THE ROLE OF BANK FINANCE IN SMALL FIRM GROWTH – A CASE STUDY

Thesis

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Sandra Musengi

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ABSTRACT

The debate concerning small firm access to finance continues. The proliferation of research of the issue underlines the importance attached in promoting a strong entrepreneurial culture within a country. Small firms are significant to economic growth if they are growing. Central to this significance is ascertaining the role of finance and in particular bank finance in accelerating small firm growth potential. The case study, through its ontological, epistemological and methodological position, draws on a document review and interview material from small firm owners and key informants to explore the role of bank finance in small firm growth. Case study evidence reveals that small firm owners do not intend to finance firm growth with bank finance but prefer to finance growth with internally generated funds. The owners indicate that non-financial and behavioural factors, such as, maintaining decision-making control, experience accessing bank finance, the perception of the banking relationship and growth aspirations of owners may be more important in determining the finance structure for firm growth. From the bank's perspective, findings suggest that risk assessment, financial viability of the enterprise and provision of collateral are more important in the lending decisions; findings supported by an analysis of selected documents. The small sample of small firm owners, bank representatives, experts and documents makes it difficult to generalize the findings. However, the findings are significant because exploring the issue from different perspectives presents invaluable insights, which can be investigated further to assist small firm owners, to develop finance products geared for small firm operations, and in the development of the knowledge base on finance-related issues in the South African context.

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ACRONYMS USED IN THE STUDY

CDE	**-**	Centre for Development and Enterprise
DTI	**-**	Department of Trade and Industry
OECD	-	Organization for Economic Co-operation and Development
SACOB	-	South African Chamber of Business
SME	-	Small and Medium-sized Enterprises
SMME	-	Small, Medium and Micro Enterprises

CHAPTER 1

INTRODUCTION

1.1 The study in context

Small firms continue to be investigated in the attempt to understand the complex yet integral entities of the economy. In addition, the potential of entrepreneurship transforming economies has generated wide interest from researchers locally and internationally. The study of entrepreneurship has become an important aspect of small firm research where entrepreneurship represents more than just an increase in the number of small firms in existence. Entrepreneurship represents a fundamental shift in the mindset in the way business operates in the business environment (Morris, Kuratko and Schindehutte, 2001). In addition, the role of the small business sector as both a driver and contributor to an economy's development at both regional and national levels has been recognised as significant and vital (Hill and McGowan, 1999; Morris and Brennan, 2000; Foxcroft, Wood, Kew, Herrington and Segal, 2002). Behind the individual small firm is the entrepreneur, who driven by opportunity, seeks to either start up a venture or expand an existing venture. Interested parties in South Africa, including the government and its support structures, non-governmental organisations, and banks to name a few have recognised the potential of the sector and in response, have established numerous support structures to foster small firm entrepreneurship. However, few small firms survive beyond the initial few years of existence (Business Times, 1997) and hence the uncertainty of the contribution of the small business sector to the economy (Karungu, Marabwa and Stettler, 2000). Central to this uncertainty is the potential of small firms to grow once created.

Small firm growth, a complex process is a defining feature of an entrepreneurial small firm (Wickham, 1998). Small firm growth is dependent on the desire of entrepreneurs' and the extent to which external factors such as government legislation and access to growth finance foster or hinder intended growth. Central to small firm growth is the issue of resources and for the purpose of this study, the attention is on the role financial resources and in particular, bank finance for intended the growth. Hill and McGowan (1999) posit that the small firm will remain entrepreneurial in pursuing growth if the entrepreneur continues trying to find a fit between elements of the dynamic growth process. This requires the need to develop entrepreneurial finance to cater for the needs of small firm growth and minimize finance gaps that may exist between small firm finance demands and investor supply of finance (Deakins, 1999; Smith and Smith, 2000). Barriers to finance may have identifiable outcomes; for example, inadequate funding will affect the speed and growth of firms and raises the question of whether small firms are actively seeking external finance for growth (Deakins, 1999); the overriding question for this research study.

Exploring the role of bank finance in small firm growth was of interest to the researcher because of four reasons. Firstly, the researcher supports Morris and Kuratko (2001) who concluded that the outcomes of entrepreneurial behaviour process are, firstly, the creation of the small firm and secondly, continued entrepreneurial behaviour results in the growth of the business. However, the entrepreneurship process in some small businesses may not continue once the venture is created. For the researcher, the interest lay in understanding how entrepreneurship may become a continued process to promote small firm growth. Secondly, though many small businesses may desire to grow their ventures, they begin to encounter barriers in their expansion efforts. For the researcher, the question that needed to be answered is why most small firms in previous studies (Rae, Ratcheva and Vyakarnam, 1997; Viviers, Van Eeden and Venter, 2001) indicate access to finance as a barrier to growth. Although several finance options exist for the small firm, bank finance is regarded as the most important source (Second Round Table of Bankers and SMEs, 1997) and thus the focus on bank finance for this study. Thirdly, although substantial literature exists on small firm entrepreneurship of the local and international types, local research on finance issues is limited in its scope. Entrepreneurship and small businesses are encouraged by local business conditions; there is the need for local research in the area. The final reason to pursue the research was the limited research and literature on process issues such as the decision-making associated with financing growth though literature on number of small firms and their characteristics was well documented.

The existing local literature focuses on barriers to access finance (Pitt, 1996; Foxcroft, *et al.,* 2002), types of finance and how to obtain finance available to the small business (DTI, 1998; Falkena, Abedian, Von Blottniz, Coovadia, Davel, Madungandaba, Masilela and Rees, 2001) to name a few. In addition, the small business sector is heterogeneous, thus for research to be useful, investigating small business phenomenon must be in light of the differences of the sector. Examples of these differences include size, age, risk profile of enterprises and types of entrepreneurs.

1.2 Purpose of the study

Currently, local knowledge of small firm owners' decision-making concerning growth and about the entrepreneurial behaviour in financing the growth is limited. The purpose of the study will be to explore the role of bank finance in small firm growth from the perspectives of small firms owners, a bank small business advisor, experts and documents.

1.3 The study questions and objectives

The grand question of the study is: What is the role of bank finance in small firm growth? The sub-questions exploring the issue of finance in the growth decision and include: What is the bank's perception of the entrepreneur and the small business sector? What are the growth objectives of the small business owners? What are the small business owner's and the bank's perception of small business finance needs? What is the role of the banking relationship for lending decisions?

Providing answers to these questions will address the study's objectives to:

- Provide insights into practices of small firm owners' with respect to decision-making for financing the firm's growth
- Present views and opinions on bank finance for growing the business

- Provide insights of the underlying decision-making elements of small firm regarding financing growth
- Provide insights on the issue from the bank's perspective, and
- Provide recommendations in light of the findings.

1.4 Scope of the study

As the study was exploratory, the study confined itself to interviewing small firms owners in Grahamstown (in the Eastern Cape province), who had been in existence for at least two years but not for more than five years. In addition, the bank finance in the research was limited to investigating was bank loans consequently other forms of bank finance, for example, factoring, leasing, the Khula guarantee scheme and hire purchase were not investigated.

1.5 Outline of the study

Chapter 1 sets the context for the study, explains the purpose of the study, presents the research questions and the objectives of the study, and the scope of the study.

Chapter 2 provides background to the nature of entrepreneurship and its role in small firms. A multidimensional approach forms the basis of discussion on entrepreneurship and the small business sector. The chapter presents evidence on entrepreneurial activity in South Africa and in the Eastern Cape province and where possible the chapter provides international comparisons.

In Chapter 3, the researcher reviews literature on small firm growth. Several theoretical models are discussed to provide insight on the complex issue of small firm growth.

Chapter 4 discusses the issue of finance in the growth phase of the business. The study particularly focuses on bank finance and provides extensive literature and discussion on the matter. The previous chapters (Chapters 2 and 3) are worked into the discussion to get insight on the role of bank finance for small growth from the literature perspective.

The study's research methodology is discussed in Chapter 5. The chapter discusses several issues on the research design including the research paradigm, the research method, data collection procedures, data analysis, and the issue of quality in qualitative research.

Chapter 6 presents the findings and the analysis of the key findings from the interviews and selected documents.

Chapter 7 presents the discussion of the study's findings and in light of the literature presented in Chapters 2-4.

Chapter 8 provides conclusions from the case study and recommendations of the study for small businesses, banks and further research. The significance of the study is discussed and the chapter concludes with the limitations of the study.

The appendices include the interview protocols for small firm owners', bank SME Business Advisor, an entrepreneurship expert and a Rhodes University academic.

CHAPTER 2

SMALL FIRM ENTREPRENEURSHIP

2.1 Introduction

A description of the small firm context is essential before addressing the nature of finance-related issues of small firms. The experience of prospering nations suggests that the small business sector is at the forefront of local economic development (Kesper, 2000). Furthermore, South Africa's recent integration into the world economy places pressure on the capabilities of South African businesses at both international and local levels. Thus, encouraging entrepreneurship in the small business sector is gathering momentum in South Africa. The small business sector has grown in importance for a number of reasons, namely the sector's potential for employment creation, source of innovation, as a means to create and redistribute wealth, and its critical role in economic development (Pitt, 1996; Kesper, 2000).

This chapter presents a discussion on the nature of entrepreneurship in small firms with an emphasis on the multidimensional approach to small firm entrepreneurship. The multidimensional approach to understanding small firm entrepreneurship examines the external environment, the individual, the firm and the process involved in shaping entrepreneurial behaviour and creating different types of entrepreneurship. The chapter proceeds to discuss the small business sector detailing evidence of entrepreneurial activity and the sector's importance for the South African economy. The chapter concludes with a discussion on international entrepreneurial activity highlighting particular countries' activities.

2.2 The nature of entrepreneurship

Currently, defining entrepreneurship involves more than just an increase in small business activity; entrepreneurship represents a new perspective on how one thinks about business, life, and the environment in which people and ventures operate (Morris, *et al.,* 2001). Entrepreneurship can be explored by examining the concept of entrepreneurship and the approaches associated with the nature of entrepreneurship.

2.2.1 Defining entrepreneurship

Researchers continue the debate on identifying and presenting a generally accepted definition of entrepreneurship; however, from Table 2.1, it is evident that this is difficult and instead differing perspectives of a definition of entrepreneurship exist.

Table 2.1: Definitions of entrepreneurship

Creation of Wealth	Entrepreneurship involves assuming the risks associated with the facilitation of production in exchange for profit
Creation of Enterprise	Entrepreneurship entails the founding of a new business venture where none existed before
Creation of Innovation	Entrepreneurship is concerned with unique combinations of resources that make existing methods or products obsolete
Creation of Change	Entrepreneurship involves creating change by adjusting, adapting, and modifying one's personal repertoire, approaches, and skills to meet different opportunities available in the environment
Creation of Employment	Entrepreneurship is concerned with employing, managing, and developing the factors of production, including the labour force
Creation of Value	Entrepreneurship is a process of creating value for customers by exploiting untapped opportunities
Creation of Growth	Entrepreneurship is defined as a strong and positive orientation towards growth in sales, income, assets, and employment

(Source: Morris and Kuratko, 2002:23)

From Table 2.1, defining entrepreneurship as 'creation of innovation' mirrors Schumpeter's (1976, cited in Hamilton and Harper, 1994:3) perspective of the phenomenon where the role of entrepreneurship is to "reform or revolutionize the pattern of production by exploiting an invention". In contrast, Van Aardt, Van Aardt and

Bezuidenhout (2000) define entrepreneurship in terms of initiating, building and expanding a venture with the intention of staying in the marketplace for an extended period. The definition provided by Van Aardt, *et al*., (2000) demonstrates the difficulty of presenting one definition of entrepreneurship. Their (Van Aardt, *et al*., 2000) definition contains elements of creating enterprise, creation of change, and creation of growth. Stevenson (1997:8) defines entrepreneurship as "the pursuit of opportunity without regard to resources currently controlled" highlighting the risk element associated with the creation of wealth approach to defining the phenomenon. Central to the definitions in Table 2.1 and others mentioned is the performance of an activity and as such, in a broad definition, entrepreneurship encompasses a process. The differing perspectives on the phenomenon suggest the influence of entrepreneurship for venture creation as well as venture expansion. Entrepreneurship in this study will be defined according to the definition presented by Van Aardt, *et al.,* (2000) because of the explicit reference to the role of entrepreneurship in both venture creation and venture growth.

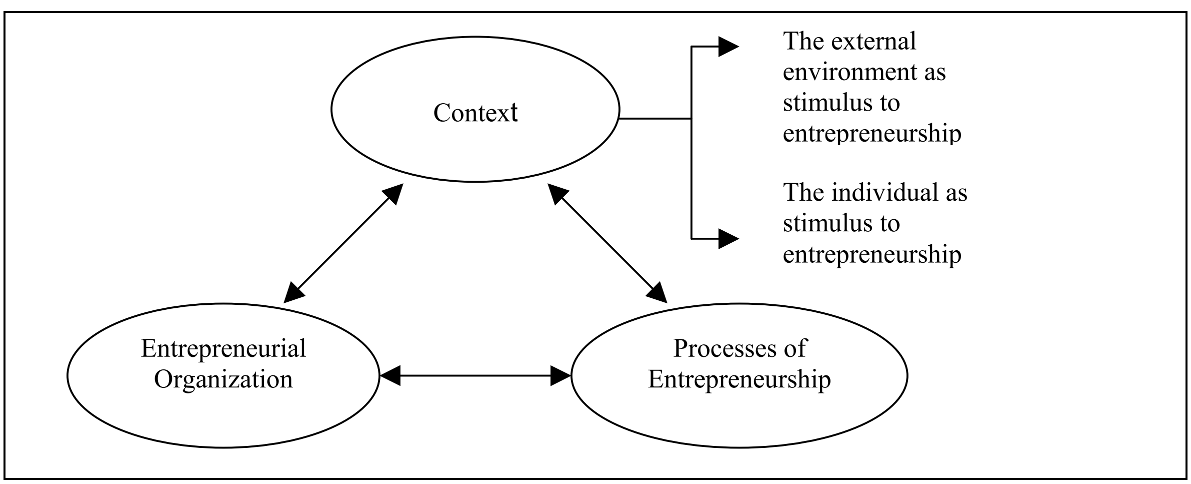
Though no comprehensive theory base of entrepreneurship exists, researchers postulate different approaches to examine and understand the nature of entrepreneurship. For example, Kuratko and Hodgetts (2001) examine activities influencing entrepreneurship with a 'schools of thought' approach, which divides entrepreneurship into macro and micro viewpoints. The macro view of entrepreneurship focuses on external factors such as the business environment and financial markets, which determine success or failure of entrepreneurial firms. The individual often cannot control these factors (Kuratko and Hodgetts, 2001:35). In contrast, the micro view of entrepreneurship examines factors, which the potential entrepreneur can control; for example, venture opportunity and strategic orientation of the firm (Kuratko and Hodgetts, 2001:36).

The other category of approaches developed to understand the nature of entrepreneurship is the 'process' approach that includes the entrepreneurial events approach, the entrepreneurial assessment approach, and the multidimensional approach. The entrepreneurial events approach described by Bygrave (1989, cited in Kuratko and Hodgetts, 2001:36) suggests that individuals plan, implement, and control their entrepreneurial activities by focusing on initiative, organization, administration, relative autonomy, risk taking, and the environment. The entrepreneurial assessment approach developed by Ronstadt (1984, cited in Kuratko and Hodgetts, 2001:41) stresses making assessments "qualitatively, quantitatively, strategically, and ethically in regard to the entrepreneur, the venture and the environment." The multidimensional approach presented by Johnson (1990, cited in Kuratko and Hodgetts, 2001:41) views entrepreneurship as a complex framework that focuses on the individual, environment, firm and the venture process. For the purposes of this study, the multidimensional approach forms the basis of discussion in understanding the nature of small firm entrepreneurship. The researcher supports this approach because it offers a comprehensive approach to understanding the nature of entrepreneurship and encapsulates aspects of the other approaches presented in the discussion.

2.2.2 Multidimensional approach to entrepreneurship

Figure 2.1, a model presented by Maas and Fox (1997) is useful in discussing the multidimensional approach to entrepreneurship.

Figure 2.1: A multidimensional approach to entrepreneurship



(Source: Maas and Fox, 1997:9)

Entrepreneurship, according to Maas and Fox (1997), results from the interaction between the following variables – the external environment (context), the individual (context), entrepreneurial organization, and the processes of entrepreneurship. The discussion on context centres on the external environment and the individual as the stimulus for entrepreneurship in an economy.

2.2.2.1 External environment stimulus for small firm entrepreneurship

Lee and Peterson (2000:402) challenge that entrepreneurial success depends mainly on the "traits or behaviours of individuals". Lee and Peterson (2000) advocate that the small firm-external business environment interaction is central for the continued existence of the small business sector. From as far back as 1993, Coetzee, Havenga and Visagie (1993:1) concluded that successful small firm entrepreneurship would require extensive networks and would have to develop a better relationship with its external environment; a stance supported by Lee and Peterson (2000). Furthermore, the environment in which small firms operate determines the strength and occurrence of their activity in an economy (Coetzee, *et al.,* 1993; Lee and Peterson, 2000; Morris and Brennan, 2000). The factors influencing entrepreneurship development discussed in this study are those factors identified in the Global Entrepreneurship Model (GEM) conceptual model (Foxcroft, *et al.,* 2002) within the broad headings of political-legal, economic conditions, social and cultural norms, infrastructure development, research and development transfer, and barriers to entry. The discussion presents evidence on how these factors influence the development of entrepreneurship and discusses it within the South African context. Given that the study was undertaken in Grahamstown, the Eastern Cape provincial context, will also be discussed to provide insights on the development of entrepreneurship at regional level compared to overall development at national level. The contribution by Foxcroft, *et al*., (2002) in their research is their distinction between formal and informal entrepreneurs operating in South Africa and the impact of the environment for the respective groups. However, for the purpose of this study, formal enterprises are the focus of the discussion.

2.2.2.1.1 Political-legal factors

The direct actions or inactions of governments are influential for creating the conditions needed for encouraging entrepreneurship and specifically, the level of entrepreneurial activity in a country is related directly to the country's regulations and policies (OECD, 1998). The political-legal factors discussed for the purpose of this study include of government and its support agencies and regulation.

Support of Government and other agencies

The South African government acknowledges that the small business sector is a key driver and contributor to economic growth at both national and regional levels (Pitt, 1996; Rogerson, 1997; Kesper, 2000; Morris and Brennan, 2000). The small business sector of the economy is thus important to the future prospect of South Africa, in terms of employment creation, black economic empowerment, improving income distribution, innovation, competitiveness, and improving regional economic growth (Pitt, 1996; Rogerson, 1997; SACOB, 1999; Kesper, 2000; Viviers, *et al.,* 2001). In recognition of the sector's potential to achieve these national objectives, the South African government has committed to its growth. The establishment of the following bodies reflect the government's commitment:

At national level, the Department of Trade and Industry (DTI) is the coordinating body for policies and programmes designed to promote the small business sector. The DTI established Ntsika Enterprise Promotion Agency (Ntsika) and Khula Enterprise Financial Limited (Khula). Ntsika is responsible for promoting and coordinating non-financial services such as enterprise management and entrepreneurship training to the small business sector. Ntiska also promotes government's three major efforts in entrepreneurship development. These include promoting local business support centres (LBSCs), manufacturing advice centres, and techno-entrepreneur programmes designed to concentrate on manufacturing support for the small business sector (CDE, 1999). Khula is responsible for promoting small firms' access to financial services (Pitt, 1996).

In addition, the responsibility for providing support and assistance to small firms falls upon a wide range of institutions, associations, and agencies. The support structures within the different provinces are unevenly developed. For example, the Western Cape, Gauteng and KwaZulu-Natal appear relatively well developed in terms of skills and capacity to support the small business sector. Furthermore, in comparison to other parts of the country, these provinces have a relatively large number of non-governmental organizations (NGOs) committed to the small business sector promotion. This, however, for example, is not the case in the Eastern Cape (Pitt, 1996; SACOB, 1999).

It is difficult to assess the overall impact of such initiatives in fostering entrepreneurship in South Africa. However, evidence from many projects suggests support structures have so far failed to achieve their objectives. Reasons are varied, but include:

- The inability to recognize the scale and intensity of support required by small and emerging businesses,
- The lack of awareness of government's programmes for promoting the small business sector by entrepreneurs due to the poor execution of promotion activities by the respective support agencies,
- The adoption of projects which are not sufficiently targeted, and which seek to achieve too many objectives, and
- The recognition of the limitations of direct interventions in the face of a macro-economic and regulatory environment, which may be hostile or indifferent towards the growth, and development of the small business sector (SACOB, 1999; Foxcroft, *et al*., 2002).

Regulation

The government can ensure that markets function efficiently by removing conditions that create barriers, market imperfections, and unnecessary regulation (OECD, 1998). The small business sector's perceptions on development, enforcement, and reliability of South

African statutes, regulations, and policies are critical in investment decisions (Ahwireng-Obeng and Piaray, 1999). Ahwireng-Obeng and Piaray (1999) identified six institutional obstacles in their study and suggested that their removal would facilitate the development of the small business sector. According to Ahwireng-Obeng and Piaray (1999:78), the South African government "has failed so far to minimize institutional uncertainty in its efforts to promote productive entrepreneurship on a large scale as a strategy for combating the country's foremost problems of unemployment and inequality." A discussion of the institutional obstacles follows.

Firstly, the uncertainty of laws and policies in South Africa can intensify, if small firm owners do not know the government's position on laws and policies. The impact on the small business sector is greater because of insufficient knowledge and participation in the drafting of new regulations (Ahwireng-Obeng and Piaray, 1999). Secondly, the credibility of government is important. From the study, small businesses perceived uncertainty of laws and policies as problems for engaging in entrepreneurial activities, for the following reasons. Entrepreneurs were of the opinion that the government had failed to consider their concerns communicated directly by them or through their business associations. In addition, entrepreneurs were inadequately informed of new regulations that affect their businesses and, finally, entrepreneurs found it difficult to cope with changes in these regulations (Ahwireng-Obeng and Piaray, 1999).

The third barrier, which South African entrepreneurs highlighted, was crime and security stating that it was one of the most serious obstacles in operating a business (Ahwireng-Obeng and Piaray, 1999; Viviers *et al*., 2001). The high levels of crime limit investment into the small business sector in South Africa because the cost of doing business increases (Ahwireng-Obeng and Piaray, 1999). The fourth institutional barrier is bureaucratic corruption and red tape. Results from the study indicate that entrepreneurs did spend time with government agents discussing changes and interpretation of laws and regulation (Ahwireng-Obeng and Piaray, 1999). However, according to Ahwireng-Obeng and Piaray, (1999:81) entrepreneurs did not invest in entrepreneurial activities "because of the problems relating to complying with government regulations and red tape."

The fifth barrier was the government-business interface, entrepreneurs in the study revealed that tax rates and regulations were restraining the government-business interface, as South African corporate tax regimes are among the highest in the world (Ahwireng-Obeng and Piaray, 1999). The three labour acts – the Labour Relations Act, the Employment Equity Act, and the Basic Conditions of Employment Act – add, according to Ahwireng-Obeng and Piaray, (1999:83) to the "inflexibility of the labour market and the cost of doing business" in South Africa. Finally, results from the study indicate the reliability of the judiciary as an obstacle for a number of reasons. The judiciary system lacks independence; moreover, the judiciary has little influence and power to enforce rulings and finally, the judiciary institution is inefficient (Ahwireng-Obeng and Piaray, 1999). These factors influence the level of entrepreneurial activity, as small businesses may perceive the judiciary system as one that does not offer the protection they require. The levels of government support, either through its support structures or regulation, may either encourage or hinder the existence of entrepreneurship in an economy (Ahwireng-Obeng and Piaray, 1999).

In addition to the identified institutional barriers, regulations and policies for the small business sector are limited. The extent of the National Small Business Act, 1996 is outlining the various bodies for promoting entrepreneurship and more importantly classifying the small business sector. However, the financial regulation of the small business sector is dependent on other legislation, for example, the Banks Act (1990) and the Usury Act, 1968 – viewed as a constraint by the banking sector in banks participation in the sector (Falkena, *et al.,* 2001). Economic factors are a direct outcome of government regulation and policies and these have an impact on creating an environment conducive to entrepreneurial activity.

2.2.2.1.2 Economic factors

The economic factors that influence the development of small business sector include economic indicators, capital availability, and unemployment. Table 2.2 presents key economic indicators for South Africa and the Eastern Cape province.

Table 2.2: Selection of key economic indicators

	Eastern Cape
Contribution to GDP (1999)	7.5%
Disposable income per capita (2000)	R7 792
Household expenditure (2000)	R52bn
Unemployment (strict definition) (1999)	29.8%
Employees earning <R500 a month (1996)	31.5%
Employees earning >R4 500 a month (1996)	8.5%

(Source: Kane-Berman, 2000:4; Forgey, Dimant, Corrigan, Mophuthing, Spratt, Pienaar and Peter, 2000: 378)

The Eastern Cape contributes 7.5 per cent to the country's gross domestic product (GDP) compared to Gauteng's contribution of 42.0 per cent. However, in a recent study by Statistics South Africa, the Eastern Cape's GDP grew by 5.3 per cent in 2001, which is above the national average of 2.8 per cent (Eastern Cape Development Corporation, 2002). However, the Eastern Cape unemployment figure (29.8 per cent) is the second highest in the country, consequently, the potential of the small business sector to absorb the excess labour cannot be understated. However, disposable income is low with only 8.5 per cent of the Eastern Cape population earning more than R4500 per month in 1996. The economic indicators signal the potential of small firms to counter the levels of poverty in the region and the ability to start new ventures depends on the capacity to engage in entrepreneurial activity in the region.

Capital availability

Issues linked to the availability of capital for small firms include access to finance, the performance of the Rand, and interest rates linked to lending. The main demand from small businesses is for accessible and affordable finance; currently, established institutions are not providing for this need (Pitt, 1996; Viviers, *et al*., 2001). In addition, banks have small business divisions in their operations but most black owned businesses still find it impossible to acquire loans from commercial banks because of in most instances, the entrepreneurs' inability to provide collateral required by banks (Pitt, 1996), a finding substantiated by recent research by Foxcroft, *et al.,* (2002). The finding in the

South African GEM research indicates that, although availability and access to finance is a problem for small business, the extent of the problem is dependent on the type and size of the business (Foxcroft, *et al*., 2002). Small firms in the Eastern Cape experience a lack of start up capital, operating capital and investment funds with their major sources of funding including personal savings, friends, and family (Pitt, 1996). Small firms who seek access to financial resources from banks have to show that they are 'financially secure' enterprises. Furthermore, banks are the main source of external finance for entrepreneurs and yet the bank-small business interface is poorly managed (Foxcroft, *et al*., 2002); a key issue in access to finance. Provincial small business councils suggested Khula provided inadequate backing and firms who made use of its loan guarantee scheme with commercial banks still encountered high interest rates (Pitt, 1996).

The fluctuating performance of Rand against the US Dollar may further hinder loan grants. Table 2.3 presents the performance of the Rand against the US Dollar for the period 1990 – 1999.

Table 2.3: Rand Performance: 1990-1999

Year	**1990**	**1991**	**1992**	**1993**	**1994**	**1995**	**1996**	**1997**	**1998**	**1999**
Value of commercial Rand in US $	0.39	0.36	0.35	0.31	0.28	0.28	0.23	0.22	0.18	0.16

(Source: Forgey, *et al*., 2000:452)

Table 2.3 discloses the Rand's depreciation over the last few years. The depreciating Rand has negative effects, such as higher operating costs for small businesses with some banks or lending institutions not convinced of the firm's ability to pay back loans (Forgey, *et al*., 2000). However, the past few months show improved performance of the Rand. The other issue affecting the availability of finance is the interest rate associated with lending. Currently the prime lending rate is 17 per cent and this represents a high cost for the borrowing small firm. Availability of capital is important in fostering entrepreneurship because it is part of the entrepreneurial process of marshalling resources needed to exploit the identified opportunity (Timmons, 1999).

2.2.2.1.3 Social and cultural factors

The social indicators and the enterprising culture of the country and province have an impact on the number of potential businesses created and developed. Table 2.4 presents key social indicators for the Eastern Cape.

Table 2.4: Social Indicators for the Eastern Cape

	Eastern Cape
Population (mid-year estimates) (2000)	6798 010
Annual growth rate	1.9%
Formal urbanization level (2000)	42.9%
Population in poverty (Census 1996)	74.3%

(Sources: Kane-Berman, 2000:2-4, Forgey, *et al*., 2000:378)

The Eastern Cape has the second largest population group in the country and at the same time has one of the highest poverty levels. Entrepreneurship is viewed as a vehicle that can redress issues such as poverty alleviation, wealth distribution and employment of creation (Pitt, 1996; Rogerson, 1997; Kesper, 2000; Viviers, *et al*., 2001). Morrison (2000:62) adds “culture is important in any discussion of entrepreneurship because it determines the attitudes of individuals towards the initiation of entrepreneurship.” A country’s current business environment in part influences the extent of an entrepreneurial culture existence in addition to the individual’s unique characteristics and motivations for engaging in entrepreneurial activities.

In a South African study, O’Neill and de Coning’s (1994) findings from their Delphi study (with 13 people selected on the basis of their sound knowledge of socio-economic issues and/or involvement in small business development) defined enterprise culture as “a culture which encourages/enables people to show initiative and to play an active role in shaping their own futures, in individual or group context." O'Neill and de Coning (1994:16) concluded from their study that the key elements of enterprise culture included "a positive policy framework, a deregulated environment, appropriate training / development …societal values and ethics [and] creativity/innovation". The South African entrepreneurial culture has enjoyed greater exposure in the local media and experts in the GEM study described local entrepreneurs as resilient, resourceful and willing to make sacrifices (Foxcroft, *et al*., 2002:50). However, several factors undermine the development of a strong entrepreneurial culture needed for entrepreneurial activity in the economy. For example, small business failure, continued racial and cultural divisions in business and the strong inclination for a job over self-employment deter increased involvement in entrepreneurial activity (Foxcroft, *et al*., 2002).

2.2.2.1.4 Infrastructure development

South African small businesses have access to good physical infrastructure, for example, port and harbour services in comparison to other developing nations. However, cheap methods of transport, namely rail and road are unreliable and although extensive telecommunications structures and computer networks exist, these are costly for small businesses (Foxcroft, *et al*., 2002). The South African commercial and professional infrastructure such as legal, accounting, and banking services adequately services the formal small business sector (Foxcroft, *et al*., 2002). However, Foxcroft, *et al*., (2002) highlight the shortage of business skills in the small business sector and the training offered is general in nature with little practical application for the small firm.

Infrastructure development includes information accessibility in the Eastern Cape for potential new businesses, education indicators (viewed as an important entrepreneurship pull/push factor), and the labour market. Table 2.5 presents the important infrastructure indicators for the Eastern Cape.

Table 2.5: Key infrastructure indicators

	Eastern Cape
Education Indicators	
Literacy rate (Census 1996) 1999	73.1%
Proportion of adults with no schooling (1999)	20.9%
Proportion of adults with Std 10/ Grade 12 (1999)	11.1%
Proportion of adults with higher education (1999)	4.7%
Labour Indicators	
Labour force (1999)	1 419 000
Labour force annual growth (1980-1996)	2.8%
Employment annual growth (1980-1996)	(0.5%)
Adults trained for work 1999	11.5%

(Source: South Africa Survey, 2000: 2-4, Forgey, *et al*., 2000:378)

The labour force is key to the development of the small business sector. From Table 2.5, the indicators highlight that the Eastern Cape does have a high labour force but the level of unemployment is high and from the indicators, the employment growth rate has actually been decreasing. These factors influence development policies for entrepreneurship in the Eastern Cape. Furthermore, in the Eastern Cape, information accessibility is underdeveloped in comparison to other provinces. This influences the spreading of support structures and support to far and remote places (Pitt, 1996).

2.2.2.1.5 Research and development transfer

South African entrepreneurs find it difficult to access finance to develop product prototypes and undertaking feasibility studies. However, the emergence of business incubation centres improved the commercialization process for some businesses (Foxcroft, *et al*., 2002).

2.2.2.1.6 Barriers to entry to the business sector

The main barriers to entry small businesses experience include compliance with standards, access to tenders, and the inability to provide outsourcing services to large organizations. In addition, the small business sector's inability to create or provide innovative product and services lowers the barriers to entry, a reflection of the types of entrepreneurship (Foxcroft, *et al*., 2002).

Having discussed the environment as a stimulus for entrepreneurship, the focus will shift to the individual. Kesper (2000:1) suggests small business performance relies not only on supportive environments, but also on the "industrial and organizational structures, the adaptiveness of firms and, above all, the capabilities, and aspirations of the entrepreneur."

2.2.2.2 The individual as stimulus to small firm entrepreneurship

The debate on defining the entrepreneur is one that has and continues to challenge researchers. The term entrepreneur dates back to 1755 and Cantillon (1971, cited in Hamilton and Harper, 1994:3) who described "the function of the entrepreneur as one that involved buying country produce at a certain price and then selling it again at an uncertain price." The description of the entrepreneur progressed from one where the entrepreneur was a profit maximizer to one where the attention was on what was expected of the entrepreneur to manage the activities associated with the enterprise (Say, 1964 cited in Hamilton and Harper, 1994). The debate continued and Schumpeter (1934, cited in Khan, 1957), adding the dimension of innovation, defined the entrepreneur as a "leader because he has to face and overcome a number of difficulties involved in carrying out innovations". Research in this area continues and several schools of thought on a definition of the entrepreneur have emerged.

The 'great person' school concluded that the entrepreneur was born with the intuition and traits associated with being an entrepreneur. Bridge, O'Neill and Cromie (1998:26) define the 'great person' entrepreneur as a person with "unique values, attitudes, and needs that drive them." Influences on the entrepreneur's behaviour are risk, need for achievement, and personal values and they too thrive in the start-up phase of a new venture. In addition, this type of entrepreneur thrives in the start-up phase of the business because of their strengths in self-esteem and intuition (Bridge, *et al*., 1998). The ‘classical’ school of thought offers that central to the entrepreneur is innovation, creativity and discovery.

According to Bridge, *et al*., (1998:26), the ‘management’ school of thought suggests that “entrepreneurs are organizers of an economic venture” who in addition assume a certain level of risk and manage it (Kuratko and Hodgetts, 2001). The ‘management’ school of thought entrepreneur can perform in the start-up or early growth phase of a venture (Bridge, *et al*., 1998). Defining an entrepreneur in the ‘leadership’ school of thought leads to focus on entrepreneurs as leaders who can motive, direct, and lead people. The entrepreneurs’ ability to adapt their style to suit the needs of the people enables them to perform well in the early growth and maturity stages of the venture (Bridge, *et al*., 1998). The final school presented in this study is the ‘intrapreneurship’ school. The definition focuses on the development of entrepreneurial skills within established and complex enterprises where entrepreneurs are successful in the maturity and change phase of the venture (Bridge, *et al*., 1998).

Generic definitions of the entrepreneur acknowledge characteristics from more than one of the schools of thought, for example, Timmons (1999) definition of the entrepreneur; or definitions fall outside the traditional schools of thought classification, for example, Rosenthal (1996) and Thompson (1999). Timmons (1999:45) defines an entrepreneur as someone who demonstrates high levels of creativity and innovation on the one hand and solid general management skills, business knowledge and networks on the other. Rosenthal (1996) conducted a mail survey of 500 hundred directors (of which 100 responded) of organizations in South Africa and one of the aims of the study was to determine the key characteristics of entrepreneurs as perceived by the directors of these organizations. Rosenthal’s (1996:16) findings revealed 18 different character traits used to define the entrepreneur and the most frequently mentioned included “strong leadership abilities, persistence, resourcefulness, risk-taking and self-confidence.” According to Rosenthal (1996:18), individuals perceived to be truly entrepreneurial were not “simple sole proprietors” but “agents of change, men or women who redefine markets and create new industries." Thompson (1999) identified the social entrepreneur who focuses on community development.

The concept of the entrepreneur is continually been refined with some evidence suggesting that entrepreneurs possess common characteristics, such as higher levels of achievement, risk takers, internal locus of control but a prototype of an entrepreneur does not exist (Kuratko and Hodgetts, 2001; Morris *et al*., 2001). For the purpose of this study, an entrepreneur is an individual who identifies an opportunity, obtains financial, technical and human resources with the intention of either starting a new venture or growing an existing business by developing new products/services, manufacturing processes, or by creating/entering new markets.

Entrepreneurship can be developed if the enterprise is responsive to changes in the small business environment.

2.2.2.2 The small firm

The entrepreneurial firm requires flexibility to adjust to the unique small firm environment. Continual learning is imperative for the enterprise to respond to new opportunities and challenges (Maas and Fox, 1997; Wickham, 1998). Maas and Fox (1997) and Thompson (1999) suggest that an articulated vision for the enterprise serves to inspire employees and gain their commitment to establish an entrepreneurial firm. Entrepreneurial firms need to train and educate employees to achieve sustainable entrepreneurship within the firm (Maas and Fox, 1997; Thompson, 1999).

Entrepreneurial firms are characterized by flat, organic structures and systems that adjust and at the same time maintain their financial and operational stability (Maas and Fox, 1997; Wickham, 1998; Thompson, 1999; Timmons, 1999). Open communication channels and participative decision-making gives the firm a chance to adapt to change quickly to avoid missing the window of opportunity that may add value for the firm (Maas and Fox, 1997; Thompson, 1999). Entrepreneurial behaviour makes the entrepreneur constantly search for new ideas in an effort to respond to the turbulent environment. The entrepreneur must synthesize the information and trends into action that will have profitable outcomes for the firm (Thompson, 1999). Systems must be designed to encourage entrepreneurial thinking. The enterprise needs an entrepreneurial culture that does not punish failure but views it as a learning experience (Maas and Fox, 1997; Timmons, 1999).

Entrepreneurship does not just occur. The discussion has constantly referred to entrepreneurship and the perspectives on the concept view entrepreneurship as an outcome of an individual engaging in a particular process.

2.2.2.4 The process of entrepreneurship

Maas and Fox (1997) present an entrepreneurial process driven by idea identification by either the entrepreneur or the employee. Creativity is an essential ingredient for this stage with the use of ‘think-tanks’ and general environment scanning to assist in idea generation (Maas and Fox, 1997). The next stage is the testing of ideas, which involves comparing the critical success factors of the idea with the profile of the entrepreneur and team to determine the level of fit (Maas and Fox, 1997). If there is a certain degree of fit the next stage of the process involves subjecting the idea to a viability study. Such a study takes into account two categories, one internal, and the other external. The internal category focuses on the financial resources of the enterprise and asks certain questions about, for example, the break-even point and cost to launch the project (Maas and Fox, 1997). The external category deals with the potential market and other related issues. If the results are favourable, the entrepreneur can pursue the opportunity, if not he must reject the idea. The implementation stage requires thorough planning to ensure that everything happens at the correct time. Maas and Fox (1997:18) suggest that entrepreneurs use their business plan as a route map to ensure that the idea is implemented correctly and managed effectively over time. The final stage in Maas and Fox’s (1997) process is the evaluation and adjustment stage, which must be an on-going process to determine the success of the idea and its implementation. The Maas and Fox

(1997) process highlights that throughout the stages the entrepreneur may encounter obstacles that may hinder the process. Such obstacles, according to (Maas and Fox, 1997:19) can be "contextual, content related or of a process nature." Such obstacles should be identified and monitored on a continual basis to allow the entrepreneur to make changes if need be (Maas and Fox, 1997).

In contrast, Timmons (1999) suggests that opportunity, resources, and the team drive the entrepreneurial process. The opportunity, according to Timmons (1999:39) is the nerve centre of the process and "the more imperfect the market the greater the opportunity." To evaluate the value of the opportunity, the entrepreneur needs to consider market demand, market structure and size, and the margins on the opportunity (Timmons, 1999). Although opportunities in transitional economies are high, innovative or high levels of entrepreneurship are difficult because of the inadequate infrastructure, financial resources, and networks that small firms need (Deakins, 1999). To this end, the entrepreneur needs to devise creative strategies to marshal and gain control over resources as opposed to owning resources (Timmons, 1999). The final aspect in Timmons's (1999) entrepreneurial process is the team. The team needs two success criteria, the leader should be entrepreneurial, and for example, the team should have quality members with motivation to excel. Timmons (1999) suggests that in order for the process to function effectively, there should be balance between the three driving forces. If one of the team, for example, does not have the required success factors, this will result in a mismatch between the opportunity and the resources.

The entrepreneurship process Wickham (1998:28) presents focuses on "four interacting contingencies" which include the entrepreneur, a market opportunity, a business organization, and resources. The actions of the entrepreneur drive the dynamic process (Wickham, 1998). An aspect of the process is the 'opportunity-organization' fit. The opportunity focused on by the entrepreneur defines the organizational structure, processes, and culture. The enterprise must form its shape to fit the identified opportunity (Wickham, 1998). The 'resource-organization' configuration requires the entrepreneur to acquire a particular mix of resources (people, funding and equipment) to form the firm's structure, processes, and its culture (Wickham, 1998). The final aspect of the process is the resource-opportunity focus. The entrepreneur must decide what resources are required to pursue the identified opportunity (Wickham, 1998).

From the literature presented, common to the entrepreneurial process are the opportunity aspects, resource aspects, and the individual aspects that drive the entrepreneurial process. Entrepreneurship does not just exist; the three abovementioned aspects need to be balanced in order for the idea to progress from a dream to an economically viable venture created to suit the individual's needs. The researcher supports the process presented by Maas and Fox (1997) because the purpose of this study is to identify the role of bank finance on growing small firms. To this end, the process presented by Maas and Fox (1997) enables the small firm with the intention to grow to methodically approach firstly, the question of growth. Secondly, the process enables the small firm assess the viability of the intended growth by drawing attention to external and internal issues. Finally, the major contribution of the process is the recognition of potential barriers to the intended growth and calls for the entrepreneur to be creative to overcome identified barriers.

The interaction between the context, firm, and process of entrepreneurship results in different types of entrepreneurship, which include routine, imitative, and Schumpeterian entrepreneurship that the individual pursues. Leibenstein (1978, cited in Yu, 1998) suggests that the entrepreneur may engage in routine entrepreneurship. Routine entrepreneurial behaviour follows that the entrepreneur has the capabilities to search and evaluate viable opportunities, assemble the needed financial resources and take on the risk attached to the opportunity and manage it accordingly. However, the entrepreneurial activities involved in the ventures are usually well known and used to operate in clearly defined markets. In contrast, imitative entrepreneurship according to Baumol (1988, cited in Yu 1998) "puts new ideas into use by [supplying] something which is still lacking." Although, entrepreneurs engaged in imitative entrepreneurship do not necessarily invent new products, services or processes, the entrepreneurs aim to serve markets which pioneering entrepreneurs do not adequately service. Imitation entrepreneurship goes beyond copying what others are doing in that entrepreneurs modify and add new features to the product, service or process. The highest level of entrepreneurship is Schumpeterian entrepreneurship (1934, cited in Yu 1998). Entrepreneurs engaged in this type of entrepreneurial behaviour introduce technological innovation to introduce new products, services or processes, which in turn may open new markets and establish a new firm in the industry (Yu, 1998). In addition, the GEM (Foxcroft, *et al.,* 2002) study distinguishes opportunity entrepreneurship and necessity entrepreneurship. Opportunity entrepreneurship represents individuals pursuing an identified business opportunity while necessity entrepreneurship represents individuals participating in entrepreneurial activity because they have no other work choices (Foxcroft, *et al*., 2002).

The discussion thus far has centred on an overall discussion of the conditions encouraging entrepreneurship in South Africa and in the Eastern Cape province. To conclude the discussion, the researcher presents the number of entrepreneurs in South African provinces.

2.3 How many entrepreneurs exist in South Africa?

Ntsika (2001) provide a measure of enterprise density – the number of entrepreneurs for every 100 people in a country or province. Table 2.6 presents the enterprise density for each of the provinces in South Africa for 1999.

Table 2.6: Enterprise density by province in South Africa for 1999

Province	Number of entrepreneurs	Population	Enterprise density (%)
Eastern Cape	**200 410**	**6 769 000**	**2.9**
Free State	87 022	2 813 000	3.1
Gauteng	382 021	7 778 000	4.9
KwaZulu Natal	382 021	9 003 000	4.2
Mpumalanga	124 242	3 000 000	4.1
Northern Cape	27 764	890 000	2.8
Northern Province	151 601	5 310 000	2.8
North West	97 583	3 592 000	2.7
Western Cape	179 992	4 171 000	4.3
Total	**1 628 797**	**43 325 000**	**3.7**

(Source: Ntsika, 2000:32)

From the table, Gauteng province has the highest density with 4.9 per cent of its population engaged in some entrepreneurial activity. The Eastern Cape province has an enterprise density is 2.9 per cent. The numbers of entrepreneurs in a particular province are strongly related to firstly, the number of economically active people per province and secondly, to a lesser extent to a province's total population. Economic participation rates differ strongly between provinces because of unequal distribution of enterprises (Ntsika, 2000). Provinces with higher urbanization rates, namely Gauteng and the Western Cape have high economic participation rates. Although the Eastern Cape province according to Ntsika (2000:32) "also has large metropolitan areas, its large rural population affects enterprise distribution towards the lower end of the spectrum." In light of the discussion on the environmental factors encouraging entrepreneurship, further issues that may hinder its development include support structures and inadequate infrastructure development.

From the multi-dimensional approach to understanding the nature of entrepreneurship presented in the chapter, the culmination of the entrepreneurship process includes – firstly, its role in the creation of new enterprises (Timmons, 1999) and secondly, its role in growing existing enterprises (Kuratko and Hodgetts, 2001). In this chapter, the focus is on the first outcome of the entrepreneurship process, namely the creation of small businesses sector.

2.4 The South African small business sector

Evidence of entrepreneurial activity in the South African context exists based on the number of new venture registrations between 1990-1998. Table 2.7 presents the figures for new enterprise.

Table 2.7: Registration of New Enterprises 1990 - 1998

	1990	1991	1992	1993	1994	1995	1996	1997	1998
Pty Ltd Companies	6 369	6 236	6 550	7 164	9 356	12 168	16 151	20 332	23 651
CC	28 008	26 426	27 570	27 950	39 170	52 408	61 884	61 884	68 067
Total	**34 377**	**32 662**	**34 120**	**35 114**	**48 526**	**64 576**	**78 035**	**88 399**	**96 765**

(Forgey, *et al*., 2000:414-415)

Information from Table 2.7 provides evidence that the small business sector is gaining in importance as revealed by the increasing number of registration of new enterprises in the period 1990 –1998. Defining the small firm is difficult and is based on measurable characteristics of the enterprise

2.4.1 Defining small business

There is no one single, generally accepted definition of a small firm. Definitions, therefore, which relate to objective measures of size such as number of employees, sales turnover, profitability, net worth, when examined at sector level according to Storey (2000:9) suggest "some sectors all firms may be regarded as small, while in other sectors there are possibly no firms that are small." The National Small Business Act of 1996 provides the definition of small business in South Africa, with number of employees, annual turnover, and gross assets as measures of size. In addition, the small business sector is distinguished in terms of size and the main size categories identified are the micro, very small, small and medium sized enterprises; referred commonly to as 'SMMEs' (small, medium and micro enterprises). In this study, the researcher uses the terms 'small firm', 'enterprise' and 'venture' when discussing individual businesses while 'small business sector' and 'small, medium and micro enterprises' (SMMEs) embody all forms of small firms in the economic sector. The term 'small and medium enterprises' (SMEs) omits the micro sized enterprise. Table 2.8 presents the National Small Business Act 1996 definitions of the small business sector.

Table 2.8: Definitions of small businesses given in the National Small Business Act

Enterprise Size	Number of Employees	Annual turnover	Gross assets, excluding fixed property
Medium	Fewer than 100 to 200, depending on industry	Less than R4 million to R50 million, depending upon industry	Less than R2 million to R18 million, depending on industry
Small	Fewer than 50	Less than R2 million to R25million, depending on industry	Less than R2 million to R4,5 million, depending on industry
Very small	Fewer than 10 to 20, depending on industry	Less than R200 000 to R500 000, depending on industry	Less than R150 000 to R500 000, depending on industry
Micro	Fewer than 5	Less than R150 000	Less than R100 000

(Source: National Small Business Act, 1996)

Micro enterprises include those that yield a turnover below the VAT registration limit (R150000) and employ less than five people. Examples of people in micro enterprises include owners of *spaza* shops and minibus taxi operations. Micro enterprises are considered to be informal, as enterprises are not registered for tax purposes, do not have formal accounting and operating procedures, and do not comply with the labour legislation. Micro enterprises with paid employees constitute at least 31.0 per cent of the small business sector and contribute 3.9 per cent of the total private sector employment. Micro enterprises with between one paid employee and five paid employees constitute in the region of 16.4 per cent of the small business sector and contributes about 6.8 per cent of private sector employment. The provincial breakdown shows that Gauteng province has the greatest number with 34.0 per cent followed by KwaZulu-Natal province with 18.0 per cent, then the Western Cape province with 14.0 per cent and finally the Eastern Cape province with 10.0 per cent (DTI, 1998; Forgey, *et al*., 2000).

The next category is the very small enterprises, which have a lower limit in employment that include the self-employed, such as professionals, and less than ten paid employees. However, if enterprises are in the following sectors, mining, electricity, construction, and manufacturing, the number increases to less than twenty paid employees. These enterprises operate on the formal market, have access to technology, and constitute 19.7 per cent of all enterprises recorded and account for 13.3 per cent employment in the private sector. Gauteng province has the greatest number of very small enterprises with 42.0 per cent, followed by Western Cape province with 16 per cent and finally the KwaZulu-Natal province with 15.0 per cent (DTI, 1998; Forgey, *et al*., 2000).

Small enterprises have fewer than fifty paid employees and have more complex business practices, as they are more established. For a small enterprise to grow to a medium-sized enterprise, accumulations of resources as well as incentives for enterprise expansion are prerequisites. Small enterprises make up an estimated 7.6 per cent of enterprises in the small business sector and small enterprises contribute 19.9 per cent of employment in the private sector. The largest concentration of small enterprises is in the Gauteng province with 46.0 per cent, KwaZulu-Natal province has 16.0 per cent and the Western Cape province 12.0 per cent (DTI, 1998; Forgey, *et al*., 2000).

Medium-sized enterprises employ up to one hundred people, although in mining, electricity, and manufacturing the number increases to two hundred paid employees. The ownership and management structures are complex and a greater division of labour is the main difference between small and medium-sized enterprises. Medium-sized enterprises constitute 1.4 per cent of enterprises recorded and are responsible for about 13.8 per cent employment in the private sector. Medium-sized enterprises are concentrated in Gauteng, KwaZulu-Natal, and the Western Cape provinces (DTI, 1998; Forgey, *et al*., 2000).

As the focus of this study is on financial issues, it is critical to distinguish between the financial requirements of the various categories of enterprises. The classification accommodates the heterogeneous nature of the small business sector; however, this adds complexity to meeting the sector's financial needs. This study focuses primarily on small firms (micro, very small and small) as represented in the National Small Business Act. Table 2.9 provides information on the number of enterprises found in the main sectors in

South Africa for 1997 and the micro, very small and small sized enterprises constitute a high number of firms in the sector.

Table 2.9: Number and proportion of enterprise by sector and size

Enterprise Size:	Micro[1]	Micro[2]	Very Small	Small	Medium
Sector					
Agriculture	13 600	26 200	17 900	20 900	3 240
Catering & Accommodation	3 300	5 700	6 600	3 450	385
Community, social & personal services	30 300	23 600	28 400	4 900	525
Construction	27 600	24 100	13 300	2 300	996
Finance & Business services	25 400	15 100	24 300	4 600	301
Manufacturing	30 900	14 800	30 600	4 800	3 840
Mining	300	2 200	500	131	112
Retail trading (incl. Motor trade)	120 300	53 200	43 300	13 100	970
Transport	28 400	14 600	6 200	1 400	293
Wholesale trade	3 200	3 300	8 900	3 270	660
Total	**283 300**	**182 800**	**180 500**	**58 851**	**11 332**

Micro[1] = No employees; Micro[2] = 1 – 4 employees (Source: Forgey, *et al*., 2000:408)

The majority of the enterprises are in the micro category with enterprises having no employees dominating the small business sector. The number of very small enterprises is high with a substantial lower number of small and medium enterprises. Retail trading, community social and personal services and agriculture sectors contain the greatest number of firms.

2.5 The importance of the small business sector for South Africa

The small business sector is a priority for South Africa for the following reasons. Firstly, the sector has a high labour absorptive capacity (Pitt, 1996). Table 2.10 presents the contribution of the small business sector to employment in the main industrial sectors.

Table 2.10: Contribution of SMMEs to employment in the main industrial sectors

Size **Sector**	**Micro** **%**	**Small** **%**	**Medium** **%**
Agriculture	4.17	13.81	52.31
Mining	0.92	2.51	2.59
Manufacturing	8.39	10.57	24.58
Electricity	0.00	0.00	0.00
Construction	2.93	37.28	13.45
Trade	35.77	23.73	13.00
Transport	11.38	23.50	20.84
Business Services	25.14	19.18	5.20
Other Services	52.68	18.22	8.23
Average: all sectors	**17.38**	**16.34**	**20.76**

(Adapted from Ntsika, 2000:24)

According to Ntsika (2000:24), "the main contribution of SMMEs to the South African economy is in terms of employment." From Table 2.10, the small business sector employs on average 54.5 per cent of all people in the formal private sector. In the micro enterprises, trade, transport, business services, and other services sectors employ the majority of the people, while the same holds for the small enterprises but with the addition of the construction sector. The medium enterprise main contributors to employment include agriculture, manufacturing, transport, construction, and trade.

The second reason is the recognition that the small business sector is critical to achieving the objective of empowering communities that have previously been disadvantaged (Pitt, 1996). The third reason offered by Rogerson (1997), is the sector's potential to improve the economic competitiveness of local industry. The final reason, regional economic development, can be facilitated through the adoption of a 'self-help', locally driven approach with emphasis on the importance of establishing cooperative networks between key stakeholders (Morris and Brennan, 2000). Establishing an enabling culture through local government policies, procedures, and practices with the small businesses, the business environment will be supportive to entrepreneurial activity, more start-up business activity, and regional economic development (Morris and Brennan, 2000). In recognition of this, a number of initiatives by a number of organizations, agencies, and government departments have looked to unleash the potential of the small business sector in, and to assist with its development (SACOB, 1999). In order for this to occur, it is imperative that small businesses grow; in addition, Petty and Martin (1997) suggest that firms should "exhibit the capacity to create economic value for the investors which goes beyond merely providing a comfortable lifestyle for the founders."

The discussion thus far has offered potential positive outcomes of entrepreneurial activities for South Africa. However, literature on the contrary offers invaluable insights on promoting entrepreneurial activity. Theodosiou (1996) offers a comprehensive critique of the White Paper on national strategy for development and promotion of small business in South Africa, however, for the purpose of this study, only those that are pertinent to this study will be discussed. The first insight is based on the underlying assumptions made in the government's White Paper on entrepreneurship development. The White Paper, according to Theodosiou (1996:19) was formulated on the assumption that "all small businesses are entrepreneurial and therefore play a vital role in job creation." However, the document makes no explicit reference as to whether the strategy focuses on the start-up or growth stage; a critical distinction according to Morris and Pitt (cited in Theodosiou, 1996). Morris and Pitt (1995, cited in Theodosiou, 1996:19) refer to a finding that "about 10per cent of small businesses are responsible for creating virtually all the new jobs generated by the small business group as a whole." For this to happen, the small businesses need to be entrepreneurial, which is not always the case. The next insight is related to the first insight, in that Karungu, Marabwa and Stettler (2000:13) question the employment capability of the SMME sector. Karungu, *et al.,* (2000) concluded that the SMME sector created eight of the ten jobs created in South Africa, however, Karungu, *et al.,* (2000) highlighted concerns over omissions from governmental reports that of the eight new jobs created five or six jobs are lost within a year. Karungu, *et al.,* (2000:13) contend that ascertaining the precise contribution of the SMME sector in terms of employment is difficult "by virtue of the very characteristics of micro and very small enterprises." Karungu, *et al.,* (2000) support Manning (1996, cited in Rogerson, 1997) in challenging that SMME promotion equates to employment creation and

Manning (1996, cited in Rogerson, 1997:5) argues, "evidence in support of the perceptions of SMEs as important sources of employment is somewhat weak."

The third insight is the role of SMMEs to redress racial income inequalities. Manning (1996, cited in Rogerson, 1997:6) warns of the danger "for policy-makers to rely on SMMEs as the main agent for economic redistribution in South Africa" and offers three reasons for this argument. The initial reason is that a reliance on SMMEs to redistribute wealth does not address the core economic power of South Africa, which is concentrated in the hands of the large white-owned corporations. In addition, the majority of black-owned businesses are small and it cannot be expected that these will significantly shift the patterns of wealth distribution. The final reason offered is that although SMMEs can be a useful channel of wealth to black entrepreneurs, this does not necessarily mean that the entire black population will become wealthier (1996, Manning, cited in Rogerson, 1997).

The final insight offered by literature highlights in the Study by Karungu, *et al.,* (2000:6) several concerns by provincial and local governments who "have not yet been effectively integrated into SMME development." Karungu, *et al.,* (2000) suggest that for the SMME sector to develop, the DTI needs to make an impact at local levels and this includes establishing an enabling culture through local government policies, procedures, and practices to be supportive for entrepreneurial activity (Morris and Brennan, 2000).

Despite the criticisms, the small business sector does have the potential to transform the South African economy and invaluable lessons from other countries experience can assist policy makers, institutions such as banks, and the entrepreneurs to develop appropriate strategies to promote entrepreneurial activity in the country.

2.6 The small business sector: An international comparison

The experience of prospering economies suggests the SME sector as instrumental to local economic development (Kepser, 2000; Morris and Brennan, 2000). To gather an overall perspective of the environment and conditions the SME sector operates, it is imperative to present how other countries are developing entrepreneurship and their SME sector (Luger, 1997). The following section of the chapter discusses the link between entrepreneurship and the small business sector using the Global Entrepreneurship Monitor (GEM) study by Reynolds, Hay, Bygrave, Camp and Autio, (2000), Reynolds, Bygrave, Autio and Hay, 2002), and Foxcroft, *et al*., (2002).

The study attempts to answer three fundamental questions (Reynolds, *et al*., 2000)

- "Does the level of entrepreneurial activity vary between countries, if so, by how much?
- Does the level of entrepreneurial activity affect a country's rate of economic growth?
- What makes a country entrepreneurial?"

Most countries are involved in some level of entrepreneurial activity, however, for the purposes of this study the focus will be on a sample drawn from the countries that form part of the GEM study. The countries selected for this study include the United States (US), Australia, Brazil, Japan, Ireland, and the United Kingdom (UK). A summary on each country will discuss the level of entrepreneurial activity and the forces that influence the development of entrepreneurship and the small business sector. The researcher selected these countries for detailed discussion because of the extensive literature available on small firm entrepreneurship and their prolonged inclusion in the GEM study. In addition, the cases represent developing economies' and developed economies' entrepreneurial activity.

Table 2.11: International comparison of entrepreneurial activity

Country	Total Population 2002	Total Labour Force 2002	TEA Index 2002 (%)	Count of TEA Participants
United States (US)	280 000 000	173 911 000	10.51	18 260 000
Brazil	176 029 000	106 442 000	13.5	14 369 000
Japan	126 974 000	81 290 000	1.81	1 463 000
Ireland	3 883 000	2 289 000	9.14	208 000
United Kingdom (UK)	59 778 000	36 927 000	5.37	1 994 000
South Africa	**43 647 000**	**24 886 000**	**6.54**	**1 617 000**

(Adapted from Reynolds, *et al*., 2002:8)

From Table 2.11, Brazil has 13.5 per cent of its population undertaking entrepreneurial activity while the UK has a total entrepreneurial activity (TEA) level of 5.4 per cent. In the US, total entrepreneurial activity is in the region of 10.5 per cent while Japan's level of entrepreneurial activity is only at 1.8 per cent. Ireland's total entrepreneurial activity is 9.1 per cent while South Africa's TEA is about 6.5 per cent. In analysing these statistics, it is evident that the level of entrepreneurial activity varies from country to country. In a global comparison, South Africa has an average level of overall activity, the lowest rate of entrepreneurship among developing countries in the GEM, a low opportunity entrepreneurship rate and a low survival rate of start-ups (Reynolds, *et al.,* 2002). The following section details the factors instrumental in the country's TEA rate.

In the United States (US), evidence shows that the small business sector is responsible for providing most of the new jobs created during the 1980s. Each year, more than 500 000 new small firms start in the US, but nearly half of the new businesses started each year go out of business within the first 18 months of operation (Paleno and Kleiner, 2000). However, entrepreneurs perceive venture failure as a learning experience and many view a career in an entrepreneurial activity as a viable employment option. Much of the success attributed to small firms in the US is because of the incentives that government makes available to small firms. Examples of such incentives include lower rates of federal taxes on lower incomes; special forms of legal organizations such as S corporations, which are taxed as individuals and the insistence of government that large contracts provide for subcontracting to small suppliers (Paleno and Kleiner, 2000, Reynolds, *et al*., 2000).

Brazil has more women involved in entrepreneurship when compared to other leading entrepreneurial countries. To encourage entrepreneurship, the government has taken steps toward deregulation and privatization but scepticism from small businesses meets the government's participation. One of the key issues is access to capital, which is a major obstacle, although it has improved in terms of availability. Brazil faces infrastructure limitations that include low education standards and literacy levels. Brazilian entrepreneurs perceive tax rates to be high and this hinders business expansion and growth. Government support for the small business sector is perceived as inadequate with programmes implemented failing to address key issues (Reynolds, *et al*., 2000).

Japan has one of the lowest levels of entrepreneurial activity in the GEM sample. The number of new ventures formed since 1981 is less than 5.0 per cent annually of the nation's total companies. From 1991 – 1994, just as many new ventures created went bankrupt. Such statistics contribute to the unfavourable business climate that is not conducive to stimulating and developing entrepreneurship. Moreover, there is preference for employment in large corporations as opposed to small business. It is difficult for Japanese entrepreneurs to raise the necessary capital to start a new venture and because of inexperience, they fail to attract venture capital and banks do not offer loans where entrepreneurs fail to offer personal guarantees. Despite these obstacles, the number of entrepreneurs in Japan *is* increasing partly because of changing values linked to the pressure that globalization places on businesses (Paleno and Kleiner, 2000; Reynolds, *et al*., 2000).

In Ireland, the business environment is supportive for inward direct foreign investment particularly in high technology sectors. In an effort to increase the level of entrepreneurial activity in the country, numerous agencies have been established to provide support for new venture creation and local entrepreneurship. There has been an increase in the number of VAT registered companies as well as an increase in quality start-ups indicating that the low levels of entrepreneurial activities are improving. However, capital markets are inadequately equipped to deal with new venture creation and growing firms and there is the perception that there is insufficient seed capital (Reynolds, *et al*., 2000).

The United Kingdom has a highly conducive environment for entrepreneurship and it has a well-developed commercial and professional infrastructure. The government is committed to developing the small business sector and for example, the government improved the taxation regime and bankruptcy legislation to assist entrepreneurs. New venture capital raised in the United Kingdom is high with high amounts invested per company but only in a few companies as opposed to other countries in the GEM sample (Reynolds, *et al*., 2000).

These findings are important because the findings confirm that the small business sector is important for economic growth. From the few countries presented, the level of entrepreneurial activity differs and this is strongly related to the country's small firm environment. From the countries presented, countries with high levels of entrepreneurial activity show above average rates of economic growth but there are some countries which have low levels of entrepreneurial activity, for example, Ireland, but high rates of economic growth. This finding is particularly useful for South Africa where entrepreneurial activity is limited but offers insights to policymakers. Developing policies aimed at improving entrepreneurial activity should not be restricted to the small business sector only but consider other factors, such as taxation regimes and bankruptcy legislation. In addition, education plays a pivotal role in developing and encouraging entrepreneurship, which is an area of concern in South Africa. The presented countries offer different perspectives on how the level of financial support influences entrepreneurial activity, for example, the level of formal venture capital invested in 1999 varied from 0.52 per cent of the GDP in the US to a low 0.022 per cent in Japan. These statistics are reflect the attitude of financiers in each of the countries where in Japan banks are not willing to supply finance when entrepreneurs cannot provide adequate collateral. In contrast, the US has an established venture capital market and alternative finance sources exist for small business finance needs.

2.7 Summary

This chapter provided background to small firm entrepreneurship and developing the small business sector in South Africa and in other countries. Although South Africa has made strides in creating an enabling environment for entrepreneurial activity, the following insights need to be addressed to better its current promotional activities: the development of appropriate legislation, improvement in the support structures, developing finance products suited to an entrepreneurial firm, and create databases of accurate information to facilitate in the monitoring of small firm activity. Secondly, from the literature, South Africa appears to have the majority of its small business sector in the micro and survivalist categories but for the type of development that South Africa requires from its small business sector, the focus of development must be on those enterprises that have growth potential. South African entrepreneurs, like many others worldwide encounter similar problems with respect to finance. Evidence from the literature suggests that there are a number of reasons why entrepreneurs fail to get the initial funding they need. Such reasons include poor financial management skills and insufficient collateral. If entrepreneurs face such difficulty in the start-up phase, it is difficult to attempt to understand what difficulties they encounter when they look to external sources to finance the growth phase of their venture.

For the purpose of this study, key contributions from literature presented about small firm entrepreneurship include:

- The difficulty of not establishing a generally accepted definition of entrepreneurship and the entrepreneur makes it difficult to formulate policies that will target the support and finance needs of small firms
- Entrepreneurship is a process and it requires entrepreneurs to understand the environment they operate in, how to behave in an entrepreneurial manner, and

how to create an entrepreneurial organization to go beyond the start up stage of the firm's existence

- The relative importance of encouraging entrepreneurship and the small business sector to drive economic development, employment creation, wealth creation in South Africa can only be achieved if the success rate of firm survival increases resulting in more businesses making the transition to sustainability
- South Africa can learn from the experiences of other countries concerning entrepreneurship development but create programmes that are tailored to the local business environment conditions
- The Eastern Cape has the potential to improve its entrepreneurial activity if issues of infrastructure development and access to finance are addressed. In addition, it is imperative that entrepreneurial activity is monitored at town level in order to improve such issues and this was substantiated by the unavailability of documented information on Grahamstown concerning economic, infrastructure, social and cultural indicators
- The availability of finance is an important factor in the development of small firm entrepreneurship because it facilitates entrepreneurs to pursue the opportunity. In the case of South Africa where the number of necessity-driven entrepreneurs is higher than opportunity-driven entrepreneurs, an investigation on the role of finance can reveal the areas of concern and suggest solutions to improve the availability of finance for small business.

CHAPTER 3

SMALL FIRM GROWTH

3.1 Introduction

Seldom do entrepreneurs intend to stop at the venture creation stage, entrepreneurs seek to grow the venture in a number of ways sustaining entrepreneurial activity in the venture. O'Dwyer and Ryan, (2000:345) argue that "enabling firms to survive the initial stages of growth and to develop the potential to expand and grow is important for the development of a strong and vibrant small business sector." Literature on small firms advocates that small firms display different growth orientations compared to large firms.

The chapter discusses the role of continued entrepreneurship for small firm growth and follows with a discussion of growth measures in the context of small firms. Small firm growth models are discussed, focusing on the individual, the firm using the Churchill and Lewis (1983) framework that identified stages of growth, growth orientation and internal capacity for growth of individual firms as the basis of discussion and the external environment. The chapter concludes with a discussion on the barriers to small firm growth.

3.2 The role of continued entrepreneurship for small firm growth

Few businesses achieve growth. To move the enterprise beyond the start-up phase continued entrepreneurial activity is imperative. This activity forces the entrepreneur to perform the same opportunity seeking and resource gathering activities as done in the start-up phase to grow the business with the focus on enterprise building. Figure 3.1 presents the boundary between entrepreneurial behaviour and management behaviour in developing the venture.

Figure 3.1: The role of entrepreneurship in venture creation and beyond

Error! Unknown switch argument.

(Source: Carton, Hofer and Meeks, 1998)

Figure 3.1 illustrates the role of entrepreneurship at the initial stages of venture creation. Entrepreneurship for new venture performance, includes according to Carton, *et al*., (1998) "the development and implementation of new venture strategy, the nature of the external environment and industry structure, the accumulation of resources, building of an organization including developing distinctive competences, establishing strategic networks, capturing customers, and establishing a organization culture and values." The significance of this model is that when the business achieves self-sustainability it moves from the entrepreneurship paradigm to a management paradigm but central to this transition is that the business must have achieved financial success to fund further growth (Carton, *et al*., 1998).

Continued entrepreneurial behaviour is important because a distinguishing feature of entrepreneurial businesses is their potential for growth where the number of new jobs created by expanding small firms is greater than that of firms in their first year of operation (Gundry and Welsch, 1997; Wickham, 1998; Wiklund, Davidsson, Delmar and Aronsson, 1997). However, the significance of this largely depends on the individual's desire and the firm's capability to grow once established. The importance of small firm growth arises from the recognition of the small business sector's contribution in promoting innovation, economic growth, and its wealth and employment creation ability in the economy (Barber, Metcalfe and Porteous, 1989; Bridge, *et al*., 1998) resides in growing and expanding enterprises regardless of their sizes (Delmar, 2000).

Before examining small firm growth, it is necessary to define growth in the context of small firms based on what observers or business owners view as important aspects of growth (Bridge, *et al.,* 1998).

3.3 Measures of growth in small firms

Small firm growth is dynamic, involves development and change within the firm, and changes in the way the firm interacts with its environment (Wickham, 1998). Greater understanding of growth management requires resolutions of two related issues, the identification of appropriate growth measures, and the delineation of rapid growth from slow growth. Bridge, *et al*., (1998) present three broad categories of small firms. The first category represents firms with a short life span, the second category includes firms that remain small despite surviving, and the final grouping represents a small number of firms that achieve rapid growth in terms of employment. Underlying these broad groupings of firms are various measures of growth identified by Wickham (1998). Wickham (1998) identified four measures of small firm growth namely financial, strategic, structural, and organizational.

Financial growth measures focus on the development of the firm by increasing turnover and determining the costs and investments needed to obtain the increase. Bridge, *et al*., (1998) add that entrepreneurs with a financial interest usually seek to increase investment value through growth in shareholder value. This desire implies the need to grow the business's earnings and net assets. However, Storey (2002) argues that though higher turnover and profitability are valid growth measures, these may not be positively correlated. That is, increased turnover and profitability may not lead to an increase in investment value. Furthermore, the use of a growth measure that focuses on changes in assets is not advocated because it concentrates on firms that are capital-intensive (Delmar, 2000), thereby limiting its use for firms who are either labour-intensive and/or are in their early years of existence and thus are building their asset bases. Strategic growth on the other hand centres on the enterprise's change with respect to its interaction with its business environment. The focus is on how the business develops its capabilities to exploit an opportunity (Wickham, 1998) in order to achieve financial growth. The third measure, structural growth, is the change in the personnel and internal systems, particularly managerial roles and responsibilities, reporting relationships, communication links, and resource control systems (Wickham, 1998). Finally, organizational growth centres on changes in processes, cultures, and attitudes as the firm develops. Focus on the changing role of the entrepreneurs and their leadership style through the growth stages is a feature of organizational growth (Wickham, 1998). The increase in number of people employed (Storey, 2000) is a common growth measure. From the definitions of growth presented, growing the business requires resources of some kind, particularly financial resources.

The following section presents several theories to discuss small firm growth. In addition, the focus of this study is financial and to this end, each discussion of growth theories concludes with a discussion on the financial implications.

3.4 Small firm growth theories

The researcher identified from the literature three approaches to discuss small firm growth. The approaches, namely the small firm owner, the small firm, and external factors enable the researcher to discuss growth emphasizing the multidimensional approach to understanding small firm growth.

3.4.1 The small firm owner and growth

The survival and development of small firms through initial growth stages is central for the sector's potential to create employment and wealth. Central to the development of the sector are the preferences of the owners/managers and their desire for growth (O'Dwyer and Ryan, 2000:234). Research efforts, according to Gundry and Welsch (1997) attempt to classify entrepreneurs according to "industry, size, region, age, capital intensity, hi/low–tech, stage of life-cycle, personality type"; however, these classifications do not guarantee firm growth. To overcome this shortcoming Carland (1984, cited in Gundry and Welsch, 1997) differentiates 'small business owners' from 'pure' entrepreneurs where pure entrepreneurs strive for growth and innovation, while small business owners are satisfied with the current state of their business. Birch (1987, cited in Gundry and Welsch, 1997) identifies an additional - 'income substitutors' entrepreneurs. Income substitutors do not necessarily want their business to grow. The reasoning follows that for these entrepreneurs the greatest satisfaction derived from owning a business is their close contact with their customers and employees. However, if the business should grow, the contact would inevitably weaken and the owner's role would change (Gundry and Welsch, 1997). Storey (1994, cited in Bridges *et al*., 1998:171) reviews several empirical studies examining which entrepreneur characteristics (including motivation) are related to growth. However, the survey conclusions do not facilitate the development of a profile or model of the growth-achieving entrepreneur. Another review by Wiklund, *et al*., (1997) of classical works (Bolton, 1971; Boswell, 1972; Stanworth and Curran, 1973; Deeks, 1976, cited in Wiklund, *et al.,* 1997) concludes that eight key aspects are important for small firm owners/managers considerations in terms of pursuing growth. These include workload, work tasks, employee well being, private finances, control, survival of crises, product/service quality and independence. Relying on the entrepreneur's characteristic profile to determine potential firm growth is insufficient, the researcher supports research which advocates that firm growth is contingent on the entrepreneur's motivation for growth.

Wiklund, *et al*., (1997) argue that the majority of research on small business growth omits motivation for growth by entrepreneurs. However, several studies (Mok and Van den Tillaart, 1987; Kolvereid and Bullvag, 1996, cited in Wiklund, *et al*., 1997) have researched the link between the entrepreneur's motivation and firm growth, and have established motivation as being a key predictor of actual firm growth. According to Orser, Hogarth-Scott and Wright (1998), research efforts to determine whether business growth results because of "the chance confluence of opportunities, conditions and capabilities" or because of "the intentional action of the owner(s)," who may seek growth have resulted in a proliferation of alternative theoretical explanations of owners' motives for enterprise development. According to Orser, *et al*., (1998) alternative theoretical explanations suggest that motivations for firm ownership include "financial goals; personal development; domestic and family development; socio-economic development and independence; technological innovation and intention." Maki and Pukkinen (2000) argue that motivation theories help us to develop a better understanding of entrepreneurial behaviour and performance than assessing growth potential based on characteristic profiles.

The small firm owner and growth: Financing implications

The entrepreneur is the driving force behind marshalling resources needed for the growth. The entrepreneur's characteristics are important in the finance decision in that the entrepreneur has to be creative in marshalling the necessary financial resources for growth purposes. However, the individual's desire for growth does not necessarily translate to actual growth; firm growth depends on the organization and the external environment within which it operates. The entrepreneur needs to have clear growth objectives before expanding the venture. However, the entrepreneur may have insufficient financial resources and management skills to grow the business and convince potential financiers about the viability of the proposed growth. The type of growth pursued is important. For example, if the owner decides to pursue routine entrepreneurial growth he or she can retain control over the business and will rely on internally generated funds to finance growth in comparison to owners pursuing Schumpeterian entrepreneurial growth. These owners would be pursuing innovation and would need external financing to avoid liquidity traps, hence the owner will be more likely to give up some control to ensure that the company achieves high-growth.

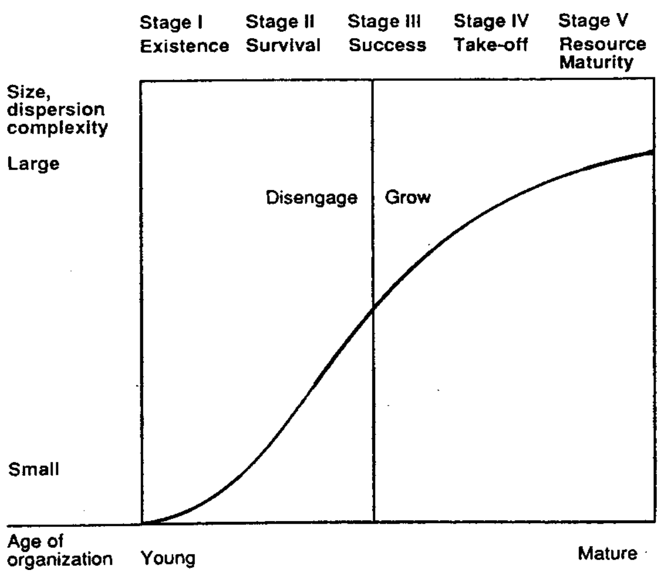
3.4.2 Small firm development and growth

The second major stream of small firm growth research focuses on the life-cycle hypothesis. Studies examine firm characteristics in predetermined growth stages (Merz, Weber and Laetz, 1994; Beverland, 2001). Categorizing the problems and growth patterns of small firms may be difficult in that they vary in size and capacity for growth. They are characterized by independence of action, differing organizational structures, and varied managerial styles. However, small firms experience common problems arising at similar stages in their development and these points of similarity can be organized into a framework such as the Churchill and Lewis (1983) small business framework.

3.4.2.1 The Churchill and Lewis small business framework

The Churchill and Lewis (1983) model is appropriate for this study because it outlines five stages characterized by an index of size, diversity, and complexity and age of the firm. Five management factors describing the model include managerial style, organizational structure, extent of formal systems, major strategic goals, and the owner's involvement in the business (Churchill and Lewis, 1983:30).

Figure 3.2 Churchill and Lewis lifecycle model



(Source: Churchill and Lewis, 1983:31)

The problems characterizing the first stage of firm existence include obtaining customers and delivering the product or service. The organization is simple with minimal to nonexistent systems and formal planning and the owner performs all the key tasks. Many companies fail to gain sufficient customer acceptance or product capability to become viable, which results in venture closure on depletion of start-up capital (Churchill and Lewis, 1983). Should the firm survive the existence stage, the firm enters the survival stage.

Firms in the survival stage demonstrate the firm's operational ability characterized by adequate customer support for its products and services. The key problem becomes the relationship between revenues and expenses. In this stage, the enterprise has the potential to grow in terms of size and profitability and these enterprises may progress to the success stage (Churchill and Lewis, 1983).

Entering the success stage emphasizes a focus on the entrepreneur. The entrepreneur needs to decide if the enterprise should exploit the capabilities that the enterprise has developed and thus expand the business or whether to keep the enterprise stable and profitable at its current size. There are two sub-stages in the survival stage. The first sub-stage is success-disengagement where the enterprise achieves economic stability and is manageable in size with a market presence that can ensure sustained economic growth. The owner may opt to stay at this stage indefinitely provided the firm's ability to adjust to environmental changes. The second sub-stage is success-growth. The owner decides to marshal resources to grow the enterprise and the main resource sought is of a financial nature. If the enterprise is successful, it may enter the takeoff stage (Churchill and Lewis, 1983).

The key concerns in the takeoff stage are how to grow rapidly and how to finance the growth. The owner and the business have become separate entities, however, the owner still has the controlling shareholding. This stage is crucial – the owner needs to have the capabilities to manage the complexities of a growing company, which are both financial and managerial. If the enterprise struggles succeed, the choices become retrenchment of employees to remain successful, drop back to the success stage, but if the firm's problems become extensive, it may go back to the survival stage (Churchill and Lewis, 1983).

The final stage in the model is resource maturity. The focuses of the enterprise are to consolidate and control the financial gains brought about by the growth and at the same time maintain the advantages that accompany company small size, for example, the entrepreneurial spirit (Churchill and Lewis, 1983).

Within the Churchill and Lewis (1983) model, there is explicit references to resources at the 'launch' phase, with the most important resources being the ability to obtain cash; develop financial procedures and enterprise leadership; establishing systems, hiring personnel and gaining product/market acceptance. The post-launch stage is survival with the main concern on inventory systems and setting direction, financial accounting, and training personnel, obtaining capital and cash management. From the point of survival, the concern is the acquisition of new capital for expansion as well as new property/plant and equipment. The last stages are characterized by formal structures and established organizational policies and possibilities of new infusions of capital are needed to expand geographically or diversify become the focus. It is implicit in the Churchill and Lewis model the role of resources is to facilitate the organizational transition from one phase to the other (Brush, Greene, Hart and Edelman, 1997).

Merz, *et al*., (1994) argue that the life-cycle studies have limited use for the investigation of growth management because of their development on the assumption that all firms go through a predictable series of predetermined stages. Although the life-cycle growth model has shortcomings, it is useful because it assists entrepreneurs in their decision-making process in terms of resource investment. The framework is useful for the study as it facilitates examination of the various stages and helps in anticipating the key requirements in particular, finance issues encountered in each stage. The framework also provides a basis for evaluating the impact of present and proposed governmental regulations and policies on a business (Churchill and Lewis, 1983). A key contribution of this framework is the identification of the Success-Disengagement stage, where entrepreneurs may not seek further growth after reaching their desired growth level (Mitra and Pingali, 1999).

Small firm development and growth: Financing implications

As the firm grows, there is a need for resources and these may be financial. External factors such as the business environment and industry influence these decisions because a founder will attempt to find the optimal combinations of resources. The financing of the venture will be dependent upon the stage of development and the type of finance required. In addition, the stage of venture development signals risk levels associated with financing the desired growth. The resource choice can have significant implications for the growth of the venture and it is important to note that some resources negatively affect the firm's growth, if, for example, they are too costly. Moreover, the decision depends on the perceived importance of the resource to the venture in terms of achieving the entrepreneur's expectations, for example, sourcing external financial resources enables the firm to grow.

3.4.3 External factors and growth

Approaches, which are macro in scope, include a focus upon specific industry sectors, regional development and emphasize the influence of external factors rather than individual firm characteristics. Factors external to the firm cannot be controlled by the owner/manager.

Table 3.1: Factors encouraging existing firm expansion

Capital	Labour	Government	Market & Operating Costs
Capital availability	Availability of labour	Attitude toward business	Access to markets
Cost of Capital	Cost of skilled labour	Consistency in policies	Demand for products
	Cost of worker's compensation insurance	Regulations	Transport costs
		Business support	Rental costs

(Adapted from Corman, Lussier and Nolan, 1996)

Government support comes in a variety of forms, but typically, according to Bridges, *et al*., (1998:181), consists of "grant aid, subsidised loans and/or the provision of subsidised services such as consultancy, training and the provision of information and advice." This is visible in South Africa with the establishment of Ntsika and Khula to assist the development of the small business sector in accessing markets and capital. Evaluating the impact of government (or government agencies) provides inconclusive findings to verify whether the financial support does stimulate further firm growth (Bridges, *et al*., 1998). There has been little systematic evidence on the incidence micro-enterprise 'graduation' or growth into larger ones in Africa (Kesper, 2000). One-person operations constitute the majority of small-scale industry in Africa; only about one per cent succeeds in graduating to an intermediate size. The emerging literature on South African small firms implies a mismatch between the small firm model used by policy makers and the realities found in the small business sector. Interest groups suggest removal of small firm constraints to growth to unleash the sector's potential. In addition to the removal of constraints through supply-side measures, it is imperative that macro-economic policies aimed at encouraging small firm growth do create an environment conducive to the sector's growth and development (SACOB, 1999).

In South Africa, research within three regions on small manufacturing firms attempted to draw conclusions about the firms' growth trajectories and the impact of external factors on growth. In the Western Cape Province (South Africa), manufacturing firms identified market development and increasing labour costs as growth constraints. In terms of employment growth, 41 per cent of the sample (n=82) had increased employee numbers between 1994-1998, but more interesting is that 38 per cent of the sample had actually decreased the number of permanent employees. The reasons offered by the firms for not pursuing employment growth ranged from desire to keep the size firm manageable, focusing on training to improve efficiency and the impact of Labour laws on wages. The second study in the Vaal Triangle indicated 35 per cent of the sample (n=66) decreased their workforce in 2000 while only 15 per cent increased their workforces in 1999. From the findings, 58 per cent of manufacturing firms had not grown and firms highlighted increased competition and rising input costs as barriers to growth, suggesting that external factors are mainly responsible. A small segment of firm owners/managers in the Vaal Triangle had no growth intentions. The final region examined was Gauteng, considered South Africa's industrial homeland. The region's manufacturing sector comprises mainly of small firms and the contribution to provincial employment is significant. From the sample (n=102), the number of manufacturing firms planning to grow their ventures was low and this suggests that there is 'jobless growth' in the manufacturing sector (Kesper, 2000).

External factors and growth: Financing implications

The extent to which external factors affect the small firm determines the type of growth pursued. The small business may have the necessary know-how and potential market but access to growth finance is, for example, hindered by regulation on potential lenders and risk associated with lending to the small business sector.

3.5 Barriers to small firm growth

Although the growth of small firms is documented as imperative for economic growth, many small firm owners seem not to be well supported by the wide range of business drivers, for example, banks, professional accountants and university researchers (Bianchi and Bivona, 2000). The constraints on small business growth can be categorized into internal barriers to growth and external barriers to growth (Rae, *et al.,* 1997).

Table 3.2: Growth Barriers identified by UK firms and South African firms

UK Firms	**South African Firms**
Raising Capital	Financial
Developing new products	Human Resources
Recruiting Staff	Social
Management Skills	Marketing
IT systems	Lack of Management skills
Business Location	Socio-economic variables
Manufacturing systems	Management views
Business Planning	Economic variables
Market Opportunities	Regulatory and technology change
Ownership of the Business	Management actions
Customer Perceptions	Competition

(Adapted from Viviers, Van Eden & Venter, 2001:7; Rae, *et al*., 1997)

The barriers identified in Table 3.2 can be grouped into internal and external barriers to growth. Of significance is the appearance of finance-related problems for both UK firms and South African firms despite the experience of UK financiers lending to the small business sector. The following sections discuss the two types of barrier in detail.

3.5.1 Internal barriers for small firm growth

A number of studies (Hay, 1992; Aston Business School, 1991, cited in Rae, *et al*., 1997) suggest that the most significant barriers for small firm growth are internal. The two main internal barriers include managerial constraints and innovation. Greiner's work highlights business development as triggered by critical stages of progression and as such, management styles must change to manage this growth. Churchill and Lewis (1983) even suggest that the entrepreneur may have to change to a managerial role. Most small businesses are imitators of existing businesses and thus have no inclination to innovate or only do so as a survival strategy (Bridges, *et al*., 1998). In addition, management weaknesses such as reluctance to take on new debt and to dilute ownership are internal barriers to growth (Bridges, *et al.,* 1998).

3.5.2 External barriers to small firm growth

Small firms are vulnerable to the business environment and market condition changes because of their inadequate resources to hedge against unexpected changes. Labour availability is another concern, in that small firms may be unable to pay market rates for skilled labour and/or there is a shortage of skilled and unskilled labour. A shortage of suitable premises is also a problem for the small firm owner. The effect of market conditions on opportunities, is that according to Hay (1992, cited in Rae, *et al.,* 1997) is "that long term growth is unattained because of the initial focus of the niche market and hence small firms may find it difficult to break free." The focus of this study is finance and thus a detailed discussion on finance-related barriers follows.

Undercapitalization, cash flow management and ability to manage costs have often been identified as the first cause of small firm failure. Although small firm owners consider financial analysis and net working capital as an important issue, a study by Nix and McFetridge (1987, cited in Bianchi and Bovina, 2000) revealed a significant proportion of firms not using concepts in managing their businesses. The study by Falkena, *et al*., (2001) highlights that although access to equity finance is a problem the findings in their study do not suggest the same for access to debt finance from banks for example. Furthermore, finance from an external source is usually needed to allow rapid expansion, accepting equity involvement and sharing ownership. Therefore, a willingness by the entrepreneur to share ownership and decision-making is key to the growth of some businesses (Bridges *et al*., 1998). The findings from a study by Burns and Choisne (1991, cited in Rae, *et al.,* 1997) concluded that of the 247 British companies in the study, 67 per cent financed growth from retained profits and only 23 per cent used bank finance. The main finding is that the stage of development of the firm, where if a firm is in its early stages it is unable to generate substantial profits thus growth is likely to constrained by inadequate availability of financial resources (Burns and Choisne, 1991, cited in Rae, *et al.,* 1997).

3.6 Summary

Under almost every definition of growth, growing a small business needs resources, especially funding. Understanding growth however, requires regard not just for these internal needs of a business but also the external influences on a business. Life-cycle models of small firm growth refer to resources as important or conditional to facilitating the small firm's move from one phase to the next, and the role of management in leading and deciding about resources is critical. Barriers to growth can be internal and external and the extent to which the entrepreneur can manage these barriers determines the growth trajectory of the firm.

For the purpose of this study, the areas identified as important in developing entrepreneurship and the small business sectors include:

- Encouraging small firm growth is important because it is an indicator of continued entrepreneurship and the creation of value for the economy is through growing firms
- The individual, the firm's capability, and the impact of the external environment are important factors in the growth decision and part of the decision involves issues on the firm's capital structure, which are influenced by the entrepreneurs' attitude toward the use of external finance.

CHAPTER 4

FINANCING SMALL FIRM GROWTH

4.1 Introduction

A fundamental characteristic of many entrepreneurial ventures is the imbalance between the resources needed to grow on the opportunity and resources currently available (Manigart, Baeyens and Van Hyfte, 1999). The majority of small entrepreneurial firms rely on bank debt as their major source of finance; as such, the extent to which finance may constrain firm growth is dependent on the efficiency and effectiveness in the provision of bank finance (Barber, *et al*., 1989). Researchers (Rae, *et al.,* 1997, Bridges, *et al.,* 1998) have found financial constraints as an aspect that can prevent the firm from growing. In addition, small business finance needs are different and have to be approached in an entrepreneurial manner and in some instances; financing available to entrepreneurs often is inappropriate (Lloyd-Reason, Marinova and Nicolescu, 2000).

The chapter reviews literature on the characteristics of entrepreneurs' growth decision making in terms of finance followed with a discussion on the features of entrepreneurial finance. The discussion then proceeds to present a comprehensive discussion on the features of debt finance, bank debt finance, bank lending in the small firm sector, the types of lending decisions, and a detailed analysis of South African banks' involvement in the sector. The nature of financing small firm growth concludes the discussion.

4.2 Small firm owners finance structure decision-making regarding growth

Small firms and finance providers such as banks have the same intention of pursuing the optimal functioning of their businesses. However, the various parties according to the Round Table (1997) differ in "insight, methods, means as well as the expectations they have of each other." Small firm owners' financial decision-making according to Landström and Winborg (1995) is a "product of the characteristics of the firm, and the manager's values and goals." Deakins and Freel (1998) add that the decisions made by entrepreneurs can be better understood through a qualitative process, which accommodates the reality of the environment in which they operate. For the purpose of this study, the discussion of the entrepreneur's decision-making process for the financial structure of the business centres on the life cycle approach, pecking order framework, and the agency theory.

The life-cycle approach

The life-cycle approach suggests small firms start out by using the owner's personal resources. However, if firms survive and start to grow, undercapitalization is a danger and owners begin to look to make use of other sources of finance that include the bank and trade credit. As the firm grows and enters the rapid growth phase, the owner is likely to be confronted with liquidity problems and the decision the owner needs to make is whether to reduce firm growth by maintaining pace with internally generated funds, or venture onto the money market or look for a venture capitalist to finance the growth. The underlying hypothesis of this decision-making approach for small firm owners is that they are likely to raise short-term debt and make little or no use of long-term debt (Falkena, *et al*., 2001).

Pecking-order theory

In contrast, the pecking-order theory (Myers, 1984, cited in Falkena, *et al*., 2001), suggests that small firm owners finance business needs in a hierarchical method. In the first instance, owners use internally generated funds, followed by debt finance and finally, external equity. Underlying this approach is the small firm owners awareness of the cost attached to the various source of finance. The hypothesis of this model suggests a negative correlation between profitability and external borrowing by the small firm. The owner works on the assumption that if the firm has high profitability, it has high levels of internal liquidity and therefore reduces the need to borrow (Falkena, *et al*., 2001).

The agency theory

The agency theory focuses on transaction costs, contracting analysis and agency theory (Coase, 1937; Jensen and Meckling, 1976; Stiglitz and Weiss, 1981 cited in Falkena, *et al.,* 2001). The model incorporates issues of ownership, management interrelationships and credit rationing. Information asymmetry, moral hazard and adverse selection often result in contractual provisions between firms and external providers of finance, which result in higher costs for the small firm. For the small firm owner who has poor financial systems and a lack of legal formalization for example, may find themselves subject to external financiers increased request for collateral (Falkena, *et al.,* 2001).

The life-cycle and pecking-order approaches to the decision-making process embrace characteristics of the entrepreneur such as the need for control and thus any decisions aim to minimize external involvement in the management of the business. However, common in both processes is the role of bank finance where the firm is unable to generate sufficient funds from operations and the next source of finance is debt finance from the bank. The agency theory suggests that the small firm owner is aware of financiers' requirements, such as supplying information, thus the owner needs to ensure that they can satisfy those needs before approaching the financier. The three decision-making models represent the outcomes of the interaction between entrepreneurs' growth aspiration, the stage of development of the firm, and the external environment; issues that have been discussed in Chapter 3.

To further understand the nature of small firm decision-making, the following section explains the features of entrepreneurial finance. Entrepreneurial finance highlights pertinent issues underlying the individual's decision-making.

4.3 Entrepreneurial finance

Financing small business growth needs to be entrepreneurial in nature in order to manage the periods of transition between the identifiable phases of growth (Ennis, 1999). It is important to distinguish entrepreneurial finance from corporate finance to minimize finance gaps that may exist between entrepreneurs' demand and financier supply of finance (Deakins, 1999; Smith and Smith, 2000). Smith and Smith (2000) present several features that distinguish entrepreneurial finance from corporate finance.

The first feature that potential external investors should consider according to Smith and Smith (2000:6) is "the inseparability of investment decisions from financing decisions". In corporate finance, a manager can make investment decisions based on the required return on the investment but need not consider the financing of the acquisitions – the two decisions are separate. However, in the small firm, the entrepreneur needs to consider both the investment and financing decisions, making the decision more complex than that of public corporations. The difference in value leads to differences in the required rates of return and a simple adjustment to the net present value of the project cannot effectively counter the differing valuations between entrepreneurs and corporations (Smith and Smith, 2000).

Secondly, the assumption according to Smith and Smith (2000:6) of "the role of diversification of risk as a determinant of investment value" in corporate finance is that investors are able to diversify at a low cost. This assumption does not hold for the entrepreneur because the entrepreneur often invests exclusively in the business. This difference influences risk allocation between the entrepreneur and potential investors, which may determine a project's viability. The third feature suggested by Smith and Smith (2000:6) is "the extent of managerial involvement by external investors". In public corporations, external investors are usually passive while in small firms, external investors often want to provide managerial services and the entrepreneur who wants to retain full control may not welcome this.

Smith and Smith (2000:6) present "effects of information problems on the firm's ability to undertake a project" as the fourth issue regarding differences between financing small firms and public corporations. Corporate finance literature suggests that market imperfections, caused by conflicts of interest and informational asymmetries between corporate insiders and investors, constrain firms in their ability to fund investment projects. Although information gaps between insiders and external investors exist in public corporations, public corporations are able to make investment decisions without immediate regard to external investors perceptions on the value of the investment. In the case of the entrepreneur, external investors are looking to realise their required return on their investment. The entrepreneur bears the burden of trying to convince potential external investors of the project's worth and this needs to be communicated by preparing a convincing and thorough business plan, which can signal the entrepreneur's confidence about the project (Smith and Smith, 2000).

The fifth issue according to Smith and Smith (2000:6) is "the role of contracting to resolve incentive problems." In large corporations, the use of incentive contracting such as managerial stock options and performance bonuses to align management and investor interests is common. In large corporations executive officers often selected on their excellent record of accomplishment, while entrepreneurs often provide little evidence of their abilities to turn ideas into successful businesses. Potential external investors rely on contractual terms designed to 'motivate' the entrepreneur to develop their idea quickly in order to deter entrepreneurs from spending effort and resources on unrealisable ideas (Smith and Smith, 2000).

The final difference Smith and Smith (2000:6) discuss is "the focus on maximizing value for the entrepreneur as distinct from maximising value for shareholders." In public corporations, the driving focus of investment decision-making is the return to shareholders because the management team is an agent of the shareholders. The entrepreneur's objective on the other hand in deciding to pursue an opportunity and how to structure finance to maximize financial value but retain control as the business grows (Smith and Smith, 2000).

From the differences discussed, the elements of risk and control strongly influence the nature of entrepreneurial finance. While, the entrepreneur may thrive on risk to exploit an opportunity, traditional finance providers such as banks aim to minimize exposure to risk, resulting in mismatched mindsets. The overriding aim by the entrepreneur is to maintain control of the enterprise regardless of the source of external finance. This aim may stand true with traditional finance providers, but if the entrepreneur is unable to obtain debt finance from the bank and forced to source external equity finance from venture capitalists, the entrepreneur may lose control of the enterprise. Providing finance for the small business sector is complex; the question the entrepreneur needs to address is the form of financing for the intended growth – debt or equity.

4.4 Sources of finance: Debt versus equity finance for small firms

The main difference between debt and equity finance is the role of the financier. With debt financing, the financier remains external to the management of the business while with equity financing; the financier becomes part of the management and control of the business. Debt finance gives the entrepreneur continued control over the business but the entrepreneur is restricted to raising funds linked to the amount of security available. Though costs of debt finance are lower and the repayments remain fixed, the business is exposed to liquidity problems because of the high gearing structure and profitability is reduced because of servicing high debt costs. In addition, there is increased enterprise exposure to financial risks because of movements in the interest rates (Victoria Government, 1998). Equity finance provides the small firm flexibility in raising funds in excess of security available but this comes at the expense of 100 per cent control and autonomy in decision-making with a greater management reporting needed and the possibility of increased conflicts between the owner and the financier. Should the entrepreneur opt for equity finance, the enterprise reduces exposure to interest rate increases and improves purchasing power because of increased liquidity. However, additional costs for acquiring equity exist and there may be a delay in raising the equity resulting in lost business opportunities (Victorian Government, 1998). Though advantages and disadvantages of each form of finance discussed here are not exhaustive, however, they provide insight into the dilemma the entrepreneur faces in making finance decisions.

In the South African GEM study (2002), interviews with 360 disadvantaged entrepreneurs in the provinces of Gauteng and KwaZulu Natal and the cities of Port Elizabeth and Cape Town in urban areas revealed a significant number of applicants successful in obtaining external finance. From the interviews, Table 4.1 presents firstly the source of finance sought by the entrepreneurs and secondly, the success rate of obtaining finance.

Table 4.1: Sources of finance and outcomes of applications

Source of finance	**% of entrepreneurs applying for finance**	**% of applicants who were successful**	**% of successful applicants who accepted the offer**	**% of all entrepreneurs who received finance**
Bank loan	84.4	25.0	85.2	18.0
Bank overdraft	18.8	62.5	76.7	9.0
Bank credit card	2.3	83.3	60.0	1.2
Micro-lender	3.1	0	-	0
Stokvel	1.2	33.3	100.0	0.4
Mortgage	0.8	100.0	100.0	0.8
Venture capital	0.4	0	-	0
Average	**-**	**33.2**	**82.4**	**27.3**

(Source: Foxcroft, *et al*., 2002:40)

The most common source of external finance used by the entrepreneurs was in the form of a bank loan followed by a bank overdraft. Of significance is that, for example, of the 84.4 per cent who applied for bank loans only 25 per cent were successful compared to 62.5 per cent of entrepreneurs who successfully obtained bank overdraft facilities. The nature of small business lending would suggest that banks offer overdraft facilities more readily because of the minimized exposure to risk for the bank. Another interesting finding in the study is the use of venture capital to finance the business; the study reflects limited use of venture capital and a zero success rate for the applicants. However, the bank remains the principal source of funds that entrepreneurs use to balance shortfalls in their ability to generate internal finance needs. This fact alone justifies the focus for this study on the role of bank finance for small firms as a source of debt finance (Fletcher, 1995).

4.4.1 The South African banking industry

The South African banking sector has 33 indigenous banks and 14 subsidiaries and branches of foreign banks (Falkena, *et al*., 2001). The number of active banks in small firm financing in South Africa is still limited. The early 1990s signalled changes for the South African banking sector, with the introduction of new bank legislation and regulatory measures (Claassen and Brookes, 2002; Falkena, *et al*., 2001). In contrast, EU member banks still encounter excessive government-imposed financial bureaucracy. The result being deficiencies in meeting SME finance needs and higher costs for both banks and SMEs (Third Round Table of Bankers and SMEs, 2000:20). The White Paper on promoting the small business sector had highlight the need to create A Small Business Finance Act that would address the fundamental issues regarding SMME access to finance; this has not materialized but a document on access to finance exists (DTI, 1995)

Differentiating banks from other financial institutions is their risk profiles where the management of credit risks is important for the functioning of the bank. South African banks are regulated firstly, by the Banks Act (1990), which extends to all areas of deposit-taking business and the Act emphasizes risk-management as the basis for supervising banks. The second piece of legislation regulating banks is the Usury Act, 1968, which determines the maximum interest rates that financial institutions may impose on lending, credit, and leasing transactions with its clients. The final form of the legislation is the Credit Agreements Act, 1980, which stipulates certain constraints on instalment sale and leasing transactions by prescribing minimum deposits, leasing conditions, and terms of payments on contracts (ABSA, 1997).

The commercial banks discussed in this study include are four local institutions – ABSA, First National Bank (FNB), NedEnterprise (a subsidiary of Nedcor) and Standard Bank and are part of the Banking Council of South Africa. The banks were chosen because firstly, these banks are indigenous and secondly, have the local knowledge of the small business sector environment.

4.4.2 Bank debt financing for small firms

Falkena, *et al*., (2001:78) argue that in South Africa and other countries, "there is a false perception that an ample supply of debt financing to SMEs will overcome most of their development problems. In practice, SMEs with a proven track record hardly ever experience a shortage of debt financing." This is the case for European Union (EU) small firms (Third Round Table of Bankers and SMEs, 2000). Although small firms lack access to sufficient equity finance, the debate centres on whether the same holds for small firm access to debt finance. According to Falkena, *et al*., (2001:79), the problems that do often arise include "inefficiencies in terms of product range, the cost of debt finance and the service provided" to small firms. Reasons put forward for such inefficiencies include competitive factors, barriers of entry for new financial services providers and small firm needs for non-financial services. Small firms are unable to provide the collateral required by banks because of insufficient private financial resources and rapid depreciation of tangible material assets (Third Round Table of Bankers and SMEs, 2000).

4.4.3 The nature of small firm lending

Little understanding of financing needs of small business poses two problems for lending banks; moral hazard and adverse selection. In small firm lending, moral hazard decisions highlight the difficulties of monitoring entrepreneurial behaviour and adverse selection decisions means making errors in lending decisions. There are two types of adverse selection errors – a bank makes a Type 1 error when it turns down a good proposal and later succeeds, and a Type 2 error is where a bank accepts a proposal, which turns becomes a business failure (Fletcher, 1995). To overcome these challenges, banks need to dedicate resources to appraisal and monitoring and these are difficult for banks to undertake because of the relatively small amounts of finance often required by entrepreneurs (Fletcher, 1995).

4.4.3.1 The lending decision: An assortment of approaches

Entrepreneurs rely heavily on banks as a source of financing for their enterprises. However, banks are faced with several problems, firstly, the inadequate development of risk assessment skills and secondly lending decisions are made under conditions of uncertainty and information asymmetry (Fletcher, 1995; Landström and Winborg, 1995). Decision-making is often delegated to bank managers with respect to providing finance to small and medium-sized enterprises. The rules set by head office influence the decision and the lending decision itself is an interaction between these rules and the manager's experience (Fletcher, 1995). Lange, Warhuus and Levie (1999) suggest that bankers faced with a lending decision are often surrounded by uncertainty because of incomplete information. This leads to the decision to being either strict interpretation rules or decisions made on complete use of the manager's own experience and attitude (Fletcher, 1995). There are several variables in commercial lending according to Fletcher (1995:38), for example, "heterogeneity of loan applicants, quality of information, presentation of the proposal" and these influence the decision. The next section presents three examples of approaches to lending decision-making utilized by banks.

Lending decisions based on meeting certain criterion

A study by Fletcher (1995) investigated how Scottish bank managers make lending decisions to small firms and the importance of the criteria used to evaluate lending propositions. Fletcher (1995) interviewed a representative sample of bank managers to determine their process of decision-making by the answers they supplied to the questions asked about their funding decisions. This enabled Fletcher (1995) to analyse the importance of different criteria actually used in the decision-making (Fletcher, 1995). From the data, Table 4.2 presents the criteria that were used or sought by Scottish bank managers in making their lending decisions.

Table 4.2: Criteria used by Scottish bank managers to make lending decisions

Criterion	Percentage
Management capabilities	76
Location	58
Forecast balance sheet and profit and loss	47
Gearing	45
Employing a chartered accountant	42
Motivation of directors	32
Role of IT consultant	24
Industry sector	29
Small business experience	21
Qualifications	16
Sources of finance/grants	53
Connection with bank	29

(Source: Fletcher, 1995:46)

Management capabilities emerged as the most important criterion used by bank managers on evaluating applications followed by location and source of finance and grants available to the small firm. Financial issues including financial statements (47 per cent), gearing (45 per cent) and the use of a chartered accountant (42 per cent) ranked as the next important factors considered by bank managers. Only 16 per cent of the managers considered the qualifications of the individual as important, which is interesting, given the high status given to role of education in entrepreneurship development.

In a South African study by Nieuwenhuizen and Kroon (2002), interview data from nine financial institutions in South Africa revealed the finance criteria followed in evaluating loan applications. The study conducted a survey to identify success factors associated with small firm success. The study analysed the relation of the success factors with their use by financiers in accessing applications. Table 4.3 presents the research findings.

Table 4.3: Number of financing criteria corresponding with the success factors

Type of success factor	Success Factor	Number of corresponding financing criteria (n=9)
Success factors relating to personal characteristics	1. Creativity and innovation	1
	2. Commitment to enterprise	5
	3. Involvement in enterprise	1
Success factors relating to management skills	4. Planning of enterprise	9
	5. Knowledge of competitors	2
	6. Mainly market-focused	2
	7. Quality work enjoys priority	1
	8. Client service	1
	9. Financial understanding	4
	10. Financial management	9
	11. Knowledge and skills	4
	12. The use of experts	4

(Source: Nieuwenhuizen and Kroon, 2002:25)

Planning of the enterprise and financial management emerged as the most important factors used in evaluating applications with the commitment to enterprise (a personal success factor) regarded as the next important factor. The findings from their study highlight management success factors as more important than personal factors. In addition, their study identified the following key success factors – "perseverance, willingness to take risks, sound human relations, positive attitude and approach, and bookkeeping for own advantage" that do not feature in financing criteria followed by financial institutions in their study. These factors demonstrate the individual's entrepreneurial skills, which Nieuwenhuizen and Kroon (2002) argue as the key for enterprise success.

Both studies (Fletcher, 1995; Nieuwenhuizen and Kroon, 2002) indicate financial management and management skills as the most important factors used to evaluate loan applications. Interestingly, the banking relationship issue does not feature in the South African context.

Lending decisions based on credit-scoring systems

In a survey, commercial banks in the Western Cape province in South Africa strongly rely on collateral existence and use automatic or semi-automatic credit-scoring systems to assess small firm risk (Falkena, *et al*., 2001). Credit scoring according to Frame, Padhi and Woosley (2001) is the "process of assigning a single quantitative measure, or score, to a potential borrower representing an estimate of the borrower's future loan performance." Feldman (1997, cited in Frame, *et al*., 2001) suggests credit scoring enables lenders to underwrite and monitor loans without meeting potential borrowers. Furthermore, Feldman (1997, cited in Frame, *et al*., 2001) suggests credit scoring should potentially reduce costs because small firms have access to more finance lenders. The final advantage of using credit scoring in the lending decision is the potential increase in credit availability because the lender will have more information regarding the business and base decisions on expected risk (Feldman, 1997, cited in Frame, *et al*., 2001). However, Falkena, *et al*., (2001), suggest there is little evidence supporting credit scoring as an effective method for risk assessment in South Africa. In addition, financiers have underdeveloped competence and financial tools to handle small firm investments (Landström and Winborg, 1995).

Lending decisions based on assessing the business plan

NedEnterprise uses the business plan to assess the character, capacity, content, contribution and collateral aspects of owners who require debt finance as part of their lending decision-making process. Character assesses the owner's honesty, integrity and creditworthiness as well as the owners' ability to operate the business on a day-to-day basis as well as their strategic long-term planning. In addition, NedEnterprise considers the owners' qualifications and relevant experience to operate the business. Under capacity, NedEnterprise analyses the financial forecasts in terms of profitability, attainability and consideration of economic changes such as inflation, taxation and set-up costs for example. NedEnterprise performs a sensitivity analysis to assess the sustainability of the business and more importantly the business's ability to accommodate debt in its capital structure. The content aspect needs for the small firm owner to discuss the purpose of the finance, for example purchasing assets for expansion, the amount of finance required, the period involved, and how the owner intends to repay the loan. NedEnterprise requires the small firm owner to contribute to the business in the form of cash or assets. NedEnterprise expects the owner to contribute between 20 per cent and 30 per cent in to the business and NedEnterprise (2001) accepts “non-interest-bearing loans from third parties (repaid after debt finance has been repaid), cash withdrawals from home loans, personal assets used solely in the business and cash savings” as own contributions. Collateral/security is the final aspect NedEnterprise considers before providing the small firm with finance. Security can be in the form of personal assets such as fixed property, deposits or business assets such as bonds over equipment and if the business is covered by the Khula Guarantee scheme. The level of security required by NedEnterprise depends on the perceived level of risk in the business (NedEnterprise, 2001). NedEnterprise’s approach is supported by UK banks that increasingly make lending decisions based on the business plan (Fletcher, 1995).

Emerging from the examples of the types of lending decisions provided is the need for information. Banks do not make decisions on intangible issues but on facts that are measurable, such as the financial performance of the business, the credit history, and the firm’s assets.

4.4.3.2 The role of information in small firm lending

In analyzing small firm finance, an underlying assumption is that small firm owners have more and/or better information about firm performance than banks. For larger firms banks can use information collected by independent sources in making lending decisions; such information is often unavailable for lending decisions for the smaller firm (Storey, 2000). When asymmetric information exists, the bank becomes more cautious in lending to smaller firms because of increased uncertainty and monitoring costs (Storey, 2000; Third Round Table of Bankers and SMEs, 2000; Berger, Miller, Petersen, Rajan and Stein, 2001). The Third Round Table of Bankers and SMEs, (2000) states that the reasons for the entrepreneur’s inability to provide this information is because, firstly, owners do not make use of professional advisors. Secondly, the consequence of bank personnel rotation (for employee skills development) often is that personnel take with them information pertaining to SMEs, and finally young and growing small firms often do not possess a proven record of accomplishment. Small firms in the EU suggest there is information asymmetry between them and the banks as they feel that banks do not make a concerted effort to inform them of the product variety available to the small firm (Third Round Table of Bankers and SMEs, 2000). Information asymmetry, moral hazard and adverse selection often result in contractual provisions between firms and external providers of finance, which result in higher costs for the small firm (Falkena, *et al*., 2001). A good banking relationship can assist the bank to learn more about the small business sector finance needs and access the information it requires from the small firm to facilitate the lending decision.

The small firm-bank interface

Although bank finance is considered important for small firms, the issue of banking relationships is under-researched, particularly in the context of small firms (Ennew and Binks, 1997). A close SME-Bank relationship has potential to provide banks with the much-needed understanding of the environment in which small firms operate; a better understanding of the small firm owner attributes and a more accurate overview of the business's viability (Ennew and Binks, 1997). In addition, Lange, *et al*., (1999) suggest that close banking relationships are "associated with greater availability of capital, lower credit lines, less frequent pledging of collateral and lower monitoring." A relationship is not unilateral; it requires active contribution from both the bank and the small firm owner. Few large banks in the UK (similar to the South African context) provide products and services to the SME sector and the banks have recognized the importance of servicing the SME sector because of its profit and revenue potential. As in South Africa, the range and variety of products available to the small business sector have expanded, while the management of the banking relationship continues to an area of concern (Ennew and Binks, 1997). In the EU, the relationship between banks and SMEs has improved over the years but there are issues that still need to be addressed. These issues are presented in Table 4.4.

Table 4.4: Differences between bank and SMEs objectives

Objectives of Banks	Objectives of SMEs
Managing risk on loans provided in order to avoid losses	Getting funding without constraints to allow flexibility in all business activities
Giving high priority to shareholder/member value by focusing the bank's strategic objectives on raising productivity, efficiency and profitability	Acquiring the necessary funding and support to start a business, develop, prosper and provide a satisfactory return to the owners and employees
Segregating the organization into autonomous business units and channels in order to maximize productivity, efficiency and individual profit contribution	Requiring single sources for customised and comprehensive packages of products and services to improve business performance
Reorganizing the branch network and reducing low margin services to cut costs and improve (short-term profitability)	Having maximum access to loans and services
Job rotation of the banks' staff, because career planning and the necessity for flexibility	Intensifying personalised interaction with Account Managers to mitigate the information gap and create mutual trust
Key positioning of IT systems in many aspects of banking, e.g. establishing clients' profit contribution, risk assessment and product distribution (virtual banking)	Creating and maintaining a personal relationship with the bank staff to ensure that loan decisions take the entrepreneur's skills and attributes into account

(Source: Third Round Table of Bankers and SMEs, 2000:15).

Fletcher (1995) suggests relationship problems are a result of "mutual misunderstanding, technical problems (bank charges, interest rates and levels of security) and mutual fear." These resulting mismatches between banks and small firms result in liquidity constraints that combined with moral hazard and adverse selection contribute to finance gaps (Fletcher, 1995). However, according to the Third Round Table Report (2000: 21) small firms suggest that banks "often don't (want to) meet their specific needs and apply excessively stringent conditions." The deficiencies according to small firms in the EU include, firstly, the nature of loans. The products and services offered by the banks are not tailored to individual specific needs making them inflexible. Small businesses highlight the slow decision processes.

The objectives of banks and small business differ on several issues. Firstly, banks aim to manage loan risks to avoid losses, while small business want easy access to finance that enables the business to operate. Small business owners/managers need to obtain finance to support the business to provide a suitable return for the owners and employees. However, banks need to ensure shareholder/member value, which forces banks to focus on the bank's strategic goals such as improving productivity, efficiency, and profitability.

The final difference focuses on the relationship between banks and small businesses. Small business owners strive to create and maintain sound relationships with bank staff in an attempt to influence loan decisions, which would take into consideration the entrepreneur's skills and characteristics. Banks, on the other hand, strive to use information technology systems in many areas of banking, for example, calculating the clients' profit contribution to the bank and risk assessment. These systems would not encourage the close personal relationship the small business owner/manager seeks (Third Round Table Report, 2000).

Within the banking industry, the debate on the profitability of the small business sector is discussed in the next section.

4.4.3.3 The profitability of the small business segment for the banks

The profitability of the small business sector varies materially between countries (Falkena, *et al*., 2001). For example, in the UK and US, banks regard the small business sector as potentially profitable, while in South Africa there is little evidence to support this finding (Falkena, *et al*., 2001). Although the sector is potentially viable, EU banks attribute their inability to meet small firm finance needs adequately due to the small loan requests and differing funding requirements for small firms (Third Round Table of Bankers and SMEs 2000). An important issue is the costs associated with the small loans required by the businesses; regulations also play their role in that banks face government imposed regulations, which lead to inefficiencies and higher costs for both parties (Third Round Table of Bankers and SMEs, 2000). These transaction and monitoring costs reduce profitability margins for banks supplying finance to small firms (Landström and Winborg, 1995; Lopez-Gracia and Aybar-Arias, 1999). Although no empirical evidence exists on the profitability of the small business sector for South African banks, South African banks face the added pressure from the political front and small business to provide affordable finance to small firms despite established international research on the risks associated with small firm lending.

4.4.3.4 Risk associated with lending to small firms

Bank financiers are reluctant to finance small firms for the following reasons: firstly, the risk is too high with potential return lower; secondly, financiers have underdeveloped competence and financial tools to handle small firm investments and finally, the transaction and monitoring costs are too high (Landström and Winborg, 1995). Banks compensate for the risk in terms of fees, and increased demand for appropriate collateral interest margins and deposit balances held in the banks (Storey, 2000; Third Round Table of Bankers and SMEs, 2000). The statistics available on the failure rate of small business makes it difficult for finance institutions such as banks to provide finance. Business Times (1997) discloses "six out of the 10 new business start-ups in South Africa fail within the first 18-24 months – and almost 90 per cent of new product launches fail in the first year." Another statistic presented by Viviers, *et al.,* (2001) is that "the estimated rate of small, medium and micro enterprises (SMMEs) is between 70% and 80% and millions of Rands are being lost on business venture because of essentially avoidable mistakes and problems" despite the good ideas. The other factors associated with their failure is entrepreneurs do not possess the required business, technical and financial skills required to run a business successfully (Business Times, 1997) and Mukoki (1997, cited in Business Times, 1997) argues "that the risk profile cannot be changed simply by making funding available."

The type of information available, the profitability and the risks associated with small firm lending makes it difficult for banks to actively finance the small business sector. However, despite these issues, the four banks have become increasingly involved in the small business sector but to the extent of their credit risk management policies and regulation governing their activities.

4.4.4 South African commercial banks' experience in financing small firms

Falkena, *et al*., (2001) report their difficulties to assess local South African commercial banks level of involvement and experience in supplying small firm finance. They (Falkena, *et al*., 2001) highlight that bank maintains discretion about their practices in the SME sector. Despite this shortcoming, Falkena, *et al*., (2001) are able to make estimations about bank SME credit portfolios. Table 4.5 provides an overview of bank involvement in the SME sector.

Table 4.5: Very rough estimate of the main banks' SME book*

	Standard Bank	Nedbank	Absa	FNB**	Total
SME clients	360 000	N/a	170 000	N/a	
Non-borrowers	226 800	N/a	N/a	N/a	370000
Borrowers	133 200	N/a	N/a	N/a	
Total book***	R5 bn	R 5-8 bn	R3-7 bn	R2-4 bn	R20 bn
Average loan size	R39 039	N/a	R47 058	N/a	R54 000
Market share	34%	33%	20%		100%

* Source: Presentations to the Parliament Portfolio Committee for Trade and Industry on the role of banks in financing SMMEs (June, 2000) and South African Banking Council – (figures computed by MFRC).
** Figures for FNB are pure guestimates. FNB, according to South African Banking Council, was not required to present to the Committee.
*** This is the most hazardous of all guesses as nearly all commercial banks have various definitions of what constitutes an SME.

(Source: Falkena, *et al*., 2001:84)

Standard Bank provides the most accurate statistics in comparison to the other three major banks. Standard Bank, according to Falkena, *et al*., (2001), is the leading bank in the SME market with a dominant presence in the lower-end SME segment. NedEnterprise comes in second in SME financing while the remaining two large banks ABSA and FNB are actively increasing their involvement in the SME sector (Falkena, *et al*., 2001).

4.4.4.1 Bank products for small firm finance needs

Although bank depositors do not make focused or direct investments in the SME sector, bank depositors rely on banks to safeguard their money. Banks consider the credit-risk profile of small firms high and, as such, are willing to risk a relatively small percentage of depositors' money in small firms (Falkena, *et al*., 2001). Banks, however, provide a range of small business debt products displayed in Table 4.6.

Table 4.6: Bank Products available for small firms financing in South Africa

Bank	Over-Draft	Bank Guar.	Khula Guar.	Revolving Credit	Medium-Term Loans	Business Mortgage	Asset Finance	Instalment Agreements
ABSA	x	x	x		x			x
FNB	x	x	x		x		x	x
Nedcor	x	x	x		x			x
Standard Bank	x		x	x	x	x	x	x

(Sources: ABSA, 2002; FNB, 2002; Nedcor, 2002; Standard Bank, 2002)

All the banks offer overdraft facilities on the current account. The overdraft facility is ideal finance for working capital needs and to cover the business's short-term cash flow requirements. Twenty-seven per cent of the SMEs who use bank products use the overdraft facility in operating their businesses (Falkena, *et al*., 2001). The interest payable is calculated on a daily basis on the amount borrowed. The four banks offer medium term loans that are payable within seven years. On average, 11 per cent of the SMEs who use bank products in their finance structure use term loans (Falkena, *et al*., 2001) The repayments follow a defined agreement. This loan enables SMEs to finance major capital expenditures such as assets and expansion. The interest rate is linked to the bank prime lending rate and is debited monthly. All the banks offer instalment sale agreements. This hire purchase facility enables SMEs to acquire fixed business assets. The facility is available between one and five years, with fixed monthly repayments. The interest rate is linked to the bank prime-lending rate. Sixty-one per cent of SMEs who use bank loans utilize the instalment sale facility in structuring their business finance (Falkena, *et al*., 2001). Small firms can make use of the Khula Loan Guarantee scheme to access bank products (revolving credit, guarantees, term loans, bank overdraft, instalment sales and construction performance guarantees) for various business dealings, if they satisfy Khula's criteria (Table 4.7).

Table 4.7: Khula Criteria to provide guarantees for SMEs

Criteria
Applicant must be a South African Citizen
Applicant must be owner/manager of the business
Applicant must live within the borders of the Republic of South Africa
Applicant must provide at least 10% own contribution
Applicant must have the necessary skills and experience or access to such skills
The business must demonstrate financial viability

(Source Khula, 2001)

The bank does the credit assessment of all applications and if the bank is satisfied that the application conforms to all its necessary lending requirements, the bank then approaches Khula for the guarantee. The individual needs to demonstrate their ability to contribute to the venture and more importantly the business venture has to be financial viable and this information is obtained from the business plan.

Standard Bank offers a business revolving credit product that is a loan facility, which can be used for the business and be repaid in equal monthly instalments. This facility allows the business owner to spread the cost of capital equipment purchases over a maximum five-year period. The interest rate is linked to the bank prime lending rate and is debited monthly. About 11 per cent of SMEs who use bank products to structure their business finance use the revolving credit facility (Falkena, *et al*., 2001). The facility may revolve after payment of at least 25 per cent on the outstanding loan balance. Standard Bank offers an SME Business Mortgage product to established SME businesses for use in buying suitable business premises. The SME may be provided with up to 80 per cent of the assessed value and the mortgage is repayable over a maximum 20-year period. ABSA, FNB and NedEnterprise offer guarantees on behalf of the SME client. There are several types of guarantees offered by the banks. These include Performance guarantees, Property guarantees, Shipping guarantees.

Falkena, *et al*., (2001:58) conclude that banks "currently provide most of these products very effectively." However, many small firms are unable to separate personal finances from business finances. This problem calls for increased non-financial support for small firms (Falkena, *et al*., 2001). The Third Round Table of Bankers and SMEs (2000) offered the suggested the following: banks should create tailor-made financial solutions by offering a total range of options, such as equity, leasing, mortgages, credit cards, factoring for example, all products readily available for the South African entrepreneur. The Third Round Table of Bankers and SMEs (2000:25) also called for favourable conditions such as lower rates, grace periods and more flexible collateral requirements.

4.4.5 Financing the growth of small business

Relatively few firms break the entrepreneurial growth barrier and become medium-sized. In Europe, lack of venture capital has been both a barrier and a reason why small firms sell off their business. Managerial resources are viewed as serious limitations of firm growth; in addition, the small firm has problems of raising capital. Studies have reported about difficulties in the early growth phases of new firms. These difficulties, for example, the opportunities he perceives, his ability, and need for growth can be related to the entrepreneur. In other cases, the difficulties could be related to the organizational structure that is making the necessary transition in organizational structure and management as the firm grows.

4.4.5.1 A life-cycle approach

SMEs have four key funding requirements according to Falkena, *et al*., (2001:56) "initial infrastructure investments, lumpy operations costs, 'next-step' expansions, and unexpected opportunities requiring quick access to funds." These funding requirements arise at different stages of a firm's development.

Life-cycle funding: the UK and US experience

The table presents the financing of small business at different stages of firm development.

Table 4.8: SME life-cycle funding: The US and EU experience

Main sources of finance	Start-up		Early Growth		Expansion		Succession		Maturity	
	US	**EU**	**US**	**EU**	**US**	**EU**	**US**	**EU**	**US**	**EU**
Own capital/Family and friends	x	x		x						
Separate SME bank units		x		x		x		x		x
Suppliers of substitutes (Credit cards, Factoring, Leasing)		x		x		x		x		x
Regional Development Agencies		x		x						
Public Funding Institutions		x		x		x		x		x
Banks	x	x	x	x	x	x	x	x	x	x
Retained Profits			x	x	x	x	x	x	x	x
Informal Investors	x	x	x	x	x	x	x		x	
Venture Capital Funds	x	x	x	x	x	x	x	x	x	x
Institutional Investors					x	x	x	x	x	x
Stock Markets					x	x	x	x	x	x

(Adapted from: Third Round Table Report, 2000:19; Timmons, 1999:421)

Table 4.8 presents the major sources of finance for SMEs in the US and EU. In the start-up stage, small firm owners rely on insider finance from the owner, family, and/or friends. The decision to finance the firm from insider funds is driven by the owner's entrepreneurial ambition and personal ties with the venture and insufficient collateral for an external financier to assess the venture's risk. As the firm is established, growth potential becomes clear and at this stage, the firm can use other sources of finance such as venture capitalists, banks, and stock markets. At this stage, potential external investors are in a better position to assess risk and viability of the business. As the firm enters its maturity stage, money markets, stock options may be used to finance business operations.

Life-cycle financing: The South African experience

Small firms in South Africa have different financing needs to their counterparts in developed countries.

Table 4.9: SME life-cycle funding: The South African Experience

Type of SME	Start-up phase	Growth phase	'Steady state' and exit
Minority: Traditional SME (e.g. white-owned family business)	Family, friends, savings, equity in residential property	Asset-backed finance, factoring, bank debt, trade credit	Often none, but debt if required
High number: Emerging enterprise from previously disadvantaged communities	Few resources available dependence on external funds		
Minority: High growth enterprises (hightech, life sciences or any other	Angel finance, team equity, some venture capital, corporates	Venture capital, private equity, asset-backed finance, some bank debt, corporates	High-yield debt market, bank debt, corporates. Exit either via capital markets or via trade sale

(Source: Falkena, *et al*., 2001:51)

From Table 4.9, only a few firms have access to a variety of finance across their stages of development and the highest numbers of small firms are from previously disadvantaged communities. Their need for external finance is emphasized by their need for external finance from the onset of venture creation in comparison to the white counterparts who have some form of personal finance needed in the start-up stage. The other minority type of small firms are the high-growth firms such as technology firms which require unique innovative financing products over their stages of development because of to the nature of their business.

Though the three countries have the similar sources of finance available for the small business sector, the difference is the accessibility to those sources. Comparing the South African experience with the EU and US experience, the main difference is the availability of bank debt throughout the small firms' stages of development, compared to South Africa where bank debt becomes accessible after the start-up phase.

4.4.5.2 The resource-based theory on small firm finance

An internal approach to financing growth in the small firm is bootstrapping. Winborg and Landström (1997) suggest many small firms structure finance needs based on the resource needs. The focus on resources supports the resource-based theory, which attempts to develop an understanding of the use of resources in businesses. By adopting this approach in financing firm growth, the small firm owner is engaged in financial bootstrapping. Winborg and Landström (1997) define financial bootstrapping as "measures used in order to meet the need for resources, without using long-term external capital from banks and/or new owners." The use of financial bootstrapping in small firms can be explained by SMEs inability to access finance from institutions or the small firm owner's desire to retain control over the business (Winborg and Landström, 1997). In their study, Winborg and Landström (1997) identified and described financial bootstrapping measures used by Swedish small firms. Initial interviews and an extensive literature review revealed 32 financial bootstrapping measures in use. The second phase of the study involved constructing a questionnaire, and mailing it to 900 Swedish small firms (excluding those in the financial and/or public sector) which had less than 100 employees. From the data, Winborg and Landström (1997) were able to identify two sets of bootstrapping measures – those aimed at minimizing capital requirements and those aimed at meeting capital requirements without bank and/or new owner involvement. Table 4.10 presents the top eight financial bootstrapping measures for each category.

Table 4.10: Financial bootstrapping measures

Measures to minimize need for capital
Buy used equipment instead of new
Use routines in order to speed up invoicing
Borrow equipment from other businesses for shorter periods
Use interest on overdue payments from customers
Hire personnel for shorter periods instead of employing permanently
Use routines in order to minimize capital invested in stock
Co-ordinate purchases with other businesses
Lease equipment instead of buying
Measures to meet need for capital
Seek out best conditions possible with suppliers
Withhold manager's payment for shorter/longer periods
Deliberately delay payment to supplier/s
Obtain payment in advance from customers
Use of manager's private credit card for business expenses
Obtain capital via manager's assignments in other businesses
Obtain loan from relatives and friends
Deliberately delay payment of value-added tax

(Adapted from Winborg and Landström, 1997)

The table indicates that entrepreneurs may utilize other financing strategies that may limit the use of external finance in a bid to either maintain control of the financial decision-making in the firm or sustain operations because of knowledge that they would not be able to access external finance for expansion. In addition, bootstrapping measures reveal continued entrepreneurial behaviour because the entrepreneur utilizes innovative approaches to manage the firm's finance needs and thus build up financial resources to use for growing the venture when the time arrives. Winborg and Landström's (1997) study provides insights into the nature of financial management strategies and in particular the use of cash within the business where the owner seeks to maximize value.

The approach to financing firm growth reflects owners' finance structure decision-making. The life cycle approach follows that owners' at some stage will look to external sources to finance growth, the type of finance will depend on issues such as management involvement, repayment schedules, interest rates to name a few. On the other hand, bootstrapping measures can be used to manage the growth of the business ensuring that there are no liquidity constraints because, for example, the cash is tied up in inventories or poor debtor collection policies. With this approach, owners' do not intend to source external finance for growth but intend using internally generated funds.

4.6 Summary

The chapter focused on bank finance. From the literature, decision-making and relationship aspects between the two parties emerge as key to obtaining growth finance. However, at the same time, there is the question of determining how entrepreneurial the funding structures are and if they do take into consideration the needs of the small firm sector. As far as direct loan support to SMEs is concerned, banks are increasing their involvement but remain discreet about it. There is a need for better research on the exact extent of their involvement, and better disclosure from their side. Possible fears of banks on the consequences of transparency about their exposures should be addressed pragmatically.

For the purpose of this study, the following issues are significant

- The underlying issues driving the decision-making process for the bank and the small business owner are fundamentally different; however, common to both is the desire to control the financial decision-making in their respective businesses
- The nature of small business lending is complex and the facets of lending need to be clearly communicated; however, information asymmetry prevents this communication
- The risk associated with lending to the small business sector is driven by the lack of understanding of the needs of small business and to begin to counter this banks need to understand the nature of entrepreneurship and accommodate it in their finance products
- The banking relationship is the cornerstone of decision-making; however, the move by banks to utilize centralized decision-making tools such as credit scoring limits the potential of banks and small firms interacting and hence developing the understanding required of one another's operations and objectives.

CHAPTER 5

RESEARCH METHODOLOGY

5.1 Introduction

The central research question is: What is the role of bank finance in small firm growth? The sub-questions exploring the issue of finance in the growth decision and include: What is the bank's perception of the entrepreneur and the small business sector? What are the growth objectives of the small business owners? What are the small business owner's and the bank's perception of small business finance needs? What is the role of the banking relationship for lending decisions? To answer these questions, selecting an appropriate research methodology was imperative. The chapter provides an overview of the study's research methodology.

The chapter discusses the assumptions and rationale for adopting a qualitative research paradigm for the study based on shortcomings identified in the quantitative research paradigm. The nature of the research questions justifies the adoption of the case study design. The chapter discusses elements of the case study design, namely the data collection and analysis procedures and shortcomings of the case study approach. The chapter concludes with a discussion of credible qualitative research with a focus on quality issues of the research.

5.2 The qualitative research paradigm

Guba and Lincoln (1994:107) describe a paradigm as a "set of basic beliefs, which represents a worldview that defines, for its holder, the nature of the world and the individual's place in it, and the range of possible relationships to that world and its part." Small business research is mainly concerned with a holistic, integrated approach to phenomena under study and is usually not suitable to objective investigation or direct experience. The underlying ontological assumption of quantitative research is that there is only one objective reality and its epistemological assumption is that the researcher is independent from that under study (Creswell, 1994). The outcomes of quantitative research include, firstly, attempts to establish correlations between variables, with insufficient attention of how variables are defined by the people under study. In addition, quantitative research focuses on purely mathematical logic, which may overlook the commonsense reasoning that may be used by both the researcher and the study participant. These identified shortcomings convinced the researcher to adopt the qualitative research paradigm for this study that was exploratory in nature.

The ontological assumption of qualitative research is that multiple realities exist and the question is thus what is there that can be known about it (Guba and Lincoln, 1994). The ontology proposed by the researcher is one that embraces the concept of multiple realities and accepts that each individual small firm owner constructs his or her own reality according to how he or she interprets and perceives the world. To understand this world, the researcher must represent the world as seen by the small firms in the study (Hill and Wright, 2000). Epistemology, according to Healy and Perry (2000:119), "is the relationship between that reality [that the researcher investigates] and the researcher." The methodological element of the qualitative paradigm requires that the researcher answer the question – how can the researcher go about finding out whatever they believe can be known. The case study methodology and the data collection techniques of interviewing and document review allowed the researcher to do research in its natural setting (Guba and Lincoln, 1994).

Characteristics of qualitative research matched the purpose of the study. The first characteristic – the focus of qualitative research, was on the process itself rather than achieving specific outcomes. Secondly, the researcher was the primary instrument for the data collection and analysis processes. Hill and Wright (2001:434) corroborates the fact that research in small firms needs an epistemological approach which dictated a minimization a distance between the researcher and the key individuals in such enterprises. Finally, research into small firm and SME finance-related issues that is rooted in the quantitative research paradigm does not yield a rich understanding of the key issues affecting small firm financing. Using qualitative research methods enabled the researcher to describe and provide meaning of people's experiences through analysing words (Creswell, 1994). The research problem was well suited to the qualitative design because exploring the experiences of SME owners/managers and finance providers with respect to financing growth the researcher had to interact with the small firm owners. Qualitative research methods allowed the small firm owners to speak and provide their perspective on the research problem. The researcher did not control the context of inquiry and this facilitated the researcher's goal of discovering the person's experience as a whole and not as a separate entity (Blaxter, Hughes and Tight, 1997).

5.3 The research design: case study

Yin (1994:13) defines a case study as an inquiry strategy that "investigates a contemporary phenomenon within its real-life context, especially when the boundaries between phenomenon and context are not clearly evident." The type of research questions for this study gave rise to an exploratory case study. The researcher selected the case study design to facilitate exploration of contemporary events on which the researcher had little or no control.

The researcher selected the case study design because it embodied the ontological assumptions that the essence of the phenomena investigated was a product of an individual's experience and belief. This view enabled the researcher to explore the research question from different perspectives (the small firm owners, key informants and selected documents) to provide an in-depth portrayal of the phenomenon. The epistemological assumption of qualitative research required the researcher to be involved with the study participants to gain the knowledge, which was personal, subjective and unique (Hill and Wright, 2001) to the study participants. In addition, the researcher selected the case study design because the researcher did not aim to control the variables because quantification of data was not the focus; the priority was rather to develop an understanding of the case itself with no pressure to provide an empirical generalization (Gomm, Hammersley and Foster, 2000; Winegardner, 2002).

A major drawback of using case studies was its limitation to generalize the findings. A second disadvantage was the concern that the case method could either exaggerate or oversimplify a situation, which could be misleading. Other drawbacks of the method were that case study method is time consuming and the researcher had skill limitations in undertaking the method (Winegardner, 2002).

5.3.1 Conducting the case study: Data collection procedures

The following section discusses the data collection procedures and begins with a discussion of the unit of analysis. The discussion moves to the ethical considerations for the study, the sampling strategies, sources of evidence, and finally, data management issues.

5.3.1.1 Unit of analysis

Table 5.1 represents the units of analysis for the case study.

Table 5.1: Units of Analysis

Units of Analysis	**Data Collection Procedure**	**Desired Outcomes**
Small Firm Owners	Interviews	To identify drivers of behaviour - Why small firm owners wish to grow their business - What their finance objectives and strategies are regarding growth - What role does the bank play in their growth decisions - What banks need to consider in small business finance
Key Informants	Interviews	- To provide factual information on the issues under study
Documents	Document review	- To provide insights to policies and approaches to small firm lending

The individual small firm owner was the primary unit of analysis. Other sources of evidence for the case study include three key informants and document review.

5.3.1.2 Ethical considerations: Access and rapport issues

Before undertaking interviews, the researcher gained access to the individuals by approaching them personally at their place of work and asking permission to interview them. To determine if the small firm was eligible for the interview, the researcher asked potential small firms the age of the firm because the researcher was only interested in interviewing small firms that had existed between two and five years. The researcher informed the small firm owner and key informants about the nature of the study and its purpose. An interview schedule was then prepared in accordance to the availability of small firm owners and key informants. Interviewees were informed before the interview took place that the information provided to the researcher would be confidential, be used for academic purposes and interviewees were provided the option of reading findings of the study to ensure that information was not presented out of context. The researcher requested permission at the initial meeting with small firm owners and key informants to tape record the interview and in all cases, the researcher obtained permission.

5.3.1.3 Sampling strategy

Qualitative researchers advocate a flexible research design. The issue of sampling and selection of the informants is a key decision area in doing qualitative research. The researcher selected several purposeful sampling strategies to allow flexibility and meet various interests and needs (Creswell, 1998). In following purposeful sampling, the number of participants was not decided beforehand but to the degree to which additional interviews would not contribute further in understanding the phenomena under study. Two types of purposeful sampling strategies used in the study included convenience sampling and criterion sampling. Creswell (1998:117) defines convenience sampling, as a sampling strategy that "saves time, money, and effort." This was particularly useful as the research purpose was exploration of small firm owner growth finance objectives;

therefore, few interviews could be undertaken. Key informants including a bank SME Business Advisor, an expert in entrepreneurship and an academic from Rhodes University were selected using stratified sampling strategy to achieve the same goals of comparison and obtaining different views. The use of criterion sampling strategy followed where cases had to meet some criterion. In the case of small firm owners, the criteria included the following: firms had to have been operating for at least two years but not more than eight and small firms satisfied the definition of 'small' according to the National Small Business Act of 1996. A mixed purposeful sampling strategy allowed the researcher to collect rich data and detailed data about small firm growth-finance objectives and behaviour/strategies.

5.3.1.4 Collecting the case study evidence

The researcher selected interviews and documentation as the sources of evidence for the study. Following two principles maximized the benefits of the sources of evidence used in the study. The first principle was the use of multiple sources of evidence, which satisfied the ontological perspective of the study that 'reality' is defined in terms of the individual and thus there is no one accepted view of reality. This approach allowed the researcher to explore the diversity of attitudinal and behavioural issues concerning the role of bank loans in financing growth in small firms. The second principle followed by the researcher was creating a case study database by transcribing interviews.

Interviewing

The main reason for using interviewing was its ability to uncover the interviewees' subjective side and experiences about their dealings with the bank and the role of the bank in growth-related decisions (Marshall and Rossman, 1989). Interviewing enabled the researcher to gather data on the area of interest and interviewing as a data collection method was appropriate for the study because of the qualitative nature of the study, which required the researcher to the primary instrument for the data collection (Creswell, 1994).

Opened-ended questions were developed for the interview to allow the researcher to obtain in-depth information. Informants were interviewed for a short period – between 45-60 minutes. Open-ended questions encouraged the interviewee to speak freely without being constrained by predetermined answers. Although interviews remained open-ended and assumed a conversational manner, the researcher followed a certain set of questions contained in the interview protocols for the different interviewees (see Appendix A, Appendix B and Appendix C). Open-ended questions assisted in reducing the researcher's bias because interviewees were free to express their opinion. However, the disadvantages associated with open-ended questioning included difficulty of data analysis and interviewees' inability to express their ideas clearly, which may cause thus valuable information to be lost (Kumar, 1996).

The strengths of interviewing included that the researcher could have face-to-face encounters with informants, which facilitated opportunities to clarify, provide a background context for the activities, behaviours and events that would assist the researcher to discover complex interconnections. Interviews were done in the natural setting, which facilitates cooperation from the interviewees. The other benefit of using structured interviews was its ability to the researcher who had limited interviewing skills (Marshall and Rossman, 1989; Kumar, 1996). Interviewing allows the researcher to explain any questions and the information can be supplemented.

However, the disadvantages of interviewing included the amount of time spent interviewing informants and there was potential bias in question development. The quality of the data relied on the researcher's ability to interview and the quality of interaction between the interviewee and the researcher. However, the quality of the data varied because the settings of the interviews varied from one case to another (Kumar, 1996; Flick, 1998). Marshall and Rossman (1989) include misinterpretation of data as a potential drawback. Interviewing was difficult to replicate and this meant a heavy reliance on the researcher's interviewing skills to be resourceful, systematic and honest to control researcher bias. Central to the representation of interviewees' credibility was the degree of honesty when providing the data (Marshall and Rossman, 1989).

Document review

The documents reviewed included, two different banks lending criteria documents, business plans of three banks, and the Banking Council of South Africa's Code of Banking Practice. These documents are available to the public and were obtained from the individual bank web sites and in the case of one bank the information was part of a starter kit available for purchase by the public. The importance of documents for the study was that it would provide another perspective on the issue under study. The strengths of using documents are firstly, the stability of data, which allows continual reviewing; secondly, it is unobtrusive; thirdly, it is accurate, in that it contains the exact details; references and details of an event; and finally, documents provide broad coverage, in that they span a long period of time, many events and many settings. The disadvantage is that there could be biased selectivity of documents and reporting bias of author (Yin, 1995:80).

5.3.1.5 Data documentation and storage

The key concerns of data collection are deciding on what material will be recorded and how it will be recorded. The interviews, with the permission of the interviewee were tape-recorded and transcribed after the interview.

5.4 The data analysis procedure

The analysis of the data and documents was undertaken using Ritchie and Spencer's (1984) framework analysis technique. The framework analysis is an analytical process, which involves a number of distinct but highly interconnected stages. It involved a systematic process of sifting, charting and sorting material according to key issues and themes. The five key stages that were undertaken in the study were familiarization, identifying a thematic framework, indexing, charting and mapping and interpretation.

Familiarization

Before the researcher could begin the process of sifting and sorting the collected data, the researcher became thoroughly familiarized with the diversity of the data to obtain an overview of the material collected. The familiarization stage involved immersing in the data and this was by listening to the recorded interviews with small firm owners and key informants, re-reading interview transcripts and studying the documents. It was possible for the researcher to review all the material because of the low number of interviews conducted and few documents gathered. The familiarization stage initiated the process of noting key ideas and recurring themes and this preceded the following stage in the data analysis of developing and identifying a thematic framework.

Identifying the thematic framework

In the familiarization stage, the researcher was able to gain an overview of the collected data's richness, depth, and diversity but in reviewing the material, the researcher also began the process of abstracting and conceptualizing ideas. On completion of reviewing interview data, the researcher attempted to identify key issues, concepts and themes, which the researcher could then examine and reference collected data. This facilitated developing a thematic framework, which the researcher could then use to sift and sort the interview data. The researcher followed the same process in developing the thematic framework for the document review. In developing the thematic framework for the small firm owner interviews, the researcher drew from issues informed by the original research questions, issues introduced during interviews by the small firm owners, and recurring analytical themes about particular views and experiences of small firm owners. The researcher followed the same procedure in developing the thematic framework for the key informants. The initial thematic frameworks for the small firm owners and key informants were mainly descriptive and heavily set in the original research questions and those introduced into the interviews. To refine the thematic frameworks, the researcher applied firstly, the small firm owner thematic framework to two small firm owner interview transcripts and secondly, applied the key informant thematic framework to one key informant interview transcript. The same process was followed for the document review. This process allowed the researcher to look for conceptualizations that would represent the diversity of the interview data in terms of experiences, attitudes, behaviours and opinions. The process enabled the researcher to find similarities and dissimilarities of practices between the banks, from the documents, which the researcher had accessed. Refining the thematic frameworks involved thinking both logically and intuitively to make decisions about meanings, relevancy and importance of issues and inferred connections between ideas. The outcome of this stage was the development of thematic frameworks for small firm owners, key informants and documents, which the researcher could use for labelling interview data. Indexing the interview data and documents was the next stage in analysing the collected data.

Indexing

Indexing involved applying the thematic framework to all interview transcripts and documents. The researcher recorded thematic references in the margins of interview transcripts and documents using a numerical system, which linked back to the thematic framework. Indexing the data involved making decisions on meaning and significance of data as it stood and in the context of the interview overall. The researcher found that some passages contained several themes and this multiple indexing often began to highlight patterns of associations within the interview data. The decision-making process in data analysis was subjective but following the indexing process made the process transparent and other people who could be interested in the data could follow how the researcher had sifted and organized the data. Having indexed the data, the researcher was able to access each thematic reference, see patterns in the data and within which context they arose. The next phase of the analysis was the charting stage, which allowed the researcher to start building an overall picture of the data.

Charting

The charting stage involved 'lifting' data from its original setting and rearranging it according to the appropriate thematic reference. The researcher devised the charts with headings and subheadings drawn from the thematic frameworks for the relevant interviewee groups and research questions. The researcher decided to present charts according to themes (see Chapter 6) and devised charts for each key issue with entries for each respondent. The charts would enable the researcher to presently each interviewee's responses and maintain the ontological assumption of the research. The researcher maintained a consistent order for interviewees on each chart to allow the reader to develop an understanding of each small firm owner within the context of their business. This context was presented in the form of vignettes, which provided background information on each small firm.

Mapping and interpretation

The final stage in framework analysis is mapping and interpretation and this process was done in the form of discussing the research findings (Chapter 7).

5.5 Quality criteria for the case study research

Lincoln and Guba (1985, cited in Creswell, 1998), suggested alternative criteria for assessing qualitative research. Lincoln and Guba (1985, cited in Creswell, 1998) suggested credibility, trustworthiness, dependability, transferability, and confirmability as appropriate qualitative research criteria. The more recent approach to ensuring rigour and quality in qualitative research by Healy and Perry (2000) was adopted because of its ability to link criteria to the ontological, epistemological, and methodological elements underlying the research.

In light of the study's ontology, the first quality control was determining the 'ontological appropriateness' of the study in terms of the research question. The qualitative research paradigm matched the research questions because the questions were dealing with a complex phenomenon perceived differently by individuals because of their context. In addition, the second criterion employed by the researcher, which was ontological in nature, was acknowledging that in an attempt to answer the research question, it was important to recognize that the shaping of the reality was contingent on the context. Vignettes were used to present the context in which small firm owners shape their reality. The researcher to improve the quality of the research was aware of contingent validity and to develop a 'family of answers'; several interviews from different perspectives (the small firm owner, the key informants and documents) enabled the researcher to describe how things operate in the world.

On the epistemological issue, the researcher interviewed cases in their natural settings to minimize the distance between the researcher and the interviewees. To ensure quality, data source triangulation enabled the researcher not to attempt to provide one reality but to illuminate the various perspectives on the reality. Triangulation was used less as a strategy for validating results but as a strategy to enriching and completing knowledge, which increase the scope, depth, and methodological procedures (Flick, 1998). In addition, where possible, the researcher provided the interviewees to review the findings to ascertain if they reflected their opinions accurately.

Within the methodological element the first criteria for quality was methodological trustworthiness, whereby by developing a case study protocol and case study database (transcribed interviews) the research can be audited. In addition, the use of the charts and quotes can then be traced to the case study database. In addition, the other technique was to create an audit trail in order to check procedural issues for the study, which are documented under procedures for case selection, data collection procedures, and data analysis procedures. The audit trail increased the reliability of the study defined by Yin (1994:33) as "demonstrating that the operations of a study…can be repeated, with the same results."

5.6 Summary

The chapter outlined the research methodology process the researcher followed to obtain data. The chapter discussed the use of the multi-case method as the research design and its adoption was justified. Interviewing, the primary data collection technique together with document review was used to enable the researcher's needs to obtain a complete as possible picture about the issue under study. Thematic coding was used to analyze the data. Issues of reliability and validity concerning data collection and analysis were discussed and audits where possible were undertaken to eliminate problems arising from reliability and validity problems. For the purpose of the study the main contributions of the chapter include:

- The justification of undertaking qualitative research and the benefits the design offers enabled the researcher to answer the research problem adequately
- The decision to use purposeful sampling enabled the researcher to interview cases that would provide rich data
- Ensuring rigour in the research in light of the study's ontology, epistemology and methodology made the researcher continually refer to the research question.

CHAPTER 6

PRESENTATION AND ANALYSIS OF DATA

6.1 Introduction

To answer the research question on the role of bank finance in small firm growth, the chapter presents the findings of the research. The researcher presents findings from interviews where in both instances, the researcher quotes liberally to present the respondent's views as accurately as possible. The findings present the within-case analysis of the interviewees and differing perspectives between data sources (the small firms and key informants) on specific issues. The use charts to display findings are restricted to interviews; the document review is presented as a comparative discussion.

6.2 Analysis of interviews

The researcher interviewed six small firm owners and three key informants to provide insight on the role of bank finance in small firm growth. The researcher presents the findings from small firm owner interviews and findings from key informants. The case study businesses were drawn from different sectors and were of different maturities and size to provide contrasting perspectives on the role of bank finance in growing their businesses. The small firm interviewees provided background information about the firm, how it came to be in existence and when. Interview data facilitated the categorization of the businesses according to sector, age of business, and number of employees. Table 6.1 presents the summary profile data on the businesses.

Table 6.1: The case study small firms profile

Small Firm (SF)	Sector	Age of Firm (years)	Number of Employees
SF 1	Cleaning Services	5	12
SF 2	Construction	5	3
SF 3	Restaurant	2	9
SF 4	Information Technology	2	4
SF 5	Tourism (arts and crafts)	5	2
SF 6	Manufacturing	2	12

From the table, firms have been in existence for two or five years, two firms (SF 6 and SF 1) employ 12 people. The sample enabled the researcher to investigate the role of finance because these firms are in their growth stage and face certain issues in this stage of existence (Churchill and Lewis, 1983, Timmons, 1999). In terms of number of employees, the small firms interviewed meet the definition of 'smallness' according to National Small Business Act (1996). The small firms interviewed are from a variety of sectors and this will allow for comparisons; however, because the study is exploratory, the researcher will not be looking to generalize findings (Creswell, 1995).

6.2.1 Opening vignettes

The use vignettes provide more depth to the research study and presents the researcher to give background to each case firm ensuring that the issue of the role of bank finance in small firm growth that is placed within the context of the individual firms and their owners.

Small Firm 1 (SF 1)

SF 1 is a carpet cleaning business and was started from scratch by one entrepreneur in 1997. The entrepreneur had been a fire fighter for 19 years before making the decision to leave and become what he termed a "full fledged business person." When the entrepreneur was starting the business, the doubt between his friends became his motivator to succeed in his endeavours. Three businesses offer this service, but offering different services and SF 1 uses the latest machines. The business has grown over the years with current turnover at R120 000. SF 1's main challenge operating in Grahamstown is that meeting customers expectations, for example, the customer may think that old carpets may be restored to becoming almost new again. Although the business has grown over the years, the entrepreneur did want the business to grow and he is the sole decision maker.

Small Firm 2 (SF 2)

The owner of SF 2 was a building contractor for a few years but because of the high number of building contractors and work was limited, the owner decided to enter the tiling business. SF 2 was created in 1998 and the owner travels across the country to carry out his job. He discussed several challenges the business faced in operating in Grahamstown. His major challenge was having the finance to actually carry out the job and to be in a position to compete with other firms tendering. The other challenges include getting work, living with the fact that people use small firms and expect cheaper services. In addition, business is slow and people do not want to spend so much money. There are other people in the tiling business and his greatest challenge is that building contractors can also do tiling and hence a client may go for the cheaper option. In addition, the legal requirements that he register with the different unions makes it very difficult to employ more people because the registration fees would cut into his profits. The owner admits that he has been trying to grow the business for a while and is committed to growing the business.

Small Firm 3 (SF 3)

Two individuals own SF 3 – a restaurant, which employs nine people. The owners identified an opportunity when the business went on sale with no goodwill value attached. One of the owners had been in the catering industry for eight years and the other owner had come to Grahamstown initially to pursue academic studies at the local university, however, this did not work out and when the opportunity arose, he decided to take the challenge because it was something he had always wanted to do. The restaurant's primary client base is the student population from the university; also their biggest challenge because the student presence dictates the operations of the business. The affects the cash flow of the business and the situation is compounded by the fact that the business needs to continue paying fixed costs such as rent. The business has experienced growth and has increased the number of employees. The owners want the business to grow further and have entered negotiations with the owner of the building to expand the premises to allow the firm to increase its operational capacity.

Small Firm 4 (SF 4)

SF 4 is an information technology company that specializes in web development and developing academic solutions for the needs of local academics and student population. The individuals in the business had an interest in web design and software development used to do the work free but then friends convinced them that they were good at it and should look to make money from it. The business has been operating as a closed corporation for the last two years and employs four people. The main market for the business is the local and surrounding tourism industry and academics (the business's niche market). The business is in competition with at least five other similar businesses in Grahamstown and this adds pressure on the cash generation ability of the business, however, the owners believe that their academic background and professionalism offers them the competitive edge. Other than the challenge of competition, the challenges facing the business include breaking the 'neighbourhood watch' way of doing business by developing their social networking skills to obtain work, dealing with business cycles and educating the local business sector about the value of using innovation within their business. The owners would like to grow the business to employ more graduates and to expand their client base by entering other markets outside the Eastern Cape.

Small Firm 5 (SF 5)

SF 5 was created to cater for the needs of crafters in Grahamstown and to provide a central place where craft could be sold to local and international tourists. The overriding motive for establishing the enterprise was to develop the local community because of the high levels of poverty. The main challenge faced by SF 5 is obtaining support from financial institutions in terms of providing them, for example, a card facility, which they can afford. The owner would like the business to grow but was weary of employing people because of the uncertainty of constant orders and prefers outsourcing working when a large order arises. The major area they would like to grow in is accessing and entering new markets for the crafters work.

Small Firm 6 (SF 6)

SF 6 is a manufacturing firm with two owners; one who had been out of a job and the other owned several other businesses. The business had been in existence for four years before they bought it from original entrepreneur it changing it from a manual manufacturing process to a mechanised manufacturing process by introducing technology. The main challenges facing the business are competing with larger manufacturing concerns, gaining market share, and uncertain business cycles. The owners plan to grow the business but at a pace they can dictate and that is dependent on the financial stability of the business.

6.2.2 Key findings from interviews

The key findings and themes presented in the following sections represent the responses provided by the interviewees in response to questions posed by the researcher.

6.2.2.1 Valuing small firm entrepreneurship

The key informants identified several themes regarding the importance of small firms in the business sector. The researcher asked the key informants to state the importance of the small business sector for South Africa, the Eastern Cape and finally for Grahamstown. The following charts present key themes underlying the importance beginning with Chart 1 – the importance of the small business sector for South Africa.

Chart 1: The importance of the small business sector for South Africa				
Key Informant (KI)	**Socio-economic**	**Political**	**Economic**	**Innovation**
KI 1	"the engine for job creation"	"black economic empowerment" "redistribution of wealth"	"the vital sector, a key to South Africa's growth"	
KI 2	"Well in terms of employment – they are creating the majority of employment compared to the corporate sector"		"They are faster moving in creating different economic situation and in the economic cake than the corporates"	"The international research indicates that from small, medium enterprises you find the most creative ideas"
KI 3	"there is a high unemployment rate and the small businesses can clear it"		"creating more wealth to the country"	

The key findings for the importance of the small business sector for South Africa identified by the key informants included the sector's potential to create employment opportunities; all the key informants agreed on this. In addition, KI 1 highlighted the small business sector's input for addressing political agendas such as redistribution of wealth and black economic empowerment initiatives. The key informants highlighted the economic importance of wealth creation by the sector. The final factor identified by KI 2 for the importance of the sector included the potential of small firms as a key source of innovation.

Chart 2 provides information on the importance of the small firm sector for the Eastern Cape. KI 2 and KI 3 were posed this question in light of their expertise on the topic.

Chart 2: The importance of the small business sector for the Eastern Cape			
Key Informant (KI)	**Socio-Economic**	**Economic**	**Innovation**
KI 2	"The Eastern Cape is the second poorest region in South Africa"	"The corporates are not going to locate here, you need to find small, medium enterprises that are going to counter that effect"	"To keep people within the Eastern Cape and grow the Eastern Cape economy you need to emphasize the importance of small businesses because they are going to be creative"
KI 3		"A business can't start big, so small business is where it all starts, where employment is created initially"	

The importance of the small business sector for the Eastern Cape was similar to that supplied for South Africa with the exception of political factor. In addition, to the recognition of the poverty in the Eastern Cape by KI 2, both key informants highlighted the need for smaller enterprises to fill a void for employment creation. KI 2 maintains the importance for small firms is fostering innovation within the Eastern Cape. The researcher raised the question of the importance of the small business sector for Grahamstown to KI 1 and KI 3 because of their involvement in business development in Grahamstown. Chart 3 presents the reasons for the importance of the small business sector in Grahamstown.

Chart 3: The importance of the small business sector for Grahamstown			
Key Informant (KI)	**Socio-Economic**	**Employment**	**Innovation**
KI 1	"so as to reduce crime and basically uplift the standard of living"	"The unemployment rate is very high in Grahamstown and now the job market is very saturated at the moment"	"They are going to be coming up and creating new ideas and employ people – like in a way sustaining themselves"
KI 3		"I am not sure of the unemployment rate in Grahamstown, but I believe it is between 60-70%, … but for that reason we need to do something to create employment"	

The reasons for the importance of small firms for Grahamstown focused on social and employment issues such as improving the standard of living (KI 1) and reducing unemployment rates (KI 1 and KI 3). In addition KI 1 highlighted innovation where small firms can develop new ideas. However, KI 2 suggests that the "lack of skills and education in terms of how this modern economy is working" and "logistical arrangements – getting things fast to the market wherever that market is and making sure that your marketing intelligence is up to date at the end of the day" are challenges faced by the small business sector in Grahamstown.

In all three instances (South Africa, Eastern Cape and Grahamstown), the importance of the small business sector centres on its potential to create employment and as a source of innovation. At the national level however, there is the added importance of the sector's input in addressing political agendas.

The next section of the findings begins the exploration of the small business sector in detail. The reasons for the importance of the small business sector have been provided by in the preceding section, but to understand why the sector is important it is imperative to know 'who' creates a small business and 'how' small business come into being. The following section presents information on 'who' creates a small business.

The researcher began the interviews by asking key informants to provide definitions on the key concepts of entrepreneurship, small business and the entrepreneur. Chart 4 presents the definitions of the terms.

Chart 4: Describing/defining the entrepreneur, entrepreneurship and small business			
Key Informant (KI)	**Entrepreneur**	**Entrepreneurship**	**Small business**
KI 1	"For the bank, SMEs are formal enterprises with an annual turnover of R150 000, who employ up to 50 staff, with an average of 12 staff, who have bank loans of less than R500 000"		
KI 2	"An entrepreneur is adding value to the broader community, not just himself. In terms of lifestyle, I think the entrepreneur is going for opportunities"	"creating a bigger economic cake and growing the economic cake"	"If it is small business as counter to big business, then these are broad categories you can subdivide into small business into small, medium and micro enterprises"
KI 3	"The entrepreneur is the one who creates the small business and takes risks"	"I think it is an attitude, you should get them to think, they don't always think that they should be satisfied with the way things are working, they should be always looking for markets, substitute products, new ways of doing things"	

KI 1 defined small business for the bank in terms of number of employees, turnover and loan levels, while KI 2 defined small business in terms of size. KI 2 defined the entrepreneur by focusing on how the person adds value and seeks opportunities. In contrast, KI 3 defines entrepreneurs on their ability to take risks and create the small business. The definitions of entrepreneurship offered by KI 2 and KI 3 emphasize undertaking some of activity. KI 3 highlights the need for people to be constantly looking for new and different ways of doing things and as such, these actions may result in the creation of new ventures. This action of looking for opportunities and creating new product or services describes entrepreneurship. KI 2, on the other hand focuses on the economic aspect of small firms in that entrepreneurship creates a bigger economic base and this is through the small firms. Inherent in this definition of creation is performing some form of activity.

The researcher posed the question "do you consider yourself an entrepreneur?" and each small firm owner provided a different definition. Chart 5 presents the owners' responses.

Chart 5: Small Firm Owner own definitions of the entrepreneur	
Small Firm (SF)	
SF 1	"When I started the business, I knew one thing against me was the colour of my skin. I said to myself I must replace that with something and then I said to myself, your personality will carry you through. In other words, my personality helped me achieve this" "It is because I believe in myself…I think I was born with the talent of doing things the right way"
SF 2	"Just the fact that I give a service to people, I employ people and I make a living for myself"
SF 3	"I came here to study and that didn't work out for me, then I started this and decided to do it my way"
SF 4	"We are definitely small, in terms of innovation…I think we've a couple of ideas different from the previous way of doing things"
SF 5	"We know that there is a huge amount of poverty and I have been concerned with community development"
SF 6	"in that you look at an opportunity and see how you can better the old production process, the whole running of it and obviously make money at the end of the day…we work long hours with the intention of making money"

The diversity of the responses revealed definitions focusing on perceived inherent characteristics such as talent, community development, opportunity identification, financial objectives, employment creators and providing services to people. The motives for starting the business are in some cases reflected in the small firm owner's definition of the entrepreneur (SF 1, SF 4, SF 5). Although the motive for starting the venture was driven by being out of a job for SF 6, the definition of the entrepreneur provided suggests a desire to develop an innovative process to make the business more profitable.

6.2.2.2 Small firm growth

The key informants were asked questions "what is small firm growth?" and "how can small firms grow their ventures?"

Chart 6: Small firm growth – measures and managing of growth		
Key Informant (KI)	**Defining growth**	**Managing growth**
KI 1	"We look at the business plan in terms of viability… the entry barriers in that market or in that industry… the competition the place where the person is situated and the target market."	
KI 2	"Just creating a business is not entrepreneurial; it is what you do overtime, if you add value and if it is a different lifestyle that you are starting to create"	"I think it is terms of how they operate as well. If you start creating your own venture capital within a company, in other words you are taking a certain percentage of profits away for new projects then you are starting to move in the right direction."
KI 3	"Growth can be measured in an increase in assets, it can be measured in an increase in the number of employees or it can be measured in an increase in turnover – they all work together, as your turnover increases you find that you probably need more assets, as you get more assets you find that you probably need more people"	"To manage growth is to manage cash. If you manage your cash and you are able to meet your commitments, then you don't grow without planning, then you can actually manage it"

Defining growth for the bank (KI 1) focused on viability, entry barriers, competition and the target market. If these factors are addressed to the satisfaction of the bank, for example, there is an identifiable market for intended growth; the bank would likely finance the growth because it would be able to calculate future revenues. In comparison, KI 2 builds on their definition of the entrepreneur by suggesting that growth is defined in terms of the value they create overtime and in light of their definition of entrepreneurship, this creation of value translates into the creation of a bigger economic cake. KI 3 offers traditional measures of growth, namely, employee number increase, turnover increase and asset increase and suggests that these are interrelated.

The small firms were asked "do you want the business to grow?" and "how will you manage the growth?" Chart 7 presents the findings of the questions.

Chart 7: Attitude toward growth			
Small Firm (SF)	**Defining Growth**	**Managing Growth**	**Growth Constraints**
SF 1	"My main goal is to create jobs …I'd also like to support the community… I would like to tender for government jobs that's why I am registering for VAT…to open an office in Port Alfred and in King Williams Town"	"the way I'd like the business to grow is that I'd like to follow up everyday on jobs" "It's by keeping everything simple, my personal life"	
SF 2	Get a big project	Continuous learning	"Sometimes I get a project but when it comes to finance you like the underdog"
SF 3	"Well, obviously at the end of the day it is all about profits, the more of that you can get the better" "We've already spoken to the landlord about making our kitchen bigger so that we can handle more orders"		
SF 4	"We would like to employ more people" "Our strategy is to expand further through SA, later aiming for developing countries globally"	"Developing innovative solutions" "Being near an academic institution gives us the ability to hire the right kind of person"	"We just need some top-secret investment" "This culture of marketing yourself on the Internet only is not as big as it is like in Europe or the States"
SF 5	"We can find markets for all of Grahamstown crafters with quite a lot of effort"	"We've done contract arrangements with people who are unemployed and trained them in skills for the order, given them the raw materials to go do what has to be done and bring it back when completed and pay accordingly"	
SF 6	"We are going to increase the size of it but over a period of time" "Well, hopefully we are going to employ more people"	"Don't over extend yourself, e.g. buy new vehicles … you obviously have to see what your cash flow is like and how your sales are going and how much profit you are making out of the product."	

All the small firm interviewees expressed the desire to grow their business in some way. The definitions of growth offered by the small firm owners are derivatives of the traditional growth measures offered by KI 3, namely, creating employment, generating profits, and increasing the size of operations. In addition, SF 1, SF 4 and SF 5 defined growth in terms of providing community support, accessing and expanding into new markets. The follow on question "how do you intend to manage the growth" aimed to trace evidence of entrepreneurial behaviour in the small firms. Key themes emerging on owners' growth management strategies included maintaining simplicity, continuous learning, product innovation, outsourcing, cash flow management and planning for growth. The main strategy offered for managing small firm growth by KI 2 and KI 3 is managing cash resources in the business. The key informants suggest that managing cash resources by either creating an internal venture capital fund for expansion or planning growth in line with cash resources provides the small firm with the flexibility to grow the business. With the exception of SF 6, the small firms in the study do not pursue this strategy. In addition, to managing growth, SF 2 and SF 4 indicated financial constraints as hindrance to desired growth. SF 4 added technology adoption by businesses as a further constraint for growth because of the poor understanding of technology.

In addition, the question on the individual's growth objectives provided the researcher the opportunity to investigate evidence of 'continued' entrepreneurship. Continued entrepreneurship (see Chart 8) differs from initial entrepreneurship in that continued entrepreneurship is the individual's continued entrepreneurial behaviour represented by growth that has occurred since the initial entrepreneurship.

Chart 8: Evidence of 'continued entrepreneurship'	
Small Firm (SF)	
SF 1	"Our business started at the end of 1997…we grew and now the business is worth R120 000" "I'm using the latest machines, so I don't know if it's right for me to classify myself as a small business anymore"
SF 3	"We've started catering for offsite catering as well…we have hired two more people for the business" "We have started using the outside section already, we are going to finish that up so that in the summer time we should be able to seat 35-40 people outside"
SF 4	"We've currently been building up a social network and fostering partnerships with the 'big players' to gain more visibility which is proving to be successful"
SF 6	"As time has gone on the factory has been cleaned up. In the past things were labour-intensive and very time consuming. We have made it a lot slicker, a lot more efficient than it used to be …putting mechanisms that are making it a lot easier to operate."

The small firms presented in the chart provided clear evidence of continued entrepreneurship in that their behaviour was characterized by entrepreneurial actions such as improving the manufacturing process (SF 6), using improved technology (SF 1) and entering new markets (SF 3) by doing offsite catering. In the case of SF 4, the development of social networks is important.

To conclude the analysis of small firm growth, the key informants provided information on the importance of growing small firms and Chart 9 presents the findings.

Chart 9: Importance of small firm growth

Key Informant (KI)	**KI 1**	**KI 2**	**KI 3**
Profitability	"If the SME sector grows then meaning the bank will get more revenue from those people"		
Economic Growth	"Economic growth around the area"	"If we want to stimulate the economy then we need to grow"	"Growth in the economy"
Socio-economic	"They are going to employ more people as they grow"	"So if we can't grow the economy then something is going to go, unemployment is going to rise leading again to a multiplier effect on crime, social stability"	"Employment"
Globalisation		"If we want to go beyond the basics as an African country, we need to grow beyond the population growth."	

Profitability, economic growth, socio-economic and globalization issues highlight the need and importance of small firm growth based on key informants responses to the question. All the key informants suggest the importance of small firm growth as the key for economic growth and employment creation. However, KI 1 adds "we feel that there is a lot of potential in the SME sector but now the problem is that there is not much expertise so it is not being cultivated in terms of growth." In addition, KI 2 highlights "The soft issues, the willingness to grow, the willingness to accept that you are going into higher risk, not unmanageable but higher risk and that there will be difficulties managing everything."

6.2.2.3 Financing small firm growth

The focus of the study shifted to address the research problem by asking owners finance-related questions regarding their desire to grow. The first finance-related question was "how do you intend financing the desired growth?" The question aimed to identify their preferred source of growth finance before introducing the question about bank finance. Chart 10 presents owners' responses.

Chart 10: Small Firm Owners and financing growth

Small Firm (SF)	Source of Finance	Growth- Finance objectives	Reason for not using bank finance	Financial Strategies
SF 1	Business Profits	"Everyone who sees me sees me growing without loans I will grow and I will take over the Eastern Cape without any loans because of my experiences approaching people"	"it's not easy to get loans these days…I'm blacklisted so I can't get a loan"	Pay cash for all transactions
SF 2	"To be honest with you, I am still waiting for my lucky break"		"But I can't depend on anything else – the banks won't help me"	
SF 3	Business Profits	"if we can't pay cash for it then we wait for it"	"we deal strictly with cash, we are not going into debt"	"Everything is paid for in cash"
SF 4	Business Profits		"we are pretty adamant we don't want to go into debt"	Minimizing overheads by not renting offices "if we concentrate on the tourism sector in the Eastern Cape, we should be able to raise enough money in the next 2-3 years to expand our operations into at least the PE, Port Alfred area"
SF 5	Business Profits		"we don't use the bank because it is just an added expense"	"I'd like to know there is an order and then use finance to get raw materials to meet that order"
SF 6	Business Profits			

Sources of finance for growth, growth-finance objectives, reasons for not using bank finance and their financial strategies concerning desired growth emerged as main themes. From the chart, all the small firms intend to finance the growth of the business using internal finance namely profits generated by the business. The small firms in the study did express their desire to remain debt free in growing their business and the finding that the majority of the small firms operated on a cash basis corroborated this decision. Financial strategies existing in the small firm operations included minimizing overhead costs by not renting office space in the case of SF 4, building up financial resources over time to fund growth (SF 1 and SF 4) and producing products based on definite orders (SF 5).

In response, the bank small business advisor highlighted the bank's initiative regarding small business finance suggesting the desire on the part of the bank to participate actively in the promotion of the small business sector by stating:

> "Our aim, objective is to reach each and every SME we have with our products. Basically we are in the business of finance, we want to target as many people as possible in that segment. If things were going our way each and every customer of ours would have our products – you would have a loan, MasterCard, will have almost every product but not every product but products that are suitable to their needs"

Although, there is willingness according to KI 1 for bank participation, the small firms in the study strongly desire not to use bank finance for growth. The reasons offered by the small firm owners included the issue of being blacklisted (SF 1), which effectively prevents that small firm owner accessing loans because of their credit history and the notion that using bank finance was an added expense because of the bank charges associated with lending.

After establishing how firms intend financing growth, the researcher asked small firm owners, "What is the role of bank finance in your decision to grow the business?" Chart 11 presents owners' responses on the role of finance in their growth decision.

Chart 11: The role of bank finance in the owner's growth decision				
Small Firm	**Attitude toward Bank**	**Experience with Bank**	**Role of bank finance in growth decision**	**Access to finance**
SF 1	"I'm reaching that point of no more I will never go to the bank for a loan, I'll never degrade myself" "Empty promises"	"From past experiences, I don't think I'll ever approach a bank for a loan because I don't want to go through that hell again"	"I only use the bank for my insurance stop orders nothing else, I pay cash"	"The one year the bank helped me with R3000; they forced my father to put his house down as security … his house is worth over R150 000"
SF 2	"I can't go to the bank because I'm not recognised there as a proper businessman" "If they want to help me they help me, if they don't want to help me that's fine"	"I've been there many times…you get hurt so many times, you burn your fingers so many times" "they are lenient if you go talk to them…but when you go back to them they'll just be more cautious"	"I just ignore the bank"	"They have lots of loopholes … that you always find out when you go and apply – they want collateral … property… money in the bank … policies – you don't have it"
SF 3			"For us the bank is where we get the float for our change"	"They won't just jump out and give us the money so we would have to present our case meticulously, by taking the books along and using my charm."
SF 4	"They need more information written in plain language but might have security reasons for not doing this – still a pain"	"they never leave you with much clarity"	"we are not looking to go to banks in the short term"	"banks are not trusting of dot.coms or IT-related companies … and banks won't put their trust in young businesspeople"
SF 5	"banks are actually killing any small business in this town"		"It's a huge factor" "it's difficult to grow from a small business to an SME because of the bank"	"I wanted to borrow about R11000-R12000 maximum, but the bank said the minimum amount they could loan me was R50000"
SF 6			"Depending on where we're going to go, what sort of factory we're going to build and what sort of vehicles we are going to have to buy and the amount of profit we have made in the last year"	"if you want a loan from the bank and you are going to overextend, and if the production can't handle the repayments of the loan that, that will probably be the first one really."

After explicitly introducing bank finance into the interview, the researcher was then able to explore the extent of bank finance on the owners' growth decision. From the responses, the researcher identified the following themes – the attitude of small firms towards banks, the role of bank finance in their desire to grow, owners' experiences dealing with banks and access to finance. SF 5 strongly emphasizes the role of the bank as destructive as opposed to being constructive in promoting the small business sector a statement contrary to KI 1's who stated the bank's pledge to provide finance to any SME. Experience with their bank underlines SF 5's statement because of their inability to access small amounts of finance from their bank. Owners highlighted several issues including their desire to refrain from using bank finance and for four interviewees, the bank did not play a major role in the decision to grow, however, the remaining two small firms regard as the bank as important in their expansion plans. Although SF 6 indicated bank finance as important for future growth, their ability to internally generate funds for expansion remained important, however, the bank would become involved depending on the extent of the intended growth.

To explore the role of finance further and arising from the small firm interviews, the researcher asked key informants "why finance was perceived by small businesses as a barrier to small business growth?" Chart 12 presents key findings.

Chart 12: Access to finance as a barrier to small firm growth				
Key Informant (KI)	**Operational capacity**	**Lending culture**	**Differing Objectives**	**Mindset**
KI 1		"I think because the criteria the bank uses to assess financial loans. People will find it very strict, especially people coming from disadvantaged backgrounds" "Even the business plan, you tell a person you need a business plan, they wouldn't know what a business plan is"	"our banking system is in a first world country now there are people in a third world country, those people have different perceptions, different ways of doing things"	"You find that banks are adamant in their ways because experience from small loans is that they are not profitable and they are very risky at times"
KI 2	"You need financial stimulation to go beyond the obvious"	"you have to have securities" "We don't trust them because it is not another bed and breakfast"	"The entrepreneur is going for opportunities, taking high risks and the financial institution is going for profits and that is not taking risks but looking after the profitable side"	"So now you have got this whole mindset of survivors and you are coming up with this brilliant idea and no one knows what the idea is"
KI 3	"If you manage your cash and you are able to meet your commitments, then you don't grow without planning, then you can actually manage it"	"The problem is real of course for a company in its growth phase because they run into cash flow problems and they don't have an adequate overdraft and they don't have assets to back their needs, you find that financial institutions won't give it to them"		"they don't take the risks with the entrepreneur; the entrepreneur takes the risk"

The responses provided deeper insights on the issue of access to finance, which had been highlighted by the small firm owners regarding the role of bank finance in their growth decisions. All key informants expressed that the lending culture and the mindset of the banking sector contributed to the perception that finance was a barrier to growth.

However, the challenges for operating a small firm in Grahamstown previously offered by the small firm owners in Chart 9 (with the exception of SF 2) indicated other factors as the key barriers to growing the business in Grahamstown. Emerging key informants interviews included the importance of business plans, the objective measures used in assessing loan applications, cash management, the risk associated with small firm lending and trust, issues which the small firm owners alluded to regarding the limited role of bank finance in the growth plans. In addition, KI 1 and KI 2 indicate differing objectives between small firms and banks add to the perception that access to finance is a barrier for growth.

The researcher presented the small firms in the study the opportunity to answer the question “what should banks know about small finance needs?” The question aimed to explore the needs of small firms intended to grow their businesses in detail. From the responses, the researcher discovered two types of responses; the first highlighted what the researcher identified as tangible factors and the other highlighted intangible factors. Tangible factors that the banks need to consider focused on objective measures and issues that the small firm owners had no control over. The intangible factors Chart 13 presents the tangible factors.

Chart 13: Tangible factors that banks need to consider concerning small firm finance			
Small Firm (SF)	**Lending Criteria**	**Products and Services Costs**	**Small Firms Operations**
SF 1	"Most of the small business people are blacklisted"		
SF 2	"I find it hard because I go to the bank, they want collateral, they want lots of stuff that you don't have as a small builder" "If you come in with at least a valid document and stuff and they do their homework and check on you and then give him a chance"		"I only make enough money to support myself and my family and my expenses, so I can't give them what they want."
SF 3	"Small businesses have the capacity to pay back loans but not in a short period of time"	Lower interest rates	
SF 4	"If you don't qualify and have some sort of collateral to go with the loan application as well as some sure fire profitable business plan or scheme that is going to come out at the end and pay them back, you're going to end up dead in the wood"	"It would be far more useful if they could make information for SMEs more easily available, with detail, for example, there is nowhere I can just read how to set up a merchant account, what is required from me as a business or individual, how much this will all cost me, etc"	
SF 5		"Bank charges for SMEs need to be evaluated"	"I wanted to borrow about R11000 – R12000 maximum – but they could only give me minimum of R50 000. But it's keeping small business out of business."
SF 6			"One week we are having a very good week and the next week things are not"

The themes emerging with tangible factors that banks need to be aware of when providing small firm finance included the lending criteria used by banks. The banks need to understand that the repayment abilities of small firms is inherently different from larger firms (SF 3) but small firms could repay loans provided the payback period took the characteristics of small firm operations into account (SF 6). Furthermore, SF 2 and SF 4 indicated the constraints of collateral requirements and SF 5 stressed the inability to provide small amounts of finance by banks for small firms to pursue identified opportunities. SF 5's contradicts KI 1's statement (refer to page 110) that the bank aims to provide finance that suits the needs of the business. The other major theme emerging was the product and service range supplied by banks to small firms. In particular, small firms highlighted the pricing structures associated with lending and the limited provision of information by banks regarding the products and services available.

The intangible factors presented in Chart 14 highlighted the issues that were subjective in nature emphasizing the individual in the venture as opposed to emphasizing the business entity.

Chart 14: Intangible factors that banks need to consider concerning small firm finance			
Small Firm (SF)	**'Value the idea'**	**'Value the Entrepreneur**	**Non-Financial Support**
SF 1	"There are many people with brilliant ideas but there is no money"		
SF 2	"There are lots of skills, lots of us with brains and lots of us with good ideas and we need their help but they just close the door"	"Every man deserves a chance. I go and you give me a chance, I mess up and then you go, they shouldn't put you in the same hat"	"They should be there helping you use your money, teaching you how to spend your money…we know nothing"
SF 4	"The bank is an expert in the financing field and you are a consultant and someone comes to you as the expert in your field and they have a particular idea and you know it's not going to work, it's your job to show them what alternatives there are"	"There is really no advice coming from their side to help us expand our business."	"They also need to help us get a better macro view of where the economy is going especially with our industry"
SF 5	"So as a small entrepreneur I fail not because I don't have the relevant skill …I am going to be killed because my ideas are not mixing in with the established culture"	"A bank is not an entrepreneurial organisation, it is a conforming institution and … it can't value an entrepreneur"	

The majority of small firms in the study suggested the need for banks to value the idea presented by the entrepreneur when making lending decisions and value the entrepreneur who provides the idea. This suggestion challenges the traditional mindset within a bank because this assertion heeds for subjective assessment and assessing entrepreneurship in the loan application. Two small firms (SF 2 and SF 4) called for need of non-financial support from banks to assist the owner to manage the finance provided by the bank and to provide the small firms with information regarding their industry.

The key informants were posed a similar question "what do banks need to consider regarding small firm lending?" to investigate similarities or differences with the responses provided by the small firms. Chart 15 presents the responses.

Chart 15: Issues that need consideration by banks regarding small firm lending			
Key Informant (KI)	**The need to understand small firm operations to finance effectively**	**Revisiting the issue of risk in small firm lending**	**Training**
KI 1	" I guess [the bank] can contribute further by really trying to understand the needs of SMEs, not use their conventional ways of assessing loans because times change –they have to be more proactive. You find in their lending criteria, there are things that you look at and see that these rarely determine if the business will be successful or not"	"You find that lending is very risky, lending any type of finance to businesses is risky, now [the bank] must try instead of being risk averse, try at least be minimal in their way of looking at risk"	"So if the bank could try and meet these people half way in a way by maybe educating them about what the bank needs"
KI 2	"They really need to know how small businesses operate and I don't think they really know. So by just merely reading what small businesses are doing is not going to help them at all … maybe one should make a distinction between how big one is operating and how small one is operating and target that effectively"		
KI 3			"I think it is important for [the bank] to train people in those areas because they are involved in the development of this sector but they don't always realise purely because of their own security and safety of their money and that they are doing more than just providing money"

Similarly to issues identified by the small firm interviewees, KI 1 and KI 2 suggested the need for banks to understand the small business sector in terms of its operations to provide appropriate types and amounts of finance thereby revisiting the lending criteria used by banks. These responses address the concerns raised by SF 2, SF 3 and SF 4 regarding lending criteria and SF 5 regarding small firm operations. In addition, KI 1 suggested banks revisiting the way banks view risk in small firm lending, a move which would begin to address the issue of collateral in small firm lending and adds that conventional methods for assessing small firm loans are inappropriate. This statement highlighted the recognition by the small business advisor the complexity of the small firm. The small firms mentioned the need for banks to provide non-financial support, a sentiment echoed by KI 1. KI 1 suggested banks educate small firm owners regarding the needs of the bank so that both parties can meet halfway for the banks to provide appropriate financing and for the small firms to be in a position to access finance for their intended growth. KI 2 suggested that banks needed to train the people who deal with small firm lending to better understand the sector and provide information to small firms, which would assist the bank to protect its money.

On the other hand, the key informants provided insights to what the small firms need to know with respect to small firm lending. The emergent themes include understanding bank lending, maintaining financial records and demonstrating the ability of the firm to finance the growth. Chart 16 presents the key informants' responses.

Chart 16: What firms need to know with respect to small firm lending			
Key Informant (KI)	**Understanding bank lending decisions**	**Maintaining stable financial records**	**Demonstrating the ability of the firm to finance the growth**
KI 1	"So the most important thing we look at is the repayment ability and the purpose of the loan and we look at the credibility of the person as well looking for a loan" "there are loans which are system scored like after six months … the credit system will give you a certain score and you get a certain loan amount without us asking for any security"	"our businesses from the townships – they don't have accounting officers, they don't have accountants – they will have no such information that we request."	"If you come in and you want to ask for a loan, you are told that this is required, you need to have a business plan, you need to make a contribution from your side as well"
KI 2	"The feasibility study is the crux in this matter because if you can show a decent, professional feasibility study, we can conduct it in detail then you are going to pretty much pass that kind of hurdle at the end of the day."	"They need to know exactly what is going on with their finances in the business, they need to know when to borrow more money and they need to know what it is going to cost them if they grow."	So if you start to create the financial system then at least you can do some sensitivity analysis finding the best strategy at the end of the day because nothing is a full blown 100% correct project from the start, it takes time"
KI 3	"I think that it is very important for the small business owner to get to know how the banks work, they also need to know that banks are moving away from bank manager-customer contact but the person they deal with at the bank is an important person for the business, so they need to know what is expected of them"	"One of the reasons why [small firms] fail is because they lose control because they don't have records in place and systems in place to keep records"	

Both the small firms and the key informants have repeated the suggestion that banks need to understand the functioning of the small business sector. On the same token the same needs to be asked of small firms by the bank; small firms need to understand how banks function in a bid to understand the lending decisions (KI 3). Consistently, KI 1 has indicated the business plan and repayment ability as important; in addition, KI highlighted the purpose of the loan and the credibility of the individual as important factors considered in small firm lending. In addition, KI 2 stated the importance of a feasibility study, which if presented professionally to the bank can assist the small firm to access finance because it demonstrates to the bank that you have gone a step further from just producing a business plan, you have tested the idea and have provided results. The maintenance of financial records assist the bank in making their lending decisions and the financial statements also assist the bank to determine the firm's ability to finance growth by assessing the financial position of the business.

The small firms in the study provided information on the nature and extent of maintaining financial systems for the business. Chart 17 presents the information.

Chart 17: Business financial recording systems

Small Firm (SF)	**Formal existence**	**Non-existence**
SF 1	"I am using cash books, invoices, duplicates because I'm not yet registered as a tax payer"	
SF 2		"The business is so small – it's petty … if I get a project for like R10000 or R50000 then you'll see some stuff with me, until then you won't find anything, just timesheets, quotations and stuff like that"
SF 3	"At the end of the day we do a cash up…that is taken to the safe" "We have a cash reconciliation book…so you can keep track of where the money is going"	
SF 4	"We keep track of all expenses and income" "Keep books on paper at the moment"	
SF 5	The business partner keeps the books	
SF 6	"Normal current account"	

All but one of the small firms in the study maintain some form of financial recording system for the business using either cash books, accountant in the case of SF 5 and for SF 6 they use their bank account to record business transactions.

The recognition of the inherent differences of small business from large business required further exploration to understand how these features impact on the nature and type of finance offered to the small firm. The following section on entrepreneurial finance sheds light on the issue.

6.2.2.4 Entrepreneurial finance

The researcher posed the question "how small finance needs differ from corporate finance needs?" to key informants. The key informants provided features that distinguished small firm finance needs from corporate finance needs in Chart 18.

Chart 18: Defining features of small business finance from corporate finance				
Key Informant (KI)	**Trust**	**Assets**	**Sources of finance**	**Risk**
KI 1	"You find with small and medium enterprises, most of these people have not established themselves in the market as well"	"It is very easy for corporate businesses because they have assets and you find that corporate businesses have been in the business for a long time, and big companies have purchasing power"		"So [the bank] doesn't look at [small businesses] as being profitable – so they don't want to take that risk – so they want those people to meet criteria, which in some cases they don't meet such criteria."
KI 2	"And then on the other side who do you trust – big business or small business. You expect that the big business is not going to fold that easily"	"Big business can provide more security than the small business, because their collateral is easier to manage whereas the small business must now look for other ways for funding on his side because not everyone has 10% collateral "		
KI 3		"Big business are normally in a position where they have big assets"	"Big business … can source money from a lot of sources including the capital market"	

The emergent themes for differences included trust, strength in assets and variety of financial sources for small firms in comparison to their larger counterparts. The features distinguishing small finance from corporate finance substantiate previous findings, namely, the risk associated with lending to small firms (KI 1, page 118), the need for small firms to provide collateral (SF 2 and SF 4, page 115) and trust (SF 4, page 111) which feature as negative factors which limit lending to small firms.

The small firms in the study provided responses to the question “do bank products cater for the needs of small businesses?” This question gave the researcher the opportunity to explore the distinction between small business finance and corporate finance from the small firm perspective. The responses presented in Chart 19 reflect the small firm interviewees perspectives on the issue.

Chart 19: Bank finance and usefulness in small firm operations

Small Firm (SF)	**Protecting self-interest**	**Usefulness of products and services**
SF 1	“The money is there but it’s not in your hands”	
SF 2	“They only help those people who can guarantee money back…they don’t take risks…like I said, the bank always gets its money back”	“It can help you in many ways, like an overdraft, it is money that is lying there for your business – for business purposes but you’re not going anywhere with R2500.”
SF 3	“I think that banks cater for themselves at the end of the day, the bank is also a business” “The smaller the client is I think, the more they try and get out of them”	
SF 4		“they are not geared for small business they are geared towards larger businesses”
SF 5	“I think there maybe needs to be a corporate conscious that instead of pretending that they are community based organisations that they are not; they are purely business”	“Definitely not” “And for us to be able to have a card facility here it is ludicrously expensive, it takes away any mini profit that there could have been to grow the business because it is going straight into the banks”
SF 6		“Yes. So far we have not had a problem with the bank, we do a lot of banking through the Internet which makes it easier”

Findings indicated that the majority of small firms in the study felt that banks protected their own interests even in providing products and services for the entrepreneur. In addition, some interviewees (SF 2 and SF 6) felt that the products and services provided were useful for their operations; these interviewees highlighted overdraft and Internet banking facilities as particularly useful. On the contrary, two small firms felt that bank products and services did not cater for the financial needs of small firms.

However, the bank small business advisor (KI 1) provides information contrary to the small firm owners' opinions by highlighting the bank's effort in providing access to growth finance. KI 1 states

> "There are quite a few schemes, which have come up in the past 8 years or so. Like the Khula Guarantee scheme, which does assist small businesses in that if the business doesn't meet the normal lending criteria of the bank, then there are some rules, which are waived. Normally a bank will want a person to have a substantial amount of security and they will look if you have some financial statements. There are some ratios that they look at like cash margin of safety has to be maybe 15% or more. Now they do cater since there is Khula, because Khula guarantees if there is a person who has a good business plan and they are well versed in what they are doing, have good management skills, business skills and they can contribute about 10% towards the loan amount – then they are willing to guarantee about 80% of the loan. But the small business has to meet certain criteria as well."

From Charts 18 and 19, the features underlying small firm finance are presented as negative aspects of providing finance to the small firm and the small firms corroborated this view by highlighting that banks do not take risks with small firms.

The final question posed to the small firms in the study focused on the relationship between the small firm and its bank.

6.2.2.5 The small firm-bank relationship

Before asking the small firm interviewees about the importance of the relationship between the bank and their businesses, the researcher asked, "what factors did you consider in choosing the bank for the business account?" The question enabled owners to evaluate their bank and provide reasons for their association. Chart 20 presents owners reasons for associating with their chosen bank.

Chart 20: Factors in choosing the bank				
Small Firm (SF)	**Products and Services**	**Customer Service (+/--)**	**Bank Reputation**	**'Connections'**
SF 1			"family bank for years"	
SF 2	"She told me how to get an overdraft, how to get a cheque account"			"I think it was because a client of mine… pulled a few strings for me"
SF 3			"when you go to [bank A]…you see businessperson after businessperson"	
SF 4	Lower product and services pricing	"the service we get for our personal bank accounts is bad…so we chose the other bank"		
SF 5	Internet banking		"it has been the bank for other businesses"	
SF 6		The bank has serviced SF 6's business partner well "over the last 15-20 years"		

All but one of the small firms did however maintain business bank accounts. The main reasons provided for the association included, the products and services offered by the bank, the customer service provided (both positive and negative), the bank reputation and in the case of SF 2 the availability of 'connections' in the bank. These factors identified offered superficial insight into the extent of the relationship. To gain deeper insight into the nature of the relationship between the small firm and the bank, the researcher asked the small firm interviewees, "What is the importance of the relationship with your bank?" The findings are presented in Chart 21.

Chart 21: The relationship between small firms and their banks				
Small Firm (SF)	**Power of banks**	**Punitive/Unforgiving**	**Reason for good banking relationships**	**Inability to value the emotional aspects of small firms**
SF 1	"It's not easy for someone to go to a bank and ask for money"		"There also needs to be relationship training for the bank staff. The bank staff must know where the people are coming from, the background of the people."	"Sometimes it takes one week for one person to gather guts to go to a bank and say listen, 'I need money'"
SF 2		"not thinking that this man has had this problem…and it was because of this problem that he messed up his account – they don't see that. You messed up and that's it"		
SF 3	"the thing is that the bank has power; they can make it or break it for you a lot of the time"			
SF 4		"The relationship between us and the bank is just don't mess up, be on time, honour your loans you ask for'	"We're less than five years old; we're experimenting in the way we do business"	
SF 5	"I don't think that you can call an entrepreneur and an SME one in the same thing, they become a SME maybe with the good financial backing or good financial input linking the right people together you can become an SME"	"Instead of saying that you have to reach this target of x amount or else we will punish you; say because you've reached this target, its more than we expected we are going to reduce the interest amount to x amount so instead of this constant punishment approach for not doing something"	"I mean it is going to be a positive spin off for the bank at the end because if your SMEs are profitable it will become profitable for the bank"	"the immense amount of energy that goes into it is unbelievable… and that is completely discredited by the banks
SF 6			"We have got to be in touch with the bank manager, informing him on how things are going all the time to keep him happy is paramount; you have to have him on the right side."	

Themes emerging from the small firms owners included the perception that the banks had power, were punitive and/or unforgiving in their dealings with small firms, and the bank's inability to deal with the emotional aspects that come with operating a small firm. However, some interviewees highlighted the reasons for the need for good relationships with their banks. The small firms in the study highlight the power of the banks to make or break the firm and point out the punitive unforgiving nature of the bank. What emerged strongly once again is the subjective emotional aspects of the small firm who wants the bank to be an understanding institution.

6.3 Document review

Three documents analyzed for the purpose of this study included the business plan formats provided by three banks, their lending criteria, and the Code of Banking Practice of which governs the conduct of banks which belong to the banking council of South Africa.

6.3.1 Key findings

The reviews of the documents will be presented in the following section, highlighting the major themes found relating to the research questions.

6.3.1.1 Review of business plans

The business plans provided by three banks (ABSA, NedEnterprise, and Standard bank) substantiated some of the information provided by the small firm interviewees and the key informants in the study. The major themes emerging from analyzing the business plan formats included provision of sufficient collateral, credit history, emphasis on the business entity and not the entrepreneur, importance of financial records, and performance of a feasibility study.

Provision of sufficient collateral

In each of the three business plan formats, the issue of collateral emerged strongly in the information requirements by the banks. The ABSA and Standard Bank business plans required information on both the entrepreneur's personal assets as well as the business assets and provided a comprehensive list of the types of assets regarded as appropriate for the purpose of accessing bank finance. In addition, ABSA and Standard bank required information on the personal and business liabilities, a requirement absent in the NedEnterprise business plan.

Credit history and importance of financial records

The business plans need detailed information of the owners' credit history to help the bank in making their decision. The business plans provided by the banks required comprehensive financial records. In addition, NedEnterprise requires audited financial statements.

Emphasis on the business entity and not the entrepreneur

The business plans focused on the business entity with the extent of owner(s) information being their education and curriculum vitas of key managers of the business. Though ABSA (2000:3) states "we take a keen interest in the business owner's character and personality traits, because a strong profile in that area is often an indicator of entrepreneurial potential" it is difficult to determine the value placed on this information in the lending decision.

Feasibility study and research and development

ABSA requires results for the market testing documenting customer's reactions, the test group's willingness to buy product at the anticipated price, and the customers' satisfaction. All three business plans require owners to perform an environmental analysis; an important requirement as it communicates to the bank the level of risk and the potential obstacles for the business. ABSA bank and NedEnterprise requires information on product/service research and development giving the entrepreneur an opportunity to share with the bank the major milestones and ongoing efforts regarding innovation.

Evidence of access to other sources of finance

The banks require the owner to prove that they have access to other sources of finance especially owners' cash contribution, cash in bank, assets, fixed property, bank overdraft, and amount owing to creditors. In addition, Standard Bank requires that cash contributions should not come from borrowed funds such as loans.

6.3.1.2 Review of lending criteria

The review is based on ABSA bank and Standard Bank because they provided this information to the public. ABSA provides a checklist, which is the starting point in the lending decision process because it provides the owner with the opportunity according to ABSA (2002) to "find out where you stand in relation to the bank's financing policies…give you an idea of how we are likely to be able to serve you best." If the owner is able to answer 'yes' to the following questions presented in Table 6. 2, the bank is likely to be in a position to assist the owner with their finance needs.

Table 6.2: Applying for business finance checklist

- Is your business registered?
- Are you technically qualified for the business?
- Do you have meaningful security?
- Do you have a valid, well-researched business plan?
- Are you willing to work long hours and make sacrifices in order to succeed?
- Are you highly committed to making a success of the business?
- Can you offer an own contribution of at least 10% of the financial requirements of the business?
- Can you provide security to cover at least 20% (of the bank's valuation of the financial requirements of the business?
- Are you willing to undergo training or to employ suitable staff to improve the management of the business in areas where the bank may deem it necessary?

Adapted from (ABSA, 2002:3)

The main themes surfacing from this checklist include the need for formality of the enterprise, collateral, success factors, sacrifices, and control. The issue of collateral has been discussed in the preceding sections of this review. ABSA requires that the enterprise be formal by ensuring that it is registered because it will facilitate the bank in getting its money back. ABSA talks about the need for the owner to make sacrifices and commit to making the venture succeed but it does not inform the individual what types of sacrifices and success factors are needed and the value attached in lending decisions. The final issue is of control and the owner will have to ask if they are willing to share decision-making because of the bank's intentions to tell them what staff to employ.

The lending process for ABSA begins with performing credit checks on all involved, emphasizing the need to manage credit histories carefully. The business plan's information is verified followed with an analysis of financial statements where the bank studies the history of the firm. If the owner is providing property as collateral, its value is assessed. The penultimate step is establishing the bank's potential risk exposure and the final step is considering the application for approval.

In contrast, Standard Bank relies on the credit risk assessment scale, which is based on the evaluation of both the business and financial risks. Business risk is a non-financial risk assessment and evaluates management and financial risk. Management risk evaluates the owners of the business and asks similar questions to the checklist provided by ABSA.

In addition, Standard Bank looks at the age of the applicant in a bid to manage for unforeseen events such as death and to demonstrate to the bank that succession plans exist. The environment risk assessment evaluates industry risk (low, medium, or high), competitors, suppliers, substitute products, foreign trade, entry barriers, seasonality, political, client base, location of business, labour, manufacturing capacity, and general economic conditions. This information comes from information presented in the balance sheet. Financial risk evaluates the business's financial information and security offered. The main issues analyzed are the owners' cash contribution ability, cash flow projections, and other financial statements. Standard Bank, like ABSA, require security to minimize the bank' credit risk exposure, because they use depositors money to finance projects. However, Standard Bank concedes to providing finance to firms with no security on rare occasions. For the loan to be approved Standard Bank requires a balance between the two elements of credit risk – business risk and financial risk.

The review highlights differences in the focus of bank evaluations but the overriding concern for both banks is managing credit risk by developing products and lending requirements that minimize this exposure.

6.3.1.3 Review of the Code of Banking Practice regarding lending

The researcher analyzed the section of the code centering on lending (Section 3.2). The main themes arising from the analysis included repayment ability, credit history, financial records, assessment techniques, and the owner's ability to provide collateral or surety for the loans. These themes are similar to those found in the business plans provided by the banks. These principles underlying lending to small businesses are presented in the business plan but detailed. Of importance in this document is the disclosure of the credit assessment techniques that could be used by a bank. In addition, the code disclosed the procedures undertaken regarding the issue of surety. The Banking Council of South Africa (1999:14) defined small business as "Juristic persons, partnerships and trusts whose turnover for the last financial year was less than R3 million."

6.4 Summary

The interviews and documents offered different perspectives on the role of bank finance in small firm growth.

The small firm owners provided diverse definitions about the entrepreneur and placed emphasis on the traits of the individual. In addition, the owners' definition matched the motivation for starting the business or pursuing the opportunity. Each owner expressed the desire to grow the business to employ more people and two owners intend to grow the size of operations. However, the challenges facing small firm operations suggest that growth will be difficult for the business. The owners do not intend to use bank loans to grow the business but to generate the funds internally from the business to finance the growth. Demand-side effects and supply-side effects influence the owners' growth capital structure decision. The demand-side effects are that the owners did not want to use bank loans because of past experiences accessing finance from banks and non-financial issues such as the need to control decision-making for the firm and dictate the rate of firm growth. The supply-side effects affecting their decision include their inability to access bank loans because of poor credit histories, the inability to provide appropriate collateral and the risk associated with small firm lending. The financial management strategies of the owners reveal that business is done on a cash basis, thus it is difficult to build up the financial resources needed to grow the business if cash is tied in machinery and inventory, because when there is a down turn in the business cycle, firms may experience liquidity crises. The issues small firm owners highlighted that banks should consider in addressing small firm finance needs are the nature of small firm operations (unstable business cycles) and valuing the traits of the individual. In conclusion, the use of bank finance did not feature in their plans to grow their business.

The bank small business advisor (KI 1) offered another perspective on the issue under study. The focus was on the use of objectivity in providing small firms with finance and this was reflected in the operational definition used by the bank concerning the small business sector. The objective measures consistently referred to included collateral, project viability, risk, lending criteria and the need for a comprehensive business plan in making decisions and not on subjective criteria. However, the key informant conceded that the bank needed to develop new approaches to assess small firm risk and educate itself to understand small firm operations in a bid to develop tailored finance. The features of entrepreneurial finance offered by the advisor were trust, the availability of 'big' assets and the risk associated with small firm lending. The advisor indicated the importance for the small business sector for South Africa and Grahamstown but did not provide clear information on how the bank was providing finance that was growth-oriented. The advisor indicated that small firm owners needed to understand how the bank operated and maintain accurate records to develop a comprehensive business plan if they wish to access bank loans. In summary, role of bank loans in small firm growth is determined by the extent to which owners can satisfy the bank's requirements.

KI 2 and KI 3 provided yet another perspective about the role of bank finance in small firm growth. The key informants highlighted the need for a small business sector to develop the economy and emphasized the role small business has for wealth and employment creation, poverty alleviation and innovation. The entrepreneur and entrepreneurship were described in terms of assuming risk and adding value to create a bigger economy base and the growth of small firms would assist to achieve this. The key informants highlighted that smalls firms had limited access to bank finance for growth because of the lending criteria, mindset of the financial institutions and the differing objectives between the two parties. In addition, the key informants suggested that small firms should learn about how banks operate, maintain financial records and demonstrate the capability that the business can finance itself from internal funds. KI 2 stressed conducting feasibility study to demonstrate the viability of the project. The features of entrepreneurial finance were similar to those of KI 1. The key informants suggested that banks needed to revisit their risk assessment techniques and staff be trained to understand the small business sector. The emphasis on the role of bank finance for small firm growth from the key informants perspective was dual in that banks needed to address certain issues and small business owners needed to manage the financial resources to demonstrate the firm's ability to finance growth.

The final perspective on the issue is provided by the findings from the document review. An analysis of the business plans indicated that banks need comprehensive information but emphasizing business information. Banks need to assess historical information to determine future financial behaviour of the owner. The lending criteria used by the banks are dependent on credit risk assessment and this is dependent on the comprehensiveness of the information provided by the owner. The policies or approaches followed by the banks regarding lending reflect principles presented in the code of banking practice. The role of bank finance in small firm growth is dependent on the owner's ability to provide the information required by banks.

CHAPTER 7

DISCUSSION OF FINDINGS

7.1 Introduction

The discussion presented in this chapter represents the researcher's interpretation of the study's findings in Chapter 6. The role of bank finance is explored from the small owners' perspectives, the key informants perspective, and the document review perspective providing insights on the issue in light of the findings and the literature presented in preceding chapters. The interpretation is within the context of this study and does not attempt to generalize about all small firms. To answer the grand research question, the discussion begins by answering each of the sub-research questions under the main headings, because these issues are central in understanding the role of bank finance in small firm growth from the various perspectives. The objectives of the research are addressed by answering the research questions.

7.2 Valuing small firm entrepreneurship within a bank setting

Three themes emerged from the findings shedding light on valuing small firm entrepreneurship within a bank context. The first theme focused on the operational definitions of the terms 'entrepreneur', 'entrepreneurship', and 'small business'. The second theme to emerge was the accommodation of small firm entrepreneurship within the bank, and the final theme was the bank's efforts to establish itself within the small business environment.

'Entrepreneur', 'entrepreneurship', and 'small business' – what do they mean?

Exploring small firm entrepreneurship requires understanding the terms 'entrepreneur', 'entrepreneurship', 'small firm', and findings reflect that the terms are not synonymous but definitions depend on the person and purpose. On the one hand, the small firm owners and the key informants (with the exception of KI 1) provided diverse descriptions of the entrepreneur, which centred on the individual adopting a particular attitude toward business. The underpinning features of this attitude included assuming the risk associated with small firms, pursuing ventures that would promote social development within their community, identifying opportunities, adding value, and providing innovative products and services. These characteristics of the entrepreneur are similar to those discussed by Bridge, *et al.,* (1998), Rosenthal (1996), and Thompson, (1999).

In contrast, KI 1 provided the bank's definition of the entrepreneur, which focused on the business entity itself, describing the identifiable and measurable elements of formality of the enterprise, number of employees, turnover, and the value of the loan. Despite existing guidelines provided by the National Small Business Act (refer to Table 2.8) defining the various sizes of the small business sector, the bank within the study and the Banking Council of South Africa still provide their own definition of the small firm. The bank's definition outlines the extent of small firm entrepreneurship valuation; valuation emphasizes objective factors of the small firm, consequently minimizing the assessment of 'soft' issues such as the entrepreneur's creativity or characteristics in the lending decision.

The bank's definition was of significance to the study because it offered insights into the bank's perception of small firm entrepreneurship. Firstly, the bank's definition suggests that the definition guidelines provided by the National Small Business Act (1996) are broad and inappropriate for the bank's purposes in terms of developing appropriate finance products and services. However, on closer inspection, the bank's definition comprises characteristics from three of the enterprise classifications provided by the National Small Business Act (1996) – micro (firm revenue of R150 000), very small (average of 12 employees), and small (employs up to 50 people). Moreover, no characteristics from the medium enterprise classification are present in the definition and yet the bank refers to SMEs. The next insight is that the bank's definition appears to recognize the fact that the majority of the firms in the small business sector reside within the micro, very small and small parts of the sector and hence their broad operational definition. Although the objective of the bank in this study is to reach every SME, one needs only to refer to the bank's definition and ask if it really wishes to do that; its definition effectively screens those enterprises that do not fall within the definition. The third insight observed is that the bank's operational definition is an effective mechanism to manage the bank's exposure to risk in the small business sector. The bank recognizes 'formal' enterprises – those that are registered, which is important for it should a business fail and it needs to recover its money; it is easier to deal with a company can be traced, a major concern of small firm finance. Fletcher (1995) argues that moral hazard is a problem associated with small firm lending decisions because it is difficult to monitor entrepreneurial behaviour. However, dealing with formal enterprises reduces the bank's resource allocation to trace owners because it has legal recourse it can use should the business become insolvent. Small firms, though risk takers may consider that issue because of the insolvency laws in South Africa, which permit debtors to apply for rehabilitation after at least one year or five years if convicted for fraudulent acts concerning the insolvency (Insolvency Act, 1936). This is not the case in the US where there are several types of bankruptcy procedures that have been formulated and are tailored for small firm operations. In addition, to the personal credit history, enterprises have to provide trade references in the business plans, which banks investigate for the loan application. This information indicates the extent of formality of the enterprise. The final insight emerging from the bank's definition is that the absence of one accepted definition demonstrates a critical problem in supplying finance to small business because of the diversity of definitions. A standard definition for banks could assist in formulating policies concerning small firm lending but that is not the critical determinant in the lending decision; critical determinants include the bank's assessment of credit risk and financial viability of the project – information supplied in the business plan.

Accommodating small firm entrepreneurship in the bank

Accommodating small entrepreneurship for institutions such as banks is difficult for two reasons. Firstly, the individual is instrumental in the creation or growth of the small firm;

this highlights the need to value the individual in determining the potential of the enterprise, however, bank assessment tools are not adequately developed to assess entrepreneurs' traits. The lending process described by the two banks in the document review was dictated by assessing objective data; there is no information sought on the traits of the individual. The personal information sought, such as age, experience and education are considered because the information is objective in nature and can be assessed. Psychometric tests can provide powerful insights but the core competency of banks is not in testing thus the reason the bank relies on objective measures such as assets and turnover, because lending decisions are based on financial return and risk associated with lending. Secondly, the motivation for starting a business varies with each entrepreneur; for example, one entrepreneur began the business because of a desire to uplift the local community while another started the venture because of an identified need to address a particular niche market. For a bank trying to offer a consistent service and one that adds value to its business, it may be difficult to attempt assigning values on the motivation and because lending decisions are centralised, the bank uses objective measures techniques such as credit scoring because they need to protect their money.

Restricted involvement

The small business sector was regarded by the key informants as important for economic reasons, social reasons, innovation and political agendas; a finding common to other research (Pitt, 1996; Kesper, 2000; Storey, 2000). Despite the urgency to promote the small business sector, the same urgency has not been reflected in the amendment or development of legislation. The underlying feature of small firm lending requirements is the issue of risk, whereby firms require risk capital at either the start-up or the expansion stages. The bank is restricted in its involvement with the small business sector because of, for example, its obligations to its depositors, which requires the bank to manage depositors' monies in a manner that will not expose them to high risk.

7.3 Small firm growth

The findings provided insights regarding small firm growth from the small firm owners' perspectives and in some instances, the key informants provided other perspectives. The emergent themes regarding small firm growth were firstly, the challenges associated with growth, the need to match finance needs with type of intended growth, dictating firm growth, and the importance of small firm growth for the bank.

Challenges associated with growing the business

The small firms had a positive orientation to growth; the majority of the cases expressed the desire to grow their business in order to employ more people and in addition, SF 3 and SF 6 intend to grow the size of the business. It is interesting that all but one entrepreneur mentioned finance as a challenge in operating the business, suggesting that the more pertinent issues include availability of market, disposal income, existing competition, and the ability to develop social networks issues raised by Carton, *et al*., (1998). The business environment challenges faced by the entrepreneurs in Grahamstown are similar to those faced by other Eastern Cape entrepreneurs. Developing networks is an important aspect of small firm operations; yet, in the lending criteria or the business plans, small firms are not required to detail their social networks. The Churchill and Lewis (1983) model proved to be an effective diagnostic tool for the study, in that the small firms expressed the challenges that their businesses faced. The small businesses were at the crossroads between the survival and success stages and the more important issue remained control of the business. Though the small firms wish to grow, their key requirements did not include sourcing external finance, because they wanted to generate their own funds internally.

Matching finance needs with type of intended growth

The type of growth pursued by the owner is important in the finance decision. The match between intended growth and external finance is thus important; for example, growing the business to increase number of employees suggests the need for the firms to identify new markets by introducing innovative products or services. However, to create such an environment requires banks to offer risk capital which would allow for such innovation; however, even in growth, the bank as indicated by KI 1 relies on the viability of the business plan leaving limited room for valuing the owners' ideas. The stage of development of the enterprise did not have a bearing on the role of finance in small firm growth as literature (Churchill and Lewis, 1983; Falkena, *et al.,* 2001) suggested. On the contrary, owners' did not intend to use bank finance but internal funds, a difficult task considering the challenges described by the owners. The owners' intention of generating internal funds needed to grow the business in effect limits the enterprises' potential to expand because owners' are not pursuing opportunities that could create the new products or markets in order to generate funds.

Dictating the pace small firm growth

In the case where owners pursue growth of a routine nature, the use of external finance is limited and this appeared to be the case in this study. The small firms' proposal of using internally generated funds to finance the growth emphasized the need to retain control in the decision-making of the business and, more significantly, it enables the owner to dictate the rate of growth. This would minimize pressure in the form of following rigid repayment schedules and uncertainty of interest rates. Moreover, business cycles in Grahamstown influence the entrepreneur's decision to expand the business and the banks providing finance. On the one hand, the owners want the business to grow but are unable to pursue growth, because banks may not be in a position to finance firms that cannot guarantee repayment of the loan, when the business cannot guarantee a constant cash flow. This insight suggests that there are limits to the use of a business plan in the lending decision, because in an economy such as Grahamstown, with uncertain business cycles, the projected cash flows may be understated or overstated. The uncertainty of cash flows could lead to small firms' failure to build up the necessary financial resources, which would produce a weaker balance sheet thereby restricting financial statement analysis. The business plan is therefore useful in providing background information for the bank and entrepreneurs should not think that they would be provided with a loan on the strength of their business plan alone. The bank advisor identified many of the financial determinants of capital structure such as profitability, capital requirements, and collateral (personal and business); information that the bank uses to avoid making Type II errors (Fletcher, 1995). Thus, the business plans reviewed are designed to solicit that type of information; small firms often do not present this information accurately.

Growing small firms are more profitable for the bank

The bank recognizes that small firm growth translates to improved profitability; it is not clear how its finance products facilitate small firm growth. However, providing non-financial support to small firms could be useful in ensuring appropriate use of finance. Crucially, the ability of banks to provide the risk capital they seek is through the effective functioning of Khula, which should reconcile the differences and needs of entrepreneurs and the banks by providing support for both parties. The market exists for a specialized institution that could serve the unique finance needs of small business owners; an institution which is somewhere between banks and venture capitalists. However, the broader economic conditions influence the capital structure decision as the findings suggest that the challenges faced by owners in Grahamstown make it difficult for the bank to lend, because they are not certain firms will grow.

7.4 Entrepreneurial finance

The features of entrepreneurial finance and preservation of self-interest will be discussed in the following sections.

Features of entrepreneurial finance

The issues of credibility and trust appear important features of entrepreneurial finance, in addition to the features provided by Smith and Smith (2000). Entrepreneurial finance does not translate to irresponsible financing by banks in a bid to appear to be actively involved in the small business sector; instead it emphasizes the need for creativity in developing financing products for small firms intending to grow the business. Moreover, labelling bank products 'SME products' equally does not mean entrepreneurial finance. Entrepreneurial finance goes beyond the availability of bank products for the small firm; entrepreneurial finance represents a change in bank mindset toward small firm finance. For banks to contribute effectively to small firm financing, banks need to recognize and accept the inseparability of the individual from all decision-making. The findings from the study suggest banks' shortcomings in providing entrepreneurial finance because of a lack of understanding of the small business sector. Underpinning small firm finance is the risk attached to small firm lending. From the bank's perspective, the entrepreneur's ability to minimize the bank's exposure to credit risk determines the extent of financing small firm growth. The bank small business advisor's reference to collateral/ security, feasible future cash flows (hence possible repayment ability) and credibility (for example credit history) outlines the ways a small firm can reduce its risk perception. This finding converges on the study by Nieuwenhuizen and Kroon (2002). As a result, banks are unlikely to accommodate blacklisted entrepreneurs. This illustrates the current mindset toward small firm entrepreneurship in South Africa. The legislation on individuals or business that have become either insolvent or blacklisted is such that to clear your name is an arduous task and underlines the negative attitude toward business failure. Developing entrepreneurial finance products requires the ability to recognize the issue of control on the part of small firm needs. This is the perception that to gain the resources needed for the organization to grow the entrepreneur has to surrender control of the company (Levie and Hay, 2000:258). This findings draw attention to the difficulties of developing entrepreneurial finance. The first consideration is that because all firms have different characteristics and are at different stages of development, it is difficult to develop products that will cover the spectrum of small firm finance needs. Secondly, understanding what entrepreneurial finance comprises is complex, because of the characteristics which small firms would like banks to consider when developing entrepreneurial finance which banks are unable to, because of the subjective nature of the factors. The centralized decision-making for the bank makes it difficult to develop entrepreneurial finance.

Preservation of self-interest

The second barrier to overcome in developing entrepreneurial finance is the preservation of self-interest masked by the common statements “banks do not understand the small business sector” and “small businesses do not provide information to the banks”. Entrepreneurial finance requires the small firm and the bank to work together to understand each other’s operations. There is a shared lack of understanding of each other’s operations. On the one hand, small firms do not understand how banks operate. For example, their own actions such as blacklisting records, operating on a cash basis and not maintaining books adds to their inability to meet bank lending requirements and that justifies the bank’s perception that lending to small firms is risk laden. On the other side, banks also display a lack of understanding of small firm finance needs. This leads to development of products, which the majority of small firms do not find useful because they are not able to access the products. Banks do not take into consideration issues such as blacklisting and small firm’s cash management behaviours. SF 5 challenges banks to engage in socially responsible behaviour with regard to the small business sector; this assertion demands further exploration. The implications of this behaviour could be a strengthened social system in which banks operate and are viewed by the small business sector, government, and other interested parties as doing their part in promoting the small business sector. This opinion highlights the conflict between economic and/or financial goals with social goals. In addition, the small firm owner suggested that banks use profits from their transactions to finance small firms. However, using company profits could translate into increased costs for the consumer in banks’ attempts to generate revenue to fund small firms and pressure from shareholders who wish to secure their investment. Legislation for South African banks is not developed on the issue and more importantly; the demands from the small business sector could weaken the economic system in which banks operate. Though banks have a role to play in promoting the small business sector, it is imperative to recognize that banks have an obligation to the individual who deposits money into the bank and that therefore is the reason it needs to minimize the risk element. This emphasizes the misunderstanding concerning the role of the bank.

7.5 The small firm-bank relationship

The banking relationship between the bank and the small firm is important because of its potential to bridge the gap between the two in understanding the needs of the other. However, the key informants in the Nieuwenhuizen and Kroon (2002) study do not regard this as important issue. However, the perception that the banks are punitive and unforgiving serves to drive the two apart because no one wishes to be involved a win-lose relationship where the bank is seen to score in terms of charges and not offering assistance to the firm while the firm seems to lose. The attitudes of the small firms emphasize the rift between the two and often comment on the need for non-financial support from the bank. The small firms highlight the need for positive relationships as both parties will benefit and the issue of profitability is addressed and the bank may fulfil its role in providing non-financial support. The rift between the two is compounded by the failure of the bank to value the entrepreneurial spirit in that they rely on objective measures.

The final discussion in this chapter answers the grand question “What is the role of bank finance in small firm growth?”

7.6 The role of bank finance in small firm growth

The purpose of the research was to explore the role of bank finance in small firm growth. For both the bank and the individual past behaviour/interactions shape future decision-making regarding finance. Having presented varying growth objectives of entrepreneurs in the study, it becomes evident that the entrepreneur will need financial resources for the intended expansion, a finding consistent with finance structure decision-making models that include the life cycle model, pecking-order model and the agency theory model. However, findings from the study indicate entrepreneurs’ preference for internally generated funds to finance the growth of the business. The findings suggest another decision-making model, which resembles the resource-based theory of bootstrapping, because owners’ do not intend to use bank finance to grow the business. In addition, from the analysis on definitions provided by the entrepreneurs' on who is an entrepreneur, their motivation for starting the business and growth objectives, the extent of the internal locus of control is quite evident. This minimizes the extent that small firms wish to borrow, for them to maintain this control; they would rather finance the business from internal profits.

The alternative finance structure decision-making model suggests that retained profit would be the prominent source of internal funding. However, a significant finding is that the use of cash to operate the business may have negative and positive implications for the entrepreneur. The negative aspects include firstly, the need for banks to review the enterprises' past performance in making their lending decision; the entrepreneur may have a weakened working capital ratio. The second issue is that the use of cash in all their requires careful financial management on the part of owners' because, the use of cash can result in restricted firm growth. The maximum rate of growth will be determined by owners' projected sales growth and hence the net assets required to achieve the projected sales growth. Underlying the maximum rate of growth the owners' can achieve is the profit retention ratio. Thus if owners' do not build the necessary financial resources, the need of external finance may increase if the profit retention ratio is not managed according to the projected sales growth and increase in net assets required for the sales growth. Owners' should not assume that using cash would protect them from using debt to grow the firm because, if owners' want to grow the business beyond the business's internal growth rate and they do not have the financial resources it could result in owners' resorting to external finance or a delay in firm growth while owners' build up funds. Thirdly, the common lending model used by commercial banks in South Africa according to Falkena, *et al.,* (2001) is the credit scoring system. Although, the entrepreneur may assume that the non-existence of a credit history is a good sign of the operations of the business, the bank may actually rate the entrepreneur as high risk because they are unable to assess the ability of the entrepreneur to pay back loans (Frame, *et al.,* 1997). Furthermore, this finding supports Landström and Winborg (1997) who suggest financiers' cautious approach in small firm lending because of high risk and potentially lower returns. As such, a lack of a credit history may compound existing risk perceptions of banks regarding small firm lending. Finally, central to the lending decision is the issue of information asymmetries where according to Storey (2000) makes banks more cautious lending to small firms. Once again, this finding may be interpreted as negatively contributing to obtaining finance because banks use certain means such as financial statements to calculate the repayment ability and credit scoring; it becomes difficult in the case of these businesses where no credit is used. On the positive side the entrepreneur may be content not to owe anyone money and unexpected demands on cash (Barber, et al., 1989) can be met safely (control issues). The use of cash may be used a mechanism to dictate the rate of growth within the firm.

Although the bank has an established small business unit, it still operates within the framework of the main bank, therefore decisions are centralized and the bank has to rely on a standard procedure to minimize exposure to risk. There is a clash between traditional banking culture and the entrepreneurial culture. To begin making progress into creating entrepreneurial finance, banks need to consider the tangible and intangible aspects of small firms. Pursuing an entrepreneurial involves the bank valuing entrepreneurs' ideas, individual entrepreneurs and providing non-financial support. These factors force the bank to broaden its knowledge of small firm entrepreneurship and to develop appropriate products because it is through interaction with entrepreneurs that it will begin to understand small firm entrepreneurship and, as such, know what type of finance products is required. The bank, in valuing the entrepreneurial mind, could become entrepreneurial itself through the establishment of innovation capital, which it sponsors from its profits. This capital would provide the bank the opportunity to learn more about the small business sector because it would not only provide the capital but also for those who desired, provide non-financial support. However, the researcher is of the opinion that banks should not be using resources in an attempt to develop small business finance, because the small business sector has unique features and banks do not have the competencies to exploit that market. With regard to the tangible factors, lending criteria needs to be accommodating of small firm operations, for example, the effect of business cycles on repayment abilities. Although the bank and key informants highlight the need for education for both the entrepreneur and the bank to develop an understanding of each other's operations, the question is who initiates the process and whether it is the duty of the bank. The researcher argues, if a bank has an obligation to ensure that a depositor's money is safeguarded, surely one way of doing this is that after lending to the entrepreneur, the bank offers – after sales support, but this could then be perceived by the individual as infringement on their control by the bank. This requires a shift in mindset and this was reflected in the acknowledgment by the bank small business advisor for the need to train staff to equip themselves with knowledge of the sector and, importantly, to assess risk differently, when it comes to small firms.

7.7 Summary

Small firm owners suggested that internal funds rather than bank loans would finance firm growth. The discussion indicated that the small business sector was perceived as important, answering the sub-question concerning perceptions of small firm entrepreneurship by the bank. These insights are significant because they highlight, the complexity of developing finance products to suit the needs of small firms because of the different characteristics of each enterprise size. From the bank's perspective, the difficulties associated with small firm lending such as risk, inadequate collateral and information asymmetries present difficulties in assessing loan applications despite how enterprise are defined. The absence of generally accepted definitions of the concepts 'entrepreneur', 'entrepreneurship' and 'small business' although important, do not deter the bank from supplying finance, the main considerations include the repayment abilities, financial viability and the strength of the business plan. The use of cash in operating the business is important in financial management because it can determine the capability of the firm to adjust if there is a change in the environment and build up financial resources to grow the business. The extent to which small firms seek to use bank loans is in part determined by control issues, availability of appropriate collateral, accurate information to supply the bank, growth aspirations, and past experiences. The bank, on the other hand relies on objective measures in their decision-making.

CHAPTER 8

CONCLUSIONS AND RECOMMENDATIONS

8.1 Introduction

The chapter presents the study's conclusions. Recommendations for the small firm, banks and further research are provided in light of the study's conclusions. The significance of the study is discussed and the limitations of the study conclude the chapter.

8.2 Conclusions of the study

The findings suggest that although the bank recognizes the small business sector as a vital sector for the South African economy, it does not come without its complexities. Firstly, the National Small Business Act provides guidelines for defining the small business sector, yet evidence from the study suggests that the definitions may be adapted to suit individual needs. From this study, the bank [1] provided its own definition to facilitate its development of finance products for small firms. Furthermore, there is inadequate legislation for the small business sector and this may limit the promotion of the sector. From the study, the researcher asserts that although small firms feel that access to bank finance is limited, access to finance is controlled partly by external factors such as legislation, over which the banks have no control. Finally, the risks associated with small firm entrepreneurship have an impact on financing small firms. The issue of liquidity, credit risk, and information asymmetry limits the bank's involvement in this sector.

The bank supports small firm growth because it recognizes that small firm growth could translate into better profitability for the bank, however, it is difficult to assess the growth potential of the firms because of the business environment in which they operate. Matching the types of growth with finance is difficult.

[1] when the term 'the bank' is used, it refers to the bank that participated in the study

For entrepreneurs to move beyond the obvious and create the value that is needed for the economy to grow, the type of entrepreneurship needed is Schumpeterian. Schumpeterian entrepreneurship is based on the premise that growth is a result of quantum leaps in terms of innovation. However, the type of finance provided by banks [2] would be inappropriate because entrepreneurs' require risk capital, which would allow for venture failure. The bank has to manage its risk exposure because it is responsible for depositors' funds. For this reason, the researcher is of the opinion that banks should not be targeted as the primary finance suppliers for growing enterprises, rather, a financial institution that would be somewhere between banks and venture capitalists should be created to meet the needs of small firm finance needs.

Developing entrepreneurial finance requires a shift in mindset; however, that is difficult for regulated institutions such as banks. The attention should shift to how banks can improve their product offerings for small firm growth to reflect the attributes of entrepreneurial behaviour. Given that owners' do not intend using bank finance to grow the business, it is imperative that owners' begin to create venture capital to finance the growth when it should occur. A balanced participatory relationship is required to facilitate the education between the small firm and the bank thus effectively providing a platform to develop appropriate finance for small firm growth.

The role and use of bank finance in growing the business is influenced by firstly, the small firm owners' understanding of what is expected of them by the bank in terms of providing relevant information in their business plans; secondly, the small firm owner's knowledge of the bank's offering for small business, including the interest rates, bank charges, and how banks operate; thirdly, the small firm owners' experience, what they know about bank finance, and the opinions of other small firm owners influence the use of bank finance. Furthermore, the issue of maintaining full control on the decision-making in the firm is important and the motivation for growth and the types of growth pursued is important for the use of bank finance.

[2] when the term 'banks' is used, it refers to banks in general

The use of cash can minimize the use of bank finance if managed in that owners' profit retention ratios must be able to accommodate the net assets increase requirements to achieve the projected sales growth. From the bank's perspective the role of bank finance in small firm growth is determined by firstly, the financial viability of the venture; secondly, the extent to which owners' can meet bank requirements; thirdly, the comprehensiveness of the business plan, and finally, the credibility of the owner in terms of how he or she conducts their business (obtained from credit history information and bank accounts).

8.3 Recommendations

The recommendations presented address the final aim of the study, which was to recommend solutions to overcome the gaps identified by the study.

8.3.1 Recommendations for small firms

The following recommendations emerge for small firms

- Small firms need to engage in self-education regarding the function, purpose and use of the bank for their operations. Through this education, they may reduce the gap between themselves and their bank regarding the operations of a bank and understand the reasoning behind the way the bank operates, and for example, understand the importance of maintaining financial records
- Financial records are important when deciding to borrow external finance
- Financial management is fundamental in planning the growth route the venture will take. The firm needs to carefully manage the use of cash in operating the business
- Small firms need to maintain good credit histories is important, as it demonstrates the repayment ability of the business
- Small firms need to provide appropriate information to banks

- Small firms need to develop plans for growth indicating the strategic orientation of the firm. These plans could be useful in demonstrating the strategies firms intend using to manage risk in the growth phase, the use of financial resources, presenting the feasibility of the intended growth
- Feasibility studies are useful because they provide banks with information such as the market feedback, market potential, and any test results, which can demonstrate the viability of the intended growth

8.3.2 Recommendations for banks

- Commit to educating themselves about the small business sector as well as commit to educating entrepreneurs about the functioning of banks
- Utilize frameworks such as Churchill and Lewis for a better understanding of the characteristics of small firms and in particular what issues firms should have addressed before proceeding with the intended growth
- Work towards creating a balanced relationship for better management of the small firm-bank interface
- The small business units need to operate with higher levels of autonomy to ensure that units develop products that will not only meet the profitability and risk management requirements of the bank but products that do provide the entrepreneur with appropriate funding
- Create an innovation fund that is geared toward the risk attributes associated with small firms; a step towards creating an entrepreneurial culture within the bank setting
- Train and sensitize employees on the nature of small firm entrepreneurs
- Provide appropriate non-financial support for the entrepreneurs to limit credit risk
- Banks need to be aware with the decision-making of small firms regarding the use of external finance and particularly the issue of finance
- To develop appropriate small firm finance, banks need to distinguish between low and high growth

- Banks need to understand how small firms operate and work this understanding into revising current lending criteria, such as the repayment ability of small firms, to limit liquidity constraints the firm may encounter and at the same time cater for owners' need to retain control of decision-making

8.3.3 Recommendations for future research

The insights from this exploratory study provided other areas of research that need to be addressed for the South African context.

- Developing an instrument that measures the risk profile of the firm and the individual in making lending decisions
- Investigating how banks can develop finance products that are sensitive the stage of development of the firm and that distinguish between low and growth potential
- Investigate the aspects that should be covered in creating legislation for small firm finance
- Assess the impact of current legislation on the performance of bank activity in the small business sector
- How local business environments impact on lending decisions within South Africa's provinces
- The development of a financial institution that is different from a bank and venture capitalists that would meet the finance needs of small firms by supplying the risk capital growing small firms require

8.4 Significance of the study

The nature of small business research requires in-depth data collection from the small business owners and quantitative methods such as surveys may be inappropriate. By using a qualitative case study, the research was able to present accurately the views of small firms and, although exploratory, the study provided insights on finance structuring, decision-making and financial behaviours of small firms in the growth phase. Secondly, the local context in which the research was undertaken offered insights of the finance preferences for growth of small firms in South Africa. Other contributions were the potential of the study for improving banking relationships between small firms and their banks.

8.5 Limitations of the study

It was anticipated that the study would not be representative of all small business in Grahamstown. The findings cannot be generalized beyond the six small businesses, as the sample was very small. The method of sampling could also have had a limiting influence on the study. The document review was useful but it was difficult to ascertain reasons for bank policies and business plans.

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APPENDIX A: Small firm owners' interview protocol

CASE STUDY PROTOCOL: Small firm owner interviewees

a. Purpose

The purpose of the study is to explore the role of bank finance in small firms growth.

The aims of the research include:

- Identifying the financing needs of growing small firms
- Discover views and opinions on bank finance for growing the business
- Identifying the gaps between the bank and small firms with respect to growth-finance objectives

b. Organisation of the interview guide

Section A: Procedures

1. Initial scheduling of field visit

Before undertaking interviews, the researcher needs to gain access to the individuals by personally approaching them at their place of work and asking permission to interview them. To determine if the small firm was eligible for the interview, the researcher must ask information on small firms age. The researcher must inform the small firm owner about the nature of the study and its purpose and inform them that their identity will not be revealed in the study.

2. Identification of people to be Interviewed and other sources of information

Entrepreneurs who have businesses that have been operating for at least two years but not more than eight years.

Section B: Case study small firm interview questions

Defining entrepreneurs and tracing entrepreneurship in the small firm

1. Can you tell me about your business?
2. Would you call yourself and entrepreneur? Why?

Growth Issues

3. What challenges do you face in operating in Grahamstown?
4. Do you want the business to grow? Why?
5. How will you manage this growth transition?

Finance issues

6. How do you intend to finance this growth?
7. Is your bank important in this decision? Why?
8. What problems do you think you may experience in accessing finance for this growth? Why?
9. What factors did you consider when choosing your bank?
10. What should banks know about small business finance needs?
11. Do you think the bank caters for your finance needs? How/Why?
12. What financial systems have you in place?

Section C: Case analysis

1. Individual Case

Each interview will be analysed using the thematic framework

APPENDIX B: Bank SME Business Advisor interview protocol

CASE STUDY PROTOCOL: Bank SME Business Advisor interviewee

a. Purpose

The purpose of the study is to explore the role of bank finance in small firms growth.

The aims of the research include:

- Identifying the financing needs of growing small firms
- Discover views and opinions on bank finance for growing the business
- Identifying the gaps between the bank and small firms with respect to growth-finance objectives

b. Outline of the interview guide

Section A: Procedures

1. Initial scheduling of field visit

Before undertaking interviews, the researcher needs to gain access to the individuals by personally approaching them at their place of work and asking permission to interview them. The researcher must inform the business advisor about the nature of the study and its purpose and inform them that their identity will not be revealed in the study.

2. Identification of people to be interviewed and other sources of information

Bank small business advisors

Section B: Case study bank key informant interview questions

General

1. Why is the small business sector important in South Africa?
2. Is the small business sector a priority for the bank? Why?
3. Who are the major financial players in the development of the small business sector? Why?
4. How does the bank define a small business?

Small business growth related issues

5. Why is it important for the bank that small businesses grow?
6. How does the bank identify small businesses with growth potential?
7. Why do some small businesses grow and others do not?
8. How does the bank contribute to small business growth?
9. How can the bank contribute to small business growth?

Finance related issues

10. Why is there a perception that one of the barriers to small business growth is a lack of finance?
11. Why are the finance needs for small business different from the corporate finance needs for this bank?
12. Who is the target market of the banks small business finance products? Why?
13. How does the bank finance small business growth? Why?
14. How does the bank develop its small business finance products?
15. How can the small business assist the bank to develop finance products?

Section C: Case analysis

1. Individual Case

The interview will be analysed using a thematic framework

APPENDIX C: Entrepreneurship expert and Rhodes University academic interview protocol

CASE STUDY PROTOCOL: Entrepreneurship expert and academic interviewee

a. Purpose

The purpose of the study is explore the role of bank finance in small firms growth.

The aims of the research included:

- Identifying the financing needs of growing small firms
- Discover views and opinions on bank finance for growing the business
- Identifying the gaps between the bank and small firms with respect to growth-finance objectives

b. Organisation of the interview guide

Section A: Procedures

1. Initial scheduling of field visit

Before undertaking interviews, the researcher needs to gain access to the individuals by personally approaching them at their place of work and asking permission to interview them. The researcher must inform the key informants about the nature of the study and its purpose and inform them that their identity will not be revealed in the study.

2. Identification of people to be interviewed and other sources of information

Expert in entrepreneurship
Rhodes University academic involved in local business development

Section B: Case study key informant interview questions

General Questions:

1. What is entrepreneurship, small business, and small-medium enterprises, entrepreneur?
2. Do we have entrepreneurs in Grahamstown? How can one identify them?
3. Can small businesses be entrepreneurial? How?
4. Why is the small business sector important in South Africa? Eastern Cape?

Growth-related issues:

5. What is growth for the small business?
6. Is the age of the company important in growth?
7. Why is it important that small businesses grow?
8. How can the entrepreneur manage the growth phase?
9. Why is there a perception that one of the barriers to small business growth is a lack of finance?

Finance-related issues

10. Why is there a perception that one of the barriers to small business growth is a lack of finance?
11. Why are the finance needs of small businesses different from corporate needs?
12. One of the reasons small businesses fail to access finance from banks is their lack of financial records, what is your opinion?
13. From a business development point of view, what should small businesses know about finance?
14. From a business development point of view, what should finance providers; especially banks know about small businesses?

Section C: Case analysis

1. Individual Case

The interviews will be analysed using a thematic framework