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# FUNDING INSTRUMENTS SUPPORTING SMMES: A SOUTH AFRICAN CASE STUDY

Flip Schutte, Regenesys Business School, 165 West Street, Sandton, Johannesburg,
Noluvo Ngwabe,Gordon Institute of Business Science, University of Pretoria

## ABSTRACT

SMMEs are drivers for economic growth because it creates jobs. Available funding to support SMME growth is crucial. This article investigates the instruments supporting SMMEs and the interaction of the demand and supply factors that impact access to funding. The research was exploratory and qualitative, done with purposive sampling. For the demand factors, seven SMMEs were interviewed. The investigation of the supply factors included financial institutions such as commercial banks, development funding institutions and SMME's financing intermediaries such as venture capital and private organisations funding. The findings indicated that the available funding instruments are rigid and inflexible. This is worsened by lack of differentiators between commercial banks and development funding with regards to their credit risk evaluation. The SMMEs lack of information on different types of funding institutions limit their access to available SMME funding.

**KEYWORDS:** SMMEs, Financial Institutions, Funding Instruments, Entrepreneurship, Entrepreneurial funding

## 1. INTRODUCTION

SMMEs are regarded as crucial drivers for stimulating economic growth in both developed and emerging economies due to their capacity to innovate and adapt easily to market volatility as well as their capacity to create jobs (Mutoko and Kapunda, 2017). SMMEs are defined as a separate and distinct entity managed predominantly by one owner, in an identified sector and are described in terms of their size, total turnover and number of people employed.

Credit facility is being tightened in South Africa as banks take precautionary measures against all financial transactions (Agwa-Eljon and Mbohwa, 2015). The level of entrepreneurship in South Africa is weak compared to other emerging economies with small businesses, start-ups and early-stage businesses struggling to access finance (Menzies and Erwin, 2020).

The South African economy has a robust and tightly regulated financial system which is dominated by major commercial banks that provide credit to private businesses and households (OECD, 2020). The funding institutions as group, for the purpose of this article, include commercial banks, development funding institutions, intermediaries such as venture capital financing that offer funding support to the SMME sector, private organisations and state entities that offer SMMEs enterprise and supplier development finance. Agwa-Ejon and Mbohwa (2015), in their study of Gauteng based SMMEs, found that financial institutions are not reaching out to SMMEs with the result that 56.5% of SMMEs are self-funded, 14% are funded by extended family members and relatives, 20.5% by bank loans, 3.3% by government, 2.8% by venture capital and 2.2% by grant funders. Access to funding is thus a challenge for SMMEs throughout the whole lifecycle of their enterprise.

### Problem Statement

The purpose of the research is to understand SMME's financing needs as well as the funding instruments which are available to them. The research aims to investigate the challenges faced by SMMEs in accessing finance and the criteria used by financial markets to finance SMMEs.

## 2. LITERATURE REVIEW

The creation of the stand-alone Ministry of Small Business Development in 2014 was an undertaking by the South African government to provide a much-needed focus and support to the needs of SMMEs (Department of Trade, Industry and Competition [DTIC], 2021). According to Smith and Chimucheka (2014), entrepreneurship is an act of initiating, creating, building, and expanding an enterprise or organisation, as well as building an entrepreneurial team and gather other resources to exploit an opportunity in the marketplace for long-term growth. SMMEs limited awareness of available funding opportunities and the level of financial literacy seems to be some of the factors creating barriers of access to funding at different stages of the entrepreneurship journey to growth and scale (Matoko and Kapunda, 2017; Mamabolo, Kerrin and Kele, 2017).

The debate of the financial markets' inadequate financing of SMMEs in the developing economies has been argued by different scholars and policy makers (Asah, Louw and Williams, 2020). According to Menzies and Erwin (2020) the lack of reasons for funding applications rejections by financial institution is not always understood by the SMMEs in need of funding. A survey conducted by McKinsey (2020) on the uptake and the disbursement of R200 billion COVID-19 relief fund allocated to the SMME sector was dismal with only R16,7 billion disbursed during the last quarter of 2020. This is indicative of a long-held view that financial institutions are not interested in financing SMMEs within developing economies (McKinsey, 2020; Fatoki, 2014).

**SMMEs Contribution to economic growth**

Globally, it is accepted that the SMME sector plays a crucial role in economic growth due to their ability to create new jobs, innovate and adapt faster in changing market conditions, increase the tax base of countries and more importantly are critical in driving inclusive growth with more women participation (Smith & Chimucheka, 2014).

The SMMEs contribution to the GDP of South Africa was 22% of the total R10,5 trillion pre-COVID-19 as reported in the 2019 Annual Financial Statistics (StatsSA, 2020). SMMEs create between 50% - 60% employment and the South African government has prioritised the SMME sector to reduce the high unemployment rate which is currently at 34.4% as per the second quarter report of 2021 (StatsSA, 2021). There is a total of 2.4 million SMMEs in South Africa (StatsSA, 2021).

Despite positive aspect of SMMEs' contribution to economic growth, they are still faced with numerous challenges. These can be attributed to constraints such as access to finance, including access to markets, the business regulatory environment, crime, and corruption as well as access to information.

**SMMEs Access to Funding Challenges**

The lack of access to funding by SMMEs is a universal problem that is widely researched and a contributory factor to the weak performance and failures of SMMEs in South Africa. Early-stage business largely depends on internal finance such as owner's own contributions and or family and friends (Menzies and Erwin, 2020). SMMEs external funding needs include access to capital for developing new products, purchase of equipment and other fixed assets amongst other operational requirements (Fatoki and Asah, 2011).

Some of the challenges faced by SMMEs in accessing funding to sustain and grow their businesses include the inadequate collateral that the funding institutions use to assess the level of risk of small business requiring a loan as well as the lack of credit history records such as audited financial statements (Mutoko and Kapunda, 2017).

Collateral is a de-risking mechanism that some funding institutions, particularly the commercial banks, use when issuing term loans to businesses that have physical assets. Funding institutions view collateral as their line of defence and mitigate against credit default, manage the information asymmetry as well as prevent the moral hazard (Fatoki and Asah, 2011; Menzies and Erwin, 2020).

**SMMEs Characteristics**

The SMMEs traits specific to the business and the owners of the business that affect the business positively or negative and can impact the access to credit (Fatoki and Asah, 2011). These characteristics include the ownership structure, directors' competencies, available collateral - which is information that is in the SMMEs' control and which credit lenders will use to assess the credit information on applications. Other information taken into account are the industry sector and the size of the business (Asah et al, 2020), as well as the internal controls of the business such as accounting practices and management control (Bhorat, Asmal, Lilenstein and Van Der Zee, 2018).

The owners of the business are also assessed, based on their personal credit history, age, gender, experience, and education level, which have an influence whether the funding institution does provide credit facility to the SMME (Fatoki and Asah, 2011). In short, the directors' balance sheet has an influence on whether the funding institutions does grant a credit facility to the SMMEs.

The issue of credit rationing has an impact on the number of SMMEs funding applications being rejected by funders despite the willingness to pay high interest rates by the SMMEs (Mbedzi and Simatele, 2020). Another factor impacting the access to finance by SMMEs is their tenure of business operation as the commercial banks are reluctant to fund start-ups and early stage SMMEs (Menzies and Erwin, 2020).

**Types of Funding Available to SMMEs**

The primary purpose of funding institutions is not only to accept deposits but to also offer financial services. This exposes the funding institutions to multiple risks that are influenced by external factors such as political climate, foreign exchange, market interest rates, liquidity, investments, and credit risks which threaten their survival (Ebrahim, Khalil, Kargbo and Xiangpei, 2016). This is further exacerbated by the cost of serving small loans and transactions, the absence of credit rating agencies and lending technologies and the lack of business readiness assessment tools for early-stage entrepreneurs compounding the risks that funding institutions must contend with in financing the SMME sector (Nheta et al, 2020; Asah et al, 2020).

However, the South African economy have a robust, sophisticated, and tightly regulated capital structure and financial system which are mainly dominated by commercial banks that provide credit to private businesses and households (OECD, 2020). The dominance of the commercial banks which holds an estimated 90% of assets does have its disadvantages in that it lowers the access to finance for SMMEs (Menzies and Erwin, 2020).

**Business Grant funding**

Business grant funding is a source of funding that is made available by government and its agencies to early-stage start-ups to encourage economic participation. It is included as part of the national transformation agenda through legislations such as black economic empowerment and tax incentives. These grants however turn to be once-off and cover a limited portion of the SMMEs funding requirements.

**Debt Finance - bridge finance for short-term capital needs**

Debt finance is a form of funding where SMMEs borrow money from the funding institutions for operational expenses or working capital which is tax deductible, thereby affording the business owner control of the business. According to Menzies and Erwin (2020), commercial banks are by far the debt financing credit issuers for short term capital needs. Some of the debt finance available to SMMEs include: overdraft facilities, business term loans, asset and vehicle finance, and leveraged finance.

**Venture Capital Investment funding**

Venture capital investments are a type of fund that is raised from investors and redeployed into high risk and high growth start-ups ventures. Venture capital is distinct in that it operates with uncertainty as well as high information asymmetry (Kato and Tsoka, 2020). The benefits, however, for SMMEs is the access to markets that maybe leveraged from the investors and also play a pivotal role in assisting the SMMEs with strategic planning to ensure sustainability of the business (Asah et al, 2020). Further to this, venture capital investment funding provides the business with technical expertise, access to new technologies and as part of the investment, the investor becomes a board member of the start-up (Mbedzi and Simatele, 2020). However, this may be viewed by the business owner as a dilution in terms of business ownership structure and may result in some business owners losing their businesses to the investors (Kato and Tsoka, 2020).

**Equity Finance**

Equity finance is a form of capital finance for commercial ventures, industrial, retail and residential property development which does not have a fixed term period in terms of repayment (Hamman, Nel and Oberholzer, 2021). This can be provided internally by business owners' personal savings and from retained earnings within the business as well as from family and friends. External equity can be raised from business angel investors and or informal investors as well as from wealthy individuals that have a long-term interest in investment opportunities (Kato and Tsoka, 2020).

**Microfinance**

Financial inclusion is still a challenge in emerging economies and in South Africa, the advent of COVID-19 has put to bear the SMMEs who are unbanked particularly the SMMEs with a turnover of less than R10 million per annum. These unserved and unbanked SMMEs are turning to microfinance lenders and or fintech to close the gap of exclusion. Microfinances provide much needed capital in small loans of not more than R5000 and do not require collateral, but they charge a high interest rate.

**Funding Institutions Credit Risk Assessment Practices**

The biggest threat faced by financial institutions is the credit risk. Financial institutions' success is dependent on how the risk is managed and leveraged. This is also impacted by the regulatory environment in that, financial institutions are unable to pull resources together to support and lend to the SMME sector (Asah et al, 2020; World Bank Report, 2017).

The funding institutions have three types of risks, namely credit, market liquidity and operational risks. The commercial banks use statistical approaches to predicting applicants risks for credit probability of defaulting that is known as credit scoring (Mbedzi and Simatele, 2020). According to McKinsey (2020) the credit scoring model that are used by most banks put the burden of probabilities to the SMMEs including the evidence of tax compliance and audited financial statement. This exclude the unbanked SMMEs and limit their access to finance. In addition to credit scoring, the fund managers use the '5-Cs' criteria for credit risk assessment for business term loans, namely character, capital, capacity, collateral and cycle/condition. Over and above these '5Cs', fund managers are likely to consider the industry performance and the SMME business performance relative to the competitors and banks' exposure to the industry, consumer demand of the product or services of the SMMEs, as well as the loan amount requested (Turvey, He, Kong, Ma and Meagher, 2011).

Other types of available funding to SMMEs in South Africa includes the "stokvels" which involves voluntary savings by members of the stokvels for the mutual benefit and profit that are equally distributed amongst members. There is also franchise finance which is providing the SMMEs opportunity to purchase into a franchise and other specialised finance that include funding for patents (Menzies and Erwin, 2020).

The digital financial service providers are also providing much needed access to finance products by leveraging technology that focus on SMMEs challenges by removing credit inefficiencies especially for the missing middle (Magwedere, Chisasa and Marozva, 2021).

**SMME regulatory environment**

The South African government has instituted a number of various policies and legislation to stimulate the growth of the SMME sector in the economy. A flexible and progressive regulatory environment promotes entrepreneurship, strengthens the enabling SMME environment and enhances competition with access to finance as the key driver to growing the SMME sector (Asah et al, 2020).

## 3. RESEARCH METHOD AND DESIGN

The main research question is: Are the available funding instruments supporting the small, micro and medium enterprises, to meet their financing needs at the different stages of their business development cycle in South Africa? The following sub questions have been investigated: What are the awareness levels of SMMEs of the available funding institutions' products and their requirements? What is the financial literacy or knowledge level of SMMEs that are looking for start-up or early-stage funding? What are the credit risk criteria used to evaluate funding applications for SMMEs? What are the funding institutions' SMMEs credit terms and reasons for rejections? What technology infrastructure is required to enable funding institutions to provide credit to the SMME sector?

This research was exploratory in nature and it was done within the interpretivist philosophical tradition (Saunders and Lewis, 2018). The research approach used was inductive to gain an in-depth understanding and insight in the field of SMME funding (Saunders, Lewis and Thornhill, 2016). The research employed qualitative data collection techniques and analysis.

Fourteen participants were interviewed of whom seven were SMMEs and seven representatives from financial institutions. The seven participants from the financial institutions were made up of three participants from commercial banks, three from development finance institution including private organisations and one from venture capital investment finance. Semi-structured interviews with open-ended questions were used to collect data.

**Population and sample**

The population relevant for this research included fund managers, senior managers and executives from the financial institutions who have worked with SMMEs such as commercial banks, development funding institutions, venture capital investment, and private organisations that provide enterprise and supplier development funding to SMMEs. The second part of the population included SMMEs with a turnover below R50 million per annum and employ less than 20 people and were operating the business for more than a year, across South Africa regardless of age, gender, and education level.

**Analysis Approach**

The transcribed data analysis was conducted using Atlas.ti. A list of codes was drawn up to enable the identification of common themes and sub-themes.

## 4. FINDINGS

The sample consisted of 14 participants with seven participants being SMMEs and the other seven representing funding institutions. The SMMEs participants were at least three years in business with a turnover of less than R15 million. The results are discussed per emerging theme:

***Awareness levels of SMMEs of the financial products available in the market***

The SMMEs were not entirely aware of funding institutions with one of the SMMEs indicating that they don't even know where to begin when it comes to government linked funding institutions: "Funding is a struggle. I haven't tried government because I don't trust the government systems. I don't even know where to start." Another SMME owner answered: "On two occasions, my requests were not successful. You are not sure where to make an application because it might be outside the scope of the funding."

At least six of the participants alluded to the fact that there is a lack of constructive feedback from unsuccessful applications which discourage them from reapplying. Whilst the SMMEs were aware of funding institutions, they were limited in their understanding of the funding scope and processes especially as they needed funding to grow their businesses.

***Awareness of SMMEs funding competition***

Overall, there was an awareness that there are limited funding and too many applications. One participant stated: "You must remember that if there are 20 "yes or no" questions, the next person is going to answer the questions, maybe with the same answers. So, you have to ask yourself, what is it that I'm bringing, that is better or different than the next person? So, when you ask for funding, it's a competition."

Those who did not approach the commercial banks and use other funding institutions also emphasised the issue of relationship building with fund managers to give them the edge in getting the required funding, leveraging on the relationship they have already, which sets them apart from the competition.

***Funding Institutions' SMMEs credit risk assessments***

All the participants indicated awareness of the credit risk assessments used by funding institutions, particularly the audited financial statements, statutory requirements and the fact that putting forward a well-articulated business plan does provide an opportunity to be considered by the funding institutions.

***Financial literacy or knowledge levels of SMMEs***

Although all the participants reported that they have tertiary education, they were unable to differentiate between the funding products offered by funding institutions. One participant emphasised that his application was rejected because of the perception from the capital funding institution that he is not knowledgeable and that his performance during the interview pitch, let him down: "Yeah, when people start a business, they are not accountants. They have an idea and hope it works. They are not bookkeeping specialists."

***Entrepreneurs' qualifications and work experience***

Three of the participants had a good grasp of their business operations attributing it to their educational level as well as working experience. One participant indicated that in fact having a qualification and work experience prior to starting a business venture does benefit SMMEs access to funding to the extent that the skills acquired from working are easily transferable and applied into your own business venture. From the responses it seems that the level of skills, including educational qualifications and prior work experience, have a bearing on SMMEs access to funding as well as on running a successful business.

***Credit risk criteria used to evaluate funding application***

There are various products offered to SMMEs by funding institutions at different levels of the business cycle as reported by all the participants. The type of funding products varies with the venture capital investment funders providing funds for high risk and potential high growth returns to start-up with no collateral. The venture capital participant indicating that their target market is high growth start-ups: "The growth, is growth potential, obviously. They should have the potential to grow."

The other participants also indicated that they offer different products to different SMMEs depending on the business development cycle and the sector. The funding products that are maybe relevant to an early-stage start-up may also be influenced by the sector they are operating in. Another participant indicated that they provide asset finance products based on the SMMEs industry sector.

The funding institutions credit risk criteria in South Africa follows the '5Cs' conventional method of assessing loans or credit facility required by SMMEs with the exclusion of venture capital investment. This is despite government's effort in creative initiatives such as incentive schemes amongst others to support the development of the SMME sector. The '5Cs' credit risk assessment is a method used by commercial banks to assess consumer credit applications including SMMEs and includes 1) Character, 2) Capital, 3) Capacity, 4) Collateral and 5) Cycle and or Conditions. One of the funding institutions' participants indicating that there is no differentiation of credit risk criteria when it comes to loan applications used by the commercial bank by saying that: "All loan applications are handled the same, because in each instance, there needs to be a demonstratable affordability for the loan, and there needs to be a sound business case. And that applies across the board, then, in addition, the risks that impact your ability to pay the loan, also apply across board".

The development funding institutions variation on credit risk assessment from their commercial counterpart is not substantive to the extent that their pricing model is similar to the commercial banks. Although development funding institutions do not require a collateral, their credit risk assessment is along the same principle of the '5Cs' as alluded by the participant who indicated that: "In the start-up phase we look at managing the start-up risk."

In contrast though, the venture capital market funding mechanism is biased towards high growth potential start-ups. They are selective with their funding and are interested in innovative SMMEs with high returns as one participant state that they are not interested in so-called 'lifestyle' type of business but ground-breaking start-up business in technology and other sectors.

The private organisation enterprise and development funding institution on the other hand are interested in fulfilling the transformation mandates as espoused in the Broad Based Black Economic Empowerment (B-BBEE) legislation. This, however, is beneficial to the SMMEs as it gives them an automatic access to the corporates as their primary market.

***SMME fund objective***

All the participants indicated that their SMME fund is aimed at growing the South African economy in enabling sustainable SMMEs who will be able to create jobs. The difference in the funding institutions' objectives was their focus areas and target. One participant said: "We, don't cover all entrepreneurial ventures…. We do biotech, engineering-tech, FinTech, Agri-tech…. We do sports-tech, medical-tech, that's all covered within our mandate."

The development funding institution focus on diversity and inclusion objectives that ensures the transformation of the South African economic agenda. A participant indicated that: "We look at the number of jobs that will be created, e.g., for black women, to promote inclusion. We look at the location where this project is. Is it in the rural area? Is it in the urban area? Are they registering their employees with all the statutory requirements of the country, e.g., UIF? So, once we are happy, we are able to advance the money."

The commercial banks have enterprise banking that focuses on the growth of the SMME sector as one participant indicated: "… the traditional, or the normal lending, the bank does for small businesses. So, the organisation does have a big, small business lending book."

***Funding Institutions SMMEs credit terms and reasons for rejection***

The SMMEs have expressed frustration with regards to the high interest the commercial funding institutions are charging, sighting that the short-term debt funding facility that is extended to them is too costly.

On the other hand, the funding institution believe that given the lack of credit track record on SMMEs part and that some of the projects undertaken are long-term in terms of breaking even, a blended financial model is maybe suited.

One participant indicated that they provide interest free loans with a repayment period of between three to five years. In some cases, the loan is linked to the sales contract the SMMEs has as an off-take agreement whilst others issue a blended finance option that includes part grant and part loan: “We have a lot of options. It might be an exclusive grant, depending on the size of the business, the stage of development, where the business is, or it may be a combination of a grant and an interest free loan.”

The pricing model of the issued loans are dependent on the funding institutions mandates with commercial funding institutions offering competitive pricing rates and the DFIs offering favourable pricing models to a certain extent. One participant stated: “The pricing model at the organisation will consider the seven pillars of the scorecards we use. So, if you are not transformative, you're not creating jobs then the pricing could be prime plus. But if your project is developmental in nature, and you've got women shareholding, or youth and people with disabilities and operate in rural areas, the pricing could be prime or prime less.”

Thus, whilst the funding institutions are indicating that the credit terms are in the best interest of the SMMEs, the SMMEs responses were not in the affirmative which may be attributed to the lack of understanding of the different products and credit risk assessment criteria.

***SMMEs funding applications rejections and exclusions***

The funding institutions require bankable and viable business plans from applicants to be able to make informed decisions in providing the right credit facility for the SMMEs. Lack of collateral, poorly structured business plans, negative credit profile of directors as well as a lack of viable market entry strategy are some of the key reasons that funding institutions rejects applications. The theme also highlighted that other funding institutions have sectors that they do not fund as part of their mandates and policy for instance, one of the participants indicated that: “We don't do military and we don't do alcohol”.

Two of the participants also indicated that the character of the small business owner is very important especially in terms of the owner’s expertise relative to the sector the business is in, one even said that: …there's the third principle behind the banking credit principles. It's about the jockey of the business. In fact, that is by far the most important in the application which is about the business owner’s expertise.”

The preference of funding institutions in South Africa is biased towards established businesses and larger corporations due in part to the legacy structure of the South African economy which is dominated by big corporations. One of the participants indicated that the venture capital market for example is small compared to other capital markets which creates the bottleneck in terms of meeting the demand for credit by SMMEs.

***Technology infrastructure used by funding institutions***

Funding institutions use various credit scoring technologies which have a capacity to predict the potential of defaulting on credit by SMMEs and/or the business directors. This involve using transactional technologies that conduct credit scoring on a matrix that is similar to consumer credit scoring data. Typically, the credit scoring system at the SMME level is basic hard data such as information on personal income, financial assets, physical assets like home ownership supported by third party credit bureau information of the directors’ credit history. This data is collated into a statistical prediction model that generate a score that determines whether the funding institution accept or rejects the funding applications.

Two of the participants did indicate that the funding technologies being used are not distinct from consumer product type technologies when it comes to SMMEs, with one stating that: “You may find somebody come into the bank, with a perfect document and then when you look at their credit history on the credit bureau system, they have credit judgements for their arrears and the very same person is also employed. Then we can’t help. They need to be credited worthy by fixing themselves first before approaching the bank”.

***Funding legislative framework including B-BBEE***

The South African financial services sector is sophisticated and is a highly regulated industry. As a result, the funding institutions must issue credit within the boundaries of the regulations to avoid reckless lending. The SMMEs also indicated that government should do more in terms of improving the legislative mandate governing credit to mitigate for lack of collateral as they are still dealing with COVID-19 impact and for some participants the recent political unrest had an indirect impact for their business.

One of the participants said that their access to finance is through the enterprise and supplier development fund which can respond to the SMME's needs much quicker that the traditional other funders. "I went to a traditional bank, because I thought that without our bank balance our purchase orders, we could do a lot more work. But what I found was that there were other institutions that were much faster in using enterprise and supply development funds to assist me with low-cost, low interest loans, versus what the bank could offer." Supporting the SMMEs through Enterprise and Supplier Development (ESD) Funds provide the big corporates with social licences to operate with which they can open new markets once their B-BBEE Scorecard level is higher than their competitor's.

***Impact of COVID-19 on SMMEs funding constraints***
One participant, when asked about the impact of unrest in their business, described that: "We were impacted by the unrest. In some of the centres, we had computers stolen, projectors stolen by random individuals. In other areas, that community stood up, and they protected our equipment from being stolen." Other participants described the impact of COVID-19 for their business by stating that: "…the impact of COVID-19 was heavy. If I didn't have any type of funding I don't know if I would have continued to be in the business." The results also shows that the inaccessible credit from funding institution persisted during the crisis of COVID-19. To conclude this section, the funding institution should innovate and revise the credit risk criteria using emerging technologies to assess the SMMEs financial requirements supported by progressive legislation governing credit in South Africa.

***SMMEs business funding readiness***
Financial literacy is important to not only understand the funding institutions' requirements but also on knowing the different financial products available in the market to be able to prepare funding proposals in line with the funding institutions requirements. Furthermore, SMMEs should be able to prepare the required documents by funding institutions to support their funding applications. The participants from funding institutions have emphasised that SMMEs ought to ensure they understand the credit risk criteria before seeking funding. Should there be a credit blemish both at directors' level and or business level, this must be declared as it is one of the barriers to accessing as one of the participants indicated: "One of the things you need to be aware of, is that it is a big challenge to making finance accessible to small businesses. They need to be funding ready. And by funding ready I mean they actually need to have the documentation in order. So, they need to be registered entities, compliant of tax, have a bank account, and be able to present bank account information. If they have got blemishes on their credit records, they need to be able to address it prior to their application."

## 5. DISCUSSION

Despite government efforts, it seems as if SMMEs continue to struggle to access funding from all the different funding institutions. The entrepreneurs lack awareness of available funding products designed to support the SMMEs sector as most of the research participants had limited information on the available funding products in the market apart from those offered by commercial banks such as short-term debt finance in the form of an overdraft. Only a few were aware of the available development finance products that is available for early-stage start-ups.

Other demand side factors that contribute to SMMEs inadequate access to funding is the information asymmetry which is when one party in a transaction does not provide accurate information needed to make a decision on applications for a credit facility. This is supported by what Nheta, Shambare, Sigauke and Tshipala (2020), posited, namely that the lack of business acumen that SMME displays, is attributable to SMMEs limited knowledge about the different funding products and their requirements.

SMMES skills are a critical component in broadening the range of funding instruments that are designed to support the SMME sector (OECD, 2018). Bowmaker-Falconer and Herrington (2020) also argue that the lack of inadequate entrepreneurial knowledge and skills needed to interpret financial information is a factor that leads to poorly structured business plans.

The funding instruments available for SMME development at different stages of business development cycle varies. The debt finance is the most favoured instrument by all funding institutions participated and is the form of funding that SMMEs rely on and understand. The funding institutions depend on the SMMEs business plan to assess their creditworthiness including the directors credit history, the industry the business operates in, the experience and the age of the business, and the location of the business, all contribute to the credit application. All funding institutions' participants indicated that the business plan is the most critical document which carries more weight in terms of SMMEs access to funding. The majority of funding institutions agree that owners' equity is important as a form of de-risking the potential loan when requesting credit from funding institutions. This is supported by Fatoki (2014) who confirmed that both the owners' equity and business cash flows are critical factors in credit risk assessments. All the SMMEs have expressed frustration with regards to high interest rates the commercial funding institutions are charging sighting that the short-term debt funding facility that is offered to them is costly.

Lack of collateral, poorly structured business plans, negative credit profile of directors as well as a lack of viable market entry strategies are some of the key reasons why funding institutions rejects applications (Bowmaker-Falconer and Herrington, 2020; Asah et al, 2020). SMMEs have internal characteristics that is within their control in terms of reasons for starting a business, the internal financing of the business such as owners' contribution which affect their applications being accepted or rejected. The external factors are out of the SMMEs' control which are the cycle and condition of the macro-economic operating environment. Funding institutions turn to conduct credit rationing in times of economic and or financial crisis. The regulatory environment is also a factor wherein the funding institutions are operating in very stringent credit regulations that affect the level of credit they can offer to SMMEs without being deemed reckless. The supply factors place significant emphasis on bankable business plans, provision of a collateral, more so the commercial banks and business owners' creditworthiness, including credit history record. The SMMEs need to focus their funding request by understanding these critical areas and do research prior to approaching any funding institution.

The emergence of intermediaries with disruptive technologies for the SMMEs market is increasing at a rapid pace. The credit gap left by the traditional funding institutions is currently fulfilled by Non-Bank Funding Institutions (NBFIs) who are nimble, innovative and have appetite for high-risk returns (McKinsey, 2020).

Typically, the credit scoring system used by funding institution is not innovative in that it is basic hard data such as information on personal income, financial assets, physical assets like home ownership supported by third party credit bureau information of the directors' credit history. This data is collated into a statistical prediction model that generate a score that determines whether the funding institution accept or rejects the funding applications.

The funding institutions have not adopted the digital funding applications platforms that are prevalent in the micro-lending and intermediary funding institutions which may be indicative of the reluctance to serve the SMME sector. The funding technologies available for funding SMMEs are still developing and there is more emphasis and focus on improving customer profiles and credit risk management.

The South African financial credit market is highly regulated by the National Credit Act legislation which is enforced by the National Credit Regulator. Whilst the principle is to protect consumers interest against the unscrupulous credit lenders, it does not make distinction between consumers and SMMEs. SMMEs as funding institutions must issue credit within the boundaries of the regulations to avoid reckless lending.

All funding institutions' participants have referred to the NCA and NCR with regards to their processes which is indicative of the legislative framework effectiveness. However, the economic crisis that befell global economies due to the coronavirus (COVID-19) pandemic found the same regulations to be inflexible and tended to favour credit being issued to mature medium enterprises and large enterprises at the expense of small and micro enterprises, some of which businesses had to close (Menzies and Owen, 2020).

The Broad-Based Black Economic Empowerment (B-BBEE) mandate is by large to promote participation of the historically disadvantaged individuals into the mainstream economy using various empowerment mechanisms that include skills development, enterprise and supplier development, structural ownership of black empowerment firms and community development trusts. With regards to the Enterprise and Supplier Development (ESD) element, the support is directed at SMMEs who have a turnover of up to R50 million per annum. The immediate benefit to SMMEs is having an immediate access to the big organisations market whilst also providing the organisations with its ESD legislative mandated points that are required in terms of B-BBEE Scorecard Code of Good Practice.

The legislative framework that supports SMMEs' access to funding must be improved to provide mechanisms to the market that support SMMEs during the economic cycling condition such as the pandemic and other financial crisis that the economy may face. The legislative framework should also regulate the intermediary funding institution that support the SMMEs to mitigate for lack of collateral as one of the barriers. The funding institution's allocation to the SMMEs lending book or enterprise development should be reviewed to take into account the operating context and realities of SMMEs on the ground; this includes shorten the turnaround time of funding applications feedback. The SMMEs should also familiarise themselves with the B-BBEE funds and the various sector codes to be able to position their funding request to the relevant industry. The funding institution should innovate and revise the credit risk criteria using emerging technologies to assess the SMMEs financial requirements supported by progressive legislation governing credit in South Africa as identified by the participants.

Some of the funding institutions pointed out the SMMEs funding readiness as a key barrier to access to funding and indicated that financial literacy is important to not only understand the funding institutions requirements but also on knowing the different financial products available in the market to be able to prepare funding proposals in line with the funding institutions requirements. This is also confirmed by the by OECD (2018), namely that SMMEs financial literacy and strategic vision enables SMMEs to increase their knowledge about different funding instruments and long-term strategic approaches to business finance and economic cycles linked to their business sectors.

## 6. CONCLUSION AND RECOMMENDATIONS

This article explored the funding institutions' available funding instruments and the credit risk criteria suitability in meeting the SMMEs needs of access to funding. The funding instruments identified, included debt finance, asset based and vehicle finance, equity finance, venture capital investments, enterprise and supplier development finance and microlending. The credit risk criteria focused on the '5Cs' which are credit, character, capital, capacity, collateral and cycle or condition.

The article further wanted to understand SMMEs awareness of the available funding instruments, and their credit risk requirements. The research found that the SMMEs awareness of various funding instruments is mostly limited to debt finance. This is illustrated through the emphasis by funding institutions needing collateral and or contract agreements for short-term debt finance.

**Short-term Recommendations**

The lack of knowledge of available funding instruments by early-stage and start-ups SMMEs could be alleviated by adding variable electives to currently available business skills development programmes to broaden skills as all the participants possess already a qualification.

The funding institutions should look into technology to eliminate the barriers to SMMEs access to funding created by the silo funding systems. The lending technologies should be able to synchronise the required SMMEs generic information, understand the number of funding requests that have already been done by the SMMEs and dove-tail this with an itemised report that focuses the SMMEs to areas of improvement for future funding requests.

**Medium to Long-Term Recommendations**

The recommendation is that government should strengthen the resources that are already in place for business development such as grants designated to SMMEs specifically for early stage and start-up business.
Funding institutions have to amplify the cost benefits of equity finance in their marketing of their SMMEs funding products which may be suitable for SMMEs at growth phase of their business cycle.

SMMEs need to expand their research prior to approaching funding institutions ensuring they understand the advantages and disadvantages of the venture capital as a funding instrument and align it to their business goals. The venture capital can be pursued by SMMEs who are in the early stage, start-ups and those that are in the growth phase.

Government policy makers have to look at improving regulations on the punitive measures that are linked to reckless lending by providing guidelines on what to do when there is an economic crisis and or contracted economic growth to stimulate economic activity in the SMME sector.

It was pointed out by the funding institutions' participants that all loan applications are in essence treated the same by the traditional funding institutions not agile to adapt to the changing of SMMEs as a consumer sector. This creates frustration for SMMEs. The recommendation is for funding institutions to adopt the new and emerging lending technologies to streamline the funding silos and accurate use of data to provide better access to funding for SMMEs.

**Recommendations of future research**

The emerging lending technologies is a developing area that is still not well understood with regards to SMMEs access to funding especially in the emerging economies. The academic literature is very limited and the recommendations for future research are:

- A quantitative study on the lending technology used by intermediary funding institutions
- The benefit of a single government run technology platform that will standardise business plans per sector for entry level and early-stage businesses
- Legislative framework that underpins technology based SMMEs credit
- The effectiveness of SMMEs business development skills training programmes

## 7. CONCLUSION

This research provided insights into the available funding instruments to SMMEs at the early stage of their business development cycle in South Africa. The venture capital markets were an interesting revelation to the researcher and provided an in-depth view of all funding products available in the market. The research contributes to the body of literature on funding instruments suitable for the SMMEs.

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