
An exploratory study of the causes of failure in construction small businesses: A case of the Johannesburg construction industry, South Africa

Chikezie EKE¹, Clinton AIGBAVBOA² and Wellington THWALA³

¹PhD Candidate, Department of Construction Management and Quantity Surveying, University of Johannesburg, Johannesburg, South Africa, 2028, PH (+27) 559-6398, FAX (+27) 559-6630, Email: chykezie2002@gmail.com

²Senior Lecturer, Department of Construction Management and Quantity Surveying, University of Johannesburg, Johannesburg, South Africa, 2028, PH (+27) 559-6398, FAX (+27) 559-6630, Email: caigbavboa@uj.ac.za

²Professor, Department of Construction Management and Quantity Surveying, University of Johannesburg, Johannesburg, South Africa, 2028, PH (+27) 559-6048, FAX (+27) 559-6630, Email: didibhukut@uj.ac.za

ABSTRACT

The objective of this study is to explore the causes of small businesses failure within the Johannesburg construction industry, a metropolitan municipality in the Gauteng province of South Africa. The data for the study was collected through a structured questionnaire survey distributed to a sample of 30 owners of small and medium construction companies in Gauteng. The research respondents were construction professionals who work in SMEs. The survey results shown that the major causes of small business failure can be divided into two aspects- which are external and internal. The internal factor revealed from the study include- lack of financial managerial ability and general administration of the business. The study findings revealed the urgent areas that small construction businesses need to be supported in order for them to be sustainable which in order guarantee job security for construction professionals who are employed in these companies; thus contributing to the macroeconomic indicators of the economy.

Keywords: Construction Industry, construction small businesses, Market Environment, Small and Medium Enterprises

INTRODUCTION

In the past, the South African government did not give enough support to the small business sector. Big business typically received more support than SMEs. However, this scenario has changed since 1990. Some of the businesses that were started in the early 1990s are no longer in existence. There are also those businesses that are not growing beyond the survivalist stage. The high failure rate can be partially attributed to the lack of support that the small and medium enterprises (SMEs) experience. The government has since initiated small business support measures aimed at developing and promoting the SMEs (Bowler & Dawood, 1996).

The National Strategy for the Development and Promotion of Small Business in South Africa White Paper was published in 1995. This initiative was followed by the National Small Business Act of 1996. Dickey (1994) reports that small businesses fail because more often than not cash flow is not properly managed. The point is made that when a business starts or expands; more money needs to be invested for a while and gives the business owner very little in return. The argument regarding the failing of small businesses is that small businesses will most likely employ poor financial information, respond badly to change and may well over trade as well as allow their gearing to rise to levels that convert normal business hazards into constant threats.

Small and medium-sized businesses form an integral part of the South African economy and therefore this industry is mostly influenced by various factors which are basically externally and internally. Many researchers have discovered that major factors or causes of failures in these SMEs are categorised in four groups which are top managerial skills, financial management, and skills shortage, loss of an important personnel or employee incompetence and the market environment. Ladzani and van Vuuren (2002) believes that a considerable number of small businesses fail just before many of them start to operate. This is caused by lack of preparedness and failing to accurately estimate the cost of starting and running one's own business. Ladzani and van Vuuren (2002) emphasise that training alone may not be the only solution that can help small businesses succeed, but that constraints such as the lack of financial resources, lack of access to markets, lack of support services, and low literacy levels should also be addressed. Therefore, the aim of the present study is to synchronize the existing body of knowledge on the subject of SMEs in the understanding of small business failure; and to identifying the remedies of the major causes of failure in SMEs as this has attracted much attention over the years to researchers and research bodies (corporate or government).

RESEARCH METHODOLOGY

This research is mainly a literature review of what has been found in previous years on the failures of SMEs. The study was conducted with reference to existing theoretical literature, published and unpublished literatures. The study was derived from passed studies on SMEs, with the specific aim of identifying the remedies of the major causes of failure in the SMEs as this has attracted much attention over the years to researchers and research bodies (corporate or government).

HISTORY AND DEFINATION OF BUSINESS FAILURE

Small business is considered primarily because any activity must start from stages of infancy: man grows from a child; huge empires and civilizations are built from small groups of people; elementary ideas and notions germinate into intricate and complex thought processes; modern giant industries of today were small business of yesterday. In any appraisal of the conditions prerequisite to the growth

and survival of a system of private enterprise, the role of small enterprise is a strategic factor. It is natural, in thinking of South African industry, to be impressed with large scale operations; but these corporate giants did not start full grown, nor can they stand alone. Large-scale industries are fed by and feed thousands of smaller suppliers and customers that link the chain from raw materials to consumers. Business failure can be defined as the inability of a firm to pay its obligations when they are due or considered as a firm's inability to exist due to loss of capital or insufficient return on investments. It mostly appears in a critical situation as a consequence of a sharp decline in sales, as a result of recession, the loss of an important customer, shortage of resources for instance; raw materials, shortages of management, and others. The researchers suggest that a business should not be categorised as "successful" unless it is sustained over a period of time. Being profitable in one year that leads to bankruptcy the next is not a correct definition of a successful business, it must have at least survived three years and still have the vision of continuing to exist in the foreseeable future. However, if a business cannot survive at least three years in the construction industry, it does not matter if it had a fruitful first year or not but if it cannot even pay its debts or loans and end up bankrupt, it is not successful but unsuccessful which results to business failure. Therefore a business should have goals and a plan on how to achieve those goals, it must know the main aim of the business and business must be for right reasons (Berryman, 1982).

SMES OWNERS AND ENTREPRENEURS

Management can exert no control over exogenous problems that manifest themselves in the economic, political, technological and international spheres. The most noticeable problems influencing SME success in this environment are the state of the economy, compliance with legislation, resource scarcity, crime and corruption and rapidly changing technology. The entrepreneurs in the previously disadvantaged townships, for example, experienced problems with understanding the impact of technological development and the state of the economy on the success of their business (Brink and Cant, 2003). In typical or economic theory, the entrepreneur can be viewed as someone who co-ordinates different factors of production, but the important difference is that this role is viewed as a non-important one. The entrepreneur becomes combined with the capitalist employer, the owner-manager, who has the wealth to enable production to take place, but otherwise does not retain any special attributes. However, Deakins and Freel (2003), reported that the entrepreneur, if recognised at all, is a pure risk-taker, the reward being the ability to appropriate profits.

They also mention that the idea that the entrepreneur has a significant role in economic development has been developed by writers outside mainstream economic thinking. Their contributions now have an important place, but it is only relatively recently that the importance of these contributions has been recognised. Since the attention has become more focused on the importance of the SME sector for the economic development and job creation, so greater attention has also been directed at

theories of entrepreneurship. In the Key Contributions of Economic Writers on the Role of the Entrepreneur, that an entrepreneur has to have the ability to spot an opportunity and also be innovative and bold enough to take risks in the construction business.

MAJOR CAUSES OF FAILURE

The Technological Capabilities Theory popularised by Lall (2001) argues that smallness is dangerous just like in the animal kingdom where younger and smaller animals are easy prey for predators. The theory postulates that small firms do not easily access funds from financial institutions because they lack collateral and hence lending to them is viewed as highly risky. This means that the only plausible way that SMEs can raise capital is through self-financing, but since their initial capital is small and their sales value is also small against very high operating costs, they are caught in a vicious circle of smallness which is hard to break out of and may result in eventual collapse of SMEs.

Kivrak and Arslan (2008) examined the critical factors causing the failure of construction companies through a survey conducted among 40 small to medium-sized Turkish construction companies. A lack of business experience and country's economic conditions were found to be the most influential factors to company failure. A scrutiny of the sub-factors related to the lack of business experience confirms that difficulties with cash flow and poor relationship with the client drove the contractors' failure. In addition, preparing an accurate and realistic bid proposal with the profit margin being carefully determined is highly critical (Arslan et al., 2006). However, due to high competition, companies are usually forced to reduce their profit in order to win the bid and this would increase the default risk substantially. Kangari (1988) found that more than half of business failures in construction were due to unrealistic profit margin.

Many researchers have discovered many different major causes of failure but those causes revolve around four important factors, which are top managerial skills, financial management, skills shortage, loss of important personnel or employee incompetence and the market environment. These factors are basically external and internal causes, and they are as follows;

EXTERNAL CAUSES

Market environment:

Competition: According to Thwala and Phaladi (2009), there are a large numbers of small contractors or businesses entering at the lower end; this sector has become extremely competitive, thereby making it difficult for new entrants to keep a sustainable workflow. This inability to sustain workflow impacts on their ability to achieve sustainable employment and economic empowerment (Construction Industry Development Board, 2006). Hence, for a company to withstand the effects of competition, before it chooses a location it should conduct a market research on their competitors and customers in order for it to understand its customers and the demand.

INTERNAL CAUSES

According to Schaefer (2006), the following are the internal causes;

Financial managerial ability

- Lack of finances,
- Insufficient capital,
- Poor estimating and job costing,
- Debt

Thwala and Phaladi (2009), concord with Schaefer (2006) because they reported that lack of effective financial management during the early stages of a business is a major cause of business failure for small and medium sized contractors. If a business does not have a good book keeping, it is planning to fail because without book-keeping the business end up losing track of their daily transactions and cannot account for their expenses and profits at the end of the month. Moreover, according to Schaufelberger (2009) also mentioned that most external problems are caused by internal problems that are neglected, and they are as follows:

- Strategic planning Issues
- Lack of comprehensive business plan

Components may include:

- Description of the business, vision, goals, and keys to success
- Work force needs
- Potential problems and solutions
- Financial: capital equipment and supply list, balance sheet, income statement and cash flow analysis, sales and expense forecast
- Analysis of competition
- Marketing, advertising and promotional activities
- Budgeting and managing company growth

In addition, most bankers request a business plan if you are seeking to secure addition capital for your company.” Schaefer’s components as they follow will help companies define goals in order to succeed and have a clear vision.

- Diversifying into unfamiliar types of projects
- Lack of managerial maturity

The following components below are under lack of managerial maturity:

- Strategic implementation/Control issues
- Increase in project size
- Poor cost-estimating skills
- Lack of equipment control
- Poor internal communications
- Financial management issues

-
- Poor use of accounting systems
 - Excessive debt

Schaefer (2006) states “A common fatal mistake for many failed businesses is having insufficient operating funds. Business owners underestimate how much money is needed and they are forced to close before they even have had a fair chance to succeed. They also may have an unrealistic expectation of incoming revenues from sales. It is imperative to ascertain how much money your business will require; not only the costs of starting, but the costs of staying in business. It is important to take into consideration that many businesses take a year or two to get going. This means you will need enough funds to cover all costs until sales can eventually pay for these costs.” Borrowing funds from financial institutions in order to be in business is good, but when the debt goes high it drains the business income and causes the capital resources of the business or company not to grow or even decline. Thus the business leaders or the company should pay attention to the cost of borrowing.

Lack of planning or managerial skills: Owners tend to manage their businesses themselves as a measure of reducing operational costs. Poor record keeping is also a cause for start-up business failure. In most cases, this is not only due to the low priority attached by new and fresh entrepreneurs, but also a lack of basic business management skills. Some owners employ family members simply because of bond relations. In some cases, these have turned out to be undisciplined and ineffectual, a factor that has led to eventual and sometimes rapid failure of businesses. Managers, who are unable to employ competent workers, deal with tendering properly, and contract documentation, mentoring, lack of entrepreneurial skills; conduct a proper training for its employees also end up with a business that is bankrupt.

Not taking risks as a company and not being innovative: If a business does not engage in new things or even become part of new project or fear challenges, which can be a hindrance for it to grow and become successful because growth in the construction industry is part of success.

FACTORS THAT CAN BE IMPLEMENTED TO REMEDY THE MAJOR CAUSES OF FAILURE IN THE SMES

The following factors can help to remedy failures in small and medium enterprises when implemented:

The Government intervention, Leadership training and skills training workshops: The South African construction industry will continue to provide jobs for historically Disadvantaged Individuals (HDI) but without such an intervention, small and medium sized contractors will remain unsustainable and their performance satisfaction. In order to address problems and challenges faced by small businesses or contractors in South Africa, it is critical for the government to review policies with regard to Contractor Development Programmes (CDP) to ensure that the government contributes to the success of small contractors in South Africa. The research had

established that there is not one critical success factor that can make small contractors to be successful but a combination of factors. In the North West Province case study it was found that some factors were critical and some were less critical. The authors recommend that the following factors to be considered as key to the success of small contractors in the North West Province. (Thwala and Phaladi, 2009).

Business skills: Location of business premises is very important. Set specific targets for your business, carry out market research, employ qualified personnel and put them in position according to their skills. Know and understand existing skills needed and attend refresher courses on business management skills. (Thwala and Phaladi, 2009).

Management skills: Thwala and Mofokeng (2012) discuss management factors and started by stating that experience in any kind of management is very important and it plays a vital role in making sure that a business fails or succeeds. Poor management was suggested as one of the main causes of failure of small enterprises. The lack of experience was seen as a cause for managers making bad business decisions within the construction industry. Thwala and Mofokeng (2012) continued on by saying that, financial mismanagement and management incompetence was among the attributes that lead to construction failures. Financial management should be emphasized as well as networking with other people with similar businesses and keeping records of workers to help in evaluation of the performance (Thwala and Phaladi, 2009). However, recommends the following remedies in order to produce a successful business.

Access to capital: One of the remedies is to join with others that have similar businesses, negotiate favourable credit purchases from the supplier, source affordable loans from financial institutions and negotiate advance payments from the clients.

Good record keeping: Financial records should be prioritised and a record of books of accounts on a daily, weekly, monthly and annual basis should be established.

Well managed cash flow: Prepare cash flow forecasts and budgets and prepare a cost-benefit analysis. Lease equipment and other financial assets to improve your cash flow, negotiate outstanding loans through payment procedures and scale down operational costs.

Family/domestic situation: Separate business activities and family obligations and look for alternatives sources of income to cater for the family's basic needs. With the above mentioned, during 2001, skills development was clearly stated as a national priority. Twenty-five Sector Education and Training Authorities (SETAs), covering all aspects of economic activity, are now entering their fifth year of existence. All SETAs are expected to make specific contributions to the National Skills Development Strategy. Specific projects initiated by different SETAs include training domestic workers, training people to work in national parks, and enhancing the skills of micro-lenders (Lazarus, 2005). Hence this stated SETA will assist in development

of SMEs by training employees and employers.

LESSON LEARNT FROM LITERATURE REVIEW

Lesson learnt from the study reveal that:

- Government should review policies with regard to Contractor Development Programmes (CDP) to ensure that the government contributes to the success of small contractors.
- Poor management is one of the main causes of failure of small or any enterprises.
- Good record keeping is one of the vital remedy to a company.
- Access to capital and constant entrepreneurship training is very influential when coming to turning a failing construction company to a success.
- Well managed cash flow is the most important remedy to a construction company, because if contractors manage their cash flow well, many SMEs will remain successful and be in existence for more than 5 years without being bankrupt and the company will remain in business.
- Recruiting new professionals is another remedies that can help failing companies to become successful.

CONCLUSION AND RECOMMENDATION

A business should have goals and a plan on how to achieve those goals, it must know the main aim of the business and must be for the right reasons. The most noticeable problems influencing SME success in this environment are the state of the economy, compliance with legislation, resource scarcity, crime and corruption and rapidly changing technology. Many researchers have discovered many different major causes of failure but those causes revolve around four important factors, which are top managerial skills, financial management, skills shortage, loss of important personnel or employee incompetence and the market environment. These factors are basically external and internal causes; thus, these findings relate with the literature from other researchers like Thwala and Phaladi, (2009) who recommended that good record keeping, access to capital, family domestic situation, entrepreneurship training and recruiting young professionals as remedies in order to produce a successful business.

REFERENCES

- Bowler, A. & Dawood, M. S. (1996). *Entrepreneurship and Small Business Management*. 3rd edition. Cape Town: NASOU Via Afrika Educational Publishers.
- Dickey, T. (1994). *Budgeting for Small Business: A Prime for Entrepreneurs*. Crisp Publications.

-
- Ladzani, W.M. & van Vuuren, J.J. (2002). Entrepreneurship Training for Emerging SMEs in South Africa. *Journal of Small Business Management* 40: 154-161.
- Lazarus, S. (2005) "An Integrated Skills Development Model For Emerging Construction Contractors In The Eastern Cape" Port Elizabeth Technikon. South Africa
- Lall, S. (2001) Competitiveness, Technology and skills Cheltenham, United Kingdom/ Northampton. M.A. USA, Edward Edgar.
- Kivrak, S. and Arslan, G. (2008) Factors causing construction company failure, *Building Abroad*, October 2008, 297-305.
- Arslan, G., Tuncan, M., Birgonul, M. T., and Dikmen, I. (2006) E-bidding proposal preparation system for construction projects, *Building and Environment*, 41(10), 1406-1413.
- Kangari, R. (1988) Business failure in construction industry, *Journal of Construction Engineering and Management*, 114(2), 172-190.
- Brink, A. and Cant, M. (2003) "A paper for the Small Enterprise Association of Australia and New Zealand 16th Annual Conference: Problems experienced by small businesses in South Africa" University of Ballarat, Ballarat, Australia.
- Deakins, D. and Freel, M. (2003), "Entrepreneurship and small firms" in K. Reade & N. Jacobs (eds) *The Entrepreneur Concepts and Evidence*, McGraw-Hill Education, UK, pp. 3-8.
- Thwala and Phaladi (2009) Thwala W.D. and Phaladi M.J. (2009) "An exploratory study of problems facing small contractors in the North West province of South Africa" *African Journal of Business Management* Vol.3 (10), pp. 533-539, October 2009, University of Johannesburg, Department of Construction Management and Quantity Surveying, Johannesburg, South Africa.
- Thwala, WD. and Mofokeng. (2012). *An Exploratory Study of Problems Facing Small and Medium Sized Contractors in the Free State Province of South Africa*, Business Dynamics in the 21st Century, Chee-Heong Quah and Ong Lin Dar (Ed.), ISBN: 978-953-51-0628-9, InTech
- Construction Industry Development Board, 2006).
- Schaefer, P. (2006) "The Seven Pitfalls of Business Failure and How to Avoid Them" Copyright 2006, Attard Communications, Inc. Available online on: <http://www.businessknowhow.com/startup/business-failure.htm> accessed 12 April 2012
- Schaufelberger, J. (2009) *Construction Business Management*, Pearson.