

Enhancing Access to External Finance for New Micro- enterprises in South Africa

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ABSTRACT New micro- enterprises are of significant importance to employment creation, poverty alleviation and the economic growth of South Africa. However, the failure rate of new micro- enterprises in South Africa is very high. The study investigated access to external finance by new micro- enterprises in South Africa. Data was collected through the use of self-administered questionnaires in a survey. Because of the difficulty in obtaining the population of micro-enterprises in the study area, convenience sampling and the snowball sampling methods were used. Descriptive statistics was used for data analysis. The results indicated that micro-enterprises encounter difficulties in accessing debt and equity finance. In addition, the awareness of government assistance programmes by the owners of micro-enterprises is limited. Recommendations to improve the access to external finance by micro-enterprises are suggested.

INTRODUCTION

Small and medium and micro-enterprises (SMMEs) are increasingly seen as playing an important role in the economies of many countries. Micro, very small and small enterprises contribute between 27- 34% of the Gross Domestic Product and 72% of all jobs in South Africa (Department of Trade and Industry 2008). South Africa suffers from high unemployment with an official unemployment rate of estimate of 24.7% (Statistics South Africa 2013). One of the best ways to address unemployment is to leverage the employment creation potential of SMMEs (FinMark Trust 2006). Rolfe et al. (2010) observe that micro- enterprise activity (especially in retail trade) is the most pervasive entrepreneurial activity in the informal sector of Africa. According to Timm (2011), the total number of small businesses in South Africa in 2006 was 2.4m. Informal businesses mainly micro-enterprises were 1.4m. SMMEs in South Africa suffer from a high failure rate. According to Ligthelm (2011), 75% of new SMMEs created in South Africa fail within the first two years of operation. Adcorp (2012) reveals that around 440,000 small businesses have closed in the last five years in South Africa. According to Arko-Achemfour (2012), access to finance is a major problem for the South African entrepreneur. A lack of financial support is the second most reported contributor to the failure of small businesses after education and training in South

Africa. There have been many attempts by debt and equity providers to improve access to external finance by the SMME sector. Commercial banks in South Africa have lending criteria to assist the small businesses on their websites. In addition, there are various government financial and non-financial assistance programmes for SMMEs. Therefore, it will be of significance to investigate the extent of accessibility to external finance by micro- enterprises that are often regarded as the smallest end (by size) of the small business sector (Munoz 2010).

Objectives of the Study

Efforts have been made by debt and equity providers and government to improve access to finance to the small business sector in South Africa. The primary objective of the study is to investigate the extent of accessibility to external finance by new micro-enterprises. In addition, the study will examine the level of awareness by the owners of new micro- enterprises of government agencies that provide financial and non-financial services to the small business sector.

Literature Review

Atieno (2009) observes that access to external finance is needed to reduce the impact of cash flow problems for new SMMEs. Financing is needed for new firms to start and expand op-

erations, develop new products, invest in new staff or production facilities. New SMMEs without access to credit are more vulnerable to external shocks. The availability of finance for investment in positive net present value projects is vital to the sustainability and viability of new SMMEs. A vast majority of new SMMEs depend on internal finance (contribution from the owners, family and friends). Internal finance is often inadequate for new SMMEs to survive and grow. Furthermore, most new SMEs have little or no retained earnings because of their newness in the market.

Carpenter and Petersen (2002) investigate the relationship between dependence on internal finance and the growth of new SMMEs. They find that growth of new SMMEs is constrained by dependence on internal finance. In contrast, firms that make use of external funds exhibit growth rates far above what can be supported by internal finance. Fiercer competition in the light of globalization trends, rapid technological development, shorter product cycles, and innovation requirements has put pressure on new SMEs to increase and speed up their development investments. It is, however, increasingly difficult to keep the costs within the constraints of self-financing. Therefore new micro-enterprises need capital from external sources. According to Demircuc-Kunt et al. (2006) the two primary sources of external finance for new SMMEs are equity and debt. Gitman (2010) defines capital structure as the mix of debt and equity that a firm uses to finance its operations. Theories on inaccessibility to external finance by new micro-enterprises include the Agency theory by Jensen and Meckling (1976) and the Pecking Order theory (POT) by Myers (1984). According to Jensen and Meckling (1976), agency problems such as asymmetric information and moral hazards can impact on the availability of credit to new micro-enterprises. Myers (1984) argues that management has a preference to choose internal financing before external financing. When a firm is forced to use external financing sources, managers select the least risky and demanding source first. When it is necessary to issue external sources, debt issuance is preferred to new equity. POT postulates that the cost of financing increases with asymmetric information. This can negatively impact on the ability of new micro-enterprises to raise external finance. Stiglitz and Weiss (1981) agree that agency prob-

lems such as asymmetric information and moral hazards can impact on the availability of credit and hence the capital structure of new micro-enterprises.

The importance of capital structure decisions is evident from the role of inadequate capitalization in the high failure rate among new SMMEs. Inappropriate capitalization can threaten the financial viability of a new SMME (Ahmed and Chowdhury 2009). Access to debt and equity markets is a major challenge for SMMEs. External equity in the form of venture capital, business angel or the stock exchange is usually not available to new SMMEs. According to the South African Venture Capital Association (2008), there are at least 65 venture capital funds in South Africa controlling a total of R29 billion with an average investment size of R15.4 million. However, new venture investment with a SMME focus is approximately R1.1 billion which is only 3.8% of the funds. Blumberg and Letterie (2008) agree that the lack of venture capital funds makes many new SMMEs dependent on bank loans, overdrafts and suppliers credit for early-stage financing.

Rogerson (2008) points out that the role of private banks in addressing the credit needs of SMEs is a major area for concern for policy makers. The Department of Business Innovation and Skills (2013) explains that the failure of commercial banks to serve the low-income market makes government intervention necessary. Market failures provide the rationale for Government intervention in SMME finance markets. There are a number of structural market failures affecting the supply of both debt and equity finance to SMMEs. This leads to some potentially viable businesses being refused finance, which is sub-optimal for economic growth.

In South Africa, there are a number of government agencies with the mandate of providing financial and non-finance assistance to SMMEs. At the national level, the Small Enterprise Finance Agency (SEFA) was established in 2012 to provide access to finance with support in an efficient and sustainable manner to survivalist, micro, small and medium enterprises throughout South Africa by delivering wholesale and direct lending, providing credit guarantees to SMMEs and developing, through partnerships, innovative finance products, tools and channels to catalyse increased market participation in the provision of affordable finance (SEFA

2013). The Small Enterprise Development Agency (SEDA) was established in 2004 to provide business development and support services for small enterprises through its national network in partnership with other role players in the small enterprise support (SEDA 2013). At the provincial level, there are agencies such as The Gauteng Enterprise Propeller (GEP) with the mandate to provide development finance to SMMEs in order to stimulate the growth and development of the Limpopo economy (Gauteng Enterprise Propeller 2013).

RESEARCH METHODOLOGY

The survey was conducted at the Johannesburg Central Business District in the Gauteng province of South Africa. The empirical approach consists of data collection through the use of self-administered questionnaire in a survey. Maas and Herrington (2006) observe that the creation of a new small firm is a two-stage process. The first phase is the start-up phase, a three month period during which individuals identify the products or services that the firm will trade in, access resources and put in place the necessary infrastructure such as staff. The next phase, a period of 3-42 months, is when the small firm begins to trade and compete with other firms in the market place. Therefore, a new micro- enterprise can be described as a business that has been in existence for a period not longer than forty- two months. Once a firm has successfully existed for more than 42 months, it becomes an established firm. The focus of the study is on new micro-enterprises in the retail sector. These are enterprises that have been in existence for 42 months or less and employ less than five employees. The number of employees is one of the quantitative determiners of SMMEs in South Africa (Parliament of the Republic of South Africa 1995). Because of the difficulty in obtaining the population of micro-enterprises in the study area, convenience sampling and the snowball sampling methods were used. According to Cooper and Schindler (2006), convenience sampling is a non-probability sampling technique where subjects are selected because of their convenient accessibility and proximity to the researcher. Snowball sampling method is a non-probability sampling technique where existing study subjects recruit future subjects from among their acquaintances. The use of conve-

nience sampling is consistent with previous empirical studies on micro and small enterprises in South Africa such as Farrington and Matchaba-Hove (2011) and Arko-Achemfuor (2012). A pilot study was conducted on the survey instrument used in this research with twelve owners of new micro-enterprises in the retail sector in order to ensure face and content validity. The pilot study led to some modifications to the questionnaire. Owners were assured of confidentiality with regard to the data collected. Data collection was done with the assistance of two trained field agents. The questionnaires were given to the owners of the micro-enterprises to complete.

RESULTS AND DISCUSSION

Response Rate and Biographical Information

96 questionnaires were distributed to the owners of new micro-enterprises in the retail stores in the study area and 46 questionnaires were returned after repeated phone calls and visits. The response rate was 47.9%. 44 respondents were sole proprietors and two partnerships. 29 respondents were males and 17 were females. 24 respondents have post-matric qualifications, 22 respondents have Matric or below. 5 respondents have no employee, 22 have one employee, 18 have two employees and 1 has three employees.

Need for External Debt Capital

Out of 46 respondents, 39 respondents are in need of external debt capital and 7 respondents do not need external capital. It can be concluded that most of the respondents are in need of external capital. Zhou and Chen (2008) identify that SMMEs need financial resources to take advantage of business opportunities. According to Winton and Yerramilli (2008), to establish and sustain a new SMME, the entrepreneur needs to have access to different types of resources (i) human capital; (ii) physical capital; and (iii) financial capital, each playing different, but equally important roles during the life cycle of a new SMME. Atieno (2009) observe that access to external finance is needed to reduce the impact of cash flow problems for SMMEs. Financing is needed for new micro-enterprises to start and expand operations, develop new products, invest in new staff or production facilities. Carpenter and Petersen (2002) investigate the relationship between dependence on internal fi-

nance and the growth of new SMMEs. They find that growth of new SMMEs is constrained by dependence on internal finance. In contrast, enterprises that make use of external funds exhibit growth rates far above what can be supported by internal finance. Therefore new micro-enterprises in the retail sector need capital from external sources.

Access to External Debt Capital

Out of the 39 respondents in need of external debt capital, 18 applied for debt capital from commercial banks and 21 did not apply. Unwillingness to apply for external debt capital by the owners of new micro-enterprises suggests a level of discouragement. Kon and Storey (2003), in the discouraged borrowers' theory define discouraged borrowers as good borrowers who do not apply for a bank loan because they feel they will be rejected. Out of the 18 that applied, 3 obtained credit from commercial banks. In addition, 22 respondents obtained trade credit. The three most cited reason for the rejection of credit application by commercial banks are lack of collateral, inadequate owners contribution, poor business plan and a bad credit record. The results indicate that access to external debt capital is limited for micro-enterprises. The results are consistent with previous empirical studies such Mutezo (2005) and Beck (2007) that SMMEs often report a widespread shortage of external finance.

Access to External Equity

The 46 respondents were asked about access to venture capitalists and business angels. No respondent has access to venture capital and two respondents have access to business angel funds. The results indicate that the use of external equity by new micro-enterprises is extremely limited. Shane (2008) contends that venture capital provided only a small proportion of the equity funding for SMEs. Venture capital funds are not interested in providing the small amounts of funding sought by many new SMMEs.

Awareness of Government Agencies that Provide Financial and Non-financial Assistance to SMMEs

The 46 respondents were asked about the awareness of government agencies that provide

assistance to small businesses at the national and provincial levels. 13 respondents indicate that they are aware of SEFA, 13 respondents indicate that they are aware of SEDA, 8 respondents indicate that they are aware of the Gauteng Enterprise Propeller. The results indicate that the awareness of government agencies that provide financial and non-financial assistance to SMMEs is limited. This can further perpetuate inaccessibility to external finance by micro-enterprises.

CONCLUSION

Micro-enterprises are very important to the reduction of unemployment, income inequality and the stimulation of economic growth in South Africa. These enterprises suffer from a high failure rate. Efforts have been made by debt and equity providers and government to improve access to finance to the small business sector in South Africa. The primary objective of the study was to investigate the extent of accessibility to external finance by new micro-enterprises. In addition, the study examined the level of awareness by the owners of new micro-enterprises of government agencies that provide financial and non-financial services to the small business sector. The results show high level of inaccessibility to external capital by micro-enterprises. Access to both debt and equity markets is limited for micro-enterprises. In addition, the awareness of government assistance programmes is limited for micro-enterprises.

RECOMMENDATIONS

Lack of collateral is the most important reason why credit is not available to new SMMEs from commercial banks. Training and communication on the requirements of banks and trade creditors can help to make new SMME owners to get investment ready and thus improve the availability of debt. Commercial banks can create awareness of their funding requirements especially the importance of collateral through advertisements and communication with micro-enterprises. The websites of the big four commercial banks have addressed business plan preparation by new SMEs. However, it is important to provide awareness to new SMEs that such facilities exist. Innovative lending policies adopted by commercial banks need to be ex-

tended to micro-enterprises. The new approach to screening and risk evaluation of loan applicants adopted by commercial banks for lending utilizes a proprietary psychometric testing process that incorporates an entrepreneur's attitude and outlook, ability, business acumen and character to measure risk and future entrepreneurial potential. In addition, commercial banks can create awareness of the new lending approach.

Government agencies can also assist in making the owners of micro-enterprises investment ready through training. In addition, government and its agencies have, over the years, expended significant resources creating and implementing market interventions. It is vital that these interventions are effective and meet the needs of those they declare to support. It is therefore incumbent on government agencies to ensure that these schemes, such as the credit guarantee scheme and non-financial services that can improve access to finance are well publicised and available to new micro-enterprises. Organisations responsible for SMMEs in South Africa such as SEDA and SEFA should have well trained field agents to visit and train owners of micro-enterprises on a regular basis on the various financial and non-financial assistance programmes available. This will significantly improve the level of awareness of the various government programmes.

There is the need for personal development by the owners of new micro-enterprises especially in the area of business and financial management skills through training. Owners of new micro-enterprises have to take greater responsibility for their own learning. Therefore, they need to create a positive attitude towards getting the necessary information about the requirements for funding by debt and equity providers. In addition, owners of new micro-enterprises need to be aware of government financial and non-financial programmes that can assist them to access finance. Joining trade associations can improve the flow of information to micro-enterprises.

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