Determinants of Choice of Alternative Financing Modes for SME’s, a Review of Literature

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Abstract
The aim of this paper is to ascertain varying literature on determinants of choice of alternative financing modes for Small and Medium-size Enterprises (SME’s) with a view of enhancing the scope and access of alternative sources of finance for SME’s, owing to their unique financial needs. Increased momentum of economic growth strains formal finance, necessitating a search for alternative finance to sustain or accelerate the positive trends. Although there are quite a number of alternative sources of finance, information is lacking scanty on some alternatives while on others, it is lacking. Consequential therefrom, SME’s fail to pursue available modes of alternative sources of finance. This review therefore, uses available literature and solely focusses on the diverse determinants of choice of alternative financing modes and makes policy recommendations. This paper underscores the nexus between financial services and economic growth. That finance in SME’s determines SME’s mortality rate, recent rapid economic developments necessitate study of alternative finance. We establish scarce mention of determinants of choice of alternative financing modes. Emergent though that some determinant of choice of alternative sources of finance include formal finance constraints, SME characteristics and business environment.
Keywords: Financial services, small and medium size enterprises, alternative finance, determinants of choice, modes of alternative finance.

Introduction
Financing is crucial in the sustenance and growth of SME’s for the sake of economic development of nations the world over (Abdulsaleh and Worthington, 2013). The amount of finance in SME’s determines their mortality rate (Ayyagari, Beck & Demirguc-Kunt, 2007; Jasra, Khan, Hunjira, Rehman, & Azam, 2011). Through financial deepening, either by a supply-leading or demand following channel (Rajan and Zingales, 2003), financial services are availed. An enormous body of pragmatic research supports the view that financial systems contribute to economic growth. Still, empirical evidence reliably underscores the nexus between finance and growth. Although financial deepening endeavors such as financial inclusion stabilizes cash flow, enhances financial planning and assures financial security, for a particular segment of society (Connolly & Hajaj 2001; Maigua and Mouni, 2016; Kiai, Ng’ang’a, Kiragu & Kinyanjui 2016), it ignores informal or alternative financing sources. Recent rapid economic developments, more
so in emerging economies have spread formal finance sources thin, necessitating a closer examination of the alternative finance market with a view of expanding it to meet and surpass market needs.

**Theory**

The Pecking Order Theory proposed by Myers (1984) posits that a firm's capital structure decisions are a function of its age. The order of preference for the financing sources for the firm therefore should be internal equity, issuing debt and issuing equity (Cassar & Holms 2003). There is therefore priority of internal equity over external debt; short term debt over long term debt; external debt over external equity (Myers 1977 & 1984; Myers & Majluf 1984; Cassar & Holms 2003; Abdulsaleh & Worthington 2013). This theory is applicable for large firms as well as small firms. Since small firms are opaque and have important adverse selection problems that are explained by credit rationing; they bear high information costs, (Psillaki, 2008). Empirical support of the pecking order theory abounds, such as works by Gregory, Rutherford, Oswald & Gardiner (2005). However, Helwege and Liang (1996) empirically refute the Pecking Order patterns.

The SME financing model presented by Myers (1984); Myers & Majluf (1984 contrasts the Financial Cycle Growth Paradigm proposed by Berger and Udell (1998) which argues that financial needs as well as financing options of an SME changes as the SME metamorphoses through a peculiar life cycle. Their formative stage is usually characterized by informational opacity, lack of trade history and a high risk of failure (Cassar, 2004; Berger & Udell 1998 & 2006; Abdulsaleh & Worthington 2013; Huyghebaert & Van de Gucht 2007). Owing to these shortcomings, during their formative stage, SME capital structure is predominantly via Insider/owner funding (Cassar & Holmes 2003; Abdulsaleh & Worthington 2013). As they progress through their business life cycle, SME’s adjust their capital structure. They gradually establish a track record and collateral capabilities. This in turn improves their credit worthiness, attracting investors. The SME’s then are able to gradually substitute internal with external finance, such as venture capital, bank loans and trade credit, Chittenden, Hall, & Hutchinson (1996). At maturity, SME’s become more transparent information wise and can easily access public listed equity markets and securitized debts into the future (Berger and Udell 1998; La Rocca, La Rocca, & Cariola 2011). Proponents of this theory include Barton and Gordon (1987, Kimhi (1997) Wu, Song, & Zeng, (2008) and La Rocca et al. (2011) to a large extent. critiques of the growth-life-cycle model claim that it does not offer a complete picture of SME financial decisions and behavior. While Berger and Udell (1998) concede, Rutherford, Oswald and Gardine (2005), partially agree.

**A Case for Alternative Finance**

With increased momentum of liberalization, globalization, and resultant economic growth, there is tremendous growth in credit demand across board, more so in the emerging and developing economies. A stagnated formal finance market would only slow down economic gains made. The race to fill in the resultant credit gap is two pronged. While the formal finance providers seek to expand their products so as to be more inclusive, the affected institutions
seek alternative or informal sources of finance. Both players arrive at the same point, “Alternative Finance” for different reasons, aimed at one ultimate goal, to seal the credit gap. It is therefore imperative for both the formal finance providers and the alternative credit/finance providers to understand the determinants of choice of alternative financing mode, Isaksson, (2002). Just like any other consumer behavior study, Subhani, Hasan, Rafiq, Nayaz, & Osman, (2012), this knowledge will help credit providers to be more responsive to the needs of the SME, avail information to regulators to streamline regulation and quench the thirst for knowledge to scholars.

**A Place for SME’s**

The European Commission (EC) (2011) defines SME’s as firms in the group of Micro, Small and Medium enterprises. Firms in these groups have less than 250 employees, their annual turnover does not exceed 50 million Euro and/or their annual balance sheet figure does not exceed 43 million Euros. A number of scholars (Djokovski, Lichtenstein & Warren, 2007; EIS, 2005; and international organizations such as EU, WBG, UN & WTO use of the term SME’s, in place of the word, ‘Small and Medium sized enterprises’. However, SME classifications in terms of size vary depending on economic regions and endowments of respective countries. SME’s form the majority of organizations in developed, emerging and developing economies, Harvie, Oum & Narjoko (2010). Thriving SME’s spur employment, proper utilization of resources, poverty eradication and economic growth (Ogujiuba, Ohuche, & Adenuga 2004). SME’s have a high potential; of being labour intensive, of employment creation and competition engines. SME’s easily cut a niche for themselves and attract academic appetite.

Consequential therefrom, different researchers have focused on different financial issues concerning SME’s growth. For instance Ruire, (2010) examined factors which hinder manufacturing SME’s growth into large businesses and found among them; interest rate, business skills and dollar rate. Information of the research was obtained from a census of 49 SME’s from the industrial area of Kenya. Ruire also sought to determine financial constraints facing SME’s in the manufacturing sector. Financial costs, followed by manufacturing costs and manufacturing efficiency were ascertained as the leading factors to the influence of SME’s growth into large enterprises. Ruire is supported by Seker & Correa (2010) who ascertain that financing constraints to SME’s pose the greatest challenge to their growth.

Among those who have tackled financing of SME’s on a broader scale are Calice, Chando & Sekioua, (2012) and Valverde, Fernandez & Udell (2008). Calice, Chando & Sekioua (2012) sought to find out the bank-SME relationship in Kenya, Uganda, Tanzania and Zambia. They sought to establish the kind of financing service banks in these four East African countries offered to their SME’s. Results showed that the banks were not averse to SME’s as most people tend to believe, but were actually interested in their financial affairs. Banks sought to tailor make financial services specifically for SME’s for SME’s could not fit into services offered to large firms. The banks pointed out challenges peculiar to SME’s due to factors such as inadequate collateral, family owned structures, availability and reliability of SME information and dollar and interest rate instability.
Valverde, Fernandez & Udell (2008) on the other hand, using a sample size of 30,897 Spanish SME’s investigated the relationship between bank loans and investment for constrained and unconstrained SME’s. Results from the study showed that investment matters to unconstrained firms but not to constrained firms. Bank loans on the other hand enable unconstrained firms to enable trade credit to bank constrained firms. Trade credit was preferred by constrained SME’s while bank loan was preferred by unconstrained firms.

Isaksson (2002), narrows down and establishes the importance of informal finance in Kenyan manufacturing sector, but discovers that informal finance is not as prevalent in the Kenyan manufacturing sector as it is with SME’s. Isaksson (2002) is supported by Kihimbo, Ayako, Omoka and Otuya, (2012), who in a study to determine financing of SME’s in Kakamega municipality found that informal financing was the most significant source of finance for SME’s in the region. Informal finance was considered the best but formal finance was also crucial for the well-being of the businesses. Abdulsaleh and Worthington (2013) agree that finance is an important segment of SME’s growth and thus determine various forms of alternative finance available to SME’s.

Degryse, Lu & Ongena, (2015) take on a different dimension and establish the correlation between informal and formal finance for SME’s. They ascertain that an optimal financing mode for SME’s is a mix of formal and informal finance. Degryse, Lu & Ongena, (2015) identify that informal finance increases the growth of SME’s while it reduces the growth of large firms. The study used a sample of 1,970 firms out of 3,837 and survey data for privately owned Chinese firms of 2006 to determine results of the study. In order to achieve the optimal financing mode for SME’s as suggested by Degryse, Lu & Ongena, more focus should be put on alternative sources as well as formal financing sources for SME’s.

Determinants of Choice of Alternative Financing Modes for SME’s.

Migiro (2005; 2006) asserts that the determinants of a particular mode of financing are the factors which influence it such as the cost of debt, asset structure and availability of loanable funds among others. Migiro (2005 & 2006), argues that all firms whether big or small choose their financing options based on the nature, cost and availability of alternative sources of finance. Migiro’s sample included small and medium manufacturing SME’s in Nairobi, Kisumu, Nakuru and Eldoret. Migiro (2005) identified collateral as one of the determinants of choice of alternative financing modes in Kenya. The other determinant was cost of formal finance. The higher the cost of formal finance in relation cost of alternative sources of finance, the higher the chances of use of alternative sources. It is required that firms have a high ratio of fixed assets to total assets to increase their chances of financial assistance from formal institutions. The most commonly used alternative source of finance was personal savings, this was despite it being the least known at 67.4%.

Erick (2014) in his study to determine the effect of alternative finance on performance of SME’s in Nairobi found the major hindrances to the access of alternative sources of finance were cost, lack of collateral, guarantor requirement and lack of audited financial statements. High cost of alternative source of financing was established as the biggest hindrance while lack of audited financial statements was ranked the least. Trade credit was the most widely used...
alternative source of finance in the study, followed by invoice discounting and retained earnings. Trade credit was widely used because of its availability and ease of access. Invoice discounting and retained earnings were mostly preferred by medium sized enterprises because of their complex nature. Erick (2014) used stratified and random sampling to sample eighty five (85) SME’s from Nairobi County. Factors that necessitated the use of alternative sources of finance in Erick’s study were stringent requirements by formal financial institutions. These stringent requirements were requirements of collateral, audited financial statements and guarantors.

Dancho (2015) identified determinants of choice of alternative financing mode as debt risk, cost of financing, level of development of infrastructure and level of decentralization. This was during a study to establish determinants of choosing financial sources for municipal projects with focus on Bulgaria. The paper identified collateral to be a requirement for SME’s before a loan was advanced. Stringent capital requirements attached during advancement of loans were seen to hinder additional debt from formal financial institutions. It is such requirements, which form the determinants of choice of alternative sources of finance. The level of development of infrastructure dictated financial services and conditions available to SME’s as well as firms in general.

Benthem (2016) identified various organizational characteristics as responsible for being determinants of choice of alternative sources of finance. The factors identified by Benthem include; level of innovation of management, the size and structure of the SME, readiness for change and the network with innovation developers and consultants. The study employed a qualitative research design with six participants. Its aim was to determine factors which lead to Dutch SME’s adoption of alternative finance. Government policy and regulations were found to have no effect on the adoption process in the study. This was contrary to Mateev and Anastasov (2010), who found a negative relationship between growth of SME’s and Government policy and regulations. Data was analyzed following the framework of Wisdom, Chor, Hoagwood & Horwitz (2013). The paper concludes that majority of SME’s financing structures are in line with the pecking order theory. Benthem (2016) also aimed at establishing the effects of norms, values and cultural ties on the adoption of alternative sources of finance. Data collected from the study proved insufficient in determining the relationships, representing a research gap.

Nguyen & Luu (2013) identified determinants of choice of alternative sources of finance as extent and strength of social as well as official networks, accounting book and geographical location of SME’s. The network of the owner in terms of ethnicity was also a matter identified not to be taken lightly when considering factors which affect the decision on alternative sources of finance by SME’s. This was after establishing that managers who came from major ethnic groups tended to increase chances of financial assistance from either formal sources of finance, informal sources of finance or both. Nguyen & Luu (2013) analyzed 7900 observations from a survey conducted on 2200 small and medium sized manufacturing enterprises in Viet Nam. They aimed at establishing Viet Nam’s SME’s driving factors in choosing formal funding, informal funding and a combination of both. Identified determinants of choice of mode of financing, for either of the two sources of finance or a combination of both, are among others,
accounting book, extent and strength of the relationship between the lender and investor and owners characteristics such as ethnic group, professional know-how and age. Location in cities did not prove any significance when it came to minimizing troubles that came with formal financial aid. The study did not establish a preferred mode of alternative finance.

Njeru (2013), in an attempt to identify driving factors for entrepreneurial finance for Small and Medium Sized enterprises in Thika found; availability of information on the various sources of alternative finance, cost of finance and purpose for which funds are intended for as the driving factors for choice of entrepreneurial finance for Small and Medium Sized enterprises. There was a general consensus that information concerning various sources of alternative finance was lacking, and SME’s would be better off if they could obtain the information freely or at a fee. Various media of information, such as radio, television and magazines, were tested the extent to which they relayed information about the various sources of alternative finance. Personal contact was rated the highest communicator of the various sources of alternative finance. Njeru (2013) recommends that SME’s seek alternative sources of finance which are less costly, in the face of financial constraints. She also recommends SME’s to be aware of their short term and long term goals in order to increase their chances of financial aid from formal financial institutions. Njeru (2013) used a sample of 259 SME’s, through stratified sampling, and questionnaires administered to SME owners, financial managers and or their representatives to determine results of her study.

Bett (2013), using Finaccess’s National survey data of 2009 identified determinants of choice of alternative sources of finance in Kenya as SME’s attitudes towards formal financial institutions. SME’s negative attitudes towards formal institutions and internal regulations lead to SME’s use of informal finance. Financial rules, laws and regulations formed by financial institutions should do away with negative attitudes SME’s have towards them. Besides negative attitudes towards formal institutions, age, the level of education of individuals and distance to formal institutions were the other determinants of choice of alternative financing modes in the study. The most preferred alternative source of finance from the study was borrowing from family and friends. This was because funds from family and friends were easily accessible and attracted little or no interest.

Harvie, Oum & Narjoko (2010) found size and the stage of development of a country as the determinants of SME’s access to finance. Size of firms was discussed in relation to financial information that SME’s could give during pursuit of financial aid from formal institutions. SME’s were seen to have little information worthy of convincing formal institutions for financial assistance. Due to this, SME’s were forced into alternative sources of finance. Large firms on the other hand were seen to have formed longer term relationships and hence were in a position to receive formal financial aid easily. The stage of development of a country influences choice of financing mode through the impact on the stage of development of the country’s financial sector. The level of development of a country’s financial sector determines services, products and conditions of financial aid to firms. Countries which were keen on property rights, issues such as bankruptcy and inefficiencies in the institutional frameworks influenced choices of modes of financing by SME’s. Harvie, Oum & Narjoko, (2010) used a uniform questionnaire
on six East Asian countries; Malaysia, Cambodia, China, Thailand, Indonesia, Philippines, Laos and Vietnam to determine results of the study.

Casey and O’Toole (2014) identify bank constraints as determinants of choice of alternative sources of finance for SME’s. They identified these findings during assessment of financial constraints imposed by banks, usage of alternative finance and trade credit during a financial crisis in Europe. The study used data from European Central Bank as well as European Commission. It covered 11 countries in its analysis. The fact that it was done during Europe’s current financial crisis makes it appropriate because changes in the financial market together with their implications could be easily detected. Casey and O’Toole (2014) found out that bank constrained firms were more likely to seek alternative sources of finance than firms which were not. Bank constrained firms were more likely to seek trade credit than non-bank constrained firms. SME’s which self-rationed (SME’s which considered other modes of financing due to high costs of formal financing) were more oriented towards grant finance. There was no significant relationship between bank constraints and SME’s seeking market finance. Bank constrained SME’s sought trade credit more than the other alternative sources of finance (Casey & O’Toole, 2014).

Conclusion

This paper has considered both theory and various literature on determinant of alternative sources of finance for SME’s. Peculiarity of and the importance of SME’s has been underscored. That the battle between pecking orders theory and financial cycle growth paradigm lingers on. That finance is desiderata for SME’s for the growth and development of economies. The paper has identified that there has been little mention and inadequate focus on determinants of choice of alternative financing modes for SME’s, thereby presenting research gaps. More efforts should be geared towards determinants of choice of the various alternative sources of finance as well as availing information on and about alternative financing modes. Identified dominant determinants of choice of alternative sources of finance include formal finance constraints, SME characteristics and business environment.
References


