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THE IMPACT OF THE SOUTH AFRICAN BUSINESS ENVIRONMENT ON THE AVAILABILITY OF DEBT FINANCE TO NEW SMALL AND MEDIUM ENTERPRISES

By

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Submitted in fulfilment of the requirements for the degree of Philosophiae Doctor (Business Management) in the Faculty of Economic and Management Sciences, University of the Free State

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ABSTRACT

South Africa suffers from high unemployment with an official estimate of approximately 24.5% of the economically active population unemployed (Statistics South Africa, 2009). 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. According to Maas & Herrington (2006) the contribution of the SME sector cannot be sustained without the creation of new SMEs. New SMEs are seen as a significant component of the solution to South Africa's development issues. Maas & Herrington (2006) also point out that the creation rate of new SMEs in South Africa, as measured by the Total Early-Stage Entrepreneurial activity is one of the lowest in the world. In addition, the failure rate of new SMEs is one of the highest in the world. Non-availability of finance is one of the primary causes of failure for new SMEs in South Africa. The two major external sources of finance for new SMEs are equity and debt. External equity is generally unavailable for new SMEs in both developed and developing countries. New SMEs in developed countries, unlike developing countries such as South Africa, are able to access debt finance from commercial banks and trade creditors.

The primary objective of this study was to determine how to improve the availability of debt from commercial banks and trade creditors to new SMEs. The argument of this study was that there are factors in the business environment that cause debt not to be available to new SMEs. Understanding the causes of non-availability of debt is important to determining how to improve the availability of debt to new SMEs. For this purpose an initial 52-item questionnaire was developed after a thorough review of the literature on the business environment and debt finance and administered to 100 respondents from commercial banks and 100 respondents that were trade creditors in a pilot study. Exploratory factor analysis resulted in the reduction of 52-item questionnaire to a 43-item questionnaire and nine underlying factors for commercial banks and 39-item questionnaire and nine underlying factors for trade creditors. The nine factors included four internal factors and five external factors. The internal factors were labelled as managerial competencies, collateral, networking and business information. The external factors were labelled the macro-economy, the legal

environment, ethics, crime and corruption. Another objective of the study was to investigate empirically if commercial banks and trade creditors perceive new SMEs as beneficial to their business.

Empirical research was conducted to investigate the impact of the nine factors on non-availability of debt to new SMEs. The instrument used was the self-administered questionnaire. The statistical analyses included descriptive statistics, frequencies, factor analysis, T-test, ANOVA and Pearson correlation. The Cronbach's alpha was used as a measure of reliability.

The research findings were:

- There is a significant positive relationship between lack of managerial competency and non-availability of debt from commercial banks and trade creditors to new SMEs.
- There is a significant positive relationship between lack of business information and non-availability of debt from commercial banks and trade creditors.
- There is a significant positive relationship between lack of collateral and non-availability of debt from commercial banks and an insignificant relationship for trade creditors.
- There is a significant positive relationship between lack of networking and non-availability of debt from commercial banks and trade creditors.
- There is a significant positive relationship between bad macro-economic environment non-availability of debt from commercial banks and trade creditors.
- There is a significant positive relationship between the inefficiency of the legal environment and non-availability of debt from trade creditors and an insignificant relationship for commercial banks.
- There is a significant positive relationship between ethical perception of new SMEs and non-availability of debt from trade creditors and an insignificant relationship for commercial banks.

- There is a significant positive relationship between crime and non-availability of debt from commercial banks and trade creditors.
- There is no significant relationship between corruption and non-availability of debt from commercial banks and trade creditors.
- Commercial banks and trade creditors perceive new SMEs as beneficial to their business.

The findings suggested that there is a significant relationship between the business environment and the availability of debt. Eight out of the nine variables in the business environment have significant relationships with the availability of either bank credit or trade credit. The findings also indicated that are some similarities and differences with respect to why debt is not available to new SMEs from commercial banks and trade creditors. In addition, the findings suggested that internal factors are more important than external factors with respect to why debt is not available from both commercial banks and trade creditors. The study suggested some recommendations to improve the availability of debt finance to new SMEs. The recommendations included the need to improve the investment readiness of new SMEs. To access debt, new SMEs must have collateral and adequate owners' equity. Training and communication can also help new SME owners to get investment ready. In addition, owners of new SMEs should network by attending seminars and trade fairs. The legal system has to be made more efficient in practice to reduce unethical behaviour, crime and corruption.

DECLARATION

I, the undersigned, Fatoki Olawale Olufunso, hereby declare that the thesis is my own original work and that it has not been submitted, and will not be presented at any other University for a similar or any other degree award.

....

Signature

25/07/2010
....

Date

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GLOSSARY OF TERMS AND ABBREVIATIONS

SMEs: Small and medium enterprises

GEM: Global Entrepreneurship Monitor

TEA: Total early-stage entrepreneurial activity

ABSA: Amalgamated Bank of South Africa

FNB: First National Bank

NEPAD: The New Partnership for Africa's Development

HDI: Human development index

GDP: Gross domestic product

GEAR: Growth Employment and Redistribution Strategy

OECD: Organisation for Economic Cooperation and Development

AsgiSA: Accelerated and Shared Growth Initiative South Africa

CHAPTER ONE
INTRODUCTION TO THE STUDY

The relative and absolute importance of small and medium enterprises (SMEs) has grown enormously over the last twenty years. This real growth has been matched by the appreciation of their role. What were previously regarded as temporary stepping stones to real business are now recognised as one of the most vital contributors to peoples incomes and to development, however they may be defined" (Hussain, Millman & Matlay, 2008:584).

1.1 INTRODUCTION

This chapter introduces a study that was undertaken to determine how to improve the availability of debt to new small and medium enterprises (SMEs) in the Eastern Cape Province of South Africa. The argument of the study was that there are factors in the business environment (internal and external environments) that cause debt not be available from commercial banks and trade creditors to new SMEs. Understanding the causes of non-availability of debt is important to improving the availability of debt to new SMEs. This chapter presents a broad overview of the study. Specifically, the following areas will be outlined: The background of the problem, the problem statement, the research objectives, the research hypotheses and the significance of the research. This chapter will, in addition, describe the research methodology, the limitations of the study and the layout of the study.

1.2 BACKGROUND OF THE STUDY

Small and medium enterprises are increasingly seen as playing an important role in the economies of many countries. Thus, governments throughout the world focus on the development of the SME sector to promote economic growth. In South Africa, SMEs contribute 56% of private sector employment and 36% of the gross domestic product (Ntsika Enterprise Promotion Agency, 2002). South Africa suffers from high unemployment with an official unemployment rate of estimate of 24.5% (Statistics South Africa, 2009). The country also suffers from rural to urban migration (causing an impoverishment of rural communities) and corporate restructuring leading to the loss of jobs. One of the best ways to address unemployment is to leverage the employment creation potential of small businesses and to promote small business

development (FinMark Trust, 2006). 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 in South Africa (Maas & Herrington, 2006:17). According to the Organisation for Economic Cooperation and Development (hereafter OECD) (2006), SMEs and entrepreneurship are now recognised worldwide to be a key source of dynamism, innovation and flexibility. SMEs are responsible for most net job creation and they make an important contribution to productivity and economic growth.

Gree and Thurnik (2003:243) argue that the contribution of the SME sector cannot be sustained without the creation of new SMEs. A new SME can be described as an SME that has been in existence for less than forty two months. Wong, Ho and Autio (2005:335) point out that Schumpeter in 1934 was one of the earliest economists to argue for new firm creation. According to Schumpeter, new firms are the vital force behind the progress of capitalism. The innovative activity of entrepreneurs feeds a creative ''destruction process'' by causing constant disturbances to an economic system in equilibrium, creating opportunities for economic rent. In adjusting to equilibrium, other innovations are spun-off and more entrepreneurs enter the economic system. New SMEs introduce new products and develop new technologies. As an important source of innovation, new firms bring competitive pressure to bear on established firms. According to Maas and Herrington (2006:19) new SMEs are seen as a significant component of the solution to South Africa's development issues. New business creation is fundamental to the growth of the South African economy and its future socio-political stability. The creation and sustainability of new SMEs are vital to the economic prosperity of South Africa. Without the creation of new SMEs, South Africa risks economic stagnation. Herrington, Kew and Kew (2009:33) in the Global Entrepreneurship Monitor (hereafter GEM), South African Report point out that given the failure of the formal and public sector to absorb the growing number of job seekers in South Africa, increasing attention has focused on entrepreneurship and new firm creation and its potential for contributing to economic growth and job creation.

However, despite the noted contribution of new SMEs, the creation rate of new SMEs in South Africa is one of the lowest in the world. Herrington *et al.* (2009:34) observe that the GEM survey, in which South Africa has participated since 2001, provides useful data on both the

extent and the nature of entrepreneurial activity in South Africa. In 2008, South Africa ranked 23rd out of 43 countries, with a Total Early-Stage Entrepreneurial Activity (TEA) of 7.8% which was below the average rate (10.6%) of all the countries surveyed by GEM. The TEA is a primary measure of new small firm creation used by GEM. South Africa's TEA rate of 7.8% is significantly lower than the average for all efficiency-driven economies (developed countries) (11.4%) as well as the average for all middle to low income countries, where South Africa belongs (13.2%). South Africa's performance in terms of relative position has, since 2001, consistently been below the median and this trend continued in 2008. The 2008 GEM survey confirmed the findings of previous GEM reports, namely that South Africa has lower than expected new firm creation rates. According to the GEM data, a country at South Africa's stage of economic development would be expected to have a TEA rate in the order of 13%, almost double South Africa's TEA rate of 7.8%. South Africa's low new SME creation rate paints a bleak picture of the SME sector's current potential to contribute meaningfully to job creation, economic growth and more equal income distribution.

In addition, 75% of new SMEs created in South Africa fail within the first two years of operation. Von Broembsen, Wood and Herrington (2005:15) state that the probability of a new SME surviving beyond 42 months and becoming an established firm is less likely in South Africa than in any other GEM country sampled in 2005. This is a distinct and adverse feature of South Africa's entrepreneurial sector. This is the converse of the situation in the United States of America and Europe where entrepreneurship has flourished significantly in the past twenty years. Timmons and Spinelli (2007:30) refer to sustainable entrepreneurship as America's secret weapon and argue that the superior position that the United States of America holds in the global economy is due to a high level of entrepreneurship, especially the creation of new SMEs.

Various challenges and impediments prevent the creation of new SMEs as well as cause the high failure rates of new SMEs in South Africa. One of these is the non-availability of formal sector financing. According to Maas and Herrington (2006:18) and Herrington *et al.* (2009:33) access to finance is a major problem for the South African entrepreneur. Lack of financial support is the second most reported contributor to low new firm creation and failure, after education and training, in South Africa. Many entrepreneurs raise the start-up capital from their own or family

savings, which is often inadequate, rather than approaching formal institutions or agencies for external finance.

OECD (2006) observes that new SMEs in developed countries do not report any generalized financing gap. Most of them are able to obtain sufficient credit from banks and other credit institutions. Reitan and Waago (2002) find that commercial banks are the most dominant source of finance for new SMEs in most European countries, financing about 61% of the capital needs of new SMEs. Statistics Canada (2007) points out that there is approximately 82% approval rate by banks for credit applications from new SMEs in Canada. In addition, 45% of new SMEs are able to access trade credit. Banks and trade creditors play a dominant role in the new venture creation process. A study by the Kauffman Foundation (2007) on the capital structure decisions of new SMEs in the United States of America finds that contrary to widely held beliefs that new SMEs rely heavily on funding from family and friends, external debt financing such as bank loans and trade credit are the more common sources of funding for many new SMEs during their first year of operation. This is consistent with the pecking order theory, which expects firms to first use internal equity before moving to debt and external equity. Availability of debt finance (both from banks and trade creditors) is one of the reasons for high levels of entrepreneurship and relatively low failure rate of new SMEs in developed countries.

Beck (2007:405) finds that new SMEs in developing countries, by contrast, report a widespread shortage of external finance. Access to bank and trade credit for new SMEs is very limited in South Africa as well as in other developing countries. This is termed the "finance gap". FinMark Trust (2006) provides evidence that only 2% of new SMEs in South Africa are able to access bank loans and that the use of suppliers' credit by new SMEs is virtually non-existent. In addition, Foxcroft, Wood, Kew, Herrington and Segal (2002) report that 75% of applications for bank credit by new SMEs in South Africa is rejected. Balkenhol and Evans-Klock (2002) put the use of trade credit by new SMEs in South Africa at only 0.2%.

Pretorius and Shaw (2004:223) and Richard (2006) agree that a finance gap exists for new SMEs in South Africa. The two authors argue that the finance gap for new SMEs is caused by their lack of investment readiness. This suggests that the lack of access to finance cannot be placed

squarely at the doors of financial institutions. For instance, ABSA's website notes that *"……Entrepreneurship is the drive behind growth and job creation in this economy; hence, we encourage emerging entrepreneurs towards financial independence"* (ABSA, 2009). The First National Bank's website states that *"Our aim is to see a business grow from a small to medium to a large corporate entity that is sustainable"* (First National Bank, 2009). This suggests that commercial banks are willing to lend to new SMEs that are investment ready.

Despite the assertions by the banks, very few new SMEs get credit from commercial banks and trade creditors especially now that the New National Credit Act has come into effect with the objective of minimizing the granting of reckless credit. According to Smorfitt (2009) new SMEs in South Africa do struggle to raise finance from banks and trade creditors. The question is why? There has been little, if any, in-depth research into why banks and trade creditors are not lining up to grant credit to new SMEs in South Africa. That is the reasons why debt is not available from commercial banks and trade creditors to new SMEs in South Africa. Understanding the reasons why debt is not available will lead to recommendations that will improve the availability of debt to new SMEs. This is the focus of this study.

1.3 RESEARCH PROBLEM

Pretorius and Shaw (2004:223) and Atieno (2009:33) observe that access to external finance is needed to reduce the impact of cash flow problems for new SMEs. Financing is needed for new firms to start and expand operations, develop new products, invest in new staff or production facilities. New SMEs 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 SMEs. A vast majority of new SMEs depend on internal finance (contribution from the owners, family and friends). Internal finance is often in adequate for new SMEs to survive and grow. A large percentage of new SME failure is attributed to inadequate capital structure or resource poverty. Carpenter and Petersen (2002:300) investigate the relationship between dependence on internal finance and the growth of new SMEs. They find that growth of new SMEs 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 SMEs need capital from external sources.

According to Demirguc-Kunt, Maksimovic, Beck and Laeven, (2006:933) the two primary sources of external finance for new SMEs are equity and debt. External equity in the form of venture capital or the stock exchange is usually not available for new SMEs. Venture capitalists often enter the firm at the middle or later stages of its life cycle. Entrepreneurs must thus primarily rely on debt when raising external funds. 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 SMEs. Less than 1% of new SMEs in the United Kingdom have financial input from venture capitalists. Berger and Udell (2002:2130) also find that angel finance (3.6%) and venture capital (1.85%) are minor providers of funding to new SMEs in the United States. In fact, the odds that a new SME in the United States of America will get venture capital money are about 1 in 4,000. 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 SME focus is approximately R1.1 billion which is only 3.8% of the funds. This indicates that the availability of venture capital is limited for new SMEs in both developed and developing countries. The lack of venture capital funds makes many new SMEs dependent on bank loans and overdrafts and suppliers credit for early-stage financing. This is consistent with the pecking order theory of financing by Myers (1984:577) which states that firms will meet investment and financing requirements of the firm in a hierarchical fashion, preferring internal funds first, external debt next and external equity as a last resort.

Blumberg and Letterie (2008:188) agree that the lack of venture capital funds makes many new SMEs dependent on bank loans, overdrafts and suppliers credit for early-stage financing. Despite the dependence of SMEs on debt finance, paradoxically access to debt finance is very limited for new SMEs, especially in developing countries. Commercial banks and trade creditors hesitate to lend to new SMEs. Stiglitz and Weiss (1981:395) refer to this phenomenon as capital rationing.

In the Stiglitz and Weiss formulation, credit rationing is said to occur if (1) among loan applicants who appear to be identical, some receive credit while others do not; or (2) there are identifiable groups in the population that are unable to obtain credit or can only obtain credit at much higher prices. The Stiglitz and Weiss' theory therefore suggests that there are significant numbers of new SMEs that could use funds productively if they were available, but cannot obtain finance from the formal financial system. Capital rationing for SMEs in general has stimulated a great deal of research in South Africa. Rogerson[1] (2008) provides a thorough review of most of the existing studies on SMEs in South Africa focusing on three important themes: (1) finance; (2) training and skills acquisition; and (3) the regulatory environment for SMME development. According to Rogerson (2008:65) the relationship between finance and SME development in South Africa has generated an enormous volume of writings over the past decade. In unpacking this large amount of scholarship several broad themes of work and analysis can be differentiated. First, there is a set of demand-side writings, which focus mainly on tracking the importance of finance, access to finance and the financing requirements of SMEs.

On the demand-side the World Bank (2004) shows that lack of credit is a core business constraint of SMEs and improvement in the investment climate is conditional upon an enhanced access of SMEs to finance. Falkena, Abedian, Von Blottnitz, Coovadia, Davel, Madungandaba, Masilela and Rees (2002*)* make a distinction between the financial needs of traditional white owned SMEs which on the one hand enjoy access to finance, and emerging SMEs from previously disadvantaged communities which represent the biggest challenge to SME development. Angela Motsa and Associates (2004) focus on the financial constraints and needs of informal and formal SMEs. FinMark Trust (2006) provides further insight into the significance of finance and argues that access to finance is a vital issue in SME development.

On the supply-side of financing the key issues of research have been evaluations of the workings of the major players involved in the supply of finance to the SME economy and of assessing the impacts of various financing programmes. FinMark Trust (2006) reveals that banks are currently servicing only the upper end of the small business market with a variety of products. Hawkins

[1] Refer to the study by Rogerson (2008:61-81) entitled "Tracking SMME Development in South Africa: Issues of Finance, Training and the Regulatory environment for a complete synthesis of existing research in South Africa on SME finance.

(2002:520) addresses the failure of commercial banks to serve the low-income market and of potential policy options available to government to stimulate involvement. Initiatives made by banks to enter the SME market have focused on delivering products to established rather than emerging SMEs. Daniels (2004:831) reviews options for government in enticing bank participation in terms of lowering risks, lowering costs and increasing returns. Daniels (2004:835) concludes that if government cannot succeed in encouraging banks to lend to SMEs through market-oriented policy measures, government should make use of non-market-oriented or direct policy measures including the redirection of credit through legislation. Angela Motsa and Associates (2004) highlight that commercial banks are not geared to financing entrepreneurs due to the fact that they developed in an economy dominated by large firms and thus do not have the skills set for assessing start-ups and small enterprises. Furthermore, banks are not able to interact effectively with entrepreneurs because of the quality of communication and the level of understanding of their businesses by bank officials.

Beck (2007:402) argues that the availability of finance to new SMEs can be influenced by both borrower-specific (internal factors) and systemic factors (external factors). Cassar (2004:265) and Barbosa and Moraes (2004) point out that borrower-specific factors include managerial competencies, quality of business information, availability of collateral and networking and other variables largely controllable by a firm. A firm's internal environment represents factors that are largely controllable by the firm. These factors may influence the availability of finance to new SMEs. Furthermore, the scope for optimization that the lender will have in managing lending costs and risks can also be constrained by external or systemic factors (also known as state variables), such as the contractual and informational frameworks, macro-economic environment, social factors (crime, corruption and ethics), technology, the regulatory environment and other characteristics of the business environment in which both the lender and borrower operate. These state variables are not only outside the reach of lenders' actions, but neither can policy makers change them in the short-run. Beck (2007:403) adds that the weaker these state variables are, the less the manoeuvring room for credit supply optimization. Given these constraints, there is the possibility that lenders will not maximize their lending opportunities to SMEs. The internal factors focused on by this study include collateral, business information, managerial competency and networking.

Coco (2000:197) points out that collateral helps to reduce informational asymmetries and moral hazard problems that arise between banks and entrepreneurs. Collateral can be repossessed by the creditor in case of default thus enhancing creditor protection. Barbosa and Moraes (2004) state that the more the business starter invests own money, the less likely it is that he will take on very risky investments. This reduces moral hazard. Blumberg and Letterie (2008:188) argue that collateral helps to reduce informational asymmetries and moral hazard problems that arise between banks and entrepreneurs. Willacy (2009b) points out that if a trade credit customer fails to meet the criteria for lending such as the provision of a business plan and acceptable references, the trade creditor will require the customer to provide collateral security. The presence of collateral positively impacts on the risk perception of a firm. This suggests that lack of collateral positively associates with non-availability of debt to new SMEs.

Kitindi, Magembe and Sethibe (2007:55) remark that creditors, banks and other lenders use business information provided by firms to analyse their present performance and predict future performance. Business information reduces information asymmetry. If an entrepreneur has spent time developing a comprehensive and a priory business plan at an early stage in the project, the risk perception should be reduced and the likelihood of obtaining capital should increase. In addition, potential investors may be more likely to invest in a project if the entrepreneur is investing his own capital (Bollingtoft, Ulhoi, Madsen, & Neergaard, 2003:538). This suggests that lack of business information can lead to non-availability of debt to new SMEs.

Hellriegel, Jackson, Slocum, Staude, Amos, Klopper, Louw and Oosthuizen (2008:5) define managerial competencies as a set of knowledge, skills, behaviors and attitudes that contribute to personal effectiveness. Studies by Shane and Stuart (2002:156) and Rudez and Mihalic (2007:191) positively associate managerial competencies with new venture performance. The higher the level of managerial competency exhibited by the owners of a new firm, the greater the viability and survival of the new SME. This suggests that credit providers may be willing to extend facilities to new SMEs whose owners exhibit a high level of managerial competencies.

Another internal environmental factor that may affect the availability of finance to a new venture is the networking of the owners of new SMEs. Coulthard and Loos (2007) describe networking in a small firm context as an activity in which the entrepreneurially oriented SME owner build and manage personal relationships with particular individuals in their surroundings. Atieno (2009:35) also points out that by utilizing network relationships as an entrepreneurial strategy, a new SME can obtain access to vital resources, capabilities and information resulting in entrepreneurial opportunity. This suggests that lack of networking can lead to non-availability of debt to new SMEs.

External factors are largely uncontrollable by SMEs and lenders. Barbosa and Moraes (2004) point out that macro-economic variables can affect the availability of debt to SMEs. The tightening of money supply has always being one of the classic ways used by monetary authorities to control loanable funds and restricts the availability of debt for all firms. This usually affects SMEs even more. The relaxation of money supply usually has an opposite effect by increasing the supply of loanable funds and the availability of debt to SMEs. Weak economic conditions can affect sales, revenues and profits, as well as the market and growth potential of new SMEs. Bad macro-economic conditions such as a recession in the economy make it difficult for firms to use debt positively and this may affect their ability to repay debt.

Hellriegel *et al.* (2008:171) note that ethics entails the code of moral principles and values that directs the behaviour of an individual or a group in terms of what is right or wrong. Business ethics furthermore defines how a company integrates core values - such as honesty, trust, respect, and fairness into its policies, practices, and decision-making. Lepoutre and Heene (2006:259) find that small firms experience more difficulties than their larger counterparts when engaging in ethically responsible behaviour. The single most unethical practice by small firm professionals is dishonesty in making and keeping contracts. Hannafey (2003:100) points out that new SMEs face significant resource pressure. Thus, liability of newness may lead new SMEs towards more individualist ethical postures. Investors risk perception may be influenced by the extent to which they perceive that they can trust the entrepreneur or entrepreneurial team. The ethical perception of new SMEs by commercial banks and trade creditors may affect their willingness to grant credit to new SMEs.

OECD (2006) shows that market imperfections such as those caused by inefficient legal systems can constrain the ability of firms to access external finance. Firms in countries with more efficient legal systems should therefore obtain more external financing than firms in countries with less efficient legal systems. The World Bank (2003a) reveals a relatively inefficient legal system in South Africa compared to developed countries. There is a shortage of judges and magistrates, backlog of cases and lower creditor protection in practice. This suggests that the inefficient legal system in South Africa could lead to non-availability of debt to new SMEs.

Crime and corruption in South Africa are high and widely believed to restrain investment. The World Bank (2008a) finds that 30% of enterprises in South Africa rate crime as a major or very severe constraint on investment, putting crime amongst the four most frequently mentioned constraints. World Bank (2008a) adds that the South African government routinely lists the high level of crime, particularly violent crime, as an impediment to growth. The costs of crime to businesses in South Africa are substantial. Because of crime, security costs are incurred. Electric fencing, alarm systems, secured parking areas and armed guards, often working around the clock, all add up to extra start-up and operating costs to SMEs. The direct costs associated with security issues are at the median 1.1% of sales, 3% of net value-added and 5% of labour costs. The costs of crime are more severe for SMEs and have limited their entrepreneurial behaviour. Furthermore, the rate of corruption in South Africa is relatively high compared to developed countries (Transparency International, 2008). Crime and corruption may affect repayment of credit granted by banks and trade creditors and their willingness to grant credit to new SMEs.

Sarapaivanich and Kotey (2006:225) observe that until the overall business environment improves it is difficult to expand access to finance to new SMEs and that more fundamental reforms must be instituted to tackle the underlying reasons why SMEs do not fulfil their growth potential. Therefore, it is important to strengthen the overall business environment if an environment that supports new SME creation and survival is to be sustained. Focusing on improving the demand-side variables without solving supply-side variables will only solve one part of the problem. A thorough review of the literature on SME financing shows that no study in South Africa has investigated empirically the impact of the business environment (both internal

and external environmental factors) on the availability of debt finance from the supply-side. This is the primary focus of the study.

In addition, as pointed out by De la Torre, Peria and Schmukler (2008) "*conventional wisdom" argues that the inadequate financing of SMEs is to a significant extent rooted in supply-side factors*. Banks and other financial institutions appear to be uninterested in SMEs. The way in which the financial system works is biased against externally financing SMEs. De la Torre *et al.* (2008) termed this phenomenon the "discrimination hypothesis". Some empirical studies on the lack of access to finance by SMEs in South Africa argue in favour of this concept. For instance, Nigrini and Schoombee (2002:736) and Angela Motsa and Associates (2004) point out that commercial banks are not geared to finance entrepreneurs due to the fact that they developed in an economy dominated by large firms and thus do not have the skills set for assessing start-ups and small enterprises. In addition, the two studies found that new SMEs are risky and have high failure rates. The perceived lack of willingness of banks to deal with the small business sector has led to the market failure theory or government intervention theory.

Reitan and Waago (2002) however argue against the conventional wisdom that banks and other financial institutions are not interested in the SME sector. According to Reitan and Waago (2002) banks and other financial agents are firms whose normal purpose of existence is to maximize the wealth of their shareholders. Banks should, therefore, be willing to deal with SMEs if they (banks) perceive SMEs as firms that can contribute to their profit-maximization objective. In addition, as pointed out by Bbenkele (2007:14), SMEs form about 80% of all enterprises in South Africa and therefore should be of great importance to banks and other financial institutions.

Another focus of this study is to investigate if commercial banks and trade creditors perceive new SMEs as beneficial to their business. De La Torre *et al.* (2008) point out that the benefits of the SME sector can be measured by the profitability, largeness, competitiveness, prospects and strategic importance of the sector to other organisations such as commercial banks and trade creditors. The argument of this study is that though new SMEs are risky and have high failure rates, they can also create business opportunities for commercial banks and trade creditors. This

suggests that the perception of new SMEs by commercial banks and trade creditors is not always about risk but also about benefits or opportunities. Two main issues have been discussed in this section. The first issue relates to the impact of the business environment on the availability of debt from commercial banks and trade creditors to new SMEs. This is the primary research problem and the main investigative part of the study. The second issue (secondary research problem) relates to whether commercial banks and trade creditors perceive new SMEs as beneficial to their business. Therefore, the research problems were:

- What is the impact of the business environment (internal and external environments) on the availability of debt from commercial banks and trade creditors to new SMEs?
- Do commercial banks and trade creditors perceive new SMEs as beneficial to their business?

Providing answers to these research problems will assist in gaining a better understanding of how to improve the availability of debt finance to new SMEs in South Africa. Solving the problem of finance is important to increasing the creation rate of new SMEs and reducing the failure rate of new SMEs in South Africa.

1.3.1 Research objectives

The research objectives of the study were:

- To investigate the impact of the business environment (the internal and the external environments) on the availability of debt from commercial banks and trade creditors to new SMEs.
- To investigate empirically if commercial banks and trade creditors perceive new SMEs as beneficial to their business.

The objectives were achieved through the following secondary objectives.

- To review the literature to determine the creation rate, the failure rate and the causes of failure of new SMEs in South Africa.
- To review the literature to determine if debt finance is available to new SMEs in South Africa.
- To review the literature to determine the business environmental variables that can affect the availability of debt finance to new SMEs in South Africa.

- To investigate empirically the impact of business environmental variables on the availability of debt finance from commercial banks and trade creditors to new SMEs.
- To investigate empirically if commercial banks and trade creditors perceive new SMEs as beneficial to their business.
- To make policy recommendations on how to improve the availability of debt finance to new SMEs in South Africa.1.3.3

1.3.2 Research hypotheses

The primary research hypothesis for the study was:

Ho There is no significant relationship between the business environment and the availability of debt to new SMEs.

Ha There is a significant positive relationship between the business environment and the availability of debt to new SMEs.

The primary hypothesis was established through the following hypotheses, which included the internal, and the external environments (the secondary hypotheses were stated negatively).

- **Internal environment**
  - *Collateral*

H1o There is no significant relationship between the lack of collateral and non-availability of debt to new SMEs.

H1a There is a significant positive relationship between the lack of collateral and non-availability of debt to new SMEs.

- *Business information*

H2o There is no significant relationship between the lack of business information and non-availability of debt to new SMEs.

H2a There is a significant positive relationship between the lack of business information and non-availability of debt to new SMEs.

- *Managerial competency*

H3o There is no significant relationship between the lack of managerial competency and non-availability of debt to new SMEs.

H3a There is a significant positive relationship between the lack of managerial competency and non-availability of debt to new SMEs.

- *Networking*

H4o There is no significant relationship between lack of networking and non-availability of debt to new SMEs.

H4a There is a significant positive relationship between lack of networking and non-availability of debt to new SMEs.

- **External environment**

  - *Macro-economy*

H5o There is no significant relationship between a bad macro-economic environment and non-availability of debt to new SMEs.

H5a There is a significant positive relationship between a bad macro-economic environment and non-availability of debt to new SMEs.

- *Legal system*

H6o There is no significant relationship between the inefficiency of the legal system and non-availability of debt to new SMEs.

H6a There is a significant positive relationship between the inefficiency of the legal system and non-availability of debt to new SMEs.

- *Ethics*

H7o There is no significant relationship between ethical perception of new SMEs and non-availability of debt.

H7a There is a significant positive relationship between ethical perception of new SMEs and non-availability of debt.

- *Crime*

H8o There is no significant relationship between crime and non-availability of debt to new SMEs.

H8a There is a significant positive relationship between crime and non-availability of debt to new SMEs.

- *Corruption*

H9o There is a no significant relationship between corruption and non-availability of debt to new SMEs.

H9a There is a significant positive relationship between corruption and non-availability of debt to new SMEs.

The secondary research hypothesis for the study was:

Ho Commercial banks and trade creditors do not perceive new SMEs as beneficial to their business.

Ha Commercial banks and trade creditors perceive new SMEs as beneficial to their business.

1.4 SIGNIFICANCE OF THE STUDY

The motivation for this study stems from the fact that one of the factors inhibiting the creation and causing the high failure rate of new SMEs in South Africa is the lack of access to finance or non-availability of finance (Maas & Herrington 2006:17). New SMEs have a major role to play in the South African economy in terms of employment creation, sustainable output growth, the equitable distribution of income and the overall stimulation of the economy (FinMark Trust, 2006).

A major weakness of previous empirical studies on SMEs and access to finance in South Africa is their tendency not to differentiate between established SMEs and new SMEs. Established SMEs are SMEs that have operated for more than forty two months. Falkena *et al.* (2002) and Berry, Von Blottnitz, Cassim, Kesper, Rajaratnam and Seventer (2002) suggest that whilst it is debatable if established SMEs in South Africa have or do not have access to debt finance, such a debate does not arise for new SMEs. According to Von Broembsen *et al.* (2005:13) new SMEs in

South Africa suffer from acute shortage of finance. This is consistent with the view of Le, Venkatesh and Nguyen (2006:212) that previous studies on the external financing of SMEs have not distinguished between firms at different stages of growth. Since firms at different growth stages have distinct characteristics and also face different problems, obstacles and solutions for getting external financing for SMEs at different stages of growth can be expected to be different. Treating SMEs as a uniform group regardless of their growth stage offers limited research and practical implications. Rogerson (2008:66) also points to a number of important research gaps that must be addressed in terms of improving access to finance for SMEs in South Africa. Rogerson (2008:75) argues that further specific issues on SME financing in South Africa include monitoring the demand versus supply of finance to SMEs in different phases (start-up versus growth phase), different sectors and different ownership types.

Furthermore, Maas and Herrington (2006:37) in the GEM South African Report suggest the future direction of research SME development in South Africa. Maas and Herrington (2006:37) point out that access to finance is a major problem for the South African entrepreneur. This issue must be addressed if an environment promoting entrepreneurship and SME development is to be encouraged. Studies have been conducted by a variety of researchers such as Antonie (2001:1-6) and Mutezo (2005) on this issue. Further research is necessary that focuses on the immediate obstacles that have to be overcome in order to eliminate this problem. Therefore, because of the noted gap in existing literature, the focus of this study is on new SMEs.

In addition, previous studies on SMEs and access to finance in South Africa such as Hawkins (2002:519-542) and Pretorius and Shaw (2004:221-242) have completely ignored the impact of trade credit. Studies on the supply-side of SME financing in South Africa have focused mainly on improving the availability of bank credit. Wilson and Summers (2002:318) point out that studies of enterprise finance in Africa and elsewhere from the supply-side typically focus on bank credit, and more particularly on bank loans. However, banks are not the only principal source of external debt finance for SMEs. Berger and Udell (2006:2949) note that although trade credit is extremely important to SMEs, it has received much less interest than commercial bank lending which provides only slightly more credit to SMEs. Trade credit provides a cushion during credit crunches, monetary policy contractions or other shocks that leave financial

institutions less willing or less able to provide small business finance. Since only a limited number of new SMEs have access to loans from financial institutions, trade credit may often be the best or only available source of external funding for working capital. New SMEs may prefer trade credit financing during the early years when the risk of default is high. Also, trade credit is a substitute to bank credit for firms that are credit-rationed by banks. The question now is whether suppliers accept those requests. If they do, then trade credit could alleviate credit rationing for SMEs. This suggests that trade credit could be one of the solutions to the credit constraints faced by new SMEs in South Africa.

Furthermore, no known South African study has investigated empirically the impact of the business environment on the availability of debt finance to new SMEs from the supply side. According to Beck (2007:405) factors such as crime, ethics, corruption and the efficiency of the legal system are becoming very relevant to SME finance and need to be investigated to determine if they constrain the availability of finance to SMEs. This study makes a unique contribution to entrepreneurial finance literature by examining both the internal and external environmental factors (business environment) that can impact on to the availability of debt finance to new SMEs. Furthermore, this study compares how the business environment impacts on non-availability of debt to new SMEs from the angles of both commercial banks and trade creditors (two suppliers of debt to new SMEs).

In addition, previous South African studies such as Molapo (2005) and Mutezo (2005) have focused on the riskiness and failure of new SMEs without investigating empirically if new SMEs present business opportunities to commercial banks and trade creditors. No known South African study has empirically investigated if commercial banks and trade creditors perceive new SMEs as beneficial to their business. Benefit was measured in terms of profitability, largeness, strategic importance, competitiveness and prospects of new SMEs. The noted gaps in the literature on entrepreneurial finance stimulated this study.

1.5 RESEARCH METHODOLOGY

The research methodology employed in this study included a review of the literature on the constructs of entrepreneurial finance to provide the theoretical foundation for the research followed by an empirical study.

1.5.1 Phase 1: Literature review

The literature review examined the link between SMEs and development. The contribution of SMEs to poverty reduction, income redistribution and employment was reviewed. In addition, the definitions of a new SME as well as the creation and failure rates of new SMEs were examined. The review also examined the theories of capital structure and determined whether there is sufficient debt funding for new SMEs in South Africa. The last past of the literature review focused on the business environmental variables that can impact on non-availability of debt finance to new SMEs. Sources that were consulted for the literature study included the following:

- Local and international peer-reviewed journals such as Small Business Economics, International Small Business journal, Journal of Finance, Journal of Banking and Finance, Journal of Money, Credit and Banking and South African journal of Accounting Research.
- Books on finance, entrepreneurship and research methodology such as Financial Management by Correia, Flynn, Uliana and Wormald (2007), Timmons and Spinelli (2007) and Business Research Methods by Cooper and Schindler (2003).
- Unpublished Masters and Doctorate dissertations such as Rungani (2008).
- Internet sources through the websites of Statistics South Africa, Global Entrepreneurship Monitor, World Bank, African Development Bank, ABSA, First National Bank, Standard Bank, Nedcor and the New Partnership for Africa's Development.

1.5.2 Phase 2: Empirical study

The empirical study was approached from the perspective of a valid research design through definition of the study population, the incorporation of suitable measuring instrument and reliable techniques for data analysis as stipulated in Cooper and Schindler (2003:64). The empirical research for the study was conducted in two ways; a pilot study and the main survey. The measuring instrument was designed to measure the internal and external environmental variables (the business environment) that can impact on the availability of debt finance to new SMEs. For this purpose, an initial 52-item questionnaire was designed after a thorough literature review of the business environment and debt finance. The questionnaire was administered to 100 respondents from commercial banks and 100 respondents that were trade creditors in a pilot

study. Exploratory factor analysis resulted in the reduction of the 52-item questionnaire to a 43-item questionnaire and nine underlying factors for commercial banks and 39-item questionnaire and nine underlying factors for trade creditors. The nine factor identified were made up of four internal factors and five external factors. These were collateral, business information, managerial competencies and networking. The external factors were the macro-economy, the legal system, ethical perception, crime and corruption. For the main survey 376 questionnaires were administered to commercial banks and 172 questionnaires returned. The response rate for commercial banks was 45.8%. For trade creditors, 315 questionnaires were administered and 233 returned. The response rate for trade creditors was 74.0%. Overall 691 questionnaires were administered to both commercial banks and trade creditors and 405 returned. The average response rate was 58.6%.

- **Research type**

According to Zikmund (2003:68) there are two basic types of research design: qualitative and quantitative and a hybrid of the two. The choice of research design centres on the nature of the research, the setting, the possible limitations and the underlying paradigm that informs the research project. The study used the quantitative research design which Ghauri and Gronhaug (2005:204) describe as *"studies whose findings are mainly the product of statistical summary and analysis"*. The main feature of quantitative research is the heavy reliance of the researcher on data analysis to arrive at findings or conclusions.

- **Data collection method**

Gerber-Nel, Nel and Kotze (2005:88) identify three primary data collection methods namely, observation, experiment and survey. Observation is a process through which primary data is obtained by observers (humans or machines) about the behavioural pattern of people, objects or occurrences. With the experiment method of data collecting, the researcher manipulates an independent variable and then measures the effect. The experimental setting can be in a laboratory or in the field. In a laboratory, experiments are conducted in an artificial or laboratory setting. In survey research, the researcher selects a sample of respondents from a population and administers a standardized questionnaire to them. This study used survey research. Surveys can be divided into four major types: personal interviews, telephone surveys, mail surveys and self-

administered surveys as pointed out by Gerber-Nel *et al.* (2005:94). Data for the research study was gathered through self-administered questionnaires.

- **Study population**

The empirical study concentrated on the branches of the four major banks and their Small Business Units in the Eastern Cape Province. The four major banks included in the study were ABSA, First National Bank, Standard Bank and Nedcor. The four banks are responsible for 82% of all assets and 80% of all liabilities in commercial banking in South Africa (Okeahalam, 2001). The population of the branches of the four big banks in the Eastern Cape Province was obtained from the Branch Locators on the websites of the four banks. The population of commercial banks was two hundred and ninety four. The empirical study also included trade creditors in the manufacturing, wholesale and retail sectors. According to Selima (2007:17) these three sectors account for most of the trade credit. The population of trade creditors was obtained from the Border Kei Chamber of Commerce, the Port-Elizabeth Regional Chamber of Commerce and the Enterprise Directory. The population of trade creditors was five hundred and forty one.

- **Statistical analysis**

Data collection and analysis was carried out with the assistance of a firm of professional statistician called Stat Analysis limited. Data analysis was done using the Statistical Package for Social Sciences (SPSS) version 12.0 for Windows. Exploratory factor analysis was used to refine the research problems and enhance the validity of the research. In addition, statistical analysis included descriptive statistics, factor analysis, T-test, ANOVA and Pearson correlation. Reliability was tested using the Cronbach's Alpha. Validity was ensured by using a statistician and a panel of experts to evaluate the research instrument for conceptual clarity and by pre-testing the research instrument in a pilot study.

- **Referencing style**

The referencing style used for the study was the Harvard method.

1.6 LIMITATIONS OF THE STUDY

It is important to recognize the inherent limitations of the scope and approach of the study. SME financing can be addressed from many different perspectives, and the thesis only aimed to

provide a bank/ trade creditor / supply-side perspective. The study concentrated on private sector sources of funds for new SMEs. Government also plays a major role in SME financing. This study did not investigate why new SMEs do not get the required funding from government agencies. Smorfitt (2009) suggests that it is important to get the opinion of commercial banks and other providers of funds on why new SMEs in South Africa do not get finance. The perception of new SME owners to funding constraints from commercial banks and trade creditors (demand-side) was not investigated. In addition, the impact of business environmental variables such as technology was not considered. Though this study makes a unique and significant contribution to the body of literature on entrepreneurial finance, it should be considered as only a part of a broader effort to crack the multi-dimensional problem of new SME financing. In addition, the study was limited to commercial banks and trade creditors in the Eastern Cape Province and was therefore a regional study. Because of the limitations pointed out, care should be exercised in the interpretation and the application of the results of this study and the generalization of the findings to the whole of South Africa.

1.7 LAYOUT OF THE STUDY

Chapter one examined the introduction, the research problem, the research hypotheses and the research objectives. In addition, the chapter discussed the significance of the study, the research methodology and the limitations of the study. The remaining chapters are organized as follows:

- Chapter two (literature review) provides an overview of the link between SMEs and development from an international and local perspective. The role of SMEs in poverty alleviation, income equality and employment are discussed. The definition of a new SME as well as the contribution of new SMEs are discussed. The creation rate of new SMEs as well as the causes of failure of new SMEs in South Africa are also discussed.

- Chapter three (literature review) examines the financing needs of new SMEs. New SMEs need funds to finance fixed asset acquisition, working capital, product development and initial losses. Capital structure theories such as the static trade-off theory, the agency theory and the pecking order theory and their implication for new SMEs are discussed. The chapter,

in addition, explores the causes of the equity and debt gap for new SMEs and the credit evaluation process of both commercial banks and trade creditors.

- Chapter four (literature review) discusses internal environmental factors such as managerial competencies, collateral, business information and networking. In addition, external environmental factors such as the legal system, the macro-economy, ethics, crime and corruption and how they can affect the availability of debt finance to new SMEs are explored.

- Chapter five concentrates on the methodology to be used in conducting the empirical research. The chapter will examine the research design, the type of research to be used, the population, the sample design as well as the data collection and analysis methods.

- Chapter six focuses on the analysis and interpretation of research results. The chapter will tabulate the results from the analysis and exploration of the data and discuss the findings.

- Chapter seven revisits the research problems and the objectives of the research. The chapter also discusses the conclusions and recommendations of the research. In addition, the limitations of the research are highlighted and the areas for further research suggested.

1.8 SUMMARY

This chapter highlighted the importance of new SMEs to sustained economic growth, employment creation and reduction of poverty and income inequality in South Africa. According to Herrington *et al.* (2009:15) the creation rate of new SMEs in South Africa as measured by the TEA is one of the lowest in the world. The failure rate of the few new SMEs created in South Africa is also very high. The lack of finance is a major inhibitor to the growth potential of new SMEs in South Africa. Access to external equity such as venture capitalists and the stock markets is very limited for new SMEs in both developing and developed countries. Access to debt finance from commercial banks and trade creditors is very low in developing countries such as South Africa leading to a "finance gap". This chapter set out the research problems. In addition, the chapter examined the research objectives, the research hypotheses and the

significance of the research. Furthermore, the chapter highlighted the research methodology, the limitations of the study and the layout of the study.

The next chapter focuses on the role of SMEs in development, and especially the impact of SMEs on employment, poverty alleviation, income equality and economic growth.

CHAPTER TWO

SMALL AND MEDIUM ENTERPRISES AND DEVELOPMENT

"If SMEs do not exist, it would be necessary to invent them. A thriving SME sector is critical to inclusive economic growth, poverty reduction and job creation" (Cosgrove, 2008).

2.1 INTRODUCTION

This chapter provides an overview of the link between SMEs and development from an international and local perspective. According to the World Bank (2004) some of the major development challenges facing South Africa and other developing countries include high and growing levels of poverty, income inequality and unemployment. The World Bank and other regional bodies such as the New Partnership for Africa's Development (hereafter NEPAD) believe that SMEs are one of the keys to solve these development challenges. This chapter will review empirical literature about the link between development and poverty reduction, income equality and employment and the role SMEs can play in fostering development. Therefore, the initial focus of the chapter will be on the definition of development and development challenges facing South Africa such as poverty, income inequality and unemployment. The definition of an SME will also be provided. As pointed out by Finlayson (2003:1) it is impossible to determine the role of SMEs without understanding their definition.

The central theme of this chapter, however, is that new SMEs must be created and sustained to complement established SMEs if the development challenges are to be addressed. New SMEs increase the stock of SMEs and inject new blood into the veins of the economy. A country with a low rate of new SME formation risks economic stagnation. New SMEs form the basis from which an economy can expand and stimulate accelerated socio-economic growth, development and job creation (Maas & Herrington, 2006). This chapter will also examine new SME creation as well as their failure rate in South Africa.

2.2. DEFINITION OF DEVELOPMENT

William (2003:37) offers sociology of development and begins by declaring that the term "development" is a puzzle. William (2003:37) asks, "*What is it that we are studying in development?*" "*What constitutes a problem as a development problem?*" "*What makes a policy a development policy?*" The author points out that the term development is an ideological project. It originated in the need to address the negative consequences of capitalism and was an integral part of imperialism. Development (especially economic development) is concerned with how to modernize backward and rural economies and to transfer resources to create modern industrial economies.

Similarly, Mukherjee, Broll and Marjit (2003:169) point out that there is one central, simple question in the study of economic development: "Why are some countries developed, and others less so?" In other words, what accounts for the phenomenal disparities in living standards around the world? In addition, will developing countries eventually catch up? If not, why not? If yes, how long will it take? According to Te Velde (2001) the issue of development has been of interest to economists from the classical period to the present contemporary time. The author further traces the origin of development and provides evidence that development was one of the main issues discussed by Adam Smith in his classical book titled "The Wealth of Nations".

Te Velde (2001) argues that the natural order of development as it proceeds from primary to secondary to tertiary activity is determined by the evaluation of the relative risk and potential profit to be earned from alternative uses of capital. This suggests that to develop, a country has to pass through stages. A country becomes more developed as it grows out of primary activity (subsistence agriculture) to secondary activities (manufacturing) and to tertiary activities (commerce).

Te Velde (2001) also refers to Schumpeter's (another classical economist) first famous book, which was entitled "A Theory of Economic Development". Development in the Schumpeterian sense covers the following four cases:

- The introduction of new goods; that is those which consumers are not yet familiar with or a new quality of a good;

- The introduction of a new method of production;
- The opening of a new market; and
- The conquest of a new source of raw material.

The classical theories of development that were proposed by Adam Smith and Schumpeter focused on economic growth mainly in developed societies. Development was understood as primarily economic growth and capital formation. Furthermore, underdeveloped countries were thought of largely as primitive or early versions of Western countries that needed to follow the pattern of development set by the West. For underdeveloped countries to develop, they needed to pursue economic growth and follow the pattern set by the West (Te Velde, 2001).

Nafzinger (2006:18) questioned the economic growth and Western approach of classical development theories. According to Nafzinger (2006:19) the greatest error of classical economics was to universalize the West's experience. Nafzinger (2006:19) argues that calling an economics textbook that analyses the United States and the United Kingdom "World Economic Principles" is analogous to calling a book dealing with horses "Animals." This implies that the Western version of development is not the only way to look at development. Therefore, development is a social phenomenon that involved more than increasing per capita output (i.e. economic growth). Development is about eliminating poverty, unemployment and inequality as well.

Todaro and Smith (2009:10) agree that development involves not only economic growth but also reducing deprivation and broadening choice. Deprivation represents a multi-dimensional view of poverty that includes hunger, illiteracy, illness and poor health, powerlessness, voicelessness, insecurity, humiliation, and a lack of access to basic infrastructure. Development embodies elements such as political freedoms, economic facilities and social opportunities. According to Todaro and Smith (2009:18) development should answer the following questions:

- What has been happening to poverty?
- What has been happening to unemployment?
- What has been happening to inequality?

If all three of these have become less severe, then beyond doubt, this has been a period of development for the country concerned. If one or two of these central problems have been growing worse, especially if all three have, it would be strange to call the result development, even if per capita income has soared.

Economic development, therefore, is the development of the economic wealth of countries or regions for the well-being of their inhabitants. It is the process by which a nation improves the economic, political, and social well being of its people. From a policy perspective, economic development can be defined 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. Economic development is different from economic growth. The term economic growth refers to the increase (or growth) in a specific measure such as real national income, gross domestic product, or per capita income. When the gross domestic product of a nation rises, economists refer to it as economic growth. The term economic development, on the other hand, implies much more. It typically refers to improvements in a variety of indicators such as literacy rates, life expectancy, poverty rates and unemployment rates (Te Velde, 2001).

Contemporary economists have expanded the definition of development to include sustainable development. Ekins (2000) argues that development has associated costs, which include an expanding population, pollution and congestion. Development has negative effects on the quality of life through environmental degradation. Furthermore, development has led to depletion of natural resources. These criticisms of economic development especially in the area of the environment stimulated interest in sustainable development. According to Valente (2005:115) sustainable development is an emerging approach to development that combines aspects of traditional economic development with elements of environmental and social policy. Sustainable development reflects a process that meets the needs of the present without compromising the ability of future generations to meet their own needs. Therefore, the interdependent and mutually reinforcing pillars of sustainable development are economic development, social development, and environmental protection.

According to the World Bank (2006), within the context of development, countries can be broadly classified into developed and developing. The term developed country is used to describe countries that have a high level of development according to some criteria. Which criteria, and which countries are classified as developed, are a contentious issue. Economic criteria have tended to dominate discussions. One such criterion is income per capita and countries with high gross domestic product (GDP) per capita are described as developed countries. Another economic criterion is industrialization. Countries in which the tertiary sector dominates the economy are also described as developed. More recently a third measure, the Human Development Index (HDI) which combines an economic measure, national income, with other measures, indices for life expectancy and education has become prominent. Developed countries are countries with a high HDI rating. A developing country is a country that has a low level of industrialization, high levels of poverty and income inequality, thus a low HDI index.

The World Bank (2008b) points out that South Africa is characterized as a developing country. However, South Africa has a two-tiered economy; one rivalling other developed countries and the other with only the most basic infrastructure. South Africa is regarded as a productive and industrialized economy that exhibits many characteristics associated with developing countries such as an uneven distribution of wealth, a high level of poverty and unemployment. South Africa's per capita gross domestic product, corrected for purchasing power parity (PPP), was $10,187 per annum in 2007, making the country one of the 50 wealthiest in the world. However, strikingly poor social indicators resulted in a ranking of 115 out of 175 countries in terms of the Human Development Index (HDI) in 2007. South Africa's HDI ranking declined from 93 in 1992 to 115 in 2007 and it is one of only a handful of countries that has experienced a decline since 1995. Despite being among the 50 wealthiest nations in the world, the country now has a life expectancy that is among the 30 worst, while projections of mortality suggest that this measure will deteriorate further as deaths from the HIV/Aids pandemic increase.

Kirstein (2006) refers to the two-tiered economy as the First and Second economy. The notion of two economies in South Africa is a metaphor implying that part of the South African economy is cutting-edge and globalised, and part is marginalised and underdeveloped. Kirstein (2006) further argues that despite government's claims that there has been some progress in

development in the past ten years, these claims cannot be substantiated by any real fact. The number of people that are in the second economy keeps expanding. Unemployment in South Africa is still one of the highest in the world. Poverty is rampant and income distribution highly uneven. These are some of the development challenges facing South Africa in the twenty-first century.

Conclusively, literature suggests that development is not only about economic growth as espoused by classical economists such as Adam Smith and Schumpeter. Contemporary economists such as Todaro and Smith (2009) and Te Velde (2001) view development as the reduction of poverty, income inequality and unemployment. Furthermore, development must be sustainable. Sustainable development also includes reduction in pollution, congestion and environmental degradation. In development term, South Africa is classified as a developing nation with high levels of poverty, income inequality and unemployment.

2.2.1 The development challenges facing South Africa

According to the World Bank (2008b) the three major development challenges facing South Africa are high levels of poverty, income inequality and unemployment. The government of South Africa agrees that solving these three development challenges is a primary objective. Pahad (2008) points out that "*South Africa's social-economic goals are clear; reduce inequalities, reduce wealth and asset gaps between rich and poor, halve unemployment by 2014 and meet the Millennium Development Goals. One of the ways of meeting the challenges is ensuring the development of the SME sector*".

2.2.1.1 The Poverty challenge

The United Nations (2008) observes that "*poverty is a scourge affecting billions of people worldwide. Every day fifty thousand people die needlessly as a result of extreme poverty. The gap between the rich and the poor is getting wider. Eradication of poverty, the aspiration of the Millennium Development Goals, is the overriding developmental objective of the 21st century*". The World Bank mission statement also reads, "*working for a world free of poverty.*"(World Bank, 2008c). In Africa, one of NEPAD's primary objectives is "*to eliminate poverty*" (NEPAD, 2008). In addition, in South Africa, according to the Accelerated and Shared Growth Initiative

South Africa (hereafter AsgiSA) "*poverty reduction and the redistribution of income and opportunities in favour of the poor*" remain some of the main aims of the South African government (AsgiSA, 2007). These statements indicate that poverty is an international as well as a local phenomenon. The statements also illustrate that the eradication of poverty is one of the primary objectives of governments and international bodies worldwide.

What is poverty? According to the Studies in Poverty and Inequality Institute (2009) there is no general definition of the term poverty. Poverty is a contested concept and it is contested with good reason. Arguments over how poverty should be conceptualized, defined and measured go beyond semantics and academic hair-splitting. Poverty is also political because it relates to the allocation or distribution of resources, and reflects the impact of past and present policy choices. The ways in which politicians, citizens and experts use the concept of poverty have very divergent and diverse roots in social, political and philosophical discourses. Hulme and Shepherd (2003:404) note that despite the fact that there is no general definition of poverty, one important thread in poverty discourse is the notion of material lack, especially the lack of resources necessary for survival. At their crudest, poverty studies and definitions have resorted to identifying what goods human beings would require to prevent them from dying. Dignity is also another important thread. People who are able to survive may still be considered poor if survival requires them to give up their self-respect, or if they are not able to fulfil their minimal social obligations in society. Another important thread is that of subjective experience. People are ordinarily considered poor if they experience forms of lack that lead to suffering.

Aguero, Carter and May (2007:785) find that approximately 57% of individuals in South Africa live below the poverty income line of two United States Dollars per day. Despite economic growth in South Africa in the past ten years, the rate of poverty has not declined. Evidence seems to indicate that poverty is proving to be much more intractable than initially hoped.

Poverty occurs throughout the world. However, the level varies worldwide. Data indicate that poverty is significantly higher in developing countries than in developed countries. Table 2.1 depicts the poverty levels in South Africa and some selected African countries as well as some developed countries.

Table 2.1: Poverty levels in selected African and developed countries

African countries	Poverty level (%)	Developed countries	Poverty level (%)
South Africa	57	France	6
Cameroon	48	UK	14
Senegal	54	USA	12
Zambia	86	Australia	8

Source: World Bank (2008c).

The questions that come to mind from Table 2.1 are: Why is poverty significantly lower in developed countries when compared to developing countries and how can poverty be significantly reduced in developing countries such as South Africa?

According to Sachs (2005:18) in his book titled "The End of Poverty: Economic Possibilities for Our Time" the elimination of poverty remains one of the key objectives of governments worldwide. Sachs (2005:20) declares that poverty can be ended before 2025. Sachs emphasizes that collective action, supplemented by effective government provision of health, education, infrastructure, as well as foreign assistance when needed, underpins economic success. Kawai and Urata (2002:42) suggest that one of the ways to reduce poverty is the development of the SME sector.

According to the Parliament of the Republic of South Africa (2005), the government of South Africa identifies SMEs as a key to poverty alleviation, income equality, employment and sustainable economic growth. "*The stimulation of 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*".

In addition, NEPAD agrees that "*SMEs offer significant prospect for increased employment, poverty alleviation, increased utilisation of Africa's productive and intellectual resources, improved tax base for government revenues and low-cost accessible investment opportunities for local populations*" (NEPAD, 2008). Beyene (2002:132) also reckons that Africa's ability to break out of its current non-impressive economic performance would, to a large extent, depends on its ability to harness the entrepreneurial potential visible on its streets, market places and in the small and medium enterprises.

The World Bank (2003b) and International Labour Organisation (2008) in addition, assert that a vibrant SME sector improves productivity, promotes economic growth and increases opportunities for the poor. SMEs are the most important driver of local economic development. This is one of the reasons why all over the world, governments are stimulating and supporting a healthy small firm sector. The pro-SME policy of the World Bank is based on three core arguments. First, SMEs enhance competition and entrepreneurship and hence have external benefits on economy-wide efficiency, innovation, and aggregate productivity growth. Second, SMEs are more productive than large firms, but the financial market and other institutional failures impede SME development. Third, SME expansion boosts employment more than large firm growth because SMEs are more labour intensive. Therefore, SMEs can be used to alleviate poverty and unemployment.

Mukras (2003:58) notes that the choice of SMEs as a strategy for poverty reduction would not run into any significant difficulty in meeting the approval of policy makers and development economists today. Such a proposition, however, would have raised eyebrows among the officials and academics during the second part of the 1960s and most of the 1970s. According to the development economists of the 1960s, the surest way for a developing country to enjoy accelerated growth and sustained development was through large firms. SMEs were seriously disadvantaged by their very rudimentary nature and characteristics. Characteristics such as simple management and organizational structures, rudimentary technologies, low skill requirements (characteristics which have made SMEs the centre of attraction today) were then looked at as factors that would spell their doom in a world characterized by stiff and brutal competition. However, and on the contrary, the experience of the late 1980s and the 1990s clearly suggests that this attitude has undergone a complete turnaround. Available statistical evidence suggests that there has been a sharp acceleration of SMEs since the 1990s.

Agbeibor (2006:36) agrees that SMEs play an important role in alleviating poverty and at the same time contributing significantly towards the growth of developing economies. The author argues that in Ghana, small scale agriculture employs about 60% of the work force and provides income for most of the rural people in Ghana. The employment and the incomes from agriculture have significantly reduced rural poverty in Ghana. Mnenwa and Maliti (2008) in a study on

poverty alleviation in Tanzania, use a sample of 225 manufacturing small firms to investigate whether the profits, salaries and jobs created by small firms contribute to poverty alleviation. The statistical results show that the average incomes generated by small firms were above the basic and food poverty lines. This suggests that small firms contribute to poverty alleviation.

Tan (2003:80) compares the poverty reduction ability of SMEs and foreign aid. Tan (2003:80) argues that traditionally, development agencies have focused on providing aid to poor countries as a means of tackling poverty. While aid and disaster relief (humanitarian assistance) remain important in helping the developing world, governments and NGOs have recognised that aid alone is insufficient to alleviate the problem of endemic poverty. Likewise, development projects have an important role to play in education, caring for the vulnerable, skills training and community-based handicraft and subsistence-farming. However, because they are not self-sustaining projects, many such projects run out of support after a while. One of the few success stories in poverty reduction in the past 30 years has been the development of the micro-finance institutions (MFIs) that provide small (a few hundred dollars) uncollateralized loans to poor entrepreneurs to start micro and small firms. The Grameen Bank which was started in 1976 in Bangladesh has become famous for its model of offering micro credit to women in small groups. The Grameen Bank believes that the lack of access to credit is the biggest constraint for the rural poor. If the poor are provided credit (without collateral) on reasonable terms, they themselves best know how to increase their incomes. The Grameen Bank targets and mobilises the poor and creates social and financial conditions so that they receive credit by identifying a source of self-employment in familiar rural non-farm activities. This indicates that giving credit to rural people to start their own small enterprises can help reduce poverty.

In contrast, a few empirical studies disagree that SMEs are a key driver of poverty reduction. Ayyagari, Beck and Demirguc-Kunt (2003:265) examine the impact of SME on poverty reduction and economic growth in a study entitled "Small and medium enterprises across the globe". The study also finds an insignificant relationship between the development of SMEs and poverty reduction, but a significant relationship between the development of SMEs and economic growth.

Beck, Levine and Demirguc-Kunt (2005:201) explore the relationship between the relative size of the SME sector, economic growth and poverty alleviation using a database of SME labour in the total manufacturing labour force in forty five countries. Their statistical results indicate a robust and significant relationship between the relative size of the SME sector and the rate of economic growth. Countries with a large SME sector tend to grow at a faster rate than those with a smaller SME sector. The study also examines the relationship between SMEs and income inequality and poverty using four different dimensions: First, the impact of SMEs on the growth rate of the income of the poorest quintile of the country. Second, the relationship between SMEs and changes in income distribution as measured by the growth rate in the Gini coefficient. Third, the link between SMEs and the changes in the percentage of people living in poverty and fourth the connection between changes in the severity and depth of poverty in the country and the role of SMEs. The results suggest that SMEs do not influence the poorest segment of society differently from the average person. Furthermore, the findings indicate that larger SME sectors do not make income distribution more equal. This suggests that the development of SME has no direct impact on how the income distribution of an economy evolves. Regressions do not identify a significant relationship between SMEs and poverty alleviation. Therefore, there is no evidence of any poverty alleviating effect of a larger SME sector.

Berry *et al.* (2002) argue that the SME sector in South Africa has achieved limited growth. Therefore, SMEs are unlikely to be a panacea for South Africa's economic and social problems. Many SMEs do not report a profit or an increase in turnover. Their constraints include high levels of competition, high wages, low sales, high input costs (especially transport costs) and lack of access to finance.

Another stream of research suggests that SMEs may not directly reduce poverty. However, if SMEs promote economic growth as found by Ayyagari *et al.* (2003) and Beck *et al.* (2005), ultimately poverty will be reduced. Dollar and Kraay (2002:196) empirically examine the relationship between economic growth and growth in average incomes, using a large sample of developed and developing countries spanning four decades. The researchers find that a basic policy package of private property rights, fiscal discipline, macro-economic stability, and openness to trade, on the average, increases economic growth and the income of the poor to the

same extent that it increases the income of the other households in the society. Dollar and Kraay (2002:215) conclude that their findings do not imply that growth is all that is needed to improve the lives of the poor. They emphasize rather that growth, on the average, does benefit the poor as much as anyone else in society, and so standard growth-enhancing policies should be at the centre of any effective poverty-reduction strategy. This view is consistent with other empirical studies on growth and poverty such as Sadoulet and De Janvry (2000:203) and Ravallion and Chen (2001:363). These researchers find that there is a significant positive relationship between the development of SMEs and economic growth as well as a positive relationship between economic growth and poverty reduction.

It can be deduced from the review of empirical literature that SMEs are a key driver of poverty reduction despite a few dissenting views such as Ayyagari *et al.* (2003) and Beck *et al.* (2005). Rogerson (2000:68) points out that despite the constraints faced by SMEs in South Africa, growing and successful SMEs are viewed as offering a critical contribution to the policy goals of poverty alleviation, employment creation and promotion of economic growth. Mukras (2003:58) agrees that amongst the menu of available poverty reduction strategies, a strategy with far reaching potential is that of strengthening SMEs. By undertaking deliberate and appropriately planned strengthening of SMEs, the following results can be achieved: enhancing their productivity; raising their employment generating capacities; and consequently placing higher incomes in the hands of the poor entrepreneurs. Aina (2007:126) notes that a more effective and fully funded SME programme will go a long way to eradicate poverty by creating employment opportunities, citizen empowerment as well as foster economic growth and rural development in Nigeria. The development of the SME sector will contribute to poverty reduction by creating jobs and improving people's living standards. In addition, the World Bank (2008c) points out that SMEs tend to employ poor and low-income workers. SMEs are sometimes the only source of employment in poor regions and rural areas. Self-employment is the only source of income for many poor. SMEs play a particularly important role in developing countries where poverty is most severe. Therefore, empirical literature mainly agrees that SMEs are a key driver of poverty reduction. Furthermore, one of the primary policy goals to eradicate poverty by international organisations such as the World Bank, the United Nations and NEPAD is to strengthen the development of SMEs. Local objectives to reduce poverty such as GEAR also focus on the

development SMEs. This implies that empirical literature and policy goals of international organisations and local bodies agree that the development of SMEs is one of the key solutions to poverty. However, for SMEs to fully achieve the objective of poverty reduction especially in developing countries such as South Africa, the constraints faced by such organisations such as the availability of finance must be addressed.

2.2.1.2 Income inequality challenge

Despite some economic gains, huge disparities remain in South African society. Although there is evidence to suggest that income inequality has narrowed somewhat over the last decade, South Africa's income inequality remains one of the highest in the world (Triegaardt, 2008).

Inequality has two equally important meanings. In a sociological sense, inequality is a characteristic of social power relations. Inequality is said to be present if membership of different social groups is linked to highly differential power relations. In this sense, inequality is closely linked to the notion of social exclusion, in that unequal power relations may be linked to differential access to political or socio-economic rights. Inequality can also be linked to the existence of deeply institutionalized social hierarchies, as between masters and servants in slave and post-slave societies, or in societies where class identity and race are closely linked. In a much narrower quantitative and economic sense, inequality can refer to an imbalance in the distribution of particular resources, such as income, in a specific population. In a well-resourced country, the existence of poverty can be said to be a manifestation of inequality (Studies in Poverty and Inequality Institute, 2009).

According to The Economist (2009a) since 1994, absolute levels of poverty have declined in South Africa. But the discrepancies in wealth are still huge despite government job-creation schemes and the expansion of welfare benefits. The income of the top 10% of the population is nearly 100 times that of the bottom 10%. Demombynes and Ozler (2005:267) point out that the Gini coefficient in South Africa is 0.58, making the country one of the most unequal countries in the world. The country also inherited vast inequalities in education, health, and basic infrastructure, such as access to safe water, sanitation, and housing. Leibbrandt, Fields and Chichello (2005:147) investigate changes in the well-being of South Africans between 1996 and

2001 across two dimensions: The distribution of income and access to basic goods and services. Their results indicate a persistent but changing population-group footprint in the structure of South African inequality and poverty. Inequality between population groups is still extremely high but continues a long-run decline in importance. In addition, inequality as measured by the Gini coefficient is much higher in developing countries compared to developed countries as shown by Table 2.2. The Gini coefficient is a measure of statistical dispersion most prominently used as a measure of income or wealth inequality. A Gini coefficient of one indicates perfect income inequality, while a Gini coefficient of 0 indicates perfect equality (World Bank, 2008c). The figures indicate that income inequality is much higher in Africa compared to developed countries. The United States of America is a glaring exception in developed countries with income inequality of 0.41 which compares with that of Senegal.

Table 2.2: Gini coefficient in some selected African and developed countries

African countries	Gini coefficient	Developed countries	Gini coefficient
South Africa	0.58	France	0.33
Cameroon	0.45	U.K	0.36
Senegal	0.41	USA	0.41
Zambia	0.49	Australia	0.25

Source: World Bank (2008c).

The World Bank (2003b) asserts that a vibrant SME sector can reduce income inequality. Mnenwa and Maliti (2008:15) study the role of SMEs in Tanzania and find that SMEs help to reduce income inequality. According to Liu and Yu (2008:139) since the 1980s, income disparity has increased significantly in the People's Republic of China, largely as a result of widening urban-rural income gaps. The urban-rural inequality stems from the dual economic structure between urban and rural areas as well as the insufficient development of non-agricultural industries and township and village enterprises in rural areas. The economic divergence across regions can also be related to the unbalanced development of small and medium enterprises (SMEs). Promoting the development of SMEs in rural areas and economically underdeveloped regions could help reduce urban-rural migration and regional income inequality.

Nugent and Seung-Jae Yhee (2003:89) also argue that SMEs are more labour intensive than large firms and have narrower wage differentials across workers. Wages are also distributed more

equally than profits, rent, and other components of national income. Hence, as the SME sector expands relative to the large firm sector of the economy, all things being equal, firstly the share of labour in national income should rise, secondly inequality among wage earners should decrease, and thirdly overall income inequality should decrease.

2.2.1.3 The unemployment challenge

"*The most pressing challenge in South Africa is that of unemployment. Significant proportions of our people do not have jobs or are in very low-paying jobs. Creating decent jobs must be the cornerstone of all economic policies*"(Zuma, 2008).

In South Africa, there are two main definitions of unemployment; the narrow and the broad definition. The narrow definition counts as unemployed all jobless persons who want work and who are searching for work. These people are referred to as the searching unemployed. The broad definition drops the search criterion and counts as unemployed all jobless persons who report that they want work even if they did not search in the reference period. In other words, the broad definition includes both the searching and the non-searching unemployed. Government agencies such as Statistics South Africa and the South African Reserve Bank adopted the narrow concept as their official definition of unemployment in 1998 (Kingdon & Knight, 2006:291).

According to the National Labour and Economic Development Institute (2008) unemployment is extremely high in South Africa and it is seen as one of the most pressing socio-political problems facing the government. South Africa has one of the most interesting labour markets in the world. Its sharp segmentation, high unemployment and low non-farm informal sector employment make it an international outlier. The developments in the labour market may hold the key to South Africa's prosperity or penury. It is from the labour market that the benefits of incomes can flow to reduce poverty or the threat to social and political stability from growing unemployment and underemployment could emerge. The current employment situation in South Africa is that the economy is unable to absorb productively all current labour force or all the increment to the labour force. The unemployment rate at 24.5% according to Statistics South Africa (2009) is one of the highest in the world.

Table 2.3: Unemployment rates in selected African and developed countries

African countries	Unemployment rate (%)	Developed countries	Unemployment rate (%)
South Africa	23	France	8.8
Cameroon	30	UK	5.3
Senegal	48	USA	7.6
Zambia	50	Australia	5.1

Source: World Bank (2009).

Table 2.3 compares the unemployment rates in selected African countries (South Africa included) and selected developed countries. The table shows that unemployment is much higher in developing countries when compared to developed countries. According to the European Union (2009) SMEs account for a large proportion of Europe's economic and professional activity. 99% of firms in the European Union are SMEs and they provide two-thirds of all private sector jobs. Therefore, SMEs are in fact the real giants of the European economy. SMEs are one of the primary reasons why unemployment is low in Europe. Large firms in Europe have been shedding jobs while employment in the SME sector has increased.

In South Africa, government expects SMEs to be the engine of employment creation. Manuel (2007) states that "*SMEs remain a vital ingredient for job creation in our economy*". FinMark Trust (2006) also points out that unemployment remains a huge problem in South Africa today. "*One of the best ways to address unemployment is to leverage the employment creation potential of SMEs and to promote SME development*".

McLarty (2000:616) notes that it was the employment generating potentials of small firms in the United States of America as pointed out in the Birch Report of 1979 that stimulated interest in the study of SMEs worldwide. Birch examined data on individual firms between 1969 and 1976 and concluded that small firms created 82% of the new jobs in the United States over the period. The report found that contrary to the popular belief that large firms created most new jobs, it was primarily the SMEs that drove the job creating efforts, and at a faster rate.

Kesper (2001:172) agrees that SMEs are seen as a vehicle to address the problem of high unemployment levels in South Africa as they have a high labour-absorptive capacity. Kesper

(2001:173) however points out that there is a mismatch between the reality and the model of the SME sector used by South African policy makers. Only a few dynamic SMEs show a potential to contribute to rapid employment creation. Whilst some SMEs have been able to increase their sales (and to a lesser extent profits), this turnover growth is not accompanied by employment growth. Nissanke (2001:345) in contrast find that in Sub-Saharan Africa, large firms were the dominant source of net job creation. While gross rates of job creation and destruction are higher in SMEs, there is no systematic relationship between net job creation and firm size. In terms of job quality, microeconomic evidence does not support the pro-SME view that small firms create better quality jobs than large firms.

Finlayson (2003:1) however argues that two decades of academic research has not settled the question of the extent to which SMEs are a source of job creation, poverty reduction and income equality. According to the author, despite a few studies challenging the notion that SMEs create more than a disproportionate share of new jobs, Birch's original study has had considerable staying power. Birch's research was revolutionary and sparked controversy because it stood in sharp contrast to the traditional belief that large firms were the backbone of the American economy. Finlayson (2003) further adds that even if SMEs do not create the most new jobs, researchers should not be distracted or minimize the economic benefits that flow from them. SMEs are a critical part of the economy and provide millions of jobs. They are more flexible than large firms. They are also a source of innovative products, processes and business methods. Even if the assumption that large firms create more jobs is true, most of the large firms started as SMEs. Therefore, SMEs should be encouraged to evolve into large firms through improvement in tax and policy environments.

The World Bank (2003b) agrees that SMEs are very important because they have shown a remarkable capacity to absorb labour, both skilled and unskilled. The SME sector is the largest provider of employment in most countries, especially of new jobs. SMEs are usually locally owned and controlled and can thus strengthen the extended family and other social systems and cultural tradition. SMEs are a nursery and a proving ground for entrepreneurship and innovation. The products of SMEs tend to reflect local technology and tend to be more appropriate for the needs of poorer people and market changes. They also fill gaps overlooked by larger firms as

they are scattered throughout the country. This ensures a more equitable distribution of employment opportunities especially in the rural areas thereby reducing rural–urban migration. The findings of the World Bank (2003b) are consistent with the conclusions of similar empirical studies on the job creation potential of SMEs. Lloyd (2009) for instance points out that the South African economy is currently characterized by high levels of unemployment. Issues such as the absence or limited availability of social safety nets in South Africa, reinforces the dire need for SMEs and self-employment. This will largely decrease the state of dependency of a large percentage of people, either unemployed or potentially unemployed. Furthermore, the development of SMEs and entrepreneurial behaviour will lead to the extension of labour market skills and will combat the possible obsoleteness of current skills due to prolonged periods of unemployment. The SME sector is considered to be one of the most viable means to create employment and well-being in the South African economy. SMEs are the logical 'kick-start' mechanism to job creation and future prosperity in the country.

Furthermore, the World Bank (2003b) points out that the contribution of SMEs in South Africa is not limited to poverty reduction, income equality, employment and economic growth. SMEs are essential for a competitive and efficient market. The adaptability of SMEs plays a major role in removing regional and sector imbalances in the economy. Easy entry and exit of SMEs make economies more flexible and more competitive. The large number of SMEs creates competitive market pressure. Okubena (2008) agrees that SMEs stimulate competition between firms, supply goods to large firms, enhance the development of rural areas and empower previously disadvantaged communities.

This section examined the importance of SMEs. The literature largely agrees that SMEs are a key deriver of poverty alleviation, income equality and employment. This view is supported by local and international bodies such as GEAR and NEPAD. In addition, SMEs are a source of innovation, competition and rural development. Section 2.3 will examine the definition of a SME.

2.3 SME DEFINED

Finlayson (2003:4) and African Development Bank (2007) note that defining the term "SME" is the first step in conducting a policy-relevant analysis to solve problems related to the sector. According to the International Labour Organisation (2008) "*if SMEs are going to be a critical factor in economic development, poverty reduction and job creation, it would be necessary to define the term*". This suggests that it is difficult if not impossible to measure the contribution of SMEs without understanding their definition.

The European Union (2005) also claims that *"small and medium-sized enterprises (SMEs) are the engine of the world economy"*. They are an essential source of jobs, create entrepreneurial spirit and innovation worldwide and are thus crucial for fostering competitiveness and employment. "*To create an improved business environment and support for SMEs with the aims of promoting entrepreneurship, investments and growth it is important to define small and medium enterprises*". This is consistent with the view of Falkena *et al.* (2002) that "*as in many other fields of analysis, it is critical to define the precise meaning of the terms used. This is particularly true of the debate around SMEs".*

Beck *et al.* (2005:200) point out that there is no universally agreed definition of the term small and medium enterprises (SMEs). Numerous factors related to a country's social-economic environment influence the definition of an SME. Most definitions currently follow quantitative and qualitative lines. Quantitative factors are primarily the number of employees, the annual turnover (sales) and the balance sheet total. The qualitative factors require that an SME have a relatively small share of its market, be run by its owners and not be a subsidiary of a large firm. Also, the definition of SMEs on the basis of a specific criterion is not uniform across countries. Some countries (e.g., the United States of America) define a SME as a firm with less than five hundred employees while some countries in the European Union define the cut-off for the definition of SMEs as two hundred and fifty employees.

The National Small Business Act of South Africa of 1996, as amended in 2003, describes an 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 an SME by satisfying the criteria mentioned in the schedule of size standards" (Government Gazette of the Republic of South Africa, 2003).

As pointed out in the definition above the National Small Business Act provides a schedule of size standards for the definition of SMEs in all the sectors of the South African economy as highlighted in Table 2.4.

Table 2.4: Schedule of size standards for the definition of SMEs in South Africa

Type of firm	**Employees**	**Turnover**	**Balance sheet**
Small	1-49	Maximum R13m	Maximum R5m
Medium	51-200	Maximum R51m	Maximum R19m

Source: Government Gazette of the Republic of South Africa (2003).

Research suggests however that a globally uniform definition of SMEs is crucial to the successful development of the SME sector. According to Castel-Branco (2003), the absence of a universal concept of SME could make the SME sector an inadequate analytical tool for economic evaluation and policy making, especially if SMEs are defined differently in the same country (in some countries such as Malaysia, different organisations have different definitions for SMEs.) Also, if SMEs are so significantly differently defined, there is little hope for a common set of policies and analytical tools to be successfully developed to address SME issues such as access to finance or their high failure rates. Ayyagari *et al.* (2003:265) also suggest that to improve the competitiveness of SMEs and to focus on policy options and provide support services it is necessary to formulate a uniform definition. Senderovitz and Philipsen (2008) agree that without a uniform definition, it is difficult to have a cross country comparison of the performance of SMEs. It is also difficult for international organisations such as the World Bank to put in place uniform support systems for SMEs. It can be deduced from literature that there is no universal definition of a SME. Most definitions (including that of South Africa) follow the qualitative and quantitative lines. Qualitatively, SMEs are firms owned by one or more persons and not a subsidiary of another firm. Quantitative definition includes certain number of employees, turnover and balance sheet total.

2.4 NEW SMEs

As pointed out by studies such as Finlayson (2003:1-5) and Ayyagari *et al.* (2003:261-300), SMEs are very important to any economy. SMEs contribute to poverty alleviation, income redistribution, employment generations and sustainable economic growth. However, if the contribution of SMEs is to be sustained, new SMEs will have to be created. New SMEs form the new basis from which an economy can expand and stimulate accelerated socio-economic growth and development and job creation (Maas & Herrington, 2006).

2.4.1 Why focus on new SMEs?

Puhakka (2007:30) provides evidence that "*research on business organisations have started to show signs of shifting the focus from the management of existing firms to the creation of new firms. This new line of enquiry criticizes the view that businesses are to be best developed and renewed by planning and controlling existing firms and hoping that they would continue to grow. The renewal capacity through the creation of new firms is crucial in today's knowledge based economy. Organizing new businesses is more important than managing the present. Creativity, motivation and discovery come to the fore instead of adaptation to existing situations. The speed of change in a competitive environment is changing and the best way to handle this is to develop readiness for new businesses*".

Reynolds, Bygrave, Antio and Hay (2003) agree that while SMEs have always mattered to policy makers, the way in which they matter has drastically changed. Confronted with rising concerns about unemployment, job creation, economic growth and international competitiveness in global markets, policy makers have responded to this new evidence with a new mandate to promote the creation of new SMEs.

According to Wong *et al.* (2005:335), Schumpeter in 1934 was one of the earliest economists to argue for new firm creation. According to Schumpeter new firms are the vital force behind the progress of capitalism. The innovative activity of entrepreneurs feeds a creative ''destruction process'' by causing constant disturbances to an economic system in equilibrium, creating opportunities for economic rent. In adjusting to equilibrium, other innovations are spun-off and

more entrepreneurs enter the economic system. In this way, Schumpeter's theory predicts that an increase in the number of new SMEs will lead to an increase in economic growth.

Gree and Thurnik (2003:244) agree that new SMEs play a key role in the evolution of an industry. Entrants introduce new products and develop new technologies. As an important source of innovation, they bring competitive pressure to bear on established firms. These pressures arise as new firms pursue customization and niche market strategies as a means of gaining market share. However, for many new SMEs life is short and uncertain. New SMEs suffer from the highest failure rate compared to other types of firms. Those that do survive often grow. Over successive years, the cumulative effect of survivors on the industry landscape is substantial.

Hong and Daly (2005:52) point out that the contribution of new SMEs to economic development includes:

- New SMEs trigger competition:
- They stir research and development and innovation.
- Push old firm to improve their efficiency.
- Inject new blood into the veins of the economy.
- Result in economic growth, technological upgrading, job creation and welfare improvement.
- Increase the stock of SMEs.

Hiscocks (2005) argues that new SMEs need to be successful in order to contribute to a country's economy. Successful new SMEs are likely to add significant benefits to the regional and national economies. The benefits are likely to be in the form of new products, new jobs, greater exports, taxation revenues (both corporate and personal) etc. All these contribute significantly to the wealth of the regional and national economy.

Davis and Haltiwanger (2000:2715) and Bruce, Deskins, Hill and Rork (2007) find that the number of births of new SMEs adds significantly to a country's GDP. In a study done in the United States of America, the researchers found that increasing the birth of new SMEs by 5% results in 4.65% growth in the economy of the USA. Deaths of new SMEs detract from GDP growth to a similar degree. This suggests that when the net birth rate of SMEs is positive (i.e.

when the birth rate exceeds the death rate), GDP grows at a faster rate and personal income and employment increase. Therefore, new SMEs provide long-term benefits to the local economy.

Maas and Herrington (2006) endorse the argument that new SMEs make a significant difference to economic prosperity and that South Africa risks economic stagnation without a high new SME creation rate. Countries that are able to replenish the stock of businesses and jobs and have the capacity to accommodate volatility and turbulence in the entrepreneurial sector are best placed to compete effectively. In countries ranking high in the GEM analysis, entrepreneurship and new SME creation is an integral and accepted feature of economic and personal life. There is a clear tendency for countries with below-average future growth projections to be clustered on the top half of the GEM graph where new SME rates are low and those with above average-growth projections to be clustered on the bottom half where new SME rates are high.

In contrast, Hitjzen, Upward and Wright (2007) disagree that new SMEs significantly contribute to economic development. They argue that new firms reduce the turnover and profitability of established firms through competition. This leads to job losses in established firms. Furthermore, the high failure rate of new SMEs leads to job losses.

Empirical literature in general supports the fact that new SMEs are important for poverty alleviation, income equality and employment. According to Chandra and Nganou (2001) South Africa has a high rate of unemployment rate and a population of 47.4 million which is growing at a rate of 2.7%. The absorption rate of the labour force is low at 41.7%. This implies that only 4 out of 10 newcomers to the labour force can be accommodated. Therefore, new SMEs need to be created in order to accommodate more people in the labour force. Mutezo (2005) points out that about 300,000 new jobs must be created annually in South Africa, if the country is to retain its present unemployment rates, especially taking into consideration the high number of new comers into the labour market. Without the creation of new SMEs, South Africa is likely to stagnate and decline economically. Social problems such as crime and corruption are likely to increase. Against this background, it is very important to examine the definition of a new SME.

2.4.2 Definition of a new SME

Maas and Herrington (2006) observe that the creation of a new SME 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 SME begins to trade and compete with other firms in the market place. Therefore, a new SME can be described as an SME that has being in existence for less than forty two months. Once a firm has successfully existed for more than 42 months, it becomes an established firm. In addition, a new SME in South Africa must meet the qualitative and qualitative definitions of an SME as prescribed by the National Small Business Act.

Coleman (2004:118) uses the liability of newness to define a new SME. According to Coleman (2004) the term liability of newness was first coined by Stinchcombe in 1965. Liability of newness implies that new SMEs face a greater risk of failure than established firms because:

- New SMEs involve new roles that have to be learned;
- New SMEs do not yet have standard routines to solve problems; and
- New SMEs do not have stable ties with those who use their services.

This suggests new SMEs are firms which suffer from the liability of newness and also have high failure rates. Grunhagen and Mittelstaedt (2002:190) define new SMEs using a five-stage growth model.

- ***Stage I: Existence.*** At the beginning, owners of new SMEs are most concerned about finding and signing up customers and being able to deliver their products and services. They grapple with the question of whether they will get enough customers and deliver enough products/services to become a viable business; and whether they have the financial resources, cash, to meet all start-up requirements.
- ***Stage II: Survival.*** The focal point at this stage then is the relationship between revenues and expenses. Owners are evaluating whether (1) they can generate enough cash to break even and cover the repair/replacement of basic assets; (2) they are able to finance growth in order to earn an economic return on assets and labour.

- ***Stage III: Success.*** This is a pivotal point for owners in that the firm has reached economic health.
- ***Stage IV: Take-off.*** What owners face at this juncture is how to grow quickly and how to finance their growth.
- ***Stage V: Resource Maturity.*** At this point, the company has the staff and financial resources to engage in detailed operational and strategic planning. It has a decentralized management structure with experienced, senior staff and all necessary systems are in place.

A venture is considered new if it has not yet reached a phase in its development where it could be considered a mature business. The precise moment in time in which a new venture becomes a mature business has not yet been determined. However, the idea of business maturation could be equated with a firm that has fully completed the transition to a Stage II as explained above (Grunhagen & Mittelstaedt, 2002:190). In South Africa according to Maas and Herrington (2006) a new SME is one that has existed for less than forty two months. After that period, the SME is considered an established firm. According to the five-stage growth model, a new SME is one that is still in the existence stage.

As pointed out in section 2.2.1 South Africa suffers from development challenges such as high levels of poverty, income inequality and unemployment. SMEs are seen as one of the keys to meeting these challenges. In addition, new SMEs must be created to complement existing ones if the challenges are to be seriously addressed. Against this background, it is important to determine the creation of new SMEs in South Africa.

2.4.3 Creation of new SMEs in South Africa

Maas and Herrington (2006) point out that the primary measure of new firm creation is the Total Early-Stage Entrepreneurial Activity (TEA) index published by the Global Entrepreneurship Monitor (GEM). The TEA index measures the percentage of individuals between the ages of 18 and 64 that is involved in starting a new SME. The TEA rate measures only new SMEs but does not measure established firms. GEM was started in 1999 as a joint project by academics at the London School of Business and the Babson College in the United States of America. The reasons behind the GEM study were to:

- Compare countries in terms of their entrepreneurial activity.
- Establish which factors promote entrepreneurship.
- Determine whether the rate of entrepreneurship in a country affects national economic growth.
- Identify policies that encourage entrepreneurial activity.

Teams from forty two countries (including South Africa) around the globe participated in the GEM study in 2006. It is the largest and most rigorous longitudinal study of entrepreneurship and new firm creation in the world. GEM focuses on small firms. Although the GEM study acknowledges the economic contribution of large corporations, GEM's specific focus is on new SMEs (Maas & Herrington, 2006).

Sandu (2008:242) agrees that GEM is considered the world's largest annual measure of new firm creation worldwide. There are three main objectives of GEM; to apply harmonized metrics to measure the level of entrepreneurial activities among countries, which allows cross country comparisons; to identify the main determinants of different levels of entrepreneurship as well as to propose strategies that foster the level of entrepreneurial activity.

Reynolds, Busma, Antio, Hunt, De Bono, Servais, Garcia and Chin (2005:208) also point out that the GEM research program provides the required fundamental knowledge by assembling relevant harmonized data on an annual basis. The data has been assembled to facilitate cross national comparisons in the level of national entrepreneurial activity, estimate the role of entrepreneurial activity in national economic growth, determine the factors that account for national differences in the level of entrepreneurship, and facilitate policies that may be effective in enhancing entrepreneurship. The GEM research program was designed to provide, at the lowest possible cost, empirical measures of the critical variables associated with the GEM conceptual model. The purpose of the model was to guide research on the role of entrepreneurship in national economic growth and adaptation, further understanding of differences in the national level of entrepreneurship, and assist in the development of effective, efficient policies to enhance entrepreneurship. In that regard the project has been more successful than could ever have been anticipated, as the results have transformed the perspectives of

policymakers and scholars alike. Never again will entrepreneurship be seen as a peripheral activity unrelated to economic adaptation and change.

De Castro, Justo and Olivares (2005) however disagree that GEM is the best measure of new SME creation. They argue that, even though there is consensus on the need to measure new SME creation, there is no consensus about how to measure it. Scholars have prepared a broad array of different definitions and measures. Therefore, GEM is not the only valid measure of new SME creation. Godin, Clemens and Veldhuis (2008) agree that there are other measures of new SME formation apart from GEM. Two other major measures are the Kauffman Index of Entrepreneurial Activity and the World Bank Entrepreneurship Survey. The Kauffman Index of Entrepreneurial Activity focuses on the United States of America and uses one measure; the rate of business creation at the individual owner level in the United States of America. Specifically, it measures the proportion of adult non-business owners per 100,000 of population who create a new SME each month, including employer and non-employer businesses, incorporated and unincorporated businesses, across all industries. The major disadvantage of the Kauffman index, however, is that it is mainly limited to American entrepreneurship. According to Godin *et al.* (2008) the World Bank Entrepreneurship Survey measures entrepreneurship using business start-up rates in 84 countries. The survey also measures business density and the distribution of businesses by industrial sector. The primary advantage of the World Bank survey is its breadth of measurement. It measures business start-up rates across a large number of countries in many different global regions with a number of different policy regimes. The major disadvantage of the World Bank survey is that the definitions and measures of business start-up rates used are not consistent across the countries surveyed. Consequently, little can be concluded about the start-up rates in different countries.

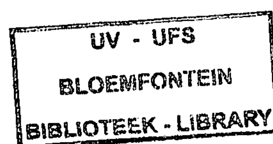
De Castro *et al.* (2005) also questioned the validity of the TEA as a measure of new SME creation. The main outcome of the GEM project is an estimate of a nation's entrepreneurial activity as measured by TEA. Therefore, it is important to ascertain the quality of the measures. De Castro *et al.* (2005) further argue that while the current GEM index is built around direct measures of individuals' entrepreneurial activities, it does not include other indirect or environmental indicators that also have a direct impact on individuals' entrepreneurial activity.

To overcome these limitations, they proposed a two factor model. The first factor corresponds to the individuals' propensity to engage in entrepreneurial activity. The second factor corresponds to the individual entrepreneurial environment. This they argue is a more complete measure of entrepreneurial activity than GEM'S TEA.

Acs and Varga (2005:324) opine that despite the limitations, GEM and its TEA are still of the best measures of new venture creation. One of the major strengths of GEM is the application of uniform definitions and data collection across countries for international comparisons. Godin *et al.* (2008) also conclude that despite the limitations of TEA it is still the most widely used measure of entrepreneurship by researchers and governments. OECD (2006) concurs that though there is no universal measure of new firm formation, the TEA is certainly the most widely used and often quoted. Empirical studies on new SME creation in South Africa such as Mitchell (2004:167-183) and Pretorius and Shaw (2004:221-242) used GEM's TEA as the measure of new SME creation.

2.4.4 South Africa's TEA rate

According to Herrington *et al.* (2009) 43 countries across the globe participated in the 2008 Global Entrepreneurship Survey. These countries were divided into three groups namely; factor-driven economies, efficiency-driven economies and innovation-driven economies. Factor-driven economies are countries with low levels of economic development, a large agricultural sector, which provides subsistence for the majority of the population who mostly still live in the rural areas. Factor-driven economies include countries such as Bolivia, Angola and Egypt. Efficiency-driven economies are emerging industrial powers in pursuit of higher productivity through economies of scale. Efficiency-driven economies include countries such South Africa, Argentina, Brazil and Turkey. Innovation-driven economies are rich, matured economies with emphasis on an expanding service sector that caters to the needs of an increasingly affluent population. This includes countries such as the United States of America, the United Kingdom and Germany. In 2008, South Africa ranked 23rd out of 43 countries, with a TEA rate below the average (10.6%) of all participating countries. This is in line with the findings of previous GEM surveys.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Maas and Herrington (2006) in the 2006 GEM Reports showed that South Africa's performance in terms of relative position has, since 2001, consistently been below the median and this trend continued in 2008. Table 2.5 depicts South Africa's TEA rate between 2005 and 2008. South Africa's present TEA rate of 7.8% is significantly lower than the average for all efficiency-driven economies (11.4%) as well as the average for all middle to low income countries (13.2%). These findings are cause for serious concern, particularly as they again confirm the trend of below-average entrepreneurial activity demonstrated in previous GEM surveys. According to the GEM data, a country at South Africa's stage of economic development would be expected to have a TEA rate in the order of 13%, almost double South Africa's actual rate of 7.8%.

Herrington *et al.* (2009) add that two further factors exacerbate the concern evoked by South Africa's low TEA rate. Firstly, South Africa is not a nation that is able to provide generous welfare benefits to the unemployed. There are thus no incentives to choose uninterrupted leisure over attempting to find some form of employment/ self-employment, as is the case in certain European countries. Secondly, South Africa has staggeringly high levels of unemployment relative to the rest of the countries in the GEM sample. South Africa's 2007 unemployment rate of 23% is double the next highest which Columbia is at 12%. The economic implications of these findings are certainly worrying. The contribution of nascent entrepreneurial firms to economic development is minimal. South Africa's low new firm and established business prevalence rates thus paint a bleak picture of the SME sector's potential to contribute meaningfully to job creation, economic growth and more equal income distribution.

Maas and Herrington (2006) agree that the TEA in South Africa is not up to standard. Despite an improvement in the TEA between 2007 and 2008, the TEA is still one of the lowest amongst developing countries (refer to table 2.5). The low TEA is an impediment to the sustainability of economic growth necessary to create wealth and reduce poverty and unemployment. With a young population, more pressure is being exerted on existing firms to create enough wealth for all. If the TEA is not improved quickly enough, the danger exists that the dependency level on existing firms will become too much. Therefore, more new firms need to be created in order to accommodate more people in the labour force. However, South Africa's TEA rate indicates that

not enough businesses are being created to offset the number of new entrants into the labour market.

Table 2.5: South Africa's TEA rate 2005 to 2008

2005	2006	2007	2008
5.4 20th position out of 34 Countries	5.2 25th position out of 34 countries	5.3 30th position out of 42 countries	7.8 23rd position out of 43 countries

Source: Herrington *et al.* (2009).

This section focused on the definition, roles and creation of new SMEs in South Africa. The literature review indicated that new SMEs are central to economic growth and the reduction of unemployment in South Africa. The creation rate of new SMEs in South Africa as evidenced by GEM's TEA has consistently been the lowest in all the countries surveyed by GEM. The low creation rate of new SMEs in South Africa is a major impediment to the reduction of unemployment. Section 2.5 will examine the failure rate as well as the causes of failure of new SMEs in South Africa.

2.5 FAILURE OF NEW SMEs

Peacock (2004:18) observes that there are two fundamental characteristics of new SMEs which separate them from large firms. One is their smallness, and the other is their rate of turnover and their failure rate. Peacock (2004:19) further notes that "*The chance of a newcomer becoming an established member of the business community is sadly slight. The SME owner carries on until his funds are exhausted and then disappears from the scene. His place is taken by another hopeful, certain that he has the abilities which will permit him to succeed where his predecessor has failed. .... Unaware of the odds against them, and largely ignorant of the weapons of trade, prospective proprietors march stolidly to the ambush*".

Titus (2008) asserts that the significant role of SMEs in the economies of countries worldwide suggests that an understanding of why SMEs fail (or are successful) is crucial to the stability and health of the global economy. Government policymakers in most countries have been spurred on by what they see as the job generation potential of SMEs. Therefore, they have a concern for the SME failure rate. The high incidence of failure is a serious waste of resources and there are not

only economic, but also human costs associated with failure. In the light of this, it is important to define failure, explain the costs and benefits of failure as well as discuss the causes of failure of new SMEs.

2.5.1 Definition of SME failure

Peacock (2004:17) reveals that there are a number of different meanings that are attributed to the word "failure" as it applies to an SME. To the economist, this would be a firm which earned a rate of return on investment which was insufficient to cover its opportunity cost, i.e. it failed to be competitive with alternative uses of economic resources. This is however not a useful approach for most purposes because many proprietors trade off reduced profits for increased psychic satisfaction from the firm. Furthermore, data is not often available to make the necessary calculations about the profitability of small firms. The easiest meaning to understand and to measure is legal failure, where a small firm is formally liquidated or in the case of an unincorporated enterprise the owner becomes bankrupt for business reasons. An alternative approach is to relate failure to the exit rate of owners or firms from the small business sector. Such discontinuances may include loss-cutting procedures (to dispose of a business to avoid further losses), or because of "failure to make a go of it".

Peacock's view is consistent with the description of SME failure by Yrle, Hartman and Yrle (2000:33). The authors point out that because there are no formal financial data publication requirements for the majority of new SMEs, it is difficult, if not impossible to obtain sufficient reliable information to measure their performance, as expressed in any economic sense, such as the rate of return on capital. Therefore, empirical studies on business failure have tended to rely on some recorded events as surrogates to measure failure. The two events for which data have been most readily available are the discontinuance of a business for any reason and formal bankruptcy proceedings. Between these two extremes two further definitions have been proposed. The first definition is termination to prevent further losses and the second definition is the failure to make a go of it. In South Africa, one of the primary measures of business failure is the statistics of liquidations and insolvencies published quarterly by Statistics South Africa.

Yrle *et al.* (2000:34) further state that out of all these definitions, the first definition, the discontinuance of a business for any reason appears to be the least homogeneous with two major variations in the way discontinuance is defined. At one end, discontinuance includes every change in ownership (referred to as discontinuance of ownership). This could come from the sale of the business or merger with another business and so may not really be defined as business failure. At the other end, discontinuance is recorded only when a business ceases to operate (referred to discontinuance of business).

Watson (2003:262-277) in his paper defining SME failure expanded the definition to include seven primary reasons:

- Bankruptcy which is defined as discontinued operations with resulting losses to its creditors;
- Discontinuance which is defined as prevention from further losses. This implies that the owner recognizes the need to end the business due to continuing personal financial losses while the creditors might still be receiving their agreed-upon payments.
- Not 'making a go of it' is the most subjective reason as it is based upon personal goals not being reached. While the business may not be running at a loss, the entrepreneur gives up because it might be too time consuming, stressful, or disapproving because his effort does not compare to the profit.
- Retirement due to bad health.
- Sale of business to realize a profit.
- Unknown.
- Other reasons.

Titus (2008) in his contribution on SME failure points out that failure occurs if the firm fails to meet its responsibilities to the stakeholders of the organization, including employees, suppliers, customers and owners. *From this viewpoint, a business failure is the termination of an entrepreneurial initiative that has fallen short of its goals.* In addition, every business has a life span that is depicted by its business life cycle. A business life cycle according to Titus (2008) is normally defined by four stages; Introduction, Growth, Maturity and Decline. Small business failure is *the last stage of an organization's life cycle*. Another definition of small business failure alluded to by Titus (2008) is that failure occurs when there are significant losses in the

capital of the business that ultimately lead to business discontinuance. A SME business that is not earning an adequate return (or is not meeting owner's objectives) may also discontinue existence. Titus argues that the simple definition of business failure is *"a firm's inability to exist due to loss of capital or insufficient return on investments"*.

Honjo (2000:560) observes that a number of firms continue to trade while earning low rates of return. However, when viewed from this rate of return perspective, a business is said to have "failed" if it meets any of the following criteria:

- *Earnings Criterion*: A firm has failed if its return on capital is significantly and consistently lower than that obtainable on similar investments.
- *Solvency Criterion:* A firm has failed if the owner, to avoid bankruptcy or loss to creditors after such actions such as execution, foreclosure or attachment, voluntarily withdraws, leaving unpaid obligations.
- *Bankruptcy Criterion:* A firm has failed if deemed to be legally bankrupt. Bankruptcy is normally accompanied by insolvency and/or liquidation.
- *Loss cutting criterion:* A firm has failed if the owner disposes of the firm or its assets with losses, in order to avoid further losses.

2.5.2 Causes of failure of new SMEs

Business failures are common and are nightmarish to entrepreneurs and financiers. Therefore, it is important to determine the causes of business failure. Pinhold (2008) suggests that a reliable analysis of the causes of new SME failure should be comprehensive and take into consideration not only the causes as stipulated by entrepreneurs but by other stakeholders as well such commercial banks, venture capitalists and government.

Pratten (2004:247) in an analysis of new SME failure provides evidence on some reasons why new SMEs fail. According to Pratten (2004:247) one line of research developed by Stinchcombe (1965) suggests that the liability of newness is an important reason for the failure of new SMEs. This viewpoint proposes that new organisations fail from a combination of internal and external factors. The liability of newness framework identifies problem factors (internal and external) which inhibit new venture success. Internal factors are factors that are largely controllable by the

organisation and include lack of management experience, lack of functional skills (e.g., planning, organizing, leading and controlling) and poor staff training and development and poor attitudes towards customers. External factors are factors largely uncontrollable by the organisation and include non-availability of a logistics chain and a high cost of distribution, competition, rising costs of doing business and a lack of finance.

Pinhold (2008) declares that the liabilities of newness are substantial for a new SME. It is far more costly to win a new market than to preserve an existing one. Pinhold (2008) also observes that it takes time to build up sales, whereas overhead expenses are incurred from day one. Mistakes are made by new SMEs and it takes time to learn from these mistakes. The new SME, therefore, needs significant advantages over existing firms in order to compete. The existing firms, against which newcomers compete, have already survived a previous selection process, and it would be foolish to assume that they are easy targets for competitive attack by newcomers.

Pearce (2005) in his study on SME failure diverges from the liability of newness to politics. According to Pearce (2005) political institutions play a fundamental role in constituting the environment in which new firms are born. These conditions have long-lasting effects on the new organization. The major role of political institutions is to provide stable and predictable environments necessary for the growth of economic activity. This is accomplished through the enactment of laws, the protection of private property and the enforcement of contracts, the provision of education and social welfare, the protection of personal safety and public order, and the organized armed protection against outside attack. The most basic role of government is to provide personal safety and public order. The relative capacity of states to perform this most basic responsibility, the provision of personal safety and public order, affect new-venture processes and outcomes. This suggests that the failure of new SMEs may be affected by factors such as crime, corruption, weak property rights and contract enforcements and an education system that does not promote entrepreneurship.

Another stream of research on new SME failure as pointed out by Ahmad and Seet (2009:100) focuses on management skills as the new small firm transits from the founding entrepreneurial stage to higher growth rate stages. This is termed the "executive limit". As the firm progresses

through its life cycle, management aptitude becomes more important than entrepreneurial skills. A critical factor in the success of a new SME is the ability of its initial leadership to continue to meet new challenges as the business evolves. New SMEs are often begun by an entrepreneur with a very specific marketable product or idea, who then brings together other founders and funding to create the new business. Start-up firms need to augment their managerial capabilities as they grow. The combination of concepts from the life cycle theory and power in executive succession provide a compelling picture of how new SMEs come to make changes in their management. The development of the venture presents changing leadership needs and a need for different managerial capabilities. Entrepreneurs reach an "executive limit" at which their inability to manage the firm becomes detrimental. In such cases, ventures that do not replace the entrepreneur with a professional manager are more apt to fail. This "executive limit" concept is consistent with the internal causes of failure, specifically, a management coordination and control problem.

Pinhold (2008) further argues that one of the primary reasons why new SMEs fail is their abnormal rate of creation. New SMEs are formed at a rate that is far higher than is needed by the economy. Also, individuals have complex motivations for starting a business and achieving a financial return is but one of them. Over-optimism fuels the process causing business founders to overestimate the returns and underestimate the risks involved. The resulting oversupply of new SMEs creates a necessity for a high business failure rate. New SMEs play an important role in economic development. They displace old firms that have ceased to adequately serve changing customer needs and are unable or unwilling to change. They introduce new ideas and new technologies. They offer new choices to consumers, thereby changing patterns of consumption. There can be little doubt that new SMEs are needed. However, the question that needs answering is how many new SMEs provide the optimum results. It seems clear that the founders of new SMEs would benefit from fewer new ventures, as this would improve overall investment returns.

Holland (2008) reports that about 90% of all new SME failures are due to management mistakes. Some of the leading management mistakes that lead to business failures are: going into business for the wrong reasons; the entrepreneur gets worn-out and/or underestimated time requirements;

family pressure on time and funds; pride; lack of market awareness; the entrepreneur falls in love with the product/business; lack of financial responsibility and awareness; lack of a clear focus.

Temtime and Pansiri (2004:20) ranked the causes of new SME failure from the viewpoint of the entrepreneurs. The authors find that factors related to marketing such as lack of market research, ineffective demand forecasting and analysis, bad customer service, and lack of training for sales staff are the most significant factors leading to the failure of new SMEs. The investment analysis and working capital management factor is rated second and includes the lack of financial record keeping and documentation, insufficient provision for contingencies, high investment in fixed assets particularly during the start-up stage, inadequately estimated capital requirements, inability or failure to analyse financial statements, misperception of turnover as profit, and under utilization of company assets. Customer relationship was also rated high by the respondents in its impact on the performance of firms. Service and merchandising firms spent much time and resources to retain their customers. Customer loyalty and retention have been the main strategy for these firms to achieve competitiveness. Managerial action and external environmental factors are rated fourth. Small business owners/managers need to develop basic managerial skills and knowledge if they are to succeed. Managers need to have adequate skills in the area of planning, organizing, directing and controlling organizational resources.

Phaladi and Thwala (2008) in a study of SME failure in South Africa also find that the lack of effective management, the lack of financial management; the lack of entrepreneurial skills; the lack of proper training; the lack of resources; the lack of technical skills; the lack of contractual and managerial skills; late payment for work done which is common with government contracts; and the inability to get credit from suppliers are seen as critical failure factors for small and medium sized contractors in the North West Province. Peacock (2004:30) however suggests that "*it needs to be noted that failed owners were the source of evidence in some of the studies, so that the problem may still be at least a managerial one because of an unawareness of sources of funds and an inability to present adequate proposals for funding*".

According to Yrle *et al.* (2000:37) a comprehensive approach towards the failure of new SMEs should examine the causes of failure not only from the angle of entrepreneurs but also from the

angle of the suppliers of capital. Yrle *et al.* (2000:33) argue that suppliers of capital such as banks and venture capitalists believe that poor management is the most important factor contributing to small firm failures. Although most entrepreneurs claim that finance is a key cause of failure, banks contend that they are willing to lend to new firms that meet their requirements for lending.

Temtime and Pansiri (2004:20) also argue that good management skills are needed by new SMEs to enable them get funds from banks, trade creditors and government agencies. 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 banks. The lack of finance therefore may be a direct cause of business failure but the indirect cause which is often more important but seldom recognized by entrepreneurs is the lack of management skills. Banks and other lending organisations have adopted a set of criteria that they use to evaluate new business proposals.

Robb and Fairlie (2008:1434) also disagree with entrepreneurs that the lack of finance is the major cause of small firm failure. Robb and Fairlie (2008:1434) compare the performance of SMEs owned by Asian immigrants and White locals in the United States. The study finds that SMEs owned by Asian immigrants face limited access to external finance and are more likely to invest personal or family savings in the business. Immigrants firms however have higher survival rates, profits, employment, and sales than white firms. The most significant factor associated with the high level of success of immigrant firms is the level of education. Asian immigrant business owners have higher education levels than white business owners. This suggests that the major cause of business failure for new SMEs is inadequate managerial skills. According to the Kauffman Foundation (2007) immigrant entrepreneurial activity grew from 0.37 percent in 2006 to 0.46 percent in 2007. The rate of activity for native-born Americans remained flat at 0.27 percent despite better access to external finance for native born Americans.

Boeker and Wiltbank (2005:127) find that to entrepreneurs the four most important factors causing failure (in the order) are poor market conditions, poor capitalization, poor management strategy and key people incompetence. To fund providers, however, the four primary causes of new SME failure (in the order) are the lack of management skills, poor product design, the lack

of technical skills and lastly inadequate capitalization. The question is whether the entrepreneur's assessment and the suppliers of capital's assessment agree with each other. This difference in perceptions may affect which solutions are pursued when a venture starts to fail. In other words, the entrepreneur and the venture capitalists may advocate different solutions based on their perceptions. Since new SMEs are resource constrained, it is critical that the two parties agree on the best available course of action. Thus, erroneous attributions can lead to actions that fail to correct the problem (or actions that may even exacerbate the problem). Considering the limited resources of new SMEs, such a mistake could be disastrous. Since it appears that entrepreneurs and venture capitalists have different perceptions about failure factors, understanding these differences may contribute to an improvement in decision-making and thereby the survival of new SMEs. Conclusively, new SMEs fail in both developed and developing countries. However, the rate of failure of new SMEs in developing countries seems to be much higher than in developed countries as depicted in Table 2.6.

Table 2.6: Failure rates of new SMEs in some selected developing and developed countries

Developing countries	**Failure rate of new small fir SMEs (%)**	**Developed countries**	**Failure rate of new SMEs (%)**
South Africa	75	Australia	30
Mexico	68	New Zealand	28
Chile	66	UK	28
Venezuela	48	Japan	24

Sources: Adapted from Maas and Herrington (2006), OECD (2006).

It can be inferred from Table 2.6 that the chances of a business surviving beyond three and a half years in a developing country is generally lower than in a developed country. South Africa has the highest failure rate of new SMEs in all the countries sampled by GEM as reported by Maas and Herrington (2006). This implies that the prognosis of survival and therefore of establishing sustainable SMEs in South Africa is particularly poor. The probability of a new SME surviving beyond 42 months is less likely in South Africa than in any other GEM country sampled in 2005. This suggests that the quality of early-stage entrepreneurship activity in South Africa is somewhat lower in comparison with other countries in the GEM sample. The empirical literature reviewed in this section subscribe to a host of factors why new SMEs fail. Table 2.7 depicts the specific causes of the failure of new SMEs in South Africa.

Table 2.7: Causes of the failure of new SMEs in South Africa

Reason	Frequency	Valid Percent
Too much competition	6	11.5
Lack of customers	6	11.5
Financial reasons	17	32.1
Found another job	2	4.3
Retirement	1	2.7
Personal reasons	12	23.1
Other reasons	8	14.7
Total	52	100

Source: Maas and Herrington (2006).

Financial constraints appear to be the primary exit reason for most entrepreneurs at 32.1%. This underscores the importance of improving the availability of finance to SMEs which is the primary objective of this study. It can therefore be concluded that despite the many reasons given for small business failure from both the entrepreneurs and the providers of funds, most failures occur because of bad management, the lack of capital and a weak external environment. It appears that the financial reason is one of the primary causes of the failure of new SMEs. It must be pointed out however that there is a significant difference in the way the financial reason is perceived by entrepreneurs and credit providers. Entrepreneurs claim that finance is a first order problem, whereas credit providers argue that management skill is the major problem and could in fact be the cause of the financial problem. This suggests that finance may not be the real cause of failure but a consequence of the problem.

2.5.3 Costs and benefits of new SME failure

According to Hart and Knott (2005:620) failure has important ramifications for a number of the stakeholders involved in the start-up process. Unincorporated SMEs do not enjoy limited liability. Failure can, therefore, lead to the loss of the business and personal assets. Unincorporated SMEs are often collateralized by the personal assets of the founder. Incorporation should help limit the personal losses to entrepreneurs in the case of failure. Maas and Herrington (2006) point out that there are also emotional costs involved in new SME failure. South Africa has a harsh attitude towards failure, which inhibits many potential entrepreneurs.

Hart and Knott (2005:621) further note that the impact of failure may also bear on government policy. New SMEs are lauded as the engines of economies around the world. Business failures have a high cost in terms of employment, lost productivity, purchasing power (unpaid wages) and finance (unpaid debts), poverty reduction and income equality. Business failures can also lead to social problems such as crime, drunkenness and prostitution. Business failure can further lead to reduced income for the government in the form of lower taxes and increased expenditures on crime prevention.

Mitchell, Mitchell and Smith (2008:227) argue that the effect of new SME failure can be portrayed both negatively and positively. While the negative effects of failure are manifest in monetary and emotional costs, its positive effects are less visible, being associated with learning, experience, and other cognitive constructs. Most lenders and venture capitalists consider a previous failure to be a virtue of finance seeking entrepreneurs. According to Mitchell *et al.* (2008:228) the meaning of new SME failure must at least be interpreted within the context of start-up experience. The link between experience and expertise is differential as experience grows. Failure can actually facilitate experience and a new beginning leading to success.

Markman, Phan and Ballkin (2007:756) point out that personal perseverance refers to a person's capability to persist in the face of difficulties, risks, and failure. Such persons consistently rise up and break through and as they persevere, they become more skilled and empowered to tackle the next adversity. Social cognitive theory proposes that since different individuals tend to sustain different levels of adversity, personal success is the degree to which individuals move forward and upward despite what appears to be insurmountable obstacles and other forms of adversity.

Peacock (2004:111) reports that the total proportion of businesses in the economy which are small tends to be stable and that a high closure (failure) rate is consistent with competition and vitality - '*for every failure, a new small business is established ... there are ....benefits arising from the elimination of less successful firms which make room for new entrants with fresh ideas.......*". People who fail in one business may learn from their mistakes in future ventures. This suggests that business failure is a good learning curve for entrepreneurs and also brings

innovation as new entrepreneurs will examine the causes of earlier business failures and look for ways to avoid them.

It can be deduced from the literature review that the failure rate of new SMEs in South Africa is one of the highest in the world. Lack of finance is one of the causes of failure. The chance of a new SME in South Africa becoming an established firm is very slight. In addition as pointed out under section 2.4, South Africa has the lowest TEA rate in all the developing countries surveyed by GEM. This implies that the country suffers from two major problems when it comes to new SMEs: Low creation rate and high failure rate. The implication of the twin problems for economic growth, employment and poverty reduction in South Africa is dire.

2.6 SUMMARY

This chapter examined SMEs in South Africa. The argument of this chapter was that SMEs are important to sustainable development in South Africa. Based on this foundation, the chapter examined the meaning of development. Te Velde (2001) points out that classical economists such as Adam Smith and Schumpeter equated development with economic growth. Contemporary economists such as Todaro and Smith (2009) expanded the definition of development to include poverty reduction, income equality, employment and the protection of the environment (sustainable development). The literature showed that South Africa suffers from development challenges such high levels of poverty, income inequality and unemployment.

To meet these development challenges, policy makers, both local and international, suggest SMEs as one of the keys to the solution. Empirical evidence supports a direct link between SME development and economic growth, but seems to be inconclusive about whether SMEs can help reduce poverty, income inequality and unemployment. Finlayson (2003:1) points out that despite varying empirical conclusions about the role of SMEs, researchers should not be distracted or minimize the economic benefits that flow from them. SMEs are a critical part of the economy and provide millions of jobs. They are more flexible than large firms. Most of the large firms of today started as small firms. This suggests that SMEs are important in meeting the development challenges of poverty, income inequality and unemployment.

The chapter also examined the definition of SMEs. The literature review shows that it is impossible to measure the role of SMEs and also to provide support to them without understanding their definition. In addition, the importance of new SMEs was examined. It was found that new SMEs are very important to the sustainable development of South Africa. New SMEs are also important in the process of creative destruction as pointed out by Schumpeter. They force existing firms to be efficient. The creation rate of new SMEs in South Africa was thus examined. The GEM and the TEA rate were used to measure new firm creation in South Africa. Empirical evidence for the use of GEM and TEA as a measure of new firm creation was provided. It was found that South Africa has the third lowest level of new firm creation as measured by the TEA amongst all the developing countries surveyed by GEM.

The failure rate of new SMEs was also examined. To understand the concept of new SME failure, the definition of small firm failure and the causes of small firm failure were investigated. It was found that 75% of new SMEs in South Africa fail within the first three years of operations. This is the highest failure rate in all the countries surveyed by GEM. The low creation rate and high failure rate of new SMEs in South Africa are an impediment to the sustainability of economic growth necessary to create wealth and reduce poverty and unemployment. Critical failure factors of new ventures were examined. The literature revealed that there are many reasons for small business failure. Access to finance appears to be one of the most consistent reasons. Entrepreneurs argued that it is a major problem, whereas fund providers suggested that the lack of management skills (which could also perpetuate the lack of access to finance) is the major contributor to the failure of new SMEs. It seems reasonable to conclude, though, that for some reasons, funds are not getting to new SMEs. The conclusion that can be derived from the review of the literature is that South Africa has one of the lowest creation rates of new SMEs. In addition, the country has one of the highest failure rates of new SMEs. There are many causes of new SME failure in South Africa. Lack of finance is one of the major causes of failure. According to Maas and Herrington (2006) "*without appropriate financing, new SMEs simply cannot grow, compete and create jobs. The issue of finance must be addressed if an environment promoting entrepreneurship and SME development is to be encouraged in South Africa*".

The next chapter will examine the importance of finance to the survival of new SMEs. Issues such as the need for capital and the capital structure of new SMEs will be discussed.

CHAPTER THREE

FINANCING NEW SMEs

"Developing financing and fund-raising strategies, knowing what alternatives are available, and obtaining funding are tasks vital to the survival and success of most new SMEs" (Timmons & Spinelli, 2007:389).

3.1 INTRODUCTION

In the previous chapter, two major issues were identified regarding new SMEs in South Africa. The creation of new SMEs as evidenced by the TEA is one of the lowest in the world. In addition, 75% of new SMEs created fail within the first few years of operation. This is the highest rate in all the developing countries survey by the Global Entrepreneurship Monitor Report (Maas & Herrington, 2006). Access to finance appears to be one of the major constraints to the creation and survival of new SMEs in South Africa. If new SMEs do not have access to finance for investments, their ability to commence operations at start-up, survive and grow is seriously impaired. Therefore, the financing decision (the use of equity and debt) of new SMEs has important implications for the economy, given the role that new firms play in employment growth, competition and innovation.

This chapter will examine the financing needs of new SMEs. New SMEs need funds to finance fixed asset acquisition, working capital, product development and initial losses. In addition, capital structure theories such as the static trade-off theory, the agency theory and the pecking order theory and how they affect the financing of new SMEs will be discussed. Furthermore, the chapter will explore the causes of the equity and debt gap for new SMEs. The chapter will also examine the credit evaluation process of both commercial banks and trade creditors.

3.2 THE FINANCIAL NEEDS OF NEW SMEs

Winton and Yerramilli (2008:52) point out that once the core of the market opportunity and the strategy for seizing it are well defined, an entrepreneurial organization can then begin to examine the financial requirements in terms of (1) asset needs (facilities, equipment, research and

development, and other one-time expenditures) and (2) operating needs (i.e. working capital for operations). Successful entrepreneurs anticipate the investment requirements of their firms so they can evaluate, select, negotiate, and craft business relationships with potential funding sources appropriately. With this careful planning process, successful entrepreneurs are more likely to avoid potential mismatches, and costly sidetracking for the wrong sources, and the disastrous marriage to these sources that might follow.

Elsenhardt and Martin (2000:1107) use the Resource Based Theory to demonstrate the financing needs of a new SME. They argue that a new SME needs resources such as fixed assets and working capital to be able to achieve a competitive advantage in the market. The Resource Based Theory of the firm refers to a theoretical framework that explains how firms achieve a competitive advantage and sustain it over time. It examines strategic capabilities as a pool of internal resources which are strategically important for the creation of competitive advantages. Resources in an expanded form include assets such as plant and machinery, financial resources and good management.

Empirical studies such as Zhou and Chen (2008) identify that new SMEs need physical resources to take advantage of business opportunities. Lack of physical resources is a critical failure factor for new SMEs because opportunity discovery needs physical resources to bring it to fruition. Zhou and Chen (2008) in addition point out that to pursue successfully their growth strategy, new SMEs should possess corresponding physical resources or capabilities. According to Bolingtoft, Ulhoi, Madsen and Neergaard (2003:538) to establish and sustain a new SME, 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 SME. Bolingtoft *et al.* (2003) further point out that there are many explanations offered for the failure of new SMEs. One of the most frequently cited reasons is "resource poverty". This is consistent with the view of Timmons and Spinelli (2007:341) that the decision on what resources are needed, when they are needed and how to acquire them are strategic decisions that fit with other driving forces of entrepreneurship.

3.2.1 Fixed assets

Fixed assets (capital investments) involve expenditure on buildings, machinery, fixtures, fittings and vehicles. These are long-term, tangible assets held for business use and not expected to be converted to cash in the current fiscal year of the firm. New SMEs need capital investments to survive, innovate and grow. While it may be possible for the founders of a new SME to fund its initial activities, it becomes increasingly difficult for them to do so when it comes to buying property, constructing buildings, purchasing equipment, or investing in other capital projects (Barringer & Ireland, 2006:231).

Berger and Udell (2006:2949) note that one advantage a new SME can obtain from having fixed assets is that it can be used as collateral. Furthermore, the value of a fixed asset is relatively more stable compared to current assets such as inventories and accounts receivable, which can fluctuate greatly as they are being consumed in the normal operation of the firm. For this reason, lenders prefer fixed assets rather than current assets as collateral. (The issue of collateral and access to finance by new SMEs is extensively discussed in chapter four.)

Falkena *et al.* (2002) show that investment by SMEs in fixed assets in South Africa is low. The shares of SMEs and large firms in the national fixed capital formation are 25% and 75% respectively. This shows that SMEs have a rather low propensity to invest in fixed assets. The low level of investment in fixed assets by SMEs in South Africa is one of the reasons for the lack of access to debt finance.

Coco (2000:195) asserts that the low level of capital formation of SMEs can be related to cost. The acquisition of fixed assets, particularly, expensive capital equipment, is a major commitment for many new small firms. How that acquisition is funded requires careful planning. This is very important to new SMEs which often do not have enough funds to buy fixed assets. Rather than pay for the asset outright using cash, it can often make sense for the firm to look for ways of spreading the cost of acquiring an asset, to coincide with the timing of the revenue generated by the firm. One of the ways that a new firm can manage the high cost of fixed assets is by bootstrapping. Van Auken (2005a:96) notes that bootstrapping includes a combination of methods that reduce overall capital requirements, improve cash flow, and take advantage of

personal sources of financing. Bootstrapping methods for fixed assets acquisition include hire purchase and leasing. The deduction from literature is that new SMEs need fixed assets to survive, grow and compete in the marketplace.

3.2.2 Working capital and cash flow

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 (Padachi, Narasimhan, Durbarry & Howorth. 2008:44).

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

According to Firer, Ross, Westerfield and Jordan (2004:5) working capital refers to a firm's short-term assets and liabilities. Short-term assets include cash, inventory, debtors and prepayments and short-term liabilities include overdrafts, accounts payable and accruals. Working capital is required for the day-to-day running of a business. It is the lifeblood of a business. Working capital is needed to pay wages, suppliers, and other expenses before sale revenues are received from customers. Positive working capital means that the company is able to pay off its short-term liabilities. Negative working capital means that a company currently is unable to meet its short-term liabilities with its current assets. Therefore, the failure to plan for increasing working capital needs can lead to serious cash flow problems.

Empirical studies find a positive relationship between a lack of working capital and the failure of new SMEs. Garcial-Teruel and Martinez-Solano (2007:166) point out that non-availability of working capital is a major constraint to the survival and growth of new SMEs. A large number of new SME failures can be attributed to a lack of working capital. The success of a firm depends ultimately on its ability to generate cash receipts in excess of disbursements. The cash flow problems of many SMEs are exacerbated by poor financial management and in particular the lack of planning cash requirements.

According to Amrehein and Katz (2000:40) the degree of a company's liquidity provides a critical measure of its mortality risk. Even if a firm is profitable, it still takes cash to pay the bills. Properly managing the area of working capital and cash flows is essential to the survival and growth of a business. This is particularly true of SMEs, which experience different circumstances than large firms including fewer available resources. Cash is also needed to maintain survival and sustain growth. As growth increases, an entrepreneurial firm's need for cash intensifies. Even if a business is enjoying success in other areas, a shortage of cash can result in technical insolvency, which will lead to bankruptcy and possible liquidation. These conclusions are consistent with the findings of other empirical studies. For instance, Gumede (2002:381) and Song, Padoynitsyna, Vander, Bij, and Halman (2008:17) also find that the availability of working capital is one of the critical success factors for new SMEs.

Nguyen and Ramachandran (2006:192) argue that one major disadvantage of working capital is that it is often unacceptable as collateral. This could affect the availability of debt finance to new SMEs. Asset structure is an important determinant of a company's ability to obtain external finance. Firms that have relatively higher levels of fixed assets compared to current assets in their asset structures are better able to access debt finance from commercial banks.

De la Pena and Fleisig (2002), in addition find that using fixed assets or working capital can also affect the cost of funds and the size of loans approved. The researchers note that the difference in interest rates between the prime rate and the rate charged on loans to Latin American SMEs arises from the inability of the typical SME to supply fixed asset collateral. SMEs that collaterize 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. SMEs that offer immovable property as collateral can get better terms. They can borrow an amount equal to 80% to 95% of the collateral and pay interest rates that are 4 to 5 percentage points above the government borrowing rate. This suggests that new SMEs that depend on current assets such as debtors and inventories (asset based lending) to secure lending find it more difficult to borrow from commercial banks.

3.2.3 Product development and initial losses

Barringer and Ireland (2006:231) state that new SMEs often need to raise funds to pay for the upfront costs of lengthy product development cycles. Product development often takes years and requires adequate funding to bring it to fruition. However, not all new SMEs develop new products. Mohamed (2005) defines product development as the process of acquiring knowledge to create a new product to serve the needs and wants of customers who are already buying a company's products. It also refers to improving an existing product. Thus product development has become a key determinant in gaining competitive advantage.

According to Todor and Alin (2008) new product development and technological innovation is the lifeblood of new SMEs. These allow the new SME to create a competitive advantage. A new SME that enters the market with a new product has the advantage of the first mover and pioneer and can use this to gain competitive advantage and acceptance. Therefore, new products critically impact such firms' ability to garner resources for survival and growth. Kakati (2003:447) however points out that new SMEs often start with an initial loss because of the cost of product development and other sunk costs before they start operation. Most new SMEs start with a loss and achieve break even after one to two years. The initial losses affect the ability of new SMEs to continue operation. Funds are therefore needed to finance these initial losses.

Baron and Shane (2005:182) indicate that while some new SMEs show profitability during their startup phase, it is more common to have income statement losses until the venture generates adequate revenues to cover expenses. This implies that most new SMEs have initial losses and negative cash flows in the early phases of the business and this may result in failure if additional cash is not available from some source. As the new firm begins operations, it is using cash (both from a fixed as well as variable cost standpoint) and reporting a negative net cash flow. Depending upon the venture and the industry in which it is operating, this negative cash flow can go on for some time. However, at some point a successful business turns the corner and begins producing positive cash flows. This might be considered the point of breakeven for the company; however, until the new venture's positive cash flows exceed the initial investment, true breakeven has not been achieved.

3.2.4 Other reasons

According to Cardon, Wennberg, Wiklund and De Tienne (2009:20) other reasons why a new SME may need financing include human capital development, training and technology. Employees contribute positively to the growth of new SMEs by helping entrepreneurs execute their objectives. A new SME may require more specific expertise and highly skilled workers than a mature firm. As the SME enters into the expansion stage, it may be able to use less skilled workers to meet production demands. In addition, while the founders are able to assume some of the responsibilities of managing the business, other activities will have to be managed by hiring some key and non-founder employees who have the knowledge and skills to help the firm grow. New SMEs also need capital for technology. According to Okubena (2008) information and communication technology (ICT) has been identified as a major area of need to develop new SMEs. ICT is vital to the development of new SMEs in the areas of information provision, access to national and international markets, and other areas of business development and support. Information and communication technologies enable entrepreneurs to manage their businesses efficiently and thus enhancing their competitiveness.

It can be concluded that the tangible and intangible assets any new SME possesses or can control is a primary determinant of its strategy and performance. Insufficient or inaccessible resources may severely limit the range of feasible strategic alternatives available and put the new SME at a disadvantage to relatively better endowed and entrenched competitors. This implies that the performance of a new SME in a given 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; it is quite another to secure the resources and build the competence necessary to implement such a strategy. Even a new SME with a carefully designed strategy cannot survive if it lacks capital. In general, the survival of a new SME will depend upon its ability to secure tangible resources. The probability of the short-term survival of a new SME with adequate tangible resources should be high because small mistakes and initial losses can be absorbed more readily (Nguyen & Ramachandran, 2006:195).

To undertake capital investments, meet working capital and develop products, new SMEs need finance. This can come in the form of equity, debt or a hybrid of debt and equity. This is known

as the capital structure. Section 3.3 will examine the definition of capital structure and also discuss capital structure theories and their impact on new SMEs.

3.3 CAPITAL STRUCTURE

Capital structure is described as the mix of debt and equity that a firm uses to finance its operations. The capital structure decision is one of the most complex decisions facing a firm. Poor capital structure decisions can result in the high cost of capital and lower profitability. Effective capital structure decisions can lower the cost of capital and enhance shareholders' wealth. The cost of capital can be described as the rate of return that a company earns on its investments to ensure that the minimum requirements of all the providers of capital are met. It is difficult to determine the optimal combination of debt and equity financing of a company (i.e. the optimal capital structure). However, corporate finance theory on profit maximization stipulates that the value of a firm is maximized when its cost of capital is minimized. The optimal capital structure, therefore, is the combination of debt and equity at which the weighted average cost of capital of a firm is minimized and shareholders wealth maximized. 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, 2003:533).

Capital structure is recognised as one of the seven most important issues in finance. This seemingly simple decision on the best mixture of capital sources to be employed in operating a firm has confounded researchers since the seminal work of Modigliani and Miller (1958). Capital structure decisions are some of the greatest challenges and most difficult issues confronting new SMEs, but are central to their viability. The importance of capital structure decisions is evident from the role of inadequate capitalization in the high failure rate among new SMEs. Inappropriate capitalization can threaten the financial viability of a new SME. A weak financial structure can affect all areas of the firm's operations, creating problems such as unreliable operations, ineffective marketing, and inability to hire qualified personnel. Adequate capitalization on the other hand can enable firms to acquire the necessary resources to pursue market opportunities successfully. Firms with growth ambitions require capital to fuel their growth. Regardless of size or age of a firm, access to capital is a matter of paramount importance (Van Praag, 2003:1). Understanding the capital structure decisions of new SMEs is important for

both theoretical and practical reasons. Studying the capital structure of new SMEs helps to shed light on existing models of capital structure by focusing on an environment in which many of the modelling assumptions are particularly salient. This provides a natural laboratory for testing the predictions of many existing theories of capital structure (Robb & Robinson, 2009).

3.3.1 Capital structure theories

The theoretical principles underlying capital structure can generally be described in terms of the static trade-off theory by Modigliani and Miller (1958:261-295) and Modigliani and Miller (1963:433-444), the agency theory by Jensen & Meckling (1976:303-360) and the pecking order theory by Myers (1984:575-592). It must be noted that capital structure theories are not restricted to these three. For a more complete analysis of capital structure theories please refer to Harris and Raviv (1991:297-355). According to Sogorb Mira (2002) the most relevant capital structure theories that explain the capital structure of small and medium enterprises (SMEs) are those related to static trade-off, adverse selection and moral hazard (agency theory) and the pecking order theory.

3.3.1.1 The static trade-off theory

Frank and Goyal (2007) state that the term static trade-off theory is used by different authors to describe a family of related theories. In all of these theories, a decision maker running a firm evaluates the various costs and benefits of alternative leverage plans. According to Andree and Kallberg (2008) the genesis of modern capital structure theory lies in the work of Modigliani and Miller (1958:261-295) in their famous proposition I – often referred to as the "irrelevance theorem". The theorem suggests that, as an implication of equilibrium in perfect capital markets, the choice of capital structure does not affect a firm's market value. Modigliani and Miller (1958) based their irrelevance theorem on certain perfect market assumptions. These assumptions include no corporate taxes, no brokerage or floatation cost for securities, and symmetrical information which implies that investors and managers have the same information about a firm's prospects and that individuals and firms can borrow at the same rates of interest. It is, therefore, the assets of a firm that determine the value of the firm and not the way by which these assets are financed.

The initial perfect market assumptions, on which the 1958 theory of Modigliani and Miller was based, were later reviewed in 1963 with the introduction of the tax benefits of debt. This is attributed to the fact that a perfect market does not exist in the real world. Since interest on debt is tax-deductible, thereby creating tax savings for the borrower, it becomes possible for firms to minimize their costs of capital and maximize shareholders' wealth by using debt. The tax advantage of debt makes it cheaper than equity. The mix of cheap debt with relatively expensive equity reduces a firm's cost of capital, which is the cut-off rate for investment acceptance decisions. This is known as the leverage effect of debt, and refers to the use of debt capital to minimize a firm's cost of capital and maximize its profitability. The tax advantage of debt substantially reduces the cost of debt in a firm's capital structure. With a corporate tax rate of 50%, tax deductibility of interest payments on debt can make the cost of debt as little as half that of equity. Therefore, debt contributes to the attainment of higher return on equity (Modigliani & Miller, 1963:433-444).

According to Miller and Modigliani (1963:435) a firm should have 100% debt in its capital structure. This way the firm can take absolute advantage of the tax-shield. Scott (1972:45-60) and Kraus and Litzenberger (1973:911-922) point out that theoretically 100% tax shield does not exist in reality because of distress costs. The main argument of these researchers is that debt leads to a legal obligation to pay interests and principal. If a firm cannot meet its debt obligations it is forced into bankruptcy and incurs associated costs. The temptation of possible tax shields from debt financing may encourage firms to use debt in their capital structures. However the opposing force of the costs of bankruptcy may force the firm to avoid debt. Therefore, the optimization 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.

According to Andree and Kallberg (2008) the tax advantage and bankruptcy costs trade-off of the static theory has stimulated perhaps the largest number of empirical studies in corporate finance with mixed results. Modigliani and Miller (1963:436) suggest that there is a positive relationship between debt and the value of a firm.

Empirical studies such as Ruland and Zhou (2005:279) and Robb and Robinson (2009) agree with Miller and Modigliani (1963:436) that the gains from leverage are significant, and that the use of debt increases the market value of a firm. Financial leverage has a positive effect on the firm's return on equity provided that the earning powers of the firm's assets (the ratio of earnings before interest and taxes to total assets) exceeds the average interest cost of debt to the firm. Other studies such as Negash (2001:115) and Phillips and Sipahioglu (2004:33) conclude that the tax benefits of leverage are insignificant. Negash (2001:118), for instance finds that the use of debt has been found to have a negative impact on the profitability of the firms quoted on the Johannesburg Stock Exchange.

The biggest contribution of this theory is, however, the fact that the optimal capital structure of businesses varies. It depends on the stability of sales, the operating leverage and the size and stability of profits (Brigham & Houston, 2003:51) A typical new SME has low profits, unstable sales and often a high operating leverage, implying a low level of debt. Balkenhol and Evans-Klock (2002) for instance point out that SMEs, especially new ones in South Africa, are faced with many difficulties regarding their return on investment. Amongst these is the dual nature of the economy, where SMEs, often, have to compete with established multi-national firms in the same sector. In South Africa, most sectors are concentrated around a few large firms. Consequently, SMEs face the constraints of entering a highly competitive market, and this affects their ability to make profits from their investment.

Kesper (2001:172) stipulates that most new SMEs in South Africa lack profitability and growth. Many SMEs do not report a profit or an increase in turnover. Their constraints include; poor micro-economic conditions and more price competitive imports coming into the domestic market, an increase in wages erodes the price competitiveness of SMEs, sales of SMEs are primarily concentrated on the local markets, and high input costs, especially transport costs. The findings of Kesper (2001) are consistent with the conclusions of other studies on the performance of new SMEs. Ihua (2009:200) finds that the performance of new SMEs in the United Kingdom as measured by profitability and turnover is weak during the start-up phase. The major factors causing the low level of profitability are low sales and high operating costs. Weak sales of new SMEs also lead to high operating leverage. Ihua (2009:201) posits that a business that

makes few sales, with each sale providing a very high gross margin, is said to be highly leveraged. A business that makes many sales, with each sale contributing a very slight margin, is said to be less leveraged. As the volume of sales in a business increases, each new sale contributes less to fixed costs and more to profitability. Weak sales and profitability and high operating leverage suggest that the usage of debt finance by new SMEs should be limited.

This is in contrast to Modigliani and Miller (1963) suggests that firms should use 100% debt in their capital structures because of the tax advantage of debt. Sogorb Mira (2002) finds that the fiscal advantage of debt cannot be applied in the new SME context because new SMEs are less likely to be profitable and therefore may not be able to use debt in order to get tax shields. Moreover, the main advantage of debt, the tax shield, can be especially complex to assess in new SMEs where business income is taxed as personal income. Abor (2004:62) also criticizes the Modigliani & Miller theory because it assumes owners' goals are targeted only at maximizing profits. Many new SMEs do not have profit motives. Barbosa and Moraes (2004) in addition argue that the works of Modigliani and Miller (1958, 1963) assume that investors and managers have access to the same information in respect of a firm. This assumption, which may hold for large listed firms, may not hold for new SMEs which are mainly unlisted. Information on the financial health of the new SME is often incomplete, inaccurate or simply unavailable. This asymmetric and incomplete information between the owners and the lenders causes potential debt financing problems for new SMEs. According to Andree and Kallberg (2008) the usability of the trade-off theory of capital structure is limited for new SMEs.

In addition, Daniel, Masli, Rahman and Selvarajah (2006:210) point out that in the case of new SMEs the expected costs of bankruptcy is quite high and the expected costs of financial distress may outweigh any potential benefits from the tax shield. Furthermore, the cost of insolvency is high because many new SMEs do not have fixed assets that are easily marketable. Also, the advantage of the tax shield of debt is limited for new SMEs. New SMEs have limited revenues and the variability of their operating income can be quite volatile. New SMEs rarely generate profit in the early stage of operations, and the potential benefit of tax shields of interest payments remains doubtful.

It can therefore be deduced that new SMEs, because of their low profitability and high bankruptcy costs, should use debt sparingly which is inconsistent with Modigliani and Miller (1963). Firms with lower levels of profitability have less use for debt-tax. SMEs are also at a greater risk of financial distress and new SMEs are more failure prone than established firms. The debt-tax shield is thus less valuable for new SMEs. Because of the combination of these factors, it can be concluded that the static trade-off theory is not a first-order consideration for new SMEs. In seeking explanations for the capital structures of new SMEs, alternative theories should be examined. It must be however be pointed out that new SMEs also have limited access to external equity capital such as venture capital and the stock market. This implies that new SMEs will have to rely only on internal equity which is often inadequate as a source of capital. The limitations of static trade-off theory suggest the reliance on internal equity by new SMEs. Yet, the reality for growing new SMEs is a reliance on debt and external equity because of the inadequacy of internal equity (Frelinghaus, Mostert & Firer, 2005:9).

Berger and Udell (2006:2948) observe that almost fifty years have passed since the seminal works of Modigliani and Miller (1958 and 1963) on the importance of capital structure, yet the seemingly simple question of how firms should best finance their assets remains a contentious issue. The empirical evidence regarding a firm's optimal mixture of financing during this time period is both voluminous and mixed in aggregate. Although there is no consensus, two other competing theories have emerged. These are the agency theory and the pecking order theory.

3.3.1.2 The agency theory

Jensen and Meckling (1976:306) identify two types of agency conflicts. The first focuses on the conflict between shareholders and managers and the second on the conflict between equityholders and debtholders. Conflicts between shareholders and managers arise because managers do not hold total residual claim thus they cannot capture the entire gain from their value-maximizing activities. The second type of conflict arises between debtholders and equityholders because debt contracts give equityholders an incentive to invest sub-optimally. The debt contract results in asymmetric distribution of the gains, meaning that, if an investment is profitable above the face value of debt, most of the gain is captured by equityholders, while if investment fails, debtholders bear all the consequences because of the limited liability of the

equityholders. As a result, equityholders may benefit from investing in very risky projects, even if they are value-decreasing. Such investments result in a decrease of 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 debtholders.

According to Falkena *et al.* (2002) and Padachi, Narasimhan, Durbarry and Howorth (2008:45) the agency theory gives vital insights into the problems of ownership, management interrelationships and credit rationing. Issues around information asymmetry, moral hazard and adverse selection are likely to arise in contractual arrangements between firms and external providers of finance. These problems may well be more severe, and the associated costs much higher for SMEs than for large ones. SMEs are also subject to the risk of asset substitution which, in practice, means a change in the firm's asset structure. For SMEs this asset substitution may well take place between the enterprise and the owner's household. Thus, the proximity to the household, lack of legal formalization, weak financial disclosure and the owner-managed nature of SMEs make it hard for lenders to track ongoing changes to the asset base of the SME. The presence of these problems in SMEs may explain the greater use of collateral lending to SMEs as a way of dealing with these agency problems. Lenders' strategies for dealing with these problems also add significantly to the cost of dealing with this sector. For a large enterprise the evaluation of an application for finance may be limited to the assessment of an (audited) set of financial statements (information asymmetry) and supporting documentation provided by the applicant. For SMEs the assessment frequently has to go far beyond this, implying a substantially higher transaction cost.

According to Stiglitz and Weiss (1981:394) agency problems such as asymmetric information and moral hazards can impact on the availability of credit and hence the capital structure of new SMEs. Stiglitz and Weiss termed this phenomenon credit rationing. In the Stiglitz & Weiss formulation, credit rationing is said to occur if (1) among loan applicants who appear to be identical - some receive credit while others do not; or (2) there are identifiable groups in the population that are unable to obtain credit or can only obtain credit at much higher prices. The core of the argument is that suppliers of finance may choose (due to asymmetric information, adverse credit selection and monitoring problems) to offer an array of interest rates that would

leave a significant number of potential borrowers without access to credit. The Stiglitz and Weiss' theory therefore suggests that there are significant numbers of SMEs that could use funds productively if they were available, but cannot obtain finance from the formal financial system.

Conclusively, the agency cost argument suggests a pattern of relationship for the capital structure of new SMEs. The pattern of the relationship pattern is low-high-high. This implies low amount debt at the beginning, high debt as the firm develops and low debt at prime when the firm would have accumulated some retained earnings. In terms of agency cost theory, new SMEs are expected to have the least debt and thus depend on internal equity and that debt levels will gradually increase as the firm develops and becomes established. Frelinghaus *et al.* (2005:10) disagree with the pattern of relationship suggested by the agency theory. The authors argue that whilst it is true that firms in latter stages do, in fact, have more debt than firms in prime, agency theory cannot explain why firms in the early stages of development, with managers owning more of the firm, have more debt than firms in prime. Frelinghaus *et al.* (2005:13) suggest that internal equity is inadequate for new SMEs, external equity is unavailable, hence the reliance of new SMEs on debt finance.

3.3.1.3 The pecking order theory

According to Myers (1984:575) the pecking order theory (POT) suggests that there is no well-defined optimal capital structure; instead the debt ratio is the result of hierarchical financing over time. The foundation of POT is that firms have no defined debt-to-value ratio. 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.

Empirical evidence such as Lopez-Gracia and Aybar-Arias (2000:58), Sogorb Mira (2002) and Ou and Haynes (2006:160) support the applicability of the POT in explaining the financing of new SMEs. These studies emphasize that small firms rely on internal sources of finance and external borrowing to finance operations and growth, and only a very small number of firms use external equity. The most important sources of funding for start-up and nascent firms are the personal funds of the firm owner, and debt funding. According to the pecking order theory, firms

in infancy with little retained earnings should seek the maximum available debt funding before resorting to external equity. Prime and stable firms, in contrast, generate substantial retained earnings and therefore need less debt than they did in their high-growth phase. Pecking order theory, therefore, also suggests a strong relationship between life stage and capital structure. In contrast to static trade-off theory, however, pecking order theory suggests a high-low-high pattern of debt ratio over time (Frelinghaus *et al.* 2005:13). This suggests that new SMEs should depend on internal equity. However, most new SMEs do not have retained earnings and so have to depend on debt which is the next source of funds in the pecking order hierarchy.

Fama and French (2002:5) believe that POT may provide an appropriate description of SMEs financing practices and that the order in which capital is raised may be affected by many factors, such as preference, cost, need for capital, and availability of information. Zoppa and McMahon (2002) argue that initially POT sought mainly to explain the observed financing practices of large publicly traded corporations. However, it was soon recognized that the theory may also apply to the financing practices of non-publicly traded SMEs that might not have the additional financing alternative of issuing external equity finance.

The pecking order theory argues that firms should use internal finance first before moving into external finance. Furthermore, when using external finance debt should be used before new equity. Contemporary finance researchers such as Crnogoj and Mramor (2008) however find that new SMEs, especially in developed countries, use internal equity together with debt at start-up. This is termed the modified pecking order theory.

Kauffman Foundation (2007) reveals that 75% of SMEs' start-up capital 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 new firms. Other key findings of Kauffman Foundation (2007) include:

- Outside debt (financing through credit cards, credit lines, bank loans, etc.) was the most important type of financing for new firms, followed closely by owner equity. These two sources accounted for about 75 percent of start-up capital.

- Insider debt (from friends, family, and spouses) and outsider equity were much less important sources of start-up capital.
- Owner debt and insider equity were the least important sources for start-up capital.

According to Statistics Canada (2007) 45% of new SMEs are able to access commercial loans, 44% commercial lines of credit, and 42% trade credit. It seems however that the modified pecking order hypothesis is limited to developed countries. In developing countries such as South Africa, most new SMEs still find it very difficult to access debt finance. FinMark Trust (2006) finds that less than 1% of new small firms in South Africa are able to access debt finance.

In general, the static-trade off theory, the agency theory and the pecking order theory all suggest the use of internal equity as the first source of finance by new SMEs. However, as pointed out by Frelinghaus *et al.* (2005:13) the three theories also realize the inadequacy of owners' contribution and the lack of retained earnings because of the newness of the SMEs. In addition, external equity is expensive and not usually available to new SMEs, hence their reliance on debt finance. The question that comes to mind thus is how much debt should a new SME use in its capital structure. This will be explained by examining the optimal capital structure of new SMEs.

3.3.1.4 Optimal capital structure

Myers (1984:583) states that the issue of how much debt or equity a firm should issue (optimal borrowing ratio) remains a puzzle. According to the static trade-off theory a firm's optimal debt ratio is usually viewed as determined by a trade-off of the costs and benefits of borrowing, holding the firm's assets and investment plans constant. The agency cost theory argues that the optimal cost of debt is the trade-off between the tax advantages of debt and the agency cost of debt. In addition, the pecking order theory also states that each firm's observed debt ratio reflects its cumulative requirements for external finance. Myers (1984:583) states "*I will start by asking, "How do firms choose their capital structures?" Again, the answer is, "We don't know." We do not know how firms choose the amount of debt, equity or hybrid securities they issue. Many of us have translated these theories, or stories, of optimal capital structure into more or less definite advice to managers. But our theories don't seem to explain actual financing behaviour, and it*

seems presumptuous to advise firms on optimal capital structure when we are so far from explaining actual decisions".

According to Firer, Ross, Westerfield and Jordan (2004:527) and Byoum and Rhim (2005:3), the static theory of capital structure suggests that a firm should borrow up to the point where the tax benefit from an extra Rand in debt is exactly equal to the cost that comes from the increased probability of financial distress. This is consistent with the findings of Rungani (2008) that a key consideration in choosing the source of finance for a new SME is to strike a balance between equity and debt to ensure that the funding structure suits the business. The overall objective in raising finance is to avoid exposing the business to excessively high borrowing thereby ensuring that the financial risk of the firm is kept at an optimal level. Martinovic (2008) agrees that abnormally high ratios of debt to equity are generally unsafe and lack fiscal stability in the long run. Conversely, abnormally high debt to equity ratios can also prove harmful if the firm is excessively leveraged. This is why it is important that a certain degree of debt financing exist in a firm's' capital structure. It is important to examine the needs of the business and the timeline for reaching certain financial goals in order to determine the appropriate capital structure for a business. Baron and Shane (2005:233) point out that it is important to determine how assets are financed during the start-up phase of a new SME. The three options available to financing assets include: (1) the aggressive approach that suggests financing fixed assets and the permanent portion of current assets with long-term sources. (2) The matching approach that suggests financing assets financing assets with terms that match their life and (3) the conservative approach that suggests financing fixed assets, permanent working capital and a portion of seasonal working capital with long-term sources. Small business texts seem to favour the conservative approach.

Baron and Shane (2005:233) agree that treating the permanent portion of current assets as long lived and using long-term debt to finance it make sense. Cassar (2004:263) agrees that the logic seems clear, when small business starts, current assets should be financed with a source of funds long enough to allow the firm to reach cash flow breakeven in an orderly manner. In most start up situations, longer-term funds should be used to finance fixed assets and permanent current assets. Barclay, Marx and Smith (2003:150) and Pindado, Rodrigues and De la Torre (2006:380)

stress that long-term debt is not the only important concern when firms make their financing decisions, but short-term debt should also be considered. Many new SMEs face difficulties gaining access to long-term debt markets and hence most of their external funds come from short-term loans. Particularly banks and trade creditors prefer to lend short-term rather than long-term in order to avoid risk taking when financing new SMEs.

Therefore, new SMEs should use short-term credit such as trade credit and overdrafts, which can easily be repaid in the normal course of the business. Kortschak (2007) argues that when used in the right amounts and for the right purposes, leverage or debt financing can be a critical part of a firm's growth. Fundamentally, incorporating leverage into a firm's capital structure offers one significant advantage; entrepreneurs can increase the value of their companies without diluting ownership. However, there are also risks. If a leveraged firm hits an unexpected rough patch and cannot make interest or principal payments, the firm may be forced to sell assets, take cash infusion to retire debt or, in the worst-case scenario, lose control of the firm. The challenge lies in determining the prudent amount of debt your company can take on without jeopardizing its well-being and long-term growth potential.

Van Auken (2005b:338), in addition, argues that traditional capital structure theories do not provide adequate guidance on financial structure decisions in SMEs. The level of debt and equity in a smaller firm is more than likely a function of the characteristics of the firm and its managers. In the private firm, the leverage theory doesn't always apply. The owners' attitudes towards personal risk, and not the capital structuring policies that public firms use, determine what amounts of debt and equity are acceptable. Van Auken (2005b:339) proposes four variables that will determine the amount of debt or equity a SME uses in its capital structure.

- *Information*

Because many firm owners are not knowledgeable about issues related to the financial management of their firms, they may accept business and financial risks greater than the potential rewards from the business. Entrepreneurs may underestimate risk due to their limited experience and over-confidence. Misinformation and/or lack of information about the process through which capital is acquired can be an obstacle to the development of a successful capital

acquisition strategy. The degree of familiarity with the process through which capital is acquired is the basis for developing a strategy that correctly identifies (1) the most likely sources of capital that meet the owner's business and personal needs, (2) the types of information that should be prepared for these sources, and (3) the methods by which providers of capital might be contacted. An inappropriate capital acquisition strategy may result in the owner being unsuccessful in raising capital or raising inappropriate levels/combinations of capital. Ultimately, inappropriate capital acquisition may result in illiquidity, financial distress, and failure. SMEs are especially vulnerable to the impact of poor financial decisions because of their limited resources. Good information is the basis for making good financial decisions. Timeliness and accuracy of information are primary determinants of good capital acquisition decisions.

- *Ease of acquisition*

Easier capital acquisition would likely lead to a greater likelihood that an owner would seek capital. More difficult capital acquisition would be expected to discourage an owner from pursuing new capital. The willingness of providers of capital to work with the SME is directly related to the ease of acquisition. SME owners would be more willing to seek capital from providers that are easier to work with than from providers that are more difficult to work with. The relationship between the ease of capital acquisition and capital acquisition decisions may also be affected by human nature. For example, owners would be expected to migrate toward sources of capital that are easier to acquire rather than sources that are harder to acquire.

- *Owners' goals*

Two aspects of capital acquisition that are affected by an owner's goals are capital structure and term of financing. The goals of the owner would be a significant factor in whether the firm is a craftsman (primarily motivated by life-style preferences) or managerial firm (primarily motivated by economic gain). The owner's goals and thus the type of firm would, in turn, directly influence the firm's financial strategies. Owners of life-style firms might, for example, be expected to rely on capital from lending institutions, profits, and personal equity. Owners of managerial firms might be expected to pursue capital that is commonly associated with risk and growth, such as angel and venture capital. In addition, the degree of risk that owners are willing

to accept would impact the financial strategy relative to capital structure (debt versus equity) financing.

- *Terms of providers of capital*

Alternative providers of capital have different requirements for providing capital to SMEs. These requirements vary according to a number of criteria, including, for example, the nature of the relationship between the firm and the provider of capital, the financial condition of the firm, and the type of capital (e.g. debt versus equity). The terms of funding affect the degree of a business owner's interest in pursuing the financing source. Business owners would be expected to pursue and prefer sources of capital that provide more favourable financing terms compared to those that offer less favourable financing terms. Debt financing terms may include, for example, interest rate, collateral requirements, and term of loan. Equity financing terms may include restrictions on cash management, reporting requirements, change in management, and loss of ownership. The bank-borrower relationship plays a significant role in the process of gathering information and setting the terms of loan contracts.

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

3.3.2 Equity

Forsaith and McMahon (2002) point out that the finance theory is equivocal in its description of the use of equity finance by SMEs. The pecking order theory suggests a preference for internal equity and an aversion to external equity, but provides not a priori prescription for the overall capital structure. The firm life-cycle theory also suggests that SMEs should start operations with internal equity before moving to other sources of finance. Equity can be described as any financing vehicle that has a residual claim on the firm, and does not create a tax advantage from its payments; has an infinite life; does not have priority in bankruptcy, and provides management control to the owner. Equity implies the owners' financial contribution to the firm on which dividends are paid. Equity holders are the real owners of a firm. Equity holders are also called residual owners, because they receive what is left after all the claims on the firm's assets and

incomes, such as debenture interests and preference share dividends, have been satisfied. They are, therefore, compensated with capital gains and dividends. Equity can be broadly divided into internal equity and external equity.

3.3.2.1 Internal equity

According to Ou and Haynes (2006:157), internal equity which can be described primarily as owners' contributions, contributions from family and friends and retained earnings, is used more widely by SMEs. The owners of a new SME contribute what is known as 'sweat equity" to the firm. It is important for the firm owner to have some personal assets in the business, and this typically comes from personal savings. Also a banker or any credit provider may not grant credit to a new SME if the owner does not have his or her own money at risk. In addition, contribution from friends and family is another important source of finance for new SMEs. This form of contribution is often called "love money" which can consist of outright gifts, loans or investments. This kind of contribution often comes in the form of delayed compensation or reduced or free rent.

Ou and Haynes (2006:158) add that a firm's demand for capital arises when the expected cash inflow falls short of the expected cash outflow. The capital needs can be fulfilled by either debt capital or by equity capital. Internal equity capital provides long-term funding with minimal cash flow drains typically associated with debt financing. Internal equity enhances the creditability of a new SME when sourcing for external finance. According to the life cycle theory as explained in Bhaird and Lucy (2006) and Bhaird and Lucy (2008:312) new SMEs tend to draw initial capital from internal sources. As the firm ages, outside investors can observe the firm's track-record and examine its creditworthiness over time. In developing a reputation, firms attenuate the problem of asymmetric information and have improved access to short-term sources of funding such as trade credit and bank overdraft facilities. In order to raise sufficient funds to meet capital investment needs, the firm may increasingly source finance from financial institutions, and debt levels increase as the firm gets larger and older. As retained earnings accumulate over time, the firm's borrowing requirements will decline and debt as a percentage of total assets declines. The life cycle theory suggests that internal equity is the most important source of finance at start-up. Debt finance is used later but retained earnings (also internal equity) are the most important

source of finance when SMEs become established. This implies that the only initial source of funding of a new small firm is internal equity and is contrary to the modified Pecking Order Theory, which finds that most new SMEs use both external debt and equity when starting a business.

Carpenter and Petersen (2002:299) note that finance literature documents that firms exhibit a clear preference for internal funds (i.e., retained earnings) over external sources of financing, such as debt or issuing shares. Various explanations have been postulated for this preference for internal funding. First, using internal funds provides managers with greater flexibility. For example, managers can more quickly finance and thus implement investment plans, and they retain the option of raising funds externally in the future. Second, firms avoid costs such as legal, accounting, and underwriting fees when using internal funds, but they must incur such flotation costs when raising funds externally. Third, because there is asymmetric information between managers and investors about a firm's investment opportunities, the market may undervalue a firm's new shares relative to the value that would be assessed if managers' information about their firm's investment plans were publicly available. Carpenter and Petersen (2002:300) argue further that to avoid the costs of potential delays in implementing projects as well as flotation and information asymmetry costs, firms can retain sufficient funds internally to be used for economically worthwhile investments. This is referred to as financial slack. The greater the level of financial slack a firm has, the less dependent it is on the external market for funds.

Bollingtoft *et al.* (2003:536) postulate that internal equity has several advantages over debt for a new SME. Internal equity can help a new SME in maintaining control of the firm. Management of a small firm would prefer to finance the firm's needs from generated funds rather than external creditors or even new stockholders because they would like to have control of strategic decisions. SMEs also avoid venture capital because they fear losing control of the firm. Debt restricts managerial flexibility in decision making as creditors will stipulate terms of a debt agreement. This is even more pronounced in new and developing small business ventures. Their credit lines will not be as strong as those of larger firms. Lenders, therefore, will demand stricter control of the terms of a credit agreement. In addition, investors' perceived risk of a new SME can be influenced by the contribution of owners as shown in the financial plan. Potential

investors may be more likely to invest in a project if the entrepreneur is investing his own capital. This will improve the credibility of the project. Aronson (2006) finds that there is a significant positive relationship between the availability of equity and venture capital funding for new SMEs.

Carpenter and Peterson (2002:300) state that a new SME often needs to source external funds to finance growth as internal equity is often limited and inadequate. Therefore, there is the need for new SMEs to source external equity or debt finance. Furthermore, most new SMEs have little or no retained earnings because of their newness in the market.

3.3.2.2 External equity

External equity implies equity contribution from external sources such as business angels, venture capitalists and the stock exchange. According to Berger and Udell (2006:2953) venture capitalists are firms who make equity investments in firms with an opportunity for growth. Venture capitalists are formal business entities that maintain strong oversight over the firms they invest in, and that have clearly defined exit strategies. The ultimate intention of a venture capitalist is to sell the SME or to nurture it to the extent that it can become a publicly listed firm. This allows a venture capitalist to realize his or her investment in the small firm. Venture capitalists look for a management team with a substantial track record and an ability to take the company to the next level of growth. The business opportunity must be substantial and profitable, and the product innovative. The potential for growth, feasible exit options and a feasible business plan will also be taken into consideration. The venture capital market is intermediated. Venture capitalists perform the typical functions of financial intermediaries, taking funds from a group of investors and deploying those funds by investment in SMEs. In addition to screening, contracting and monitoring, venture capitalists also determine the time and form of investment exit. In performing these functions, the venture capitalist is the consummate active investor, often participating in strategic planning and even occasionally operational decision-making.

Berger and Udell (2006:2954) point out that business angels on the other hand, are a diverse group of high net worth individuals who invest part of their assets in high-risk/high-return

entrepreneurial ventures. They are usually wealthy investors who are willing to invest in promising early stage firms in exchange for a portion of the firm's equity. As equity partners, business angels can bring specific skills into a business. They may also be prepared to be involved in the development of the business, and be prepared to take higher risks than most investors. Potentially, they enjoy the highest returns if the business does well, but should equally be prepared to lose their entire investment if the business fails. Angel finance differs markedly from most other categories of external finance in that the angel market is not intermediated. Instead, it is an informal market for direct finance where individuals invest directly in small companies through equity contracts, typically common stock.

New SMEs can also source for equity investments through the stock exchange. In South Africa, the Alt X was launched in October 2003 as a parallel market to the Main board of the Johannesburg Stock Exchange (JSE). The Alt X is specifically aimed at attracting SMEs to list on the JSE. The intention is to contribute to the sustainable growth of the South African economy by providing growth opportunities for SMEs. The Alt X is a partnership between the JSE limited and the Department of Trade and Industry. It gives SMEs the opportunity to issue new shares, raise capital, widen investor base and have their shares traded in a regulated market (Johannesburg Stock Exchange, 2009).

The availability of external equity can impact on the growth and performance of new SMEs. Kutsuna and Honjo (2005) investigate the relationship between external equity and the performance of new SMEs in Japan. They find that new SMEs financed by business angels are more likely to increase sales. Business angels are involved in monitoring the project and coaching the owners. Business angel at start-up positively contributed to a large number of the fastest growing small firms. This indicates that the use of external equity plays an important role in assisting new SMEs to achieve high performance. Van Auken (2002:289) also finds that venture capital funding is a signal about the quality of the new SME and also provides information about the credibility of the firm. This can help the new SME source other forms of finance such as debt capital. However, as pointed out by Bate and Bradford (2008:491), the positive relationship between external equity and performance must be understood in the light of the fact that theoretically, external equity is the most expensive source of finance for a firm

because of floatation and other costs. Therefore, the use of external equity increases a firm's weighted average cost of capital. This may negatively impact on performance. Furthermore, as pointed out by the Pecking Order Theory, external equity should only be used when a firm has exhausted its use of internal equity and debt. This suggests that external equity should be the last capital resort for new SMEs. Furthermore, external equity such as venture capital is not available to new SMEs. This implies that internal equity is the only source of finance for new SMEs.

Despite the many sources of external equity for new SMEs, access to external equity remains a major constraint for new SMEs. This phenomenon is termed the equity gap.

3.3.2.3 The equity gap

According to Harding and Cowlings (2006:116) the equity gap is described as the situation where there is a shortage of equity investments during the initial stages of a firm's life-cycle. Harding and Cowlings (2006:116) further note that discussions on the equity gap for new SMEs have been ongoing since the MacMillan Committee Report in the United Kingdom in 1931, generally known as the MacMillan Gap. The report highlighted a perceived structural failure within the capital market to meet the long-term investment needs of new SMEs. Other reports such as the Bolton Committee (1971) and the Wilson Committee (1979) (as cited in Harding and Cowlings (2006:117) confirm the existence of an equity gap for SMEs.

Forsaith and McMahon (2002) point out that an additional factor impacting on the financial structure of SMEs is the limited availability of certain sources of funding to SMEs. External equity finance in the form of venture capital is generally unavailable to SMEs without strong growth prospects. This includes both venture capital funds and wealthy individual investors known as business angels. Widespread access to external equity through public listing on the stock exchange is unavailable until the firm is relatively large and is able to meet the minimum size requirements for listing. For most new SMEs, the only feasible source of equity funding apart from owners contribution is contribution from relatives and friends, thus internal equity.

According to Shane (2008) access to venture capital is very limited for new SMEs in both developed and developing countries. Less than 1% of new SMEs in the United Kingdom had

financial input from venture capitalists. In the United States, venture capitalists provide only 1.85% of funding requirements of new SMEs. In fact, the odds that a new SME in the United States will get venture capital money are about 1 in 4,000. Venture capital funds also provide a small proportion of equity funding for new SMEs in South Africa. Table 3.1 depicts venture capital as a proportion of the gross domestic product (GDP) in South Africa and some selected developed countries. South Africa has venture capital as percentage of GDP of 1.5%, which is higher than what is available in some developed countries such as the Netherlands (0.9%), Australia (0.4%) and Sweden (0.7%), but lower than Israel (5.9%), USA (4.1%) and U.K (3.2%).

Table 3.1: Venture capital as % of GDP in selected countries

Country	Private equity & venture capital as a % of GDP
South Africa	1.5%
Israel	5.9%
USA	4.1%
UK	3.2%
Netherlands	0.9%
Australia	0.4%
Sweden	0.7%

Source: South African Venture Capital Association (2008).

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, investments with a SME focus are approximately R1.1 billion which is only 3.8% of the funds.

Venture capitalists argue that it costs them virtually as much to perform due diligence analysis on a small investment opportunity as it does on a large one. Therefore, they find it more cost efficient to concentrate on the larger opportunities. New SMEs that intend to grow should thus look for other sources of finance (Falkena *et al.*, 2002). In addition, Equinox Management Consultants (2001) find that the major reason why venture capital funds are not investing in new SMEs is that they (new SMEs) are not investment ready. The number of proposals received by venture capital firms frequently outweighs their capability to manage them relative to their staff size. Most proposals go through an initial screening phase to determine if they meet the criteria for investment by venture capitalists.

Apart from the low access to venture capital by new SMEs, access to other forms of external equity such as the stock exchange or the public equity markets is also very limited. Balkenhol and Evans-Klock (2002) note that instruments listed on the Johannesburg Securities Exchange (JSE) may not be appropriate for SME financing. The control of the JSE is quite strict. The JSE is the biggest stock market in Africa and any perceived increase of risk by role-players may taint its reputation. The fact that even established SMEs find it difficult to list on the Alt X suggests that the exchange will not improve the availability of external equity to new SMEs. Berry *et al.* (2002) agree that in South Africa, SMEs do not have the option of issuing shares in the capital market. Owing to their inability to access the public equity markets, SMEs tend to be heavily reliant on debt finance as their only source of external financing.

3.3.3 Debt

Gitman (2003:410) describe debt is as any financing vehicle that is a contractual claim on the firm, creates a tax deductible interest payment, has a fixed life and has priority claims on cash flows in both the operating and bankruptcy periods. Bankruptcy occurs when the total liabilities of a firm exceed its total assets. The priority claim of debt implies that debt has to be serviced (principal and interests paid) irrespective of whether the firm makes a profit or not. The duration of debt is determined at inception, and if a firm becomes insolvent and its assets are sold, the debt holder will be paid before the equity owners are paid. The principal sources of private sector debt for new SMEs are commercial banks and trade creditors.

3.3.3.1 Commercial banks

According to Coleman and Cohn (2000:85) commercial banks are a principal source of debt finance for new SMEs. Commercial banks offer new SMEs a wide range of services in their own right or through wholly or partially owned subsidiaries. These services cover every aspect of the financial market such as overdraft facilities, term loans, trade bill financing, factoring, leasing, export and import finance, and even government loan guarantee schemes. Commercial banks are in a better position to gather information on SMEs through established relationships, which they and their staff have with SMEs and their owners. In addition, commercial banks have extensive branch networks that can be accessed by new SMEs even in remote locations. Furthermore, the

financial conditions of small firms are usually rather opaque to investors, and the costs of issuing securities directly to the public are prohibitive for most SMEs. Thus, without financial intermediaries like banks it would simply be too costly for most investors to learn the information needed to provide the credit, and too costly for the small firm to issue the credit itself. Banks, performing the classic functions of financial intermediaries, solve these problems by producing information about borrowers and monitoring them over time, by setting loan contract terms to improve borrower incentives, by renegotiating the terms if and when the borrower is in financial difficulty.

Feakins (2005:56) points out that overdrafts and term loans are the two major products offered by commercial banks to new SMEs. Overdrafts are the most common type of short-term finance whereby a small firm is allowed by a bank to run a current account into deficit up to an agreed limit. Overdrafts are flexible in that the borrower uses the facility only when the need arises and, as a result, does not borrow redundant funds. Deposits can create a positive balance, again. The overdraft is useful to a firm in meeting temporary financial needs. It is, normally, granted to finance transactions that will generate cash flows in the near future. Interest is calculated only on the overdrawn daily balances, and not on the debt limit. The facility is, normally, repaid as cash flows back into the firm. Overdrafts are technically repayable on demand and, therefore, must be matched with short-term working capital needs and not long term fixed asset investment in plant and machinery. Term loans could be short term, medium term or long term and could cover periods between one and twenty years. They are usually used to purchase fixed assets or to extend productive capacity as well as for purposes of a change in company control or an acquisition of a business. They are relatively more expensive for small firms, because apart from the higher interest rates relative to overdrafts, they, most of the time, involve other expenses such as legal fees on the perfection of security. Interest rates on term loans can either be fixed or variable. A fixed rate is one in which the interest rate is known in advance for the lifetime of the loan. A fixed rate can be favourable or unfavourable for a company, depending on the movements of the interest rate. A variable rate varies with market forces and can work for or against a company, depending on interest rate movements.

Similarly, Hogan, Avram, Brown, Ralston, Skully, Hempel and Simonson (2001:315) and Nieman (2002:241) state that the products offered by commercial banks to new SMEs include leasing, hire purchase and credit cards. Leasing enables a firm to obtain the use of certain fixed assets, for which it must make a series of contractual, periodic, tax-deductible payments. The lessee is the receiver of the assets under contract, and the lessor is the owner of the assets. A lease can be described as a contractual arrangement in which the lessor of an asset (usually a bank) becomes the owner of an asset by paying the supplier the total cost of the asset. The lessee has complete use of the asset but does not own it, and does not need to find funds to purchase it. The most important principle of leasing is that the asset must be used for productive activity.

Viney (2007:45) points out that leasing can be classified into two categories, namely an operating lease and a financial lease. An operating lease is a contractual arrangement whereby a lessee agrees to make periodic payments to the lessor for a period of five years or less to obtain an asset's services. Such leases are cancellable at the option of the lessee who may be required to pay a penalty for cancellation. Assets, which are leased under an operating lease agreement, have a usable life longer than the lease period, and could become technologically obsolete and less efficient if leased for a longer period. The lessor usually assumes the responsibility for the maintenance and insurance of the assets. A financial lease is a long-term lease that is non-cancellable and obligates the lessee to make payments for the use of the assets over a predetermined period of time. With financial leases the total payments over the lease period are greater than the lessor's initial cost of the leased assets. The lease agreement, which falls under the financial leasing category, usually allows the lessee the option of buying the asset at the termination of the lease. Maintenance and insurance of the asset are usually the responsibility of the lessee (Hogan *et al.*, 2001:316)

Van Aardt, Van Aardt and Behuidenhout (2000:158) point out that banks or their subsidiaries can finance the hire purchase of assets such as motor vehicles, machinery and equipment. The ownership of such products purchased through a hire purchase agreement rests with the bank until the final instalment is paid. Hire purchase or an instalment credit transaction, as it is officially known in South Africa, can be described as a credit sale in which it is agreed that the purchase price of the item will be paid in instalments. Although the buyer takes possession of the

item, ownership of the item sold will not pass to the buyer until the last instalment is paid. An initial deposit, which is a portion of the cash price, is usually payable on the item. In South Africa, the Credit Agreement Act of 1980, as amended, guides instalment credit transactions. The interest on hire purchase is usually fixed and more expensive than a bank loan. However, hire purchase is currently the most common means of financing to purchase most types of business assets in South Africa.

Gitman (2003:65) notes that another product offered to new SMEs by commercial banks is factoring. In factoring, a bank, also known as a factor, buys selected accounts receivable from its borrowing customers at a percentage of their face value. Factoring is not a form of collateralised lending, but rather an outright purchase of the customer's assets. Small firms that have limited assets to offer as security on a term loan are increasingly using factoring. Factoring costs to a small firm include commissions charged by a bank, interest levied on advances by a bank, and cost savings made by the firm.

Furthermore, as pointed out by Feakins (2005:58) and Bertocco (2007:102) SMEs may turn to alternative sources of bank debt financing if they find themselves unable to obtain traditional forms of bank credit. Credit cards are a form of non-traditional bank credit. Credit cards can serve as a convenient alternative to paying expenses in cash if a business pays balances on time and in full each month. Credit cards do not constitute money, despite being generally acceptable as a means of payment. They are quick and easy loan transactions. The credit card account must be settled by the cardholder at the end of a particular month or at least to some specified minimum amount. In addition, a credit card serves to identify the customer and makes pertinent information about the customer available when the privilege of using the card is exercised.

- **Credit evaluation by commercial banks**

Berger and Udell (2002:2129) postulate that commercial banks handle lending to new SMEs by using five main technologies. The first technology is financial statement lending. Financial statement lending involves underwriting loans based on the strength of a borrower's financial statement. There are two requirements for this technology. First, the borrower must have informative financial statements (e.g. audited statements prepared by reputable accounting firms

according to widely accepted accounting standards such as GAAP). Second, the borrower must have a strong financial condition as reflected in the financial ratios calculated from these statements. The loan contract that arises out of the analysis of these financial statements may reflect a variety of different contracting elements including collateral, personal guarantees and/or covenants. However, under financial statement lending, the lender will view the expected future cash flow of the company as the primary source of repayment.

Financial statement lending, unlike all of the other lending technologies, is reserved for relatively informational transparent firms. For these firms, financial statement lending provides a distinct advantage; the informativeness of the financial statements addresses the information problem in a very low cost manner and financial statement lending underwriting and monitoring is based on hard information. Importantly, however, the efficacy of financial statement lending depends crucially on the lending infrastructure. Specifically, it depends on the existence of a strong information environment, particularly with respect to accounting standards and credible auditors. Thus, it seems likely that it is not feasible for financial institutions in many developing economies to offer a substantial amount of financial statement lending (Berger & Udell, 2002:2128).

Berger and Udell (2002:2129) further note that small business credit scoring is a transactions lending technology based on hard information about the SME and its owner. The information on the owner is primarily personal consumer data (e.g. personal income, debt, financial assets, and home ownership) obtained from consumer credit bureaus. This is combined with data on the SME collected by the financial institution and in some cases from commercial credit bureaus. The data are entered into a loan performance prediction model, which yields a score, or summary statistic for the loan. The key motivation for using this technology may often be its low cost as external providers typically charge a modest fee for each score.

Under asset-based lending, the financial intermediary looks to the underlying assets of the firm (which are taken as collateral) as the primary source of repayment. For working capital financing, banks use short-term assets, such as accounts receivable and inventory. For long-term financing, they use equipment. Under asset-based lending the extension of credit is primarily

based on the value of specific borrower assets rather than the overall creditworthiness of the borrower. Under asset-based lending, the amount of credit extended is linked to the value of the collateral on a formula basis to a dynamically managed estimation of the liquidation value of the underlying assets that are used as collateral (i.e., the accounts receivable, inventory and equipment). Thus, asset-based lending is a transactions-based technology based on hard information generated nearly continuously about the value of the assets (Berger & Udell, 2002:2130)

Degryse and Cayseele (2000:95) posit that relationship lending is designed to address information problems that are not feasible or cost-effective. The primary information used by lenders is based on "soft" information about the relationship between the lender and the borrower. Its emphasis on soft information distinguishes it from all of the other technologies. Under relationship lending, the lender acquires proprietary information about the borrower and the business over time with respect to the provision of loans. Relationship lenders collect information beyond that which is available on the firm's financial statements and information that is readily available to the public. This includes information on the entrepreneur's local community/business environment and the entrepreneur and the SME's interaction with that environment. The labour-intensive nature of relationship lending likely makes it quite costly. These costs may be passed on to the borrower in the form of higher fees and a higher interest rate.

For SMEs in information rich environments, small business credit scoring may be feasible. In very strong lending environments, asset-based lending may be feasible for those borrowers with good quality accounts receivables, inventory and/or equipment. Factoring is feasible even in weak lending environments, but it depends on the existence of high quality receivables. Thus, for opaque SMEs for whom small business credit scoring, asset-based lending or factoring are not feasible or cost-effective, relation lending may be the best alternative (Berger & Udell, 2002:2135).

According to Hawkins (2002:525) banks have some credit criteria that they follow in evaluating loan applications of clients. Bbenkele (2007:14) agrees that SMEs are expected to meet certain

criteria for the banks to be able to assist them with their financial needs. For these roles to be fulfilled, it is important that expectations from both parties are well understood by both the SMEs and the commercial banks.

Arthur (2009) asserts that one of the most common questions among small business owners seeking financing is: "What will the bank be looking for from me and my business?" Banks follow certain principles in evaluating credit applications and making credit decisions. The purpose of any credit assessment or analysis is the measurement of credit risk. Borrowers' credit assessment is done using the five Cs of lending; character, capacity, capital, conditions and collateral. 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 analyzing the stream of cash flows, the character of financial discipline, and the financial health of the borrower and other qualitative factors.

Willacy (2009) states that the 5Cs of credit include:

- *Character*

The character of the borrower indicates two things; the ability to pay versus the willingness to pay. The ability to pay refers to the borrower's financial credibility to pay. A good character is one that has the ability and a willingness to pay. Measures of character include managerial experience and track record of integrity and repayment.

- *Capacity*

Capacity refers to the sources of repayment, i.e. the cash flow. The borrower must be able to meet all his financial obligations on the due dates. Capacity is the ability to repay the loan together with interest as per the pre-determined schedule. A borrower's capacity depends on two factors; first, the borrower's financial position should be sound, and second, the borrower must be able to generate sufficient net income to service the loan repayment. In the case of businesses, lenders usually ask for audited financial statements and projected cash flows to determine the financial soundness or creditworthiness of the business borrower.

- *Capital*

Capital refers to the capital contribution that the borrower proposes to make in the total investment. An investment is usually financed partly by bank loan and partly by the capital contribution of the owner. The owner's contribution is called the owner's margin. The greater the owner's contribution to a project the greater is the lenders confidence in the venture.

- *Collateral*

Collateral is the lender's second line of defence. If the payback is derived from cash flows, then the collateral will not be liquidated for repayment. Collateral is also known as a secondary source of repayment. When a loan cannot be paid out of primary sources, lenders usually take possession of collateral and dispose of it and use the proceeds to offset the outstanding loan amount.

- *Conditions*

Condition refers to the external environment of a business. The external environment is systemic and largely uncontrollable by SMEs. Factors in the external environment include the economic environment, the legal environment, government regulations, ethical perception, crime and corruption.

Pretorius and Shaw (2004:230) further categorize the 5C's of credit evaluation into objective and subjective criteria. Criteria that could be measured (ratios and values) are rated as objective and those where opinion or judgment was the main contribution to the decision is rated as subjective. Objective measures include capital and collateral as measured by owners' cash contribution, collateral, business plan, marketing and growth potential of the business. Subjective variables include the usefulness of the business plan and whether the owner understands the content of the plan, competent management structure, crime as well as the failure rate of businesses in the area in which the business is located, the feasibility of the business in terms of competition, viability, demographics, location, access, transport and security as well as the economic environment.

According to Willacy (2009a) credit evaluation is now a combination of the traditional method (the five C's) and the modern approach to credit risk management. The measurement and

management of credit risk have undergone a revolution in recent years. The advances in technology have enabled financial engineers to try new methods of model building and analysis for credit risk measurement. Several factors have contributed to this recent surge in technology based analysis methods. Increased competition in the loan market necessitated the development of methods that are quicker, more accurate and more cost effective. Consumer expectations have increased and most consumers now expect efficient loan approval from financial institutions. Where lending institutions have been found to be a little tardy, consumers have shifted to other institutions. Loyalty is less and less evident among consumers. Banks now need methods of credit assessment that cater to the changed customer needs. Also in recent years, bankruptcies and global competition have increased, so accurate credit analysis has become more important. In addition, banks want to reduce the cost of lending. Modern approaches help to achieve this aim. The more commonly used modern approaches to credit analysis include the following as pointed out by Willacy (2009a).

- Econometric techniques (credit scoring) involved in the modelling of the probability of default. This probability is used as a dependent variable (effect) whose variance is explained by a set of independent variables (cause). Financial ratios and other external variables are generally used as independent variables. Econometric techniques include linear and multiple discriminant analysis, multiple regression, logit analysis and probit analysis.
- Optimisation models use mathematical programming techniques to minimize lender error and thus maximise profits.
- Neural networks try to emulate the human decision-making process using data as used in econometric techniques.

Willacy (2009a) concludes that most banks use a combination of the traditional and modern credit evaluation techniques when making decisions about credit applications.

3.3.3.2 Trade credit

Burkart and Ellingsen (2004:569) ask "*why does trade credit exist at all. Why is it that a majority of non-financial firms simultaneously take credit from suppliers and give credit to their customers?*"

According to Selima (2007:17) trade credit theories can be broadly classified into four main groups. These are asymmetric information, transaction costs, price discrimination and finance. The asymmetric information theory occurs when sellers face uncertainty about their customers' creditworthiness and financial health. Because of asymmetric information sellers cannot reliably make the best selling decisions. Likewise, when buyers face uncertainty about their suppliers' products/services they cannot confidently make the best purchasing decisions. In such circumstances, trade credit is used to deal with this asymmetric information problem. Buyers will have a sufficient period of time to investigate and assess the quality of the product and its value for money and to pay when they are satisfied. On the other hand, sellers will gather valuable information about customers' financial health through their payment patterns and their abilities to take advantage of discounts for early payment when offered, and they will use credit periods as a signal to the market of high and consistent product quality or of long-term presence.

In articulating the transaction cost theory, Frank and Maksimovic (2004) argue that the combination of the supply of both goods and finance from one source can lead to cost advantages and to a reduction in transaction costs. Furthermore, when the transactions take place on credit, the timing of the payment is less uncertain which enables firms to improve their cash-flow forecasts and simplify cash management. In addition, if all bills are accumulated and paid for together, transaction costs are kept to a minimum. The unpredictability, which may be found in cash-based businesses and which may be due to fluctuations in daily sales (that result in unpredictable patterns of cash receipt) can be reduced through companies offering trade credit. According to the terms offered, suppliers have a better idea about when customers are likely to settle their bills. Better knowledge of customer behaviour gained from experience leads to better

forecasts that reduce the need to carry large amounts of cash, and subsequently decrease the cost of holding precautionary cash balances.

Presenting the price discrimination theory, Selima (2007:18) contends that as demand for a product can vary, sellers can manipulate the product price through the variation of the credit terms offered to each separate customer. So varying the trade credit terms gives the seller a more flexible approach to pricing and to discriminate among customers, as it is much easier to adjust credit terms (based on the payment period) than product price in order to respond to fluctuating demand. Furthermore, there is a difference between offering credit terms and enforcing them. Suppliers may allow a customer to pay after the agreed date without a penalty; or they may vary their two-part-terms (discount for early payment) and offer higher discount rates to selected customers or even allow them to take an unearned discount. Thus, giving longer credit than that agreed or increasing the discount rate offered, is effectively the same as reducing the price of the product/service.

Providing explanation for the financing theory, Frank and Maksimovic (2004) state that when non-financial institutions offer credit, they play an intermediary role by obviating the need for buyers to obtain finance from their banks to pay for their purchases. Furthermore, customers that are rationed by financial institutions tend to turn to trade credit, considering it a cheap way of getting short-term funds. So suppliers that are financially sound and can relatively easily get access to external funds tend to play this intermediary role by financing their customers' stock through trade credit. Therefore, trade credit becomes an attractive way of obtaining required finance. Trade credit works as a facilitator, in that firms that are able to borrow do so and pass on the benefit to those that do not have access to funds in the same way.

What is trade credit? Huyghebaert, Van de Gucht and Van de Hulle (2007:436) point out that trade credit arises when a firm purchases goods and services for which payment is delayed. SMEs can make use of trade credit as a form of credit or as a convenient alternative to paying cash each time a purchase is made. It is a spontaneous source of financing, as it arises from ordinary business transactions. However, it is evident that a supplier who offers extended credit

is likely to build the cost of such credit into the pricing structure of the goods or services. Trade credit is usually extended for an intermediate period of thirty to sixty days at which point payment is due. If payment is not made on the date, financing charges are applied and trade credit becomes an alternative method of financing business expenses. Frequently, suppliers will offer cash discounts typically one percent to two percent of the purchase price for early payment not more than fifteen days after delivery.

According to Huyghebaert *et al.* (2007:437) recent evidence from developing countries suggests that trade credit provides a signal to the availability of more bank loans to new SMEs. Trade credit in economic environments with weak informational infrastructure and less developed banking systems can play an even more important role in SME financing because of its strength in addressing the information problem. New SMEs face high failure rates in the early years of their life. This high failure rate limits their access to bank loans and they therefore tend to rely on their suppliers for financing. In addition, suppliers are more lenient than banks towards financially distressed firms. Banks tend to follow a strict liquidation policy when debtors encounter financial distress; if upon default a borrower's liquidation value exceeds its going concern value, banks will liquidate the firm. Suppliers, on the other hand, earn positive rents from selling goods to their customers. These rents arise from the profits suppliers can earn on future sales of their product to the client firm. If a customer is liquidated upon default, such supplier rents are lost. Suppliers therefore have an implicit equity stake in their customers and therefore are more willing than banks to renegotiate their claims or grant additional debt when debtors get into financial problems. In other words, suppliers may be willing to reorganize the defaulted debt even when the firm's liquidation value exceeds its going concern value.

Similarly, Wilner (2000:155) argues that suppliers are more dependent on their customers than commercial banks. The sunken investments in the customer–buyer relationship also make suppliers more lenient towards financially distressed buyers. Finally, bank loans are frequently secured, and thus more senior than suppliers' credit. Seniority and collateralization may induce banks to liquidate a distressed company prematurely following default. Therefore new SMEs

may prefer trade credit financing during the early years when the risk of default is high. In addition, any formal collateral does not usually guarantee trade credit.

Wilson and Summers (2002:330) note that trade credit, however, is considered to be an expensive financing source if payments are not made within the stipulated credit window. The credit term most frequently adopted by suppliers is "2/10 net 30". This term represents a 2% discount for payment within the 10-day discount period; the net period ends on day 30. Furthermore, the cost of the credit is usually imputed into the cost of goods sold on credit. This may indirectly make trade credit an expensive source of finance.

Berger and Udell (2006:2950) add that despite some of the disadvantages associated with trade credit; it is an extremely important source of finance for new SMEs. Furthermore, trade credit has received much less interest from researchers compared to commercial bank lending which provides only slightly more credit to SMEs. Trade credit may also provide a cushion during credit crunches, monetary policy contractions or other shocks that leave financial institutions less willing or less able to provide small business finance. During these times, large firms may temporarily raise funds in public markets such as commercial papers and lend these additional funds to SMEs through trade credit. Since only a limited number of new SMEs have access to loans from financial institutions, trade credit may often be the best or only available source of external funding for working capital.

- **Credit evaluation by trade creditors**

Willacy (2009b:156) notes that many of the procedures and processes associated with the other lending technologies appear to be utilized in underwriting trade credit. Credit scoring and similar quantitative techniques have long been a part of the underwriting process used by credit managers. For larger accounts, financial statements are analyzed as part of the underwriting process. No doubt, soft information and mutual trust play a role in some trade credit underwriting similar to relationship lending.

Willacy (2009b:157) examine the criteria for lending from trade creditors. The researchers point out that if payment is made after delivery, the seller in effect is extending credit to the customer. There are two basic forms of trade credit. The first one specifies that full payment is due a certain number of days after delivery. For example "net 30" means full payment is due in 30 days after invoice. After that day the buyer is at default. The second form has three components; (1) the discount percentage (2) the discount period (3) the effective interest rate (an example is "2/10 net 30). This implies that there is a discount of two percent for payment within ten days and full payment is due in 30 days. After 30 days, interest starts accumulating. According to Willacy (2009b:158) the criteria for lending by trade creditors are similar to those by banks and include:

- Acceptable financial conditions.
- Projected financial statements (cash flow, income statement and balance sheet, working capital and profitability trend).
- Any report from credit rating agencies.
- Acceptable bank and trade references.
- A statement of the legal composition of the customer (limited liability, close corporation).
- Management of the firm.
- Statement that customer is not operating under bankruptcy law or creditor protection.
- Verification that no significant collection lawsuits or judgments are outstanding which would seriously impact upon the customer's ability to remain solvent.
- If the customer fails to meet the above credit criteria, the trade creditor will require the customer to provide security.

Despite the importance of both commercial banks and trade credit as sources of finance, their availability to new SMEs is severely limited in South Africa as well as many developing countries leading to the debt gap.

3.3.3.3 The debt gap

According to Poutziouris, Wang and Chan (2002:385) the debt gap represents the problematic flow of debt from financial agents to SMEs. Debt finance is viewed as a critical element for the

development of new SMEs. Lighthelm, Brink and Cant (2003) highlight the limited access to debt finance for new SMEs in South Africa compared to established SMEs and large firms. FinMark Trust (2006) points out that the incidence of loans and borrowing from the formal financial sector by new SMEs in South Africa is extremely low. The main source of financial borrowing for new SMEs is from family and friends.

In addition OECD (2006) argues that the debt gap is more pervasive for new SMEs in developing countries compared to those in developed countries. New SMEs in developed countries are able to obtain sufficient credit from banks and other credit institutions. In developing countries, by contrast, new SMEs report widespread shortage of debt finance. Despite the fact that SMEs in general account for a large share of enterprises and employment in developing countries, they receive a very low share of credit from the formal financial markets. Foxcroft *et al.* (2002) in the Global Entrepreneurship Monitor South African Report point out that 75% of credit applications by new SMEs to banks are rejected. In addition, the use of trade credit by new SMEs in South Africa is virtually non-existent. The non-availability of trade credit, which could act as a substitute for bank debt further compounds the debt gap. The situation is however markedly different in developed countries. According to Statistics Canada (2007) there is approximately 82% approval rate for credit applications by new SMEs in Canada. In addition, more than 40% of new SMEs in Canada use trade credit. In England 71% of applications for credit by new SMEs from financial institutions between 2004 and 2007 were approved and only 26% were wholly or partially rejected. In addition, in the United States of America more than 50% of new SMEs are able to access credit from commercial banks and trade creditors (Berger & Udell, 2002:2130). Reitan and Waago (2002) find that banks are still the dominant source of finance for new SMEs in Norway and most European countries.

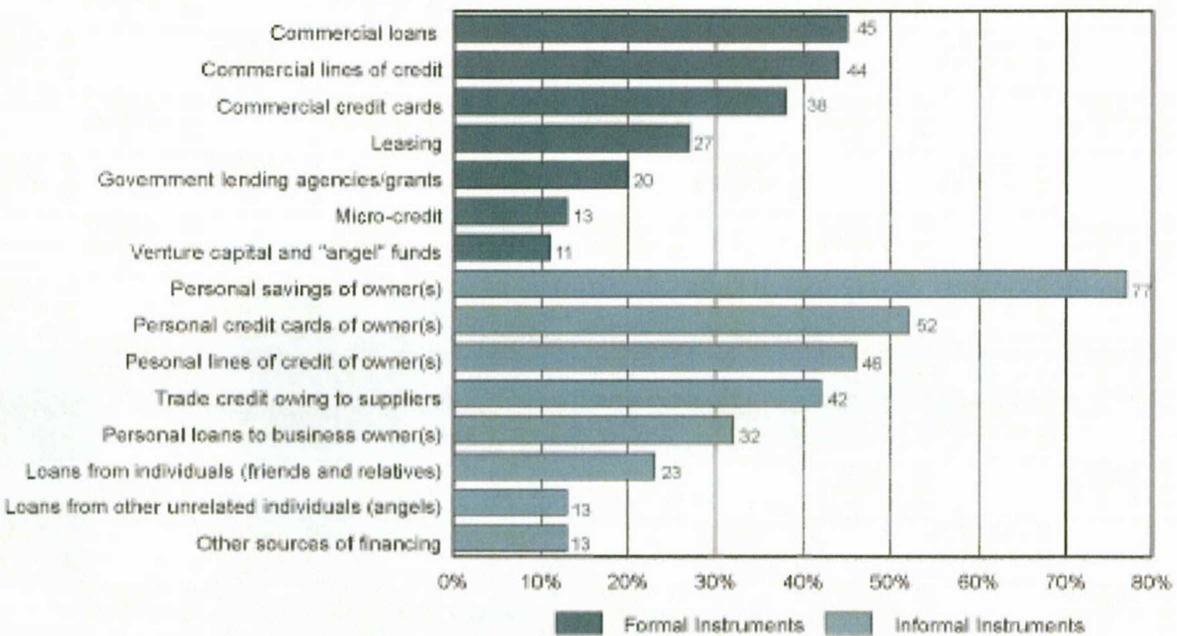
The differences in the sources of finance for new SMEs in developing countries (e.g. South Africa and Ghana) and developed countries (e.g. Canada) are graphically depicted in Table 3.2 and Figure 3.1.

Table 3.2: Sources of finance for new SMEs in South Africa and Ghana

Sources of finance	South Africa (%)	Ghana (%)
Internal equity	78	82
Banks	5	6
Trade credit	1	4
Government	1	1
Other sources	17	7

Source: Balkenhol and Evans-Klock (2002), Abor (2004:65).

Figure 3.1: Sources of finance for new SMEs in Canada



Source: Statistics Canada (2007).

One noticeable finding from the table and figure is that internal equity, especially owners' contribution, is the major source of finance for new SMEs as suggested by the static trade-off theory, the agency theory and the pecking order theory of capital structure. Empirical literature confirms however that new SMEs that depend only on internal equity find it difficult to survive and grow. In addition, as suggested by the capital structure theories, the use of venture capital and other sources of external equity by new SMEs is extremely limited in both developed and developing countries. Debt finance is relatively more available in developed countries than in developing countries. This reinforces the fact that external equity, especially from private

investors or the stock market is not an available source of finance for new SMEs. Therefore, improving the availability of debt finance seems to be one of the options to reduce the high failure rate of new SMEs in South Africa as well as in other developing countries.

3.3.3.4 Risk in lending to new SMEs

According to Hogan *et al.* (2001:82), commercial banks are in the risk business. In the process of providing financial services, they assume various kinds of financial risks. The most common risks to commercial banks are credit risk, currency risk, capital risk, investment risk, interest rate risk, exchange rate risk, and liquidity risk. The risks directly involved with the financing of small firms are credit risk, capital risk, and liquidity risk.

Saunders (2002:46) points out that credit risk arises because promised cash flows on the primary securities or loans held by financial institutions may or may not be paid in full. Credit risk is the risk that the principal or interests or both on securities or loans will not be paid as promised. In this case commercial banks provide financial resources and the credit risk results from the inability of small businesses to honour their financial obligations to the bank. Companies carry credit risk when, for example, they do not demand up-front cash payment for products or services. By delivering the product or service first and billing the customer later, the company is carrying a risk between the delivery and payment. The selection criteria used by banks is a mechanism through which commercial banks seek to minimize the credit risk. To manage the credit risks of loans, commercial banks should conduct a careful analysis of the borrower to measure default risk.

Molapo (2005) describe capital risk as the risk that the firm's capital resources will be adversely affected by unfavourable external developments. Commercial banks increase their capital in order to attract additional capital on the equity market. This is also known as the capital adequacy ratio. The capital adequacy ratio determines the price or interest rate at which the bank pays for credit in both local and international money and capital markets. A low capital adequacy ratio causes commercial banks to become undercapitalized and they may not be able to absorb even minor shocks. Thirdly, a high capital adequacy ratio provides protection to banks' creditors

in case of solvency. The high risk of default by small firms reduces the capital adequacy ratio as this non-repayment of loans negatively affects commercial bank's assets.

According to Hogan *et al.* (2001:79) and Molapo (2005) liquidity is the ability to fund increases in assets and to meet obligations as they come due. This process is important in banking as banks act as financial intermediaries between depositors and borrowers. Borrowers and lenders have different liquidity preferences, as borrowers prefer long maturity periods while lenders prefer short maturity periods. The liquidity risk can also be defined as the risk of a funding crisis, which results from unexpected events such as a loss of confidence in the bank or from a currency crisis. These factors may prompt the bank's clients to withdraw more and this can affect the bank's liquidity. The inability of small businesses to honour their obligation may affect the banks' ability to honour its obligations to its other clients.

Tagoe, Nyarko and Smurfit (2005:333) remark that the credit risk is the most important reason why banks and suppliers often reject credit applications from new SMEs. The risk perception of new SMEs is high because of their high failure rate and this is one of the reasons for their low access to debt finance. Credit guarantee schemes offered by government are a means through which credit risk can be shared between the government and commercial banks. To reduce credit risk, credit guarantee schemes are offered by government as means through which credit risk can be shared between the government and commercial banks.

3.4 PERCEPTION OF NEW SMEs BY COMMERCIAL BANKS AND TRADE CREDITORS

Literature on the causes of the debt gap for SMEs in South Africa is rich and conflicting. Research from the demand side tends to perceive that commercial banks discriminate against SMEs. According to Bbenkele (2007:14), this is the opinion often accepted by policy makers. This has led to the establishment of a host of government initiatives such as Khula Finance Enterprises, Industrial Development Corporation, National Empowerment Fund, National Development Agency, and Umsobomvu Youth Fund. Despite these initiatives the availability of debt finance for new SMEs in South Africa has not improved significantly.

Antonie (2001:1) notes that the South African government expects the commercial banking sector to be one of the major drivers of development by lending to small and medium enterprises. In performing this role, South African banks are confronted by three sets of pressures:

- The imperatives which dictate that the South African economy be substantially transformed, the distribution of income equalized and large numbers of people integrated into the mainstream of South African economic life.
- Maintaining the soundness of the South African financial sector.
- The practical difficulties in lending to start-up businesses with debatable business propositions, no risk capital or collateral and limited management resources.

This implies that the commercial banks in South Africa have to find a middle ground between financing SMEs and maintaining sound business practices. This is particularly important with the promulgation of the New National Credit Act in 2006 that prevents the granting of reckless lending by commercial banks and other financial agents such as trade creditors. In addition, the New National Credit Act is expected to promote a fair and non-discriminatory marketplace for access to consumer credit and for that purpose to provide for the general regulation of consumer credit and improved standards of consumer information. Furthermore, the Act is expected to prohibit certain unfair credit and credit-marketing practices and to promote responsible credit granting (National Credit Regulator, 2009).

Mutezo (2005) reports that among all the problems confronting SME few have proved to be as difficult to solve as those embracing the financial variables applicable to the sector. In South Africa, not even short-term funds such as overdrafts and trade credit are easily available to new SMEs. Put at its crudest, the financial problem of new SMEs is that of finding funds for expansion at the right time, or the right type, and in the right quantities at various stages of development. According to Mutezo (2005) three fundamental difficulties facing new SMEs in this regard are:

- The new SME may not be able to demonstrate its chance of success.

- The existing lending and financial institutions may not cater for the special problems involved in the finance of new SMEs.
- The business owners and their advisors may not know where to get the money.

Angela Motsa and Associates (2004) contend that banks do not have many products specifically targeted at SMEs and suggest that banks should develop products specifically targeted toward this sector. Napier (2006) agrees that banks can ensure the financial penetration of the SME sector through financial products such as transactions, insurance, credit and savings. Hawkins (2002:520) observes that existing evidence points to a banking sector that has been slow to change its focus to consumer-based development of products. This is particularly so in the case of meeting the needs of small businesses. Increasing attention has been given by banks to retaining corporate and niche accounts at the cost of neglecting the universal provision of services.

Driver, Wood, Segal, and Herrington (2001) observe that South African financial institutions have a history of dealing mainly with large corporations that undertake large projects. Their management skills in handling SMEs are not properly developed as they focus on large businesses with sufficient resources. Driver *et al.* (2001) further postulate that banks would rather lend R200 million to one customer than lend R50 000 to 25 000 customers because it is messy, costly and involves too much paperwork for the banks.

Authors such as Driver *et al.* (2001), Hawkins (2002) Angela, Motsa and Associates (2004) and Napier (2006) suggest that banks discriminate against the SME sector when it comes to lending. Some other empirical studies such as Richard (2006) argue however that SMEs do not get funds from commercial banks because they are not investment ready. According to OECD (2006) SMEs suffer from a debt gap because a wider range of profitability and growth than large enterprises characterizes the SME sector. SMEs also exhibit greater year-to-year volatility in earnings. The survival rate of SMEs, especially new ones, is considerably lower than that of large firms. OECD (2006) finds that manufacturing SMEs are five times more likely to fail in a given year than larger firms. Maas and Herrington (2006) point out that in South Africa, 75% of

new SMEs fail within the first few years of operation. The average for most developed countries is less than 50%. Failure of SMEs affects their ability to repay loans and consequently affect the willingness of suppliers of funds to give credit to SMEs. The potential failure of new SMEs is one of the reasons why credit approval is low.

Berry *et al.* (2002) submit that new SMEs are not always able to present full accounting records and other documents which banks require, thereby making the appraisal of their applications very difficult. Furthermore, the high operating costs relative to the size of small firm accounts deter banks from dealing with the small firm sector. Costs are incurred in screening potential borrowers to establish the risk of default, and in monitoring borrowers to prevent default. This suggests that the problem with finance could be the incompetence of the owner. From this perspective, there is increasing evidence that suppliers of capital perceive a shortage of investment-ready opportunities. Investment readiness refers to the capacity of an entrepreneur who is looking for external finance to understand the specific needs of an investor and to be able to respond to these needs by providing an appropriate structure and relevant information, by being credible and by creating trust to increase the probability of an investor to invest in the project.

Richard (2006) declares that "*it has always been difficult for me to reconcile the fact that the investors are finding it difficult to invest their capital at the same time entrepreneurs are decrying the lack of it. This strongly suggests we have a completely different issue to contend with; a readiness gap – a lack of firms that are ready for investment. A lot of small firms desire funding, but are not in a position to be invested in. Whether they are unrealistic about how much they are worth, or have not developed a strong enough team, or their core proposition is simply not saleable, they have fallen short on some basic criteria. There is a great deal we can do to help small firms up their game. But we cannot blame it on an absence of capital or a failure of nerve by the investors.*"

One of the main objectives of this study therefore is to empirically investigate whether commercial banks and trade creditors perceive new SMEs as beneficial to their business. De la Torre *et al.* (2008) suggest that five factors can be used to measure the beneficial effects of new

SMEs. The factors are profitability, prospects, strategic importance, competitiveness and the largeness of the sector. According to Business Dictionary (2009) strategic importance implies that new SMEs are important to commercial banks and trade creditors in the achievement of their long-term goals, which include increased profitability and market share. Competitive implies rivalry between two or more businesses striving for the same customer or market. This means that the SME sector is seen as a source of competition by the banking sector and other businesses. Banks and trade creditors have to find ways to attract the SME sector. Positive prospects imply that commercial banks and trade creditors perceive a bright future for SMEs. Large implies that the SME sector including new ones account for most of the business enterprises in South Africa. Profitable implies that the SME sector is perceived as a source of profitability by commercial banks and trade creditors.

The perception of these factors by commercial banks and trade creditors will indicate their desire to get involved with new SMEs. According to De la Torre *et al.* (2008*) the "conventional wisdom" argues that the inadequate financing of SMEs is to a significant extent rooted in "supply-side" factors. Banks and other financial agents to be uninterested and biased against new SMEs.*Beck *et al.* (2008) indicate that *"there is often the perception among policy-makers and SMEs that banks, especially large ones, are not interested in financing SMEs"* Therefore, it is important to empirically investigate whether commercial banks and trade creditors perceive new SMEs as beneficial to their business.

This is of importance because as pointed out by Reitan and Waago (2002) banks and trade creditors are firms whose normal purpose of existence is to maximize the wealth of its shareholders. These firms should therefore be willing to deal with SMEs, if they (banks and trade creditors) perceive new SMEs as firms that can contribute to the profit-maximization objective. Bbenkele (2007:14) therefore concludes that since SMEs both new and established form about 80% of all enterprises in South Africa and therefore should be of great importance to banks and trade creditors. Furthermore, it seems that SMEs are becoming a sector of great strategic importance to banks. Previous empirical studies on the financing of SMEs such as Mutezo (2005) and Molapo (2005) have focused primarily on the risk factors especially the credit risk

and the high failure rates of new SMEs. No known South African study has empirically investigated if there are benefits to be derived by commercial banks and trade creditors from new SMEs. This study seeks to fill that void.

3.5 SUMMARY

This chapter has examined the financing of new SMEs. New small firms need capital to finance capital investments, working capital, product development and initial losses. The empirical literature revealed that investment in fixed assets by SMEs in South Africa is low compared to working capital. This may affect the ability of new SMEs to give collateral for loans. In addition, capital structure theories such as the static trade-off theory, the agency theory and the pecking order theory were explored. The theories suggest internal equity is the cheapest and best source of finance for new SMEs. However, internal equity is limited for most growing new SMEs. In addition, external equity is not available and also very expensive as pointed out by Timmons & Spinelli (2007:410). This suggests that debt finance is one of the financing options that new SMEs can utilize. Determining the amount of debt new SMEs should use is a huge debate. Myers (1984:580) calls it a puzzle. Rungani (2008) points out that a key consideration in choosing the source of finance for a new small firm is to strike a balance between equity and debt to ensure that the funding structure suits the business. Martinovic (2008) suggests that debt should be used to finance working capital and fixed assets be financed with equity.

The sources of finance for new SMEs were divided into equity and debt. Sources of equity such as owners' contribution, contribution from family and friends and retained earnings (internal equity) and venture capital and angel investors (external equity) were explored. It was discovered that new SMEs in South Africa suffer from an equity gap, especially external equity. The use of venture capital by new SMEs is extremely limited. This is not limited to South Africa alone. In developed countries such as Canada, Norway and the United States of America, the use of external equity is also severely limited for new SMEs. This is referred to as the equity gap. Non-availability of external equity suggests that new SMEs will often need to use debt, especially debt finance from commercial banks and trade creditors. The literature revealed that new SMEs also find it difficult to access debt finance leading to a debt gap. However, the debt

gap is more pronounced in developing countries than in developed countries. The lack of equity and debt indicates that new SMEs are capital rationed. The implication of this development is that for new SMEs there are three major sources of funds; internal equity, debt and external equity. For new SMEs in South Africa debt and external equity are unavailable. This implies a dependence on internal equity and hence the high failure rate of new SMEs. The sources of the debt gap were also investigated. Entrepreneurs and policy makers believe that the lack of access to debt is the result of discrimination against the SME sector by credit suppliers. Credit providers tend to argue that new SMEs are not investment ready. It is therefore important to examine if this discrimination hypothesis is true by investigating how commercial banks and trade creditors in terms of opportunity and cost perceive SMEs.

The next chapter will review the literature on the internal and the external factors (business environment) that can lead to non-availability of debt from commercial banks and trade creditors to new SMEs in South Africa. According to Beck (2007:402) the business environment is important to the survival and growth of new SMEs. Variables in the business environment may affect the availability of external finance to new SMEs. The variables in the business environment have been introduced under the 5C's of lending but need to be discussed in detail. Improving the availability of finance to new SMEs is one of the key drivers in addressing the weak TEA rate and reducing the high failure rate of new SMEs in South Africa.

CHAPTER FOUR

THE BUSINESS ENVIRONMENT AND NEW SMEs

4.1 INTRODUCTION

The problem of SME financing cannot be separated from considerations about the environment in which these firms operate. The institutional characteristics of the financial sector and various factors affecting the volatility of the business environment can impact on the ability of firms to access credit directly and indirectly by raising SMEs perceived risk (OECD, 2006). For credit to flow to new SMEs, the risk perception of lending to them must be reduced. The argument of this chapter is that there are certain factors in new SMEs' internal and external environment (business environment) that can reduce the risk perception of lending to them. Identification of these factors will encourage lending to new SMEs.

This chapter will review the literature on the business environment. The business environment is broken down into the internal environment and the external environment. The internal factors to be reviewed include collateral, business information, managerial competency and networking. In addition, the literature on external factors such as the legal system, the macro economy, ethics, crime and corruption and how they can impact on the availability of debt finance to new SMEs will be explored.

4.2 THE BUSINESS ENVIRONMENT

Smit, Cronje, Brevis and Vrba (2007:62) define a business environment as all those factors or variables, both inside and outside the organization that may influence the continued and successful existence of the organization. An environment can be defined as anything which surrounds a system. Therefore, the business environment is anything which surrounds the business organisation. It affects the decisions, strategies, processes and performance of the business. Cassar (2004:264) demonstrates that the business environment as well as the competence and expertise of the entrepreneur have a direct impact on the performance of a new SME. Disturbances in the environment may spell profound threats or opportunities for new

firms. The successful firm will identify, appraise, and respond to the various opportunities and threats in its environment. The business environment also has a significant impact on the capital structure of firms.

Beck and Demirguc-Kunt (2006:2933) argue that for new SMEs to grow, it is important to strengthen not only the internal business environment but also the external environment. More fundamental reforms must be undertaken to tackle the underlying reasons why SMEs do not fulfil their growth potential. OECD (2006) agrees that differences in the business environment could be a major factor in the observed differences in the availability to debt finance to SMEs in developing and developed countries. The business environment of a firm can be divided into the internal and the external environments.

4.2.1 The internal environment

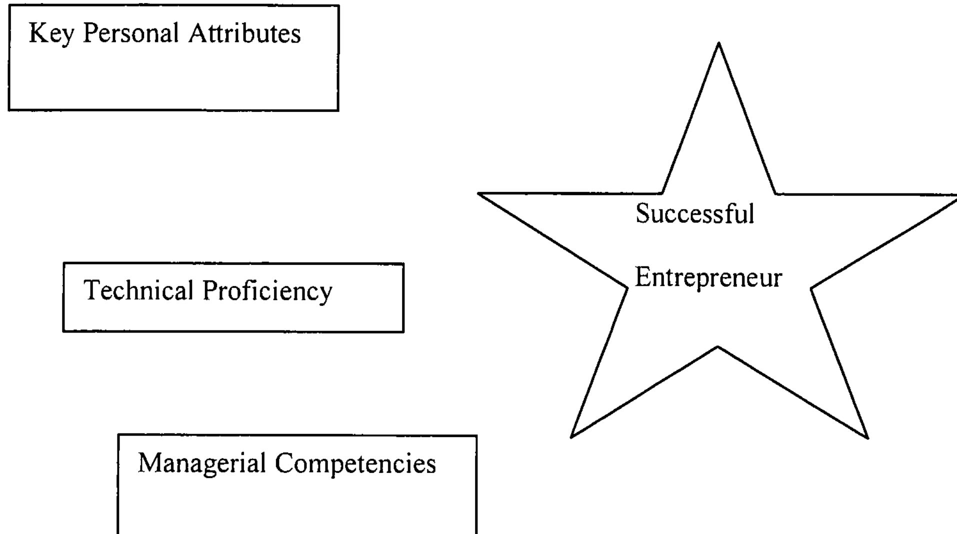
These are factors in a firm's internal environment that are largely controllable by the firm. In the capital structure context, the internal environment consists of factors largely controllable by the firm but which can influence its access to debt and/or external equity. The factors include managerial competencies as measured by education and experience (also known as owners' characteristics). Managerial competencies as well as the credit history of the customer are the two major measures of character. Other variables in the internal environment of a firm include collateral, business information and networking (Cassar, 2004:263), (Barbosa & Moraes, 2004).

4.2.1.1 Managerial competencies

Managerial competencies are sets of knowledge, skills, behaviours and attitudes that contribute to personal effectiveness (Hellriegel *et al.,* 2008:5). According to Cizel, Anafarta and Sarvan (2007:15), competencies are either observable performance or the standards or quality of the outcome of the person's performance or the underlying attribute of a person. The purpose of defining competencies is to improve performance. Therefore, competencies are the things people have to be, know, and do to achieve required outputs. Competencies are skills, ability or characteristics associated with high performance. Managerial competencies are part of the capabilities or assets of a firm. It is these skills, which allow the organization to transform itself,

improve performance and grow. Managerial competencies are a key success factor for entrepreneurs as depicted by Figure 4.1.

Figure 4.1: Managerial competencies and successful entrepreneurs



Source: Hellriegel *et al.* (2008:5).

Managerial competencies are very important to the survival and growth of new SMEs. The SME Financing Data Initiative (2009) examines the role of experience in SME growth using the Managerial Capacity Index (MCI). The MCI presents a composite measure of managerial experience and activity. To measure experience, two factors are taken into consideration. These are the breadth (scope) of experience as well as the depth of experience. Breadth of management experience can be measured across two time periods. First, the firm owner or management team is asked to indicate if he or she had initiated or managed a number of specific management activities prior to establishing their current business. Secondly the firm owner or management team is given the same list of management activities and asked if he or the management team had initiated or managed the activity in the current business setting. These two lists of activities are categorized into seven general or functional disciplines (general management, strategic management, human resource, marketing, financial management, capital management and product management. The total number of activities the owner or management team had

undertaken in each of the categories is calculated. The frequency with which a firm owner or management team has placed in the top half of each of the seven categories is calculated. This is divided by the depth of experience, which is defined as years of related industry experiences. The study finds that a high score in the managerial capacity index is positively associated with both strategic planning practices (planning sophistication, ability to communicate business intentions) and high firm performance and growth.

Consistent with the study by SME Financing Data Initiative (2009) are other studies on managerial competencies and firm performance such as Lefebvre and Lefebvre (2002) and Martin and Staines (2008). Lefebvre and Lefebvre (2002:285) report that innovative capabilities of the management team (e.g. ability to undertake research and development, knowledge intensity and unique know-how) are strongly associated with export performance and firm growth. Martin and Staines (2008) examine the importance of management competence in small firm success. The researchers point out that the failure rate of new business start-ups is very high in the United Kingdom with nearly half of new business start-ups disappearing within four years. Lack of managerial experience, skills and personal qualities as well as other factors such as adverse economic conditions, poorly thought out business plans and resource starvation are found as the main reasons why new firms fail. The distinguishing feature of high growth and low growth small firms is the education, training and experience of senior managers. The owners of high-growth small firms are more likely to take an active interest in their immediate market environment, place more emphasis on organizational structure and specialist management skills, recognize the importance of human resources management and the acquisition, development and retention of managerial talent.

Lyles, Saxton and Watson (2004:352) evaluate managerial competencies as measured by the education of the founder, managerial experience, entrepreneurial experience, start-up experience and functional area experience versus new venture performance. The performance of new ventures was measured by return on assets (ROA), return on sales (ROS), return on employees (ROE), growth rate of assets (GRAS) and growth rate of employees (GREP). The results show that relative profits tend to be high when an entrepreneur has more education and experience in

the line of business. On the other hand, the profitability tends to be low when the entrepreneur has only start up and managerial experience, but lacks an educational background. The results confirm the importance of education to new venture success. A similar effect is shown on the growth of the firm. The positive effect is on growth if an entrepreneur has a professional knowledge of the product, which is gained through previous work experience related to the product. However, if the entrepreneur has start-up experience and managerial experience, but lacks knowledge of the business, this results in a negative effect on growth. The implications are that a good understanding of the product is essential to the success of a new venture.

Bosma, Van Praag, Thurnik and De Wit (2004:227) also find that the endowed level of talent of a small business founder is not the unique determinant of performance. Rather, investment in industry-specific and entrepreneurship-specific human capital contributes significantly to the performance of small firm founders. The authors measured human capital in three ways. The first is entrepreneurship-specific investments measured by experience in business ownership and experience in activities relevant to business ownership. The second is industry-specific investment measured by experience in industry and the third is general investment measured by high education and experience as an employee. The result shows that human capital appears to influence the entire set of performance measures (profitability, employment and survival). Former experience of the business founder in the industry in which he starts his business appears to improve all performance measures. Moreover, experience in activities relevant to business ownership (e.g. experience in leadership) increases the firm's survival time. Finally, high-educated people make more profits, while those who have experience as an employee create more employment. Other empirical studies such as Smallbone and Welter (2001:251) and Hisrich and Drnovsek (2002:178) find that managerial competencies as measured by education, managerial experience, start-up experience and knowledge of the industry positively impact on the performance of new SMEs.

In South Africa, Herrington and Wood (2003) in the Global Entrepreneurship Monitor Report reached similar conclusions about managerial competencies and firm performance. Herrington and Wood (2003) point out that lack of education and training have reduced management

capacity in SMEs in South Africa. This is one of the reasons for the low level of entrepreneurial creation and the high failure rate of new ventures. The quality and context of the educational system do not promote the development of managerial competencies. Until recently, the school curriculum did not adequately integrate entrepreneurship and this has left a legacy of lack of confidence, initiative and creative thinking. Lack of skills, experience and knowledge are also key limiting factors for entrepreneurship in South Africa. New SME owners in South Africa often lack the expertise, experience and training related to the business they establish. Because of the managerial deficiency, there is the prevalence of necessity (survivalist) compared to opportunity entrepreneurial activity in South Africa. This is one of the reasons why South Africa appears to lag behind other developing countries in entrepreneurship. Smit *et al.* (2007:5) agree that South Africa has a critical shortage of skilled managers. This makes it difficult for new SMEs to attract highly competent managers. Recruiting highly skilled employees is one of the biggest challenges facing small firms, and a key component of organizational success.

Nguyen and Ramachandran (2006:206) point out that new SMEs management practices, such as a highly centralized decision making system, overdependence on one or two key individuals for the firm's survival and growth, an inadequate repertoire of managerial skills and training, and a paternalistic approach often create a poor business image for new SMEs. Managerial competency is one of the key criteria for banks to grant loans. This criterion is even more important when banks lack accurate financial information about the borrowing firms. From the bankers' point of view, the lack of management competency of new SMEs decreases their legitimacy.

Managerial competencies are also an important factor in the post-failure earning capacity of the owners of new SMEs. Von Broembsen *et al.* (2005) reveal that about 75% of new SMEs in South Africa usually fail within the first two years of operations. Blumberg and Letterie (2008:191) find that the earning capacity of a business starter in a subsequent job, i.e. the job after the eventual failure of the business, is a signal to the bank of whether the business starter can meet his credit obligations even if the business fails. The income that a business starter earned previously is an indicator, which signals the earning capacity after an eventual failure.

Highly educated business starters are more likely to have a high post-failure earning capacity than less educated people. This suggests that the greater the level of managerial competency the greater the performance and survival of new SMEs. Consequently, it is hypothesized that there is a significant relationship between managerial competency and the availability of debt finance to new SMEs.

4.2.1.2 Collateral

Gitman (2003:651) defines collateral as assets that are pledged by a borrower to a lender as security for the payment of debt. 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 for the loan. A copy of the security agreement is filed with the court. Filing provides subsequent lenders with information about which assets of a prospective borrower is unavailable for use as collateral. The filing requirement thus protects the lender by legally establishing the lender's security interest. Assets held by collateral can be the current assets of a firm or the fixed assets of the firm or firm owner. Current assets such as inventory or accounts receivable are the most desirable collateral for short-term loans. This is because they can normally be converted into cash sooner than fixed assets. The lender determines the percentage to be advanced against a current asset and this is normally between 30 to 100% of the book value of the collateral. Fixed assets such as land and building are used to secure long-term loans. Table 4.1 depicts assets that can be used by a firm as collateral.

Table 4.1: Assets that can be used by a firm as collateral

Security	**Credit capacity**
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 salability
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**

There are many conflicting views in financial literature about the role that collateral (especially fixed assets) can play in determining financial leverage. Barbosa and Moraes (2004) put forward arguments to justify an expected negative relationship between the ratio of fixed to total assets and financial leverage. Their reasoning is that since the use of fixed assets can magnify the variability in the firm's future income, the firm's proportion of fixed assets should be negatively related to the percentage of debt in its financial structure. Some other empirical studies favour an expected positive relationship between the ratio of fixed assets and financial leverage. Barbosa and Moraes (2004) argue that firms that invest heavily in tangible assets tend to have higher financial leverage since they can borrow at lower interest rates if their debt is secured with such assets. Therefore, higher fractions of total assets in tangible form are associated with higher financial leverage. Debt may be more readily used if there are durable assets to collateralize it.

According to Daskalakis and Psillaki (2007:90), the structure of assets that a firm possesses can be a determinant of its debt-equity ratio. Assets structure is closely related with the notion of financial distress costs. The costs of financial distress depend on the type of assets that a firm has. A firm with large investments in land, equipment and other tangible assets will have smaller costs of financial distress than a firm, which relies on current assets. Therefore, a firm with more tangible assets should have better access to debt.

Most of the empirical studies on asset structure and leverage have concentrated on large firms. As pointed out by Coleman and Cohn (2000:88), "empirically the emphasis on large firms has led us to ignore or study less than necessary the rest of the universe especially the SMEs who make important contributions to the growth of a country". Recently, some studies such as Barbosa and Moraes (2004) and Daniel, Masli, Rahman, and Selvarajah (2006:204) have examined the impact of asset structure on leverage of SMEs. Whereas Daniel *et al.* (2006:205) find that asset composition positively affects the use of debt by SMEs. Barbosa and Moraes (2004) find a strong negative association between asset composition and financial leverage. In addition Barbosa and Moraes (2004) note that a high proportion of fixed assets do not mean

higher capacity to collaterize debt. Most SMEs acquire plant and equipment before acquiring property. Plant and equipment are often considered unacceptable as viable security.

- **Collateral and creditor protection**

One of the ways to protect creditors is through the use of collateral. Collateral helps reduce several types of problems that arise when informational asymmetries between banks and entrepreneurs are present. According to Coco (2000:191) collateral can solve problems derived from asymmetries in 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. Collateral requirements can solve or at least mitigate the impact of these factors on credit extension. Hence, if collateral is pledged, lenders will feel more confident and will charge a lower interest rate than what they would have if the uncertain project itself were the only guarantee.

Collateral requirements also reduce moral hazard problems. Collateral requirements can reduce moral hazard problems by adding a potential cost to borrowers if they do not make their best effort. Additionally, a borrower can be tempted to engage in opportunistic behaviour once a credit has been granted. If the lender cannot monitor the borrower, the latter 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 may be willing to divert funds towards private use or extract the whole surplus from the project. When collateral requirements are in place this perverse incentive is diminished, since that sort of action would increase the chance of losing the assets pledged as collateral (Barbosa & Moraes, 2004).

Theoretical findings regarding the role played by collateral in mitigating the problems that lead to credit rationing are based on the presumption that collateral can be repossessed by the creditor in case of default. That is, it is presumed that a third party stands ready to protect and enforce the creditor's rights over the collateral stipulated in the debt contract. The right to repossess collateral, as well as efficiency in doing so, acts as a threat that can ensure that borrowers will not engage in inadequate behaviours (Coco, 2000:195).

- **Collateral and new SMEs**

Reitan and Waago (2002) posit that lending to new SMEs is more risky than lending to large firms by all objective measures. Banks can respond to this risk by ensuring that even in the event of failure, it can obtain some return. Obtaining collateral can do this. Collateral may be in the form of either personal resources of the entrepreneur or some identifiable assets of the business over which banks can assert a prior claim over other creditors. For new SMEs, providing collateral represents a major problem. Not all new SME owners have access to collateral and this may cause their exclusion from the market place.

Berger and Udell (2006:2953) agree that new SMEs are the most informational opaque due to their lack of track record. Therefore taking collateral, as security is attractive to bankers for two reasons: First, the willingness to offer collateral signals the confidence of an entrepreneur in both his/her abilities and also in the likely success of the project. Secondly, taking collateral can align the interests of the entrepreneur with that of the banker. It therefore addresses both the adverse selection problem at loan origination and the moral hazard problem after the loan has been granted. Berger and Udell (2006:2954) further argue that collateral is a powerful tool that allows financial institution to offer credit to firms whose credit opacity might otherwise result in credit rationing or the extension of credit only on relatively unfavourable terms. Collateral addresses adverse selection problems at loan origination and moral hazard problems that arise after credit has been granted. Collateral can be divided into two types; inside and outside collateral. Inside collateral involves pledging assets owned by the firm. Outside collateral involves assets belonging to the firm's owners. Outside collateral may help resolve adverse selection problems when the borrower has more information about the quality of the investment than the lender, and may help prevent credit rationing. Similarly pledging outside collateral may attenuate moral hazard by reducing the incentives to switch to riskier projects or reduce effort. The pledging of some of the firm's assets to the debt holder may ensure that firms invest in relatively safe projects.

Cassar (2004:265) argues that asset structure should also be related to capital structure, particularly for new SMEs. The more tangible and generic the firms' assets are, the greater the

firms' liquidation value, thereby reducing the financial loss incurred by financiers should the company default and the firms' assets be realized. Firms can also 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. This will result in firms with assets of greater liquidation value getting easier access to finance, and lower costs of financing, leading in turn to these firms acquiring a higher level of debt or outside financing in their capital structure. In addition, potential investors may be more likely to invest in a project if the entrepreneur is investing his own capital. Internal capital includes founders' capital and contribution from family and friends. This will improve the credibility of the project (Bollingtoft *et al.*, 2003:535).

Hawkins (2002:530) and the World Bank (2004) reiterate that owners of new SMEs often lack collateral. Umsobomvu Youth Fund (2008) observes that most new SMEs in South Africa start business without any acceptable collateral. In addition, their personal contribution (owners' equity contribution) is often very low and inadequate. Owners of new SMEs expect funds providers to contribute more than half of the financial requirements of their projects.

One way to mitigate the requirement of collateral for new SMEs is through the use of trade credit. Unlike bank loans and overdraft facilities, trade credit is often not guaranteed by any formal collateral. Therefore, the often heard argument that credit constraints are due to lack of collateral may not be applicable to trade credit. Willacy (2009b:154) however notes that during credit evaluation by trade creditors, if new SMEs fail to meet some of the criteria for lending, they will be requested to provide security. Therefore, since creditors feel better protected if there is collateral, it implies that creditors may be willing to lend only to new SMEs that are able to present adequate collateral. Consequently, it is hypothesised that there is a significant positive relationship between lack of collateral and non-availability of debt to new SMEs.

4.2.1.3 Business information

Kwok (2002:353) points out that business information which also includes financial information is one of the primary measures of the capacity of a business to effect repayment of credit. Financial information means accounting information such as cash flows. Accounting information is information provided by accountants and accounting systems. Financial information and

business information are usually contained in the business plan of the new SME. In addition, financial statements are prepared as the new SME continues operations. The business plan is a written narrative that describes what a new firm plans to accomplish and how it plans to accomplish it. For a new SME the business plan is a dual-purpose instrument used both inside and outside the firm. Inside the firm, the plan helps the firm to develop a road map to follow in executing its strategies and plan. Outside the firm, the business plan introduces potential investors and other stakeholders to the business opportunity the firm is pursuing and how it plans to act to achieve its goals. Barringer and Ireland (2006:205) add that the business plan is important to new SMEs for two main reasons. A business plan is an internal document that helps a new firm flesh out its business model and solidifies its goals. A business plan is a selling document for the firm. It provides a mechanism for the new SME to present itself to potential investors, suppliers and business partners.

According to Pretorius and Shaw (2004:225) a good business plan is perceived as one of the most essential documents to be prepared by the entrepreneur or small venture owner when setting up a business. Entrepreneurs and small business owners are encouraged to prepare a business plan for presentation to banks, financial institutions and venture capitalists to stand a chance of obtaining financial support. The business plan is an essential document to be used in setting codes and business relationships between the parties. However, most new 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 banks or investors. Bridging the information divide between entrepreneurs and financiers can facilitate the functioning of markets.

Kitindi, Magembe and Sethibe (2007:55) find that creditors, banks and other lenders use financial information provided by firms to analyse their present performance and predict future performance. The researchers find that formal lenders in Botswana require annual financial statements and audit reports. 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 acts as indicator of

borrower's future prospects and ability to service a loan. Therefore banks and other creditors prefer, demand and use financial information.

Wiedenhofer (2006:84) discusses the SME finance markets within the principal-agent framework. The SME is the agent of the finance provider, and as such undertakes to generate returns from its investment project on behalf of that provider. In a perfect market setting with full information available to both parties in the contract, a finance gap would not occur. However, finance markets are characterized by a number of market imperfections, including information asymmetry. Additionally, the SME finance market is characterized by risk and uncertainty regarding the future condition of the firm. From the creditors' perspective, there is incomplete information regarding the underlying quality of the project and the management of the small firm giving rise to the problem of adverse selection. Furthermore, the management of the SME may fail to perform to their full capabilities, giving rise to the problem of moral hazard. This leads to credit rationing and a shortfall in debt provision.

The generation and effective use of financial information are essential to accessing funds from external sources. Compared with their larger counterparts, new SMEs face greater constraints in accessing capital because they lack adequate financial information to enable outside investors to assess their performance. This leads to information asymmetry. Information asymmetry occurs when capital providers have less information on the financial circumstances and prospects of a firm than owner/managers. This is regarded as the root of small business finance problems (Holmes & Cassar, 2003:126).

Sarapaivanich and Kotey (2006:221) agree that the existence of information asymmetry leads to credit rationing. Where information asymmetry exists, banks may curtail the extent of lending leading to credit rationing or they may raise the interest rate. The implication of raising interest rates and/or curtailing lending is that firms will not be able to finance as many projects as otherwise would have been the case. Investment will be below the level that would have occurred had there not been information asymmetry. However, if an entrepreneur has spent time

developing a comprehensive and a priory business plan at an early stage in the project, risk perception should be reduced and the likelihood of obtaining capital should increase.

According to Frame, Padhi and Woosley (2001:817) the use of credit scoring has reduced the information asymmetry associated with small business lending. Originally, efforts to reduce information asymmetry focused on building long-term relationships and continuous interactions between the credit provider and the SME that generate useful information about the borrowers' financial states. The use of credit scoring has reduced the importance of the bank-borrower relationship in credit approval and pricing. The personal information obtained from the credit bureaus is predictive of the loan repayment prospects of the business. However, this needs to be augmented with some basic business-specific data to adequately predict repayment.

Another factor which may be contained in the business plan, but which is different from the financial viability as measured by the cash flows, is the market potential and growth prospects of the business. Market prospect is the estimated size of a firm's current or future market. In general, demand and supply characteristics associated with products determine their market prospects. The demand for a new firm's product can be thought to arise from consumers in domestic and international markets. On the supply side, firms will continue the production of commodities for which a market exists and may also include new products (Razzaque, 2003).

Entrepreneurs who start their firms primarily motivated by perceived market needs have a higher chance of success. According to Zhou and Chen (2008) the marketing potential of new firms can be directly linked to their growth opportunities. Market potential as measured by the characteristics of the market and also the characteristics of the product or service has direct impact on the future growth opportunities of a new firm. Investment decisions by creditors are not based only on the credibility of management but also on market prospects. New innovative products also enhance the market potential of a new firm. Innovation represents the whole process from the research and development of new products to their commercial application. The motivating force of innovation comes from the market. The market is the starting point and

terminal point of innovation. Therefore, a new SME that innovates will have better market potential.

The extent of competition and potential competition also impact on the market potential and growth opportunities of new SMEs. Potential entrants are entrants that enter an industry for the first time and offer a substitute product or service to a particular sector. The potential competitor is very important in competitive industry analysis. To survive and achieve success, new firms need to understand the dynamics of competition in their industry and develop skills and competencies that give them a competitive advantage. Therefore, managers of new firms have to scan and interpret environmental changes (especially the extent of present or future competition) to maintain their firms' viability and performance (Zahra, Neubaum & El-Hagrassey, 2002:5).

Dahl and Sorenson (2007) note that location also impacts on the market potential and growth opportunities of new firms. Geographical proximity to either critical buyers or suppliers produces a form of enhanced environmental scanning that enables new firms to more easily identify and exploit growth opportunities in the market. Geographical location has implications for access to markets and other resources such as finance, skilled labour and infrastructure. New firms in geographic clusters benefit tremendously by having access to abundant supply of funds and other sources of information. In addition, proximity to participants in the supply chain (customers and suppliers) reduces the search cost new ventures would otherwise encounter in gathering the needed resources and overall operation. This impacts on the market prospect of new firms.

Gilbert (2008) points out that the geographical area where the firm is launched has implications for its access to markets and resources. Firms located in metropolitan areas may therefore have higher chances of success than those located in rural areas. The researcher finds a positive a relationship between density and growth of human population and new firm formation rate. Stable access to markets is crucial for enhancing entrepreneurship while inadequate access to profitable markets inhibit entrepreneurship. This suggests that credit providers will be willing to extend facilities to new small firms that have market and growth potential.

According to Coleman (2004:118) from a banker's point of view, lending to new SMEs is a challenging task. New SMEs usually do not disclose all important information related to their firm's business transactions. In addition, most new SMEs lack skills in preparing financial statements and business plans. These amplify the problem of information asymmetry (i.e., borrowers have more information about their firms than banks do). Gumede (2002:381) points out that only a tiny fraction of new SMEs in South Africa engage in market research before commencing operation. Most of them are necessity rather than opportunity enterprises. The level of use of marketing research is positively related to company effectiveness. The information obtained through market research can affect the aimed market, customer needs and potential competition. In addition, poor location also affects the market potential of new SMEs in South Africa. Lack of market research limits the market potential and growth prospects of new SMEs. Thus, it is hypothesized that there is a significant positive relationship between lack of business information and non- availability of debt finance to new SMEs.

4.2.1.4 Networking

According to Premaratne (2002), the concept of networks and networking was originally developed in sociology and anthropology, and then used in organizational behaviour and small business development. A network is seen as a specific set of relations amongst various groups/actors. However, throughout the existing literature, particularly in organizational behaviour, two different and conflicting definitions of networks can be found. The first is that networks and networking have become fashionable conceptual devices for theorizing about the internal organization of larger businesses. The second is that entrepreneurship has been conceptualized as a dynamic process that requires linkages or networks between key components of the process for its successful development. This approach is viewed as being embedded in a social context. Networks in the context of this study are defined as personal relationships between an entrepreneur and his external actors. The external actors (outsiders) can be individuals or organizations. Entrepreneurs build up such network relationships (contacts) in order to obtain necessary resources and to perform activities. In this view, entrepreneurial networks consist of four major components, namely; actors, resources, activities and linkages.

Scalera and Zazzaro (2009:218) affirm that a social network is a set of agents connected to each other by relationships related to some specific activities or goals. In the case of inter-firm networks, agents are legally independent firms, while links and their motivations can be of various nature, like contracts, ownership, community, ethnicity, family, personal or political connections. Networks are stable coordination devices for economic transactions among members, grounded on formal and informal links and governed with a common goal.

Coulthard and Loos (2007) describe networking in a small firm context as an activity in which entrepreneurially oriented SME owners build and manage personal relationships with particular individuals in their surroundings. In general, networking includes the exchange of affect (liking, friendship), information, benefit and influence. Entrepreneurial firms may use networking to exploit opportunities. Inter-personal networking also plays an important role in enterprise creation and growth. Networking is seen as a means of raising required capital, identifying market opportunities, obtaining personnel, identifying suppliers, identifying and developing technology.

Premaratne (2002) divides entrepreneurial networks into three categories; demand-related networks, supply-related networks, and support functions such as banks and accountants. The demand-related network comprises ties associated with clients and the maintenance or establishment of contacts with clients. The second type that is the supply-related network covers network ties associated with the cooperative supply of services or products. The third considers support networks, for example banks, business advisers, family and friends. Supply-related networks are further divided into two types: Firstly, small business service firms form networks with other SMEs, or even individuals to increase the range of services and advice they can provide. Secondly, sole practitioners combine together into a network to provide a formal vehicle for their activities. Ngoc, Le and Nguyen (2009:868) also categorized networks into three main types: (1) official networks - or networks with government officials; (2) managerial networks - networks with top managers of suppliers, customers and business associations and (3) social

networks - networks with relatives and friends and networks with members of social organizations and clubs.

Networking is very important to SMEs, both new and established, and can positively impact on their performance and access to finance. Okten and Osili (2004:1225) examine the impact of network formation on SME growth. The researchers define networking as belonging to professional, trade, and social associations. Results suggest that networking has an influence on the growth of an SME, especially through contacts with other entrepreneurs. In addition, the researchers argue that SMEs face two major problems, namely limited resources and market share. Gaining access to required resources is considered the first entrepreneurial problem, while the expansion of the market share is the second major problem faced by new SMEs. The formation of networks helps new SMEs to tap resources in external environment successfully. At the same time, such networks pave the way to new markets.

Shane and Cable (2002:366) agree that networking can be used to reduce information asymmetry in creditor/debtor relationships. Social obligations between connected parties, and information transfer through social relationships, influence venture finance decisions. Shane and Cable (2002:367) argue that social 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 both parties to search for integrative rather than zero-sum outcomes. In this way, embedded ties both create new collaborative opportunities and induce the mutual rather than selfish distribution of rewards.

In addition, networks increase a firm's legitimacy, which in turn positively influences the firm's access to external financing. Ngoc *et al.* (2009:872) point out that in the absence of effective market institutions; networks play an important role in spreading knowledge about a firm's existence and its practices. Networks also help a firm learn appropriate behaviour and therefore obtain needed support from key stakeholders and the general public. In large part, networking substitutes for the lack of effective market institutions, and can be an effective way for SMEs to access external financing, including bank loans in emerging economies. Networking could be

expected to provide to the banks information on legitimacy, which in turn should give the SMEs advantages in accessing commercial bank loans. This suggests that networking is a measure of the character as well as the capacity of small entrepreneurs.

Networking can also help SMEs to access other kinds of debt finance apart from bank loans. Hussain, Millman and Matlay (2006:585) note that much of the entrepreneurship, finance, and economic literature on SME financing indicate that it is often difficult and expensive for SMEs to access bank financing, due in a large part to information asymmetry between banks and firms. Thus, it is both necessary and desirable for SMEs to find alternative sources of capital to satiate their need for capital. Various alternative sources of external debt financing may be available to SMEs, including trade credit, loans from relatives and friends, and support from governments. These alternative sources of financing appear to be critically important for SMEs in emerging economies, where more formal and extensive financial markets are typically underdeveloped and where problems pertaining to information asymmetry and opportunism are often more pronounced. Further, these alternative sources of financing are often more accessible, convenient, and, sometimes, cheaper; government support programs provide loans with interest rates well below those offered by commercial banks. Networking, by helping SMEs access these sources, could reduce the need for bank loans. This suggests that networks provide contradictory forces to affect a firm's use of bank loans. On the one hand, a well-networked SME has legitimacy, information, and knowledge advantages, which promote the firm's access to bank loans. On the other hand, networks can reduce the need for bank loans by helping a firm access other sources of funding.

Robb and Fairlie (2008:1435) examine the reasons why Chinese, Indians and Korean SMEs are successful in the diaspora. The authors argue that the economic success of Chinese and Japanese immigrants is in part due to their ownership of SMEs. One of the explanations for high rates of economic success is the extensive social or ethnic resources. 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 entrepreneurs through rotating credit associations, direct loans, and equity investments in the

business. The results are consistent with the findings of similar empirical studies on the impact of ethnic network on firm performance. Hayer and Ibeh (2006:515) for instance used a sample of 21 UK-based Indian SMEs to explore the impact of ethnic networks on the internationalisation of minority ethnic businesses. Issues examined include the perceived importance of such networks in the study firms' international expansion and how this perception might have been affected by the firms' overall level of development. It emerged that these network resources provided useful intelligence and contacts that bridged critical gaps in international knowledge and experience, and facilitated the successful development of ethnic SMEs.

Gulati and Gargiulo (2000:39) add that the relationship between creditors and new SME owners usually takes place under conditions of uncertainty and information asymmetry. Networking therefore can provide an advantage to people who seek to obtain resources from others. The explanation for this behaviour depends largely on two factors; social obligation and access to private information. Theoretically, direct social ties between parties could shift the logic of the transaction from one of economic behaviour to one of a social relationship. In addition, unlike arm's-length transactions, which are governed by norms of self-interest, social relationships are governed by norms of fairness and equity. Moreover, networking between parties transfers expectations about people's behaviour from a prior social setting to the new business transaction. By embedding a transaction in an ongoing social relationship, networking (a) motivates both parties to maintain the relationship in a fair and trusting manner, and (b) generates a sense of obligation between the parties, which causes the parties to behave generously towards each other. Networking also enhances resource acquisition under conditions of information asymmetry because it provides a fast mechanism for obtaining private information about the quality of people's talents and their tendency to behave opportunistically.

Gumede and Rasmussen (2002:165) find that SMEs in South Africa that engage in networks, like business associations, have enhanced exporting probabilities. Enterprises through business linkages and networks gather useful information on market access, consumer information and suppliers and bank credit requirements. However, most new SMEs in South Africa do not engage in networking because of cost implications and lack of awareness. Kiggundu (2002:29) and Barr

(2002:15) find that networks contribute to business success and continuity. However, it seems as if the South African entrepreneur experiences difficulties in establishing and maintaining business networks which function effectively.

Atieno (2009:33) for instance contends that, while networking does provide advantages, firms with limited resources, such as new SMEs, may also be discouraged from joining or establishing contact because of the associated costs. This limits the extent to which small businesses can influence the support mechanisms such as policies, legislations and infrastructure that affect their operations. Small firms, therefore, face a number of constraints that are institutional in nature, but their weak organizational ability and the minimal or non-existent linkages limit the extent to which they can address these issues.

Ngoc *et al.* (2009:870) agree that most new SMEs do not network with providers of funds when starting their businesses. In addition, very few new SMEs belong to professional associations. The lack of networking affects the legitimacy of the new SMEs. An organization's legitimacy refers to the extent that key stakeholders, the general public, key opinion leaders, and/or government officials know about and accept the organization and its practices. Thus, an organization can increase its legitimacy by spreading the knowledge of its existence among key stakeholders and the general public. This suggests that a lack of networking could be one of the obstacles to the availability of finance to new SMEs in South Africa. Consequently, this research hypothesized that there is a positive significant relationship between lack of networking and the non-availability of debt to new SMEs.

4.2.2 The external environment

Ehlers and Lazenby (2007:106) remark that the external environment (*"conditions"* under the 5C's of lending) represents the variables in the environment that have a direct as well as an indirect influence on the organization. The external environment is largely uncontrollable by the organization. The external environment continuously changes. The external environment can play a very important role in the availability of finance to firms. The external environmental factors focused on in this study include the legal environment, the economic environment and the

social environment (ethics, crime and corruption). According to Barbosa and Moraes (2004), the legal environment may have implications for the capital structure of SMEs. Furthermore, the legal environment is directly related to the political environment because government makes and implements laws.

4.2.2.1 The legal environment

- **Definition of law**

Meiners, Ringleb and Edwards (2005:115) point out that there is no general definition of law. Law is an abstract term that can be defined in many ways. Law is a statement of the circumstances in which the public force is brought to bear through the courts. Law can also be defined as a principle or rule of conduct so established as to justify a prediction with reasonable certainty that the courts will enforce it if its authority is challenged. Law in its generic sense therefore means a body of rules of action or conduct prescribed by controlling authority and having legal binding force. Laws must be obeyed and followed by members of a society subject to sanctions or legal consequences. Therefore, laws may 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, commercial practices and ethics.

Therefore, law and the legal system serve several key roles in society. These roles include:

(1) Influencing the behaviour of members of the society. The legal system is a major social institution that helps to define acceptable behaviour and control unacceptable behaviour. Law thus restricts activities that are detrimental to the public interest and encourages beneficial activities. Law restricts business activities that are viewed as outside the ethical and social norm of a society.

(2) Resolving dispute within a society. Disagreements in business are inevitable since societies are made up of people with differing desires and social preferences. Disputes both potential and actual are prevented and settled by appealing to law.

(3) Social maintenance. A society is shaped by its values and customs. Law plays a crucial role in maintaining the social environment. Honesty and integrity are reflected by the enforceability of contracts, respect for other people and their property as reflected in property law and acceptable behaviour as reflected by criminal law.

(4) Social change. The legal system provides a way to bring about changes in acceptable behaviour (Meiners *et al.*, 2005:117).

- **Legal traditions**

La Porta, Lopez-De-Silanes, Shleifer and Vishny (1997:1131-1150) (henceforth LLSV) and Levine (1999) set up the theoretical basis for the development of empirical studies in respect of the relationship between law and finance. LLSV argue that in the traditional finance theory of Modigliani and Miller (1958), securities (debt and equity) are recognized by their cash flows. According to Modigliani and Miller (1958) debt has a fixed promised stream of interest payments, whereas equity entitles the owner to receiving dividends. LLSV (1997:1139) argue that cash flow alone does not tell the whole story and that the defining feature of various securities is the rights that they bring to their owners. Shares typically give the owners the right to vote for the directors of the companies and shareholders receive dividends on their equity because they can vote out directors who do not pay them. Also, debt entitles creditors the power to repossess collateral when the company fails to make promised payments and creditors are thus paid because they have this power. Without these rights investors would not get paid and therefore firms would find it difficult to raise external finance. LLSV however dispute the view that securities are inherently characterized by some intrinsic rights and argue that this ignores the fact that these rights depend on the legal rule of the jurisdictions where 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 firms, corporate finance may critically turn to these legal rules and their enforcement. Therefore, the differences in legal protection of investors might help explain why firms are financed differently in different countries.

The actual starting point of LLSV's argument is that laws in different countries are typically not written from scratch but transplanted voluntarily or otherwise (through conquest, imperialism, borrowing or imitation) from a few legal families or traditions. Commercial laws have two major traditions[2]. One is Common law[3], which is English in origin, and the other is Civil law[4], which derives from the Roman law. Within the Civil tradition, there are three major families that modern commercial law operates from; French, German and Scandinavian. The Scandinavian countries developed their civil codes in the 17th and 18th centuries. These countries have remained relatively unaffected by the far-reaching influences of the English, German and French legal traditions. The French Civil Code was written in 1804 when France was ruled by Napoleon. Napoleon saw the permanence of the Code as more important than the fleeting nature of his military conquests. He had the Code adopted in all conquered counties. Through conquest and colonization France extended her legal influences to Africa, Asia, French Guiana and the French Caribbean. Furthermore, since the French Civil Code exerted a great influence on the Portuguese and Spanish legal systems, this helped spread the French legal tradition to Central and South America, which were colonized by Spain and Portugal.

The German Civil Code was completed in 1896 following German unification under Bismarck. The German Code exerted a great influence on Austria, Switzerland, China, the Czeck Republic, Slovakia, Greece, Hungary, Italy, Japan and Korea (Levine, 1999:39). LLSV (1998:1113-1155) assembled data covering legal rules pertaining to the rights of investors and the quality of enforcement of those rules (for creditors, these rules cover the respect for security of the loan, the ability to repossess collateral and the inability of management to seek protection from creditors voluntarily) in forty nine countries (South Africa included) that have publicly traded companies. They found that laws vary a lot across countries, due in part to differences in their legal origin. Common law countries generally have the strongest and French civil law countries the weakest

[2] The criteria used to define legal families include (1) historical background and development of the legal system (2) theories and hierarchies of sources of law (3) the working methodology of jurists within the legal system (4) the characteristics of the legal concepts employed by the system (5) the legal institution of the system (6) division of law employed within the system (Levine, 1999:39).

[3] The common law family includes the law of England and those modeled on English law. The common law is formed by judges who have to resolve specific disputes. Precedents shape common law. Common law has spread to English colonies such as USA, Australia and South Africa (Levine, 1999:39).

[4] The civil law tradition originates from Roman law. It uses statutes and comprehensive codes and also relies heavily on legal scholars to ascertain and formulate its rule (Levine, 1999:41).

legal protection of investors and creditors. German and Scandinavian civil law countries are located 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.

- **The South African legal tradition**

The South African law is based on Roman-Dutch law but contemporary 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, the South African law were further enriched and developed (Visser, Pretorius, & Mischke, 2005:25).

The Roman Dutch law was brought to South Africa in 1652 by Jan van Riebeeck and despite the English occupation the system remained in force in South Africa. Although England never officially imported the English legal system to South Africa, South African law was strongly influenced by English law. The reasons for this influence include the importation of judges and magistrates versed in English law from England. The fact that local jurists studied in England, English court decisions were often referred to, many South African Acts were based on corresponding English Acts and the final court of appeal was the Privy Council in England. The South African legal system is therefore a mixed or hybrid system with a combination of Roman Dutch law and English law. The great influence of English law means South Africa is usually classified under the common law tradition (Visser *et al.*, 2005:26).

In South Africa, commercial contracts between parties are governed by the law of contracts, which are mainly based on Roman legal principles regarding the law of obligations with limited influence of English law. In terms of Roman law, a legal obligation created a legal tie between legal subjects, resulting in rights and corresponding duties recognized by law. A legal obligation consists of two elements namely 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. However, creditor protection, bankruptcy and insolvency of firms and protection of creditors are governed by the Insolvency Act 24 of 1936 as amended and the Bankruptcy Act (Visser *et al.*, 2005:26).

- **Insolvency law in South Africa**

Nagel (2005:10) reports that insolvency law was developed as a collective debt collecting procedure in order to provide a fairer distribution of the proceeds of the debtor's property amongst the creditors where the debtor does not have sufficient assets to settle his debt which means his estate is insolvent. The law of insolvency can therefore be described as the totality of rules regulating the situation where a debtor cannot pay his debts or where his total liabilities exceed his total assets. The law of insolvency is based on two principles. The two principles are that the right which creditors have to satisfy their claims through the process of execution against assets and the concurrency of creditors who do not have a preferent or secured claim. When sued by his creditors, there are many procedures available to a debtor who is unable to pay his or her debts. The debtor can for example apply for an administration order from the Magistrates Court provided his debts do not exceed fifty thousand Rand. When such application is made, the debtor must thereafter make certain regular payments to the administrator. The debtor can also voluntarily submit his estate. The debtor may also enter into a release or a novation with any or all of the creditors.

When a debtor proposes a release or where he gives written notice to the creditor(s) of his or her inability to pay his debts, an act of insolvency is committed, on which ground the creditor may apply for the sequestration of the debtor. Where a debtor fails to fulfil any contractual obligation or satisfy his or her liabilities, each creditor can individually apply claim performance from the debtor and where the debtor does not respond, the creditor can issue a summons and obtain civil judgment against the debtor. The creditor may thereafter attach the property of the debtor if the latter still fails to pay the judgment debt. Attached property may then be sold in execution at a judicial sale, and the creditor will be entitled to claim from the proceeds of such a sale. If the creditors are more than one, they can jointly apply for the sequestration of the debtor's assets by

means of compulsory sequestration. The debtor loses control over his estate immediately a sequestration order is given by the High Court. The property is then vested in the Master of the High Court until the appointment of a trustee. The trustee realizes the estate and distributes the proceeds to the creditors in the manner provided for in the Act. The general interest of the creditors as a group ranks in priority over the interests of individual creditors (Nagel, 2005:11).

Visser *et al.* (2005:44) argue that although the insolvency Act 24 of 1936 is the main source of insolvency law in South Africa, it is not the only source. The Companies Act 61 of 1973 (Bankruptcy act) and the Close Corporations Act 69 of 1984 also govern the insolvency of companies. The High Court of South Africa generally has exclusive jurisdiction over insolvency matters, although close corporations may be liquidated through an application to the lower Magistrate' Court. Standard and Poor's (2007) observe that the vast majority of business insolvencies result in liquidations. Liquidation can be a voluntary winding up by a special resolution of the shareholders or a compulsory winding up involving a petition that the company itself, the directors, a shareholder or a creditor files with the court. Liquidation proceedings are by far the most common insolvency proceedings in South Africa. These proceedings can either occur as a voluntary winding up by way of a special resolution (initiated by a 75% majority shareholders) or by a compulsory winding up by the company itself, directors, a shareholder, or a creditor.

- **Creditor protection in South Africa**

When investors finance firms, they typically obtain certain rights or powers that are generally protected through the enforcement of regulations and laws. Some of these rights include disclosure and accounting rules, which provide investors with the information they need to exercise other rights. Protected shareholder rights include those to receive dividends, to vote for directors, to participate in shareholders' meetings, to subscribe to new issues of securities on the same terms as the insiders, to sue directors or the majority for suspected expropriation, to call extraordinary shareholders' meetings, etc. Laws protecting creditors largely deal with bankruptcy and reorganization procedures, and include measures that enable creditors to repossess collateral, to protect their seniority, and to make it harder for firms to seek court protection in

reorganization. All outside investors, whether large or small, shareholders or creditors need to have their rights protected. 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 (LLSV, 2000:183).

According to Djankov, McLeish and Shleifer (2007:300) creditor protection is measured by the creditor right index. The index ranges from 0 (weak creditor rights) to 4 (strong creditor rights). A score of one is assigned when each of the following rights of secured lenders are defined by laws and regulations. First, there are restrictions, such as creditor consent or minimum dividends, from a debtor to file for reorganization. Second, secured creditors are able to seize their collateral after reorganization petition is approved. This implies there is no automatic stay or asset freeze. Third, secured creditors are paid first out of the proceeds of liquidating bankrupt firm, as opposed to government or workers. Finally, management does not retain administration of its property pending the resolution of reorganization. Table 4.2 depicts the creditor right index of South Africa and some other developing and developed countries.

Table 4.2: Creditor rights index in South Africa and selected developing and developed countries

Country	Creditor rights index
South Africa	3
Botswana	3
Nigeria	4
United Kingdom	4
USA	1
Cameroon	0
France	1
Sweden	1

Source: Djankov, McLeish and Shleifer (2007:315).

Table 4.2 shows that Nigeria and United Kingdom with indexes of 4 have very strong creditor protection. South Africa and Botswana with indexes of 3 have relatively strong creditor protection. All these countries belong to the English legal origin. While the United States of America, France, Sweden and Cameroon with indexes ranging from 1 to 0 have very weak

creditor protection. France and Cameroon belong to the French legal origin. This implies that on paper creditors in South Africa enjoy high protection.

Though creditor protection on paper is relatively strong, the efficiency of contract enforcement is quite low in South Africa. Standard and Poor's (2007) investigate debt recovery for creditors and the law of insolvency in South Africa. They find that South Africa is a friendly jurisdiction for secured creditors and perhaps the friendliest in Africa. However, in contrast 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 of up to two years in some instances. Therefore, 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 World Bank (2003a) reveals a relatively inefficient legal system in South Africa compared to developed countries. There is a shortage of judges and magistrates, backlog of cases and lower creditor protection. This view is consistent with Cronje (2003) which finds that creditors often display a lack of interest in the administration of insolvent estates. One of the reasons for this lack of interest is that concurrent creditors seldom receive any benefit of substance from the insolvent estate. Furthermore it takes a long time to finalize bankruptcy proceedings. Conclusively, South Africa's creditor right index is relatively strong which implies that on paper creditor protection is high. However, the long procedures, duration and cost it takes to register property, enforce contracts and close business upon bankruptcy suggest a relatively inefficient legal system. This may affect the availability of debt finance to new SMEs. Consequently, it is hypothesised that there is a significant positive relationship between the inefficiency of the legal system and non-availability of debt to new SMEs in South Africa.

4.2.2.2 The macro-economic environment

According to Ehlers and Lazenby (2007:108) economic forces ultimately result in prosperity or adversity, and have specific implications for an organization or its management. Business

organizations have to study the economic environment to identify changes and trends, and their strategic implications. Economic factors have a direct impact on the potential attractiveness of various strategies and consumption patterns in the economy and have significant and unequal effects on organisations in different industries and in different locations. Ehlers and Lazenby (2007:108) add that economic variables include the fiscal and monetary policies of the government, inflation, interest rates, and foreign exchange rates. These variables influence the demand for goods and services because consumers are forced to reconsider their consumption priorities. It is therefore important for SME owners to understand the economic situation in the country. SME owners must understand the employment rate, the level of disposable income, the availability and cost of credit and the trends in the gross domestic product. Furthermore they must understand the monetary policies of the government and movements in the rate of interest as these will influence consumer spending. Understanding the economic environment can help managers predict how trends and events in those environments might affect their companies' future performance.

Correia *et al.* (2007:420) point out that debt use can either be positive or negative for the profitability of a firm. Debt is positive if the firm is able to earn a return on assets that is higher than the before tax interest rate on debt. A situation of high interest rates currently operating in South Africa suggests that it will be difficult for firms to have a positive leverage especially with the current economic downturn. According to Correia *et al.* (2007:420) positive leverage occurs when a firm operates under favourable conditions, when sales and profit margins are high and the firm is able to generate a good return on assets. Negative leverage happens when a firm faces difficult times, and sales and profit margins are low. The current economic downturn suggests that it will be difficult times for SMEs. Especially new ones may not be able to use leverage positively. This may affect the willingness of banks and trade creditors to grant credit to new firms. Coleman and Cohn (2000:82) state that an economic down turn usually impacts negatively on SMEs; especially new ones that have just entered the market, do not have many loyal customers and cannot reduce prices. Mollentz (2002) affirm that market issues and demand for their products are the most important factors that positively influence new SME growth.

According to Barbosa and Moraes (2004) a depressed economic condition is a characteristic associated with the likelihood of a firm's failure to repay its debt. During economic expansions even marginal firms have ready access to debt capital. However, in recessions or downturns, the established firms that have both a record of past success and relatively good performance obtain a large percentage of new debt. This suggests that new SMEs may find it difficult to pay back debt in the environment of high interest rates. Credit grantors for this reason may not want to lend to new SMEs.

Baum and Caglavan (2008:73) note that as banks must acquire costly information on borrowers before extending loans to new or existing customers, uncertainty about economic conditions (and the likelihood of loan default) would have clear effects on their lending strategies. Higher uncertainty will hinder managers' ability to accurately predict returns from available lending opportunities. When the macro-economic environment is tranquil, bank managers will be able to predict returns from each potential project more easily and channel funds towards projects with higher expected returns. Contrarily, when the economic environment is in turmoil, bank managers' ability to predict returns accurately will be hindered resulting in more conservative lending behaviour across all banks. Baum and Caglavan (2008:75) find 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 Economist (2009b) reports that South Africa's current economic environment is characterized not only by high interest rates but also by low growth rates (low consumption), high inflation rates and volatile exchange rates. In addition, the country is officially in economic recession for the first time in seventeen years due mainly to the global economic meltdown. These factors can impact on the availability of debt finance to SMEs. Consumption and confidence have fallen with a lot of firms showing reduced sales. Unemployment is high. All these factors can affect sales, revenues and market potential of new SMEs. Furthermore, inflation has increased to double digits since 2008 and the Rand (South African currency) has depreciated by about 30%. These two components of the economic environment push up the cost of inputs

for SMEs and lead to an increase in the prices of their products. This may negatively impact on sales and the profit margin.

According to Barbosa and Moraes (2004), in a period of inflation, firms generally need more capital. Therefore, inflation can play a part in the determination of financial leverage. Empirical studies on the impact of inflation on financial leverage are however inconclusive as to direction. Barbosa and Moraes (2004) find a positive impact of inflation on financial leverage. The corporate debt positions of firms were highest in high inflationary periods and lowest in low inflationary periods. Soares and Procanoy (2000:16) however find a significant and negative association between inflation and the total debt ratio in a sample of 204 listed firms in Brazil.

In summary, weak economic conditions can affect sales, revenues, market and growth potential of new SMEs. Weak economic conditions make it difficult for firms to use debt positively and this may affect their ability to repay debt. Thus, it is hypothesised that there is a significant positive relationship between a bad macro-economic environment and non-availability of debt to new SMEs.

4.2.2.3 Ethics

Smit *et al.* (2007:412) describe ethics as the code of moral principles and values that direct the behaviour of an individual or a group in terms of what is right or wrong. Ethics is a set of values and rules that define right and wrong behaviour. Ethics includes distinguishing between fact and belief; defining issues in moral terms and applying moral principles to situations. Ethics affects both individuals and business organisations. At individual level ethical questions arise when people face issues involving individual responsibility, such as being honest, accepting a bribe or using organizational resources for personal purposes. At business level, ethics relates to the principles of conduct within organizations that guide decision making and behaviour. Business ethics are the standards used to judge the rightness or wrongness of a business' relations to others.

Hellriegel *et al.* (2008:64) furthermore define ethics as how a company integrates core values such as honesty, trust, respect and fairness into its policies, practices, and decision making. Business ethics also involves a company's compliance with legal standards and adherence to internal rules and regulations. Business ethics is complementary to other governance mechanisms, like the free market, government policies and social ethics. Generally speaking Business Ethics can be defined as the methods, principles and processes a business or organization brings to bear oncompliance to legislation; compliance to regulatory and professional standards; compliance to company standards; keeping promises and commitments; and abiding by general principles or values e.g. fairness, truth, honesty and respect.

Ethics has been recognized as important to the conduct of businesses in South Africa. This led to the King Reports in 1994 and 2002.

- **King Report 1994**

The King Committee on Corporate Governance was formed in 1992 under the auspices of the Institute of Directors to consider corporate governance in the South African context. The committee's report titled the King Report was released in 1994. The purpose of the report was to promote the highest standards of corporate governance in South Africa. The King Report 1994 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 1 Report, 1994).

- **King Report 2002**

The 1994 report was later reviewed leading to the King Report 2 of 2002. The Report listed seven characteristics of good corporate governance:

- *Corporate discipline:* This implies a commitment to adhere to behaviour that is universally recognized and accepted to be correct and proper.
- *Transparency:* This implies the ease with which an outsider is able to make meaningful analysis of a company' actions;

- *Independence:* This implies the extent to which mechanisms have been in place to minimize and avoid potential conflicts of interests that may exist;
- *Accountability:* This means individuals or groups in a company, who make decisions and take actions on specific issues need to be accountable for their decisions and actions;
- *Responsibility:* This means behaviour that allows for corrective action and for penalizing management;
- *Fairness:* Which implies that the systems that exists within the company must be balanced in taking into account all those that have an interest in the company; and
- *Social responsibility:* This means a well managed company should be aware of, and respond to social issues, placing a high priority on ethical standards (King 11 Report, 2002).

- **Ethics and firm performance**

Kotter and Hesket (1972:37-46) set up the theoretical foundation for a host of empirical studies on the impact of ethics on firm performance. The researchers in a study of 107 American firms conclude that the more a firm focuses on the needs of shareholders alone, the lower the performance. Firms perform better when their cultures emphasize the interests of all stakeholders (customers, employees, stockholders, suppliers, providers of funds). Over the eleven year period of the study, those companies that look beyond the balance sheet increased revenues by an average of 682% compared to 166% for those that did not, expanded their work forces by 282% versus 36%, grew their stock prices by 901% versus 74% and improved their net incomes by 756% versus 1%. The study concludes that while these results are highly impressive, they do not guarantee that being ethically correct will always lead to positive results for the company. However, the findings do suggest that exhibiting integrity and ethics in business does not rule out financial success. In fact, ethics may actually boost the company's performance. Kotter and Hesket's study stimulated a great interest of research into ethics and business.

Donker, Poff and Zahir (2008:530) examine corporate values, codes of ethics and firm performance in Canada and find statistically significant evidence that corporate values positively correlated with firm performance. Ethics is vital for management, employees, stakeholders and the community. Ethics can also have an impact on employee commitment to work and lead to

improvement in the financial performance of a firm. In addition, the stock markets react negatively to firms that commit socially irresponsible or illegal acts. These findings are consistent with the results of other empirical studies on ethics and firm performance such as Kaler, (2000:161-173) and Erondu, Sharland and Okpara (2004:349-357).

Kaler (2000:165), Erondu *et al.* (2004:355) argue that it is in the interest of the business organisation to behave in a way that recognizes the need for ethical and moral content in managerial decision making because it will ultimately benefit the business. The researchers note that it is necessary for business to be ethical because the society will eventually force recalcitrant businesses to behave ethically through legislations or other regulatory requirements. It is assumed that by embracing ethics, business can pre-empt their operations from being regulated or penalized. When business organisations behave ethically, they are helping to create a society that is imbued with such virtues as honesty, integrity and fairness, which will ultimately benefit them. Therefore, business has a moral obligation to support and assist the society by endorsing an ethical culture.

However, some studies disagree that ethics has any positive value to a business. Friedman (1970) in his classic paper on social responsibility of business argues that the responsibility of business is solely to increase profits and obey the laws of the society and not necessarily to be ethical. Business ethics therefore overlaps with the philosophy of business. If a company's main purpose is to maximize the returns to its shareholders, then it could be seen as unethical for a company to consider the interests and rights of anyone else.

Bauer, Derwa and Otten (2007:114) also find a negative association between business ethics and firm performance. The researchers examined the performance and risk profile of Canadian Mutual Funds identified as maintaining ethics-related criteria for tier investment portfolio versus peer mutual funds, which were not explicitly involved, in ethics related investments. The researchers point out that the need for ethical screening of corporate behaviour has become exceptionally fashionable since the recent corporate accounting scandals involving corporate giants such as ENRON and WORLDCOM. The incorporation of ethical criteria into the stock

selection process may eventually affect corporate finance as companies may fall out of favour within the investment community when behaving unethically. The importance of ethics in corporate behaviour has led to an increase in assets in ethical investments in Canada to approximately 50 billion Canadian dollars as at year 2000. Bauer *et al.* (2007:117) however find that the average ethical fund earned a lower annualized return of 5.12% compared to 5.48% for conventional ones. Furthermore, corresponding standard deviations of 14.21% for ethical investments and 14.05% for conventional ones suggest that ethical funds are also more risky. Therefore conventional funds outperformed ethical funds on a return-to-risk basis.

- **Ethics and new SMEs**

According to Spence and Rutherfoord (2003:1) the major thrust of ethics research has been large organisations. There is little information on SMEs. The researchers argue for a reorientation away from the large multi-national firm as the benchmark study of business ethics research. While it is true that business ethics as a discipline emerged at a time when the large firm was seen as the main focus of business study, today, SMEs remains the dominant form of business organization in both developed and developing countries. SMEs are seen as the engine of economic growth, employment, job creation, innovation and productivity. Failure to address small firm ethics is totally inappropriate and a fundamental flaw in current business ethics research.

Howorth and Moro (2006:30) point out that ethics and trust play an important role in reducing agency problems such as moral hazard and adverse selection. The decision to lend by providers of funds is often based on the evaluation of from financial statements and/or the provision of collateral, and/or credit scoring. These three lending technologies are all grounded on hard facts and public information available. Private information is often soft data, which, by definition, is difficult to summarise in numeric score, and is influenced by the context in which it is collected. This indicates the central role of soft information in the lending process since the essence of successful lending is overcoming asymmetric information problems between the borrower and the lender that would otherwise create incentives for borrowers to default their loans. This implies that there are different sources of information that lead to the decision to lend. Where

ethics is low, the general perception of riskiness is greater. In addition, contracts will be more stringent with tight terms and conditions. This includes tight monitoring and collateral.
Spence and Lozano (2000:45) indicate that there are certain differences between a large firm and an SME. Unlike large firms, SMEs are likely to be owner-managed. This provides greater scope for individual beliefs and moral decision making to affect the practice of the business as a whole. In addition, social relationships and networks in which these owner managers are entwined cannot be separated from the business. Therefore, researchers examining business ethics may not generalize their findings to SMEs. Grayson (2005) explores the question of whether ethics differs in the settings of large firms and SMEs and provides the answer as "Yes" and "No". No because the same principles apply. These are minimizing your negative social impacts and maximizing your positive impacts. Yes because there are differences between the two types of business organizations. SMEs are primarily driven by the personal beliefs and values of their owners. SMEs are also owner managed and highly personalized.

Fassin (2005:268) and Lepoutre and Heene (2006:260) find that new SMEs experience more difficulties than their larger counterparts when engaging in socially responsible behaviour. The single most unethical practice by small business professionals is dishonesty in making and keeping contracts. Top management is expected to set the ethical tone for the organisation and has the most influence on ethical excisions. It is because of these peculiar characteristics of new SMEs that ethics is particularly important to them. Spence and Rutherfoord (2003:3) indicate that SMEs, due to their particular dependency on the network of interpersonal relationships that determine how they function, should be interested in investing in ethics or social capital.

According to Hannafey (2003:100) and Mouzas, Hanneberg and Naude (2007:1020) another entrepreneurial field with numerous unethical practices in recent years has been the start-up sector. Ethical issues are involved in the different steps of the start-up process from idea to a successful firm, concerning intellectual property, confidentiality of information, marketing, insider trading and raising of funds. Young firms face significant resource pressure. Thus liability of newness may lead new firms towards more individualist ethical postures such as non-repayment of credit. Hannafey (2003:111) further argues that although certainly the least

quantifiable, ethics (which includes the character and personality) may well be the most important assessment that a lender can make about the prospective borrower. Regardless of the positive attributes of capacity, collateral and credit history that the borrower may have, if he does not demonstrate integrity and trustworthiness, any credit proposal may be declined. Ethics and character are important because amongst other things, they reveal intent. If the creditor senses that the borrower is somewhat untrustworthy toward fulfilling responsibilities with regard to the deal, even toward the business, the creditor will most certainly move away from the proposal. The lender must be made to believe that, in addition to the legal agreement, the borrower feels a certain moral obligation to repay the facility. Therefore, the subjectivity of business lending cannot be over stressed. Although, there certainly are concrete, quantifiable issues which the lender looks for, in the end, the decision whether or not to grant credit will often come down to subjective measurements, the comfort level that can be forged between the lender and the borrower. Thus it is hypothesised that there is a significant positive relationship between the ethical perception of new SMEs and non-availability of debt.

4.2.2.4 Crime

Schubert (2004:17) defines crime as a wrong committed against the public. Defining a wrong against the public is the responsibility of the government. According to Voigt, Thornton, Barrile and Seaman (2006:15) there is no single objective definition of crime. These researchers however define crime as any intentional act or omission in violation of the criminal law, committed without defence or justification, and sanctioned by the state as a felony or misdemeanour. The distinction between felony and misdemeanour generally serves to define the seriousness of the offence. A felony is a more serious offence and usually results in a heavier penalty (e.g., the offender can be sentenced to imprisonment for a long term and in addition be fined or sentenced to death). A misdemeanour by contrast is a lesser offence and typically involves a fine and/or imprisonment of less than one year.

Schubert (2004:119) adds that various mechanisms are employed to regulate behaviour, including rules codified into laws, policing people to ensure that they comply with those laws, and other policies and practices designed to prevent crime. In addition, there are remedies and

sanctions, and collectively these constitute a criminal justice system. Usually the perpetrator of the crime is a natural person, but in some situations legal persons can also commit crimes. Despite the fact that there are sanctions for crime, it remains a major social problem throughout the world but with different levels in different countries.

- **Crime rate in South Africa**

The United Nations Human Settlement Programme (2002) points out that South Africa has the dubious distinction of being amongst the world's five most-murderous nations. South Africa is ranked amongst the top five countries with the highest murder rates in the world together with Colombia, Jamaica, Guatemala, and Venezuela. In 1998, there were 59 recorded murders per 100,000 of the country's population. The high level of crime in developing countries as compared to developed countries is evidenced by tables 4.3 and 4.4. According to the OECD (2006) the low crime rate is one of the reasons for sustained economic growth in most developed countries. In addition, crime could be one of the reasons for the observed differences in the sustainability of SMEs in developed countries compared to developing countries. This suggests that crime reduction is necessary for the development of new SMEs in South Africa and other developing countries.

Table 4.3: Murder rate per capita in selected developing countries

Country	Murder per 1000 people	Rank
Colombia	0.617847	1
South Africa	0.496008	2
Jamaica	0.324196	3
Venezuela	0.316138	4
Zimbabwe	0.0749938	16

Source: United Nations Office on Drugs and Crime (2007).

Table 4.4: Murder rate per capita in selected developed countries

Country	Murder per 1000 people	Rank
USA	0.042802	24
United Kingdom	0.0140633	46
New Zealand	0.0111524	52
Switzerland	0.00921351	56
Japan	0.00499933	60

Source: United Nations Office on Drugs and Crime (2007).

- **Impact of crime on business**

Brown (2001:270) asserts that business is the largest organized group suffering from crime and violence. The effect of crime on business in South Africa is not only alarming but also growing. According to the South African Police Service Crime Statistics (2009) while the incidences of virtually all major categories of crime has fallen during the past year, business related crime is on the increase. The incidence of murder – that is the number of cases per 100,000 has fallen by 4.7%, attempted murder by 7.5% and assault by 4.6%; however crimes that affect the business community have increased. Burglary at non-residential premises rose by 6.8%, commercial crimes went up by 4.8% and shoplifting rose by 1.3%. Government acknowledges that, though crime statistics show a steady decline, crime levels are still unacceptably high. The actual raw number of robberies at business premises went up by a massive 47.4% from 6,689 to 9,862 between 2006 an 2008. Most of these robberies were on small business premises.

Demombynes and Ozler (2005:267) agree that crime is among the most difficult of the many challenges facing South Africa in the post-apartheid era. The country's crime rates are among the highest in the world and no South African is insulated from its effects. Beyond the pain and loss suffered by crime victims, crime also has less direct costs. The threat of crime diverts resources to protection efforts, exacts health costs through increased stress, and generally creates an environment that is not conducive to productive activity. Additionally, the widespread emigration of South African professionals in recent years is attributable in part to their desire to escape a high crime environment. All of these effects are likely to discourage investment and stifle long-term growth in South Africa. Consequently, it is important to understand the factors that contribute to crime in South Africa. The World Bank (2007) reports that enterprises in South Africa rate crime as a major problem. Direct losses due to crime and the cost of security were higher in South Africa than they are in other middle income countries such as China, Poland, Brazil and even Russia.

Does crime affect the economic growth of a country and what impact can crime have on businesses especially start-up SMEs? Gaviria (2002:249) assesses the effect of crime on firm performance in Latin America. Latin America countries such as Jamaica, Honduras and

Colombia have the highest rate of crime in the world. Drawing on firm-level data, the study finds that crime substantially reduces sales, investment, and employment growth. Countries with high crime rates tend to have slower economic growth as crime reduces domestic investment, human capital development and innovation and increases the operating costs of firms.

Krkoska and Robeck (2006) also examine the impact of crime on the business enterprises in transition economies (European countries that used to be under the communist system but are now transiting into capitalist system such as Poland) and find that a high incidence of crime may induce enterprises to exit from the marketplace or relocate to safer locations. A high level of crime, and in particular organized crime, can also have a detrimental effect on potential new entry of enterprises, both local and foreign companies, and their expansion. The World Bank (2003b) finds that crime is one of the main reasons for weak economic development in Jamaica due to its substantial costs on businesses in the country. Crime is costing Jamaica at least 4% of its gross domestic product yearly.

Manuel (2008) reiterates that crime is undermining growth in South Africa. The commitment of the South African government to fight crime is based on the strategic choices that have been made in restructuring the criminal justice system and the massive resources that have been diverted to the criminal justice system. In 2008, the government intends to spend 55 billion Rand on crime prevention. This is three times more than what was spent ten years ago and as a proportion of the gross domestic product, it is three times the global norm. Various programmes have been tried to combat crime in South Africa but the problem remains severe with the business community experiencing a significant portion of crime.

- **Crime and new SMEs**

Maas and Herrington (2006) in the Global Entrepreneurship Monitor South African Report point out that crime is one of the major factors that influence people negatively towards the creation of their own businesses in South Africa. The costs of crime are higher for SMEs than large firms and a major crime incident can hit a small firm very hard and leads to its failure to meet due obligations. Crime necessitates that entrepreneurs invest money in burglary bars, alarm systems

and security companies to ensure that their property and products are well protected. The result is that crime increases insurance premiums and thus decreases profits. It negatively impacts on sustainability and success and can cause business closure.

A survey sponsored by Standard Bank and Fujistu Siemens Computers (2009) find that crime has once again become the key concern for SMEs in South Africa after briefly being usurped by electricity, interest rates and petrol prices in 2008. Because of crime owners of SMEs are not aggressively pursuing avenues to grow their market shares and stay ahead of competitors. Rather they are focusing on operational matters because of the high crime rate. Isaacs and Freidrick (2007:9) investigate the impact of crime on the performance of SMEs in South Africa and find that crime negatively affects the SME sector. Crime increases expenditures or investments in security measures to eliminate or minimize the likelihood of crime. The increase in expenditure negatively impacts on the profitability of SMEs.

This is consistent with a Grant Thornton survey (2007), which finds that 84% of medium sized and large firms claim their staff or family members of staff had been the victims of personal contact crime. This substantially impacted on employers. Nearly 90% of companies have had to fund increased security costs, with 65% saying crime had decreased productivity and motivation. Forty-one percent said crimes had decreased creativity, ingenuity and resourcefulness, 32% said their companies had lost staff members to crime and 18% said they had lost customers. The survey concludes that lower levels of business confidence, despite the economic boom, can be attributed to high crime levels.

Empirical studies on the impact of crime in South Africa have mainly concentrated on large firms located in big cities while neglecting SMEs. A study commissioned by the South African Presidency (2008) on the impact of crime on small firms points out that studies assessing the impact of crime on business have tended to focus on the large corporate sector. The specific problems of the small and emerging sectors of business have been less intensively considered. Also, while small and micro firms are less likely to be targeted by criminals than larger firms, when they are victimized, their costs are proportionately much higher. Evidence also suggests

that SMEs are very likely to under-report crimes to the police. Furthermore, research shows that most emerging SMEs are not insured. Given the importance of small business as a driver of economic growth and job creation, particularly in developing countries, the extent to which crime deters the formation and sustainability of SMEs needs to be clearly understood. It is also important to understand the links between a more vibrant small enterprise sector and reduced crime. In addition, most new SMEs in South Africa do not have insurance policies to protect their assets, both fixed and current. Chidokufa (2009) found that less than half of all South African SMEs surveyed did not have any insurance cover in the event of a crime, citing that they did not have enough money to insure their business. Most of the uninsured respondents also replied that in the event of a serious crime incident, they would be forced to rely on loans or credit cards or money from family to keep going. 20% said they would probably have no choice but to close down.

In addition, a high crime rate reduces the value of properties that are used to collaterize loans. According to Linden and Rockoff (2006) in response to the crime risk, residents generally have two options; they can vote for anticrime policies, or they can vote with their feet. When individuals exercise the latter option, local response to crime will be observed in the housing market. The study finds a decrease in property values of 10 percent for a one standard deviation increase in property crime. Therefore, crime may affect the capacity of new SMEs to repay credit granted (increased credit risk). This may affect the willingness of banks and other creditors to extend credit to new SMEs located in high crime areas. Consequently, it is hypothesised that there is a significant positive relationship between crime and non-availability of debt to new SMEs.

4.2.2.5 Corruption

According to the World Bank (2005) there is nothing more important in the current work of the World Bank than the fight against corruption. It is a disease that permeates societies around the world and is at the core of the problems of social inequality and poverty. Transparency International (2008) describes corruption as the abuse of entrusted power for private gain. Corruption hurts everyone whose life, livelihood or happiness depends on the integrity of people

in a position of authority. Corruption has dire global consequences, trapping millions in poverty and misery and breeding social, economic and political unrest. Corruption is both a cause of poverty, and a barrier to overcoming it. It is one of the serious obstacles to reducing poverty. Human rights are denied where corruption is rife as the courts are also corrupted. Corruption undermines democracy and the rule of law, distorts national and international trade, jeopardizes sound governance and ethics in the private sector and threatens domestic and international security and the sustainability of natural resources. Corruption compounds political exclusion because if votes can be bought, there is little incentive to change the system that sustains poverty. Corruption hurts everyone.

- **Corruption in South Africa**

According to Transparency International (2008) corruption both in the public and private establishments is growing in South Africa. Transparency International has published the Corruption Perception Index (CPI) annually since 1995. CPI puts the issue of corruption on the international policy agenda. The CPI ranks 180 countries by their perceived levels of corruption, as determined by expert assessments and opinion surveys. CPI scores range from ten which means highly clean to zero, highly corrupt. Tables 4.5 and 4.6 show the corruption perception index in selected developed and developing countries. The two tables show that corruption is much higher in developing countries compared to developed countries.

Table 4.5: Corruption perception index of selected developed countries

Country	**CPI**	**Rank**
Denmark	9.4	1
New Zealand	9.4	1
Sweden	9.3	4
Canada	8.7	9
United Kingdom	8.4	12
USA	7.2	20

Source: Transparency International (2008).

Table 4.6: Corruption perception index of some selected developing countries

Country	CPI	Rank
Botswana	5.4	38
South Africa	5.1	43
Uganda	2.8	111
Nigeria	2.2	147
Zimbabwe	2.1	150
Somalia	1.4	179

Source: Transparency International (2008).

- **Corruption and firm performance**

According to Ackay (2006:21) there are two opposing approaches in the literature regarding the impact of corruption; efficiency enhancing and efficiency reducing. Advocates of the efficiency-enhancing approach argue that corruption greases the wheels of business and commerce and facilitates economic growth and investment. Thus, corruption increases efficiency in an economy. Corruption might raise economic growth through two mechanisms. First corrupt practices (e.g. paying bribes to speed the wheel of bureaucracy) would enable individuals to avoid bureaucratic delay. Secondly, government employees who are allowed to levy bribes would work harder especially where bribes act as appease rate. Bribes may have beneficial effects as they can serve as lubricants in an otherwise sluggish economy and improve its efficiency.

Ackay (2006:21) point out that the efficient grease hypothesis suggests that corruption can lower the cost of capital because government officials may have discretionary powers over which firms receive subsidized loans and at what terms. Therefore, firms that pay bribes should have better access to credit and cheaper credit hence lower cost. Klapper, Laeven and Rajan (2006:596) provide evidence that corruption reduces the negative impact of regulation. Regulation is less burdensome in corrupt countries because officials can be bribed to ignore them. Khwaja and Mian (2004:19) show that in Pakistan, politically connected firms receive substantial preferential treatment. Not only do such firms receive twice as large loans from government owned banks, but they also have 50% higher default rates on these loans. Meon and Sekkat (2005:72) find that corruption is very high in Russia. However, economic boom (the average gross domestic product growth rate in Russia between 2000 and 2007 was 6%) in the midst of persistent corruption calls

into question directly the notion that corruption per se constitutes an obstacle to economic growth.

A rich body of empirical studies disagree that corruption has positive consequences and suggest that corruption reduces efficiency. Kaufman and Wei (2001:37) state that corruption may negatively affect economic growth and increase government expenditure. The study used indices of corruption drawn from the International Country Risk Guide and the Economist Intelligence Unit and measures for each country the likelihood that high government officials will demand special payments and those illegal payments are usually expected throughout the lower levels of government. The study finds a significant association between corruption and economic growth. The magnitude of the effects is considerable. A one standard deviation increase in the corruption index is associated with a four-percentage point increase in the country's investment rate and over a half percentage point increase in the per capita growth rate. This implies that if a given country were to improve its corruption grade from 6 out of 10 to 8 out of 10, its annual growth rate per capita would rise by almost half a percentage point. In addition, Kaufman and Wei (2001:38) find that corruption increases a firm's cost of capital, which is inconsistent with the results of Klapper *et al.* (2006:591). This is inconsistent with the efficient grease hypothesis.

Gaviria (2002:250) examines the effect of corruption on firm performance and the types of firms that are likely to complain about corruption in Latin America. The study focused on three indices of firm performance; reported growth of sales, investment and employment. Results show that corruption has a noticeable effect on the economic outcome of firms in the sense that outcomes tend to be lower in firms where managers report that corruption is an obstacle to doing business than in firms where managers report otherwise. The effect of corruption on sales growth is positive and statistically significant, but the effect of corruption on investment and economic growth though positive is not statistically significant. Several mechanisms can explain the adverse effect of corruption and crime on firm performance. First, corruption raises operational costs, lowering competitiveness and ultimately lowering sales. Secondly, corruption prevents firms from entering profitable business, limiting the opportunities for growth and lowering sales,

investment and employment. Finally corruption may cause firms to lose valuable human and financial resources, likewise lowering competitiveness.

- **Corruption and new SMEs**

Most empirical studies on corruption have focused on how it affects large firms in developed countries. OECD (2006) calls for more to be done to highlight the issue of bribery and corruption within the SME community, on the basis that corruption has the potential to affect smaller firms just as much as large firms. The World Bank (2005) argues that studies on corruption have mainly focused on large firms. Little research has been done in the sphere of SMEs, which make up 90% of all established businesses worldwide. Corruption has been found to distort fair competition and the rules of the free market economy, has a negative impact on quality of products and services, weakens the prospect of economic investment and undermines business ethics. Corruption is detrimental to all types of business, large or small, local or multinational. It is however the smaller firms that are the most affected. More than 70% of SMEs perceive corruption as an impediment to their business compared to approximately 60% for large firms. Corruption affecting SMEs can be public or private. Public corruption involves government officials seeking personal gains in order to grant licenses, permits and tax incentives. Private corrupt interactions include embezzlement by employees, bribing and extortion by employees of larger companies in order to obtain contracts and corrupt bank officials approving loans that do not meet basic financial criteria and can therefore not be collected later. Due to enormous structural differences that exist between large firms and SMEs, the question arises whether the findings of the general private sector assessments are valid for SMEs to the same extent.

Gaviria (2002:249) further argues that the reason why SMEs engage in corruption is often linked to problems with regulatory compliance and bureaucracy. As the costs of dealing with bureaucratic requirements do not increase/decrease in proportion to firm size, burdensome regulations at national, regional and municipal levels usually affect SMEs disproportionately. SMEs that refuse to provide officials with additional payments, while most of the others do, will sooner or later have to face marginalization. They will not get the necessary permits and licenses on time or at all, they will not receive public contracts, or they will not succeed in complying in

the case of inspectors, deteriorating the companies' competitive position in the market. The costs imposed on SMEs in this respect are very arduous and therefore in many cases might encourage smaller business units to engage in corrupt behaviour. In comparison to larger firms, SMEs lack the bargaining power and the influence to oppose requests for unofficial payments and similar solicitations, as they usually do not have strong ties and connections to higher bureaucrats or politicians.

According to the United Nations Industrial Development Organisation (2007) corruption hurts all, but the pain is greatest among SMEs. Many factors influence the ability of entrepreneurs to set up and expand small businesses, such as financial issues, education, training, technology, access to information, property rights, infrastructure, and export possibilities, but corruption has been identified as a major obstacle to SME development. SMEs are more liable to be affected by corruption than large companies for the following reasons:

- *The structure of SMEs:* Both the relatively greater degree of informality, and the closer relationships between staff in SMEs, can create a culture where corruption is more easily tolerated.
- *The short-term vision and perspective of SMEs:* Whereas larger companies have the capacity to look ahead and consider the long-term drawbacks of corrupt practice, it is a pronounced characteristic of the staff of many SMEs to only think about the present or very short-term future. Therefore, there is a tendency for SMEs to see the short-term benefits of corruption.
- *The limited financial resources of SMEs:* Shortage of capital and smaller profit margins mean that SMEs in certain environments cannot always afford to refuse to pay bribes or other unofficial payments. The repercussions of refusing to engage in corrupt practices could put a SME out of business.
- *The inability of SMEs to exert a strong influence over officials and/or institutions:* In comparison with larger companies, SMEs lack the bargaining power and influence to oppose requests for unofficial payments and similar solicitations, as they usually do not have strong ties and connections to higher bureaucrats or politicians. Consequently, corrupt officials do not have to fear much resistance or counteractions on the part of SMEs.

- *The capital structure of SMEs:* Whereas larger firms are generally publicly quoted and are therefore dependent on the public perception of their prospects and are subject to even stricter stock exchange regulations, SMEs are often tightly held, without a clear line of separation between shareholders, management and board of directors.

Furthermore, corrupt bank officials, for instance, are often targeted to approve loans that do not meet basic financial criteria and can therefore not be collected later on. There have been a variety of reported incidents in that respect, but the question is whether private-to-private sector corruption poses a challenge to SMEs. In addition, corruption especially affects new SMEs that take government contracts. Contract payments may not be made unless the new SME is willing to bribe or share funds with the government official. Corruption therefore may affect the capacity of new SMEs to repay credit granted to them (United Nations, 2008).

According to Weill (2009) the key argument that corruption should be expected to hamper bank lending is based on the law and finance theory pioneered by LLSV (1997). Legal institutions protecting banks and enforcing contracts are likely to encourage greater bank lending by increasing the willingness of banks to grant loans. In the case of borrower default, the bank may wish to force repayment, to grab collateral or even in some cases to take control of the borrower in case of a corporate loan. Therefore, the institutions that empower the bank to proceed to these actions exert an influence on its lending behaviour. As corruption adds to uncertainty for banks to enforce their claims against defaulting borrowers, it diminishes the willingness of banks to grant loans. Greater corruption adds to uncertainty of judicial decisions for banks, as they cannot count on the courts to enforce damages recoveries for losses or deficiency judgments against defaulting debtors, and consequently banks are expected to refrain from lending. This implies that corruption is not limited to the misuse of public office as underlined by its common definition provided by Transparency International.

Weill (2009) notes that corruption can also take place in lending through bribes given to bank officials to receive a loan. While corruption in courts is expected to have a negative impact on bank lending, the role of corruption in lending is not straightforward. Corruption can be

considered as a financing obstacle, as it acts as a tax that increases the cost of the loan to the borrower. A theoretical argument can also be advanced to support this positive impact of corruption in lending. Stiglitz and Weiss (1981:398) have shown that adverse selection, resulting from ex ante information asymmetry between the bank and the borrower, causes credit rationing (i.e. loan applications from borrowers willing to pay more than the loan rate charged by the bank are rejected). The bank is motivated to do so to avoid adverse selection that results in attracting only bad borrowers. Nevertheless, the existence of credit rationing suggests that some borrowers are willing to pay more than the official loan rate to obtain credit. As a consequence, they have an incentive to bribe bank officials to obtain the loan. In South Africa, corruption is high as shown by Transparency International Annual Reports. In addition, the legal system, though strong on paper, is weak in practice. Corruption is endemic in government institutions and the legal system to an extent. Corruption may also affect the repayment of loans. Thus, it is hypothesised that there is significant relationship between corruption and the availability of debt finance to new SMEs.

4.3 SUMMARY

This chapter reviewed the literature on the business environment and new SMEs in South Africa. The business environment comprises of both the internal environment and the external environment. Factors in the internal environment include collateral, business information, managerial competency and networking. Factors in the external environment include the legal system, the macro-economy, ethics, crime and corruption. The literature showed that managerial competency positively impacts on firm performance. Managerial competency is also an important factor in the post-failure earning capacity of the owners of new SMEs. Also, collateral helps reduce several types of problems that arise when informational asymmetries between banks and entrepreneurs are present. Collateral signals the confidence of an entrepreneur in both his/her abilities and also in the likely success of the project. The generation and effective use of business information is essential to accessing funds from external sources. The absence of a business plan leads to information asymmetry between the creditor and the debtor. Furthermore, the market and growth potential of a firm is a critical success factor. Networking is also very important to the survival of new SMEs. Networking increases a firm's legitimacy, which in turn may

positively influence the firm's accessibility to external financing. This suggests that lack of managerial competency, collateral, business information as well as networking may lead to non-availability of debt finance to new SMEs from banks and trade creditors in South Africa.

Also, the literature reviewed showed that although creditor protection on paper in South Africa is relatively strong, the efficiency of contract enforcement is quite low in South Africa. Thus, the long procedures, duration and cost it takes to register property, enforce contracts and close business upon bankruptcy suggest a relatively inefficient legal system. This could be an obstacle to the availability of credit to new SMEs. In addition, new SMEs face significant resource pressure. The liability of newness may lead new firms towards more individualist ethical postures. Hannafey (2003:101) shows that although certainly the least quantifiable, ethics may well be the most important assessment that lender can make about the prospective borrower. Ethics in this respect implies the ethical perception of new SMEs by commercial banks and trade creditors. Furthermore, the rates of crime and corruption in South Africa are very high. Crime as well as corruption may affect the capacity of new SMEs to repay credit granted. The primary objective of this study is to investigate empirically the impact of the business environmental factors discussed in this chapter on non-availability of debt finance to new SMEs in South Africa. Therefore, the next chapter will focus on the research methodology that will be used for the empirical study.

CHAPTER FIVE

RESEARCH METHODOLOGY

"Because of the social and economic importance of new SMEs, studies leading to an improved understanding of the performance of new SMEs represent a significant contribution to the literature" (Chrisman, Bauerschmidt & Hofer 2000:6). "The failure rates of new SMEs are very high in most developing countries. Therefore, more fundamental reforms must be instituted to tackle the underlying reasons why new SMEs do not fulfil their growth potential" (Beck & Demirguc-Kunt, 2006:2935).

5.1 INTRODUCTION

The statements above indicate that despite the importance of SMEs, especially new ones, to the social and economic development of a country, their high failure rates specifically in developing countries such as South Africa prevents them from fully making their expected contributions. This necessitated a thorough review of the literature. The literature review shows that the availability of debt finance is one of the major obstacles faced by new SMEs in South Africa. As pointed out by Maas and Herrington (2006) in the Global Entrepreneurship Monitor South African Report, the availability of finance is a critical problem causing the failure and limiting the growth of new SMEs in South Africa. The review of the literature revealed that no South African study has explored empirically the impact of the business environment on the availability of debt finance and hence the sustainable growth of new SMEs in South Africa.

The aim of this chapter is to explain the research methodology followed in the empirical part of the study. According to Cooper and Schindler (2003:663) research methodology refers to the way in which data are gathered for a research project. It is the blueprint for the collection, measurement, and analysis of data in order to achieve the objectives of a research project. The research methodology used for this study will follow a research process. The research process is divided into seven steps. Step one of the research process will focus on the problem statement, the research questions, the research hypotheses and the research objectives. Step two will present

the various types of research designs such as qualitative, quantitative, exploratory, descriptive and causal. The motivation for the type of research chosen for this study will be given. Step three will explain the primary data collection methods such as observation, experiment and survey. The motivation for the primary data collection method used for this study will also be given. This will be followed by step four. In step four, the sampling method used for this study will be presented. Step five will present how data was gathered for the study. Step six will present the data analysis methods that can be used for research as well as the motivation for the data analysis method used for this study. Finally, step seven will give an idea of how the research results will be presented.

5.2 RESEARCH DEFINED

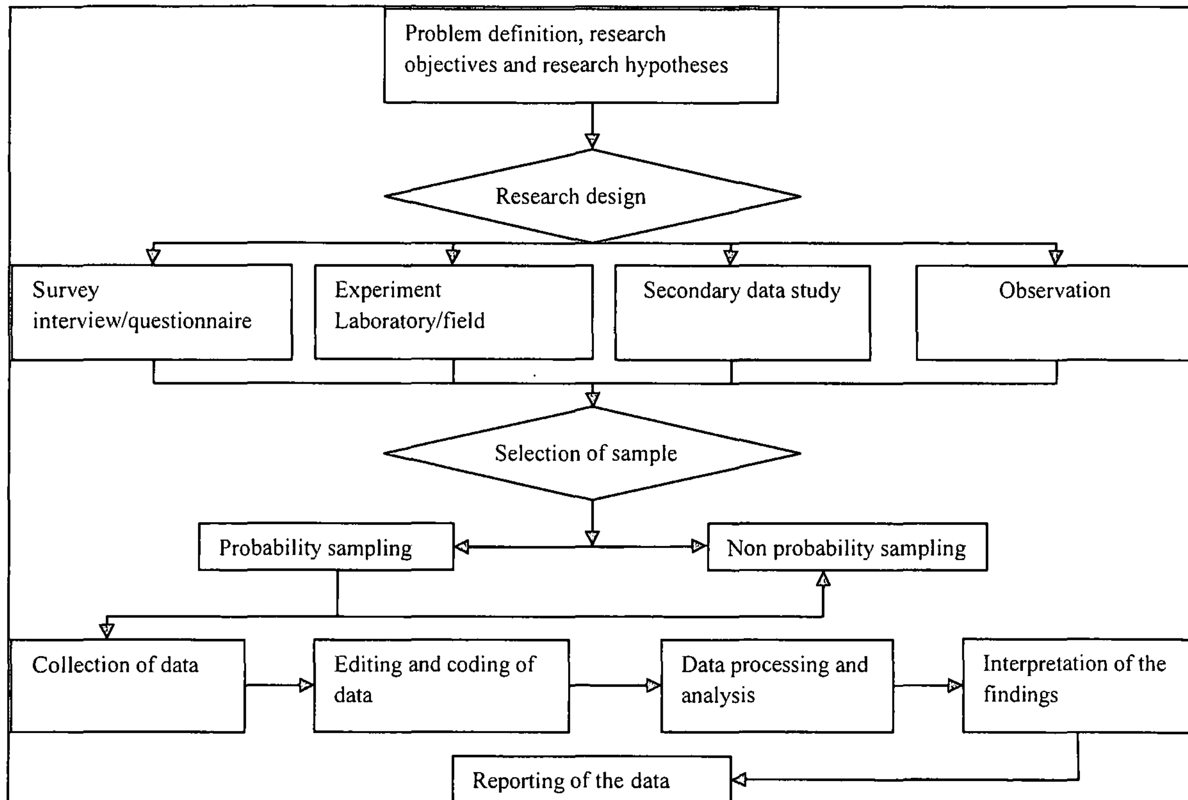
In the broadest sense of the word, the definition of research includes any gathering of data, information and facts for the advancement of knowledge. Research can also be defined as a systematic process of collecting, analysing and interpreting data to increase the understanding of a phenomenon or concern of interest (Wheather & Cook, 2000:11). In every subject area, knowledge and unresolved problems can be addressed by asking relevant questions and then seeking answers through systematic research (Cooper & Schindler, 2003:8). Because this study focused on new SMEs, which are businesses, the term business research will be used. Gerber-Nel *et al.* (2005:13) define business research as the systematic and objective process of planning, gathering, analyzing and reporting data, which may be used to solve a specific problem or opportunity. Business research is a systematic and objective process of gathering, recording and analyzing data for aid in making business decisions. Business research must follow a process termed the research process. The next section will discuss the research process followed for this study.

5.3 THE BUSINESS RESEARCH PROCESS

The research methodology follows a process termed the research process. Cooper and Schindler (2003:64) describe the business research process as the ordered set of activities focused on the systematic collection of information using accepted methods of analysis as a basis for drawing conclusions. Similarly, Bryman and Bell (2003:57) stipulate that the business research process is

a sequence of steps in the systematic collection and analysis of business data. The business research process offers a description of how research is designed and implemented. Figure 5.1 depicts the phases of the business research process and followed by the study.

Figure 5.1: Steps in the business research process



Source: Adapted from Zikmund (2003:61).

5.3.1 Step 1: Problem statement, research objectives and research hypotheses

5.3.1.1 Problem statement

"*The formulation of the research problem is far more often essential than its solution, which may be merely a matter of mathematical or experimental skill. To raise new questions, to regard old problems from a new angle requires creative imagination and marks real advance in science*" (Cooper & Schindler, 2003:64).

Cooper and Schindler (2003:66) point out that problem definition is essential before conducting a research project, especially quantitative research. Formal quantitative research should not begin until the problem has been clearly defined. Defining a research problem is the fuel that drives the research process and is the foundation of any research method. According to Gerber-Nel *et al.* (2005:37) the business research process begins with the identification of the research problem. A research problem indicates a specific managerial decision-making area to be clarified or problem to be solved. The research problem should, therefore, be clearly defined and formulated to ensure that the results obtained through research are relevant.

The motivation for this study stems from the fact that new SMEs have a major role to play in the South African economy in terms of employment creation, sustainable output growth, the equitable distribution of income and the overall stimulation of the economy. However, the rate of new SME creation is very low. In 2008, South Africa ranked 23rd out of 43 countries, with a Total Early-Stage Entrepreneurial Activity (TEA) of 7.8%, which was below the average rate (10.6%) of all countries that were surveyed by GEM. South Africa's TEA rate is significantly lower than the average for all developed countries (11.4%) as well as the average for all middle to low income countries (13.2%). In addition, the failure rate of new SMEs in South Africa at 75% is one of the highest in the world (Herrington *et al.*, 2009). Non-availability of finance remains a major constraint. External equity finance (venture capital, stock exchange) is universally unavailable to new SMEs. Debt finance therefore remains a major option. However, most new SMEs, especially in developing countries like South Africa, find it very difficult to obtain debt finance from banks and trade creditors (Beck, 2007:405). The primary research problem of this study was to investigate the impact of business environmental variables (internal and external environments) on non-availability of debt finance to new SMEs in South Africa. The secondary problem was to investigate whether commercial banks and trade creditors perceive new SMEs beneficial to their business. Improving the availability of debt finance to new SMEs will not only improve the low TEA rate (new SMEs creation rate) but could also reduce the high failure rate of new SMEs in South Africa.

5.3.1.2 Research objectives

Bryman and Bell (2003:37) state that a research objective is the researcher's version of a business problem. Objectives explain the purpose of the research in measurable terms and define standards of what the research should accomplish. This study had the following objectives:

- To investigate the impact of the business environment (the internal and the external environments) on the availability of debt from commercial banks and trade creditors to new SMEs.
- To investigate empirically if commercial banks and trade creditors perceive new SMEs as beneficial to their business.

The objectives were achieved through the following secondary objectives.

- To review the literature to determine the creation rate, the failure rate and the causes of failure of new SMEs in South Africa.
- To review the literature to determine if debt finance is available to new SMEs in South Africa.
- To review the literature to determine the business environmental variables that can impact on the availability of debt finance to new SMEs in South Africa.
- To investigate empirically the impact of business environmental variables on the availability of debt finance from commercial banks and trade creditors to new SMEs.
- To investigate empirically if commercial banks and trade creditors perceive new SMEs as beneficial to their business.
- To make policy recommendations on how to improve the availability of debt finance to new SMEs in South Africa.

5.3.1.3 Research hypotheses

According to Cooper and Schindler (2003:118) a hypothesis refers to possible answers to stated research questions. A hypothesis can be defined as an unproven statement or proposition about a factor or phenomenon that is of interest to the researcher. A hypothesis is a proposition that is empirically testable. Hypotheses are educated guesses about a problem's solution or expectations

about groups in a population expressed in empirically tested form. Tredoux and Durrheim (2002:128) point out that in order to answer research questions, they must first be translated into hypotheses (null and the alternate). The null hypothesis, which is usually represented by Ho, is a statement that maintains that there are no differences between groups or no relationship between measured variables. The alternate hypothesis represented by the symbol Ha maintains that there is a difference or relationship between measured variables. Therefore, the alternate hypothesis makes a conjecture that is diametrically opposed to the null hypothesis. The alternate hypothesis can be directional or non-directional. Directional alternate hypothesis specifies the direction of relationship (i.e. a positive or negative relationship). Non-directional alternate hypothesis does not specify the direction of the relationship (i.e. there is a relationship). The hypotheses listed below are for both commercial banks and trade creditors.

The primary research hypothesis for the study was:
Ho There is no significant relationship between the business environment and the availability of debt finance to new SMEs.
Ha There is a significant positive relationship between the business environment and the availability of debt finance to new SMEs.

The primary hypothesis was established through the following hypotheses. The hypotheses consisted of nine variables of the business environment. The variables were sub-divided into the internal and the external environmental variables. (the secondary hypotheses were stated negatively)

Internal environmental variables

- *Collateral*

Coco (2000:191) notes that collateral can solve problems derived from asymmetries in 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. Collateral requirements can reduce moral hazard problems by adding a potential cost to borrowers if they do not make

their best effort. Additionally, a borrower can be tempted to engage in opportunistic behaviour once a credit has been granted (Barbosa & Moraes, 2004). The right to repossess collateral, as well as efficiency in doing so, acts as a threat that can ensure that borrowers will not engage in inadequate behaviours (Coco, 2000:195). Thus it is hypothesised that:

H1o There is no significant relationship between lack of collateral and non-availability of debt to new SMEs.

H1a There is a significant positive relationship between lack of collateral and non-availability of debt to new SMEs.

- *Business information*

Kitindi *et al.* (2007:55) assert that creditors, banks and other lenders use financial information provided by firms to analyse their present performance and predict future performance. Financial information reduces information asymmetry. Sarapaivanich and Kotey (2006:221) agree that the existence of information asymmetry leads to credit rationing. From the creditors' perspective, lack of business information regarding the underlying quality of the project gives rise to the problem of adverse selection (Wiedenhofer, 2006:84). Financial information is one of the primary measures of the capacity of a business to effect repayment of credit (Barringer & Ireland, 2006:205). Sarapaivanich and Kotey (2006:221) concur that the existence of information asymmetry leads to credit rationing. However, if an entrepreneur has spent time developing a comprehensive and a priory business plan at an early stage in the project, risk perception should be reduced and the likelihood of obtaining capital should increase. This suggests that lack of business information can significantly impact on non-availability of debt. Consequently, it is hypothesised that:

H2oThere is no significant relationship between lack of business information and non-availability of debt to new SMEs.

H2a There is a significant positive relationship between lack of business information and non-availability of debt to new SMEs.

- *Managerial competency*:

Nguyen and Ramachandran (2006:206) point out that managerial competency can help to reduce information asymmetry before a loan is granted and potential moral hazard after the loan is granted. Bosma *et al.* (2004:227) find that managerial competencies positively impact on the performance of new SMEs. Similarly, Lyles *et al.* (2004:352) find that the profitability of a firm tend to be high when an entrepreneur has education and experience in the line of business. This suggests that lack of managerial competency can significantly impact on non-availability of debt to new SMEs. Consequently it is hypothesised that:

H3o There is no significant relationship between lack of managerial competency and non-availability of debt to new SMEs.

H3a There is a significant positive relationship between lack of managerial competency and non-availability of debt to new SMEs.

- *Networking*

Shane and Cable (2002:366) find that networking can be used to reduce information asymmetry in creditor/debtor relationships. In addition, networks increase a firm's legitimacy, which in turn positively influences the firm's access to external financing. Ngoc *et al.* (2009:872) point out that in the absence of effective market institutions, networks play an important role in spreading knowledge about a firm's existence and its practices. Networks also help a firm learn appropriate behavior and therefore obtain needed support from key stakeholders and the general public. Kiggundu (2002:29) states that networks contribute to business success and continuity. This suggests that lack of networking can significantly impact on non-availability of debt to new SMEs. Consequently, it is hypothesised that:

H4o There is no significant relationship between lack of networking and non-availability of debt to new SMEs.

H4a There is a significant positive relationship between lack of networking and non-availability of debt to new SMEs.

- **External environmental variables**
  - *Macro-economic environment*

According to Correia *et al.* (2007:420) positive leverage occurs when a firm operates under favourable conditions, when sales and profit margins are high and the firm is able to generate a good return on assets. Negative leverage happens when a firm faces difficult times, and sales and profit margins are low. Barbosa and Moraes (2004) note that a depressed economic condition is a characteristic associated with the likelihood of a firm's failure to repay its debt. Baum and Caglavan (2008:73) find that as banks must acquire costly information on borrowers before extending loans to new or existing customers, uncertainty about economic conditions (and the likelihood of loan default) would have clear effects on their lending strategies. Higher uncertainty will hinder managers' ability to accurately predict returns from available lending opportunities. Consequently, it is hypothesised that:

H5o There is no significant relationship between a bad macro-economic environment and non-availability of debt to new SMEs.
H5a There is a significant positive relationship between a bad macro-economic environment and non-availability of debt to new SMEs.

- *Legal environment*

Beckand Demirguc-Kunt (2006:2933) state that efficient legal institutions reduce the risk of lending by mitigating moral hazard as well as adverse selection problems, thereby increasing lenders' willingness to lend. This has a benign effect of increasing capital mobility in the economy, which in turn leads to financial development. Beck (2007:405) finds that market imperfections, such as those caused by underdeveloped financial and legal systems, may constrain firms in their ability to fund investment projects. Haselmann and Wachel (2009) note that banks' loan portfolio composition depends on the legal environment. If banks operate in a well-functioning legal environment they lend relatively more to SMEs and provide more mortgages. On the other hand, banks lend more to large enterprises and to the government if the legal system is inefficient: Consequently, it is hypothesised that:

H6o There is no significant relationship between the inefficiency of the legal system and non-availability of debt to new SMEs.
H6a There is a significant positive relationship between the inefficiency of the legal system and non-availability of debt to new SMEs.

- *Ethics*

Howorth and Moro (2006:30) point out that ethics and trust play an important role in reducing agency problems such as moral hazard and adverse selection. The decision to lend by providers of funds is often based on the evaluation of from financial statements and/or the provision of collateral, and/or credit scoring. These three lending technologies are all grounded on hard facts and public information available. Private information is soft data that, by definition, is difficult to summarise in numeric score and is influenced by the context in which it is collected. This indicates the central role of soft information in the lending process since the essence of successful lending is overcoming asymmetric information problems between the borrower and the lender that would otherwise create incentives for borrowers to default their loans. This implies that there are different sources of information that lead to the decision to lend. Where ethics is low, the general perception of riskiness is greater. In addition, contracts will be more stringent with tight terms and conditions. Consequently, it is hypothesised that:

H7o There is no significant relationship between ethical perception of new SMEs and non-availability of debt.
H7a There is a significant positive relationship between ethical perception of new SMEs and non-availability of debt.

- *Crime*

Beck (2007:407) finds that crime is one of the major obstacles to the growth of SMEs in developing countries. Falkena *et al.* (2002) point out that crime increases moral hazards after the granting of credit and can affect the ability of SMEs to repay credit. Isaacs and Freidrick (2007:9) stipulate that crime negatively affects the SME sector. Crime increases expenditures or investments in security measures to eliminate or minimize the likelihood of crime. Chidokufa

(2009) finds that less than half of all South African SMEs have insurance covers in the event of a crime. Linden and Rockoff (2006) observe that a high crime rate reduces the value of properties that are used to collaterize loans. This suggests that crime increases credit risk. Consequently, it is hypothesised that:

H8o There is no significant relationship between crime and non-availability of debt to new SMEs.
H8a There is a significant positive relationship between crime and non-availability of debt to new SMEs.

- *Corruption*

According to Weill (2009) the key argument that corruption should be expected to hamper bank lending is based on the law and finance theory pioneered by LLSV (1997:1131-1150). Legal institutions protecting banks and enforcing contracts are likely to encourage greater bank lending by increasing the willingness of banks to grant loans. In the case of borrower default, the bank may wish to force repayment, to grab collateral or even in some cases to take control of the borrower in case of a corporate loan. Therefore, the institutions that empower the bank to proceed to these actions exert an influence on its lending behaviour. Weill (2009) adds that corruption increases the uncertainty for banks to enforce their claims against defaulting borrowers. This diminishes the willingness of banks to grant loans. Greater corruption adds to uncertainty of judicial decisions for banks and trade creditors, as they cannot count on the courts to enforce damages recoveries for losses or deficiency judgments against defaulting debtors. Consequently, it is hypothesised that:

H9o There is a no significant relationship between corruption and non-availability of debt to new SMEs.
H9a There is a significant positive relationship between corruption and non-availability of debt to new SMEs.

- **Perception of the benefit of new SMEs (secondary hypothesis)**

According to De la Torre *et al.* (2008) the "conventional wisdom" argues that the inadequate financing of SMEs is to a significant extent rooted in "supply-side" factors. Banks and other financial agents appear to be uninterested and biased against new SMEs. Beck *et al.* (2008) in addition point out that "there is often the perception among policy-makers and SMEs that banks, especially large ones, are not interested in financing SMEs". Therefore, it is important to empirically ascertain whether commercial banks and trade creditors perceive new SMEs as beneficial to their business. Reitan and Waago (2002) suggest that banks and trade creditors are firms whose normal purpose of existence is to maximize the wealth of its shareholders. Banks and trade creditors should therefore be willing to deal with new SMEs, if they perceive new SMEs as firms that can contribute to the profit-maximization objective. In addition, as pointed out by Bbenkele (2007:14) SMEs both new and established form about 80% of all enterprises in South Africa and therefore should be of great importance to banks and trade creditors. Consequently, it is hypothesised that:

Ho Commercial banks and trade creditors do not perceive new SMEs as beneficial to their business.

Ha Commercial banks and trade creditors perceive new SMEs as beneficial to their business.

5.3.2 Step 2: Research design

"*The best statistics cannot save an inferior design. This is the foundation of a good dissertation*" Chisnall (2005:16).

Cooper and Schindler (2003:181) point out that a research design provides the glue that holds a research project together. The research design involves plans that promote the systematic management of data collection. Therefore, the research design is the plan, structure, and strategy of investigation conceived so as to obtain answers to research questions and to control variances. The research design includes an outline of what the researcher will do from writing the hypotheses and their operational implications to the final analysis of the data. It is used to structure the research, to show how all of the major parts of the research project such as

sampling, data collection and data analysis will try to address the central research questions. The research design provides answers to questions such as: What techniques will be used to gather data? What sampling techniques will be used? How will time and cost constraints be dealt with?

5.3.2.1 Types of research design

There are three basic types of research design: qualitative, quantitative and a hybrid of the two. Zikmund (2003:68) notes that the choice of research design centres on the nature of the research, the setting, the possible limitations and the underlying paradigm that informs the research project.

- **Qualitative research**

Chisnall (2005:18) explains that qualitative research aims to gather an in-depth understanding of human behaviour and the reasons that govern such behaviour. A major strength of the qualitative approach is the depth to which explorations are conducted and descriptions are written, usually resulting in sufficient details. The ultimate aim of qualitative research is to offer a perspective of a situation and provide well-written research reports that reflect the researcher's ability to illustrate or describe the corresponding phenomenon. One of the greatest strengths of the qualitative approach is the richness and depth of explorations and descriptions.

- **Quantitative research**

According to Cooper and Schindler (2003:563) quantitative research is a systematic scientific investigation of quantitative properties and phenomena and their relationship. The objective of quantitative approach is to develop and employ mathematical models, theories and/or hypotheses pertaining to a phenomenon. The provision of measurement is central to quantitative research because it provides the fundamental connection between empirical observation and mathematical expression of quantitative relationships. Cooper and Schindler (2003:563) add that the requirements for quantitative research include:

- The generation of models, theories and hypotheses.
- The development of instruments and methods for measurement.
- Collection of empirical data.

- Modelling and analysis of data.
- Evaluation of results

Table 5.1 presents the differences between qualitative and quantitative research.

Table 5.1: Differences between qualitative & quantitative research

Qualitative	Quantitative
The aim is a complete, detailed description.	The aim is to classify features, count them, and construct statistical models in an attempt to explain what is observed.
Researcher may only know roughly in advance what he/she is looking for.	Researcher knows clearly in advance what he/she is looking for.
The design emerges as the study unfolds.	All aspects of the study are carefully designed before data is collected.
Researcher is the data gathering instrument.	Researcher uses tools, such as questionnaires or equipment to collect numerical data.
Data is in the form of words, pictures or objects.	Data is in the form of numbers and statistics.
Subjective – individual's interpretation of events is important (e.g. uses participant observation, in-depth interviews).	Objective – seeks precise measurement & analysis of target concepts (e.g. uses surveys, questionnaires).
Qualitative data is more time consuming, and less able to be generalised.	Quantitative data is more efficient and able to test hypotheses.

Source: Neill (2007).

The present study used the quantitative research design, which Ghauri and Gronhaug (2005:204) describe as studies whose findings are mainly the product of statistical summary and analysis. The main feature of quantitative research is the heavy reliance of the researcher on data analysis to arrive at findings or conclusions. Numbers are assigned to the properties in the phenomena to represent their qualities. According to Ghauri and Gronhaug (2005:204) qualitative research on the other hand is referred to as "that research which produces research findings that are not arrived at by statistical summary or analysis and lack quantification altogether".

Rubin (2005:145) notes that qualitative research allows for in-depth, more open and detailed study of selected issues while quantitative research is more generalised. Follow-up questions can be asked during interviews or focus groups in qualitative research whereas quantitative research does not provide respondents with such an option. In quantitative research analyses are conducted through the use of diagrams and statistics. The choice of a quantitative research design for this study was informed by its primary strengths because, according to Blanche, Durrheim and Painter (2006:132) "the findings are generaliseable and the data are objective". Ghauri and Gronhaug (2005:109) also assert that a quantitative research design is more scientific than a qualitative research design.

There are three types of research that can be used in quantitative research or qualitative research or both, depending on the information required by the research problem. The three types of research are exploratory, descriptive and casual.

- **Exploratory research**

Gerber-Nel *et al.* (2005:30) describe exploratory research is initial research 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. The information required is only loosely defined at this stage, as the process forward is still flexible and relatively unstructured. Exploratory research can thus be defined as research that is used to gather preliminary information to help clarify the research problem. Exploratory research collects information in an unstructured, informal manner. The purpose of this type of research is to progressively narrow the scope of the research topic and consequently paraphrase the problem or opportunity clearly. Investigating previous studies on the subjects, talking with knowledgeable individuals, and informally investigating the situation through secondary data conduct exploratory research

The researcher in this study used exploratory research for the following purpose:

- To discover what has been done by other studies related to the research problem;

- To discover whether there are any significant gaps in the literature that necessitate this study;
- To formulate the research problem and questions for more precise investigation, in order to formulate hypotheses;
- To develop and refine the questionnaire items; and
- To gather information about practical problems of carrying out this research.

Gerber-Nel *et al.* (2005:31) identify five types of exploratory research. They are secondary data analysis, experience survey, pilot studies, case studies and exploratory factor analysis. Secondary data analysis is an inexpensive and easy source of data that researchers use to gain background information on a particular situation. Researchers could consult sources such as trade literature and published articles. An experience survey is an exploratory research technique in which individuals, who are knowledgeable about a particular research problem or opportunity, are interviewed. By doing this researchers can gather background information that will help them define and formulate a research problem or opportunity clearly.

Gerber-Nel *et al.* (2005:30) describe a pilot study as the collective term for any small-scale exploratory research technique that uses sampling, but does not apply rigorous standards. Pilot studies usually generate primary data for qualitative analysis. A case study is an exploratory research technique that intensively investigates the existing records of one or a few situations similar to the problem. The purpose of the technique is to gain information from the case studies that is similar to the problem or opportunity at hand.

A large number of questionnaire items that were perceived as obstacles to the availability of debt finance were developed through exploratory research. According to Cooper and Schindler (2003:480) an exploratory factor analysis can be used to explore whether the questionnaire items could be clustered clearly and meaningfully into smaller groups or factors. Exploratory factor analysis helped to refine the research questions and to develop the hypotheses.

To conduct exploratory research as pointed out by Gerber-Nel *et al.* (2005:30) the researcher also used secondary data analysis by reviewing peer-reviewed journal articles, books, and other sources of information related to the study at hand such as the Global Entrepreneurship Monitor South African Reports. The secondary data analysis helped to refine the research question and problems. The researcher used experience survey by asking former and present bank officers to clarify some issues related to the research. In addition, discussions were held with two researchers who are experts in the field of entrepreneurial finance to clarify issues related to the research questions and to refine the questionnaire. Furthermore, the researcher conducted a pilot study with some bank managers and officers and also managers of some big and small firms (trade creditors). The discussions helped to refine the research problems and also to develop and refine the questionnaire. This helped to improve the validity of the research.

- **Descriptive research**

The exploratory research identified that the issue of availability of debt finance was still critical to the creation and survival of new SMEs in South Africa. This significant gap in the literature stimulated this empirical study. Descriptive research is use to describe the research problem in detail. Gerber-Nel *et al.* (2005:32) note that descriptive research answers questions: who, what, when, where and how? Implicit in descriptive research is the realisation that the researcher already knows or understands the underlying relationships of the research problem. The researcher may have a general understanding of the research problem but conclusive evidence that provides answers to the question should still be collected to determine a course of action. Descriptive research can be conducted in two ways, namely longitudinal or cross-sectional.

According to Cooper and Schindler (2003:45) longitudinal studies are investigations involving a fixed sample of element (a panel) that is measured repeatedly. There are two types of longitudinal study:

- True panels are fixed samples of respondents whose variables are measured repeatedly over time.
- Omnibus panels are fixed samples of respondents who are measured repeatedly and whose variables change from measurement to measurement.

Cross-sectional studies on the other hand are a type of research that involves the collection of information from any given sample population elements only once. Cross-sectional studies are usually performed by means of sample surveys. In sample surveys, a sample is selected as representative of the target population and the emphasis is on the generation of summary statistics, such as averages and percentages (Gerber-Nel *et al.,* 2005:32). This study used the cross-sectional approach where data was collected from the respondents only once through the survey method. Descriptive statistics such as mean, standard deviation, bar chart and tables were also used during data analysis.

- **Causal research**

Cooper and Schindler (2003:46) point out that causal research examines whether one variable causes or determines the value of another variable. A variable is a symbol or concept that can assume any one of a set of values. Causal research reveals a cause-and-effect relationship between dependent and independent variables. A dependent variable is a symbol or concept that is expected to be explained or caused by an independent variable. An independent variable is a symbol or concept over which the researcher has some control. It is hypothesised that the independent variable causes or influences the dependent variable. Researchers can also use causal research to test hypothesis. Causal research can be done in a laboratory experiment or a field experiment. The primary research question is to investigate the impact of the business environment on the availability of debt finance to new SMEs in South Africa. This is a cause-and-effect relationship. Causal research through the use of Pearson correlation was one of the research methods used for this study.

5.3.3Step 3: Selecting the primary data collection method

The next step in the research process is data collection. This section will discuss the various methods of data gathering as well as the questionnaire design.

5.3.3.1 Basic primary data collection methods.

Gerber-Nel *et al.* (2005:88) identify three primary data collection methods namely observation, experiment and survey.

- **Observation**

Cooper and Schindler (2003:114) describe observation as a process through which primary data is obtained by observers (humans or machines) about the behavioural pattern of people, objects or occurrences. Observation is an effective method when: specific behaviours can be observed; the behaviour is repetitive, predictable and frequent; and the behaviour is relatively short-lived. Observation was inapplicable for this kind of result study because the researcher wanted to obtain critical information from the respondents and not observe their behaviour.

- **Experiment**

Cooper and Schindler (2003:115) point out that under the experiment method of data collection, the researcher manipulates an independent variable and then measures the effect. The experimental setting can be in a laboratory or in the field. In a laboratory, experiments are conducted in an artificial or laboratory setting. The research is isolated from the natural setting or routine of respondents. Laboratory experiments allow the researcher to have direct control over most of the crucial factors that may have an effect on the experiment. Field research is done in the natural setting of the respondents. This study however was not about the manipulation of variables. Therefore, experiment was not used as a method of data collection. This study used the survey as the research method because other methods of data collection such as observation and experiment were inapplicable to collecting data to investigate the research problems.

- **Survey**

Wheather and Cook (2000:195) note that the broad area of survey research encompasses any measurement procedures that involve asking questions to respondents. A survey will ask a series of questions that require answers from these groups which are then analyzed at the end of the survey when the participant level has been reached. In survey research, the researcher selects a

sample of respondents from a population and administers a standardized questionnaire to them. The study used survey research for the following reasons as pointed out by Cooper and Schindler (2003:663):

- Surveys are relatively inexpensive (especially self-administered surveys).
- Surveys are useful in describing the characteristics of a large population. No other method of data collection can provide this general capability.
- Surveys can be administered from remote locations using mail, email or telephone. Consequently, very large samples are feasible, making the results statistically significant even when analyzing multiple variables.

The study followed the survey research process as pointed out by Gerber-Nel *et al.* (2005:94):

- The population to be studied was defined.
- A representative sample was selected.
- Data was collected through the use of self-administered questionnaires.
- SPSS (Statistical Package for Social Sciences) was used to tabulate and analyze the sample to produce various sample statistics.
- Inferences were made from sample statistics to population parameters of interest.

- **Methods of conducting survey research**

Gerber-Nel *et al.* (2005:94) point out that surveys can be divided into four major types: personal interviews, telephone surveys, mail surveys and self-administered surveys. Gerber-Nel *et al.* (2005:94) further define a personal interview (i.e. face-to-face communication) as a two-way conversation initiated by an interviewer to obtain information from a participant. This implies that the people selected to be part of the sample are interviewed in person by the researcher. The researcher used the personal interview at the exploratory stage to refine the questionnaire. The personal interview was not used during data collection because it is a costly method of data collection. The researcher would have needed to personally visit the respondents a couple of times. This would have resulted in a longer period for data collection.

According to Gerber-Nel *et al.* (2005:94) telephone interviews take place when respondents are telephoned in order to gather primary data about a specific research problem. The researcher decided not to use telephone interviews because its response rate is lower than for personal interview or self-administered questionnaires, responses to the questions may be less than complete and many of the phone numbers may not be working making directory listings unreliable. Cooper and Schindler (2003:430) describe a mail survey as a survey that takes place when the researcher selects a sample of names and addresses and send questionnaires to these respondents with the aim of collecting data. The researcher decided not to use mail survey because of the following reasons: the respondents may not return the questionnaires and mail surveys are a very slow method of data collection.

Because of the limitations associated with the other methods of conducting surveys, data for the research study was gathered through self-administered questionnaires. Self-administered questionnaires are research questionnaires personally delivered to the respondent by the interviewer but completed by a respondent with no interviewer involvement (Cooper & Schindler, 2003:326). The researcher used self-administered questionnaires for the following reasons:

- Self-administered questionnaires ensure anonymity and privacy of the respondents, thereby encouraging more candid and honest responses.
- Self-administered questionnaires have proved to have a higher response rate than other data gathering techniques such as mail surveys.
- Self-administered questionnaires are less expensive than other data gathering methods such as personal interviews where the researcher must be present with respondents at all times (Cooper & Schindler, 2003:369).

The researcher was also able to obtain the names and telephone numbers of the respondents when the questionnaires were distributed. Repeated call backs were made to the respondents to ensure they completed the questionnaires. Links with top officials at the Regional offices of the four banks helped to ensure the completion of the questionnaires. Two fieldworkers working for

a data collection and analysis firm assisted in the distribution and collection of the questionnaires as paid assistants.

5.3.3.2 Questionnaire design and content

- **Questionnaire**

The primary research instrument to be used by the researcher was the questionnaire. Wheather and Cook (2000:195) define a questionnaire as a formalized set of questions for obtaining information from respondents. A questionnaire can further be described as a booklet of structured standardised procedure, pre-coded and containing open-ended questions at times that are used to collect information from the respondents who record their own answers. It can also be regarded as a data-collection instrument that sets out the questions to be asked in a formal way in order to produce the desired information. The researcher used questionnaires for the research study for the following reasons:

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

- **Survey questions**

Gerber-Nel *et al.* (2005:150) point out that there are two basic types of survey questions from which to choose: open-ended and closed-ended. For open-ended question format, respondents use their own words to respond to certain questions or statements. No response options are given to respondents. This implies that the respondents are not influenced by a predetermined set of alternative responses. Open-ended questions are ideal when the researcher is doing exploratory research and does not know the possible responses to questions or statements. Gerber-Nel *et al.* (2005:150) further note that the use of open-ended questions should be limited for self-administered questionnaires because respondents will often give very elaborate answers. The

researcher did not use any open-ended question for this research because it is difficult to categorise respondents' responses as they vary from one respondent to another. In addition, open-ended questions are difficult to code and analyse.

Wheather and Cook (2000:195) point out that close-ended (structured) questions specify the permitted responses and make information available to the respondents. For self-administered questionnaires, respondent cooperation is improved if the majority of the questions are structured. Close-ended response format questions offer a respondent a selection of possible responses. The researcher used closed-ended questions because as pointed out by Cooper and Schindler (2003:520) they are more easily analyzed. Every answer can be given a number or value so that a statistical interpretation can be made. Closed-ended questions are also better suited for computer analysis. If open-ended questions are analyzed quantitatively, the qualitative information is reduced to coding and answers tend to lose some of their initial meaning. In addition, closed-ended questions can be more specific, thus more likely to communicate similar meanings. Because open-ended questions allow respondents to use their own words, it is difficult to compare the meanings of the responses. Closed-ended questions take less time from the interviewer, the participant and the researcher, and so is a less expensive survey method. The response rate is higher with surveys that use closed-ended question than with those that use open-ended questions.

Gerber-Nel *et al.* (2005:152) stipulate that close-ended questions include dichotomous questions and multiple choice questions such as ordinal questions and Likert scale questions. Dichotomous questions only have two response alternatives such as yes or no or male and female (Dichotomous questions were used in the biographical part of the questionnaire. Ordinal also referred to as rank order scales require the respondents to rank objects that are presented to them simultaneously according to some kind of criteria. In ordinal questions, the number assigned to the answer category has meaning. The answer categories are ranked from highest to lowest (or lowest to highest). Ordinal questions were used by the researcher to rank the importance attached to internal and external factors about why credit is not granted by commercial banks and trade creditors to new SMEs.

According to Cooper and Schindler (2003:420) the Likert scale is a type of response scale often used in questionnaires and is the most widely used scale in survey research. A Likert item is simply a statement that the respondent is asked to evaluate according to any kind of subjective or objective criteria; generally the level of agreement or disagreement is measured. When responding to a Likert questionnaire item, respondents specify their level of agreement to a statement. A typical test item in a Likert scale is a statement. The respondent is asked to indicate his or her degree of agreement with the statement. The statements can be positively or negatively phrased. The seven-point Likert scale was used. The researcher used Likert scale questions because of the under listed reasons as pointed out by Cooper and Schindler (2003:421):

- The Likert scale eliminates the development of response bias amongst the respondents.
- The Likert scale can be used to assess attitudes, beliefs, opinions and perception.
- Using the Likert scale makes the response items standard and comparable amongst the respondents.
- Responses from the Likert scale questions are easy to code and analyse directly from the questionnaires.
- They are easy to code and analyse.
- Interviewer bias is reduced.
- Questions can be administered more quickly.

- **Items included in the questionnaire**

The items included in the questionnaire were similar for both commercial banks and trade creditors. The two areas of difference were (1) there was a question to determine if responding firms grant trade credit. This question was necessary because the literature review suggested that not all retail and manufacturing firms grant trade credit. Secondly (2), biographical questions for trade creditors included questions such as the product line, the number of employees and whether the firm was independent or belonged to a group (which were not asked to banks). The question items were divided into the following sections:

- *The perception of new SMEs (Section A for commercial banks and section B for trade creditors).*

The question items in this section were to determine whether commercial banks and trade creditors perceive new SMEs as beneficial to their business (refer to hypothesis number 11). Question items included in this section were developed through the review of the literature such as Reitan and Waago (2002), Beck *et al.* (2008), De la Torre *et al.* (2008).

- *Important factors when evaluating the credit applications of new SMEs (section B for commercial banks and section C for trade creditors).*

The primary objective of this study was to investigate the business environmental variables that impact on non-availability of debt finance to new SMEs. The questions in this section were to determine the importance attached to the ten business environmental variables when credit decisions are made by commercial banks and trade creditors. The questions in this section were a prelude to the main investigative questions.

- *Perception of factors that are obstacles to the availability of debt finance to new SMEs (section C for commercial banks and section D for banks).*

The questions in this section were used to achieve the primary research purpose (refer to hypotheses 1 to 10). This section contained forty-five questions that were used to determine the environmental factors that are obstacles to the availability of debt finance to new SMEs. The questions were developed through a thorough review of the literature in chapters 2, 3 and 4 of this study and refined through exploratory research and pretesting. The questions in this section were asked negatively because the objective of the study was to determine the obstacles to the availability of debt finance.

- *Ranking of internal environmental factors (section D for commercial banks and section E for trade creditors).*

The questions in this section were to determine through ranking by respondents the importance attached to the internal environmental factors when commercial banks and trade creditors reject credit applications.

- *Ranking of external environmental factors (section E for commercial banks and section F for trade creditors).*

The questions in this section were to determine through ranking by respondents the importance attached to the external environmental factors when commercial banks and trade creditors reject credit applications.

- *Approval of credit applications of new SMEs (section F for commercial banks and G for trade creditors).*

The question in this section was used to determine the percentage of credit applications approved by commercial banks and trade creditors.

- *Biographical information of respondents*

The questions in this section were to determine the biographical information of the respondents. Questions in this section included the age of the respondent, the gender of the respondent, the experience, the product line, the number of employees and whether the firm is part of a group or independent.

- **Pre-testing (pilot study)**

Churchill (2002:250) refers to pre-testing as the testing of the questionnaire on a small sample of respondents to identify and eliminate potential problems. Pre-testing is essential for the researcher to be satisfied that the questionnaire he has designed will perform its various functions in the interview situation, and that the data collected will be relevant and accurate. Respondents for the pre-test should be drawn from the same population. Pre-testing can be used to improve the content, phrasing, sequence, layout and instructions of a questionnaire. The researcher pre-tested the questionnaire because as pointed out by Churchill (2002:251), pre-testing:

- Permits a thorough check of the planned statistical and analytical procedures, giving the researcher a chance to evaluate their usefulness for the data. The researcher may then be able to make needed alterations in the data collecting methods, and therefore, analyze data in the main study more efficiently.

- Can greatly reduce the number of unanticipated problems because the researcher has an opportunity to redesign parts of the study to overcome difficulties that the pilot study reveals.
- Saves a lot of time and money. The pre-testing almost always provides enough data for the researcher to decide whether to go ahead with the main study.

The pre-testing provided the basis for the exploratory factor analysis and the refinement of the research hypotheses. The results of the pre-testing also showed that bank managers were reticent to complete the questionnaire if the name of the bank or the name of the respondent was included in the questionnaire. Because of this, the names of the firms and respondents were removed. Furthermore, some sensitive questions were removed. In addition, bank managers were only willing to complete the questionnaires in their personal capacities and that their opinions did not reflect the position of their banks but their personal opinions. Furthermore, it was discovered that bank managers were more willing to complete the questionnaire if they were linked through a colleague or a friend.

5.3.4 Step 4: Sample design

According to Cooper and Schindler (2003:179) the basic idea of sampling is that by selecting some of the elements in a population, it is possible to draw conclusions about the entire population. Sampling is the act, process, or technique of selecting a suitable sample, or a representative part of a population for the purpose of determining parameters or characteristics of the whole population. The purpose of sampling is to make generalizations about the whole population which are valid and which allow prediction. It allows the researcher to draw conclusions about the entire population as it is impossible to observe all relevant events in the population because of time and cost. Compelling reasons for sampling for this study included (1) lower cost, (2) greater accuracy of results, (3) greater speed of data collection, and (4) availability of population elements. The issues that will be discussed under sampling design are population (for both commercial banks and trade creditors), the sampling methods and the sample size.

5.3.4.1 Population

Defining the universe or population is the first and critical step in the sampling process. Goddard and Melville (2001:35) note that population is the subject of research interest. Population is the study subject, which may be individuals, groups or organisations. It encompasses of all units of analysis about which the researcher wishes to draw conclusions. This study was a regional study focusing on the branches of the four big commercial banks and trade creditors in the Eastern Cape Province.

- **Commercial banks**

The Banking Association of South Africa (2009) point out that there are thirty five banks in the country made up of twenty local banks and fifteen foreign banks. However, the banking sector in South Africa is highly concentrated with the four large banks dominating the retail-banking sector. The banks are ABSA, Standard Bank, First National Bank and NEDCOR. The four banks are responsible for 82% of all assets and 80% of all liabilities in commercial banking in South Africa. Studies such as Okeahalam (2001), Pretorius and Shaw (2004) and FinMark Trust (2006) on commercial banks and SMEs in South Africa also focused on the four major banks. The population of the branches of the four big banks in the Eastern Cape Province was obtained from the Branch Locators on the websites of the four banks. The population of the branches of the four banks in Eastern Cape was two hundred and ninety four.

- **Trade creditors**

The researcher focused on trade creditors in the wholesale, retail and manufacturing sectors. According to Selima (2007:17) these two sectors account for most of the trade credits. The population frame of trade creditors was obtained from the Border-Kei Chamber of Commerce, the Port Elizabeth Regional Chamber of commerce and the Enterprise Black Business Directory 2008. The Directory is sponsored by the Department of Trade and Industry and publishes a list of SMEs in all the provinces. The names of firms were crosschecked to eliminate double counting.

The population of big firms and SMEs that are in the wholesale, retail and manufacturing was five hundred and forty one.

5.3.4.2 Types of sampling design

Bryman and Bell (2003:100) note that there are two major types of sampling design. These are probability and non-probability sampling. This study used the probability sampling method.

- **Probability sampling**

Bryman and Bell (2003:100) define probability sampling as a controlled procedure that assures that each population element is given a known non-zero chance of selection. In contrast, non-probability sampling is arbitrary (non-random) and subjective. Each element of the population does not have a known non-zero chance of being included in the study. This study used probability sampling because as pointed out by Bryman and Bell (2003:101) probability sampling allows the researcher to make inferences from information about a random sample to the population from which it was selected. This implies that findings derived from a sample can be generalized to the population. With probability sample, there is substantial confidence that the sample is representative of the population from which it is drawn. Furthermore, if the non-probability sampling method was used, there was the possibility that human judgment would have affected the selection process, making some elements of the population more likely to be selected than others. This kind of bias was eliminated through the use of probability sampling.

Cooper and Schindler (2003:192) identify four major types of probability sample. These are systematic sampling, stratified sampling, cluster sampling and simple random sampling. Under systematic sampling, every k^{th} element in the population is sampled, beginning with a random start of element in the range of 1 to k. Systematic sampling selects an element of the population at a beginning with a random start and following the sampling fraction selects every k^{th} element. The main advantage of systematic sampling is that it is simple to design and it is also easy to determine sampling distribution of mean or proportion. The disadvantage is that periodicity within the population may skew the sample and results. Most populations can be segregated into several mutually exclusive subpopulations or strata. The process by which sample is construed to

include elements from each of the segments is called stratified sampling. The main advantage of stratified sampling is that it provides data to represent and analyse subgroups. The main disadvantage of stratified is that increased error will result if subgroups are selected at different rates. It is also time consuming.

According to Cooper and Schindler (2003:192) cluster sampling involves the division of the population into mutually exclusive and collectively exhaustive clusters or subgroups after which certain clusters are selected in the sample. The advantage of cluster sampling is that it easy and cost effective. However, cluster sampling is often imprecise and results are difficult to compute and interpret. With simple random sampling, each member of the population has an equal probability of inclusion in the sample. This study used the simple random sampling method. Simple random sampling is simple to apply, in that, 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 the elements of the population. The researcher used the following steps in the simple random sampling process as pointed out by Cooper and Schindler (2003:192).

- The population frames of both banks and trade creditors were defined.
- The sample sizes of both banks and trade creditors were defined.
- Each element within the population frames is given a unique number from 1.
- The random number table was used.

5.3.4.3 Sample size

The sample size is the total number of elements included in the research. Goddard and Melville (2001:59) assert that the correct sample size is dependent on the population and the significance of the study. The Raosoft sample size calculator can be used to calculate the sample size. Raosoft is statistical software used in the calculation of sample size. Raosoft takes into consideration four factors in determining sample size. These factors include the margin of error, the confidence level, the population and the response distribution.

- *The margin of error:* The margin of error (also known as the confidence interval) measures the precision with which an estimate from a single sample approximates the population value. The margin of error ranges from 3% to 7% in business research, with 5% being the most commonly accepted.

- *Confidence level:* The confidence level is the estimated probability that a population estimate lies within a given margin of error. It is the amount of uncertainty that the researcher can tolerate. The confidence interval in business research varies from 90% to 100% with 95% being the most commonly accepted.

- *The population:* This population to be used for the study (refer to section 5.3.4.1, p.220).

- *Response distribution:* This answers the question, "for each question in the questionnaire, what does the researcher expects the answer to be". If the answer is skewed highly one way or the other, the population is probably skewed too. 50% is usually used as the response distribution as it gives the largest sample size (Raosoft, 2008).

Using the Raosoft sample size calculator at 5% margin of error and 95% confidence interval the sample size for banks was 167. However, two questionnaires were distributed to each branch (one each for the manager and the credit consultant). In addition in the Regional Offices in East London and Port Elizabeth and King Williams Town where the Small Business Units of the banks were located got five questionnaires each. The number of distributed questionnaires was 376. Using the Raosoft sample size calculator at 5% margin of error and 95% confidence interval the sample size for trade creditors was 225. This is the minimum recommended sample size by the Raosoft sample size calculator. However, 315 questionnaires were distributed to trade creditors.

5.3.5Step 5: Gathering the data

This section will describe the actual data collection and the treatment of missing values. The researcher and two paid fieldworkers working for the data analysis firm to the respondents

between June and October of 2009 distributed the questionnaires. The questionnaires for commercial banks were distributed to bank branches and SME units. Two questionnaires were distributed per branch to the Branch Manager and the consultant in charge of credit. Additional questionnaires were distributed at the SME units of the banks in East London, Port Elizabeth and King Williams Town. The respondents were given two weeks to complete the questionnaires. The researcher was also able to obtain the names and telephone numbers of the respondents when the questionnaires were distributed. Repeated call backs were made to the respondents to ensure they completed the questionnaires. Links with top officials at the regional offices of the four banks helped to ensure the completion of the questionnaires.

5.3.5.1 Missing values

Allison (2001:172) points out that a missing value may represent or is a product of an unknown value. In surveys, respondents may not answer certain questions. It is very important for the researcher to manage missing values efficiently. If the researcher does not handle the missing values properly, then he/she may end up drawing an inaccurate inference about the data. Due to improper handling of missing values, the result obtained by the researcher will differ from those where the missing values are present. Graham (2009:550) in addition, points out that a researcher must fully understand the concept of missing values. Item non-response occurs when the respondent does not respond to certain questions due to stress, fatigue or lack of knowledge. Sometimes the respondent does not respond because some questions are sensitive. This leads to missing values. There is no fixed rule about the proper handling of missing values. The researcher may leave the data or do data imputation to replace the missing values. It entirely depends upon the researcher's experience in dealing with missing values.

Graham (2009:551) further notes that there are three basic options when dealing with missing values. The first option is to do nothing. Leave the data as it is, with the missing values in place. This is the most frequent approach, for a few reasons. First, the number of missing values is typically small. Second, missing values are typically non-random. However, if a researcher chooses the first option, he must keep in mind how SPSS will treat the missing values. SPSS will

either use listwise deletion or pairwise deletion of the missing values. The researcher can elect either one when conducting each test in SPSS.

- **Listwise deletion**

According to Graham (2009:551) under listwise deletion, SPSS will not include cases (subjects) that have missing values on the variable(s) under analysis. If only one variable is been analysed, listwise deletion simply analyses the existing data. If multiple variables are being analysed, listwise deletion removes cases (subjects) if there is a missing value on any of the variables. The disadvantage is a loss of data because you are removing all data from subjects who may have answered some of the questions, but not others (e.g., the missing data).

- **Pairwise deletion**

Graham (2009:551) notes that with pairwise deletion, SPSS will include all available data. Unlike listwise deletion, which removes cases (subjects) that have missing values on any of the variables under analysis, pairwise deletion only removes the specific missing values from the analysis (not the entire case). In other words, all available data is included. Pairwise deletion is useful when the sample size is small. The second option is to delete cases with missing values. For every missing value in the dataset, the researcher can delete the subjects with those missing values. This means that the researcher is left with complete data for all subjects. The disadvantage to this approach is that the sample size is reduced. The third option to replace missing values is imputation. This could be done by mean substitution or regression substitution. Mean substitution replaces the missing value with the mean of the variable. Regression substitution uses regression analysis to replace the missing value. Regression analysis is designed to predict one variable based upon another variable, so it can be used to predict the missing value based upon the subject's answer to another variable. Missing values presented a problem that had to be addressed in this research before evaluation could proceed. There were only three cases of missing values and pairwise deletion method under SPSS was used.

5.3.6 Step 6: Data analysis

The objective of this section is to indicate how the data collected will be analysed by the researcher. Data analysis usually involves the reduction of accumulated data to a manageable size, developing summaries, looking for patterns and applying statistical techniques. It also includes the interpretation of research findings in the light of the research questions, and determines if the results are consistent with the research hypotheses and theories. Data analysis is a process of gathering, modelling, and transforming data with the goal of highlighting useful information, suggesting conclusions, and supporting decision making. Data analysis has multiple facets and approaches, encompassing diverse techniques under a variety of names, in different business, science, and social science domains (Cooper & Schindler, 2003:87).

Gerber-Nel *et al.* (2005:204) point out that the purpose of analytic methods is to convert data into information needed to make decisions. The choice of the methods of statistical analysis depends on (1) the type of question to be answered, (2) the number of variables, and (3) the scale of measurement. The type of question the researcher is attempting to answer is a consideration in the choice of the statistical technique. Based on this factor, the researcher may be concerned about the central tendency of a variable or the distribution of that variable. The number of variables is also considered to determine whether the statistical techniques applied should be the univariate data analysis, the bivariate data analysis or the multivariate data analysis. The scale of measurement on which the data are based or the type of measurement reflected in the data determines the permissible statistical technique and whether the appropriate empirical operation may be performed. Data analysis for the study included descriptive statistics, factor analysis, T-test, ANOVA and Pearson correlation.

5.3.6.1 Descriptive statistics

Gerber-Nel *et al.* (2005:204) note that descriptive statistics are used to describe the basic features of the data in a study. Descriptive statistics are used to describe the main features of a collection of data in quantitative terms. They provide simple summaries about the sample and the measures. Together with simple graphics analysis, they form the basis of virtually every quantitative

analysis of data. Descriptive statistics are used to present quantitative descriptions in a manageable form. In a research study we may have a lot of measures. Descriptive statistics help us to simply large amounts of data in a sensible way. Each descriptive statistic reduces a lot of data into a simpler summary. In this study, the following statistical techniques were use as the tools of descriptive analysis as pointed out by Gerber-Nel *et al.* (2005:204).

- *The Distribution:* The distribution is a summary of the frequency of individual values or ranges of values for a variable. Tables and bar charts were used.

- *Central Tendency:* The central tendency of a distribution is an estimate of the "centre" of a distribution of values. The mean and standard deviation were used. The mean or average is probably the most commonly used method of describing central tendency. The median is the score found at the exact middle of the set of values. The standard deviation is a more accurate and detailed estimate of dispersion. The standard deviation shows the relation that set of scores has to the mean of the sample.

5.3.6.2 Factor analysis

Cooper and Schindler (2003:591) describe factor analysis as a multivariate statistical method used to describe variability among observed variables in terms of fewer unobserved variables called factors. Factor analysis is a statistical approach that can be used to analyze inter-relationships among a large number of variables and to explain these variables in terms of their common underlying dimensions (factors). The statistical approach involving finding a way of condensing the information contained in a number of original variables into a smaller set of dimensions (factors) with a minimum loss of information. Factor analysis could be used to verify a construct of interest. Factor analysis has two main purposes. Firstly, it is used for data reduction and secondly for detection of structure (underlying dimensions) in a set of variables. Factor analysis also helps to confirm the validity and reliability of the measuring instruments. Factor analysis was used in this study to enhance the reliability and 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. There are two types of factor analysis: Exploratory factor analysis (EFA) and confirmatory factor analysis (CFA).

According to Cooper and Schindler (2003:591) EFA is used to uncover the underlying structure of a relatively large set of variables. This is the most common form of factor analysis. There is no prior theory and one uses factor loadings to intuit the factor structure of the data. CFA seeks to determine if the number of factors and the loadings of measured (indicator) variables on them conform to what is expected on the basis of pre-established theory. Indicator variables are selected on the basis of prior theory and factor analysis is used to see if they load as predicted on the expected number of factors. The primary objectives of an 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.

Leech, Barrett and Morgan (2005:79) point out that the decision about which factor to retain 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. Varimax rotation was used to transform the components into factors that were more clearly interpretable. To facilitate an easier interpretation of principal components, factor rotation methods were developed. This research study uses Varimax orthogonal rotation method. This rotation method is based on the criterion of maximizing the factor loadings of dominant variables in each principal component. Varimax rotation facilitates 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. Factors with Eigenvalues greater than one are usually retained.

- **Assumptions of factor analysis**

Leech *et al.* (2005:80) note the assumptions for factor analysis include:

- *Normality:* Factor analysis is robust to the assumption of normality. However, if variables are normally distributed, then the solution is enhanced.

- *Sampling adequacy:* Bartlett's test of sphericity and the Kaiser-Meyer-Olkin (KMO) measure the sampling adequacy and can be used to determine the factorability of the matrix as a whole. If Bartlett's test of sphericity is large and significant, and if the KMO is greater than .6, then factorability is assumed. The Kaiser-Meyer-Olkin (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 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 (Leech *et al.*, 2005:82).

- **Procedures followed for factor analysis**

The procedures followed for the factor analysis in this study were as pointed out by Leech *et al.* (2005:80).

- Eigenvalues greater than 1.00 were identified.
- The variables are 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 are carried out for the factors. Item analysis is then carried out for all the factors.
- A confirmatory factor analysis is performed to test the homogeneity of underlying constructs.

5.3.6.3 Bivariate data analysis

Cooper and Schinder (2003:531) define bivariate data analysis as data analysis and hypothesis testing when the investigation concerns simultaneous investigation of two variables using tests of differences or measures of association between two variables at a time. The T-test and ANOVA were used to test the differences in the results and Pearson correlation was used to test the association. The T-test was used to test the differences in information obtained through data

collected from commercial banks and trade creditors. According to Coakes (2005:73) a T-test is used to determine whether there is significant difference between two sets of scores. ANOVA was also used to test for significant differences in situations where the variables were more than two.

- **Pearson correlation**

The Pearson was used to test for the direction and strength of relationship between the business environmental factors and availability of debt. According to Coakes (2005:18) the main result of a correlation is called the correlation coefficient (or "r"). It 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 significance. 5% level of significance was used for this study. This is consistent with the significance level of most of the empirical studies on business finance. Table 5.2 depicts the value of r and the implication for the strength of the relationship.

Table 5.2: 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 Coakes (2005:18).

5.3.6.4 Statistical Package for Social Sciences (SPSS)

This study used SPSS Version 12.0 for Windows as the statistical software for data analysis. According to Coakes (2005:5) SPSS is software for performing statistical procedures in the social sciences field. SPSS is among the most widely used programs for statistical analysis in social science. SPSS is a complete statistical package that is based on a point and click interface.

SPSS has almost all statistical features available and is widely used by researchers to perform quantitative analysis.

5.3.6.5 Validity, reliability and errors

A researcher has to ensure that the evidence and conclusions from a research can stand up to scrutiny. This depends on how scientifically sound the measuring instrument is. Validity and reliability are two important characteristics of a sound measurement instrument (Cooper & Schindler, 2003:156). 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 the errors.

- **Validity**

Babbie and Monton, (2002:15) point out that validity determines whether the research truly measures that which it was intended to measure or how truthful the research results are. Validity refers to whether an instrument actually measures what it is supposed to measure given the context in which it is applied. Babbie and Monton, (2002:15) identify four major types of validity. These are face (content) validity, criterion related validity, content validity and construct validity.

According to Babbie and Monton, (2002:15) face (content) validity refers to the fact that the concept being measured is done so appropriately. Face validity of a measuring instrument is the extent to which the instrument provides adequate coverage of the concept. 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 instrument meets the standard. Cooper and Schindler (2003:214) note 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. Gerber-Nel *et al.* (2005:30) point out that content validity refers to the use of measures that will incorporate all of the meanings associated with a specific concept. Cooper and Schindler (2003:214) refer to construct validity as how adequately a scale or a test

measures what it proposes to measure. The researcher used the following steps to ensure the validity of the study as pointed out by Cooper and Schindler (2003:214).

- Using a statistician and a panel of experts to evaluate the research instrument for conceptual clarity.
- Pre-testing the research instrument in a pilot study.
- Sampling was carried out using probability methods ensuring 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%.
- Comprehensively reviewing the literature for theoretical constructs and empirical conclusions.

- **Reliability**

Babbie and Monton (2002:81) point out that the extent to which results are consistent over time and an accurate representation of the total population under study is referred to as reliability. If the results of a study can be reproduced under a similar methodology, then the research instrument is considered to be reliable. Reliability is concerned with consistency of measures. The level of an instrument's reliability is dependent on its ability to produce the same result when used repeatedly. According to Babbie and Monton (2002:81) the Cronbach's alpha can be used to measure reliability. The Cronbach's alpha is a test for a survey's internal consistency. It is also called the scale reliability test. The Cronbach's alpha is a measure of how well each individual items in a scale correlates with the remaining items. Reliability also shows the extent to which the measurements of a test remain consistent over repeated tests on the same subject. The alpha coefficient ranges in value from 0 to1. The higher the score, the more reliable the generated scale is. Cooper and Schindler (2003:417) note that a score of 0.7 is the acceptable reliability coefficient but lower thresholds are sometimes used in the literature. Reliability for the following steps as also enhanced this study pointed out by Babbie and Monton (2002:81):

- Pre-testing the research instrument in the survey development stage through a pilot study.

- Discussions were held with senior researchers who had had previous experience in similar studies.
- Keeping open-ended questions to the minimum; devising response scales that are likely to increase the variability of responses thereby ensuring higher statistical value from the data by using a large sample size.
- Performing a thorough review of the literature in the field of interest review of literature.
- Having the questionnaire thoroughly reviewed by the promoter and other experienced researchers.

- **Errors**

According to Cooper and Schindler (2003:332) errors, especially the response and non-response errors, can also pose a serious threat to the reliability of data and must be minimised by the researcher. Response errors are the estimated inaccuracies that can be introduced by the researcher, the interviewer or the respondents. The researcher may make the error in the design of the measurement instrument or may not properly define the problem and the related information required. Response errors can also occur when the respondent deliberately or mistakenly provide incorrect answers to the survey questions.

Gerber-Nel *et al.* (2005:231) describe a non-response error as an error caused by failure to contact all members of a sample and/or the failure of some contacted members of the sample to respond to all or a specific part of the questionnaire. The non-response error occurs because people who respond to the survey might not have characteristics similar to those who do not. The following steps were used to reduce non-response errors as pointed out by Babbie and Monton (2002:81):

- Using self-administered questionnaires, which involved a direct meeting between the researcher and the respondents.
- Repeated telephone calls and visits to the respondents.
- Removing sensitive questions from the questionnaire.
- Carefully constructing and pre-testing the questionnaires.

5.3.7 Step 7: Reporting the results

The final stage in the business research process as depicted by figure 5.1 is the interpretation of the results and the drawing of conclusions relevant to managerial decision-making. During this step, the researcher reports the research findings, conclusions and makes recommendations (Gerber-Nel *et al.,* 2005:234). The research results will be presented in the next chapter.

5.3 SUMMARY

This chapter examined aspects of the research methodology for this study. Research was defined and then the business research was described. The steps in the business research process were identified and followed by the researcher. As pointed out in the business research process, the problem statement, the research hypotheses and the research objectives were identified. Cooper and Schindler (2003:64) point out that the formulation of the research problem is of utmost importance in research. The two major types of research design, namely qualitative and quantitative research, were explained. The motivation for using quantitative research for the study was discussed. In addition, the three types of research that can be used in quantitative research or qualitative research were discussed. The three types of research are exploratory, descriptive and casual. The study used a combination of the three. Gerber-Nel *et al.* (2003:88) identified three primary data collection methods namely observation, experiment and survey. The motivation for using the survey method was given.

The chapter also discussed the four major of survey: personal interviews, telephone surveys, mail surveys and self- administered surveys. The motivation for using the self-administered survey was discussed. A questionnaire was used as the data collection instrument. The questionnaire contained close ended questions and Likert scale questions. The questionnaire was presented in a pilot study. This helped to refine the research questions and modify the questionnaire. The four major probability sampling techniques which included systematic, stratified, cluster and the simple random were discussed and the motivation for choosing simple random was explained. A missing value may represent or is a product of an unknown value. In surveys, respondents may not answer certain questions. It is very important for the researcher to manage missing values

efficiently. Missing values present a problem that must to be addressed in a research before evaluation could proceed. The pairwise deletion method under SPSS was used. Data analysis usually involves the reduction of accumulated data to a manageable size, developing summaries, looking for patterns and applying statistical techniques. The data collected for this study was analysed using descriptive statistics, factor analysis, T-test, ANOVA and Pearson correlation. Validity and reliability are two important characteristics of a sound measurement instrument. The four types of validity namely face, criterion-related, content and construct were discussed as well as the methods for ensuring validity. The Cronbach's alpha was used as the measure of reliability. The final step in the research process concerns the analysis of results of the empirical study. This will be presented in the next chapter.

CHAPTER SIX

RESEARCH RESULTS

6.1 INTRODUCTION

Chapter five presented aspects of the research methodology including the research design, the sampling method as well as the data collection and data analysis methods that were used for this study. The purpose of this chapter is to present and interpret the empirical findings of this research. In interpretation, the immediate results will be translated into integrated and meaningful general references and findings. The findings must be relevant to the objectives of the research. If both the data analysis and interpretation are not carried out properly, the success of the study cannot be assured (Proctor, 2000:273). The objectives of this chapter are (1) to systematically present the findings of the research study, and (2) to interpret the findings.

This chapter begins with the empirical findings. The section on empirical findings is structured into nine sub-sections. Sub-section 6.2.1 examines the response rates from commercial banks and trade creditors. Sub-section 6.2.2 focuses on the normality of the data. The Kolmogorov-Smirnov test will be used to test the normality of the data. Sub-section 6.2.3 presents the findings of the demographic variables. Visual distributions of demographic variables will be presented in tables and figures. Sub-section 6.2.4 presents the findings on the granting of credit by trade creditors. Sub-section 6.2.5 presents the findings on the perception of new SMEs by commercial banks and trade creditors. In the section, data will be analysed using descriptive statistics, T-test and ANOVA. Sub-section 6.2.6 presents the findings on the important factors considered when the credit applications of new SMEs are evaluated by commercial banks and trade creditors. Sub-section 6.2.7 presents the empirical findings of why credit is not granted to new SMEs. This section is the main investigative part of the study. Data will be analysed using factor analysis, descriptive statistics, T-test, ANOVA and Pearson correlation. Sub-section 6.2.8 examines the ranking of internal and external environmental variables. Sub-section 6.2.9 presents the findings on the rejection rates of credit applications of new SMEs by commercial banks and trade creditors. Because of the huge volume of data analysis, only the summary results are

presented in this chapter. The full data analysis is presented in the appendices section (refer to appendices 3 to 22).

6.2 EMPIRICAL FINDINGS

6.2.1 Response rate

In Table 6.1 the response rates of both commercial banks and trade creditors are presented. The response rate for commercial bank was 46% and for trade creditors was 74%. The mean response rate was 58.6%. The results indicated that trade creditors responded better to the survey than commercial banks.

Table 6.1: Response rate

Respondents	No. sent out	No. Returned	Response rate
Commercial banks	376	172	45.8%
Trade creditors	315	233	74.0%
Total	691	405	58.6%

The response rate for commercial bank is consistent with similar studies on commercial bank lending to SMEs. Reitan and Waago (2002) point out that the response rate from commercial banks is usually low because of the sensitivity of commercial banks to making information available to the public. Smorfitt (2009) however suggests that when it comes to research about the availability of debt to new SMEs in South Africa, the opinion of commercial banks is of utmost research importance. New SMEs in South Africa struggle to raise funds from commercial banks. There has been little, if any, in-depth study on why banks are not lending to new SMEs. The question is why? Out of the 233 returned questionnaires for trade creditors, 11 respondents (refer to Table. 6.4, p. 224) said that they have never granted trade credit and they were eliminated from the research. The usable response for trade creditors was 222.

6.2.2 The normality of the data

According to Coakes (2005:35) the normality of the data can be determined by using the Kolmogorov-Smirnov test (if the sample size is above 100) and the Shapiro-Wilks test (if the

sample size is below 100). If the significance level is greater than 0.05 using either of the two tests, then normality is assumed. This study used the Kolmogorov-Smirnov test to determine the normality of the data because the sample sizes were more than 100. The significance of the Kolmogorov-Smirnov test was greater than 0.05 in all the tests. This implies that the normality of the data can be assumed.

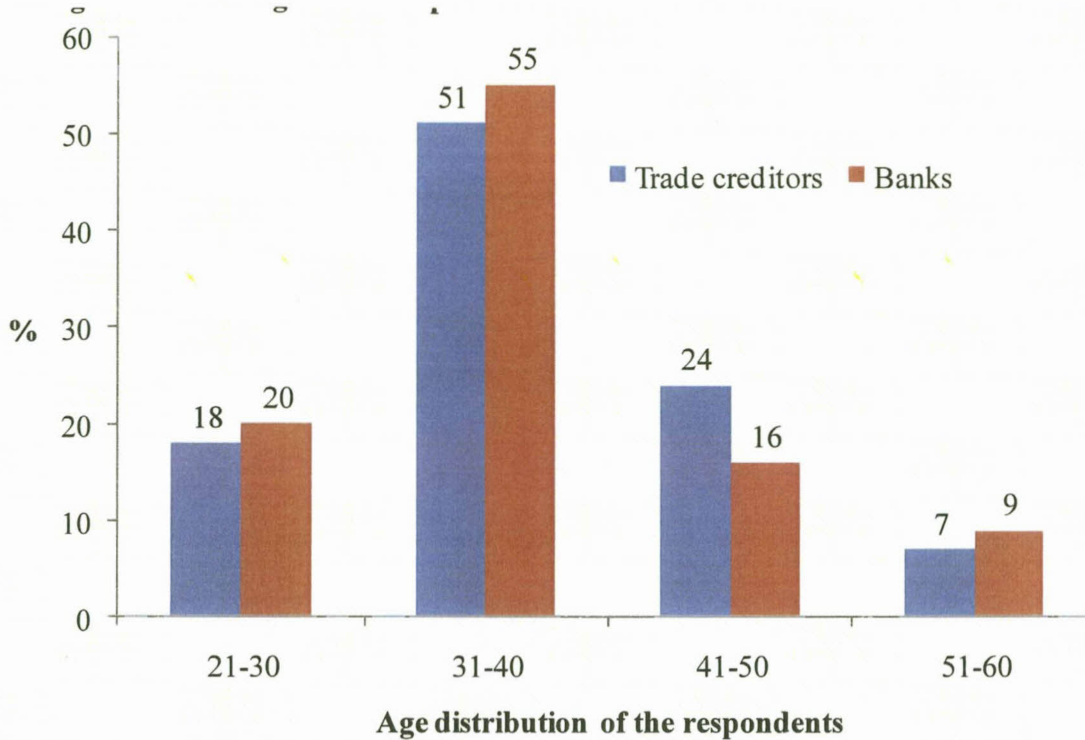
6.2.3 Demographics

The demographic variables for which data was collected and information obtained included age (banks and trade creditors), gender (banks and trade creditors), educational qualification (banks and trade creditors), experience (banks only), length of operation (trade creditors only), product line (trade creditors only), number of employees (trade creditors only) and part of a group or independent (trade creditors only). The demographics are presented below. Visual distributions of the demographic variables are presented in tables and figures.

6.2.3.1 The age of the respondents

Figure 6.1 depicts the age of the respondents for both commercial banks and trade creditors. The average age for trade creditors is 34 years and for commercial banks is 37 years. The results indicated that respondents that are trade creditors were younger than commercial banks respondents. The results furthermore indicated that most respondents for both banks and trade creditors are in the 31-40 age brackets.

Figure 6.1: The age of the respondents



6.2.3.2 The gender of the respondents

Table 6.2 depicts the gender of the respondents for both commercial banks and trade creditors.

Table 6.2: The gender of the respondents

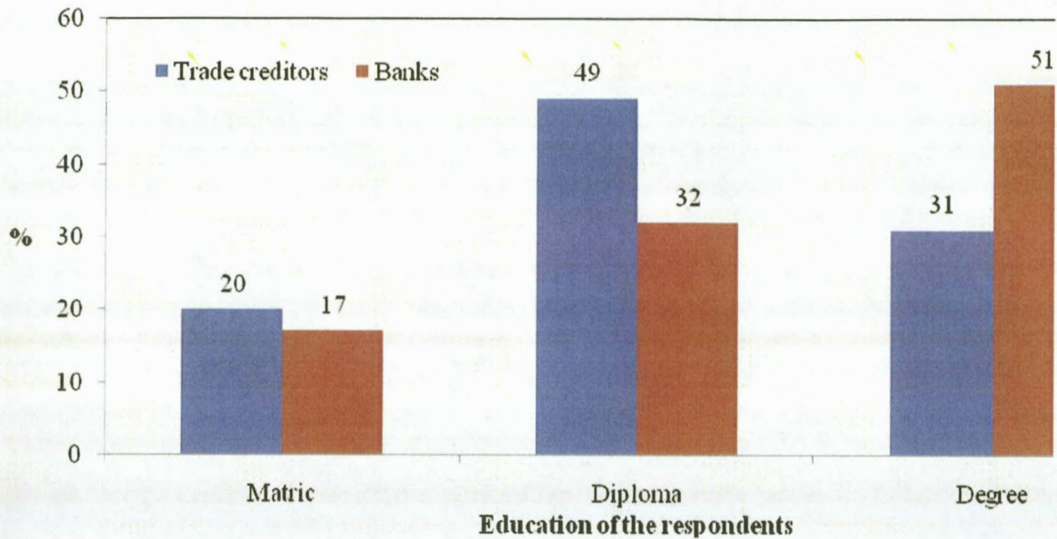
	Commercial banks		Trade creditors		Total	
Gender	Frequency	Percent	Frequency	Percent	Frequency	Percent
Male	117	68.0	171	77.0	288	73.1
Female	55	32.0	51	23.0	106	26.9
Total	172	100	222	100	394	100

The results indicated commercial banks' respondents are more evenly split (68% male and 32% female) than the respondents from trade creditors (77% male and 23% female). For both sets of respondents, males dominate.

6.2.3.3 The educational qualifications of the respondents

Figure 6.2 presents the educational qualifications of the respondents for both commercial banks and trade creditors.

Figure 6.2: The educational qualifications of the respondents



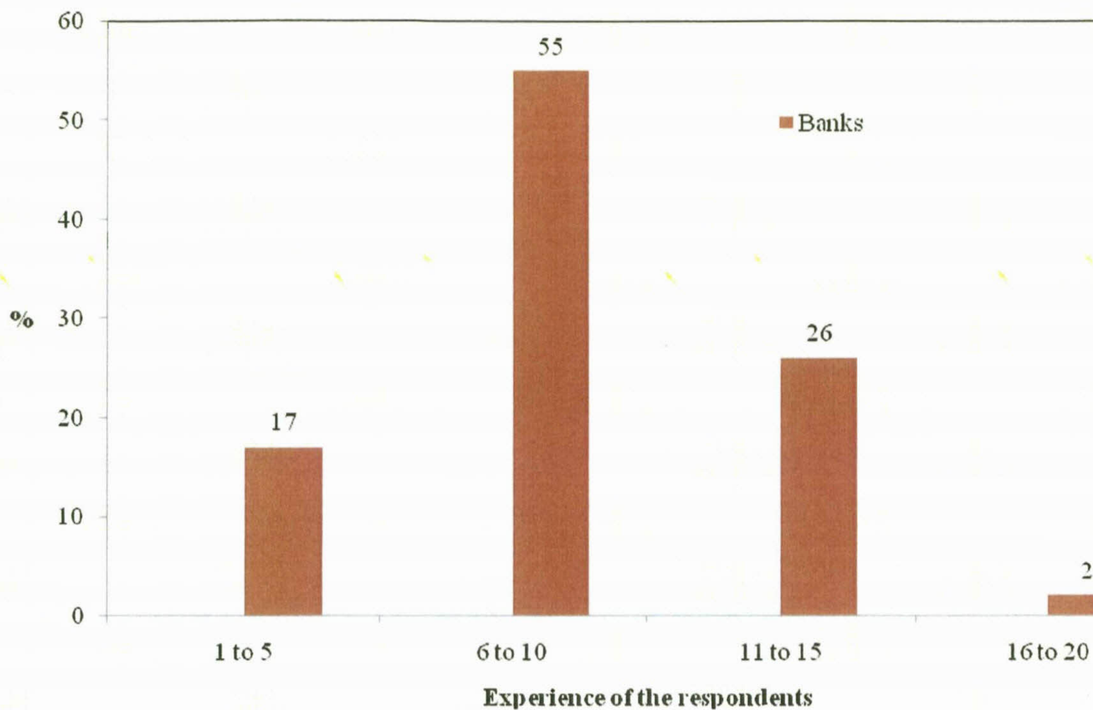
The results indicated that on the average respondents from commercial bank and trade creditors have post matric qualifications (83% and 80% respectively). This implies that the respondents were well educated and were able to give informed responses to the questions. It is also interesting to note that more than 50% of the bank respondents had degrees.

6.2.3.4 The experience of the respondents (commercial banks only)

Figure 6.3 depicts the experience of the respondents. Data for experience was obtained from commercial banks only.

The average experience of the respondents is 8.7 years. The results indicated that on the average the respondents have worked in the banks for between 6 and 10 years. This implied that on the average the respondents were well experienced in commercial banking and so were able to give informed responses to the questions.

Figure 6.3: The experience of the respondents (commercial banks)



6.2.3.5 Length of operation, product lines, number of employees and part of a group or independent (trade creditors only)

Table 6.3 presents the responses of the respondents in respect of the length of operation, the product lines, the number of employees and whether the respondents' firms are independent or belong to a group. Data for the four variables were obtained from trade creditors only.

Table 6.3: Length of operation, product lines, number of employees and part of a group or independent (trade creditors)

Length of operation (years)		Product line		No. of employees		Part of a group or independent	
1-10	51	Manufacturing	148	1-100	139	Independent	191
11-20	135	Wholesale & retail	74	101-200	50	Part of a group	31
21 and above	36			201 and above	33		
Total	222		222		222		222

Table 6.3 combined four demographic variables. The four variables applied only to trade creditors. As depicted by the table, most of the respondents have been in operation for between 15 and 20 years. The firms have been in existence for long and therefore have the experience to participate in the survey. Most of the respondents are in the manufacturing sector. In addition, with regards to the number of employees; most of the respondents are in the 1-100 brackets. The results show that the respondents' firms are predominantly independent, small to medium size businesses in the manufacturing sector.

6.2.4 Granting of trade credit (only trade creditors)

The question is to solicit responses from firms whether or not they grant trade credit. The review of the literature shows that not all firms grant trade credit. This study is interested in examining firms that generally grant trade credit to other firms.

Table 6.4: Responses on granting of trade credit by firms

Response category	Frequency	Percentage
Always	142	61.0
Often	62	26.6
Sometimes	18	7.7
Seldom	0	0
Never	11	4.7
Total	233	100

The results indicated that 222 (approximately 94%) respondents grant trade credit and 11 respondents (approximately 5%) do not grant trade credit. All the respondents who do not grant credit at all were eliminated from the survey. This made the usable sample of trade creditors to be 222 firms. The results confirms that trade credit is widely granted by firms in South Africa. The question this study wants to answer is why trade credit is not available to new SMEs.

6.2.5 Perception of whether commercial banks and trade creditors perceive new SMEs as beneficial to their business

This section presents the data analysis in respect of whether commercial banks and trade creditors perceive new SMEs as beneficial to their business. The section will, in addition, present data on their perception of the riskiness of new SMEs. Five variables were used to measure benefit. The variables are strategic importance, competitiveness, positive prospects, largeness and profitability. Risk was measured by the perception of the failure rate of new SMEs and the perceived credit risk of new SMEs. Questions related to this section are in Section A of the questionnaire for commercial banks and section B of the questionnaire for trade creditors. Data was analysed using descriptive statistics, T–test and ANOVA. The mean scores of the perception of benefits and risk of new SMEs by commercial banks and trade creditors are presented in figure 6.4. The mean scores are based on a 7-point Likert scale and 4 is the average value. Thus any score greater than 4 indicates a positive perception of benefit and any score lower than 4 indicates a negative perception. The converse is for the perception of risk. (The full descriptive statistics are presented in Appendix 3 due to the volume of data analysis).

Figure 6.4: Mean scores of the perception of benefits and risk of new SMEs by commercial banks and trade creditors

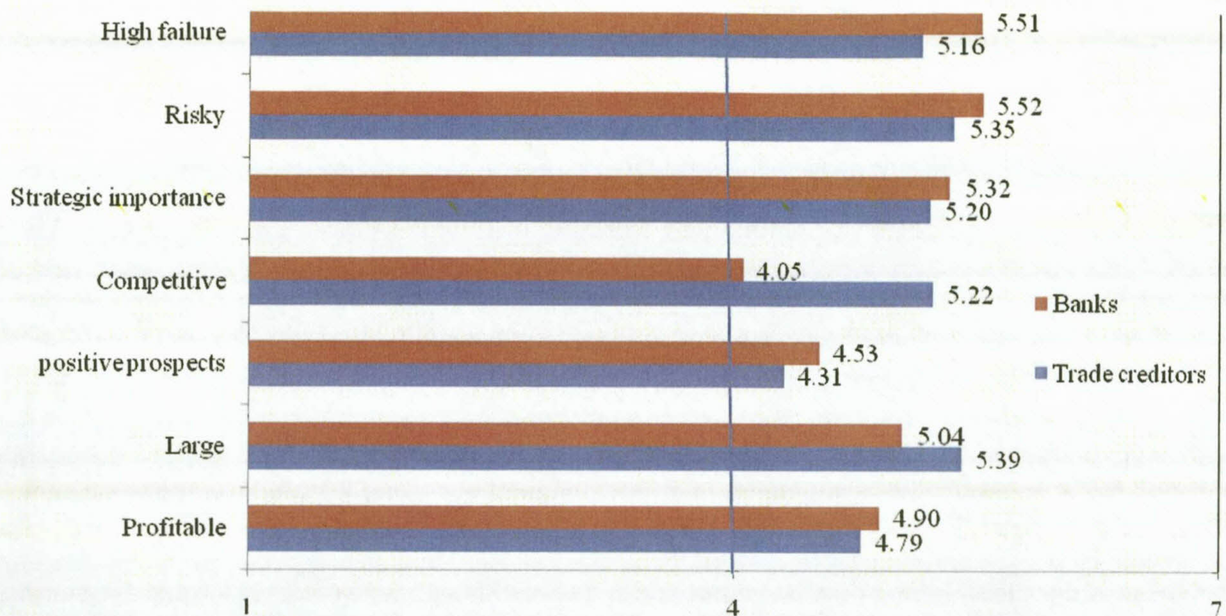


Figure 6.4 shows the mean scores of how new SMEs are perceived in terms of opportunity and risk by both commercial banks and trade creditors.

6.2.5.1 Benefits

In terms of benefits, the perceived strategic importance (mean of 5.32 on a 7 point Likert scale) of new SMEs has the highest mean for commercial banks. In addition, commercial banks perceive new SMEs as a large sector (5.04) that is potentially profitable (4.90) with good prospects (4.53). The benefit variable with the lowest mean is the competitiveness of new SMEs. The relatively weaker result for competitiveness could suggest that although commercial banks do perceive the SME market positive, they doubt the competitiveness of new SMEs and thus its potential riskiness is relative high. All the five benefit variables have means above 4 which indicates that commercial banks have a positive perception about the benefits of new SMEs in South Africa.

For trade creditors, the potential largeness (mean of 5.39 on a 7 point Likert scale) of the new SME market is perceived as the most important driver of benefits. In addition, trade creditors

perceive SMEs as a competitive (5.22) and strategically important sector (5.20). The profitability and prospects of new SMEs are also positively perceived by trade creditors but with lower rankings. All five measures of benefits have results above 4. This indicates that trade creditors also perceive benefits in new SMEs. The scale mean (obtained by adding the means of the five benefits variables and dividing the results by 5) for opportunity for commercial banks is 4.78 and for trade creditors 4.92. The results indicate that both commercial banks and trade creditors perceive new SMEs as beneficial to their business. The results furthermore suggest that trade creditors perceive greater benefits in new SMEs compared to commercial banks.

6.2.5.2 Risk

Risk was measured by the perception of the failure rate of new SMEs and the perceived riskiness (credit risk) of new SMEs. Risk will impact on the willingness of commercial banks and trade creditors to get involved with new SMEs. The results indicate that both commercial banks and trade creditors perceive new SMEs as a risky sector with high failure rate average means of 5.52 and 5.26 for the two measures of risk respectively. The results suggest that commercial banks have a higher perception of the riskiness of new SMEs compared to trade creditors.

6.2.5.3 Benefits and risk compared

The results indicate that both commercial banks and trade creditors perceive benefits in new SMEs with scale means of 4.78 and 4.92 respectively. However, the results also indicate that both commercial banks and trade creditors perceive new SMEs as a highly risky sector with scale means of 5.52 and 5.26 respectively. The results suggest that commercial banks and trade creditors perceive the risk of new SMEs as greater than the benefits. This implies that both commercial banks and trade creditors perceive new SMEs as a beneficial market but with high risk.

6.2.5.4 Differences in the perception of benefits by commercial banks and trade creditors

The T-test was used to determine if there are significant differences in the mean scores of commercial banks and trade creditors. Table 6.5 presents the mean values for the measures of

opportunity and risk for commercial banks and trade creditors and the significance of the T-test (refer to Appendix 4 for the complete results).

Table 6.5: T-test for the differences in the perception between banks and trade creditors

Variable	Mean scores for commercial banks	Mean scores for trade creditors	T-test significance
Profitable	4.90	4.79	.323
Large	5.04	5.33	.408
Positive prospects	4.53	4.31	.385
Competitive	4.05	5.22	.079
Strategic importance	5.32	5.20	.890
Risky	5.52	5.35	.475
Failure	5.51	5.16	.405

Sig. at 0.05 (2-tailed)

The results of the T-test indicate that there are no significant differences in the mean scores of both groups of respondents.

6.2.5.5 Demographic factors and perception of new SMEs

This section will examine whether there are differences in the perception of commercial banks and trade creditors with respect to demographic factors. The demographic variables include age, gender, education, experience, and length of operation, product lines, number of employees and being independent versus part of a group. For two variables such as the gender, product line and being independent or part of a group, the T-test will be used. ANOVA will be used when the variables are more than two. Because of the huge amount of data analysis, only the variables with significant differences are presented in table (Refer to Appendices 5, 6 and 7 for the complete data analysis).

Table 6.6: T-test and ANOVA and demographic variables (trade creditors)

Variable	Demographic factor	Sig.
Profitable	Group or independent	0.04
Positive prospects	Group or independent	0.01
Profitable	Number of employees	0.02
Positive prospects	Number of employees	0.00

Sig 0.05 (2-tailed)

The results indicate that there are significant differences in the mean scores of trade creditors that are independent and those that belong to a group regarding their perception of the profitability (sig. 0.04) and prospects (sig. 0.01) of new SMEs. The ANOVA also shows that there are significant differences with regards to the perception of different employee groups and profitability (sig. 0.02) and prospects (0.00). If a significant result is obtained in an ANOVA, the researcher needs to go further and determine, using a Tukey HSD test, where the significance lies (Refer to appendix 8 for the complete Tukey HSD test results).

Table 6.7: Tukey HSD test for the differences in the perception of employees and profitability and prospect of SMEs

No. of employees	Profitable (sig.)	Positive prospects (sig.)
1-50	.437	.158
51-100	.255	.679
101-150	.154	.203
151-200	.335	.164
201 above	.004	.002

Sig at 0.05 (2-tailed)

The results of the Tukey HSD test show that the significant difference is with the 201 and above number of employees at 0.04 and the profitability (0.04) and prospects (0.02) of new SMEs.

6.2.5.6 Conclusions

The significance of this approach is that it focused on whether commercial banks and trade creditors perceive new SMEs as beneficial to their business but also examined the risk of involvement with new SMEs by commercial banks and trade creditors. The results indicate that both commercial banks and trade creditors perceive new SMEs as beneficial to their business. Previous empirical studies on the availability of debt finance to SMEs in South Africa such as Hawkins (2002:519-542) and FinMark Trust (2006) have focused mainly on the risk factor. The results of this study confirm the findings of previous empirical studies that new SMEs are risky and have high failure rates. This study however extended previous research by investigating if commercial banks and trade creditors also perceive benefits in new SMEs. The results indicated

that both commercial banks and trade creditors perceive benefits in new SMEs. All the benefit variables have means greater than 4 on a 7-point Likert scale. Therefore, **the null hypothesis that commercial banks and trade creditors do not perceive benefits in new SMEs is rejected in favour of the alternate hypothesis. However, the results also indicate that new SMEs are perceived as a high-risk sector with high failure rates. The benefit/risk profile of new SMEs indicates that the perceived risk of new SMEs is greater than the perceived benefits.**

Therefore, the results obtained by this study must be interpreted with caution. Despite the fact that commercial banks and trade creditors perceive benefits in new SMEs, their perception of risk is relatively higher. What this results indicate however is that the perception of new SMEs by both commercial banks and trade creditors is not always about risk but also about benefits. Despite the riskiness and high failure rate of new SMEs, commercial banks and trade creditors perceive benefits in new SMEs. The sector is perceived as profitable with positive prospects. New SMEs are also perceived as strategically important with profit potential. The results suggest that non-availability of debt finance to new SMEs is not caused by a lack of interest or discrimination by commercial banks and trade creditors, but by risk.

The results reinforce the importance of new SMEs to commercial banks and trade creditors. Beck *et al.* (2008) and De la Torre *et al.* (2008) point out that commercial banks consider new SMEs as a sector of strategic importance. In South Africa, the big four commercial banks now have small business units and products specifically dedicated to both established and new SMEs. Banks have realized the importance of new SMEs especially as margins in other banking markets narrow. In particular, as the public sector and large corporations have gained access to local and international capital markets, and as competition in the retail sector has increased substantially, banks have greater incentives to incur the switching costs needed to pursue new business in the SME market. According to Standard Bank and Fujistu Siemens Computers (2009) in the South African SME Survey, there are two million four hundred thousand firms in South Africa; two million, two hundred thousand of them are SMEs including new ones. This indicates the largeness of the SME sector in South Africa. The results of this section shows that contrary to the

"conventional wisdom" by government policy makers and some researchers that commercial banks and trade creditors discriminate against new SMEs because of they are unprofitable, banks and trade creditors perceive new SMEs as a source of profitability. Banks and trade creditors also perceive the new SME market as large and with good prospects.

However, commercial banks and trade creditors also perceive new SMEs as highly risky. The risk affects the willingness of commercial banks and trade creditors in granting credit to new SMEs. Tagoe *et al.* (2005:333) point out that risk is the most important reason why banks and trade creditors often reject credit applications from new SMEs. The risk perception of new SMEs is high because of their high failure rate and this is one of the reasons for their low access to debt finance. Reitan & Waago (2002) suggest that banks and trade creditors are firms whose normal purpose of existence is to maximize the wealth of their shareholders. The riskiness and high failure rate of new SMEs can negatively impact on the wealth maximization objective of banks and trade creditors. Therefore, commercial banks and trade creditors often tread with caution when dealing with new SMEs.

6.2.6 Important factors when evaluating the credit applications of new SMEs

The objective of this section is to evaluate the importance of internal and external environmental factors by commercial banks and trade creditors when evaluating credit applications from new SMEs. This is section B of the questionnaire for commercial banks and section C of the questionnaire for trade creditors. Nine factors comprising of four internal factors and five external factors were identified using factor analysis (refer to Section 6.2.7.1, p. 239). The internal factors are collateral, business information, managerial competencies and networking. The external factors are crime, corruption, the macro economy, ethics and the efficiency of the legal system. This section forms the prelude to the main investigate part of the study. Data will be analysed using descriptive statistics, T-test and ANOVA.

6.2.6.1 Mean scores of the importance attached by the respondents to internal factors

Figure 6.5 presents the mean scores of the importance attached to internal factors by commercial banks and trade creditors when evaluation credit applications from new SMEs. The figure will

show the relative importance of each internal factor in the credit evaluation process by commercial banks and trade creditors. (Refer to Appendix 9 for the complete data analysis).

Figure 6.5: Mean scores for the importance attached by the respondents to internal factors

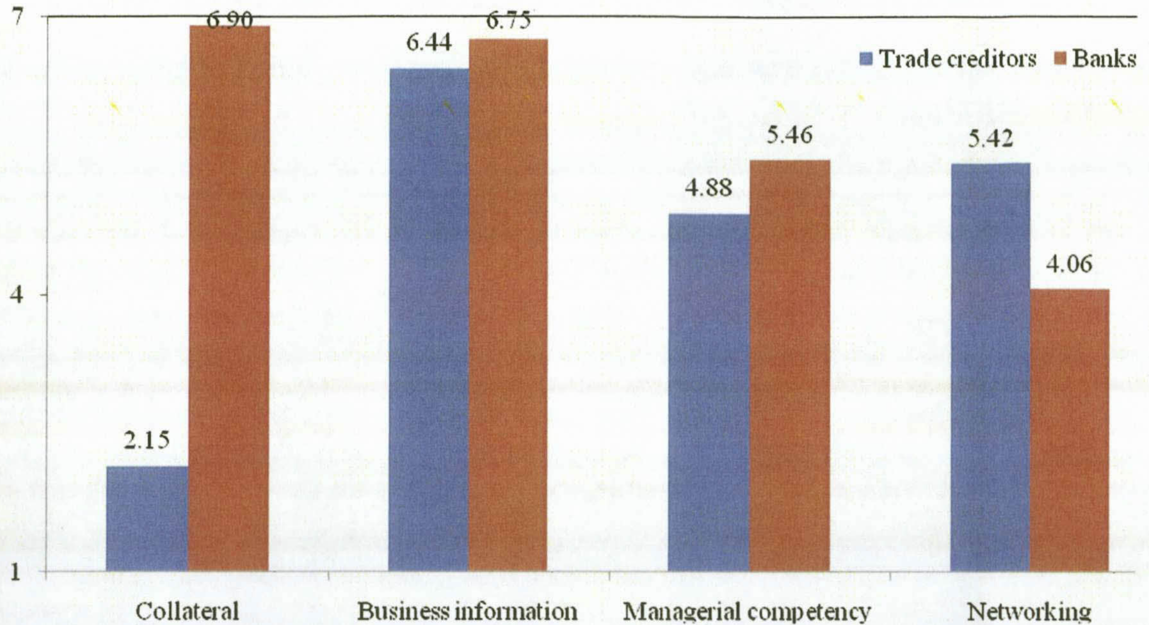


Figure 6.5 shows the importance attached to internal factors by commercial banks and trade creditors when evaluating credit applications from new SMEs. The most important internal factors for commercial banks are collateral and business information respectively (both are above 6 on a 7 point Likert scale). This is followed by managerial competency and networking in the order of importance. All four internal factors have mean scores of more than 4, indicating that the respondents from commercial banks regard all these factors important. The most important internal factor for trade creditors is business information followed by networking and managerial competencies. The least important internal factor to trade creditors is collateral (at 2.15 the only score below the average mean value of 4). These results bear some similarities and contrasts to the importance attached to internal factors by commercial banks and trade creditors. To both commercial banks and trade creditors the quality of business information and managerial competency are very important. Networking is of more importance to trade creditors compared to commercial banks. Collateral is of great importance to commercial banks but not important at all to trade creditors. The average mean of internal factors for commercial banks is 5.79 and for

trade creditors 4.72 (the average means were obtained by adding together the four internal factors and dividing the results by 4). This suggests that internal factors are important to both commercial banks and trade creditors in credit evaluation. The results furthermore suggest that commercial banks (5.79) attach higher importance to internal factors than trade creditors (4.72). However, if the collateral is excluded from the variables for trade creditors the average mean of internal factors for trade creditors becomes 5.68, which is similar to the results for commercial banks 5.79. Willacy (2009b:155) points out that trade creditors at times do not take collateral when granting credit to other firms. This implies that internal factors are of great importance to both commercial banks and trade creditors in the credit evaluation process.

Commercial banks attach the highest level of importance to collateral (6.90 on a 7-point Likert scale) in the credit evaluation process. Collateral could be the physical assets (personal house) of the owners of new SMEs, the physical assets of the firm (buildings, plant and machinery) and equity contribution by the owners of the new SMEs. Coco (2000:197) points out that from a theoretical perspective, the collateral pledged by borrowers may help attenuate the problem of adverse selection faced by the bank when lending. Collateral acts as a signal enabling the bank to mitigate or eliminate 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 and Letterie (2008:189) argue that even if there is symmetry *ex ante* between borrower and lender (i.e. the bank knows the credit quality of the borrower), collateral helps to alleviate moral hazard problems once the loan has been granted. In this sense, the collateral pledged helps align the interests of both lenders and borrowers, avoiding a situation in which the borrower makes less effort to ensure the success of the project for which finance was given. Thus, collateral makes it possible to limit the problem of the moral hazard faced by all banks when they lend money. Collateral can therefore be seen as an instrument ensuring good behaviour on the part of borrowers, given the existence of a credible threat (Degryse & Cayseele: 2000:94). In contrast, trade creditors seldom demand for collateral from their customers in the normal course of business. Most trade credit transactions are done on the basis of trust (Willacy, 2009b:155).

The availability and the quality of business information are attached almost equal level of importance by commercial banks (6.75) and trade creditors (6.44) in the credit evaluation process (which are extremely high scores). According to Sarapaivanich and Kotey (2006:221) the lack of business information regarding the underlying quality of the project gives rise to information asymmetry and adverse selection problems and leads to credit rationing. Wiedenhofer (2006:84) points out that from the creditors' perspective the existence of financial information is one of the primary measures of the capacity of a business to effect repayment of credit. Barringer and Ireland (2006:205) agree that the existence of information asymmetry leads to credit rationing. However, if an entrepreneur has spent time developing a comprehensive and a priory business plan at an early stage in the project, risk perception should be reduced and the likelihood of obtaining capital should increase.

Managerial competency is also of high importance to both commercial banks (5.46) and trade creditors (4.88) in the credit evaluation process. According to Nguyen and Ramachandran (2006:206) managerial competencies can help to reduce information asymmetry before a loan is granted and potential moral hazard after the loan is granted. Bosma *et al.* (2004:227) find that managerial competencies positively impact on the performance of new SMEs. Lyles *et al.* (2004:352) note that relative profits tend to be high when an entrepreneur has more education and experience in the line of business. Managerial competency significantly impacts on the survival and performance of new SMEs. This suggests that managerial competency can reduce the credit risk of lending to new SMEs.

Trade creditors (5.42) attach greater importance to networking than commercial banks (4.06). Shane and Cable (2002:366) find that networking can be used to reduce information asymmetry in creditor/debtor relationships. In addition, networks increase a firm's legitimacy, which in turn positively influences the firm's access to external financing. Ngoc *et al.* (2009:872) point out that in the absence of effective market institutions; networks play an important role in spreading knowledge about a firm's existence and its practices. Networks also help a firm learn appropriate behaviour and therefore obtain needed finance from creditors. Given that commercial banks rely more on collateral and have better access to credit ratings of potential customers, it is

understandable that the rely less on networks. However, trade creditors, in the absence of collateral, probably use the networks to assess the creditworthiness of the SME and that is why networking is so important to them.

6.2.6.2 Mean scores for the importance attached to external factors in the credit evaluation process

Figure 6.6 presents the mean scores of the importance attached to external factors by commercial banks and trade creditors when evaluation credit applications from new SMEs.

Figure 6.6: Mean scores for external factors

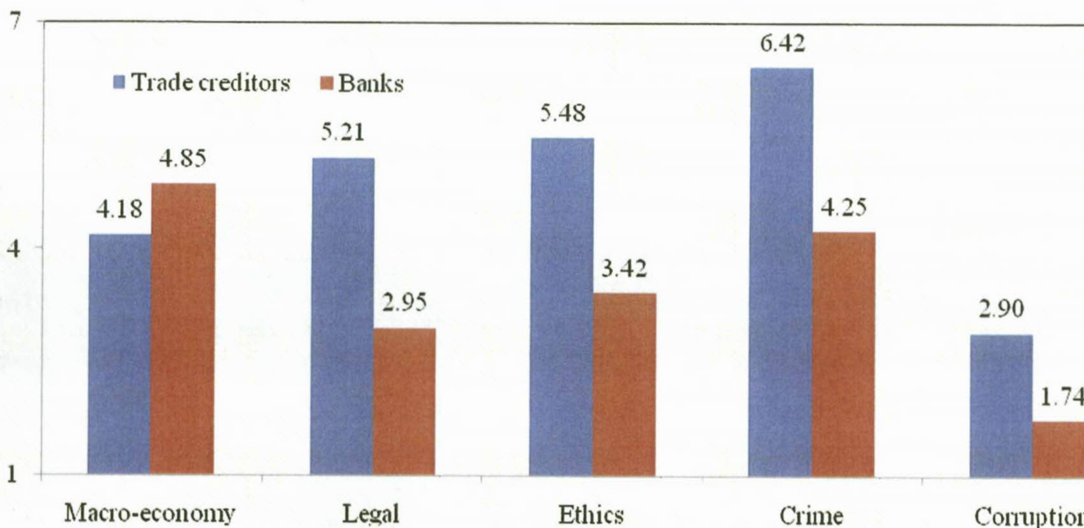


Figure 6.6 shows that the most important external environmental factor for commercial banks is the macro-economy (4.85). Baum and Caglavan (2008:73) find that as banks must acquire costly information on borrowers before extending loans to new or existing customers, uncertainty about economic conditions (and the likelihood of loan default) would have clear effects on their lending strategies. Higher uncertainty will hinder managers' ability to accurately predict returns from available lending opportunities. For trade creditors crime is the most important external factor (6.42) when evaluating credit applications from new SMEs is crime. Falkena *et al.* (2002) point out that crime increases moral hazards after the granting of credit and can affect the ability of SMEs to repay credit. Chidokufa (2009) finds that less than half of all South African SMEs do not have any insurance cover in the event of a crime. In addition, a high crime rate reduces the

value of properties that are used to collaterize loans (Linden & Rockoff, 2006). This suggests that crime increases credit risk.

Trade creditors rate ethics (5.48) and the efficiency of the legal environment (5.21) as very important in the credit evaluation process. Commercial banks attach lower levels of importance to both ethics (3.42) and the efficiency of the legal system (2.95). Both these scores are below the average of 4.00, indicating that banks attach relatively little value to these to external factors. This is surprising, because the response from the trade creditors makes much more sense, giving both these external factors high values. Beck (2007:405) finds that efficient legal institutions reduce the risk of lending by mitigating moral hazard as well as adverse selection problems, thereby increasing lenders' willingness to lend. Howorth & Moro (2006:30) point out that ethics and trust play an important role in reducing agency problems such as moral hazard and adverse selection. Shane and Cable (2002:367) point out that ethics and the efficiency of the legal system are very important for trade creditors because trade creditors seldom take collateral. A possible explanation for this apparent contradiction why banks regard ethics and legal environment relatively unimportant is most probably centred in collateral. If you have sufficient collateral, the ethical behaviour of the entrepreneur or the efficiency of the legal system becomes much less of an issue in the credit granting decision. The least important external factor for both sets of respondents is corruption. However, trade creditors seem to attach more importance to corruption than commercial banks.

6.2.6.3 Internal and external factors compared

The average means for internal factors for commercial banks and trade creditors are 5.79 and 4.72 respectively. Adding together all the means of the four internal factors and dividing the figure obtained by four obtained the average means. However, if the collateral is excluded from the variables for trade creditors the average mean of internal factors for trade creditors becomes 5.68, which is similar to the results for commercial banks 5.79. The average means for external factors for commercial banks and trade creditors are 3.44 and 4.84 respectively. Adding together all the means of the five external factors and dividing the figure obtained by five obtained the average means. The results suggest that internal factors are important to commercial banks and

trade creditors when evaluation the credit applications of new SMEs. The furthermore suggests that commercial banks rate internal factors (5.79 to 4.72) higher than trade creditors in the evaluation of credit applications from new SMEs. However, if collateral is excluded, both commercial banks and trade creditors rank internal factors similarly. In addition, the results suggest that external factors (4.84 to 3.44) are more important to trade creditors than commercial banks in the evaluation of credit applications from new SMEs.

The background of these findings can be traced to the importance of collateral in the capital structure of firms. Berger and Udell (2002:2140) find that most commercial loan agreements require collateral as security. The value of collateral posted by small businesses exceeds the value of loans. This implies that commercial banks seldom lend to new SMEs without collateral. Coco (2000:192) finds that asymmetric information, moral hazard and adverse selection are plausible explanations for the use of collateral. Willacy (2009b:155) notes that trade creditors are mainly relationship lenders and do not normally take collateral from their customers. Therefore, factors in the external environment, which can increase credit risk, such as crime, ethics and the efficiency of the legal system, are of greater importance to trade creditors in the absence of collateral.

6.2.6.4 Differences in the mean scores of commercial banks and trade creditors

Table 6.8 depicts the results of the T-test for differences in the mean scores of commercial banks and trade creditors with respect to the importance attached to internal and external factors when evaluating the credit applications of new SMEs. Only the summary results are presented. (Refer to Appendix 10 for the complete data analysis).

Table 6.8 shows that there are no significant differences in the mean scores of both banks and trade creditors with regard to managerial competency, availability of business information, networking, macro economy, crime and corruption. The results also indicate that there are significant differences in the mean scores of collateral, ethics and efficiency of the legal system. Collateral is very important to commercial banks but much less important to trade creditors.

Ethics and the efficiency of the legal system are very important to trade creditors but significantly less important to commercial banks.

Table 6.8: T-test for the differences in the mean scores of respondents

Variable	Mean scores of commercial banks	Mean scores of trade creditors	T-test significance
Collateral	6.90	2.15	**0.02**
Business information	6.75	6.44	0.48
Managerial competencies	5.46	4.88	0.22
Crime	4.25	6.42	0.16
Macro-economy	4.85	4.18	0.52
Networking	4.06	5.42	0.31
Ethics	3.42	5.48	**0.04**
Legal	2.95	5.21	**0.01**
Corruption	1.74	2.90	0.19

Sig at 0.05 (2-tailed)

6.2.6.5 The importance attached to internal and external factors and demographic variables

This section examines whether there are significant differences in demographic variables with respect to the importance attached to internal and external factors in the evaluation of credit applications from new SMEs. The complete data analysis is presented in Appendices 11, 12 and 13). The demographic variables include gender, product line and belonging to a group or independent. The T-test was used to test for differences in the scores for the three variables. The other demographic variables are age, education, experience, length of operation and number of employees. ANOVA was used to test for the differences in the scores of these variables. The results of the T-test and ANOVA show that there are no significant differences in the criteria for evaluating the credit applications of new SMEs and demographic factors. Because of the fact that there are no significant results, no summary table is presented.

6.2.7 Internal and external factors why credit is not available to new SMEs.

The study has examined the benefits/ risk profile of SMEs. The results indicate that commercial banks and trade creditors perceive new SMEs as beneficial to their business but also perceive

new SMEs as very risky. In addition, the importance attached to internal and external factors by commercial banks and trade creditors in the evaluation of credit applications of new SMEs was examined. The results suggest that internal factors are more important to commercial banks compared to trade creditors. The results also suggest that external factors are more important to trade creditors compared to commercial banks. The objective of this section is to determine the reasons why credit is not available from commercial banks and trade creditors to new SMEs (non-availability of debt). This is the C part of the questionnaire for commercial banks and D part of the questionnaire for trade creditors. Data for this section will be analysed using factor analysis, descriptive statistics, T-test, ANOVA and Pearson correlation. Because of the huge volume of data in this section (this section is the main investigative part of the study) only the summary of the data analysis will be presented. (Refer to Appendices 14 to 20 for the complete data analysis).

6.2.7.1 Factor analysis

The measuring instrument was designed to measure the internal and external environmental variables (the business environment) that impact on the availability of debt finance to new SMEs. For this purpose an initial 52-item questionnaire was designed through a review of literature on how the business environment can impact on non-availability of debt. The questionnaire was administered to 100 respondents from commercial banks and 100 respondents that were trade creditors in a pilot study. Exploratory factor analysis resulted in the reduction of the 52-item questionnaire to a 43-item questionnaire and nine underlying factors for commercial banks (refer to appendices 14 and 15) and 39-item questionnaire and nine underlying factors for trade creditors (refer to appendices 16 and 17). Questionnaire items with factor loading lower than 0.300 were removed as suggested by Leech *et al.* (2005:13). Commercial banks had 9 items with loadings lower than 0.300 and trade creditors had 13 items with loading lower than 0.300 (refer to the asterisked items in appendices 15 and 17). Confirmatory factor analyses were performed on the final 172 questionnaires returned by respondents from commercial banks and 222 questionnaires returned by trade creditors in the main survey to test the homogeneity of the underlying constructs. The analysis confirmed nine factors each for both commercial banks and trade creditors. The results of the factor analysis are presented from sections A to D.

A. KMO and BTS

To ensure the use of factor analysis, the Barlett Test of Sphericity (BTS) and Kaiser-Meyer-Olkin (KMO) test of appropriateness were carried out accordingly. The results of the two tests for both commercial banks and trade creditors are presented in table 6.9.

Table 6.9: KMO and BTS

Variables	Commercial banks	Trade creditors
KMO	0.780	0.812
BTS	498.065	557.161
Sig.	0.001	0.003

Sig. at 0.05 (2-tailed)

The results (BTS = 498.065; sig. =0.001for commercial banks) and (BTS = 557.161; sig. =0.003) indicated that the data were appropriate for the purpose of factor analysis. Statistically, this meant that there exists relationships between the variables and that they can be appropriately included in the factor analysis. The result of the KMO measure of sampling adequacy was 0.780 and 0.812 for commercial banks and trade creditors. The results indicate that there are sufficient items for each factor. The two tests support the appropriateness of the factor analysis technique.

B. Total variance explained

Appendix 14 indicates the total variance explained by factor analysis for commercial banks. Nine factors with Eigenvalues greater than one account for 82.561% of the total variance. The nine factors are further confirmed by the rotation sums of squared loading after Varimax rotation. According to the rules of factor analysis only factors that have Eigenvalues greater than one should be retained. In addition, the higher the percentage of the total variance the greater the contribution of the factor. Appendix 16 shows the total variance explained by factor analysis for trade creditors. Nine factors with Eigenvalues greater than one account for 78.566% of the total variance. The nine factors are further confirmed by the rotation sums of squared loading after Varimax rotation.

C. Rotated factor loadings for commercial banks and trade creditors

This section depicts the rotated factor loading for commercial banks and trade creditors. Nine factors were identified for both sets of respondents (refer to Appendices 15and 17 for the complete data analysis).

Commercial banks

The nine factors for commercial banks are presented below in the order of importance as indicated by their contribution to the percentage of total variance.

- Factor one was labelled as *lack of collateral*. The Eigen value for the factor is 13.225. The factor includes four items. This factor is internal to the firm. This is the most important factor according to the factor analysis. Cronbach's alpha for the factor yielded a value of 0.8105 indicating the reliability of the factor.
- Factor two was labelled *lack of business information*. The Eigenvalue for the factor is 6.432. The factor includes nine items. The factor is largely internal to the firm. Cronbach's alpha for the factor yielded a value of 0.8207 indicating the reliability of the factor.
- Factor three was labelled *lack of managerial competencies*. The Eigenvalue for the factor is 3.740. The factor consists of seven items. The factor is largely internal to the firm Cronbach's alpha for the factor yielded a value of 0.7918 indicating the reliability of the factor.
- Factor four was labelled as *bad macro-economy*. The Eigenvalue for the factor is 2.967. The factor consists of three items. The factor is external to a firm. The factor is largely external to the firm. Cronbach's alpha for the factor yielded a value of 0.8113 indicating the reliability of the factor.
- Factor five was labelled as *crime*. The Eigenvalue for the factor is 2.532. The factor consists of three items. Crime is largely an external factor. Cronbach's alpha for the factor yielded a value of 0.7981 indicating the reliability of the factor.
- Factor 6 was labelled *lack of networking*. The Eigenvalue for the factor is 2.356. The factor consists of five items. The factor is internal to a firm. Cronbach's alpha for the factor yielded a value of 0.7217 indicating the reliability of the factor.

- Factor seven was labelled *ethical perception.* Ethical perception implies the perception of commercial banks as to the ethical behaviour of new SME owners. The Eigenvalue for the factor 2.156. The factor consists of four items. Ethics is largely external to a firm. Cronbach's alpha for the factor yielded a value of 0.8551 indicating the reliability of the factor.
- Factor eight was labelled *inefficiency of the legal system*. The Eigenvalue for the factor is 1.835. The factor consists of five items and is external to a firm. Cronbach's alpha for the factor yielded a value of 0.7327 indicating the reliability of the factor.
- Factor nine was labelled *corruption*. The Eigenvalue for the factor is 1.322. The factor consists of three items and is external to a firm. The Cronbach's alpha is 0.7108 indicating the reliability of the factor.

- **Trade creditors**

The nine factors for trade creditors are presented below in the order of importance as indicated by their contribution to the percentage of total variance.

- Factor one was labelled as *lack of business information*. The Eigenvalue for the factor is 10.225. This factor consists of eight items and is internal to the firm. Cronbach's alpha for the factor yielded a value of 0.8210 indicating the reliability of the factor.
- Factor two was labelled *lack of networking*. The Eigenvalue for the factor is 4.104. The factor consists of five items and is internal to the firm. Cronbach's alpha for the factor yielded a value of 0.7654 indicating the reliability of the factor.
- Factor three was labelled *crime*. The Eigenvalue for the factor is 6.441.The factor consists of two items and is largely external to the firm. Cronbach's alpha for the factor yielded a value of 0.7865 indicating the reliability of the factor.
- Factor four was labelled as *ethical perception.* The Eigenvalue for the factor is 3.276. The factor consists of four items and is external to a firm. Cronbach's alpha for the factor yielded a value of 0.8523 indicating the reliability of the factor.
- Factor five was labelled as *lack of managerial competencies*. The Eigenvalue for the factor is 3.015. The factor consists of six items and is internal to the firm. Cronbach's alpha for the factor yielded a value of 0.7119 indicating the reliability of the factor.

- Factor 6 was *inefficiency of the legal system*. The Eigenvalue for the factor is 2.284. The factor consists of six items and is external to a firm. Cronbach's alpha for the factor yielded a value of 0.7432 indicating the reliability of the factor.
- Factor seven was labelled *bad macro-economy*. The Eigenvalue for the factor 2.015. The factor consists of two items and is external to the firm. Cronbach's alpha for the factor yielded a value of 0.7608 indicating the reliability of the factor.
- Factor eight was labelled *lack of collateral*. The Eigenvalue for the factor is 1.846. The factor consists of four items and is internal to the firm. Cronbach's alpha for the factor yielded a value of 0.8107 indicating the reliability of the factor.
- Factor nine was labelled *corruption*. The Eigenvalue for the factor is 1.424. The factor consists of two items and is external to a firm. The Cronbach's alpha is 0.7112 indicating the reliability of the factor.

D. Comparison of factors of commercial banks and trade creditors

This section compares the factors of commercial banks and trade creditors. The comparison is presented in table 6.10.

Table 6.10: Comparison of factor loading

Factor	Commercial banks	Trade creditors
1	Collateral	Business information
2	Business information	Networking
3	Managerial competencies	Crime
4	Macro-economy	Ethical perception
5	Crime	Managerial competencies
6	Networking	Legal system
7	Ethical perception	Macro-economy
8	Legal system	Collateral
9	Corruption	Corruption

The exploratory factor analysis showed that the three factors with the highest Eigenvalues for commercial banks were collateral, business and financial information and managerial competencies. These are all internal factors. The three factors with the lowest Eigenvalues were ethics, legal and corruption. These are all external factors. The results suggest that internal factors are more important to the commercial banks than external factors. For trade creditors, the

three factors with the highest Eigenvalues were business and financial information, crime and networking. The results also indicate the dominance of internal factors for trade creditors but with the presence of an external factor. The results of the factor analysis suggest that internal factors are more important than external factors with regards to the reasons why credit is not available from commercial banks and trade creditors to new SMEs.

6.2.7.2 Item analysis, T-test and correlation

An item analysis was performed to investigate the means, standard deviation, skewness and kurtosis of the identified factors for both commercial banks and trade creditors. The Cronbach's alpha was used as the measure of reliability. In addition, the T-test was used to determine if there are significant differences in the mean scores of commercial banks and trade creditors. Furthermore, the results of the correlation will be presented. Since the results of item analysis, T-test and the correlation are related; the discussions of their results will be done together.

A. Item analysis

Tables 6.11 and 6.12 present the mean scores of the reasons why credit is not available from commercial banks and trade creditors to new SMEs. The Cronbach's alphas are also presented.

Table 6.11: Mean scores and Cronbach's alphas of internal and external factors for commercial banks

Factor	Item	Mean	Factor	Item	Mean
Lack of collateral	No tangible asset as collateral	6.95	**Crime**	Business not insured	6.02
	Low equity contribution	6.92		Business is located in high crime area	5.05
	No guarantee	5.15		Collateral is located in high crime area	4.08
	No current asset as collateral	5.02		**Scale mean** **Cronbach's alpha**	**5.05** **0.832**
	Scale mean **Cronbach's alpha**	**6.01** **0.825**	**Lack of networking**	No prior relationship	6.62
Lack of business inform.	No business plan	6.92		No verifiable distribution of products arrangement	5.98
	Cash flow does not show that credit can be repaid	6.90		Lack of good reference on integrity	5.20
	Business is not viable	6.36		No verifiable supply of inputs agreement	4.17

	No market potential	6.24		Short prior relationship	3.02
	No growth potential	6.20		**Scale mean** **Cronbach's alpha**	**4.98** **0.878**
	Business plan does not articulate opportunities	5.26	**Ethical perception**	Perception of willingness to divert funds to non-core activities	3.45
	Lack of documentation	5.15		Perception of payment default	3.26
	Business plan not thorough in its coverage of key issues	5.11		Perception of dishonesty in keeping commitments	3.08
	No suitable business premise	4.22		Perception of false information and paddling of financial statements	1.92
	Scale mean **Cronbach's alpha**	**5.82** **0.874**		**Scale mean** **Cronbach's alpha**	**2.92** **0.789**
Lack of managerial competencies	Bad credit record	6.95	**Inefficient legal system**	Costly to get judgment	4.02
	Founder not familiar with industry	6.82		Takes time to get judgment	3.48
	Lack of experience	6.34		Courts are not fair or impartial	2.35
	Lack of education	5.72		Court decisions are not enforced	2.16
	Lack of business skills	4.77		Weak confidence in the legal system	2.02
	Lack of resources	4.25		**Scale mean** **Cronbach's alpha**	**2.81** **0.777**
	Lack of demonstrated managerial ability	4.08	**Corruption**	Corruption of government official	3.25
	Scale mean **Cronbach's alpha**	**5.56** **0.772**		Corruption of court official	2.88
Bad Macro-economy	Economy in recession	6.08		Corruption of company officials	1.22
	Fall in the value of real estate	5.72		**Scale mean** **Cronbach's alpha**	**2.45** **0.713**
	High interest rate	4.65			
	Scale mean **Cronbach's alpha**	**5.48** **0.799**			

Table 6.12: Mean scores and Cronbach's alphas of internal and external factors for trade creditors

Factor	**Item**	**Mean**	**Factor**	**Item**	**Mean**
Lack of business information	Cash flow does not show that credit can be repaid	6.96	**Lack of managerial competency**	Bad credit record	6.88
	Business is not	6.90		Lack of experience	6.24

	financially viable				
	No business plan	6.85		Lack of resources to manage the firm	5.18
	No market potential	6.62		Lack of education	4.88
	No growth potential	5.85		Lack of business skills	4.82
				Lack of documentation	4.26
	No business premises	5.62		**Scale mean** **Cronbach's alpha**	**5.38** **0.721**
	Business plan not thorough in coverage of key issues	4.90	**Inefficient legal environment**	Costly to get judgment	6.34
	Business plan does not articulate opportunity	4.55		Takes time to get judgment	6.30
	Scale mean **Cronbach's alpha**	**6.03** **0.811**		Weak confidence in the legal system	4.62
Lack of networking	No prior relationship	6.94		Courts not fair or impartial	4.60
	Short prior relationship	6.76		Court decisions not enforced	4.18
	Lack of good reference on integrity	6.68		Corruption of court official	4.09
	No distribution of output arrangement	5.44		**Scale mean** **Cronbach's alpha**	**5.19** **0.710**
	Do not belong to same professional association	3.98	**Bad macro-economy**	Recession in the economy	4.88
	Scale mean **Cronbach's alpha**	**5.97** **0.757**		High interest rate	4.72
Crime	The business is not insured	5.78		**Scale mean** **Cronbach's alpha**	**4.80** **0.750**
	The business is located in high crime area	5.56	**Lack of collateral**	Low equity contribution	6.02
	Scale mean **Cronbach's alpha**	**5.67** **0.800**		No guarantee	2.05
Ethical perception	Perception of payment default	5.72		No current asset as collateral	2.01
	Perception of dishonesty in keeping commitments	5.66		No tangible asset as collateral	1.22
	Perception of willingness to divert funds to non-core activities	5.34		**Scale mean** **Cronbach's alpha**	**2.83** **0.825**
	Perception of false information and paddling of financials	5.44	**Corruption**	Corruption of government officials	3.88
	Scale mean **Cronbach's alpha**	**5.54** **0.789**		Corruption of firm officials	1.64
				Scale mean **Cronbach's alpha**	**2.76** **0.706**

B. T-test

The T-test was used to determine if there were differences in the mean scores of commercial banks and trade creditors with respect to the internal and external factors. Table 6.13 presents the results of the T-test.

Table 6.13: T-test for differences in the mean scores of commercial banks and trade creditors

Factors	Scale means for commercial banks	Scale means for trade creditors	T-test significance
Lack of collateral	6.01	2.83	**0.01**
Lack of business information	5.82	6.03	0.52
Lack of managerial competency	5.56	5.38	0.59
Bad macro-economy	5.48	4.80	0.69
Crime	5.05	5.67	0.75
Lack of networking	4.98	5.97	0.13
Ethical perception	2.92	5.54	**0.04**
Inefficient legal system	2.81	5.20	**0.03**
Corruption	2.45	2.76	0.27

Sig. at 0.05 (2-tailed)

C. Correlation

The Pearson was used to test for the direction and strength of relationship between the business environmental factors and non-availability of debt. Table 6.14 presents the results of the correlation.

Table 6.14: Correlation results for commercial banks and trade creditors

Factor	Commercial banks		Trade creditors	
	R	P-value	R	P-value
Lack of collateral	.956	0.01	.191	0.26
Lack of business information	.922	0.03	.938	0.01
Lack of managerial competency	.745	0.01	.668	0.01
Bad macro-economy	.722	0.01	.622	0.03
Crime	.664	0.04	.860	0.02
Lack of networking	.638	0.01	.889	0.01
Ethical perception	.168	0.18	.732	0.03
Inefficient legal system	.146	0.25	.657	0.01
Corruption	.103	0.22	.117	0.18

Sig. 0.05 (2-tailed)

- **Lack of collateral**

The scale means of lack of collateral for commercial banks and trade creditors are 6.01 and 2.83 respectively. The seven-point Likert scale was used and 4 is the midpoint. The mean scores indicate that there is a relationship between lack of collateral and non-availability of debt from commercial banks and a weak relationship for trade creditors. The Cronbach's alpha for the factor yielded a value of 0.825 for commercial banks and 0.725 for trade creditors indicating the reliability of the factor. The significance of the relationships was tested through the Pearson correlation (r=0.956, p-value=0.01) for commercial banks and (r=0.191, p value=0.26) for trade creditors. The results indicate that there is a significant positive relationship between lack of collateral and non-availability of debt from commercial banks and a weak insignificant relationship for trade creditors. In addition, the T-test shows a significant difference in the mean scores of the two sets of respondents.

The null hypothesis that there is no significant relationship between lack of collateral and non-availability of debt from commercial bank is rejected. For trade creditors, the null hypothesis is not rejected.

For commercial banks, lack of collateral is the most important reason why credit is not granted to new SMEs. The results show that a lack of tangible collateral and/or owners' equity will almost certainly lead to the decline of a loan application. This suggests that the availability of debt for new SMEs depends on their capital structure. This pecking order theory suggests that the availability of internal funds can impact on the availability of debt. Barbosa and Moraes (2004) find the more own money is invested by the business starter, the less likely it is that he will take on very risky investments. This reduces moral hazard. Blumberg and Letterie (2008:188) argue that collateral helps to reduce informational asymmetries and moral hazard problems that arise between banks and entrepreneurs. Collateral can be repossessed by the creditor in case of default thus enhancing creditor protection (Coco, 2000:191). Keasey and Watson (2000:247), and Storey (2004:401) point out that credible commitments guaranteeing the repayment of the debt, even if a new SME fails, are linked to collateral underlying the loan. Such collateral, which could be the business starter's private wealth as well as the firm's assets, reduce the bank's exposure in the case of loan default. The results suggest that the availability of collateral will positively impact

on the availability of debt from commercial banks. Huyghebaert (2006:320) did not find a significant positive relationship between the possession of tangible fixed assets by new SMEs and the use of trade credit, which is confirmed in this study.

According to Berger and Udell (2006:2950) taking collateral as security is attractive to bankers for two reasons: First, the willingness to offer collateral signals the confidence of an entrepreneur in both his/her abilities and also in the likely success of the project. Second, collateral acts as a signal enabling the bank to mitigate or eliminate the adverse selection problem caused by the existence of information asymmetries between the bank and the borrower at the time of the loan decision. Even if there is symmetry ex-ante between borrower and lender (i.e. the bank knows the credit quality of the borrower), the collateral helps to alleviate moral hazard problems once the loan has been granted. In this sense, the collateral pledged helps align the interests of both lenders and borrowers, avoiding a situation in which the borrower makes less effort to ensure the success of the project for which finance was given. Thus, collateral makes it possible to limit the problem of the moral hazard faced by all banks when they lend out money.

- **Lack of business information**

The scale means of lack of business information are 5.82 and 6.03 for commercial banks and trade creditors. The Cronbach's alpha for the factor yielded a value of 0.874 for commercial banks and 0.811 for trade creditors indicating the reliability of the factor. The Pearson correlation results are: Commercial bank (r=0.922, p value=0.02); trade creditors (r=0.938, p value=0.01). The mean scores indicate that there is a relationship between lack of business information and non-availability of debt from commercial banks and trade creditors. The T-test does not show any significant differences in the mean scores of both sets of respondents. The results of the correlation indicate a statistically significant positive relationship between lack of business information and non-availability of debt from both commercial banks and trade creditors.

The null hypothesis that there is no significant relationship between lack of business information and non-availability of debt from commercial banks and trade creditors is rejected and the alternate hypothesis is accepted.

The results suggest that the availability of reliable business information will positively impact on the availability of debt from both commercial banks and trade creditors. The results are consistent with the agency theory that asymmetric or incomplete information restricts access to external funds. Blumberg and Leterrie (2008:191) find that for instance if the owner of a new SME provides detailed and reliable business information, especially by writing a business plan, banks are more willing to grant a loan. The provision of information is costly for the entrepreneur and enhances the bank's faith in the success potential of the business idea. Pretorius and Shaw (2004:225) point out that a good business plan is perceived as one of the most essential documents to be prepared by the entrepreneur or small venture owner when setting up a business. Entrepreneurs and small business owners are encouraged to prepare a business plan for presentation to banks, financial institutions and venture capitalists to stand a chance of obtaining financial support. Kitindi *et al.* (2007:55) find that creditors, banks and other lenders use financial information provided by firms to analyse their present performance and predict future performance. New SME owners that are able to produce good business plans enhance their chances of loan approval from commercial banks and trade creditors.

- **Lack of managerial competency**

The scale means of lack of managerial competency are 5.56 and 5.38 for commercial banks and trade creditors respectively. The Cronbach's alpha for the factor yielded a value of 0.772 for commercial banks and 0.721 for trade creditors indicating the reliability of the factor. The Pearson correlation results are: Commercial banks (r =0.745, p-value=0.01), and trade creditors (r =0.668, p-value=0.01). The T-test does not show any significant difference in the mean scores of the two sets of respondents. The results indicate that there is a statistically significant positive relationship between lack of managerial competency and non-availability of debt from both commercial banks and trade creditors.

The null hypothesis that there is no significant relationship between lack of managerial competencies and non-availability of debt from commercial banks and trade creditors is rejected and the alternate hypothesis is accepted.

The results suggest that the managerial competency of the owners of new SMEs will positively impact on the availability of debt from commercial banks and trade creditors. Storey (2004:405) finds that a high education by the owner of new SME reduces the denial of loan applications. Blumberg and Letterie (2008:191) find that even in the case of the failure of a new SME, the earning capacity of the business starter in a subsequent job is a signal to the bank whether the business starter can meet his credit obligations. Highly educated business starters are more likely to have post-failure earning capacity than less educated people. Education together with experience in the field of the business increases the chances of loan approval. Lefebvre and Lefebvre (2002:283) find that managerial competency is the key element in investment readiness. Managerial competencies are positively associated with firm performance across a variety of organizational and industry settings. Access to all forms of debt capital is positively associated with business owners' managerial capacity.

- **Bad macro-economy**

The scale means of a bad macro-economy are 5.48 and 4.80 for commercial banks and trade creditors respectively. The Cronbach's alpha for the factor yielded a value of 0.799 for commercial banks and 0.750 for trade creditors indicating the reliability of the factor. The T- test does not show any significant differences in the two sets of means. The Pearson correlation results are: Commercial banks (r=0.722, p-value=0.04), trade creditors (r=0.622, p-value=0.02). The results indicate that there is a statistically significant positive relationship between a bad macro-economy and non-availability of debt from both commercial banks and trade creditors.
The null hypothesis that there is no significant relationship between a bad macro-economic environment and non-availability of debt from commercial banks and trade creditors is rejected and the alternate hypothesis is accepted.

The results suggest that a good macro-economy will positively impact on the availability of debt from commercial banks and trade creditors. Kutsuna and Cowling (2003) find that the availability of bank loan deteriorates under recessionary economic conditions. The authors find that during the Japanese economic recession in 1998 a significant proportion of loan applications from new SMEs were turned down. According to Barbosa and Moraes (2004) a depressed economic condition is a characteristic associated with the likelihood of a firm's failure to repay

its debt suggesting a reduction in credit approval. Gonzalez, Lopez and Saurina (2007) find that during the period of economic expansion, new firms use more trade credit. Baum and Caglavan (2008:73) find that as banks must acquire costly information on borrowers before extending loans to new or existing customers, uncertainty about economic conditions (and the likelihood of loan default) would have clear effects on their lending strategies. This implies that weak macroeconomic environment can cause information asymmetry.

- **Crime**

The scale means of crime are 5.05 and 5.67 for commercial banks and trade creditors respectively. The Cronbach's alpha for the factor yielded a value of 0.832 for commercial banks and 0.800 for trade creditors indicating the reliability of the factor. The T-test does not show any significant differences in the mean scores of both sets of respondents. The Pearson correlation results are: Commercial banks (r=0.664, p-value=0.04); trade creditors (r=0.860, p-value=0.02). The results indicate that there is a statistically significant positive relationship between crime and non-availability of debt from both commercial banks and trade creditors.

The null hypothesis that there is no significant relationship between crime and non-availability of debt from commercial banks and trade creditors is rejected and the alternate hypothesis is accepted.

The findings suggest that a reduction in crime rate in South Africa will positively impact on the availability of debt to new SMEs. Linden and Rockoff (2006) find that crime has a major impact on property values. Collateral located in high crime area is often unacceptable for credit. Furthermore, businesses located in high crime areas have lower access to debt finance than businesses located in low crime areas. Falkena *et al.* (2002) point out that crime increases moral hazards after the granting of credit and can affect the ability of SMEs to repay credit. An incidence of crime can lead to the bankruptcy of a new SME.

- **Lack of networking**

The scale means of networking are 4.98 and 5.97 for commercial banks and trade creditors respectively. The Cronbach's alpha for the factor yielded a value of 0.878 for commercial banks and 0.757 for trade creditors indicating the reliability of the factor. The T- test does not show any significant differences in the two sets of means. The Pearson correlation results are: commercial banks (r=0.638, p-value=0.01), trade creditors (r=0.889, p-value=0.01). The results indicate that there is a significant positive relationship between lack of networking and non-availability of debt from both commercial banks and trade creditors.

The null hypothesis that there is no significant relationship between lack of networking and non-availability of debt from commercial banks and trade creditors is rejected and the alternate hypothesis is accepted.

The results suggest that networking by the owners of new SMEs will positively impact on the availability of debt from commercial banks and trade creditors. Gulati and Gargiulo (2000:36) point out that the relationship between creditors and new SME owners usually takes place under conditions of uncertainty and information asymmetry. Networking therefore can provide an advantage to people who seek to obtain resources from others. Ngoc *et al.* (2009:870) agree that most new SMEs do not network with providers of funds when starting their businesses. In addition, very few new SMEs belong to professional associations. The lack of networking affects the legitimacy of the new SME. Robb and Fairlie (2008:1435) examine the reasons why Chinese, Indians and Korean SMEs are successful in the diaspora. The authors argue that the economic success of Chinese and Japanese immigrants is in part due to their networking. One of the explanations for high rates of economic success is the extensive social or ethnic resources such networks and credit associations. Networks 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 entrepreneurs through rotating credit associations, direct loans, and equity investments in the business.

Ebben and Johnson (2006:854) find that new SMEs get more trade credit from their suppliers when they have long-term business or personal relationships with suppliers, have frequent

interactions with suppliers, or are in the same networks with suppliers. Strong ties with suppliers should help convince suppliers to grant trade credit to a firm, thereby reducing the use of bank loans. The results are inconsistent with Owualah (2002:89) which find that long-standing relationship between a bank and new SME owner does not convey any advantage in the case of bank loans. The rejection of loan requests by banks has become a common phenomenon for old and new customers.

- **Ethical perception**

The scale means of ethical perception are 2.92 and 5.54 for commercial banks and trade creditors respectively. The Cronbach's alpha for the factor yielded a value of 0.789 for commercial banks and 0.752 for trade creditors indicating the reliability of the factor. The T-test (sig. 0.04) shows that there is a significant difference in the two sets of means. The Pearson correlation results are: Commercial banks (r=0.168, p-value=0.12), trade creditors (r=0.732, p-value=0.03). The results indicate that there is no significant relationship ethical perception of new SMEs and the non-availability of debt from commercial banks. For trade creditors, the results show that there is no significant relationship between ethical perception of new SMEs and non-availability of debt from commercial banks. However, the results show that there is a significant positive relationship between ethical perception of new SMEs and non-availability of debt from trade creditors.

The null hypothesis that there is no significant relationship between ethical perception of new SMEs and non-availability of debt from commercial banks is not rejected. For trade creditors, the null hypothesis is rejected and the alternate hypothesis is accepted.

The results suggest that positive ethical perception of new SMEs will positively impact on the availability of debt. Howorth and Moro (2006:28) as well as De la Torre *et al.* (2008) suggest that ethics and trust are important in small firm finance. Trust mitigates adverse selection and moral hazard, reduces screening and monitoring costs. However, banks can use other types of hard information such as credit scoring and financial statements for objective and justifiable decisions. This allows procedural fairness to be demonstrated and decisions to be more reliable. In addition, the possession of collateral by banks reduces the moral hazard and adverse selection of lending to new SMEs. However, according to Shane and Cable (2002:367), ethics is much

more important for trade creditors. A large amount of transactions in inter-firm trade is done on trust and ethical perception. Such relationships are governed by norms of fairness and equity. In addition, trade creditors seldom take collateral in inter-firm trade. This increases moral hazard. Therefore, positive ethical perception and trust of the owners of new SMEs will positively impact on the availability of debt especially from trade creditors.

- **Inefficient legal system**

The scale means of the inefficient legal system are 2.81 and 5.20 for commercial banks and trade creditors respectively. The Cronbach's alpha for the factor yielded a value of 0.777 for commercial banks and 0.710 for trade creditors indicating the reliability of the factor. The T-test shows that there is a significant difference in the two sets of means. The Pearson correlation results are: Commercial banks (r=0.146, p-value=0.25), trade creditors (r=0.657, p-value=0.01). The results indicate that there is no significant relationship between the inefficiency of the legal system and the non-availability of debt from commercial banks. However, the results indicate a significant positive relationship between the inefficiency of the legal system and non-availability of debt from trade creditors.

The null hypothesis that there is no significant relationship between the inefficiency of the legal system and non-availability of debt is not rejected for commercial banks. For trade creditors, the null hypothesis is rejected and the alternate hypothesis is accepted.

Beck *et al.* (2008) suggest that banks adapt to the legal environment in which they operate by offering instruments that allow them to circumvent existing deficiencies in the legal system. De la Torre *et al.* (2008) find that the pledging (as collateral) of assets that do not lose much value over time and are easily tradable provide greater assurances to banks of repayment, even where contract enforcement processes are relatively imperfect. Also, reliable accounts receivable can underpin factoring, while the renting of tangible and marketable assets through leasing can help overcome costly contract enforcement processes (as the creditor retains the property rights over the asset). In this way, banks can compensate for weaknesses in the legal environment. Frank and Maksimovic (2004) however find that the efficiency of the legal environment is critical to the availability of trade credit. The fact that most trade creditors do not take collateral increases the risk of moral hazard. Even, where the trade creditor has the right to repossess the goods in the

case of default, secondary sale of such goods is usually less than the original amount the seller is owned. The seller thus becomes an unsecured creditor. Conclusively, the results suggest that the efficiency of the legal system will positively impact on the availability of debt especially from trade creditors.

- **Corruption**

The scale means of corruption are 2.45 and 2.76 for commercial banks and trade creditors respectively. The Cronbach's alpha for the factor yielded a value of 0.713 for commercial banks and 0.706 for trade creditors indicating the reliability of the factor. The T- test shows that there is no significant difference in the two sets of means. The Pearson correlation results are: Commercial banks (r=0.103, p-value=0.22), trade creditors (r=0.117, p-value=0.18). The results indicate that there is no significant relationship between corruption and the non-availability of debt from commercial banks and trade creditors.

The null hypothesis that there is no statistically significant relationship between corruption and non-availability of debt from commercial banks and trade creditors is not rejected.

The results suggest that corruption does not significantly impact on the availability of debt from both commercial banks and trade creditors. The results are inconsistent with Weill (2009), which finds that a high level of corruption discourages banks from engaging in lending. Greater corruption adds to uncertainty of judicial decisions for banks, as they cannot count on the courts to enforce damages recoveries for losses or deficiency judgments against defaulting debtors, and consequently banks are expected to refrain from lending. However, commercial banks can reduce the hazards of corruption by taking collateral.

6.2.7.3 Internal and external factors compared

This section compares the results of the internal and external factors about why credit is not available from commercial banks and trade creditors to new SMEs as evidenced by Table 6.15.

The average means for internal factors for commercial banks and trade creditors are 5.59 and 5.05 respectively. The average means were obtained by adding together all the scale means of the four internal factors and dividing the figure obtained by four (refer to tables 6.11 & 6.12).

Table 6.15: Comparison of internal and external factors

Factor	Commercial banks	Trade creditors
Internal	5.59	5.05
External	3.74	4.86

The average means for external factors for commercial banks and trade creditors are 3.74 and 4.86 respectively. The average means were obtained by adding together all the scale means of the five external factors and dividing the figure obtained by five. In addition, all four the internal factors (collateral, business information, managerial competencies and networking) have strong significant relationships with availability of debt from commercial banks while only three (business information, managerial competencies and networking) have significant relationships for trade creditors. The results suggest that internal factors are important to commercial banks and trade creditors for the granting of credit. This furthermore suggests that commercial banks rate internal factors (5.59 to 5.05) higher than trade creditors with regards to the reasons why credit is not available to new SMEs. Collateral is the major source of difference in the results for commercial banks and trade creditors with respect to internal factors. If collateral is excluded for trade creditors, the mean becomes 5.79, which is similar to the mean for commercial banks (5.59). This indicates the importance of internal factors to both commercial banks and trade creditors.

In addition, the results suggest that external factors (4.86 to 3.74) are more important to trade creditors than commercial banks. To both commercial banks (5.59 to 3.74) and trade creditors (5.05 to 4.86) internal factors are the more important reason why credit is not available to new SMEs. To trade creditors, however, external factors are also very important. Four out of the five external factors (crime, macro-economy, ethical perception and legal system) are significant for trade creditors, while only two external factors (crime and bad macro-economy) are significant for commercial banks. De la Torre *et al.* (2008), and Beck *et al.* (2008) suggest that because commercial banks usually take collateral before approving loan requests from SMEs, the importance of external factors is reduced. Trade creditors are more interested in the external environments such as the efficiency of the legal system and ethics because this could reduce the moral hazard of granting credit to new SMEs.

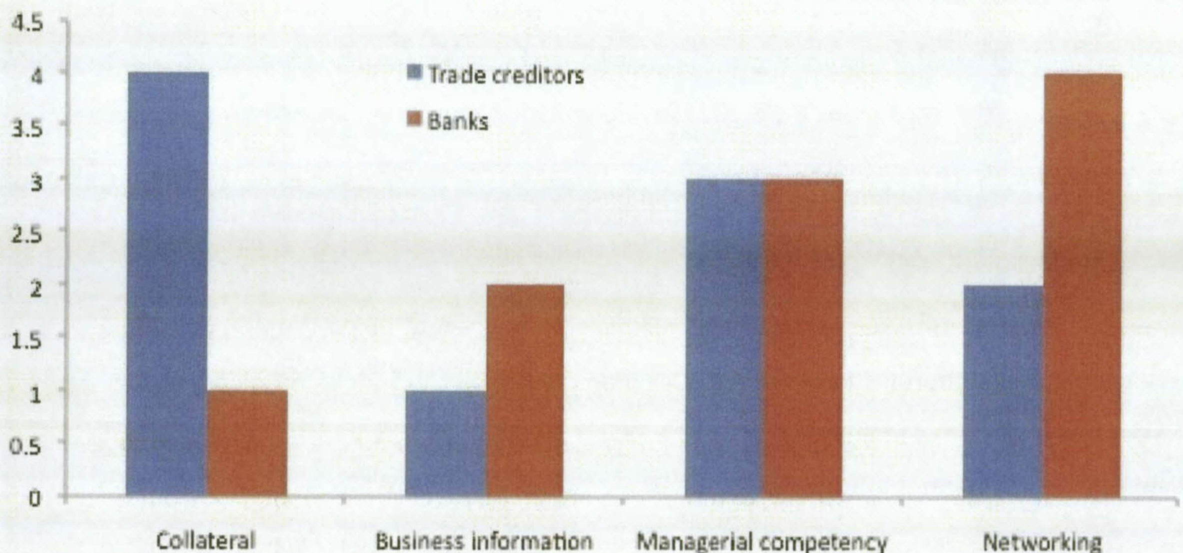
6.2.7.4 Internal and external factors and demographic variables

Appendices 18, 19 and 20 indicate the results of the T-test and ANOVA. The results indicate that there are no significant differences in demographic variables versus internal and external factors.

6.2.8 Ranking of internal and external factors by the respondents

The respondents were requested to rank the internal and external factors with respect to why credit is not available to new SMEs. Because there are four internal factors, the ranking is from 1 to 4, with 1 being the most important factor and 4 being the least important factor. In addition, since there are five internal factors, the ranking is from 1 to 5, with 1 being the most important factor and 5 being the least important factor. This is the section E of the questionnaire for commercial banks and section F of the questionnaire for trade creditors. Figures 6.7 and 6.8 present the results.

Figure 6.7: Ranking of internal factors by commercial banks and trade creditors



According to Figure 6.7 collateral is ranked first by commercial banks, business information is ranked second, managerial competency is ranked third and networking is ranked fourth. For trade creditors business information is ranked first, networking is ranked second, managerial competency is ranked third and collateral is ranked fourth. These rankings by the respondents further confirm the results of the factor analysis and the item analysis. The results furthermore confirm the importance of business information and managerial competencies to the granting of

credit to new SMEs for both commercial banks and trade creditors. However, collateral is the most important factor for commercial banks with networking the least, with almost exactly the opposite ranking for the trade creditors.

Figure 6.8: Ranking of external factors by commercial banks and trade creditors

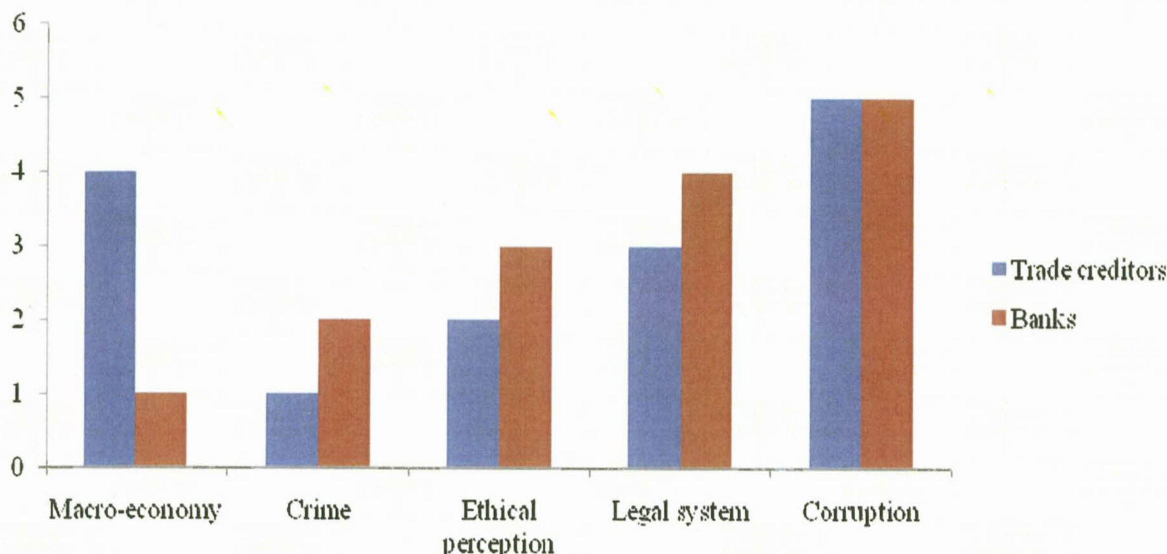


Figure 6.8 shows that commercial banks rank the macro-economy as the most important external factor. Loans from commercial banks are significantly influenced by tough macro-economic conditions, while trade creditors might be the only debt option to new SMEs in difficult times. This confirms the importance of trade creditors in difficult economic times. Crime is ranked second by commercial banks. The efficiency of the legal system, ethics and corruption are ranked third, fourth and fifth by commercial banks. For trade creditors, crime is ranked as the most important external factor, followed by ethical perception, the efficiency of the legal system, the macro-economy and corruption. The results furthermore confirm that the high crime rate in South Africa inhibits the availability of debt to new SMEs. Again, it is apparent that trade creditors put a much larger premium on ethics than commercial banks. In the absence of collateral, this makes sense. The ranking of the five external factors by commercial banks and trade creditors further confirms the results of the factor analysis and item analysis.

6.2.9 Rejection of the credit applications by commercial banks and trade creditors

This section examines the perception of the respondents about the rejection rates of the applications for credit of new SMEs by commercial banks and trade creditors. This is section G of the questionnaire for commercial banks and section H of the questionnaire for trade creditors. Table 6.16 presents the results.

Table 6.16: Perception of rejection rates by commercial banks and trade creditors

Variable	Bank (%)	Trade creditors (%)
Extremely high	78	72
Very high	15	13
Moderately high	6	14
Do not know	0	0
Moderately low	1	1
Very low	0	0
Extremely low	0	0
Total	100	100

Table 6.16 shows that the rejection rates of credit applications of new SMEs by commercial banks and trade creditors are extremely high. According to Blumberg and Letterie (2008:191) the rejection rate of SMEs can be used as a proxy for the availability of debt finance to new SMEs. The extremely high rejection rates indicate low availability of debt finance to new SMEs. The findings indicate that commercial banks and trade creditors perceive new SMEs as a very risky market. This implies that commercial banks and trade creditors need to tread very carefully in their dealings with new SMEs and this negatively impacts on the availability of debt to new SMEs.

The results highlight the limited availability of debt to new SMEs in South Africa compared to established SMEs and large firms. According to FinMark Trust (2006) the incidence of loans and borrowing from the formal financial sector by new SMEs in South Africa is extremely low. The results furthermore confirm that both commercial banks and trade creditors consider new SMEs

as very risky despite the perceived benefits of the sector. Von Broembsen *et al.* (2005) point out that 75% of credit applications by new SMEs to banks in South Africa is rejected. In addition, the use of trade credit by new SMEs in South Africa is virtually non-existent. The situation is however markedly different in developed countries. According to Statistics Canada (2007), there is approximately 82% approval rate for credit applications by new SMEs in Canada. In addition, more than 40% of new SMEs in Canada use trade credit. In England 71% of applications for credit by new SMEs from financial institutions between 2004 and 2007 were approved and only 26% were wholly or partially rejected. In addition, in the United States of America more than 50% of new SMEs are able to access credit from commercial banks and trade creditors (Berger & Udell, 2002:2130). Reitan and Waago (2002) find that banks are still the dominant source of finance for new SMEs in Norway and most European countries. This study has been able to point out the internal and external factors why the credit is not available to new SMEs in South Africa. Recommendations to improve the availability of debt to new SMEs are therefore of utmost importance.

6.3 SUMMARY

This chapter presented the empirical findings of the study. Using the Koglomorov-Smirnov test ensured the normality of the data. The response rate for commercial banks was 45.8% and for trade creditors 74.0%. The mean response rate for the two sets of respondents is 58.6%. The empirical findings on demographic variables were presented using figures and tables. The chapter also presented the empirical findings about whether commercial banks and trade creditors perceive new SMEs as beneficial to their business. The results indicate that commercial banks and trade creditors perceive new SMEs as beneficial to their business. However, new SMEs are also perceived as very risky. The perception of risk is greater than the perception of benefit. In addition, the chapter examined the importance attached to certain internal and external variables during the credit evaluation process. The results showed that both internal factors and external factors are important in the credit evaluation process. The average means for internal factors for commercial banks and trade creditors are 5.79 and 4.72 respectively. The average means for external factors for commercial banks and trade creditors are 3.44 and 4.84 respectively. The results suggest that commercial banks rate internal factors higher than trade creditors, while trade creditors rate external factors higher than commercial banks. Furthermore,

the chapter presented empirical findings on the relationship between internal and external environmental variables and non-availability of debt finance to new SMEs. The results indicated that there is a significant relationship between lack of collateral and non-availability of debt from commercial banks. In the case of trade creditors, the results found an insignificant relationship.

In addition, the study found significant relationships between lack of business information, lack of managerial competencies, lack of networking, crime and a bad macro-economy the availability of debt from both commercial banks and trade creditors. The results furthermore indicated that for commercial banks, there are insignificant relationships between the inefficiency of the legal environment and ethical perception and non-availability of debt from commercial banks. In the case of trade creditors, the relationships are significant. Also, the results suggest an insignificant relationship between corruption and non-availability of debt from commercial banks and trade creditors. Finally, the availability of debt to new SMEs was examined. It was found that the rejection rates of new SMEs' application for credit by commercial banks and trade creditors are very high indicating a high degree of non-availability of debt.

The next chapter will examine the conclusions and recommendations of the study. In addition, the achievement of the objectives of the study will be presented. Furthermore, the limitations of the study and areas for further study will be discussed.

CHAPTER SEVEN

CONCLUSIONS AND RECOMMENDATIONS

7.1 INTRODUCTION

This chapter concludes a study that was undertaken to determine how to improve the availability of debt to new SMEs in the Eastern Cape Province of South Africa. According to the literature, lack of finance is one of the major factors causing the low creation rate and high failure rate of new SMEs in South Africa. The argument of the study was that there are factors in the business environment (internal and external environments) that cause debt not be available from commercial banks and trade creditors to new SMEs. Therefore, to improve the availability of debt to new SMEs, the causes of non-availability must be determined. In the final chapter of the thesis, the research findings and the recommendations will be discussed. In addition, the limitations of the study and the areas for future research will be stated. The chapter proceeds as follows. Section 7.2 of this chapter presents a brief summary of each chapter including the findings. Section 7.3 will highlight the recommendations. Section 7.4 discusses the achievement of objectives. Section 7.5 will examine the limitations of the study and section 7.6 will highlight the areas for further study. Finally, section 7.7 will conclude the study.

7.2 SUMMARY

This thesis is made up of seven chapters. The summary of the chapters is presented from section 7.21 to 7.26.:

7.2.1 Introduction to the study (Chapter One)

This primary focus of this thesis was to determine how to improve the availability of debt to new SMEs. Specifically the thesis investigated the factors in the internal and external environments cause of the aversion of commercial banks and trade creditors to granting credit to new SMEs. According to the World Bank (2007) the major development challenges that South Africa face are high unemployment and high levels of poverty and income inequality. The proportion of the population living below the poverty line is 57% and the Gini coefficient (a measure of income inequality) is at 0.58 the highest in the world. Unemployment is 24.5% according to Statistics

South Africa (2009). SMEs, especially new ones, are expected to be one of the important vehicles to address the development challenges. As pointed out by Maas and Herrington (2006) new firms stir development and innovation, push old firm to improve their efficiency, inject new blood into the veins of the economy, result in economic growth, with positive impact on poverty alleviation, income inequality and job creation. A country without a high new firm start-up rate risks economic stagnation.

The creation of new SMEs is very low in South Africa. According to Herrington *et al.* (2009) South Africa was ranked 23rd out of 43 countries surveyed by GEM in 2008. In 2008, South Africa's TEA was 7.8% which was below the average rate of 10.6% surveyed by GEM. South Africa's TEA rate of 7.8% is significantly lower than the average for all efficiency-driven economies (11.4% in developed countries) as well as the average for all middle to low income countries (13.2%), where South Africa belongs. A country at South Africa's stage of economic development would be expected to have a TEA rate in the order of 13%, almost double South Africa's TEA rate of 7.8%. South Africa's low new small firm creation rates paint a bleak picture of the SME sector's current potential to contribute meaningfully to job creation, economic growth and more equal income distribution.

In addition, as pointed out by Herrington *et al.* (2009) 75% of new SMEs created in South Africa fail within the first two years of operation. The lack of external finance is one of the major reasons for the low creation and high failure rates. Internal equity is often inadequate to sustain growth. Also, most new SMEs in both developed and developing countries do not have access to outside equity such as venture capitalists and the stock market. Therefore new SMEs need to access debt finance, especially from commercial banks and trade creditors. These sources of finance, which are readily available to new SMEs in developed countries, are often not available to new SMEs in developing countries such as South Africa. Factor analysis established nine factors comprising of four internal factors and five external factors. Based on the introduction and the background of the study, the research problems and hypotheses were stated. The research problems for the study were:

- What is the impact of the business environment (internal and external environments) on non-availability of debt from commercial banks and trade creditors to new SMEs?

- Do commercial banks and trade creditors perceive new SMEs as beneficial to their business?

In order to provide solutions to these problems, it was necessary to first perform a review of the literature and develop hypotheses. The primary research hypothesis for the study was:

Ho There is no significant relationship between the business environment and non-availability of debt to new SMEs.
Ha There is a significant positive relationship between the business environment and non-availability of debt to new SMEs.

The primary hypothesis was established through the following hypotheses, which included the internal and the external environments.

- **Internal environment**
  - *Collateral*

H1o There is no significant relationship between lack of collateral and non-availability of debt to new SMEs.
H1a There is a significant positive relationship between lack of collateral and non-availability of debt to new SMEs.

- *Business information*

H2o There is no significant relationship between lack of business information and non-availability of debt to new SMEs.
H2a There is a significant positive relationship between lack of business information and non-availability of debt to new SMEs.

- *Managerial competency*

H3o There is no significant relationship between lack of managerial competency and non-availability of debt to new SMEs.
H3a There is a significant positive relationship between lack of managerial competency and non-availability of debt to new SMEs.

➢ *Networking*

H4o There is no significant relationship between lack of networking and non-availability of debt to new SMEs.

H4a There is a significant positive relationship between lack of networking and non-availability of debt to new SMEs.

- **External environment**

➢ *Macro-economy*

H5o There is no significant relationship between a bad macro-economic environment and non-availability of debt to new SMEs.

H5a There is a significant positive relationship between a bad macro-economic environment and non-availability of debt to new SMEs.

➢ *Legal system*

H6o There is no significant relationship between the inefficiency of the legal system and non-availability of debt to new SMEs.

H6a There is a significant positive relationship between the inefficiency of the legal system and non-availability of debt to new SMEs.

➢ *Ethics*

H7o There is no significant relationship between ethical perception of new SMEs and non-availability of debt.

H7a There is a significant positive relationship between ethical perception of new SMEs and non-availability of debt.

➢ *Crime*

H8o There is no significant relationship between crime and non-availability of debt to new SMEs.

H8a There is a significant positive relationship between crime and non-availability of debt to new SMEs.

- *Corruption*

H9o There is a no significant relationship between corruption and non-availability of debt to new SMEs.

H9a There is a significant positive relationship between corruption and non-availability of debt to new SMEs.

The secondary research hypothesis for the study was:

Ho Commercial banks and trade creditors do not perceive new SMEs as beneficial to their business.

Ha Commercial banks and trade creditors perceive new SMEs as beneficial to their business.

7.2.2. SMEs and development (Chapter Two)

Chapter two of this thesis focused on the role of SMEs in development. As pointed out by Todaro and Smith (2009:10) development should answer three basic questions: What has been happening to poverty? What has been happening to income inequality? And what has been happening to unemployment? The chapter examined literature with respect to the role of small firms in solving the basic question of development. SMEs, especially new ones, are found to have a major role to play in answering the questions of development. Literature revealed that there are many reasons for small business failure. Non-availability of finance appears to be one of the consistent reasons for the failure of new SMEs. Entrepreneurs argued that it is a major problem, whereas fund providers suggested that lack of management skills (which could also perpetuate non-availability of finance) is the major problem for the failure of new SMEs. The conclusion of this chapter as pointed out by Maas and Herrington (2006) is that "*without appropriate financing, new SMEs simply cannot grow, compete and create jobs. The issue of finance must be addressed if an environment promoting entrepreneurship and SME development is to be encouraged in South Africa*".

7.2.3 Financing new SMEs (Chapter Three)

Chapter three of this thesis explored the financing of new SMEs. The chapter started by examining the needs for capital and sources of capital for new SMEs. The needs for capital for SMEs include working capital, fixed asset purchases, product development and initial losses and other reasons such as human capital development and training. The sources of capital were explained through the capital structure. Capital structure theories such as the static trade-off theory, the agency theory and the pecking order theory were explored. Conventional capital structure theory concludes that there must be a balance between the use of equity and debt in any business. The static trade-off theory suggests that new SMEs should use debt because of the tax advantages, the disciplining effect of debt and ability of the owner of the firm to maintain

control. However, debt also has the disadvantages of bankruptcy, agency problems and moral hazards suggesting that new SMEs should use equity. Finding the balance between the tax benefits of debt versus the bankruptcy cost, agency problems and moral hazards of the excessive use of debt is at the heart of the capital structure debate. Determining the amount of debt to be used by new SMEs is a huge debate. Myers (1984:583) calls it a puzzle. Rungani (2008) points out that a key consideration in choosing the sources of finance for a new SME is to strike a balance between equity and debt to ensure that the funding structure suits the business. Literature revealed that credit from commercial banks and from trade creditors is a major component of start-up capital to new SMEs and is also readily available in most developed countries, such as the USA, Canada, England and most European countries. However, new SMEs in specifically developing countries such as South Africa find it difficult to access debt finance leading to a debt gap. Beck (2007:404) points out that "*there are certain factors in the internal and external environment (the business environment) of new SMEs that cause the aversion of commercial banks and trade creditors to granting credit, thus the major sources of debt capital.*"

7.2.4 The business environment and new SMEs (Chapter Four)

Chapter four examined the literature in respect of the business environment and new SMEs. The chapter specifically reviewed the literature on how the business environment can impact on non-availability of debt to new SMEs. For credit to flow to new SMEs, the risk perception of lending to them must be reduced. The argument of this chapter is that there are certain factors in the internal and external environment (business environment) of new SMEs that can increase the risk perception of lending to them. Identification of these factors will encourage lending to new SMEs. The internal environment includes factors such as managerial competencies, collateral, networking and business information. In addition, literature on the impact of external environmental factors such as the legal system, ethics, macro-economic conditions, crime and corruption were explored. The conclusion of the chapter was that "*there is the need to investigate empirically the impact of the business environment on non-availability of debt finance to new SMEs in South Africa*".

7.2.5 Research methodology (Chapter Five)

Chapter five of the thesis dealt with the research methodology. This chapter examined aspects of the study, including research designs, variable definitions and measurements, model development, data collection methods, and data analysis. This study was a combination of exploratory, descriptive and causal research in which the simple random sampling technique was used to draw a sample. Data was collected through the use of self-administered questionnaires. Data collected was transformed into more suitable format for analysis by utilizing Excel software. After data processing, the Statistic Package for Social Science (SPSS) was utilized for data analysis. Statistical techniques used in this study included descriptive statistics. Other statistical analysis techniques such as factor analysis, correlation, T-tests and ANOVA were used in the study.

7.2.6 Research findings (Chapter six)

The research findings were explained according to the formats of the questionnaires for commercial banks and trade creditors.

7.2.6.1 Response rate

The response rate for commercial bank was 45.8% and for trade creditors was 74.0%. The mean response rate was 58.6%. The results indicated that trade creditors responded better to the survey than commercial banks.

7.2.6.2 Demographics

Most respondents for both banks and trade creditors were in the 31-40 age bracket. For both sets of respondents, males dominated. Most of the respondents were well educated with diplomas and degrees with about 6-10 years experience. In addition, the trade creditor respondents' firms are predominantly independent, medium-size businesses in the manufacturing sector.

7.2.6.3 Granting of trade credit (trade creditors only)

The question was necessary to establish whether the responding firms grant trade credit. The results indicated that 222 (approximately 95%) respondents grant trade credit. Only 11 respondents (approximately 5%) do not grant trade credit to SMEs. The 11 respondents who do not grant credit at all were eliminated from the survey. This made the usable sample of trade creditors to be 222 firms.

7.2.6.4Perception of the benefits in new SMEs

Table 7.1 summarises the benefit/risk profile of new SMEs by commercial banks and trade creditors as shown by the findings of the study. The means of the measures of benefit and risk are given.

Table 7.1: Benefit/risk profile of new SMEs by commercial banks and trade creditors

Variable	Commercial banks	Trade creditors
Benefit	4.77	4.98
Risk	5.52	5.26

The scale mean for benefits (obtained by adding the means of the five benefits variables and dividing the results by 5) for commercial banks is 4.77 and for trade creditors 4.98 (on a 7 point Likert scale). The results indicate that both commercial banks and trade creditors perceive benefits in new SMEs. The results furthermore suggest that trade creditors perceive greater benefits in new SMEs compared to commercial banks. The results also indicate that both commercial banks and trade creditors perceive new SMEs as a risky sector with high failure rates with a scale mean of 5.52 and 5.26 respectively. Commercial banks have a higher perception of the riskiness of new SMEs compared to trade creditors. Thus, commercial banks and trade creditors perceive the risk of new SMEs as greater than the benefits. **The null hypothesis that commercial banks and trade creditors do not perceive benefits in new SMEs is rejected in favour of the alternative hypothesis. However, the results also indicate that new SMEs are perceived as a high risk sector with high failure rates. The risk/benefit profile of new SMEs indicates that the perceived risk of the sector is greater than the perceived benefit.**

7.2.6.5 Importance attached to internal and external factors in credit evaluation by commercial banks and trade creditors

Table 7.2 summarises the importance attached to internal and external factors in credit evaluation by commercial banks and trade creditors as depicted by the findings of the study. The means for the internal and external factors are given.

Table 7.2: The importance attached to internal and external factors by commercial banks and trade creditors

Factor	Commercial banks	Trade creditors
Internal	5.79	4.72
External	3.44	4.84

Factor analysis identified nine factors made up of four internal factors and five external factors. The internal factors are collateral, business information, networking and managerial competencies. The external factors are crime, the macro-economy, ethics, legal system and corruption. The average mean of internal factors for commercial banks is 5.79 and for trade creditors 4.72. This suggests that internal factors are important to both commercial banks and trade creditors in credit evaluation. The results furthermore suggest that commercial banks attach higher importance to internal factors than trade creditors. The most important internal factors for commercial banks are collateral and business information respectively (both are above 6 on a 7 point Likert scale). This is followed by managerial competency and networking in the order of importance. The most important internal factor for trade creditors is business information followed by networking and managerial competencies. The least important internal factor to trade creditors is collateral. However, if the collateral is excluded from the variables for trade creditors the average mean of internal factors for trade creditors becomes 5.68, which is similar to the results for commercial banks 5.79.

The average means for external factors for commercial banks and trade creditors are 3.44 and 4.84 respectively. The most important external environmental factors for commercial banks when evaluating credit applications from new SMEs are the macro-environment and crime. Both factors have mean scores above 4 on a seven point Likert scale. The least important is corruption for both sets of respondents. In addition, ethics and the efficiency of the legal environment are

more important to trade creditors as compared to commercial banks. The results suggest that external factors (4.84 to 3.44) are more important to trade creditors than commercial banks in the evaluation of credit applications from new SMEs.

7.2.6.6 Reasons why credit is not available to new SMEs

The nine factors as determined by the factor analysis were investigated to determine the impact of the business environment on non-availability of debt from commercial banks and trade creditors to new SMEs. This was the main investigate part of the study. Nine secondary hypotheses were developed. Pearson correlation was used to determine the significance of the relationships. The findings were as follows:

- *Lack of collateral (internal)*

The scale means of lack of collateral for commercial banks and trade creditors are 6.01 and 2.83 respectively. The Cronbach's alpha for the factor yielded a value of 0.825 for commercial banks and 0.725 for trade creditors indicating the reliability of the factor. The significance of the relationships was tested through the Pearson correlation (r=0.956, p-value=0.01) for commercial banks and (r=0.191, p value=0.26) for trade creditors. The results indicate that there is a significant positive relationship between lack of collateral and non-availability of debt from commercial banks and a weak insignificant relationship for trade creditors.

The null hypothesis that there is no significant relationship between lack of collateral and non-availability of debt from commercial bank is rejected. For trade creditors, the null hypothesis is not rejected.

It can therefore be concluded that to improve the availability of debt from commercial banks, new SMEs must provide collateral.

- *Lack of business information (internal)*

The scale means of lack of business information are 5.82 and 6.03 for commercial banks and trade creditors. The Cronbach's alpha for the factor yielded a value of 0.874 for commercial

banks and 0.811 for trade creditors indicating the reliability of the factor. The Pearson correlation results are: Commercial bank (r=0.922, p value=0.02); trade creditors (r=0.938, p value=0.01). The results of the correlation indicate a statistically significant positive relationship between lack of business information and non-availability of debt from both commercial banks and trade creditors.

The null hypothesis that there is no significant relationship between lack of business information and non-availability of debt from commercial banks and trade creditors is rejected and the alternate hypothesis is accepted.

It can be concluded that both commercial banks and trade creditors are significantly more inclined to grant credit if sufficient and reliable business information from the new SME is available.

- *Lack of managerial competency (internal)*

The scale means of lack of managerial competency are 5.56 and 5.38 for commercial banks and trade creditors respectively. The Cronbach's alpha for the factor yielded a value of 0.772 for commercial banks and 0.721 for trade creditors indicating the reliability of the factor. The Pearson correlation results are: Commercial banks (r =0.745, p-value=0.01), and trade creditors (r =0.668, p-value=0.01). The results indicate that there is a statistically significant positive relationship between lack of managerial competency and non-availability of debt from both commercial banks and trade creditors.

The null hypothesis that there is no significant relationship between lack of managerial competencies and non-availability of debt from commercial banks and trade creditors is rejected and the alternate hypothesis is accepted.

It can therefore be concluded that the managerial competency of the owners of new SMEs will positively impact on the availability of debt from both commercial banks and trade creditors.

- Bad macro-economy

The scale means of a bad macro-economy are 5.48 and 4.80 for commercial banks and trade creditors respectively. The Cronbach's alpha for the factor yielded a value of 0.799 for commercial banks and 0.750 for trade creditors indicating the reliability of the factor. The Pearson correlation results are: Commercial banks (r=0.722, p-value=0.04), trade creditors (r=0.622, p-value=0.02). The results indicate that there is a statistically significant positive relationship between a bad macro-economy and non-availability of debt from both commercial banks and trade creditors.

The null hypothesis that there is no significant relationship between a bad macro-economic environment and non-availability of debt from commercial banks and trade creditors is rejected and the alternate hypothesis is accepted.

The results indicate that both commercial banks and trade creditors are therefore significantly more hesitant to grant credit in economically difficult times. This suggests that a good macro-economic environment will positively impact on the availability of debt.

- *Crime (external)*

The scale means of crime are 5.05 and 5.67 for commercial banks and trade creditors respectively. The Cronbach's alpha for the factor yielded a value of 0.832 for commercial banks and 0.800 for trade creditors indicating the reliability of the factor. The Pearson correlation results are: Commercial banks (r=0.664, p-value=0.04); trade creditors (r=0.860, p-value=0.02). The results indicate that there is a statistically significant positive relationship between crime and non-availability of debt from both commercial banks and trade creditors.

The null hypothesis that there is no significant relationship between crime and non-availability of debt from commercial banks and trade creditors is rejected and the alternate hypothesis is accepted.

There exists a significant negative relationship between the perception of crime and the availability of debt from both commercial banks and trade creditors. This suggests that a reduction in crime rate will positively impact on the availability of debt.

- *Lack of networking (internal)*

The scale means of networking are 4.98 and 5.97 for commercial banks and trade creditors respectively. The Cronbach's alpha for the factor yielded a value of 0.878 for commercial banks and 0.757 for trade creditors indicating the reliability of the factor. The Pearson correlation results are: commercial banks (r=0.638, p-value=0.01), trade creditors (r=0.889, p-value=0.01). The results indicate that there is a significant positive relationship between lack of networking and non-availability of debt from both commercial banks and trade creditors. This suggests that networking significantly impacts on the availability of debt from commercial banks and trade creditors.

The null hypothesis that there is no significant relationship between lack of networking and non-availability of debt from commercial banks and trade creditors is rejected and the alternate hypothesis is accepted.

Both commercial banks and trade creditors regard networking by start-up entrepreneurs as significantly important in deciding to grant credit to new SMEs. Although there is not a significant difference (sig. 0.13) as to the importance of networking to both sets of respondents, trade creditors regard it as even more important in the credit granting decision to new SMEs.

- *Ethics (external)*

The scale means of ethical perception are 2.92 and 5.54 for commercial banks and trade creditors respectively. The Cronbach's alpha for the factor yielded a value of 0.789 for commercial banks and 0.752 for trade creditors indicating the reliability of the factor. The Pearson correlation results are: Commercial banks (r=0.168, p-value=0.12), trade creditors (r=0.732, p-value=0.03). The results indicate that there is no significant relationship ethical perception of new SMEs and the non-availability of debt from commercial banks. For trade creditors, the results show that there is a positive significant relationship between ethical perception of new SMEs and non-availability of debt from trade creditors.

The null hypothesis that there is no significant relationship between ethical perception of new SMEs and non-availability of debt from commercial banks is not rejected. For trade creditors, the null hypothesis is rejected and the alternate hypothesis is accepted.

Thus, trade creditors regard the ethical behaviour of entrepreneurs as significantly important to grant credit to new SMEs. In the absence of expecting collateral from SMEs by trade creditors, this makes perfect sense. Commercial banks regard collateral as critically important in granting credit and therefore rely less on the ethical behaviour of the entrepreneur.

- *Inefficiency of the legal system (External)*

The scale means of the inefficient legal system are 2.81 and 5.20 for commercial banks and trade creditors respectively. The Cronbach's alpha for the factor yielded a value of 0.777 for commercial banks and 0.710 for trade creditors indicating the reliability of the factor. The Pearson correlation results are: Commercial banks (r=0.146, p-value=0.25), trade creditors (r=0.657, p-value=0.01). The results indicate that there is no significant relationship between the inefficiency of the legal system and the non-availability of debt from commercial banks. However, the results indicate a significant positive relationship between the inefficiency of the legal system and the non-availability of debt from trade creditors. This suggests that the efficiency of the legal system significantly impacts on the availability of debt from trade creditors. For commercial banks, the relationship appears to be insignificant.

The null hypothesis that there is no significant relationship between the inefficiency of the legal system and non-availability of debt is not rejected for commercial banks. For trade creditors, the null hypothesis is rejected and the alternate hypothesis is accepted.

Again, trade creditors need an efficient legal system to grant credit to new SMEs, because they do not have collateral. To commercial banks the legal system is less important because they rely on sufficient collateral in granting credit to new SMEs.

- *Corruption (external)*

The scale means of corruption are 2.45 and 2.76 for commercial banks and trade creditors respectively. The Cronbach's alpha for the factor yielded a value of 0.713 for commercial banks and 0.706 for trade creditors indicating the reliability of the factor. The Pearson correlation results are: Commercial banks (r=0.103, p-value=0.22), trade creditors (r=0.117, p-value=0.18). The results indicate that there is no significant relationship between corruption and the non-availability of debt from commercial banks and trade creditors. This suggests that corruption does not significantly impact on the availability of debt from both commercial banks and trade creditors.

The null hypothesis that there is no statistically significant relationship between corruption and non-availability of debt from commercial banks and trade creditors is not rejected.

It can be concluded that corruption do not impact directly on the availability of debt financing by both commercial banks and trade creditors. Thus, the respondents perceive that corruption do not significantly influence the riskiness of new SMEs.

Table 7.3 summarises the average means for internal and external factors for the reasons why credit is not available from commercial banks and trade creditors to new SMEs.

Table 7.3 Comparison of internal and external factors on why credit is not available to new SMEs

Factor	Commercial banks	Trade creditors
Internal	5.42	4.85
External	3.56	4.54

The average means for internal factors for commercial banks and trade creditors are 5.42 and 4.85 respectively. The average means for external factors for commercial banks and trade creditors are 3.56 and 4.54 respectively. In addition, all the four internal factors (lack of collateral, lack of business information, lack of managerial competency and lack of networking) have significant positive relationships with non-availability of debt from commercial banks while only three (lack of business information, lack of managerial competency and lack of

networking) have significant relationships for trade creditors. The results suggest that internal factors are important to both commercial banks and trade creditors. The furthermore suggests that commercial banks rate internal factors (5.42 to 4.85) higher than trade creditors with regards to the reasons why credit is not available to new SMEs.

The average means for external factors for commercial banks and trade creditors are 3.56 and 4.54 respectively. The results suggest that external factors are more important to trade creditors than commercial banks with respect to non-availability of debt. To both commercial banks (5.42 to 3.56) and trade creditors (4.85 to 4.54) internal factors are the more important reasons why debt is not available. To trade creditors, however, external factors are also very important. Four out of the five external factors (crime, bad macro-economy, ethical perception and the inefficiency of the legal system) are significant for trade creditors, while only two external factors (crime and bad macro-economy) are significant for commercial banks.

The results show that lack of collateral (including owners' equity contribution) is the most important reason why credit is not available to new SMEs from commercial banks. Owners' equity contribution is also very important to trade creditors. Commercial banks are generally risk-averse and always look for ways to mitigate the risks in lending. According to Jimenez and Saurina (2004:2195) the collateral pledged by borrowers may help attenuate the problem of adverse selection faced by the bank when lending. Thus, collateral makes it possible to limit the problem of the moral hazard faced by all banks when they lend money. In addition, the availability of business information, networking and managerial competencies significantly impact on the availability of debt. Sarapaivanich and Kotey (2006:221) point out that lack of business information regarding the underlying quality of the project gives rise to information asymmetry and adverse selection problems and leads to credit rationing. Nguyen and Ramachandran (2006:206) note that managerial competencies can help to reduce information asymmetry before a loan is granted and potential moral hazard after the loan is granted. Shane and Cable (2002:366) find that networking can be used to reduce information asymmetry in creditor/debtor relationships. Furthermore, Falkena *et al.* (2002) point out that crime increases moral hazards after the granting of credit and can affect the ability of SMEs to repay credit. Barbosa and Moraes (2004) find that a depressed economic condition is a characteristic

associated with the likelihood of a firm's failure to repay its debt suggesting a reduction in credit approval. Howorth and Moro (2006:30) state that ethics mitigate adverse selection and moral hazard and also reduce screening and monitoring costs in lending. Frank and Maksimovic (2004) find that the efficiency of the legal environment reduces moral hazard.

7.2.6.7 Ranking of internal and external factors by commercial banks and trade creditors

Regarding the internal factors, collateral is ranked first by commercial banks, business information is ranked second, managerial competency is ranked third and networking is ranked fourth. For trade creditors business information is ranked first, networking is ranked second, managerial competency is ranked third and collateral is ranked fourth. Referring to the external environment, commercial banks rank the macro-economy while trade creditors rank crime as the most important external factor. Crime is ranked second by commercial banks. The efficiency of the legal system, ethics and corruption are ranked third, fourth and fifth by commercial banks. Ethics, the efficiency of the legal system, macro-economy and corruption are ranked as second, third, fourth and fifth by trade creditors. The ranking of the internal and external factors by commercial banks and trade creditors further confirms the results of the factor analysis and item analysis. The ranking shows the importance of capital structure in obtaining debt. A firm needs equity and assets to obtain debt.

Based on the empirical results, the big difference between commercial banks and trade creditors regarding their willingness to grant credit to new SMES relates to collateral. Both sets of respondents regard three of the internal factors as extremely important (business information, managerial competency and networking), but only commercial banks also put a huge emphasis on collateral with their credit granting decisions to new SMEs. The reason why trade creditors do not regard collateral so important is because it is not common business practice for trade creditors to expect collateral as part of the credit granting decision, while it is critical for commercial banks. It also explains why two of the external factors (ethics and the legal system) are much more important to trade creditors than it is to commercial banks. Sufficient collateral mitigates the importance of ethical behaviour and an efficient legal system to commercial banks. However, in the absence of collateral from new SMEs, the trade creditors regard ethical behaviour and an efficient legal system as extremely important to make debt available to new

SMEs. It is the opinion of the author that if the government in South Africa expects commercial banks to grant debt to new SMEs without sufficient collateral, there would have been a similar significant positive relationship between unethical behaviour and an inefficient legal system versus non-availability of debt finance to new SMEs from commercial banks.

7.2.6.8 Rejection rates of credit applications by commercial banks and trade creditors

The results indicate extremely high rejection rates and thus low availability of debt finance to new SMEs from commercial banks and trade creditors in the Eastern Cape of South Africa. As pointed out by findings of the benefits/ risk analysis, commercial banks and trade creditors perceive new SMEs as beneficial to their business. However, they also consider new SMEs as very risky and the perceived risks outweigh the perceived opportunity / benefits. In an internal environment with limited business information, a lack of managerial competencies, insufficient networking and limited collateral, combined with an external environment of high crime, weak economic conditions, unethical behaviour and an inefficient legal system, commercial banks and trade creditors regard new SMEs as very risky. This implies that commercial banks and trade creditors are very cautious in their dealings with new SMEs and this impacts negatively on the availability of debt to new SMEs.

7.3 Recommendations

New SMEs have a crucial role to play in the South African economy. They are a key source of economic growth, poverty alleviation and reduction of income inequality. SMEs also contribute to employment, help diversify economic activity and make a significant contribution to exports and trade. Lack of finance is a key obstacle to their growth and survival. The findings of this study revealed that factors in the internal and external environment impact on non-availability of debt finance from both commercial banks and trade creditors to new SMEs. The empirical findings of this research show that commercial banks and trade creditors consider new SMEs as beneficial to their business but also very risky. The findings show that the perception of risk by commercial banks and trade creditors is greater than the perception of benefits. Therefore, commercial banks and trade creditors always want to mitigate the risk of granting credit to new SMEs. 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. The results indicate there are some factors in the business environment (internal and external environments) of new SMEs that accentuate the problems of moral hazards, information asymmetry and adverse selection.

Lack of collateral (especially lack of tangible assets and equity contribution) is the most important reason why credit is not available to new SMEs from commercial banks. Blumberg and Letterie (2008:188) argue that collateral helps to reduce informational asymmetries and moral hazard problems that arise between banks and entrepreneurs. Banks generally do not finance firms without an equity contribution and tangible collateral. Therefore, to improve the availability of debt, there is the need for new SME owners to plan and save to have some amount of equity contribution. Without equity, it is virtually impossible to get the required funding from commercial banks. According to Beck (2007:403) the international best practice is a capital structure of 50% equity and 50% debt. In addition, to get debt funding from banks, it is necessary for the owner of a new SME to have either business or personal assets to be used as collateral. Therefore, to get the required funding from commercial banks, it is first about the owner of the new SME getting 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 investor*".

Training and communication on the requirements of banks and trade creditors can help to make new SME 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 trade associations. 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 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 and other stakeholders to ensure that these schemes, such as the Small Firm Loan Guarantee, are well publicised and available to new SMEs.

A novel idea recently introduced in India could help to reduce the demand of banks for collateral. Some commercial banks in India have introduced the "Competency-as-Collateral" scheme. The scheme integrates measures of management competency with the conventional credit risk assessment criteria. Customized evaluation systems built on the basis of this platform help SMEs that would not have been eligible for a loan under the conventional criteria to become eligible by allowing them to show their management competence as part of their collateral.

Lack of business information and managerial competencies are also important internal reasons why funds are not available from both commercial banks and trade creditors. Wiedenhofer (2006:84) note that lack of business information regarding the underlying quality of a project or business gives rise to the problem of adverse selection. Nguyen and Ramachandran (2006:206) find that managerial competencies can help to reduce information asymmetry before a loan is granted and potential moral hazard after the loan is granted. The availability of business information and managerial competencies will improve the investment readiness of new SMEs. Therefore, to improve the availability of debt, there is the need for personal development by the owners of new SMEs especially in the area of business and financial management skills through training. Owners of new SMEs have to take greater responsibility for their own learning. Therefore, they need to create a positive attitude towards entrepreneurship and training. The present system where government agencies such as the Small Enterprise Development Agency (SEDA) use consultants that write business plans for entrepreneurs which they cannot articulate does make sense, but could potentially be counterproductive. The personal involvement of the entrepreneur in gathering the relevant information and in the writing of the business plan is critical to learn about the industry and to the success of the new venture. Entrepreneurs also need to acquire business and financial management skills if they want to get the required funding from investors.

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. As pointed out by Rungani (2008), the use of computers and internet is very low amongst SMEs in South Africa. Government agencies such as SEDA can subsidize the cost of computers to new SMEs and also offer training on how to use the internet. Similarly, the South African Business

Toolkit was launched in 2008 to assist entrepreneurs to assess their investment readiness through the latest information and communication technologies. Awareness need to be created for programmes like this through advertisements in local and national media. Subsidies could also be provided to help the owners of new SMEs obtaining the professional advice they require to make them business ready. This means helping them to produce a credible business and finance plan, sourcing appropriate types of finance and even coaching in presentation skills. The programme can also be designed to provide post-investment mentoring to help the businesses achieve their objectives once funding has been secured.

Educational institutions should introduce and strengthen entrepreneurial education. When learners are oriented into entrepreneurship from an early age, it becomes easier to develop successful ventures. Presently, entrepreneurship is predominantly been presented to students in management, business and economic related courses and not to students in all the faculties in the universities in South Africa. The model introduced by Achievers University in Nigeria can be adapted to improve entrepreneurship training in South Africa. At Achievers University, learners are taught in their respective disciplines like Engineering, Economics and Agriculture. In addition, learners 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 will be in line with the suggestion by Kiggundu (2002:29) that entrepreneurship education should become a mainstream activity in the educational systems of African countries.

The government should broaden its efforts to ensure that a high level of financial literacy is universal to entrepreneurs. Government agencies such as SEDA and Development Corporations can organize training for new SMEs. Awareness should be created for the training programmes through advertisements in local and national media. Furthermore, a "learning from peers" or mentorship approach can be instituted by government agencies to help new SMEs. New SMEs should look at using non-executives at an early stage to bring external expertise and guide

investment decisions. Canada for example has a system where successful businessmen are linked to new SME owners in an advisory role to train and mentor for the first two or three years.

Another internal reason why commercial banks and trade creditors do not give credit to new SMEs is lack of networking. Networking is particularly important to trade creditors. Shane and Cable (2002:366) find that networking can be used to reduce information asymmetry and moral hazard in creditor/debtor relationships. To improve networking SME owners should always ensure that they maintain good relationships with commercial banks and trade creditors. Agreements such as repayment of credit extended should always be met. In addition, entrepreneurs need to attend seminars and trade fairs and also join trade associations. The banks can also encourage networking activities. Bank officers need to be trained in more conventional risk management techniques. Besides financial analysis, business planning, and credit scoring, bankers need to be competent in developing interpersonal networks that can help to gather information about new SMEs.

Crime is one of the most important external environmental factors affecting the availability of debt to new SMEs from commercial banks and trade creditors. Falkena *et al.* (2002) point out that crime increases moral hazards after the granting of credit and can affect the ability of SMEs to repay credit. The high crime rate in South Africa must be reduced to improve the availability of debt from commercial banks and trade creditors. The best way to reduce crime and (and also corruption) is to make the legal system more efficient (especially the speed of court judgments) so that criminals are promptly arrested and punished. Government should work in partnership with organisations such as Business Against Crime South Africa and Business Unity South Africa. The literature review showed that poverty is one of the causes of crime. There is the need to create work opportunities for the vast number of the unemployed in South Africa. There is also a need for a well-publicized educational campaign against crime. More effective policing is needed, including better police visibility, area coverage and faster response times. New SMEs should be encouraged to insure their businesses. Government can assist in subsidizing the cost of insurance. Government can also help to subsidize once-off security costs such as burglar proofing.

Ethics is another very important factor why debt is not available to new SMEs, especially from trade creditors. Creditor protection is strong on paper but weak in practice in South Africa. To improve ethics, unethical behaviours (such as deliberately not paying back debt) must be swiftly punished. Non-payment of debt will negatively impact on the credit history of the owners of new SMEs. In addition, owners of new SMEs that are unable to pay back debt can use debt counsellors to help them restructure their debts as stipulated by the New National Credit Act. The legal system has to be made more efficient through quick court judgments. Research has shown a positive relationship between the efficiency of the legal system and good ethical behaviour. There is the need for a campaign by the government to change the minds of the people that unethical practices are bad. Business ethics should be introduced as a major module in the universities and colleges in South Africa to prepare likely entrepreneurs about the importance of ethics. SME owners should be trained on the importance of business ethics. Governmental and professional business entities should provide proficiency training that is grounded in sound ethical management. The South African government and agencies responsible for SMEs such as SEDA needs to actively promote organizational ethics by developing and sponsoring legislation that supports socially responsible business.

To further improve the efficiency of the legal system and improve the availability of debt, it is important to reform the legal frameworks for creditor rights and insolvency proceedings in general. 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 of up to two years in some instances. Therefore, 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. To improve the efficiency of the legal system, specialized courts to act against SMEs that default on loan obligations could be established. More judges are also needed as there is a shortage of judges and magistrates. In addition, the long procedures, duration and cost it takes to register property, enforce contracts and close business 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 environment.

The macro-economy is another external factor affecting the availability of debt. Therefore, South Africa needs to continue to sustain strong economic and financial fundamentals. As pointed out by the World Bank (2009) prudent fiscal management have seen South Africa's budget deficit drop dramatically in recent years. Inflation targeting has helped to reduce inflation. However, there is the need to also reduce interest rates to enable new SMEs to use debt positively.

Conclusively, internal factors affecting the availability of debt are mainly under the control of entrepreneurs. Therefore, entrepreneurs should first make themselves investment ready by saving and providing equity contribution and tangible collateral. Entrepreneurs should also improve their business and financial management competencies by attending training. Networking can be improved by joining trade associations. Government can also help through loan guarantee schemes and training. Although the internal factors are predominantly the responsibility of the prospective entrepreneur, government has still a huge role to play. It is not realistic to create the expectation that any person with limited education, no entrepreneurial or management knowledge, no collateral and a bad credit record can obtain debt financing from commercial banks and trade creditors.

The external environment is largely uncontrollable by the firms. Therefore, government has a large role to play in improving the external environment. Government needs to take crime reduction more seriously through better policing, education and poverty reduction measures. The legal system must be made more efficient. The speed of court judgment must be enhanced. Public awareness campaigns are necessary to change the mindsets of the public that unethical behaviours and corruption are bad and counterproductive. Strong fiscal and monetary policies must be sustained.

7.4 ACHIEVEMENT OF OBJECTIVES

This section measures the success of the study against the research objectives formulated in section 1.3.2.

The primary objective of this study was to investigate the impact of the business environment on the availability of debt finance to new SMEs in South Africa. The attainment of the primary objective was dependent upon realizing the secondary objectives listed below.

- To review the literature to determine the creation rate, the failure rate and the causes of failure of new SMEs in South Africa.
- To review the literature to determine if debt finance is available to new SMEs in South Africa.
- To review the literature to determine the business environmental variables that can impact on the availability of debt finance to new SMEs in South Africa.
- To investigate empirically the impact of business environmental variables on the availability of debt finance from commercial banks and trade creditors to new SMEs.
- To investigate empirically if commercial banks and trade creditors perceive new SMEs as beneficial to their business.
- To make policy recommendations on how to improve the availability of debt finance to new SMEs in South Africa.

The first objective was to review the literature to determine the creation rate, the failure rate and the causes of failure of new SMEs in South Africa. This was achieved in chapter two of the study. The chapter examined the role of SMEs in development and the importance of SMEs to employment, poverty alleviation and income equality. The chapter also defined a new SME and examined the contribution of new SMEs. The review of the literature found that South Africa has the third lowest level of new firm creation as measured by the TEA amongst all the developing countries surveyed by GEM. It was also found that 75% of new SMEs in South Africa fail within the first two years of operations. This is the highest failure rate in all the countries surveyed by GEM. The literature revealed that there are many reasons for the failure of new SMEs. Lack of finance appears to be one of the most consistent reasons according to the literature.

The second objective was to review the literature to determine if debt finance is available to new SMEs in South Africa. The second objective was achieved by reviewing the literature in chapter three. It was discovered that new SMEs in South Africa suffer from an equity gap especially external equity. The use of venture capital by new SMEs is extremely limited. This is not limited

to South Africa alone. In developed countries such as Canada, Norway, the use of external equity is also severely limited for new SMEs. The literature revealed that new SMEs also find it difficult to access debt finance leading to a debt gap. However, the debt gap is more pronounced in developing countries than in developed countries. The lack of equity and debt indicates that new SMEs are capital rationed.

The third objective was to review the literature to determine the internal and external environmental variables that can impact on the availability of debt finance to new SMEs in South Africa. This was achieved in chapter four of the study. The literature revealed that internal factors such as collateral, business and financial information, managerial competency and networking positively impacts on the performance of new SMEs and could also impact on the availability of debt finance. In addition, the literature revealed the macroeconomic environment legal system, ethics, crime and corruption could impact on the availability of debt finance to new SMEs.

The fourth objective was to investigate empirically the impact of internal and external environmental variables on the availability of debt finance from commercial banks and trade creditors to new SMEs. This was achieved through chapters five and six of the study. Chapter five focused on the research methodology used for the empirical study. In the chapter, the population and the sampling design were defined. The primary data collection method and the motivation for the use of self-administered questionnaires were established. Data was analysed using SPSS and included descriptive statistics, factor analysis, T-tests, ANOVA and Pearson correlation. The statistical analysis of data, results and discussions were presented in chapter six.

The fifth objective was to investigate empirically whether commercial banks and trade creditors perceive new SMEs as beneficial to their business. This objective (just like the fourth objective) was achieved through chapters five and six of the study.

The sixth and final objective was to make policy recommendations on how to improve the availability of debt finance to new SMEs in South Africa. This was achieved in section in section 7.2.7 of this chapter where practical recommendations were made to all relevant stakeholders.

The stakeholders focused on were new SME owners, commercial banks, trade creditors, government and government related organizations focusing on SME development in South Africa.

Based on the achievement of all the secondary objectives, it is concluded that the primary objective of this study was achieved. In addition, eight out of the nine business environmental factors significantly impact on the availability of debt from either commercial banks or trade creditors. Only corruption is insignificant for both sets of respondents. Therefore, it can be concluded that the business environment impacts on the availability of debt to new SMEs.

7.5 LIMITATIONS OF THE STUDY

A limitation of this study is that it investigated only the internal and external variables that impact on non-availability of debt to new SMEs from the perspective of commercial banks and trade creditors. Government agencies such as Development Corporations, Umsobumvu Youth Fund also provide both debt and equity to new SMEs. However, the hit rate is about 20%. Government agencies were omitted to reduce the complexity of the study. In addition, another limitation is that not all the factors in the business environment were considered. Factors such as the technological environment and the international environment were not included in the study. Furthermore, the study only focused on the supply side of debt financing and the perception of providers of funds. It is also important to examine the demand side to understand the perception of the owners of new SMEs about why they do not get credit. Finally, the study was a regional study and focused only on the branches of commercial banks and trade creditors in the Eastern Cape Province of South Africa.

7.6 AREAS FOR FURTHER STUDY

Further studies can examine the barriers to lending by government agencies. Another source of capital for new SMEs is external equity from venture capitalists. In addition a dyadic survey to examine the obstacles to credit as perceived by both providers of funds (banks and trade creditors) and SMEs could help to further confirm the findings of this study. Further studies could investigate whether new small firms understand the criteria employed by banks to determine whether to grant a loan or not. If the probability to obtain a loan is small, there will be

little incentive to apply. As pointed out by Blumberg and Letterie (2008:188) if the probability of obtaining a loan is small, there is little incentive to apply. Individuals who do not apply because they fear that their requests will be denied are also affected by credit rationing.

7.7 SUMMARY

This chapter examined the conclusions, recommendations, achievement of objectives, limitations and areas for further study in respect of a study titled the availability of debt to new SMEs in South Africa. According to the World Bank (2008b), the three main development challenges facing South Africa are unemployment, poverty and income inequality. New SMEs hold the key to solving these challenges. Maas and Herrington (2006) point out that the creation rate of new SMEs in South Africa is very low and the failure rate is very high. Various challenges and impediments prevent the creation of new SMEs as well as cause the high failure rates of new SMEs in South Africa. One of these is the non-availability of formal sector financing. The purpose of this study was to find ways to improve the availability of debt finance to new SMEs in South Africa by examining the business environmental factors that cause non-availability.

In addition, the study investigated if commercial banks and trade creditors perceive new SMEs as beneficial to their business. The results indicated that commercial banks and trade creditors perceive new SMEs as beneficial to their business but also very risky. The perception of risk is greater than the perception of the benefits. The findings showed that the rejection rates of credit applications of new SMEs by commercial banks and trade creditors are extremely high indicating a low availability of debt financing to new SMEs. In addition, the importance of the business environment in the credit evaluation process was investigated. Internal factors were found to be more important to commercial banks than trade creditors in the credit evaluation process. Collateral is the most important internal factor for commercial banks. The study also found that external factors are more important to trade creditors than commercial banks in the evaluation of credit applications from new SMEs.

Furthermore, the study investigated the relationship between business environmental factors and the non-availability of debt from commercial banks and trade creditors. The average means for internal factors for commercial banks and trade creditors are 5.42 and 4.85 respectively. The

average means for external factors for commercial banks and trade creditors are 3.56 and 4.54 respectively. In addition, all four the internal factors (lack of collateral, lack of business information, lack of managerial competency and lack of networking) have significant positive relationships with non-availability of debt from commercial banks while only three (lack of business information, lack of managerial competency and lack of networking) have significant relationships for trade creditors. The results suggest that internal factors are more important to commercial banks than trade creditors. The average means for external factors for commercial banks and trade creditors are 3.56 and 4.54 respectively. The results suggest that external factors are more important to trade creditors than commercial banks. Four of the five external factors (crime, bad macro-economy, ethical perception and the inefficiency of the legal system) have significant positive relationships with non-availability of debt from trade creditors. Only two factors (crime and bad macro-economy) have positive relationships with non-availability of debt from commercial banks.

To improve the availability of debt to new SMEs (which will reduce the failure rate of new SMEs), the study recommended that new SME owners must improve on their investment readiness by having collateral and owners' equity contribution. Also, the government must improve the situation in the external environment by reducing crime, improving the efficiency of the legal environment and maintaining strong economic and financial fundamentals.

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APPENDICES

Appendix 1: Questionnaire: (Banks)

1st July, 2009

Dear participant

My name is Olawale Fatoki and I am a PhD student in Business Management at the University of the Free State under the supervision of Professor Van Aardt Smit. I am writing to invite you to participate in my research in the form of a questionnaire.

My PhD project is entitled "The availability of debt to new SMEs". Specifically, the study focuses on business environmental factors that that can constrain the availability of debt from commercial banks to new SMEs. The failure rate of new SMEs in South Africa is about 75%. This is one of the highest levels in the world. According to a report by the Global Entrepreneurship Monitor, non-availability of finance is one of the major reasons for failure. Through the questionnaire, I hope to be able to determine the factors that constrain the availability of debt finance to new SMEs and make necessary recommendations to appropriate authorities. The questionnaire should take about 20 minutes to complete. The information supplied by participants will be treated as strictly confidential. Completion of the questionnaire is voluntary. If you would like to obtain a summary of the results of this research, I would be happy to send you a copy.

Please feel free to contact me on 0820737350 or funsofatoki@yahoo.com with regards to any queries you may have, or my supervisor, Van Aardt Smit on 0514012285 or smitava.EKW@ufh.ac.za

Section A: Perception of new[5] small and medium enterprises (SMEs) by commercial banks

	Please indicate your level of agreement or disagreement with the following statements about how new SMEs are perceived by commercial banks **New SMEs are:**	Strongly disagree	Moderately disagree	Slightly disagree	Neutral	Slightly agree	Moderately agree	Strongly agree
		1	2	3	4	5	6	7
	A profitable sector							
	A large sector							
	The sector has positive prospects							
	Banks compete for new SME business							
	The sector is of strategic importance to the banks							
	The sector is risky							
	The sector has a high failure rate							

Section B: Important factors when evaluating the credit applications of new SMEs

	Please indicate the importance of these factors when evaluating the credit applications of new small firms	Unimportant	Slightly important	Fairly Important	Moderately Important	Quite Important	Very Important	Extremely Important
		1	2	3	4	5	6	7
	Managerial competency of the owner							
	Availability of business information							
	Acceptable collateral							
	Networking with the bank							
	The macro-economic environment							
	The efficiency of the legal environment							
	Ethical behaviour of small business owner							
	In the case of government contract, the corruption of government official							
	The firm is located in high crime area							

[5] New SMEs are firms that have been in existence for forty two months or less.

Section C: Perception of the reasons why credit is not available to new SMEs

Please indicate your level of agreement or disagreement with the following statements about why credit is not available to new SMEs		**Strongly disagree**	**Moderately disagree**	**Slightly disagree**	**Neutral**	**Slightly agree**	**Moderately agree**	**Strongly agree**
		1	**2**	**3**	**4**	**5**	**6**	**7**
	Collateral							
	No tangible assets (e.g. building as collateral)							
	Low level of equity contribution by founder							
	Lack of guarantee by the owner of the firm							
	No current assets (e.g. inventories) as collateral							
	Business information							
	The business does not have business plan							
	Cash flow does not show that credit can be repaid							
	The business is not financially viable							
	The business does not have market potential							
	The business does not have growth potential							
	The business plan does not do an excellent job in articulating the opportunity							
	The founder does not have necessary business documentation							
	The business plan is not thorough in its coverage of key issues							
	The founder does not have suitable business premises							
	Managerial competency							
	Lack of experience relevant to the venture by the founder							
	Founder is not familiar with market/industry							
	Lack of education by the founder							
	Lack of business skills by the founder							
	Bad credit record							
	Lack of resources to manage the firm							
	Founder lacks demonstrated managerial ability							
	Networking							
	No prior relationship between the bank and the founder							
	Short professional relationship between the bank and founder							
	Lack of good reference on integrity and ability of							

	the founder							
	No verifiable distribution of goods agreement in place for the entrepreneur							
	No verifiable supply of input in place for the entrepreneur							
	The business does not belong to a professional association (e.g. chambers of commerce)							
	Crime							
	The business is located in high crime area							
	Collateral is located in high crime area							
	The business is not insured against crime							
	Ethical perception							
	Perception of willingness to divert funds to non-core business activities							
	Perception of payment default							
	Perception of dishonesty in keeping promises and commitments							
	False information and paddling of financial statements							
	Legal system							
	Courts are not fair and impartial							
	In the situation of legal action against the customer, it takes a long time to get judgment							
	Court decisions are not enforced							
	In the situation of legal action against the customer, it is costly to get judgment							
	Weak confidence in the legal system to enforce contracts and property rights							
	Macro-economy							
	Recession in the economy							
	Continuous fall in the value of real estate (collateral value)							
	Corruption							
	In the situation where the credit application is for government contract, the perception that the corruption of government official may delay payment							
	In the situation that legal action is taken against customers to recover loan, the perception that corruption of court official may delay judgment							
	In the situation where the credit application is for contracts from firms, the perception that the corruption of firm official may delay payment							

Section F: Please rank in order of importance the following internal factors about why credit is not available from commercial banks to new SMEs (with 1 being the most important and 4 being the least important)

Factor	**Level of importance**
Lack of collateral	
Lack of business information	
Lack of managerial competency	
Lack of networking	

Section G: Please rank in order of importance the following external about why credit is not available from commercial banks to new SMEs (with 1 being the most important and 5 being the least important)

Factor	**Importance**
Bad macro-economic environment	
Inefficient legal system	
Unethical behaviour of SME owners	
High level of corruption	
Business is located in high crime area	

Section H: Rejection of the credit applications of new SMEs by trade creditors

From your experience, how would you rate the rejection of credit applications of new SMEs?

Extremely high	Very high	Moderately high	Do not know	Moderately low	Very low	Extremely low

Section I: Biographical information of respondent

Age of the respondent

Below 20 years	21-30 years	31-40 years	41-50 years	51-60 years	Above 61 years

Gender of the respondent

Male	
Female	

Educational qualification of the respondent

Matric	Diploma	Degree

Experience in the banking sector (years)

1-5	6-10	11-15	16-20	Above 20

Other comments you may wish to make in respect of this research

....

....

Thank you for your cooperation and participation

Appendix 2: Questionnaire (trade creditors)

1st July, 2009

Dear participant

My name is Olawale Fatoki and I am a PhD student in Business Management at the University of the Free State under the supervision of Professor Van Aardt Smit. I am writing to invite you to participate in my research in the form of a questionnaire.

My PhD project is entitled "The availability of debt to new SMEs". Specifically, the study focuses on business environmental factors that that can constrain the availability of debt from trade creditors (suppliers) to new SMEs. The failure rate of new SMEs in South Africa is about 75%. This is one of the highest levels in the world. According to a report by the Global Entrepreneurship Monitor, non-availability of finance is one of the major reasons for failure. Through the questionnaire, I hope to be able to determine the factors that constrain the availability of debt finance to new SMEs and make necessary recommendations to appropriate authorities. The questionnaire should take about 20 minutes to complete. The information supplied by participants will be treated as strictly confidential. Completion of the questionnaire is voluntary. If you would like to obtain a summary of the results of this research, I would be happy to send you a copy.

Please feel free to contact me on 0820737350 or funsofatoki@yahoo.com with regards to any queries you may have, or my supervisor, Van Aardt Smit on 0514012285 or smitava.EKW@ufh.ac.za

Section A:

Question 1: Does your firm offer suppliers' credit to other firms?

Always	Often	Sometimes	Seldom	Never

Section B: Perception of new[6] small and medium enterprises (SMEs) by suppliers

	Please indicate your level of agreement or disagreement with the following statements about how new SMEs are perceived by suppliers **New SMEs are:**	Strongly disagree	Moderately disagree	Slightly disagree	Neutral	Slightly agree	Moderately agree	Strongly agree
		1	2	3	4	5	6	7
	A profitable sector							
	A large sector							
	The sector has positive prospect							
	Suppliers compete for new SME business							
	The sector is of strategic importance to the suppliers							
	The sector is risky							
	The sector has a high failure rate							

[6] New SMEs are firms that have been in existence for forty two months or less.

Section C: Important factors when evaluating the credit applications of new SMEs

	Please indicate the importance of these factors when evaluating the credit applications of new small firms	Unimportant	Slightly important	Fairly Important	Moderately Important	Quite Important	Very Important	Extremely Important
		1	2	3	4	5	6	7
	Managerial competency of the owner							
	Availability of business information							
	Acceptable collateral							
	Networking with the supplier							
	The macro-economic environment							
	The efficiency of the legal environment							
	Ethical behaviour of small business owner							
	In the case of government contract, the corruption of government official							
	The firm is located in high crime area							

Section D: Perception of the reasons why credit is not available to new SMEs

	Please indicate your level of agreement or disagreement with the following statements about why credit is not available from suppliers to new SMEs	Strongly disagree	Moderately disagree	Slightly disagree	Neutral	Slightly agree	Moderately agree	Strongly agree
		1	2	3	4	5	6	7
	Collateral							
	No tangible assets (e.g. building as collateral)							
	Low level of equity contribution by founder							
	Lack of guarantee by the owner of the firm							
	No current assets (e.g. inventories) as collateral							
	Business information							
	Cash flow does not show that credit can be repaid							

	Business is not financially viable							
	No business plan							
	No market potential							
	No growth potential							
	No business premises							
	Business plan not thorough in coverage of key issues							
	Business plan does not articulate opportunity							
	Managerial competency							
	Bad credit record							
	Lack of experience							
	Lack of resources to manage the firm							
	Lack of education							
	Lack of business skills							
	Lack of documentation							
	Networking							
	No prior relationship							
	Short prior relationship							
	Lack of good reference on integrity							
	No distribution of output arrangement							
	Do not belong to same professional association							
	Crime							
	The business is not insured							
	The business is located in high crime area							
	Ethical perception							
	Perception of payment default							
	Perception of dishonesty in keeping commitments							
	Perception of willingness to divert funds to non-core activities							
	Perception of false information and paddling of financials							
	Legal system							
	Courts are not fair and impartial							
	In the situation of legal action against the customer, it takes a long time to get judgment							
	Court decisions are not enforced							
	In the situation of legal action against the customer, it is costly to get judgment							
	Weak confidence in the legal system to enforce contracts and property rights							
	Corruption of court official							

	Macro-economy							
	Recession in the economy							
	High interest rate							
	Corruption							
	In the situation where the credit application is for government contract, the perception that the corruption of government official may delay payment							
	In the situation where the credit application is for contracts from firms, the perception that the corruption of firm official may delay payment							

Section F: Please rank in order of importance the following internal factors about why credit is not available from suppliers to new SMEs (with 1 being the most important and 4 being the least important)

Factor	**Level of importance**
Lack of collateral	
Lack of business information	
Lack of managerial competency	
Lack of networking	

Section G: Please rank in order of importance the following external about why credit is not available from suppliers to new SMEs (with 1 being the most important and 5 being the least important)

Factor	**Importance**
Bad macro-economic environment	
Inefficient legal system	
Unethical behaviour of SME owners	
High level of corruption	
Business is located in high crime area	

Section H: Rejection of the credit applications of new SMEs by trade creditors

From your experience, how would you rate the rejection of credit applications of new SMEs?

Extremely high	Very high	Moderately high	Do not know	Moderately low	Very low	Extremely low

Section I: Biographical information of respondent

Age of the respondent

Below 20 years	21-30 years	31-40 years	41-50 years	51-60 years	Above 61 years

Gender of the respondent

Male	
Female	

Educational qualification of the respondent

Matric	Diploma	Degree

Length of operation of the respondent's firm

1-10 years	11-20 years	21-30 years

Product line of the respondent's firm

Manufacturing	
Retail	

Number of employees of the respondent's firm

1-50	51-100	101-150	151-200	201 and above

Is your firm independent or does it belong to a group?

Yes	
No	

Other comments you may wish to make in respect of this research

....

....

Thank you for your cooperation and participation

Appendix 3: Descriptive statistics on the perception of new SMEs by commercial banks and trade creditor

Variable	Mean	Standard deviation	Skewness	Kurtosis
Profitable				
Commercial banks	4.90	2.06	.424	.162
Trade creditors	4.79	1.76	.201	.155
Large				
Commercial banks	5.04	1.91	.397	.132
Trade creditors		1.72	.322	.149
	5.39			
Positive prospects	4.53			
Commercial banks		1.84	.298	.216
Trade creditors	4.31	1.57	.453	.318
Competitive				
Commercial banks	4.05	1.83	.465	.139
Trade creditors	5.22	1.74	.399	.298
Strategic				
importance	5.32	1.86	.256	.165
Commercial banks	5.20	1.65	.322	.212
Trade creditors				
Risky				
Commercial banks	5.52	1.78	.399	.215
Trade creditors	5.35	1.88	.365	.174
High failure rates				
Commercial banks	5.51	1.79	.223	.139
Trade creditors	5.16	1.69	.166	.185

Appendix 4: T-test for the differences in the perception between banks and trade creditors

	Levene's test for equity of variance		T-test for equality of means						
								95% confidence interval of the difference	
	F	Sig.	T	Df	Sig (2-tailed)	Mean difference	Std.Error difference	Upper	Lower
Profitable sector Equal variances assumed Equal variances not assumed	3.991	.02	.395 .397	50 16.107	.323	1.000 1.000	1.326 1.334	-1.076 -1.079	4.288 4.291
Large sector Equal variances assumed Equal variances not assumed	5.106	.01	.653 .656	50 15.649	.408	1.000 1.000	1.529 1.534	-1.014 -1.007	3.775 3.791
Positive prospects Equal variances assumed Equal variances not assumed	4.221	0.00	.442 .447	50 15.204	.385	1.000 1.000	1.118 1.125	-1.235 -1.239	4.771 4.779
Compete Equal variances assumed Equal variances not assumed	3.309	.00	.755 .758	50 17.755	.079	1.000 1.000	1.753 1.759	-1.217 -1.223	3.295 3.298
Strategic importance Equal variances assumed Equal variances not assumed	4.377	.011	.723 .723	50 19.732	.890	1.000 1.000	1.297 1.297	-1.455 -1.459	4.240 4.245
Risky Equal variances assumed Equal variances not assumed	2.881	.042	.851 .851	50 18.459	.475	1.000 1.000	1.179 1.179	-1.465 -1.462	3.562 3.591
Failure Equal variances assumed Equal variances not assumed	2.390	.00	.845 .845	50 16.755	.405	1.000 1.000	1.254 1.254	-4.009 -4.016	4.663 4.695

Appendix 5: T-test for the differences in the mean scores of gender, product lines and independent or part of a group and perception of SMEs

	Gender				**Product line**						**Independent or group**	
	Levene's test		T-test (Sig. (2-tailed)		Levene's test (Sig.)		T-test (Sig. (2-tailed)		Levene's test (Sig.)		T-test (Sig. (2-tailed	
	F	Sig	T	Sig.	F	Sig.	T	Sig.	F	Sig.	T	Sig.
Profitable												
Bank	4.231	.02	.820	.432								
Trade creditor	3.971	.00	.833	.406	5.000	.03	.529	.342	4.876	.00	.633	**.04**
Large												
Bank	3.999	.00	.655	.105								
Trade creditor	4.651	.00	.496	.366	3.867	.00	.109	.234	3.647	.01	.342	.09
Prospects												
Bank	7.322	.00	.133	.109								
Trade creditor	3.357	.00	.109	.176	3.999	.02	.853	.101	4.655	.04	.110	**.01**
Competitive												
bank	3.659	.01	.642	.110								
trade creditor	4.612	.03	.504	.345	3.678	.02	.110	.243	3.476	.00	.324	.09
Strategic importance	4.442	.02	.722	.355								
Bank	2.176	.00	.534	.076	3.753	.04	.152	.316	3.647	.01	.112	.12
Trade creditor												
Risky												
Bank	3.790	.02	.842	.09								
Trade creditor	5.767	.00	.633	.16	4.237	.00	.682	.19	5.570	.02	.456	.19
Failure												
Bank	7.122	.00	.114	.27								
Trade creditor	4.657	.00	.347	.69	4.985	.04	.243	.35	5.743	.00	.365	.48

Sig. at 0.05 (2-tailed)

Appendix 6: One way ANOVA for the differences between age, education and experience of respondents and perception of SMEs

	Age				**Education**				**Experience**			
	Levene's test		T-test (Sig. (2-tailed)		Levene's test (S		T-test (Sig. (2-tailed)		Levene's test (Sig.)		T-test (Sig. (2 tailed	
	F	Sig.	T	Sig.	F	Sig	T	Sig	F	Sig.	T	Sig.
Profitable												
Bank	3.451	.01	.322	.48	4.562	.00	.820	.432	4.231	.02	.870	.11
Trade creditor	4.784	.00	.485	.54	2.890	.00	.833	.406				
Large												
Bank	2.344	.03	.254	.31	5.832	.04	.655	.105	3.980	.03	.675	.16
Trade creditor	3.536	.04	.564	.43	6.432	.03	.496	.366				
Prospects												
Bank	5.355	.00	.432	.63	4.212	.01	.133	.109	7.322	.00	.133	.19
Trade creditor	4.343	.00	.522	.48	2.902	.04	.109	.176				
Competitive												
bank	4.650	.03	.521	.110								
trade creditor	3.652	.03	.588	.345	3.522	.04	.110	.243	3.222	.00	.410	.13
Strategic importance	2.647	.02	.253	.23	2.234	.00	.642	.110	3.659	.01	.642	.15
Bank	3.733	.04	.542	.12	5.333	.04	.504	.345				
Trade creditor												
Risky												
Bank	4.292	.00	.389	.34	4.109	.04	.698	.10	5.978	.01	.609	.37
Trade creditor	2.323	.02	.200	.45	5.361	.02	.365	.08				
Failure												
Bank	2.323	.01	.603	.18	2.780	.00	.842	.09	3.790	.02	.832	.22
Trade creditor	4.123	.00	.404	.30	4.000	.00	.633	.16				

Sig. at 0.05 (2-tailed)

Appendix 7: ANOVA for the differences between the length of operations, number of employees and the perception of SMEs

	Length of operation				Number of employees			
	Levene's test (Sig.)		T-test (Sig. (2-tailed)		Levene's test (Sig.)		T-test (sig 2-tailed)	
	F	Sig.	T	Sig.	F	Sig	T	Sig
Profitable Bank Trade creditor	4.876	.00	.864	.400	4.255	.01	.522	**.02**
Large Bank Trade creditor	3.756	.00	.496	.324	3.545	.00	.100	.254
Prospects Bank Trade creditor	4.654	.04	.100	.176	2.903	.03	.832	**.00**
Competitive Bank Trade creditor	3.334	.04	.126	.176	3.825	.03	.755	**.88**
Strategic importance Bank Trade creditor	3.854	.03	.504	.340	3.733	.01	.163	.203
Risky Bank Trade creditor	5.668	.00	.315	.09	2.370	.02	.202	.20
Failure Bank Trade creditor	5.489	.04	.643	.26	4.097	.02	.612	.40

Sig. at 0.05 (2-tailed)

Appendix 8: Tukey HSD test for the differences in the perception of number of employees and prospects (trade creditors only)

No of employees/ Prospect	Mean difference	Standard error	Sig.	95% confidence interval Lower Bound	Upper Bound
1-50	13.121	14.008	.158	-18.55	18.65
51-100	11.196	14.008	..679	-17.32	13.62
101-150	7.008	14.008	.203	-15.98	17.79
151-200	13.115	14.008	.164	-56.91	20.99
201 above	68.257	14.008	**.002**	-18.52	-14.55

The mean difference is significant at the 0.05 level

Appendix 9: Descriptive statistics of importance attached to internal and external factors

Variable	Mean	Standard deviation	Skewness	Kurtosis
Managerial competencies				
Commercial banks	5.46	1.58	.250	.116
Trade creditors	4.88	.93	.265	.109
Business information				
Commercial banks	6.75	.73	.432	.198
Trade creditors	6.44	.50	.345	.172
Collateral				
Commercial banks	6.902.15	.59	.134	.243
Trade creditors		0.63	.273	.202
Networking				
Commercial banks	4.06	1.92	.454	.432
Trade creditors	5.42	1.02	.543	.234
Macro economy				
Commercial banks	4.25	1.08	.205	.300
Trade creditors	4.18	1.38	.333	.256
Legal system				
Commercial banks	2.95	1.40	.500	.100
Trade creditors	5.21	1.32	.492	.099
Ethics				
Commercial banks	3.41	1.66	.305	.071
Trade creditors	5.48	1.03	.292	.111
Crime				
Commercial banks	4.85	1.54	.461	.393
Trade creditors	6.42	1.33	.383	.278
Corruption				
Commercial banks	1.74	1.32	.295	.420
Trade creditors	2.90	1.01	.370	.260

Appendix 10: T-test for significant differences in the mean scores of commercial banks and trade creditors

	Levene's Test for Equality of Variances		T-test for Equality of Means						
								95% confidence interval of the difference	
	F	Sig.	T	Df	Sig. (2-tailed)	Mean Difference	Std. Error Difference	Lower	Upper
Managerial competency									
Equal variances assumed	4.620	.00	.620	50	.221	1.000	1.250	-1.110	4.430
Equal variances not assumed			.620	12.532		1.000	1.250	-1.118	4.490
Business information									
Equal variances assumed	3.970	.03	.830	50	.482	1.000	1.849	-1.015	4.499
Equal variances not assumed			.830	10.786		1.000	1.849	-1.230	4.375
Collateral									
Equal variances assumed	3.654	.00	.715	50	.021	1.000	1.011	-1.452	3.872
Equal variances not assumed			.715	10.139		1.000	1.011	-1.511	3.700
Networking									
Equal variances assumed	3.547	.00	.159	50	.31	1.000	1.011	-1.152	3.725
Equal variances not assumed			.159	12.131		1.000	1.011	-1.111	3.704
Macro- economy									
Equal variances assumed	3.800	.02	.754	50	.52	1.000	1.100	-4.115	5.921
Equal variances not assumed			.754	19.001		1.000	1.100	-4.230	5.815
Ethics									
Equal variances assumed	2.780	.02	.280	50	.04	1.000	1.619	-4.226	4.772
Equal variances not assumed			.280	12.322		1.000	1.619	-4.315	4.745
Legal									
Equal variances assumed	2.999	.01	.800	50	.01	1.000	1.345	-1.500	3.652
Equal variances not assumed			.800	11.061		1.000	1.345	-1.462	3.491

Crime Equal variances assumed Equal variances not assumed	3.100	.00	.970 .970	50 12.795	. 16	1.000 1.000	1.006 1.006	-4.005 -4.019	4.630 4.530
Corruption Equal variances assumed Equal variances not assumed	4.860	.00	.710 .710	50 15.693	.19	1.000 1.000	1.813 1.813	-1.189 -1.200	3.459 3.421

Sig. at 0.05 (2-tailed)

Appendix 11: T-test for gender, product line and independent or group

	Gender				Product line				Independent group			
	Levene's test F Sig.		T-test (Sig. (2-tailed) T		Levene's test (Sig.)		T-test (Sig. (2-tailed)		Levene's test (Sig.)		T-test (Sig. (tailed	
	F	Sig.	T	Sig.	F	Sig.	T	Sig.	F	Sig.	T	Sig.
Managerial competency												
Bank	4.231	.02	.820	.432								
Trade creditor	3.971	.00	.833	.406	3.634	.02	.840	.514	4.788	.00	.870	.623
Business information												
Bank	3.999	.00	.655	.105								
Trade creditor	4.651	.00	.496	.366	4.708	.03	.400	.102	3.001	.04	.375	.814
Collateral												
Bank	7.322	.00	.133	.109								
Trade creditor	3.357	.00	.109	.176	3.111	.04	.114	.405	7.104	.03	.165	.824
Networking												
Bank	4.442	.02	.722	.355								
Trade creditor	2.176	.00	.534	.076	2.987	.01	.507	.230	6.994	.03	.721	.14
Macro- economy												
Bank	5.556	.00	.698	.10								
Trade creditor	2.188	.00	.365	.08	8.538	.04	.609	.067	3.571	.02	.329	.282
Legal												
Bank	3.790	.02	.842	.09								
Trade creditor	5.767	.00	.633	.16	2.311	.01	.832	.68	6.790	.00	.623	.70
Ethics												
Bank	7.122	.00	.114	.27								
Trade creditor	4.657	.00	.347	.69	2.106	.00	.304	.249	7.808	.03	.543	.139
Crime												
Bank	3.221	.04	.322	.30								
Trade creditor	5.771	.00	.181	.19	5.406	.01	.564	.78	2.102	.04	.600	.88
Corruption												
Banks	7.000	.03	.697	.159								
Trade creditors	3.072	.01	.592	.142	4.590	.00	.352	.98	3.892	.03	.235	.66

Sig at 0.05 (2-tailed)

Appendix 12: ANOVA for age, education and experience

	Age				Education				Experience			
	Levene's test		T-test (Sig. (2-tailed)		Levene's test (S		T-test (Sig. (2-tailed)		Levene's test (Sig.)		T-test (Sig. (2-tailed	
	F	Sig.	T	Sig.	F	Sig	T	Sig	F	Sig.	T	Sig.
Managerial competency												
Bank	4.200	.00	.117	.400	5.008	.04	.398	.49	4.205	.02	.804	.14
Trade creditor	3.901	.00	.308	.436	3.611	.01	.422	.55				
Business plan												
Bank	3.540	.04	.621	.115	2.443	.00	.205	.39	3.999	.03	.414	.13
Trade creditor	4.061	.03	.440	.368	6.758	.02	.523	.41				
Collateral												
Bank	7.822	.01	.600	.197	2.400	.03	.483	.60	2.953	.00	.198	.56
Trade creditor	3.019	.04	.559	.134	3.592	.01	.510	.44				
Networking												
Bank	6.563	.01	.100	.350	5.182	.00	.573	.49	4.043	.03	.530	.17
Trade creditor	3.167	.03	.350	.076	3.101	.04	.452	.89				
Macro-economy												
Bank	5.008	.04	.522	.18	6.052	.00	.300	.39	1.870	.02	.355	.37
Trade creditor	2.121	.02	.385	.54	8.090	.00	.279	.56				
Legal												
Bank	3.743	.00	.499	.90	3.940	.03	.629	.32	4.007	.03	.656	.20
Trade creditor	5.856	.00	.231	.85	2.749	.01	.424	.47				
Ethics												
Bank	2.000	.03	.726	.37	6.730	.02	.521	.33	5.813	.01	.393	.16
Trade creditor	1.007	.00	.500	.69	2.333	.04	.399	.65				
Crime												
Bank	5.568	.02	.612	.19	6.111	.00	.356	.40	1.010	.04	.119	.57
Trade creditor	2.701	.04	.392	.50	8.000	.00	.291	.51				
Corruption												
Bank												
Trade creditor	6.009	.01	.362	.172	4.547	.02	.211	.29	3.333	.01	.666	.89
	5.258	.03	.266	.355	5.230	.00	.573	.33				

Significant at the .05 level

Appendix 13: ANOVA for length of operation and number of employees

	Length				Number of employees			
	Levene's test (Sig.)		T-test (Sig. (2-tailed)		Levene's test (Sig.)		T-test (sig 2-tailed)	
	F	Sig.	T	Sig.	F	Sig.	T	Sig.
Managerial competency Bank Trade creditor	2.130	.04	.804	.06	5.255	.00	.800	.09
Business plan Bank Trade creditor	5.932	.02	.625	.16	3.115	.00	.696	.224
Collateral Bank Trade creditor	2.712	.01	.149	.11	2.293	.04	.190	.123
Networking Bank Trade creditor	3.908	.01	.721	.10	5.933	.00	.588	.074
Macro-economy Bank Trade creditor	4.864	.00	.325	.37	2.250	.00	.311	.07
Legal Bank Trade creditor	2.730	.03	.800	.19	4.437	.04	.603	.21
Ethics Bank Trade creditor	3.750	.01	.375	.31	5.476	.03	.330	.08
Crime Bank Trade creditor	2.645	.03	.873	.57	4.651	.02	.643	.51
Corruption Bank Trade creditor	5.864	.03	.405	.67	2.110	.00	.641	.09

Sig at 0.05

Appendix 14: Total variance explained for commercial banks

Component	Initial Eigenvalues			Extraction sums of squared loading			Rotation Sums of Squared Loadings		
	Total	% of Variance	Cumulative %	Total	% of variance	Cumulative	Total	% of Variance	Cumulative %
1	13.225	30.057	30.057	13.225	30.057	30.057	12.142	27.596	27.596
2	6.432	14.618	44.675	6.432	14.618	44.675	8.759	19.907	47.503
3	3.740	8.500	53.175	3.740	8.500	53.175	4.055	9.216	56.719
4	2.967	6.743	59.918	2.967	6.743	59.918	2.989	6.793	63.512
5	2.532	5.755	65.673	2.532	5.755	65.673	2.071	4.709	68.221
6	2.356	5.355	71.028	2.356	5.355	70.485	1.745	3.966	72.187
7	2.156	4.900	75.928	2.156	4.900	75.385	1.689	3.839	76.026
8	1:835	4.171	80.099	1.835	4.171	79.556	1.591	3.616	79.642
9	1.322	3.005	83.104	1.322	3.005	82.561	1.524	3.462	83.104
10	.895	1.688	84.230						
11	.779	1.498	85.728						
12	.701	1.323	87.051						
13	.653	1.232	88.283						
14	.601	1.134	89.417						
15	.552	1.041	90.458						
16	.492	0.928	91.386						
17	.452	0.853	92.239						
18	.401	0.757	92.996						
19	.369	0.696	93.692						
20	.301	0.568	94.260						
21	.215	0.406	94.666						
22	.198	0.373	95.039						
23	.182	0.343	95.382						
24	.173	0.326	95.708						
25	.167	0.313	96.021						
26	.161	0.304	96.325						
27	.152	0.287	96.612						
28	.147	0.277	96.889						
29	.141	0.266	97.155						
30	9.721E-02	0.254	97.409						
31	9.621E-02	0.242	97.651						
32	9.323E-02	0.211	97.862						
33	9.001E-02	0.198	98.060						
34	8.771E-02	0.172	98.232						
35	8.421E-02	0.168	98.400						
36	8.211E-02	0.161	98.161						
37	7.981E-02	0.158	98.719						
38	7.531E-02	0.151	98.870						
39	6.988E-02	0.132	99.002						
40	6.121E-02	0.127	99.129						
41	5.923E-02	0.121	99.250						
42	5.401E-02	0.100	99.350						
43	4.901E-02	9.298E-02	99.441						
44	4,402E-02	8.251E-02	99.492						
45	3.988E-02	7.401E.02	99.531						
46	3.397E-02	6.543E.02	99.568						
47	3.105E-02	6.118E-02	99. 597						
48	2.822E-02	5.759E-02	99.624						

49	2.590E-02	5.655E-02	99.666						
50	2.154E-02	5.331E-02	99.701						
51	1.553E.02	4.997E-02	99.805						
52	1.211E.02	4.641E-02	100.00						

Extraction Method: Principal axis factoring; Rotation method: Varimax with Kaiser normalisation

Appendix 15: Rotated factor loading and Cronbach's alpha (commercial banks)

Variables	Factor 1	Factor 2	Factor 3	Factor 4	Factor 5	Factor 6	Factor 7	Factor 8	Factor 9
No tangible assets (e.g building as collateral	0.8846								
Low level of equity contribution by founder	0.8711								
No guarantee	0.6539								
No current assets (e.g. inventories) as collateral	0.6217								
The business does not have business plan		0.8918							
Cash flow does not show that credit can be repaid		0.8614							
The business is not financially viable		0.8423							
The business does not have market potential		0.8411							
The business does not have growth potential		0.8407							
The business plan does not do an excellent job in articulating the opportunity		0.8106							
The founder does not have necessary business documentation		0.7978							
The business plan is not thorough in its coverage of key issues									
The founder does not have suitable business premises		0.7623							
The product is new		**0.2674**							
The business plan is not produced with the assistance of an accountant/consultant		**0.2226**							
The technology is new		**0.1994**							
High competition		**0.1942**							
Bad credit record			0.8995						
Founder is not familiar with the market/industry			0.8827						
Lack of experience relevant to the venture by the founder			0.8429						
Lack of education by the founder			0.7999						
Lack of business skill by the founder			0.7655						
Lack of resources to manage the firm			0.5582						
Founder lacks demonstrated managerial			0.5217						

ability									
Founders has not received any training related to business			**0.1997**						
Recession in the economy				0.8996					
Continuous fall in the value of real estate (collateral value)				0.7673					
High interest rate				0.5988					
High inflation rate				**0.2351**					
High unemployment rate				**0.1775**					
Low business confidence				**0.1651**					
The business is located in high crime area					0.7429				
The business is not insured against crime					0.7321				
Collateral is located in high crime area					0.6563				
No prior relationship between the bank and the founder						0.8992			
No verifiable distribution of goods agreement in place						0.7311			
Lack of good reference on integrity and ability of the founder						0.6988			
No verifiable supply of input agreement						0.6147			
Short professional relationship between the bank and founder						0.4231			
The business does not belong to a professional association (e.g. chambers of commerce)						**0.1998**			
Perception of willingness to divert funds to non-core business activities							0.6559		
Perception of payment default							0.5421		
Perception of dishonesty in keeping promises and commitments							0.4557		
False information and paddling of financial statements							0.4219		
In the situation of legal action against the customer, it is costly to get judgment								0.6322	
In the situation of legal action against the customer, it is takes time to get judgment								0.6229	

Court decisions are not fair and impartial								0.6111	
Court decisions are not enforced								0.5988	
Weak confidence in the legal system to enforce contracts and property rights								0.4547	
In the situation where the credit application is for government contract, the perception that the corruption of government official may delay payment									0.6981
In the situation that legal action is taken against customers to recover loan, the perception that corruption of court official may delay judgment									0.5214
In the situation where the credit application is for firm contact, the perception that the corruption of firm official may delay payment									0.3774
Cronbach's alpha	**0.8105**	**0.8207**	**0.7918**	**0.8113**	**0.7981**	**0.7217**	**0.8551**	**0.7327**	**0.7108**

(Items with factors loading less than 0.300 will be omitted)

Appendix 16: Total variance explained for trade creditors

Component	Initial Eigenvalues			Extraction sums of squared loading			Rotation Sums of Squared Loadings		
	Total	% of Variance	Cumulative %	Total	% of variance	Cumulative %	Total	% of Variance	Cumulative %
1	10.225	22.228	22.228	10.225	22.228	22.228	11.302	24.569	24.569
2	6.441	14.002	36.230	6.441	14.002	36.230	7.464	16.227	40.796
3	4.104	8.921	45.151	4.104	8.921	45.151	3.270	7.108	47.904
4	3.276	7.122	52.273	3.276	7.122	52.273	2.906	6.317	54.221
5	3.015	6.554	58.827	3.015	6.554	58.827	2.479	5.839	60.060
6	2.284	4.965	63.792	2.284	4.965	63.792	2.395	5.206	65.266
7	2.015	4.380	68.172	2.015	4.380	68.172	1.972	4.287	69.553
8	1.846	4.013	72.185	1.846	4.013	72.185	1.680	3.654	73.207
9	1.424	3.096	75.281	1.424	3.096	75.281	1.110	2.074	75.281
10	.601	1.134	89.417						
11	.552	1.041	90.458						
12	.492	0.928	91.386						
13	.452	0.853	92.239						
14	.401	0.757	92.996						
15	.369	0.696	93.692						
16	.301	0.568	94.260						
17	.215	0.406	94.666						
18	.198	0.373	95.039						
19	.182	0.343	95.382						
20	.173	0.326	97.708						
21	.167	0.313	97.021						
22	.161	0.304	96.325						
23	.157	0.297	97.167						
24	.152	0.287	98.612						
25	9.452E-02	9.401E-02	98.715						
26	9.450E-02	9.399E-02	98.825						
27	8.436E-02	8.401E-02	98.865						
28	8.401E-02	7.990E-02	98.879						
29	7.399.E-02	7.200E-02	98.901						
30	7.100E-02	7.050E-02	98.957						
31	7.061E-02	6.980E-02	98.980						
32	6.778E-02	6.771E-02	98.987						
33	6.578E-02	6.501E-02	98.001						
34	5.998E-02	5.990E-02	98.126						
35	5.809E-02	5.678E-02	98.207						
36	4.998E-02	4.880E-02	98.367						
37	4.673E-02	4.086E-02	98.678						
38	3.997E-02	3.990E-02	98.789						
39	3.773E-02	3.156E-02	98.801						
40	3.534E-02	3.026E-02	99.037						
41	2.895E-02	2.601E-02	99.099						
42	2.778E-02	2.501E-02	99.127						
43	2.756E-02	2.301E-02	99.216						
44	2.498E.02	2.217E.02	99.327						
45	2.330E.02	1.988E-02	99.388						
46	2210E-02	1.887E-02	99.426						
47	2007E-02	1.624E-02	99.516						
48	1.977E-02	1.576E-02	99.622						

49	1.775E-02	1.434E-02	99.701						
50	1.628E-02	1.331E-02	99.801						
51	1.441E-02	1.228E.02	99.903						
52	1.327E-02	1.117E-02	100.00						

Extraction Method: Principal axis factoring; Rotation method: Varimax with Kaiser normalisation

Appendix 17: Rotated factor loading and Cronbach's alpha (trade creditors)

Variables	Factor 1	Factor 2	Factor 3	Factor 4	Factor 5	Factor 6	Factor 7	Factor 8	Factor 9
Cash flow does not show that the credit can be repaid	0.8841								
The business is not viable	0.8420								
The business does not have a business plan	0.8100								
The business does not have market potential	0.6116								
The business does not have growth potential	0.5711								
The business does not have suitable business premises	0.5342								
The business plan is not through in its coverage of key issues	0.4782								
The business plan does not do an excellent job in articulating opportunity	0.4500								
Business plan not produced by an accountant	**0.2116**								
High competition	**0.1996**								
The product is new	**0.1179**								
The technology is new	**0.1110**								
No prior relationship		0.7352							
Short prior relationship		0.6975							
Lack of good reference on integrity		0.6662							
No distribution of output agreement		0.5986							
The business does not belong to a professional association		0.6530							
No social relationship		**0.1971**							
The business is not insured against crime			0.8100						
The business is located in high crime area			0.7654						
Collateral is located in high crime area			**0.1775**						
Collateral is not insured against crime			**0.1003**						
Perception of payment default				0.7895					
Perception of dishonesty in keeping				0.6988					

commitments									
Perception of willingness to divert funds to non-core activities				0.6760					
Perception of false information and paddling of financial statements				0.6531					
Bad credit record					0.7880				
Lack of experience relevant to the venture					0.7651				
The entrepreneur does not have the resources to manage the business					0.6558				
Lack of education					0.6110				
Lack of business skills					0.4331				
Lack of documentations					0.4116				
Founder lacks demonstrated managerial ability					**0.2739**				
Founder has not received any training related to the business					**0.1622**				
In the situation of legal action against the customer, it is costly to get judgment						0.8010			
In the situation of legal action against the customer, it takes a long time to get judgment						0.7632			
Court are not fair and impartial Court decisions are not enforced						0.6783			
In the situation that legal action is taken against customers to recover loan, the perception that corruption of court official may delay judgment						0.5984			
Weak confidence in the legal system to enforce contracts and property rights						0.4861			
Recession in the economy							0.6920		
High interest rate							0.6543		
High inflation rate							**0.2006**		

High unemployment rate							**0.1661**		
Low business confidence							**0.1224**		
Continuous fall in the value of real estate							**0.1004**		
Low equity contribution								0.6980	
No guarantee								0.5987	
No current asset as collateral								0.4821	
No fixed asset as collateral								0.3885	
In the situation where the credit application is for government contract, the perception that the corruption of government official may delay payment									0.7543
In the situation where the credit application is for private contract, the perception that corruption may delay payment									0.6988
Cronbach's alpha	**0.8210**	**0.7654**	**0.7865**	**0.8523**	**0.7119**	**0.7432**	**0.7608**	**0.8107**	**0.7112**

Appendix 18: T-test for gender, product line and independent or group and environmental factors

	Gender				**Product line**						**Independent or group**	
	Levene's test		T-test (Sig. (2-tailed)		Levene's test (Sig.)		T-test (Sig. (2-tailed)		Levene's test (Sig.)		T-test (Sig. (2-tailed	
	F	Sig	T	Sig.	F	Sig.	T	Sig.	F	Sig.	T	Sig.
Lack of managerial competency												
Bank	3.211	.02	.670	.400								
Trade creditor	2.901	.00	.603	.432	8.000	.03	.519	.331	3.806	.00	.423	.04
Lack of collateral												
Bank	3.911	.00	.675	.109								
Trade creditor	4.666	.00	.488	.306	4.860	.00	.115	.211	3.324	.01	.202	.00
Weak quality of business information												
Bank	6.319	.00	.103	.129								
Trade creditor	2.357	.00	.139	.186	4.998	.02	.773	.101	4.655	.04	.110	.01
Lack of networking												
Bank	4.620	.01	.702	.150								
Trade creditor	5.602	.03	.604	.255	3.768	.02	.130	.243	4.470	.00	.327	.02
Weak macro-economic environment	2.442	.02	.729	.385								
Bank	1.176	.00	.527	.016	4.753	.04	.102	.216	2.647	.01	.133	.12
Trade creditor												
Inefficiency of the legal system												
Bank	2.796	.02	.642	.09								
Trade creditor	4.760	.00	.303	.16	4.117	.00	.612	.19	5.511	.02	.424	.19
Ethical perception												
Bank	7.165	.00	.104	.27								
Trade creditor	4.683	.00	.283	.69	5.905	.04	.243	.35	2.703	.00	.311	.02
Crime												
Bank	3.200	.04	.422	.30								
Trade creditor	6.783	.00	.281	.19	5.937	.01	.325	.10	3.604	.00	.321	.40
Corruption												
Bank	2.112	.02	.829	.315								
Trade creditor	1.106	.00	.607	.045	4.223	.04	.232	.229	1.647	.01	.113	.12

Appendix 19: ANOVA for age, education and experience and environmental factors

	Age				Education				Experience			
	Levene's test		T-test (Sig. (2-tailed)		Levene's test (S		T-test (Sig. (2-tailed)		Levene's test (Sig.)		T-test (Sig. (2 tailed	
	F	Sig.	T	Sig.	F	Sig	T	Sig	F	Sig.	T	Sig.
Management competency												
Bank	2.411	.01	.300	.48	3.532	.00	.620	.312	3.001	.02	.670	.11
Trade creditor	5.704	.00	.456	.54	1.800	.00	.523	.336				
Collateral												
Bank	2.004	.03	.233	.31	4.831	.04	.555	.205	2.900	.03	.575	.16
Trade creditor	3.136	.04	.522	.43	3.402	.03	.366	.306				
Business information												
Bank	5.305	.00	.400	.63	4.012	.01	.132	.119	7.112	.00	.103	.19
Trade creditor	4.223	.00	.532	.48	2.872	.04	.111	.106				
Networking												
Bank	2.007	.02	.276	.23	2.004	.00	.602	.199	3.600	.01	.656	.15
Trade creditor	3.283	.04	.598	.12	5.663	.04	.594	.353				
Macro-economy												
Bank	4.220	.00	.300	.34	4.129	.04	.665	.10	5.078	.01	.629	.37
Trade creditor	2.113	.02	.233	.45	5.361	.02	.343	.08				
Legal environment												
Bank	2.303	.01	.673	.18	2.750	.00	.802	.09	3.722	.02		
Trade creditor	4.223	.00	.464	.30	4.660	.00	.673	.16				
Ethics												
Bank	2.709	.03	.420	.49	5.084	.03	.104	.27	7.210	.00	.503	.31
Trade creditor	4.090	.04	.290	.24	3.526	.00	.327	.69				
Crime												
Bank	4.110	.00	.370	.34	5.129	.04	.685	.10	7.078	.01	.609	.37
Trade creditor	2.143	.02	.223	.45	6.361	.02	.320	.08				
Corruption												
Bank	8.749	.03	.720	.49	5.884	.03	.114	.27	5.210	.00	.673	.31
Trade creditor	5.190	.04	.590	.24	2.526	.00	.390	.69				

Appendix 20: ANOVA for length of operation and number of employees and environmental factors

	Length of operation				Number of employees			
	Levene's test (Sig.)		T-test (Sig. (2-tailed)		Levene's test (Sig.)		T-test (sig 2-tailed)	
	F	**Sig.**	**T**	**Sig.**	**F**	**Sig**	**T**	**Sig**
Management competency Bank Trade creditor	5.806	.00	.724	.00	4.200	.01	.522	.02
Collateral Bank Trade creditor	6.756	.00	.406	.314	3.005	.00	.137	.00
Business information Bank Trade creditor	4.004	.04	.111	.196	2.283	.03	.752	.09
Networking Bank Trade creditor	5.394	.03	.521	.780	3.692	.01	.183	.02
Macro-economy Bank Trade creditor	6.688	.00	.205	.09	2.850	.02	.213	.20
Legal Bank Trade creditor	5.489	.04	.643	.26	4.097	.02	.612	.40
Ethics Bank Trade creditor	6.702	.03	.384	.69	5.003	.01	.231	.05
Crime Bank Trade creditor	6.409	.04	.730	.29	4.117	.00	.432	.80
Corruption Bank Trade creditor	7.628	.00	.335	.18	4.620	.01	.343	.78

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