FINANCING OF SMALL AND MEDIUM-SIZED ENTERPRISES (SMES) IN DEVELOPING COUNTRIES

Dr Nehale Farid Mostapha
Professor of Finance and Investments, Dean Faculty of Business Administration, Beirut Arab University

Abstract

The aim of the current study is to investigate the economic role of SMEs in the world economy, especially in the Arab countries. The study explored the different sources of SMEs financing comparing the traditional sources of financing like government programmes, the banking sector financing, leasing, venture capital and business angels with the non-traditional sources mainly Islamic finance. Moreover, the current study explored the relationship between SMEs and the Pecking Order theory.

Key Words: Economic role of SMEs, SMEs Financing, Traditional Financing, Islamic Financing, Developing countries, Arab countries.

Small and medium-sized enterprises (SMEs) are the driving force behind economic development. By their existence and their growth, they perform an essential role as providers of employment and innovation opportunities and act as key players for regional and local development and social cohesion.

Improving access to finance for SMEs, and more specifically initial investment and the ongoing injection of equity, is essential if an SME is to tap into its growth and innovation potential. However, a large number of SMEs face an equity gap. When their initial funds have been exhausted, entrepreneurs have to obtain external finance to develop their project.

Financing SMEs is, however, often considered too risky on account of the low rates of return, particularly during the seed phase. There is thus a serious lack of business angels and venture capital funds that are willing to invest in young innovative SMEs. The inability to obtain early-stage investment prevents many SMEs from reaching a size where they can attract expansion capital, thus stunting their growth. In all countries, the growth of SMEs make a significant contribution to the transition of agriculture-based economies to industrial ones, furnishing plain opportunities for processing activities which can generate sustainable sources of revenue and enhance the development process. However, there are many who believe that the single most important factor constraining the growth of the SME sector is the lack of finance. This paper will explore an overview of SMEs financing by developing the following points:

• The contribution of SMEs Financing to the development of an Economy;
• The traditional and non-traditional Sources of SMEs Financing;
• The constraints of SMEs financing.

1- THE ECONOMIC ROLE OF SMEs IN THE WORLD ECONOMY

SMEs are vital for economic growth and development in both industrialized and developing countries, playing a key role in creating new jobs. SMEs are the main generator of employment in Asia and in Africa, creating employment for up to 90% of the domestic workforce in many Arabic countries and up to 60% in many European countries. In this part, we will develop the economic role of SMEs and their definition as applied in our research.

"In much of the developing world the private economy is almost entirely comprised of SMEs and they are the only realistic employment opportunity for millions of poor people throughout the world"1

SMEs are important to almost all economies in the world, but especially those in developing countries and, within that broad category, especially to those with major employment and income distribution challenges. In those countries, SMEs constitute the middle of the size range, a fact that explains much of their strategic importance.

SMEs constitute about (99%) of the total number of economic institutions in the private nonagricultural sector in Egypt, and contribute around (80%) of the total added value produced by the private sector, employing nearly two thirds of the labor force and three quarters of workers in jobs outside the private agriculture sector. Similarly, in
Kuwait this sector constitutes about 90% of people working in private institutions, including immigrant labor, totaling about 45% of the labor force, with a national employment rate of less than 1%, and in Lebanon, they form more than 95% of total enterprises, contributing to roughly 90% of all jobs. In the United Arab Emirates, SMEs form about (94.3%) of the state economy, and employ about 62% of the labor force, contributing to about (75%) of the state GDP (ALASRAG, 2006).

In addition, the contribution of SMEs to the national economy was estimated at about 96% of GDP in Yemen in 2005, and about 77%, 59%, and 25% in Algeria, Palestine, and Saudi Arabia, respectively (ALASRAG, 2006). Small businesses have given millions of individuals across the world a chance for economic opportunity and upward mobility. In Arab countries, for example, SMEs are not only seen as potentially a key engine for economic growth, but also as playing a crucial role in poverty reduction, which is why the Governments accord high priority to the development of small and medium-sized enterprises; such firms can increase incomes and reduce poverty. In the European Union today, SMEs are economically important, with 98% of an estimated 193 million enterprises defined as SMEs, prodding around 65 million jobs. Again, almost all of these are small enterprises, with 18 million enterprises (93.2%) employing less than ten people and only 35,000 enterprises employing more than 250 people. The average European business provides employment for four people, including the owner/manager.

On a global scale, small and medium-sized enterprises provide some 66% of jobs in the European Union (EU) - a percentage which is predicted to rise as SMEs face challenges and opportunities associated with increased globalization, largely through E-commerce and greater Internet usage by entrepreneurs. In the last decade, SMEs were the principle creators of new jobs, whilst on average; big industry has downsized and reduced employment.

In Asia: 'It has been recognized that some of the world's best performing economies, notably Taiwan and Hong Kong, are very heavily based on small enterprises'. 81% of all employment in Japan is in SMEs where the average enterprise employs nine staff as opposed to four in the EU.

Figure 1: contribution of SMEs to developing countries

SMEs play strategic roles in private sector development. As economies modernize and industrialize, SMEs provide the much-needed inter-firm links required to support large companies to ensure that they remain competitive in world markets. With support from all stakeholders, not least of which the financial sector, a competitive and innovative SME sector will hold out many gains in terms of higher income growth, fuller domestic employment, gainful integration into the global economy and greater equity in terms of wealth distribution.

2-TRADITIONAL and NON TRADIONAL SOURCES of SMEs FINANCING

Financing is necessary to help SMEs set up and expand their operations, develop new products, and invest in new staff or production facilities. Many small businesses start out as the idea of one or two people who invest their own money and probably turn to family and friends for financial help in return for a share in the business. In
this part, we will explain the traditional sources and the non-traditional (Islamic) sources of financing for SMEs. Then, we will describe if the Pecking order theory (POT) can explain the financial behavior of SMEs.

a) The traditional sources of SMEs financing
There are a variety of different sources of finance for SMEs. A distinction can be made between ‘internal’ and ‘external’ financing sources. Internal financing is the most common source of SMEs financing, and includes owner investment, as well as funding through retained profits, and / or the sale of assets.

-Governments Programmes for SMEs Financing
The public sectors have been actively promoting SMEs development in the last two decades. Common commercial credit programmes initiated by the public sector and implemented throughout developing countries include: interest subsidies, credit guarantees, insurance schemes, loan quotas, export financing, and also promissory notes. These programmes are delivered to SMEs either via private bank and nonbank institution, such as cooperatives and associations, and/or state-owned bank institutions and government line agencies. Direct intervention efforts by the government take the form of grants, tax breaks and holidays, the creation of dedicated development financial institutions and various business development services to enhance the competitiveness and skill level of SMEs. The most successful financing programmes are the ones funded by international agencies. The international community provides credit, guarantees and equity investment to support SME development. These agencies work in conjunction with, government ministries and agencies to administer various lending programmes to SMEs. In developing countries, these include the EU SME Development Fund, the World Bank SME Finance Programme and the SME development programme that is administered by the United Nation (UNDP).

-Banking Sector Financing
Debt financing, or taking on a small business loan, is one important source of money for small businesses. A commercial bank is usually where small businesses turn first for a loan. It can be difficult for a start-up small business to get a commercial, bank loan from a commercial bank because of perceived risk. Mature small and medium businesses obtain loans regularly through commercial banks, though access has been more difficult during the Great Recession. Banks collect public resources mainly through identifying the accounts and lend to enterprises. This banking sector has a wide range of genetic short, medium and to a lesser extent, long term credit and various supplementary financing instruments including trade credit, export financing, factoring and discounting. The interest rate is negotiable between the Banks and the SMEs and takes into account the cost of resources used for the financing, the collateral security offered, the risk of the investment, the credibility of the investor and the economic and social impact of the project. In general, banks believe that SME loans have higher risk. The common reasons for regarding SME loans as higher risk include lack of capital, skills and professionalism, poor transparency and limited market access.

-Informal Sector Financing
The informal sector comprises lending between family and friends, savings and credit associations, and moneylenders (alternatively known as grey or black markets). The informal sector is the one of the main channels of financing for SME.

-Trade Financing - Leasing
Leasing is a common source of funding for SMEs. In a typical lease agreement, an owner (lessor) of machinery or equipment grants the user (the lessee) the right to use the equipment for an agreed period of time in exchange for a series of specified payments. There are two variants. In an operating lease, the term of the lease is less than the expected useful life of the equipment. At the expiration of the lease, the equipment is returned to the lessor typically with no further obligation on the part of the lessee. Capital leases, by contrast, usually run for much of the useful life of the equipment and the lessee in most cases is expected to obtain ownership of the equipment at the end of the lease term. Leases are often provided by standalone finance companies, but may be offered as well by the financing arms of non-financial corporations or by subsidiaries of banking organizations where this activity is not prohibited. An advantage of leasing is that it converts what would otherwise be a large, lump sum expenditure into a series of smaller expenditures, thereby freeing up funds for investment in inventory, working capital, or other shorter term assets. It is sometimes argued as well that leasing is a more practical funding alternative to loans from commercial banks, as leasing firms typically use less stringent underwriting criteria.
Venture Capital (VC)
Venture capitalism can be defined as: 'an activity by which investors support entrepreneurial talent; with finance and business skills to exploit market opportunities and thus obtain long term capital gains'.
The original ethos of VC was to provide support for high-growth, high-risk ventures (typically new companies and/or technologies). The following characteristics emerged as the bedrock, of this form of finance:

- Equity-based financing;
- Funding linked to managerial assistance;
- Rewards through capital gains rather than running (dividend) yields;
- Investment in young and start-up companies hence . . .
- Long-term, patient investment.

VC still comprises longer-term finance in unquoted companies where the primary reward is an eventual capital gain. However, as we shall see later, the bulk of global venture funds are now directed to larger deals in later stage investments. Venture capitalists, ‘which often enter the firm at the middle to later stages of its life cycle, provide a link between the SME and institutional sources of capital Funds are usually obtained from institutional investors, especially pension funds, but financial intermediaries and the corporate sector, as well as the official sector, are also major investors. At the end of the process, the venture capitalist aims to realize a return on the investment through “exit” via trade sale or a public issue (initial public offering, i.e. IPO). While trade sales are much larger than IPOs in volume terms, in almost all instances and places, IPOs are important in establishing valuation and in setting standards to which newer companies can aspire.

Business angels
"Business angels", individuals who commit business experience as well as their own capital, often play key roles in the formative stages of a firm's life. The role of business angels in early-stage finance appears to be growing and is increasingly recognized as a vital link in the financing chain. It is also an area where government technical support may have a very high payoff.

Figure 2: TRADITIONAL SOURCES OF SMEs FINANCING

Islamic Banking
Islamic finance started as a small cottage industry in some Arab countries in the late 1970s. It distinguishes itself from conventional finance in its ostensible compliance with principles of Islamic law, or Shari‘a. Its growth has been accelerating ever since, in terms of the number of countries in which it operates, as well as the areas of finance in which it has ventured. However, reliable data are not available on Islamic finance at the country regional or global levels. In recent years, the industry has attracted a number of western multinational financial institutions, such as Citigroup and HSBC which started offering Islamic financial products in some Arab countries (notably Bahrain and the United Arab Emirates), and to a lesser extent in the Western world (including the U.S., where HSBC offers various Islamic financial products in New York, including home financing, checking accounts, etc). A number of Islamic financial products also involve the acquisition of assets (e.g., real estate, small corporations, etc.) in the West (including the U.S.) in "Islamically structured" financing deals.
In Islamic countries, Arabic Entrepreneurs in the SME sector are more inclined towards using Shariah-compliant products and services, provided that required products are available with competitive features and pricing. Currently, most of the Arab banks offering Islamic banking products are represented in this sector. Product
development is not an issue for this sector as the majority of the transactions are Murabaha-based, the structure of which is approved by the respective Shariah Advisor. The most prominent benefit of preferring Islamic banking (IB) over conventional banking is the elimination of the risk of a misuse of banks funds. The mandatory purchase & sale of assets ensures vigor in economic activity. It also shuts the doors on the possibility of using fresh financing to pay off old stuck-up non-performing loans in which all the conventional banks are stuck due to which the portfolio is always on the rise. Note that one of the major reasons for huge outstanding portfolios at various banks remains the misuse of the facility extended, whereas the very nature of IB products (Murabaha, Ijar a, Istisna, Salam, Wakala Istismaar, Sukuk etc.) makes them an excellent banking tool in this era of high inflation, economic distress, political instability etc. The underlying involvement of “asset” itself in every transaction ensures that the funds lent through any IB product are utilized, for the purpose for which they were sought, thereby eliminating the risk of their misuse for any other purpose. In the case of any Islamic banking product, the physical sale and purchase of the asset for which a facility is extended is made mandatory.

- **The common instruments offered by Islamic finance**

  With the prohibitions dictated by Islamic Finance, the method to undertake transactions differs, in concept, to western philosophies. The main instruments are:

  **Shariah compliant Current and Saving Accounts**

  In the absence of interest, there needs to be some incentive to gain a customer and this is done through a profit-sharing exercise whereby at the end of the year, banks allocate profits to the account holders, which may be equivalent to, but not the same as, a conventional saving rate. In the UK, the Consumer Credit Act requires all lenders to show a comparative rate of interest to comply with the Consumer Credit Act 2006 (CCA). Often the sight of an interest rate is misunderstood as trading in interest when in reality it is only used as a benchmark and to comply with the CCA. Also, since an overdraft facility would amount to charging interest, banks may offer interest free loans (Qard- Hassan) in certain cases. This is not obligatory for the bank, as it has to ensure it keeps a commercial viewpoint on its trading operations. Consider this, if an Islamic Bank offered Qard Hassan to all its customers, there would be no trading profit to pay its operating costs and share of profit to its depositors – the bank wouldn't be in business for very long.

  **Murabaha (Cost-plus sale)**

  Murabaha essentially is undertaking a trade with a markup and is used for shortest financing, similar in form to purchase finance. An example would be a bank purchasing a tangible asset of some sort from a supplier with the resale based on the cost plus an agreed markup. This is most often used to finance property, since the bank would not be allowed to charge interest on any loan. Once such a debt covenant is in place between a bank and the customer, repayments can begin until a completion point where the asset is transferred to the customer. There is no exposure to variations in interest rates as there is a fixed markup percentage, identified at the outset.

  **Ijara (Leasing)**

  Ijara is a leasing contract whereby one party leases an asset for a specific amount of time and cost from another party, usually a bank. The bank would bear all the risk and a portion of the installment payment goes towards the final purchase of the asset at the time of transfer of asset. This can also be set up as a lease-purchase contract for the term of the asset's specified lifetime.

  **Musharaka (Equity Participation)**

  There is very little difference between this and a joint venture agreement. The parties involved contribute in varying degrees of assets, technical expertise, etc. and agree to a percentage of the returns as well as the risk. All parties must invest a certain amount of capital. In the case of purchasing a property under this sort of arrangement, it is purchased by both the bank and the customer together, and the repayments made are partly rent and partly a buyback.

  **Mudaraba (Partnership Financing)**

  Mudaraba is very similar to Musharaka and is a trustee type finance contract under which one party provides the labour, while the other provides the capital.

  **Istinaa (Commissioned Manufacture)**

  Istinaa is a solution for the manufacture of goods since speculation prevents the selling of something that one does not yet own. With a promise to produce a specific product that can be made under certain agreed specifications at a determined price and on a fixed date, an Istinaa contract is established. Specifically, in this case, the risk taken is
by a bank that would commission the manufacture and sell it on to a customer at a reasonable profit for undertaking this risk.

The following are some proposed products for SMEs under the Islamic mode of financing:

Table 1: Islamic Modes of Financing

<table>
<thead>
<tr>
<th>Products</th>
<th>Islamic Financing</th>
</tr>
</thead>
<tbody>
<tr>
<td>Asset Acquisition and Business Expansion</td>
<td>Ijarah, Diminishing Musharaka</td>
</tr>
<tr>
<td>SME Auto (Transport sector-Buses, coaches or Trolleys or Oil tankers, Fleet Car Finance).</td>
<td></td>
</tr>
<tr>
<td>Plant Factory Financing.</td>
<td></td>
</tr>
<tr>
<td>Equipment Financing (Photo Copter, X-ray, digital Lab).</td>
<td></td>
</tr>
<tr>
<td>SMS Trade Finance</td>
<td></td>
</tr>
<tr>
<td>Letter of Credit</td>
<td>Ijarah, Diminishing Musharaka</td>
</tr>
<tr>
<td>Export Credit Financing</td>
<td></td>
</tr>
<tr>
<td>Back Guarantee</td>
<td></td>
</tr>
<tr>
<td>Bills of Exchange</td>
<td></td>
</tr>
<tr>
<td>Purchased</td>
<td></td>
</tr>
<tr>
<td>Trust Receipts</td>
<td></td>
</tr>
<tr>
<td>Development of Rural Areas infrastructure as required by local government. This may include schools, hospitals, roads, power houses targeting rural areas.</td>
<td></td>
</tr>
<tr>
<td>Housing Sector Development and construction of houses, god owns and commercial buildings</td>
<td></td>
</tr>
<tr>
<td>Financing the productive activities particularly agriculture, agro-based industries.</td>
<td></td>
</tr>
<tr>
<td>Financing for commodities market.</td>
<td></td>
</tr>
<tr>
<td>3-THE CYCLE OF SMEs FINANCING</td>
<td></td>
</tr>
<tr>
<td>There are a number of stages in the SME life cycle. These include the initial startup phase, the early development phase, and the growth and maturity phases. SME financing needs will vary depending on a number of variables, including the stage of development of a business, its growth objectives, the sector in which the firm operates, and management attitudes towards risk. The various phases of the SME life cycle are set out in Figure 4.</td>
<td></td>
</tr>
</tbody>
</table>

Figure 3: the SME life cycle
Table 2: DEVELOPMENT STAGES OF FIRMS

<table>
<thead>
<tr>
<th>Phases in SME lifecycle</th>
<th>Type of Financing required</th>
</tr>
</thead>
<tbody>
<tr>
<td>Seed Stage</td>
<td>Informal equity and loans from founder and associates. Bank loan if available and needed.</td>
</tr>
<tr>
<td>Start-up stage</td>
<td>Informal equity and loans from founder and associates and contact. Bank loan if available. Leasing for equipment</td>
</tr>
<tr>
<td>Expansion stage</td>
<td>Equity from original sources, plus trade investments or venture capital. Loans from bank. Other sources of finance including leasing and factoring. Retained profits.</td>
</tr>
<tr>
<td>Replacement Capital</td>
<td>Trade investment, venture capital or IPO</td>
</tr>
</tbody>
</table>

Source: European Venture capital association (EVCA)

The definitions above apply particularly in the case of high growth companies - other companies may have more stable financing patterns. Internal sources of finance - informal equity, loans and retained profits - are particularly important for smaller SMEs and those with a low growth trajectory.

4. SMEs AND THE PECKING ORDER THEORY:

The following outline of the POT (PECKING ORDER THEORY) of business financing is provided by Myers (1984, p. 581): 9 Firms prefer internal finance

- They adapt their target dividend payout ratios to their investment opportunities, although dividends are sticky and target payout ratios are only gradually adjusted to shifts in the extent of valuable investment opportunities.
- Sticky dividend policies, plus unpredictable fluctuations in profitability and investment opportunities, mean that internally generated cash-flow may be more or less than investment outlays. If it is less, the firm first draws down its cash balance or marketable securities portfolio.
- If external finance is required, firms issue the safest security first. That is, they start with debt, then possibly hybrid securities such as convertible bonds, then perhaps equity as a last resort. In this story, there is no well defined target debt-equity mix, because there are two kinds of equity, internal and external, one at the top of the pecking order and one at the bottom.

In summary the POT states that businesses adhere to a hierarchy of financing sources prefer internal financing when available; and, if external financing is required, debt is preferred over equity.

Initially, the POT sought mainly to explain the observed financing practices of large, publicly traded corporations. However, it was soon recognized that the theory may also apply to the financing practices of non-publicly traded SMEs that might not have the additional financing alternative of issuing external equity finance. Scherr et al. (1990, p. 10) consider the POT to be an appropriate description of SMEs' financing practices, because the 'Peeking order hypothesis is in keeping with the prior findings that debt is by far the largest source of external finance for small business'. In addition, Holmes and Kent (1991, p. 145) suggest that in SME 'managers tend to be the business owners and they do not normally want to dilute their ownership claim'. Thus, the issue of external equity finance, and the consequential dilution of ownership interest, may be further down the pecking order. The theory's application to SMEs implies that external equity finance issues may be inappropriate. In relation to the owner-manager's control over operations and assets, if the POT holds, then internal equity finance will be preferred, because this form of finance does not surrender control. When external financing is required, obtaining debt rather than equity finance is favored, because this places fewer restrictions on the owner-manager. Hall et al. (2000 p. 299) argue that the information asymmetry and agency problems arising between owner-managers and outside investors providing external finance which give rise to the POT are 'more likely to arise in dealings with small enterprises because of their "close" nature, i.e. being controlled by one person or a few related people, and their having fewer disclosure requirements'. Scherr et al. (1993, p. 21) indicate the costs information asymmetry creates are more important for SMEs than for large enterprises, 'making differences in costs between internal equity, debt, and external equity consequently greater. Therefore, the hierarchical approach should have even more appeal to small firms than to large.' In addition, the theory's assumption that managers act on behalf of existing shareholders is more relevant to SMEs, because of their closely held nature, and because the managers are usually the existing shareholders.
Since the POT is pertinent to both SMEs and large enterprises, the theory may therefore explain the observed differences between SMEs' and large enterprises' financial structures. Holmes and Kent (1991, pp. 145-146) explain that the application of the POT to SMEs is constrained by the following two factors:

- Small firms usually do not have the option of issuing additional equity to the public.
- Owner-managers are strongly averse to any dilution of their ownership interest and control (which are normally one and the same). This is in contrast to the managers of large firms who usually only have a limited degree of control and often have limited, if any ownership interest, and are therefore prepared to recognize a broader range of funding options.

Ang (1991) provides an alternative to this constrained POT, proposing a modified pecking order of financing preferences for SMEs. This involves new capital contributions from owners ranking behind internal finance, but in front of debt finance. Ang (1991, p. 9) reasons that the actual equity contributions made by the owner-managers of SMEs are often difficult to measure, because 'There are also implicit equity contributions in the form of reduced or below market pay and overtime. The exact cost of these sources is not well understood'.

Cosh and Hughes (1994, p. 33) argue that within an overall POT, SMEs, when compared to large enterprises, would:

- Rely more on carrying 'excess' liquid assets to meet discontinuities in investment programs.
- Rely more on short-term debt including trade credit and overdrafts.
- Rely less on new shareholders' equity compared to 'internal' equity and to debt in raising new finance.
- Rely to a greater extent on hire purchase and leasing arrangements.

Thus, in relation to SME’s debt financing, Cosh and Hughes (1994) propose a refinement of the theory, because of the lack of information to assess risk, both, individual and collective, of SMEs.

Fama and French (2000, p. 28) reveal a blemish in the application of the POT to SMEs in that 'less levered non-payers [of dividends] are more profitable, which is consistent with the pecking order model. But less levered non-payers also have better investments'. Fama and French (2000, p. 28) suggest that 'the spread of investment ... and earnings ... is higher for less levered non-payers. From the perspective of the simple pecking order model, the low leverage (book and market) of these firms is anomalous'. That is, the lower free cash flows or higher spreads of investment over earnings for enterprises with lower leverage are not consistent with the POT. Fama and French (2000, p. 28) go on to reveal that:

"The less levered non-payers are typically small growth firms. It is possible that these firms conform to the complex rather than the simple version of the pecking order model; they keep leverage low to have low-risk debt capacity available to finance future growth. But ... they seem to achieve this result by violating the pecking order. Specifically, the least levered non-payers make the largest net new issues of stock ... (the form of financing most subject to asymmetric information problems), even though they have low risk debt capacity. This is not proper pecking order behavior." This quotation recognizes the possibility of modifying the financing pecking order for growth SMEs. This could be so because of owner-managers' attitudes to the option of raising external equity and to any dilution of their control. Thus, the theory may explain the observed differences between SME's and growth SME's financial structures.
NOTES:
2 Source: www.worldbank.org
3 Source: www.worldbank.org

REFERENCES:

www.pme.gouv.fr
www.undp.org
www.worldbank.org