previous chapter provided conceptualisation of SMEs. Two fundamental challenges were identified in Chapter 2 regarding the development of SMEs in South Africa. Firstly, the very high failure rate of SMEs (at 75%) is one of the highest in the world and is also the highest failure rate of all developing countries surveyed by the GEM report of 2014 (Hove-Sibanda, Sibanda & Pooe, 2017:2). Secondly, of the many challenges faced by SMEs, SMEs contend that the availability of and access to finance from the formal financial sector is the primary constraint to the development of SMEs in South Africa (Baltar & Icart, 2013:203; Gastrow, 2013:10; GEM, 2016; Jenkins & McKelvie, 2016:176; Makomeke *et al.*, 2016:69). Non-availability of and non-access to credit for investment by SMEs seriously compromise the performance of SMEs. As a consequence, the financing decision of SMEs whether to use external equity or debt has major implications to the economy of South Africa, given the role SMEs play in employment growth, poverty alleviation and income distribution.

The purpose of this chapter is to provide a review of the literature in order to determine: the financing needs of SMEs, if credit from the formal financial sector is available and accessible to SMEs; the availability and accessibility of different types of equity and debt for SMEs; how formal financial institutions assess and evaluate credit applications from SMEs; and how formal financial institutions perceive investment in SMEs. Owners/managers of SMEs require funds to finance working capital, product development and initial losses and the acquisition of fixed assets. The capital structure theories, such as the static trade-off theory, the agency theory, the agency theory and the hierarchy pecking order theory and how these theories affect the financing of SMEs are also discussed in this chapter. Furthermore, challenges faced by formal financial institutions in lending to SMEs are examined and discussed.

3.2 THE FINANCIAL NEEDS OF SMEs

It is well documented that a well-functioning formal financial sector plays a fundamental role in driving economic growth and development through their ability to spur entrepreneurship development and technological innovation (Brown, Fazzari & Petersen, 2012; Hsu, Tian & Xu, 2014:8; Comin & Nanda, 2014). The formal financial sector is believed to play this role by allocating capital to SMEs with the greatest potential to implement new products and processes and commercialise new technologies. Timmons and Spinelli (2007:389) state that developing financing and fund-raising strategies, knowing what alternatives are available, and obtaining funding are responsibilities fundamental to the success and survival of every SMEs. According to Winton and Yerramilli (2008:52), an SME can start to examine the financial requirements in terms of (1) operating needs (working capital for operations) and (2) asset needs (facilities, equipment, research and development (R&D) and other one-time expenditure) only when the core of the market opportunity and strategy for seizing it are properly defined. Successful owners/managers of SMEs anticipate the investment requirements of their enterprise in order to evaluate, select, negotiate and craft business relationships with the most appropriate potential funding sources.

Garg and De (2014:311) used the Resources Based View Theory (RBVT) to demonstrate the financing needs of owners/managers of SMEs. In accordance with the RBVT, the authors argue that owners/managers of SMEs can only achieve a high level of performance and sustain their competitive advantage provided they can acquire heterogeneous resources (both tangible and intangible resources) that are difficult to create, substitute or imitate by rivalry enterprises. Tangible resources include adequate working capital and fixed assets, among others, and intangible resources include knowledge, expertise and entrepreneurial skills, among others (Ferreira, Azevedo & Ortiz, 2011:101). However, Ferreira *et al.* (2011:101) posit that owners/managers of SMEs with such resources and superior capabilities will build up a basis for gaining and sustaining competitive advantage which, will in turn, yield better performance for the enterprise. Garg and De (2014:312) point out that understanding these resources does not only have a great impact on the enterprise's performance but it also defines the future prosperity of the enterprise.

An empirical study by Ismail, Rose, Uli and Abdullah (2012) revealed that owners/managers of SMEs need physical resources (tangible resources) to seize advantage of business

opportunities. Lack of physical resources is a major constraint for most owners/managers of SMEs considering the fact that opportunities of discovery and recognition requires physical resources to materialise. Thus, owners/managers of SMEs require the essential physical resources and capabilities to successfully pursue their growth strategy. Besides tangible resources, other types of resources (such as human and financial resources) are required to launch and sustain a new business (Ahmad, Halim & Zainal, 2010:69; Akhalwaya & Havenga, 2012:13; Fatoki, 2014:187). Akhalwaya and Havenga (2012:13) state that these resources play different, but equally important roles during the life cycle of the business, be it a new or established business. In addition, Akhalwaya and Havenga (2012:15) argue that one of the most cited reasons for enterprise failure (according to contemporary literature) is 'resource poverty'. Akhalwaya and Havenga (2012:15) conclude that the decisions on what resources are needed, when they are needed and how they are to be acquired are strategic decisions which fit with other driving forces of the development of SMEs.

Since finance is one of the primary resources mandatory in the start-up and survival of a business, non-access to financial resources seriously impairs the ability of owners/managers of SMEs to launch operation at start-up, survive and move the enterprise forward (Tenkorang, Tenkorang, Ujah & Ziwoya, 2016:22). Thus, the financing decision (the use of external equity and/or debt) in financing the operations of SMEs will have fundamental implications for the economy given the role SMEs play in employment and growth. Owners/managers of SMEs need credit from the formal financial sector for different purposes in their operations such as fixed assets, working capital and product development as discussed below.

3.2.1 Fixed assets

Investment in fixed assets (capital investment) involves expenditure on property, machinery, equipment, fixtures, fittings and vehicles. These are long-term tangible assets held for business use for a period greater than 12 months and are not expected to be converted to cash in the current fiscal year of the firm (Correia & Cramer, 2008:33). According to Tenkorang *et al.* (2016:23), one very crucial benefit revered by owners/managers of SMEs from having fixed assets is the fact that it can be used as collateral when applying for credit. Nevertheless, lenders prefer to use fixed assets compared to current assets as collateral given that the value of fixed assets is relatively more stable compared to current assets such as inventories and account receivable.

Studies by Falkena, Abedian, Von Blottnitz, Coovadia, Davel, Madungandaba, Masilela and Rees (2002) and Olawale, Lombard and Herbst (2010) revealed that investment by owners/managers of SMEs in fixed assets in South Africa is very low. Both studies revealed that 75% of the national fixed capital formation is for large companies while SMEs account for only 25% of the national fixed capital formation. This figure reveals that owners/managers of SMEs have a low propensity to invest in fixed assets. The low level of investment in fixed assets is one of the reasons for the high rate of rejection with regard to applications for credit from such owners/managers by the formal financial sector as concluded in both studies.

The low level of investment in fixed assets by owners/managers of SMEs can be associated with the cost of purchasing fixed assets (Bates, Lofstrom & Servon 2010; Manyani, 2014:13). According to these authors, acquiring a fixed asset is a capital intensive project and such owners/managers must be fully committed to it and the source of funding must be carefully planned. For owners/managers of SMEs who heavily depend on support from their families and small social lending groups, it becomes a daunting task to source such huge finance in order to secure a fixed asset. However, Olawale, Lombard and Herbst (2010) point out that one of the ways which owners/managers of SMEs can use to undertake the acquisition of high cost of fixed asset is through ‘bootstrapping’. Bootstrapping is a method of financing that includes a combination of methods (e.g. hire purchase and leasing) that reduces the overall capital requirements, improve cash flow and take advantage of personal sources of financing. Manyani (2014) also found that owners/managers of SMEs with personal wealth, primarily through home ownership, have a very significant chance of securing credits from the formal financial sector compared to those without personal wealth. It can, therefore, be construed that wealthier owners/managers are better positioned to negotiate better credit terms and obtain larger credits for their businesses. If this is true in practice, then the process of assessing and approving credit applications by the formal financial sector from owners/managers of SMEs can be termed “biased”. However, the most likely inference from the literature is that such owners/managers need fixed assets to compete, survive and grow in the market place.

3.2.2 Working capital and cash flow

“Cash flow and cash are the king and queen of entrepreneurial finance” (Timmons & Spinelli, 2007:391).

According to Van Horne (1969) (as cited in Bandara, 2015:355; Roy, 2016:76), the concept of working capital evolved with the identification of components that constitute working capital. Working capital has been defined according to quantitative and qualitative characteristics. From a quantitative perspective, working capital is defined as a collective term for short-term assets such as inventories, cash and cash equivalents (Gitman, 2010; Van Horne, 1969). From the qualitative perspective, working capital is defined as the excess of current assets over current liabilities (Roy, 2016:78). These authors (Nazir & Afza, 2009:144; Pais & Gama, 2015:346; Roy, 2016:76; Saleem & Rehman, 2011:97; Tauringana & Afrifa, 2013:458) are of the opinion that it is in defining working capital according to the different approaches (quantitative and qualitative) that paved a way to the concept of managing working capital components.

Combining the quantitative and qualitative definitions of working capital, Bartlett, Beech, De Hart, De Jager, De Lange, Erasmus, Hefer, Madiba, Middleberg, Plant, Streng, Thayser and Van Rooyen (2014) consider working capital as a firm's short-term assets (cash, inventory, debtors and prepayments) and liabilities (overdrafts, accounts payable and accruals). Padachi, Narasimhan, Durbarry and Howorth. (2008:44) state that "*the need for maintaining adequate working capital can hardly be questioned. Just as circulation of blood is very necessary in the human body to maintain life, the flow of funds is very necessary to maintain a business. If it becomes weak, the business can hardly prosper and survive*". The simple inference to draw from this citation is that SMEs with positive working capital are able to pay off their short-term liabilities and vice-versa (Bandara, 2015:356; Roy, 2016:77).

Empirical studies (such as Havoutis, 2003; Mathuva, 2010; and Sandu, 2008) revealed a significant positive relationship between lack of working capital and failure of enterprises. These authors attribute the high failure rate of SMEs to lack of working capital given that the success and survival of an enterprise largely depends on its ability to generate cash receipts in excess of disbursement. Padachi *et al.* (2008:48) state that the cash flow problems of most owners/managers of SMEs are worsened by poor working capital management.

Despite the noted importance of working capital, one fundamental drawback of this concept with regard to credit application, is that, it is often not accepted as a guarantee or collateral and this might affect the chances of securing external finance (Mills, 2014). Mills (2014) argues that asset structure is an important determinant of a firm's ability to obtain external finance. As

a consequence, firms that have relatively higher levels of fixed assets compared to current assets in their asset structures are better placed to negotiate and access credit from commercial banks and trade creditors.

Consistent with the views of Mills (2014), Tenkorang *et al.* (2016:22) argue that using fixed assets or working capital can also affect the cost of funds and the size of the loan approved. The scholars note that the difference in interest rates between the prime rate and the rate charged on loans to owners/managers of SMEs in Ghana arise from the inability of the typical SME to supply fixed asset collateral. Owners/managers of SMEs that collateralise their loans with current assets are given 50% of their requests and pay an interest rate of about 6 to 8 percentage points above the government borrowing rate. Meanwhile, owners/managers of SMEs that offer fixed assets as collateral, usually get better offers as they can borrow an amount equal to 80% to 95% of the collateral and pay less interest rates around 4 to 5 percentage points above the government borrowing rate. Therefore, it can be construed from this debate that owners/managers of SMEs who depend on current assets such as debtors and inventories (asset-based lending) to secure a loan, find it more difficult to obtain finance from the formal financial sector.

3.2.3 Product development

It is well-known that product development leads to the improvement of an existing product or introducing a new product on the market for the continuous success of the business (Kok and Ligthart, 2014:32). In turn, product development contributes to the growth of the SME, has a significant impact on the profitability of the enterprise and its role as a key factor in business planning cannot be underestimated (Ulrich & Eppinger 2011). Bhuiyan (2011:747) defines product development as the process whereby a firm acquires knowledge to create a new product or improve an existing product that will serve the needs and wants of customers who are already buying a firm's product. Bhuiyan (2011:747) and Ulrich and Eppinger (2011) argue that though product development requires ample time and funding to bring it to fruition, product development has become a key determinant in gaining competitive advantage.

New product development and technological innovation is the life blood of most new and established enterprises that enter the market and can benefit from the advantage of being the first mover and pioneer which they can use to gain acceptance (Mahdavi-Mazdeh, Jafari,

Akhaven and Mousavi, 2016:122). Fatoki (2014:184) and Smith and Watkins (2012:6326) moot that because of the cost associated with product development and other sunk costs involved before launching the business, most SMEs often start with initial losses. According to Fatoki (2014:184) and Smith and Watkins (2012:6326), most SMEs start with a loss and then achieve breakeven after several months or even years. Such initial losses often affect the ability of the enterprise to continue operation. As a result, funds are needed to finance these initial losses.

3.2.4 Other reasons for finance

According to OECD (2015), other reasons why owners/managers of SMEs may require external finance include the development of human capital, training, expansion, investment in research and development (R&D) and technology. The Theory of Human Capital developed by Becker in 1964 suggests that both knowledge and skills are a form of human capital and, though it is substitutable, it is not transferable like land, labour, or fixed capital. Although the general application of human capital is on employees in order to assist owners/managers of SMEs achieve their objectives, there is no reason why it should not apply to such owners/managers as well. Owners/managers of SMEs with higher general and specific managerial skills are expected to show higher levels of performance than those with lower levels of general and specific human capital. This is termed Entrepreneurial Human Capital (EHC). EHC refers to an individual's knowledge, skills and experiences related to entrepreneurial activity and is fundamental to the development of SMEs (Hessel & Terjesen, 2008; Ramezanzpour, Amiriyani & Shirazi, 2014:600). Fatoki (2014:185) states that novel owners/managers of SMEs will require more specific expertise and highly skilled employees compared to established SMEs to attain their growth objective.

Information and communications technology (ICTs) and R&D are also major areas of concern for owners/managers of SMEs. According to Ebrahim, Ahmed and Taha (2010:917), the SME sector is one of the sectors that has a strong potential to benefit from advances in ICTs. According to Ebrahim, *et al.* (2010:918), both new and established enterprises should make proper use of latest ICTs as it is considered a strategic factor for innovation and growth. Given that owners/managers of SMEs face unprecedented challenges in an ever dynamic, constantly changing and complex business surrounding, such owners/managers can better access external services and resources such as debt finance and also create business networks through

collaborative R&D and ICTs (Ebrahim, *et al.*, 2010:918; Redoli, Mompo, Garcia-Diez, & Lopez-Coronado, 2008:423). Therefore, ICTs and R&D are important for the development of SMEs in the areas of information provision, access to national and international markets, and other areas of business development and support. ICTs also enable owners/managers of SMEs to manage their businesses efficiently and thus, enhancing their competitiveness.

To summarise, the tangible and intangible assets possessed by most owners/managers of SMEs are primary determinants of their strategy and performance. Limited resources may severely hamper a range of possible strategic alternatives available to owners/managers and put enterprises at a disadvantage to relatively better endowed and entrenched competitors. Thus, it could be interpreted that the performance of owners/managers of SMEs in a particular industry depends upon more than just a good idea. It is one thing to formulate a broad scope, low-cost strategy based on a new technological process; and it is quite another to secure the resources and build the competence necessary to implement such strategy. Finance, being the lifeblood of any enterprise, even established enterprises with carefully planned and designed strategies cannot survive if such enterprises do not have sufficient capital to finance operations. However, access to external finance is also dependent upon the owners/managers' ability to secure tangible resources that can be used as collateral. Thus, the probability of the short-term survival of SMEs with adequate tangible resources should be high because initial losses can be easily absorbed (Mills, 2014).

Summarily, owners/managers of SMEs need credit from the formal financial sector to meet working capital requirements, fixed assets investment, employment of skilled employees and development of markets and new products. The finance can come in the form of equity, debt or a hybrid of debt and equity. The combination of the different financing options (debt and equity) constitutes the capital structure of an enterprise. Section 3.3 provides a definition of capital structure, a discussion on different theories on capital structure as it relates to SMEs and how they impacts on the performance of SMEs.

3.3 CAPITAL STRUCTURE

One of the areas in corporate finance that has attracted a great deal of academic research is the relationship between an enterprise's cost of capital, its value and its capital structure (Claude, 2016:106; Gitman, 2010:488; Mathuva, 2010:2). Claude (2016:106) defines capital structure

of an enterprise as the mix of long-term debt and equity used by the enterprise to finance its operations. According to Claude (2016:106) and Gitman (2010:490), the capital structure decision is one of the most difficult decisions faced by any enterprise considering the fact that effective capital structure decisions can lead to lower cost of capital and enhance shareholders' wealth. Poor capital structure decisions can lead to high cost of capital and low profitability.

Gitman (2010:452) defines the cost of capital as the rate of return that a SME must earn on its investments in order to ensure that the minimum requirements of all the providers of funds are met. In other words, it is the value that providers of funds expect from their investment. Though it is difficult to determine the optimal combination of equity and debt financing of an enterprise (optimal capital structure), corporate finance theory on the maximisation of profit asserts that the value of a SME is maximised when its cost of capital is minimised. The optimal capital structure, therefore, is the combination of debt and equity at which the weighted average cost of capital of a SME is minimised and shareholders' wealth maximised. The weighted cost of capital can be described as the average cost of debt and equity funding weighted by the proportion of the firm's capital structure that the two components constitute (Gitman, 2010:453; Claude, 2016:107). In addition, Palombini and Nakamura (2012:56) highlight that the difference in the optimal capital structure of SMEs and large companies is primarily as a result of information asymmetry between SMEs, large companies and credit providers. Palombini and Nakamura (2012:56) further highlight that SMEs have stronger incentives to source external debt relatively to external equity in order to maintain the leverage of ownership and control.

Forte, Barros and Nakamura (2013:350) state that the theory of Capital Structure is critical because the financing mix of an enterprise can have significant impacts on its performance. The importance of capital structure decisions is evident from the role of inadequate capitalisation in the high failure rate of SMEs. Ahmeti and Prenaj (2015:915) and Alifani and Nugroho (2013:3) argue that a poor capital structure can affect all areas of an enterprise's operations, creating problems such as unreliable operations, ineffective marketing and the inability to hire qualified personnel. On the contrary, adequate capitalisation can enable enterprises to acquire the necessary resources to pursue market opportunities successfully, thus leading to business growth.

Tucker and Stoja (2011:209) argue that enterprises with growth ambitions need capital to fuel their growth irrespective of the age or size of the enterprise. In addition, Barringer and Ireland (2008), Fain, Moes and Duhovnik (2010:524) and Fatoki (2014:5) assert that access to capital by enterprises is a matter of extreme importance and understanding the capital structure of SMEs is important for both theoretical and practical reasons. Capital structure theories are discussed below.

3.3.1 Capital structure theories

According to Alifani and Nugroho (2013:3) and Lemmon and Zender (2010:1164), a theory is a set of systematically interrelated concepts, definitions, and propositions that are advanced to explain and predict facts. It can be explained by the framework of assumptions and concepts in which it is embedded. Hence, theoretical frameworks according to Lemmon and Zender (2010:1165), can be explained as orientations or ways of looking at the problem in a research. They narrow the range of facts needed in a study, summarise what is known about an object of study, and identify the uniformities that lie beyond immediate observation. Alifani and Nugroho (2013:3) add that theoretical frameworks also provide collections of assumptions, concepts, and forms of explanation. Concepts and constructs are used at the theoretical level, while variables are used at the empirical level.

The different theoretical models on the financing of SMEs are extant, originating from the traditional concept of Modigliani and Miller (1958) regarding the financial behaviour of SMEs. Since then a number of theories have been postulated on the financial behaviour of SMEs these theories seek to explain such behaviour, taking into account the characteristics and problems of the SME. Alifani and Nugroho (2013:3), Palombini and Nakamura (2012:57) and Lemmon and Zender (2010:1164) highlight that the theoretical principles underlying capital structure can generally be described in terms of the static trade-off theory of Modigliani and Miller (MM) (1963, 1958), the agency theory of Jensen and Meckling (1976) and the pecking order theory of Myers (1984). For the purpose of this study, these three theories constitute the theoretical framework used in this study.

3.3.1.1 Static Trade-off Theory (STT)

Lemmon and Zender (2010:1163), Palombini and Nakamura (2012:57) point out that the term trade-off theory is used by different authors to describe a family of related theories. The Static

Trade-off Theory maintains that a decision-maker running an enterprise (owners/managers of SMEs) evaluates the various costs and benefits of alternative leverage plans. According to Berzkalne and Zelgalve (2014:23), the origin of STT grew out of the debate over the seminal work of Modigliani and Miller theorem, in their famous Proposition I- often referred to as the 'Irrelevance theorem'. The irrelevance theorem emphasises that, as an implication of equilibrium in perfect capital markets, the choice of capital structure of an enterprise does not affect the enterprise's market value. Moreover, Berzkalne and Zelgalve acknowledge that Modigliani and Miller made two fundamental contributions in the context of the modern theory of finance.

Firstly, it represents one of the first formal uses of a no arbitrage argument (*via* the 'law of one price' is longstanding). More profoundly, it structures the debate on why irrelevance fails around the theorem's assumptions: (i) neutral taxes; (ii) no capital market frictions (i.e., no transaction costs, asset trade restrictions or bankruptcy costs); (iii) symmetric access to credit markets (i.e. firms and investors can borrow or lend at the same rate); and (iv) firm financial policy reveals no information. Though all these assumptions do not hold in a real world, they constitute the basis of the theories that trailed after Modigliani and Miller's irrelevance theorem. Based on all these assumptions, it is, therefore, construed that it is the assets of an enterprise that determine the value of the enterprise and not the way in which these assets are financed (Berzkalne & Zelgalve, 2014:24).

Secondly, the Modigliani and Miller (1963) theorem added corporate income tax to the original proposition based on the fact that a perfect capital market condition does not exist in the real world. Given that interest payments on business debt are tax-deductible, this results in debt being cheaper compared to equity since it can serve to shield earnings from taxes. Therefore, by creating tax savings for the borrower, it becomes possible for businesses to minimise their costs of capital and maximise shareholders' wealth by using debt. According to Berzkalne and Zelgalve (2014:25), the mix of cheap debt with relatively expensive equity reduces a firm's cost of capital. This is known as the leverage effect of debt, and refers to the use of debt capital to minimise an enterprise's cost of capital and maximise its profitability. Convincingly, the tax benefit of debt significantly reduces the cost of debt in an enterprise's capital structure. Given a 28% corporate tax rate in the Republic of South Africa, tax deductibility of interest payments on debt can make the cost of debt much lower than that of equity. Debt, therefore, contributes to the achievement of a higher return on equity (Modigliani & Miller, 1963).

According to Miller and Modigliani (1963:435), the only way a firm can take absolute advantage of the tax-shield is to have 100% debt in its capital structure. Scott (1972:45-60) and Kraus and Litzenberger (1973:911-922) as cited by Jong, Verbeek and Verwijmeren (2011:1304) point out that theoretically, 100% tax shield does not exist in a real world because of the costs of financial distress. The main argument of these researchers (Kraus & Litzenberger, 1973:911-922; Jong *et al.*, 2011:1304) is that debt leads to a legal obligation to pay interests and principal. If an enterprise cannot meet its debt obligations, it is forced into bankruptcy and incurs associated costs. Gunasekaran (2010) found that the physical advantage of debt might not be applied to the SMEs context because these institutions are less likely to be profitable and, therefore may not be able to use debt in order to get tax shields. Moreover, the primary advantage of debt, the tax shield, can be especially complex to assess in SMEs where business income is often taxed as personal income. Nevertheless, given the tax shields of debt financing, enterprises may be tempted to use more debt in their capital structure. Berzkalne and Zelgalve (2014:23) warn enterprises of the cost of bankruptcy to avoid the use of debt. Berzkalne and Zelgalve state that the cost of bankruptcy is high and the expected costs of financial distress may outweigh any potential benefit from the tax shield. In addition, the cost of insolvency is high because many SMEs do not have fixed assets that are easily marketable and the variability of their operating income can be quite volatile. Given that SMEs rarely generate profit in the early stage of operations, the potential benefits of tax shields of interest payments remain uncertain. Therefore, the optimisation of capital structure involves a trade-off between the present value of the tax rebate associated with a marginal increase in leverage and the present value of the costs of bankruptcy.

A number of empirical studies (Ahmeti & Prenaj, 2015:915; Akinlo & Asaolu, 2012; Chowdhury & Chowdhury, 2010; Robb & Robinson, 2012) are in accord with the views of Modigliani and Miller (1963) that the benefits from debt are significant, and that the use of debt increases the market value of the firm. According to Modigliani and Miller, financial leverage has a positive effect on the firm's return on equity, if only the earning powers of the firm's assets (i.e. the ratio of the earnings before interest and taxes to total assets) is greater than the average interest cost of debt to the enterprise. On the contrary, studies by Adenugba, Ige and Kesinro (2016); Phillips and Sipahioglu (2004) found that the tax rewards of leverage are insignificant.

Considering the fact that the performance of SMEs in South Africa has been under scrutiny, the most significant contribution of STT is the fact that the theory advocates that the optimal capital structure of SMEs varies. According to Anderson and Carverhill (2012:799), the capital structure of SMEs depends on the stability of sales, the operating leverage and the size and stability of profits. Given the high failure rate of SMEs in South Africa, it can be understood that majority of SMEs in South Africa have low profits, unsteady sales and often a high operating leverage. This, however, implies a low level of debt. The major factors causing the low level of profitability of SMEs in South Africa can be attributed to low sales and high operating costs as weak sales leads to high operating costs. Correia, Flynn, Uliana and Wormald (2011) point out that enterprises with low sales, with each sale contributing a very high gross margin are said to be highly leveraged and vice-versa. Thus, weak sales and profitability and high operating leverage suggest that SMEs should use less debt finance in their capital structure. This point however contradicts the fact that Modigliani and Miller (1963) suggest that firms should make use of the tax advantage of debt and go for 100% debt in their capital structure. Therefore, it can be concluded that the main advantage of debt, “the tax shield” cannot be applicable in the SMEs context.

Despite the fundamental contributions of the Modigliani and Miller proposition (1958, 1963) in the context of the modern theory of finance, the seminal work of Modigliani and Miller was heavily criticized for the fact that it assumes owners’ goals are targeted only at maximizing profits (Abor, 2004:62; Bartlett, et al.,2014). In addition, Bartlett et al., (2014) debated the assumption that investors and managers have access to the same information about the enterprise may only be valid for companies as the majority of enterprises especially SMEs in South Africa are unlisted. Base on this assumption, Tengeh, Ballard, and Slabbert (2011:5) highlight that information about the financial wellbeing of SMEs are often either incomplete or inaccurate or unavailable. As such, the issue of information asymmetry between the borrowers and lenders (formal financial sector) might cause potential debt financing problems for most enterprises.

3.3.1.2 The Agency Theory

The article by Jensen and Meckling (1976) entitled “*Theory of the Firm: Managerial Behaviour, Agency Costs and Ownership Structure*” helped in establishing the agency theory as a dominant theoretical framework of corporate governance literature, and positions

shareholders as the main stakeholder (Daily, Dalton, & Cannella, 2003:373; Fama, 1980:289; Heath, 2009:499; Lan & Heracleous, 2010:297). According to Lan and Heracleous (2010:299), the agency theory addresses what has become a growing concern, that management engages in gathering wealth for themselves and possesses a general disregard for shareholders' interest; what Jensen (1989:64) refers to as "*the systematic fleecing of shareholders and bondholders*". Jensen (1989:66) argues that the systematic fleecing of shareholders (owners of the business) and bondholders provide a pathway and guidance as to how shareholders should control the agent to curb managerial opportunism and self-interest.

The agency theory is built on the existence of information asymmetry, causing conflict among different agents, shareholders and managers (Heath, 2009:498; Mahajan & Tartaroglu, 2008:756; Shapiro, 2005:265). According to Jensen and Meckling (1976:306), the primary cause of conflicts between shareholders and managers arise simply because managers do not hold total residual claim thus, they cannot capture the entire gain from their value-maximising activities. Therefore, the interests of managers and shareholders are not always the same given that the inside manager has, on average, more and better information than the outside investor, resulting in conflict as to how the enterprise should be governed.

Degryse, de Goeij and Kappert (2012:434) point out that information asymmetry is not only limited to managers and shareholders but also exists between equity holders and debt holders; with transaction costs being the centre of the debate. These costs prevent markets from operating efficiently given that they occur both on the side of the lender and the borrower. The costs involved on the lender's side are: the costs of information gathering; loan administration; enforcement; and other costs associated with lending. Meanwhile, the different charges imposed by lenders such as interest payments, application fees and administration fees are some of the costs associated to the borrower.

However, Jensen and Meckling (1976:306) explain that the conflict between equity and debt holders arise simply because debt contracts give equity holders an incentive to invest sub-optimally. The debt contract results in asymmetric distribution of profits, implying that if an investment is profitable above the face value of debt, most of the profit is captured by equity holders, while if investment fails, debt holders bear all the consequences because equity holders are protected by the limited liability clause. Consequently, equity holders may benefit from investing in very risky projects, even if they are value-decreasing. Such investments result in a

decrease in the value of debt, while the loss in the value of equity due to poor investment is more than offset by the gain in equity value transferred from debt holders.

Empirical studies, such as Fatoki (2014:95); Lan and Heracleous (2010:298); Padachi, Howorth and Narasimhan (2012:128) revealed that the agency theory provides vital insights into the problems of ownership, management interrelationships and credit rationing. Issues such as information asymmetry, moral hazard and adverse selection are most likely to arise in contractual agreements between enterprises and external providers of funds such as the formal financial sector. The severity of these issues and the high costs associated to it has proved to be more damaging for SMEs than for large companies. SMEs are also subject to the risk of asset substitution, which, in practice, implies a change in the enterprise's asset structure. This change may take place between the enterprise and the owner's household. In effect, the proximity to the household, weak financial disclosure, lack of legal formalisation and the owner-manager nature of SMEs, make it very tough for lenders to keep track of changes to the asset base of SMEs. The use of asset as collateral for lending to SMEs may be the explanation for dealing with these agency problems. However, strategies used by the formal financial sector in dealing with these agency problems also contribute significantly to the cost of dealing with the sector. For instance, the evaluation of an application for credit by a large company may be limited to the assessment of an audited set of financial statements and other supporting documents provided by the applicant. The case is, however, very different for SMEs as it goes far beyond, implying a substantially higher transaction cost, given that most SMEs might not have the proper set of financial statements required by the lender. According to Fatoki (2011:98), the two primary problems in lending are moral hazards and adverse selection.

Dobbie and Marta (2013:257) explain that moral hazard occurs in credit markets when SME owners/managers engage in risk sharing under situations such that their personal dealings is likely to affect their chances of the final outcome. Moral hazard may also occur in a credit market in situations where increasing interest rate encourages the borrower to invest in a project that yields a lower return than a project with a higher return as the borrower has a choice of projects to choose from. The assumption under this situation is that both the lender and the borrower are risk neutral and has the option to choose from two available projects (safe or risky). The risky project has a higher return but with a lower probability of success compared to the safe project with a lower return but a higher probability of success. Given that the formal financial sector does not know which project has been considered, the interest rate in a case

like this will act as an incentive mechanism and not as a selection mechanism as in the case of adverse selection, since it affects the dealing of the borrower once the credit is obtained. However, as the interest rate keeps on increasing, the borrower is encourage to switch from the safer project to the risky project because of the negative net returns the safe project will produce in times ahead.

Degryse *et al.* (2012:436) posit that the formal financial sector prefers to keep interest rates low and, instead, ration credit in order to restrict excess demand due to their risk averse attitude. Thus, information asymmetry, adverse selection and moral hazard can have a significant impact on the availability of credit from the formal financial sector. Stiglitz and Weiss (1981:394) refer to this phenomenon as “*credit rationing*”. According to Stiglitz and Weiss, credit rationing can only occur if:

- Among credit applicants who appear to be identical - some receive credit while others do not; and
- Within a certain population, there are identifiable groups that are not able to obtain credit or can only obtain credit at a much higher interest rate.

The central debate by Stiglitz and Weiss is the fact that the formal financial sector may choose to offer different interest rates that would leave a huge number of potential borrowers without access to credit. The Stiglitz and Weiss philosophy thus, suggest that there are a significant number of SMEs that could make proper use of debt finance if they were available. It is for this reason that Adzido and Azila-Gbettor (2014:197), Ramlee and Berma (2013:118) explain that moral hazard and adverse selection are more severe in SMEs compared to large companies because the transaction costs of debt are business specific and investors (such as the formal financial sector) prefer to invest in established and stable businesses where it would be easier for them (the formal financial sector) to monitor. The monitoring is to avoid unnecessary costs arising from post-contractual opportunism (i.e. moral hazard costs). It is for this reason that Adzido and Azila-Gbettor (2014:197), Ramlee and Berma (2013:118) further suggest collateral lending to SMEs as a way of dealing with these agency problems.

However, despite the problems, credit providers such as formal financial institutions write credit contracts that include elements that will make it more likely that the credit will be paid. Lending activities entails: (a) acquisition of information regarding the characteristics of credit applicants (screening problem); (b) the exchange of goods today for payment in the future in

the case of trade credit; (c) measures to ensure that borrowers take those actions which make repayment most likely (incentive problem); and (d) enforcement actions to increase the likelihood of repayment by those borrowers who are able to do so.

Adzido and Azila-Gbettor (2014:197) state that the agency costs argument suggests a pattern of relationship for the capital structure of SMEs. This pattern is low-high-low. This implies that owners/managers of SMEs should have low amounts of debt at the beginning of their business, high amounts of debt as the enterprise develops and low amounts of debt at prime when the enterprise would have accumulated enough retained earnings. The agency cost theory thus, suggests that SMEs should depend heavily on internal equity with very minimal debt as the debt level will increase gradually as the enterprise grows to become established. Contrary to the agency theory, Frelinghaus, Mostert and Firer (2005:11) question why enterprises at the growth/developed stages should have more debt than those in the beginning and prime stages. Considering the fact that internal equity is not enough for SMEs to survive and grow since external equity is very expensive and not available for most SMEs, such enterprises rely heavily on debt finance for survival and growth.

3.3.1.3 The Pecking Order Theory

One of the most influential theories in corporate finance is the Pecking Order theory (POT), initially propounded by Donaldson (1961) and later developed by Myers (1984) and Myers and Majluf (1984) in an attempt to explain the reasoning behind an enterprise's financing decisions. This theory is built on the premise of information asymmetry and can be seen as a model of financial hierarchy (Armada, Nunes & Serrasqueiro, 2011:386; Atiyet, 2012:6; Seifert & Gonenc, 2010:4). According to Atiyet (2012:7), information asymmetry exists for two reasons: (a) it is assumed that managers of the enterprise always act in the best interest of existing shareholders (Myers, 1984:576; Myers & Majluf, 1984:189); and (b) it occurs between the managers of the enterprise and potential investors as a result of the leverage (information) managers have over potential investors, which, in turn, creates an adverse selection problem. As a result, potential investors are unable to make correct investment decisions based on the information managers convey. Investors are, therefore, strong-armed to explicitly use the financial strategy of the enterprise and make rational decisions accordingly.

Due to the adverse selection problem, certain types of debts are preferred by management of an enterprise over others. Management will have preference to choose internal financing instead of external financing since the former has the advantage of no transaction costs and no adverse signal sent to the market. The concept of information asymmetry, as highlighted by Armada *et al.* (2011:387), suggests that external finance would be more expensive than internal finance, as financiers add a risk premium to cover financing risk. In a case where managers are forced to make use of external sources of financing, managers select the least risky and demanding source first. When it is necessary to issue external sources, debt issuance is preferred to new equity (Myers, 1984:577; Myers & Majluf, 1984:189). Irrespective of the amount of equity financing or debt financing in the capital structure of the enterprise, Myers (1984:577) suggests that there is no well-defined optimal capital structure: as the debt to equity ratio is the result of hierarchical financing over time.

Contemporary studies on the financing of SMEs such as Adair and Adaskou (2015:2), Bhaird and Lucey (2010:359), Kira and He (2012:110), Menike (2015:57) are in agreement with the application of POT in explaining the financing of SMEs. According to these studies, SMEs should heavily depend on internal sources of finance rather than using external borrowing to finance their operations and growth. According to POT, internal sources of financing (retained earnings and internal equity) should be prioritised while the use of external sources should be delayed until internal sources are exhausted. As such, when seeking finance, an enterprise prefers internal equity to external debt, short-term debt to long-term debt, and external debt to external equity. Therefore, the order of preference for the sources of financing for SMEs should follow retained earnings, internal equity, issuing debt and then issuing equity. However, only a handful of SMEs use external equity such as angel and venture capital as concluded by Adair and Adaskou (2015:2), Bhaird and Lucey (2010:359), Kira and He (2012:110), Menike (2015:57). Thus, owners/managers of SMEs will always prefer debt finance to equity finance as a source of additional financing for investment in situations where internal finances are insufficient.

Adair and Adaskou (2015:2-3), Arena (2011:393), Menike (2015:56) explain that personal finances, finances from families and friends, and debt financing are the most important sources of financing for start-up businesses. With respect to the growth lifecycle of an enterprise (lifecycle theory), POT suggests that every enterprise in the early stages of development (start-up businesses), with little retained earnings and internal equity, should go for maximum

available debt finance before resorting to external equity. On the contrary, established enterprises (according to POT) should go for less debt finance than they did in their high-growth phase because they generate sufficient retained earnings. Studies by Abdulsaleh and Worthington (2013:37), Oswald and Gardiner (2005:385), and Sanchez-Vidal and Martin-Ugedo (2005) also support the fact that older and established enterprises should be less reliant on external sources of financing than new and younger enterprises because older and established enterprises have more opportunities to accumulate retained earnings than younger ones. In South Africa and most other developing economies, SMEs do not have sufficient retained earnings. As a result, they have to depend on debt, which is the next source of finance in the POT hierarchy.

Helwege and Liang (1996) tested POT in an attempt to examine the financial decisions of a sample of SMEs between 1984 and 1992. The results of their study revealed that the financing patterns followed by enterprises in their sample did not match the pattern suggested by POT. Contrary to what POT suggests, they further found no evidence of a significant relationship between the raising of finance externally and a deficit in internal sources. In addition, while POT predicts that the issuance of equity should be avoided by enterprises with greater information asymmetry, their findings show that asymmetric information variables have no power to affect such decisions.

Summarily, it is recommended in POT that enterprises should first use internal finance before moving into external finance (such as credit from the formal financial sector). Furthermore, in case an enterprise decides to use external finance, debt finance should be used before new equity. On the contrary, Crnogoj and Mramor (2008) found that SMEs in developed countries, use internal equity together with debt at start-up. This is termed the 'modified POT'. The modified POT involves new capital contributions from owners ranking behind internal finance, but in front of debt finance. Therefore, the order of preference for the sources of financing for an enterprise should follow retained earnings, internal equity, debt and external equity (Ang, 1991). The modified POT seems to be limited only to SMEs in developed countries. For instance, research conducted by the Kauffman Foundation (2007) revealed that 75% of the start-up capital of SMEs in the United States of America is made up in equal parts of owner equity and bank loans and/or credit card debt, underscoring the importance of liquid credit markets to the formation and success of SMEs. Meanwhile, most SMEs still find it very

difficult to access debt finance in a developing country, such as South Africa, as revealed by Fatoki and Smith (2011).

When considering the three theories together (the static trade-off theory, the agency theory and the pecking order theory), Frelinghaus *et al.* (2005:13) highlight that the theories are in agreement with the fact that the inadequacy of owners' contribution and lack of retained earnings for most SMEs are responsible for their poor performance. Furthermore, the fact that most SMEs in South Africa experience low sales and profit (highly leverage) makes all three theories very applicable. In addition, external equity is very expensive and not usually available to SMEs in South Africa, hence their reliance on credit from the formal financial sector. Thus, the question that comes to mind is how much debt should an SME use in its capital structure. This is explained by examining the optimal capital structure of SMEs in the next section.

3.3.2 Optimal Capital Structure

Ahmadimousaab, Anuar, Sofian and Jahanzeb (2013:891) state that the issue of optimal capital structure remains a puzzle to scholars. Ahmadimousaab *et al.* (2013:892) further posit that there are a number of theoretical conceptions in which scholars try to formulate a formula to determine an optimal capital structure given that the theories of finance have failed to determine a common formula which would enable an indication of a target optimal capital structure for a particular enterprise. As a consequence, Graham (2000) and Strebulaev (2007) argue that most researchers in the field of capital structure have observed that many enterprises are geared below the optimal levels (just to list a few, MM proposition I suggests 100% debt to 0% equity, Gitman (2010) suggests 60% debt to 40% equity, Havakimian, Opler and Titman (2001) suggest 100% equity to 0% debt) that are predicted by theory.

In practice, however, though there are many problems associated with the determination of an optimal capital structure of an enterprise, most theoretical conceptions are based on the assumption that the optimal capital structure is the one that provides the maximum value of an enterprise. According to the static trade-off theory, an enterprise that uses debt finance has its value shaped depending on both tax benefits (resulting from including the interest into tax costs) as well as on financial distress stemming from the risk of insolvency that accompanies the use of debt finance. In line with the static trade-off theory, the argument of the agency cost

theory is that the optimal cost of debt is the trade-off between the tax advantages of debt and the agency cost of debt (Adzido & Azila-Gbettor, 2014:198). The pecking order theory, on the other hand, which is based on the assumption that there is no optimal capital structure, advocates that the observed debt ratio of each enterprise reflects its requirements for external finance (Menike, 2015:57). Ghazouani (2013:623) defines the optimal capital structure of an enterprise as the debt to equity ratio that minimises the value of the weighted average cost of capital (WACC), and, as such, maximises the value of the enterprise.

According to Mangafic and Martinovic (2015:182), one of the primary objectives in raising finance is to avoid exposing the business to excessively high borrowing thereby, ensuring that the financial risk of the enterprise is kept at an optimal level. Mangafic and Martinovic concur with the fact that a very high debt to equity ratio is not healthy for the enterprise and the enterprise might lack fiscal stability in the future. Equally, the South African Reserve Bank (2015) maintains it is very vital for every business to examine its financial needs and the timeline for reaching certain financial goals in order to determine the optimal capital structure of the business.

Abdulsaleh and Worthington (2013:38) point out that since collateral has become very vital to credit providers, such as the formal financial sector, when it comes to the approval of credit, it is also very vital to determine how assets are financed. The three options an enterprise can use to finance its assets include: (a) the aggressive approach that suggests financing fixed assets and the permanent portion of current assets with long term sources; (b) the moderate approach that suggests financing assets with terms that match their life span; and (c) the conservative approach that suggests permanent working capital, financing fixed assets and a portion of seasonal working capital with long-term sources.

Doove, Gibcus, Kwaak, Smit and Span (2014) suggest that the conservative approach is most likely to favour SMEs. Consistently, Chin and Nor (2016:282) agree that SMEs should make use of long-term debt finance in financing their fixed and permanent current assets in order to allow the enterprise to reach cash flow breakeven. Chin and Nor (2016:283) and Doove *et al.* (2014) argue that though debt finance allows owners/managers of SMEs to increase the value of the enterprise without diluting ownership, in case of any hardship, such owners/managers might be forced to sell assets, take cash infusion to retire debt or principal payments or, in the worst case scenario, lose control of the enterprise. Mangafic and Martinovic (2015:184) argue

that SMEs must not only rely on long-term debt but should also make use of short-term debt. According to Mangafic and Martinovic (2015:184), the fact that most SMEs find it difficult to access long-term credit from the formal financial sector, most debt finance of owners/managers of such enterprises come from short-term credits. Mangafic and Martinovic conclude that due to the risk averse attitude of the formal financial sector, they prefer to lend to SMEs on a short-term rather than long-term bases.

As pointed out by the various capital structure theories, the sources of finance for SMEs are debt and equity. Equity can be divided into two types: internal and external equity. Sections 3.3.2 and 3.3.3 focus on the various sources of equity and debt available to SMEs.

3.3.3 Equity

Abdulsaleh and Worthington (2013:40) define equity capital as that capital invested in the business without a specific repayment date, where the suppliers of equity have a residual claim on the business, and do not create a tax advantage from its payments. The authors maintain equity contribution has an infinite life, does not have priority in bankruptcy and provides management control to the owner. Abdulsaleh and Worthington (2013:39) argue that providers of equity are often referred to as the real owners of the business and their equity contribution to the business demands that dividends be paid to them in cases where the business makes profits. However, in situations where the business is not making any profit, equity holders of the business bear all the loss. Equity holders are also referred to as residual owners, because they receive what is left after all the claims on the business' assets and incomes, such as debenture interests and preference share dividends, have been satisfied. Abdulsaleh and Worthington (2013:37) highlight that equity can be raised either internally or externally.

3.3.3.1 Internal equity

Abdulsaleh and Worthington (2013:40) state that equity finance is finance obtained from the current owners/managers, family and friends or from the retained earnings within the business. Internal equity, is best represented by owner-manager(s) personal savings and is a critical source of financing for SMEs in the early stages of operations (see financing and start-up). Wang (2016:168) moots that the most difficult time for an enterprise to raise finance is when it is starting up or just beginning to expand. A start-up enterprise typically has few assets and no market track record, so the chances of raising debt capital from the formal financial sector

is very slim. Internal equity financing is preferred over debt and external equity as a mode of financing for SMEs because the marginal cost of capital is significantly lower for internal financing compared to external financing. In addition, the authors maintain the formal financial sector finds it very difficult to grant credit to SMEs if the owners are not willing to put their own money at risk.

Universally, Cant, Erdis and Sephapo (2014:570) point out that the capital needs for most SMEs arise when the expected cash outflows outweigh the expected cash inflow. Under such circumstances, the capital needs can be fulfilled either by equity capital or debt capital. According to Cant *et al.* (2014:570), two fundamental merits of using internal equity financing capital over other sources of capital are as follows: firstly, internal equity financing offers long-term financing with minimum cash outflow in the form of interest; and secondly, internal equity financing capital helps to enhance a new/young enterprise's creditability by indicating that the enterprise has the approval of sophisticated financial professionals. Cant *et al.* (2014:571) further note that internal equity can assist owners of SMEs to keep control of the enterprise as they will like to have control of strategic decisions and considering the fact that debt restricts managerial flexibility in decision-making as creditors will stipulate terms of the debt agreement. Furthermore, Cant *et al.* (2014:571) argue that costs such as legal, accounting, and underwriting fees are avoided when SMEs use internal finance, but such costs are incurred when raising capital externally. With these advantages, SMEs prefer internal sources of financing over external sources. Despite the huge desire for external finance by most SMEs, Abdulsaleh and Worthington (2013:40) and Cant *et al.* (2014:570), Hahn and Kwon (2013:220) state that SMEs exhibit a clear preference for internal sources of financing (internal equity and retained earnings) over external sources of financing such as debt or external equity.

3.3.3.2 External equity

External equity is defined as financial capital acquired from external channels other than the existing partners and their relatives (Abdulsaleh & Worthington, 2013:40). Examples of external equity include venture capital, angel investors and crowd funding. Venture capital is that form of financing (as explained by Abdulsaleh & Worthington, 2013:41; Capizzi, 2015:272) in which funds are raised from investors and redeployed by investing in high-risk and innovative informationally opaque enterprises which, for the most part, are young or start-up enterprises. According to Memba, Gakure and Karanja (2012:33), venture capital is a

source of non-bank financing, which is quite prevalent in developed financial markets for promising start-up and young SMEs that have very high prospects for growth. When venture capitalist invest in a business, they preserve strong oversight over the enterprise and they also have clearly defined exit strategies in place in case.

On the other hand, angel investors, as pointed out by GEM (2016) and Shane (2012:502), are highly-selective wealthy individuals with extensive business experience who invest directly in high-risk/high-return growth SMEs with which they have had no previous relationship. Business angels are typically private minority investors (Capizzi, 2015:272) who are mostly interested in financing early stage enterprises with their own private finances through the form of equity capital. The primary reason why business angels are interested in financing early stage enterprises with their own private finances is to realise a financial gain when selling their shares as well as to obtain non-pecuniary benefits related to their non-institutional nature. Furthermore, not only do business angels provide their investee businesses with equity capital, but they also bring specific skills into the business and the fruits of their personal networks, filling not only the above-mentioned financing gap, but also the reputation and experience.

Abdulsaleh and Worthington (2013:42) state that angel financing is an appropriate option for SMEs for the following reasons: Firstly, angels are more active in the early stages of enterprises (seed and start-up) closing the so-called 'equity gap' by forming a 'bridge' between outside investors and internal financing sources; secondly, by having lower rates of rejection and being a more patient form of capital with longer exit horizons, angel financiers tend to be more obliging to the needs of owners–managers of SMEs; and thirdly, angel investors, unlike venture capitalists, prefer to invest in their local economies where the majority of SMEs operate.

Meanwhile, crowd funding is the newest viable external equity model of uncollateralised financing for SMEs. This type of financing is focused on entrepreneurial projects in which owners/managers of SMEs pitch their projects to prospective lenders through an online platform, such as kickstarter or Indiegogo with the primary aim for how much financing they need to finance their project. According to GEM (2017), crowd funding is appropriate for the financing of SMEs given the flexible nature with respect of how owners/managers of such enterprises can finance their projects as well as compensate investors.

Belleflamme, Lambert and Schwienbacher (2014:587) state that owners/managers of SMEs prefer crowdfunding to venture and angel capital for three reasons. First and foremost, it provides a viable alternative for collecting funds. Secondly, it offers owners/managers public attention for themselves and their products. Lastly, it allows such owners/managers to gain immediate feedback on their products, which can be incorporated into future interactions. Crowd funding also facilitates more direct interaction with customers and more press coverage (Mollick, 2014).

Contemporary literature theorises that the availability of external equity has a positive impact on the growth and performance of SMEs considering the fact that debt is very difficult to access (Abdulsaleh & Worthington, 2013:41; Capizzi, 2015:273; Githaiga & Kabiru, 2015:476; Hsu *et al.*, 2014:5; Smolarski & Kut, 2011:40). Studies by Bammens and Collewaert (2013) and Smolarski and Kut (2011) revealed that SMEs financed by external equity (angel capital, crowd funding and venture capital) realised a significant sales and profit increase (better performance) given that external equity providers are involved in screening, monitoring and contracting the projects in which they invest their finance. In addition, Capizzi (2015:274) argues that external equity in the form of angel capital, crowd funding and venture capital is a signal about the quality of the SME and also provides information about the credibility of the enterprise. This can assist the SME source other forms of finance such as debt capital. Despite the many sources of external equity for SMEs, access to external equity remains a primary constraint for SMEs in South Africa. This phenomenon is termed the equity gap. The next section focuses on the equity gap.

3.3.3.3 The equity gap

The issue of financing gap (shortage of finance) in the provision of equity as a constraint on the development of SMEs is not new in contemporary SMEs financing debate. As a result, there are concerns that the associated financing gap may be limiting the growth of enterprises and, as a consequence, constraining economic recovery in South Africa. The equity gap, according to Diaz-Moriana and O’Gorman (2013:630), is described as the situation where there is a shortage of equity investments during the early stages of development of an enterprise’s life-cycle. According to the authors, perceived structural failure within the capital market to meet the long-term investment needs of SMEs brought about discussions on the equity gap with regard to SMEs.

According to Venturelli and Gualandri (2009:89), the limited availability of certain resources of financing to SMEs has a significant impact on the financial structures of SMEs. SMEs without sustainable growth prospects will seldom access external equity in the form of angel capital, crowd funding and venture capital. Instead, access to external equity through public listing on the stock exchange is not available up until the SME is relatively developed and is able to meet the minimum size requirements for listing. As a result, the only feasible source of equity financing for SMEs apart from owners' contribution, is contribution from relatives and friends, thus internal equity (Adair & Adaskou, 2015:2-3; Menike, 2015:56).

Snyman, Kennon, Schutte and von Leipzig (2014:164) note that the availability of venture capital is very limited for SMEs in both developed and developing nations. Shane (2012:503) states that less than 5 % of SMEs in the United Kingdom and the United States of America had access to venture capital. Shane further states that the probability that an SME in the United States will have access to venture capital is 0.00025. Meanwhile, in South Africa, only a hand full of SMEs have access to venture capital. The South African Venture Capital Association (2016) states that the South African private equity industry had a total of R165.3 billion in funds under management with an average investment size of R19.7 million in 2016. The report also revealed that the value of private equity investments made during 2015 was R10.5 billion, which is approximately equal to 6.35%. Thus, considering the fact that SMEs in South Africa do not have the option of accessing the public equity market, SMEs tend to rely on debt finance as their only source of external finance.

3.3.4 Debt finance

Debt finance, as defined by Githaiga and Kabiru (2015:475), is finance obtained in the form of a loan from the formal financial sector or it can be raised from investors by means of a public issue of corporate debt. Debt capital includes all long-term borrowing incurred by an enterprise, including bonds. Correia *et al.* (2011:14-3) argue that debt finance usually has a contractual interest commitment and capital repayments to be considered as it can be used to the advantage of the enterprise through the effect of gearing. Correia *et al.* (2011:14-3) further argue that by using debt finance, the enterprise exposes itself to financial risks, especially in a situation of an economic decline. In the event of economic decline, interest payments and capital payments must still be fulfilled, and if the enterprise has not generated enough income, it may be unable

to meet these payments. As a consequence, the enterprise might be forced into bankruptcy. Bankruptcy occurs when the total liabilities of an enterprise exceeds its total assets or the inability of an enterprise to discharge all of its debts as they come due. Under such circumstances, debt holders of the enterprise will be settled before equity holders. However, given that exposure to debt increases the risk of the enterprise, the extent of the risk can be managed by the choice of the form in which the debt is placed. According to corporate finance theory, owners-managers of SMEs expect higher return for an increased risk to the enterprise. The primary source of debt finance is the formal financial sector.

3.3.4.1 Formal financial sector

Abdesamed and Wahab (2014:718) state that the formal financial sector (which constitutes all the commercial banks) is the primary source of debt finance for SMEs. The authors further note that the formal financial sector offers a variety of different products to SMEs such as export and import finance, factoring, leasing, overdraft facilities, term loans, credit cards, trade bill financing and even government loan guarantee schemes. According to Lekhanya (2015:413), the advanced banking system in South Africa puts the formal financial sector in the best position to gather information on SMEs through networking, which they and their staff have with owners/managers. In addition, the extensive banking network between the branches of the different banking institution make it easier for them to access even SMEs in remote areas. Given the problem of information asymmetry that exists between the owners/managers of SMEs and possible investors and the fact that SMEs find it difficult to issue securities to the public because they do not meet the requirements, intermediaries such as formal financial institutions play a crucial role in bridging the information gap between owners/managers of such enterprises and possible investors. Therefore, in the absence of financial intermediaries, such as formal financial institutions, it will simply be too expensive for most investors to be aware of the requirements needed to provide credits and too costly for SMEs to issue the credit itself. Performing the role of financial intermediaries implies that formal financial institutions will help produce information about borrowers that will assist investors to monitor their investment, set contract terms for credit to improve borrowers' incentive and renegotiate credit terms in case the borrower experiences financial difficulties.

Among the different products offered by the formal financial sector, Abdesamed and Wahab (2014:717-718) argue that overdrafts and term loans are the two main products offered by most

formal financial institutions to SMEs. The Banking Association of South Africa (2018) contends that overdrafts are the most common form of short-term finance because of their flexibility as borrowers make use of it only when it is necessary. With an overdraft, owners/managers of SMEs who hold a current account are allowed to drain the account to a deficit, but without exceeding the limits agreed by the formal financial institution and owners/managers of such enterprises. Despite the importance of overdrafts to SMEs in meeting their temporary needs, they are most often granted on the basis that they will be repaid in the nearest future (repayment period less than six months). As a consequence, the Banking Association of South Africa (2018) states that SMEs should match overdrafts with short-term working capital needs and not long-term investment opportunities such as investment in plant and machinery.

On the other hand, term loans could be short, medium or long-term source of finance that could be invested in working capital needs and other medium or long-term needs such as investment in fixed assets and machinery given that they cover periods between one to twenty years, or to increase their production capacity as well as for purposes of a change in enterprise control or diversification into other line of businesses (Lawless, Connell and Toole, 2014:2380). Though the interest rate charged on term loans can be fixed or variable, the interest rates charged on term loans are usually higher than those charged on overdrafts. Fixed interest rates are usually tied to life time projects and are well-known in advance while variable interest rate varies due to other forces in the market.

Quaye, Abrokwah, Sarbah and Osei (2014:345) note that factoring is a type of supplier financing (the supplier of finance known as the factor is the formal financial institution) in which SMEs sell their credit-worthy accounts receivable at a percentage of their face value and receive immediate cash. Quaye *et al.* (2014:344) further state that factoring is often done “without recourse”, meaning that it is an outright purchase of the customer’s assets. Therefore, the factor that purchases the receivables assumes all the credit risk for the buyer’s ability to pay. For the factors, factoring is a way to develop new relationships with suppliers – formal financial institutions can use factoring to build a credit history on SMEs, including information on their cash, accounts receivable and inventory turnover. Hence, factoring is a comprehensive financial service that includes credit protection, accounts receivable bookkeeping, collection services and financing. Factoring costs to SMEs include commissions charged by formal financial institutions and interests levied on advances by formal financial institutions.

Credit card financing is another credit facility offered by formal financial institutions in case they (SMEs) are unable to access other forms of credits. Credit cards are a non-traditional form of credit offered by formal financial institutions (Jones-Evans, 2014; Padachi *et al.*, 2012:129). Owners-managers of SMEs can pay in cash for their goods using credit cards but if only they pay their balances on time and in full each month before it becomes overdue. Despite the fact that credit cards are generally an acceptable means of payment, it does not constitute money. Credit cards are quick and easy loan transactions and the credit card account must be settled by the holder of the account at the end of a particular month or at least some specified minimum amount. Additionally, credit cards can be used to identify a customer and can reveal very relevant information about the customer's availability when using the card.

With regard to hire purchasing, Manyani (2014:12) points out that formal financial institutions are the main brain behind hire purchase of assets such as motor vehicles, machinery and equipment. Considering the fact that owners/managers of SMEs do not have enough finance to buy such assets in cash, the owner of the product purchases it through a higher purchase agreement that rests with the formal financial institution until the final instalment is paid. In South Africa, hire purchase can be described as sale in which it is agreed that the purchase price of the item will be paid in instalments on credit basis. Even though the buyer possesses the item, complete ownership of the item will not be passed to the buyer until the last instalment is paid. However, though the interest rate charged on hire purchase is higher than that of overdrafts and term loans, it remains the most common means of financing to purchase most types of business assets in South Africa.

3.3.4.2 The debt gap

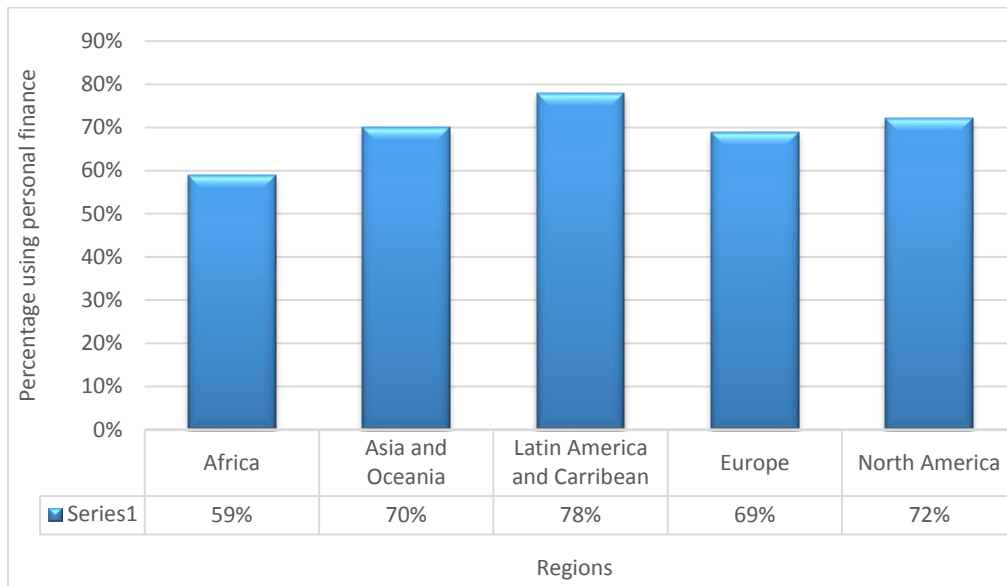
According to Quaye *et al.* (2014:341), the debt gap can be described as a situation in which a sizeable portion of economically relevant SMEs cannot access financing from the formal financial sector and other capital markets or otherwise, providers/suppliers of finance. The capital market for SMEs include finance from friends, family, employer, banks, private venture capital, government and crowd funding (GEM, 2017). Quaye *et al.* (2014:341) note that the formal financial sector is reluctant to provide SMEs with credit because of their structural characteristics (such as low revenue and profitability, ownership structure and few employees,

among others) and the perception that SMEs that do not have access to credit would not have the capacity to manage them productively should they be provided with one.

Despite SMEs accounting for a greater portion of enterprises and employment in developing countries, OECD (2016), the World Bank (2016) and OECD (2015) state that the debt gap for SMEs in developing countries is more prevalent than in developed countries. Majority of SMEs in developed countries are able to access sufficient credit from the formal financial sector and other credit institutions. For instance, Statistics Canada (2016) revealed an 82.1% approval rate for credit applications from SMEs by formal financial institutions, a 98.3 % approval rate for trade credit, a 98.2% approval rate for leasing and an 82.8 % approval rate by the government. In England, the United Kingdom Small Business Statistics (UKSBS) (2016) revealed that over 80% of SMEs are getting finance from formal financial institutions, 85% approval rate for leasing and over 70% approval rate by the government. UKSBS (2016) also revealed that approximately 71.4% of SMEs have access to credit from formal financial institutions and about 90% have access to credit from the government in the United States of America (USA).

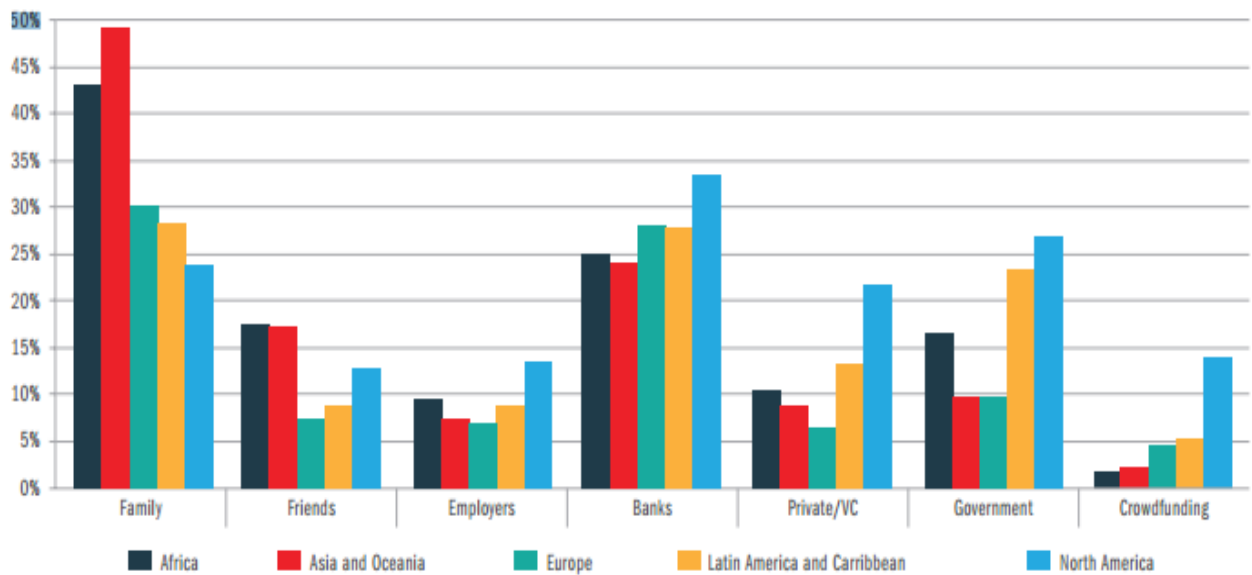
In developing economies such as Thailand, about 53% of SMEs have access to credit from formal financial institutions and approximately 42% of SMEs in Sri-Lanka have access to credit from formal financial institutions (GEM 2016). In Morocco, approximately 45% of SMEs have access to credit from formal financial institutions whereas approximately 40% of SMEs in Egypt have access to credit from the formal financial sector. In South Africa, the Small Enterprise Development Agency (hereafter SEDA) (2015) maintain access to finance by SMEs from the formal financial sector remains a major challenge as majority of credit applications (about 75%) by SMEs to formal financial institutions are rejected. As a consequence, majority of owners/managers of SMEs depend on personal and family savings for additional capital as shown in Figures 3.1 and 3.2.

Figure 3.1: Average percentage of owners/managers of SMEs using personal finances to finance their businesses according to regions



Source: GEM, 2016

Figure 3.2: Sources of finance for SMEs according to regions



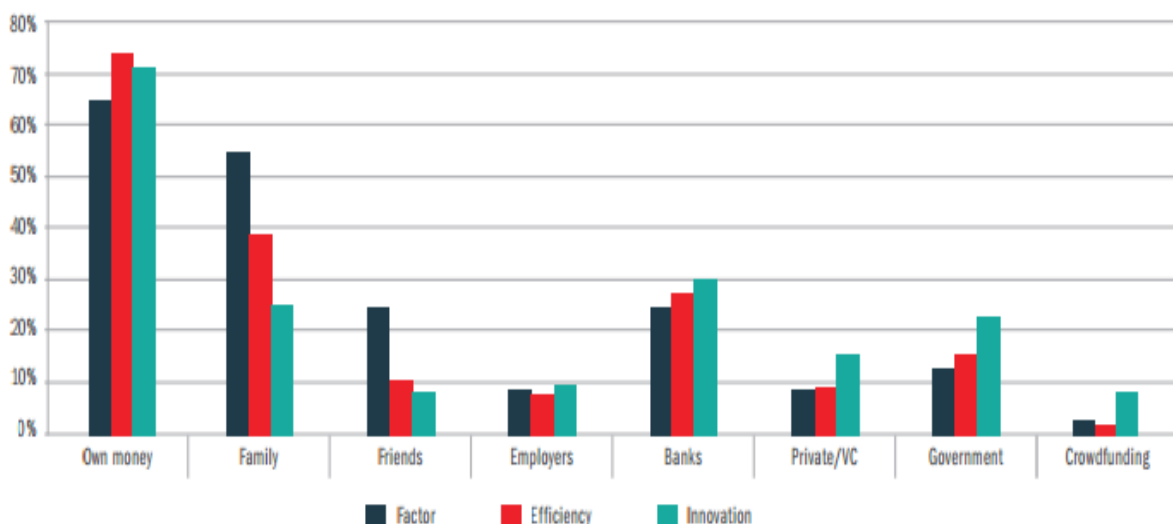
Y-axis - the percentage of the primary sources of finance for SMEs according to regions.
 X-axis - the primary sources of finance for SMEs by regions (Africa, Asia & Oceanic, Europe, Latin America & Caribbean and North America)

Source: GEM, 2016

Figures 3.1 and 3.2 reveal that the regions differ significantly in terms of the primary sources of financing for SMEs. More than three-quarters (more than 75%) of SMEs in Latin America and the Caribbean depend on personal savings as the primary source of financing, whereas Africa, as a region, has the lowest use of personal savings (about 59%). From a financial perspective, Asia and Oceania have the highest level of family support for SMEs (about 49%), followed by Africa (about 43%). In addition, the statistics reveal that Africa, Asia and Oceania are regions that are less likely to have access to credit from formal financial institutions. Hence, owners/managers of SMEs must rely more on their own or family resources for growth and survival, which is most often inadequate. These insights further confirm the reason behind the high failure rate of SMEs in developing countries, such as South Africa.

Banks (formal financial institutions) are also an essential source of finance in all regions as their funding contributions range from a quarter of SMEs in Africa, Asia and Oceania, up to providing financing for a third of SMEs in North America. The significant levels of government financing support in Europe and North America, as well as a growing support in Africa are likely to be as a result of government becoming increasingly cognisant of the fact that the development of SMEs plays a fundamental role in the growth of economies.

Figure 3.3: Sources of finance for SMEs according to phase of economic development



Y-axis - percentage of the primary sources of finance for SMEs according to phase of economic development. Meanwhile, X-axis - the primary sources of finance for SMEs according to phase of economic development (factor-driven, efficiency-driven and innovation-driven economies).

Source: GEM, 2016

NB: Factor-driven economies (e.g. Cameroon, Egypt, Botswana and India), **Efficient-driven economies** (Morocco, South Africa, China and Poland) and **Innovation-driven economies** (Germany, UK, Australia, USA and Canada) (Source: GEM, 2016)

SMEs in efficiency-driven economies (such as South Africa, Egypt, China, Malaysia, Brazil, Poland as noted in the previous chapter) heavily rely on their personal financial capital, with about 75% of owners/managers using personal savings as a primary source of SMEs finance (GEM, 2017). SMEs in factor-driven economies (such as Cameroon, Burkina Faso, Senegal, India and Iran) depend more on family and friends, compared to SMEs in the other two economic development phases. SMEs in innovation-driven economies (such as Australia, Hing Kong, Germany, France and Korea) took most advantage of crowd funding. The findings by GEM (2016), that personal and family savings is a primary source of SMEs finance, are in accord with the static trade-off, the agency and the pecking order theories of capital structure of SMEs. From the discussion in Section 3.3.2.3, it can be concluded that SMEs that primarily depend on internal equity, find it very difficult to survive and grow. The use of venture capital and other sources of external equity by SMEs is very limited in most developing and some developed economies as advocated by the capital structure theory. Debt finance is readily more available in developed economies than in developing ones. In essence, this further strengthens the hypothesis that external equity, especially from private investors or the stock market, is not a sustainable source of finance for SMEs. As a result, finding ways to improve the availability of credit from the formal financial sector seems to be one of the primary options to reduce the high failure rate of SMEs in South Africa as well as other developing countries.

3.3.4.3 Credit assessment and evaluation by formal financial institutions

Credit assessment and evaluation remains at the heart of the decision-making process, thus leading to the granting of credit to a borrower. Makomeke *et al.* (2016:66) point out that formal financial institutions, over the years, have experienced problems with non-performing credit as a result of weak credit analysis, resulting in the high rejection rate of applications for credit. With such high rejection rate, most owners of SMEs are confronted with questions such as: “What are formal financial institutions looking for from me and my business?” These authors

(Liang, Huang, Liao and Gao, 2017:136; Makomeke *et al.*, 2016:66) argue that most formal financial institutions have set up standard risk assessment and evaluation criteria in screening credit applications, which is a major hindrance to most SMEs. The primary purpose of any credit assessment and evaluation procedure is to measure or ascertain the amount of risk involved and to help formal financial institutions make good credit decisions. According to the authors, most formal financial institutions follow certain principles in evaluating credit applications and making credit decisions. These principles are summarised in the ‘5 Cs’ which have been applied as a rule of thumb in the lending market. Makomeke *et al.* (2016:66) state that while no one “C” is more important than another “C” (all “Cs” are relatively equal and together, help to form an entire picture of the project and client). The principle of the ‘5 Cs’ of credit is to establish the creditworthiness of a borrower. The concept, if correctly applied, seeks to evaluate the key criteria of repayment ability, by analysing the stream of cash flows, the character of financial discipline, and the financial health of the borrower and other qualitative measures. Makomeke *et al.* (2016:67) list the 5 Cs of lending to include character, capacity, capital, conditions and collateral.

a) Character

According to Dankwa and Badu (2013:14), the character of the borrower signifies two important aspects as follows: the ability of the borrower to pay; versus the willingness of the borrower to pay. The ability to pay refers to the borrower’s financial trustworthiness to pay. A good character is one that has the ability and a willingness to pay. The character may also refer to the managerial ability and the personal integrity of the borrower. Makomeke *et al.* (2016:67) caution that judging the personal integrity of any borrower is a crucial issue and lenders are looking for indications which reflect these personality traits. The personality traits of borrowers can help inform business and credit managers’ decisions as to the credit worthiness of the proposal and the character of the borrower, customers served, skills to do the business, personality and commitment to repay the credit facility. Makomeke *et al.* (2016:68) conclude that measures of borrowers’ character include managerial experience and track record of integrity and repayment.

b) Capacity

Capacity, as highlighted by Liang *et al.* (2017:136) and Makomeke *et al.* (2016:67), refers to the ability of the borrower to generate enough cash sales to meet the operating needs of the business and to also meet all debt repayments (current debt payment and projected). That is to

say, borrowers must be able to meet all their financial obligations on or before the due dates. Thus, capacity is the ability to repay the credit, together with interest as per the pre-determined schedule. Liang *et al.* (2017:138) explain capacity in other words as the sources of repayment. According to Liang *et al.* (2017:138), borrower's capacity depends on two factors as follows: firstly, the financial wellbeing of the borrower must be healthy; and secondly, the borrower must be able to generate sufficient net income to service the credit repayment. For business credits, credit providers or lenders (formal financial institutions) most often request for audited financial statements and projected cash flows to determine the creditworthiness of the business borrower. Capacity includes customers, competition, suppliers, market strategy and product or service.

c) Collateral

The most primary source of credit repayment is cash generated from the business. Irrespective of the best efforts and analysis, credit delinquent and borrowers may default. When this happens, lenders or credit providers turn to secondary sources of repayment, which is the collateral. Hence, collateral is the lender's second line of defence and is considered the secondary source of repayment. In situations where the payback is derived from cash flows, then the collateral will not be liquidated for repayment. On the contrary, when a credit cannot be paid out of primary sources, lenders usually take possession of the pledged collateral and dispose of it and use the proceeds to offset the outstanding credit amount. Adequate collateral coverage is necessary to protect the banks in case of default. This mainly focuses on liquidity, location of the business and legal considerations (Liang *et al.*, 2017:138).

d) Condition

The fact that all businesses, including SMEs are influenced by the economic environment in which they operate, there are certain general conditions which can have a positive as well as negative bearings on their performance. These influences can come from main sources, including both macro and micro economic changes and the legal environment. Both the macro and micro changes and the legal environment are systematic and largely uncontrolled by SMEs. Uncontrollable factors include the macroeconomic environment, the legal and judicial system and crime (Rusu and Roman, 2016:143).

e) Capital

Capital represents what the borrower can lose personally if the credit goes into default and, subsequently, declared bankrupt/non-solvent. It is referred to as the capital contribution that the borrower proposes to make in the total investment. An investment is usually financed partially by credit from a formal financial institution and partly by the capital contribution of the owner (Quartey *et al.*, 2017:19). The owner's contribution is called the owner's margin or Owners Equity or Shareholders' Equity. According to the authors, the greater the owner's contribution to a business, the greater is the lender's confidence in the business. In most developing economies, lenders have made it a duty to ensure that when they give out credit and the credit goes into default, then the borrower (as the enterprise and personality) is hurt as much greater than the lender. According to lenders, the potential for hurt is a greater motivator to help ensure that the business operates as successfully as possible.

Fatoki (2014:96) categorises the 5 Cs of credit evaluation into objective and subjective criteria. Objective criteria are those that could be measured in terms of ratios and values; while subjective criteria are those where the opinion or judgement of the credit and business managers was the main contribution to the decision. Objective measures include capital and collateral as measured by owners' cash contribution, collateral, business plan, marketing and growth potential of the business. Subjective measures include the usefulness of the business plan and whether the owner understands the content of the business plan, competent management structure, feasibility of the business in terms of competition, viability, demographics, location and the economic environment.

As highlighted by Fatoki (2014:96), present day credit assessment and evaluation is a combination of the traditional method (the 5 Cs) and the modern method to risk management given that the measurement and management of credit risk have undergone quite a revolution in recent years. Technological advances have enabled financial engineers to construct new methods of model building and analysis for credit risk measurement. A number of factors such as increase in competition in the credit market, which necessitate the development of methods that are quicker, more accurate and more cost effective, have contributed significantly to this recent surge in technology-based analysis methods. Increase in consumer expectations have now made most customers to expect more efficient credit approval from formal financial institutions. In circumstances where certain formal financial institutions have made credit access tardy, customers have shifted their attention to other institutions. Confidence and loyalty are highly questioned among consumers. Due to the increase in bankruptcies and global

competition in recent times, formal financial institutions are calling on their business and credit managers to be more careful in assessing and evaluating credit.

3.3.4.4 Perception of formal financial institutions with regard to lending to SMEs

Ebrahim, Khalil, Kargbo and Xiangpei (2016:59) state that the primary purpose of formal financial institutions is not only to accept deposits but also to provide financial services (give out credit facilities) which inevitably exposes them to a number of risks. These risks, caused by the unpredictable, unstable economic and political atmosphere, include credit risk, liquidity risk, operational risk, capital risk, market risk, investment risk, foreign exchange risk, and interest rate risk, along with other risks, which may possibly threaten the survival and success of different financial institutions (Ebrahim *et al.*, 2016:60). Rahman, Zheng and Ashraf (2015:96) argue that credit risk is by far the most threatening risk faced by most formal financial institutions and their success greatly depends on how well this risk is managed. According to Rahman *et al.* (2015:96), formal financial institutions have to deal with the uncertainties in every dimension of their operations as they operate in a multifaceted and competitive 21st century business atmosphere.

Konovalova, Kristovska and Kudinska (2016:92) define credit risk as a risk of borrower default, which may arise as a result of the possibility that formal financial institutions' borrowers or counterparts will fail to meet their obligations in accordance with agreed terms. In simple words, credit risk is the risk that the principal or interest or both on securities or credit will not be paid as agreed. Konovalova *et al.* (2016:92) state that there can be many reasons for default. One of the most cited reasons is that the obligor is in a financially stressed situation. Besides, if a borrower with high credit quality has a deteriorated profile, it can also cause credit risk loss to the financial institution. Enterprises carry credit risk when, for instance, they do not demand cash up-front for products or services. Konovalova *et al.* (2016:92) argue that credit risk is the most fundamental reason behind the high rejection rate of credit to SMEs by formal financial institutions. Formal financial institutions provide financial resources and the results of credit risk from the inability of SMEs to honour their financial obligations towards formal financial institutions.

Fatima (2014:772) considers capital risk as the risk that an organisation's capital resources will be negatively affected by unfavourable exterior developments. In this case, formal financial

institutions increase their capital in order to attract more capital on the equity market. This situation is quantified by the capital adequacy ratio. Fatima (2014:773) defines capital adequacy ratio as the ratio of formal financial institutions capital in relation to its current liabilities and risk weighted assets. Risk weighted assets is a measure of the amount of formal financial institutions assets, adjusted for risks. According to the author, an appropriate level of capital adequacy ensures that formal financial institutions have adequate capital to increase their activities, while at the same time, their net worth is sufficient to absorb any financial recession without becoming bankrupt. It is this ratio that determines a formal financial institution's capacity to meet the time liabilities and other risks such as credit, market and operational risks. This implies that a low capital adequacy ratio causes formal financial institutions to become undercapitalised to the magnitude that they may not be able to absorb minor shocks. Meanwhile, a high capital adequacy ratio provides protection to creditors of formal financial institutions in case of solvency. The high-risk defaults by SMEs result in a decrease in the capital adequacy ratio as non-repayment of credits negatively affects the assets of formal financial institutions.

The intermediation role of formal financial institutions in transforming liquid liabilities (deposits) into illiquid claims (credits) relies on a maturity mismatch between assets and liabilities, which in effect, exposes formal financial institutions to liquidity risk (Matis and Matis, 2015:1189). Matis and Matis (2015:1189) moot that liquidity risk is the most important financial market risk and can be defined as a situation in which formal financial institutions do not have enough liquidity to meet their financial obligations. Liquidity risk becomes a threat to formal financial institutions when they are unable to predict the demand for new loans or deposit withdrawals. The primary source of liquidity is the liquid assets that can be sold immediately for a price as close to the nominal value as possible. Liquidity risk can also occur if formal financial institutions hold in their portfolio, too many liquid financial assets compared to needs. On the other hand, too little liquidity can create financial problems, especially for small financial institutions, to a level that can result in bankruptcy. Therefore, preserving an adequate level of liquidity in all formal financial institutions is also of extreme importance in order to minimise systemic risk, which is due to contagion through inter-institutional transactions.

However, Matis and Matis (2015:1190) argue that formal financial institutions have developed their own procedures for monitoring and limiting liquidity risks, which constitute provisions

with regard to the following elements: more restrictive internal limits in the case of the liquidity ratio; to separately establish and monitor the thresholds of every client in order to control high liquidity risk; the institution's own liquidity indicators; and the information system on liquidity for financial institution management. Nonetheless, Bateni, Vakilifard and Asghari (2014:110) point out that the inability of SMEs to honour their financial obligations towards formal financial institutions may affect the institutions' ability to meet-up with their financial obligations towards other clients.

3.3.4.5 Challenges faced by formal financial institutions in lending to SMEs

The formal financial sector in every country plays a pivotal role in the development and growth of the economy. Baby and Joseph (2016:2), Haven (2015:3758), Kwaning, Nyantakyi and Kyereh (2015:20) and Robb and Fairlie, (2008:1434) state that formal financial institutions in developing economies face a number of challenges that prevent them from pulling financial resources together and lending to SMEs. These challenges, according to Baby and Joseph (2016:2), account for the huge credit financing gap between supply capacities of formal financial institutions and the demanding needs of SMEs.

One of the most serious challenges, as asserted by Baby and Joseph (2016:2) and Haven (2015:3758) in most developing countries such as South Africa, is the absence of a proper legal and regulatory framework for dealing with default cases. The absence of proper and efficient bankruptcy laws makes the job of formal financial institutions very tough when dealing with defaulters of credit. As such, the primary and only approach followed by most formal financial institutions is to file criminal cases against defaulting customers (SMEs), as the last resort. Such a harsh measure drives panic waves in the business sector, which ultimately harm the relationship between formal financial institutions and SMEs. In addition, Baby and Joseph (2016:2) state that the absence of a detailed credit bureau for SMEs, which has sufficient information about borrowers (SMEs) and their credit history, only helps to further complicate the lending process.

The lending process, as highlighted by Kwaning *et al.* (2015:20), is also further complicated by the fact that SMEs in both developed and developing economies by law, are not compelled to report their financial performance in a standardised manner if they do not reach a significant threshold in total assets, turnover and/or number of employees. This, therefore, implies that

most SMEs do not produce reliable financial information, which could be used by creditors or investors in evaluating their credit worthiness. In addition, Robb and Fairlie (2008:1436) argue that lack of reliable information usually leads to comparably high interest rates even if there is a long-term relationship between the borrower (SMEs) and formal financial institutions. Lack of information also hinders the ability of formal financial institutions to evaluate the level of risk involved. This, as a result, leads to huge credit rationing given that access to credit depends on an open trade of information between the one receiving the credit and the provider of such credit. Furthermore, Kwaning *et al.* (2015:21) are of the opinion that the opaqueness or unwillingness of SMEs in relinquishing control of the enterprise over to outsiders or having control of every aspect of the business, is a serious challenge that hampers their ability to access credit from formal financial institutions.

Another challenge faced by formal financial institutions in lending to SMEs, as explained by Kapunda (2015), is the high transaction costs involved in doing business with SMEs. Formal financial institutions incur costs to assess an application for credit, process the application and monitor the credit when issued. The fact that transaction cost is directly related to profitability, implies that the higher the cost of processing a transaction will result in a lower return. Kwaning *et al.* (2015:21) remarks that credits directed towards SMEs, most often consume time to assess, monitor and manage. Thus, most formal financial institutions and credit managers acknowledge that SMEs require much more advisory support-hand than large corporate clients, which all involves cost.

The absence of credit rating agencies, as highlighted by Mutoko (2015:3), is another serious challenge faced by formal financial institutions with regard to lending to SMEs. The author notes that credit rating agencies help to make accurate risk assessment of credit applications without generating high cost per application. According to the author, one of the ways formal financial institutions can use in assessing credit risk is by using credit rating agencies or credit bureaux. Credit rating agencies, therefore, publish general financial details of most small, medium and large businesses, together with a credit rating. They also produce a special report on credit worthiness of businesses if requested for fees. In the absence of credit rating agencies, especially in developing economies, it has become difficult to assess credit worthiness of customers and it is costly to generate information about the repayment morale of potential enterprises. In addition, lack of credit bureaux and other mechanisms for gathering and exchanging information on payment performance inevitably exacerbates the informational

asymmetries between borrowers (enterprises) and credit providers (formal financial institutions). The World Bank (2016) advocates that in order to foster a credit culture, it is essential that progress be made in the area of credit information.

From the challenges presented above, Baby and Joseph (2016:2), Kwaning *et al.* (2015:21) and Matis and Matis (2015:1189) argue that formal financial institutions in different economies experience different challenges. Considering the fact that the studies cited above focused on developed and developing economies such as Nigeria, Ghana, Kenya, the United Arab Emirates and the United States of America, their findings have substantially contributed to the literature, however, their findings may not be applicable to other countries due to differences in political, economic and legal environments. A thorough review of the literature revealed lack of empirical evidence with regard to challenges faced by formal financial institutions in a South African context. Thus, one of the objectives this study was to investigate challenges faced by formal financial institutions with regard to lending to SMEs.

3.5 SUMMARY OF CHAPTER

This chapter has provided a review on the financing of SMEs. Of the many challenges faced by SMEs, these enterprises contend that the availability of and access to finance from the formal financial sector is the primary constraint towards the development of SMEs in South Africa (Baltar & Icart, 2013:203; Gastrow, 2013:10; GEM, 2016). In this chapter, the second and the third secondary research objectives (demand-side) which aimed at investigating the financial needs of SMEs from the formal financial sector; and to examine the relationship between access to credit from the formal financial sector and the performance of SMEs is addressed. SMEs primarily need financial capital for various purposes in the operation of the business, which includes the financing of capital investments, initial losses, product development and working capital. Contemporary literature on the financing of SMEs in South Africa revealed that investment in SMEs is low compared to working capital. As a consequence, the probability of SMEs to secure collateralised loans is very low. In addition, the exploration of capital structure theories such as the static trade-off, agency and the pecking order theories suggest that internal equity is the cheapest and best source of finance for SMEs. However, given that internal equity is insufficient for most growing SMEs in developing countries, such as South Africa, and the fact that external equity is very expensive and also not available for SMEs, most SMEs have to heavily rely on external debt financing for growth and

survival. Debt finance is, thus, suggested as one of the financing options that can be explored by SMEs, especially SMEs in developing countries such as South Africa.

This chapter also address all three secondary research objectives (supply-side) which are to establish the challenges faced by the formal financial sector in assessing and approving credit to SMEs; to determine how the formal financial sector assesses credit applications from SMEs; and to ascertain how the formal financial sector perceives investment in SMEs. As a result of a greater risk of financial distress, high bankruptcy costs and low profitability, comparing the three theories, it is advocated in this study that the static trade-off theory is not the first-order consideration for SMEs. While the theoretical foundation of the agency theory lies on the existence of asymmetric information with great emphasis on transaction cost, the pecking order theory lays emphasis on issues that SMEs should rely on such as internal sources of finance and external borrowing to finance their growth and survival.

This chapter has also provided the sources of finance for SMEs under two broad categories, equity and debt. SMEs in South Africa suffer from an equity gap, especially external equity as angel capital, crowd funding and venture capital are very limited to SMEs not only in South Africa but also to enterprises in other developing and some developed countries. This is, thus referred to, as the equity gap. The non-availability of external equity suggests that SMEs have no other choice than to rely on debt finance with formal financial institutions being the primary sources of debt for SMEs worldwide (Abdesamed & Wahab, 2014:718). The literature also revealed that debt from formal financial institutions is also not easy to access, thus leading to the debt gap. Nonetheless, the debt gap is more conspicuous in developing economies compared to developed ones. The inadequacy of both equity and debt for SMEs in South Africa is an indication that SMEs in South Africa are capital rationed. It can also be concluded from this development that the heavy reliance of SMEs on internal equity is the primary reason behind the high failure rate of SMEs. According to contemporary literature, formal financial institutions argue that SMEs are not investment ready. As a consequence, it is necessary to research if the discrimination hypothesis is true by investigating how formal financial institutions perceive investment in SMEs, how they assess credits and challenges faced in assessing and approving credit geared towards SMEs and factors that impact on the willingness of the formal financial sector to provide credit to SMEs.

Chapter Four focuses on the review of literature on the financing of SMEs in order to determine the various supply-side and demand-side factors that might impact on the availability of and access to credit from the formal financial sector.

CHAPTER FOUR

INVOLVEMENT OF THE FORMAL FINANCIAL SECTOR IN SMEs: SUPPLY-SIDE AND DEMAND-SIDE FACTORS

4.1 INTRODUCTION

The involvement of the formal financial sector in SMEs is and always has been a fundamental issue of concern among policy makers and practitioners in developed and developing countries (such as South Africa), especially at a time of very low or no economic growth and development. The previous chapter focused on the financing of SMEs, their financial needs, theories of debt financing and how the theories relate to SMEs financing, different forms of equity and debt finance, credit assessment and evaluation and how formal financial institutions perceive lending towards SMEs. It emerged in the chapter that the high failure rate of SMEs in South Africa is due to the high reliance on finance from family members or personal savings, which is often insufficient for growth and survival. However, if finance is the lifeblood of every SMEs, Bartlett *et al.* (2014) and Mills (2014) articulate that the problem of financing SMEs stem from the quality of service they receive from the formal financial sector. According to Bartlett *et al.* (2014), the terms on which these services are provided are fundamental to the success of SMEs. If this is the case, then the risk perception of lending to SMEs should be reduced if such enterprises are to access credit from the formal financial sector. It is argued in this chapter that there are certain factors that can constrain formal financial institutions from lending to SMEs and for such enterprises to access credit from the formal financial sector. The identification of these factors can help promote lending to SMEs.

This present chapter focuses on the involvement of the formal financial sector in SMEs, with emphasis on the supply and demand-side factors that impact on the willingness of the formal financial sector to provide credit to SMEs. To give effect to the supply-side objective stated in this study (Chapter 1, Section 1.4.1), from a theoretical perspective, factors that impact on the willingness of the formal financial sector to provide credit to SMEs in South Africa are critically evaluated. These factors include cost of lending, information asymmetry, lending technology, institutional structure and credit supply to SMEs and lenders' risk appetite. In order to give effect to the demand-side objective stated in this study (Chapter 1, Section 1.4.3), from a theoretical perspective, factors that impact on access to credit from the formal financial sector

by SMEs in South Africa are critically evaluated. These factors include collateral, business information, managerial competency, business networking, legal and judicial system, macro-economic environment, business intelligence, entrepreneurship education and business ethics. The next section focuses on supply-side factors.

4.2 SUPPLY-SIDE FACTORS LIMITING THE FORMAL FINANCIAL SECTOR FROM LENDING TO SMEs

Weiss (2013) states that there are a number of location-specific factors that shape opportunities and incentives for the formal financial sector to productively invest in SMEs and create jobs. A study conducted by the International Finance Corporation (hereafter IFC) (2013) on more than 45,000 SMEs in developing countries found that lack of investment by the formal financial sector in SMEs is the number one obstacle for operations and growth of such enterprises. According to the IFC (2013), investment of the formal financial sector in SMEs also has a fundamental impact on the capital structure of SMEs. According to Weiss (2013), the willingness of the formal financial sector to invest in SMEs is largely controlled by factors that influence the ability of institutions to provide credits to SMEs, thus accounting for the differences observed in the availability of and access to credit in favour of SMEs in developed and developing countries. These factors include the cost of lending, information asymmetry, lending technologies, institutional structure and lenders' risk appetite as discussed below.

4.2.1 Cost of lending

Iyer, Lopes, Peydro and Schoar (2014:349) state that changes in a formal financial institution's capital or balance sheet liquidity might significantly influence the cost of funds available to borrowers. For formal financial institutions to be able to lend money to businesses, they need to attract funds (for instance, bank capital, deposit liabilities, or wholesale funds) by paying a return or interest on them. Using the loanable funds theory, Iyer *et al.* (2014:340) argue that formal financial institutions need to aim to hold deposits for similar lengths of time as the term of loans financed. In order to survive, formal financial institutions have to cover the interest rates they pay on deposits from interest rates they charge on loans (referred to as the interest margin). Higher interest rates charged on loans, in turn, affect the quantity of funds intermediated by formal financial institutions.

Hubbard, Kuttner and Palia (2002) conducted a study on the effects of the financial condition of banks on the borrowers' cost of funds after controlling for borrower risk and information costs. The authors found that banks, that are capital constrained, charge higher interest rates on loans than well-capitalised formal financial institutions and this cost difference is especially associated with borrowers for which 'information costs' and 'incentive problems' are most important (Hubbard *et al.*, 2002:561).

Ntiamoah, Li and Kwamega (2016:562) believe policies adopted by most formal financial institutions in conjunction with government policies on capital requirements may have a significant impact on the cost of lending and hence, lending to SMEs. The enforcement of capital requirements and direct government intervention have the ability to directly influence the quantity and cost of lending to SMEs. Gozzi and Schmukler (2016:4) posit that governments often intervene in the lending market to influence the quantity of credit supply through the use of interest rate subsidies, directed lending to specific sectors, loan guarantee schemes and a variety of other approaches. Taking into consideration government direct intervention in lending and policies on capital requirement, formal financial institutions are forced to sell securities, sell other assets, charge off loans or reduce lending to SMEs in order to improve their capital requirement. Thus, formal financial institutions, with larger capital requirements, respond to monetary policy tightening by lending relatively less, which in turn affects the ability of their borrowers to invest and hire (Aiyar, Calomiris & Wieladek, 2014:6; Gomez, Landier, Sraer & Thesmar, 2016:2).

Gomez *et al.* (2016:3) concur with Ntiamoah *et al.* (2016:562) that the capital position of formal financial institutions strongly predicts the level of lending with regard to movements of interest rates. Given that the cash flows of formal financial institutions are affected when exposed to interest rate risks (Aiyar *et al.*, 2014:6), it in-turn affects their ability to lend, especially if external funding is expensive. Borrowers (SMEs), on the other hand may become discouraged to borrow from formal financial institutions due to the high interest rate. With the recent economic meltdown, which saw the Rand reach a historic low to other currencies such as the United States Dollars and South Africa's credit status downgraded to junk status, the government of South Africa is looking to SMEs to provide much needed jobs and to help pull the economy out of the slump, putting SMEs back into the public eye of development.

4.2.2 Information asymmetry

The issue of availability of credit in favour of SMEs has recently garnered concern across the globe. Equilibrium credit rationing models that point to moral hazard and adverse selection problem, such as that of Stiglitz and Weiss (1981), suggest that SMEs may be particularly susceptible because of information asymmetry. In simpler terms, the information wedge between insiders and outsiders tends to be more acute for SMEs, which as a result, makes the availability of credit from the formal financial sector particularly challenging. It is for the same reason that SMEs with opportunities to invest in projects with positive net present value (NPV) may be blocked from doing so because the formal financial sector cannot readily verify that SMEs have access to such value-added projects (adverse selection problem) or ensure that the finance will not be diverted to alternative projects (moral hazard problem). Thus, SMEs are more vulnerable because of their dependence on credit from formal financial institutions. Huang, When and Liu (2014:28) argue that the primary cause of financing difficulties faced by SMEs lies in the severe information asymmetry between SMEs and formal financial institutions. Information asymmetry in the financing of SMEs implies that owners/managers of such enterprises possess privileged information about their businesses that cannot be easily accessed by prospective lenders. Wang (2012:268) argues that such a scenario could lead to two potential problems.

Firstly, Wang (2012:29) notes that the lender/investor may not be able to differentiate adequately between 'high quality' and 'low quality' SMEs and projects. As a consequence, price variables (i.e. interest rates) may not work well as a good screening device, because high interests may lead to an excessively risky portfolio (adverse selection problem). Secondly, the moment the lenders/investors have provided the funding, they may not be able to assess whether the SME is using the funds in an appropriate manner (moral hazard problem). In order to mitigate these problems, credit and business managers of formal financial institutions responsible for credit recommendation, evaluation and approval may adopt precautionary measures, such as requiring that financing be collateralised. Otherwise, they may simply turn down the request for financing (credit rationing).

According to Osano and Languitane (2016:3), information asymmetry is considered one of the essential determinants of credit supply decisions because the availability of information in the decision to lend is important as it enables formal financial institutions to evaluate the risk-

return profile of the loan application, thus setting the level and terms of credit to be extended to borrowers (SMEs). The authors argue that information asymmetry in lending leads to sub-optimal investment decisions due to restricted credit flow as lenders are expected to raise interest rates in order to compensate for the potential of adverse selection and moral hazard. As such, lenders become hesitant to supply credit to SMEs since they are not able to establish the quality of projects and the management of the SMEs. Owners/managers of SMEs with a high-risk business may succeed in receiving credit at a high interest rate while those with a less risky project may be refused credit because the SMEs may not be viable at this high interest rate. In circumstances where the interest rate is raised, owners/managers with higher risk tendency are favoured with high probability that such borrowers will later default and hence, threaten the capital base of the lender. This implies that formal financial institutions may fail to lend to SMEs that would otherwise eventually become successful. However, Cailloux, Landier and Plantin (2014:7) explain that SMEs that are fortunate to be given credit may be tempted to divert the credit to more risky projects, thus reducing the ability of credit repayment.

From a strategic standpoint, Lin, Chen and Lu (2015:1299) state that formal financial institutions have adopted a credit screening lending methodology as a strategy for minimising lender risk. Implementing this approach requires that borrowers, whose applications are successful, ought to have strong performance reporting systems with enhanced regulatory systems that ensure availability of reliable accounting data. The power of computer technology has helped formal financial institutions to predict credit scoring which, in return, has increased the reliance by formal financial institutions on credit bureaux scores as a tool to overcome information asymmetry in the credit market.

On the contrary, Paloni (2014) argues that information asymmetry is, in practice, not very significant (according to the post-Modigliani and Miller theory). According to the author, neither do the lenders nor borrowers know the prospective yield of an investment project. In this regard, credit rationing exists because borrowers and lenders have asymmetric expectations about the probability of repayment. In addition, formal financial institutions are failing to communicate properly their lending guidelines and policies (aimed at reducing information asymmetry, moral hazard and adverse selection) to SMEs (Amadhila & Ikhida, 2016:285; Ramlee & Berma, 2013:116). Lending policies and guidelines relating to the evaluation of credit applications by SMEs are meant to reduce information asymmetry and minimise the twin-lending risks of moral hazard and adverse selection. SMEs, on their part, content that they

do not know exactly what formal financial institutions want from them as they seldom provide reason as to why their applications for credit were rejected. From this explanation, it could be understood that information asymmetry is not only on the part of SMEs but also on the part of formal financial institutions.

4.2.3 Lending technologies

Contemporary literature (Amadhila & Ikhida, 2016:285; Gomez *et al.*, 2016:3; Gozzi & Schmukler, 2016:2; Paloni, 2014) on the financing of SMEs reveal that formal financial institutions make use of lending technologies to address the types of problems that can lead to either “credit rationing” (Stiglitz and Weiss, 1981) or “over lending” (de Meza and Webb, 1987). Since formal financial institutions are the major source of credit for SMEs in developed and developing economies, the relationship between formal financial institutions and SMEs suffer from information opacity that most often result in credit rationing (Gobbi & Sette, 2014; Cenni, Monferra, Salotti, Sangiorgi & Torluccio 2015:250). As a result, formal financial institutions employ lending technologies as tools to mitigate the situation of information asymmetries. Lending technology, as defined by Berger and Udell (2011:249), is a combination of primary sources of information, screening and underwriting procedures, loan contract structures and monitoring mechanisms. It includes a set of transaction technologies and relationship lending, which plays a fundamental role in the process of credit valuation and approval. Lending to SMEs, as explained by Cenni *et al.* (2015:251), can be categorised into four main distinct lending technologies as follows: financial statement lending; asset-based lending; small business credit scoring; and relationship lending.

Financial statement lending, asset-based lending and small business credit scoring are referred to as transactions-based lending (Amadhila & Ikhida, 2016:285; Cenni *et al.*, 2015:250; Gozzi & Schmukler, 2016:2). Transaction-based lending decisions are based on ‘hard’ information that is relatively easily available at the time of loan origination and does not rely on the ‘soft’ data gathered over the course of the relationship with the borrower.

According to Cenni *et al.* (2015:250), financial statement lending places most of its emphasis on evaluating information from the financial statements of SMEs. In such a case, the decision to lend and the terms of the credit contract are predominantly based on the strength of the income statements and balance sheet. Financial statement lending is best suited for relatively

transparent enterprises with certified audited financial statements. The fact that most SMEs cannot afford to provide certified audited financial statements, Berger and Black (2011:249) warn that using this technology will not be favourable for some SMEs.

With regard to asset-based lending, decisions on credit approval are primarily based on the quality of the available collateral. This type of lending is highly monitoring-intensive and relatively expensive for SMEs as highlighted by Gobbi and Sette (2014:528). Generally, the collateral is in the form of accounts receivable and inventory and requires that the bank intensively monitors the turnover of the assets. Asset-based lending is available to business enterprises of any size, but is expensive and requires that the enterprises have high-quality receivables and inventory available to pledge at the time of application for credit (Gozzi & Schmukler, 2016:4).

Small business credit scoring is an adaptation to business lending of discriminant analysis and other statistical techniques long used in consumer lending. This lending technology is now commonly used by most formal financial institutions in developed and some developing economies to improve their competitive position in lending to SMEs. This is because formal financial institutions, using credit scoring, base their credit decisions on quantifiable information instead of private, more qualitative information acquired through direct interaction with SMEs (Berger & Black, 2011:249; Cailloux *et al.*, 2014:5; Lin *et al.*, 2015:1298). Instead of making more subjective judgments based on direct interactions with SMEs, credit scoring applies statistical methods to quantifiable data, summarising borrower characteristics to produce a score that can be used to evaluate the likelihood of repayment, which is often the ultimate concern of any credit provider, especially formal financial institutions. Nonetheless, Berger and Black (2011:251) caution that the wide use of credit scoring in assessing credit worthiness may produce some automatic reactions in credit supply as a consequence of the reduction in enterprises' wealth, hence affecting the borrowing capacity of the enterprise. This is evident in the works of Hasumi and Hirata (2010) and Albertazzi and Marchetti (2010), as both studies revealed a negative lending attitude towards SMEs lending using the credit scoring technology.

According to the literature on SME finance, relationship lending was first emphasised as the defining characteristic of SME lending by Berger and Udell (1995). Under relationship lending, lenders base their decisions in substantial part on proprietary information about the SME and

its owner through a variety of contacts over time. Unlike transactional lending, relationship lending provides lenders with the unique opportunity to make use of the private information it acquires during the course of the relationship. This information is obtained in part through the provision of credits and deposits and other financial products (Huang *et al.*, 2014:27; Ntiamoah *et al.*, 2016:562). Lin *et al.* (2015:1299) also note that credit lenders can gather additional information through contact with other members of the local community, such as suppliers and customers, who may provide specific information about the SME and its owner or general information about the business environment in which the SMEs function. Most importantly, Osano and Languitone (2016:3) observe that such information collected over time has significant value beyond the financial statements, collateral and credit score of SMEs, thus helping the relationship lender deal with informational opacity problems better than potential transactions lenders.

Summarily, though all four lending technologies are used by formal financial institution in assessing applications for credit from SMEs, Hoque, Sultana and Thalil, (2016:3) highlight that relationship lending plays a significant role in the financing of SMEs. Due to the problem of asymmetrical information, formal financial institutions would prefer to deny credit to opaque SMEs rather than increasing the cost of borrowing (Aiyar *et al.*, 2014; Amadhila & Ikhida, 2016; Cenni *et al.*, 2015; Hoque *et al.*, 2016). As such, collateral would be an important tool for formal financial institutions to mitigate informational asymmetries and thus, solve the problem of credit-rationing. With regard to relationship lending, Hoque *et al.* (2016:5) argue that the strength of the relationship affects the pricing and availability of credit. Relationship lending can increase trust between SMEs and credit officers of formal financial institutions, thus assisting credit and business managers to analyse credit risks of the borrower (D'Aurizio, Oliveiro & Romano, 2015:281). Empirical studies by Cotugno, Monferra, Sampagnaro (2013), Madill, Lisa, Alan, George and Haines (2002), Moro and Fink's (2012: 927) and Hernandez-Canovas and Martínez-Solano (2010) also found that where there is personal contact between the credit manager and the SME borrower, there is a strong correlation between the lending products of the formal financial institution and satisfaction of SMEs with the overall services of institutions.

4.2.4 Institutional structure and credit supply to SMEs

The structure of formal financial institutions and lending to SMEs has received huge attention from researchers (D'Aurizio *et al.*, 2015:283; Gama & Durate, 2015:23; Hoque *et al.*, 2016:4). If small financial institutions have a comparative advantage in lending to SMEs than their large counterparts, then SME borrowers should go to small financial institutions to access credit otherwise, they will be credit rationed, thus hindering their growth. Gama and Durate (2015:23) argue that large financial institutions have more difficult organisational organograms and decision-making on the approval of credits since most of them are centralised. As a result, the transfer of soft information is difficult within large financial organisational structures compared to hard information, which is based on accounting numbers. Hence, the relative ease of transferability of soft information through small financial organisational structures gives small financial institutions an advantage over their large counterparts. This explains why small financial institutions should be more efficient in SMEs lending than large ones.

According to Stein (2014:368), goal setting and mitigating agency problems in the lending decisions by formal financial institutions requires an appropriate organisational structure. According to Stein, such structure is a requirement for achieving different tasks, identifying new opportunities and converting organisational policies into realities. In addition, Stein (2014:369) points out that the manner in which an organisational structure is designed can be used as a managerial tool to ensure that there is adequate communication and interaction between lower level managers to senior managers, the delegation of authority and setting up control mechanisms. Pavlovska and Kuzmina-Merlino (2013:1045) argue that a system of control in an organisational structure involving diagnostic, interactive, belief and boundary systems, helps in creating and maintaining balanced decision-making processes. The foundation of Pavlovska and Kuzmina-Merlino's argument stem from the view that organisational structure is a mechanism that determines levels of coordination, control, centralisation and formalisation of power as a framework of facilitating organisational objectives.

Janicijevic (2013:37) defines organisational structure as a stable, either planned or spontaneous, pattern of actions and interactions that organisation members undertake for the purpose of achieving the goals of the organisation. Organisational structure is a conformation of the organisation hierarchy that maps out the formal rules governing different levels of the

organisation to respond to its goals. Janicijevic (2013:38) argues that organisational structure influences the processing of information and the general behaviour of the organisation, formalisation of rules, authority, communication, compensation, standardisation of work processes and skills, control of output and the degree of centralisation of decision-making. From this standpoint, organisational structure can be confirmed as an influencing factor in the flow of authority from top management to credit managers and the communication channels used in lending decisions.

Nickels, McHugh and McHugh (2016:281) state that the design of every organisational structure is a determining factor whether the organisation is mechanistic or organic in nature. According to the authors, organisational structures that highlight formalisation and centralisation of control are known as mechanistic organisation. Such structures are suitable for tasks that rely on routine information that is easily recognised, understood and predictable in terms of the input-output framework of production. Del Prete, Pagnini, Rossi and Vacca (2017) further argue that mechanistic organisations are also suitable for tasks that require high levels of skills and competence where rules, regulations and standard operation procedures are required to manage low levels of uncertainty.

According to Nickels, McHugh and McHugh (2016:282), organic organisational structures are characterised by tasks that require special skills, knowledge and experience and the exchange of information on a continuous basis with others in order to resolve non-standardised situations that occur in decision-making processes. This structure promotes a network structure of control where authority and communication are emphasised rather than hierarchy, to gather knowledge from all functional areas of the organisation. Del Prete *et al.* (2017) advise that the choice of organisational structure to adopt should be made purposeful and consistent with the nature of the environment in which the organisation operates. Del Prete *et al.* (2017) further state that in situations where mechanistic structures are appropriate for stable environments, organic structures are better suited for less stable and less predictable ones.

Considering the fact that both organic and mechanistic organisational structures require a certain level of skills, knowledge, competence and experience, it can be applicable to credit decision-making in formal financial institutions. Since credit and business managers have to deal with complex tasks in assessing and evaluating credit risks for a diverse population of borrowers, they have to implement various lending policies, procedures and guidelines within

a prescribed hierarchy. This requires a clear design of structures to enable credit and business managers handle lending decisions to SMEs in a manner consistent with the expectations of formal financial institutions. The adopted structure should enable formal financial institutions to minimise the risk due to moral hazard and adverse selection while at the same time, offering quality services to SMEs that require credit.

Berger and Black (2011:250) argue that the structure of formal financial institutions affects the lending methodology they implement in serving SMEs. Berger and Black (2011:251) further point out that formal financial institutions need a structure that allows for a hierarchy of agreements to exist between SMEs, credit officers and top management. Adopting a hierarchy structure implies that credit and business managers, who are the primary managers of the relationship with SMEs' borrowers, cannot make the final decision on certain credit approval. Though credit and business managers may be disgruntled sometimes by some of the decisions made by top management, it also provides room for them to learn from top management. This system minimises the risk of making wrong lending decisions but also creates room for conflict among the different levels of credit decision-makers.

4.2.5 Lenders' risk appetite

Since the seminal work of Stiglitz and Weiss (1981) on lenders' behaviour, Coppola (2014) argues that formal financial institutions are only willing to lend to borrowers, especially SMEs, when the risk and return profile of the enterprises are in their favour. Coppola (2014) defines risk appetite as the extent to which lenders are willing to provide credits to borrowers. It is usually measured as positive, negative or neutral. Positive risk appetite, on the one hand, is when the lender is willing to take risky investment for greater returns or attaches increasing utility to each increment in wealth. On the other hand, negative risk appetite is when the lender is averse to taking risk or attaches decreasing utility to each increment in wealth. Neutral appetite for risk is when the lender attaches equal utility to each increment in wealth (Coppola, 2014).

The Banking Association of South Africa (2018) states that the risk appetite of formal financial institutions is shaped by a number of factors as follows: history of previous credit performance; the risk profile of the business sectors being financed; the amount of credit security; financial regulations; and general economic and financial conditions. From the perspective of formal

financial institutions, the amount and price of credit supplied to a borrower reflects its credit performance data and the probability of the borrower not being able to repay the debt. As a consequence, lenders tend to charge high interest rates on credit in order to cover the likely loss. Given the economic downturn of South Africa's economy over the last ten years, coupled with the new financial services regulations, formal financial institutions are now becoming more risk averse. According to the new regulations instituted by the Reserve Bank of South Africa, formal financial institutions are now required to hold more capital against certain types of assets. This is to ensure that formal financial institutions remain solvent and depositors are secured, even if the credit becomes impaired (The Banking Association of South Africa, 2018; Weber 2018:29).

McLeay, Radia and Thomas (2014:2) argue that the perception that the quantity of reserves created drives the amount of credits granted by formal financial institutions is incorrect because their decisions to lend are principally based on the availability of profitable lending opportunities at any given point in time. The authors further state that lending is driven by every institution's risk appetite. According to McLeay *et al.* (2014:4), monetary policies focus on the price of money (interest rate), not its quantity, since changes in the price of money will influence the returns available to formal financial institutions for lending and hence, their willingness to lend. In addition, McLeay *et al.* (2014:6) argue that a monetary policy is the ultimate constraint on lending to SMEs. McLeay *et al.* (2014:6) note as follows:

The interest rate that formal financial institution can obtain on money placed at the Reserve Bank influences the rate at which they are willing to lend on similar terms in real money markets — the markets in which formal financial institutions lend to each other and other financial institutions... Changes in interbank interest rates then feed through to a wider range of interest rates in different markets and at different maturities, including the interest rates that banks charge borrowers for credits and offer savers for deposits. By influencing the price of credit in this way, monetary policy affects the creation of broad money (McLeay et al., 2014:8).

Summarily, whether a formal financial institution decides to hold more or less capital, the Banking Association of South Africa (2018) maintains it is the ultimate responsibility of formal financial institutions to protect depositors from losses and reinforce consumer confidence in the banking sector. Though there is cost associated with holding this capital, the fact that formal financial institutions have increased the amount set aside, this cost has risen along with it. In addition, the amount of risk faced by formal financial institutions is also influenced by the level

of security offered by borrowers. For instance, when commercial property is used as security, the risk increases when the value of the commercial property falls. Other than fixed assets, formal financial institutions also accept life insurance policies, credible surety and treasury bonds as collateral for credit from owners/managers of SMEs.

4.3 DEMAND-SIDE FACTORS AFFECTING LENDING TO SMEs

While the OECD (2016) and the World Bank (2016) argue that inadequate financing of SMEs in developing nations such as South Africa is influenced mainly by supply-side factors, contemporary literature on the financing of SMEs maintain a number of demand-side factors affect the supply of credit to SMEs (Bartlett *et al.*, 2014; Fatoki, 2014:186; Nieman & Nieuwenhuizen, 2014:26; Ramlee & Berma, 2013:116; Weiss, 2013). This section will focus on demand-side factors that might influence the supply of credit to SMEs. These factors include collateral, business information, managerial competency, business networking, legal and judicial system, macro-economic environment, business intelligence, entrepreneurship education and business ethics as discussed below.

4.3.1 Collateral

The use of collateral has become a very prominent feature of credit contracts between SMEs and lenders such as formal financial institutions. Collateral, in the form of business or personal assets or life insurance, are used to reduce the risk of lending, which is caused by the presence of asymmetric information, adverse selection and moral hazard. Collateral, as defined by Gitman (2010:786), are assets used by borrowers to pledge to lenders as security for the repayment of credit. The lender obtains a security interest in the collateral through the execution of a security agreement with the borrower that specifies that the collateral is to serve as a guarantee for the credit. A copy of the security agreement is filed with the court in order to provide information to subsequent lenders about which assets of a prospective borrower cannot be used as collateral. The filing requirement, therefore, protects the lender by legally establishing the lender's security interest. Assets held as collateral can be current assets or fixed assets of the SMEs. Inventory or accounts receivable are the most desirable current assets formal financial institutions prefer to hold as collateral for short-term credits because they can easily be converted into cash sooner than fixed assets. Fixed assets, such as land and buildings, are usually used for long-term credit application. Irrespective of the type of credit, formal

financial institutions usually demand between 30 to 100% of the book value of the collateral to be paid in advance. Table 4.1 shows assets that can be used by SMEs as collateral.

Table 4.1: Assets that can be used by enterprises as collateral

<u>Security</u>	<u>Credit capacity</u>
Land and buildings	More than 80% of value
Accounts receivable	70-85% of those less than 90 days of accepted receivables
Inventory	20-70% depending on obsolescence risk and saleability
Equipment	70-80% of equipment
Conditional sales contract	60-70% or more of purchase price
Plant improvement loan	60-80% of appraised value or cost
Source: Timmons and Spinelli (2007:495)	

➤ **Collateral and leverage**

According to Gitman (2010:790), there are conflicting views in financial literature regarding the role that collateral, especially fixed assets, can play in determining financial leverage. Abubakar (2015:761) argues that there is a negative relationship between the ratio of fixed to total assets and financial leverage. Abubaka believes that since the use of fixed assets can increase the variability in the future income of SMEs, the proportion of fixed assets of such enterprises should be negatively related to the percentage of debt in its capital structure. On the contrary, Harc (2015:215) proposes a positive relationship between the ratio of fixed assets and financial leverage. Harc (2015:216) argues that SMEs that hugely invest in tangible assets instead, have high financial leverage since such SMEs can borrow at lower interest rates given that their credit is secured with such assets. In addition, Harc (2015:216) highlights the fact that the debt to equity ratio of an SME can be determined by the assets structure of the SME since the assets structure is closely related to the notion of financial distress costs. The fact that the costs of financial distress depend on the type of assets possessed by SMEs, enterprises with huge investments in fixed assets, such as land, equipment and other tangible assets will have smaller costs of financial distress than SMEs that rely on current assets. As such, it could be said that enterprises with more tangible assets should have better access to credit from formal financial institutions.

Forte, Barros and Nakamura (2013:349) and Van Caneghem and Van Campenhout (2012:343) examined the impact of asset structure on leverage of SMEs. Their findings revealed that asset composition positively affects the use of debt by SMEs. Another study by Ezeoha and Botha (2011) found a strong negative association between asset composition and financial leverage. In addition, Ezeoha and Botha (2011) observed that a high proportion of fixed assets does not mean higher capacity to collateralise debt.

➤ **Collateral and credit protection**

One of the ways to protect creditors in today's business world is through the use of collateral. Collateral helps reduce a number of problems that arise between formal financial institutions and SME borrowers due to information asymmetry. Problems derived from asymmetries in the valuation of projects, uncertainty about the quality of projects and the riskiness of borrowers and problems related to the cost of monitoring or supervising borrowers' behaviour can be mitigated or solved using collateral (Fatoki, 2014:95). Collateral can also mitigate the problem of credit extension. As such, lenders feel more confident when collateral is pledged and they charge a lower interest rate than what they would have if the project had no collateral.

Moral hazard problems can be reduced by collateral requirements by increasing and adding a potential cost to borrowers should they fail to give in their best effort. In addition, once a borrower has been granted credit, a borrower can be tempted to engage in opportunistic behaviour and the fact that the lender cannot monitor the borrower, the borrower can choose to invest the funds in a riskier project than that initially agreed upon, at an interest rate that will not compensate the lender for the higher risk. The borrower might also be tempted to divert the credit for private use. Hence, the use of collateral requirements helps to keep the borrower in check for fear of losing the assets pledged as collateral. Collateral, as such, plays a disciplinary role in the behaviour of the borrower (Osano and Languitane, 2016:5).

➤ **Collateral and lending to SMEs**

According to Forte *et al.* (2013:348), from an objective standpoint, lending to SMEs is far riskier than lending to large corporations. Holding collateral is the only means through which formal financial institutions can use to ensure that they obtain something in return in the event of failure. Collateral may be in the form of either personal resources of owners/managers of SMEs or some identifiable assets of the business over which formal financial institutions can declare a prior claim over other creditors. Providing collateral is a major challenge for most

SMEs and lack of collateral may cause their application for credit to be denied by formal financial institution. Hence, leaving them out of the financial market.

Huang *et al.* (2014:29) affirm that information opaque in SMEs is accredited to their lack of a track record. As a result, holding collateral as security is attractive to formal financial institutions for two basic reasons: Firstly, the ability and willingness to offer collateral signals the confidence of the owners/managers about the likelihood of success of the project; and secondly, holding collateral can align the interests of the borrower (SMEs) with that of the lender. In this case, both the adverse selection problem of credit origination and the moral hazard problem after the credit has been granted are addressed.

Forte *et al.* (2012:350) and Van Caneghem & Van Campenhout (2012:343) argue that the asset structure of the enterprise should be related to its capital structure. The authors further argue that the more tangible and generic the enterprises' assets are, the greater the enterprises' liquidation value, thus reducing the financial loss incurred by lenders should there be any default and the enterprises' assets realised. Considering the fact that enterprises can reduce adverse selection and moral hazard costs by pledging their assets as collateral or contracting for fixed charges to be placed on particular tangible assets, will boost SMEs with assets of greater liquidation value to access credit from formal financial institutions easily at lower costs. This will in turn lead SMEs to acquire higher levels of debt finance in their capital structure.

The World Bank (2016) states that most owners/managers of SMEs often lack collateral to pledge as security when applying for credit. Consistently, the Umsobomvu Youth Fund (2016) maintains SMEs in South Africa start business without any acceptable collateral and their personal contribution is often very low and inadequate. The fact that lenders feel protected and comfortable when SMEs present collateral as security, implies that formal financial institutions may be willing to lend to SMEs that are able to present adequate collateral. As a consequence, it is hypothesised that there is a significant positive relationship between lack of collateral and access to credit from formal financial institutions to SMEs in South Africa.

4.3.2 Availability of business information

One of the principal measures of the capacity of SMEs to effect repayment of credits as highlighted by Taneli and Ohl (2014:586), is business information, which also includes

financial information. Financial information is accounting information such as cash flows and is usually prepared as the business operates on a daily or weekly or monthly or yearly basis. Accounting information is information prepared and provided by accountants and accounting systems. The business plans of SMEs usually contain both the financial and business information. Testa and Frasccheri (2015:12) posit that a business plan is a set of written documents modelling the future of an enterprise as it provides a road map to follow in executing the enterprise's strategies and plan. It is a written document that spells out what an enterprise plans to accomplish and how it plans to accomplish it. It also introduces potential investors, the management team and other stakeholders to the business opportunity the enterprise is pursuing and how it plans to accomplish its goals. In other words, Testa and Frasccheri (2015:14) maintain a business plan is very important to SMEs for two fundamental reasons. Firstly, it is an internal document that helps the enterprise to express its business model and solidify its goals; and secondly, it is a selling document for the enterprise as it provides a mechanism for the SME to present itself to potential investors, suppliers and business partners.

According to Ferreira, Loiola and Gondim (2017:141), a good business plan is acknowledged as one of the most essential documents prepared by owners/managers of SMEs when setting up a business and also to access external resources such as financial capital. The business plan is an essential document used in setting codes and business relationships between parties. Testa and Frasccheri (2015:13) moot that most owners/managers of SMEs in developing countries find it difficult to access credit from formal financial institutions since they have a shallow knowledge in corporate finance as well as the capability to articulate a good business plan that meets the requirements of appropriate investors.

Research by Fatoki and Smith (2011:1420) revealed that creditors, banks and other lenders use financial information provided by SMEs to analyse their present performance and predict future performance. The researchers found that formal financial institutions in South Africa require annual financial statements and information about SMEs in order to evaluate their credit worthiness. Information from the financial statements, together with other information obtained through discussions with prospective borrowers, are the main sources of information to lenders. Information obtained from the financial statements act as indicators of borrower's future prospects and ability to service credits.

The generation and effective use of credit information are essential to accessing finance from external sources. Compared to large corporations, SMEs face greater challenges in accessing capital from external sources because they do not have adequate financial information to enable external investors to assess their performance, thus leading to information asymmetry. Information asymmetry occurs when external capital providers have less information on the financial circumstances and prospects of owners/managers of SMEs. Information asymmetry is often described as the root of the finance problems of SMEs (Amadhila & Ikhida, 2016:285; Lin *et al.*, 2015:1300).

Information asymmetry leads to credit rationing as confirmed by Amadhila and Ikhida (2016:284). The authors highlight that formal financial institutions may limit the amount of credit granted to SMEs in circumstances where information asymmetry exists, thus resulting in credit rationing. In other circumstances, information asymmetry may force formal financial institutions to increase interest rates in order to compensate for potential adverse selection and moral hazard. The end result of such situation is that formal financial institutions may not be able to finance many projects as otherwise would have been the case. From this argument, it could be construed that if owners/managers of SMEs had spent time to develop a comprehensive and prior business plan at an early stage in the business, the risk perception would be reduced and the likelihood of obtaining external capital would increase.

Gupta, Guha and Krishnaswami (2013:2) point out that market potential and growth prospect is another distinguishing feature that may be contained in the business plan that is different from business financial viability as measured by cash flow projections. The authors consider market prospect as an estimated size and growth rate of the enterprise's current and future market. The market size is generally determined by the demand and supply characteristics of the enterprise's products. The limited availability and access to capital by SMEs most often force them to operate only in local markets. Operating in local markets suggest that most SMEs will often produce only goods that are demanded by local consumers. SMEs may run the risk of failure should they invest in a new product line that is not known by local customers. Gupta *et al.* (2013:4) further highlight that SMEs that are motivated to go into business because of a perceived market need, stand a very high chance of succeeding.

From the standpoint of formal financial institutions, lending to SMEs is a daunting task given that owners/managers of such enterprises do not disclose all important information related to

their transactions (Aiyar *et al.*, 2014:6; Bartlett *et al.*, 2014; Mills, 2014). In addition, most owners/managers of SMEs do not have adequate accounting and corporate finance background and skills in preparing financial statements and drawing up sound business plans. All these only help to further amplify the problem of information asymmetry. Garwe and Fatoki (2012:451) posit that very few owners/managers of SMEs in South Africa engage in market research before commencing operation as most of them are necessity rather than opportunity enterprises. The information obtained through market research can affect the future market, customer needs and potential competition. Lack of market research further limits the market potential and growth prospects of SMEs. As a result, it is hypothesised that there is a significant positive relationship between lack of business information and access to credit from formal financial institutions to SMEs.

4.3.3 Managerial competency

Managerial competencies, as defined by Fatoki (2014:141), is a set of knowledge, skills, behaviours and attitudes that contribute to personal effectiveness, which positively impacts on the performance of the enterprise. From the explanation of managerial competencies ((Fatoki, 2014:142), it can be understood that competencies are either observable performance or the standards or quality of the outcome of an individual's performance or the underlying attribute of an individual. Hence, competencies are attributes people have, possess, know and do to achieve required results. Competencies are, therefore, skills, ability or characteristics associated with high enterprise performance. According to Brito and Sauan (2016:4), managerial competencies are valued as part of the asset of an enterprise as these skills allow businesses to transform themselves, improve performance and grow to become established and successful businesses.

Managerial competencies are very important to the growth and survival of SMEs. Ahmad, Halim and Zainal (2010) point out that critical resources are likely to be held by managers of SMEs that are likely to be reflected in their skills, knowledge, experience and education. The skills, experience and level of education of such managers suggest that they are responsible for how good or bad their businesses perform. According to Herrington, Kew and Kew (2013), the hardships encountered by managers often stem from lack of knowledge, skills and experience.

Furthermore, a study by Mohsin *et al.* (2017) revealed that the innovative capabilities (the ability to undertake research and development, technical know-how and strategic management knowledge) of owners/managers of SMEs are strongly correlated with the growth and high performance of such enterprises. Tehseen and Ramayah (2015:52) investigated entrepreneurial competencies and the success of SMEs and found that such enterprises fail due to lack of managerial experience, lack of proper business planning, skills and personal qualities as well as other factors such as resource starvation and adverse economic conditions. The distinguishing features of high and low growth SMEs as revealed by the study are the education, training and business experience of managers.

In a study on the impact of managerial competencies on the performance of immigrant-owned SMEs, Fatoki (2014:143) revealed that owners/managers with high levels of business experience achieved higher profits. The study also revealed that owners/managers of SMEs with only start-up and managerial experience but lacked professional educational background, achieved low profits. This is an indication that even though entrepreneurs may have a start-up and managerial experience, lack of professional knowledge about their businesses and products have a positive relationship towards the performance of an enterprise.

In South Africa, the GEM (2014) report attributes the low level of entrepreneurial activities and the high failure rate of SMEs to lack of education and training of owners/managers of such enterprises, thus reducing management capacity. In the past, the quality and context of the educational system did not promote the development of managerial competencies. Until recently (2005), the school curriculum did not adequately integrate entrepreneurship, and this has left a legacy of lack of confidence, initiative and creative thinking. World reputable organisations such as the OECD (2016), the World Bank (2015) and GEM (2014) affirm that the lack of skills, experience and knowledge are also key limiting factors for entrepreneurship in South Africa. According to these organisations, entrepreneurs in South Africa often lack the expertise, experience and training related to the business they establish. Due to managerial deficiency, there is the dominance of necessity (survivalist) compared to opportunity entrepreneurial activity in the country and one of the primary reasons why South Africa appears to lag behind other developing countries in entrepreneurship. Nieman and Nieuwenhuizen (2014:28) assert that South Africa currently has a critical shortage of highly skilled managers. This makes matters worse for SMEs as they cannot afford to recruit highly skilled and competent managers and employees.

SMEs management practices such as the highly centralised decision-making system, overdependence on one or two key individuals for the enterprise's survival and growth, an inadequate range of managerial skills and training and an authoritarian approach, as highlighted by Fatoki (2014:143), often create a poor business image for most SMEs. The author further states that managerial competency is one of the key criteria for formal financial institutions to grant credit to SMEs. This criterion becomes very crucial in circumstances where formal financial institutions lack substantial and accurate financial information about the borrowing enterprises. From the credit provider's standpoint, Adzido and Azila-Gbettor (2014:197) note that lack of management competency of owners/managers decreases their legitimacy. It could, therefore, be deduced from the different views that the greater the level of managerial competency, the greater the performance and chances of survival of SMEs. Thus, it is hypothesised that there is a significant positive relationship between managerial competency and access to credit from formal financial institutions to SMEs.

4.3.4 Business networking

The role of networks and networking for SMEs has become a major research theme in contemporary research as these enterprises need to gain access to other organisations' resources (Ford & Mouzas, 2013:434; Wang & Fang, 2012:312; Naude, Zaefarian, Tavani, Neghabi & Zaefarian, 2014:632). According to Wang and Fang (2012:313), the concept of business network and networking was originally developed in Sociology and Anthropology, and then further developed in the business context. In the social context, Ford and Mouzas (2013:434) define a network as a specific set of relationships among various groups/actors. Two conflicting definitions of a network can be found in the business context as noted by Mbura (2014:98). The first considers a network and networking as a fashionable conceptual device for theorising about the internal organisation of larger businesses. The second is that entrepreneurship has been conceptualised as a dynamic process that requires linkages or networks between key components of the process for its successful development. A critically analysis of the two definitions reveals they are more embedded in the social context. For the purpose of this study, a business network is defined as the personal relationship between owners/managers of SMEs and their external actors. External actors, in this definition, can be either individuals or business organisations or institutions. Owners/managers of SMEs build such network relationships in

order to perform activities and access other resources. From this definition, business networks consist of four key components, namely; actors, resources, activities and linkages.

Naude, Zaefarian, Tavani, Neghabi and Zaefarian (2014:632) consider networking within the context of SMEs as an activity in which entrepreneurially-oriented owners of SMEs build and manage personal relationships with particular individuals in their surroundings. In general, networking includes the exchange of affect (liking and friendship), information, benefit and influence. According to Mbura (2014:98), entrepreneurial SMEs may use networking to exploit opportunities that will give them competitive advantages. In addition, inter-personal networking also plays a crucial role in the survival and growth of SMEs given that networking is seen as a means of raising required capital, identifying market opportunities, obtaining skilled personnel, identifying suppliers, identifying and developing technology.

In today's competitive business world, networking is hailed by academics and marketing practitioners alike as the new way to improve business performance. Thrikawala (2011:109) suggest that just as society is based on a complex network of relationships, so is business and that by actively networking, owners/managers of SMEs can gain a business advantage over their competitors. Thrikawala (2011) examined the impact of strategic networks for the success of SMEs and found that networking has a positive influence on the growth and success of an SME, especially through contacts with other business individuals. The researcher argues that SMEs face two crucial problems as follows: limited access to resources; and market share, which can be solved through networking. The researcher also argues that the formation of networks and networking could assist owners/managers of SMEs to better access new markets.

Networking can also be useful in reducing information asymmetry in a debtor and creditor relationship as affirmed by Arruda, Araujo Pontes Girao, and Lucena (2015:319). Social obligations between connected parties, and information transfer through social relationships can significantly influence business finance decisions. According to Arruda *et al.* (2015:320), social networking ties, interject expectations of trust and reciprocity into the economic exchange that, in turn, activate a cooperative logic of exchange. This logic promotes the transfer of private information and resources and motivates the parties involved to search for integrative rather than zero-sum outcomes. In this manner, embedded ties create new collaborative opportunities and also induce mutual rather than selfish distribution of rewards.

From the supply perspective of credit, belonging to networks increases the legitimacy of SMEs, which in turn, positively influences access by SMEs to external resources, such as credit, from formal financial institutions (Nieman & Nieuwenhuizen, 2014:31). According to Nieman and Nieuwenhuizen (2014:31), networks play a fundamental role in spreading knowledge about an enterprise's existence and its practices in the absence of effective market institutions. Networks also help an enterprise learn appropriate behaviour.

Mbura (2014:98) and Ntiamoah *et al.* (2016:562) suggest that networking can assist SMEs tap financial resources from alternative sources such as trade credit, credit from relatives and friends and support from governments. Considering the fact that formal and extensive financial markets in most developing economies are underdeveloped, alternative sources of credit will be of crucial importance to the growth and survival of SMEs. These alternative sources of financing are often more accessible, convenient, and, sometimes, cheaper though not usually enough. Thus, networking can assist SMEs to access other sources of credit thus, reducing their reliance on credit from formal financial institutions. Networking by SMEs contribute to business success and continuity. According to Ngoc, Le and Nguyen (2009:873), SMEs in South Africa find it difficult to establish and maintain networks that function effectively.

Robb and Fairlie (2008:1435) attribute the high success of Chinese, Indian and Korean SMEs in the diaspora to their close and tight network. Networks of co-ethnics provide valuable resources such as customers, labour, and technical assistance to assist in starting and running businesses. Co-ethnic networks are also useful in providing access to financial capital for SMEs through rotating credit associations, direct loans and equity investments in the business.

Despite the benefits of networking, Atieno (2009:33) contends that enterprises with limited resources may be discouraged from joining or establishing contacts because of the associated costs. This limits the extent to which SMEs can influence support mechanisms such as policies, legislation and infrastructure that affect their daily operations. SMEs, therefore, face a number of challenges that are institutional in nature, but their weak organisational ability and the minimal or non-existent networks limit the extent to which they can address these issues. Given that lack of networking affects the legitimacy of SMEs, this, therefore, is an indication that lack of networking could be one of the factors affecting the availability of and access to credits by SMEs in South Africa. Thus, it is hypothesised in this study that there is a significant

positive relationship between lack of business networking and access to credit from formal financial institutions to SMEs in South Africa.

4.3.5 Legal and judicial system

According to Tamanaha (2012:233), there is no universal definition of the term ‘law’. However, law in its generic sense, can be defined as a body of rules of action or conduct prescribed by controlling authority and having binding legal forces, which must be obeyed and followed by citizens subject to sanctions or legal consequences (Mayer, Warner, Siedel & Lieberman, 2012:9). From this definition, laws could be viewed as a collection of rules and principles intended to limit and direct human behaviour. Nations have formal rules that are commonly referred to as laws and informal rules that come from a society’s history, customs, culture, commercial practices and ethics (Mayer, Warner, Siedel & Lieberman, 2012:10).

➤ Law and finance

The theoretical foundation for the development of empirical literature on the relationship between law and finance was proposed by La Porta, Lopez-De-Silanes, Shleifer and Vishny (1997:1131-1150). The authors argue that securities (debt and equity) in the traditional theory of finance by Modigliani and Miller (1958), are recognised by their cash flows. Debt, as emphasised by Modigliani and Miller (1958), has a fixed promised stream of interest payments, whereas equity entitles the owner to receiving dividends. However, cash flow alone does not tell the whole story as argued by La Porta *et al.* (1997:1114) and that the defining feature of various securities are the rights that they bring to their owners. As such, those who own shares of the enterprise are granted the right to vote for the directors of the companies and such shareholders receive dividends on their equity because they can vote out directors who do not compensate them. Similarly, debt entitles creditors with the powers to repossess collateral when the company fails to make promised payments. Without these rights, investors would not get paid and, therefore, businesses would find it difficult to raise external finance. La Porta *et al.* (1997:1114) disagree with the view that securities are inherently characterised by some intrinsic rights and argue that this ignores the fact that these rights depend on the legal rule of the jurisdictions in which the securities are issued.

Law and the quality of its enforcement are potentially important determinants of what rights security holders have and how well these rights are protected. Since the protection of investors

determines their readiness to finance enterprises, corporate finance may critically turn to these legal rules and their enforcement. Thus, the differences in legal protection of investors might help explain why enterprises are financed differently in different countries. It is for this reason that La Porta *et al.* (1997:1115) question whether being a shareholder in France gives an investor the same privileges as being an investor in the United States, India or Mexico and whether a secure creditor in Germany fares as well when borrowers default as one in Sri Lanka or Italy with the value of the collateral assumed the same in all cases.

In a study conducted by La Porta *et al.* (1997:1116), the researchers collected data in forty nine countries that have publicly traded companies (South Africa included) covering legal rules pertaining to the rights of investors and the quality of enforcement of such As for creditors, these rules cover the respect for security of the credit, the ability to repossess collateral and the inability of management to seek protection from creditors voluntarily. The study revealed that laws vary a lot across countries, due in part to differences in their legal origin. Generally, Common Law countries have the strongest legal protection of investors and creditors while French Civil Law countries the weakest. The German and Scandinavian Civil Law countries are found somewhere in the middle, implying that creditor protection in these countries is weaker than in British Common Law countries but stronger than in French Civil Law countries.

Within the South African context, the Roman-Dutch Law forms the foundation of the South African Law, though present-day South African law is not limited thereto as regards its sources. Through court decisions, a vast number of legislative enactments and the introduction of certain legislation from English Law, South African laws were further enriched and developed (Rautenbach, 2008:2; Stoop & Churr, 2013:515). According to Rautenbach (2008:4), the South African legal system is a mixed or hybrid system with a combination of Roman Dutch Law and English Law. According to Rautenbach (2008:4), the significant influence of English Law means South Africa is usually classified under the Common Law tradition.

In South Africa, the law of contracts, which are predominantly written in accordance to the Roman legal principles regarding the law of obligations with limited influence of English Law, provide legal guidance for commercial law contracts between parties. According to the Roman Law, a legal obligation created a legal tie between legal parties, resulting in rights and corresponding duties recognised by law. A legal obligation consists of two elements as follows: the right of the creditor to claim performance; and the corresponding right of the debtor to

perform accordingly. One of the ways legal obligations could arise is from a contract. A contract is described as a lawful agreement, made by two or more persons within the limit of their contractual capacity with a serious intention of creating a legal obligation, communicating such intention, without vagueness, each of the other and being of the same mind as to the subject matter, to perform positive or negative acts which are possible of performance (Rahman *et al.*, 2015:172). However, creditor protection, bankruptcy and insolvency of enterprises and protection of creditors are governed by the Insolvency Act 24 of 1936 as amended by the Bankruptcy Act of 1973.

With regard to insolvency law in South Africa, Kanamugire (2013:20) argues that insolvency laws have a great impact on the economy of South Africa as the laws offer security for investors and lenders in both consumer and commercial borrowing transactions. This, in turn, influences credit market risks, which can affect the cost and availability of credit from credit providers such as formal financial institutions. In the commercial sphere, the reliability of the insolvency system plays a role in attracting domestic and foreign investment, as well as in promoting entrepreneurship and innovation. One of the primary ways to increase competitiveness in enterprises is how to make the insolvency process as efficient as possible, while maintaining fairness (Kanamugire, 2013:20).

Insolvency law was developed as a collective debt collecting procedure (Kanamugire, 2013:21) in order to provide a reasonable distribution of the earnings of the debtor's property among creditors where the debtor does not have the necessary assets to settle his or her debt which, as a consequence, implies that his or her estate is insolvent. According to the author, the law of insolvency can be described as the totality of guidelines shaping the situation where a debtor cannot pay his or her debts or where his or her total assets is less than his total liabilities. It is worth mentioning fact that the law of insolvency is based on two principles namely; voluntary surrender and compulsory sequestration.

Irrespective of whether liquidation is voluntary or compulsory, investors are granted certain rights or powers by laws in order to safe guard their investments. Some of these rights include disclosure and accounting rules, which provide investors with the information they need to exercise other rights. Laws protecting creditors largely deal with bankruptcy and reorganisation procedures, and include measures that enable creditors to repossess collateral, protect their seniority and make it harder for enterprises to seek court protection in reorganisation. Without

effectively enforced rights, the debtor would not have much of a reason to repay the creditors and external financing mechanisms would tend to break down.

According to Rahman, Zheng, Ashraf and Zheng (2015:163) creditors' protection is measured by the creditor right index (CRI). The CRI ranges from 0 (indicating weak creditors' rights) to 4 (indicating strong creditors' rights). A score of one is assigned when each of the following rights of secured lenders are defined by laws and regulations. Firstly, there are restrictions, such as creditor consent or minimum dividends, from a debtor to file for reorganisation. Secondly, secured creditors are able to seize their collateral after a reorganisation petition is approved, an indication that there is no automatic stay or asset freeze. Thirdly, secured creditors are paid first out of the proceeds of liquidating bankrupt enterprises, as opposed to government or workers. Finally, management does not retain administration of its property pending the resolution of reorganisation. Table 4.2 shows the CRI of selected developed and developing countries.

Table 4.2: CRI in selected developed and developing countries, including South Africa

<u>Developed countries</u>	<u>CRI</u>	<u>Developing countries</u>	<u>CRI</u>
New Zealand	4	South Africa	3
United Kingdom	4	Nigeria	4
Italy	2	India	2
Canada	1	Brazil	1
Australia	3	Ghana	1
Japan	2	Egypt	2
Source: Rahman, Zheng, Ashraf and Zheng (2015:163)			

Nigeria, New Zealand and the United Kingdom, with indexes of 4, signifies a very strong creditor protection. South Africa, with an index of 3, has a relatively strong creditor protection. This implies that creditors in South Africa are highly protected. Rahman *et al.* (2015:171) argue that some countries may have very strong CRI on paper but the efficiency of contract enforcement is quite low. This view is strongly supported by Standard and Poor (2007) which investigated debt recovery for creditors and the law of insolvency in South Africa. Their study revealed that South Africa is a friendly jurisdiction for secured creditors and, perhaps, the friendliest in Africa. However, contrary to some of the most creditor-friendly jurisdictions

around the world, secured creditors in South Africa do not have an unrestricted ability to foreclose on collateral outside of court proceedings, and such proceedings can be relatively slow and inefficient, with delays of enforcement for more than a year in some instances. Consequently, while debt recovery prospects for secured creditors are generally strong, such recoveries may be reduced by procedural delays and also the relatively high costs and fees of the enforcement process. The shortage of judges and magistrates, backlog of cases and lower creditor protection make the legal system in South Africa inefficient. Creditors in South Africa often display lack of interest in the administration of insolvent assets because creditors seldom receive any benefit of substance from the insolvent assets as bankruptcy proceedings takes a long time to be finalised. Given the long procedures, duration and cost it takes to register property, enforce contracts and close business upon bankruptcy, suggest a relatively inefficient legal system as opposed to the country's high CRI on paper. This, as a consequence, might affect the accessibility of credit by SMEs. Thus, it is hypothesised that there is a significant positive relationship between the inefficiency of the legal and judiciary system and access to credit from formal financial institutions to SMEs in South Africa.

4.3.6 Macro-economic environment

The macroeconomic environment, as highlighted by Rusu and Roman (2016:143), has significant implications for SMEs or their management considering the fact that economic forces ultimately influence the performance of SMEs, either positively or negatively. Karadag (2016:23) points out that an economic downturn usually has a negative effect on the performance of businesses, especially SMEs. Karadag further argues that most large companies adjust their prices (lower their prices) to maintain their loyal customers and also to attract new ones given that market issues and demand for a company's product are the most essential factors that positively influence the growth and survival of enterprises. According to Karadag, economic downturn is a characteristic associated with the likelihood of failure of enterprises to repay their debt. Meanwhile, Valsamis *et al.* (2011:78) state that economic expansion is a period whereby formal financial institutions have enough cash to lend out and most enterprises have access to debt capital, which positively impact on their performance. However, during periods of economic downturn, large and established companies that have both a record of past success and relatively good performance, have access to the largest portion of debt capital issued by formal financial institutions.

Considering the impact of the macro-economic environment on SMEs, it is the responsibility of owners/managers of SMEs to study the economic environment in order to be acquainted with changes and trends, and their strategic implications. The potential attractiveness of various strategies and consumption patterns in most economies are directly influenced by economic dynamics and have significant and unequal effects on enterprises in different industries and in different locations. Economic variables, as highlighted by Rusu and Roman (2016:143), include government's fiscal and financial policies, inflation, interest rates and foreign exchange rates. These variables significantly influence the demand for goods and services as consumers are forced to reconsider their consumption priorities. Thus, understanding the economic situation in a country is of paramount importance to all owners/managers of SMEs as they are bound to understand the employment dynamics, the level of disposable income, the availability of and cost of accessing credit and trends in the GDP. In addition, such owners/managers must comprehend the monetary policies of the government and changes in the interest rate as these have a significant effect on consumer buying power. Understanding the economic environment will, therefore, assist managers predict how trends and events in these environments might affect the future performance of their enterprises.

The present and future performance of an enterprise can be negatively or positively affected by the use of debt finance in its capital structure (Siddik, Kabiraj & Joghee 2017:3). The use of debt is positive if the enterprise is able to earn a return on assets that is higher than before tax interest rate on debt. The current state of the South African economy (an economy characterised by high interest rates) suggests that it will be difficult for SMEs to have a positive leverage, especially with the current economic downturn. A positive leverage occurs when SMEs operate under favourable conditions, when sales and profits margins are high and SMEs are able to generate a good return on assets (Valsamis *et al.*, 2011:77). During difficult times, cost of lending becomes high and SMEs experience low sales and profit margins, thus leading to negative leverage. The high cost of lending also suggests that it will be difficult for enterprises to access credit from formal financial institutions. Formal financial institutions, on their part, also try to minimise lending risk by not lending to SMEs as they are not certain if SMEs can repay the principal and interest on the principal.

During periods of economic downturn, as mentioned above, the Banking Association of South Africa (2018) contends that formal financial institutions have to acquire costly information on borrowers before extending credits to new or existing customers, uncertainty about economic

conditions (and the likelihood of credit default) would have significant effects on their lending strategies. The fact that not all businesses and credit managers are risk lovers, some managers find it difficult to predict returns from available lending opportunities under such condition of high uncertainty. McLeay *et al.* (2014:3) argue that credit and business managers of formal financial institutions find it easy to predict returns from potential projects and channel investment capital towards projects with high expected returns when the macro-economic environment is calm. On the contrary, when the economic environment is in fuss, formal financial institutions resort to more conservative lending behaviour as the ability of business and credit managers to predict returns accurately will be hindered. Baum and Caglavan (2008:75) found that the magnitude of macroeconomic uncertainty on lending is significant; a change of 6% to 10% in the dispersion of banks' loan-to-asset ratios in response to a doubling of macroeconomic uncertainty.

The United Nations Conference on Trade and Development (2016) maintains the current economic environment in South Africa is characterised not only by high interest rates but also by low or zero growth rate, low consumption, high inflation rates and volatile exchange rates. More so, the country is officially experiencing economic recession for the first time in more than a decade due mainly to the country's uncertain economic environment and lack of investors' confidence. These factors can impact on the availability of and access to credit from formal financial institutions to SMEs. The consumption index and confidence level of clients have fallen with a lot of enterprises showing reduced sales. Unemployment is very high. All these factors can affect sales, revenues and the market potential of SMEs. Furthermore, inflation has increased to double digits since 2008 and the Rand (South African currency) has depreciated by about 30% to the United States' Dollar. These two components of the economic environment push up the cost of inputs for SMEs, thus leading to an increase in the prices of products and may negatively impact on sales and profitability margins (Weber, 2018:26).

Olawale and Garwe (2010:732) state that during periods of inflation, enterprises, especially SMEs, need financial capital as inflation has a significant role in determining the financial leverage of an enterprise. Empirical studies on the impact of inflation on financial leverage are, however, inconclusive as to direction. Abaidoo and Kwenin (2013) investigated the relationship between macroeconomic conditions and business profit growth and found that expected inflation positively influences the financial leverage of SMEs. Abaidoo and Kwenin (2013) argue that monetary policy influences corporate default through its impact on inflation

and inflation expectations and, consequently, the financial leverage of enterprises. On the contrary, Shubita, and Alsawalhah (2012) and Cant and Wiid (2013) found a negative association between inflation and the total debt ratio of enterprises.

Summarily, weak economic conditions can affect sales, revenues, market and growth potential of most SMEs. Fluctuations in the exchange rate, if left unchecked may ultimately result in a macroeconomic disequilibrium that could lead to real exchange rate devaluation. Weak economic conditions also make it difficult for enterprises to use debt positively and this may affect their ability to repay the debt. Economic laws state that fluctuations in the exchange rate, if left unchecked could ultimately result in a macroeconomic disequilibrium that could lead to real exchange rate devaluation. Thus, it is hypothesised that there is a significant positive relationship between the macro-economic environment and access to credit from formal financial institutions to SMEs in South Africa.

4.3.7 Business intelligence

Due to lack of business information and knowledge, managers of SMEs in the contemporary business world face a number of unforeseen events that normally have a detrimental impact on their progress and performance. Business intelligence (hereafter BI) is currently perceived as a solution to such unsettling events that constrain SMEs unexpectedly (Fourati-Jamoussi & Niamba, 2016:38; Lueg & Lu, 2013:110). It is in this regard that Ivers, Byrne and Byrne (2016:3) argue that information and knowledge in a contemporary business world represent a fundamental wealth in any enterprise and such institutions try to make use of this wealth to gain competitive advantage, access external resources and drive enterprise performance. BI includes a set of concepts, methods and processes to improve business performance, using information from multiple sources and applying past experience to develop a sound understanding of business dynamics (Lueg & Lu, 2013:110). Soilen (2015:36) considers BI as knowledge about the business environment (for example, markets, customers, suppliers and competitors) and the organisation (for example, business performance and economic issues).

From the explanation of BI highlighted above, owners/managers of SMEs are required to make sound and quick decisions in order to access vital resources and remain competitive as the business world is rapidly changing and business processes are becoming more complex (Johns & Van Doren, 2010:553). Before strategic decisions can be made, managers need to have a

sound understanding of the business environment (Soilen, 2015:36). The timely, consistency, quality and the quantity of information available to managers are a main cause of the success or failure of BI initiatives (Ivers *et al.*, 2016:5). The fact that enterprises are struggling to make sense of the rapidly increasing capacity and high request for a variety of information and knowledge generated by both internal and external resources, BI has become a critical foundation of competition for several SMEs and has consistently been ranked among the top two agenda items of most managers nowadays (Ivers *et al.*, 2016:4).

According to Amabile, Laghzaoui, Peignot, Peneranda and Boudrandi (2013:103), Johns and Van Doren (2010:553), BI is used to improve the timeliness and quality of information and enable managers to better understand the position of their enterprises in comparison with competitors. In addition, BI applications and technologies help enterprises to analyse changing trends in the market share, interest rates, new business opportunities, changes in customer behaviour and spending patterns (Caron-Fasan, Lesca & Falcy 2012:127), customers' preferences, enterprise capabilities and market conditions (Tutunea & Rusa, 2012:867). It is used to help managers determine which modifications are most likely to respond to changing trends. Thus, BI has emerged as a concept for analysing collected data with the purpose to assist managers get a better wide-ranging knowledge of an enterprise's operations, make better business decisions and access valuable resources such as financial capital (Amabile *et al.*, 2013:105; Caron-Fasan *et al.*, 2012:128; Ivers *et al.*, 2016:6).

Boonsiritomachai, Mcgrath and Burgess (2014) point out that BI has become an imperative part of the solution to providing SMEs with the vital decision-making information and knowledge they need to access external resources such as debt finance, ensure the survival of enterprises, sustainability and growth. Accordingly, BI encompasses the whole “*decision spectrum*”, ranging from strategic decisions, through tactical decisions and to operational decisions.

Though empirical literature on the impact of BI on the performance of SMEs is limited in developing economies and non-existent within the South African context, a few studies carried out in developed economies show a significant positive relationship between BI, access to debt finance and performance of SMEs. A recent study by Gauzelina and Bentz (2017) focused the impact of BI systems on organisational decision-making, access to external resources such as financial capital and performance in France. The study revealed that when BI systems are deployed in SMEs, they facilitate timely decision-making, improve organisational efficiency,

and SMEs have more access to capital from external sources such as banks, SMEs have more growth potential, enable SMEs to meet the needs of clients appropriately, thus leading to more satisfied employees.

Curraj (2017:150) argues that there is a significant positive relationship between BI and access to debt finance. Curraj (2017) believes the problem of asymmetry information between lenders and SME borrowers can be solved when SMEs embrace BI. BI also plays a fundamental role in harmonising the lending relationship between the lender (formal financial institutions) and borrowers (SMEs) (Amadhila & Ikhida, 2016:285; Osano & Languitane, 2016:3; Ramlee & Berma, 2013:116; Wang, 2012:29). However, considering the fact that research in the area of BI in SMEs remain sparse, there is insufficient knowledge in understanding the adoption, benefit and implementation of BI by SMEs in developing countries in general and South Africa in particular. Thus, it is hypothesised that there is a significant positive relationship between BI and access to credit from formal financial institutions to SMEs in South Africa.

4.3.8 Entrepreneurship education

It is well-documented that entrepreneurship is a fundamental element for economic growth and social transformation, and part of the contemporary global economic crisis is attributed to lack of entrepreneurial dynamism in modern, western and African economies (Emmanuel, 2017:368; GEM, 2016; Stamboulis & Barlas, 2014:366; Welsh, Tullar & Nemati, 2016:126; Zhang, Duysters & Cloudt, 2014:624). Thus, the increasing emphasis on policy aims and initiatives, in order to raising both the awareness and capacity of societies for entrepreneurial activities. Despite entrepreneurship being fundamental for economic growth and social transformation, the interest of both high school and university graduates in entrepreneurship differs significantly from one country to another.

While the interest of university graduates in entrepreneurship in developed nations has always been high (European Commission, 2015; GEM, 2014; Welsh *et al.*, 2016:27), the same cannot be said for developing nations in general and South Africa in particular. Many European countries have started to integrate entrepreneurship in the national primary, secondary and tertiary education curricula. About two thirds of European countries explicitly recognise entrepreneurship education (hereafter EE) at the primary level, while about half of European countries integrate entrepreneurship into a compulsory subject at the secondary level (European

Commission, 2015; Huber, Sloof & Van Praag, 2014:77). In addition, the number of courses that are devoted to entrepreneurship or new venture creation in American business schools has also increased considerably throughout the years (GEM, 2014).

In Africa, some developing economies are beginning to appreciate the importance of EE. For instance, the Federal Government of Nigeria recently incorporated EE into the curricula of most tertiary institutions as a means to stimulate self-reliance and self-employment in the society. Emmanuel (2017:268) attributes the high level of entrepreneurship among Nigerian graduates to EE. Additionally, the author advances that the Nigerian economy is currently the best growing developing economy in Africa, attributed partially to the entrepreneurial mindset of its citizens. The importance of EE has spurred most Nigerians to demonstrate a positive attitude towards self-employment, identify viable business opportunities, portray a significant desire to venture into business, demonstrate managerial skills for running successful enterprises, encourage new start-ups and other entrepreneurial ventures (Emmanuel, 2017:268; Huber, Sloof and Van Praag, 2014:77).

Despite the noted importance and contributions of EE, GEM (2015) attributes the low level of entrepreneurship in South Africa over the years to the low level of EE among South Africans. Zhang *et al.* (2014:624) define EE as the process of providing individuals with the concepts and skills to recognise opportunities that others have overlooked and to have the insight and self-esteem to act where others have hesitated. EE indoctrinates in its recipients, entrepreneurial competencies and skills geared towards focusing their minds towards self-reliance and self-employment (Zhang *et al.*, 2014:624). Kautonen, van Gelderen and Fink (2015:657) argue that the appreciation of EE in a nation, such as South Africa, will help the country stimulate and regain its competitiveness in entrepreneurship which, in-turn, will promote knowledge-based entrepreneurs and improve the survival rates and performance of new start-ups and establish SMEs. As mentioned earlier, an improved survival rate and performance of SMEs will lead to the creation of more jobs, a reduction in the rate of unemployment and, consequently, increase economic growth. Furthermore, the authors posit that EE significantly contributes to the development of entrepreneurial attitudes such as risk-taking behaviour, creative and critical thinking and self-confidence (Aminu & Shariff, 2015:158; Kautonen *et al.*, 2015:657; Zhang *et al.*, 2014:624).

Empirical studies on EE with emphasis on entrepreneurship and the performance of enterprises (in terms of access to finance) are limited and still undergoing empirical testing with mixed findings thus far. Studies by Ahmad, Abdullah and Roslan, (2012), Aminu and Shariff (2015) and Emmanuel (2017) found a clear correlation between EE and access to finance. Some studies (Oosterbeek, van Praag & Ijsselstein, 2010; von Graevenitz, Harhoff & Weber, 2010) revealed no relationship between EE and access to financial capital. Given the inconclusive findings and the limited empirical studies on the effect of EE on entrepreneurship and the performance of enterprises, it is, therefore, hypothesised that there is a significant positive relationship between EE and access to credit from formal financial institutions to SMEs in South Africa.

4.3.9 Business ethics

Rambe and Ndofirepi (2017:2) consider ethics as a code of moral principles and values that direct the behaviour of an individual or a group of individuals in terms of what is right or wrong. Smith, Cronje, Brevis and Vrba (2007:142) state that ethics include distinguishing between fact and belief; defining issues in moral standings and applying moral principles to circumstances at an individual and organisational level. According to Smith *et al.* (2007:142), ethics, therefore, affects both individuals and business enterprises. At an individual level, being honest, accepting a bribe or using organisational resources for personal purposes are some of the ethical demands that arise when individuals are confronted with individual responsibilities. Ethics at the business level relates to the principles of conduct within enterprises that guide decision-making and behaviour and the use of resources. Hence, business ethics are the standards used to appraise the rightness or wrongness of a business' relations to others.

From the perspective of an enterprise, Turyakira (2018:2) considers business ethics as how an enterprise integrates core values such as honesty, trust, respect and fairness into its policies, practices and decision-making. According to Turyakira (2018:2), business ethics involves an enterprise's compliance with legal standards and to internal rules and regulations. Business ethics is complementary to other governance mechanisms, like the free market, government policies and social ethics. From the above explanations, business ethics can be viewed as the methods, principles and processes a business or organisation brings to bear on compliance to legislation, compliance to regulatory and professional standards, compliance to organisational standards; keeping promises and commitments; and abiding by general principles or values.

Fatoki and Chiliya (2012:14) posit that business ethics has been accredited as imperative to the conduct of businesses in South Africa and led to the King Reports in 1994, 2002, 2009 and 2016. The King I, II, III and IV focused on promoting the highest standard of good corporate governance level in South Africa. To promote the highest standard of corporate governance, the King I Report went beyond the financial and regulatory aspects of corporate governance in advocating an integrated approach to good governance in the interests of a wide range of stakeholders having regard to the fundamental principles of good financial, social, ethical and environmental practices (King I Report, 1994). The King IV Report (a later review of the King I Report), on the other hand, makes provision for seven characteristics of good corporate governance as follows:

- *Accountability* demands that individuals or groups in an enterprise, who make decisions and take actions on specific issues must be accountable for their decisions and actions;
- *Corporate discipline* is about the commitment to adhere to behaviour that is universally recognised and accepted to be correct and proper;
- *Responsibility* implying behaviour that allows for corrective action and for penalising management;
- *Transparency* implies the ease with which an outsider is able to make meaningful analysis of an enterprise's actions;
- *Independence* implies the extent to which mechanisms have been in place to minimise and avoid potential conflicts of interests that may exist;
- *Fairness* means that the systems that exist within the enterprise must be balanced in taking into account all those that have an interest (stakeholders) in the enterprise; and
- *Social responsibility* implies a well-managed enterprise should be aware of, and respond to social issues, placing a high priority on ethical standards (King IV Report, 2016).

With regard to the seven characteristics listed above, Jamnik (2017:96) cautions that most research on business ethics focused on large enterprises and emerged as a discipline at a time when large enterprises were seen as the main focus of business study. Since contemporary SMEs are seen as the engine of economic growth, employment, job creation, innovation and productivity world-wide (Peprah *et al.*, 2016:26; Quaye *et al.*, 2014:340; World Bank, 2015), the importance of business research ethics on SMEs comes to the fore (Jamnik, 2017:89).

Within the SMEs context, ethics and trust, as highlighted by Jamnik (2017:90), play a significant role in reducing information asymmetry. Jamnik (2017:90) explains that trust between credit and business managers and owners/managers of SMEs help reduce information asymmetry between the two parties, increase relationship lending which, in turn, increases the legitimacy and credit worthiness of the information provided by owners/managers of such enterprises.

Despite the credit worthiness of the information provided by owners/managers of SMEs in reducing agency problems, Rambe and Ndofirepi (2017:4) moot that credit providers, such as formal financial institutions, will decline credit applications of SMEs if the owners/managers applying for such credit fail to demonstrate integrity and trustworthiness. According to Rambe and Ndofirepi (2017:4), ethics and character are important because, among other things, they reveal intent. In other words, if credit providers sense that the borrower is somewhat untrustworthy towards fulfilling responsibilities with regard to a credit, even towards the business, the credit provider will most certainly decline a credit application. Thus, the credit provider must believe that, in addition to the legal agreement, the SME will honour the moral obligation to repay the credit. Unfortunately, Turyakira (2018:3) asserts that the ethical practices within the SME sector has become questionable in recent years. Ethical challenges pertaining to intellectual property, confidentiality of information, marketing, insider trading and accessing external financial resources are frequently exploited by owners/managers of SMEs (Rambe & Ndofirepi, 2017:4; Turyakira, 2018:3). For instance, it has become a common practice for owners/managers of SMEs to divert funding obtained from formal financial institutions (that is meant for business) for personal use or to finance projects that formal financial institutions are not aware of (Osano & Languitane, 2016:5; Turyakira, 2018). Rambe and Ndofirepi (2017:4) conclude that it is in the interest of the enterprises to behave in a way that recognises the need for ethical and moral content in managerial decision-making as it will ultimately benefit the enterprise.

Empirical studies by Erundu, Sharland and Okpara (2004:349-357) and Lepoutre and Heene, (2006:260) revealed that good ethical behaviour has a positive effect on enterprises' access to external resources and performance. Research by Donker, Poff and Zahir (2008:530) also revealed a positive correlation between the values of an enterprise, employee commitment and enterprise performance. Contrarily, Bauer, Derwa and Otten (2007:114) found a negative association between business ethics, access to financial capital and the performance of firms.

Consistent with the findings by Bauer *et al.* (2007), a study by Phillips, Freeman, Wicks (2003:481) also revealed that lenders prefer to invest in conventional projects that yield higher return on investment under poor economic conditions than ethical projects with low return on investment. According to Phillips *et al.* (2003:482), ethical enterprises in economies characterised by low growth, high inflation and high interest rates such as South Africa, might find it difficult to access funds from fund providers offering high interest rates. An empirical study by Kaler (2000:165) also found a negative association between business ethics, access to financial capital and the performance of firms. Phillips *et al.* (2003:482), acknowledge that the inconsistent empirical evidence does not lead to a compelling conclusions regarding business ethics, access to financial capital and the performance of firms. Moreover, most of these studies cited above have focused on developed countries such as Canada and the United States of America. Almassawi (2001) states that although studies conducted in developed countries have contributed substantially to the literature, their findings may not be applicable to other countries, due to differences in cultural, economic and legal environments. A thorough review of the literature revealed no researcher has investigated business ethics and access to financial capital in South Africa. Based on the inconclusive empirical results, it is, therefore, hypothesised that there is a significant positive relationship between the ethical awareness of owners/managers of SMEs and access to credit from the formal financial sector.

Summarily, the demand-side factors can be conceptualised as shown in Figure 4.1.

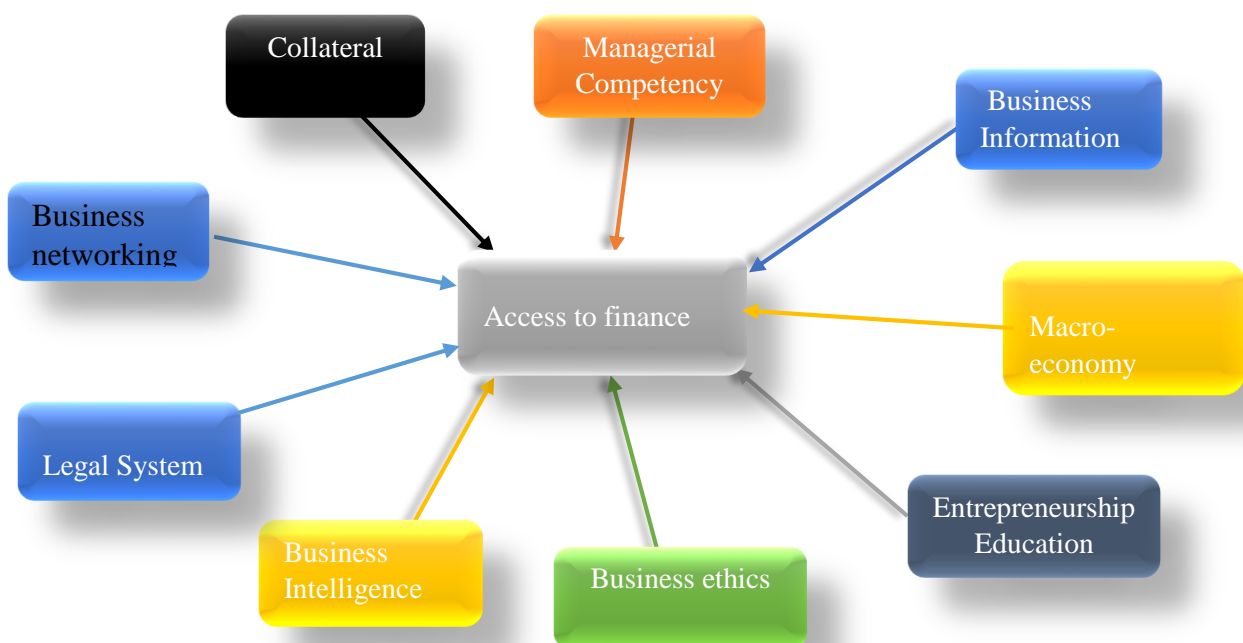


Figure 4.1: Conceptual framework

The conceptual framework shows that collateral, managerial competency, business information, macro-economy, entrepreneurship education, business ethics, business intelligence, legal system and business networking can impact access to credit from the formal financial institutions. All these factors will be tested in Chapter 7 after analysing the quantitative data.

4.4 SUMMARY OF CHAPTER

This chapter has provided a review of literature on the involvement of formal financial institutions in activities of SMEs (both supply and demand-side factors) in South Africa. This chapter addresses the primary research objectives (supply and demand-side). The objectives were to investigate the factors that impact on the willingness of formal financial sector to provide credit to SMEs (supply-side) and to investigate factors that impact on access to credit from the formal financial sector by SMEs (demand-side). The supply-side factors discussed included cost of lending, information asymmetry, lending technology, institutional structure and credit supply to SMEs as well as lenders' risk appetite. On the other hand, the demand-side factors discussed included collateral, business information, managerial competency, business networking, legal and judicial system, macro-economic environment, business intelligence, entrepreneurship education and business ethics.

A discussion of the supply-side and demand-side factors in this chapter, enabled the researcher to address the primary objectives of this study (as stated in Chapter 1, Sections 1.4.1 and 1.4.3 respectively). The next chapter focuses on the research design and methodology used in conducting this empirical study.

CHAPTER FIVE

RESEARCH DESIGN AND METHODOLOGY

5.1 INTRODUCTION

Maxwell (2016:15) states that before engaging in any research, researchers must first understand what research is all about. Research is a systematic and methodical process of enquiry and investigation that increases knowledge and that attempts to answer questions that have no plausible answers (Hair, Wolfinbarger, Bush & Ortinau, 2008:4). According to Hair *et al.* (2008:4), the term “research” is taken from the word “*re*” which means “again” and “search again” meaning to “investigate”. Al Kindy, Shah and Jusoh (2016:892) posit that research involves a thorough, rigorous enquiry, objective and systematic process of collecting, analysing and interpreting data to increase the understanding of a phenomenon of interest in order to ease decision-making. This process of ensuring that data is collected and analysed properly is termed research methodology. Khan (2014:226) argues that the quality of any research and its outcome is directly related to the validity of the methodology used.

Hammarberg, Kirkman and de Lacey (2016:499) define research methodology as a framework within which facts are placed so that meaning can be extracted from them. According to Hammarberg *et al.* (2016:450), research methodology is the core of any research project. Creswell (2014) refers to research methodology as a model for undertaking a research process in the context of a particular paradigm. It is concerned with why, what, from where, when and how data for a research is collected and analysed. According to Hammarberg *et al.* (2016:500), research methodology is very essential in any research given that research can only be successful if it is properly planned, structured and implemented. In addition, Maxwell (2016:17) highlights that research methodology is important not only because it embodies philosophical assumptions, but also because it guides the selection of research methods.

The purpose of this chapter is to discuss and describe the research methodology used in conducting this study. As mentioned earlier (Chapter One), the main aim of this study was to analyse the availability of and access to credit from the formal financial sector and the performance of SMEs. This chapter focuses on the research methodology used to achieve this aim. A sound research methodology must also cover the research design. Maxwell (2016:19)

notes that a good research methodology includes the research design, scope, sample size, techniques, data collection and analysis as discussed below.

A research design is a blueprint or a plan that guides the arrangement of how a researcher anticipates to collect and analyse data in a manner that aims to combine the relevance to the research purpose with efficiency in procedure (Creswell, 2014:24). Terre Blanche, Durrheim and Kelly (2006:322-326) consider a research design as a strategic framework for action that serves as a bridge between the research questions and the implementation of the research. The aim of a research design is to plan and structure a given research study in such a manner that the ultimate validity of the research findings is maximised with minimum expenditure, time and money (Terre Blanche *et al.*, 2006:328). An appropriate research design ensures that the right decision is taken in relation to data collection techniques, sampling methods, research instruments and time period while, at the same time, minimising expenditure and providing direction to the research. In this chapter, a justification is provided for the research paradigm selected for this study, the research design, sampling unit and sampling methods, data collection methods, pre-test and pilot test of data collection instruments, interview guide and questionnaire administration, data preparation, as well as data analysis.

5.2 RESEARCH PARADIGM

Maxwell (2016:21) states that the origin of the term paradigm can be traced to the seminal work of Thomas Kuhn (1962). A research paradigm, as defined by Collis and Hussey (2014:43), is a philosophical framework (worldview or set of assumptions and beliefs, values and methods) that guides how scientific research should be conducted. According to Saunders (2012:39), a research paradigm is “a way of examining social phenomena from which particular understandings of these phenomena can be gained and explanations attempted”. While research has been dominated by two main paradigms (positivism and interpretivism), Collis and Hussey (2014:43), Creswell (2014) and Ngulube and Ngulube (2015:1) argue that three research paradigms prevail in the social sciences: interpretivism, positivism and pragmatism. Table 5.1 compares the two philosophical assumptions of the two main paradigms (positivism and interpretivism). Positivism is associated to quantitative research while interpretivism is associated to qualitative research. Pragmatism is the combination of positivism and interpretivism in a single study referred to as mixed method research. In this

study, the research design and methodology were underpinned by the pragmatic research paradigm.

When considering the nature of a research, Collis and Hussey (2014:43), Creswell (2014), Ngulube and Ngulube (2015:1) note that there are certain differences between qualitative (interpretivist) research, quantitative (positivist) research and mixed method (pragmatist) research approaches as shown in Table 5.1.

Table 5.1: Assumptions of the two main paradigms

Philosophical assumption	Positivistic paradigm	Interpretivist paradigm
Ontological assumption (form and nature of reality)	Reality is objective	Reality is subjective
	There is one reality	There are multiple realities
Epistemological assumption (what constitutes valid knowledge)	The researcher is objective	The researcher is subjective
	The researcher is distant from what phenomena is studied.	Researcher interacts with what is being researched.
Axiological assumption (the roles of values)	The researcher is independent from the phenomena under study	The researcher acknowledges that the research is subjective.
	The results are unbiased and value free	The findings are biased and value-laden
Rhetorical assumption (the language of research)	Researcher writes in a formal style and uses passive voice, accepts quantitative words and set definitions.	Researcher writes in an informal style and uses personal voice, accepts qualitative terms and limited definitions.
Methodological assumption (the process of research)	Process is deductive, study of cause and effect with a static design (categories are isolated beforehand).	Process is inductive, study of mutual simultaneous shaping of factors with an emerging design (categories are identified during the process).
	Research is context-free	Research is context bound

	Generalisations lead to prediction, explanation and understanding.	Patterns and/or theories are developed from understanding
	Results are accurate and reliable through validity and reliability.	Finding are accurate and reliable through verification.

Source: Creswell (1994:5)

Given the differences between the two main paradigms (as shown in Table 5.1), Creswell (2014) cautions that researchers must consider carefully the philosophical assumptions that underpin positivism and interpretivism in order to determine whether their orientation is broadly positivist or interpretivist. However, mixed method research uses both approaches in a single study. A sequential exploratory mixed method research design was adopted in this study; using a two phased approach. Firstly, qualitative data was collected and analysed in Phase 1. The qualitative data, together with contributions from the literature, provided the basis for designing the research instrument to collect the quantitative data in Phase 2 of data collection in this study. In Phase 2, quantitative data was also analysed. Sequential implies data is collected sequentially in phases, where Phase 1 informs Phase 2, and greater emphasis placed on Phase 1 (Hashemi & Babaii, 2013:829). On the other hand, exploratory implies research that is initially conducted to clarify and define the nature of the research problem or opportunity by giving ideas or insights as to how the research problem can be addressed (Al Kindy, Shah & Jusoh, 2016:892).

By adopting a sequential exploratory mixed method research design, the following are, therefore assumed in this study: the ontology (nature of reasoning) is abductive; the axiology (nature of reality) assumes multiple realities exist (multiple realities extend to those of the researcher, research participants as well as those reading the final report of this study); and the epistemology (the nature of knowing) is inter-subjective (Ihuah and Eaton, 2013:936; Narh, 2013). The methodology (process of the research), on the other hand, is influenced by the manner in which reality is investigated (Collis and Hussey, 2014:43). Since methodology is concerned with why, what, from where, when and how data is collected and analysed, an interpretive stance was adopted in this study, when interacting with literature and also when interviewing credit and business managers during data collection in Phase 1. Analysing the

qualitative data also required that an interpretive approach be adopted in the study for greater understanding of the perspectives of credit and business managers with regard to the lending process, factors that impact on the willingness of the formal financial sector in lending to SMEs, challenges faced by the formal financial sector in lending to SMEs and how the formal financial sector perceives investment in SMEs.

A positivist stance was adopted in Phase 2 (of data collection) since as the researcher did not have any formal interaction with respondents when they were completing the questionnaires (the researcher was independent). The researcher issued the questionnaires to respondents and collected the completed versions after a few days. However, an interpretive stance was adopted during the analysis, reporting and interpretation of the quantitative results.

Having considered the differences between the three research paradigms, and since the pragmatic paradigm was considered in this study, it is further conceptualised. Pragmatism, as highlighted by Kalolo (2015:155), stems from the Greek word ‘pragma’, which means practice and practical or action and affair. It also refers to pragmatisch, as noted by Kalolo (2015:155), which means experimental, empirical, and a purposive thought that is based on and applies to experience. The etymological meaning of the term, as highlighted by Kalolo (2015:155), identifies pragmatism as a practical (action-oriented) approach to finding solutions for existing problems and issues. Actions are taken based on practice and the fact that multiple realities exist, it is, therefore, important to have an in-depth understanding of the phenomenon under scrutiny. Thus, pragmatism signifies practicality, compromise, prudence and a clear goal orientation in dealing with problems.

Pragmatism is a concept that tries to solve human problems (Creswell, 2013; Bezzina & Saunders, 2014:31). To a pragmatist, the dictate of science is not only to find truth or reality, but to facilitate human problem-solving. Thus, science should gain understanding of what is necessary to solve problems as they arise. The impression that knowledge comes from actions, situations and consequences remain dominant to most pragmatists. Pragmatists see their actions as driven by dialectics, a process of arriving at truth through confrontation of different points of view. The most common interpretation of the term pragmatism is applying what works best, making it a philosophy or theory of ‘workability’ (Creswell, 2014). Hence, to the pragmatists, what is true is what works best in enabling one to overcome an immediate problem.

Summarily, an idea that underpins the pragmatic worldview, as highlighted by Creswell (2014), Bryman and Bell (2015), Kalolo (2015:155) would be: (i) it is not connected to only one system or reality; (ii) it has freedom of choice; (iii) it does not see the world as an absolute unity; (iv) it sees truth as what works at the time; and (v) it accepts that research always occurs in social, historical, political and other contexts. Therefore, pragmatism was considered appropriate for this study because it deals with the practical objective perspective of credit and business managers on lending to SMEs where decisions are made based on their experience and knowledge. Their perspectives provide the researcher with in-depth insights on bank lending to SMEs. In other words, pragmatism is appropriate to explore a phenomenon in depth and then measures its prevalence and generalises results across different groups. The researcher thus, used insights to develop another research instrument (questionnaire) to further understand how owners/managers of SMEs perceive access to finance from formal financial institutions.

5.3 RESEARCH DESIGN

There are three main research designs available to any researcher to select from, namely; experimental, survey and descriptive research designs (Babbie, 2011:32; Bambale, 2014:866; Fujimori, Shirai, Asai, Kubota, Katsumata and Uchitomi, 2014:2167; Ponto, 2015:167). Of the three research designs, the survey design was considered in this study. While experimental research design is appropriate and accurate in the laboratory, it was not appropriate for this study because it is intrusive and difficult to carry out in practical situations because of the inability to get two groups with identical characteristics, especially when applied to human beings (Babbie, 2011:32). Descriptive research design on the other hand, was not suitable to use in this study because of the many factors the research study seeks to investigate and all the factors cannot be realistically controlled at the same time.

5.3.1 Survey design

Survey research, as defined by Ponto (2015:167), is the collection of information from a sample of individuals through their responses to questions. In survey research, a variety of methods can be used to recruit respondents and collect data through the use of different methods of instrumentation (the use of an interview guide and questionnaire) (Ponto, 2015). In survey research, qualitative research strategies (for instance, using open-ended questions), quantitative research strategies (for instance, using questionnaires with numerically rated items), or both strategies (i.e., mixed methods) can be used. In survey research, the researcher selects a sample

of respondents from a population and administers an interview guide or questionnaire to them. A survey research design was used in this study for the following reasons as noted by Fujimori, Shirai, Asai, Kubota, Katsumata and Uchitomi (2014:2167):

- Survey research is relatively cheaper compared to experimental and observation research;
- Survey research is useful in describing the characteristics of a large population. Other methods of data collection, such as experimentation and observation, cannot provide this general capability; and
- Surveys can be administered from remote locations using face-to-face, mail, email or telephone. As a result, very large samples are feasible, making the results statistically significant even when investigating multiple variables.

Ponto (2015:168) states that there are four main methods used to collect data in survey research as follows; personal interviews; self-administered surveys; telephone surveys; and mail surveys. Personal interviews and self-administered surveys (within the sequential exploratory mixed methods design) were used in this study (using a two phased approach). In the first phase, qualitative data was collected through personal interviews with credit and business managers of selected formal financial institutions (banks, supply-side). In the second phase, data was collected through a self-administered survey with selected SMEs (owners/managers of SMEs, demand-side). These phases are discussed below.

5.4 PHASE 1, QUALITATIVE DATA COLLECTION

This section focuses on the sampling process with regard to the supply-side of this study. The sampling process includes the population, sampling frame and unit, sample size and sampling method and the interview guide.

5.4.1 Sampling process

According to Collis and Hussey (2014), and Terre Blanche *et al.* (2006:323-326), the different stages involved in the sampling process are as follows: defining the population; specifying the sampling frame; determining the sample size; specifying a sampling method for selecting items from the sampling frame; implementing the sampling plan; and collecting data. The sampling process, as explained by Collis and Hussey (2014), involves the selection of specific sources of data from which data is collected to address the objectives of the study. Given that the

purpose of sampling is to enable researchers to select a particular source (population) from which data could be collected, the following stages in the sampling process (population, unit of analysis, sampling method and size, and method of data collection) are discussed below.

5.4.1.1 Population

Knowing and defining the population is the first and critical step in the sampling process. The population in a study could include individuals, groups or organisations. A population, as defined by Fujimori *et al.* (2014:2168), is any complete group or body of people, events, objects, or any collection of items having common characteristics under consideration in a particular research. Such a group or collection has comparable characteristics that are easily identifiable. Considering the fact that the purpose of this study was to analyse the availability of and access to credit from the formal financial sector and the performance of SMEs, the population (phase 1 of the study) consisted of all credit and business managers of the 27 commercial banks listed on the website of the Banking Association of South Africa (2018).

5.4.1.2 Unit of analysis

The unit of analysis comprises the complete group of specific population elements relevant to a research study from which data will be collected (Terre Blanche *et al.*, 2006:133). The sampling frame (phase 1 of the study) comprised the 27 commercial banks while the unit of analysis comprised the 8 commercial banks (ABSA, Standard Bank, FirstRand Bank, First National Bank, NEDCOR, Bidvest Bank, African Bank and CAPITEC). The reasons for choosing the eight banks are explained in Section 5.4.1.3. The sampling unit is a distinct element or group of elements subject to being selected from the sampling frame. All credit and business managers of the eight commercial banks formed the sampling unit. In this study, the sampling unit comprised an estimated 106 credit and business managers of the eight commercial banks. An estimated figure of 106 was decided on after repeated phone calls and visits to the head offices of the eight banks located in Johannesburg. Despite most of the banks refusing to disclose the exact number of credit and business managers at the head offices due to confidential reasons, the researcher was provided with an estimated number of credit and business managers in the entire Gauteng Province.

5.4.1.3 Sampling method and size

The two main types of sampling methods are probability and non-probability sampling (Ponto, 2015:167). Both sampling methods were used in this study, however, in this phase of the study, non-probability sampling was used. According to Gogtay and Thatte (2016:66), non-probability sampling is a sampling method in which members of a population do not have an equal chance of being selected. With non-probability sampling, randomisation is not important in selecting the sample from the population. Instead, subjective methods are employed to decide which elements should be included in the sample. Etikan, Musa and Alkassim (2016:1) point out that non-probability sampling includes convenience sampling, quota sampling, accidental sampling and purposive/judgemental sampling.

Purposive sampling is typically used in qualitative research to identify and select information-rich cases for the most proper utilisation of available resources (Gogtay and Thatte, 2016:66). Gogtay and Thatte (2016:67) further note that purposive sampling involves the identification and selection of individuals that are proficient and well-informed with a phenomenon of interest. Such valuable information also contributes to a better understanding of the theoretical framework since participants are proficient and well-informed of the phenomenon under investigation. In addition to the knowledge and experience of participants, as noted by Etikan *et al.* (2016:3), Gogtay and Thatte (2016:66) also add the importance of willingness and availability of such individuals to participate, and the ability to communicate experiences and opinions in an articulate, expressive and reflective manner. In this study, purposive sampling was used to select a sample size of 8 banks (sampling unit) from the 27 banks as explained in Section 5.4.1.2 above. Sample size refers to the number of elements in a particular sample included in a research study (Al Kindy, Shah & Jusoh, 2016:896). The correct sample size is dependent on the population and the significance of the study. These eight banks were selected because of their substantial contribution to commercial banking in South Africa, and for being responsible for about 91% of all assets and 85% of all liabilities in the commercial banking sector and also because the head offices of these 8 banks are located in Gauteng Province.

From the estimated 106 credit and business managers representing the eight commercial banks, one credit manager and one business manager from each bank (16) represented the sample for this phase of the study. The 8 credit and 8 business managers from each bank were purposively selected because they were responsible for credit recommendation, evaluation and approval in

the eight banks. Furthermore, the head offices of these banks are in Johannesburg responsible and are for designing and implementing policies and guidelines for all credit and business managers. Thus, these managers were considered to be representative of what all credit and business managers do in a particular bank located anywhere in South Africa. Besides, credit and business managers at the head offices are more informed in terms of their knowledge and experience in lending as they make the final lending decisions for other credit and business managers at branch offices. Thus, interviewing credit and business managers at the head office yielded more insights than doing so at branch offices.

5.4.1.4 Method of data collection

Data collection is the process of gathering required information in order to achieve the purpose, objectives and research questions raised in a study. To achieve the objectives and research questions raised in Phase 1, primary data was collected by conducting in-depth interviews with one credit and one business manager from each of the eight commercial banks. The overall purpose of the in-depth-interviews (with these managers) was to achieve the first set of research objectives (supply-side) as highlighted in Chapter 1, Section 1.4.1. All the interviews were audio-recorded, and each recording assigned a code (in an interview register). The date and time of the interview(s) were also indicated in the register. The researcher travelled to the different banks and all interviews were conducted in the offices of the credit and business managers. The interviews were then transcribed, filed and stored in a safe place (computer hard drive).

The interview guide was divided into six sections as follows:

➤ Section one: Demographical characteristics of participants

In section one of the interview guide, participants were requested to provide personal information such as their nationality, gender, ethnicity, age range, highest level of education, current position, previous position, number of years of service with current and previous employer and role in the financing process. Such information was necessary in order to understand the profile of participants.

➤ Section two: Credit assessment and evaluation

Questions in this section sought to establish the main priority investment focus areas of formal financial institutions, their lending criteria and to ascertain the lending criteria used for immigrant-owned SMEs. Responses to questions in this section of the interview guide were

used to respond to the primary research question: *What are the factors that impact on the willingness of formal financial institutions to grant credit to SMEs?* Responses to this research question gave effect to the primary research objective: to investigate factors that impact on the willingness of the formal financial sector to grant credit to SMEs.

➤ Section three: Understanding challenges in lending to SMEs

This section sought to determine challenges faced by formal financial institutions in assessing and approving credit to SMEs. Responses to questions in this section were used to respond to the subsidiary research question: *What are the challenges faced by formal financial institutions in assessing and approving credit to SMEs?* Responses to this research question gave effect to the first secondary research objective: to establish challenges faced by the formal financial sector in assessing and approving credit to SMEs.

➤ Section four: Financing process

Before the approval of credit in favour of SMEs, the application goes through a rigorous process. Responses to questions in this section were used to establish the process of applying for credit, different persons involved in the credit process and the role performed by each person. Responses to questions in this section were used to provide answers to the research question: *How does the formal financial sector assess credit applications from SMEs in South Africa?* Responses to this research question gave effect to the second secondary research objective: to determine how the formal financial sector assesses credit applications from SMEs.

➤ Section five: Lending attitude of banks

SMEs contend that formal financial institutions are not interested in lending to them. Responses to questions in this section were used to determine if formal financial institutions are committed to investing in SMEs or not. Responses to the question items were also used to provide answers to the research question: *How does the formal financial sector perceive investment in SMEs?* Responses to this research question gave effect to the third secondary research objective: to ascertain how the formal financial sector perceives investment in SMEs.

➤ Section six: Improving access to finance

The purpose of this section was to establish whether formal financial institutions were making any efforts to improve SMEs' access to credit or not. Responses in this section assisted the researcher to make valuable recommendations.

Responses to all the research questions gave effect to the supply-side research aim of this study: to analyse the availability of credit from the formal financial sector to SMEs. The interview guide consisted of closed and open-ended and semi-structured questions. Closed questions

were used to solicit information on the demographic characteristics of participants. All the other sections in the interview guide comprised open-ended questions, allowing credit and business managers to express themselves freely about their experiences and knowledge in lending to SMEs. Responses to the open-ended questions (after analysis) resulted in new themes (business intelligence, business education, ethics and management team and product quality). After the interviews and data analysis, the literature on these emerging themes was reviewed and the themes included in Chapter 4, Sections 4.3.7, 4.3.8 and 4.3.9 respectively. The questions assisted the researcher in capturing specific details of participants such as their job title, job description and job specification. The semi-structured questions also ensured a level of consistency in responses received (Bambale, 2014:866).

High costs of travelling, potential data overload, excessive amounts of time required to complete interviews as well as limitations related to the quality of interview data are some of the limitations of interviews. To ensure the information obtained from the interviews were of high quality, the researcher equipped himself with knowledge of best practices in interviewing. These included maintenance of respect, active listening and use of effective probing techniques such as silent probes, “uh-huh” probes and “tell-me-more” probes where necessary (Bambale, 2014:867). At the beginning of the interview, the purpose of the study was explained and participants requested to sign an informed consent form. The interviews then proceeded with questions as reflected in the interview guide.

The quality criteria relevant to qualitative research are discussed below.

5.4.2 Quality criteria in qualitative research

One of the main purposes of research, as highlighted by Remenyi (2013), is for researchers to be able to persuade their audiences that the findings of an inquiry are trustworthy and worth paying attention to (Moon, Brewer, Januchowski-Hartley, Adams & Blackman, 2016:19), especially in qualitative research where the interview process is open to the challenge of informant and researcher bias (Bengtsson, 2016:12). The quality criteria pertinent to this phase of data gathering was a fundamental concern in this study. As such, the criteria of confirmability, transferability, dependability and credibility are essential in guiding the quality of a study (Bengtsson, 2016:12; Lichtman, 2014:386-387; Remenyi, 2013). These criteria and their application in this study are discussed below.

5.4.2.1 Confirmability

According to Lichtman (2014:387), confirmability can be likened to objectivity. It refers to the “degree to which results could be confirmed or corroborated by others” and the degree of objectivity of the researcher in data collection and reporting (Mabuza, Govender, Ogunbanjo & Mash, 2014:3). Mabuza *et al.* (2014:4) state that the close relationship between researcher and interviewee is a fundamental issue that affects opinions on validity because of potential bias and subjectivity in interpretation. Given the extent of the researcher’s involvement in the research process, a reflexive approach was adopted.

Reflexivity is the process of examining both oneself as researcher, and the research relationship (Salazar, Crosby and DiClemente, 2015:157). It involves self-examination of one’s assumptions and preconceptions to see how they shape the research decisions made, and an examination of the researcher’s relationship with the participant and how the relationship dynamics affect the responses to the questions (Salazar *et al.*, 2015:458). Commencing the interviews with open-ended questions (after completing the section on demographic characteristics) helped to minimise prejudices and foster reflexivity, thereby allowing interviewees to express their experiences freely. The documented transcription and content analysis processes detailing coding also assisted in establishing confirmability for the research, demonstrating that the findings emerged from the data and were not the researcher’s personal predispositions. Besides, rich and thick verbatim descriptions of participants’ accounts are provided to support the findings in Chapters Six. In addition, no relationship was established with interviewees prior to the commencement of the study. Other measures taken to ensure objectivity of the results included the following: comparing the transcription of one of the interviews done by a senior colleague (more experienced in qualitative research) with the transcription of the same interview done by the researcher (to ensure the researcher captured all what was stated in the interview correctly) and the data analysis was reviewed by one of the participants for objectivity. Using a diary also helped to add value to the transcribed texts.

5.4.2.2 Transferability

Transferability refers to the possibility of transferring particular findings to another similar context or situation, while still preserving the meanings and inferences from the completed study (Houghton, Casey, Shaw and Murphy 2013:13). Moser and Korstjens (2017:274) substitute generalisability with the idea of transferability and explain the concept of

transferability or applicability to the possibility of generalising the results of the study to another group or in another setting. Thick descriptions, provided by the researcher, enable the reader to determine the value of the findings. Thus, thick descriptions are the main tool for transferability (Blanchard and Horan, 1998). Readers can then decide for themselves the value that the descriptive vignettes provide for their situation.

5.4.2.3 Dependability

Dependability, as explained Moon *et al.* (2016:20), is often associated to the concept of reliability in quantitative research as it is related to the stability and consistency of the study. Dependability is aimed at proving that the study would produce consistent results if it were repeated in the same setup with the same interviewees. In order to demonstrate dependability, each process in the study should be reported in detail to enable an external researcher to achieve similar results if they repeat the inquiry. Following the pragmatic approach adopted in the current study, the criterion of dependability is a challenge to establish due to the multiplicity and complexity of assumed realities, as indicated in this Chapter (Section 5.2).

5.4.2.4 Credibility

According to Houghton *et al.* (2013:14), validity is associated to the credibility or trustworthiness of the research. Credibility involves conducting the research in a believable manner and being able to demonstrate credibility in view of the rigour of methods and techniques, the credibility of the researcher as well as the philosophical belief in the value of the inquiry (Bengtsson, 2016:13). Credibility establishes confidence (the value and believability) in the findings of a study and builds trust with the research participants (Bengtsson, 2016:12). In the context of this study, the researcher is well-experienced and well-trained in conducting research and interviews in both academic and professional settings. The fact that the interview guide and the data analysis were based on a valid and reliable framework and also reviewed by the researcher's promoter and an independent expert researcher, increased the credibility of the research findings.

5.4.3 Qualitative data analysis

Analysing qualitative data is considered a fundamental activity in the research process in order to be able to make sense of, interpret and theorise the collected data (Neale, 2016:1096). It is a process that is highly intuitive and aimed at making sense out of the information gathered. In

analysing qualitative data, there is no clear separation between data collection and analysis because it is not necessary that the researcher must have all his or her data collected before commencing with the analysis (Neale, 2016:1097).

At the beginning of the interview, the researcher made use of a diary in which he wrote reflective field notes and impressions of the interview following the completion of each interview. These field notes were very useful in the final data analysis stage because it added meanings to the transcribed texts. The full length of each interview was recorded and transcribed. Pauses and other non-verbal behaviours were excluded (see Annexure D an example of one of the transcribed interviews). To conform to the principle of anonymity, care was taken to clean the transcribed data files, removing any references of the name of institutions. After transcription, content analysis was used to analyse the data obtained. Content analysis in this study was guided by the five-step process of analysing qualitative data proposed by Terre Blanche *et al.* (2006:322-326). The five steps include familiarisation and immersion, inducing themes, coding, elaboration, interpretation and checking as discussed (see Sections 5.4.3.1 to 5.4.3.5). The findings of the content analysis are presented in Chapter 6, supported by “thick descriptions” (Bakker, 2015). The next section provides an explanation and illustration of the process, as suggested by Terre Blanche *et al.* (2006), used in analysing the qualitative data in this study. This process is also in conformity with the quality criteria in qualitative research explained in Section 5.4.2.

5.4.3.1 Familiarisation and immersion

Analysis of qualitative data essentially begins with the process of familiarisation and immersion in the data. The primary objective of this phase is for the researcher to gain an overview of the depth and diversity of the interviews, and identification of recurrent themes and issues (Austin and Sutton, 2014:437). According to Austin and Sutton (2014:438), a number of methods useful for early familiarisation and analysis of research data include the following: listening to the interview tapes, writing up a contact summary sheet as soon as transcripts have been typed so as to provide a useful reflective overview of the interview, much of which would have been lost if summarised later; reading transcripts; and studying notes. The researcher analysed the data by reading, and re-reading each transcribed text, repeatedly listening to the audio recordings, making notes and developing portraits and reflective notes (Neale, 2016:1098). By carefully and repeatedly listening to the interview recordings (with

credit and business managers), the researcher gained an in-depth understanding of credit assessment, evaluation and approval processes and also was able to identify various themes that emerged from the interviews.

5.4.3.2 Inducing themes (creating a thematic framework)

Having identified a number of pertinent themes at the familiarisation phase, these themes were then examined in detail. As suggested by Terre Blanche *et al.* (2006:323-326), themes should preferably arise naturally from the data yet, still have a bearing on the research question. As a consequence, the data derived from the interviews with credit and business managers were examined and compared to determine patterns, similarities and differences. Having gained an in-depth understanding of the data, the next task of the researcher was to identify key words, chunks of text and recurring ideas relating to credit assessment, evaluation and approval. Thereafter, the data was grouped into specific themes and sub-themes. Hence, the relationship between the data and the research question, as recommended by Terre Blanche *et al.* (2006:323), was considered in the course of the analysis.

5.4.3.3 Coding (also referred to as indexing)

After identifying themes, the next stage involved applying codes to the data. Coding, as defined by Terre Blanche *et al.* (2006:325), is the process in which data is marked as different sections based on the relevance to the themes. Terre Blanche *et al.* (2006:326) further considers coding as the process of identifying aspects of the data that relate to the research problem. Data was broken down into meaningful pieces during the coding process and subsequently, grouped together and the data placed under different headings. In this study, coding occurred simultaneously with developing categories. The researcher coded the materials using the reviewer feature in Microsoft Word. An example of an excerpt of coded material (using Microsoft Word) is shown in Table 5.2.

Table 5.2: Excerpt of coded material using Microsoft Word

Interviewer	Comment scope	Comment text	Author	Date
C ₃	We need some form of security before we do the lending.	Col Factors that impact on willingness to lend	Francis	23-Aug-2018

5.4.3.4 Elaboration

The process of elaboration, as highlighted by Terre Blanche *et al.* (2006:324-326), allows the researcher to explore the themes more closely. It also allows the researcher to revise the coding system and build up a picture of the data as a whole. Further coding and elaboration of the data was done by the researcher until no new insight emerged from the data.

5.4.3.5 Interpretation and checking

After elaboration, the final stage in the process of analysing qualitative data entailed interpreting and checking the data by means of thematic categories. The researcher reviewed the charts and research field notes, compared and contrasted perceptions and searched for connections and patterns that could assist in explaining the phenomenon under investigation. The various themes were further re-examined by the researcher for possible meanings and relationships. As part of the process of interpretation and checking, the researcher used the services of a qualitative data analyst to re-evaluate the various themes for likely misinterpretations, whether important issues were overlooked and whether biases of the researcher, although guarded against, might have misrepresented the final themes. The interpretation of the data was then presented and discussed with the qualitative data analyst with the intention of checking whether the interpretation made was in fact accurate thus, ensuring internal validity of the findings. In addition, to ensure that the findings of this study were indeed trustworthy or dependable, the qualitative data analyst also checked the processes of data collection and analysis. As highlighted by Terre Blanche *et al.* (2006:326), it is essential to discuss the results of a study with people who are familiar with the topic as well as those who are not, as the latter may be able to provide a fresh perspective.

5.5 PHASE 2: QUANTITATIVE DATA COLLECTION

This section focuses on the sampling process used in the second phase of data collection (with regard to the demand-side of the study).

5.5.1 Sampling process

The sampling process included the following: definition of the population; sampling unit; sample size; sampling methods; and methods of data collection. Validity and reliability, error and data analysis were also considered in this phase.

5.5.1.1 Population

The number (4000) of SMEs in Johannesburg, Gauteng Province, obtained from the Bureau for Economic Research (2016) comprised the population for this study. As outlined in Chapter 1 (Table 1.1), only SMEs in the formal sector (registered SMEs) were included in this study since their activities are regulated by government (see Chapter 1, Section 1.7.4).

5.5.1.2 Unit of analysis

Raosoft, a statistical software calculator, was used to calculate the SME sample for this study. Raosoft is a calculator and not an analysis tool. In doing so, Raosoft considers four factors in determining an appropriate sample. These factors include the margin of error, the confidence level, the population and the response distribution (Raosoft, 2018).

a) Margin of error

The margin of error is the amount of error which can be tolerated and is selected by the researcher depending on the precision needed to make population estimates for a given sample. The margin of error ranges from 3% to 7% in business research, with 5% margin of error being the most appropriate (Lloria & Moreno-Luzon, 2014:693). A 5% margin of error was used in calculating the sample size for the study.

b) Confidence level

The confidence level is the amount of uncertainty that the researcher can accept. It is the estimated probability that a population estimate lies within a given margin of error. The confidence interval in business research varies from 90% to 100% with 95% being the most commonly accepted (Lloria & Moreno-Luzon, 2014:694). The higher the confidence level, the larger the sample size. A 95% confidence level was considered for this study.

c) Population

The population for this study was 4000 SMEs as stated above.

d) Response distribution

Using the Raosoft calculator, a response distribution of 50% is usually used because it gives the largest sample (Raosoft, 2018). Using the Raosoft calculator at a 5% margin of error and a

95% confidence level, the minimum recommended sample for this study was 351. Due to the limitations associated with using questionnaires as a data collection tool, including non-response, the researcher doubled the minimum recommended sample size for the study. Thus, the sampling frame for this study was 702.

5.5.1.3 Sample size

As determined by the response distribution, a total of 702 questionnaires were distributed to SMEs.

5.5.1.4 Sampling methods

Probability sampling was used (in this phase of the study) to select SMEs. Etikan *et al.* (2016:1) define probability sampling as having the “distinguishing characteristic that each member in the targeted population has a known, nonzero chance of being included in the sample”. In probability sampling, the findings derived from a sample can be generalised to the population because the sample is representative of the population from which it is drawn. Gogtay and Thatte (2016:68) identify five main categories of probability sampling as follows: simple random sampling; systematic sampling; stratified sampling; cluster sampling; and disproportional sampling. From the five main categories of probability sampling, a simple random sampling method was used to select SMEs that participated in the study. Furthermore, this study can make inferences from the 702 randomly selected SMEs that would be representative of the SMEs (4000) in Johannesburg.

Gogtay and Thatte (2016:68) note that with simple random sampling, each member of the population has an equal chance or probability of being selected as a participant. Simple random sampling is simple to apply, in that, a random sample is chosen from a population and without any order. Furthermore, data analysis is reasonably easy and has a sound mathematical basis. The sample was obtained from all elements of the population. The researcher used the following steps (in the simple random sampling process) as pointed out by Gogtay and Thatte (2016:68) in selecting respondents for the study:

- Defining the population frames of SMEs;
- Defining the sample sizes of SMEs;
- Giving each element within the population frames a unique number from 1; and
- Using the random number table.

5.5.1.5 Method of data collection

Quantitative data in this study was collected through a self-administered questionnaire. A questionnaire is a set of questions designed to gather data from a research sample. In using a questionnaire, all respondents are asked the same questions and given similar instructions on how to answer them. A questionnaire can be open-ended, where respondents are asked to express their opinions, or closed-ended, given no room for self-expression (Hofstede, 2006:133). Hofstede (2006:134) cautions that open-ended questions should be minimised in a questionnaire as answers given by respondents may be difficult to analyse or quantify. The questionnaire used for this study had no open-ended questions. A questionnaire was used for the following reasons:

- Questionnaires help to ensure that information from different respondents is comparable;
- Questionnaires increase the speed and accuracy of responding;
- Questionnaires facilitate data processing;
- Questionnaires are economical in terms of time and money; and
- Questionnaires enable respondents to remain anonymous and be honest in their responses.

In this study, the self-administered questionnaire was issued to the randomly 702 selected owners/managers of SMEs. The questionnaire consisted of six sections, with each section containing statements and questions intended to provide information to address the demand-side empirical objectives (as highlighted in Section 1.4.4 of Chapter One).

➤ Section A: Demographic characteristics of respondents

In section A, respondents were requested to provide their personal information such as gender, age range, nationality, highest level of education, legal status of their enterprise, registration status of the enterprise, number of employees, previous work experience and the main activities of the enterprise.

➤ Section B: Type and situation of the SMEs

In section B, information was sought on the investment of owners/managers of SMEs in the business, future plans of the owners/managers about the business and challenges faced by the enterprise. This section consisted of 18 statements and responses to the statements were used

to provide answers to the following research question: *What are the challenges faced by SMEs in accessing credit from the formal financial sector?* Responses to this research question gave effect to the first secondary research objective: to ascertain challenges faced by SMEs and their impact on the performance of SMEs.

➤ Section C: Financing SMEs

Section C focused on the financing of SMEs and consisted of 8 statements. The statements included access to credit by SMEs, their financial needs and their financing choices. Responses to the statements in this section were used to provide answers to the following research questions: *What are the financing needs of SMEs from the formal financial sector in South Africa?* And

What are the financing choices of SMEs from the formal financial sector in South Africa? Responses to these research questions gave effect to the second and third secondary research objective: to investigate the financial needs of SMEs from the formal financial sector; and to examine the financing choices of SMEs from the formal financial sector respectively.

➤ Section D: Important factors to consider when applying for credit from banks

In section D, respondents were asked to rate the level of importance of certain factors (the factors addressed in section E) considered by formal financial institutions as vital in the credit application process. This section consisted of 13 statements.

➤ Section E: Reasons why formal financial institutions may refuse to give credit to SMEs
Section E consisted of 38 statements. Respondents were asked to indicate the extent to which they agreed or disagreed with statements about why banks may reject their credit applications. The responses were used to provide answers to the primary research question with regard to the demand-side as follows: *What are the factors that impact on the access to credit from the formal financial sector?* Responses to this research question gave effect to the primary research objective: to investigate factors that impact on access to credit from the formal financial sector by SMEs.

➤ Section F: Performance of SMEs

Section F consisted of 8 statements that measured the performance of SMEs. Respondents were asked to indicate the extent to which they agreed or disagreed with statements on the performance of their enterprise. Responses obtained were used to provide answers to the following research question: *What is the relationship between access to credit from the formal financial sector and the performance of SMEs in South Africa?* Responses to this research question gave effect to the fourth research objective: to examine the relationship between access to credit from the formal financial sector and the performance of SMEs.

Responses to all the research questions gave effect to the demand-side research aim of this study: to analyse the accessibility of finance from the formal financial sector and the performance of SMEs. The respondents were requested to respond to a 7-point Likert interval scale with 1 denoting strongly disagree or unimportant or least challenging and 7 denoting strongly agree or most challenging or extremely important (Cooper & Schindler, 2003:420). Using the 7-point Likert interval scale in this study allowed for inferential statistical analysis of data (Collis & Hussey, 2014), thus making it easier to use advance statistical tests such as regression and t-test (Cooper & Schindler, 2003:421). All sections in the questionnaire comprised closed-ended statements. Sections C and F were generated from the literature review as presented in Chapters 2 and 3 as well as selected scale items from validated research instruments (Fatoki & Asah, 2011), a process that is fully supported by various scholars (Collis & Hussey, 2014; Cooper & Schindler, 2006:231-240). In the context of this study, the questionnaire was meant to collect data to be used to test the hypotheses (as stated in Chapter 1 Section 1.5) in order to analyse access to credit from the formal financial sector and the performance of SMEs.

The questions used in section C of the questionnaire were obtained from a previous study by Fatoki and Asah (2011), in which the impact of enterprise and entrepreneurial characteristics on the access to debt finance and performance of SMEs in King William's Town was investigated. In their study, the Cronbach alpha coefficient scores for the five items on access to debt finance was 0.793 and for the five items on performance of SMEs stood at 0.802. The high Cronbach alpha coefficient show the reliability of the question items and the validity of the research instrument.

Data was collected by the researcher, assisted by three research assistants. Prior to data collection, the researcher had a brief meeting with the research assistants in order to brief them on the structure of the questionnaire and some questions that could need clarity. The completed questionnaires were put in envelopes, sealed and collected by the researcher and the research assistants after two or three days. After collecting the sealed envelopes from respondents, they were opened, the questionnaires removed, placed in a box and later prepared for data cleansing, capturing and analysis.

One pivotal aspect that must not be forgotten when collecting quantitative data is how the data will be coded before analysis. Theron (2015:4) considers coding as the pivotal link between data collection and explaining the meaning of the data. Theron (2015:5) argues that coding does not constitute the totality of data analysis, but is a method to organise the data so that underlying messages portrayed by the data may become clearer and understandable to the researcher. Sutton and Austin (2015:228) define coding as the process of assigning a code or symbol, preferably a number to each possible answer to a particular question. The purpose of coding is to transform responses provided by respondents into codes and symbols that can be easily entered and read in a statistical analysis software package. Numbers were used to code the questionnaires. For instance, the age of respondents was coded as follows:

Table 5.3: Sample of Coding

Age	Less than 20	21 – 30	31 – 40	41 – 50	51 – 60	61 and above
Code	1	2	3	4	5	6

Considering the fact that the validity of a research instrument is fundamental, it is critical to test the questionnaire in an actual situation. Thus, it was essential to conduct a pilot test. Aaker, Kumar and Day (2003:118) state that pilot testing refers to testing the survey instrument on a small number of respondents in order to identify and eliminate or rephrase difficult questions. Pilot testing ensures that the questionnaire meets the researcher’s expectations in terms of information obtained. Participants in the pre-test are usually drawn from the same population. Pre-test is necessary for the researcher to be satisfied that the data collected will be relevant and accurate. Pre-testing of the questionnaire, used in this phase of the study, was done with five owners/managers of SMEs. The result of the pilot testing was very encouraging as some statements were modified or rephrased. The questions were rephrased and the final questionnaire formatted accordingly. Pre-testing led to the test-retest reliability.

5.5.2 Validity, reliability and error

Validity and reliability are fundamental concepts in research as they are used to enhance the accuracy of the assessment and evaluation of a research work (Creswell, 2014). Creswell (2014) further states that validity and reliability are two fundamental characteristics of a sound questionnaire. To ensure the credibility of the findings and conclusions of this study, steps were taken to ensure both the reliability and validity of the instrument and reduce error margins.

5.5.2.1 Reliability test

Reliability refers to the consistency, stability and repeatability of results of a study (Creswell, 2014:201). In a similar manner, if the findings of a study can be reproduced under a similar methodology, then the research instrument is considered to be reliable. This implies the level of a research instrument's reliability is reliant on its ability to produce the same result when used repetitively (Creswell, 2014:201). Heale and Twycross (2017:66) posit that the Cronbach's alpha coefficient item scores can be used to measure reliability. The Cronbach's alpha coefficient is a measure of how well each individual item in a scale correlates with the remaining items (Heale & Twycross 2017:66); in other words, a test of internal consistency. The value for Cronbach's alpha coefficient ranges from 0 to 1. The higher the score, the more reliable the generated scale is. Heale and Twycross (2017:67) warn that a Cronbach's alpha coefficient of less than 0.5 means the reliability of the measuring instrument is questionable (unacceptable), likewise the findings of a study. For the purpose of this study, a Cronbach's alpha coefficient of ≥ 0.6 was considered as reliable.

The following steps were also taken to enhance the reliability of the measuring instrument (questionnaire for this study) as pointed out by Cant *et al.* (2008:188):

- Pre-testing the questionnaire during the development stage of the survey through a pilot study;
- Discussing the questionnaire with the promoter and other senior researchers with extensive knowledge and experience in the field of study;
- Keeping open-ended questions to the minimum; devising response scales that were likely to increase the variability of responses, thus ensuring higher statistical value from the data by using a large sample size;
- Performing a thorough review of the literature in the field; and
- Using the supply-side (qualitative) findings as a point of reference to generate questions for the demand-side.

5.5.2.2 Validity

Heale and Twycross (2017:66) state that validity determines whether the research truly measures that which it was intended to measure or how truthful the research results are. Validity is defined as the extent to which a concept is accurately measured and whether a measuring instrument actually measures what it is supposed to measure given the context in which it is

applied (Heale & Twycross, 2017:66). There are four major types of validity as highlighted by Heale and Twycross (2017:66) as follows: content validity; face (content) validity; criterion-related validity; and construct validity.

Content validity, as explained by Mohamad, Sulaimanb, Sern and Salleh (2015:167), is whether the research instrument adequately covers all the content that it should with regard to the variable or construct being investigated. In other words, validity questions whether the research questionnaire covers the entire domain related to the variable it was designed to measure or the concept being measured is done so appropriately (Heale & Twycross, 2017:66). Face validation is a judgmental process that can be done in many ways. The researcher may choose to do it alone or may use a panel of experts or senior researchers in the field of study to judge how well the questionnaire was designed to measure what it was designed to measure. Heale and Twycross (2017:68) explain that face validity is established when an individual (and or researcher), who is an expert on the research subject reviewing the questionnaire, concludes that it measures the characteristic of interest.

Creswell (2014) states that criterion-related validity (also referred to as instrumental validity) is used to demonstrate the accuracy of a measure or procedure by comparing it with another measure or procedure, which has been demonstrated to be valid. On the other hand, construct validity is concerned with how adequately a scale or a test measures what it proposes to measure (Cresswell, 2014). The following steps were taken by the researcher to ensure the validity of the study as noted by Creswell (2014):

- Using a statistician and a panel of experts to evaluate the questionnaire for conceptual clarity;
- Pre-testing the research instrument in a pilot study;
- Using probability sampling methods to ensure external population validity;
- Using self-administered questionnaires, which generally have a high response rate.
- Using a big sample size with a margin of error of not more than 5% and a confidence level of 95%; and
- Comprehensively reviewing the literature for theoretical constructs and empirical conclusions.

5.5.2.3 Error

Creswell (2014:26) states that errors, such as response and nonresponse, can pose a critical threat to the reliability of the data and must, therefore, be minimised by the researcher. Response errors are the estimated inaccuracies that can be introduced by the researcher, the interviewer or respondents. For instance, the researcher might make such an error when designing the research instrument or the research problem is not properly defined. On the part of respondents, response errors can also occur when respondents deliberately or mistakenly provide incorrect answers to the survey questions.

On the other hand, nonresponse error can be caused by failure to contact all members of a sample and/or failure of some contacted members of the sample to respond to all or a specific part of the research instrument. The following steps were used to reduce non-response errors in this study (Creswell, 2014:21):

- Using self-administered questionnaires, which involved a direct meeting between the researcher and respondents;
- Follow up telephone calls and visits to respondents;
- Removing sensitive questions from the research instrument;
- Carefully constructing and pre-testing the research instrument;
- Thorough training of field assistants in order to minimise administrative errors; and
- Employing three paid research assistants to help with the distribution, follow-up and collection of completed questionnaires.

5.5.3 Analysis of quantitative data

Analysing quantitative data necessitates that the researcher must have all the data collected before commencing with the analysis. Hence, a clear separation between data collection and analysis with regard to a quantitative study (Neale, 2016:1097). According to Bihani and Patil (2014:96), the choice of statistical analysis methods used in analysing quantitative data depends on the following three factors: (a) the type of question to be answered; (b) the number of variables; and (c) the scale of measurement. Based on these three factors, a researcher may choose to focus on the central tendency of a variable or the distribution of that variable. The statistical technique used, irrespective of whether it is a univariate data analysis, bivariate data analysis or multivariate data analysis, is highly determined by the number of variables. Quantitative data analysis in this study included descriptive statistics, factor analysis,

Cronbach's alpha coefficient (reliability test), Kolmogorov-Smirnov test for normality of the data, t-test, Spearman's Rho correlations, logistic regression analysis and Mann-Whitney U mean test.

5.5.3.1 Descriptive statistics

Egboro (2015:74) states that descriptive statistics are used to explain the elementary features of data in a quantitative study. It enables the researcher to summarise and organise the data in an effective and meaningful manner, involving the use of tables, charts, graphs, mean, modes, median, standard scores and correlation to treat data collected. In this study, the following descriptive statistical techniques were used:

- *Distribution*: This is the summary of the frequency of individual values or ranges of values for a variable. One of the most common ways to describe a single variable is to use a frequency distribution. Frequency distribution can be depicted in two ways, as a graph or as a table. Tables, frequencies and percentages were used in this study.
- *Central Tendency*: The central tendency of a distribution is an estimate of the "centre" of a distribution of values. The three essential types of estimates of central tendency include the mean, median and mode. Only the mean, in conjunction with the standard deviation, were used in this study. The mean or average is probably the most commonly used method of describing central tendency. The standard deviation shows the variability or the relation that a set of scores has to the mean of a sample (Egboro, 2015:74).

5.5.3.2 Factor analysis

Khula and Moroke (2016:41) considers factor analysis as a data reduction technique pioneered by the seminar works of Spearman (1904). It is a multivariate statistical method, whose primary purpose is data reduction and summarisation. It is a statistical technique that addresses the problem of analysing the interrelationship among a large number of variables and then explaining these variables in terms of their common, underlying factors. This statistical technique is used to find a way of summarising information contained in a number of original variables into a smaller set of dimensions (factors) with a minimum loss of information. It could be used to verify a construct of interest. Factor analysis was used in this study in order to enhance the validity of the measuring instrument, as well as for data reduction. Factor analysis also assisted in classifying the variables and in developing and refining research

questions. Khula and Moroke (2016:42) state that there are two major categories of factor analysis: Exploratory Factor Analysis (EFA); and Confirmatory Factor Analysis (CFA).

According to Williams (2012:3), EFA is heuristic in the sense that the researcher has no expectations of the number or nature of the variables and, as the name suggests, is exploratory in nature. That is, it allows the researcher to explore the main dimensions to generate a theory, or model from a relatively large set of latent constructs often represented by a set of items. In addition to the fact that EFA is used to uncover the underlying structure of a relatively large set of variables, there is no prior theory and the researcher uses factor loadings to intuit the factor structure of the data. The principal goals of EFA are to determine the number of common factors influencing a set of measures and to measure the strength of the relationship between each factor and each observed measure (Melecky, 2013:1710). On the other hand, the researcher in CFA seeks to determine if the number of factors and the loadings of measured (indicator) variables in them conform to what is expected on the basis of pre-established theory or model. Williams (2012:3) asserts that CFA is a form of structural equation modelling. Contrary to EFA, CFA has assumptions and expectations based on a priori theory regarding the number of factors, and which factor theories or models best fit (Williams, 2012:4). EFA was used in this study.

Using exploratory factor analysis, Khula and Moroke (2016:42) advance that the decision about which factor to retain primarily depends on the percentage of the variance accounted for the variable, the absolute variance accounted for by each factor, and whether the factor can be meaningfully interpreted. Using exploratory factor analysis in this study, an equamax rotation was used to transform the components into factors that were more clearly interpretable. To simplify an easier interpretation of prime components, factor rotation methods were developed. Equamax rotation, which is an orthogonal rotation method that combines varimax and quartimax techniques was used in this study. This rotation method is based on the criterion of maximising the factor loadings of dominant variables in each prime component. Equamax rotation simplifies an easier interpretation of factors. Rotation makes it so that, as much as possible, different items are explained or predicted by different underlying factors, and each factor explains more than one item. Only factors with Eigenvalues greater than one are usually retained. The assumptions of factor analysis (as highlighted by Khula & Moroke, 2016:43; Leech, Barrett & Morgan, 2009:80-81) include the following:

- *Normality*: EFA is robust to the assumption of normality. Nevertheless, if variables are normally distributed, then, the solution is enhanced.
- *Sampling adequacy*: Bartlett's test of sphericity (BTS) and the Kaiser-Meyer-Olkin (KMO) measure sampling adequacy and can be used to determine the factorability of the matrix as a whole. If BTS is large and significant, and if the KMO is greater than 0.6, then factorability is assumed. The KMO measure of sampling adequacy is an index used to examine the appropriateness of factor analysis. High values (between 0.5 and 1.0) indicate that factor analysis is appropriate. Values below 0.5 imply that factor analysis may not be appropriate. The KMO tells the researcher whether or not enough items are predicted by each factor. The Bartlett test should be significant (i.e., a significance value of less than .05). This means that the variables are highly correlated enough to provide a reasonable basis for factor analysis. $KMO \geq 0.5$ was used in this study.

The criteria for used for assessing EFA in this study as supported by Khula and Moroke (2016:43) and Leech *et al.* (2009:81) were as follows:

- Eigenvalues greater than 1.00 were identified.
- The variables were subjected to exploratory factor analysis. Where the variables loaded were found to be less than 0.300, they were removed and another round of exploratory factor analysis carried out.
- Rotated, unrotated and sorted factor analyses were carried out for the factors. Item analysis was then carried out for all the factors.

5.5.3.3 Normality of data

According to Khula and Moroke (2016:43), the normality of data in survey research can be determined by using the Kolmogorov-Smirnov test (if only the sample size is greater than 100) and the Shapiro–Wilks test (if only the sample is less than 100). If the significance level is greater than 0.05, using either of the two tests, then normality of the data is assumed. The Kolmogorov-Smirnov test was used in this study to determine the normality of data since the sample size was greater than 100.

5.5.3.4 Cronbach's Alpha

Cronbach's alpha is a measure used to test the reliability of a survey, or internal consistency, of a set of scale or test items (Heale & Twycross 2017:67). It is also referred to as the scale reliability test. Cronbach's alpha is a measure of how well each individual item in a scale correlates with the remaining items. Cant *et al.* (2008:188) state that the reliability also shows the extent to which the measurements of a test remain consistent over repeated tests on the same subject. The coefficient of Cronbach's alpha ranges in value from 0 to 1. The higher the score, the more reliable the generated scale is (Heale & Twycross 2017:67). According to Babbie (2011:82), only Cronbach's alpha coefficient value ≥ 0.5 is acceptable (reliable). Cronbach's alpha coefficient was used to test for the reliability of factors influencing accessibility to credit from the formal financial sector by SMEs.

5.5.3.5 Bivariate data analysis

Cooper and Schindler (2006:590) define bivariate data analysis as data analysis and hypothesis testing when the research concerns simultaneous investigation of two variables using tests of differences or measures of association between two variables at a time. Hence, T-test and Spearman's Rho correlations were applicable.

a) Spearman's Rho correlations

Spearman's Rho correlations was used to test for the direction and strength of the relationship between access to finance by SMEs from the formal financial sector, performance and other factors influencing credit accessibility from the formal financial sector by SMEs. Gogtay and Thatte (2017:79) state that the main result of a correlation is called the correlation coefficient (denoted by "r"). It (r) ranges from -1.0 to +1.0. The closer r is to +1 or -1, the more closely the two variables are related. If r is close to 0, it means there is no relationship between the variables. The P-value measures the level of significance. A 5% level of significance (P-value) was used in this study. This is consistent with the significance level of most empirical studies on Business Management. Table 5.2 shows the value of r and the implications for the strength of the relationship.

Table 5.4: Value of correlation and strength of relationship

Value of r	Strength of relationship
-1.0 to -0.5 or 1.0 to 0.5	Strong
-0.5 to -0.3 or 0.3 to 0.5	Moderate

-0.3 to -0.1 or 0.1 to 0.3	Weak
-0.1 to 0.1	None or very weak
Adapted from Gogtay and Thatte (2017:79)	

b) The T-test

A t-test, as highlighted by Kim (2015:540), is a type of statistical test used to compare the means of two groups. The t-test assesses if the means of two groups are statistically different from each other. It is one of the most widely used statistical hypothesis tests. To test significance, there is need to set a risk level (referred to as the alpha level). It is worth mentioning that the “rule of thumb” in most social science research is set as the alpha level at 0.5 (Kim, 2015:540). This means that five times out of a hundred, there is statistical significance between the means even if there was none (i.e. “by chance”). With t-test, there is also the need to determine the degrees of freedom (df) for the test. The degrees of freedom are the sum of the persons in both groups minus 2. Kim (2015:540) states that there are three types of t-test as follows:

➤ One-sample t-test

It is used to compare a sample mean with a known population mean or some other meaningful, fixed value.

➤ Independent samples t-test

It is used to compare two means from independent groups.

➤ Paired samples t-test

This type of t-test is used to compare two means that are repeated measures for the same participants – scores might be repeated across different measures or across time.

From the three types of t-tests listed above, the independent t-test, was considered appropriate for this study, as it was used to compare the two means from owners/managers of SMEs who had access to debt finance and those who did not. The independent t-test is the most common, well-known and widely used statistical test of all time. It is simple, straightforward, easy to use and adaptable to a broad range of situations. Levene's test for homogeneity of variance was

used in this study to test for the difference in means between SMEs with debt and those without debt (Nordstokke & Zumbo, 2010:411).

5.5.3.6 Logistic regression

Logistic regression is a statistical method used to analyse a dataset in which there are one or more independent variables that determine an outcome, and the outcome is measured with a dichotomous variable (Barasa & Muchwanju, 2015:245). According to Barasa and Muchwanju (2015:246), the goal of logistic regression is to find the most appropriate fitting model to describe a relationship between the dichotomous characteristic of interest dependent variable (response or outcome variable) and a set of independent (predictor or explanatory) variables. There are two models of logistic regression as highlighted by Jin, Yan and Zhu (2015:226), binary logistic regression and multinomial logistic regression. Binary logistic regression is a type of logistic regression used when the dependent variable is dichotomous, and the independent variables are either continuous or categorical. When the dependent variable is not dichotomous and comprises more than two categories, a multinomial logistic regression can be employed. In general, logistic regression, as concluded by Jin *et al.* (2015:228), is well suited for describing and testing hypotheses about relationships between a categorical outcome variable and one or more categorical or continuous predictor variables. Binary logistic regression models were used in this study to establish whether there are significant relationships between access to bank finance, performance of SMEs and factors that influence access to credit from the formal financial sector to SMEs.

5.5.3.7 Mann-Whitney U test

Mann-Whitney U test is a non-parametric statistical technique. It is used to analyse differences between the medians or means of two data sets (Derrick, Dobson-McKittrick, Toher & White, 2015:3). It can be used in place of a t-test for independent samples in cases where the values within the sample do not follow the normal or t-distribution but also when the distribution of values is unknown. In other words, this statistical technique examines the differences between two independent groups on a continuous scale (Derrick *et al.*, 2015:4). In order for the Mann-Whitney U test to be applied, values need to be measurable on an ordinary scale and comparable in size (Guo & Yuan, 2017:1324). The fact that all values are compared, makes it distinct from the t-test, which compares the sample means. The Mann-Whitney U test was used in this study in order to establish the mean differences between SMEs with access to bank

finance and those without such access. It was also used to test the correlation between access to bank finance and factors that influence access to credit from the formal financial sector to SMEs.

5.5.4 Ethical considerations

According to Subedi (2016:571), ethical considerations in a mixed method research need to attend to typical ethical issues that surface in both forms of research methods. To begin with, approval to conduct the study was granted by the Rhodes University Ethics Standards Committee for both phases data collection. Permission to collect qualitative data (Phase 1) was requested by sending a formal letter to each institution (Annexure E). Approval was granted by each institution to conduct the study (Annexures F₁ to F₈). The names of interviewees and their institutions as well as the names of participants were not disclosed to the public (file recordings and transcripts were saved using pseudonyms).

Prior to commencing the interviews in Phase 1, the purpose of the study was explained in a cover letter to participants, who were also requested to give their informed consent (Annexure G). The rights of participants were clearly explained, and participants were informed that they could withdraw from the study at any point if they felt that they did not wish to continue. Permission to audio-record the interviews was also sought before the recordings.

Ethical considerations in gathering quantitative data in Phase 2 of this study also involved obtaining permission, protecting anonymity of respondents, communicating the purpose of the study, avoiding deceptive practices, respecting vulnerable populations, being aware of potential power issues in data collection, respecting indigenous cultures and not disclosing sensitive information (Creswell, 2013, 2014; Olivier, 2017:10; Subedi, 2016:575). Before collecting the quantitative data for the study, permission was first sought from and granted by the Rhodes University Ethics Standards Committee. Before completing the questionnaire, the purpose of the study was explained to respondents and they had to agree to the statements outlined in the consent form, inserted at the beginning of the questionnaire, by ticking a block and signing the form. The researcher also explained to respondents that they were not obliged to complete the questionnaire and that they could withdraw at any point if they felt that they did not wish to continue. Strict anonymity was maintained at all times and the names of respondents not disclosed to the public. Some respondents declined to complete the

questionnaire as they were not willing to disclose or share some private financial information with the researcher.

5.6 SUMMARY OF CHAPTER

A pragmatic research paradigm was considered the most appropriate for this study. Thus, an exploratory sequential mixed methods approach was used in collecting data in the two phases. In phase 1 (supply-side), qualitative data was collected from eight formal financial institutions whose head offices are located in Johannesburg. The purpose of this phase was to collect qualitative data to address the supply-side objectives of the study as stated in Chapter 1, Section 1.4.1. Using an interview guide, face-to-face interviews were conducted with 8 credit and 8 business managers. Data collected in this phase was analysed and the findings presented in Chapter 6. The qualitative findings, in addition to other previous empirical studies, were used to design the research instrument to collect data in the second phase of the study.

In phase 2 (demand-side), a survey design was used and a self-administered questionnaire used to collect data. A total of 702 questionnaires were issued to owners/managers of SMEs with the assistance of three research assistants. The purpose of this phase was to collect quantitative data to address the demand-side objectives of the study as stated in Chapter 1, Section 1.4.3. Data collected in this phase of the study was analysed and the results presented in Chapter 7.

The next chapter focuses on the analysis of qualitative data and presentation of findings.

CHAPTER SIX

ANALYSIS AND PRESENTATION OF QUALITATIVE DATA AND FINDINGS

6.1 INTRODUCTION

The previous chapter focused on the research design, the research methodology, the research paradigm, sampling and sample sizes, data collection techniques and methods used in analysing data. This chapter focuses on the analysis of the qualitative data and presentation of findings with regard to the availability of debt finance (from the formal financial sector) to SMEs from the perspective of the supply-side. Peersman (2014:2) states that unless both data analysis and interpretation are carried out properly, the success of any research study cannot be assured. Hence, the purpose of this chapter is to systematically present and critically interpret the qualitative and empirical findings of this study.

By reporting and analysing the qualitative and empirical findings, this chapter, in part, contributes towards the main aim of the study (to develop a framework for understanding the availability of and access to credit from the formal financial sector).

The empirical objectives of this study were to:

1. Examine factors that impact on the willingness of the formal financial sector to provide credit to SMEs in South Africa;
2. Determine how the formal financial sector assesses credit applications from SMEs in South Africa;
3. Establish challenges faced by the formal financial sector in assessing and approving credit to SMEs in South Africa; and
4. Ascertain how the formal financial sector perceives investment in SMEs in South Africa.

The section that follows provides information on the demographic characteristics of participants and a presentation of the qualitative findings.

6.2 DEMOGRAPHIC CHARACTERISTICS OF PARTICIPANTS

The demographic characteristics of participants provided in Table 6.1 below, gives details of the nationality, gender, ethnic group, age group, current position, number of years of experience in the current position of participants and the highest level of education.

Table 6.1: Demographic characteristics of participants

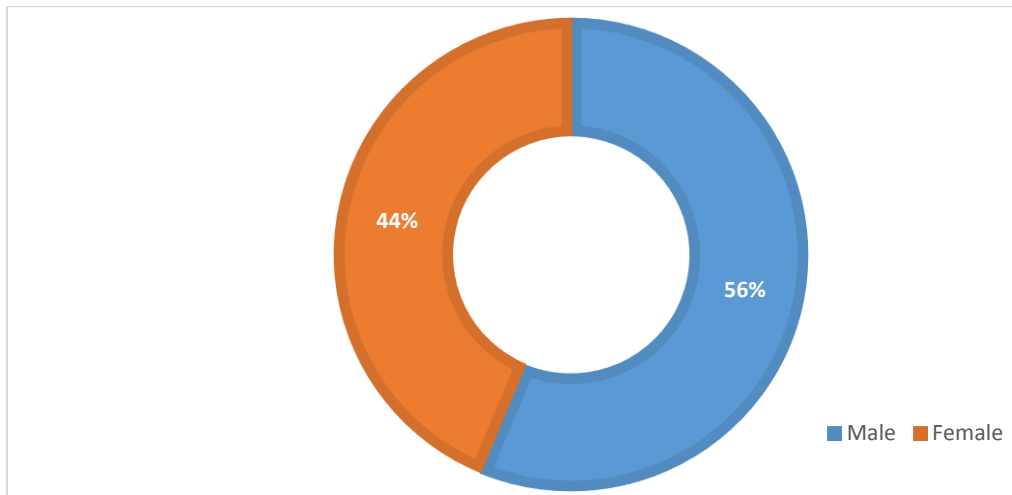
Participants	Nationality	Gender	Age range	Ethnic group	Current position	Duration in current position	Highest level of education
C ₁	South African	Male	35-40	Black	Credit manager	5 years	Degree
C ₂	South African	Female	30-34	Black	Credit manager	3 years	Diploma
C ₃	South African	Male	41-45	White	Credit manager	7 years	Degree
C ₄	South African	Male	35-40	Black	Credit manager	6 years	Degree
C ₅	South African	Female	35-40	Black	Credit manager	6 years	Adv. Diploma
C ₆	South African	Male	41-45	Black	Credit manager	4 years	Degree
C ₇	South African	Female	35-40	Black	Credit manager	6 years	Degree
C ₈	South African	Male	35-40	Black	Credit manager	6 years	Degree
M ₁	South African	Female	35-40	Black	Business manager	7 years	Degree
M ₂	South African	Female	35-40	White	Business manager	4 years	Degree
M ₃	South African	Female	30-34	Indian	Business manager	5 years	Post G. Degree
M ₄	South African	Male	50-55	White	Business manager	11 years	Matric (NSC)
M ₅	South African	Male	41-45	White	Business manager	5 years	Degree
M ₆	South African	Female	41-45	Black	Business manager	8 years	Adv. Diploma
M ₇	South African	Male	35-40	Black	Business manager	6 years	Degree
M ₈	South African	Male	35-40	Black	Business manager	4 years	Degree

Source: Author's own contribution

6.2.1 Gender of participants

Out of the total number of participants who took part in the study, seven (44%) were females - three credit managers and four business managers, while nine (56%) were males - five credit managers and four business managers. The distribution of participants according to gender is depicted in Figure 6.1 below.

Figure 6.1: Distribution of participants according to gender



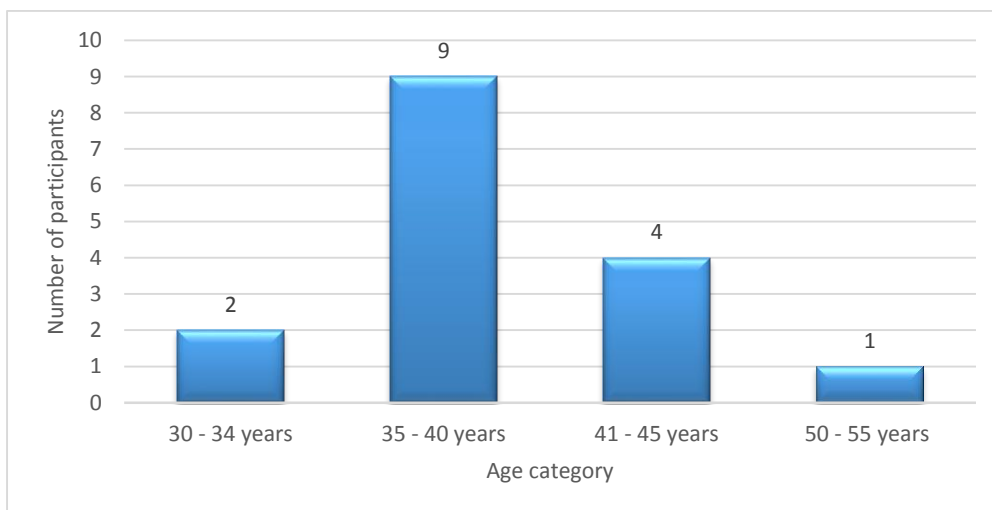
Source: Author's own contribution

Studies by Brown and Mcgranahan (2016) confirm the dominance of men over women in managerial positions in most financial institutions.

6.2.2 Age of participants

The distribution of participants according to age is provided (in range) in Figure 6.2. Nine (56.25%) of the participants were aged between 35 and 40 years, four (25%) were between 41 and 45 years, two (12.5%) were between 30 and 34 years, while only one (6.25%) was between 50 and 55 years old.

Figure 6.2: Distribution of participants according to age

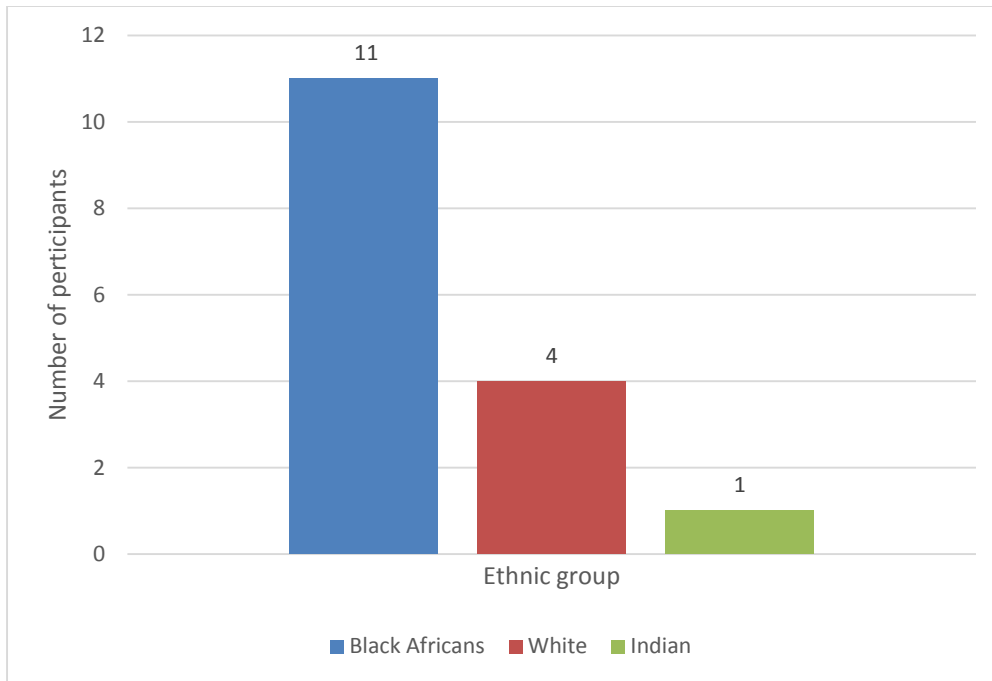


Source: Author's own contribution

6.2.3 Ethnic group of participants

All participants were South Africans representing three ethnic groups as follows: one Indian; four Whites; and eleven Black Africans as illustrated in Figure 6.3.

Figure 6.3: Distribution of participants according to ethnic group



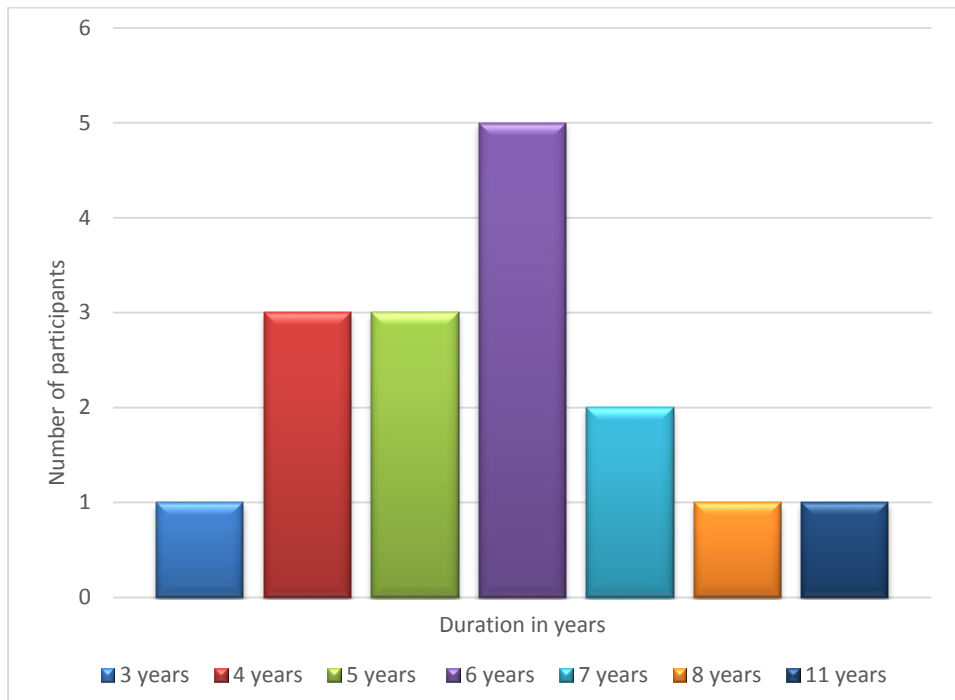
Source: Author's own contribution

As shown in Figure 6.3, the dominance of Black Africans in the banking sector is evidence of the Broad-Based Black Economic Empowerment (BBBEE) growth strategy aimed at realising South Africa's full economic potential, while helping to bring the black majority into the economic mainstream. This strategy is aimed at reducing the level of unemployment and poverty among Black Africans.

6.2.4 Duration of participants in current position (experience)

Eight credit managers and eight business managers were interviewed during the study. Out of this number, two had seven (7) years of experience in their current position, five had six (6) years of experience, three had five (5) years of experience, three had four (4) years of experience in their current position while one participant had 11 years of experience as depicted in Figure 6.4.

Figure 6.4: Distribution of participants according to duration in current position (experience)



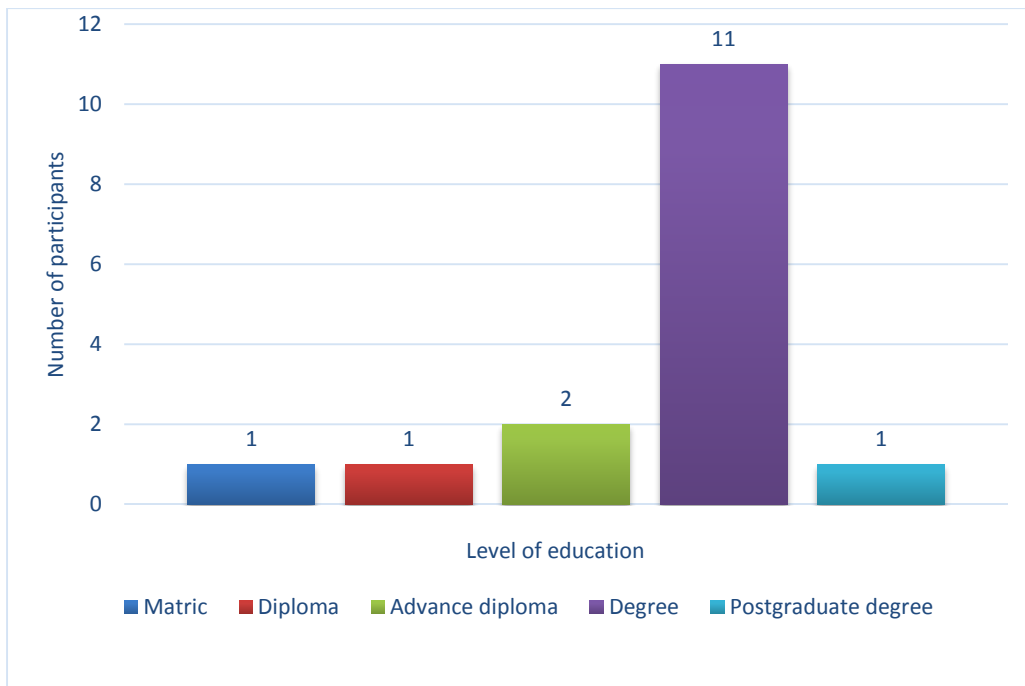
Source: Author's own contribution

Figure 6.4 shows that twelve (75%) of participants had been in their current position for at least five years and more. According to Brito and Sauan (2016:4), such experience on the job, coupled with past experience, is valued as part of the asset of the institution and contributes vastly to personal effectiveness and the quality of work.

6.2.5 Highest level of education of participants

Figure 6.5 shows the highest level of education of participants. Out of the sixteen participants, one (6.25%) had a National Senior Certificate (NSC), one (6.25%) had a diploma, two (12.5%) had an advanced diploma, eleven (68.75%) had a degree while one (6.25%) had a post graduate degree.

Figure 6.5: Highest level of education of participants



Source: Author’s own contribution

Figure 6.5 shows that twelve (75%) participants had at least a Bachelor’s degree, an indication that participants were well educated and able to give informed responses to the questions.

6.2.6 Previous position of participants

Participants were also requested to provide information with regard to their previous position, duration of previous position as well as their employer at the point in time.

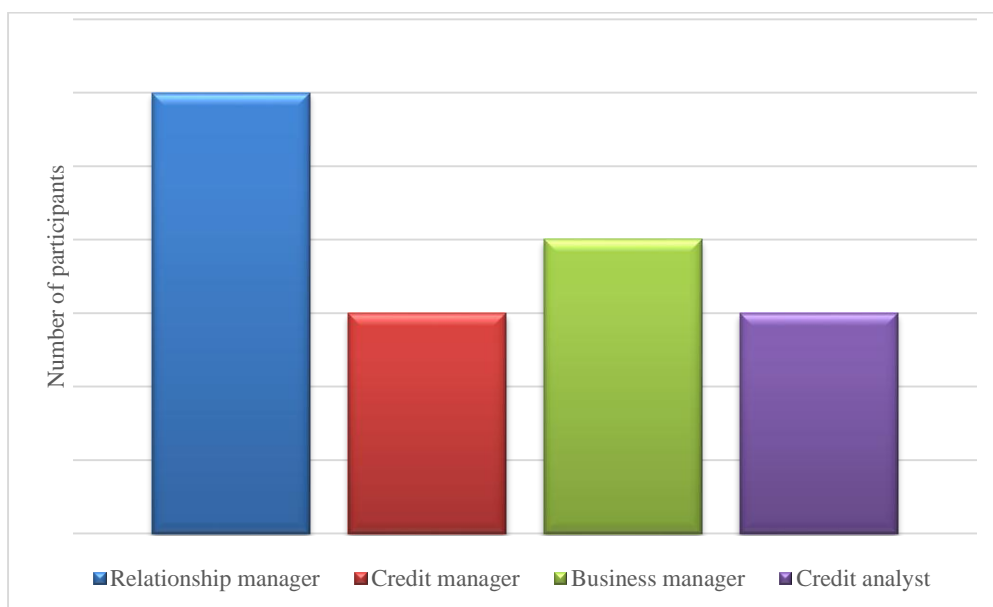
Table 6.2: Previous position of participants

Participant	Current position	Previous position	Number of years spent in previous position	Previous employer
C ₁	Credit manager	Relationship manager	7 years	Another employer
C ₂	Credit manager	Relationship manager	6 years	Same employer
C ₃	Credit manager	Relationship manager	4 years	Same employer
C ₄	Credit manager	Credit analyst	5 years	Another employer
C ₅	Credit manager	Credit manager	7 years	Same employer
C ₆	Credit manager	Credit manager	7 years	Same employer
C ₇	Credit manager	Business manager	8 years	Another employer
C ₈	Credit manager	Credit manager	4 years	Same employer

Participant	Current position	Previous position	Number of years spent in previous position	Previous employer
M ₁	Business manager	Credit analyst	5 years	Another employer
M ₂	Business manager	Relationship manager	7 years	Same employer
M ₃	Business manager	Relationship manager	6 years	Same employer
M ₄	Business manager	Business manager	5 years	Same employer
M ₅	Business manager	Business manager	5 years	Same employer
M ₆	Business manager	Relationship manager	5 years	Same employer
M ₇	Business manager	Business manager	4 years	Same employer
M ₈	Business manager	Credit analyst	6 years	Another employer

Source: Author's own contribution

Figure 6.6: Previous position of participants



Source: Author's own contribution

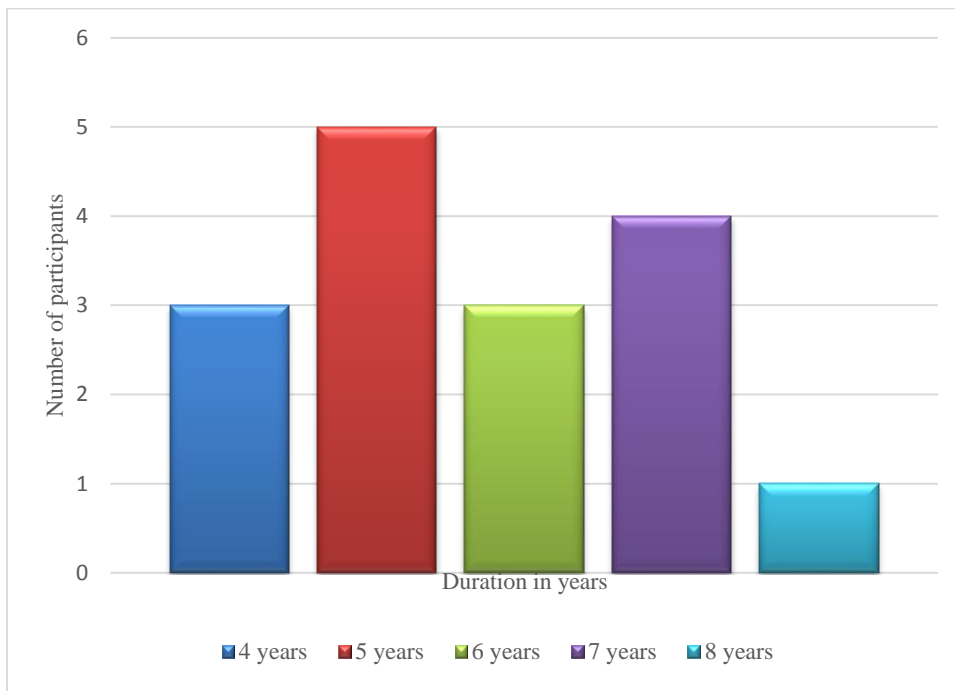
6.2.7 Previous position of participants

Table 6.2 shows that only five (31.25%) participants moved from one institution/employer to another, six (37.5%) participants (C₅, C₆, C₈, M₄, M₅, M₇) maintained their position within their respective institutions but were transferred from one branch to their current branch, five (37.5%) participants (C₂, C₃, M₂, M₃, M₆) were promoted internally (from relationship manager to either business or credit manager).

6.2.8 Number of years spent in previous position

Thirteen (81.25%) participants worked for at least five years in their previous jobs as shown in Table 6.2. Figure 6.7 shows the overall distribution of participants according to number of years spent in their previous positions.

Figure 6.7: Number of years spent in previous position by participants



Source: Author's own contribution

6.3 QUALITATIVE FINDINGS

Interviews were conducted with eight credit and eight business managers (C_1 to C_8 and M_1 to M_8) and the findings are presented in this section. It should be noted that the findings are not limited to individual interview questions. Rather, they are integrated statements arising from the interviews held with the eight credit and eight business managers.

Section 6.3.1 provides a tabular summary of the perspectives of credit and business managers on factors that impact on the willingness of the formal financial sector to provide credit to SMEs. As stated previously, the perspectives of both credit and business managers are combined in the presentation of findings in this section. Through content analysis, as explained in the previous chapter (section 5.4.3), the perspectives of participants on lending to SMEs are presented in an integrated manner (Sections 6.3.1 to 6.3.4). Factors that impact on the

willingness of the formal financial sector in lending to SMEs include collateral, business turnover, audited financial records, credit profile, relationship with the bank, nature of the business, business plan, economic climate, nationality, management team, equity contribution, government policy and valid ID/permit document. New themes that emerged in the study that were not revealed in the literature include entrepreneurship education, management team, business intelligence, ethics and product quality.

Section 6.3.2 focuses on how the formal financial sector assesses and approves credit applications submitted by SMEs. This process involves risk assessment, inspection of financial records, proper documentation and background checks of owners/managers of SMEs and the business itself for various reasons. With regard to challenges faced by the formal financial sector in assessing and approving credit in favour of SMEs, lack of investment capital, lack of collateral, lack of proper financial records, poor managerial knowledge, poor business plan, lack of industrial knowledge and poor legal credit laws constituted challenges faced by participants (as explained in Section 6.3.3).

Section 6.3.4 focuses on how the formal financial sector perceives investment in SMEs. Contrary to the notion that formal financial institutions are not interested in investing in SMEs, on average, 70% of SMEs that apply for credit, receive such credit. Hence, the study revealed that the formal financial sector is very interested and committed in investing in SMEs.

6.3.1 Factors that impact on the willingness of the formal financial sector to provide credit to SMEs

Access to credit plays an important role in determining the growth and success of SMEs. As highlighted by the National Planning Commission (2015) SMEs in South Africa constitute 99% of all businesses, contributing 77% of all private sector employment, which is important in the light of the decrease in formal employment. Additionally, SMEs also contribute 40% of GDP of the economy, compared to the one percent of large businesses that contribute about 60% to GDP and 46% to total employment (National Planning Commission, 2015). Non-availability of and non-access to the formal sector financing has been allude to as the primary constraint to the development of SMEs in South Africa (OECD, 2015; World Bank, 2015). Given that the majority of SME owners in South Africa raise their start-up capital from their personal or family savings, which are often inadequate for survival and growth, SMEs have to rely on

financial support from formal financial sector (Akinboade, 2015:185; Baltar and Icart, 2013:202; Fatoki, 2014:184; Herrington & Kew, 2014). In this section, the findings on factors that impact on the willingness of the formal financial sector to provide credit to SMEs (Table 6.3) are discussed.

Table 6.3: Perception of participants with regard to factors that impact on the willingness of the formal financial sector to provide credit to SMEs

Participants	Factors that influence the provision of credit to SMEs	Frequencies (n)
C ₁ ; C ₂ ; C ₃ ; C ₄ ; C ₅ ; C ₆ ; C ₇ ; C ₈ ; M ₁ ; M ₂ ; M ₃ ; M ₄ ; M ₅ ; M ₆ ; M ₇ ; M ₈	Collateral	32
C ₁ ; C ₂ ; C ₄ ; C ₅ ; C ₇ ; C ₈ ; M ₁ ; M ₂ ; M ₄ ; M ₅ ; M ₇ ; M ₈	Annual business turnover	24
C ₁ ; C ₂ ; C ₅ ; C ₆ ; C ₈ ; M ₁ ; M ₂ ; M ₅ ; M ₆ ; M ₈	Audited financial records	16
C ₁ ; C ₂ ; C ₄ ; C ₅ ; C ₆ ; C ₈ ; M ₁ ; M ₂ ; M ₅ .	Relationship with the bank	13
C ₅ ; C ₆ ; C ₇ ; C ₈ ; M ₅ ; M ₆ ; M ₇ ; M ₈	Credit profile	10
C ₄ ; C ₇ ; C ₈ ; M ₄ ; M ₇ ; M ₈	Nature of the business	10
C ₆ ; C ₇ ; C ₈ ; M ₆ ; M ₇ ; M ₈	Economic climate	9
C ₁ ; C ₂ ; C ₅ ; C ₈ ; M ₁ ; M ₂ ; M ₄ ; M ₆	Ethics	8
C ₆ ; C ₇ ; C ₈ ; M ₆ ; M ₇ ; M ₈	Nationality	6
C ₅ ; C ₇ ; C ₈ ; M ₅ ; M ₇ ; M ₈	Government policy	6
C ₄ ; C ₇ ; M ₅ ; M ₇	Management team	5
C ₁ ; C ₂ ; C ₃ ; C ₇ ; M ₁ ; M ₂ ; M ₃ ; M ₇	Valid ID/permit document	4
C ₂ ; C ₇ ; M ₃ .	Equity contribution	3
C ₁	Entrepreneurship education	1
C ₄	Quality of product	1
M ₃	Business intelligence	1

Source: Author's own contribution

In Table 6.3 the number of participants are indicated in the left column and the frequency of citations of a particular factor (middle column) is given in the right column. This means that for example, in terms of collateral, while all the credit and business managers regarded this factor as being important, the importance was further enhanced by the frequencies (n = 32) of mention by these respondents. The level of importance of each factor is thus determined by the

frequency of mention rather than the number of respondents. Therefore, the factors that impact on the willingness of the formal financial sector to provide credit to SMEs from the most to the least are collateral, annual business turnover, audited financial records, relationship with the bank, credit profile, nature of the business, economic climate, ethics, nationality, government policy, management team, valid ID/permit, equity contribution, entrepreneurship education, product quality and business intelligence. The new factors that emerged were ethics, management team, entrepreneurship education, product quality and business intelligence as discussed below.

6.3.1.1 Collateral

Collateral security (as shown in Table 6.3) is the most important ($n = 32$) requirement considered by the formal financial sector in granting credit to SMEs. Osano and Languitone (2016:4-5) state that the ability and willingness to offer collateral signals the confidence of owners/managers of SMEs about the likelihood of success of a business. In addition, contemporary literature (Fatoki 2014:95; Forte *et al.*, 2013:348; Harc, 2015;216; Huang *et al.*, 2014:29; Osano and Languitone, 2016:5) further reveal that holding collateral as security is attractive to formal financial institutions as it counterweights the information opaque in SMEs due to their lack of track record. According to the eight credit managers (C_1 to C_8) and eight business managers (M_1 to M_8), holding collateral is a way of protecting the bank's interest as owners of SMEs would be bound to give their all to ensure the repayment of the credit.

Respondents (from the formal financial sector) indicated that they generally consider granting credit to SMEs that have collateral in the form of an asset (land or property), investment account, contract letter, investment policy and surety (that is worth the size of the credit). These different types of collateral accepted by banks, in order of importance, are presented in Table 6.4.

Table 6.4: Types of collateral accepted by banks

Participants	Different types of collateral preferred by the formal financial sector	Frequencies
C ₁ ; C ₂ ; C ₃ ; C ₄ ; C ₅ ; C ₆ ; C ₇ ; C ₈ ; M ₁ ; M ₂ ; M ₃ ; M ₄ ; M ₅ ; M ₆ ; M ₇ ; M ₈	Assets (building and land infrastructure)	24
C ₁ ; C ₂ ; C ₃ ; C ₄ ; C ₅ ; C ₆ ; C ₇ ; C ₈ ; M ₁ ; M ₂ ; M ₃ ; M ₄ ; M ₅ ; M ₆ ; M ₇ ; M ₈	Investment account	24
C ₁ ; C ₂ ; C ₃ ; C ₄ ; C ₅ ; C ₆ ; M ₁ ; M ₂ ; M ₃ ; M ₄ .	Contract letter	16
C ₁ ; C ₂ ; C ₃ ; C ₄ ; C ₅ ; C ₆ ; C ₇ ; C ₈ ; M ₁ ; M ₂ ; M ₃ .	Investment policy	10
C ₁ ; C ₂ ; C ₃ ; C ₄ ; M ₁ ; M ₆ .	Surety	7

In Table 6.4 the number of participants are indicated in the left column and the frequency of citations of a particular factor (middle column) is given in the right column. This means that for example, in terms of assets, while all the credit and business managers regarded this factor as being important, the importance was further enhanced by the frequencies ($n = 24$) of mention by these respondents. The level of importance of each factor is thus determined by the frequency of mention rather than the number of respondents. Therefore, Table 6.4 shows that fixed assets (such as building and land infrastructure) ($n = 24$) and investment accounts ($n = 24$) are the most preferred forms of collateral accepted by the formal financial sector (as it makes the balance sheet of the SME stronger). However, contract letters ($n = 16$), investment policies ($n = 10$) and surety ($n = 7$) are less preferred forms of collateral. Selected excerpts from participants to support each perspective (as shown in Table 6.4) are provided and briefly discussed below. SMEs that pledged assets such as buildings, land infrastructure and investment accounts were more likely to access credit. One of the participants (C₃) declared as follows:

C ₃	South Africa	Male	41-45	White	Credit manager	7 years	Degree
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We need some form of security before we do the lending. So, it depends. Usually, it would be either a property (such as a house or productive land infrastructure) or an investment account has to be opened with us. So, it would be sort of like an investment with a certain amount. So, they are basically securing the credit with this investment. This investment will not be cashed before the loan is paid up or they will not have access

to the investment until we basically get to know whatever they are owing onto their loan.

Another participant (M₅) indicated that banks also consider granting credit if the investment constitutes collateral in itself as captured in the following excerpt:

M ₅	South African	Male	41-45	White	Business manager	5 years	Degree
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If you are a start-up business and you come to us and you say I am buying or I need funding to foot a kitchen and this has X amount of equipment, you do not need to give us collateral for that equipment because that equipment in itself is the collateral. Even if you are in a growth phase or expansion phase and you say here is my equipment plant that I want to purchase, that becomes collateral too. We still call for the financials but you do not have to necessarily give us any of your personal property as collateral.

However, M₃ mentioned the use of a contract letter as collateral to secure credit from banks as captured in the excerpt below.

M ₃	South African	Female	30-34	Indian	Business manager	5 years	Post G. Degree
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..... we would also consider contract letter to verify if the owner person has already been awarded the contract. Then, we will do some verification checks with the department that has issued the contract and how they expect the project to be carried out and when they expect the project to be finished. This information will help us to plan on how we are going to release the money the client is asking from us and also when the client is requesting to pay back the money.

One of the participants (M₆) also maintained as follows:

M ₆	Female	41-45	Black	Business manager	8 years	Adv. diploma
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It is either the directors or the shareholders will sign surety, that is one which you can sign. Let me tell you one way of surety to say that okay I am going to take 5 million but I sign surety that should it happen that I fail to pay, then the surety is liable to pay us the loan or the surety could pledge something like insurance policy or anything that is equal to the value of the loan.

M₆ maintained an investment policy (such as life insurance) could also be used as collateral as captured in the excerpt below.

M ₆	Female	41-45	Black	Business manager	8 years	Adv. diploma
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For us to consider insurance policy such as life insurance as collateral is risky but we do accept it. But first, we must do a proper background check with the insurance company to

know if the person has not defaulted payment in the past and if the person has been honouring the conditions of the policy. We then look at the condition under which the insurance is not valid. For example, some life insurance is considered invalid if the person takes his own life or commits suicide. We also do a serious background check about the medical and criminal history of the person. If we are satisfied with all our investigations, then we can accept the policy as collateral.

6.3.1.2 Business annual turnover

Participants indicated that the annual turnover of an SME was the second most important factor (n = 24) in determining access to credit from the formal financial sector in South Africa. SMEs with favourable annual turnover, as affirmed by Gozzi and Schumkler (2016:4), are most likely to breakeven and generate sufficient revenue for owners. If the business can generate sufficient revenue, then the owners of the business stand a good chance of paying back any debt that the business might incur.

One of the participants (M4) indicated as follows:

M4	South African	Male	50-55	White	Business manager	11 years	Matric (NSC)
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Most of our lending are systematic as we take into consideration the annual turnover. The annual turnover is very important to us because the annual turnover helps us to determine whether if we give you the loan, you will be able to pay back on time. You know, the annual turnover of your business tells us if your business is doing well or your business is not doing well.

One credit manager (C₂) indicated that formal financial institutions would normally not give credit that surpasses the annual turnover of any SME as captured in the excerpt below.

C ₂	South African	Female	30-34	Black	Credit manager	3 years	Diploma
----------------	---------------	--------	-------	-------	----------------	---------	---------

We look at the project and check what is their annual turnover and that will they be able to get out of the business after we finance it and we would also ensure that the loss will not be detrimental to our business as well. So, we look at the annual turnover of the business for the year and if we are not satisfied with the annual turnover, it means the business is struggling and we will likely reject such application. How can you pay your debt if you are struggling to sell your products?

6.3.1.3 Audited financial records

The third most important criterion (n = 16) required by formal financial institutions with regard to granting credit to SMEs were well-maintained and audited financial records. Credit and

business managers maintained the decision to lend and the terms of the credit contract were predominantly based on the strength of the income statements and balance sheet. M₈ maintained as follows:

C ₃	South African	Male	41-45	White	Credit manager	7 years	Degree
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Basically, if a client comes to you, they would give us the amount they want us to lend to them or that they want to apply for. So, the main process or the first thing that we basically ask for is their latest audited financials. So, the business has to be trading for 2 years or more, at least, have sound financials. But if is a new business that is less than 2 years, we would need the business financial for six months before we can make a decision.

Another business manager M₁ noted that:

M ₁	South African	Female	35-40	Black	Business manager	7 years	Degree
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To us, audited financials are very important. If not available then a management account, if not available then bank statements. I think audited financial statements are good enough even though a lot of credit managers do not really like them. Audited financial statements are also evidence to show that the client can pay or not.

6.3.1.4 Relationship lending

The relationship between owners/managers of SMEs and the formal financial sector plays a vital role in granting credit to SMEs and is the fourth most important factor (n = 13). Study by Nieman and Nieuwenhuizen (2014:31) revealed that SMEs that have a close and long-standing relationship with banks will access credit easily compared to those that do not have such a relationship. During the interview, interviewees revealed that the relationship between owners/managers of SMEs could help in reducing information asymmetric between the two parties and to also build trust. C₆ spoke of the importance of such relationship as captured in the following excerpt:

C ₆	South African	Male	41-45	Black	Credit manager	4 years	Degree
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If the financials have declined, then, financial restitution would do. Some other lending are based on the relationship that you have with the bank, meaning it is not systematic. It would be a relationship that you have. So your credit or business manager would be able to put in a motivation for your credit application.

One of the participants (M₃) also noted that:

M ₃	South African	Female	30-34	Indian	Business manager	5 years	Post G. Degree
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The relationship between client and manager is very important to us because it gives us the opportunity to know our client and their businesses. Because when you know your clients and

their businesses, you can easily tell if the business is a good business that has growth prospect. But if the business is struggling, then we can easily tell if the owner will be able to pay back the loan or not. So the relationship is very important to us.

6.3.1.5 Credit profile

Interviews with credit and business managers revealed that the credit profile of the SME and its owner(s) was an important aspect (fifth on the list, n = 10) considered in determining access to finance. A credit history and record of diligent payment is an important aspect of a successful application. C₇ revealed that for banks to decide to offer credit to any SME, they have to evaluate the credit worthiness of the business and its owners as captured in the excerpt below:

C ₇	South African	Female	35-40	Black	Credit manager	6 years	Degree
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If you have been in the business, let's say for 5 years, we would look at your personal credit record and your business credit record because obviously, after 5 years, you would have a credit record. We would look if you will be able to pay your debt on time or if your business in the past failed to pay its debt on time. When we check the credit record of the owners, we want to know if they have not failed to pay their debt in the past. If any of the owners once failed to pay their debt in the past, then we will carefully look at the collateral they have offered for this credit.

This is quite ironical as one must prove indebtedness in order to be given more debt (credit).

6.3.1.6 Nature of the business

The nature of the business is also important (n = 10) in determining if SMEs can have access to finance from the formal financial sector. It emerged that there are certain business ventures, which for ethical reasons, some financial houses would normally not fund. The nature of certain businesses has made most formal financial institutions resorting to doing business only with those that adhere to the concept of business ethics. One of the business managers (M₄) indicated as follows:

M ₄	South African	Male	50-55	White	Business manager	11 years	Matric (NSC)
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So, if it is environmental, we do not want to finance something that may end up with people being displaced or from an erosion perspective or an environmental perspective, which is going to create more problems with the ozone layer, we would rather favour something which is going to be carbon-based that would be able to reduce the footprints and tap into things like being able to get part of the carbon credits. So, morality and ethical perspective,

we would rather lean in that direction that we would view each item displayed before us on its own merit.

6.3.1.7 Economic climate

The overall economic climate determines whether formal financial institutions will have that willingness to lend or not (n = 9). For instance, it emerged during interviews that during a period of recession or an economic slump, formal financial institutions are generally reluctant to lend to SMEs. Hence, weak economic conditions do not only discourage financial institutions from lending to SMEs but may also make it difficult for enterprises to use credit positively, thus affecting their ability to repay the credit. C₈ indicated as follows:

C ₈	South African	Male	35-40	Black	Credit manager	6 years	Degree
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Although we are a bank and we take risks, we cannot take 100% risks where you can see that there is no possibility of these businesses surviving. Every bank wants to make a profit. You must understand that no bank will give out money when they are not sure they will get their money back. The owners of the bank also want reward for their money and I can sincerely tell you that not all business can pay back the money they borrow and the interest in this time because the economy is not growing and many people are losing their jobs and many businesses are closing down because people are not buying because of the hard times.

6.3.1.8 Ethics

Ethics also emerged as a fundamental factor (n = 8) that prevent formal financial institutions from lending to SMEs. Ethics and trust, as highlighted by Jamnik (2017:90), play a significant role in reducing information asymmetry between credit providers such as formal financial institutions and borrowers such as SMEs. C₈ indicated as follows:

C ₈	South African	Male	35-40	Black	Credit manager	6 years	Degree
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If it is unethical and it is going to involve the bank's name and tarnish the name, we do not want to get involved with something like that. Some clients come to us for funding that they want to expand their business or buy an asset for their business. When we offer them the funding. They divert the money for personal use. Some even buy a luxury car and register the car under another person's name, say like the wife because they do not want the bank to take the car if they fail to pay back the loan. We do not accept such behaviour from our clients. That is dishonesty and next time when you come to us for a loan may be you really need the money this time for your business, but because we do not trust you, we may not give you what you are requesting or we will give you say only 50% of what you are asking.

6.3.1.9 Nationality

Interviewees indicated that some formal financial institutions do not give out or lend to anyone who is not a South African national (n = 6), or who does not hold a South African Identity Document. Formal financial institutions believe that it is very difficult to track and manage foreigners. It could be construed from the interviews that some formal financial institutions in South Africa are very reluctant to fund SMEs owned by immigrants since they do not have sufficient information about their businesses. Furthermore, lack of trust in businesses owned by immigrants makes the problem more complicated as captured in the excerpt below by M₆.

M ₆	South African	Female	41-45	Black	Business manager	8 years	Adv. diploma
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No, we do not borrow to non-South African businesses. The business must be registered in the country and owners must be using a South African ID and the reason why we are not extending credit to anybody who does not use a South African ID is because in the past, we did it but we had big write-offs because we must remember if somebody holds a passport of another country, it is easy for them when things do not work out in business to pack and go so that is what basically happened. It was not possible to find people that you have given money to, etc. The policy was allowing us previously to provide assistance to people with passports but we stopped it.

6.3.1.10 Government policy

The laws governing lending in South Africa, as determined by the Reserve Bank and the Banking Association of South Africa, generally play a very important role (n = 6) in access to finance, especially by SMEs owned by immigrants. The regulations of the Credit Agreements Act, as noted by the Banking Association of South Africa (2018), create a bias in the allocation of credit for SME finance. This bias is created both through the interest rate limitation in the Credit Agreements Act, which discourages high-risk or high cost credit provision, and through the limitation on the amount of loan and term in the Usury Exemption Notice. M₇ maintained as follows:

M ₇	South African	Male	35-40	Black	Business manager	6 years	Degree
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So, there is a different criterion that is applied to different people. So, you have a natural person, which is an immigrant from another country and if they would like to own property in South Africa, they would have to put down a 50% deposit, which is governed by the Reserve Bank policy. So, again, we have to then look to the Reserve Bank policy. If a person is bringing in a company from overseas, we would have to verify everything before we could look at financing but there are a lot of things that we are still going to be governed by the Reserve Bank so, whether it is for imports or exports, there are different criteria.

6.3.1.11 Management team

Interviews with participants also revealed that the management team of a business was also a vital factor that impacted on access to credit from the formal financial sector (n = 5) to SMEs.

One of the participants (M₅) maintained as follows:

M ₅	South African	Male	41-45	White	Business manager	5 years	Degree
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.... the business plan gives an indication of how much time and effort the persons or management team spend running their business. I think one of the key issues in any business to succeed is the management team, the ability of the management team to run a business not just to be good from a professional perspective but also their commitment to the business.

6.3.1.12 Valid Identity Document or passport

For formal financial institutions that grant credit to all businesses, even those owned by immigrants, a valid Identity Document or passport with a valid permit was fundamental in accessing credit (n = 4). M₇ indicated as follows:

M ₇	South African	Male	35-40	Black	Business manager	6 years	Degree
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As I explained to you earlier, if you are a foreigner, who is operating a business in South Africa, you must have a valid passport with a valid stamped permit, be it work permit or business permit. So, if you want a credit, I will organise the credit according to the duration of the permit. So, the passport and the permit must be valid for the time that the client is asking to repay the loan. What I am saying is that, assume that a person wants to take a loan of R2 million to pay back the loan in five years, the passport and the permit of the client must be valid for more than five years. So, it will give the bank enough time to monitor the payment of the loan if the client is actually paying, if not, we can track the client before they escape the country.

6.3.1.13 Equity contribution

C₇ spoke of equity contribution of foreigners who want to operate a business in South Africa and require funding from the formal financial sector to invest in fixed asset or working capital or any investment related to their business (n = 3). C₇ declared as follows:

C ₇	South African	Female	35-40	Black	Credit manager	6 years	Degree
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So, with an immigrant in South Africa who has a passport with a stamped permit and you are operating a business, you have to prove that you have brought in 2 million Rand capital and you must also have an account with us. Now, I assume that a person that is bringing in

R2 million, they have got very legitimate intentions to be able to make money out of that. The processes are okay but we are still busy trying to review it at this stage as it could take up to 6 weeks to be able to open up an account instead of over the counter. So, if you have a company overseas, we need to know who the directors are in terms of the AML (Anti-money laundering law). We need to also confirm what their personal address is, the IDs we need to have is signed off by a notary or an attorney or person that is being appointed as a commissioner. So, with that, we have to get confirmation from overseas to confirm that the account is in good standing.

6.3.1.14 Entrepreneurship education

Entrepreneurship education emerged as an important factor (n = 1) that determines lending to SMEs by formal financial institutions. C₁ spoke of the importance of entrepreneurship education as captured in the excerpt below:

C ₁	South African	Male	35-40	Black	Credit manager	5 years	Degree
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So, I have met many people that might be brain surgeons but they do not know how to run a business. So, it has to be a combination of an all-rounder one, someone who has undertaken a business course, who knows what entrepreneurship is all about and who also has a support team to be able to provide those kinds of qualities.

6.3.1.15 Quality of product

With regard SMEs that do not yet have a turnover, especially new ones, a key determining factor would be the projection and quality of the products offered by the enterprises (n = 1). Thus, the marketability of the products plays a fundamental role in accessing credit. In other words, the solidity of the products could influence the financial institution to grant funding as indicated by one of the credit managers (C₄):

C ₄	South African	Male	35-40	Black	Credit manager	6 years	Degree
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We look at the projections. Where are they really going, are they really going to be able to afford clients based on their portfolio and as to how long they have been around in the industry. We would consider like the years, experience and the product if it is a selling product or if it is like a recognised product. Then, we would obviously consider giving finance because remember that would be someone who is not yet in the market so, we have to also not only look at the consequences more. We have to assist them in order to uplift them.

6.3.1.16 Business intelligence

Business intelligence (n = 1) has a crucial bearing on efforts by SMEs to access funding from formal financial institutions as advanced by M₃:

M ₃	South African	Female	30-34	Indian	Business manager	5 years	Post G. Degree
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.. as I was saying, another thing I have also come to understand with some of our clients is that they do have a business but they do not have that business insight in the type of business they are doing. Sometimes, we ask these clients to pitch their business to us and we could see that they are struggling. They do not have that business intelligence. One can easily tell that this client is doing business because he wants to survive and such clients, we consider them as high-risk clients.

The next section focuses on the assessment of credit applications by the formal financial sector.

6.3.2 Assessment of credit applications from SMEs by the formal financial sector

From the interviews with participants, as shown in Table 6.5, risk assessment, scrutiny of financial records, background checks and proper documentation were identified as guidelines used by the formal financial sector in assessing credit applications received from SMEs.

Table 6.5: Participants’ perspectives on assessment guidelines used by the formal financial sector to grant credit

Participants	Assessment guidelines	Frequencies (n)
C ₁ ; C ₂ ; C ₃ ; C ₄ ; C ₅ ; C ₆ ; C ₇ ; C ₈ ; M ₁ ; M ₂ ; M ₃ ; M ₄ ; M ₅ ; M ₆ ; M ₇ ; M ₈ .	Risk assessment	16
C ₁ ; C ₂ ; C ₃ ; C ₄ ; C ₅ ; C ₆ ; C ₇ ; C ₈ ; M ₁ ; M ₂ ; M ₃ ; M ₄ ; M ₅ ; M ₈	Scrutiny of financial records	14
C ₃ ; C ₄ ; C ₅ ; C ₆ ; C ₇ ; C ₈ ; M ₃ ; M ₄ ; M ₆ ; M ₇ .	Background checks	10
C ₃ ; C ₄ ; C ₆ ; C ₇ ; C ₈ ; M ₃ ; M ₄ ; M ₇ .	Proper documentation	8

In Table 6.5 the number of participants are indicated in the left column and the frequency of citations of a particular factor (middle column) is given in the right column. This means that for example, in terms of risk assessment, while all the credit and business managers regarded this factor as being important, the importance was further enhanced by the frequencies (n = 16)

of mention by these respondents. The level of importance of each factor is thus determined by the frequency of mention rather than the number of respondents.

6.3.2.1 Risk assessment

Assessing risk in a credit application is considered the most critical (n = 16) aspect which formal financial institutions have to deal, thus the credit risk level of every enterprise is often evaluated by the institution's internal credit scoring models. Credit scoring is a technique that assists formal financial institutions to determine if the enterprise is credit worthy or not. The decision to grant or not is dependent on the basis of a set of predefined criteria explained in Section 6.3 above. Hasan (2016:136) states that assessing the risk of a business is an important aspect in determining access to finance from formal financial institutions. Considering the fact that formal financial institutions are out to make profit, it is important for them to carefully assess the profile of SMEs that apply for credit as indicated by one of the participants (C₃):

C ₃	South African	Male	41-45	White	Credit manager	7 years	Degree
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They are there to say you know what, the bank can give this funding to this person but they want this, they want extra security, should anything happen to the business, how will they cover this. So, they use financial information of the business, debt history of the business, payment history of the business and personal information of the owners to check the risk level of the business and the owners.

With regard to risk assessment, one of the participants (M₆) indicated as follows:

M ₆	South African	Female	41-45	Black	Business manager	8 years	Adv. diploma
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When it comes to risks with our bank, they are very strict and they look into all areas before basically approving or lending even to businesses and even individuals. So, our credit team or our risk credit team are very strict and they basically dive deep into checking you. Knowing your background, basically checking like your ITC records, your track records with other financial institutions and so forth. So, they are tired of losing millions in the form of bad debt because the business is nowhere to be found anymore after collecting our money. So, I must say it plays a huge role basically.

It also emerged from the interviews that financial sectors sometimes work with businesses to enhance their cash flow so as to reduce the risk of the credit application as indicated in the excerpt below by one of the business managers (M₈):

M ₈	South African	Male	35-40	Black	Business manager	4 years	Degree
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Most small businesses do not understand how to work with a working capital so that is the biggest thing I focus on to try to help them manage their cash flow effectively, investing in assets the proper way if I can help finance the different assets. The proper way because you would find businesses taking cash and using it to buy say machinery when the cash flow should actually be kept for working capital while they grow the businesses and we finance those kind of things with external finance from banks.

6.3.2.2 Scrutiny of financial records

A thorough scrutiny of the financial records of an SME is the second most important (n = 14) aspect usually considered by formal financial institutions when examining an application for credit. Participants revealed that ‘financial statement lending’ focuses more on evaluating information from the financial statements of SMEs’. In such situation, the decision to lend and the terms of the credit contract are predominantly based on the strength of the income statements and balance sheet. According to participants, information in the financial statements, together with other information obtained through discussions with prospective borrowers, constitute the main sources of information to lenders. Information obtained from financial statements acts as an indicator of borrower’s future prospects and ability to service the credits. M5 articulated on the importance of scrutinising financial records as captured in the excerpt below:

M5	South African	Male	41-45	White	Business manager	5 years	Degree
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You look at their financials and you can just grant the funding looking at their financial records because they are already in the business. So, we will just refer to their financials, how they have been doing in the past years and what is the funding for, you know. Is it to really expand? Then, you need to give us the proof that you are really expanding the business or is it just to maintain the current one maybe or you just need capital for running the expenses of the business?

One of the credit manager (C8) also concurred with M5 and maintained as follows:

C8	South African	Male	35-40	Black	Credit manager	6 years	Degree
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Our audited financials of the business and the owners are the most important. If not available, then a management account, if not available, then bank statements I think they are good enough even though a lot of credit managers do not really like them. Bank statements are also evidence to show that the client can pay back the loan or not.

Scrutinising financial records is much easier in cases where the SME is already a customer of the bank (from where finance is sought as indicated by M6:

M ₆	South African	Female	41-45	Black	Business manager	8 years	Adv. diploma
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For new and established SMEs, we have a scoring model as long as the customer banks with us. The information is automatically pulled from the system, applied into the scoring model which basically takes into consideration everything else that I have already mentioned. So it is purely history, so, we now assess the risk based on the history that we already have and if it is a customer banking with us and we are not able to do the automatic scoring, we use judgemental credit process, where we then ask for information from their previous bankers for general reports, bank statements and not forgetting ITC as well.

6.3.2.3 Background checks

Background checks are an important (the last aspect, n = 8) aspect in order to grant access to finance. This is important in establishing the trustworthiness of the personnel of SMEs. It generally involves checking for criminal records or whether any individuals involved in the business has been sequestrated in the past. One of the participants (C₂) indicated as follows:

C ₂	South African	Female	30-34	Black	Credit manager	3 years	Diploma
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We use credit checks, the ITC and then also, we will require if maybe the client, how many directors are there and then we require each and every ID of the director of the company and then we also check the company on ITC. We also check all the individuals involved in the company through ITC. Remember, sometimes, if let us say we cannot be lending money to people who were maybe sequestrated or maybe people who had criminal offence and then if maybe we cannot also be providing money to people who cannot look after their finances. So, the people that we would be lending money to, it must be people that when it comes to their credits, they are on par, they are on point, there is nothing there is no list against them whatsoever.

Another participant (M₁) stated as follows:

M ₁	South African	Female	35-40	Black	Business manager	7 years	Degree
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You should have books, your book-keeping, if you do not have an account. You should have records, you should have invoices, we would actually look at such things. We should make sure that if we are lending to this person, they have an idea of who they are and where they want to be because any business would not lend to a company that is not profitable.

However, for businesses owned by immigrants, it is particularly difficulty to conduct background checks due to the difficulties involved in verifying information from outside the

country. This is a compounding factor to access to finance in favour of such businesses as captured in the excerpt below by one of the participants (M₆):

M ₆	South African	Female	41-45	Black	Business manager	8 years	Adv. diploma
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When it comes to immigrants, what we normally do is check if their passport is up-to-date, is not expiring and then also, we look if they have working permits into South Africa. It is difficult to check someone who is not a South African under the ITC. Remember, when it comes to ITC, it goes hand in hand with South Africans and then also it is really difficult dealing with immigrant SMEs because there is lot of fraud happening and people coming to South Africa. So, we are really sceptical providing facilities to them.

6.3.2.4 Proper documentation

Proper business registration documentation is also important (n = 10) in securing finance. This is particularly important in the case of an immigrant-owned business as indicated by M₇:

M ₇	South African	Male	35-40	Black	Business manager	6 years	Degree
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Key documents for immigrants - so it is their valid passport of their directors and on the passport, it has to have sort of like a permit to basically you know say it is a work permit or are they here for basically indefinite or are they applying for residence. So, we need those, we need affirming documents that will state that the client or director is this side basically wanting to open up a business, know the purpose and all the business profile. We also require the business profile and the business needs to be registered this side. We do not take their previous registration document. So, the business has to be opened this side and to be registered this side.

Participant (M₅) maintained as follows:

M ₅	South African	Male	41-45	White	Business manager	5 years	Degree
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Mine is to collect information and do a motivation. For me to do those things, I will need a business plan. I will need your cash flow projection projected for 12 months. I will also need your personal balance sheet and income statement. I will also need your ID, company documents and then, once I have that information, I can try and see is it possible for us to put in credit information. I will obviously look at your credit record whether you can be able to do that application.

Participant (C₃) noted as follows:

C ₃	South African	Male	41-45	White	Credit manager	7 years	Degree
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So, for a start, credit application, we will ask for financials from the customer two years preferably. We will look at 6 months banking history, will ask for personal balance sheet from the customer to understand you know his collateral that he is able to offer, first class security is what we require. We will then send out an evaluation team to evaluate the property, get a for-sale value on the property and thereafter, we submit and collect a credit application, together with cash flow full costs that the client will provide.

The next section focuses on challenges faced by the formal financial sector in assessing and approving applications for credit by SMEs.

6.3.3 Challenges faced by the formal financial sector in assessing and approving applications for credit by SMEs in South Africa

The formal financial sector in developing economies face a number of challenges that prevent them from lending to SMEs. These challenges account for the huge credit financing gap between the supply capacities of formal financial institutions and the demanding needs of SMEs (Baby and Joseph, 2016:2; Haven, 2015:3758; Kwaning, Nyantakyi and Kyereh, 2015:20). Table 6.6 shows that the perspectives of participants with regard to challenges faced by the formal financial sector in providing credit to SMEs are lack of investment capital, lack of collateral, lack of proper financial records, poor managerial knowledge, poor business plan, lack of industry knowledge and poor legal and credit laws.

Table 6.6: Perspectives of participants with regard to challenges faced by the formal financial sector

Interviewee	Perspectives of business and credit managers	Frequencies (n)
C ₁ ; C ₂ ; C ₃ ; C ₄ ; C ₅ ; C ₆ ; C ₇ ; C ₈ ; M ₁ ; M ₂ ; M ₃ ; M ₄ ; M ₅ ; M ₆ ; M ₇ ; M ₈	Lack of investment capital	26
C ₁ ; C ₂ ; C ₃ ; C ₄ ; C ₆ ; C ₈ ; M ₁ ; M ₂ ; M ₃ ; M ₄ ; M ₆ ; M ₈	Lack of collateral	20
C ₁ ; C ₂ ; C ₃ ; C ₄ ; C ₆ ; C ₇ ; C ₈ ; M ₁ ; M ₂ ; M ₃ ; M ₄ ; M ₈	Lack of proper financial records	18
C ₁ ; C ₂ ; C ₃ ; C ₅ ; C ₆ ; C ₇ ; C ₈ ; M ₁ ; M ₂ ; M ₅ ; M ₆	Poor managerial knowledge	13
C ₃ ; C ₆ ; C ₇ ; M ₅ ; M ₇ ; M ₈	Poor business plan	7

C ₁ ; C ₄ ; C ₇ ; M ₃ ; M ₆ ; M ₇	Lack of industrial knowledge	6
C ₂ ; M ₁ ; M ₃	Poor legal and credit laws	3

Source: author's own contribution

In Table 6.6 the number of participants are indicated in the left column and the frequency of citations of a particular factor (middle column) is given in the right column. This means that for example, in terms of lack of investment capital, while all the credit and business managers regarded this factor as being important, the importance was further enhanced by the frequencies (n = 26) of mention by these respondents. The level of importance of each factor is thus determined by the frequency of mention rather than the number of respondents.

6.3.3.1 Lack of investment capital

Consistent with contemporary literature, lack of finance by SMEs has always been a bone of contention (n = 26). While SMEs contend that formal financial institutions are not providing them with the desired support in terms of financing, formal financial institutions, on the other hand, disagree with SMEs as captured in the excerpt below by one of the business managers (M₅):

M ₅	South African	Male	41-45	White	Business manager	5 years	Degree
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.... When someone comes to the bank for credit and when you ask the persons how much do they have to invest in the business idea, they tell you that nothing and that is why we are coming to the bank so that the bank can help. Let me tell you this, it is a standard practice that we only give 50% of what the equity of a business is. So, in other words, if you put R50000, we look at R50000. However, we have got some instances with the DTI (Department of Trade and Industry) that they will also give some guarantee from their side to be able to take it up to 80%. So, one needs to understand what will actually happen in such situation like that. If I put 80% into a business, say R80000 out of a total of a hundred thousand, and you put in R20000, technically, you owe me R80000. You have put in R20000. So, you are R60000 short. Therefore, you are technically insolvent and the law says that we are not supposed to lend to an insolvent or technically insolvent business. That is the reason why it becomes very difficult to just give out loans when the clients themselves do not have anything to motivate that they are serious in their business.

One of the credit managers (C₂) spoke about funding entrepreneurs (persons with brilliant business ideas but working for another company) and maintained as follows:

C ₂	South African	Female	30-34	Black	Credit manager	3 years	Diploma
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There are some people with good business ideas but they are working in another company. Some of these people, when they approach the bank for funding, because they want to start their own business, what we do is, we ask the person to present us with a business plan. Then, we will review the business plan and if we see that is a good business idea, then, the bank will pay his salary for 12 months and also provide you with the starting capital on condition that you must resign from that company and commit yourself to the business completely. The bank will also appoint someone to assist you on the day-to-day running of the business. The bank will negotiate how the profit will be shared but most often, is 60:40 or 70:30 and the entrepreneur always takes the greater percentage. In cases like this, the person will not need any collateral. This is the type of project that my bank is really happy to fund because the success rate is good.

6.3.3.2 Lack of collateral

The use of collateral has become a very prominent feature of credit contracts between enterprises and formal financial institutions. Collateral in the form of business or personal assets or life insurance is used as one of the ways to protect creditors in today's business world.

One of the business managers (M₃) indicated as follows:

M ₃	South African	Female	30-34	Indian	Business manager	5 years	Post G. Degree
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As I told you earlier, first class security in the form of investment account, personal assets or insurance scheme is what we prefer to keep as security for any client that wants credit. Unfortunately, most of the security offered by most clients do not qualify. Some do not have security to offer at all. A number of our clients, most often, offer an empty land or a land with a shack building on it. When we send our evaluation team to evaluate the value of the land with the shack on it, it does not meet the value of the loan they are asking from the bank. In some situations, I will advise the client to reduce the amount they are asking for. Some will take the advice and some will tell you the amount we offer is too small for what they want to do.

At times, some clients will offer a first class security as collateral but the problem is that they want a loan that is equal to their collateral. In such situations, the bank will normally reject the credit application because the value of the security in future may not be the same. According to the bank policy, the value of the security must be greater than the loan one is applying for.

One of the credit managers (C₃) indicated as follows:

C ₃	South African	Male	41-45	White	Credit manager	7 years	Degree
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Situation may happen that the credit application of my client is denied because the client does not qualify for such amount of credit. For example, your business and asset which you offer as collateral is worth R5 million and you apply for a loan of R5 million. We will never

give you such amount of credit because the risk is too high and your collateral can not cover the loan in case you default. So, yeah. In that case, the credit application will be denied.

6.3.3.3 Lack of proper financial records

Formal financial institutions make use of financial records from SMEs to determine their present and predict their future performance (Amadhila and Ikhide, 2016:284). Given the importance of financial records, one of the greatest challenges faced by SMEs in accessing financial capital from external sources is lack of adequate financial information to enable banks to assess their performance, thus leading to information asymmetry as captured in the excerpt below by one of the credit managers (C₄):

C ₄	South African	Male	35-40	Black	Credit manager	6 years	Degree
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Most of the time, it is a hustle to get the financial record documents, especially let us say it is a new business or a client that deals with services and then they do not provide us with any financial records to control, then, we will turn our attention to the account they have with us. So, we will require a four years management account. Another thing I will like to tell you is that some clients do not take time to keep their financials in order and that makes our job very difficult. Some want to do their financial only when they are preparing to apply for a loan and when we ask about their past financial record, they tell us they do not have it.

6.3.3.4 Poor management skills

Poor management skills emerged as one of the challenges faced by formal financial institutions in assessing and approving applications for credit by SMEs. According to participants, the poor management skills of owners/managers of SMEs reduces the legitimacy of their credit application as captured in the excerpt by C₇:

C ₇	South African	Female	35-40	Black	Credit manager	6 years	Degree
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In the past year, I have realised some clients use business funds to purchase personal asset that does not bring any revenue to the business. How can you use money that you use in running your business to pay for a private car and you then apply for a loan that you want to settle some business expense? That is a wrong decision. You cannot even use the car as a security to apply for a loan. This is the kind of decision some of this client do. So, when this kind of client applies for a loan, we look at the cash flows from the financials of the business in the past months, say six to twelve months and then try to come out with projections over the coming months. So, if it is a business that generates enough revenue, we will look at the amount of the loan and the estimated time the clients request to pay back

the loan. If I am satisfied with my calculations, and the amount requested by the client, then I will process the credit application.

6.3.3.5 Poor business plan

A business plan is considered as one of the most essential documents prepared by owners/managers of SMEs when setting up a business and when seeking external finance from external investors such as formal financial institutions. During the interviews, participants indicated that one of the reasons why owners/managers of SMEs find it difficult to access credit from formal financial institutions is because of their inability to design a good business plan that meets the requirements of investors such as formal financial institutions. C₁ maintained as follows:

C ₁	South African	Male	35-40	Black	Credit manager	5 years	Degree
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You will find someone who will give you a business plan that is not detailed and you will sit and read this business plan and think, not really understanding what the client wants to do. That one, I have seen it most often and is a major one. Also, the way some others write their business plan, you will see someone also giving you a business plan of about 50 pages which can be scaled down to about 10 pages, which makes it easier for me to read the entire document. But if you give me 50 pages business plan, obviously, I will end up reading only about 10 to 20 pages and not really understand your business plan. So, the issue of writing business plans is a major problem with small business owners. We even advise them to look at our website and they will find a sample of a business plan. They do not listen because they want to give you what they have.

6.3.3.6 Lack of industry knowledge

Information and knowledge about an industry represent a fundamental wealth to every owners/managers of SMEs and they try to make use of this wealth to gain competitive advantage, access external resources and improve performance. In the absence of such information and knowledge, owners/managers, most often, fail to access external resources such as financial capital, which compromises the health of the enterprise as explained by M₁:

M ₁	South African	Female	35-40	Black	Business manager	7 years	Degree
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Just being prepared, you know most of the time, people are keen to have businesses but they do not do their homework. It is almost like I go to the bank and I expect the bank to take a risk on me but when you ask a question about the type of business they want to do, you realise that they actually do not know what they want to do. So, how do you fund somebody

who does not even have a vision of their own business they want to do? You see, they are taking short cuts, they want the business to be just something easy, they do not do their proper homework in terms of you see you need to know your strength, weaknesses, opportunity and competitors. You need to know your industry and the risk involved in operating within that industry.

6.3.3.7 Poor legal and credit laws

Credit laws, according to participants, constitute a serious challenge in assessing and approving applications for credit by SMEs. Poor creditor’s protection laws, coupled with a shortage of judges and magistrates and the backlog of cases between debtors and creditors in South Africa, portray the legal system as being inefficient. Such situation forces credit providers (formal financial institutions) to be very strict in granting credit to SMEs as captured in the excerpt by M4:

M4	South African	Male	50-55	White	Business manager	11 years	Matric (NSC)
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As I told you earlier, we have lost a lot of money in the past. At first, we gave some business loans without holding certain things. After some time, I mean months, when we realised that they are not paying the monthly instalments, we went to the business premise to check what was happening only to find out that the business is no longer operating there. We know the persons we gave the loan to and we see some of them most of the time. But we cannot do them anything. We took some to court and when the court asked them to sign a document that they will pay back the loan, they signed but they keep on saying they do not have money because the business took all their money. We expect the court to do something to force these people to pay but nothing is happening. But some are paying. Is just that the way they are paying is not encouraging. So yeah.

The next section focuses the perception the formal financial sector with regard to investing in SMEs.

6.3.4 Perception of the formal financial sector with regard to investing in SMEs

Despite the challenges faced by formal financial institutions with regard to lending to SMEs, they are still committed to assisting such enterprises. Though contemporary literature on the financing of SMEs reveal the unwillingness of the formal financial sector to lend to SMEs (Baltar and Icart, 2013:204; and Fatoki, 2014:186; Ramlee and Berma, 2013:116), formal financial institutions are not in harmony with such stance as indicated by participants C₂, C₃ and M₃. M₃ indicated as follows:

M ₃	South African	Female	30-34	Indian	Business manager	5 years	Post G. Degree
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With a lot of small business clients that we hold in our books, is an indication that we are committed to invest in small businesses. We also believe in empowering SMEs because I think it is the main thing that will empower our economy at this point because not everyone you know will be an employee but if you know you are an employer, then, it opens up a lot of job opportunities for a lot of people. Hence, I will say we really like to invest in SMEs and for people to become employers, especially at this time when many companies are cutting down, you know retrenching, and you know when you empower a client, you do not only empower one person but you empower more people around your community because the person you fund will hire other people in the community.

Highlighting the willingness and commitment to invest in SMEs, C₃ indicated as follows:

C ₃	South African	Male	41-45	White	Credit manager	7 years	Degree
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We are so committed and confident in lending to SMEs because even top management recommends that we do not decline many credit applications because when we give credit to businesses, they will be able to hire more people from the locations. I can tell you now we have about 3869 business accounts in this branch office and as a senior credit manager, I have to handle about 2000 of these accounts. It is my responsibility to make sure that my clients have their credit when they request for it because I make sure that I communicate with the clients on issues concerning their accounts and I also help them to put their credit applications in order so that they can have their credit. Another thing that we ask from our clients when we approve you a loan sometimes is that, can we also look after your payroll? So, we are saying, if you have got for example, 100 employees, since you are banking with us, we will want all your employees to also open their salary accounts with us. So, in other words, it will also be a business to us and this also helps us to know how the business is doing and it can also help you as a business to make your credit application worthy.

A very high rejection rate of applications for credit from SMEs was highlighted in the literature as a major concern. Contrary to the literature, most participants were in agreement that about 70% of applications for credit were approved as captured in the excerpt by one of the credit managers (C₂):

C ₂	South African	Female	30-34	Black	Credit manager	3 years	Diploma
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I can tell you that about 80% of all the credit applications I have processed were approved. That is to say, for every twenty application I have processed this year, at least, 17 are approved and the three that were rejected, had a little problem to do with their collateral but they have re-applied last week and I am sure they will get their credit this time. We just need to have our normal meetings as credit managers to review

all those that have applied for credit this month. But like I said, the credit applications must contained all the relevant documents before I can process the application.

6.4 SUMMARY OF CHAPTER

In this chapter, a summary of the demographic characteristics of participants was provided, which showed almost an equitable and even representation of eight credit managers and eight business managers. 75% of both credit and business managers had been in their current position for at least five years. The main findings revealed that factors that impact on the willingness of the formal financial sector to provide credit to SMEs were collateral, annual business turnover, audited financial records, relationship with the bank, credit profile, nature of the business, economic climate, ethics, nationality, government policy, management team, valid Identity Document/permit, equity contribution, entrepreneurship education, quality of product and business intelligence.

Assessing credit applications from SMEs, risk assessment, inspection of financial records, proper documentation and background checks are some of the different tasks performed by participants. The main challenges faced by the formal financial sector in assessing and approving applications for credit by SMEs included the following: lack of investment capital, lack of collateral, lack of proper financial records, poor managerial knowledge, poor business plan, lack of industrial knowledge and poor legal and credit laws. Contrary to the notion that formal financial institutions are not interested in investing in SMEs, on average 80% of SMEs that applied for credit, received such credit. Thus, the study revealed that the formal financial sector is very interested in investing in SMEs. Analysis of the quantitative data is presented in the next chapter.

CHAPTER SEVEN

ANALYSIS AND PRESENTATION OF QUANTITATIVE DATA AND FINDINGS

7.1 INTRODUCTION

The previous chapter focused on the analysis of the qualitative data and presentation of findings. The findings revealed that collateral, annual business turnover and audited financial records were the three most important factors that impact on the willingness of the formal financial sector to grant credit to SMEs. New themes that emerged from the interviews with participants were ethics, management team, entrepreneurship education, quality of product and business intelligence. Contrary to the literature, the findings also revealed that the formal financial sector is very committed to lending to SMEs, with an average approval rate of about 75%. This chapter focuses on the analysis of the quantitative data and presentation of findings in order to address the objectives and research questions stated in Chapter 1, Sections 1.4.3 and 1.4.4 as well as the research hypotheses stated in Chapter 1, Section 1.5.

As mentioned in Chapter 1, SPSS version 24 was used to analyse the data. All tests were carried out at 5% level of significance. A descriptive analysis was used to present the demographic features of respondents. Descriptive statistics, such as graphical tables, frequency, percentages and bar charts were also used in the analysis in order make the results clearer. A correlational analysis was used to determine whether there was any significant relationship with the theoretical attributes of the study. Binary logistic regression was also used to infer on the research hypotheses. Tests for normality were done using the Shapiro–Wilks test.

7.2 PRESENTATION OF FINDINGS

The findings presented in this section are in accordance with the structure of the questionnaire. However, the response rate should always be calculated before proceeding with the analysis of data.

7.2.1 Response rate

Response rate (also referred to as completion rate or return rate) in survey research, refers to the number of persons who answered the survey divided by the number of people in the sample (Creswell, 2014). Table 7.1 shows the response rate in this study.

Table 7.1: Response rate

Number of questionnaires sent out	Number of questionnaires returned	Response rate
702	300	42.735%

Brijlal (2013), Abor and Quartey (2010), Fatoki (2014), Hair *et al.* (2008:4) and Cooper and Schindler (2011:72) agreed that a response rate greater than 40% is most common and acceptable in social science research. As such, a response rate of 42.735% is acceptable for this study.

7.2.2 Normality of the data

As explained in Chapter 5, Section 5.5.3.3, using the Kolmogorov-Smirnov test to test for the normality of the data, the significance of the Kolmogorov-Smirnov test was greater than 0.05 in all the tests. This, therefore, implies that the normality of the data could be assumed.

7.2.3 Demographic characteristics of respondents

This section focuses on the demographic characteristics of SMEs and respondents. Basic demographic analysis was used in the study for two reasons: to identify characteristics of the population in order to determine basic information about respondents; and to identify respondents with regard to gender, age, nationality, level of education, legal status of the business, level of business experience, number of years in operation, registration status, number of employees and activity of the SME. This information is summarised in Table 7.2.

Table 7.2: Demographic characteristics of respondents

Gender	Frequency	Percentage
Male	184	61.333
Female	116	38.667
Total	N = 300	100
Age	Frequency	Percentage
Below 20 years	8	2.667
21 – 30 years	84	28
31 – 40 years	128	42.667
41 – 50 years	42	14

51 – 60 years	24	8
Above 60 years	14	4.667
Total	N = 300	100
Nationality	Frequency	Percentage
South African by birth	214	71.333
Naturalised South African	52	17.333
Immigrant	34	11.333
Total	N = 300	100
Qualification	Frequency	Percentage
Matric (National Senior Certificate (NSC)	72	24
Diploma	42	14
Degree	126	42
Advanced Diploma	20	6.667
Post graduate qualification	40	13.333
Total	N = 300	100
Legal status	Frequency	Percentage
Sole proprietorship	34	11.333
Partnership	102	34
Close corporation	98	32.667
Companies	66	22
Total	N = 300	100
Years in operation	Frequency	Percentage
Less than 1 year	16	5.333
2 – 5 years	40	13.333
6 – 10 years	38	12.667
11 – 15 years	50	16.667
16 – 20 years	100	33.333
Above 20 years	56	18.667
Total	N = 300	100
Work experience	Frequency	Percentage
No previous experience	86	28.667
1 – 5 years	136	45.333

6 – 10 years	56	18.667
11 – 15 years	14	4.667
Above 16 years	8	2.667
Total	N = 300	100
Number of employees	Frequency	Percentage
Less than 10	130	43.333
10 - 49	116	38.667
50 - 200	54	18
More than 200	0	0
Total	N = 300	100
Business activity	Frequency	Percentage
Construction	30	10
Manufacturing	50	16.667
Whole sale /retail trade	124	41.333
Service industry	74	24.667
Transport	22	7.333
Total	N = 300	100

Table 7.2 shows that the majority of respondents (61.333% or n = 184) who took part in the study were men. The findings also indicate that the majority of respondents (42.667% or n = 128) were between 31 and 40 years, followed by those aged between 20 and 30 years. This is an indication that the level of entrepreneurial activity was common among respondents aged 31- 40. Respondents aged below 20 represented 2.667% or 8. The findings show that owners/managers of SMEs are generally active between 20 and 40. The findings are consistent with those of Kuratko and Audretsch (2009) who found two natural age peaks correlated to entrepreneurship, namely: the late twenties and mid-thirties. The majority (71.333% or n = 214) of respondents were South Africans, 42% or 126 had at least a degree, while 13.333% or 40 had a post graduate qualification. This is an indication that many university graduates in South Africa are getting into entrepreneurship.

Table 7.2 also shows that partnership (34% or n = 102) was the most dominant business status of respondents, followed by corporation (32.667% or n = 98). The findings are inconsistent with the study by Delmar and Wiklund (2008) which revealed that close corporations were the

dominant business status in South Africa. This could be due to the new Companies Act 2008 which did away with close corporations. 68.667% or n = 206 respondents had been operating for more than ten years, 16.667% or n = 50 had been operating between 11 and 15 years, 33.333 or 100 between 16 and 20 years, 18.667% or 56 for more than twenty years, while 18.337% or n = 56 respondents had been in operation for five years or less. This result is consistent with the GEM (2014) report that the rate at which new SMEs are established in South Africa was very low.

74% of respondents (222) had previous work experience of five years or less, 45.333% or n = 136 had 1 to 5 years work experience while 38.667% or 86 had less than a year of experience. This result is also consistent with the GEM (2017) report that since 2014, more South Africans have been embracing entrepreneurship as a career option after the huge corporate retrenchment post-2013. From the definition of SMEs as presented in Chapter 2 (Table 2.1), 18% of businesses (n = 54) were medium enterprises, 82% (n = 246) were small enterprises, 41.333% (n = 124) were whole sale /retail trade, while 24.667% (n = 74) were involved in the service industry.

7.2.4 Situation of the enterprise

The questions in this section of the questionnaire (Section B) sought to address challenges faced by SMEs and the impact of such challenges on their performance in South Africa. This section focuses on the findings with regard to respondents' original investment in assets such as inventories, plant and machinery, buildings and the future plans for their enterprises. Challenges faced by SMEs and the impact of such challenges are also addressed in this section. Data was analysed using descriptive statistics and Spearman's Rho correlations (r). The mean scores and the value for r (Spearman's Rho correlations) were based on a 7-point Likert scale and 4 considered as the average value. Thus, any score greater than 4 indicates a positive challenge and any score lower than 4 indicates a negative challenge.

7.2.4.1 Original investment in assets (inventories, plant, machinery and buildings)

Inventories, plant and machinery/equipment are all assets that strengthen the balance sheet of the enterprise when applying for credit (Gozzi & Schmukler, 2016:4) and could be used as collateral. Table 7.3 shows the level of original investment of respondents in terms of assets.

Table 7.3: Investment in inventories, plant and machinery/equipment

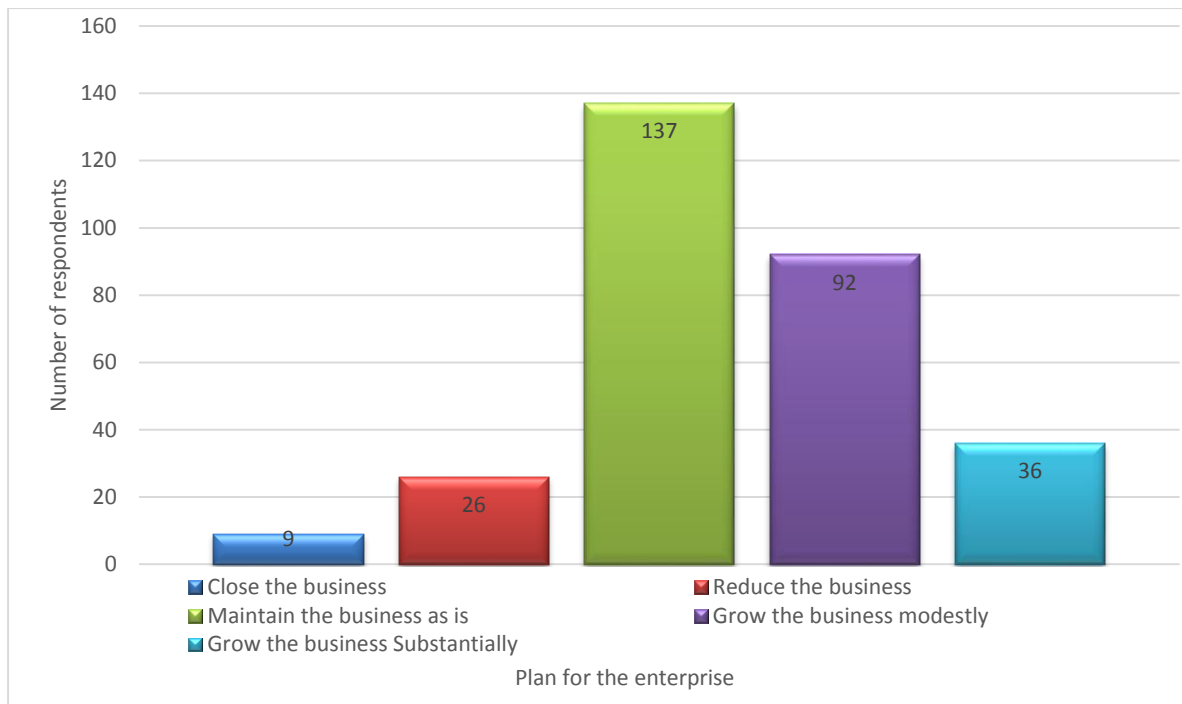
Amount	Frequency	Percentage
Less than R1,000,000	47	15.667
R1,000,000 – R2,999,999	102	34
R3,000,000 – R4,999,999	68	22.667
R5,000,000 – R9,999,999	40	13.333
More than R10,000,000	43	14.333
Total	N = 300	100

Table 7.3 shows that 34% of respondents (102) had invested between R1,000,000 and R2,999,999 in assets. The results also indicate that 15.667% of respondents (47) had less than a million invested in inventories, plant and machinery/equipment. Approximately 49.667% of respondents had invested less than R3,000,000 in assets. These figures are consistent with the results obtained by Bates *et al.* (2014) and Falkena *et al.* (2002) who found that owners/managers of SMEs have a low propensity to invest in assets. However, 17.667% of respondents (83) had invested more than R5,000,000 in assets.

7.2.4.2 Plan for the enterprise for the next two years

The anticipated future plan of owners/managers of SMEs could signal if the SME is performing well or not or if the owners/managers are still fully committed in investing in the enterprise. Figure 7.1 shows the responses of respondents with regard to the future plan of the enterprise over the next two years.

Figure 7.1: Plan for the enterprise for the next two years



Source: Author's own contribution

Figure 7.1 shows that most (45.667% or $n = 137$) respondents preferred to maintain their enterprise in its current situation, 42.667% ($n = 128$) had plans to grow their businesses either modestly or substantially, 3% of respondents (9) had plans to close their businesses within the next two years, which could be an indication of the unhappiness or dissatisfaction of owners/managers with the performance of the enterprise. With regard to respondents who had plans to reduce their businesses (8.667% or $n = 26$), such decision was either because they wanted to increase their profit margins by cutting costs or diversify their interest into other business opportunities that may require more financial backing.

7.2.4.3 Challenges faced by the enterprise

Business challenges, as explained by Jenkins and McKelvie (2016:177) are unpredictable and dynamic changes that require thinking and actions that are responsive to addressing such changes. Such unpredictable and dynamic changes often have a negative impact on the performance of the enterprise and could lead to the failure of the enterprise. Table 7.4 shows the means and standard deviations of challenges faced by SMEs in this study.

Table 7.4: Challenges faced by SMEs

Challenges	Mean	Standard deviation
Finding customers	3.56	1.688
Regulations (laws and policies governing SMEs)	3.89	1.740
Availability of book-keeping and accounting services	3.63	1.669
Access to bank finance	4.54	1.996
Competition from other similar domestic enterprises	4.66	1.677
Enterprise operates within a small margin	3.66	1.637
Skilled and experienced managers	4.09	1.756
Cost of production	4.17	2.124
Cost of labour	5.09	1.689
Other (Crime)	0.77	1.985

(Valid N = 300)

The results in Table 7.4 show that cost of labour had the highest mean (5.09) with a standard deviation of 1.689. This result is justified by the intense competition in the market. Competition from other similar domestic enterprises had the second highest mean of 4.66 and a standard deviation of 1.677, access to finance had the third highest mean (4.54) and a standard deviation of 1.996. If labour cost is high, competition would be tight and owners/managers of SMEs would find it difficult to access finance due to limited sales and profit margin. Thus, the results show that most owners/managers of SMEs prefer to carry out activities of the businesses themselves instead of hiring employees to perform such duties in order to minimise cost and maximise profit. This further justifies the reason why majority of respondents employ less than ten employees (43.333%) as shown in Table 7.1. Crime emerged as the least challenge faced by owners/managers of SMEs with a mean score of 0.77 and a standard deviation of 1.985. The low level of crime is an indication of the hard work of the government of South Africa to curb crime in the province. The results are consistent with the GEM (2017) report that crime in the province has reduced significantly over the past three years.

To determine if these challenges have an impact on the performance of SMEs, it was imperative to perform a correlational analysis between the performance of SMEs and challenges faced by these enterprises. The results obtained by Spearman's Rho correlation analysis are presented in Table 7.5.

Table 7.5: Spearman’s Rho correlations (r) and significance probabilities (p) for relations of performance to challenges faced by SMEs

Theoretical Constructs	r	p
Finding customers	-0.018	0.827
Regulations	-0.061	0.464
Book-keeping and accounting services	0.007	0.930
Access to bank finance	0.164	0.046*
Competition	0.032	0.703
Enterprise operates within a small margin	0.013	0.872
Skilled and experienced managers	0.047	0.568
Cost of production	0.013	0.874
Cost of labour	0.092	0.270

*Correlation is significant at 0.05 level (2-tailed)

**Correlation is significant at 0.01 level (2-tailed)

To give effect to the first secondary hypothesis, the following sub-hypothesis is stated.

Hs^{1a}: There is a significant positive relationship between access to bank finance and the performance of SMEs.

Hs^{1o}: There is no significant positive relationship between access to bank finance and the performance of SMEs.

Table 7.5 shows that of all the variables (challenges), access to bank finance was the only variable (challenge) that had a significant correlation with the performance of SMEs ($r = 0.164$; $p = 0.046$).

Therefore, the null hypothesis that there is no significant positive relationship between access to bank finance and the performance of SMEs was rejected

This result signifies that, of all the challenges faced by SMEs, it can be construed that lack of finance is the number one cause of failure of SMEs, thus access to bank finance could assist in improving the performance of SMEs and reducing the failure rate of these enterprises. The World Bank (2016), OECD (2016) and GEM (2017) share the same view.

7.2.5 Financing of SMEs

This section focuses on the results obtained with regard to the financing of SMEs in accordance with section C of the questionnaire. The research question addressed in this section was: “What are the financial needs of SMEs with regard to the formal financial sector in South Africa?” The number and percentage of SMEs that applied for credit, enterprises whose credit applications were rejected, those that were approved and those that did not apply for credit are presented in this section. In addition, the reason for applying, and the reason for not applying for credit, the percentage of banking finance received for those whose applications were approved and the sources of finance used by respondents the past three years are also presented (see Table 7.6).

Table 7.6: Summary of results with regard to the financing of SMEs

	Frequency	Percentage
Applied for external finance	248	82.667
Did not apply for external finance	52	17.333
Total	300	100
Reasons for applying for external finance from the bank		
To increase working capital	31	12.5
Purchase fixed assets	116	46.774
Buy another business	42	16.936
Business expansion, training/ staff development	0	0
Other (to buy a car)	59	23.790
Total	248	100
Outcome of credit application		
Approved	167	67.339
Rejected	81	32.661
Total	248	100
Reasons for not applying for external finance from the bank		
Did not need bank finance	28	53.846
Denied access to finance previously	9	17.308
Not aware of bank finance	0	0
Bank finance is too expensive	11	21.154

	Frequency	Percentage
Procedure to obtain bank finance is too complicated	4	7.692
Total	52	100
Finance facilities requested for approved applications		
Term loan	66	39.521
Working capital	32	19.162
Cash credit	16	9.581
Overdraft	35	20.958
Factoring	9	5.389
Export financing	9	5.389
Total	167	100
Percentage of banking finance received		
Less than 50%	8	4.790
Between 50% and 74%	19	11.377
Between 75% and 99%	57	34.132
100% requested	83	49.701
Total	167	100
Sources used (excluding banks) to raise finance for the business over the past three years		
Trade credit	98	32.667
Credit from friends and families	72	24
Venture capital	34	11.333
Crowd funding	38	12.667
Selling shares	31	10.333
Government assistance schemes	27	9
Total	300	100

Table 7.6 shows that out of the 300 respondents who completed and returned the questionnaire, 82.667% (248) applied for external finance from the formal financial institutions. Out of the 248 respondents who applied for external finance from the formal financial institutions, most 46.774% (n = 116) applied for external finance to purchase fixed assets. This result shows the importance of fixed assets to banks when approving applications for credit. Out of the 248 applications received for external finance, 67.339% (n = 167) were approved. With regard to

the 52 respondents who did not apply for bank finance, most (53.846% or n = 28) indicated that they did not apply because they did not need such finance. However, it was revealed that 17.308% (n = 9) of the 52 respondents did not apply for credit from the formal financial institutions because they were previously denied access to finance.

With regard to respondents whose application for external finance was approved by the bank, the majority (39.521% or n = 66) applied for a term loan while 20.958% or 35 applied for an overdraft. With regard to the percentage of banking finance received, 49.701% (83) received 100% of what they requested from the formal financial institutions, while 34.132% (n = 57) received 75% to 99% of the amount they requested. Trade credit (32.667% or n = 98) and credit from friends and family (24% or n = 72) were the other two most common sources used by respondents to raise finance. Considering the fact that not all SMEs had access to trade credit, reliance on friends and members of the family for credit was usually not sufficient for the survival and growth of the enterprises. Thus, SMEs heavily rely on bank finance for their survival and growth. Descriptive statistics (mean score) were used to rank the different sources of finance as shown in Table 7.7.

Table 7.7: Different sources of finance

Different sources of finance	Mean score
Trade credit	3.48
Credit from friends and members of the family	3.30
Venture capital	2.32
Bank finance	3.86
Selling shares	3.19
Government assistance scheme	2.79
Crowd funding	2.75
Missing values	0.81

Table 7.7 shows that bank finance was the most preferred source of finance, with the highest mean score of 3.86, thus justifying the heavy reliance on bank finance by SMEs. The second most preferred source of finance was trade credit, with a mean score of 3.48 and credit from friends and members of the family occupying third position, with a mean score of 3.30. Venture

capital (with the lowest mean score of 2.32) was the last option for owners/managers of SMEs as revealed in the literature (Adair & Adaskou, 2015:2; Menike, 2015:57).

7.2.6 Important factors to consider when applying for credit from the formal financial sector

Table 7.8 shows the mean scores of important factors considered by owners/managers of SMEs when applying for credit from the formal financial sector (Section D of the questionnaire). The Table further shows the relative importance of each factor in the credit application process by owners/managers of such enterprises.

Table 7.8: Important factors to consider in applying for finance from banks

Factors	Mean	Std. deviation
Managerial competency of owners/managers of SMEs	4.87	1.691
Credit information about the business	5.87	1.518
Acceptable collateral	6.05	1.426
Relation with the bank	4.79	1.821
The macro-economic environment	4.25	1.619
Credit laws on business credit	4.79	1.620
Equity contribution	5.54	1.658
Knowledge of entrepreneurship by owners/managers of SMEs	5.04	1.509
Knowledge of business ethics by owners/managers of SMEs	5.52	1.417
The SME does not generate sufficient sale	4.94	1.439
Credit information about the owners/managers of SMEs	5.35	1.381
South African Identity Document	6.27	1.533
International passport document with valid permit	5.12	2.049

Table 7.8 further shows that the most important factors considered by SMEs when applying for credit were a South African Identity Document and acceptable collateral (both had a mean score above 6 on a 7 point Likert scale). Credit information about the enterprise, equity contribution of owners/managers and knowledge of business ethics by owners/managers of SMEs were the other factors that had a mean score above 5.50 on a Likert scale of 7. Macro-economic environment was the least in terms of importance with a mean of 4.25.

The importance attached to the South African Identity Document (with the highest mean of 6.27) is a clear reflection of the current labour law in the country aimed at promoting enterprises owned by South Africans. The importance of the South African Identity Document is so significant that some formal financial institutions have adopted a policy of not lending to clients who do not hold a South African ID as one of the participants noted in Chapter 6 Section 6.3.1.9. It was revealed collateral helps to eliminate or mitigate the adverse selection problem caused by the existence of information asymmetries between the bank and the borrower at the time of the loan decision (Blumberg & Letterie, 2008:189). Credit information about the enterprise, equity contribution of owners/managers and the knowledge of business ethics of owners/managers, coupled with the credit information about such owners/managers (with mean 5.35), help to establish trust (Turyakira, 2018:2), reduce lending risks (Valsamis *et al.*, 2011:77) and moderate the problem of information asymmetry and moral hazard (Huang *et al.*, 2014:28). Overall, the fact that all the factors listed in Table 7.8 had a mean score above 4, is an indication that all the factors are important for owners/managers of SMEs when applying for credit.

7.2.6.1 Demographic characteristics and the importance of factors when applying for credit from banks

This section focuses on the influence of demographic variables on factors when applying for credit from the formal financial institutions. The demographic characteristics include gender, main activity of the enterprise and legal status, age, nationality, education, experience, length of operation, registration status and number of employees. The results of the T-test revealed no significant influence of demographic characteristics on factors when applying for credit from the formal financial institutions. Because of the fact that there are no significant results, no summary table was presented.

7.2.7 Reasons why formal financial institutions may refuse to grant credit to SMEs

The aim of this section is to determine the reasons why formal financial institutions may refuse to grant credit to SMEs (non-accessibility of debt) (Section E of the questionnaire). Responses obtained from respondents sought to answer two research questions raised in the study as follows: What are the factors that impact access to credit from the formal financial sector by SMEs in South Africa? and What is the relationship between access to credit from the formal financial sector and the performance of SMEs in South Africa? Data was analysed using factor

analysis, descriptive statistics, T-test and Spearman’s Rho correlations. Due to the huge volume of data obtained in this section, only the summary of the analysis is presented.

7.2.7.1 Factor analysis

The measuring instrument was designed to measure factors that impede the willingness of the formal financial sector to grant credit to SMEs. For this purpose, 38-item statements were generated in Section E of the questionnaire based on the findings obtained from the qualitative section of the study (Phase 1). An EFA was performed on these 38 items to determine the level of factor loadings for each item. The most parsimonious result was achieved using equamax rotation, which is an orthogonal rotation method that combines varimax and quartimax techniques. The cumulative variance accounted for the two factors and the password creation was 69.99% (as shown in Table 7.9), thus accounting for almost 70% of the total variability. Moreover, according to the Kaiser Rule, the retained factors had an eigenvalue greater than 1 (Mertler & Vannatta, 2016:9). For the purpose of this study, the acceptance level of factor loading was 0.300. This implies that, questionnaire items with factor loading lower than 0.300 would have been removed as suggested by Hair *et al.* (2008:23) and Watkins (2018:221). Using the guidelines suggested by Watkins (2018:221), all 38 items loaded high (i.e., ≥ 0.5) on the primary loadings of their respective components as shown in Table 7.10.

Table 7.9: Total Variance Explained

Component	Initial Eigenvalues			Rotation Sums of Squared Loadings		
	Total	% of Variance	Cumulative %	Total	% of Variance	Cumulative %
1	11.293	29.719	29.719	3.336	8.778	8.778
2	3.392	8.926	38.645	3.147	8.281	17.059
3	2.592	6.822	45.468	3.052	8.030	25.090
4	1.985	5.223	50.691	3.031	7.975	33.065
5	1.913	5.034	55.725	3.008	7.915	40.980
6	1.719	4.523	60.248	2.972	7.822	48.802
7	1.532	4.031	64.279	2.957	7.783	56.584
8	1.158	3.046	67.326	2.636	6.938	63.522
9	1.010	2.659	69.985	2.456	6.462	69.985

Note: Extraction Method: Principal Component Analysis

A summary of the results of the rotated factor matrix is presented in Table 7.10. After evaluating the survey items and associated variables, the nine (9) factors identified were as follows: “collateral”; “business information”; “managerial competency”; “business networking”; “business intelligence”; “business ethics”; “entrepreneurship education”; “legal system”; and “macro-economy”.

Items 1 to 4 (Table 7.10) contributed to Factor 4 (collateral). These four items loaded higher than or equal to 0.517 on Factor 4. Factor 1 (business information) comprised five items. These items had high loadings (i.e., all ≥ 0.507), suggesting strength to the empirical validity of the construct. Factor 9 (managerial competency) comprised items 10 to 13 and the items had high loadings (i.e., all ≥ 0.521), suggesting strength to the empirical validity of the construct. A summary of the other factors is provided in Table 7.10 (all of them displaying a loading of ≥ 0.50). To determine the reliabilities of the empirical factors established, Cronbach’s alpha coefficient was determined for each factor and the results presented in Table 7.11.

Table 7.10: Rotated Component Matrix

Items	Loadings on Primary Factor/Components								
	F 1	F 2	F 3	F 4	F 5	F 6	F 7	F 8	F 9
Collateral									
Limited tangible assets to use as collateral.				0.517					
Owners/managers of SMEs do not have an insurance policy to use as collateral.				0.774					
Owners/managers of SMEs do not have surety.				0.788					
Limited current assets to use as collateral (e.g. inventories).				0.616					
Business information									
Business does not have a proper business plan.	0.537								
Cash flow is poor and does not encourage the bank.	0.623								
Business is not financially viable.	0.596								
Enterprise does not have a growth potential.	0.579								

Items	Loadings on Primary Factor/Components								
	F 1	F 2	F 3	F 4	F 5	F 6	F 7	F 8	F 9
Owners/managers of SMEs do not have the required documentation to apply for credit.	0.507								
Managerial competency									
Owners/managers of SMEs lack experience that is relevant to the business.									0.590
Owners/managers of SMEs are not fully committed to the business.									0.675
Lack of entrepreneurial skills by owners/managers of SMEs.									0.521
Poor personal credit record of owners/managers of SMEs.									0.634
Business networking									
No prior relationship between the bank and owners/managers of SMEs.							0.799		
Short relationship between the bank and owners/managers of SMEs.							0.879		
Lack of good reference with regard to the integrity and ability of owners/managers of SMEs.							0.697		
No verifiable agreement in place for the distribution of goods.							0.768		
Enterprise does not belong to a professional association.							0.606		
Business intelligence									
Owners/managers of SMEs are not familiar with the market/industry.					0.500				
Owners/managers of SMEs are not capable of making strategic decisions.					0.419				
Owners/managers of SMEs are not able to analyse the market situation.					0.741				
Owners/managers of SMEs do not know about SWOT.					0.768				
Business ethics									
Willingness of owners/managers of SMEs to divert funds to non-core business activities.								0.549	
Inability of owners/managers of SMEs to honour a repayment.								0.750	
Dishonesty of owners/managers of SMEs in keeping promises and commitments.								0.825	
Provision of false financial statements by owners/managers of SMEs.								0.510	

Items	Loadings on Primary Factor/Components								
	F 1	F 2	F 3	F 4	F 5	F 6	F 7	F 8	F 9
Entrepreneurship education									
Owners/managers of SMEs do not have formal training on managing the enterprise.						0.794			
Lack of formal business management education by owners/managers of SMEs.						0.806			
Owners/managers of SMEs do not consider entrepreneurship as a career choice.						0.731			
Legal system									
Courts judgments/decisions are not fairly executed.		0.533							
In situations of legal action against owners/managers of SMEs, it takes long to get judgment.		0.643							
Non-enforcement of court decisions		0.775							
Weak confidence in the legal system to enforce contracts rights.		0.731							
Weak confidence in the legal system to enforce property rights.		0.700							
Macro-economy									
Recession in the economy.			0.691						
Continuous decline in the value of real estate (collateral value).			0.726						
Continuous decline in the value of the Rand.			0.772						
The interest rate of banks is higher than the rate requested by owners/managers of SMEs.			0.807						

The nine factors are presented below in the order of importance as indicated by their contribution to the percentage of total variance.

- Factor one was labelled as business information. The Eigen value for the factor is 29.719. The factor includes five items. This is the most important factor according to the factor analysis. Cronbach's alpha for the factor yielded a value of 0.849 indicating the reliability of the factor.
- Factor two was labelled as legal system. The Eigen value for the factor is 8.926. The factor includes five items. This is the second most important factor according to the

factor analysis. Cronbach's alpha for the factor yielded a value of 0.830 indicating the reliability of the factor.

- Factor three was labelled as macro-economy. The Eigen value for the factor is 6.822. The factor includes four items. This is the third factor according to the factor analysis. Cronbach's alpha for the factor yielded a value of 0.840 indicating the reliability of the factor.
- Factor four was labelled as collateral. The Eigen value for the factor is 5.223. The factor includes four items. This is the fourth factor according to the factor analysis. Cronbach's alpha for the factor yielded a value of 0.769 indicating the reliability of the factor.
- Factor five was labelled as business intelligence. The Eigen value for the factor is 5.034. The factor includes four items. This is the fifth factor according to the factor analysis. Cronbach's alpha for the factor yielded a value of 0.778 indicating the reliability of the factor.
- Factor six was labelled as entrepreneurship education. The Eigen value for the factor is 4.523. The factor includes three items. This is the sixth factor according to the factor analysis. Cronbach's alpha for the factor yielded a value of 0.825 indicating the reliability of the factor.
- Factor seven was labelled as business networking. The Eigen value for the factor is 4.031. The factor includes five items. This is the seventh factor according to the factor analysis. Cronbach's alpha for the factor yielded a value of 0.773 indicating the reliability of the factor.
- Factor eight was labelled as business ethics. The Eigen value for the factor is 3.046. The factor includes four items. This is the eighth factor according to the factor analysis. Cronbach's alpha for the factor yielded a value of 0.781 indicating the reliability of the factor.
- Factor nine was labelled as managerial competency. The Eigen value for the factor is 2.659. The factor includes four items. This is the least important factor according to the factor analysis. Cronbach's alpha for the factor yielded a value of 0.751 indicating the reliability of the factor.

7.2.7.2 Reliability of factors that influence access to credit

Cronbach's alpha coefficient was used to test for the reliability of factors that influence access to credit (from the formal financial sector to SMEs). Table 7.11 shows the reliability of each

scale item in relation to the variables measured. If the alpha value is higher than 0.9, then the reliability is excellent, and if it is at least higher than 0.7, then the reliability is acceptable (Maskey, Fei & Nguyen, 2018:103). Table 7.11 shows that all the Cronbach's alpha reliability coefficients for the factor scale items in this study ranged between 0.751 and 0.849. The Cronbach's alpha coefficient item scores confirmed the strength of the empirical reliability of factors in this section of the study.

Table 7.11: Reliability Analysis

Main factors	Valid N	Items used	Cronbach's α
Collateral	300	4	0.769**
Business information	300	5	0.849**
Managerial competency	300	4	0.751**
Business networking	300	5	0.773**
Business intelligence	300	4	0.778**
Business ethics	300	4	0.781**
Entrepreneurship education	300	3	0.825**
Legal system	300	5	0.830**
Macro-economy	300	4	0.840**
Performance	300	6	0.839**

**Significantly acceptable reliability

7.2.7.3 Descriptive statistics of factors that influence access

Table 7.12 shows a summary of the descriptive statistics of factors that influence access to credit (from the formal financial sector to SMEs). The data is presented in accordance with the total number of respondents, minimum, maximum, mean scores and standard deviation of the data set from the sample. It shows the mean levels of the following factors: collateral (mean = 4.9161; n = 300; SD = 1.10534); business information (mean = 4.9197; n = 300; SD = 1.22227); managerial competency (mean = 3.2374; n = 300; SD = 1.18871); business networking (mean = 3.9693; n = 300; SD = 1.14147); business intelligence (mean = 4.7219; n = 300; SD = 1.21674); business ethics (mean = 5.2432; n = 300; SD = 1.30701); entrepreneurship education (mean = 4.5731; n = 300; SD = 1.21784); legal system (mean = 4.2819; n = 300; SD = 1.12403); macro-economy (mean = 4.4931; n = 300; SD = 1.24841); and performance (mean = 4.8512; n = 300; SD = 1.13174).

Table 7.12: Summary of descriptive statistics of factors that influence access to credit (from the formal financial sector to SMEs)

Factors	N	Min	Max	Mean	S.D
Collateral	300	1.50	7.00	4.9161	1.10534
Business information	300	1.00	7.00	4.9197	1.22227
Managerial competency	300	1.25	7.00	4.8300	1.18871
Business networking	300	1.00	7.00	3.9693	1.14147
Business intelligence	300	1.00	7.00	4.7219	1.21674
Business ethics	300	1.25	7.00	5.2432	1.30701
Entrepreneurship education	300	1.00	7.00	4.5731	1.21784
Legal system	300	1.20	7.00	4.2819	1.12403
Macro-economy	300	1.25	7.00	4.4931	1.24841
Performance	300	1.67	7.00	4.8512	1.13174

Statistically significant differences (* $p < .05$). Statements were rated on a 7-point scale from 1 (strongly disagree) to 7 (strongly agree)

In order to establish the levels of significance of these factors, a one sample T-test was performed and the results are presented in Table 7.13

Table 7.13: One sample T-tests for the mean responses of factors that influence access to credit (from the formal financial sector to SMEs)

	Factor	Mean	t-value	df	p-value
1	Collateral	4.9161	9.911	300	<0.0001*
2	Business information	4.9197	8.967	300	<0.0001*
3	Managerial competency	4.8300	8.552	300	<0.0001*
4	Business networking	3.9693	-0.329	300	0.743
5	Business intelligence	4.7219	7.290	300	<0.0001*
6	Business ethics	5.2432	11.572	300	<0.0001*
7	Entrepreneurship education	4.5731	5.686	300	<0.0001*
8	Legal system	4.2819	3.010	300	0.003*
9	Macro-economy	4.4931	4.739	300	<0.0001*
10	Performance	4.8512	9.181	300	<0.0001*

Statistically significant differences (* $p < .05$)

Table 7.13 shows that the mean scores were compared to a stipulated mean level of 4 on the 7-point Likert scale. Mean levels significantly higher than 4 were regarded as respondents agreeing that the respective factor was important while those that were significantly lower than 4, were considered by respondents as being less important. There was a strong significant evidence that respondents generally agreed to all the factors as follows: collateral (mean = 4.9161; $t = 9.911$; $p = <0.0001$); lack of business information (mean = 4.9197; $t = 8.967$; $p = <0.0001$); lack of managerial competency (mean = 4.8300; $t = 8.552$; $p = <0.0001$); lack of business intelligence (mean = 4.7219; $t = 7.290$; $p = <0.0001$); lack of business ethics (mean = 5.2432; $t = 11.572$; $p = <0.0001$); lack of entrepreneurship education (mean = 4.5731; $t = 5.686$; $p = <0.0001$); inefficiency of the legal system (mean = 4.2819; $t = 3.010$; $p = 0.003$); macro-economy (mean = 4.4931; $t = 4.739$; $p = <0.0001$); and performance (mean = 4.8512; $t = 9.181$; $p = <0.0001$). Except for business networking (with a mean of 3.9693, a t-value of -0.329, df of 300 and a p-value of 0.743), all the factors listed in Table 7.13 were significant. This implies that there was no significant positive relationship between business networking and performance of SMEs. All the other factors showed a significant positive relationship to performance. This finding is in accord with the Agency theory. According to this theory, the lack of information and close relationship between lenders and borrowers is the sole cause of credit rationing and moral hazard.

7.2.8 Inferential analysis: Correlation analysis

A correlational analysis, supplemented by binary logistic regression models were performed in order to establish significant relationships between access to bank finance (approved credit applications), performance and other factors that influence access to credit (from the formal financial sector to SMEs). It was hypothesised that there is some form of linear relationship between access to bank finance, performance and factors that influence access to credit (from the formal financial sector to SMEs). It was necessary to check whether there was a linear relationship in the data, which allowed for regression analysis. To achieve this, a non-parametric Spearman's rho Bivariate Correlation coefficient (one-tailed test) was used. Table 7.14 shows the Spearman's rho Bivariate Correlation coefficient (r) and significance probabilities for relations between access to bank finance and factors that influence access to credit (from the formal financial sector to SMEs).

Table 7.14: Spearman's Rho correlations (r) and significance probabilities (p) between access to bank finance and factors that influence access to credit

Factors	r	p
Collateral	0.340	<0.0001**
Business information	0.247	0.008**
Managerial competency	0.237	0.009**
Business networking	0.025	0.401
Business intelligence	0.312	0.001**
Business ethics	0.350	<0.0001**
Entrepreneurship education	0.332	<0.0001**
Legal system	0.198	0.025*
Macro-economy	0.301	0.001**

**Correlation is significant; level is 0.01(1-tailed test)

*Correlation is significant; level is 0.05(1-tailed test)

The results in Table 7.14 show that access to bank finance had moderate significant and positive correlations with most factors that influence access to credit (from the formal financial sector to SMEs), used to measure the reasons why formal financial institutions may refuse to grant credit to SMEs. Thus, access to bank finance had a moderate significant and positive relationship with lack of collateral ($r = 0.340$; $p = <0.0001$), lack of business information ($r = 0.247$; $p = 0.008$), lack of managerial competency ($r = 0.237$; $p = 0.009$), lack of business intelligence ($r = 0.312$; $p = 0.001$), lack of business ethics ($r = 0.350$; $p = <0.0001$), lack of entrepreneurship education ($r = 0.332$; $p = <0.0001$), inefficiency of the legal system ($r = 0.198$; $p = 0.025$) and macro-economy ($r = 0.301$; $p = 0.001$). However, there was no significant correlation between access to bank finance and business networking ($r = 0.025$; $p = 0.401$).

A further correlational analysis on the relationships between the performance of SMEs and various factors that influence access to credit (from the formal financial sector to SMEs), as shown in Table 7.15, was performed.

Table 7.15: Spearman's Rho correlations (r) and significance probabilities (p) between the performance of SMEs and factors that influence access to credit

Factors	r	p
Collateral	0.275	<0.0001**
Business information	0.213	0.006**
Managerial competency	0.245	0.001**
Business networking	0.039	0.320
Business intelligence	0.372	<0.0001**
Business ethics	0.371	<0.0001**

Entrepreneurship education	0.304	<0.0001**
Legal system	0.250	0.001**
Macro-economy	0.304	<0.0001**

** Correlation is significant; level is 0.01(1-tailed test)

* Correlation is significant; level is 0.05(1-tailed test)

The results in Table 7.15 show moderate and positive significant correlations between the performance of SMEs and factors that influence access to credit (from the formal financial sector to SMEs). Thus, the performance of SMEs had moderate significant and positive relationships with lack of collateral ($r = 0.275$; $p = <0.0001$), lack of business information ($r = 0.213$; $p = 0.006$), lack of managerial competency ($r = 0.245$; $p = 0.001$), lack of business intelligence ($r = 0.372$; $p = <0.0001$), lack of business ethics ($r = 0.371$; $p = <0.0001$), lack of entrepreneurship education ($r = 0.304$; $p = <0.0001$), inefficiency of the legal system ($r = 0.250$; $p = 0.001$) and macro-economy ($r = 0.304$; $p = <0.0001$). However, there was no significant correlation between the performance of SMEs and business networking ($r = 0.039$; $p = 0.320$).

7.2.9 Hypotheses testing

Binary logistic regression analysis was used to test the hypotheses (as stated in Section 1.5, Chapter 1) with regard to access to bank finance by SMEs and the reasons why formal financial institutions may refuse to grant credit to SMEs (i.e. factors that influence access to credit from the formal financial sector). In performing the binary logistic regression analysis, a Mann-Whitney U test was performed in order to establish the mean differences between SMEs with access to bank finance and those without such access (Table 7.16).

Table 7.16: Mann-Whitney U means test for correlation between access to bank finance and factors that influence access to credit

Factors	Approved(n =167)	Rejected (n = 81)	Mann-Whitney Z-Test Statistic	U p-value
	Mean \pm SD	Mean \pm SD		
Collateral	5.24 \pm 0.97	4.37 \pm 1.18	-3.352	0.001*
Business information	5.23 \pm 1.26	4.59 \pm 1.25	-2.408	0.016*
Managerial competency	5.09 \pm 1.20	4.48 \pm 1.29	-2.370	0.018*
Business networking	4.03 \pm 1.18	4.01 \pm 1.08	-0.251	0.801
Business intelligence	5.11 \pm 1.20	4.34 \pm 1.13	-3.137	0.002*
Business ethics	5.74 \pm 1.01	4.75 \pm 1.29	-3.505	<0.0001*
Entrepreneurship education	4.83 \pm 1.24	4.01 \pm 1.28	-3.283	0.001*
Legal system	4.61 \pm 1.14	4.05 \pm 1.23	-1.962	0.050*

Macro-economy	4.93 ± 1.20	4.13 ± 1.22	-2.960	0.003*
Performance	5.79 ± 0.63	3.29 ± 0.61	-7.839	<0.0001*

* Significance level is 0.05 (1-tailed test)

Table 7.16 shows that the mean for approved collateral was 5.24 ± 0.97 , which was significantly higher than the mean for collateral that was rejected (4.37 ± 1.18). The p-value for collateral was 0.001*, and lower than the significance level of 0.05, thus confirming the significant correlation between access to bank finance and collateral. The results were similar for all the other factors, with the exception of business networking. The mean for approved business networking was 4.03 ± 1.18 , thus showing no significant differences with the rejected group ($z = -0.251$; $p = 0.801$) (see Annexure H for boxplots depicting the findings of these means test). The p-value for business networking was greater than the p-value for significance level, thus confirming the fact that there was no significant correlation between access to bank finance and business networking. Table 7.17 shows a summary of the binary logistic regression models.

Table 7.17: Binary Logistic regression for access to finance and the relationship with factors that influence access to credit

Predictor factors	Model -2LL (R ²)	Parameter estimates		
		B (SE)	OR (95% CI)	p-value
H1 Collateral	107.302	0.771	2.162	(1.385 0.001*
H2 Business information	113.960	0.406	1.501	(1.049 0.026*
H3 Managerial competency	117.787	0.395	1.484	(1.045 0.027*
H4 Business networking	125.283	0.012	1.012	(0.698 0.950
H5 Business intelligence	116.634	0.535	1.707	(1.168 0.006*
H6 Business ethics	109.577	0.738	2.092	(1.397 <0.0001*
H7 Entrepreneurship	111.473	0.504	1.656	(1.153 0.006*
H8 Legal system	116.715	0.413	1.512	(1.030 0.035*
H9 Macro-economy	111.684	0.566	1.760	(1.186 0.005*

*Significance level is 0.05 (1-tailed test)

➤ **Collateral**

Ho¹: There is no significant positive relationship between lack of collateral and access to credit from the formal financial sector to SMEs.

Ha¹: There is a significant positive relationship between lack of collateral and access to credit from the formal financial sector to SMEs.

Binary logistic regression was performed to ascertain the effect of lack of collateral on the likelihood that enterprises have access to bank finance. The logistic regression model was statistically significant, $p = 0.001$. The model explained 18.1% (Nagelkerke R^2) of the variance in access to bank finance. SMEs with approved credit were 2.172 times more likely to agree that lack of collateral was one of the reasons why formal financial institutions may refuse to grant credit to SMEs. Thus, since $p < 0.05$, the null hypothesis was rejected, and the alternate hypothesis supported since there was a significant positive relationship between lack of collateral and access to credit.

➤ **Business information**

Ho²: There is no significant positive relationship between lack of business information and access to credit from the formal financial sector to SMEs.

Ha²: There is a significant positive relationship between lack of business information and access to credit from the formal financial sector to SMEs.

Binary logistic regression was performed to ascertain the effect of lack of business information on the likelihood that enterprises have access to bank finance. The logistic regression model was statistically significant, $p = 0.026$. The model explained 7.5% (Nagelkerke R^2) of the variance in access to bank finance. Enterprises with approved credit were 1.501 times more likely to agree that lack of business information was one of the reasons why formal financial institutions may refuse to grant credit to SMEs. Therefore, since $p < 0.05$, the null hypothesis was rejected, and the alternate hypothesis supported as there was a significant positive relationship between lack of business information and access to credit.

➤ **Managerial competency**

Ho³: There is no significant positive relationship between lack of managerial competency and access to credit from the formal financial sector to SMEs.

Ha³: There is a significant positive relationship between the lack of managerial competency and access to credit from the formal financial sector to SMEs.

Binary logistic regression was performed to ascertain the effect of lack of managerial competency on the likelihood that SMEs have access to bank finance. The logistic regression model was statistically significant, $p = 0.027$. The model explained 7.0% (Nagelkerke R^2) of the variance in access to bank finance. SMEs with approved credit were 1.484 times more likely to agree that lack of managerial competency was one of the reasons why formal financial institutions may refuse to grant credit to SMEs. Therefore, since $p < 0.05$, the null hypothesis was rejected, and the alternate hypothesis supported as there was a significant positive relationship between lack of managerial competency and access to credit from the formal financial sector to SMEs.

➤ **Business networking**

Ho⁴: There is no significant positive relationship between lack of business networking and access to credit from the formal financial sector to SMEs.

Ha⁴: There is a significant positive relationship between lack of business networking and access to credit from the formal financial sector to SMEs.

Binary logistic regression was performed to ascertain the effect of lack of business networking on the likelihood that SMEs have access to bank finance. The logistic regression model was not statistically significant, $p = 0.950$. Thus, since $p > 0.05$, the null hypothesis was not rejected, and the alternate hypothesis not supported as there was no significant relationship between lack of business networking and access to credit from the formal financial sector to SMEs.

➤ **Legal system**

Ho⁵: There is no significant positive relationship between the inefficiency of the legal system and access to credit from the formal financial sector to SMEs.

Ha⁵: There is a significant positive relationship between the inefficiency of the legal system and access to credit from the formal financial sector to SMEs.

Binary logistic regression was performed to ascertain the effect of the inefficiency of the legal system on the likelihood that SMEs have access to bank finance. The logistic regression model was statistically significant, $p = 0.035$. The model explained 6.6% (Nagelkerke R^2) of the

variance in access to bank finance. SMEs with approved credit were 1.512 times more likely to agree that inefficiency of the legal system was one of the reasons why formal financial institutions may refuse to give credit to SMEs. Thus, since $p < 0.05$, the null hypothesis was rejected, and the alternate hypothesis supported as there was a significant positive relationship between the inefficiency of the legal system and access to credit from the formal financial sector to SMEs.

➤ **Macro-economy**

Ho⁶: There is no significant positive relationship between a poor macro-economic environment and access to credit from the formal financial sector to SMEs.

Ha⁶: There is a significant positive relationship between a poor macro-economic environment and access to credit from the formal financial sector to SMEs.

Binary logistic regression was performed to ascertain the effect of poor macro-economic environment on the likelihood that SMEs have access to bank finance. The logistic regression model was statistically significant, $p = 0.005$. The model explained 12.4% (Nagelkerke R^2) of the variance in access to bank finance. SMEs with approved credit were 1.760 times more likely to agree that poor macro-economic environment was one of the reasons why formal financial institutions may refuse to give credit to SMEs. Thus, since $p < 0.05$, the null hypothesis was rejected, and the alternate hypothesis supported as there was a significant positive relationship between a poor macro-economic environment and access to credit from the formal financial sector to SMEs. A summary of the binary logistic regression hypotheses are presented in Table 7.18 and Figure 7.2 below.

➤ **Business intelligence**

Ho⁷: There is no significant positive relationship between lack of business intelligence and access to credit from the formal financial sector to SMEs.

Ha⁷: There is a significant positive relationship between lack of business intelligence and access to credit from the formal financial sector to SMEs.

Binary logistic regression was performed to ascertain the effect of lack of business intelligence on the likelihood that SMEs have access to bank finance. The logistic regression model was statistically significant, $p = 0.006$. The model explained 11.5% (Nagelkerke R^2) of the variance in access to bank finance. SMEs with approved credit were 1.707 times more likely to agree that lack of business intelligence was one of the reasons why formal financial institutions may

refuse to grant credit to SMEs. Thus, since $p < 0.05$, the null hypothesis was rejected, and the alternate hypothesis supported as there was a significant positive relationship between lack of business intelligence and access to credit from the formal financial sector to SMEs.

➤ **Entrepreneurship education**

Ho⁸: There is no significant positive relationship between lack of entrepreneurship education and access to credit from the formal financial sector to SMEs.

Ha⁸: There is a significant positive relationship between lack of entrepreneurship education and access to credit from the formal financial sector to SMEs.

Binary logistic regression was performed to ascertain the effect of lack of entrepreneurship education on the likelihood that SMEs have access to bank finance. The logistic regression model was statistically significant, $p = 0.006$. The model explained 11.4% (Nagelkerke R^2) of the variance in access to bank finance. SMEs with approved credit were 1.656 times more likely to agree that lack of entrepreneurship education was one of the reasons why formal financial institutions may refuse to grant credit to SMEs. Thus, since $p < 0.05$, the null hypothesis was rejected, and the alternate hypothesis supported as there was a significant positive relationship between lack of entrepreneurship education and access to credit from the formal financial sector to SMEs.

➤ **Business ethics**

Ho⁹: There is no significant positive relationship between lack of ethical awareness of owners/managers of SMES and access to credit from the formal financial sector to enterprises.

Ha⁹: There is a significant positive relationship between lack of ethical awareness of owners/managers of SMEs and access to credit from the formal financial sector to enterprises.

Binary logistic regression was performed to ascertain the effect of lack of ethical awareness on the likelihood that SMEs have access to bank finance. The logistic regression model was statistically significant, $p = <0.0001$. The model explained 19.5% (Nagelkerke R^2) of the variance in access to bank finance. SMEs with approved credit were 2.092 times more likely to agree that lack of ethical awareness was one of the reasons why formal financial institutions may refuse to give credit to SMEs. Thus, since $p < 0.05$, the null hypothesis was rejected, and the alternate hypothesis was supported as there was a significant positive relationship between

lack of ethical awareness of owners/managers of SMEs and access to credit from the formal financial sector to enterprises.

Table 7.18: Summary of results of the binary logistic regression hypotheses

	Description (Null Hypothesis)	Test Statistic	P -value	Decision
Ho ¹	There is no significant positive relationship between lack of collateral and access to credit from the formal financial sector to SMEs.	OR = 2.162	0.001	Rejected
Ho ²	There is no significant positive relationship between lack of business information and access to credit from the formal financial sector to SMEs.	OR = 1.501	0.026	Rejected
Ho ³	There is no significant positive relationship between lack of managerial competency and access to credit from the formal financial sector to SMEs.	OR = 1.484	0.027	Rejected
Ho ⁴	There is no significant positive relationship between lack of business networking and access to credit from the formal financial sector to SMEs.	OR = 1.012	0.950	Not rejected
Ho ⁵	There is no significant positive relationship between the inefficiency of the legal system and access to credit from the formal financial sector to SMEs.	OR = 1.512	0.035	Rejected
Ho ⁶	There is no significant positive relationship between a poor macro-economic environment and access to credit from the formal financial sector to SMEs.	OR = 1.760	0.005	Rejected
Ho ⁷	There is no significant positive relationship between lack of business intelligence and access to credit from the formal financial sector to SMEs.	OR = 1.707	0.006	Rejected
Ho ⁸	There is no significant positive relationship between lack of entrepreneurship education and access to credit from the formal financial sector to SMEs.	OR = 1.656	0.006	Rejected
Ho ⁹	There is no significant positive relationship between lack of ethical awareness of owners/managers of SMEs and access to credit from the formal financial sector to SMEs.	OR = 2.092	<0.0001	Rejected

Alpha = 0.05 (reject the Null Hypothesis when P-value < Alpha)

Figure 7.2: Summary of results of the binary logistic regression hypotheses

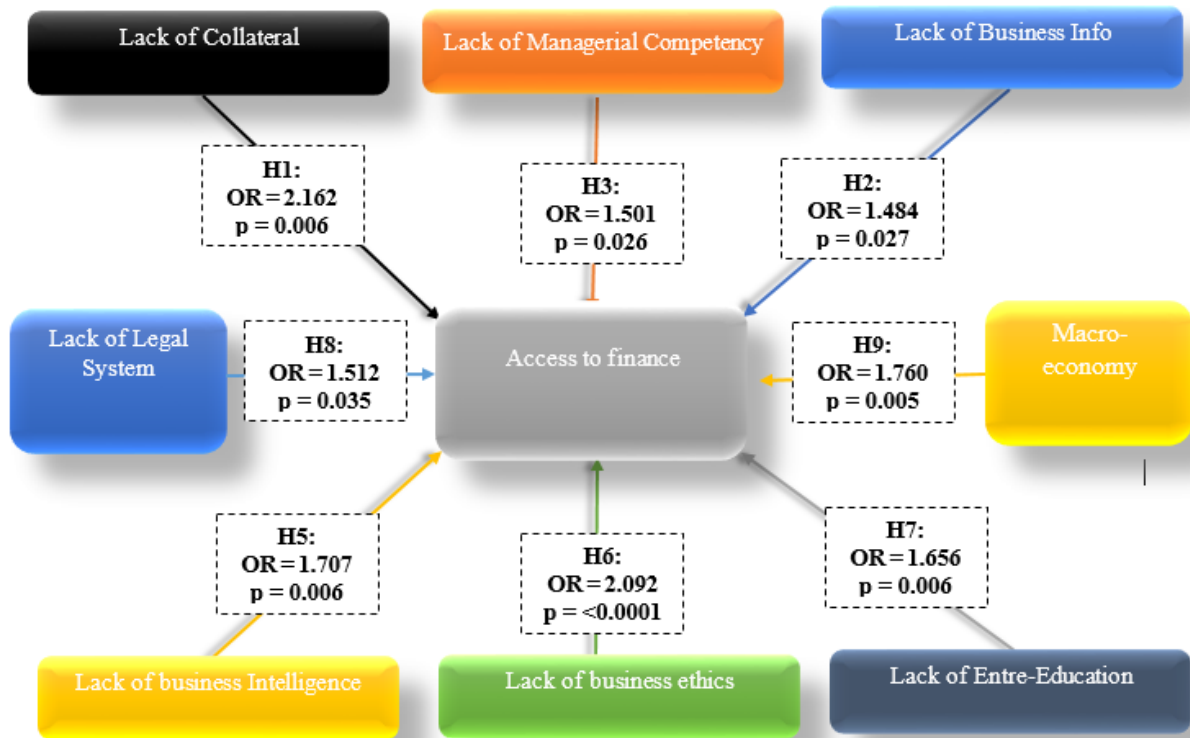


Figure 7.2 shows a summary of only the factors that showed a significant positive relation with performance. Factor such as business networking that did not show a significant positive relationship to performance was left out.

7.2.10 Sample t-test

To give effect to the second set of secondary hypothesis, the following sub-hypothesis was stated.

Hs²o: There is no significant positive relationship between access to credit from the formal financial sector and the performance of SMEs.

Lastly, a sample T-test was performed to compare the performance between SMEs with debt finance in their capital structure and those without debt finance. The sample T-test compares the means of the performance of SMEs (that is, between those with debt finance and those without such finance as shown in Table 7.19).

Table 7.19: T-Tests for mean performance differences between enterprises with and without debt

Study Variable	Gender	Mean	SD	Levene's Test for Equality of Variances		t-test for Equality of Means				
				F	Sig.	t	df	Sig. (2-tailed)	Mean Difference	Std. Error Difference
Debt Status	Without	3.2874	0.60569	0.468	0.496	-18.191	81	<0.0001**	-2.50607	0.13777
	With	5.7934	0.63275							

N = Without debt (rejected): 81; With debt (approved): 167 for all comparisons

Note: 9 respondents were denied access to finance previously

**Significant differences with equal variances assumed

*Significant differences with equal variances not assumed

Levene's test for homogeneity of variance was used in this study. This test was used to verify if the assumption of equal variances hold. Significant differences in means ratings between the two groups were noticed. The results in Table 7.19 show that SMEs with debt finance (mean = 5.7934; SD = 0.63275) had a significantly ($t = -18.191$; $Pr > |t| = <0.0001$) higher mean in performance rating than those without such debt (mean = 3.2874; SD = 0.60569). Thus, SMEs with debt finance performed better than those without such finance.

Therefore, the hypothesis that there is no significant positive relationship between access to credit from the formal financial sector and the performance of SMEs was rejected.

This result is consistent with the Modigliani and Miller (1958, 1963) theory which states that SMEs should go for more debt if available.

7.3 SUMMARY OF CHAPTER

This chapter had provided the results of the second phase (quantitative phase) of the study. The Koglomorov-Smirnov test was used to ensure the normality of the data. The response rate for this study was 42.735%. Results on the demographic characteristics of respondents were presented in tables. The empirical results with regard to respondents' original investment in assets, the future plan for their enterprises, challenges faced by SMEs and how such challenges impact on the performance of SMEs were also presented. The results revealed that most

respondents (34% or 102) had invested between R1,000,000 and R2,999,999 in assets while 45.667% or 137 preferred to maintain their enterprise in their current state. With regard to challenges faced by SMEs, cost of labour was the most challenging factor while access to bank finance was the only challenge that showed a significant correlation with performance. Out of the 300 respondents who completed and returned the questionnaires, 82.667% (248) did apply for external finance from the formal financial institutions, 46.774% (116) applied for external finance to purchase fixed assets while 67.339% (167) of applications were approved.

The study also revealed that the South African Identity Document and Collateral were the most important factors considered when applying for credit from the formal financial institutions. With regard to reasons why formal financial institutions may refuse to grant credit to SMEs, it was revealed that there was no significant positive relationship between lack of business networking and access to credit from the formal financial sector to SMEs. A significant positive relationship was found between collateral, business information, managerial competency, business intelligence, business ethics, entrepreneurship education, legal system and macro-economy and access to credit from the formal financial sector to SMEs. It was also established that there is a significant positive relationship between access to credit from the formal financial sector and the performance of SMEs. The next chapter focuses on the recommendations, conclusions, limitations of the study and areas for further research.

CHAPTER EIGHT

SUMMARY, DISCUSSION, RECOMMENDATIONS AND CONCLUSIONS

8.1 INTRODUCTION

The aim of this study was to analyse the availability of and access to credit from the formal financial sector and its relationship with the performance of SMEs. In this final chapter, an overview of the study is provided followed by a discussion of the most significant findings. The main findings are also interpreted in accordance with the aim and objectives of the study. Recommendations are made based on the empirical findings, followed by areas for further research, contributions of the study and the conclusions.

8.2 OVERVIEW OF THE STUDY (SUMMARY)

In both developed and developing economies, the relative and absolute importance of SMEs has been well-documented in the literature. Thus, SMEs have been qualified as “*the engine for economic development*” (European Commission, 2015; OECD, 2016; United Nations, 2015; United Nations Development Programme, 2016; World Bank, 2015). In a developing economy such as South Africa, SMEs constitute 99% of all businesses, contributing 77% of all private sector employment, 40% of the GDP of the economy and 46% of total employment (Statistics South Africa, 2018). Nonetheless, despite the noted contribution of SMEs to the economy of South Africa, the failure rate of these enterprises (at 75%) is the highest of all efficiency-driven economies sampled by GEM (2016). According to GEM (2016) and the World Bank (2016), the availability of and access to finance from the formal financial sector is reported as the most primary challenge to the survival and performance of SMEs. Quartey *et al.* (2017:19) state that the future survival and performance of SMEs in South Africa is pegged onto the amount of financial capital available to address their capital needs. Contemporary literature on the financing of SMEs contend that SMEs in most developing economies, such as South Africa, heavily depend on debt capital from the formal financial sector since financial capital from friends and members of the family is often insufficient for growth (Baltar & Icart, 2013:204; Fatoki, 2014:186; La Rocca *et al.*, 2011:112; Quartey *et al.*, 2017:20; Ramlee & Berma, 2013:116). Thus, the primary aim of this study was to analyse the availability of and access to credit from the formal financial sector and its relationship with the performance of SMEs. Specifically, the researcher(s) investigated factors that impact on the willingness of the formal

financial sector to grant credit to SMEs (supply-side), factors that impede SMEs from accessing credit from the formal financial sector (demand-side) and its impact on the performance of SMEs.

To achieve the aim of this study, Chapter 2 of this study conceptualised SMEs. The chapter provides a comprehensive literature review on SMEs, the importance of SMEs to development (economic development, economic growth, sustained economic growth, sustainable development and development of SMEs), the concept of SME failure and the causes of such failure. In addition, the challenges faced by SMEs in accessing finance from the formal financial sector, the performance of SMEs and measures of such performance were also discussed. Chapter 3 focused on the financing of SMEs. SMEs need debt finance to invest in working capital, product development, preliminary losses and even the acquisition of fixed assets. The Capital Structure Theories, the causes of equity and debt gap, and the challenges faced by formal financial institutions in lending to SMEs were discussed. Chapter 4 focused on the supply and demand-side factors that impact on the availability of and access to credit from the formal financial sector towards SMEs. Chapter 5 explained the research design and methodology used in conducting this study. Chapter 6 provided Phase 1 (qualitative) data analysis and interpretation of the findings while Chapter 7 provided Phase 2 (quantitative) data analysis and interpretation of the results. Chapter 8 provided the recommendation and conclusions of this study.

In order to achieve the primary aim of this study, two sets of objectives were developed, as stated in Chapter 1, Section 1.4.1 (supply-side) and Section 1.4.3 (demand-side). To achieve the two sets of objectives, a sequential exploratory mixed method research design (located in the pragmatic research paradigm) was adopted in the study, using a two phased approach. The first phase (qualitative data collection and analysis phase) informed the second phase (quantitative data collection and analysis phase). Thus, by using a pragmatic approach, the researcher relied on more than one philosophy and reality and pursued what worked well in answering the research questions.

In Phase 1, in-depth face-to-face semi-structured interviews were conducted with 8 credit and 8 business managers. Qualitative data collected was analysed using the five-steps process of content analysis, as illustrated by Terre Blanche *et al.* (2006:322-326). (Chapter 5, Section

5.4.3). Qualitative data analysis was evaluated against the quality criteria in qualitative research as explained in Chapter 5, Section 5.4.2.

In Phase 2, a self-administered questionnaire was used to collect data from owners/managers of SMEs in the city of Johannesburg, Gauteng Province, South Africa. The study focused on SMEs in the formal sector since they are under government regulation. Out of the 702 questionnaires issued by the researcher and the three research assistants, 300 were returned, representing a response rate of 42.735%. Data analysis was done using the Statistical Package for the Social Sciences (version 24). Test for normality was performed using the Shapiro–Wilks test. Binary logistic regression was later used to infer on hypothesised frameworks. A correlational analysis, supplemented by Binary logistic regression models was used to establish whether there were significant relationships between access to bank finance, the performance of SMEs and other factors that may impact on the willingness of formal financial institutions from lending to SMEs. An independent sample T-test (Levene’s test of homogeneity of variance) was performed to compare the performance between SMEs with debt finance in their capital structure and those without such finance. The analysis also included factor analysis models to refine the research problem and to enhance the validity of the study. Reliability was tested using the Cronbach’s Alpha Coefficient analysis and exploratory factor analysis tested the validity of the factors that impact on the willingness of formal financial institutions from lending to SMEs. The study was divided into eight chapters and a complete layout of this study provided in Chapter 1, Section 1.10.

8.3 INTERPRETATION OF FINDINGS

This section focuses on the interpretation of the findings and results presented in Chapter 6 (Phase 1: Qualitative findings of the supply-side) and Chapter 7 (Phase 2: Quantitative results of the demand-side) of this study.

8.3.1 Phase 1: Qualitative findings of the supply-side

The following order was followed in the presentation based on the analysis in Chapter 6:

- Demographic characteristics of participants;
- Willingness of the formal financial sector to provide credit to SMEs;
- Assessment of applications for credit from SMEs by the formal financial sector; and

- Challenges faced by the formal financial sector in assessing and approving credit in favour of SMEs.

8.3.1.1 Demographic characteristics of participants

The results of the demographic characteristic of the participants revealed that Black Africans dominate the banking sector. This result is consistent with NPC (2015) report that the dominance of Black Africans in the banking sector is evidence of the Broad-Based Black Economic Empowerment (BBBEE) growth strategy aimed at realising South Africa's full economic potential, while helping to bring the black majority into the economic mainstream, thus, reducing the level of unemployment and poverty.

8.3.1.2 Willingness of the formal financial sector to provide credit to SMEs

In Chapter 6, it was revealed that a number of factors impact on the willingness of the formal financial sector to provide credit to SMEs. These factors include: collateral and equity contribution; annual business turnover and audited financial statements (business information); relationship with the bank (networking); credit profile; ethical practice; economic climate and government policy; nationality and documentation; entrepreneurship education; and business intelligence as interpreted below.

a) Collateral and equity contribution

Out of all the factors, collateral (p-value = 0.0001**) was the most significant. Collateral in the form of assets (building and land infrastructure) and an investment account were the most preferred collateral by the formal financial sector as a guarantee when considering lending to SMEs. This implies that lack of collateral was the main reason why credit was not granted to SMEs. Thus, lack of collateral (building and land infrastructure) and/or an investment account will almost certainly lead to the non-approval of an application for credit. This is an indication that the availability of credit depends on the capital structure of SMEs. According to the pecking order theory, availability of internal funding (investment account) could impact on the availability of debt. Quartey *et al.* (2017:19) found that the greater the owner's contribution to a business, the greater the lender's confidence in the business and the less likely that the owners/managers of the business will take risky investments, thus reducing moral hazard. In addition, collateral can be repossessed by the creditor in case of default thus, enhancing creditor protection (Stoop & Churr, 2013:515). Thus, collateral makes it possible to limit the issue of

moral hazard faced, in addition to financial loss, by all banks when lending out money. This finding is consistent with the findings of Brijlal (2013) and Fatoki (2014).

b) Business information

Annual business turnover and audited financial statements were the second and third most important factors considered by the formal financial sector that impacted on their willingness to grant credit to SMEs respectively. This implies that in the absence of collateral, formal financial institutions then look at the business information (annual business turnover and audited financials) of SME to make a decision on whether to approve the credit or not. Taneli and Ohl (2014:586) point out that one of the principal measures of the capacity of SMEs to effect repayment of credits is business information. Thus, owners/managers of SMEs who are able to produce complete business information about their annual turnover and financials, enhance their chances of credit approval from banks and other lenders. As discussed in Chapter 4, Section 4.3.2, this result is consistent with those of Adzido and Azila-Gbettor (2014:197) and Gupta *et al.* (2013:4).

c) Relationship with the bank

Relationship with the bank was the fourth most important factor that impeded the approval of credit to SMEs. This is an indication that SMEs that have a close and long-standing relationship with banks will access credit easily compared to those that do not have such a relationship. Participants who maintained a long-standing relationship was an advantage for SMEs in terms of lending relationship (as trust was established and information asymmetry reduced). In addition, this aspect was very important as it increased the acceptability of SMEs (Nieman & Nieuwenhuizen, 2014:31). This is consistent with the findings of Robb and Fairlie (2008:1435) and Naude *et al.* (2014:632) as explained in Chapter 4, Section 4.3.4.

d) Credit profile

The credit profile of an SME and its owners is very important to formal financial institutions as it signals the credit worthiness of the SME and its owners. The credit profile of the SME and its owners help formal financial institutions to assess the amount of risk in lending to such SME and its owners (the credit worthiness of the SME and its owners). This means that if the SME and its owners have a good credit profile (have not defaulted credit payment in the past), they stand a good chance of accessing more credit. In circumstances where the credit profile of either the SME or its owners is bad (due to default in credit payment in the past), then the

approval of such credit will largely depend on the collateral and business information presented. This is consistent with the findings of Makomeke *et al.* (2016:67) and Liang *et al.* (2017:138) as discussed in Chapter 4, Section 4.3.2.

e) Ethical practice

The nature of the business and business ethics are two factors that emerged during the interviews with participants that impact on the willingness of formal financial institutions in lending to SMEs. According to participants, this aspect emerged due the distrust between owners of SMEs and formal financial institutions. This suggests that owners of SMEs who demonstrate good ethical behaviour, stand a good chance of accessing finance from formal financial institutions. In addition, good ethical behaviour of owners of SMEs also build trust between such owners and formal financial institutions as trust mitigates adverse selection and moral hazard, thus reducing screening and monitoring costs. This is consistent with the findings of Erundu, Sharland and Okpara (2004:349-357), Lepoutre and Heene, (2006:260) and Turyakira (2018:3) as discussed in Chapter 4, Section 4.3.9.

f) Economic climate and government policy

Economic climate and government policy were the seventh and tenth aspects that prevented formal financial institutions from granting loans to SMEs. This could be an indication that SMEs will have easy access to credit from formal financial institutions in a good economic climate with favourable government policy on lending such as low interest rates. This is consistent with the findings of the United Nations Conference on Trade and Development (2016) and Abaidoo and Kwenin (2013).

g) Nationality and Passport document

Nationality was also a factor highlighted by participants that had an impact on the willingness of formal financial institutions to lend to SMEs. This implies that if one was not a South African, no matter the collateral or business information or initial investment one had, one would not access credit from some formal financial institutions. This means that owners/managers of SMEs without a South Africa Identity Document found it very difficult to access credit from the formal financial sector compared to locals. This finding is consistent with the findings of Bruder, Neuberger, and Rathke-Doppner (2011) and Robb and Fairlie (2008:1434).

h) Entrepreneurship education

Entrepreneurship education is one of the new concepts that emerged during the study. Participants maintained it is an important factor that impacts on the willingness of formal financial institutions to grant credit to SMEs. This could be interpreted as owners/managers of SMEs with good entrepreneurship education, coupled with their collateral and business information, stand a better chance of easily accessing credit from formal financial institutions. In addition to their good entrepreneurship education, they could also use their entrepreneurship education to write convincing business plans. Hence, entrepreneurship education of owners of SMEs, combined with collateral, business information, investment capital and other aspects, would highly favour the owners to access credit from the formal financial sector. Studies by Fatoki and Smith (2011:1420) and Testa and Frasccheri (2015:12) revealed similar findings. On the other hand, studies by Oosterbeek, van Praag and Ijsselstein (2010) and von Graevenitz, Harhoff and Weber (2010) found no significant relationship between entrepreneurship education and access to debt finance.

i) Business intelligence

Business intelligence is also a new concept in the finance literature on SMEs that impact on the willingness of formal financial institutions to grant credit to SMEs. This suggests that owners of SMEs who are well-knowledgeable about their business and industry, could easily access credit from formal financial institutions when they requested to explain why they needed credit. Thus, owners with collateral, business information, start-up capital and who have a good mastery of their business and industry, stand a very high chance to access credit from formal financial institutions. This finding is consistent with that of Curraj (2017:150).

8.3.1.3 Assessment of applications for credit from SMEs by the formal financial sector

The credit assessment guideline put in place by formal financial institutions in assessing credit applications from SMEs include risk assessment, scrutiny of financial records, background checks and proper documentation in order of merit. The fact that formal financial institutions accept to lend to SMEs, is an indication that they are willing to accept a certain amount of risk. Thus, the amount of risk they are willing to accept depends on the amount of credit they are willing to provide. Therefore, assessing the amount of risk, scrutinising financial records, performing thorough background checks and requesting all relevant documents constitute ways

used by formal financial institutions to measure the amount of risk associated with a particular SME credit application.

First of all, risk assessment in a credit application is associated to the amount of credit requested by the borrower, the collateral pledged, and other supporting documents submitted. Without any expectation, formal financial institutions then assess the riskiness of the application by using the institution credit scoring model to determine if the application is credit worthy. In case the application is credit worthy (that is, the risk is tolerable), then the financial records of the borrower will be further scrutinised to confirm if they are legitimate or not. However, in case the credit application is not worthy (that is, the risk is not tolerable based on the institution's credit scoring model), the credit application is most often rejected upfront or the applicant advised to revise the application. This is because the institution's credit scoring model cannot predict if the financial records were forged.

After scrutinising the financial records (by assessing the present and predicting the future performance in terms of sales and profit margins), then a decision can be reached if the credit application should continue to the next stage (background checks). Should the financial records be good, then background checks will be performed on personal and business levels. This is to ensure that the SME and its owners had not defaulted in the payment of a credit in the past. If there was any default in payment in the past, either by the SME or its owners, then the credit application will definitely be denied. A situation may arise where the SME or its owners are paying another credit with another bank while applying for more credit from another bank as well. Under such circumstances, the bank will do a follow-up with the other bank to find out the state of the payment of the credit before making a decision. If the SME or its owners have been honouring the repayments of the previous credit, then they stand a good chance of obtaining more credit from other banks.

The final stage in the credit assessment process is to validate the credit application by ensuring that all the relevant documents were submitted. Any credit application that reaches this stage, has a high chance of being approved as most credit applications are rejected before they reach this stage. It is at this stage that participants (credit and business managers) write their motivation letter and submit the credit application to the credit committee for further review before approval. Sometimes, the credit committee may reject the credit application not because such application did not meet the requirements for approval but simply because the risk might

be high, according to the committee. In such case, the committee might want to reduce the original amount requested by the borrower before approving the credit or better still, consult the participant who processed the credit application for further deliberation as to the outcome of the credit application. Thus, for an SME or its owners to be able to secure credit from formal financial institutions, the credit application has to pass through these stages before the credit application could be approved as there are no guarantees. These findings are consistent with that of Makomeke *et al.* (2016:66) as the authors advocate that credit assessment and evaluation remains at the heart of the decision making process leading to the granting of credit to a borrower given that formal financial institutions over the years have experience problems with non-performing credit as a result of weak credit analysis resulting to the high credit application rejection rate. Research by Liang *et al.* (2017:136) on the impact of SMEs' lending and credit guarantee on bank efficiency in South Korea revealed that the stringent risk assessment standard and evaluation criteria in screening credit applications is a major hindrance to most SMEs. Liang *et al.* (2017:136) and Makomeke *et al.* (2016:66) call on formal financial institutions to adopt a more flexible but rigorous standards and procedure so that more SMEs can access credit from the formal financial institutions if formal financial institutions are really interested in lending to SMEs.

8.3.1.4 Challenges faced by the formal financial sector in assessing and approving credit in favour of SMEs

This section focuses on the interpretation of challenges (highlighted in Chapter 6, Section 6.5) that impact on the willingness of the formal financial sector to lend to SMEs. These challenges include lack of investment capital, lack of collateral, lack of proper financial records, poor managerial knowledge, poor business plan, lack of industry knowledge and poor legal system as discussed below.

a. Lack of investment capital

Lack of investment capital was the most serious challenge faced by formal financial institutions when assessing applications for credit from SMEs. In other words, investment capital was the most important reason why SMEs could not access credit from formal financial institutions. Most SMEs did not have that start-up capital to start a business. As a result, they tended to rely on formal financial institutions for start-up capital. Formal financial institutions, on their part, maintained they were only willing to finance SMEs that were investment-ready. Formal

financial institutions further maintained they could only finance 50% of the total equity of the enterprise as stated by one of the participants (C₂): *it is a standard practice that we only give 50% of what the equity of a business is*. This finding is consistent with that of Beck (2007:403) who found that the international best practice is a capital structure of 50% equity and 50% debt. Contemporary studies (Baby & Joseph, 2016:2; Haven, 2015:3758; Kwaning *et al.*, 2015:20) posit that lending to SME owners with little or no equity contribution is more risky than lending to large company by all objective measures. As a result, formal financial institutions have resorted to collateral as a means to reduce the amount of risk in lending to SMEs. When considering the three theories together (the static trade-off theory, the agency theory and the pecking order theory), Frelinghaus *et al.* (2005:13) highlight that the theories are in agreement with the fact that the inadequacy of owners' contribution and lack of retained earnings for most SMEs are responsible for their poor performance.

b. Lack of collateral

Lack of collateral was the second most serious challenge or reason why formal financial institutions were not willing to grant credit to SMEs. This is an indication that lack of acceptable collateral and/or investment capital (owner's equity) will almost certainly lead to the rejection of the application for credit. It can, therefore, be construed from the explanation that most SMEs do not have acceptable collateral to support their applications for credit when seeking credit from formal financial institutions. Kanamugire (2013:20) argues that credible commitments guaranteeing the repayment of the credit, even if the owners/managers of SMEs fail, are linked to the collateral underlying the loan. Thus, collateral pledged, helps align the interests of both lenders and borrowers, avoiding a situation where the borrower makes less effort to ensure the success of the business for which finance was given. This result is consistent with the findings of Fatoki and Smith (2011:1414) and Phaladi and Thwala (2008). Holding collateral according to Fatoki and Smith (2011:1414) and Phaladi and Thwala (2008) is a means of trying to respond to this risk by ensuring that even in the event of failure, it can obtain some returns. Given that collateral is a tool that allows formal financial institutions to offer credit to SMEs whose credit opacity might otherwise result in credit rationing, GEM (2016) cautioned that SME owners must start saving for collateral if they are to access credit from formal financial institutions given the turbulent economic environment. The turbulent economic environment is forcing formal financial institutions to be more cautious when it comes to lending to SMEs.

c. Lack of proper financial records

Lack of proper financial records was the third important reason why formal financial institutions were not willing to grant credit to SMEs. This implies that formal financial institutions consider granting credit to SMEs provided sufficient and reliable information about the performance of SMEs was provided. Research by Fatoki and Smith (2011:1420) revealed that creditors, banks and other lenders use financial information provided by SMEs to analyse their present and predict future performance. The researchers also found that formal financial institutions in South Africa require annual financial statements and information about SMEs in order to evaluate their credit worthiness. Research findings by Baby and Joseph (2016:2) and Fatoki and Smith (2011:1420) share the same view. Kwaning *et al.* (2015:22) propound that the weak financial disclosure and the owner-managed nature of SMEs make it hard for credit providers such as formal financial institutions to track ongoing changes to the asset base of the SME. As such, the presence of this problem in SMEs may explain the reason behind the greater use of collateral lending by formal financial institutions to SMEs as a way of dealing with these agency problem. In addition, Cenni *et al.* (2015:250) note that the decision to lend and the terms of the credit contract are predominantly based on the strength of the income statements and balance sheet. The fact that most SMEs cannot afford to provide certified audited financial statements, the author warned that using financial statement lending technology will not be favourable for SMEs most especially new ones with no history.

d. Poor management skills

Poor management skills was the fourth important reason why formal financial institutions were not willing to grant credit to SMEs. Managerial skills are very important for the growth and survival of SMEs. Poor management skills imply that the SME will struggle to survive, thus increasing the risk that the SME will not be able to pay back the interest plus principal if the SME was granted credit. This implies that formal financial institutions are most likely to reject the credit application of an SME with poor management skills. Adzido and Azila-Gbettor (2014:197) argue that lack of management competency of owners/managers of SMEs decreases their legitimacy, thus increasing credit rationing among SMEs. This result is consistent with the results of Boeker and Wiltbank (2005:127) as the authors advocate that SME owners must demonstrate management skills such as the ability to prepare a good business plan before they can ever hope to get funding from formal financial institutions. The lack of finance therefore may be a direct cause of business failure but the indirect cause which is often more important but seldom recognised by SME owners is the lack of management skills as noted by Fatoki

(2014:186) and Ramezanpour et al. (2014:602). Study by Hessel and Terjesen, (2008) revealed that SME owners/managers with higher general and specific managerial skills achieve higher levels of performance than those with lower levels of general and specific management skills.

e. Poor business plan

According to participants, some owners of SMEs find it difficult to access credit from formal financial institutions because they do not know how to write a proper business plan. A poorly written business plan was one of the reasons why formal financial institutions were most likely to reject an application for credit. This implies that owners of SMEs with a good business plan, collateral and business information were most likely to have their applications for credit approved. This is consistent with the findings of Ferreira, Loiola and Gondim (2017:141) and Testa and Frasieri (2015:13) who noted that the business plan is an essential document that is used in setting codes and business relationships between lenders and borrowers. SME owners in South Africa are not familiar with many aspects of finance as well as the capability to articulate a business plan that meets the requirements of formal financial institutions or other investors (Testa & Frasieri, 2015:14).

f. Lack of industry knowledge

Lack of industry knowledge was also one of the reasons why formal financial institutions were not willing to grant credit to SMEs. This suggests that formal financial institutions will most likely reject applications for credit from owners of SMEs who lacked industry knowledge. Industry knowledge assists owners of SMEs to make strategic decisions, understand the business environment and draw up a good business plan. Thus, lack of industry knowledge means that the owners cannot make strategic decisions, do not understand the business environment and cannot draw a good business plan. Such SMEs are considered high-risk and formal financial institutions will certainly avoid granting credit to such high-risk SMEs. Thus, applications for credit from such SMEs will most likely be rejected. This finding is consistent with that of Kwaning, Nyantakyi and Kyereh, (2015:20)

g. Poor legal and credit laws

Poor legal and credit laws also emerged as an important reason why formal financial institutions were unwilling to lend to SMEs. This signifies that poor legal and credit laws negatively impact on the availability of credit to SMEs. To formal financial institutions, the fact that credit laws were weak in South Africa, they were unwilling to grant credit to any risky

project or SME that was not within their risk tolerance level as credit laws are difficult to enforce in case an SME defaults in payment. Thus, formal financial institutions will most likely reject an application for credit from any SME they considered to be of high-risk. In other words, in the absence of an acceptable collateral, good financial records, good management skills of the owners and a good business plan, will certainly lead to a rejection of the application. Study by Findings by Fatoki and Smith (2011) found that the efficiency of the legal system must be improved in order to improve the availability of credit from the formal financial institutions. This can only be done if only the legal frameworks for creditor rights and insolvency proceedings in general are reformed.

Thus, the absence of collateral, owners' equity (an investment account or start-up capital), business information (annual turnover and audited financial statements), relationship with the bank (networking), credit profile (SME and the owners), ethical practice, economic climate and government policy, nationality and South African Identity Document, entrepreneurship education, business intelligence, business plan, management skills, industry knowledge and legal and credit laws justify why credit from the formal financial sector in favour of SMEs is usually not approved. However, the formal financial sector is committed to investing in SMEs as revealed in Chapter 6, Section 6.6. The next section focuses on the interpretation of the theoretical construct variables in Phase 2 (quantitative findings of the demand-side as presented in Chapter 7).

8.3.2 Phase 2: Quantitative findings of the demand-side

The following order was followed based on the analysis done in Chapter 7:

- Demographic characteristics of respondents;
- Challenges faced by SMEs;
- Financing of SMEs;
- Important factors when applying for finance from formal financial institutions;
- Reasons why formal financial institutions may refuse to grant credit to SMEs; and
- Comparing the performance between SMEs with debt finance in their capital structure and those without such finance.

8.3.2.1 Demographic characteristics of respondents

The demographic characteristics of the respondents revealed that men are more involved in entrepreneurship than women. The age between 31 and 40 is the age group that most men and women are most active in entrepreneurship. This findings are consistent with the findings of GEM (2016).

8.3.2.2 Challenges faced by SMEs

Out of the challenges faced by SMEs, access to bank finance was the only challenge that showed a significant correlation with the performance of SMEs ($r = 0.164$; $p = 0.046$). Thus, the null hypothesis that there is not a significant positive relationship between access to bank finance and the performance of SMEs was rejected. It could, therefore, be concluded that lack of bank finance was the number one cause of failure and access to bank finance could go a long way in improving the performance of SMEs, thus reducing the failure rate of SMEs. Therefore,

Hs¹_o: There is no significant positive relationship between access to bank finance and the performance of SMEs is rejected.

International organisations such as OECD (2016) and World Bank (2016) proclaim are in agreement that access to finance is the main challenge that cause SMEs failure in developed and developing nations. Atieno (2009:33) observe that access to credit from the formal financial institutions is needed to reduce the impact of cash flow problems for SMEs. Financing is needed for SMEs to start and expand operations, develop new products, invest in new staff or production facilities. Atieno (2009:34), Baltar and Icart (2013:203), GEM (2016) and Quartey *et al.* (2017:20) concluded that SMEs without access to credit are more vulnerable to external shocks given that the availability of finance for investment in positive net present value projects is vital to the sustainability and viability of SMEs.

8.3.2.3 Financing of SMEs

With an approval rate of 67.339% (167) indicated that formal financial institutions perceived SMEs as beneficial to their businesses. In addition, the fact that most of the approved applications requested funds to purchase fixed assets, is an indication that owners of SMEs are beginning to value the importance of fixed assets with regard to applications for credit and banks are also very interested in financing SMEs that wish to buy fixed assets as part of the

investment in the enterprise. This finding is consistent with that of Kauffman Foundation (2007) which revealed that 75% of the start-up capital of SMEs in the United States of America is made up in equal parts of owner equity and credit from the formal financial institutions and/or credit card debt, underscoring the importance of liquid credit markets to the formation and success of SMEs. Statistics Canada (2016) revealed an 82.1% approval rate for credit applications from SMEs by formal financial institutions. In England, the United Kingdom Small Business Statistics (UKSBS) (2016) revealed that over 80% of SMEs are getting finance from formal financial institutions. With such approval rates, it is evidence that formal financial institutions in developed and developing economies as South Africa are beginning to appreciate their investment in SMEs that are investment ready.

8.3.2.4 Important factors when applying for credit from formal financial institutions

Thirteen aspects were identified to be important factors considered when applying for credit from formal financial institutions as follows: managerial competency; credit information about the business; acceptable collateral; relationship with the bank; macro-economic environment; credit laws on business credit; equity contribution; entrepreneurship knowledge; business ethics; sales; credit information of the owners/managers of SMEs; and a South African Identity Document and International passport with a valid work permit . From the thirteen factors, the South African ID was the most important with a mean value of 6.27, followed by acceptable collateral with a mean value of 6.05 on a Likert scale of 7. This result implies that most formal financial institutions are likely to reject any application for credit from owners of SMEs without a South African ID before even considering the collateral of the applicant. Research by Reginald and Millicent (2014) and Fatoki (2014:189) found out that formal financial institutions in South Africa are very reluctant to fund immigrant owned SMEs because they do not have sufficient information about their businesses and the lack of trust in immigrant businesses makes the problem more compound. Research conducted by Robb and Fairlie (2008:1434) compare the performance of SMEs owned by Asian immigrants and White locals in the United States revealed that SMEs owned by Asian immigrants face limited access to credit from the formal financial institutions. Thus, an application by an immigrant with a passport is highly likely to be rejected even before considering the collateral of such immigrant. However, Robb and Fairlie (2008:1434) attributed the high success rate of immigrant businesses in the United States to their willingness to invest personal or family savings in the business and commit themselves to the business to see that it is successful.

8.3.2.5 Reasons why formal financial institutions may refuse to grant credit to SMEs

From the factor analysed, nine were determined. Thus, the nine factors were investigated in order to determine their impact on the non-accessibility of credit from banks to SMEs. Nine secondary hypotheses were stated from the nine factors and Spearman's Rho correlations (r) used to determine the significance of the relationships. The following results were obtained:

➤ Collateral

The results as presented in Section 7.2.7.3 in Chapter 7 showed a significant positive relationship between lack of collateral and access to credit from the formal financial sector to SMEs. Thus, the null hypothesis that there is no significant positive relationship between lack of collateral and access to credit from the formal financial sector to SMEs was rejected ($r=0.340$, p -value <0.0001). It can, therefore, be concluded that to improve the accessibility of credit from the formal financial sector, SMEs must provide collateral. This means that collateral reduces the risk of lending to SMEs as confirmed by Brijlal (2013). In addition, research by Forte *et al.* (2013:349) revealed that the use of collateral in lending to SMEs is the explanation for dealing with the agency problem between formal financial institutions and SME borrowers due to information asymmetry. Fatoki, (2014:95), Osano and Languitane (2016:5) further support that collateral also helps to mitigate the problem of credit extension. As such, lenders feel more confident when collateral is pledged and they charge a lower interest rate than what they would have if the SME owners had no collateral.

➤ Business information

The results as presented in Section 7.2.7.3 in Chapter 7 revealed a significant positive relationship between lack of business information and access to credit from the formal financial sector to SMEs. Thus, the null hypothesis that there is no significant positive relationship between lack of business information and access to credit from the formal financial sector to SMEs was rejected ($r = 0.247$, p -value = 0.008). It can, therefore, be concluded that the formal financial sector is more inclined to granting credit if sufficient and reliable business information from the SME is presented. Thus, to improve accessibility of credit from the formal financial sector, SMEs must provide sufficient and reliable business information. This implies that the availability of business information increases the legitimacy of SMEs as put forward by Huang *et al.* (2014:29) and Nieman and Nieuwenhuizen (2014:31). These authors (Amadhila &

Ikhide, 2016:285; Lin *et al.*, 2015:1300) in their study found that SMEs face greater challenges in accessing financial capital from external sources because they do not have adequate financial information to enable external investors such as formal financial institutions to assess their performance, thus leading to information asymmetry. Information asymmetry occurs when external capital providers have less information on the financial circumstances and prospects of SME owners and is often described as the root of the finance problems of SMEs.

➤ **Managerial competency**

The results as presented in Section 7.2.7.3 in Chapter 7 showed a significant positive relationship between lack of managerial competency and access to credit from the formal financial sector to SMEs. Thus, the null hypothesis that there is no significant positive relationship between lack of managerial competency and access to credit from the formal financial sector to SMEs was rejected ($r = 0.237$, $p\text{-value} = 0.009$). It can, therefore, be concluded that the managerial competency of owners of SMEs positively impacts on access to credit from the formal financial sector to SMEs. Choo and Wong (2009) share the same view as the authors point out that managerial competency is a critical factor required in running a business successfully. From the view point of Brito and Sauan (2016:4), managerial competencies are valued as part of the asset of an enterprise as these skills allow businesses to transform themselves, improve performance and grow to become established and successful businesses. Study by Herrington, Kew and Kew (2013) point out that the hardships encountered by SME owners often stem from their lack of knowledge, skills and experience. Meanwhile, Tehseen and Ramayah (2015:52) investigated entrepreneurial competencies and the success of SMEs and found that SMEs fail due to lack of managerial experience, lack of proper business planning, skills and personal qualities as well as other factors such as resource starvation and adverse economic conditions. Thus, formal financial institutions will consider lending to owners/managers of SMEs with sufficient managerial competency because they trust their investment will be well managed.

➤ **Business networking**

The results as presented in Section 7.2.7.3 in Chapter 7 showed no significant positive relationship between lack of business networking and access to credit from the formal financial sector to SMEs. Thus, the null hypothesis that there is no significant positive relationship between lack of business networking and access to credit from the formal financial sector to SMEs was accepted ($r = 0.025$, $p\text{-value} = 0.401$). From the perspective of owners/managers of

SMEs, it can, therefore, be concluded that business networking of owners of SMEs has no impact on access to credit from the formal financial sector. In other words, irrespective of the relationship between owners/managers of SMEs and the bank, such relationship does not impact on their ability to access credit from the formal financial institutions. This findings is contrary to the findings in Phase 1 in Chapter 6. From the formal financial institutions' perspective, their relationship with owners/managers of SMEs is very important as it help to reduce information asymmetry. Thrikawala (2011) examined the impact of strategic networks for the success of SMEs and found that networking has a positive influence on the growth and success of an SME, especially through contacts with other business individuals. Research by Arruda *et al.* (2015:320) revealed that business networking is be useful in reducing information asymmetry in a debtor and creditor relationship. Nieman and Nieuwenhuizen (2014:31) found that networks play a fundamental role in spreading knowledge about an SME's existence and its practices in the absence of effective market institutions. Given the mix finding of this study on the impact of business networking, this study thus support that information asymmetry between formal financial institutions and owners/managers of SMEs is the reason why most SMEs find it difficult to access credit from formal financial institutions. The agency theory by Jensen and Meckling (1976) is in accord with this findings.

➤ **Business intelligence**

The results as presented in Section 7.2.7.3 in Chapter 7 indicated a significant positive relationship between lack of business intelligence and access to credit from the formal financial sector to SMEs. Thus, the null hypothesis that there is no significant positive relationship between lack of business intelligence and access to credit from the formal financial sector to SMEs was rejected ($r = 0.312$, $p\text{-value} = 0.001$). It can, therefore, be concluded that the business intelligence of owners of SMEs will positively impact on access to credit from the formal financial sector to SMEs. Business intelligence plays an essential role in harmonising the lending relationship between the lender (formal financial institutions) and borrowers (SMEs) as concluded by Amadhila and Ikhide, (2016). Study by Curraj (2017:150), Gauzelina and Bentz (2017) and Ramlee and Berma (2013:116) focused on the impact of business intelligence system on organisational decision-making, access to external resources such as financial capital and performance of SMEs. The studies revealed that when business intelligence systems are deployed in SMEs, the SMEs facilitate timely decision-making, improve organisational efficiency, SMEs have more access to capital from external sources such as formal financial

institutions, SMEs have more growth potential, enable SMEs to meet the needs of clients appropriately, which as a result lead to more satisfied employees.

➤ **Business ethics**

The results as presented in Section 7.2.7.3 in Chapter 7 showed a significant positive relationship between business ethics and access to credit from the formal financial sector to SMEs. Thus, the null hypothesis that there is no significant positive relationship between business ethics and access to credit from the formal financial sector to SMEs was rejected ($r = 0.350$, $p\text{-value} < 0.0001$). It can, therefore, be concluded that the ethical behaviour of owners of SMEs positively impact on access to credit from the formal financial sector to SMEs. This finding is in agreement with the findings of Rambe and Ndofirepi (2017:4). According to Rambe and Ndofirepi (2017:4), business ethics integrates core enterprise values such as honesty, trust, respect and fairness into its policies, practices and decision-making. Jamnik (2017:90), Peprah *et al.* (2016:26) and World Bank (2016) explain that trust between credit and business managers and owners/managers of SMEs help reduce information asymmetry between the two parties, increase relationship lending which, in turn, increases the legitimacy and credit worthiness of the information provided by owners/managers of such enterprises. Empirical studies by Erondu, Sharland and Okpara (2004:349-357) and Lepoutre and Heene, (2006:260) revealed that good ethical behaviour of SME owners have a positive effect on enterprises' access to external resources such as financial capital and better enterprise performance. Research by Donker, Poff and Zahir (2008:530) also revealed a positive correlation between the values of an enterprise, employee commitment and enterprise performance.

➤ **Entrepreneurship education**

The results as presented in Section 7.2.7.3 in Chapter 7 showed a significant positive relationship between entrepreneurship education and access to credit from the formal financial sector to SMEs. Thus, the null hypothesis that there is no significant positive relationship between entrepreneurship education and access to credit from the formal financial sector to SMEs was rejected ($r = 0.332$, $p\text{-value} < 0.0001$). It can, therefore, be concluded that knowledge of entrepreneurship education by owners of SMEs positively impacts on access to credit from the formal financial sector to SMEs. Given that entrepreneurship education significantly contributes to the development of entrepreneurial attitudes, this finding is in

agreement with the findings by Zhang *et al.* (2014). According to Zhang *et al.* (2014) entrepreneurship education indoctrinates in its recipients, entrepreneurial competencies and skills geared towards focusing their minds towards self-reliance and self-employment. Kautonen, van Gelderen and Fink (2015:657) and Aminu and Shariff (2015) argue that the appreciation of entrepreneurship education in a nation such as South Africa, will help the country stimulate and regain its competitiveness in entrepreneurship which, in-turn, will promote knowledge-based entrepreneurs and improve the survival rates and performance of new start-ups and establish SMEs. In addition, Aminu and Shariff (2015) and Zhang *et al.* (2014) found out that SME owners with high level of entrepreneurship education are smarter, can easily identify opportunity in the market and access external resources such as external capital from external investors such as formal financial institutions.

➤ **Legal system**

The results as presented in Section 7.2.7.3 in Chapter 7 showed a significant positive relationship between the legal system and access to credit from the formal financial sector to SMEs. This is an indication that the efficiency of the legal system significantly impacts on access to credit from the formal financial sector. Thus, the null hypothesis that there is no significant positive relationship between the legal system and access to credit from the formal financial sector to SMEs was rejected ($r = 0.198$, $p\text{-value} = 0.025$). It can, therefore, be concluded that the legal system positively impacts on access to credit from the formal financial sector to SMEs. In other words, the formal financial sector needs an efficient legal system to grant credit to SMEs. Study conducted by La Porta *et al.* (1997) share similar conclusion. Study by Porta *et al.* (1997) revealed that laws vary a lot across countries, due in part to differences in their legal origin. Generally, Common Law countries have the strongest legal protection of investors and creditors while French Civil Law countries the weakest. The German and Scandinavian Civil Law countries are found somewhere in the middle, implying that creditor protection in these countries is weaker than in British Common Law countries but stronger than in French Civil Law countries. Kanamugire (2013:20) on his part finds that insolvency laws have a great impact on the economy of South Africa as the laws offer security for investors and lenders in both consumer and commercial borrowing transactions. This, in turn, influences credit market risks, which thus affect the cost and availability of credit from credit providers such as formal financial institutions.

➤ **Macro-economy**

The results as presented in Section 7.2.7.3 in Chapter 7 revealed a significant positive relationship between macro-economy and access to credit from the formal financial sector to SMEs. Thus, the null hypothesis that there is no significant positive relationship between the legal system and access to credit from the formal financial sector to SMEs was rejected ($r = 0.301$, $p\text{-value} = 0.001$). It can, therefore, be concluded that a good macro-economy will positively impact on access to credit from the formal financial sector to SMEs. In other words, the formal financial sector is significantly more hesitant to grant credit to SMEs in economically difficult times. During difficult times, cost of lending is high and SMEs cannot afford the high interest rate. Consistently, the Banking Association of South Africa (2018) contends that formal financial institutions have to acquire costly information on borrowers before extending credits to new or existing customers, uncertainty about economic conditions (and the likelihood of credit default) would have significant effects on their lending strategies. Research by McLeay *et al.* (2014:3) found that credit and business managers of formal financial institutions find it easy to predict returns from potential projects and channel investment capital towards projects with high expected returns when the macro-economic environment is calm. Olawale and Garwe (2010:732) and Valsamis *et al.* (2011) found that during periods of inflation, SMEs need financial capital as inflation has a significant role in determining the financial leverage of SMEs.

8.3.2.6 Comparing the performance of SMEs with credit in their capital structure to those without credit

The results revealed that the scale mean for SMEs with debt finance was 5.7934 and a standard deviation of 0.63275. The results revealed a significantly ($t = -18.191$; $Pr > |t| = <0.0001$) higher mean in performance rating than SMEs without debt finance. Thus, the null hypothesis that SMEs without debt finance in their capital structure perform better than those with debt finance was rejected. It can, therefore, be concluded that SMEs should go for more debt if available, in order to finance the operations of the enterprise. The MM theory by Modigliani and Miller (1958, 1963) advocate that SMEs should make use of the tax benefit of credit and go for more credit, thereby creating tax savings for the SME owners. This will help the SME owners to maximise their cost of capital and wealth by using cheap debt. The mix of cheap credit with relatively expensive equity reduces a SME's cost of capital, which is the cut-off rate for investment acceptance decisions. However, Adzido and Azila-Gbettor (2014:197) and Ramlee

and Berma (2013:118) warned that debt leads to a legal obligation to pay interests and principal. That means, if SME owners cannot meet their debt obligations, they will be forced into bankruptcy and they will have to incur associated costs. Given the temptation of possible tax shields from debt financing may encourage SME owners to use debt in their capital structures. On the other hand, the opposing force of the costs of bankruptcy may force the SME owners to avoid the use of debt. Therefore, the optimisation of capital structure involves a trade-off between the present value of the tax rebate associated with a marginal increase in leverage and the present value of the costs of bankruptcy.

8.4 RECOMMENDATIONS

Given that SMEs have a crucial role to play in the South African economy (in terms of economic growth, employment, poverty alleviation and reduction of income inequality), lack of finance is the main challenge to their growth and survival. The findings of this study revealed that though formal financial institutions are risk averse, formal financial institutions acknowledge investing in SMEs to be beneficial to their business and are very interested to invest in SME owners who can contribute a portion of the starting capital. This implies that formal financial institutions always want to mitigate the risk of granting credit to SMEs. The findings of this study also revealed that there are factors that impact on non-availability of and access to credit from formal financial institutions to SMEs. Based on the findings in this study and the literature review, the following recommendations are made with the aim of enhancing the financing of SMEs.

➤ Access to bank finance

It was established that access to bank finance was the number one challenge that impacts on the performance of SMEs, thus leading to their failure. In addition, SMEs with access to bank finance performed better than those without. In order to reduce the high failure rate of SMEs, there is need for government and the formal financial sector to put in place strategies (by developing different lending technologies that combine different sources of information about a borrower, screening and underwriting procedures, structure of a loan contract and monitoring mechanisms) aimed at developing a long-term capital market for novel and established SMEs. Thus, there is need for policy makers to pay greater attention on the facilitation of equity capital, especially as it is considered the base for further borrowing. Even though it is suggested in this study that SMEs should go for more debt if available, other policies aimed at

encouraging SMEs to access public equity capital could be developed by subsidising floatation cost. Such policies should motivate SMEs to restructure their financing so as to rely on less debt, particularly short-term debt, thus improving their liquidity. For academics, trainers and consultants, it could be beneficial in order to assist SMEs access equity capital and to work towards structuring transactions that minimise perceptions of threats through workshops and training organised by business schools in partnership with formal financial institutions and government support institutions such as SEDA as sponsors.

➤ **Motivation to invest in SMEs**

In order for the formal financial sector to be encouraged to have special credit schemes for SMEs, government could grant tax relief at the end of each financial year to formal financial institutions that focus more on financing SMEs. For this to be effective, formal financial institutions will have to submit annual reports and budgets on approved credit each year to the South African Revenue Services (SARS) and SARS should then decide on the percentage of tax relief to grant to the formal financial institution (maybe 0.1% more or less). The whole idea behind this point is that the government can extend the BBEEE point's model in lending. Introducing this model in lending, formal financial institutions are able to gain points when they support local owner SMEs. The points accumulated by each formal financial institution each year can be used for enterprise tax rebates, awards and recognition which normally plays a key role on share prices. In addition, government, in collaboration with the formal financial sector, should consider developing special funding packages for promoting SMEs. These policy directions would not only help improve access by SMEs to long-term finance, but would also encourage potential individuals to become entrepreneurs, which, will in turn, boost the level of entrepreneurship, reduce unemployment and poverty.

➤ **Lack of collateral**

Lack of collateral (especially tangible assets and equity capital) was the most important reason why formal financial institutions were not willing to grant credit to SMEs. Formal financial institutions normally do not fund SMEs without any equity contribution and tangible assets. Therefore, to improve the accessibility of credit to SMEs, there is need for owners of such enterprises to plan and save in order to have some amount of equity contribution. Without equity, it is virtually impossible to get the required funding from formal financial institutions. Thus, in order for owners of SMEs to get the required funding from formal financial institutions, it is essential that such owners are investment-ready. Richard (2006) points out

that “investors look out for very specific things when they assess requests for funding. Entrepreneurs must be made aware of the needs and concerns of particular types of investors”.

➤ **Alternatives to collateral**

To further motivate and expand lending to SMEs, formal financial institutions also need to develop alternatives to property as collateral to secure long-term credits. Personal guarantees, sales contracts and lien on equipment financed could be explored. Formal financial institutions could also work in partnership with informal finance providers in granting credit to small businesses. With such arrangement, formal financial institutions could take advantage of the privileged information held by informal finance lenders about small customers (only small businesses) and the relatively low cost of frequent small transactions. In addition, formal financial institutions are encouraged to set up departments that would focus solely on granting credits to SMEs. The creation of such departments will help speed-up the credit assessment and approval process, and feedback on credit application will be provided quicker.

Another viable and novel practice that could help reduce the demand of formal financial institutions for collateral is the introduction of the ‘Competency-as-Collateral’ scheme. This scheme has been tested in India and is currently gaining currency due to its significant success rate. This scheme integrates measures of management competency with the conventional credit risk assessment criteria set by formal financial institutions. Customised evaluation systems built on the basis of this platform, could assist SMEs that did not qualify for credit under the conventional criteria to become eligible by allowing them to show their management competence as part of their collateral. The only difficulty with such approach is that owners of SMEs must be very educated to be able to pitch their idea and business plans to convince formal financial institutions that they are aware of their market and business industry, thus the importance of entrepreneurship education and business intelligence.

➤ **Sources of information to SMEs**

There is need for policy makers to ensure that they provide better information on the different sources of financing available to SMEs. This could encompass pursuing the financing initiatives of a more aggressive and continuous marketing communication campaign to inform SMEs of the various financing schemes accessible to them and the requirements to access such schemes. The credit criteria set by formal financial institutions should be more flexible to enable more SMEs to qualify for access to such finances as noted by one of the participants:

“... when you empower a client, you do not only empower one person but you empower more people around your community because the person you fund will hire other people in the community and the people will come open an account with us. So, it is a win-win situation”.

Thus, routing these facilities through formal financial institutions should be reconsidered. Evaluation of applicants’ credit application could be done by qualified consultants affiliated to these schemes and formal financial institutions should rather be appointed as managers of the loan facilities for a fee. This situation will allow formal financial institutions to monitor the credit and ensure that the funds are used for the purpose for which they were granted. This could further accelerate processing and give credit applicants a better chance of accessing these facilities. These policy prescriptions could go a long way towards improving access by SMEs to long-term financing, thus improving growth.

➤ **Use of internet**

The use of the internet has become fundamental in doing business today. Given that the websites of most formal financial institutions have addressed the issue of preparation of business plans by SMEs, it is important to create awareness among SMEs that such facilities exist and that there are trained personnel willing to assist at all times. Since the use of computers and the internet is very low among SMEs in South Africa (as pointed out by Rungani (2008)), government agencies such as SEDA could assist in bearing such cost and provide training on how to use the internet. Similarly, the South African Business Toolkit (launched in 2008) is there to assist owners/managers of SMEs in assessing their investment readiness using the latest information and communications technology. In addition, SEDA could also provide subsidies to assist owners of SMEs to obtain professional advice require to make them business ready. One way of doing so is by assisting them with information on how to produce a credible business and financial plan and coaching them in administrative and presentation skills.

➤ **Relationship between the formal financial institutions and SMEs**

This study revealed that SMEs do not consider their relationship with formal financial institutions and other professional associations as important while formal financial institutions consider their relationship with SMEs as very important. Owners/managers of SMEs are advised to reconsider their relationship with formal financial institutions because it could assist in reducing information asymmetry and moral hazard, thus improving their accessibility of debt finance. Stiglitz and Weiss (1981:393-410) develop the main theoretical contributions about credit rationing and suggest that the problems of information asymmetry, moral hazard and

adverse selection have the greatest limitations on productive credit granting. According to the author, this is perpetuated by the lack of credit relationship between the lender and the borrower. Stiglitz and Weiss (1981:393-410) further advocate that, apart from a credit relationship between the lender and the borrower, there are also certain factors such as business information and documents that reveal pertinent information about the borrower (SMEs) that accentuate the problems of moral hazards, information asymmetry and adverse selection. In addition, formal financial institutions could promote creditor/debtor relationship by being actively involved in the development of a better ‘bank-client-relationship’, one which would mitigate the problem of information asymmetry, moral hazard and adverse selection. SMEs, on their part, are advised to join professional associations, attend trade fairs and seminars organised by formal financial institutions and other professional organisations. Apart from financial analysis, business planning, and credit scoring, bankers need to be competent in developing interpersonal networks that could assist in the gathering of information about SMEs.

➤ **Access to credit**

To improve access to credit, there is need for personal development (by owners of SMEs), especially in the area of business and financial management skills through training. Owners of SMEs have to take greater responsibility for their own learning. As such, they need to create a positive attitude towards entrepreneurship and training. The current system where government agencies, such as the SEDA, use consultants that write business plans for owners/managers which they cannot articulate (as highlighted by Fatoki & Smith, 2011; Ferreira *et al.*, 2017), is wrong, but could potentially be counterproductive. The personal involvement of the owners/managers of SMEs in gathering relevant information and in the writing of business plans is critical to learn about the industry and for the success of SMEs. Owners of SMEs also need to acquire business and financial management skills if they wish to have the required funding from formal financial institutions.

➤ **Financial literacy**

Financial literacy is a powerful tool to enhance the capacity of SMEs to identify and access financing that is most suited to their needs. Targeted financial education programmes could assist owners/managers of SMEs to address specific challenges, such as disentangling their personal and business finances, keeping financial records, using financial statements and financial ratios, identifying and approaching formal financial institutions and other investors,

managing financial risk, as well as understanding the economic and financial environment of relevance to their business.

➤ **Management information**

With regard to managing information, there is need for owners/managers of SMEs to develop and improve on their information management practices by keeping proper and accurate records of the operation of the enterprise. By so doing, the risk perception of formal financial institutions will be reduced, which in turn, could facilitate access to financing at favourable lending terms. Furthermore, initiatives by SMEs could be channelled to assist in reducing information asymmetry through improving managerial capabilities, business knowledge and also building their asset base. Another way through which owners/managers of SMEs could use to improve on their managerial capacity is by adopting good corporate governance structures. Corporate governance can greatly assist SMEs by promoting better management practices, better business ethical practices, stronger internal financial reporting and auditing, greater opportunities for growth and new strategic outlook. Such a move could give SMEs an extra advantage in accessing credit from formal financial institutions. Adopting a good corporate governance policy would ensure proper accounting practices and adequate disclosure of information. Proper accounting practices and adequate disclosure of information would increase the confidence of formal financial institutions, reduce problems associated with information asymmetry and make the SME less risky to invest in. The presence of external supervisory parties from formal financial institutions and monitoring system could also curb the problem of moral hazard by discouraging owners/managers from redirecting borrowed funds to invest in unapproved projects.

➤ **Entrepreneurship education**

The government and educational institutions should introduce entrepreneurship education curricula not only at tertiary level but also at secondary level across all disciplines in order to stimulate self-reliance and self-employment in the society and motivate South Africans to appreciate entrepreneurship as a career choice. Managing partners in disciplines such as Pharmacy, Medicine, Engineering, Economics and Agriculture requires knowledge in entrepreneurship to be better partners and managers in their respective disciplines. For instance, at Achievers University in Nigeria, learners in all the highlighted disciplines are taught in one field of entrepreneurship. Learners get two degrees for the price of one. This implies that students are encouraged to take entrepreneurship as a career rather than depending on jobs that

are not there. Peacock (2004:17), for instance, points out that “...*a small business management course delivered to students and apprentices via the education system is the most effective way to provide basic management training*”. This is in line with the suggestion of Kiggundu (2002:29) that entrepreneurship education should become a mainstream activity in the educational systems of African countries. Moreover, when learners are oriented in entrepreneurship from an early age, it is easier for them to write good business plans, embrace entrepreneurship and are able to develop successful businesses. At present, entrepreneurship is predominantly presented to students in management, business and economics-related courses and not to students in all the faculties in tertiary institutions. Owners/managers of SMEs should also be encouraged to take on professional business degrees/certificates courses that will improve their knowledge on entrepreneurship and business ethics.

➤ **Business intelligence**

Owners/managers of SMEs should embrace business intelligence as it is increasingly making its way in the business world by combining business processes, best practices and technology to offer managers in-depth understandings of business dynamics that could guide them in making and implementing strategic decisions that could give them competitive advantage. Embracing business intelligence will improve decision making, access vital resources such as debt capital, help reduce costs and identify new business opportunities. This can be achieved by instituting a clear vision of business intelligence and aligning it to the organisation’s vision.

➤ **Importance of communications**

Formal financial institutions, educational institutions and government support agencies aimed at promoting the financing of SMEs and development should use continuous marketing communication campaigns to inform SMEs of innovative sources of financing such as crowd funding. Debt crowdfunding is an attractive innovative source of financing for SMEs that lack collateral or a credit history to access loans from traditional formal financial institutions. Equity crowd funding could provide a complement or substitute for seed financing for both established SMEs and start-ups that have difficulties in raising capital from traditional sources.

➤ **Poor ethics and legal system**

Ethics and the legal system also constitute some of the reasons why formal financial institutions refuse to grant credit to SMEs. Creditor protection is strong on paper in South Africa but weak in practice. To improve ethics, unethical behaviours (such as deliberately not paying back debt

or diverting credits to unapproved projects) must be promptly punished. Non-payment of debt negatively impacts on the credit history of owners of SMEs. In addition, such owners who are unable to pay back debt, could make use of debt counsellors to assist them restructure their debts as stipulated by the new National Credit Act. On the other hand, the legal system has to be made more efficient through speedy court judgments. Research by Kanamugire (2013:21) revealed a positive relationship between the efficiency of the legal system and good ethical behaviour. Thus, there is need for a campaign by the government to change the mind-set of the people that unethical practices are bad. Business ethics should be introduced as a major module at universities and colleges in South Africa to prepare and train novel and established owners of SMEs about the importance of ethics. Governmental and professional business organisations should provide proficiency training that is grounded in sound ethical management. There is need for the South African government and agencies responsible for SMEs (such as SEDA) to actively promote organisational ethics by developing and sponsoring legislation that supports socially responsible SMEs.

To further improve the efficiency of the legal system and access to credit from formal financial institutions, it is fundamentally important to reform the legal frameworks for creditor rights and insolvency proceedings in general in South Africa. South Africa does not have an unrestricted ability to foreclose on collateral outside of court proceedings, and such proceedings could be relatively slow and inefficient, with delays of enforcement for a year or even more in some instances. Thus, while credit recovery prospects for secured creditors are generally strong, such recoveries may be reduced by bureaucratic delays and also the relatively high costs and fees of the enforcement process. To improve the efficiency of the legal system, specialised courts to act against SMEs that default on credit obligations could be established. More judges are also needed as there is shortage of judges and magistrates. There is need for the Department of Home Affairs to relax the criteria for granting permanent residence permits to judges and magistrates, academic doctors and professors and other professionals who wish to stay and work in South Africa. In addition, the long procedures, duration and cost to register property, enforce contracts and close businesses upon bankruptcy must be reduced. Addressing these areas would require the comprehensive reform of commercial credit laws and the strengthening of systems for the enforcement of debts and commercial bankruptcy. The government has a big role to play in improving the legal system.

➤ **Government agencies**

Government agencies can also assist in making SME owners investment ready through training. In addition, government and its agencies have, over the years, expended significant resources in an attempt to creating and implementing market interventions. It will therefore be of vital essence that these interventions are effective and meet the needs of those they declare to support. It is therefore incumbent on Government and other stakeholders to ensure that these schemes, such as the Small Firm Loan Guarantee, are well publicised and available to all SMEs. In addition, the government should broaden its efforts to ensure that a high level of financial literacy is universal to all SME owners/managers. Financial literacy of SME owners/managers will help improve their managerial and financial literacy, which will help reduce the failure rate of SMEs.

➤ **Creating an environment conducive for SMEs development**

There is need for the South African government to channel more efforts in combating corruption in order to restore the confidence of foreign investors and create a better macro-economic environment for entrepreneurship to flourish. South Africa needs to continue to sustain strong economic and financial fundamentals. As pointed out by the World Bank (2016), prudent fiscal management has seen South Africa's budget deficit increased dramatically over the past ten years. Inflation targeting has also helped to reduce inflation. However, there is a need to also reduce interest rates to enable SMEs to be able to access and use debt from formal financial institutions positively.

However, in order for all the recommendations mentioned above to be feasible, owners of SMEs must first of all, make themselves investment ready by saving and providing equity capital and tangible and acceptable collateral. Owners of SMEs have to also improve on their business and financial management competencies by attending trainings and seminars. Furthermore, owners of enterprises and formal financial institution must take responsibility to make their relationship work. This will ensure that information asymmetry becomes a reality thus reducing moral hazard. Government could also assist through credit guarantee schemes and training. It is also not realistic to create the expectation that owners of SMEs with limited business education, no entrepreneurial or management knowledge, no collateral and a poor credit record can obtain debt financing from formal financial institutions.

8.4.1 Areas for further research

Further research could be conducted on the barriers to lending by government agencies and other financial institutions involved in lending to SMEs. Such studies should also include lending criteria and the background of the lending consultant, specifically in terms of assessing the viability of SMEs. Further studies could also focus on examining if consultants have the right knowledge and suitable experience to make decisions on applications for finance by SMEs. In addition, given that this study focused only on eight banks, further research could focus on the lending criteria and challenges faced by the other commercial banks in South Africa. Further research could also be conducted in other region or province or countries to confirm if the lending criteria and challenges are similar.

8.5 CONTRIBUTIONS OF THE STUDY

The findings and results of this study add to the body of knowledge and scholarly understanding of the financing of SMEs with particular emphasis on the analysis between the availability of and access to credit from the formal financial sector and the performance of SMEs in Johannesburg, Gauteng Province, South Africa. The findings revealed unconventional factors such as entrepreneurship education, business intelligence, business ethics and management team as important in explaining access to finance by SMEs from formal financial institutions. In addition, the recommendations of this study is important to academics, policy makers, educational and training institutions, and government agencies involved in the financing of SMEs through its theoretical and practical implications. The above recommendations can be achieved through training, workshops, partnership between SMEs, formal financial institutions, business schools in higher institutions of learning and research institutions in promoting education programmes for inter alia academic and education sector. Thus, the findings and results would contribute towards improving support programmes for SMEs by government, policy makers, credit providers, educational and training institutions, novel entrepreneurs and government agencies. Furthermore, using a mixed method research design (MMRD), located in the pragmatic research paradigm, would further contribute, from a methodological perspective, to the literature on the financing of SMEs, which is predominantly presented from a quantitative perspective in both supply and demand perspectives. Through this study, the researchers were able to design an interview guide and a research questionnaire that could be used by other researchers to conduct research on the financing of SMEs.

8.6 CONCLUSIONS

From the findings of this study, it is evident that majority of SMEs tend to rely more on credit from formal financial institutions. However, some SMEs are often discriminated against since ‘collateral’ is used as the most important, if not the only measure for accessing long-term credit according to contemporary literature. According to contemporary literature, SMEs that do not have collateral will find it very difficult to access credit from the formal financial institutions. This study concludes that, collateral in the form of an investment account or fixed assets of the owners of SME is the most important criteria used by formal financial institutions when considering lending to SMEs but must not be the only criteria used in SMEs lending. This study advocates that formal financial institutions should also consider other criteria such as annual business turnover, audited financials, and other criteria highlighted in Chapter 6 Table 6.3 important when assessing credit applications from SME owners/managers.

As for the sources of financing, SMEs are mostly unaware of other alternative sources of financing. These sources of financing have not been proactive enough in creating awareness among SMEs on available financing for SMEs. The implementation of a good governance system is likely to address two main problems that SMEs tend to experience with suppliers of finance. It could reduce problems associated with information asymmetry and make SMEs less risky to invest in. Furthermore, the presence of external supervisory parties and monitoring systems could curb the problem of moral hazard by discouraging owners/managers of SMEs from diverting borrowed funds to invest in unapproved projects. The incorporation of entrepreneurship education in the curricula of secondary schools and tertiary institutions across all disciplines will motivate young South Africans to embrace entrepreneurship as a career choice.

Finally, the fact that the primary research objectives and the secondary research objective were achieved through literature review and empirically, it can therefore be concluded access to credit from the formal financial sector significantly impact on the performance of SMEs. It can also be concluded that, lack of finance is the number one cause of the high failure rate of SMEs.

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ANNEXURES

ANNEXURE A: INTERVIEW GUIDE

FORMAL FINANCIAL SECTOR FINANCING TO SMEs

INTERVIEW GUIDE: BUSINESS/CREDIT MANAGERS

SECTION 1: INTRODUCTION

Despite South Africa being considered the fastest growing developing economy over the past two decades, the country suffers from high unemployment with an official estimate of approximately 29.7% of the economically active population being unemployed (Statistics South Africa, 2017). In addition, the country experiences high levels of poverty and income inequality. SMEs are expected to be an important vehicle to address the challenges of job creation, sustainable economic growth, equitable distribution of income and the overall stimulation of economic development as proclaimed by international organisations such as GEM (2016), IMF (2016) and World Bank (2017). These organisations affirm that availability of and access to finance from the formal financial sector is the primary challenge to SMEs survival and performance. The researcher for this study is interested in understanding more about the provision of financing to SME's by the formal financial sector. As such, your participation in this research study will contribute towards a better understanding and improvement of how formal financial institutions view lending to SMEs, assess credit applications, and the challenges they face when lending to SMEs. Your contribution will enable the development of a theoretical framework for understanding formal financial sector financing. This framework will inform the development of appropriate intervention strategies to help improve SMEs access to credit from formal financial institutions. Your identity and institution will be treated with complete confidentiality and anonymity. This semi-structured in-depth interview will take one hour to complete. Data gathered for this study will be used for academic purposes only. Respondents will be accorded the right to withdraw from the study at any given time during the study without penalty.

SECTION 1: DEMOGRAPHICS

Interviewer Name	Francis Tangwo Asah
Date of Interview	
Respondent institution	

Nationality of respondent	
Sex of respondent	
Ethnicity (e.g. Black, White, Coloured)	
Age range of respondent (e.g. 25 – 30; 31 – 35; 36 – 40)	
Highest level of education of respondent	
Current Position	
How long have you been in your current position?	

1. What position did you hold before your current position and what was your role/function? (*For instance, you were the manager of operations in the organisation, account relation manager, employee in an organisation, business partner etc.*)
 - a. Was your previous position with your current employer or another employer?
 - b. For how long did you work in your previous position? (In months/years)
 - c. Presently, as a business/credit manager of your institution, can you explain your role in the financing process?

SECTION 2: CREDIT ASSESSMENT AND EVALUATION

2. Given your experiences in lending over the past years, what are your main priority investment focus areas with regard to SMEs? (e.g. SMEs in the construction industry, chemical industry, manufacturing, biotech, technology, etc.)
3. With respect to the major investment areas you have highlighted, what decision-making criteria do you consider when lending to start-up, established and expanding SMEs (e.g. those SMEs considering expanding their outlets or expanding to international markets):
4. What other factors besides the lending criteria you previously highlighted above might influence your willingness to lend to SMEs?
5. How do these factors highlighted in the previous question influence your willingness to lend?
6. Are the criteria similar when considering lending to immigrant SMEs? If so, please identify the additional documents required from immigrant SME owners.

SECTION 3: UNDERSTANDING THE CHALLENGES IN LENDING TO SMEs

7. Given the lending criteria put in place by your institution, to what extent do SMEs comply with these criteria?
8. If compliance with the lending criteria is a problem, what, if anything, is your institution doing to improve compliance?
9. What are the challenges your institution is facing in trying to address the problem of compliance with lending?

SECTION 4: FINANCING PROCESS

10. The Banking Association of South Africa note that *business managers and credit managers* of commercial banks are responsible for business credit assessment, evaluation and approval to SMEs. So, when SMEs submit their credit applications, who receives the application?
11. Explain your role in the evaluation and approval process?
12. After you have completed your role in the evaluation and approval process, to whom do you send the credit application?
13. What is the subsequent recipient role in the process?
14. Apart from the business and credit managers, are there any other persons involve in the credit assessment, evaluation and approval process? If yes, who else is involve and what is their role in the process?

SECTION 5: BANK LENDING ATTITUDE

15. For the length of time you have worked with this institution, do you believe that your institution is committed to lending to SMEs? If yes, can you please explain how.
16. In your opinion, given the lending criteria your institution has put in place, do SMEs feel encourage to apply for credit from your institution? Please explain your response.

SECTION 6: IMPROVING ACCESS TO FINANCE

17. Assuming that the lending criteria is practicable to SMEs, in your experience as a credit /business manager, can you explain why access to finance from formal financial institutions (commercial banks) still a major challenge to SMEs?
18. In your opinion, what measures do you think should be put in place to mitigate these challenges?

THANK YOU FOR YOUR INPUT AND TIME

ANNEXURE B: SELF-ADMINISTERED QUESTIONNAIRE



RHODES UNIVERSITY

INFORMED CONSENT FORM

Department of Management

Research Project Title:	An analysis of the availability of and access to credit from the formal financial sector and the performance of SMEs in South Africa
Principal Investigator:	Mr Francis Tangwo Asah

PARTICIPANT CONSENT

- I hereby certify that my response to the information in this document is correct to the best of my knowledge.
- I understand the purpose of the research study and my involvement in it.
- I understand the benefits of participating in this research study.
- I understand that I may withdraw from the research study at any stage without any penalty.
- I understand that participation in this research study is done on a voluntary basis.
- I accept that I will not be identified and that no confidential information will be required.
- I confirm that I am not participating in this study for financial gain
- I hereby give consent to the researcher to use the information contained in this document for the purpose of completing his research project and for academic publication.

Voluntary Consent

Based on the above, I hereby agree to voluntary consent to participate in this research as described in the attached cover letter.

Yes	<input type="checkbox"/>	No	<input type="checkbox"/>
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Signature:

Date: / / 2018

SECTION A: BIOGRAPHICAL INFORMATION OF RESPONDENT

Please complete this section by responding in the appropriate section by means of a cross.

a) Gender of the respondent:

Male		Female		Non-binary	
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b) Age of the respondent:

Below 20 years	21-30 years	31-40 years	41-50 years	51-60 years	Above 61 years

c) Nationality of the respondent

South African by birth	Naturalised South African	Immigrant

d) Educational qualification of the respondent:

Matric		Diploma		Degree		Advance diploma		Post grad degree	
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e) Indicate the legal status of your enterprise

Sole proprietorship	Partnership	Close corporation	Company

f) Indicate the number of years that your enterprise has been in operation

Less than 1 year	2 - 5 years	6-10 years	11-15 years	16-20 years	Above 20 years

g) Indicate whether your enterprise is registered with SEDA or DTI?

Yes		No	
-----	--	----	--

h) Indicate whether you have had any previous working experience

No previous business experience	1 – 5 years	6 – 10 years	11 – 15	Above 16 years

i) How many persons does your enterprise currently employ?

Less than 10	10 - 49	50- 149	More than 150

j) Indicate the main activity of your enterprise

Construction	Manufacturing	Whole sale or retail trade	Services industry	Transport	Others (specify)

SECTION B: THE SITUATION OF THE SMEs

Please complete this section by making a cross in the appropriate box.

1. Please indicate how much original investment the owner invested in assets (example, inventories, plant and machinery, buildings).

Less than R1000,000.00	R1000,000 to R2,999,999	R3,000,000 to R4,999,999	RR5,000,000 to R9,999,999	More than R10,000,000

2. Please indicate the plan for the enterprise for the next two years.

Close the business	Reduce the business	Maintain the business as is	Grow the business modestly	Grow the business substantially

3. Please rate each of the following challenges the enterprise is currently facing in doing business (1= least challenging to 7 = most challenging).

Finding customers	1	2	3	4	5	6	7
Regulations (laws and policies governing SMEs)	1	2	3	4	5	6	7
Availability of book keeping and accounting services	1	2	3	4	5	6	7
Access to bank finance	1	2	3	4	5	6	7
Competition from other domestic similar enterprises	1	2	3	4	5	6	7
Enterprise operates within a small margin	1	2	3	4	5	6	7
Skill and experienced managers	1	2	3	4	5	6	7
Cost of production	1	2	3	4	5	6	7
Cost of labour	1	2	3	4	5	6	7
Other (specify)							

SECTION C: FINANCING SMEs

Please complete this section by making a cross in the appropriate box.

4. Please indicate whether you applied for external finance from a bank over the past three years.

Yes	<input type="checkbox"/>	No	<input type="checkbox"/>
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- 4.1 If **Yes**, please indicate the reason for applying for external finance from the bank.

To increase working capital	To purchase fixed assets	Buy another business	Business expansion	Training /staff development	Other (Specify)

- 6.2 Please indicate the outcome of your application for bank finance.

Application was approved	<input type="checkbox"/>	Application was rejected	<input type="checkbox"/>
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- 6.3 If **No**, please indicate the reason for not applying for external finance from the bank.

Did not need bank finance	Denied access to finance previously	Not aware of bank finance	Bank finance is too expensive	Procedure to obtain bank finance is too complicated	Other (specify)

5. If your application was approved, please indicate which of the following financial facilities were requested.

Term loan	Working capital	Cash credit	Overdraft	Factoring	Export financing	Other (Specify)

6. Please indicate the percentage of banking finance you received.

100% of requested	Between 75% to 99%	Between 50% to 74%	Less than 50%

7. Besides financing from a bank, please indicate all other sources you have used to raise finance for the business over the past three years

Trade credit	Credit from friends and families	Venture capital	Crowdfunding	Selling shares	Government assistance schemes	Other (specify)

8. Please number the different sources you would use to raise finance for the enterprise (in order of preference 1st, 2nd, 3rd, ... 8th)

Trade credit	Credit from friends and families	Venture capital	Bank finance	Selling shares	Government assistance schemes	Crowd-funding	Other (specify)

SECTION D: IMPORTANT FACTORS WHEN APPLYING FOR CREDIT FROM BANKS

Please complete this section by making a cross in the appropriate box.

In your own opinion, please indicate the importance of the following factors when you are applying for finance from banks (1= unimportant to 7 = extremely important).

Important factors to consider when applying for finance from banks	Unimportant	Slightly important	Fairly important	Moderately important	Quite important	Very important	Extremely important
Managerial competency of the SME owners/managers	1	2	3	4	5	6	7
Credit information about the business	1	2	3	4	5	6	7
Acceptable collateral	1	2	3	4	5	6	7
Relationship with the bank	1	2	3	4	5	6	7
The macro-economic environment	1	2	3	4	5	6	7
Credit laws on business credit	1	2	3	4	5	6	7
The equity contribution	1	2	3	4	5	6	7
SME owners/managers' knowledge of entrepreneurship	1	2	3	4	5	6	7
SME owners/managers' knowledge of business ethics	1	2	3	4	5	6	7
The enterprise does not generate sufficient sales	1	2	3	4	5	6	7
Credit information about the SME owners/managers'	1	2	3	4	5	6	7
South African ID documents	1	2	3	4	5	6	7
International passport document with valid permit	1	2	3	4	5	6	7

SECTION E: REASONS WHY BANKS MAY REFUSE TO GIVE CREDIT TO SMEs

Please complete this section by making a cross in the appropriate box.

In your own opinion, please indicate the extent to which you agree or disagree with the following statements about why banks may reject credit applications from SMEs (1= strongly disagree to 7 = strongly agree).

Statements about why banks may reject credit applications from SMEs	Strongly disagree	Moderately disagree	Slightly disagree	Neutral	Slightly agree	Moderately agree	Strongly agree
Collateral	1	2	3	4	5	6	7
Limited tangible asset to use as collateral (e.g. building)	1	2	3	4	5	6	7
The SME owners/managers' do not have insurance policy to use as collateral	1	2	3	4	5	6	7

Statements about why banks may reject credit applications from SMEs		Strongly disagree	Moderately disagree	Slightly disagree	Neutral	Slightly agree	Moderately agree	Strongly agree
	The SME owners/managers' do not have surety.	1	2	3	4	5	6	7
	Limited current assets to use as collateral (e.g. inventories).	1	2	3	4	5	6	7
	Business information	1	2	3	4	5	6	7
	The business does not have a proper business plan	1	2	3	4	5	6	7
	The cash flow is poor and does not encourage the bank	1	2	3	4	5	6	7
	The business is not financially viable	1	2	3	4	5	6	7
	The enterprise does not have growth potential	1	2	3	4	5	6	7
	The SME owners/managers' do not have the required credit application documentation	1	2	3	4	5	6	7
	Managerial competency	1	2	3	4	5	6	7
	The SME owners/managers' lack experience that is relevant to the business	1	2	3	4	5	6	7
	The SME owners/managers' are not fully committed to the business	1	2	3	4	5	6	7
	Lack of entrepreneurial skills by the SME owners/managers'	1	2	3	4	5	6	7
	Poor personal credit record of the SME owners/managers'	1	2	3	4	5	6	7
	Business networking	1	2	3	4	5	6	7
	No prior relationship between the bank and the SME owners/managers'	1	2	3	4	5	6	7
	Short relationship between the bank and SME owners/managers	1	2	3	4	5	6	7
	Lack of good reference on the SME owners/managers' integrity and ability	1	2	3	4	5	6	7
	No verifiable distribution of goods agreement in place for the enterprise	1	2	3	4	5	6	7
	The enterprise does not belong to a professional association (e.g. Chamber of Commerce)	1	2	3	4	5	6	7
	Business intelligence	1	2	3	4	5	6	7
	The SME owners/managers' are not familiar with the market/industry	1	2	3	4	5	6	7
	The SME owners/managers' are not capable of making strategic decisions	1	2	3	4	5	6	7
	The SME owners/managers' are not able to analyse market situation	1	2	3	4	5	6	7
	The SME owners/managers do not know what the strengths, weaknesses, opportunities and threats are.	1	2	3	4	5	6	7

Statements about why banks may reject credit applications from SMEs		Strongly disagree	Moderately disagree	Slightly disagree	Neutral	Slightly agree	Moderately agree	Strongly agree
	Business ethics	1	2	3	4	5	6	7
	The SME owners/managers' willingness to divert funds to non-core business activities (divert the funds for personal use not related to the business)	1	2	3	4	5	6	7
	The inability of the SME owners/managers' to honour a repayment	1	2	3	4	5	6	7
	Dishonesty of the SME owners/managers' in keeping promises and commitments	1	2	3	4	5	6	7
	The SME owners/managers provide false financial statements	1	2	3	4	5	6	7
	Entrepreneurship education	1	2	3	4	5	6	7
	The SME owners/managers' do not have formal training on managing the enterprise.	1	2	3	4	5	6	7
	Lack of formal business management education by the SME owners/managers'	1	2	3	4	5	6	7
	The SME owners/managers' do not consider entrepreneurship as a career choice	1	2	3	4	5	6	7
	Legal system	1	2	3	4	5	6	7
	Courts judgements/decisions are not fairly executed.	1	2	3	4	5	6	7
	In situations of legal action against SME owners/managers', it takes long to get judgement	1	2	3	4	5	6	7
	Court decisions are not enforced	1	2	3	4	5	6	7
	Weak confidence in the legal system to enforce contracts rights.	1	2	3	4	5	6	7
	Weak confidence in the legal system to enforce property rights	1	2	3	4	5	6	7
	Macro-economy	1	2	3	4	5	6	7
	Recession in the economy	1	2	3	4	5	6	7
	Continuous decline in the value of real estate (collateral value)	1	2	3	4	5	6	7
	Continuous decline in the value of the Rand	1	2	3	4	5	6	7
	The banks' interest rate is higher than the interest rate requested by SME owners/managers'	1	2	3	4	5	6	7

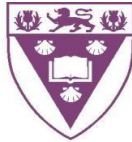
SECTION F: PERFORMANCE OF SMEs

Please complete this section by making a cross in the appropriate box.

In your own opinion, please indicate the extent to which you agree or disagree with the following statements on the performance of the enterprise (1= strongly disagree to 7 = strongly agree).

	Statements on the performance of SMEs	Strongly disagree	Moderately disagree	Slightly disagree	Neutral	Slightly agree	Moderately agree	Strongly agree
	The SME owners/managers' are satisfied with the sales growth of the enterprise for the last three years.	1	2	3	4	5	6	7
	The SME owners/managers' are satisfied with the growth in profitability of the enterprise for the last three years.	1	2	3	4	5	6	7
	The SME owners/managers' are satisfied with the performance of the enterprise compared to the performance of their competitors.	1	2	3	4	5	6	7
	The SME owners/managers' are satisfied with the employee growth of the enterprise over the past three years	1	2	3	4	5	6	7
	The SME owners/managers' are satisfied with the responses they received from customers over the past three years	1	2	3	4	5	6	7
	The SME owners/managers' are satisfied with the overall performance of the enterprise over the last three years.	1	2	3	4	5	6	7

THANK YOU FOR YOUR TIME



RHODES UNIVERSITY
Grahamstown • 6140 • South Africa

ANNEXURE C₁: INSTITUTIONAL PERMISSION LETTER

DEPARTMENT OF MANAGEMENT • Tel: (046) 603 8250 • e-mail: t.amos@ru.ac.za

Date: 18 July 2018

Dear Francis Asah

Research Ethics Approval Feedback (Letter 2: Institutional/Gatekeeper Permissions)

Research Title: An analysis of the availability of and access to credit from the formal financial sector and the performance of SMEs in South Africa.

Research Type: PhD

Supervisor: Prof Lynette Louw and Prof John Williams Ethics

Application Reference: Ref: 2018 Man 01.

As indicated and required by the previous application the following Institutional (Gatekeeper) Permissions have been received as required.

List of Permissions as per Ethics Application:

ABSA Bank; African Bank; Bidvest Bank; Capitec Bank; First National Bank; First Rand Bank; Nedbank Ltd; Standard Bank

At a meeting of the Department of Management Ethics Sub-Committee held on 17 July 2018 the Committee resolved to **Recommend the application for approval to the RUESC.**

Please note that data collection can now commence.

Notes (if applicable):

Sincerely

Trevor Amos (Mr)

Head: Department of Management
Chair: Department of Management
Human Research Ethics Committee

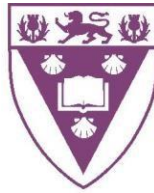
Mark Maritz (Mr)

Department of Management Human
Research Ethics Committee Member

Please note that this letter needs to be considered in the context of the following:

- [Ethical Standards for Research on Human and Animal Subjects](#)
- [Introduction to ethics of research involving humans](#)
- [Rhodes University Ethical Standards Handbook](#)

ANNEXURE C₂: INSTITUTIONAL PERMISSION LETTER



RHODES UNIVERSITY

Grahamstown • 6140 • South Africa

DEPARTMENT OF MANAGEMENT • Tel: (046) 603 8250 • e-mail: t.amos@ru.ac.za

Date 26 October 2018

Dear Francis Asah

Research Ethics Approval Feedback (Letter 1: Initial Application) Ref: 2018 Man 01.04

Research Title: An analysis of the availability of and access to credit from the formal financial sector and the performance of SMEs in South Africa.

Research Type: PhD

Supervisor: Prof Lynette Louw and Prof John Williams

Nature of application

An original application	
A re-application	√

At a meeting of the Department of Management Ethics Sub-Committee held on 25 October 2018 the Committee resolved to:

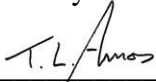
Allow for Institutional (Gatekeeper) Permissions to be requested from the following:	
<i>NOTE: No data can be collected at this stage!</i>	
Modifications Required and Resubmission (see below and annotations on application)	
The project is to be monitored/has stipulations (see below)	
No approval required	√
Not approved (see below)	

Notes (if applicable):

- Thank you for your submission of the covering letter, questionnaire and informed consent forms as outlined in your ethics application.
- As per initial application approval is now given to continue with phase two of the research study.

Consensus decision

Sincerely



Trevor Amos (Mr)

Head: Department of Management
Chair: Department of Management
Human Research Ethics Committee



Mark Maritz (Mr)

Department of Management Human
Research Ethics Committee Member

Please note that this letter needs to be considered in the context of the following:

- [Ethical Standards for Research on Human and Animal Subjects](#)
- [Introduction to ethics of research involving humans](#)
- [Rhodes University Ethical Standards Handbook](#)

ANNEXURE D: TRANSCRIPTED INTERVIEW
FORMAL FINANCIAL SECTOR FINANCING TO SMEs
INTERVIEW GUIDE: BUSINESS/CREDIT MANAGERS

SECTION 1: INTRODUCTION

Despite South Africa being considered the fastest growing developing economy over the past two decades, the country suffers from high unemployment with an official estimate of approximately 29.7% of the economically active population being unemployed (Statistics South Africa, 2017). In addition, the country experiences high levels of poverty and income inequality. SMEs are expected to be an important vehicle to address the challenges of job creation, sustainable economic growth, equitable distribution of income and the overall stimulation of economic development as proclaimed by international organisations such as GEM (2016), IMF (2016) and World Bank (2017). These organisations affirm that availability of and access to finance from the formal financial sector is the primary challenge to SMEs survival and performance. The researcher for this study is interested in understanding more about the provision of financing to SME's by the formal financial sector. As such, your participation in this research study will contribute towards a better understanding and improvement of how formal financial institutions view lending to SMEs, assess credit applications, and the challenges they face when lending to SMEs. Your contribution will enable the development of a theoretical framework for understanding formal financial sector financing. This framework will inform the development of appropriate intervention strategies to help improve SMEs access to credit from formal financial institutions. Your identity and institution will be treated with complete confidentiality and anonymity. This semi-structured in-depth interview will take one hour to complete. Data gathered for this study will be used for academic purposes only. Respondents will be accorded the right to withdraw from the study at any given time during the study without penalty.

SECTION 1: DEMOGRAPHICS

Interviewer Name	Francis Tangwo Asah
Date of Interview	8th August 2018
Respondent institution	N/A
Nationality of respondent	South African

Sex of respondent	Female
Ethnicity (e.g. Black, White, Coloured)	Indian
Age range of respondent (e.g. 25 – 30; 31 – 35; 36 – 40)	34 years
Highest level of education of respondent	Honours in Accounting
Current Position	Business manager
How long have you been in your current position?	5 years

1. What position did you hold before your current position and what was your role/function? (*For instance, you were the manager of operations in the organisation, account relation manager, employee in an organisation, business partner etc.*)

Before this current position, I was the relationship manager with this bank and my function was more of a support one because I help clients with their queries. I inform the clients on the different product the bank is offering and the benefit they will get when they use a particular product. I also help clients who want to apply for a loan what they are supposed to do, how to download the loan form on our website and how to complete the loan form, the document they must attached to the form. So yeah. But if a client comes to me and I cannot attend to the problem, then I direct the customer to the person that will help solve the problem of the client.

2. Was your previous position with your current employer or another employer?

Same employer

3. For how long did you work in your previous position? (In months/years)

I worked as the relationship manager for about six years.

4. Presently, as a business/credit manager of your institution, can you explain your role in the financing process?

As a business manager, I oversee different portfolios. When it comes to my role in the financing process to small businesses, first you must know that all clients are not the same. As a business manager, I deal with clients that come for a loan of about 20million, some 10million or 5million you know. So my value proposition is more focused on clients within this particular portfolios. So when these clients come to me for a loan, I first ask the clients how much they want and if they are banking with us, if they have applied for a loan before with us or if they have taken any loan with any other bank. Why they want a loan of such amount because it is my responsibility to advice my clients when they come requesting for a loan. I assist them in putting together the credit application, just general maintenance of the portfolio. I also do calling to clients, introduce myself to them and updating them about their accounts, try to keep them inform of the different products available to them, more like trying to position the bank. So yeah that is it.

SECTION 2: CREDIT ASSESSMENT AND EVALUATION

19. Given your experiences in lending over the past years, what are your main priority investment focus areas with regard to SMEs? (e.g. SMEs in the construction industry) chemical industry etc)

I think we have a nice mix, but there is obviously the high risk industries that we might come out to say based on past losses that we have incurred, we might require more security or we might require first class security and that is non-negotiable and construction industry is one of those. But overall, we do not have any specific investment focus area. We have appetite for any type of business in the different industries be it in the construction or manufacturing or chemical or retail industry but provided they meet out minimum criteria. It just depends on the particular business or client, what they want, the credit worthiness of the business, the risk the bank is willing to accept and what they have to offer as collateral to cover the risk. That is just it. Like I said, you must also know that businesses in different industries have different risk profile. So, it all depends on the particular client.

20. With respect to the major investment areas you have highlighted, what decision-making criteria do you consider when lending to SMEs (start-ups, established, expanding SMEs)

The decision making criteria are the same for all SMEs. First of all we will like to know the reasons for applying for a loan then we will require;

- Their latest audited financials: your audited financials are the most important and must be signed by the directors. If not available then a management account, if not available then bank statements. I think they are good enough even though a lot of credit managers since they are the ones to approve the loan do not really like them. Bank statements are also evidence to show that the client can pay or not.
- Collateral: We somehow require some kind of security if it is sort of like a large amount that they require before we do the lending. So it depends usually if it would be either the call account or an investment account has to be opened with us.
- Turnover per annum: We look at their turnover to see if they qualify for the requested amount.
- Credit profile of the business and it owners: we check if they have had credit in the past and how payment was honoured. So we will determine if the client is credit worth base on the credit score and the risk of lending to such client.
- The nature of the business will also tell us the riskiness of lending to such business.
- Investment capital: the initial capital is also very important because it tell us how committed the owner of the business is willing to commit to the business.

So those are the main things we need from any client before we process the credit application.

21. What other factors besides the lending criteria you previously highlighted above might influence your willingness to lend to SMEs?

I think ethical factor, environment factors and economic factors can also affect the lending criteria. Also that business insights of the client can also make you to think otherwise when it

comes to given them credit. These are the common factors I think can also influence our judgment from lending to small businesses.

22. How do these factors highlighted in the previous question influence your willingness to lend?

So if it is environmental we do not like to finance projects that will cause environment hazard or projects that does not contribute to our community. You know we like to finance small business that we will see it grow to become a big business. So investing our money in projects that does not contribute to uplifting our community is not a good investment to us.

Economically, you know sometimes the credit market is expensive especially when the interest rate is increase and we borrow from the reserve bank at high interest rate. That means we are forced to increase the interest rate on loans. This usually affects small businesses as most of them cannot afford loans at such high interest rate. You know, under such circumstance, we cannot do anything because the bank too is out to make profit.

Ethically, we do not finance anything that is going to bring disrepute to the bank's name. That is just it. Before I was employ in this bank, I was told that. So for ethical reasons, our bank may decide not to invest in a project.

Also, how can you given someone money when you can really see that the person is not convincing you to do so. So as I was saying, another thing I have also come to understand with some of our clients is that they do have a business but they do not have that business insight in the type of business they are doing. Sometimes we ask this clients to pitch their business to us and we could see that they are struggling. They don't have that business intelligence. One can easily tell that this client is doing business because he wants to survive and such clients we consider high risk clients. Even if such clients have the right collateral, like I said our business is not to buy our clients assets.

23. Are the criteria similar when considering lending to immigrant SMEs? If so, please identify the additional documents required from immigrant SME owners.

The lending criteria is the same even for immigrant businesses. But the immigrant business owner must have a valid passport and permit that allow him/her to do business in South Africa and the passport and permit must be valid throughout the period of the loan. The person also need to deposit 50% of the loan amount in any bank in South Africa even though we prefer the deposit in our bank. If the person can produce all these, then we will process the loan application like any other loan with the other documents.

SECTION 3: UNDERSTANDING THE CHALLENGES IN LENDING TO SMEs

24. Given the lending criteria put in place by your institution, to what extent do SMEs comply with these criteria?

Generally, we do have a lot of customers that inquire and when we have given them the actual requirements, we might not get their feedback because firstly, they do not have a second source of repayment or if they do, they might have a property where there is no equity left in it. You know it has already been bonded and for us the bank that can be an automatic decline. Because without a second source of repayment we might not have the risk appetite. Well, but generally speaking, in my portfolio, I will say there is at least a 70% success ratio. Success ratio here I mean all those who enquire and we advise on the requirements and they submit a credit application, I will say 15 out of every 20 application is approved. So I can say the level of compliance is good.

25. If compliance with the lending criteria is a problem, what, if anything, is your institution doing to improve compliance?

I think for us as the head office and our space, we try to encourage our credit and business managers at the branches because I don't work in that environment, to partner with their business clients regularly because it will help them understand the needs of their clients. As for given them access to credit, they must make the clients understand from the onset that they need to be the risk that the client is willing to take as well because all in all, the bank is running a business and cannot be a case where we take 100% in lending to clients. So we cannot have a case where a start-up client is coming to us without taking any risk. That we will not fund.

26. What are the challenges your institution is facing in trying to address the problem of compliance with lending?

The challenges we are facing as a bank is mostly common to most of our business clients. Some do not have the right collateral for the amount of loan they are asking from us, so sometimes we ask the client to reduce the amount they want so that we can try and support them. For some, as I told you earlier, first class security in the form of investment account, personal assets or insurance scheme is what we prefer to keep as security for any client that wants credit. Unfortunately, most of the security offered by most clients does not qualify. Some don't have security to offer at all. A number of our clients most often offer an empty land or a land with a shack building on it. When we send our evaluation team to evaluate the value of the land with the shack on it, it doesn't meet the value of the loan they are asking from the bank. In some situation, I will advise the client to reduce the amount they are asking for. Some will take the advice and some will tell you the amount you we offer is too small for what they want to do. Some do not have that initial capital to start the business but they have collateral like fixed asset. In a case like this, it is like the client is selling the house to the bank for money to start a business. What if the business fails? You know as a bank, we are doing business, but buying client property is not the type of business we do. If we start funding such client then I promise you that we will own almost all the properties in Johannesburg. Also, some clients do not have the enough managerial skills to run their business, they cannot even write a proper business plan. Some don't even understand the industry they are operating within, and lack of proper financial records. So these are the challenges we have with some of our clients.

SECTION 4: FINANCING PROCESS

27. The Banking Association of South Africa note that *business managers and credit managers* of commercial banks are responsible for business credit assessment, evaluation and approval to SMEs. So, when SMEs submit their credit applications, who receives the application?

You know a client may decide to submit a credit application online or manually through our branch offices. But no matter how the credit application is submitted, the relationship manager or the business manager or the credit manager can access the application and forward to the person that is supposed to be responsible for such application. What I am saying is that if a client submit a credit application online requesting for 5million, either the business manager or credit manager can handle such application but if the amount is say more than 10 million, it must be processed by the credit manager who is also a member of the credit committee because the credit committee treat such applications with care you know because the money is much. Also, there are times that even the branch manager can receive credit application and forward to the relevant person. So any of these person can receive a credit application but only the business managers and credit managers will process the application before it can be submitted.

28. Explain your role in the evaluation and approval process?

My role as a business manager in the process is to ensure that all the relevant support documents submitted by the business clients is valid and the application form is correctly completed. I check their ITC records, assess the risk in each application using our credit scoring model and then if I am satisfied with the results, I then make my recommendation.

29. After you have completed your role in the evaluation and approval process, to whom do you send the credit application?

After I finish processing each client applications, I make my recommendations and then forward the application to the credit manager. Sometime, we have weekly meetings with the credit managers to discuss the processed credit applications before they go to the credit committee for the final decision. And sometimes the credit manager will make some adjustments.

30. What is the subsequent recipient role in the process?

The role of the credit manager is to confirm that I have included all the relevant documents in the application and the number of application I have submitted correspond with my weekly or monthly credit report. There are also circumstances where I might underestimate or overestimate the risk in a credit application. The credit manager might see it differently. Then we have to sit again the two of us and go through the application before we submit to the credit committee. That's is basically it.

- 31.** Apart from the business and credit managers, are there any other persons involve in the credit assessment, evaluation and approval process? If yes, who else is involve and what is their role in the process?

The credit committee are the last persons to go through all the credit applications and assess the risk in each application from their point of view since they are the expert in the field and then decide if the credit application will be approved or rejected. For details about what the credit committee does before they decide to approve or reject a credit application can be explained to you by the credit manager because she too is a member of the credit committee and I am not.

SECTION 5: BANK LENDING ATTITUDE

- 32.** For the length of time you have worked with this institution, do you believe that your institution is committed to lending to SMEs? If yes, can you please explain how.

For the number of years I have worked in this bank, I can truly say the bank is very committed to supporting SMEs. I can tell you that with a lot of small business clients that we hold in our books is an indication that we are committed to invest in small businesses. We also believe in empowering SMEs because I think it is the main thing that will empower our economy at this point because not everyone you know will be an employee but if you know you are an employer, then it opens up a lot of job opportunities for a lot of people. Hence, I will say we really like to invest in SMEs and for people to become employers especially at this time when many companies are cutting down, you know retrenching, and you know when you empower a client, you do not only empower one person but you empower more people around your community because the person you fund will hire other people in the community

- 33.** In your opinion, given the lending criteria your institution has put in place, do SMEs feel encourage to apply for credit from your institution? Please explain your response.

I can say yes because most of our business clients are happy when they apply for a loan because most of them always get what they requested. For those that got their application rejection, I often do a follow-up as to why their application was rejected by the credit committee and we may end up applying again. This time taking into consideration the feedback from the credit committee and the outcome will most likely be different.

SECTION 6: IMPROVING ACCESS TO FINANCE

- 34.** Assuming that the lending criteria is practicable to SMEs, in your experience as a credit /business manager, can you explain why access to finance from formal financial institutions (commercial banks) still a major challenge to SMEs?

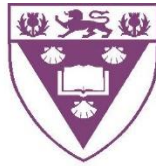
If you say access to finance is still a major challenge to SMEs, then I can tell you that the problem is not from our side because like I told you, most of my business clients who apply for credit often get it. But for those who had their credit application rejected, then the problem is not from our side. It is from the client's side because if they don't meet the minimum criteria, then their application will be rejected. If I understand you well, you mean to say there are clients whose application met the minimum criteria but their application was rejected that very true. Such application was rejected most likely because of the risk. As I told you earlier, there are clients that must provide us with first class collateral before we can approve their credit application simply because the risk is too high. They might have provide us with some collateral but the collateral cannot cover the risk in lending to such client. So yeah the challenges I told you before is not from us but it is what we are facing when processing credit applications from our business clients.

35. In your opinion, what measures do you think should be put in place to mitigate these challenges?

What we the banks are doing currently that we were not doing in the past is partnering more with our clients. For over a year now, the credit team now go out to partner with our clients. The credit team involve the head office credit and business managers and if the business is a high level business then the credit team leader (head of the credit department) may join us. But the credit team has done so much over the past year such that we now leave the head office structure and go out to meet with our clients in order to understand their business, their financial needs, to understand the operations of the business and how to us lending to that particular business can fit our lending model. So I may say that there is nothing better than seeing the actual business than reading the actual business plan. By going out there partnering with our clients, it help us to understand our clients businesses, the industry and the risk involve.

THANK YOU FOR YOUR INPUT AND TIME

ANNEXURE E: REQUEST TO CONDUCT RESEARCH



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08 June 2018

To whom it may concern

Permission to conduct PhD research on “an analysis of the availability of and access to credit from the formal financial sector and the performance of SMEs in South Africa”

My name is Francis Tangwo Asah. I am a PhD candidate in the Department of Management at Rhodes University, Grahamstown South Africa under the supervision of Professor Lynette Louw. My research is entitled “An analysis of the availability of and access to credit from the formal financial sector and the performance of SMEs in South Africa”. The aim of this research is to gain an in-depth understanding on the availability of and access to credit from the formal financial sector and how access to credit impact on the performance of SMEs.

The interview will require about 50 minutes to complete. During the interview, participants will have the opportunity of responding to questions pertaining to factors affecting credit lending, challenges and willingness of formal financial sector in lending to SMEs in South Africa.

This research study has been approved by the Rhodes University Higher Degree Committee and the ethics application approved by the Rhodes University Ethics Standards Committee. Participants will be accorded the respect and dignity that is due to them. To achieve this, the researcher will adhere to the principles of respect and dignity, transparency and honesty, accountability and responsibility, integrity and academic professionalism as iterated in the Rhodes University Ethical Standards Handbook.

In addition, participation in this research study is completely voluntary and should any of your business and credit managers choose to participate in this research study, they will be required to complete a written consent form at the beginning of the interview process. Participants will also be accorded the right to withdraw from the study at any given time without penalty. The name of your institution and the individual participants from your institution will be treated as being anonymous. The name of your organisation will not appear in any published or distributed materials. The information will only be used for academic research purposes. It is important to note that the final approval from the Rhodes University Human Ethics Standards Committee is based on your approval for me to conduct the interviews. A written report summarising the research findings will be provided to your institution for internal use, should it be required, after the study has been completed.

I will be very grateful if my request is given due consideration. Please could you append your signature and /or official stamp at the bottom of this letter and indicate your approval choice.

Yours sincerely,

Handwritten signature of L. Louw in blue ink, with a horizontal line underneath.

FTAsah

Research Student
Approved (Bank)

Professor Lynette Louw
Supervisor

Signature:
Approved / Not

ANNEXURE F₁: APPROVAL LETTER FROM BANKS

REMOVED

ANNEXURE F₂: APPROVAL LETTER FROM BANKS

REMOVED

ANNEXURE F₃: APPROVAL LETTER FROM BANKS

REMOVED

ANNEXURE F4: APPROVAL LETTER FROM BANKS

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ANNEXURE F5: APPROVAL LETTER FROM BANKS

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ANNEXURE F: APPROVAL LETTER FROM BANKS

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ANNEXURE F7: APPROVAL LETTER FROM BANKS

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ANNEXURE F8: APPROVAL LETTER FROM BANKS

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ANNEXURE G: INFORMED CONSENT FORM



RHODES UNIVERSITY

INFORMED CONSENT FORM

Department of Management

Research Project Title:	AN ANALYSIS OF THE AVAILABILITY OF AND ACCESS TO CREDIT FROM THE FORMAL FINANCIAL SECTOR AND THE PERFORMANCE OF SMEs IN SOUTH AFRICA
Principal Investigator(s):	FRANCIS TANGWO ASAH

Participation Information

- I understand the purpose of the research study and my involvement in it
- I understand the risks of participating in this research study
- I understand the benefits of participating in this research study
- I understand that I may withdraw from the research study at any stage without any penalty
- I understand that participation in this study is done on a voluntary basis
- I understand that while information gained during the study may be published, I will not be identified and my personal results will remain confidential
- I understand that I will receive no payment for participating in this study
- Rich and thick verbatim descriptions of participants' explanations will be provided to support the research findings.
- Participant validation: Participants will be asked to comment on the interview transcript to check whether it accurately reflects their views.
- Participants will be accorded the complete respect and dignity that is due to them.

Information Explanation

The above information was explained to me by: _____

The above information was explained to me in: English Afrikaans isiXhosa
isiZulu

Other: French

and I am in command of this language

OR, it was comprehensibly translated to me by: _____

Voluntary Consent

I hereby voluntarily consent to participate in the above-mentioned research.

Signature:

OR, right hand thumb print



Witness signature:

Date: / /

Investigator Declaration

I, _____, declare that I have explained all the participant information to the participant and have truthfully answered all questions ask me by the participant.

Signature:

Date: / /

ANNEXURE H: BOX PLOT

