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# CHAPTER ONE

# INTRODUCTION

## 1.1Introduction and Background

In Nigeria, availabledata from the Registrar General Department indicates that 90% of companiesregistered are micro, small and medium enterprises (Mensah, 2004). This targetgroup has been identified as the catalyst for economic growth of the country asthey are a major source of income and employment to many Nigeriaians. Accordingto Mensah (2004) Small enterprises employ between 6 and 29 employees with fixedassets of $100 Thousand with Medium enterprises employing between 30 and 99employees with fixed assets of up to $1 Million, Hallberg (2001) put forwardthat SMEs account for majority of firms in an economy and a significant shareof employment. Like other countries of the world, SMEs in Nigeria have thetendency to serve as sources of livelihood to the poor, create employmentopportunities, generate income and contribute immensely to economic growth.Small firms are the engines for economic development of several developedcountries such as the US and Japan (Hallberg, 2001).

Developingcountries such as Zimbabwe have also identified the potential of small firms toturn economies with negative growth into vibrant ones. For this reason, severalgovernments in developing countries offer funding to small firms eitherdirectly or by guaranteeing the payment of such loans as lack of funding iscited as one of the major challenges faced by small businesses. Obert andOlawale (2010) argues that due to limited resources by governments, not allsmall firms receive funding from the government; therefore, the other option wouldbe to go for bank loans Obert and Olawale (2010)**.** Despite its increasingroles, access to credit by



SMEsremains one major constraint to Nigeriaian SMEs. According to Augusto et al(2008), most large companies usually start as small enterprises, so the abilityof SMEs to develop and invest becomes crucial to any economy wishing toprosper.

Althoughcountries' definitions of what constitutes an SME for legal or statisticalpurposes are typically based on the number of employees, banks generally defineSMEs in terms of average annual sale; an indicator that is more easilyobservable, a good proxy of an SME level of business activity, and, thus, moreuseful to banks' business and risk management purposes (Augusto et al 2008).Augusto et al (2008) further points out that the threshold of annual sales usedby banks varies by country, according to the size of the economies andstructure of their corporate sector. Augusto et al (2008) hints that inArgentina, a company is considered

to be an SME when its average annual salesare approximately between 300,000 and 30 million US dollars. In Chile, therange goes from around 90,000 to 24 million US dollars.

In Colombia,banks consider SMEs those firms with annual sales between 400,000 and 13million US dollars (although for most domestic banks the range is between100,000 and 5 million. In Serbia, SMEs are typically defined as having annualsales between 500,000 and 10 million Euros. A vast number of data on SMEs inNigeria also suggest SMEs are more financially constrained than large firms.For example, using data from 10,000 firms in 80 countries, Beck et al (2006)showed that the probability that a firm rates financing as a major obstacle is39% for small firms, 38% for medium-size firms, and 29% for large firms.

Mensah (2004)states that a major barrier to rapid development of the SME sector is ashortage of both debt and equity financing. However Mensah (2004) postulatethat
equityshortage occurs because Equity investors seek highest return consistent with



therisk of the investment and since SME investments are difficult to evaluate,their investments take time to mature and among others major institutionalinvestors such as insurance companies are not allowed to invest in privateSMEs. Hence there are many who believe that the single most important factorconstraining the growth of the SME sector is the lack of finance.

There are manyfactors that can be adduced for this lack of finance according to Mensah(2004). For instance a relatively undeveloped financial sector with low levelsof intermediation; Lack of institutional and legal structures that facilitatethe management of SME lending risk; High cost of borrowing and rigiditiesinterest rates. Thus Because of the persistent financing gap, manyinterventions have been launched by governments and development partners tostimulate the flow of financing to SMEs over and above what is available fromexiting private sector financial institutions. Karimunda and Barumwete (2006)put forward the fact that, there are several reasons why a SME need a loan suchus the financing of new branches, of new projects and more. Companies do notalways have the capacity for finance their own business that is why they havesometimes to turn to other financers. However, when companies need new capital,they firstly resort to their internal generated funds.

After thesesources, SMEs turn to equity financing by addressing closely related investors.These sources exhibit very low costs and may be for example equity capital fromthe owner, family or friends. Despite these, there are others types offinancing that one can use: external equity financing and external debtfinancing. For SMEs, possibilities for using external equity finance arelimited since the majority of these companies are privately managed. Companiescan also use venture capitalist as alternative means of equity financing.

However,these possibilities are difficult for SMEs since most of them do not alwaysmeet the return expectations. They thereby become less attractive for thisgroup of investors. Other alternatives to financing are private placements andcorporate bonds. Unfortunately, these types of financing are too expensive forSMEs or have limited resources. Therefore bank loans seem to be an appropriateway to finance SMEs' capital requirements and seem to be an appropriate way. Asa result, SMEs prefer most frequently debt funding by bank loans. The bankfinancing is tremendously attractive and seems to be realistic and a morereliable source to SMEs. Mensah (2004) states that recently, as banks and otherfinancial institutions have sought to broaden their loan portfolio, SMEs havebecome an increasingly attractive customer group. Traditionally, however,financial institutions in Nigeria have been cautious with lending to SME groupsbecause of high default rates and risks associated with the sector. Few bankshave therefore developed an explicit policy for SME target groups taking theparticular requirements and needs into consideration, an example is thedevelopment of customized financial products and appropriate credit managementsystems.

Onlyfew banks have SME specific loan products, and many of these are donor funded.Since SMEs are scarcely finance by equity due to risk in its operation amongstothers, the last resort is thus debt financing and this is usually financed byfinancial institutions through the granting of loans. Debt financing accordingto Ayadi et al (2009) continues to be the primary source of financing for SMEsin Europe, much more important than venture capital. This implies, for onething, that an efficient functioning of credit markets is of utmost importancefor SMEs – and the economy at large – to thrive. This problem seems to beparticularly severe in transition economies, whose catching-up may suffer fromcontinued wide-spread exclusionof SMEs from external bank finance. Of recent, there has been an increase



inthe recognition of the role played by small firms in national economies. Theircontribution to job creation and poverty alleviation has been recognized byseveral governments of developing countries to the extent that they now includethem in their development plans.

Abor(2005) proposed among the support structures include offering funding to thesmall firms' sector, usually at concessionary rates. But whether the use ofsuch debt improves the profitability, thereby enhancing sustainability, is notwell known Abor (2005). However, despite the importance of the small businesssector, access to finance is a frequently cited problem. Sources of capital aremore limited for SMEs compared to large firms.

Therefore,unlike large, particularly publicly-listed firms, SMEs do not have the optionof issuing shares or debentures in the capital market. Even if they are allowedto participate in the capital market, the high transaction costs associatedwith publicly issued debt and equity will be too expensive for them. Owing totheir inability to access the public debt and equity markets, SMEs tend to beheavily reliant on commercial banks as a source of debt financing (Berry etal., 2002). Research by Berry et al. (2002), documents the

reliance ofSMEs on bank debt as a source of financing. These researchers, however, pointout that access to bank debt is, paradoxically, a frequently cited challengefor SMEs.

SMEsare often relatively new and lack a consistent track record of profitabilitythat would demonstrate the capability to repay a loan. In addition, many SMEslack assets that could be used as collateral. SMEs are also more prone tofinancial distress and failure. Commercial banks, because of these factors,consider lending to SMEs a high risk. Therefore, commercial banks often denyloans or offer loans to SMEs at higher ratesof interest to accommodate the perceived high credit risk of SMEs according



Colemanand Cohn (2001). The inaccessibility of debt finance to SMEs can further beattributed to information asymmetry. Rwelamila et al. (2004) indicates thatthis arises when one party to a transaction has better information than theother.

SMEs may havemore information about their future prospects than the banks. Since banks donot have the necessary information, even small firms with profitable investmentopportunities are turned down when requesting credit facilities. Banks,therefore, introduce restrictive covenants and also collect collateral fromsmall firms to mitigate this problem Bose and Cotheren (1997).The question iswhat the impact of this loan on these SMEs is? Traditionally, debt finance hasbeen viewed as less expensive than equity. It furthermore has been used both todecrease the average cost of capital and enhance shareholders returns.

However, thereis a negative side to debt, since interest payments must be made regardless ofmarket conditions. This vulnerability is an important factor that firms mustconsider when making capital structure decisions. In addition Glen (2004) states,there is a very strong economic and statistical link between macroeconomicvariables and a firm's ability to meet debt obligations. The macro-economicenvironment implies the level of aggregate demand, the level of interest rates,and the level of inflation. A positive macro-economic environment results in arise in aggregate demand and positively impacts on the ability of a firm tomeet debt obligations.

The ability toservice debt becomes problematic when the macro-economic environmentdeteriorates; resulting in the insolvency of firms (Glen, 2004). Rwelamila etal. (2004) affirm that, during the early stages of starting a firm, many

ownerscommit themselves to the use of debt, which might be one of the sources of



financeavailable to them. The use of debt can be disastrous, as high interest ratesand unfavorable repayment schedules are often overlooked due to the pressure offinancing the firm.

Against thisbackground, the study investigates whether SMEs in developing countries can usedebt and still

remain solvent in this era of high interest rates. Furthermore,SMEs often pay interest premiums and a host of non-interest fees such asapplication and other transaction fees when borrowing from commercial banks.The cause of this is that SMEs are considered a high credit risk compared tolarge firms. This high cost of funds because of increased risk increases thecosts of debt for small firms.

**1.2Problem statement**

Inferring fromthe above, SMEs serve as sources of livelihood to the poor, create employmentopportunities, generate income and contribute to economic growth. There is alsothe potential of small firms to turn economies with negative growth intovibrant ones, not to mention the fact that most large companies usually startas small enterprises, so the ability of SMEs to develop and invest becomescrucial to any economy wishing to prosper. From the argument above the onlyeasier finance options for SMEs are loans (Debt financing) assess fromfinancial institutions, thus it's necessary to examine the impact of theseloans on the performance of SMEs. Are they having negative or positive impacton their performance .this is worth investigating because majority of thebusinesses fall within the SME category especially in developing countries.



**1.3Objectives**

The generalobjective of this work therefore is to investigate the contributions of loans to SMEsperformance.

The specificobjectives of the study are:

a) Tofind out what SMEs classify as disadvantages and advantages of accessing loans.

b) Tofind out how loans provided by financial institutions are utilized by the SMEs.

c) Toinvestigate whether loans to SMEs actually lead to increase in statedperformance or otherwise.

**1.4 Researchquestions**

a) Whatare the disadvantages and advantages of taking a Bank Facility?

b) Howdo SMEs utilize loans?

c) DoSME loans affect performance ?

**1.5 Relevance ofthe study**

A research ofthis sort is necessary with respect to the fact that;

1) Worldwide,the SMEs have been accepted as the engine of economic growth and for promotingequitable development. Thus its leverage should be of great concern.

2) Accessingfinance has been identified as a key element for SMEs to succeed in their driveto build productive capacity, to compete, to create jobs and to contribute topoverty alleviation in developing countries.

3) Smallbusiness especially in Africa can rarely meet the conditions set by financialinstitutions, which see SMEs as a risk because of poor guarantees and lack of



informationabout their ability to repay loans. Without finance, SMEs cannot acquire orabsorb new technologies nor can they expand to compete in global markets oreven strike business linkages with larger firms (UNCTAD, 2002).

**1.6Research Methodology**

**1.6.1Type of research**

The researchwill be descriptive in nature and employs the survey method in assessing theimpact of loans on SMEs development Nigeria. In order to effectively conduct avalid analysis in the presentation and analysis of the data collected on theresearch field, the researcher will use descriptive statistics such as tablesand charts to depict the relevant data. The study will utilize primary sourcesof data in which structured questionnaire are extensively used.

The purpose is to generate data aboutthe opinion and perceptions of SMEs owners in relation to the effectiveness ofloans to the performance of their companies. Thus, in addition provide means ofanalyzing the likely impact of loans on SMEs.

**1.7Scope of study**

The research covered the whole SMEindustry in Nigeria since one SME was picked randomly from each sector .namelyprimary, secondary and tertiary. Thus making it more representative of theoverall Nigeriaian industrial sector.

**1.8Limitations**

Although the data collected concentratedon one SME each from each industry, it might not have reflected a truerepresentation of realistic issues, but at least it showed a bit of whathappens in each Segment. Another limitation may the fact that a singleresearcher collected and analyze the data. Because of this, some explanationsmay be



skewed toward personalinterpretations to distort the meaning of the results. The research is alsoconstraint with time since the time frame for the thesis is limited.

**1.9Organization of the Study**

The study isdivided into five main chapters and each chapter is divided into various subsections.

**Chapterone** is the general introduction. Itelaborates on the setup of small and medium enterprises (SMEs) and itsfinancing options among others reviews also focuses on the impact of loans onSMEs and presents

problems identified. It also presents the researchobjectives, rational, methodology and scope of the study.

**Chaptertwo** reviews literature related to theproblem under study. It mainly reviews literature on Small and mediumenterprises and access to finance, Alternative sources of financing SMEs.

**Chapterthree** chroniclesthe methodology and approach for the study.

**Chapterfour** focuses on the presentation of data andanalysis of the data collected. It starts with the test Accessibility toloans and moves on to establish loans Contributions toward SMEs Sales andMarketing Activities and overall performance. Chapter five which is the finalchapter is the presentation of the major findings, conclusions andrecommendations.

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