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Sources and types of credit for construction of small and medium enterprises in the South Africa: A literature review

Olanrewaju O. Balogun[1], Justus N. Agumba[2], Nazeem Ansary[3]

Abstract

Small and medium enterprises (SMEs) have a distinct role to play in the South African economy; not only to solve the unemployment issues but also to act as a poverty alleviation mechanism. However, construction SMEs are faced with challenges to access suitable credit facilities. The purpose of this paper is to identify the different types and sources of credit lines available to construction SMEs. This paper is based on a review of literature focusing on the various types of credit facilities and mode of obtaining such facilities. The literature review was based on both South African context and international trends. Findings revealed that there are different types of credit facilities available for construction SMEs, which can be formal or informal. Formal sources include commercial bank, co-operative, micro-finance institutions and government agencies, while informal sources include friends, family/relative, trade credit, private money lender and/or stokvel. Knowledge of the various sources of funding available could help construction SMEs to make informed business decisions about their investments.

Keywords: construction, credit facilities, SMEs, sources, types

1. Introduction

The availability of finance has been highlighted as a major factor in the development, growth and successfulness of construction SMEs (Ou & Haynes, 2006; Cook, 2001). Financing methods employed by SMEs vary from initial internal sources, such as owner–manager's personal savings and retained profits (Wu, Song & Zeng, 2008) to informal outside sources, including financial assistance from family and friends (Abouzeedan, 2003), trade credit, venture capital and angel financiers (He & baker, 2007), and thence to formal external sources represented by financial intermediaries such as banks, financial institutions and securities markets (Chittenden, Hall, & Hutchinson, 1996).

According to the financial growth cycle paradigm proposed by Berger and Udell (1998), financial needs and the financing options available for SMEs change throughout the various phases of a firm's lifecycle. In other words, at different stages of the firm's growth cycle, different financing strategies are required. In general, because of the unique features that characterise SMEs during the start-up phase, such as informational opacity (Berger & Udell, 1998), a lack of trading history (Cassar, 2004) and the high risk of failure (Huyghebaert & Van der wijst, 1989), SMEs in this stage depend heavily on insider funding sources.

As SMEs advance through their business lifecycle, they begin to gradually adjust their capital structure (La Rocca, La Rocca, & Cariola, 2011). During subsequent growth stages as SMEs mature, they start to

establish a track record in addition to the ability to provide collateral. This serves to improve the creditworthiness of the firm and thereby attracts the attention of investors willingly inject money into the business. As a consequence, firms begin substituting internal with external financing sources, including venture capitalists, trade credit and bank loans to name a few. In the more advanced stages of their growth cycle, when SMEs become more transparent with information, they may develop access to securitised debt and publicly listed equity markets (Berger & Udell, 1998).

1.1 Definition of small and medium construction

According to Berry *et al.* (2009), when defining SMEs it is important to differentiate it from small, micro and medium-sized enterprises (SMME's). Although both terms are used to refer to small businesses, SMMEs comprise a wider range of firms, from established businesses employing over one hundred employees to self-employed owners of informal micro- enterprises. SMEs form an upper end of the ranges contained by SMMEs; these are larger in size compared to the micro and very small medium sized enterprises. The definition of small and medium sized contractors can vary from one country to the other. However, the definition used for this research study will be largely based on turnover and the number of permanent employees. Dlungwana *et al.* (2002) defines small construction companies in South Africa as those companies with an annual turnover of less than ten million rands (R10 million), while medium contractors have a turnover ranging between ten million rands (R10 million) up to fifty million rands (R50 million). The National Small Business Act No 102, 27 November 1996 (1996) defines small contractors as firms that employ between five (5) and fifty (50) permanent employees, while medium contractors employ between fifty (50) and two hundred (200) permanent employees.

1.2 Importance of small and medium enterprises to the economy

The importance of small businesses is recognised in numerous African countries such as Togo, Uganda, Ghana, Cote d'Lvoire, Nigeria, Kenya, Malawi, Burkina Faso, as well as others. According to Rwigema and Karungu (1999), SMEs are dominant in numbers in most economies. In First World countries like the United States of America and the United Kingdom, small enterprises play an important role in the economy, accounting for an estimated one third of industrial employment and a lower %age of output. In Third World countries where SMEs dominate economically active enterprises, the SMEs prosperity is considered far more important than in First World countries (Rwigema and Karungu, 1999). The activities of SMEs in Africa are of vital importance for the promotion of economic growth, job creation and the mitigation of poverty (Rogerson, 2001). However, research conducted on SMEs in Africa by Mead and Liedholm (1998) confirmed that on average, there are more SME closures than expansions, with approximately only 1% of micro enterprises growing from five or less employees to ten or more. It has long been debated that SMEs are pivotal to employment creation and economic growth, particularly in countries such as South Africa that has a high unemployment rate, estimated at up to 40% (Friedrich, 2004; Watson, 2004).

Upgrading the roles of the SME sector in the South African economy to improve economic growth through increasing competitiveness, and by generating employment and redistributing income (Rogerson, 2004; 2006) has been the focus of new development policies since the democratic transition (Berry et al., 2002). In order to aid in the facilitation of the SME environment, the South African government tabled the National Small Business Act of 1996 amended with Act 29 of 2004 to provide equal standing to SME enterprises (Rwigema and Venter, 2004; Ntsika, 2001) in South Africa's economy. The vital role the SME sector plays in the South African economy in addressing sustainable

development, was highlighted by the 2003 Human Development Report (UNDP, 2003) for South Africa (Rogerson, 2004).

In South Africa, it is estimated that 90% of all formal businesses are small, medium or micro enterprises (Rwigema and Karungu, 1999). The SME sector is one of the largest contributors to the South African economy. The SME is not only seen as an employment creator, but this sector also acts as an absorbent of retrenched people coming from the private and public sector (Ntsika, 2001).

1.3 Problem

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 construction 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

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, 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. The objective of the current paper is therefore to investigate the sources and types of credit available to construction SMEs while highlighting the ease of accessibility of the credit types.

2. Literature Review

2.1 Introduction

This chapter on literature reviews discuss various theories that underpin source and the challenges facing construction SMEs in accessing credit facilities. Specifically, sources of credit theory. This is followed

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by conceptual framework, empirical review of literature related to the topic under the study and critique of the literature.

2.2 Sources of credit for construction small and medium enterprises

2.2.1 Equity financing

Due to moral hazard and problems with information opacity typically being more severe during the initial stages of SME development, internal equity financing, as best represented by owner–manager personal savings, is a critical source of funding for SMEs in these early stages (seed financing and start-up). Subsequently, in later stages, in order to develop and grow SMEs tend to reduce their dependence on these sources and start seeking alternative channels for raising capital. Internally generated profits and venture capital exemplify just two of the other equity options SMEs seek to expand as they grow.

In general, "...equity capital is that capital invested in the firm without a specific repayment date, where the supplier of the equity capital is effectively investing in the business" (Ou &Haynes, 2006, p. 156). Equity capital can be raised either internally or externally. Internal equity is funds obtained from the current owner–manager(s), family, and friends or from the retained earnings within the firm. External equity, however, is capital acquired from external channels other than the existing partners and their relatives.

As mentioned above, equity financing is preferred over debt as a mode of financing for new and young SMEs as they undergo a typical cash shortage and are generally unable to secure loans with collateral during the founding phase. The advantages of equity financing in this regard are twofold (Ou & Haynes, 2006). First, unlike debt, equity offers long-term financing with minimum cash outflow in the form of interest. Second, equity capital helps enhance the new/young firm's creditability by indicating that the firm has the approval of sophisticated financial professionals.

Ou and Haynes (2006) determined two situations when SMEs pursue financing from equity capital sources in order to meet expansion needs. The first case is when SMEs face financial distress coupled with a lack of alternative sources of finance. The second case is when cash outflows exceed the cash inflows generated from regular sources. Ou and Haynes (2006) attributed this attitude adapted by SMEs in these two particular cases to the reluctance of regular lenders to lend to the firm because of uncertainty about the firm's future growth opportunities. As a result, these firms are usually classified as high risk. Inconsistent with this, in their investigation of the determinants of financing mode chosen by young innovative SMEs in Germany, Schafer, Werwatz and Zimmermann (2004) found that risky SMEs are more likely to receive equity financing.

Other arguments suggest that some SMEs owner–managers may choose not to use equity as a source of financing in order to avoid any undesirable changes in the ownership of their firm (Reid, 1996). Other entrepreneurs, nevertheless, may choose to source funding from external equity in order to share the risk with less risk-averse investors. However, the valid judgement of the importance of the external equity for SMEs should be based on the eventual success of firms that receives it, not on the quantity that the firm utilises (Berger & Udell, 1998).

2.2.2 Venture capital

Venture capitalists are financial intermediaries. Venture capital is that form of financing in which funds are raised from investors and redeployed by investing in high-risk firms which for the most part are young or start-up firms (Potter & Porto, 2007). Further, venture capitalists decide the timing and type of investment in addition to their role in monitoring, screening and contracting (Gorman & Sahlman, 1989).

Moreover, by performing these functions, venture capitalists virtually participate in strategic planning and decision making in the firm. The venture capital market includes a variety of organisations, including public corporations, small business investment corporations and private limited partnerships.

Compared to other more conventional financing sources, venture capital displays some particular characteristics. To start with, investments employing venture capital often involve high levels of asymmetry information and uncertainty as well as higher intangible assets (Gompers, 1995). In addition, Hellmann (1998) explained that the situation in which a company has a sufficiently large incentive for active monitoring takes place only when the venture capitalist has a concentrated stake invested in that company. He added, monitoring in such cases may include spending more time in the company and regular meetings with the managers. Finally, venture capitalists can provide the firm with strategic access to new suppliers and clients as well as strategic partners (Bygrave & Timmons, 1992).

As discussed, venture capital investment is uniformly associated with high risk and uncertainty. For example, when providing external finance to firms, venture capitalists encounter a significant adverse selection problem and moral hazard (Smolarski & Kut, 2011). Another problem that may arise is the agency problem (Berger & Udell, 1998). This occurs in the relationship between the venture capitalist and the entrepreneur when the latter lacks sufficient information or skills to make optimal production decisions. This problem might also be combined as information about the project is imperfect and revealed over time (Bergemann & Hege, 1998). In order to alleviate these problems and reduce uncertainty, particular mechanisms can be implemented. In this context, Gompers (1995) emphasised three control strategies. These strategies are: (i) the use of convertible securities, (ii) the syndication of investment, and (iii) the staging of capital infusions.

According to Cumming (2006), most venture capital transactions include convertible securities. Bascha and Walz (2001) asserted that unlike traditional debt and/or equity instruments, convertible securities have the ability to mitigate the agency problem effects by leaving the owner–manager with some control during the investment period. In addition, as the price of conversion is a function of performance, the venture capitalist has a better chance to recover the investment if the venture is not successful. Other studies show other motivations for employing convertible debt, with examples including reducing the risk-shifting incentives of the entrepreneur (Green, 1984), resolving problems arising with debt financing and gaining indirect equity financing when issuing traditional equity is unattractive (Stien, 1992).

Syndication is a common form of venture capital risk alleviation and refers to two or more venture capitalists sharing in a single financing round. The syndication mechanism is used in order to decrease problems associated with adverse selection through the participation of a co-investor sharing the investment risk (Smolarski & Kut, 2011). A study by Cumming (2006) reached a broadly similar conclusion stating that venture capital syndication significantly mitigates adverse selection problems. Additionally, Lerner (1994) suggested that adverse selection problem can be efficiently mitigated in the

presence of high information asymmetry in venture capital financing by implementing the syndication strategy. It was also found that syndication reduces the entrepreneur's opportunistic behaviour (Wright & Lockett, 2003).

Another main characteristic of venture capital is staged financing. As the term suggests, venture capital staging refers to that mode of financing in which venture capitalists invest in stages in order to maintain the project under control (Organization for Economic Co-operation and Development (OECD), 2004). Gompers (1995) provided evidence indicating that staged investment enables venture capitalist to gather more information allowing him/her to monitor the firm prior to refinancing decisions to be made. As such, the venture capitalist has the option of abandoning the project if and when any unattractive information regarding the investment emerges. Wang and Zhou's (2004) results showed that the staging financing plays a crucial role in controlling moral hazard. Therefore, it is an effective mechanism in controlling agency problems.

Not only do venture capitalists provide an alternative source of funding for SMEs, they also help resolving many informational problems plaguing SMEs. Hence, by helping increasing the financial flexibility of SMEs, they offer them the chance of sourcing finance from other financial channels, such as banks and insurance companies. However, the supply of venture capital appears to be relatively inflexible, at least in the short-term, as it requires years of experience to develop the necessary skills (Kortum & Lerner, 2000).

2.2.3 Business angels

Unlike other external sources of financing, business angel finance is not intermediated. It is instead an informal market for direct finance (Berger & Udell, 1998). Angels are highly-selective wealthy individuals with long business experience who invest directly in high growth SMEs with which they have had no previous relationship (Madill, Haines, & Riding, 2005). This form of investment is usually based on an equity contract, typically common stock. Though angels by definition are individuals, they sometimes coordinate their investment in small investment groups.

According to Harrison and Mason (1992), there are three features that make angel financing an appropriate option for SMEs. First, angels are more active in the early stages of enterprises (seed and start-up) closing the so-called 'equity gap' by forming a 'bridge' between internal financing sources and outside investors. Second, by having lower rates of rejection and being a more patient form of capital with longer exit horizons, angel financiers tend to be more obliging to the needs of SME owner–managers. For example, German entrepreneurs have ranked business angels as the most desirable funding providers (Brettel, 2003). Finally, unlike venture capitalists, angel investors prefer to invest in their local economies where the majority of SMEs operate.

Angel investors are a crucial source of financing for many SMEs, especially start-ups. According to Morrissette (2007), the amount of capital that angels provide is estimated to be eleven times that provided by venture capitalists. Data collected by Shane (2012) from different surveys conducted between 2001 and 2003 showed that between 140 000 and more than 260 000 angels injected investments between $12.7 and $36 billion into between 50 000 to 57 000 ventures each year. In Germany, for example, a study by Stedler and Peters (2003) estimated the total capital assets for each business angel in the country at €2.5million to €5 million distributed across a portfolio of between 1 and 5 firms, all start-ups.

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The extent to which angels are involved in the firms in which they invest is debatable. Barry (1994) claimed that angels are not active investors. Yet, other empirical research show opposing results (e.g. Harding & Cowling, 2006; Landström, 1993). In terms of benefits, Mason and Harrison (1996) questioned a sample of 20 dyads regarding the role played by business angels apart from their financial stake. The respondents reported that nonfinancial contributions made by angels included assistance with management functions, finance and accounting functions, strategic advice, financial advice, general administration, networking and marketing. Further, 50% of the entrepreneurs rated these angel contributions as either helpful or extremely helpful.

Worldwide, and based on quantitative analysis, angel financing dominates venture capital financing in terms of both the number of firms utilizing it and the financial value of investment (Fairchild, 2011). However, as a source of financing, business angels have two main limitations (Wall, 2007). First, few angels are prepared to inject additional money into a firm to enable it to grow and be a real competitor in its market. Second, most angel investors do not have neither the skills nor the interest in investing in a firm after it has access to other external sources of finance, including public equity markets.

2.2.4 Debt financing

It is well known that capital structure decisions, in SMEs as in large firms, relate to the use of either equity or debt or both. However, Berger and Udell (1998) believe that in the case of SMEs, this is partly incorrect because information opacity is more severe in SMEs. Issuing additional equity to satisfy the firm's financial needs would then lead to a dilution in ownership and control. Therefore, in order to keep full ownership and control of their businesses, SMEs owner–managers may prefer to seek debt financing rather than external equity.

Three significant differences between debt financing for SMEs and that of large firms have been identified in the literature (Wu et al., 2008). First, unlike managers of large firms who usually have the choice of broader range of debt financing resources, SMEs tend to be more attached to commercial lenders, especially institutional lenders, as a source of short-term debt financing that can be renewed for long-term debt. Second, as information asymmetry problems are more acute in SMEs than in large firms, long-term lending relationships are important for SMEs in order to deal with the resultant agency problems along with the other three conventional mechanisms; signalling, monitoring and bonding (the provision of guarantee or collateral). Third, in concentrated owner–managed SMEs, and contrary to what the agency theory suggests, it is not clear whether debt can lower the agency costs that result from information asymmetry arising due to different motives of owners and managers.

2.2.5 Trade credit

One of the most important sources of external financing for SMEs is trade credit. For instance, Berger and Udell (2006) estimated that one-third of the total debt of SMEs in the US in 1998 was represented by trade credit. According to García-Teruel & Martínez-Solano (2010), trade credit is a delay in the payment for goods or services after they have been delivered or provided as a result of an agreement between the supplier and the firm. Therefore, for the firm this is a source of financing appears in the balance sheet under current liabilities, whereas for the supplier it is an investment in accounts receivable. The rationale behind the widespread use of trade credit among SMEs has been argued in the literature. Ellihausen and Wolken (1993) attributed this attitude to both transaction motive and financing motive. The transaction motive suggests the better ability for both parties (the seller and the buyer) to predict

their cash needs in the short-term. As such, cash management transaction costs can be economized. The financing motive is that SMEs resort to trade credit when alternative sources of finance are unavailable or more expensive. In addition, (Fatoki & Odeyemi, 2010) argued that trade credit financing is preferred by new and young SMEs when the risk of default is high during the early years of operations. Moreover, in relation to financial motives, firms with easier access to credit market can act as a financial intermediaries and offer funding for firms that face difficulties in accessing external financing (Demirgüç-Kunt & Maksimovic, 2001).

2.2.6 Non-bank financial institution debt

As finance institutions tend to differ from banks in their lending policies possibly in part because of regulatory differences (Berger & Udell, 1998) and following Ayyagari, Demirgüç-Kunt and Maksimovic (2010) who separate bank finance from other non-bank financial institutions funding, the focus in this section is on nonbank financial institutions as the role of banks will be discussed in the later section.

Non-bank debt offers a channel for SMEs to raise funding in both developing and developed nations. In Zimbabwe, for example, loans granted by non-bank financial institutions account for nearly 30 % of total debt, and were ranked second in order of importance by domestic SMEs (Aryeetey, 1998). A more recent study conducted by the Federation of Small Businesses found that 15,000 financial institutions in the US competed to lend to SMEs, of which half were nonbank lenders in the form of credit unions (Goff & Nasiripour, 2012). Still in the US, an earlier study by Denis and Mihov (2003) using a sample of 1,560 new debt issuers firms during 1995–96 showed that of the total amount of debt of $350 billion raised by the firms in the sample, nonbank debt was responsible for almost $40 billion.

Johnson (1997) explained that while banks prefer short-term debt (as their liabilities are also short term), non-bank financial institutions such as insurance companies are generally in favour of long-term loans as they have long-term liabilities. However, Johnson (1997) believes that non-bank financial institutions can act as a financial intermediate between banks and public debt.

In general, the main advantage that encourages SMEs to use more debt than other external sources of finance in their capital structure is the tax shield benefit. In addition, when seeking external funding, SME owner–managers tend to limit the use of equity in order to meet control aversion and maintain control of their firms (Hutchinson, 1995). However, Abor (2008) found that SMEs with many shareholders (group-owned SMEs) may choose to utilize low debt levels to avoid bankruptcy and the agency costs accompanied with debt financing.

3. Research Methodology

The literature review of scholarly work spanned the period September 1995 to 2015 and was based on a systematic Keyword combination search on the following debases: UJDigispace/Multidisciplinary, Sabinet /Multidisciplinary, ProQuest MTD, Emerald on Business studies and Entrepreneurship, Scopus /Economics Engineering and Technology, OECDilibray, Oxford journals online and Socio-logical Abstracts.

The search was conducted by deducing the main keywords and the keyword variables based on the aim of this paper and above stated background. From here the search was continuously expanded with new

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keyword variables as they appeared throughout the search in the specific databases. Following this, the search was conducted in every single database by searching the main keywords in combination with every single keyword variable. Where the results exceeded 30 hits yet another and keyword variable was added to the search. The review established the source and the types of credit facilities and challenges affecting the construction SME accessing credit to be; creditworthiness of the borrower, collateral requirement by the banks, risk default and lack of business plan.

4. Summary of Findings and Discussion

The following sources of financing have been identified: equity financing, debt financing, venture capital, trade credit, business angels and non-bank financing institution debt. Others were indicated to be vendor financing in the form of loans or preference shares; loans or debentures (Aryeetey, 1998; Johnson, 1997); preference shares issued to banks and assets securitisation or Initial Public Offering (IPO).

This seems to suggest that the various types of credit available could be formal or informal. Informal sources tend to have less stringent criteria and are more easily accessible to construction SMEs, while on te other hand, formal sources are more challenging to obtain. This is partly as a result of the high risk associated with providing credit to SMEs. According to Malhotra *et al.* (2007), 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.

5. Conclusion and Recommendations

The study provided a concise discussion on access to finance issues. Issues surrounding the types and sources as well as the relative ease of accessing the various types of credit were discussed. It was suggested that construction SMEs are a risky investment. To mitigate risk, government intervention in form of credit guarantee schemes may be an effective step towards addressing access to formal finance challenges.

The central government must work hand in hand with the private sector financial services to support funding for construction SMEs. More research is needed to identify barriers to obtaining these credit facilities and feasible strategies to overcome the barriers. It is paramount for future research to assess the effectiveness of policy recommendations in the South African literature as well as monitor progress in as far as improving access to finance by SMEs concerned.

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