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Potential Sources of Financing for Small and Medium Enterprises (SMEs) and Role of Government in Supporting SMEs

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Abstract

There is no second thought that financing is a key tool for the growth of any firm and accessing the right kind of financing according to the firm's need is of more vital importance. Access to finance for Small and medium enterprises (SMEs) is always a hot discussion for the researchers. Having known that SMEs are considered as backbone of economy and play key role for the growth and development of country, they face hindrances while accessing the finance from financial institutes. Keeping in view the importance of SMEs, this paper aims to widen the understanding on the available alternative financing options accessible to SMEs and entrepreneurs; this will enhance their knowledge about the full scope of financing instruments that they can access in various circumstances and by having healthy discussion among stakeholders about new methodologies and creative strategies for SME and business enterprise financing. Other than that, this paper also aims to highlights the SME demographics and role of government for supporting the SMEs.

Keywords: Small and Medium Enterprises (SMEs); SME Financing; Financial Instruments; SME Demographics; Government Support for SMEs.

Introduction

Small and medium enterprises (SMEs) represent a large share of ventures and employment in the private segment of utmost economies. SMEs are considered to be the foundation and backbone of all economies and are considered as key segment and players in national development and improvement. They are regularly depicted as capable and productive job makers, the seeds of huge organizations and the oil of national financial engines. SME sector has an upper hand on big businesses in terms of employment creation, even in the developed industrial economies (Mullineux, 1995).

The dynamic part they play in economic growth of nations have been exceedingly underlined; SMEs are a noteworthy wellspring of financial improvement in creating nations. They additionally assume a key part in the economic advancement of developed nations. SMEs tend to have benefits over their enormous size rivals in that they can adjust effortlessly to economic situations and similarly they are ready to withstand hostile economic conditions due to their flexible attributes (Dalisto& Peter, 2000).

Financing is an important tool for any firm growth and required throughout the firm's lifecycle. The accessibility of fund has been highlighted as a central point in the improvement, development and accomplishment of SMEs (Ou and Haynes, 2006). However, SMEs usually face obstacles to raise the funding; they consistently report higher financing hindrances than large enterprises (Beck, Demirgüç-Kunt, Laeven and Maksimovic, 2006).Bank credit/lending is the most widely recognized an outer source of money for some SMEs and business visionaries, which are intensely dependent on conventional debt to satisfy their start-up, income and investment needs.

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However, due the repercussion of financial crisis in 2008-09, SMEs experienced the banks' strict credit constraints and highlighted the vulnerability of SME sector to fluctuating conditions in bank lending. Therefore, it is important to widen the scope of financing instruments accessible to SMEs and business visionaries, with a specific end goal to empower them to keep on playing their part in development, advancement and employment.

Obtaining finance is a long journey, the achievement of which relies upon the methodology used during assessment and granting of credit by investor (Clarke et al., 2001). Financing techniques utilized by SMEs vary from initial internal sources, for example, owner–manager's personal savings and retained earnings, to informal external sources, comprising monetary help from family and companions, trade credit, venture capital and angel investors, and thus to formal outer sources represented by financial intermediaries, for example, banks, by financial intermediaries and securities markets (Abdul Saleh and Worthington, 2013).

The objective of this paper is to help widen the understanding of the alternative financing options accessible to SMEs and entrepreneurs, by enhancing their knowledge about the full scope of financing instruments that they can access in various circumstances and by having healthy discussion among stakeholders about new methodologies and creative strategies for SME and business enterprise financing. The paper is arranged as: second section talks about the SME demographics to have better understanding on SMEs; third part of paper discusses the potential sources of SME financing; the fourth chapter highlights the role of government policies to support SMEs; last section concludes the paper.

SME Demographics

Definition & Classification

Small and medium-sized enterprises (SMEs) are non-subsidiary, independent firms which employ limited specified number of employees. This number differs crosswise over nations. As per EU recommendation, 361 (2003)[3], the main factors determining whether an enterprise is an SME are:

- Staff headcount and
- Either turnover or balance sheet total.

Company category	Staff headcount	Turnover	or	Balance sheet total
Medium-sized	< 250	≤ € 50 m		≤ € 43 m
Small	< 50	≤ € 10 m		≤ € 10 m
Micro	< 10	≤ € 2 m		≤ € 2 m

As per EU definition, SME can maximum employee 250 workers, whereas; according to the World Bank's definition, a SME has no more than 300 employees and annual turnover / total assets no more than US$ 15 million.

Job Creation

SMEs are considered to be key contributors in jobs creation in all the economies, especially young and smaller firms. Claudia Deijl; Jan de Kok Christi Veldhuis-Van-Essen (2013), studied almost 50% recent research studies on job creation by SMEs and concluded that SMEs role is significant in job creation, they provide 2/3 formal jobs in developing economies whereas this ratio is higher with 80% in low income countries. There is a misconception that due to short life of SMEs, they don't create many jobs but this study has showed that it's not true; 50% employment generates from SMEs with less than 100 employees. OECD report shows that SMEs play a vital role in producing jobs in all OECD countries. It is apparent that SMEs play an important role in all OECD economies: they constitute over 95% of enterprises and reason for 60 to 70% of jobs in most OECD countries (Business, S., 1997).

Ownership/Legal Form

The ownership/legal form of small business/private sector is categorized into three main forms; sole proprietorships, ordinary partnerships and companies[4]. The most common legal form under SMEs is sole proprietorship. In UK, in the beginning of 2015, 62% of SMEs were sole-proprietorship concerns i.e. 3.3 million, 1.6 million trading companies (30% of total) and remaining 436,000 (8%) SMEs were ordinary partnerships.[5]

[3] http://ec.europa.eu/growth/smes/business-friendly-environment/sme-definition_en
[4] Companies include Public Limited Companies, Private Limited Companies, Limited Liability Partnerships, and others.
[5] Source: SME statistical report by UK Department for Business Innovation & Skills. October 2015.

Gender

Mostly SMEs are being owned by men, however; the women ownership in small businesses is increasing specially the number of women ownership in entrepreneur ventures is growing. In Canada, in 2013 47% of SMEs were being owned by women partially or fully.[6] Whereas, in USA women fully owned 36% SMEs and 9% SMEs are jointly owned (Lichtenstein, 2014).

Owners age and Business experience

SME owners are considered to be older than non-business owners. Mostly SME owners age more than 50 years old and this average is growing. In USA, in 2012, owners age 50 and over owned 51% businesses as compared to 46% ownership in 2007. 33% SMEs owners are aged between 35 to 49, whereas; 16% SME owners were under age of 35(Lichtenstein, 2014).

Mostly SME business around the globe possesses more than 10 years' experience. In Canada, approximately 77% SMEs are running the operation for more than 10 years, 18% SMEs fall under the 5 to 10 years' bracket and 5% have less than 5 years' business experience.[7]

Education

Generally, SME owners are not highly educated but still run the business successfully. IC, 2013 report shows that, in 2011 in Canada, the majority of SME owners had some post-secondary education 67% (32% college education, 22% Bachelors and 13% Masters). Almost 24% possess high school education and less than 10% of SME owners had less than a high school diploma. Whereas, Lichtenstein (2014) report shows that, in USA in 2012, approximately 39% owners were having bachelors' degree or above, 33% and 28% owners possessed college and high school education respectively.

Sectoral distribution

SMEs have the maximum representation of overall population in each of the main industry sectors. SMEs mostly account in construction, services, retail and wholesale trade sectors. Sectoral distribution of SMEs within Canada in 2011 revealed that 71.4% of SMEs run in the services sector (including 20% in retail & wholesale trade), 15.2% in construction and 6.7% in manufacturing sectors. Similarly, mostly SMEs in Germany are also service oriented, three quarters SMEs operate in service industry (including 17.5% trade), approximately 7.3% and 10.3% SMEs run in manufacturing and construction areas respectively.[8]

Potential sources of Financing for SMEs

Numerous studies have been conducted on financing research; the two most fundamental sources of financing are debt and equity (Broom et al., 1983; Longenecker et al. 1994). Debts are described as funds borrowed to be paid in future specified time period with interest amount (Hisrich and Peters 1995; Anderson and Dunkelberg, 1993). Whereas in equity, investment is made in order to get share/ownership part in firm and whose profits are essentially in view of the benefits. SMEs can be funded internally and externally; internally generated funds include investment profits, sales of assets, extended payment terms, reduction in working capital and accounts receivable; whereas, external sources are firm owners, companions and relatives, banks and financial institutes, suppliers and merchants, government and non-government offices (Hisrich and Peters, 1995).

Debt and Equity are divided into different financing practices; financing techniques utilized by SMEs vary from initial internal sources; for example, owner–manager's personal savings and retained earnings, to informal external sources, comprising monetary help from family and companions, trade credit, venture capital and angel investors, and thus to formal outer sources represented by financial intermediaries, for example, banks, by financial intermediaries and securities markets (Abdul Saleh and Worthington, 2013). This section gives an overview of different available SMEs sources of financing including overview on debt and equity financing.

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[6]Statistics on Canadian Women in Business by Susan Ward. Accessible on: https://www.thebalance.com/statistics-on-canadian-women-in-business-2948029

[7] Source: Key small business statistics released by Canadian Department for Innovation, Science and Economic Development, June 2016.

[8] Source: Profile of SME Sector in Germany published by KFW group in October 2015.

SME Owners, Friends and Family

When SME owners face lack of capital, the first and foremost option is to invest by himself from available sources and to seek help from his family and friends. This kind of financing is considered as source of trust capital. In Nigeria 73% of SMEs raised their financing through their own funds from personal savings; whereas, only about 2% opted financial institutions for financing (Terungwa, 2011). Due to high cost and complex procedure, SMEs in Pakistan rank bank credit at 3rd followed by funding from NGOs and family and friends (Nenova et al., 2009). Hypothetically, financing from friends and family is very good alternative as the investors solely purpose is not monetary and is ready to accept the lower or no interest on their investments. Financing from friends and family has few downsides; risk remains within the social circle of owner and can affect the relationship in negative way (Lee and Persson, 2016); another drawback is such kind of financing is limited.

Angel Investor/Business Angel

Angel investor or business angels are those people who have high net worth, willing to invest in new businesses (usually SMEs) without having any personal family relationships, in order to have some stocks in that business (Mason and Harrison, 2008; Sohl, 2012). Business angels play a vital role in SME financing by providing the small amount of loans to the firm in early stages of its growth. Stats show that business angels offer almost same amount of funding as used to offer by formal funding financial specialists and finance a large number of projects (Sohl, 2012). Therefore, business angels assist firms to increase the flow of finance by contributing directly. They do have few drawbacks, which are; takes long time to find the appropriate angel investor, can be dishonest and owner has to give up some of his business share, many investors often ask for certain share in company's stake (Mondal and Shrivastava, 2016; Elitzur and Gavious, 2003).

Trade Credit

Trade credit is an alternative way of financing business needs. It emerges when a company purchases good and services on deferred payment (Huyghebaert, 2006). It's a short-term credit and payment becomes due in thirty to sixty days; if payment is not made within the stipulated time period, interest charges are imposed and becomes a source of financing. Trade financing is universal; other than conventional bank lending, it's the following most external significant approach of SME financing in almost all developed and developing countries (Demirgüç-Kunt and Maksimovic, 2002). Trade credit is an impulsive kind of financing for SMEs, as it arises directly from ordinary business transactions.

Though, if payments are not paid within the required credit window, trade credit can become an expensive way of financing. In addition, cost of credit is generally assigned into the cost of goods sold on credit, which indirectly makes trade credit as an expensive financing approach (Wilson and Summers, 2002). Period of trade credit is limited, if any SME is more open to risk, suppliers may be reluctant to stretch the credit period further. Although, trade credit has few disadvantages but it is still an important source of financing for start-up SMEs (Berger and Udell, 2006).

Factoring and invoice discounting

Factoring is a kind of financial service and debt finance in which business sells its account receivables (i.e. invoices) to the third party (known as factor) at discount; the factor is responsible to collect the receivables from the debtor's customers on behalf of invoices collected from the business (Vasilescu, 2010). Whereas, in invoice discounting lender gives the money to business by keeping the account receivable/sales ledger as collateral for loan, but does not take the authority to collect the receivables like in factoring approach (IFG, 2012).

Factoring is quite beneficial for SMEs; allow them to grow rapidly, improve cash flow, productivity and profitability. Factoring is very effective in economies having high SME financing obstacles and it is also necessary during financial crisis and liquidity congestions when banks enforce severe credit conditions on small businesses (Vasilescu, 2010). Likewise factoring, invoice discounting is very useful and efficient source of cash, enabling SMEs to raise the cash immediately by keeping their outstanding invoices as collateral. Nesta (University of Cambridge) UK studies suggest that the significant reasons that SMEs in UK use invoice discounting is because speed, control, ease of use and flexibility (Baeck et al., 2014).Both of these sources of finance allow SMEs to generate funding against the collateral of their outstanding receivables. But these both are also for limited period of time and very expensive (Vasilescu, 2010; Chen and Chen, 2012). Factoring can also affect the buyer-seller relationship in negative way (Ivanovic et al., 2011).

Leasing

Leasing is an asset based financing, which allow SMEs to get the short- and medium-term financing. Leasing can be referred as source of financing for procurement of capital equipment, in which two parties agree to sign a contract where one party (lessor) provides an asset to another party (lessee) for using that asset for limited/fixed period of time against the specified regular payments. At the end of contract lessee is allowed to buy that equipment. (Amiri, 1998 and Fletcher et. al., 2005).

Leasing is considered as one of the vital financing tool for SMEs which allow them almost same to the investment period of leased assets. It is different than traditional loan as there is no cash given to client by a finance company, but an asset. Government support for this financing tool may assist to minimize the market weaknesses and to expand the SMEs access to finance. Leasing is quite effective for small businesses when they face difficulty to access the traditional bank credit due to having limited credit track and lack of collateral but leasing enables them to use capital equipment. (Gollardo, 1997 and Berger and Udell, 2006). Leasing is mostly used by fast-growing SMEs specially in European countries (Kraemer and Lang, 2012).

In the present financial and monitory situation, leasing companies have also limited access to (re-)financing. Mostly leasing companies are owned by banks; in Europe 90% leasing companies are bank-owned and other than bank-owned leasing companies, sovereign and captive leasing companies also heavily depend on banks funding to run their operations (Mignerey, 2012). SMEs assume leasing as an essential part of their financing solution but the supply side has been affected due to financial and economic crisis. The recent financial crisis not only affected the banking industry but also the leasing sector by the deteriorating of re-financing conditions and several banks have condensed or completely abandoned the refinancing of leasing companies, because of lack of bank's own resources, strict monitoring requirements and management pressure to focus on core business activities. In addition, mostly sovereign leasing companies are also affected by organizational structure problems; for example, low equity base or scarce of specialization which usually leads to comparatively low residual value of leased assets in their balance sheets (Arzeni et al. 2015).

Venture Capitalist

Venture capitalists are financial intermediaries and source of non-banking financing. Venture capitalist is an investor who invests by providing capital and support to SMEs and entrepreneurs for expansion of their business who don't have access to equities markets. According to Potter & Porto (2007), venture capital is one kind of financing in which funds are generated from investors and redeployed by investing in high-risk instructively obscure firms which generally are start-up businesses. VC is relatively widespread for small and young businesses in developed financial markets (Keuschnigg, 1998). Venture capitalists are just not an alternative option of financing for SMEs, they effectively take part in strategic planning and decision making of the firm and assist SMEs to solve many organizational problems which trouble them.

However, venture capitalists are associated with high uncertainty; hypothetically expecting high-return on their investment portfolio. They make investment for profit in uncertain business proposals of SMEs that have auspicious but yet unproven idea. In order to get funded by VC, SME must have a promising business idea which may generate high profits for VC as per his expectations. Therefore, for many SMEs running the regular business, VC financing might not be possible. Venture capital financing option is moderately obstinate, at least in short-term, as itneeds plentiful experience to grow such vital skills to invest in small businesses promising ideas (Kortum& Lerner, 2000). Having sufficient management experience to run the newly invested business is another major consideration for venture capitalist in evaluating financing prospects (Ambrose, 2012).

Equity Financing

Equity financing is a source of financing through which companies raise the capital by selling the stocks to investors, and obtain the ownership rights in the company. According to Ou& Haynes, (2006, p. 156) "equity capital is that capital invested in the firm without a specific repayment date, where the supplier of the equity capital is effectively investing in the business" In equity finance, funds are generated either internally (owner, family, friends and retain earnings of company) or externally (through various channels). Equity financing is suitable for SMEs that have high risk and return portfolio, seeking long-term corporate investment for expansion, enduring innovation and value creation. Equity financing is preferred over debt financing, as debt financing is costly, not suitable for short-term and difficult to access.

Equity financing benefits the SME by providing long-term financing with least cash outflow in terms of interest and assist the new businesses to expand their credibility by showing that they have seasoned financial experts (Ou and Haynes, 2006). These firms are generally referred as high risk. Troubles confronting SMEs looking for public equity financing are not only constrained to cost (confirmation charges, guides and broker commissions), formalities and reporting necessities. Social variables and administration rehearses additionally constitute challenges for SMEs. Uncertainty to experience the offering procedure, apprehension of being exposed to share price volatility, repugnance for sharing sensitive information and life after an IPO is imperative purposes behind SME hesitance to join value capital markets (Nassr and Wehinger, 2016). Reid (1996), argued that some SMEs many not opt equity as source of financing to avoid any unwanted changes in the ownership of their firms.

Debt Financing

It is a method of financing in which company receives the loan, don't give up the ownership or profits and bound to pay back the principal and interest at specified dates. This kind of financing usually comes with strict conditions and secured by collateral as a guarantee that loan will be repaid. Hence, to have full authority and ownership of their businesses, SMEs choose debt financing over equity financing.

However, debt financing is not suitable for young, innovative and rapid growing firms, having a higher risk-return profile. They often face difficulties to access debt financing due to uncertain outcomes. The financing requirements can be particularly serious on account of new companies or small organizations that depend on intangibles in their business plan, as these are extremely firm-specific and hard to use as collateral in conventional obligation relations (OECD, 2010). SMEs unnecessary reliance on debt financing (compared to equity) enforce heavy costs, which may lead the company to bankruptcy and financial distress.

Crowdfunding

Crowdfunding is an external source to raise financing through large number of individuals, by providing minor amount of financing requested. The idea of "crowdfunding" is identified with the one of "crowdsourcing", which alludes to the outsourcing to the "group" of particular tasks; for example, the growth, assessment or sale of an item, by method for an open call over the web (Howe, 2008). While according to Lambert and Schwienbacher, (2010); "Crowdfunding involves an open call, essentially through the Internet, for the provision of financial resources either in form of donations (without rewards) or in ex-change for some form of reward and/or voting rights in order to support initiatives for specific purposes".

Crowdfunding is an intend to raise reserves, as well as represent a vital mechanism to impart data to a large public openly, increasing mindfulness about tasks and products, seeking suggestions and input to enhance them, and get acknowledgment which may assist in future commercialization (Metzler, 2011). A component of crowdfunding is that it enables individuals a chance to explore for and put resources into thoughts and tasks that they have an interest or a faith in. Consequently, these investors are in some cases willing to take risks and acknowledge lower returns than would be normal. Another element is that, there is scope for cooperation inside the group which may integer other supporters of a specific thought to take an interest. Crowdfunders may in certainty have intrinsic inspirations; for example, the joy of undertaking the project or taking part in a group, and additionally outward inspirations, identified with financial rewards, career growth, learning or disappointment with the present products (Kleeman et al. 2008).

Crowdfunding via internet/web is newly fundraising approach for SMEs, and has the scope to be very beneficial to them. It allows them to overcome funding difficulties by contacting and appealing directly to investors, who may be willing to take the risk involved in funding the new technologies and innovations, which SMEs are usually so good at producing. In crowdfunding SMEs don't loss control and ownership as they offer only small portion of shares and it requires lower cost of capital. On the other hand, investors take advantage of funding in high risk-return projects by using small amount of money and can be part of the projects of their interests. However, the downsides are funds could be misused, loss of capital if project fails and inexperience investors.

Bank Financing

Plentiful research has been done on SME financing through bank and documented that banks are the main external source of funding for SMEs in both developed and growing economies (Vera &Onji, 2010; Ono &Uesugi, 2009; Zhou, 2009; Wu et al., 2008; Carey & Flynn, 2005).

Bank credit is considered to be more expensive as compare to other available sources of finance but it generates huge return for SMEs, further SME can perform better at all level under bank credit due to being monitored by and answerable to banks (Keasey and McGuinness, 1990). Since 2008-09 financial crisis, banks have imposed strict conditions on credit lending to SMEs. Another drawback is bank credit sanctioning is time consuming and also costly, in addition strict requirements of collateral. All these and other downsides have urged the researchers, and SME supporting agencies to look for other alternative available financing sources. Bank credit is regularly utilized by small organizations, though traditional bank funding postures difficulties to SMEs, specifically to start-ups, innovative and rapidly growing businesses, with a higher risk-return profile and this may also not be well suited on various life stage of firm's lifecycle. Besides, banks will regularly require personal guarantee from the proprietor/directors of the SME, which implies the proprietor/directors need to risk his personal wealth with a specific end goal to subsidize the organization.

Role of Public/government Policies to support SMEs

Government policies have great influence on economic development of any country. SMEs are great source of economic development, income generation and job creation in an economy. Government policies are key elements that influencesthe success and performance of SMEs (Jasra et. al, 2011). Thus, it is essential that administration should support and initiate such projects for SMEs, with the goal that should have a sustainable development of the economy. Mostly governments are determined and focused to support the SME industry, to have a steady economy (Ganbold, 2008). Governments are generally keen to help the SMEs from that extent where they can't generate funds for their profitable projects, in addition governments are interested in supporting innovative ventures, which is one area where SMEs generally exceed expectations, and also keen to support the SMEs growth due to their job creation. Recently, with the support of government projects for SMEs in many countries, it has turned out to be progressively conceivable to offer such mixture of tools to SMEs having low credit ratings and insignificant financing needs than what might be in actual in private capital markets (Demirgüç-Kunt, 2006).

Recently worldwide, keeping in view the importance of SMEs, governments and international SME support associations primarily mediate through: i) involvement in the business market with investment funds that honor orders to private ventures pros; ii) direct open financing to SMEs under projects supervised by public financial institutions; iii) guarantees to private establishments that offer financing to SMEs; iv) subsidizing of private financing organizations at exceedingly attractive terms. These interventions by governments for support, benefiting the SMEs at larger scale. The advantages include; - relaxed financing constraints, improving access to finance; - assisting SMEs to grow further by provision of grants and expert advices; - offering wide range of financing products to SMEs and entrepreneurs; making it flexible to conduct business in public sector; - helping SMEs through tax relaxation; - SMEs without collateral may seek government's assistance; - and by guaranteeing the loan and providing equity investment (Kraja et al. 2014).

As we discussed earlier, SMEs are backbone of economies, the government of each country should play vital role in protecting and creating such facilities for SMEs so that they can run the business in effective ways and grow to strengthen the economy. The governments can expand and modify their financing policies for SMEs to improve their conditions and can initiate various financing schemes for SMEs and entrepreneurs. These policies and projects may help them to grow and survive in the market.

Conclusion/Future work

The growing importance of SMEs and contribution made by them for the growth and development of economy, demands that to have improved knowledge and understanding of SMEs, their financial behavior and practices and role of government policies to support them. This paper provides the overview of alternative financing solutions available to SMEs including SMEs' demographics to have better understanding and role of public policies. This paper will help the SMEs owners to widen their knowledge on available potential financing sources other than traditional bank financing and improves the understanding about opportunities and challenges of financing instruments alternative to traditional debt. In addition, derives public policy suggestions and encourages discussion among policy makers, financial institutions and SME representatives about new ways to SME financing.

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