

# **SMALL AND MEDIUM SIZE ENTERPRISES' ACCESS TO EXTERNAL FINANCE IN LESOTHO**

by

**Mpho Armistice Mokoatleng**

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**Supervisor: Dr. Liezel Alsemgeest**

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## ABSTRACT

The objective of this study is to identify the main obstacles to SMEs' access to external finance in Lesotho. The research is conducted against a backdrop of access to external finance continuing to be a significant challenge for SMEs, resulting in their failure to continue operations, grow or maintain competitiveness. The lack of access to finance by SMEs is highly pertinent – especially for a least-developed country like Lesotho – as it not only constrains SMEs growth and success, but also hampers the economic growth and development of countries.

An empirical research was conducted using a quantitative approach and non-probability, convenience sampling technique. The sample size of 82 was drawn from a population of SME owners and managers in Lesotho and the research instrument used was a self-administered questionnaire.

The study found that only 50% of the SMEs surveyed have tried to access credit, and personal savings of owners was the leading source of start-up capital. Working capital was the leading reason SMEs needed external finance. Retained earnings remain the leading source of current funding, followed by up to 63.4% of SMEs that still used personal savings of owners as source of current funding. Meanwhile, a majority of SMEs preferred banks as their main source of future funding over other sources.

The main demand-side obstacles to access to external finance for SMEs in Lesotho, identified by this research and in order of significance, are; 1) SME owners/managers believe they do not need credit, 2) inadequate cash flow to cover monthly loan repayments, 3) high interest rates and other costs of getting a loan, 4) lack of collateral, 5) equity base that is too small, 6) not wanting to be told how to run their businesses by financiers, 7) lack of the required business plan, 8) lack of information required by financiers, 9) financing is not available at all and, 10) lack of time to understand and complete loan applications.

**Key words:** *SMEs, entrepreneurs, demand-side obstacles, access to credit, external finance, financing gap, debt, equity, collateral*

### **DECLARATION**

I declare that the field study hereby handed in for the qualification Master's in Business Administration at the UFS Business School at the University of the Free State is my own independent work and that I have not previously submitted the same work, either as a whole or in part, for a qualification at/in another university/faculty.

I also hereby cede copyright of this work to the University of the Free State.

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Signed

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Date

**DEDICATED TO  
MARY LEBOHANG MOKOATLENG,  
MOTHER.**

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# **CHAPTER 1**

## **OVERVIEW OF THE STUDY**

### **1.1 INTRODUCTION**

This study set out to determine the main obstacles with respect to access to external financing for small and medium size enterprises (SMEs) in Lesotho. The study determined these obstacles from a demand-side perspective. This chapter provides an overview of this field study. The background to the study and thereafter the problem statement to explore the access to finance issues for SMEs in Lesotho are presented. The primary and secondary objectives are presented, as well as the research methodology employed in reaching the objectives of the study. Lastly, a demarcation of the field study is offered and a conclusion of the chapter.

### **1.2 BACKGROUND TO THE STUDY**

Small and medium size enterprises (SMEs) are widely acknowledged as drivers of economic development for countries around the world (Beck, 2007). However, SMEs face numerous barriers to their emergence, growth and sustainability - resulting in a high failure rate. In Lesotho, one of these barriers is a lack of access to external financing (MTICM, 2008b). The ability of the business to access finance determines its ability to conduct its operations, invest in capital equipment and finance research and development (Bannock, 2005).

While there are ways to finance businesses, access to such finance for SMEs remains a problem. The perceived high risk associated with financing new SME ventures renders them unattractive to formal finance institutions such as banks and non-bank finance providers. The lack of access to finance is more pronounced in developing countries than developed ones and although entrepreneurs believe that funds are available, it is access to these funds that proves to be problematic (Maas & Herrington, 2006). This

has left the financing of new ventures as one of the most intricate problems to solve (Mutezo, 2005). SMEs need finance in the form of either debt or equity to realize their plans and their ability to access this finance or not, has a major impact on the venture itself and the general economy (OECD, 2013e).

The life-cycle stage of a business is an integral factor in determining the type of financing that SMEs need and use (Jones, 2010). It is generally held that at start-up, firms have great difficulty accessing financing because of their failure to meet the requirements of suppliers of finance. Consequently, the owners become the sole resource of equity and quasi-equity in the form of personal assets that are used by the firm. As the SME firms progress through the life-cycle stages and become successful, the need for more financial resources becomes more pronounced as the owner's and retained earnings become insufficient to finance high-growth strategic investments (Mac an Bhaird, 2010). Barriers such as information opacity then create the gap between suppliers of finance and SMEs, resulting in a financing gap (OECD, 2006b).

The existence of the financing gap results in a number of negative effects both on the enterprises and the macro-economy. When an entrepreneur cannot get access to the finance needed to start a venture, then the business fails before it even starts. Often, highly innovative firms present the highest risk for the formal finance sector because of their new, untested business ideas and unconfirmed market. Thus, the number of innovative and market-gap closing businesses that get started is adversely affected (OECD, 2006b). For SMEs already in operation, failure to secure the requisite financing may impede sustainability and the ability to invest in capital equipment. This then stunts growth of the business and of the overall economy by limiting such factors as employment, competition and innovation. A developing economy such as Lesotho cannot afford to have these limitations (MTICM, 2008b).

Some of the barriers on the supply side to accessing external finance include limited track-record information (Udell, Kano, Uchida & Watanabe, 2011), lack of collateral, inadequate legal framework to manage the relations between financiers and the enterprises and limited financing products that involuntarily exclude SMEs (Angela, 2012b).

There are several economic benefits to SMEs, suppliers of finance and the economy in general if SMEs can access finance. Banks get more business through increased transactions with SMEs, while SMEs get the finance they need to start, grow or sustain operations. Increased competitiveness, innovation and the introduction of new products and processes can then lead to an economic upswing (Beck, 2007).

In Lesotho, small, micro and medium size enterprises (SMMEs) combined provide up to 85% of all private sector jobs (MTICM, 2008b). However, the focus of this study shall be SMEs because of their relatively higher potential for growth and greater impact on economic development (European Union, 2011). The definition of SMEs adopted for this study shall be that of the MTICM (2002a) which is in terms of the number of permanent employees and annual turnover.

**Table 1.1: The Definition of SMMEs in Lesotho**

Size of Enterprise	Number of Employees	Annual Turnover
Micro	< 3	< R 200 000
Small	3 – 9	R 200 000 – R 999 000
Medium	10 – 49	R1 million – R5 million

The government of Lesotho has initiated several projects to close the financing gap for SMEs while banks have introduced flexible financing products. However, accessibility is still a problem for businesses that need credit. This is indicated by the lack of progress in the period 2005 – 2012 in the area of 'Getting Credit' as measured by the World Bank (2013c). Generally, Lesotho SMEs also have meagre or no growth, with less than 40% of registered SMEs experiencing turnover growth over a three-year period (Theko, 2009).

This study thus seeks to explore the access to finance issues for SMEs through an empirical study and literature review of the financing options available for SMEs, the obstacles they face and the approaches that can be adopted to bridge the financing gap.

### **1.3 PROBLEM STATEMENT**

While the role of SMEs in driving economic development is widely accepted, they continue to face daunting challenges in accessing the financing they need. This impedes their ability to invest in capital projects, launch new products and sustain operations. Consequently, SMEs fold or remain stunted leading to failure to have the expected macroeconomic impact. Lesotho is a small, developing economy that does not have the infrastructure, technology and market size to attract sizable foreign direct investment. Furthermore, the country is not resource-rich, implying a further limit to foreign exchange earnings. As a result, it is vitally important that Lesotho have a bustling and growing SME sector (Central Bank of Lesotho, 2011).

In Lesotho, the majority of SMEs are owner-managed. While the owners might be knowledgeable with the products of the enterprise, they often lack the financial training to maintain and prepare the financial information required by the creditors. Such financial information is often incomplete or inaccurate rendering it unacceptable to financial institutions or investors (Ackah, 2011).

Most entrepreneurs are control averse, effectively making debt finance the most sought after type of financing by SMEs. This leads to an inadequate capital base for most SMEs, which then translates into failure to meet collateral requirements of lenders when financing is sought. The absence of an active capital market further limits financing options for start-up SMEs, leading to a decline in emerging enterprises (Berggren, Olofsson and Silver, 2000a).

Long-term growth of SMEs is negatively affected by failure to access finance. Often debt financing available is short-term, and thus also limited in size. Hence, SMEs experience difficulties in accessing tailor-made finance products to facilitate the growth of the business (Mac an Bhiard, 2010).

There are challenges identified in literature relating to SMEs' access to finance. Such challenges, from the supply side, are easily applicable from country to country because of the globalised nature of the banking industry. On the other hand, the demand-side

challenges as identified in literature may not necessarily be the challenges that Lesotho SMEs face. Some of the more common supply-side and demand-side challenges are shown in Table 1.2.

**Table 1.2 Access to external finance challenges faced by SMEs**

Supply-side challenges	Demand-side challenges
Lack of sound business plan	Investment readiness
Lack of collateral	Costly services of financial institutions
Inadequate cash flow	Control aversion
Information asymmetry	Risk aversion
Limited owner investment	Inability to exploit existing sources of funding

## **1.4 OBJECTIVES OF THE STUDY**

### **1.4.1 Primary Objective**

To identify the main obstacles to SMEs' access to external finance in Lesotho.

### **1.4.2 Secondary Objectives**

- To review the obstacles to and the requirements for access to external finance for SMEs.
- To identify the main reasons SMEs in Lesotho seek external finance.
- To identify the alternative financing sources that SMEs are turning to in Lesotho.
- To investigate the viability of these alternative funding sources.
- To identify possible approaches that can be adopted to bridge the financing gap.



## **1.5 RESEARCH METHODOLOGY**

A literature review and an empirical study were employed to achieve the objectives of this study.

### **1.5.1 Literature Review**

The fundamental question of this study forms the basis of the literature review, which in turn provides the foundation of this study. The literature review will provide the background to the research objectives, while the salient themes emanating from the literature review were guided by previously published and unpublished research on this topic.

### **1.5.2 Empirical Study**

#### **1.5.2.1 Research Design**

A descriptive research design and quantitative approach were used for this study to highlight the main challenges faced by Lesotho SMEs in accessing external finance.

This research method is efficient and cost-effective (Sekeran & Bougie, 2013) and this was helpful given the time and budgetary constraints faced by the researcher.

#### **1.5.2.2 Target Population**

The target population for this study was constituted by the owners and managers of SMEs in Lesotho.

#### **1.5.2.3 Sampling**

A non-probability, convenience sampling technique was used. This technique was used because the total number of SMEs operating in Lesotho is unknown as some businesses, especially small enterprises, are not registered legally. Furthermore, it ensured that respondents were involved willingly and thus boosted response rates.

The targeted sample size was 100 SMEs owners.

#### **1.5.2.4 Data Collection Technique**

Data were collected using structured questionnaires that were distributed to SME owners or managers in Lesotho to gather first-hand primary data to be processed towards achieving the research objectives of this study.

The questionnaires were distributed by the researcher.

#### **1.5.3 Ethical Considerations**

The following ethical considerations guided this study:

- Information obtained from the respondents for the purpose of this study will be treated with strict confidentiality.
- Respondents participated in the study voluntarily.
- The purpose of the study was explained to the respondents.
- Anonymity of the respondents was assured.
- Data collected during the study were not misrepresented.

### **1.6 DEMARCATION OF THE FIELD STUDY**

This study aims at identifying the main challenges that are faced by SME owners in accessing external finance in Lesotho. SME owners and managers constituted the target population for this investigation. It is anticipated that the study will guide policy designs aimed at bridging the financing gap faced by SMEs.

This study was conducted within a three month-period with a limited budget.

The field of study is Business Management.

## **1.7 CONCLUSION**

This chapter presented the background and the problem statement of this study. The definition of SMEs as was used throughout this study has also been given. The objectives of the research have also been detailed.

Lastly, the chapter has provided the details of the methodology that the researcher employed to achieve the objectives of the study as well as the demarcation thereof.

Chapter two of this study is the literature review of the issues around access to finance by SMEs in general and by Lesotho SMEs in particular. The focus will be mainly on the demand-side challenges of accessing external financing. The research methodology used for this study will be extensively presented in chapter 3, while chapter four will deal with data analysis and findings. Finally, chapter five will present recommendations and conclusion of the study.

## **CHAPTER 2**

### **LITERATURE REVIEW**

#### **2.1 INTRODUCTION**

This chapter explores the published literature on the varied issues related to access to external finance by SMEs. The unique characteristics of SMEs are reviewed critically and the bank requirements for loan access by SMEs are explored. Furthermore, the demand-side constraints to access to external finance by SMEs are presented.

In line with the objectives of this study, this chapter discusses the reasons SMEs need finance and the different types of financing that are available. The efforts by various agencies to close the SME financing gap are also critically reviewed.

#### **2.2 DEFINING SMEs**

Definitions of SMEs help governments and international development institutions to target appropriate policy interventions and special support to deserving enterprises. Definitions are therefore used to determine eligibility of enterprises for special support through various interventions provided by governments and multilateral development organizations. Such interventions include loan guarantees, tax breaks, special credit lines and targeted business development services (Gibson & Van der Vaart, 2008).

There is no definition of SMEs with universal applicability. This is because the definitions of SMEs offered by most proponents have been influenced by numerous factors related to the socio-economic environment of a given environment (Falkena, 2010). Most commonly however, the number of employees, the value of fixed assets and turnover are used to define SMEs (OECD, 2000a). However, Gibson and Van der Vaart (2008) argue that these factors have led to definitions that have resulted in lack of clarity and a standard definition of SMEs. They posit that the vagueness in the way that

governments and development organizations have sought to define what SMEs are and do has done more harm than good to the concept of ‘SME’ – both as a distinct part of the business sector and as a specific concern of economic development strategies. The absence of a standard definition has resulted in different definitions as exemplified by the definitions of various developmental organizations in Table 2.1.

**Table 2.1 SMEs Definitions Used by Multilateral Institutions**

Institution	Maximum # of employees	Maximum revenue or turnover (\$)	Maximum value of assets (\$)
World Bank	300	15 000 000	15 000 000
MIF- IADB	100	3 000 000	None
African Development Bank	50	None	None
Asian Development Bank	<i>Uses definitions of individual national governments</i>	<i>N/A</i>	<i>N/A</i>
UNDP	200	None	None

Source: Gibson and Van der Vaart (2008).

To minimize the problem of the wide variations in the quantitative definitions of SMEs by various governments and international organizations, Gibson and Van der Vaart proposed a formula that defines SMEs by their annual turnover (in US dollars) that is between 10 and 1000 times the mean per capita gross national income – at purchasing power parity – of the country in which the SMEs are. This definition provides an opportunity for a consistent approach across all countries, while taking into account the local context as well (Gibson & Van der Vaart, 2008).

## 2.3 CHARACTERISTICS OF SMEs IN LESOTHO

In highlighting the characteristics of SMEs, the ensuing considerations should be borne in mind;

- a) The research deficits. The problems faced by SMEs in Africa, and Lesotho specifically, are widely known. However, little has been empirically verified on SMEs in Lesotho. This is partly because in both absolute and relative terms,

few studies have been conducted and partly because studies that have been conducted have focused mainly on the enterprise sector as a whole (BEDCO, 2010).

- b) The lack of statistical data on the activities of SMEs. Since there is no systematic recording of SME activities data, available statistical data often is obtained from sample results. Analogous to observations elsewhere in Africa, SME issues are usually incorporated in broader industrial policies (MTICM, 2008b).

The most significant distinguishing feature of SMEs is their limited access to external financing relative to large scale enterprises (LSEs). Access to finance for LSEs extends beyond banks to international and local capital markets. The fixed costs associated with regulatory compliance are the same for both SMEs and LSEs despite the latter's bigger resources and easier access to finance. Additionally, higher intermediation costs of small projects foster the exclusion of SMEs from capital markets and export product markets (Kayanula & Quartey, 2000).

### **2.3.1 Dynamic Aspects**

The first characteristic of SMEs to be reviewed is enterprise dynamism. Three shifts are observed which are start-ups, growth patterns and closures. These shifts are market-driven processes that have an impact on economic activity by way of pull forces. The shifts indicate that the SME sector is in a continuous state of flux. During any given period, new enterprises are being started while existing ones are expanding, contracting in size or even closing. The extent of the churning that occurs within the sector is masked by the net change as these dynamic components of change move in different directions. The discussion that follows deals with these three components of enterprise dynamics (Liedholm & Mead, 1998).

#### **2.3.1.1 Start-ups**

A study by Aghion, Fally and Scarpetta (2007) found that higher finance development is positively correlated with an increased number of new start-ups. This is especially true

for businesses in, for instance, manufacturing that depend heavily on external finance to get off the ground. However, a high number of new start-ups is still observed in developing countries but are confined to survivalist and mostly retail/trade small enterprises that require minimal capital to launch.

According to MTICM, 100 new businesses get started every year in Lesotho. This has been the trend over the last five years. Additionally, many more unregistered businesses get started that fit the description of SMEs proposed in Chapter One. The reason why some owners do not register their business is two-fold: firstly, to avoid paying tax and, secondly; - because they do not do business with government or any organization that requires that its suppliers are registered to trade and for tax purposes (MTICM, 2008b).

#### **2.3.1.2 Growth Patterns**

In Lesotho, less than 40% of businesses reported revenue growth over a three-year period. This means that for approximately 60% of SMEs, revenue growth either stayed the same or decreased over the same period. Even more discouragingly, only 14% of businesses surveyed by the MTICM reported having increased their employee numbers (MTICM, 2008b). This situation is indicative of a stagnated growth of the SME sector. Access to finance is a disproportionately significant factor in supporting growth of SMEs, especially in high-growth information technology businesses (OECD, 2008c).

#### **2.3.1.3 Closures**

It is difficult to determine the rate of business closures particularly in low-middle income economies because businesses are either unregistered or no formal procedures are followed to wind businesses down. Some of the main reasons businesses in Lesotho fold are due to lack of demand, high operational costs and inadequate infrastructure (Theko, 2009). The lack of systematic data collection in this regard makes assessment of data in respect of business closures extremely difficult.

## **2.3.2 Structural Aspects**

The structural aspects of enterprises provide their competitive premise. There are factors that determine the extent of competitiveness and sustainability of an enterprise. These include the size of the enterprise, legal status, firm ownership and formalisation of management activities and market linkages (Matambalya, 2000). All of these are discussed in more detail next.

### **2.3.2.1 Firm Size**

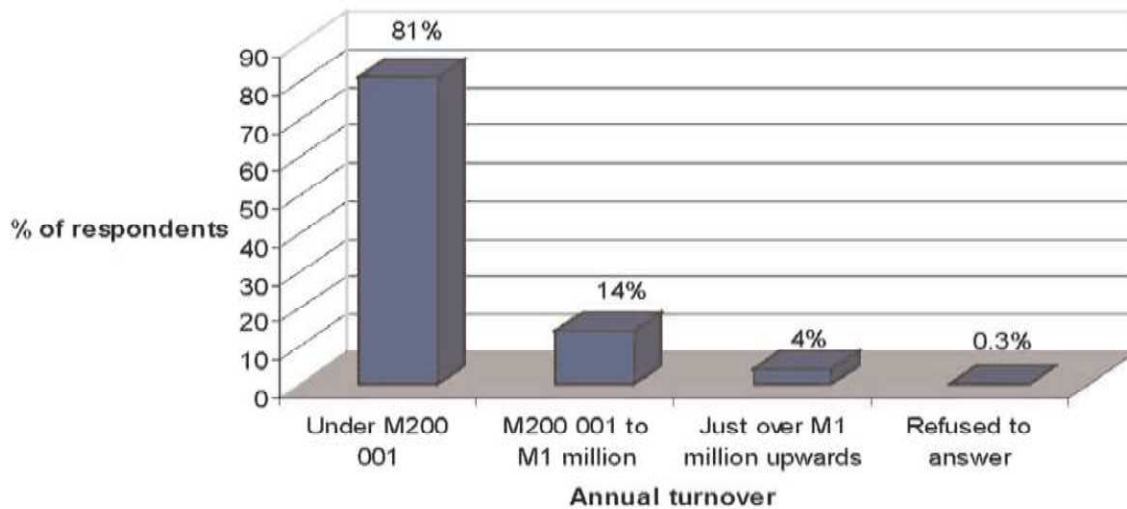
The aspect of enterprise size has a far reaching effect on the activities of the enterprise. It can have an effect on the enterprise's ability to trade internationally; have inter-business strategic alliances - such as technology transfers and licensing – and to weather economic challenges (Matambalya, 2000).

Generally, in comparison to their Western counter parts, even LSEs in Africa or within the South Africa Development Community (SADC) region would be considered as SMEs by European standards (OECD, 2006b). However, even sticking to the local definitions of SMEs, most SADC region SMEs are considered to be small in size. In this regard, a study conducted by the MTICM reveals that the majority of businesses in the Lesotho SME sector are micro enterprises. About ninety-three percent of SMEs are small enterprises while only seven percent are of medium size. This is as per the number of employees a business employs. While the figures differ slightly, measuring the sizes of enterprises using the turnover aspect gives the same general trend in terms of size distribution of SMEs as indicated in Figure 2.1.

Figure 2.1 shows the composition of the SME sector in Lesotho, as measured by the size of turnover. Turnover is given in the local currency, the Maloti. The figure shows that 81% of enterprises are micro enterprises, 14% as small and just 4% as medium enterprises as classified according to their income.



**Figure-: 2.1: Composition of the Lesotho SME sector by size of turnover**



*Source:* (MTCIM, 2008b)

The dominance of micro enterprises underscores the structural disequilibrium of the enterprise sector, a problem further exacerbated by the lack of LSEs in Lesotho. The effect of this configuration of the business sector is the diminishing of the potential of the enterprise sector to promote economic growth and international competitiveness (MTICM, 2008b).

### **2.3.2.2 Ownership**

The dominant form of enterprise ownership in Lesotho is sole proprietorship. As indicated previously, a vast majority of enterprises are micro enterprises with a survivalist bent, and this is attributable partly to the form of ownership that is often not too inclined or well-resourced to finance growth. Registered limited private companies and partnerships comprise about 20% of all SMEs, while privately held companies make up about 70% of all formal SMEs (MTICM, 2008b).

Liedholm and Mead (1998) state that in most countries, including Sub-Saharan Africa, women own the majority of SMEs. This view is, however, rendered archaic by recent studies that show a more or less equal ownership of enterprises between males and females (Theko, 2009). Women do tend to dominate in ownership of unregistered,

home-based enterprises and this explains the fact that male-owned enterprises tend to have more revenue, are generally larger and in the formal sector. In a 2008 study, it was found that up to seventy-seven percent of medium size businesses are owned by males (Theko, 2009).

Female entrepreneurs are thus inadvertently left out of official statistics as they operate mainly in the informal business sector. This adversely affects their ability to access financing, since such funding programmes are designed without sufficient consideration for the needs of female-owned businesses (Abor & Quartey, 2010).

### **2.3.2.3 Legal Status**

The most effective way, in low-income economy countries and especially Sub-Saharan Africa, to assess the legal status of businesses is through tax registration. It provides the most unambiguous definition of formality. Tax registration is positively correlated with the size of the business. Over ninety percent of medium size enterprises are registered for tax, while the proportion of small enterprises that are registered for tax is lower (MTICM, 2008b).

### **2.3.2.4 Formalisation of Business and Management Activities**

It is often difficult to distinguish the personal finances of small business owners and their businesses. This is as a result of limited formality in enterprises specifically sole proprietors and small businesses. The lack of registration, particularly for tax purposes, removes the need for business owners to be compliant with financial reporting requirements. This factor negatively impacts on the businesses' ability to access finance and increase information opacity (NCR, 2011).

The low levels of usage of basic office technology such as computers, internet and landline telephones contribute to the lack of formalization and organisation within SMEs. Consequently, the SME sector remains unsophisticated and with limited prospects to expand through connections with other businesses in the region and globally (Liedholm, 2001).

### **2.3.2.5 Market Linkages**

An enterprise's forward business linkages, or market linkages, is defined by the linkage of the business to its product markets. Product market linkages within the SADC region are fairly similar to those in other African economies. The efforts by the regional unions such as SADC to remove traditional trading barriers, such as trade restrictions, price controls, exchange rate overvaluations and others, have been very helpful to traders. On the other hand, these positive measures are pushed back by poor physical infrastructure, poor information and communication technological infrastructure, restricted sales quantities due to limited purchasing power, under development of channels of distribution and others that remain in place (Liedholm, 2001).

The geographically restricted market outreach is evident throughout Africa where market linkages are rather limited. Results from surveys in Malawi, Swaziland and Zimbabwe have revealed that over 96% of SMEs sell directly to final consumers (Matambalya, 2000). In Lesotho, it has been shown that over 96% of all SMEs also sell directly to the final consumer and trade domestically and within their locality. Only 3% of surveyed businesses provided goods and service to LSEs and the foreign market (MTICM, 2008b).

Adverse market linkage issues impact negatively on the efficiency of enterprises and are an impediment on the SME sector's ability to foster growth. This issue furthermore has an impact of increasing transaction costs, choking of markets integration and encouraging the inefficient allocation of resources (Matambalya, 2000).

The significance of SMEs to the development and growth of the economy is discussed next.

## **2.4 THE IMPORTANCE OF SMES TO ECONOMIC DEVELOPMENT**

A growing SME sector contributes significantly to the economic development and growth of any country. SMEs raise economic productivity by spurring innovation, encouraging productive churn and promoting stronger competition. External finance is

an important market mechanism for allocating resources within the economy. Economic development is facilitated by enabling new businesses with innovative products or more efficient production processes to displace older, less efficient ones. This process leads to improved productivity and initiates the optimization of under-utilised resources within the economy (BIS, 2012b).

SMEs also provide a larger number of private sector jobs than LSEs. In most OECD countries, SMEs account for 60-70% of employment (IFC, 2010a; OECD, 2000a). In least developed countries, the number of SME sector jobs is even higher and, for Lesotho specifically, the MSME sector provides 85% of all private sector jobs (Theko, 2009).

The ability of SMEs to access finance to fund business investment facilitates new business start-ups and ensures that they reach their full growth potential. A thriving SME sector that provides jobs thus leads to income growth and poverty reduction (Ackah, 2011; IFC, 2010a).

The constraints that entrepreneurs face as they try to access finance are elucidated in the following section. The section starts by looking at requirements of banks and other financiers before they can avail funding to SMEs. The demand-side obstacles to access to external finance by SMES are also reviewed.

## **2.5 CONSTRAINTS TO SMEs' ACCESS TO EXTERNAL FINANCE**

It is accepted that SMEs are a significant source of economic growth and job creation. Furthermore, they are an indispensable driver of innovation through their dynamism and flexibility. Even with this economic contribution profile, SMEs' access to external finance continues to be a key constraint to SME development, especially in emerging economies. The difficulty in accessing external financing is even more pronounced in least-developed countries (LDCs), with forty-one percent of SMEs in LDCs reporting access to finance as a major constraint to their sustainability and growth, as compared to thirty percent in middle-income countries and only fifteen percent of SMEs reporting such difficulty in developed economies (IFC, 2011b). This finding is further supported by

Ardic, Mylenko and Saltane (2012), who established through a statistical analysis study that there is a positive correlation between the level of overall economic development of a country (measured by income per capita) on the one hand, and the level of SME financing, on the other side.

The constraints on SMEs' access to external finance are both supply-side and demand-side constraints. This study focuses specifically on the demand-side constraints, however, a brief presentation of the main requirements by formal financial institutions and banks for loans or funding requests is also presented.

### **2.5.1 The Requirements to Access External Finance**

Financial industry institutions are highly globalised, with foreign-owned banks operating not only in multiple countries but on more than one continent as well. It is for this reason that most financial institutions offer standardized financial services/products that are for the most part not tailored to meet the unique challenges of the region within which the bank operates. On the other hand, regional or indigenous financial institutions are often too low-resourced to offer credit access needed by SMEs (ADB, 2012).

Traditionally, financial institutions and banks tend to have highly inflexible requirements or conditions for granting credit funding. All banks undertake a thorough assessment before they approve applications for funding from SMEs. There is greater dependence on transaction lending, which relies on 'hard' quantitative data, as opposed to relationship lending, which depends more on 'soft' qualitative information obtained over time through relationship with SMEs (Ackah, 2011).

The Lesotho banking sector is very small, comprising only four major banks. Three of these banks are South African subsidiaries and only the Postbank is a local, government-owned bank. These banks generally adhere to South African standards for internal regulation, which are stricter, despite being under the regulation of the Central Bank of Lesotho (CBL) (PSCEDP, 2013).

The overriding concern for the banker when considering a request for credit by SMEs is to ensure that the borrower has the requisite character, capacity and capital. The main requirements, which are almost common to all the banks, that banks demand to be met

by SMEs before their applications for funding can be approved include a viable business plan, the business's ability to operate as a going concern, turnover trend and other transactions of the business, investment in the business, the business's cash flows, collateral and loan documentation (Mori & Richard, 2012).

***a) A viable business plan***

This is a very crucial element in any application for funding, whether to a bank or venture capital organization. For a start-up enterprise, it presents the prospective funder with the envisaged future of the enterprise, while it also describes the past and present status of the business for existing funding applicants. More specifically, a bank will want the plan to explain the specific use of the funds requested, how the money will help the business and how repayments on loan will be made. Banks expect business plans to be complete, sincere, factual, well-structured and easy to read (UNCTAD, 2012).

***b) Information on the ability of the business to operate as a going concern.***

The bankers are often in need of information on how long the business has been in operation. This allows them to assess the future longevity of the business. Information on previous loans that were repaid in time and good profit prospects enables easy decision making on the part of the banker. Banks prefer previous borrowers because they prefer low-risk, low-profit ventures as opposed to venture capitalists that make high-risk investments even in businesses with no previous record of accomplishment (Alliance Bank, 2013).

***c) Information on the trend of turnover as well as other transactions***

This allows the banker to assess the success of the business and thus its capacity to afford the repayment of the loan. It reflects the level of professionalism with which business transactions are handled and whether turnover will be adequate to support the repayments of funds provided (NEAF, 2012).

***d) Information on the business investment in terms of the total value and premises.***

Commercial banks are further interested in the extent to which the entrepreneurs are financially invested in their businesses. Consequently, banks often ask for a percentage of the required loan as a deposit before granting a loan. This provides them with the comfort of knowing that the entrepreneur is also prepared to shoulder risk associated with his/her firm. Furthermore, capital investments and premises increase the value of the business and provide prospect of collateral (Kavitha & Nagaraju, 2013).

***e) Information on the business's cash flows***

The cycle of cash flow – starting with the purchases of inventory to the settlement of accounts payable – is a significant consideration for granting short-term debt funding. The lender's main concern in this case is to assess whether the business operations will generate adequate cash to service the loan. Through cash flow analysis, the banker is also able to see how the business's main cash expenditures relate to its main cash resources. Both historic and projected cash flow statements are required and the information that the banker gleans gives him insight into the business's market demand, management competence, business cycles and any significant changes in the business over time (Alliance Bank, 2013).

***f) Information concerning collateral for the loan required***

Collateral is required so the banker can have the comfort of knowing that the borrower will fulfill its obligations under the credit agreement. It provides the security of funds the bank lends. Collateral also enables the bank to reduce or eliminate the problem of adverse selection caused by information asymmetries. Furthermore, moral hazard uncertainty is removed as collateral aligns the interests of both the creditor and the debtor and thus becomes the means to discipline the behaviour of the latter with respect to making the business project funded a success (Badulescu, 2011b).

### ***g) Loan documentation***

The documents that comprise the loan application include not only the business plan, but the application forms, income statements, projected and historic financial statements and other documents depending on the specific type of loan sought. The forms must be completed satisfactorily and all the required documents availed (Alliance Bank, 2013).

### **2.5.2 Demand-side Obstacles To SMEs' Access To External Finance**

Demand-side obstacles to financial access can be defined as a capital market imperfection which leads to an adverse effect on the performance of a firm due to factors internal to the firm (Cressey & Olofsson, 1996). These factors lead to SMEs either not applying for finance and or failing to successfully secure funding in the event that they do apply (BIS, 2012b). This observation provides a plausible explanation of the fact that a low number of African enterprises have any loans at all. Only twenty-three percent of the African enterprises without a loan actually have applied for a loan at all as compared to 40% in developed countries (European Investment Bank, 2013).

The demand-side obstacles that result in SMEs experiencing problems accessing external financing are analysed in the ensuing sub-sections.

#### **2.5.2.1 Investment Readiness**

A business plan serves as a roadmap that diligently articulates the realisation of a potential opportunity, its requirements, risks, merits and potential rewards. It serves as a starting point for prospective lenders to begin their due diligence in assessing the likely risks and success prospects of an enterprise. A bankable business plan is indispensable in successfully obtaining debt or equity financing for any enterprise (Bakhas, 2009). As a matter of fact, Mullen (2012) contends that securing funding for businesses is tied to how well a business makes itself investment-ready for prospective investors or lenders.

The low quality of business/project plans that are submitted to the financiers for funding presents a conundrum wherein entrepreneurs complain of lack of funding for their



projects while providers of finance decry the lack of investment readiness in the projects submitted for consideration. The inability of SME owners to prepare sound business plans is cited by Udell, Santiago and Fransisco (2009) as one of the most significant barriers to securing business investment. Another factor that leads to rejection of business plans, and thus inability to access business funding, is that entrepreneurs submit business plans that have been entirely developed by business consultants. This practice adversely affects financing applications since most banks disapprove of this practice as the entrepreneur was not involved (Bakhas, 2009).

#### **2.5.2.2 Inability to Exploit Existing Sources of Funding**

SMEs owners are often unable to successfully exploit the available funding opportunities and to diversify financing sources, irrespective of the intrinsic quality of their projects. This is firstly as a result of their inability to convincingly articulate business ideas. The second reason is the unwillingness to spend time dealing with financial institutions. This situation is often viewed by small entrepreneurs as a “waste of time” as they are pre-disposed to the belief that their funding applications, cumbersome as they are, will wind up unsuccessful. Finally, it is fair to attribute the failure to exploit and diversify funding sources to the limited or non-existent professionalisation of management of enterprises, particularly in the field of economic sciences. For example, the Department of Business Innovation and Skills found in study conducted in 2012 that only 25% of the surveyed small businesses had a formally qualified financial manager, although this figure increased to 66% for medium size enterprises (BIS, 2012b).

Non-traditional financing sources exist, but are often unknown by the SMEs because of either the ability to get information or absence of interest (Briozzo & Vigier, 2009). As a result of the inability to get information with regard to existing source of financing, CBR (2008) found in a survey that only 20% of the SMEs knew the local venture capital provider.

The limited awareness of the business information that can be exploited to diversify enterprise financing is, therefore, a significant constraint to access to finance for SMEs.

The OECD (2006b) established even entrepreneurs who are highly skilled in their own specialties often lack information about the possibilities to obtain finance for their enterprises.

### **2.5.2.3 Information Asymmetry**

Information asymmetry defines a situation wherein prospective lenders or funders have less information on the business financial circumstances and prospects than the owners. They are therefore unable to assess the quality of the investment opportunity (Bakhas, 2009).

Information asymmetry constitutes one of the main stumbling blocks to SME financing in Sub-Saharan Africa. Several factors contribute to this informational asymmetry between SMEs owners and providers of finance, especially within the context of Sub-Saharan Africa. The first factor is that most SMEs start in the informal sector and are therefore not in a position to provide financiers with the information they generally require (such as legal documents, budgets and financial statements). The limited financial literacy of entrepreneurs, especially within this informal sector, results in limited administrative capacity which leads to the businesses not having financial records. The information that the entrepreneur shares often lacks detail and rigor (Lefilleur, 2009). This is a very unfavourable position for entrepreneurs to be in because, as Shanker (2013) contends, financial literacy is even more indispensable in the light of increasingly complicated financial reporting requirements in the present day. The problem of not being able to produce documents such as financial statements is further exacerbated by the fact that most SME owners in low income countries cannot afford professional accounting fees (Beck, 2007).

The second factor is the lack of transparency within the SME sector. Entrepreneurs often disseminate erroneous or extremely limited information with the aim of evading taxes. It has been established by Switch-Asia (2013) that some SMEs produce two financial statements with profits being re-calculated down on one of them to minimize tax obligations. Furthermore, it is often difficult to distinguish between the financial situation of the business and that of its owners. A clear example is the use of business

resources, such as company cars, and private homes for business purposes (OECD, 2006b). These problems present suppliers of credit and equity with difficulties in assessing the suitability of the firm for financing as determining its asset base and financials is not easy (World Bank, 2012a).

Thirdly, there usually are no tools to allow providers of finance to learn about the credit payment behaviours of SME owners. Credit bureaus either do not exist or are nascent in Sub-Saharan Africa, excluding South Africa which has a well-developed credit reporting system (Turner, Varghese & Walker, 2008). This however, is confined to the first economy, implying that SMEs will continue to not benefit from its existence as they mostly operate at the lower rungs of the economic ladder (Bakhas, 2009). Lesotho does not have a credit bureau, implying that banks rely solely on previous dealings with existing SMEs for credit payment assessments (PSCEDP, 2013). It is important to develop credit reporting infrastructure because as studies (Beck, 2007; OECD, 2006b) show, advanced credit reporting and information-sharing can significantly improve SMEs access to external finance (Lefilleur, 2009).

Asymmetric information makes it difficult for lenders to distinguish between borrowers who are likely to repay their loans and those who are unlikely to repay. The bank does not get adequate and reliable information to screen prospective borrowers. The two consequences of asymmetric information in this case are adverse selection and moral hazard, which have an effect on the quality of the loan the bank will offer. Adverse selection refers to a situation in which the probability of default increases with the interest rate. This leads to the decline in the quality of the borrower pool due to the rising cost of borrowing. As a result, a higher interest rate will attract risky borrowers and exclude good borrowers (Stiglitz & Weiss, 1981). Small enterprises are more likely to be rationed because they are seen as being riskier.

Moral hazard defines a situation wherein the borrower behaves in a way that has an adverse impact on the return of the principal. In this case, the borrower may not work hard enough to ensure success or may change to a riskier project in a bid to increase his/her profits. Moral hazard occurs if the two parties have divergent interests and the

actions of the borrower cannot be easily monitored by the lender. The borrower may also have deliberately withheld information that could have been used by the lender to screen the loan application. As a result of these information imperfections and costly monitoring mechanisms that may have to be conducted by the lender, collateral has become a preferred means to secure loans and investments (Fatoki and Mazanai, 2012).

The inability and reluctance to produce, keep and update financial and strategic information render SMEs highly information opaque. They are thus unable to convey their status in a credible way, and have difficulty developing a reputation as high quality borrowers. Furthermore, information asymmetry leads to increased transaction costs (due to efforts in gathering information, screening and monitoring that the lender has to undertake), excessive collateral requirements and high risk premiums. This can only prevent easy access to external finance by SMEs (Balling, Bernett & Gnan, 2009).

#### **2.5.2.4 Lack of Collateral and Significant Own Contribution**

Collateral is typically requested by lenders in debt financing to mitigate the risks associated with the issue of moral hazard and is usually in the form of fixed assets. The provision of collateral is meant to ensure that the borrower bears the risk of loss to some extent and the lender has an alternative means of repayment should the borrower default on payments or go insolvent (Zavata, 2008).

The lack of collateral and own capital investment is the most widely cited obstacles encountered by SMEs in accessing finance. While commercial banks place a lot of value on the importance of bankable business plans, the decision to avail credit is mostly made based on the ability of the enterprise to provide acceptable collateral. South African commercial banks have been found to have a very little appetite for risk and are not future-orientated with respect to SMEs development. Consequently, requests for credit are turned down because of inadequate collateral, in spite of the viability of the business plan presented (Rogerson, 2008). Furthermore, credit was found to be available at affordable cost only conditional upon acceptable collateral. This implies that, for start-up and existing SMEs with a good track record, collateral

requirements have the effect of severely limiting access to finance and increasing the cost of borrowing to unaffordable levels (Gounder & Sharma, 2012).

The willingness of the entrepreneurs to provide collateral of the required quality and amount can be reflective of the confidence of the entrepreneurs in the viability of the business or the investment proposition, and their credit worthiness (OECD, 2006b). However, entrepreneurs are often reluctant to provide collateral because of the riskiness of SMEs. The high prospect of failure of SMEs in the short-term increases the riskiness of the business in the eyes of the owners (Falkena, 2010). This risk factor thus renders SMEs operators timid of providing collateral and, by extension, getting loans. This leads to self-exclusion from accessing finance requisite to start, sustain and grow enterprises (Decker, Scheifer & Bulander, 2006).

Another factor that makes collateral requirements difficult to meet for entrepreneurs has been the under-developed system of land ownership and transfer regulations in Sub-Saharan African countries. This makes it difficult to use land, an asset most start-up entrepreneurs have, as collateral (Ackah, 2011). This could partly explain, therefore, why in least-developed and developing countries the issue of ability to provide collateral is comparatively much more severe (Zavata, 2008). In Lesotho, the Land Act of 2010 is a step in the right direction to addressing this problem by providing a legal framework for land title holding and transfers (Government of Lesotho, 2012a).

#### **2.5.2.5 Services of Financial Institutions Perceived as too Costly**

Transaction costs that lenders levy on borrowers come in the form of interest, administrative and other costs related to documentation requirements. In a 2013 study, the OECD found that in the period 2007-2010, SMEs increasingly faced more demanding credit conditions than did LSEs in most countries (OECD, 2013d).

While high financing costs are restraining on all borrowers, it is arguable that they confine SMEs even more. The diversity of SMEs' characteristics and relative informational opacity increases the assessment and monitoring costs of lenders (Beck, 2007). These costs are passed on to the borrower in the form of transactional costs stated above, resulting in SMEs not being able or willing to pay such high fees. In

Lesotho, interest rates for short term loans reach as high as 16% and, considering that SMEs still need to cover other costs such as feasibility studies, financial services are viewed as too cumbersome, time-consuming and costly by SMEs (Switch-Asia, 2013).

#### **2.5.2.6 Control Aversion**

Two motives have been found to be the source of starting a new business venture: opportunity-based entrepreneurship and necessity-based entrepreneurship. Moreover, numerous studies have established that, irrespective of the motive or geographical context, most businesses get started because entrepreneurs want to be their own bosses and avoid any external control (Gelderen & Jansen, 2006). This great need for autonomy is also known as control aversion and, leads SMEs owners to avoid choosing external financing options unless the business is at stake (Berggren, Olofsson & Silver, 2009b; Berggren *et al*, 2000a).

The *pecking order hypothesis* (POH) as first described by Myers (1984) asserts that under conditions of informational asymmetry, firms will opt for financing sources in a particular order that minimizes external interference and ownership dilution. The implication here then, is that internal funding sources (owner capital, retained earnings and trade debt) will be used first, followed by bank debt and finally outside equity financing (Cressy & Olofsson, 1996).

The control aversion of most SMEs owners, therefore, results in them not proactively seeking equity investments for their enterprises. This results in limited growth prospects, and the businesses' life spans being tied to the longevity of the owners' interest in them (Berggren *et al*, 2000a).

## **2.6 EXTERNAL FINANCING NEEDS OF SMEs**

The competitive advantages of SMEs include the ability to respond quickly to new business opportunities and innovativeness. These advantages imply that new production processes, products and services are brought to an ever changing market. In this way, niche markets are exploited and market gaps are closed. However, to be able

to exploit the opportunities presented by market gaps and inefficiencies, SMEs need access to finance (Longenecker, Petty, & Moore, 2013). SMEs need financing to meet short-, medium- and long-term financial demands as discussed below.

In the short-term, SMEs need start-up and working capital to finance daily production and administrative costs associated with running businesses. These costs include rent, payroll, marketing, interest payments, energy and others. Short-term finance further enables the development of prototypes, production of bulk orders and the necessary participation in trade fairs (NCR, 2011). In a study conducted among medium size businesses in the United Kingdom, the Business Innovation and Skills department (2010a) established that working capital ranked highest amongst reasons for seeking bank finance. It is obvious then, that access to external finance in the short-term plugs the cash flow gaps that result due to credit sales and delayed payments. In Lesotho, this is even more critical for SMEs as the government is the largest customer, and is notorious for late payments to suppliers (MTICM, 2008b).

Medium-term finance is needed by SMEs mainly to procure and upgrade physical assets for future benefits. These assets may include equipment, machinery and property (such as industrial buildings). Access to finance at this stage facilitates investment in efficiency-enhancing and clean technologies that improve the competitiveness of SMEs (Switch-Asia, 2013).

Finally, long-term financing is needed by SMEs for growth and market expansion. Beck (2007) found that financing is one of only three features of the business environment that is directly and robustly linked to business growth while other features have an indirect effect on business growth. Market expansion is the process of offering a product to a wider section of an existing or new market. Products may need to be re-adjusted to increase market share, development and implementation of market entry strategies, the pursuit of a high growth strategy or the development of products and services based on new technology are all examples of very costly investment

requirements for business growth that highlight the need for long-term financing (Switch-Asia, 2013).

The different types of financing resources and instruments to address these needs of SMEs are explored in the following section.

## **2.7 TYPES OF FINANCING SOLUTIONS AVAILABLE TO SMEs**

The previous section reviewed the financing needs of SMEs and established that working capital and fixed investments are the main needs for external finance. This section explores the whole range of financing sources potentially available to SMEs. The types of financing sources can be broadly categorized into debt and equity and, can be used by SMEs to complement each other or to substitute each other (Zavata, 2008).

While the overarching decision is between debt and equity, these financing sources are not necessarily appropriate for, or accessible to all of the different types of SMEs. The nature of funding required by and accessible to an enterprise depends on its financial growth life-cycle stage (Mullen, 2012). The funding choices made by the entrepreneurs are generally explained by two specific theories: the **pecking order theory** and the **trade-off theory**.

The *pecking order theory* argues that there is a *pecking order*, or ranking of the preferred sources of financing by owners of SMEs. The premise of this theory is that there is no well-defined, optimal capital structure, as it is up to the owner-manager to decide which financing sources to approach at any given time. In this theory, Myers (1984) posits that entrepreneurs tend to prefer own, internal sources of finance over debt, which in turn takes precedence over external mezzanine finance and external equity as the last-ranked source of financing preferred by entrepreneurs. Consequently, this hierarchical financing over time determines the debt ratio (Briozzo & Vigier, 2009; Fatoki & Smit, 2012).



On the other hand, the trade-off theory posits that entrepreneurs opt for financing sources on the basis of a trade-off between increased tax savings and increased bankruptcy costs. The theory acknowledges that interest payments are tax-deductible thus minimising the cost of capital and maximising equity holders' wealth through the use of debt. On the contrary, there is a real risk of over-gearing, financial distress and consequently bankruptcy (Fatoki & Smit, 2012; NEAF, 2012).

The following sub-sections, on debt and equity, discuss the various types of financing sources and their suitability for the various stages of an enterprise's life-cycle.

### **2.7.1 Debt**

Debt financing comprises financial borrowing activities by SMEs that entail the repayment of the borrowed funds with interest and within a specified period of time. The lender does not get any ownership stake in the business as long as the loan is paid within the agreed parameters. SMEs can source financing from friends and relatives of the owner, commercial banks and business suppliers (Longenecker *et al*, 2013).

- **Debt supplied by friends and family**

Loans and contributions obtained from family and friends of an entrepreneur are a consistently indispensable source of financing, specifically for start-up enterprises. At start-up stages, firms usually lack a track record and collateral and thus are unable to meet the requirements for other types of external financing. Furthermore, the lending terms of friends and relatives, though limited, tend to be much more favourable and flexible than other financing sources as there are no transaction costs. This form of debt funding is viewed as internal and informal. As the business grows however, it is likely that the entrepreneur has exhausted all the resources from the so called 3Fs (founder, family and friends) financing sources and therefore cannot continue to fund the business, necessitating the next source of funding as per the *pecking order theory* discussed previously. (Ackah, 2011; Longenecker *et al*, 2013; NEAF, 2012).

- **Debt supplied by commercial banks**

Bank debt financing is generally the most important source of external financing for SMEs (Switch-Asia, 2013). Even so, in Sub-Saharan Africa the top five of the banks

serving SMEs still reach only about 5% of formal micro enterprises and SMEs (Dalberg Global Development Advisors, 2011). This issue is further exacerbated by the fact that global bank lending has been in decline since 2009 as a result of the 2008 global credit crunch. The reason for this decline is two-fold: firstly, SMEs are deleveraging and putting off investment plans due to economic uncertainty, and secondly, banks have become more risk averse and face regulatory demands to hold more capital or liquidity (BIS, 2012b).

Bank debt can be short-, medium-, or long-term and is usually used by SMEs to finance working capital and fixed asset investments. The debt is offered by banks in a variety of loans. Bank debt is often accompanied by the requirement for collateral in the form of fixed assets and property. SMEs are relatively labour intense, implying low investments in equipment and machinery, hence the insufficient collateral (Fatoki & Mazanai, 2012). The main advantages of bank debt for an entrepreneur are the tax shield effects and preservation of control as no ownership needs to be ceded (NEAF, 2012).

Encouragingly, African banks are very bullish about the prospects for the African SMEs market and a majority of them are actively involved in some form of marketing to attract SME clients. However, a study conducted by the African Development Bank determined that only 13% of the banks surveyed offered their SME clients tailor-made financial products, indicating lacklustre product innovation is occurring given the extent of need and the potential business for banks. To further emphasise the need for collateral, the same study found that up to 94% of bank respondents demand collateral from their SME borrowers (ADB, 2012). This results in a great number of SMEs not being able to access bank finance, with only 2% of SMEs in South Africa being granted bank finance while 75% of SMEs bank credit applications were rejected (FinMark Trust, 2006).

- **Debt provided by business suppliers**

Debt provided by business suppliers includes trade credit, leasing and factoring.

Firstly, trade credit allows a purchasing firm access to some form of credit. It is a form of credit where the supplier allows the firm some time to pay for goods or services

supplied. The purchasing firm is usually granted 30 to 120 days to settle the debt. This helps SMEs with effective cash flow management and may act as a substitute for more formal, short-term bank financing. Trade credit is especially useful in meeting short-term working capital needs. However, suppliers often try to encourage quicker debt settlements by offering discounts if payment is made within a specified period and failure to take such advantages constitutes an opportunity cost. Trade credit facilitates access to finance by enabling SMEs to trade under relatively favourable conditions that include; using only the credit standing of an enterprise and not requiring collateral as a condition for trade credit, being flexible with respect to adherence to terms of credit and easy upgrade of credit limits in line with increases in purchasing volumes (Mitter & Kraus, 2011).

Secondly, factoring provides an important additional source of working capital finance for SMEs. Factoring entails the surrender of accounts receivables by a firm to the lender in exchange for a discounted payment. The lender then collects payments from the parties that owe money (IFC, 2010a).

Lastly, leasing is an indispensable complementary source of investment finance. This is more so in least-developed countries where the collateral regime and credit information infrastructure are underdeveloped. With leasing, a lessor provides an asset to the lessee, to be used over a specified period of time in exchange for specified payment. Leasing enables SMEs to earn profits through the use, rather than ownership of equipment and machinery. The main advantage of leasing for SMEs is that its only condition is that the firm is able to generate cash flows from business operations to service the leasing payment, and it does not focus on credit history or ability to provide collateral. Risk mitigation for the lessor is through repossession and sale of the leased asset in case of payment defaults by the lessee. On the other hand, it is an appropriate for small entrepreneurs who are reluctant to pledge their personal property as collateral for a loan (IFC, 2010a).

### **2.7.2 Equity**

Equity financing entails selling partial ownership in the business to outside investors and does not carry a direct obligation to pay back the invested funds. On reaching maturity in their financial life-cycle development, a firm generally has access to an array of financing sources available to it as it can easily meet the requirements for debt financing. At this stage, in order for SMEs to grow into large firms, there must be a combination of equity investment by the entrepreneur debt finance and retained earnings. For SMEs requiring large amounts of external financing for investment however, short- or medium-term debt is neither adequate nor appropriate. Long-term investment needs can be fulfilled by raising external capital through private placement or an initial public offering (IPO) of the firms ordinary shares (IFC, 2010a; Mac an Bhaird, 2010).

Capital markets provide a platform to raise equity financing. Lesotho does not have a stock exchange or any form of formalized capital market implying limited liquidity to support SME financing. The absence of capital markets or, alternatively, the lack of adequately developed capital markets in terms of depth and adequate liquidity is an obstacle to accessing external finance for SMEs in Africa (Oteh, 2010).

Equity financing is ideal not only because it can support long-term, costly investments, but also because it sidesteps the need for collateral specifically for SMEs that do not have adequate assets for this purpose. Additionally, it is suitable if a business's cash flow is not enough to support loan repayment obligations. On the contrary, a significant setback of equity financing is the loss of control which, however, is mitigated by the potential introduction of new business skills by the new investors (Berggren *et al*, 2009b).

Equity financing can be sourced in various forms which include personal finances, business angels, private equity, venture capital and mezzanine capital (Switch-Asia, 2013). With the exception of personal finances, these examples of equity funding are external sources of finance for SMEs and are discussed next.

- **Business angels**

Business angels are individuals who make equity investments individually or as part of a syndicate. The equity investments made by business angels tend to be smaller than those made by venture capitalists (VCs) and target start-up or early-stage SMEs. The enterprises targeted by business angels for investment are often of a high-tech and high-risk nature. Business angel risk capital provides an important bridge between internal finance and access to more formal forms of capital. The informal nature of angel capital finance implies that it is cheaper than other forms of capital due to minimal due diligence and transaction costs. Angels often operate locally and within industries they have previous experience in (Falkena, 2010).

- **Venture capital**

Venture capital firms (VCs) tend to invest expansion financing in later-stage businesses with a distinctive selling point or competitive advantage and a potential for high returns. VCs are much more formal than business angel financing, and often require a proven track record and a detailed business plan. As a result, securing VC funding can be a long and complex process for SMEs.

VCs often keep their investment in a firm until a firm goes public through an IPO and cash in at substantially higher price per share relative to the VC's cost of acquisition (NEAF, 2012).

- **Private equity**

Private equity firms (PEs) make capital investments in established firms with high-growth potential. The investments are medium to long-term in nature and come with the active participation of the investor with respect to introducing operational improvements over the investment period. PEs exits investments through the sale of their stake to other PEs or trade buyers, and IPOs (Mullen, 2012).

- **Mezzanine finance**

Mezzanine finance is a form of a quasi-equity financing instrument that is a hybrid of equity and debt. With quasi-equity, the remuneration of the investor is largely or entirely

dependent on revenue and or profit performance of the enterprise. This form of finance is often used to finance expansion of existing enterprises. Mezzanine finance can be in the form of preference shares, convertible bonds, shareholder loans and unincorporated joint ventures. Naturally, these types of instruments require a high degree of informational symmetry between investor and SMEs owners (Mullen, 2012; Zavata, 2008).

The international community and governments around the world have taken steps to ease access to external financing for SMEs. The interventions come in various forms depending on the agency and the extent of need. The next section deals with the roles of government and international financial institutions (IFIs) in improving SMEs' access to financing.

## **2.8 CLOSING THE FINANCING GAP**

A significant number of SMEs remain without access to finance. This, as previously discussed is partly because of demand-side factors and weak capital markets, specifically in Africa. Collier (2009) points out that Africa's current financial system is ill-equipped to mediate investment finance for SMEs. This leads to scarcity of funding for viable enterprises and projects, resulting in the financing gap. Given the importance of the SME sector for economic growth and development, cooperation amongst various stakeholders is crucial to bridge the financing gap that SMEs continue to face (Sharma & Brimble, 2012).

The roles of government, non-governmental organizations (NGOs) and international financial institutions (IFIs) in removing particularly demand-side barriers to SMEs' access to external finance, are examined in the next section.

### **2.8.1 The Role of Government**

The role of governments in easing SMEs' access to external finance revolves mainly around creating enabling regulatory and legal framework for various types of SMEs financing. Such measures include tax regimes that are clear and neutral, insolvency regimes that clarify the rights of lenders and borrowers, collateral registries and

repossession. All of these factors should be clearly defined and enforceable. Some of the more direct government interventions include partial credit guarantee schemes, direct lending schemes and lending by state-owned financial institutions (IFC, 2011b).

The government of Lesotho, through the Ministry of Finance, has implemented a partial credit guarantee scheme worth R50m that aims to ease the lack of collateral concerns and consequently ease SMEs' access to credit (Government of Lesotho, 2012a). Additionally, to minimize informational asymmetries that exist between financiers and SMEs, the government has recognized the need for credit reporting structure development, resulting in a nascent credit bureau project (Central Bank of Lesotho, 2011). The Land Act of 2010 also provides a strong collateral alternative for SME owners through land regularisation. Finally, the Lesotho government provides entrepreneurial training to improve skills of entrepreneurs and promotes SMEs through its Ministry of Trade, Industry, Co-operatives and Marketing as well as a business development service called Basotho Enterprise Development Corporation (BEDCO) (MTICM, 2008b).

While government interventions and support mechanisms can significantly increase access to finance for SMEs, it is important to ensure that their potential market distorting consequences are minimised. In the long run, financial services for SMEs are best served by banking and non-banking institutions that can develop business models to optimize the balance between risk, reward and cost (IFC, 2011b).

### **2.8.2 The Role of IFIs**

IFIs play a significant role in improving access to finance for SMEs in developing countries. IFIs work through intermediaries, provide technical assistance and derive benefits due to cost efficiency, incentive alignment and sustainability. Consequently, they are better placed than donor governments to effect improvement in access to finance. The capital and technical assistance that IFIs provide for SMEs addresses the barriers to finance that have been previously discussed (Dalberg Global Development Advisors, 2011).

## **2.9 CONCLUSION**

Closing the financing gap for SMEs has become a major goal for countries and development organisations alike, around the world. This is as a result of the recognition of the significance of the SME sector for economic growth and development. It is evident from this literature study that, while developed countries have significantly closed the SME financing gap, developing and least-developed countries still struggle to deepen financial markets and continue to depend heavily on the banking system for business financing.

In this chapter, the exposition covered the demand-side constraints to access to external finance for SMEs. The reasons SMEs need external financing and the various financing options available to them were explored. Finally, the roles played by the government and multilateral developmental institutions were explored. The next chapter elucidates the research methodology used to conduct this study.



## **CHAPTER 3**

### **RESEARCH METHODOLOGY**

#### **3.1 INTRODUCTION**

The research methodology used in this study is discussed in detail in this chapter. The subsections in this chapter expound the research design, the target population, the sampling method, the data collection technique and the research ethical considerations. The framework of the research methodology as adopted for this study allowed the researcher to make best use of the information in the literature review in a survey in order to identify the main demand-side obstacles to access to external funding in Lesotho.

#### **3.2 RESEARCH DESIGN**

The research design provides a blueprint for the collection, measurement and analysis of the requisite data in order to achieve the objectives of the research. The research design opted for by a researcher is indicative of a range of decisions regarding the dimensions of the research process prioritised for a particular study. Such dimensions include the purpose of the study, the research strategy, the study setting, the extent of researcher interference, the temporal aspects and the level at which data will be analysed (Sekaran & Bougie, 2013).

Sekaran and Bougie (2013) identify three study purposes within the framework of research design namely: exploratory, descriptive and causal studies.

The descriptive research design and quantitative approach were used for this study.

A descriptive study enables researchers to think systematically about aspects in a given situation, to understand the characteristics of a group in a given situation and to

describe populations, event or situations through associations among variables (Sekaran & Bougie, 2013).

### **3.2.1 Sampling**

#### ***Population***

The target population for this research study was the managers and owners of SMEs in Lesotho.

#### ***Sample frame***

This provides the physical representation of the elements in the population from which the sample is obtained. The lists of SMEs for the purposes of this study were obtained from the Trade, Industry, Cooperative and Marketing (MTICM), trade organisations and entrepreneurs that the researcher could meet randomly at their businesses.

#### ***Sample design***

A non-probability, convenience sampling design was adopted for this research.

The non-probability sampling design does not attach any probability of being chosen as sample subjects to the elements in the population. Convenience sampling enables the collection of data from the elements of the population who are conveniently available to provide it. The convenience sampling technique enables researchers to obtain a large number of completed questionnaires both promptly and economically (Zikmund, Babin, Carr & Griffin, 2010).

The sampling design chosen is appropriate for this study as the total number of small and medium size enterprises is not known due to the fact that some businesses are not legally registered. The quality and accuracy of responses was enhanced by the fact the respondents took their time to answer the questionnaires.

### **Sample size**

The targeted size of the sample was 100. Accordingly, 100 questionnaires were distributed to SME owners and managers. A total of 82 were returned representing an 82% response rate.

Based on the information from the literature review, there is minimal variability in the population of SMEs owners and managers. Furthermore, the cost considerations and time constraints convinced the researcher that the indicated sample size was adequate to attain the objectives of the study.

### **3.2.2 Data Collection**

A quantitative research strategy entails collection of primary data and assessments that involve numerical measurement and analysis in addressing research objectives (Zikmund *et al*, 2010). The methods of data collection are given by Sekaran and Bougie (2013) as interviews, observation, questionnaires, physical measurement and unobtrusive methods.

The research strategy used for this study was survey research.

The data for this field study was collected using structured, self-administered questionnaires.

The questionnaires were divided into two sections. The first section focused on the classification data of the respondents' enterprises such as:

- ownership structure
- age of business
- number of employees
- average annual revenue
- business activity

This information facilitated the identification of the enterprise as per the SMEs definition proffered in previous chapters.

The second section of the questionnaires comprised closed questions intended to answer the primary and secondary objectives of the study.

Finally, this section also sought to establish the future prospects of businesses and viability in the presence of an improved funding access environment.

Questionnaires, as a method of data collection, generally allow data to be collected at a much lower cost than interviewing. The means of distribution presented an advantage of being able to reach a large number of SME owners and managers as widely as possible since the study sought to reach entrepreneurs country-wide. Self-administered, structured questionnaires have the advantage of minimising researcher interference, making statistical analysis easier and do not require a very high degree of literacy for respondents to answer them. Moreover, the risk of social desirability responses is significantly reduced (Zikmund *et al*, 2010).

### **3.2.3 Research Ethics**

Ethical conduct should pervade each step of the research process and research should never be conducted for any self-serving reason (Sekaran & Bougie, 2013).

The researcher was guided by the following ethical considerations and procedures in collecting, analysing data and general conduct of this research:

- Information given by respondents was kept confidential and the anonymity of the respondents was assured.
- The purpose of the study was explained to the respondents and no misrepresentation of the nature of the study was made.
- The respondents were involved willingly with the study, implying informed consent.
- The researcher took care to avoid any misrepresentation or distortion in reporting the data collected during the study.

### **3.2.4 Demarcation of the Field Study**

The primary purpose of this research is to identify the main challenges that are faced by SMEs owners and managers in accessing external finance in Lesotho. SME owners and managers will be the target population for this investigation. It is anticipated that the study will guide policy designs aimed at bridging the financing gap faced by SMEs.

This study was conducted within a three month period with a limited budget.

The field of study is Business Management.

### **3.3 CONCLUSION**

This chapter presented the research methodology that was used to gather and analyse the requisite data to meet the primary objective of this study. The various components of the research design and the motivation for their selection were discussed. The next chapter presents an analysis and a discussion of the data collected.

## **CHAPTER 4**

### **RESEARCH FINDINGS AND ANALYSIS**

#### **4.1 INTRODUCTION**

The research design described in chapter three is implemented in this chapter. The data collected from the respondents through self-administered questionnaires is presented, analysed and interpreted using the techniques described in the research design. A total of one hundred questionnaires were distributed to SMEs' owners and managers. Eighty-two questionnaires were returned representing a response rate of 82%. This chapter comprises presentation of biographical data of SMEs and data on the issues around access to external finance as observed from a demand-side perspective.

#### **4.2 CHARACTERISTICS OF SMEs**

The research findings on the data relating to the characteristics of the SMEs in Lesotho are presented in this section. This is done by using one way frequency distributions.

The dominant ownership structure for the businesses surveyed is that of limited liability companies. This accounts for 45.1% of the respondents, followed by sole proprietorships at 28.0%. Family-owned enterprises made-up 12.2%, 7.3% were partnerships, 6.1% were registered as joint ventures and only 1.2% were public limited companies. Table 4.1 shows the frequency distributions of the ownership structure of SMEs in the sample.

**Table 4.1 Frequency distribution of ownership structure of surveyed enterprises**

<b>Form of Ownership</b>	<b>Frequency</b>	<b>Percentage</b>
Private Limited Companies	37	45.1
Sole Proprietorships	23	28.0
Family-owned	10	12.2
Partnerships	6	7.1
Joint Ventures	5	6.3
Public Limited Companies	1	1.2

Table 4.2 illustrates the frequency spread of the respondents with respect to the industrial sector in which they operate. The industry most represented in this case is the services industry at 24.4%, followed by the wholesale/retail industry with a frequency of 20.7% of the total sample. Manufacturing accounts for 14.6%, real estate 12.2%, construction 9.8%, farming 6.1% transport 3.7% and industries under the 'other' category 8.5%.

**Table 4.2 Frequency distribution of industry/sector in which respondents operate**

<b>Industry</b>	<b>Frequency</b>	<b>Percentage</b>
Wholesale/Retail	17	20.7%
Service	20	24.4%
Manufacturing	12	14.6%
Real Estate	10	12.2%
Construction	8	9.8%
Other	7	8.5%
Farming	5	6.1%
Transport	3	3.7%

**Figure 4.1 Length of time business has been in operation**

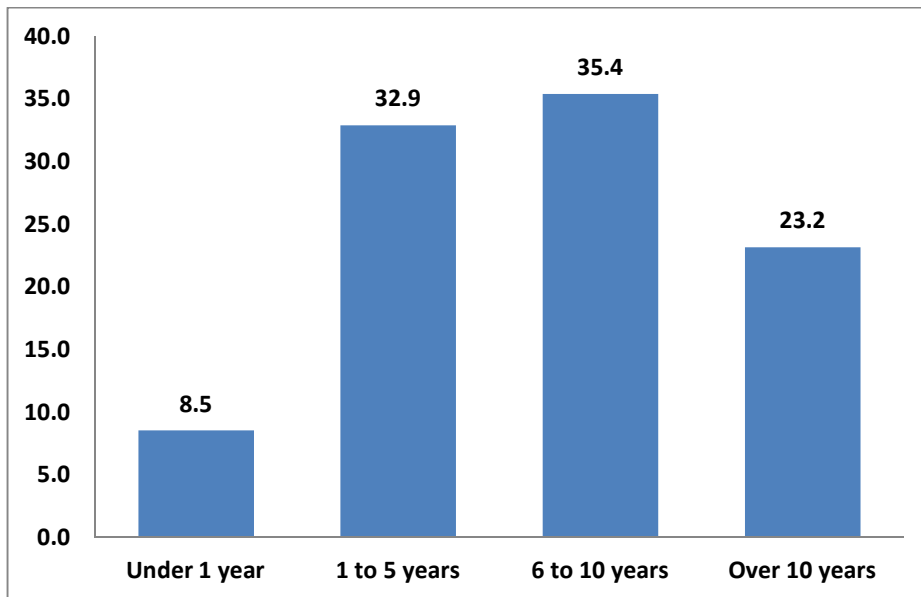
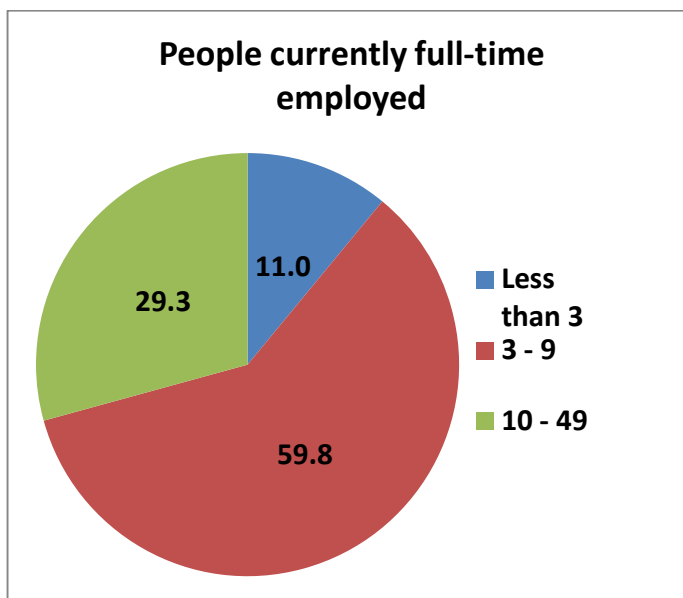


Figure 4.1 above indicates that 8.5% of the respondents have been operating for less than one year, 32.9% have been a going concern for one to five years, 35.4% for six to ten years and 23.2% for over ten years.

**Figure 4.2 Number of full-time employees**

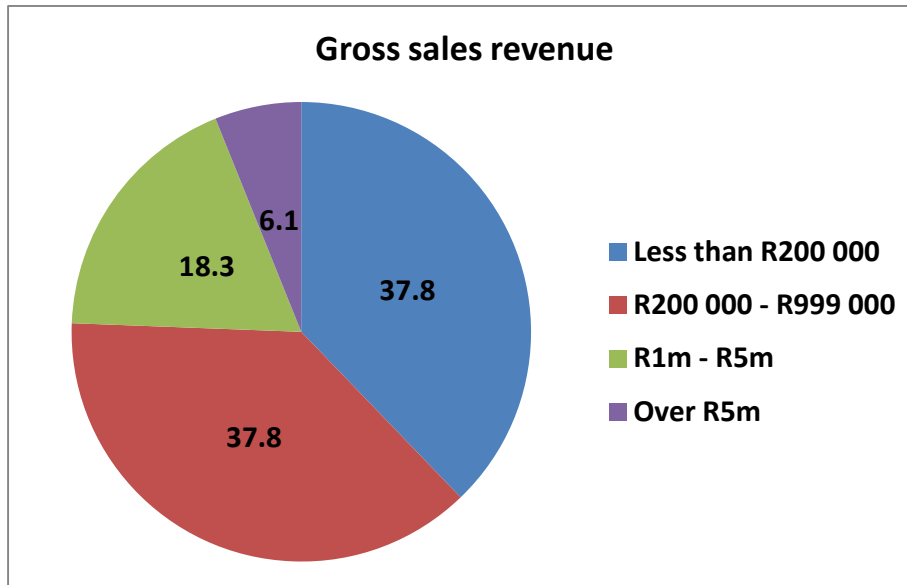


The model in Figure 4.2 reveals that 11% of the enterprises in the study have less than three full-time employees while 59.8% have between three and nine full-time



employees. Businesses with ten to forty-nine full-time employees made up 29.2% of the total sample. The dominance of the wholesale/retail and service sectors businesses in the sample could explain the high frequency of the 3-9 full-time employees band as most of them have this number of people in their employ.

**Figure 4.3 Amount of annual turnover**



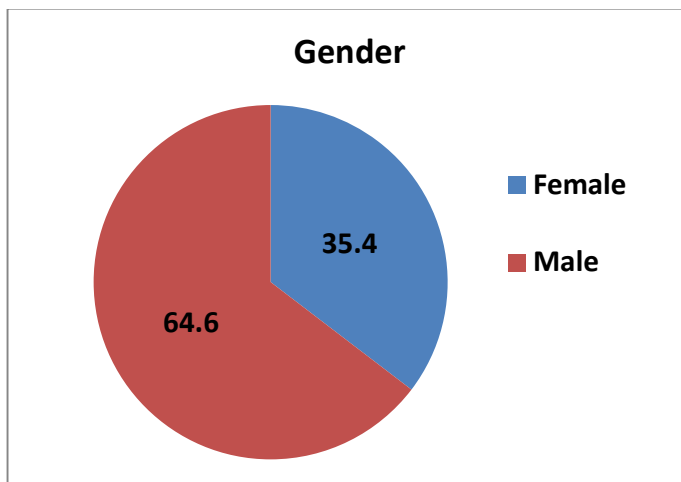
It can be observed in Figure 4.3 above that the sample contained an equal number of enterprises whose annual revenue was less than R200 000.00 (37.8%) and those whose revenue was between R200 000.00 and R999 000.00 (37.8%). The number of enterprises declines, however, as the value of annual turnover increases. Only 18.3% of the respondents had turnover of R1m and R5m and 6.1% had annual turnover of over R5m. This suggests businesses could be facing obstacles, including access to external finance, and are therefore unable to scale. Consequently, only a small number of respondents generate revenues in excess of R5m.

**Table 4.3 Frequency distribution of average monthly sales revenue**

Average Monthly Revenue	Frequency	Percentage	Cumulative
Less than R10 000.00	7	8.5%	8.5%
R10 000 – R24 999.00	28	34.1%	42.6%
R25 000 – R49 999.00	8	23.2%	65.8%
R50 000 – R100 000.00	19	9.8%	75.6%
Over R100 000.00	20	24.4%	100%
<b>Total</b>	<b>82</b>	<b>100</b>	

Table 4.3 shows that a cumulative 65.8% of the enterprises that participated in this study have average monthly revenues of less than R50 000.00. Specifically, 34.1% make revenues of R10000 – R24 999.00 and this is the majority of the respondents. This implies that businesses cannot access significant credit that would enable them to scale, as their cash flow is just too low. Operators whose average monthly revenue was over R100 000.00 accounted for 24.4% of all respondents.

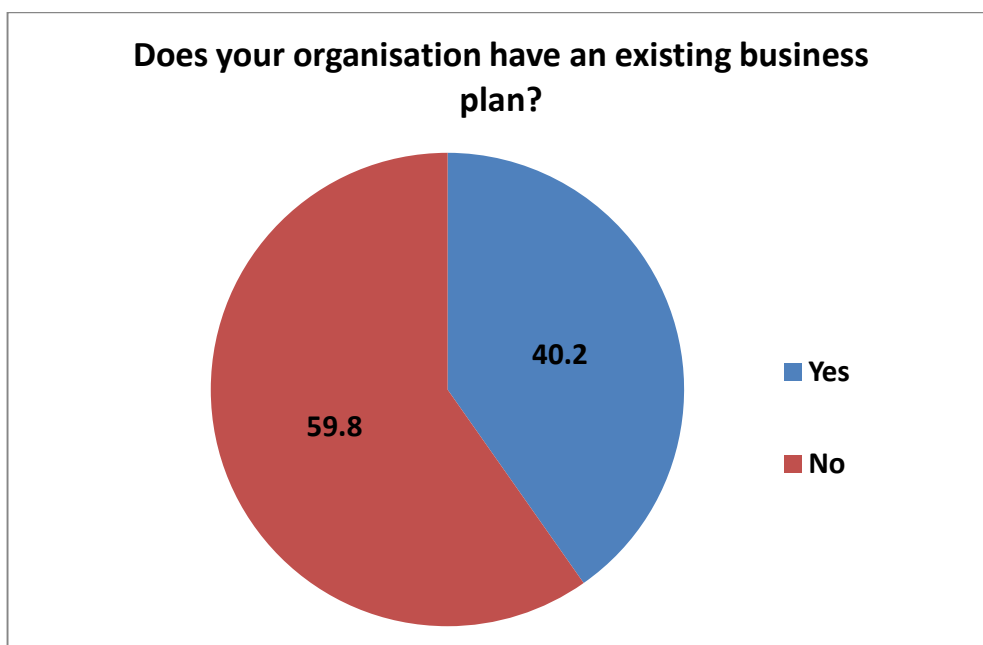
**Figure 4.4 Gender of SMEs owners/highest ranking officer**



The gender of SME operators involved in this study was split unequally with female business owners making up 35.4% and male owners 64.6% of the total sample. The low number of female entrepreneurs could be due to overall higher level of risk aversion by

females relative to males. Additionally, family obligations and lack of confidence present challenges for women in starting businesses, fostering what Blaszczyk (2002) has labelled a cult of domesticity. Women tend to be confined to survivalist micro-enterprises engaged in activities such as sewing, gardening and arts and crafts, which have little or no support. Therefore, women are exposed to high risks and poor outcomes (Mandipaka, 2014). Furthermore, 61% of the businesses had qualified professionals in their employ while 39% did not have qualified staff in specialised managerial positions.

**Figure 4.5 Presence of an existing business plan**



The results above indicate that only 40.2% of businesses had an existing business plan and 59.8% did not have business plans. This reveals that a majority of SMEs surveyed did not have a business roadmap requisite to reach their goals and achieve their objectives.

From the above results, it can be observed that the SMEs that participated in the study are well represented, both geographically and by sector.

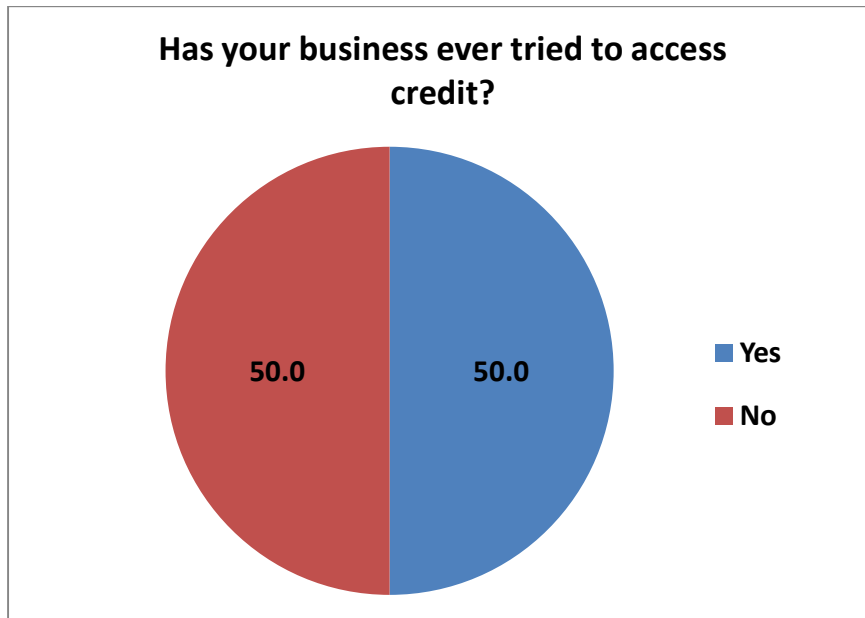
### **4.3 SMEs' ACCESS TO EXTERNAL FINANCE IN LESOTHO**

This section presents data on the financing issues of SMEs in Lesotho. In addition to one-way frequencies, results under this section are presented using cross tabulations, factor values and the chi-square tests. The presentation of the results below is guided by the objectives of this study as expounded in Chapter one, with the main objective being to identify the main obstacles to SMEs' access to external finance in Lesotho. The results offer a demand-side perspective as previously alluded to.

A Likert scale was used for a majority of the questions, ranging from 1 for strongly disagree to 5 for strongly agree. The responses were then added and divided by the number of respondents, giving a mean (average) value ranging from 1.00 to 5.00 with 3.00 being the middle value. A mean value below 3.00 indicates that respondents on average disagree, while a mean closer to 5.00 indicates that respondents are on average more positive regarding the specific issue. Since the study is dealing with categorical variables, the mean for each question is then converted into factor values (FV), or an average score. A mean of 3.00 is therefore, equal to a factor value of 0.5 (50%). A factor value greater than 0.5 means that the majority of respondents agree with the statement, while the lower the factor value, the less the number of respondents who agree with the statement. The mean and factor values are presented in the tables in the sub-sections that follow.

### 4.3.1 Access to and availability of external finance

Figure 4.6 Has the business ever tried to access credit?



The above pie chart (Figure 4.6) reveals an equal split of 50% for business that have tried to access credit and 50% that have never tried to access credit. This result is in line with the findings of the European Union (2011).

The SMEs that have not tried to access external financing cite not needing credit as the main reason for not trying to get funding. This is in line with the findings of Beck, Maimbo, Faye and Triki (2011) whose study found that SMEs that did not apply for loans cited not needing credit as the main reason for not applying, while also ranking lack of collateral as the fourth most significant reason. The second most important reason entrepreneurs raise for not trying to get credit is that they believe they do not have adequate cash flow to enable payment of monthly instalments. On the other hand, businesses disagreed strongly with the reason that they do not have time to understand and complete loan applications. Table 4.4 presents these results and the reasons or obstacles are listed in the table from the main reason to the least significant one. Factor values were used to inform the order of these reasons.

**Table 4.4 SMEs' obstacles to access to external finance**

Main reasons for not trying to access credit	N	Rank	Mean	FV
Have never needed credit	41	1	3.09	0.52
Do not have enough cash flow to finance monthly loan repayments	42	2	2.98	0.49
Interest rates and other costs involved in getting a loan or capital are too high	42	3	2.83	0.45
Lack of collateral	42	4	2.76	0.44
Too small equity base	42	5	2.55	0.39
I do not want to be told how to run my business by my lenders/financiers	42	6	2.50	0.38
Do not have the required business plan	41	7	2.39	0.35
Do not have all the information lenders/financiers want	42	8	1.98	0.24
There is no financing available at all	42	9	1.98	0.24
Do not have time to understand and complete the loan applications	42	10	1.64	0.16

Table 4.5 presents the frequency distribution of SMEs that have been denied a loan or not. The results indicate that 39% of the respondents have been denied a loan before, while 61% have never been denied a loan. The respondents who have never been denied a bank loan comprise those who have never applied for a bank loan.

**Table 4.5 Have you ever been denied a loan by a bank?**

Have you ever been denied credit by a bank before?	Frequency	Percentage
Yes	32	39
No	50	61
Total	82	100

**Table 4.6 Main reasons given by bankers for refusing SMEs loans**

Main reasons given for refusing a loan application	N	Rank	Mean	FV
Lack of acceptable collateral for the loan	31	1	4.39	0.85
Lack of owner investment in the business or required deposit (for 'order financing')	31	2	3.16	0.54
Default on previous loan	31	3	1.81	0.20
Poor or no business plan	31	4	2.03	0.26
Did not have all the documents required	31	5	1.61	0.15
Increased riskiness of my business	31	6	2.77	0.44
Unsatisfactory cash flow	31	7	4.10	0.77
No reason given	33	8	1.67	0.17

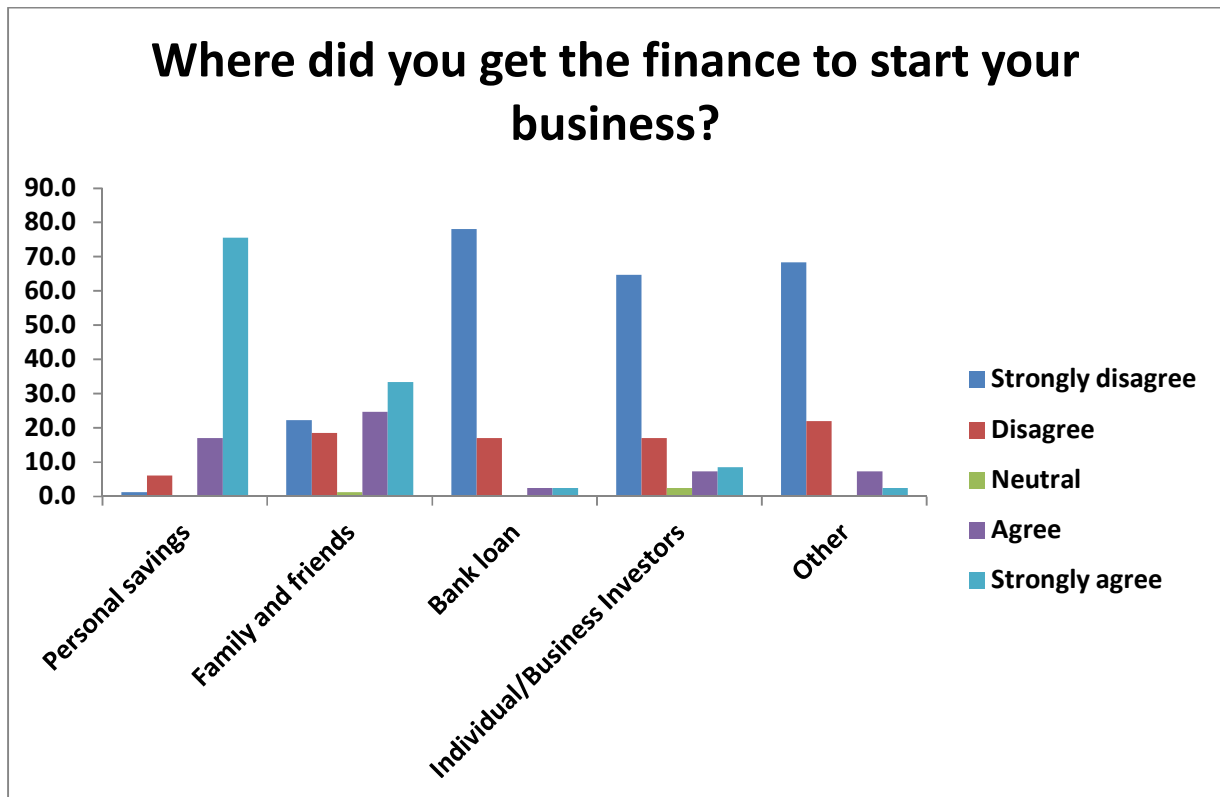
The results in Table 4.6 reveal that a majority of SMEs were given lack of collateral as the leading cause of their failure to secure bank credit. The second main reason is unsatisfactory cash flow. It can be observed that most SMEs are able to submit all the requisite documentation for loan applications, therefore not having all the documents required is ranked last as a reason bankers give for turning down loan applications.

**Table 4.7 Sources of finance to start businesses**

Source of finance	N	Rank	Mean	FV
Personal savings	82	1	4.60	0.90
Family and friends	81	2	3.28	0.57
Individual/Business Investors	82	3	1.78	0.20
Other	82	4	1.54	0.13
Bank loan	82	5	1.34	0.09

Table 4.7 above gives, in order of significance, the sources of finance that entrepreneurs used to start their enterprises. It can be observed from the results that personal savings has the highest factor value and is therefore a leading source of financing for purposes of starting a new business. The second most frequent source of finance is family and friends, followed by investors and other sources respectively. Bank loans rank last as the source of finance for starting new enterprises.

**Figure 4.7 Sources of finance to start business**



It can be seen from figure 4.7 that up to 92.7% of SMEs used personal savings to start their businesses, 58% obtained finance from family and friends, 15.8% from individual/business investors. Other sources accounted for 9.7% and only a miniscule 4.8% got their start-up funding from banks.



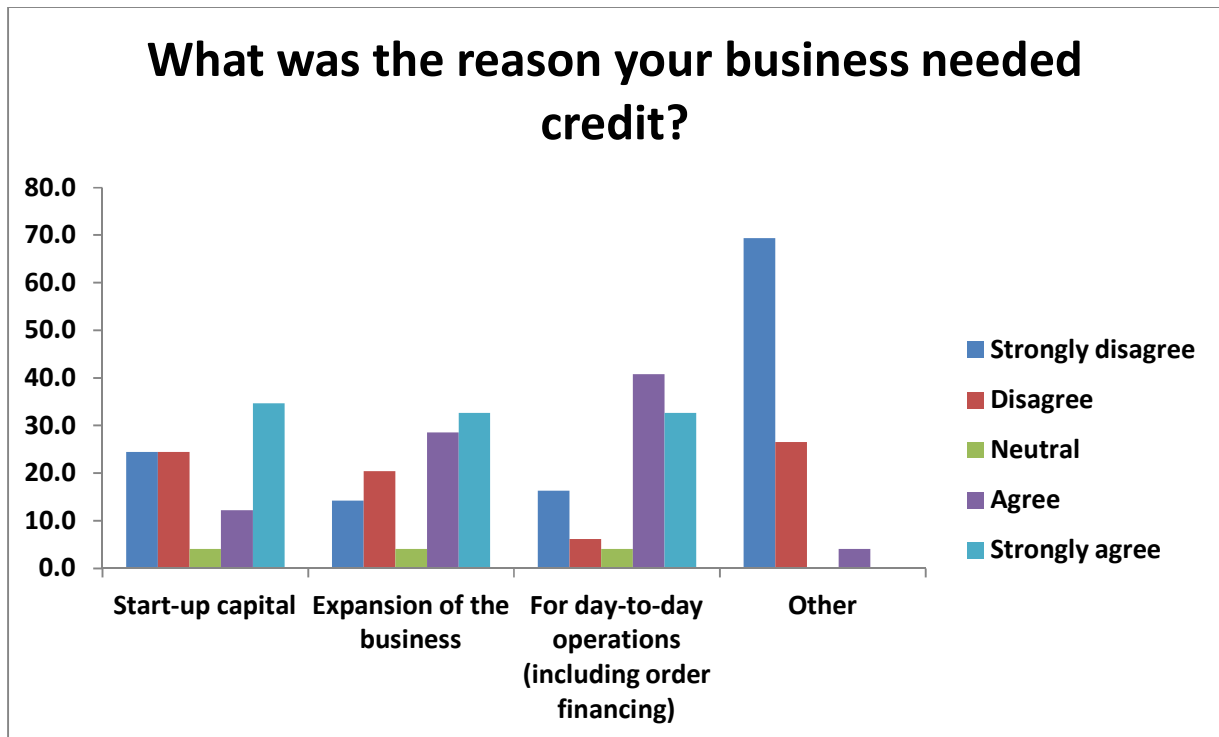
### 4.3.2 The main reasons SMEs need external finance

**Table 4.8 Purpose of the loan for businesses that applied for credit**

<b>Reason business needed credit</b>	<b>N</b>	<b>Rank</b>	<b>Mean</b>	<b>FV</b>
<b>For day-to-day operations (including order financing)</b>	<b>49</b>	<b>1</b>	<b>3.67</b>	<b>0.668</b>
<b>Expansion of the business</b>	<b>49</b>	<b>2</b>	<b>3.45</b>	<b>0.612</b>
<b>Start-up capital</b>	<b>49</b>	<b>3</b>	<b>3.08</b>	<b>0.520</b>
<b>Other</b>	<b>49</b>	<b>4</b>	<b>1.39</b>	<b>0.097</b>

Day-to-day operations or working capital and business expansion were the two leading purposes for businesses needing credit. Working capital was the reason 73.5% of the businesses needed credit, while business expansion accounted for 61.3% of the need for loans. Only a few SMEs (4.1%) needed credit for other purposes as can be observed in Figure 4.8.

**Figure 4.8 Reasons businesses needed credit**

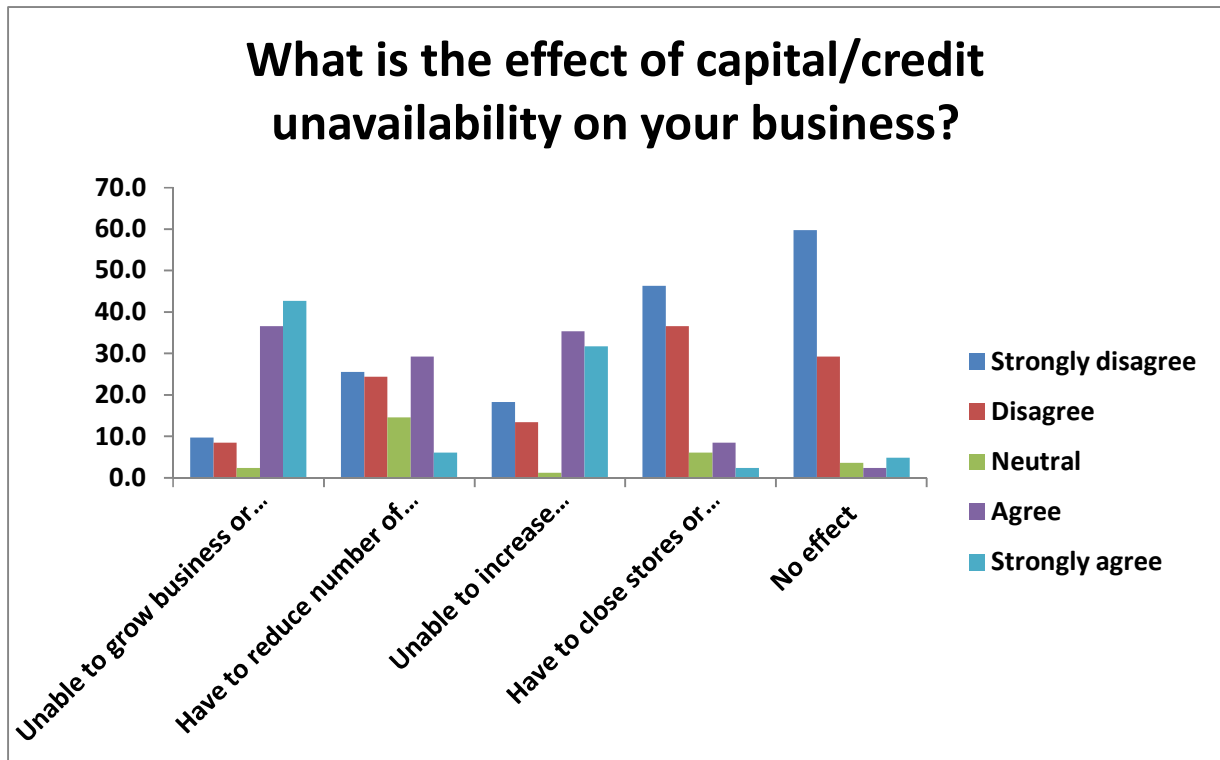


The unavailability of capital and or credit financing was cited by 79.3% of the entrepreneurs as the reason they are unable to grow their businesses, while 67.1% said they were unable to increase inventory to meet increasing demand. Figure 4.9 also reveals that 35.4% have had to reduce the number of their employees, 10.9% have had to close down stores or branches. Only 7.3% of the SME owners indicated that credit unavailability had no effect on their businesses. The results are also shown in Table 4.9 and ranked in order of frequency using factor values.

**Table 4.9 Effects of credit unavailability on respondents' businesses**

Effect	N	Mean	FV
Unable to grow business or expand operations	82	3.94	0.735
Unable to increase inventory/stock to meet increasing demand	82	3.49	0.622
Have to reduce number of employees	82	2.66	0.415
Have to close stores or branches	82	1.84	0.210
No effect	82	1.63	0.159

Figure 4.9 Effects of credit unavailability on SMEs



### 4.3.3 Alternative sources of funding and their viability

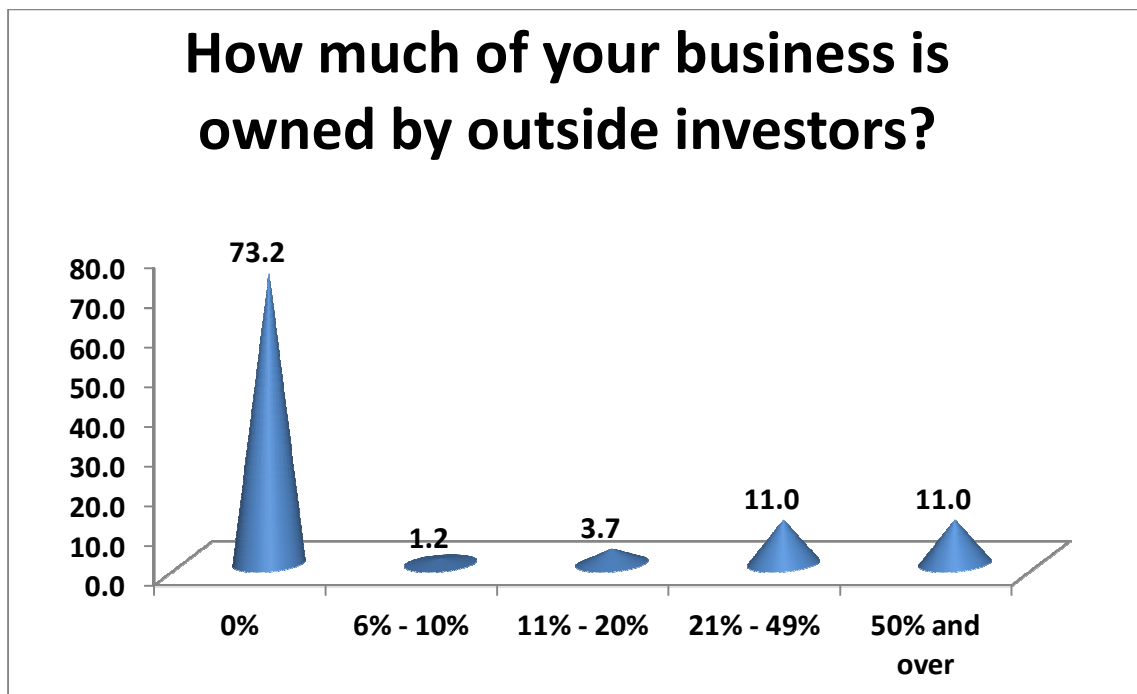
Table 4.10 Sources of financing currently used by SMEs

Source of Finance	N	Rank	Mean	FV
Retained earnings/business profits	82	1	4.90	0.976
Personal savings	82	2	3.52	0.631
Family and friends	82	3	2.68	0.421
Trade credit	82	4	2.54	0.384
Bank loans	82	5	2.38	0.345
Business co-operatives	82	6	1.72	0.179
Other	82	7	1.51	0.128
Private lenders (loan sharks, micro lenders)	82	8	1.50	0.125
Individual/Business investors (equity)	82	9	1.38	0.095
Leasing or factoring	82	10	1.34	0.085

Retained earnings is a leading source of funding, followed by use of personal savings, family and friends as well as trade credit as can be seen from Table 4.10.

The relatively low percentage of individual/business investors is reflected also in the low number of SMEs that have outside investors. As much as 73.2% of the respondents indicated that they do not have outside investors. Only a total of 22% had outside investors with shareholding of 21%-50% and over. These results are shown in Figure 4.10.

**Figure 4.10 Percentage of business ownership by outside investors**



A total of 76.8% of the respondents indicated that it was easier to get funding from other sources than from banks, with only 23.2% indicating it was not easier. However, the equity market in Lesotho is infantile at best, while retained earnings and personal savings can be severely limited in funding planned business investments (for growth or to increase competitiveness). Bank credit financing (debt) is, therefore, the only viable source of large investment funding. This form of debt is seen by SMEs as more difficult to access than other sources of financing and this implies that very limited investment

activity is undertaken by SMEs. Consequently, businesses do not grow and - by extension - the county's economy does not grow or diversify as it otherwise would.

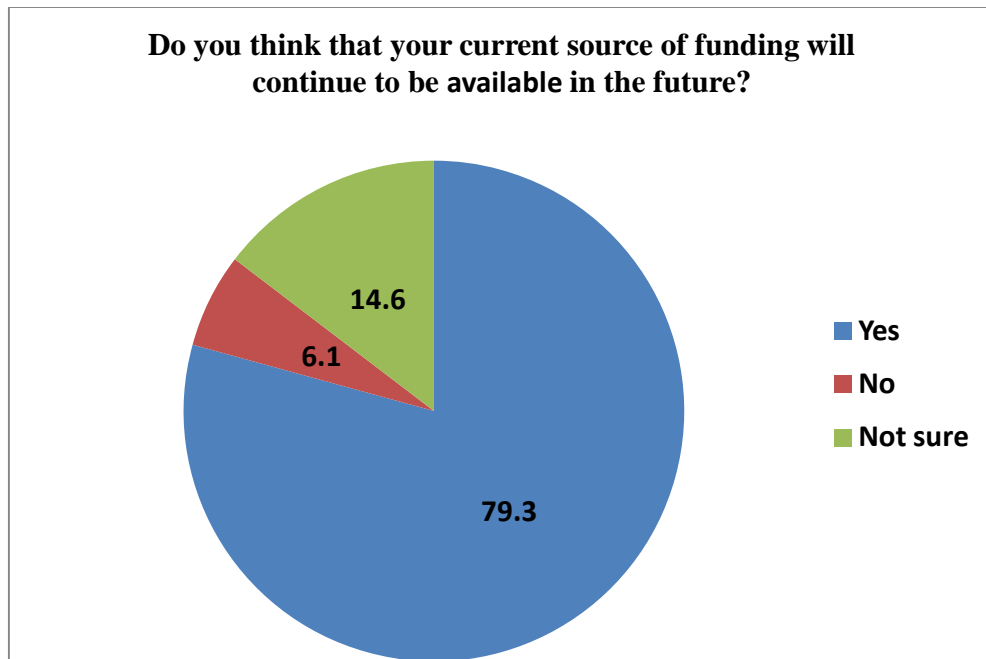
**Table 4.11 Preferred type of external financing for future use**

Preferred external financing to be used in future	N	Rank	Mean	FV
Bank credit	82	1	4.07	0.768
Loans from other businesses (such as trade credit, leasing or factoring)	82	2	3.52	0.631
Equity from business and individual investors	82	3	2.73	0.433
Loans from family and friends	82	4	2.27	0.317

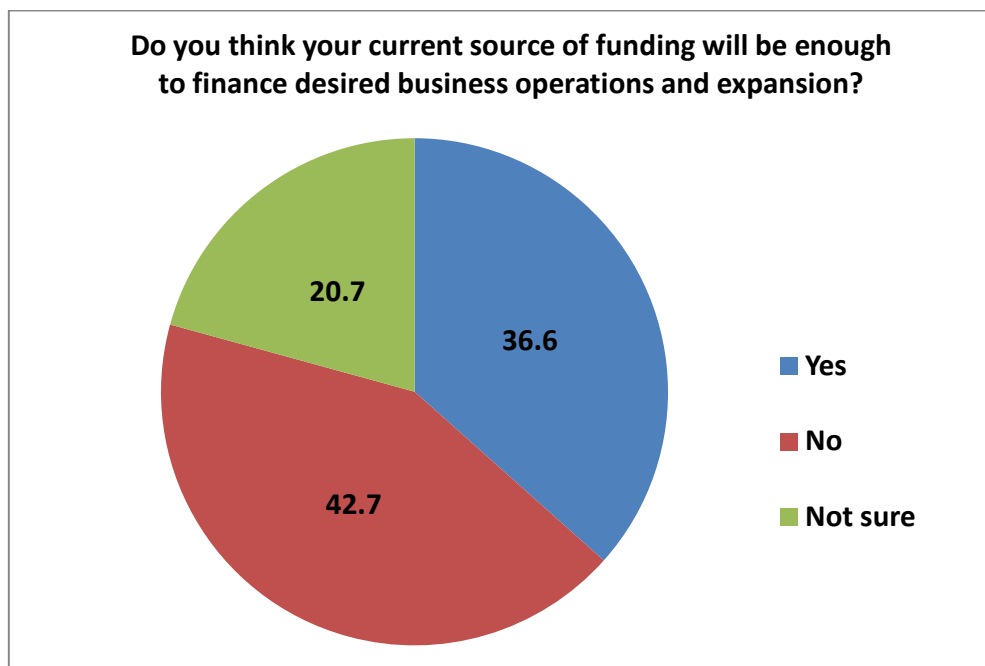
Bank credit is most preferred as a source of external financing that entrepreneurs would like to use in future. It is followed by the use of loans from other businesses and the least preferred source of funding with respect to future use is loans from family and friends.

A large proportion of respondents, 79.3%, thought that their current source of funding shall continue to be available in future. A smaller proportion, 14.6% were unsure and only 6.1% thought that current source of funding will not continue to be available. These results are represented in Figure 4.11. However, Figure 4.12 illustrates that only 36.6% of respondents thought that their current source of funding will be adequate to finance desired business expansion and operations. As much as 42.7% answered in the negative and 20.7% were uncertain.

**Figure 4.11 Continued future availability of current source of funding**



**Figure 4.12 Adequacy of current funding source to finance desired business expansion**



**Table 4.12 Expected growth (in terms of revenue) in the next three years**

<b>Rate of Growth</b>	<b>Frequency</b>	<b>Percent</b>	<b>Valid Percent</b>	<b>Cumulative Percent</b>
Grow substantially by over 20% per year	11	13.4	13.4	13.4
Grow moderately by under 20% per year	29	35.4	35.4	48.8
Stay the same size	28	34.1	34.1	82.9
Become smaller	14	17.1	17.1	100.0
Total	82	100.0	100.0	

A total of 51.2% of the respondents expected their businesses to stay the same size (34.1%) or become smaller (17.1%). Moderate growth was expected by 35.4% of respondents while only 13.4% were optimistic that their enterprise revenues will grow substantially by over 20% per annum. Considering that SMEs in low income countries like Lesotho account for around 45% of employment and contribute on average of 29% to formal GDP (IFC, 2010a), the anticipated lack of growth in over half the SMEs surveyed will not lead to economic growth and reduction of unemployment in Lesotho.

### **4.3.3 Importance of factors on future finance**

Respondents were asked to rate the importance of four mechanisms to help their enterprises' future financing using a 1-5 Likert scale (where 1 is 'not important at all' and 5 is 'extremely important'). SMEs in this study rated tax incentives as the most important mechanism (mean score = 4.22). This was followed by business support services with a mean score of 3.91, measures to nurture equity financing (3.16) and lastly government-backed guarantees for loans (3.09).

**Table 4.13 Importance of factors in SMEs future financing**

<b>Factors</b>	<b>N</b>	<b>Mean</b>	<b>FV</b>
Tax incentives	82	4.22	0.804878
Business support services (e.g. Advisory, training, business networks, etc)	82	3.91	0.728659
Measures to nurture equity financing	82	3.16	0.539634
Government-backed guarantees for loans	82	3.09	0.521341

Overall, all types of SMEs ranked tax incentives as a leading mechanism to help their future financing, with the exception of family-owned businesses that ranked business support services highest (mean: 3.60), followed by tax incentives (3.50), government-backed guarantees for loans (3.20) and measures to nurture equity financing (2.10).

#### **4.3.4 Chi-Square tests and cross tabulations**

Chi-Square tests are used to examine the relationship or association between two variables. Variables can be either independent or dependent on each other. The results or conclusion of the tests are reported based on the p-value. If the p-value is less than 0.1, the conclusion is that the two variables are dependent or associated. However, if the p-value is greater than 0.1, the conclusion is that the two variables are not associated or are independent. The frequency of two variables at a time is established using cross-tabulations, also known as two-way frequency tables.

Table 4.14 shows a number of variables and significant associations are in bold. A significant, dependent association exists between how long the business has been operating and whether it has ever tried to access credit as indicated by a p-value of 0.006. Table 4.15 shows that 100% of enterprises who have been operating for under a year never tried to access credit, while 70.4% of those which 1-5 years old have tried to access credit. Additionally, accessing credit is also seems to be related to the size of



**Table 4.14 p-values for selected variables**

<b>VARIABLES</b>	<b>Ownership structure</b>	<b>Industry/Sector</b>	<b>How long has the business been in operation?</b>	<b>Number of full-time staff</b>	<b>Number of Qualified/professional employees</b>	<b>Highest educational qualification of owner</b>	<b>Presence of business plan</b>	<b>Annual Gross sales revenue</b>	<b>Average monthly sales revenue</b>
<b>Has your business ever tried to access credit?</b>	0.214	0.204	<b>0.006</b>	<b>0.008</b>	<b>0.024</b>	0.149	0.115	<b>0.003</b>	<b>0.001</b>
<b>Have you ever been denied a loan/credit by a bank?</b>	0.626	0.617	0.401	<b>0.069</b>	0.490	0.656	0.955	0.316	0.105
<b>Have you ever had a problem repaying a loan?</b>	<b>0.054</b>	<b>0.022</b>	<b>0.031</b>	<b>0.002</b>	<b>0.065</b>	0.479	0.343	<b>0.001</b>	<b>0.003</b>
<b>How long were you given to repay the loan?</b>	<b>0.034</b>	<b>0.014</b>	<b>0.015</b>	0.954	<b>0.046</b>	<b>0.000</b>	0.157	0.123	0.682
<b>Would you say it is easier to get funding from other sources than from banks?</b>	0.161	0.255	<b>0.058</b>	0.311	0.067	0.732	0.209	<b>0.007</b>	<b>0.026</b>

<b>Do you think that your current source of funding will continue to be available in the future?</b>	<b>0.065</b>	0.577	<b>0.000</b>	0.100	<b>0.050</b>	0.744	0.994	0.471	<b>0.006</b>
<b>Do you think your current source of funding will be enough to finance the desired/planned business expansion &amp; operations?</b>	<b>0.000</b>	0.760	<b>0.020</b>	<b>0.018</b>	<b>0.026</b>	<b>0.020</b>	<b>0.001</b>	<b>0.001</b>	<b>0.000</b>
<b>How much of your business is owned by outside investors?</b>	<b>0.011</b>	0.419	0.836	0.207	0.591	0.113	0.591	<b>0.002</b>	0.367

the business (as defined by the number of full-time employees (p-value of 0.008) and amount of annual gross sales revenue (p-value of 0.003)). As can be observed from Table 4.16, up to 75% of SMEs with between 10 and 49 full-time employees have tried to access credit. It can be observed that the longer the business has been in operation, the more likely that it has tried to access external credit, especially in the first five years. The same trend is revealed with majority of businesses that have the greatest number of employees having tried to access credit. Disturbingly, 63.3% of SMEs with between 3 – 9 employees indicated that they have never tried to access credit. This has significant ramifications for growth prospects for such SMEs.

**Table 4.15 Attempt to get credit and the time business has been operating**

		Has the business ever tried to access external financing/credit	
		Yes	No
Length of time business has been operating	Under 1 year	0%	100.0%
	1 to 5 years	70.4%	29.6%
	6 to 10 years	41.4%	58.6%
	Over 10 years	52.6%	47.4%

**Table 4.16 Attempt to get credit and number of full-time employees**

		Has the business ever tried to access credit/external finance?	
		Yes	No
Number of people full-time employed by the business	Less than 3	55.6%	44.4%
	3 - 9	36.7%	63.3%
	10 - 49	75.0%	25.0%

Another notable association is observed between the number of full-time employees and whether a business has ever been denied bank credit as indicated by a p-value of 0.069. Medium enterprises (10 – 49 employees) that said they have been denied credit made up 58.3%, while 66.7% and 69.4% of those with staff less than 3 and 3 – 9 respectively said they have never been denied bank credit, mostly because they have never applied for it before. Table 4.17 presents these two-way frequencies.

**Table 4.17 Number of employees and whether the business has ever been denied a bank loan**

		Has the business ever been denied bank credit?	
		Yes	No
Number of people full-time employed by the business	Less than 3	33.3%	66.7%
	3 - 9	30.6%	69.4%
	10 - 49	58.3%	41.70%

The size of the business and the strength of cash flow are also related to the issue of whether SMEs have ever had a problem repaying a loan. Table 4.18 shows that as much as 65% of those enterprises that have monthly revenues of over R100 000.00 have previously had problems repaying their bank loans. This high default rate partly explains why SMEs struggle so much to access bank credit. The low percentages of those SMEs that have cash flow of R100 000.00 or less are due to the fact that most of them have never applied for bank credit.

**Table 4.18 Average monthly sales revenue and problems repaying bank loans**

		Has the business ever had a problem repaying bank loans?	
		Yes	No
Average monthly sales revenue	Less than R10 000	14.3%	85.7%
	R10 000 - R24 999	14.3%	85.7%
	R25 000 - R49 999	26.3%	73.7%
	R50 000 - R100 000	25.0%	75.0%
	Over R100 000	65.0%	35.0%

There is a dependency between whether SMEs operators thought it was easier to get funding from alternative funding sources than from banks and the age of the enterprise as well as the SMEs' annual turnover. The directions of the relationships between the variables are presented in Table 4.19 and indicate that a majority of SMEs with annual revenues less than R5m said that it was easier to access funding from other sources than banks. The exception is businesses that have turnover of over R5m, and this could

be explained by their strong cash flow and significant asset bases that make it easier for these enterprises to access bank financing. All of the SMEs that are less than one year old said that it was easier to get funding from other sources than banks, indicating the perception that banks do not provide start-up funding because of the lack of collateral and assets that usually typifies such enterprises.

**Table 4.19 Age and annual turnover of SMEs and whether it is easier to get alternative source than bank funding**

		Would you say it is easier to get funding from sources other than banks?	
		Yes	No
<b>Length of time business has been operating</b>	Under 1 year	100.0%	-
	1 – 5 years	74.1%	25.9%%
	6 – 10 years	86.2%	13.8%
	Over ten years	57.9%	42.1%
<b>Annual sales revenue</b>	Less than R200 000.00	80.6%	19.4%
	R200 000.00 – R999 000.00	87.1%	12.9%
	R1m – R5m	66.7%	33.3%
	Over R5m	20.0%	80.0%

A strong association can also be observed between the variable of whether entrepreneurs think their current source of funding will continue to be available in future

and the ownership structure of the business, age of the business and average monthly sales revenue. Table 4.20 indicates that 57.1% of SMEs aged less than 1 year are unsure about the continued viability of their current source of funding, while certainty with continued availability of the source of funding increases as the age of the business increases, with 77.8% for who have been operating for 1 – 5 years, 82.8% and 100% for 6 - 10 and over 10 year-olds respectively. A great level of certainty can also be observed as assessed by ownership structure, with only partnerships displaying uncertainty (66.7%).

**Table 4.20 Ownership structure, age of business and whether the current source of funding will continue to be available in future**

		Do you think your current source of funding will continue to be available in future?		
		Yes	No	Not sure
<b>Length of time business has been operating</b>	Under 1 year	14.3%	28.6%	57.1%
	1 – 5 years	77.8%	3.7%	10.3%
	6 – 10 years	82.8%	6.9%	18.5%
	Over ten years	100.0%	-	-
<b>Ownership structure of the business</b>	Public limited company	100.0%	-	-
	Private limited company	83.8%	5.4%	10.8%
	Joint venture	100.0%	-	
	Partnership	33.3%	-	66.7%
	Sole proprietor	73.9%	8.7%	17.4%
	Family-owned	90.0%	10.0%	-

There is almost universal association between the variable of whether the source of funding will be adequate to fund desired or planned business expansion with all the other variables in Table 4.14, with the exception of the variable of the industry or sector in which SMEs operate. This could be due to every entrepreneurs' desire to grow their business irrespective of what the business's circumstances are with respect to ownership, annual turnover, number of full-time employees and others.

#### **4.4 CONCLUSION**

The results indicate that the SME sector is dominated by the service industry with a share of 24.4%. Additionally, the sector is mostly small enterprises with annual revenues less than R1m (75.6%) and full-time employees of 3 – 9 for 59.8% of SMEs surveyed. The entrepreneurial landscape is gender-biased with only 35.4% of SME operators being female.

Furthermore, the results show that just half of the SMEs surveyed have previously tried to get credit or external financing. Entrepreneurs claim not needing credit, lack of adequate cash flow and high interest rates and other loan costs as the three main reasons they have never tried to access credit. This results in SME owners using mostly personal savings to start their business and retained earnings to finance operations and investments.

Finally, the associations between various variables related to the financing issues of the SMEs and their characteristics were presented and discussed.



## **CHAPTER 5**

### **CONCLUSIONS AND RECOMMENDATIONS**

#### **5.1 INTRODUCTION**

The primary objective of this study was to identify the main obstacles to SMEs' access to external finance in Lesotho. In pursuit of this, a comprehensive literature review was conducted to understand the characteristics of SMEs in Lesotho, the challenges or obstacles to external finance access, the main reasons SMEs seek external funding as well as the alternative funding sources being used and their viability. Thereafter, a research survey was undertaken to obtain primary data on the issues pertaining to SMEs' access to external finance in Lesotho.

This chapter presents the conclusions of the field study as guided by the study objectives and findings. The recommendations, significance and limitations of the study are also contained in this chapter. Lastly, recommendations for further research are made.

#### **5.2 RESEARCH CONCLUSIONS**

As indicated in the introduction, the primary objective of this study was to identify the main obstacles to SMEs access to external finance in Lesotho. This objective has been achieved through the collection and analysis of primary data and findings. The findings indicate that demand-side obstacles do exist, as observed in the literature review. The significance of each of the challenges, however, may differ from country to country as different countries introduce different policy interventions vis-a-vis the financing of SMEs. The main demand-side obstacles to SMEs' access to external finance, in order of significance, are the following:

- I. SMEs owners believe they do not need credit or external financing.
- II. SMEs do not have enough cash flow to finance monthly loan repayments.
- III. Interest rates and other costs involved in getting a loan are too high.
- IV. A lack of collateral.
- V. An equity base that is too small.
- VI. SMEs owners do not want to be told how to run their businesses by financiers.
- VII. Lack of a business plan.
- VIII. Lack of information required by lenders/financiers.
- IX. SMEs believe there is no financing available.
- X. SMEs operators do not have time to understand and complete the loan application documents.

The study also sought to identify the main reasons SMEs in Lesotho seek external finance. SMEs in Lesotho seek external finance or credit for various reasons. The major reason credit is needed by Lesotho SMEs is to finance day-to-day operations (including order financing), followed by expansion of the business, start-up capital and other reasons.

Struggling to secure funding from financial institutions, SMEs in Lesotho use a number of alternative sources of financing. Retained earnings are the leading source of finance, followed by personal savings, family and friends as well as trade credit. Private lenders, individual/business investors and leasing and factoring are the least used sources of funding by SMEs. For start-up financing, entrepreneurs predominantly use personal savings, followed by funding from family and friends and others. Banks are the least used source of funding for the purposes of finance business start-ups.

The viability of alternative sources of funding that SMEs use was another objective of this study. This objective was achieved by collecting data on the continued availability of the current source of funding and the adequacy of such financing for desired future

business investment/expansion and operations. While SMEs operators are confident that their sources of funding will continue to be available in future, they do not believe that they will be enough to finance their businesses' future plans. Successful businesses have distinct competitive advantages and grow. They achieve this by undertaking requisite investments and changes. Therefore, the inability of these sources to fund SMEs' desired future investments and operations means that such sources have limited viability. The current funding sources merely keep the enterprises afloat, maintaining their status as subsistence businesses with no growth. Furthermore, the preference for banks by SMEs as the source of future financing undermines confidence in what their current sources of funding can help SMEs achieve.

### **5.3 OTHER FINDINGS**

The research results indicate that there is an association between the length of time business has been operating and whether it has ever tried to access credit. The longer the business has been operating, the more likely it is to access external finance. In addition, only a minority of small enterprises try to access credit, while a majority of medium size enterprises do try to access external funding. This indicates that the larger the business, the bigger the chances of accessing external finance.

Another finding is that the risk of defaulting on loan repayments is related to monthly sales revenue. The greater the amount of monthly sales revenue, the greater the likelihood of defaulting on loan repayments.

Most SMEs do not have outside investors. The association between size of SME and whether or not the SME has outside investors indicates that the likelihood of an enterprise having outside investor increases as annual turnover increases.

The current sources of funding for SMEs and their continued future availability are also associated with the age of the business. The longer the business has been operating, the more confident it is that its current source of funding will continue to be available in

future. Older businesses tend to have established relationships with banks, which are their current sources of finance, unlike newer or start-up enterprises that depend on their owner's personal financing.

The approaches that can be used by stakeholders to bridge the financing gap are presented with recommendations.

## **5.4 RECOMMENDATIONS**

This section puts forth recommendations that can help improve SMEs' access to external finance.

- The training offered by business development services agencies (BDS) should be tailored towards the formalisation of business and management activities. This will encourage SMEs to transition from being businesses that just 'take care' of their owners and therefore survivalist, but to be orientated towards growth and competitiveness. The result here will remove the leading demand-side obstacle to access to external finance since in order to grow and compete, enterprises will have to seek external funding in the form of debt or equity. Furthermore, emphasis should be placed on the development of business plans not only for new SMEs - but also going concerns - to serve as a framework for business and management activities as well as a roadmap to growth and competitiveness.
- Government should strive to develop and deepen financial and capital markets in Lesotho. The increased availability of capital investment will support the SMEs start-up environment, encourage SMEs owners to be more willing to share ownership of their businesses and reduce the overarching dependence on personal saving and family and friends as the leading sources of funding to start businesses. Findings in Chapter four indicate that a large proportion (73.2%) of SMEs have no outside investors at all, and this has significant, adverse effects on access to requisite operating and investment financing.

- Banks should manage risks more innovatively and be more willing to take reasonable risks. This could be guided by an approach to SME product development that integrates demand- and supply-side challenges with reference to SMEs' access to bank financing. Results in Chapter four show that 50% of SMEs surveyed have never bothered to access external finance, yet bank financing is the leading or most preferred source of financing that SMEs would like to use in the future. This presents a huge opportunity for banks exploit this market by offering appropriate products.
- Financiers should drastically lower the cost of access to finance for SMEs. This can be achieved through innovative banking approaches such as optimisation of mobile platforms, portable POS and low-cost branches tailored for serving SMEs.
- Government should assist in the promotion of and encourage factoring as a source of operating finance. Factoring provides uncapped funding to SMEs and therefore, helps promote growth. Additionally, factoring has fewer requirements than bank loans.
- There must be greater emphasis on SME clusters development to facilitate financiers' access to SMEs, information dissemination and product targeting.
- SMEs should be encouraged to form co-operatives to increase their bargaining power. The power of the collective would facilitate access to trade credit and increase the capacity of SMEs to lobby financiers for financial products tailor-made for SMEs.
- There should be efforts to gather SME finance data in a coordinated and consistent manner across the country. This will help in informing planning and monitoring of relevant policy implementation. The Central Bank of Lesotho, can be a centralised collector of supply-side SME financing data while other data can be collected through regular surveys.

## **5.5 SIGNIFICANCE OF THE STUDY**

The study has revealed that despite attempts by government, business development services agencies and IFIs to ease access to external finance difficulties faced by SMEs in Lesotho, specific and significant demand-side challenges still remain and financial product development should be guided more by these challenges. The identification of the demand-side challenges can be used by banks and other institutions to inform their SMEs product offering so that they are more responsive to the SMEs' external financing needs. Furthermore, this study has revealed that, despite only 50% of surveyed SMEs reporting that they have previously tried to access bank loans, bank financing is the most popular source of funding that SMEs would like to use in future. This presents a huge opportunity that banks can leverage by offering more relevant SMEs financing products. The value of the findings of this study is that they may well be used to inform policy and planning as well as be considered for future interventions regarding SMEs' financing challenges.

## **5.6 LIMITATIONS OF THE STUDY**

The study was subject to limitations that should be borne in mind when dealing with its findings. The limitations of the study are:

- The sample size of the study was not large enough for the findings to be generalised.
- The study population was SMEs operators in Lesotho, as such the findings of the study cannot be generalised to other regions or countries.
- The study was conducted in Lesotho which has low levels of data on SMEs and their activities.

## **5.7 FURTHER RESEARCH**

Research into the motivators or instigators of entrepreneurship could go a long way in enhancing understanding of the drivers of the SME sector in Lesotho and thus help in further clarifying its needs, including the need for increased access to external finance. Also, research into the extent and adequacy of financial innovation and competitiveness within the banking sector in Lesotho. Another avenue of research could be on the supply-side challenges to SMEs access to external finance, with specific focus on Lesotho, can also shed more light into addressing the challenge of SME financing gap.

## **5.8 CONCLUSION**

Chapter five presents the conclusions and recommendations of this study. The conclusions made are drawn from the primary data results as presented in Chapter four and expose the main obstacles to SMEs' access to external finance in Lesotho, the main reasons these SMEs seek external financing, the alternative financing options that they are turning to and the viability of these alternatives. Lastly, the significance of this study and the limitations of it have also been covered in this chapter.

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**APPENDIX A**  
**QUESTIONNAIRE**

**SECTION A: GENERAL INFORMATION OF THE BUSINESS**

**Q1. Which of the following best describes the ownership structure of the business? (Please tick the appropriate)**

- |                            |                          |                    |                          |
|----------------------------|--------------------------|--------------------|--------------------------|
| 1. Public limited company  | <input type="checkbox"/> | 4. Partnership     | <input type="checkbox"/> |
| 2. Private limited company | <input type="checkbox"/> | 5. Sole proprietor | <input type="checkbox"/> |
| 3. Joint venture           | <input type="checkbox"/> | 6. Family owned    | <input type="checkbox"/> |
| 7. Other                   | <input type="checkbox"/> |                    |                          |

If other, please specify.....

**Q2. In which industry or sector does your business operate? (Please tick the appropriate)**

- |                     |                          |                |                          |
|---------------------|--------------------------|----------------|--------------------------|
| 1. Wholesale/Retail | <input type="checkbox"/> | 5. Real estate | <input type="checkbox"/> |
| 2. Manufacturing    | <input type="checkbox"/> | 6. Transport   | <input type="checkbox"/> |
| 3. Services         | <input type="checkbox"/> | 7. Farming     | <input type="checkbox"/> |
| 4. Construction     | <input type="checkbox"/> | 8. Other       | <input type="checkbox"/> |

If other, please specify.....

**Q3. How long has the business been in operation (please tick as appropriate)**

- |                  |                          |                   |                          |
|------------------|--------------------------|-------------------|--------------------------|
| 1. Under 1 year  | <input type="checkbox"/> | 2. 1 to 5 years   | <input type="checkbox"/> |
| 3. 6 to 10 years | <input type="checkbox"/> | 4. Over ten years | <input type="checkbox"/> |

**Q4. How many people are currently full-time employed by the business/company?**

- |                |                          |
|----------------|--------------------------|
| 1. Less than 3 | <input type="checkbox"/> |
| 2. 3 – 9       | <input type="checkbox"/> |
| 3. 10 - 49     | <input type="checkbox"/> |

**Q5. Do you have qualified/professional people in specialised managerial positions in the business? (Please tick the appropriate)**

1. Yes                       2. No.

**Q6. What is the highest educational qualification of the business owner/director/CEO/highest ranking officer?**

- |                        |                          |                               |                          |
|------------------------|--------------------------|-------------------------------|--------------------------|
| 1. C.O.S.C/Matric      | <input type="checkbox"/> | 4. First Degree               | <input type="checkbox"/> |
| 2. College Certificate | <input type="checkbox"/> | 5. Postgraduate qualification | <input type="checkbox"/> |
| 3. Three year Diploma  | <input type="checkbox"/> |                               |                          |

If the owner has a qualification **not** listed above, please specify.....

**Q7. What is the gender of the business owner/director/CEO/highest ranking officer?**

1. Female                       2. Male

**Q8. Does your organisation/business have an existing business plan?**

1. Yes                       2. No.

**Q9. What was the gross sales revenue or turnover of your most recent financial year?**

- |                              |                          |
|------------------------------|--------------------------|
| 1. Less than R200 000.00     | <input type="checkbox"/> |
| 2. R200 000.00 – R999 000.00 | <input type="checkbox"/> |
| 3. R1m – R5m                 | <input type="checkbox"/> |
| 4. Over R5m                  | <input type="checkbox"/> |

**Q10. What is the average monthly sales revenue of your business?**

- |                             |                          |
|-----------------------------|--------------------------|
| 1. Less than R10 000.00     | <input type="checkbox"/> |
| 2. R10 000 - R24 999.00     | <input type="checkbox"/> |
| 3. R25 000.00 - R49 999.00  | <input type="checkbox"/> |
| 4. R50 000.00 – R100 000.00 | <input type="checkbox"/> |
| 5. Over R100 000.00         | <input type="checkbox"/> |



**SECTION B: The following questions relate to the financing issues of your business: access to and availability of capital and credit financing, the alternative financing options you are using and the future of your business.**

*Unless indicated otherwise, please indicate the extent to which you agree with each of the answers for the questions that follow by circling the appropriate level.*

**1= Strongly Disagree, 2 = Disagree, 3 = Neutral, 4 = Agree, 5 = Strongly Agree**

**Q11. Has your business ever tried to access credit (external financing)?**

1. Yes                       2. No

If you answered 'No' to question 11, please answer question 12.

**Q12. What are the main reasons you have not tried to access credit?**

- |  |   |   |   |   |   |
|--|---|---|---|---|---|
| 1. Have never needed credit  | 1 | 2 | 3 | 4 | 5 |
| 2. Lack of collateral  | 1 | 2 | 3 | 4 | 5 |
| 3. Too small equity base   | 1 | 2 | 3 | 4 | 5 |
| 4. Do not have the required business plan  | 1 | 2 | 3 | 4 | 5 |
| 5. Do not have time to understand and complete the loan applications                 | 1 | 2 | 3 | 4 | 5 |
| 6. Do not have all the information lenders/financiers want                           | 1 | 2 | 3 | 4 | 5 |
| 7. Do not have enough cash flow to finance monthly loan repayments                   | 1 | 2 | 3 | 4 | 5 |
| 8. I do not want to be told how to run my business by my lenders/financiers          | 1 | 2 | 3 | 4 | 5 |
| 9. Interest rates and other costs involved in getting a loan of capital are too high | 1 | 2 | 3 | 4 | 5 |
| 10. There is no financing available at all   | 1 | 2 | 3 | 4 | 5 |

If there is another reason why you have not tried to access credit, please specify  
 .....

**Q13. Have you ever been denied a loan/credit by a bank? (Please tick the appropriate)**

1. Yes                       2. No

If you answered 'Yes' to question 13, please answer question 14

**Q14. What were the main reasons given by your bankers/financiers for refusing you the loan?**

- |   |   |   |   |   |   |
|---|---|---|---|---|---|
| 1. Lack of acceptable collateral for the loan   | 1 | 2 | 3 | 4 | 5 |
| 2. Lack of owner investment in the business<br>or required deposit ( <i>for 'order financing'</i> ) | 1 | 2 | 3 | 4 | 5 |
| 3. Default on previous loan   | 1 | 2 | 3 | 4 | 5 |
| 4. Poor or no business plan   | 1 | 2 | 3 | 4 | 5 |
| 5. Did not have all the documents required  | 1 | 2 | 3 | 4 | 5 |
| 6. Increased riskiness of my business   | 1 | 2 | 3 | 4 | 5 |
| 7. Unsatisfactory cash flow   | 1 | 2 | 3 | 4 | 5 |
| 8. No reason given  | 1 | 2 | 3 | 4 | 5 |

If there is another reason given by your bankers for refusing the loan, please specify.....

**Q15. What was the reason your business needed credit?**

- |  |   |   |   |   |   |
|--|---|---|---|---|---|
| 1. Start-up capital                                      | 1 | 2 | 3 | 4 | 5 |
| 2. Expansion of the business                             | 1 | 2 | 3 | 4 | 5 |
| 3. For day-to-day operations (including order financing) | 1 | 2 | 3 | 4 | 5 |
| 4. Other   | 1 | 2 | 3 | 4 | 5 |

If other, please specify.....

**Q16. Have you ever had a problem repaying a loan? (Please tick the appropriate)**

1. Yes                       2. No

If you answered 'Yes' to question 16, please answer question 17.

**Q17. What was the cause of the problem in repaying the loan?**

- |  |   |   |   |   |   |
|--|---|---|---|---|---|
| 1. Monthly repayment amount was too high | 1 | 2 | 3 | 4 | 5 |
| 2. Interest rate charged was too high    | 1 | 2 | 3 | 4 | 5 |

- |                                    |   |   |   |   |   |
|------------------------------------|---|---|---|---|---|
| 3. Loan repayment period too short | 1 | 2 | 3 | 4 | 5 |
| 4. Loan repayment period too long  | 1 | 2 | 3 | 4 | 5 |
| 5. Inadequate cash flow            | 1 | 2 | 3 | 4 | 5 |

If there was another cause of the problem in repaying the loan, please specify.....

**Q18. How long were you given to repay the loan (maturity period of the loan)? (Please tick the appropriate)**

- |                  |                          |
|------------------|--------------------------|
| 1. Up to 1 year  | <input type="checkbox"/> |
| 2. Up to 2 years | <input type="checkbox"/> |
| 3. Up to 4 years | <input type="checkbox"/> |
| 4. Up to 5 years | <input type="checkbox"/> |
| 5. Over 5 years  | <input type="checkbox"/> |

**Q19. Where did you get the finance to start your business?**

- |                                  |   |   |   |   |   |
|----------------------------------|---|---|---|---|---|
| 1. Personal savings              | 1 | 2 | 3 | 4 | 5 |
| 2. Family and friends            | 1 | 2 | 3 | 4 | 5 |
| 3. Bank loan                     | 1 | 2 | 3 | 4 | 5 |
| 4. Individual/Business Investors | 1 | 2 | 3 | 4 | 5 |
| 5. Other                         | 1 | 2 | 3 | 4 | 5 |

If other, please specify.....

**Q20. Other than banks, what other sources of financing do you currently use?**

- |   |   |   |   |   |   |
|---|---|---|---|---|---|
| 1. Personal savings                             | 1 | 2 | 3 | 4 | 5 |
| 2. Retained earnings/business profits           | 1 | 2 | 3 | 4 | 5 |
| 3. Family and friends                           | 1 | 2 | 3 | 4 | 5 |
| 4. Business co-operatives                       | 1 | 2 | 3 | 4 | 5 |
| 5. Private lenders (loan sharks, micro lenders) | 1 | 2 | 3 | 4 | 5 |
| 6. Trade credit                                 | 1 | 2 | 3 | 4 | 5 |
| 7. Leasing or factoring                         | 1 | 2 | 3 | 4 | 5 |
| 8. Individual/Business investors (equity)       | 1 | 2 | 3 | 4 | 5 |

9. Bank loans 1 2 3 4 5

10. Other 1 2 3 4 5

If there is another source of financing that you use, please specify.....

**Q21. Would you say it is easier to get funding from other sources than from banks? (Please tick the appropriate)**

1. Yes  2. No

**Q22. Do you think that your current source of funding will continue to be available in the future?**

1. Yes   
2. No   
3. Not sure

**Q23. Do you think your current source of funding will be enough to finance the desired/planned business expansion and operations?**

1. Yes   
2. No   
3. Not sure

**Q24. How much of your business is owned by outside investors? (Please tick the appropriate)**

1. 1% – 5%   
2. 6% – 10%   
3. 11% – 20%   
4. 21% – 49%   
5. 50% and over   
6. I do not have   
outside investors

**Q25. Do you currently, or have you previously had any of the following as investors?**

**(Please tick the appropriate)**

- |                         |                              |                             |
|-------------------------|------------------------------|-----------------------------|
| 1. Friends and family   | Yes <input type="checkbox"/> | No <input type="checkbox"/> |
| 2. Business investors   | Yes <input type="checkbox"/> | No <input type="checkbox"/> |
| 3. Individual investors | Yes <input type="checkbox"/> | No <input type="checkbox"/> |
| 4. Government           | Yes <input type="checkbox"/> | No <input type="checkbox"/> |
| 5. No investors         | Yes <input type="checkbox"/> | No <input type="checkbox"/> |

**Q26. What is the effect of capital/credit unavailability on your business?**

- |   |   |   |   |   |   |
|---|---|---|---|---|---|
| 1. Unable to grow business or expand operations                 | 1 | 2 | 3 | 4 | 5 |
| 2. Have to reduce number of employees                           | 1 | 2 | 3 | 4 | 5 |
| 3. Unable to increase inventory/stock to meet increasing demand | 1 | 2 | 3 | 4 | 5 |
| 4. Have to close stores or branches                             | 1 | 2 | 3 | 4 | 5 |
| 5. No effect  | 1 | 2 | 3 | 4 | 5 |

If there is another effect of capital/credit unavailability on your business, please specify.....

**Q27. Over the last three years, how much did your firm grow in terms of the number of full-time employees? (Please tick the appropriate)**

- |   |                          |
|---|--------------------------|
| 1. There was growth in the number of full-time employees      | <input type="checkbox"/> |
| 2. No change in the number of full-time employees             | <input type="checkbox"/> |
| 3. The number of full-time employees got smaller              | <input type="checkbox"/> |
| 4. Not applicable, the business was only recently established | <input type="checkbox"/> |

**Q28. Over the last three years, how much did your firm grow in terms of sales revenue?**

**(Please tick the appropriate)**

- |   |                          |
|---|--------------------------|
| 1. There was growth in the amount of sales revenue            | <input type="checkbox"/> |
| 2. No change in the number of amount of sales revenue         | <input type="checkbox"/> |
| 3. The amount of sales revenue got smaller                    | <input type="checkbox"/> |
| 4. Not applicable, the business was only recently established | <input type="checkbox"/> |

**Q29. How much does your business expect to grow in the next three years in terms of sales revenue? (Please tick the appropriate)**

- 1. Grow substantially by over 20% per year
- 2. Grow moderately by under 20% per year
- 3. Stay the same size
- 4. Become smaller
- 5. Close down

**Q30. If you use external financing in future, which type of external financing would you prefer?**

- 1. Bank credit 1 2 3 4 5
- 2. Loans from family and friends 1 2 3 4 5
- 3. Equity from business and individual investors 1 2 3 4 5
- 4. Loans from other businesses (such as trade credit, leasing or factoring) 1 2 3 4 5

If there is another type of external financing you would prefer, please specify.....

**Q31. How important are each of the following factors in financing your business in the future? (Please rank the factor in terms of how important it is for you)**

**1 = Not Important At All, 2 = Unimportant, 3 = Not Sure, 4 = Important, 5 = Extremely Important**

- a) Government-backed guarantees for loans 1 2 3 4 5
- b) Measures to nurture equity financing 1 2 3 4 5
- c) Tax incentives 1 2 3 4 5
- d) Business support services (e.g. Advisory, training, business networks, etc) 1 2 3 4 5

**THANK YOU!**

