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The Relationship between Small, Medium and Micro Enterprises And Financial Institutions in Limpopo Province, South Africa

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ABSTRACT The importance of SMMEs to the South African economy has been acknowledged by government. Yet, extensive research reveals that access to financing is one of several important factors that are critical for business survival and growth. SMMEs in the Limpopo Province are currently experiencing their worst liquidity crisis in decades. SMMEs have been stereotyped as a credit risk by financial institutions. This paper draws attention to the key role played by financial institutions in providing credit to SMMEs in Limpopo Province. It evaluates the key constraints that hinder local SMMEs from securing capital and recommends a basic SMME financial model that could be applied by local financial institutions. The purpose is to assist financial institutions to apply appropriate financial application processes and move away from "one-size-fits-all" application criteria. Using a qualitative design, this study employed a case study method. Purposive and convenience sampling techniques were used to select two hundred SMMEs in the Limpopo Province as key informants. Eight financial institutions also participated in the study. The study identified numerous possible interventions to narrow the widening "financing gap" in the SMME sector in the Limpopo Province. Financial institutions should be encouraged by means of incentives provided by these spheres of government to invest in small businesses, create a pro-SMME investment climate, develop distinct financing products for SMMEs and provides SMMEs with sound financial education.

INTRODUCTION

Worldwide, SMMEs contribute significantly to job creation, social stability and economic welfare (Netshandama 2014). The South African government has prioritised SMME development to address high levels of unemployment. The national unemployment rate, currently estimated at 28.4 percent (Limpopo Economic Development Agency 2014), increasing at an alarming rate. SMMEs generate 34.8 present of Gross Domestic Product (GDP), contribute 42.7 percent of the total value of salaries and wages paid in South Africa, and employ 54.5 percent of all formal private sector employees (Edwards 2015). The gap between the high and low income groups is increasing over time. Small businesses and entrepreneurship development can bridge this gap. This paper focuses on the valuable role financial institutions play in providing finance to SMMEs. It identifies important constraints faced by local SMMEs in Limpopo Province in unlocking vital credit from the local capital borrowing market. Development scholars agree that improving access to business finance can single-handedly drive small enterprise viability, growth and long term sustainability (The Economic Development Department 2014). According to Netshandama (2014), a thriving SMME sector in an emerging market requires a tailor-made financing framework that caters to its specific financial needs and complexities. This study profiles the challenges faced by owners of SMMEs in Limpopo Province in securing business finance. The paper aims to determine the various financial needs of SMMEs based in the Limpopo Province; assess the role of local financial institutions in improving the financial and operating leverage of local SMMEs; and provide guidelines to improve access to financial institutions. Finally, the paper explores various ways in which government institutions in Limpopo Province can assist financial institutions to bridge the inherent business financing gaps that SMMEs are experiencing (The Banking Association of South Africa 2013).

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Purpose of the Study

It is critical for SMMEs to receive financing to establish and expand their operations, develop new products, and invest in new staff and production or service facilitates. A conducive climate for the funding of SMMEs in emerging markets like Limpopo Province is of critical importance for the success of these businesses. Furthermore, the general view in South Africa is that the relationship between SMMEs and financial institutions has never been healthy. The Limpopo Economic Development Agency Report (2014) reaffirms the long held view that a lack of business finance is a stumbling block in building thriving and resilient SMMEs in South Africa. The report highlights that unlocking vital investment finance streams to SMMEs at favourable market related rates has the potential to:

- Single-handedly enhance the sector's viability and future sustainability,
- Substantially increase the liquidity of this sector,
- Improve capacity utilisation and the job absorption abilities of the SMME sector,
- Facilitate the acquisition of breakthrough technology and ICT facilities,
- Drastically improve the work capital modelling framework of the sector, and
- Significantly drive the sector's competitiveness on the local, national and international front.

According to the National Empowerment Fund (2014), SMMEs are prolific job creators, plant the seeds of big businesses, and are the drivers of economic growth and catalysts for wealth and redistribution in the economy. The question of SMMEs' access to business finance should therefore be discussed in the context of the pivotal role these businesses play in driving job creation and economic growth in local economies. Addressing the funding issues that hinder the growth of local SMMEs could have a long term, positive bearing on the socio-economic conditions of local communities in the Limpopo Province (Economic Development Agency Report 2014).

Problem Investigated

The problem investigated was the lack of start-up capital and finance in general provided to SMMEs by financial institutions in the Limpopo Province Economic Development Agency Report (2014). The study aimed to investigate, identify and describe the challenges impeding access to financial management support services by SMMEs. Most surveys of small enterprises have found that concessionary finance is the most urgent need. On the other hand, access to financing is one of several important factors that are critical for business survival and growth, the others being market access and financial management skills. SMMEs based in the Limpopo Province have been subjected to decades of marginalisation by financial institutions. The reports show that 40 percent of local financial institutions are passive actors in financing SMMEs. Furthermore, the available evidence points to the fact that many banks still require SMMEs to meet the same stringent lending criteria as large companies. There is a tendency for financial institutions in Polokwane to apply a "one-size-fits all" approach when processing SMMEs' loan applications (National Empowerment Fund 2014). One of the aims of the study was to identify and rank the constraints facing SMMEs in securing critical business start-up or expansionary finance from existing financial institutions in the Limpopo Province. The study sought to evaluate the key constraints that hinder local SMMEs from acquiring finance from financial institutions (Netshandama 2014). The ultimate aim is to design SMMEs finance criteria that can be applied by local financial institutions. This will hopefully lead to financial institutions moving away from the current approach of "one size fits all "application criteria. The intention is to design an appropriate application format that will accommodate SMMEs' needs (Economic Development Agency Report 2014):

Arising from the above problem, this paper poses the following questions:

- What are the pressing financial needs of SMMEs based in the Limpopo Province?
- What are the major constraints faced by SMMEs in sourcing business finance from financial institutions?
- Can interventions be made to narrow the widening "financing gap" between SMMEs and financial institutions?
- What realistic measures can be adopted to improve the financing framework of SMMEs in Limpopo Province?

Definition and Explanation of Terms

A common understanding of the concepts used in this study is central to situating them in the context of the meanings they are assigned. The following concepts are thus defined:

Enterprise

Masson (2015) define an enterprise as any concern whose primary motive is to make profit and increase the owner's wealth, rather than merely the employment of oneself or other people. An enterprise is interchangeably used with a firm or a company and therefore has the connotation of an organisation. In this study, an enterprise represents an organisation engaged in the trade of goods and services to the customer with the principal objective of extracting profits.

Small Medium and Micro Enterprises (SMMEs)

Small, micro and medium scale enterprises are defined as follows:

Micro-Enterprises

Micro-enterprises are very small businesses often involving the owner, some family member(s), and at most one or two paid employees (Montague et al. 2014). They usually lack formality in terms of business licenses, value added tax (VAT) registration, formal business premises, and operating permits and accounting procedures. Most have a limited capital base and rudimentary technical or business skills amongst operators. However, micro-enterprises differ widely depending on the particular sector, the growth phase of the business and access to relevant support (Schroeder 2014).

Small Enterprises

These constitute the bulk of established businesses, with employment ranging between five and 50. Such enterprises are usually owner-managed or directly controlled by the owner community. They are likely to operate from business or industrial premises, be registered for tax and meet formal registration requirements. Classification in terms of assets and turnover is difficult given the wide differences in various business sectors like retailing, manufacturing, professional services and construction (Zhong and Zhang 2015).

Medium Enterprises

Medium enterprises constitute a category difficult to demonstrate vis-a-vis the "small" and "big" business categories. These enterprises are also mainly owner/manager controlled, although the shareholding or community control base could be more complex. Employment ranges from 50 to 200 and capital assets (excluding property) of about R5 million are often seen as the upper limit (Uggla 2014).

Debt Finance

Eric and Chong (2015) note that debt finance is a form of financing where a firm raises money for working capital or capital expenditure by selling bonds, bills, or notes to individual and/or institutional investors. In this study it is used in a restricted sense to mean a commercial loan which is a debt-based funding arrangement that a business sets up with a financial institution. Debt finance is often used in business finance due to expensive upfront costs and regulation related hurdles that make it difficult for smaller businesses to have direct access to the debt and equity markets for financing purposes.

Literature Review

Economic Value of SMMEs in South Africa

The SMME sector is growing in stature, size and significance in the South African economy. It is forecast that, in the next 20 years, this sector will be a substantial contributor to Gross Domestic Product (GDP) (Economic Development Agency Report 2014). Emerging businesses play a key role in addressing the socio-economic ills of unemployment, income inequalities and poverty in South Africa (Oliver 2013). Generally the development of SMMEs is seen as accelerating the achievement of broader economic and socio-economic objectives, including poverty reduction (Basu 2014). Although economists differ in their opinions on the quality of SMMEs' net contribution to economic growth in South Africa, they concur that SMMEs play a key stabilization role in the economy. Zhong and Zhang (2015) observes that black-owned retails shops are emerging as the main source of employment for the urban black population. SMMEs are prolific job creators, plant the seeds of big businesses and are indeed the fuel for South Africa's economic growth engine. Lam et al. (2015) notes that, South Africa's unemployment rate of 24, 3 percent is stubbornly high and one of the worst in the world. SMMEs' contribution to job creation can therefore not be overemphasized. SMMEs provide 66 percent of all jobs in South Africa. This sector contributes between 52 and 57 percent of the nation's GDP. The Economic Development Agency Report (2014) estimates that 71 percent of all private enterprises in South Africa fall into the SMME category. More than 82 percent of South African businesses are in the SMME sector. The report also reveals that 42 percent of the total value of salaries paid to employees emanates from this sector. These statistics support the notion that the SMME sector is the lifeblood of the South African economy. The goal of any firm is to reduce and contain risks in such a way that it maximises shareholder value and profits. Sixty percent of SMME operators in South Africa face the dilemma of how to find a winning strategy to maximise returns on their assets. It would seem that SMMEs in South Africa are in dire need of financial management guidance.

Their survival rate is thus lower than that of larger companies. It is estimated that between 70 and 80 percent of SMMEs suffer business failure. Limpopo Economic Development Agency (2014) confirms that manufacturing firms in South Africa that employ fewer than 20 employees are five times more likely to fail in a given year than larger firms. All these factors make SMMEs unattractive to financial institutions in Polokwane.

SMMEs and Debt Financing Trends

The financing of SMMEs in South Africa is at an alarmingly low rate. This is an indication that the country's SMMEs do not readily make use of debt finance. For example, in the 2012 financial year, Lam et al. (2015) reported that only 2 percent of new SMMEs in South Africa made use of debt finance. While the low participation of SMMEs in the debt market is not new, no reforms are being put forward by financial institutions to remove known and perceived market entry barriers. The unanswered question remains: With 90 percent of the global economy now firmly in the hands and control of SMMEs, will the continued non-financing of SMMEs by South African financial institutions adversely affect their survival? The appetite for debt finance as a viable financing option is relatively weak in the SMME sector compared to large companies. Basu (2014) observe that due to banks' stringent documentation requirements, SMMEs are increasingly looking elsewhere for funding. Economic Development Agency Report (2014) confirmed that private savings, which include family and individual savings and retained earnings from a previous business, are the principal source of business finance in South Africa. Family savings are used by 29 percent of firms as their main source of investment capital, while 19 percent of firms use this source for all their financing needs. Individual savings are used by 49 percent of firms as their main source of investment capital and 32 percent use them for all financing. Finally, retained earnings from a previous business are used by 10 percent of firms as their main source of investment capital, while 6 percent use them for all financing. However, in a situation of growing unemployment and poverty coupled with dwindling household savings, this source of business finance will necessarily diminish (Schroeder 2014).

RESEARCH METHODOLOGY

This research study evaluated a mix of qualitative and quantitative data sources. A total of 2000 SMME owner-managers participated in the study. Participating SMMEs were drawn from different economic sectors in the Limpopo Province. Eight senior representatives from selected local banks and Development Financial Institutions (DFIs) also participated as key informants. Three factors shaped the decision to select a qualitative approach (Guercini 2014). Firstly, in the Limpopo Province, SMMEs financing issues occur in an environment where the relationship between formal banks and SMMEs is historically perceived to be unfriendly. Secondly, local SMME financing trends are not well known and documented. Finally, local SMME financing models are not harmonised and integrated across the local financial industry. A qualitative approach enabled a deeper understanding of local SMMEs' financing dynamics in the context of the local financial sector. Edwards (2015) confirms that the qualitative method helps a researcher to understand a phenomenon from the point of view of the research participants and its particular social and institutional context.

Population and Sample Size

Apart from owner-managers of SMME businesses, senior managers of financial institutions based in the Limpopo Province area also constituted the sample frame. The population of the study comprised all SMMEs in Limpopo Province that directly or indirectly made use of SEDA services during the 2010-2011 financial years. According to the Banking Association of South Africa (2013) database, 420 such enterprises approached the Agency for Business Development Support Services which included assistance with access to finance. The sample frame was derived from the records of the Database and Customer Records Management (CRM) system at SEDA's Limpopo Province Office. Of an estimated population of 420 SMMEs, 21 percent finally participated in the study. Non-probability sampling approaches were employed due to the qualitative nature of the study. Two non-probability sampling methods were used. According to Hair et al. (2014) a purposive sampling method is imperative in studies that require the researcher to leverage his or her own personal experience, tuition and judgement to select study respondents.

Data Collection Methods

As stated earlier, both primary and secondary data were used for this study. Primary data includes events, data collected through surveys, interviews, questionnaires, observations and focus group discussions (Lee 2014). In this study, primary data was obtained using a closed-ended structured questionnaire. The respondents completed the questionnaire either electronically via e-mail or in an interview setting. Secondary data, which represents value-add data gathered from available sources, was collected partly during the literature review process and partly through documentary evidence review processes. In line with conventional research practice, the questionnaire was subjected to a suitability test. This pre-testing process was designed to check ambiguity, subjectivity, and the relevance and applicability of the proposed questions. Three senior employees at a local SMME company were randomly picked to test the suitability of the questionnaire. Feedback on the suitability of the questions was solicited from respondents and appropriate adjustments were effected to make the questionnaire as relevant as possible. Guided by the interview schedule, questionnaires were distributed either electronically or in person to key informants and reference groups (Parker 2014).

Analysis and Validation of Data

Once the data was coded into the computer, the quantitative data was summarized using frequency tables and column graphs. While the quantitate data was subjected to deductive and trend analysis, the qualitative data was analysed inductively and textually. Data was transcribed and coded into the main themes, and further categorised into minor themes for analysis (Eriksson 2013). The data analysis exercise was made possible with the use of the Excel software program. After a draft report had been compiled, a debriefing meeting was convened with all stakeholders. The draft report was circulated to all key informants for further consolidation. Feedback from the debriefing process helped to clarify certain positions and the necessary adjustments and corrections were made to the draft report. The debriefing ensured that an accurate and fair report which reflects the true and accurate views of the study participants was produced. Due to the study's objective framework and context, the study was deemed qualitative in nature and structure. Although there are many qualitative research designs, this study employed a case study. SMMEs which used SEDA's services during the 2010-2013 financial periods were used as case sites. Senior Managers of local banks and DFIs were key informants. Interviews aided by a structured checklist questionnaire were used as key data gathering instruments. The next section unveils the findings of the study in both narrative and statistical format (Guercini 2014).

OBSERVATIONS AND DISCUSSION

The key findings of the study are aligned with the research questions as follows:

Demographic Analysis

Two-thirds of the informants were men while the rest were women (Netshandama 2014). This highlights the shifting historical role of men as breadwinners in a traditional African family. As ''bread winners'' men assume the responsibility of taking care of the family's financial needs. However, this study shows that due to changing family income dynamics, both men and women are increasingly joining the SMME sector (Montague et al. 2014). In families headed by single mothers, women are the key source of income and livelihoods (Edwards 2015). Due to the increase in the number of women-headed families in South Africa, more women are now owners of small businesses (Limpopo Economic Development Agency 2014). The empowerment of women through wealth creation is viewed as a means to liberate historically disadvantaged groups from abject poverty and economic marginalisation. An analysis of the informants' age reveals that youth participation in venture creation initiatives is still emerging (Masson 2015). Thirty three percent of the study respondents were in the 51years age group', while the average age was 44 years. The study therefore shows that a significant proportion of small business owners are ageing. Investment in programs to promote greater youth involvement in venture creation initiatives need to be intensified to absorb more youths into entrepreneurial activities (Limpopo Economic Development Agency 2014).

What are the Pressing Financial Needs of SMMEs Based in the Limpopo Province?

The study found that a lack of finance is a key setback in promoting resilient SMMEs in Limpopo Province and, for that matter, the rest of South Africa. Ninety two percent of the respondents stated that 75 percent of their annual budgets are assigned to operational and administrative overheads. The rest is used for capital expenditure aspects of the business. Due to the weak capital rationing framework, investment in machinery and technology is considered by 75 percent of SMMEs as a non-critical activity. Due to the unavailability of funds, the bulk of available funds are directed to fixed costs like salaries, rent, electricity, water, municipal levies and some business consumables (Kennedy and Avila 2013). The lack of investment in capital items could be one of the reasons why a number of SMMEs produce sub-standard products that have low market appeal (National Empowerment Fund 2014). What are the constraints faced by SMMEs when applying for business finance from local financial institutions?

In their quest to narrow the financing gap, local SMMEs are confronted by countless challenges that can be classified in two broad categories. The first is constraints that can be traced to SMMEs' internal challenges, while the second constitutes supply distortions that are traced to external factors (the borrowing market) that impact on SMMEs. These challenges can be best addressed by reforming financial institutions' unfriendly lending policies and regulations to make them more SMME responsive and sensitive. External constraints impacting on SMMEs in the Limpopo Province. The following supply side constraints were identified by the study (National Empowerment Fund 2014):

- Lack of knowledge of SMME financing dynamics (91 percent)
- The culture of banks demanding that SMMEs comply with stringent lending conditions
- Poor real-time loan processing systems (79 percent)
- Excessive documentation and too much paper work (68 percent)
- Stereotyping SMMEs as high risk and not creditworthy (66 percent)
- Rigorous application processes (60 percent)

Participants rated and ranked the negative implications of each constraint. The following impediments confronting SMMEs in Limpopo Province were identified (Zhong and Zhang 2015): the lack of tailor-made financial products and services for SMME clients (the one-size-fits-all approach by financial institutions); regulatory rigidities or gaps in the legal framework; a lack of information on the part of both the banks and SMMEs; and banks avoiding providing financing to certain types of SMMEs, in particular, start-ups and very young firms that typically lack sufficient collateral, or firms whose activities offer the possibility of high returns but at a substantial risk of loss.

Internal Constraints Affecting SMMEs in the Limpopo Province

While this study acknowledges the existence of insensitive lending conditions that are blamed for alienating small businesses from the formal lending market it must be stated that SMMEs need to put their house in order. While the lending sector has its own weaknesses, the SMME sector needs to do more to improve its creditworthiness (Chung-Fun 2015). These businesses must prove that they are credible and authentic partners to do business with. The following demand-side constraints make the SMME sector unattractive to potential investors and credit providers: in the Limpopo Province SMMEs are infamous for volatile year on year growth patterns and earnings with greater fluctuations than larger companies and the long term success rate of SMMEs is relatively low compared with larger companies in the Limpopo Province. According to the National Empowerment Fund (2014), the success rate of SMMEs in Limpopo Province is a low 22 percent. Furthermore, the SMME sector's owner-manager perspective makes accountability more difficult to enforce; financial institutions often find it difficult to distinguish between the assets of the owner and those of the company (Eric and Chong 2015).

CONCLUSION

SMMEs are one of the primary catalysts of innovation and social transformation. They are thus important assets that should be nurtured and harnessed in South Africa to enable the economy to quickly and effectively adapt to the challenges of globalization and reap its benefits. However, government's efforts to support the SMME sector have so far been dismal. While the Limpopo Provincial Government has acknowledged SMMEs' economic importance, government alone cannot make firms grow and employ staff; it has to make the financial environment more conducive for entrepreneurship by implementing a favourable institutional and regulatory environment. What is needed is a new approach. Although government has put policies and institutions in place with the aim of improving small business owners' access to finance, their success has been minimal. It is there imperative that management capability and financial management acumen be regarded as the key to easy access to funding by both the entrepreneurs themselves, and those supporting and promoting them.

RECOMMENDATIONS

After careful consideration of the above findings, the following recommendations are made:

This study highlighted the casual approach to SMME financing in the Limpopo Province. Fixing the financing problem without addressing other key issues such as skills training,

The relationship between SMMEs and banks in the Limpopo Province has been and is still characterised by mistrust, suspicion and a lack of understanding of how these two sectors can add value to each other's businesses. Eighty six percent of the participating SMMEs revealed that have an uneasy relationship with financial institutions. Due to a huge 'financing gap" (the difference between supply and demand of finance) in the SMME sector, a number of SMMEs in the Limpopo Province are facing serious cash flow problems. The study also determined that productive capacity in the SMME sector is at its lowest in years due to poor financial and operating leverage. Mechanisms to narrow the "financial gap" mainly rely on family and individual savings. The study drew attention to the economic stabilisation role played by SMMEs in the economy of the Limpopo Province. Eighty five percent of the SMME owners confirmed that they have one to five employees, while 17 percent employed between six and 20 people. This underscores the fact that SMMEs are active players in the job market. This makes it extremely important for financial institutions to address the current "financing gaps" in this sector. Current lines of credit available to local SMMEs have been criticised for not being sensitive to their financing needs. Small businesses are a niche market with complex features. It is therefore critical for financial institutions to design a tailor-made model for SMMEs. This view was supported by 91 percent of SMMEs that participated in the study. The majority of SMMEs deploy 87 percent of their budgets to operational and administrative costs. This study found that few small businesses invest in capital items like plant and machinery. Despite their tendency to express negative views on the financing of SMMEs in Polokwane, this study concludes that financial institutions are a credible source of alternative financing for SMMEs. This study has demonstrated that in a developmental state like South Africa, government cannot only play a regulatory function. Local and central government should intervene to secure finance for SMMEs. It is recommended that the financial industry and government join hands to fund efforts to improve SMMEs' financial literacy and intelligence. This would address the financial information gaps and needs of small business. In an increasingly dynamic business world, investment in appropriate technology is no longer a choice but an imperative. This is one way in which the SMME sector can spruce up its ''bad boy image'' in the marketplace. Financial institutions are advised to devise sector-specific financing models for SMMEs. This would address the distinct financing challenges of different economic sectors. Tailor-made financing solutions to best address the challenges confronting SMMEs should be at the centre of the financial sector's strategies. For example, the financial needs of a small business in the manufacturing sector differ significantly from those of a SMME operating in the services sector. Business finance should not be seen as an end in itself, but as a means to achieve the desired long term end result of a successful SMME industry in Limpopo Province and the rest of South Africa. Due to financial and time constraints, the study relied on the views of a relatively small sample of 60 local SMMEs and 8 financial institutions in the Limpopo Province. A study that canvassed the views of a larger number of SMMEs and financial institutions in Limpopo's four municipal districts could have significantly improved the validity and reliability of the findings. It would be ideal to conduct a similar study in all of South Africa's nine provinces. Furthermore, the study failed to capture first-hand experiences and data on large companies in Limpopo Province. Such data would have provided more clarity on why and how the financing of SMMEs and large companies differ in Limpopo Province and would be key to assessing whether financial institutions treat all the sectors in the borrowing market fairly.

FURTHER RESEARCH

The following recommendations are made regarding further research:

- One of the areas this study did not effectively address is the implications of the current lending rate regime for the long term sustainability of SMMEs.
- Further studies to explore the effect of the high cost of capital and associated flotation costs on the technical leverage of SMMEs are urgently required.
- Further research could be conducted by the Limpopo Government using the findings of this study to devise progressive and impact-driven SMME funding models and policies for the province.
- The study could play a catalytic role in motivating the development of an integrated approach to sector-wide SMME capacity building models in the province.
- The study could be used as a basis for further research on the effectiveness of current funding mechanisms by local financial institutions.
- Finally, the study could be used to benchmark similar studies or theoretical work in South Africa's other eight provinces.

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