

## Factors Influencing the Financing of Business Start-ups by Commercial Banks in South Africa

Olwale Fatoki

Department of Business Management, Turfloop Campus, University of Limpopo,  
Limpopo Province, South Africa E-mail: Olwale.fatoki@ul.ac.za

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### Abstract

The failure rate of new business start-ups is very high in South Africa. Inaccessibility to debt finance from commercial banks is one of the causes of failure. The study examined the factors that influence the financing of business start-ups (specifically new small and medium enterprises) by commercial banks in South Africa. The websites of the four big banks were critically reviewed for the lending requirements. Interviews were conducted with four bank officials responsible for credit about the important factors that banks take into consideration when evaluating the credit applications of new small and medium enterprises. The findings indicated that the availability of business plan, collateral, maintenance of a good relationship, managerial competency and a good credit score are critical lending requirements. The study recommends that there is the need for small business owners to be proactive and be aware of the lending requirements. In addition, commercial banks need to better communicate the lending requirements to small business owners. Government agencies that assist small businesses can also help to create awareness of the lending requirements.

**Keywords:** financing, business start-ups, commercial banks, South Africa

### 1. Introduction

Small and medium enterprises (SMEs) are increasingly seen as playing an important role in the economies of many countries. South Africa suffers from high unemployment with an unemployment rate of 25.2% (Statistics South Africa, 2014). SMEs are expected to be an important vehicle to address the challenges of job creation, sustainable economic growth, equitable distribution of income and the overall stimulation of economic development in South Africa (Maas and Herrington, 2006). The contribution of the SME sector cannot be sustained without the creation of new businesses (Gree and Thurnik (2003). According to Herrington et al. (2009), given the failure of the formal and public sector to absorb the growing number of job seekers in South Africa, increasing attention has focused on entrepreneurship and new SMEs and their potential for contributing to economic growth and job creation. A new SME can be described as an SME that has being in existence for less than forty two months (Maas and Herrington, 2006).

However, despite the noted contribution of new SMEs, the creation rate of new SMEs in South Africa is one of the lowest in the world. According to Turton and Herrington (2012), South Africa's Total Entrepreneurial Activity (TEA) rate decreased from 9.1% in 2011 to 7.3% in 2012. In addition, the failure rate of new SMEs is very high in South Africa. Van Scheers (2011) notes that 40% of new business ventures fail in their first year, 60% in their second year, and 90% in their first 10 years of existence.

Various challenges and impediments prevent the creation of new SMEs as well as cause the high failure rates of new SMEs in South Africa. One of these is the non-availability of formal sector financing. Herrington et al. (2009) point out that access to finance is a major problem for the South African entrepreneur. Many entrepreneurs raise the start-up capital from their own or family savings, which is often inadequate, rather than approaching formal institutions for external finance. FinMark (2010) finds that that 75% of applications for credit by new businesses in South Africa are rejected. 2% of SMEs are able to access loans and only 2% of businesses seeking private equity succeed. Richard (2006) agrees that a finance gap exists for new SMEs and that the gap is caused by their lack of investment readiness. This suggests that the lack of access to finance cannot be placed squarely at the doors of financial institutions and investors. Arthur (2009) asserts that "*small businesses need to grow or expand, banks are cautious about how they lend their money, particularly in today's economy. How do they determine who gets a loan and who doesn't?*" Thus, it is of significance for business start-ups to understand the important factors that commercial banks take into consideration when evaluating credit applications.

## **2. Objective of the Study**

The objective of the study is to investigate the important factors that commercial banks take into consideration when evaluation credit applications from new SMEs. Understanding the factors banks take into consideration will assist in gaining a better understanding of how to improve the availability of debt finance to new SMEs in South Africa. Solving the problem of finance is important to increasing the creation rate of new SMEs and reducing the failure rate of new SMEs in South Africa

## **3. Literature Review**

### *3.1 The financial needs of new SMEs*

Winton and Yerramilli (2008) point out that once the core of the market opportunity and the strategy for seizing it are well defined, an entrepreneurial organization can then begin to examine the financial requirements in terms of asset and operating needs. Successful entrepreneurs anticipate the investment requirements of their firms so they can evaluate, select, negotiate, and craft business relationships with potential funding sources appropriately. Elsenhardt and Martin (2000) use the Resource Based Theory to demonstrate the financing needs of a firm. New SMEs need resources such as fixed assets and working capital to be able to achieve a competitive advantage in the market. Zhou and Chen (2008) point out that the lack of resources is a critical failure factor for new SMEs. The two major financial resources for new SMEs are debt and equity. These financial resources form the capital structure of a firm (Gitman, 2003).

### *3.2 Capital structure theories*

The theoretical principles underlying capital structure can generally be described in terms of the static trade-off theory by Modigliani and Miller (1958) and Modigliani and Miller (1963), the agency theory by Jensen & Meckling (1976) and the pecking order theory by Myers (1984). According to Andree and Kallberg (2008) the genesis of modern capital structure theory lies in the work of Modigliani and Miller (1958) in their famous proposition I – often referred to as the “irrelevance theorem”. The theorem suggests that, as an implication of equilibrium in perfect capital markets, the choice of capital structure does not affect a firm’s market value. Modigliani and Miller (1963) introduced the tax benefits of debt. Because interest on debt is tax-deductible, thereby creating tax savings for the borrower, it becomes possible for firms to minimize their costs of capital and maximize shareholders’ wealth by using debt. The agency theory by Jensen and Meckling (1976) gives vital insights into the problems of ownership, management interrelationships and credit rationing. Issues around information asymmetry, moral hazard and adverse selection are likely to arise in contractual arrangements between firms and external providers of finance. According to Myers (1984), the pecking order theory argues that firms should use internal finance first before moving into external finance. When using external finance, debt should be used before new equity.

### *3.3 Access to equity and debt by new SMEs*

Demircuc-Kunt et al. (2006) ascertain that the two primary sources of external finance for new SMEs are equity and debt. External equity in the form of venture capital or the stock exchange is usually not available for new SMEs. Venture capitalists often enter the firm at the middle or later stages of its life cycle. Shane (2012) contends that venture capital provided only a small proportion of the equity funding for SMEs. Venture capital funds are not interested in providing the small amounts of funding sought by many new SMEs. Less than 1% of new SMEs in the United Kingdom have financial input from venture capitalists. Berger and Udell (2002) also find that angel finance (3.6%) and venture capital (1.85%) are minor providers of funding to new SMEs in the United States. In fact, the odds that a new SME in the United States of America will get venture capital money are about 1 in 4,000. According to the South African Venture Capital Association (2008) there are at least 65 venture capital funds in South Africa controlling a total of R29 billion with an average investment size of R15.4 million. However, new venture investment with a SME focus is approximately R1.1 billion which is only 3.8% of the funds. This indicates that the availability of venture capital is limited for new SMEs in both developed and developing countries. Harding and Cowlings (2006) term this phenomenon “equity gap”. An equity gap is described as the situation where there is a shortage of equity investments during the initial stages of a firm’s life-cycle.

Blumberg and Letterie (2008) agree that the lack of venture capital funds and other sources of equity makes many new SMEs dependent on bank loans, overdrafts and suppliers credit for early-stage financing. Despite the dependence of

SMEs on debt finance, paradoxically access to debt finance is very limited for new SMEs, especially in developing countries. Commercial banks often hesitate to lend to new SMEs. This leads to a debt gap. Poutziouris et al. (2002) assert that the debt gap represents the problematic flow of debt from financial agents to SMEs. Debt finance is viewed as a critical element for the development of new SMEs. Commercial banks are one of the major sources of finance to new SMEs (Feakins, 2005).

### 3.4 Credit evaluation by commercial banks

Berger and Udell (2002) postulate that commercial banks handle lending to new SMEs through the use of some factors. These are (1) financial statement lending: Financial statement lending involves underwriting loans based on the strength of a borrower's financial statement. (2) credit scoring: this is a lending technology based on hard information about the SME and its owner. (3) asset-based lending: the financial intermediary looks to the underlying assets of the firm (which are taken as collateral) as the primary source of repayment. (4) relationship lending: this is based on soft information about the relationship between the lender and the borrower.

Hawkins (2002) points out that banks have some credit criteria that they follow in evaluating the loan applications of clients. Bbenkele (2007) agrees that SMEs are expected to meet certain criteria for the banks to be able to assist them with their financial needs. For these roles to be fulfilled, it is important that expectations from both parties are well understood by both the SMEs and the commercial banks. Arthur (2009) asserts that banks follow certain principles in evaluating credit applications and making credit decisions. The purpose of any credit assessment or analysis is the measurement of credit risk. Borrowers' credit assessment is done using the five Cs of lending; character, capacity, capital, conditions and collateral. The principle of the 5 Cs of credit is to establish the creditworthiness of a borrower. The concept if correctly applied seeks to evaluate the key criteria of repayment ability, by analysing the stream of cash flows, the character of financial discipline, and the financial health of the borrower and other qualitative factors. Pretorius and Shaw (2004) further categorize the 5C's of credit evaluation into objective and subjective criteria. Criteria that could be measured (ratios and values) are rated as objective and those where opinion or judgment was the main contribution to the decision is rated as subjective. Objective measures include capital and collateral as measured by owners' cash contribution, collateral, business plan, marketing and growth potential of the business. Subjective variables include the usefulness of the business plan and whether the owner understands the content of the plan, competent management structure and the feasibility of the business in terms of competition.

## 4. Research Methodology

Both secondary and primary data were used. The secondary data was obtained through a critical review of the lending requirements on the websites of the four big banks (ABSA, Standard Bank, First National Bank and Nedbank) and a thorough review of the literature on the requirements for lending by commercial banks. Primary data was obtained through the use of qualitative research technique. In-depth interviews were conducted with four bank officials (one from each bank) responsible for credit in Johannesburg. According to Bricki and Green (2007), qualitative research is characterised by its methods which generate words, rather than numbers, as data for analysis. Guion et al. (2011) point out that in-depth interviews are a qualitative data collection technique that can be used for a variety of purposes. In-depth interviews are very suitable for situations in which the researcher wants to use open-ended questions to obtain information in depth from relatively few people. Interviews were conducted with the participants and recorded. Each interview took about 40 minutes and was done at the convenience of the participant. The participants were encouraged to expand their answers through additional probing questions relating to the objectives of the study.

## 5. Results and Discussions

Four bank officials were interviewed about the important factors taken into consideration in evaluating the credit applications of new SMEs. The summary of the interviews is presented in each of the subsections below.

### 5.1 Business plan and financial information

*Participant 1 "We do not lend to a new small business without a business plan. We need a lot of information about the needs and the viability of the business. This can easily be obtained through the analysis of the business plan. Applications for funding by businesses are often rejected because of unworkable business plans"*

The websites of the four big banks also confirm that one of the requirements for the granting of credit to a new small business is a business plan. In addition, financial information about the company must be presented. According to Nedbank (2014), *"in an application for finance, a business plan serves two purposes. Firstly, as a management tool it forces the applicant to arrange his or her thoughts logically in such a way as to know exactly what the business entails, and to anticipate potential problems. Secondly, as a selling document, it is a tool used by the applicant to sell the company, its management and the products / services to the financial institution"* An accurate cash flow projection is absolutely critical, as it provides a clear picture of the financial viability of the business, as well as the ability of the business to service any additional debt. It can also be used as a tool to determine the amount of debt required and the period over which it is required. An application for a certain amount of finance should be justified by a cash flow projection.

Pretorius and Shaw (2004) notes that a good business plan is perceived as one of the most essential documents to be prepared by the entrepreneur or small venture owner when setting up a business. Kwok (2002) points out that business information which also includes financial information is one of the primary measures of the capacity of a business to effect repayment of credit. Kitindi et al. (2007) find that creditors, banks and other lenders use financial information provided by firms to analyse their present performance and predict future performance. Sarapaivanich and Kotey (2006) point out that new SMEs face greater constraints in accessing capital because they lack adequate financial information to enable outside investors to assess their performance. This leads to information asymmetry.

## 5.2 Collateral

*Participant 2 "Collateral is key to lending to new small business. We want to see the owner's contribution to the business and the assets that will be used to secure the credit facility"*

The websites of the banks also confirmed that collateral is one of the requirements for granting a loan. Nedbank (2014) points out that *"included in the offer letter will be a list of the collateral or security to be perfected"*. However, some banks do not require collateral for certain credit facility up to a certain amount of money. In addition, many small businesses do not have assets to put up as collateral for a bank loan. To assist these businesses, the government's small business finance agency, Khula, offers them a credit guarantee scheme.

Coco (2000) and Barbosa and Moraes (2004) note that collateral can solve problems derived from asymmetries in valuation of projects, uncertainty about the quality of projects and the riskiness of borrowers, and problems related to the cost of monitoring or supervising borrowers' behaviour. Collateral requirements also reduce moral hazard problems. When collateral requirements are in place this perverse incentive is diminished, since that sort of action would increase the chance of losing the assets pledged as collateral. Berger and Udell (2006) agree that new SMEs are the most informational opaque due to their lack of track record. Therefore taking collateral, as security is attractive to bankers for two reasons: First, the willingness to offer collateral signals the confidence of an entrepreneur in both his/her abilities and also in the likely success of the project. Secondly, taking collateral can align the interests of the entrepreneur with that of the banker.

## 5.3 Relationship building

*Participant 1 "We want to do business with a small business owner that we can trust before and after the loan is granted"*  
*Nedbank (2014) reveals that "A close relationship develops, as the success of Small Business Services depends on the success of its customers. Frequent visits to the business premises and regular analysis of key financial indicators form the basis of this relationship"*

Shane and Cable (2002) point out that relationship building and networking can be used to reduce information asymmetry in creditor/debtor relationships. Ngoc et al. (2009) ascertain that networking could be expected to provide to the banks information on legitimacy, which in turn should give the SMEs advantages in accessing commercial bank loans.

## 5.4 Competency

*Participant 3 "the competency of the entrepreneur in his line of business is a critical part of a credit analysis. We want a customer who understand their business and has the competency to make it thrive"*

*Nedbank (2014) asserts that "Do you believe you have the necessary tenacity, self-confidence, enthusiasm and commitment to hard work, the technical know-how..... for this type of business. Once you have decided that you have the personal attributes required to make a success of your business, your next step would be to prepare yourself for running your own business, and then prepare a plan for your business"*

Standard Bank (2014) notes that "banks will use all the information obtained from you to analyse the risk. We take the overall business and financial risk of your business into consideration when evaluating your loan application.

Sarwoko et al. (2013) find that business success is positively associated with the skill and the ability (competence) of the owner/manager. Bosma et al. (2004) also find that industry-specific and entrepreneurship-specific human capital contribute significantly to the performance of SMEs. Industry-specific human capital is measured by experience in industry and entrepreneurship-specific human capital is measured by high education and experience as an employee. Experience in activities relevant to business increases the firm's survival time. Managerial competencies as measured by education, managerial experience, start-up experience and knowledge of the industry positively impact on the performance of new SMEs and access to credit.

### 5.5 Credit bureau check on business and owners

*Participant 4 "Credit bureau report is part of the credit evaluation process. The report helps us to identify good borrowers"*

Berger and Udell (2002) and Gregory (2013) note that small business credit scoring is a transactions lending technology based on hard information about the SME and its owner. The information on the owner is primarily personal consumer data (e.g. personal income, debt, financial assets, and home ownership) obtained from consumer credit bureaus.

## 6. Conclusions

The creation rate of new SMEs in South Africa is one of the lowest in the world. In addition, the failure rate of new SMEs is very high in South Africa. Various challenges and impediments prevent the creation of new SMEs as well as cause the high failure rates of new SMEs in South Africa. One of these is the non-availability of formal sector financing. The two primary sources of external finance for new SMEs are equity and debt. External equity in the form of venture capital or the stock exchange is usually not available for new SMEs. This makes many new SMEs dependent on bank loans, overdrafts and suppliers credit for early-stage financing. Despite the dependence of SMEs on debt finance, paradoxically access to debt finance is very limited for new SMEs, especially in developing countries. Commercial banks are one of the major sources of finance to new SMEs. However, Commercial banks often hesitate to lend to new SMEs. The objective of the study was to analyse the factors that commercial banks take into consideration when lending to new SMEs in South Africa. The results indicated that to obtain credit from commercial banks, the business start-up must have a well-written business plan and collateral. In addition, the competency of the owner, maintaining a good relationship with the bank and a good credit score are significant factors.

## 7. Recommendations

Lack of collateral (especially lack of tangible assets and equity contribution) is one the most important reason why credit is not available to new SMEs from commercial banks. Therefore, to improve the availability of debt, there is the need for new SME owners to plan and save to have some amount of equity contribution. To get the required funding from commercial banks, it is first about the owner of the new SME getting investment ready. Training and communication on the requirements of banks can help to make new SME owners to get investment ready and thus improve the availability of debt. Commercial banks can create awareness of their funding requirements through advertisements and communication with trade associations. Government agencies can also assist in making SME owners investment ready through training. In addition, government and its agencies have, over the years, expended significant resources creating and implementing market interventions. It is vital that these interventions are effective and meet the needs of those they declare to support. It is therefore incumbent on Government and other stakeholders to ensure that these schemes, such as the Small Firm Loan Guarantee, are well publicised and available to new SMEs. There is the need for personal development by the owners of new SMEs especially in the area of business and financial management skills through training. Owners of new SMEs have to take greater responsibility for their own learning. This will enable small business

owners to have the skills to manage their business and write a business plan. The websites of the big four commercial banks have addressed business plan preparation by new SMEs. However, it is important to provide awareness to new SMEs that such facilities exist.

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