Factors Influencing Credit Accessibility for Small and Medium Company in South Africa's Construction Industry: A Literature Review

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Abstract:
The study provides a comprehensive discussion on access to credit by the Small and Medium Enterprises (Construction SMEs) sector in South Africa. Access to credit has been noted as one of the major challenges impeding the survival and growth of the Construction SME sector in South Africa. The problems of access to finance, gaps and the reasons for the gaps in SME financing in South Africa are discussed. Gaps in SME financing were discussed in relation Stiglitz and Weiss (1981) credit rationing theory which advocates that agency problems and asymmetric information are the main reasons for the credit rationing behaviours of credit providers to Construction SMEs. This paper is a review to identify gaps in literature regarding the financing of Construction SMEs in South Africa. It is revealed that access to credit by Construction SMEs is still a major challenge impeding the realisation of the full potential of construction SMEs as engines of poverty alleviation, employment creation and economic growth at large. Therefore it is recommended that policy recommendations aimed at solving access to credit challenges must be empirically tested on a regular basis and progress in that regard must be constantly monitored and revised to reduce the problem.

Keywords:
Credit accessibility, Construction SMEs, South Africa

1. Introduction

The construction industry, by nature, has many peculiar problems and requirements (Ofori, 2009). For instance Kayanula and Ofori (2009) reported that the construction industry in South Africa has been affected by many problems including mismanagement, skills shortage, corruption, lack of technology, inflexible credit terms, late payments to contractors and difficulties in accessing credit accessibility.

The ability of SMEs to grow depends highly on their potential to invest in restructuring and innovation. All these investments require capital and therefore access to credit. Against this background, the consistently repeated conception of SMEs about their problems regarding access to credit is a priority area of concern, which if not properly addressed, can endanger the survival and growth of the SMEs sector. Ganbold (2008) argued that Investment Climate Survey conducted by the IBRD/World Bank (2008) showed that one of the major impediments of nurturing firms is lack of access to financial services which would expand economic growth and employment generation as well as reducing poverty in many developing countries.

In South Africa it is evident that construction SMEs has constrained access to financing they need to flourish (Maas and Herrington, 2006). Access to finance is therefore a priority issue for developing and supporting the construction SME sector as an engine for employment creation, poverty alleviation and socio-economic stability at large. The objective of this paper is to explore access to financing issues faced by construction SMEs in South Africa. This include a theoretical review of financing options for construction SMEs, financing gaps in the SMEs sector and exploring various approaches to close the gaps in construction SMEs financing.

2. Financing Construction SMEs

There are various sources available for financing of construction SMEs. However, despite various breakdowns in names of these sources, they fall into either debt or equity financing. Although, equity as a source of financing for construction SMEs has received little attention in literature, it is an important source of financing for SMEs. Despite emphasises by several authors on fostering access to debt, Churchill and Frankiewicz (2006) argued that credit is not sufficient as a developmental tool. Therefore other sources of financing such as equity financing, and in particular venture capital, should be considered.

The challenge of access to finance has been thought of in terms of credit rationing behaviours of financial institutions which according to several authors have an adverse impact on previously disadvantaged groups who have limited access to resources. Çorreia *et al.* (2008) discussed an important issue of Black Economic Empowerment (BEE) entities financing. BEE entities are being considered here due to the fact that in South Africa the majority of BEE entities fall into the SMEs category.

In South Africa, Black Economic Empowerment (BEE) legislation was passed as a means to redress past economic imbalances. Correia *et al.* (2008) argued that limited access to finance by BEE entities has created challenges for restructuring of ownership of companies.
It was propounded that the result was complex and highly leveraged financing structures, some of which have failed and others of which have become highly successful as equity markets have rebounded. The following sources of financing for BEE entities have been suggested; Vendor financing in the form of loans or preference shares; loans or Debentures; preference shares issued to banks and assets securitisation or Initial Public Offering (IPO).

Despite the promising potential in fostering SME financing of the above mentioned financial arrangements, their relevance to SMEs, particularly start-ups, who in many circumstances to do not have assets to pledge as collateral security for these transactions is controversial.

Furthermore, issues of optimal financing structures (another controversial issue in SMEs) should be considered in SME financing. Correia *et al.* (2008) described the optimal capital structure as the debt-equity ratio that the company adopts so that its Weighted Average Cost of Capital (WACC) is at its lowest point. Correia *et al.* (2008) confirm that over the years, a number of theories have been developed to explain the relevance of capital structure. However, Modigliani and Miller (1958) as cited by Correia *et al.* (2008) presented a rigorous analysis in which he argued that there is no optimal capital structure. Their argument was based on the premise that, irrespective of the level of gearing (the degree to which the firm's activities are financed by owner's funds versus debt financing), a firm's weighted cost of capital will not change.

The issue of capital structure in the SME sector received little in South African literature. However, the focus of this paper is more on access to finance for SMEs irrespective of whether its equity or debt financing. In South Africa, SMEs face constrained access to both debt and equity financing. Theoretically and in practice a problem of access to finance exist when there is a need for finances from a client with an investment project that warrantees financing, but are impeded access to external financing. This occurs due to the gaps that exist between the suppliers of external financing and the demand for financial resources.

3. Gaps in Credit Accessibility

Extensive literature construction SMEs in terms of financial accessibility has highlighted various gaps. Notable among, these gaps that review of literature is silent on are guarantors who facilitate the credit for construction SMEs. However credit, Park *et al.*, (2008) defined accessibility gap as the difference between the demand for funds by SMEs and the supply of funds, occurs because of various reasons. Some argue that the fundamental reasons behind SMEs' lack of access to credit can be found in their peculiar characteristics, while others argue that SMEs suffer from financing gaps because of market imperfections on the supply side (Park *et al.*, 2008). Further, Park *et al.* (2008) argued that construction SMEs face financing gaps probably because of a combination of reasons originating from both the supply and demand sides. The supply side refers to providers of finance (financial institutions and investors), while the demand side is composed of SMEs who require financing from financial institutions and other providers of finance. The financing gap for construction SMEs is most prominent in capital market financing. Most countries, including the developed ones, have problems in SME financing through capital markets (Park *et al.*, 2008: 1).

Park *et al.* (2008) also reviewed that substantial financial gaps exists in a large numbers for both Organisation for Economic Co-operation and Development (OECD, 2006) and non-OECD countries.

The results of their studies indicated an 80% financial gap in OECD countries and a 90% financial gap in non-OECD countries. Furthermore, a break-down of debt and equity also indicate significant gaps except for debt in OECD countries. Several authors and researchers have alluded to the financial gap, but a few of them attempt to find solutions to closing that gap.

One of the most important theories that focused on credit gap analysis is the credit rationing theory by (Stiglitz and Weiss 1981). In their formulation, Stiglitz and Weiss (1981) argued that agency problems (a conflict of interests between management (agents) and the shareholders (owners) of the organisation) and information asymmetries are the major reasons why construction SMEs has constrained access to credit.

They argued that only SMEs know their real financial structure, the real strength of the investment project and the effective intention to repay the debt, that is, firms have superior private information (asymmetric information).

Hence, the bank manager makes decisions under asymmetric information, and operates under a moral hazard and adverse selection risk. Therefore, government subsidies can be used by financial institutions as collateral against some projects.

Furthermore, from an analysis of the financial markets' behaviour we can review the following bases for credit rationing behaviours which restrict access to finance for SMEs.

Bases for credit rationing behaviours: Quite a substantial number of authors attempted to draw conclusions on various issues relating to credit rationing behaviours of financial institutions. One of the notable contributions is by Green (2003). In his study, Green (2003) argued that limited access of small enterprises to formal credit in developing and emerging economies is largely due to the relatively underdeveloped nature of the financial system, the lack of liquidity, and inexperience in small-scale lending in many of these countries. Bank branches outside the capital cities frequently provide only cash and do not have the authority to make loans, leaving small enterprises in rural areas disproportionally disadvantaged. If commercial banks do extend credit to small firms, it may take up to several months to process applications.

Construction SMEs typically require relatively small credit compared with large firms. The transaction costs associated with processing and administering loans are, however, fixed, and banks often find that processing small SME loans is inefficient. They lack the techniques, such as credit scoring, to increase volume and lower costs (Malhotra *et al.,* 2007). Since most of the administrative costs of lending are fixed, that is, they are independent of the size of the administered loan, economies of scale arise; the larger the loan, the lower the per unit costs of extending credit.

Furthermore, administrative costs also include information gathering costs, for example visiting borrowers, analysing their applications and monitoring their loans. For a number of reasons, these costs tend to be higher for small than for large firms. Small enterprises are often located away from the main urban centres, their accounting skills and standards are usually lower, and banks lack experience in servicing them. In the case of developing and emerging economies, these difficulties, and therefore the costs involved, are multiplied (Green, 2003). However in a study by Cziraky *et al.* (2005) it was concluded that, among all SME loan requests, banks preferred smaller firms that requested smaller loans. The results suggest that individual banks differ in their criteria and in their loan-size preferences and that there is no positive correlation between the bank's size and its loan size preference.

Financial institutions are more likely to approve loans to firms that are able to provide collateral and to those firms that have established long term relationships with lenders. Due to the existence of asymmetric information, banks base their lending decisions on the amount of collateral available. Collateral acts as a screening device and reduces the risk of lending for commercial banks. By pledging his assets, a borrower signals the quality of his project and his intention to repay. In the case of default, collateral serves to put the lender into a privileged position with regard to other creditors (Green, 2003).

Small firms are disadvantaged in this regard, due to the fact that they lack collateral security and also they lack a proven credit track record. Therefore, start-up firms with new innovative products may be constrained access to finance due to the fact that they may fail to furnish collateral security and also due to information asymmetries, financial institutions may fail to see the profitability and viability of the proposals. More intensively, collateral requirements militate against technology based firms. This is mainly because many technology-based small firms usually begin as small conceptions and may not yet have developed relationships with providers of financial services.

In South Africa; the risk perception on SMEs in attributed to the high failure rates. Therefore, it is reasonable for financial institutions to ration SMEs; particularly start-up SMEs who have

little or even no credit history. Tightening collateral security requirements is one of the ways through which financial institutions attempt to protect themselves against such risks. Such collateral militate against potentially viable small, emerging enterprises because of lacking financial resources.
Bridging gaps in access to finance Malhotra *et al.* (2007) contends that, experience from the microfinance industry shows that one way to successfully bridge the gap between the demand for and supply of credit is through innovative lending methodologies. Such methodologies include; according to Holtmann *et al.* (2000) the following:

- A Loan analysis that focuses on the prospective client's ability to pay (cash flow). Less emphasis should be placed on collateral. The analysis should be highly standardized, and loan processing times kept to minimal;
- Entitle repeat borrowers to increasingly larger loans;
- Loan officers should bear full responsibility throughout the entire life of the loan and should be paid performance based salaries. If payment problems occur, there should be a powerful incentive structure in place for immediate follow-up;
- Appropriate decision-making and control mechanisms should be in place and supported by a strong Management Information System (MIS) and information technology (IT) to assist in the management and administration of the loan portfolio
- (Holtmann *et al.*, 2000).

In another study, (Park et al. 2008) argued that many banks have developed tools, such as credit scoring models and other sophisticated techniques, to discriminate between high-risk and low-risk borrowers, thus reducing the risk of lending to SMEs.

Despite, the potential for the above mentioned methodologies of being effective in addressing the access to finance challenge for SMEs, applying these approaches fail to provide a clear path to closing the information asymmetry gap, a major reason why SMEs cannot adequately access financial resources. Therefore, there is a need to find effective ways to ensure that the information gap between financial institutions and SMEs is closed.

According to studies done by (Foxcroft et al. (2002) and Wood Kew, Herrington et al. (2008) reported that significantly large numbers of construction SMEs fail to gain access to credit from financial institution Wood kew, Herrington *et al* (2008) further explained that bank credit are the most preferred source of external finance by entrepreneurs and a significant proportion of applicants to banks failed to get financed. Another study done by Angela and Motsa Associates (2004) reviewed that entrepreneurs face several problems in their efforts to access credit, particularly from banks. These are lack of collateral security, lack of owner contribution/ owner's equity, lack of good business plan, high interest rate, location of the business, lack of managerial ability, lack of cash flow statement, lack of information on the cost obtaining the credit, lack of good reference on the integrity, lack of experience and exposure on construction project also cited the firm characteristic was measured by looking at the risk profile of either the business or the individuals who borrowed loan. The loan characteristics was measured by the interest rate and collateral provided by the client. The observable characteristics were measured by the age of the individual or the business and the credit history of the loan applicants, (Angela *et.al* 2004).

Independent Variable **Dependent Variable**

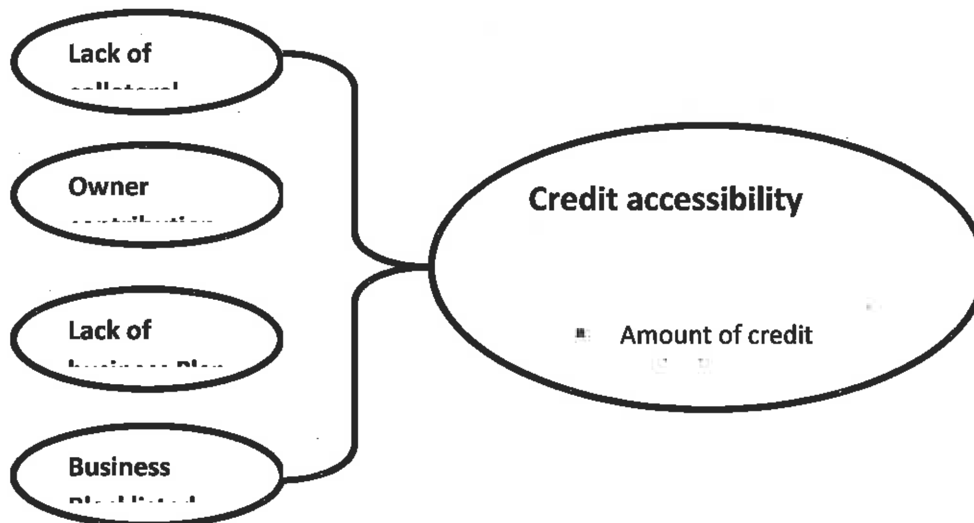

Figure 1: Conceptual model credit accessibility.

4. Discussion and findings

Foxcroft *et al.* (2002) also considered challenges hindering entrepreneurs from borrowing money for banks and the construction SME's side. Banks may avoid providing financing to certain types of SMEs, in particular, start up sand very young firms that typically lack sufficient collateral, or firms whose activities offer the possibilities of high returns but at a substantial risk of loss (OECD, 2006).

Furthermore due to the particular nature of various SMEs, it can be difficult for potential financiers to distinguish the financial situation of the company from that of its owners. The entrepreneur may have mortgaged his or her house to acquire the start-up funds for the company, for example. If there are two cars in the driveway, can one or both be considered part of the company's assets? SMEs also fail to operate as a going concern; they usually die with their owners (OECD, 2006). Therefore, financial institutions and potential investors find it difficult to invest in such risky businesses.

In an effort to address access to finance challenges facing SMEs in South Africa, the government of South Africa, through the Department of Trade and Industries, has put in place several institutions to help SMEs gain access to finance for both start-ups and for growth purposes. The effectiveness of these institutional arrangements in addressing challenges particularly on access to finance remains a controversial issue. SMEs face several impediments in their effort to access finance (Rogerson, 2008). The questions that remain are whether government interventions are necessary to address challenges facing SMEs or should the market forces be left to determine access.

Several policy reforms have been suggested and efforts have been put to implement them, however the challenges remain unsolved. The finding that lack of finance is a key problem are a common feature of research on problems facing entrepreneurs and is apparent in both developing and developed countries (Foxcroft *et al.*, 2002). The following sections is depicts some discussion of policies and institutional arrangements attempted at addressing access to finance challenges facing SMEs in South Africa and the world at large

Towards addressing access to credit challenges:
The high risk associated with providing credit to SMEs is a major reason or impediment to coming up with a sound intervention to address access to finance challenges. To mitigate risk, government intervention in form of credit guarantee schemes may be an effective step towards addressing access to finance challenges facing SMEs. The government of South Africa, through its Department of Trade and Industries has put in place such a guarantee scheme, under Khula Enterprise Finance Limited, a government initiative to address challenges facing SMEs.

Malhotra *et al.* (2007) revealed that a number of commercial banks around the world have learned the lending and pricing strategies that allow them to compensate for the high transaction costs of making many small loans and have adopted risk management techniques commensurate with the higher risk profiles of their SME clients. Many of the innovations originated in serving clients at the lower end of the private sector range using microfinance technologies. These innovations consisted of providing small, uncollateralized working capital loans; promising access to larger amounts for longer terms based on repayment performance; and permitting small savings accounts that were safe, convenient, and flexible in terms of withdrawal.

Nigrini and Schoombee (2002) suggested that guarantees can be used to share the risk between the bank and the guarantee institution in an agreed ratio. Thus the bank's risk and operation costs are lowered and its returns increased. This encourages banks to lend to SMEs who are unable to provide adequate collateral. In their analysis of Khula's Credit Guarantee Scheme, Nigrini and Schoombee (2002) propounded that, regarding the sharing of risk, should borrowers default on their loans, must provide the necessary incentives to encourage banks to participate in guarantee schemes. The risk-sharing proportion usually depends on the track record of the financial institution's SME loan portfolio, the adequacy of the guarantee fund, and the general culture of debt repayments in the country.

Evidence from schemes in Japan showed that loans are guaranteed up to 100 percent Levitsky and Prasad, (1987) in Nigrini and Schoombee, (2002). It must, however, be noted that these schemes operate in an environment where loan defaults may seriously affect future business and credit prospects, and consequently the incentive not to default is very high. Other schemes allow banks to decide what proportion of the loan – up to a certain maximum – will be concluded at their own risk. If conducted in such a way, most loans tend to be guaranteed to the maximum allowed. However, the conditions found in Japan do not exist in developing countries; it is therefore important to make sure that banks use guarantee schemes prudently and accept some of the risk involved. In China, credit guarantee schemes emerged as an important tool through the central and local governments used to ensure access to credit by SMEs (Yibin, 2002).

Although Khula states that it takes an 80 percent risk of the indemnity amount when loan default occurs, it is not the case if collateral is available. Khula will then only pay 80 per cent of the value of the loan minus the collateral. The potential risk for banks is then the unsecured portion of the loan plus the collateral value, as the collateral may not yield its full value in the case of a forced sale. Some banks are unhappy with this situation. South Africa although they are not compelled by Khula to take up security from SMEs, banks often undertake this on their own free will (Nigrini and Schoombee, 2002).

Nigrini and Schoombee (2002) concluded that despite the problems associated with the government's credit guarantee scheme, it is a viable way for the government to lower the normally high risk involved for banks in dealing with SMEs and, in this way, to entice them to serve SMEs. This will help reducing access to finance challenges facing SMEs.

Despite the potential for the guarantee scheme in solving in part collateral and risk problems it remains a challenge for some of the SMEs, particularly start-ups, who cannot even have the capacity to present even the minimal collateral required to qualify into the guarantee scheme. Furthermore, access to such guarantee schemes by SMEs is a controversial issue, since despite such schemes; there is still a huge outcry from SMEs, particularly start-ups, failing to access financial resources.

Angela and Motsa Associates (2004) argued that the large majority of South African households that live on the very fringes of the formal economy, are not easily able to reach institutional arrangements to help them in accessing financial resources.

There have also been initiatives by banks to help construction SMEs with their crippling financial access problems. Banks are instrumental in facilitating access to credit for construction SMEs by providing savings and transaction services particularly for micro and survivalist enterprises. For example, the First National Bank's (FNB) People Benefit Scheme which linked the bank to informal financial intermediaries, in this instance to stokvels, is one such an important initiative. Loans, in the range R1500 to R20000, were also linked to borrower savings. Savings were used for both screening and for collateral purposes. However the scheme was operational for approximately 5 years and was shelved in 1997, due to a lack of demand for loans as members mainly used the scheme for savings purposes while the intention was as a credit programme. Possible reasons for its failure to attract credit seeking clients is the absence of the Non-governmental Organisation (NGO) that could identify and train prospective borrowers as is commonly done in linkage schemes (Angela and Motsa Associates,2004).

Over and above the guarantee schemes, quite a number of institutional arrangements has been established to help in addressing challenges facing SMEs in South Africa (DTI, 2005). These institutions operate hand in hand with private sector institutions designed to assist SME development, survival and growth. These in this paper are termed Business Development Services Providers (BDS). Again the effectiveness of BDS in addressing challenges facing SMEs, particularly on access to finance is subject to debate. Therefore an enquiry should be made from both the supply side and the demand side of SMEs financing to find strategies that works towards reducing the access to finance challenge facing the SMEs at the same making it sustainable and attractive for the financial institutions to provide credit to the SME sector.

5. Conclusions

The study provided a concise discussion on access to finance issues. Issues surrounding the definition and measurement of access to finance were discussed. Furthermore, the paper provided the financial gap analysis, whose foundation has been discussed in this paper with specific reference to Stiglitz and Weiss (1981)'s credit rationing theory. Gaps in financial access has been noted and discussed, including reasons and attempts to close these gaps.

The study revealed that SMEs are victims of the credit rationing behaviours of financial services provider and hence face challenges in their attempts to access credit financing.

Therefore resolutions by both the private and public sector to address these challenges should be sought. One such notable attempt is in the form of both private and public institutional arrangements supported by the central government in South Africa in the form of BDSs. The central government must work hand in hand with the private sector financial services provide to curb the problems facing SME sector in terms of access to financing. The effectiveness of these BDSs and government subsidies in addressing access to finance challenges facing SMES is a controversial issue that need to be empirically investigated. It is therefore paramount to assess the effectiveness of the policy recommendations in the South African literature as well as monitor progress in as far as improving access to finance by SMEs is concerned.

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