The role of the Government in resolving the funding gap for SMEs in South Africa

Sedzani Faith Mudau

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ABSTRACT

Business funding is essential for growth and it appears that Small and Medium Enterprises (SME) often struggle to secure external funding.

This study sought to determine whether a funding gap exists for SMEs in South Africa and also sought to ascertain the extent of interventions made by the South African Government through the Development Finance Institution (DFI).

A qualitative data collection method was used for this study, and respondents were interviewed face-to-face, in a one-on-one setting.

Some of the key findings included the confirmation that there indeed exists a funding gap for SMEs in South Africa. Although there are many government interventions through the DFI, it appears that the gap is not reducing rapidly enough. The study found that the factors listed below were among the main contributors to the funding gap.

i) Poor integration among DFI's business funding programmes;
ii) Equity requirements that cannot be met by SME owners;
iii) Commercial banks appear to be unwilling to extend financing to small businesses due to lack for information; and
iv) Long turnaround times by the DFI on business funding applications.

However, it appears that this gap can be narrowed over time if processes within the DFI can be enhanced and if SME owners can enhance their skills.

DECLARATION

I, Sedzani Faith Mudau, declare that this research report is my own work except as indicated in the references and acknowledgements. It is submitted in partial fulfilment of the requirements for the degree of Master of Business Administration in the University of the Witwatersrand, Johannesburg. It has not been submitted before for any degree or examination in this or any other university.

Sedzani Faith Mudau

Signed at ……………………………………………………

On the …………………………….. day of ………………………… 20…..

DEDICATION

I dedicate this research to my mother, Cathrine Azwinndi Mudau, who has been the rock throughout my life and has continued to show her love and unfailing support to this very moment. I thank God for you.

ACKNOWLEDGEMENTS

I would like to acknowledge my Lord and Saviour, Jesus Christ, who enabled me to complete this project for "I can do all things through Christ who strengthens me" (Philippians 4:13).

I am grateful for my super children, Akonaho and Mukhethwa, who were robbed of many moments with mommy whilst I was studying; I thank God that we still have a lifetime to make more memories.

To my two beautiful sisters, Lufuno and Khathu, thank you for the love and for babysitting whenever I needed the help.

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CHAPTER 1: INTRODUCTION

1.1 Purpose of the study

The purpose of this research was to examine whether there is a funding gap for Small to Medium Enterprises (SMEs) in South Africa. Secondly, the research sought to determine the challenges faced by SMEs in the process of seeking funding.

The research paper focused on three areas: First, it assessed the existence of the funding gap for SMEs in South Africa. Second, it analysed the government's intervention through state-owned development finance institutions (DFIs) which are mandated to extend credit to small businesses and examined challenges that influence the extension of such funds. Third, it investigated the challenges faced by SMEs that apply for funding from financial institutions, including DFIs in South Africa.

The focus of the research was limited to assessing businesses that have or have had a need for funding. These SMEs must have approached commercial banks or Development Finance Institutions (DFIs) for financial assistance.

1.2 Context of the study

Business funding is often viewed as one of the primary areas in which young or small businesses experience challenges and these difficulties may be detrimental to their long-term success (Watson, Hogarth-Scott, & Wilson, 1998). The situation is no different in South Africa, as it is apparent that there is a low success rate for business loan applications. This was confirmed by a study conducted on 507 entrepreneurs in Durban that indicated that only 3.9% of the population that applied for credit from banks were successful in receiving credit(Skinner, 2005). The main reason for credit being denied, as cited by those who responded during the study, was a lack of the required collateral by the banks (Skinner, 2005). This low approval rate emphasises that business expansions may be constrained by lack of credit extension in South Africa.

According to (Pretorius & Shaw, 2004), another challenge noted was that commercial financial institutions in South Africa do not advance credit based on the strength of a business plan, especially for small businesses. The decision appears to be purely based on the availability of sufficient collateral, or the credit worthiness of the applicant. One of the contributing factors may be that South African banks may not have sufficient experience in dealing with small businesses due to the country's history that has been dominated by large enterprises. Most of the financial institutions in South Africa appear to be risk averse and limit extension of credit to anything that appears risky and this is mainly achieved by making demands for collateral (Pretorius & Shaw, 2004).

Essentially, the gap between the demand and supply of financing resources is defined as the funding gap (Lam, 2010).

According to Moore and Garnsey (1993), governments have a role to play where there are market failures and should provide solutions to challenges faced by SMEs. Governments are not conflicted in granting finance because they are not driven by profits but have a developmental agenda and the absence of such a conflict is vital at the early stages of the business (Moore & Garnsey, 1993).

The South African government has made headway in developing strategies that can improve small enterprises' sustainability, as observed from its three pillar strategy as outlined in the Integrated Strategy on the Promotion of Entrepreneurship and Small Enterprises. The three pillars include the following:

i) Increase supply for financial and non-financial support services
ii) Create demand for small enterprise products and
iii) Reduce small enterprise regulatory constraints.

1.3 Problem statement

1.3.1 Main problem

The purpose of this research was to determine the existence of a funding gap for small businesses in South Africa and to assess the contributing factors thereof.

1.3.2 Sub-problems

The first sub-problem explores government's interventions through state-owned DFIs and to identify challenges faced by such institutions in extending credit to small businesses.

The second sub-problem analyses challenges faced by small businesses when accessing financing from state-owned institutions.

1.4 Significance of the study

There have been studies on the funding constraints for entrepreneurs in South African by Falkena et al. (2002) and Pretorius and Shaw (2004).

This particular study may provide guidance to policy makers as it may indicate aspects that are not working with the current structure of state-owned DFIs. Small business owners may also be enlightened regarding the factors that might successfully improve the outcomes of their funding applications.

1.5 Delimitations of the study

The research centred on small businesses that attempted to source external funding and that might have either failed or succeeded. The sources that were considered to provide such funding may be commercial banks or DFIs. The study attempted to determine the outcome of these applications as well as to ascertain factors that contributed to the outcomes. Businesses that might have failed to secure funding from commercial banks were preferred to establish the factors that contributed to such an outcome when compared to an outcome from DFI. Essentially, the research sought to determine the factors that enabled SMEs to approach external organisations for funding, once DFIs and banks were deemed unsuccessful avenues for receiving financial aid. The factors that resulted in funding being rejected by DFIs and the banks also required attention.

Representatives from two main state-owned DFIs, namely the Small Enterprise Finance Agency (SEFA) and Industrial Development Corporation (IDC) were interviewed to obtain their views regarding the institutions' roles in the economy and to deduce the factors that contribute to limited or non-extension of funds to small businesses funding applications.

The population was limited to small business owners based in Gauteng. This was mainly because, according to Falkena et al. (2002), 45% of South Africa's SME population is situated in Gauteng province..

1.6 Definition of terms

Small Businesses Enterprise (SME): According to the National Small Business Act of 1996, small business is defined as a separate and distinct business entity, together with its branches or subsidiaries, if any, including co-operative enterprises and non-governmental organisations, managed by one owner or more which, including its branches or subsidiaries, if any, is predominantly carried on in any sector or subsector, the thresholds per sector are listed in Appendix A.

Funding gap: The funding gap is defined as the gap between the ample demand for financing and the limited supply (Lam, 2010).

1.7 Assumptions

The following assumptions have been made regarding this study:

- All selected participants were willing to reveal their source of business capital.
- Those participants who were unwilling to correctly disclose certain information would have informed the researcher.

CHAPTER 2: LITERATURE REVIEW

2.1 Introduction

There is consensus among policy makers that SMEs are significant drivers of the South African economy. A healthy SME sector contributes to the economy by creating more employment opportunities, increasing export and introducing innovation, as well as entrepreneurial skills (National Credit Regulator, 2011).

It has also been observed that small businesses' main sources of financing are the owner's funds that include equity, credit cards and loans. These sources of finance account for approximately 70% of business funds. However, sources of financing for medium-sized financing are strikingly different with a larger portion of the funds being sourced from commercial banks and other finance companies (Berger & Udell, 1998).

This supports the situation observed in Africa where approximately 84% of small and medium businesses are financed by internal funds, which is higher than the 70% in developed countries. It suggests that African SMEs that have similar growth prospects as firms in developed economies are more dependent on internal funds and are more constrained from accessing external funds. In Africa, 22% of companies have loans or lines of credit, which was found to be below the 43% average reported in developed countries (African Development Bank, 2013).

As already indicated, this study focused on the funding gap in the South African market for small and medium business enterprises, as defined in the Small Business Act of 1996. The study sought to analyse the type of government business finance interventions through the use of Development Finance Institutions (DFI) as well as to investigate challenges experienced with these interventions.

This chapter reviews the literature relevant to the study.

2.2 The Role of SMEs in the economy

SMEs are critical in introducing competitiveness, flexibility and mobilising entrepreneurship in the economy. Economies like South Africa, due to the historical policies coupled with an underdeveloped SME sector, may be at a disadvantage (World Bank, 2007). This was supported by a report done on SME's access to finance in South Africa which indicated that the SME sector in South Africa is estimated to contribute approximately 50% of the GDP and to employ in excess of 60% of the total labour force. Increase in the output of SMEs can therefore significantly reduce the level of unemployment in the country (Falkena et al., 2002).

Entrepreneurship generally contributes in achieving greater levels of economic growth (Grilo & Irigoyen, 2006). Recent evidence of the relation between entrepreneurship and economic performance has prompted many policy makers to create policies that promote and enhance an entrepreneurial friendly environment. Some of the policies include better access to finance by entrepreneurs and general business support (Grilo & Irigoyen, 2006).

2.3 The funding gap

As already indicated, the funding gap is the cavity between the huge demand for funding and the limited supply of such funding (Lam, 2010).

It was observed that, unless business start-ups, which are included in the SME category, receive the necessary funding, they may never be viable and reach the levels of successful innovative firms. Generally, there is a shortage of capital for funding as debt financing by commercial institutions cannot be advanced on the back of future prospects of the business plan, but only if the required collateral is available and it has been noted that most SMEs are not likely to meet such requirements (Moore & Garnsey, 1993).

The shortage of capital may be a serious challenge as it has been noted that start-up capital for new ventures is crucial for SME growth and a lack thereof serves as a critical stumbling block (Pretorius & Shaw, 2004). Moreover, new businesses are vulnerable during the initial stage following start-up (Watson et al., 1998) and this is mainly because these small firms are seen as being more fragile, and increasing the debt-to-equity proportions for small firms may not be viable (Cressy, 2002).

2.3.1 Existence of the funding gap in South Africa

This section explores the literature on the funding gap for small businesses in South Africa.

Approximately 95% of all businesses started in South Africa are funded from entrepreneurs' own resources, which is generally aligned to the global trend. However, it is concerning that this is still the case in South Africa where there are large quantities of financial aid earmarked for DFIs which should fund these businesses. South Africa also has a low level of entrepreneurial activity and a lack of financing has been identified as a major impediment to entrepreneurial activity (Global Enterpreneurship Monitor, 2009).

Another concerning matter is that approximately 75% of new SMEs in South Africa do not become established firms. This has been attributed to three main obstacles which include the lack of access to finance and the lack of collateral required by banks as well as insufficient owners' equity contributions (Olawale & Garwe, 2010). Access to financing was cited as one of the major constraints to growth by SMEs surveyed in Johannesburg. It was also observed that most of the surveyed businesses' start-up capital was covered from personal savings and most of the young, smaller and mostly black firms were constrained from securing finance due to collateral constraints (Jeffrey Lewis, 2001).

Another peculiar factor is the South African history, which presents unique challenges as different players in the market have differing funding sources depending on their social background. It has been observed that there is a gap in the previously disadvantaged individuals' (PDI) abilities to advance the required collateral due to limited resources being available when compared to their white counterparts, whose businesses are financed from their social circles, which are mainly family and friends (Falkena et al., 2002). This view is supported by the World Bank that reported that there appears to be a greater demand for business funding from the predominately black majority and this results in a funding gap for PDI entrepreneurs who may not be able to secure funding from commercial banks that primarily require collateral to advance funding to small businesses (World Bank, 2007).

The World Bank also reported that the South African financial market lacks institutions that cater for the lower end of the SME market. There is limited access to funding due to high administrative costs of small-scale lending, there is a perception that risk is high in lending to smaller enterprises, and there is a lack of collateral and financial records (World Bank, 2013).

2.3.2 Barriers for SME access to funding

Certain barriers which restrict SMEs' abilities to access funding have been identified. Below are some of the barriers that were noted during the review of literature.

2.3.2.1 Lack of collateral

According to Falkena et al. (2002), the provision of finance to micro and small businesses is directly related to access to personal finance in the financial sector. Most SMEs have to access debt through the name of the owners and this is mainly due to the high risk profile associated with SMEs as well as the bank's unwillingness to advance credit.

As already indicated, business financing in South Africa is directly related to the owner's credit worthiness as well as the owner's ability to provide security. Banks place little emphasis on the viability of the business based on the business plan (Pretorius & Shaw, 2004).

It has been reported that since the 2008 Global Recession, most assets that small businesses were likely to use as collateral have lost value, though this has been gradually changing as the global economy starts to recover (Forbes, 2014). This exacerbates the funding challenges faced by small businesses.

2.3.2.2 Relationship based funding limitation

The advancement of funding is impacted by the existence of a relationship with financial institutions, as such, the shortness of such a relationship results in lack of track records, which negatively impacts decisions to advance credit. Banks use transactional history in their decisions to extend credit to larger or more established firms where there will be limited monitoring required (Cressy, 2002). Therefore SMEs are on the back foot, due to the short transactional history or even, the lack of such records.

The existence of a relationship can reduce the information gap for small businesses or start-ups. However, the kind of relationships that might reduce the gap are often established over an extended period of time, which on average is approximately 9.4 years; this may be impractical for small businesses (Berger & Udell, 2002).

It has also been reported that effort invested by business owners in building trust often has a positive effect on their business outcomes and funding sources for business ventures. Business owners' efforts in creating better relations with prospective funders often yield positive results (Lam, 2010).

2.3.2.3 Information asymmetry

The information gap serves as another factor that deters credit from being advanced to small businesses or start-ups. The unavailability of information in the public domain relating to the performance of small businesses and the lack of such information also serves as a deterrent for financial institutions to extend credit to small businesses. This is coupled with the notion that small businesses have high failure rates and their businesses are yet to be tested; financial institutions often redirect funds elsewhere (Berger & Udell, 2002; Forbes, 2014).

However it appears that small business financing options change when the business grows and the information gap narrows during the financing growth cycle. The financing growth cycle is mainly characterised by the fact that start-up business heavily rely on owner financing or angel financing by clients or family. However, as it continues to exist, access to other forms of financing such as commercial institutions financing or public equity is unlocked. The funding gap is thus reduced over the life of the business (Berger & Udell, 1998).

It appears that financial intermediaries can contribute in narrowing the information gap by scrutinising and evaluating these small businesses on behalf of the lender (Lerner, 2002). Financial intermediaries are agents or brokers who may introduce a client to the lender.

2.3.2.4 Risk aversion by financial institutions

Financial institutions have adopted a low risk stance since the 2008 Global Recession, resulting in low funds flowing to SMEs. This has been further exacerbated by the increase in the regulation on banks that has negatively impacted the extension of credit to small businesses (Forbes, 2014).

The additional capital charge requirement introduced by BASEL III negatively impacts on the bank's return on equity and determines that the banks charge high lending rates to boost their returns. It is obvious that these actions are not favourable to small businesses (Norton Rose Fulbright, 201).

2.3.3 Sources of business financing

Small businesses can be funded from a variety of sources and alternative sources of funding are often sought to address funding challenges. Some of the alternative sources of business finances are stated below.

2.3.3.1 Bootstrapping

Bootstrapping is a form of business financing wherein the primary source of funding was personal rather than from outside investors, banks or government agencies. Bootstrapping can include borrowing from friends and family, delaying entrepreneur's own remuneration, etc. (Global Enterpreneurship Monitor, 2009).

Minimising the need for financial capital is also considered to be another means of bootstrapping; this may include selecting an industry with low start-up capital requirement. Individuals can shape their environment or circumstances based on some of their perceptions, actions and decisions. Such actions can serve as a lever used by entrepreneurs to narrow the funding gap as the funding gap is dynamic and manageable (Lam, 2010).

It appears that bootstrapping is most common in low income countries where small businesses rely significantly on informal sources, such as family and friends (Falkena et al., 2002). This was supported by Ayyagari, Demirgüç-Kunt, and Maksimovic (2010) who stated that only 20% of SMEs in a developing country like China are financed by banks and this is representative of other developing countries, such as India and Indonesia.

2.3.3.2 Angel or informal investors

Businesses can also be financed through funds accessed from angel investors who are mainly rich or self-made entrepreneurs who invest in businesses for a return and they are mostly experienced in business (Global Enterpreneurship Monitor, 2009). Business angel financing is typically from private investors who invest in privately owned businesses and thus provide the bridge between personal finance and external formal finance (Collewaert, Manigart, & Aernoudt, 2010).

2.3.3.3 NGO support

In South Africa, this source of financing mainly arose from the requirements outlined in the Broad Based Black Economic Empowerment Act, which necessitates that large corporates should have enterprise development programmes to assist SMEs (Republic of South Africa, 2013). This requirement has unlocked funding for SME as corporates have established funds for this purpose. The Anglo American owned section 21 company, Zimele Investment

(Pty), that funds small businesses is one example of enterprise development within the corporate sphere (Global Enterpreneurship Monitor, 2009).

2.3.3.4 Debt financing

Debt financing is described as an instance when an entrepreneur borrows from a financial institution at an agreed rate and the funds can be repaid over an agreed period (Global Enterpreneurship Monitor, 2009). Bank loans are usually extended against the security of an asset, instead of future prospects (Moore & Garnsey, 1993).

2.3.3.5 Venture capitalist

Venture capital refers to external equity financing for entrepreneurial companies (Cumming, 2007). According to Berger and Udell (1998), venture capitalists mainly invest in a business that has successfully progressed from the marketing stage and this is often after the business has received one or two rounds of angel financing or owner's equity.

2.3.4 The business financing cycle

According to Berger and Udell (2002), small businesses should be viewed from the position of a financial growth cycle, wherein different capital structures are optimal at different points in the cycle that determine their need for financing at different stages of growth. This is mainly because the information gap narrows over time, making it easier for outside financers to assess the business and to extend credit.

Figure 1 reflects the different stages of the business as well as different financing sources at those stages. This reflects that when the firm is initially small, its main sources of finance are internal, when it transitions to medium size, external investors, such as venture capitalists may start investing, and when the firm is large, its source of capital may be public equity following a listing on the stock exchange.

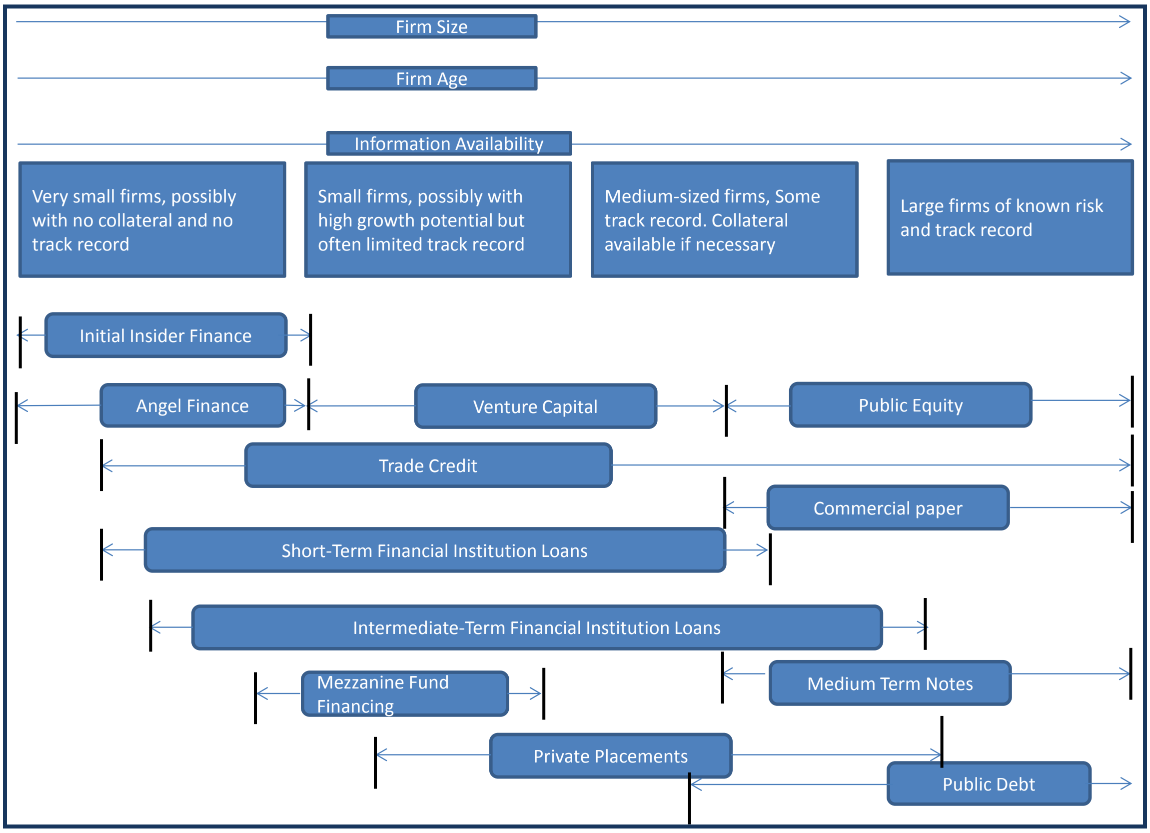

Figure 1: Financing sources for different business growth cycle (Berger & Udell, 2002)

In South Africa, the SME funding cycle is the same as demonstrated in Figure 1 above, according to Falkena et al. (2002). Figure 2 below reflects the cycle in South Africa which is generally similar to the general cycle depicted in figure 1 one above except for the influence of race in the sources of funding which is peculiar during the certain stages in the cycle.

SME life and funding cycles in South Africa				
Type of SME	**Start-up phase**	**Growth phase**	**'Steady state' and exit**	**Remarks**
<u>Minority:</u> 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	These enterprises form the majority of white medium-sized firms in South Africa. A number of 'better-off' businesses from PDI backgrounds (e.g. Indian businesses) may also fall into that category.
<u>High number:</u> Emerging enterprise from previously disadvantaged communities	Few resources available – dependence on external funds			For the moment, those enterprises have barely arrived beyond the start-up phase

Minority: High growth enterprises (high-tech, life sciences or any other sector)	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	Presumably a significant share (30%) of very small and small enterprises belong to this category

Figure 2: Funding sources for businesses in South Africa (Falkena et al., 2002)

2.3.5 Supply-side funding constraints

Supply-side financing constraints are defined as market imperfections that lead to incorrect allocation or supply of funds to projects. It was also observed that if two projects offer the same return but differ in borrower quality, banks may not be willing to extend funds to a project with higher borrower risk and this creates a deficiency in the market (Cressy & Olofsson, 1997).

This may be influenced by the financial institution's discriminatory processes being applied when extending credit between small and large businesses. Such discrimination may depend on the market concentration of that institution. For instance, if the institution is highly concentrated in large low-risk businesses, it may raise the bar of requirement to eliminate some of the unwanted applicants (Cavalluzzo, Cavalluzzo, & Wolken, 2002).

In South Africa, supply-side constraints are exacerbated by the limited experience of the country's financial institutions in managing small businesses as these were never properly developed because in the past, the focus was on large businesses (Pretorius & Shaw, 2004).

2.3.6 Demand-side funding constraints

A demand-side finance constraint is defined as a situation in which capital market imperfection means that the performance of a firm is adversely affected by factors internal in the firm. This may include poor internal processes or skills (Cressy & Olofsson, 1997).

However, in South Africa, the demand-side of business financing is further constrained because most emerging entrepreneurs are under-skilled and also lack business experience (Falkena et al., 2002). This contradicts a study in Durban that demonstrated that lack of credit is a major constraint for SMEs (Skinner, 2005).

2.3.7 Existence of a funding gap in South Africa

The existence of the funding gap for SMEs in South African has been reviewed in the literature and there appears to be studies that demonstrate that such a gap exists. It appears that there are supply and demand constraints that exist in the market and these should be explored.

2.4 Assessment of Government's intervention in resolving the funding gap

It has been found that innovative firms face difficulties in attracting private sector funds due to information asymmetry and differing interests between the firm and the potential lenders. An example is that governments are found to be the most relevant funder for such firms. Governments should strengthen market mechanisms to allow for an efficient market, especially when the market fails (Moore & Garnsey, 1993). It has been asserted further that governments are expected to provide funding to the extent that there is a funding gap (Cressy, 2002).

It is recommended that Government's funding should be channelled toward small enterprises for two main reasons, namely:

- To address market failures without crowding out the private sector funding. Market failure is the inability of the market to allocate resources efficiently (Economics online, 2015).
- Pursue activities that are not privately profitable but may have positive externalities in the long-term (Hyytinen & Väänänen, 2002). Externalities are the benefits that might not be reflected in the market price of a good or service (Business dictonary, 2015)

2.4.1 Assessment of Government's intervention

Small businesses are most vulnerable to financing and regulatory constraints, the role of government in resolving any of these constraints is vital (Beck, Demirgüç-Kunt, & Maksimovic, 2005). However, targeted government policies, instead of general and biased policies, should be formulated to create an enabling environment (Chen, 2005; World Bank, 2007). This further confirms the view that each government policy strongly influences the contribution of the SMEs in the transformation of the economy. Positive effects are often experienced if policies and programmes implemented to assist SMEs in resolving challenges arising due to their size (Smallbone & Welter, 2001).

Different governments have played some role in the provision of finance for small businesses and this has evolved since the Soviet Union's era, which set a precedent for the rest of Europe, Asia and the US. Government's intervention has been predicated on the premise that the private sector is unwilling to advance credit to small businesses (Lerner, 2002).

This is particularly the case because most governments around the world have identified the vital role of entrepreneurs in economic growth, particularly in high-tech start-up companies that are mainly supported by venture capitalists during the early stages. Governments have thus moved to establish support programmes to stimulate venture capital financing for innovative concepts and thereby foster economic growth. Most industrialised countries, such as the US, UK and Canada, have government supported programmes that provide capital for hi-tech industries, which has proved to contribute to the country's economic growth (Cumming, 2007). The Small Business Innovation Company (SBIC), which is the largest venture capital support program backed by the US government, has invested in companies such as Intel and Apple which are just a two of the successful investments to date. Another example is the Business Angel Network (BAN), which is another US government supported programme and which has been successful in solving financial challenges in entrepreneurial companies (Collewaert et al., 2010).

Government support, as noted above, is supported by the public finance theory that emphasizes that subsidies are the appropriate response to activities that generate positive externalities. Because firms making such investments cannot capture all the externalities, public subsidies may thus be an appropriate response (Lerner, 1996). Externalities are the benefits that might not be reflected in the market price of a good or service (Business dictonary, 2015)

However, Government initiatives should make appropriate assessments when decisions to assist businesses are made, this may include re-assessment of the viability of the business concept and skills of the business founders to package the correct solution for each business case (Watson et al., 1998). In extending such credit, governments should utilise carefully defined criteria which may include the following (Lerner, 2002):

a) Intervene in areas that are currently not attractive to the private sector.
b) Be prepared to adopt a flexible funding approach and long-term commitment to a firm, despite the inevitable vicissitudes of the business.
c) Be willing to follow-up other rounds of funding when the market is unwilling.
d) Avoid investing in firms that are already recipients of other government funding initiatives.
e) Evaluate the effectiveness of management with the view to identifying the effect of past awards on subsequent performance.

f) Carefully access the commerciality of each firm’s technology or research.
g) Evaluate other exogenous factors exclusive to the company that may impact company’s performance.
h) Adopt research evaluation criteria from emerging research.

Governments should also guard against the lack of integration among its programmes that are targeted at SMEs (Smallbone & Welter, 2001).

2.4.2 The South African government’s response

The South African government noted the importance of the role of SMEs in the economy as early as 1995. The White Paper on National Strategy for Development and Promotion of Small Businesses noted that SMEs are vital to addressing issues of job creation, economic growth and equity in South Africa (Republic of South Africa, 1995). Since then, the Government has introduced many strategies targeted at addressing challenges faced by SMEs. The Department of Trade and Industry delineated the increase in the supply of financial and non–financial support as one of its strategic pillars in its Integrated Strategy on the Promotion of Entrepreneurship and Small Enterprises document (The Department of Trade and Industry, 2005).

In 2014, a new ministry of small businesses was introduced in South Africa to further reduce the challenges being faced by SMEs (Fredericks, 2014). Due to the history of South Africa that is characterised by a trade regime that promoted domestic capital intensity, influenced by sanctions which were imposed on the apartheid government, the World Bank noted that measures which promote Small Micro Medium Enterprises (SME) are significant in the transition of the country into a high growth economy (World Bank, 2002).

The Government of South Africa has included the creation of decent employment through inclusive economic growth as one of its strategic outcomes (The Government of South Africa, 2010).

It is reported that in all economically strong and socially equitable states DFIs have played a critical role (Development Bank of South Africa, 2011). South

Africa has also followed suit by establishing a number of DFIs, these DFIs' objectives are to extend finance to address existing market gaps. The diagram in figure 3 below depicts the gap that should be filled by DFIs. The market gap occurs when there is a market failure arising from the market's inability to allocate resources efficiently (Economics online, 2015). Inasmuch as the extent to which there is market gap in relation to availability of business financing, government should seek to reduce such a gap.

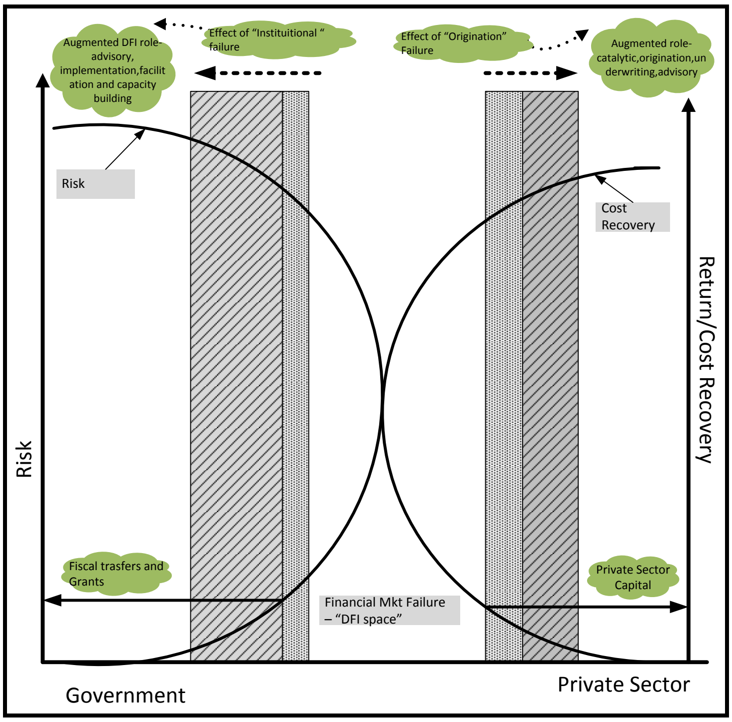

Figure 3: Key failures impacting on development process(Development Bank of South Africa, 2011)

The South African government has also introduced many DFIs, some of which will be briefly discussed below.

a) National Youth Development Agency
   This has been established by the government to take youth development to a larger scale through skills development, skills participation, social cohesion and support (Global Enterpreneurship Monitor, 2009).

b) The National Empowerment Fund (NEF)

The NEF was established in 1998 with the objective of promoting and facilitating economic equality and transformation. The NEF intended to support previously disadvantaged individuals to realise economic participation by providing the necessary business funding.

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c) Industrial Development Corporation (IDC)

The IDC provides funding financing to entrepreneurs in competitive industries in order to contribute to a sustainable economic growth (Global Enterpreneurship Monitor, 2009).

d) Small Enterprise Finance Agency (SEFA)

Provides financing to small entrepreneurs to meet funding requirements of up to R5 million.

e) Technology Innovation Agency (TIA)

Provides financing for Research and Development projects, undertaken by small business owners or innovators.

2.4.3 Research Question 2

The government’s role in addressing the market gap through the establishment of DFIs was assessed in this study. It appears that the South African government has implemented many initiatives to support small businesses.

2.5 Conclusion of Literature Review

As noted in the literature, SMEs play a significant role in the economy. Simultaneously, there are many challenges which SMEs face that may potentially impact their growth, one of these challenges appears to be funding.

It appears that there are peculiar challenges facing South African SMEs, particularly in relation to funding as it appears that the majority of the population, the PDIs, cannot produce the collateral required by financial institutions to successfully gain funding.

It has also been strongly affirmed that governments have a significant role to play in addressing challenges faced by SMEs, which includes funding. The South African government has also followed suit by implementing a variety of initiatives to support SMEs.

The matters noted above were discussed in the context of South Africa and the following research questions have been attempted to be answered by this research paper:

2.5.1 **Research Question 1:** It is the case that there is a funding gap for small businesses and there are certain contributing factors which will be analysed further.

2.5.2 **Research Question 2:** It is also the case that the government has developed a number of initiatives though DFIs to fill the funding gap for small businesses but there are still challenges in extension of credit by these institutions.

2.5.3 **Research Question 3:** It is also the case that small business experience challenges when they approach for funding.

CHAPTER 3: RESEARCH METHODOLOGY

Research either provides answers to questions or creates new knowledge by examining unsearched phenomena. The discovery of knowledge lies at the heart of research (Goddard & Melville, 2004).

This section outlines the proposed methodology that was used to conduct this study. It also discusses the research design, the population that was used, data collection methods and interpretation. Literature on research methodology is also discussed.

3.1 Research methodology /paradigm

According to Creswell (2009), the research process has three possible designs which are either qualitative, quantitative or mixed research methodology.

The qualitative research methodology was applied for this research study. Qualitative research is defined as a situated activity that locates the observer in the world (Creswell, 2013). It is said to comprise of a set of interpretive material practices that make the world visible.

Qualitative methods are suggested as vital in entrepreneurial related studies as it allows for different views to be explored.

Data was collected through a series of semi-structured interviews which were conducted with ten (10) small business owners who had funding needs and had approached state-owned institutions for funding. Two executives from two state institutions that extend credit were interviewed to determine factors that contribute to unsuccessful applications. It was noted that one of the main advantages of interviews is the opportunity it presents to probe for historical information and allows the researcher control over the line of thought (Creswell, 2009).

Due to the nature of engagement which was undertaken with respondents to gain clarity regarding the impact of the funding gap in their business, qualitative research is more suitable as it allows for better engagement with respondents.

3.2 Research Design

As already indicated, semi-structured interviews were conducted with ten small business owners as defined by the Small Business Act of 1996 and two executives or representatives of state finance institutions.

Semi-structured interviews present many advantages. However, the possible bias of the researcher by being present with the respondent is a limitation of this process (Creswell, 2009). Respondents were interviewed at their business premises to allow the researcher to relate the information provided during the interview.

3.3 Population and sample

3.3.1 Population

The population consisted of small business owners based in Gauteng. Gauteng has been selected because, according to Falkena et al. (2002), Gauteng is home to approximately 45% of South Africa’s SME population.

Ten small business owners, as defined by the Small Business Act of 1996 as amended, were approached to determine their funding experience and how they closed the gaps; the study was focused on SMEs that approached commercial banks and DFIs for funding. Two executives or other suitable representatives of the Small Enterprise Finance Agency (SEFA) and the Industrial Development Corporation (IDC) were interviewed to determine the funding assessment process and to discuss the remaining barriers for businesses that might still not be eligible for funding. These two DFIs were selected based on their mandates that are intended to extend funding for businesses.

3.3.2 Sample and sampling method

Purposeful sampling is a suitable approach for qualitative research as it involves a selection of the study’s participants and the sample to be studied (Creswell, 2013).

Ten small business owners were interviewed in a semi-structured manner. The objective of the interviews was to determine their funding challenges prior to establishing their businesses. The interview also sought to discover whether they approached state-owned DFIs for funding, as the researcher desired an account of the challenges encountered in this process. The study focused on the role played by DFIs in closing market gaps, hence banks were not considered during this research study.

The second interviews were conducted with two representatives that included executives from SEFA and IDC. The objective was to determine the challenges experienced by the institutions in extending credit to small businesses It was hoped that the interviews would provide a more profound understanding of the approval processes and allow for reasons regarding why some of the applicants with viable business are still not successful for funding (Vos, Yeh, Carter, & Tagg, 2007).

3.4 The research instrument

Semi-structured interviews were conducted with each participant. Follow-up interviews were scheduled with participants where the gaps were identified based on the information collected.

3.5 Procedure for data collection

Interviews were arranged at the preferred location of the respondents, though their business location was advised to be the preferred location. The business location provided better insight and enabled the interviewer to relate to the participant’s experience.

During the interview, participants were recorded. The transcription of the notes was completed after each interview. However, if a participant preferred not to be recorded, hand written notes were taken during the interview meeting.

The questions indicated in Appendix B were asked during the one-on-one sessions with participants. The questions were distributed prior to the meeting at the request of the participants.

3.6 Data analysis and interpretation

The process of data analysis involves the process of making sense out of text and image data (Creswell, 2009).

The main aim of data analysis is to obtain condensed and broad descriptions of the phenomenon. The outcome is the concepts that describe the phenomenon (Elo & Kyngäs, 2008).

Creswell (2009) recommended that data analysis commences with organising and transcribing field notes. This is then followed by generating a general sense after reading through collected data. This is followed by coding, which involves segmenting information into categories and labelling those categories with a term. The coded information should then be used to generate a description of those labelled items. This is followed by creating a qualitative narrative that best presents the information. The final step involves the interpretation of the collected data.

The above process was employed to decode the information that was collected during the interviews conducted for this study.

3.7 Limitations of the study

The limitations of this study included that it was based on the population selected from one out of the nine provinces in South Africa, which might not be representative of circumstances in the other eight provinces. Another limitation was that small business owners who did not approach commercial banks or DFIs were excluded from the study as they were not relevant for this study. This exclusion may result in limitations regarding the exploration of other dynamics in sourcing funding solutions that might exist in the South African market.

3.8 Validity and reliability

Validity entails that certain procedures are employed to check the accuracy of the findings in a study (Creswell, 2009).

3.8.1 External validity

It is questionable whether findings from a sample of a study can be said to be of relevance beyond the sample (Jane Lewis & Ritchie, 2003). The limitations of the generalisability of qualitative studies as noted by Creswell (2013), were that qualitative research lies in the particular description and themes developed in the context of the specific site.

3.8.2 Internal validity

Johnson (1997) warned researchers against "researcher bias", which is when a researcher finds only what they want to find, this is said to be particularly common in qualitative research. In order to avoid this biased position, a researcher should actively engage in a process of critical assessment of potential personal biases. For this study, strategies, such as triangulation, were applied to ensure that bias is eliminated, as this involves checking the data against multiple sources (Johnson, 1997). The outcome of the research interviews were compared with articles relating to the research study.

The use of a semi-structured interview questionnaire ensured that consistent information was obtained from all participants to level the playing field. The principles of applying open-ended questions, as advocated by J. A. Lewis (2009), were used in questions when engaging with participants. Follow-up interview questions were also designed to ensure clarification of concepts as described by participants.

3.8.3 Reliability

Reliability refers to the stability of responses to multiple coders of data sets (Creswell, 2013). Reliability for this study was assured by recording, whenever the participant was agreeable and the audio recordings were transcribed. Whenever recording was not possible, detailed notes were made of all the participants' responses.

3.9 Demographic profile of respondents

Interviews were conducted with ten small business owners as well as two representatives from state-owned DFIs. All business owners were based in Gauteng, with the exception of one whose business has relocated to Limpopo to be closer to clients.

Six of the business owners were male whilst the other four were females. All respondent had different business backgrounds that ranged from construction, consulting, property investment, general merchandise sales, pharmaceuticals, etc.

Out of the representatives interviewed from state-owned institutions, one was female whilst the other one was male, they represented SEFA and IDC.

CHAPTER 4: PRESENTATION OF RESULTS

4.1 Introduction

This section presents the outcome of the data collected via semi-structured interviews with respondents. Respondents were classified into two different categories. The ten interviews conducted with small business owners were in one category, and two interviews conducted with one state-owned DFI representative were in another category. The results for the two categories are presented and discussed separately. The last section of the chapter discusses the conclusion of the results. Detailed analysis of the results is detailed in Chapter 5 of the report.

4.1.1 Responses from small business owners

The first two questions in the questionnaire were intended to obtain business background information of all participants to determine whether their businesses qualified as SMEs. All participants' businesses qualified as SMEs and they provided their businesses background. The SMEs covered in the research included a variety of industries such as civil and construction, pharmaceuticals, property developers or investors, general suppliers, health and wellness, steel fabrication, etc.

Respondent	1	2	3	4
1. Does your business qualify to be an SME according to the Small Business Act of 1996, as amended?	Yes, three employees.	Yes, four contract employees.	Yes, less than 50 contract employees.	Yes, seasonal contract employees.
2. Please provide a background of your business.	consulting, printing and property	steel fabrication and manufacturing company	construction company	health and wellness company as well as interior decorating
3. How was/is your business funded?	Self-funded.	Self-funded and DFI (SEFA).	Self-funded/borrowings from family or friends.	Self-funded.
4. Have you ever approached commercial banks or state-owned institutions business financing?	Yes, both bank and DFI.	Yes, both bank and DFI.	Yes, both bank and DFI.	Yes, both bank and DFI.
5. If yes to the above, what was the outcome?	Unsuccessful with the bank and DFI.	Unsuccessful with the bank, but successful with the DFI.	Unsuccessful with the bank and DFI.	Unsuccessful with the bank and DFI.
6. If the outcome was unsuccessful, what were the reasons provided for such or contributing factors?	Bank did not have appetite for my printing business venture as it was a franchise model. DFI perceived my printing venture to be of high market risk.	Bank criteria were not met, mainly the period required from business banking which was 12 months. DFI requirements were met.	Banks were unwilling to advance funds for a project shortfall. DFI did not clearly disclose the reasons.	Banks were unwilling to advance credit as a director had an old judgement. DFI not willing to advance due to the old judgement associated

				with the director.
7. If the outcome was unsuccessful, how did you overcome the funding obstacle?	Have concentrated on consulting which does not require a lot of capital outlay and raising capital for my other business venture through consulting income.	Though the application with DFI was successful, I have not gone back due to long turn-around time and have resorted to borrowing from family or friends if there is a shortfall in the business.	Self-funded and also turned to other business associates who charge in the range for 30% - 40% for funds advanced for a project.	Self-funded and also other business associates who charge high rates for funds advanced.
8. What are your views on a potential funding gap for small business owners in South Africa? Kindly cover the demand and supply side of financing	There is funding gap for SMEs in SA. Demand: SMEs are approaching the DFIs for funding with no success due to variety of factors. Supply: DFIs are too risk averse and do not embrace the developmental mandate in funding businesses.	There is a gap. Demand: SMEs do not have the information or resources on where to source funding. Supply: DFIs are not putting themselves in the public. Their processes are too long resulting in SMEs business not being adequately serviced.	There is a gap. Demand: Many construction firms are searching for finance for projects, and are unable to access this funding from banks or DFIs. Supply: The government is not monitoring DFIs to ensure that they are advancing funds where needed.	There is a gap. Demand: Directors with old history of bad credit record are not forgiven in the system. Supply: Financers are unwilling to consider other information other than an old credit record.
9. What was your experience with the state institutions which you approached when compared to the experience with the commercial bank?	There is no difference in the criteria and risk appetite between banks and DFIs. However, there was difference in turn-around times as the DFI take	Banks are too strict when compared to DFIs who are more accommodative. However, the main difference is in turn-around time and	Both are unwilling to advance funds, there is no difference.	The big difference was with the level of competence of the staff encountered at the DFI who appeared not to be sufficiently trained.

	about two months or more to respond whilst the bank is only a week. The level of staff competency in the DFI is also low.	mechanism of funding applied DFIs require cessation of income and pay directly to suppliers whilst the banks would give you the funds for own application.		
Respondent	**5**	**6**	**7**	**8**
1. Does your business qualify to be an SME according to the Small Business Act of 1996, as amended?	Yes, no employees.	Yes, three employees.	Yes, 11 full time professionals.	Yes, eight employees.
2. Please provide a background of your business.	General merchandise sale to the government.	Property investment, accounting services, SMEs support and Venture capital.	Civil engineering and construction, geological surveys, environmental services.	Pharmaceutical, two pharmacies.
3. How was/is your business funded?	Self-funded, my mom funded it.	Self-funded, started with consulting to raise capital.	Self-funded, started by consulting to raise capital.	Commercial bank loan.
4. Have you ever approached commercial banks or state-owned institutions business financing?	Yes, both bank and DFIs.	Yes, both bank and DFIs.	Yes, both banks and DFIs.	Only approached a bank.
5. If yes to the above, what was the outcome?	Successful in both instances.	Unsuccessful with both bank and DFI.	In both instances it was unsuccessful.	It was successful as I had the required collateral.
6. If the outcome was	n/a	DFI (IDC) the venture	Lack of the required	n/a

unsuccessful, what were the reasons provided for such or contributing factors?		was too risky, application was below their mandate of R5million, unwilling to fund the goodwill attached to the business venture.	capital, could not meet the requirements for a loan which required supplier invoices.	
7. If the outcome was unsuccessful, how did you overcome the funding obstacle?	n/a	I have resorted to raising my own capital through consulting and approaching private equity funders.	Started consulting to raise capital as there is little capital required in consulting.	n/a
8. What are your views on a potential funding gap for small business owners in South Africa? Kindly cover the demand and supply side of financing.	Yes. Demand: Some SMEs don't run their business finances accordingly and such don't build a good track with the banks, which makes up for information asymmetry. Supply: The banks have become strict in advancing credit unlike in the older days. DFIs do not really give out the information to the public, only limited people have	Yes there is a gap. Demand: There are a lot of small business owners in need of funding for viable ventures but are unable to secure such funding. Supply: Banks are unwilling to lend money without collateral. DFIs lending model is too risk averse and does not adequately support entrepreneurs for instance SEFA wants to pay suppliers for raw	Yes, there is a gap. Supply: most DFIs don't make their services known to the public, there is not a lot of outreach and the way in which their financing solution is structured does not suit entrepreneurs. Banks does not consider one without security. The DFIs employees are not knowledgeable to assist. Demand: Skill and patience are a challenge.	Yes, there is a gap if one does not have the required collateral required by the bank.

	information as it is based on who you know.	material without funding labour and consumables. Their model is not suitable for business but for tender orientated SMEs.		
9. What was your experience with the state institutions which you approached when compared to the experience with the commercial bank?	Banks are strict in following up for payments and can easily sell your assets whilst DFIs have a more relaxed approach.	DFIs processes are too long, there is a long turn-around time. Their application forms are too long as well 32 pages compared to a four page by another private institution. The DFI funding model is not suitable for funding real business ventures consideration should be made to use venture capital or private equity models as the DFIs are too risk averse.	The staff are poorly skilled and don't even understand processes. The requirements of some of these institutions are impractical for entrepreneurs. Banks requirements are clear up front, it's easy for one to assess it you meet requirements or not.	The banks requirements were clear and they did not make unwarranted changes.
Respondent	**9**	**10**		
1. Does your business qualify to be an SME as per Small Business Act of 1996, as amended?	Yes, no employees.	Yes, no employees.		
2. Please provide a	Initially focused on sales	Property development		

background of your business.	and marketing of innovative products. Innovative products development and sales.	and rental.		
3. How was/is your business funded?	Initially self-funded, but lately secured funding from DFIs (IDC and TIA). f	Self-funded.		
4. Have you ever approached commercial banks or state-owned institutions business financing?	Yes, I could not meet commercial banks requirements' so I did not approach them. I approached DFIs.	Yes, approached both DFIs and commercial banks.		
5. If yes to the above, what was the outcome?	It was successful with DFIs, though there were challenges.	Unsuccessful in both instances.		
6. If the outcome was unsuccessful, what were the reasons provided for such or contributing factors?	With the banks, I was defaulting on my credit cards and loans and I did not have a good credit record.	The explanation form the DFI was not clear.		
7. If the outcome was unsuccessful, how did you overcome the funding obstacle?	Initially I self-funded the project.t	The bank wanted an equity stake in the residential development project, whilst the DFIs factors were not understandable as they claimed certain information was not		

		included in the application which was not correct.		
8. What are your views on a potential funding gap for small business owners in South Africa? Kindly cover the demand and supply side of financing	Yes, there is a gap. Supply: DFIs mandates are not well synchronised and there is no clear links of funding. Staff employed to assess application do not have entrepreneurial background. Demand: Entrepreneurs do not fully understand that they should invest some money in the business. Some don’t have skill to look for solutions.	Yes, there is funding gap as it appears that it is impossible to unlock funding and the DFIs do not appear to have set and clear requirements.		
9. What was your experience with the state institutions which you approached when compared to the experience with the commercial bank?	State institutions are different from banks because they have programmes where they provide grants for R&D which does not have to be repaid, unlike commercial banks.	State institutions’ requirements are not clear and it appears that they don’t properly assess applications.		

Table 1: Summary of small business owners interview respondents

4.1.2 Summary of DFI representatives responses

Questions	Respondent 1 (SEFA)	Respondent 2(IDC)
1. What is the main purpose of the institution as mandated by Government?	To increase the access to funding for small businesses this includes co-operatives. The broader mandate is contribution to job creation and reduction to poverty. SEFA provides lending for small businesses up to R5 million.	To capacitate the industrial capacity of the country in order to be the leader in industrial capacity. This is mainly through funding to small businesses and entrepreneurs in general.
2. How has the institution fulfilled this mandate thus far, particularly relating to SMEs?	There are a two finance categories which are covered namely the finance gap between R500 and R50 000 which is called micro enterprise finance and between R50 000 and R5 million which is called SMEs and is mainly funded directly by direct lending but we also use third parties like joint venture, retail financial intermediaries to support these SMEs.	Funds are lent from a minimum of R1 million, there is a focus on SME; this is reflected by the support offered through a department intended to offer entrepreneurial support to applicants who might not meet all requirements for funding.
3. What is the process of evaluation for applicants especially SMEs?	SEFA promise to improve access to funding is reliant on cash flow from the company because most black entrepreneurs do not that have adequate equity to fund these transactions. However we do encourage that there should be some equity contribution on a case by case basis. Cash flows from the transaction as well as the rest of the business are considered. SEFA is also regulated by the National Credit Act so we cannot fund a technically insolvent business.	An application which is mostly in the form of business plan is received, a desktop due diligence is conducted which is followed by an onsite due diligence if the desktop due diligence found merits for such to be pursued. All processes take approximately 6 to 8 weeks.
4. In your view, is the process different from that of a commercial institution? Provide reasons	Without making a direct comparison, the main difference is that commercial banks have some form of transactional history with the client; SEFA does not have	It is different because as a DFI, we perform detailed analysis on the viability of the business as loan repayment is dependent on the

	history with the clients except repeat client. Most of the clients that approach SEFA cannot be serviced by commercial banks largely due to lack of information which makes it difficult to price for the risk appropriately yet clients complain of high prices on transactions. It is generally difficult to get information on small businesses which can be used consistently to review the credit and future prospect of the business.	business success rather than security. Whilst the bank's focus is mainly on security, with a DFI there is not much reliance placed on the viability of the business.
5 Do you think the process has the potential of rejecting viable business plans? Provide reasons	No, viable businesses are never rejected.	Yes, sometimes there if can be changes in priorities as directed by Management (change in sector focus) or if there is general decline in the sector where the applicant is operating or there is no take-off agreements secured. Viable business may be rejected if some of these factors are at play.
6. Why do you think there are still SME business owners who are still complaining about lack of business finance?	The reason for credit has not been communicated effectively for business people to understand that credit cannot be extended unless it contributes towards the growth of the business and as such the extension of credit should be supported by business prospects.	In as much as we receive a lot of applications from businesses, quality of such applications are an issue especially from start-ups or SMEs. Most often the applications are turned back for the business plans to be enhanced for a variety of reasons which might include poor technical ability by the owners, poor market analysis or segmentation.
7. What do you think should be implemented to address the gap	Difficult as the government has implemented a lot of programs already.	DFIs should introduce incubation for the unsuccessful applications.

you identify, if any?		
8. How do political and fiscal constraints influence the extension of credit to small businesses?	Not everybody will be able to get the subsidy we looking now at our financial model which will help us get along in terms of different how do we re-strategically rebalance those portfolios given the funding that is available to SEFA if there is fiscal constraints.	There are some policies that can have an impact on the focus areas for IDC, as our mandate or focus is in line with government policy. For instance areas like retail and franchise has been removed in our mandate in order to align to NDP and IPAP.

Table 2: Summary of DFI representatives interview respondents (SEFA and IDC representatives)

4.2 Discussion on relating to research question 1

This question was meant to establish the existence of the funding gap for SMEs in South Africa. This question was covered mainly through questions 3, 4, 5, 7 and 8.

4.2.1 Determination of sources of initial start-up capital

The third question posed to respondents sought to determine the source of capital for their business.

With the exception of one respondent, representing 10% of the population, all other participants responded that their businesses were self-funded at start-up phase. One participant succeeded in securing financing from a commercial bank at start-up phase as he was buying an existing business and had the collateral that the bank required.

Three more respondents were able to secure funding from DFIs and a commercial bank following the owner's initial capital being injected. Out of the three respondents who secured such funding, one secured the funds from a commercial bank and this was primarily based on the satisfactory track record built on their business account. The remaining two satisfied the DFIs requirement and also had to negotiate the terms proposed by the DFI, however it appears that there was great weight placed on the fact that they had already invested some equity into their businesses.

The remaining six respondents' businesses have still not secured funding from DFIs or commercial banks. These businesses were funded from owners' resources, as well as family and friends borrowings.

All respondents had either approached commercial banks or DFIs to request business funding. Eight respondents had approached both commercial banks and DFIs. Of the remaining two, one had not approached DFIs as their initial application with their bank was successful and the other one did not approach the banks as he had a bad credit record.

4.2.2 Factors that contributed to unsuccessful outcomes

A variety of factors contributed to the unsuccessful outcomes. However there were some similarities noted between the factors noted from application to the DFIs and the commercial banks.

The main factors quoted for unsuccessful applications to commercial banks were the following:

1. Lack of the required collateral by the respondent.
2. Respondent's adverse credit record.
3. The bank's lack of appetite for the perceived risk.
4. Lack of the required track record with the bank.
5. Bank request for a high equity stake in the business.

Whilst factors noted from applications to DFIs were mainly as follows:

1. High risk associated with the business venture.
2. The application outside of the DFIs mandate.
3. Respondent's lack of collateral.
4. Respondent's adverse credit record.

4.2.3 Existence of the funding gap

All respondents acknowledged the existence of a funding gap for SMEs in South Africa when responding to question eight.

It was noted that factors that influence the demand-side gap is that most entrepreneurs do not have the skills and knowledge to approach relevant institutions. Many factors quoted were supply-side, which included poor visibility of DFI funders and low risk appetite resulting in a high rejection rate.

4.3 Discussion relating to question2

This research question sought to establish whether there are grounds determining the limited extension of credit to small business owners by DFIs, if any.

Based on the responses, it could be determined that the government has strategically established relevant DFIs to address funding challenges for SME owners, as can be seen by the establishment of SEFA which offers small business financing up to a maximum of R5 million

Such institutions appear to implement different assessment criteria to those employed by the banks that place great emphasis on transactional history, as noted by one interview respondent below.

"*SEFA premise to improve access to funding is that we rely on cash flow of the company because most black entrepreneur do not that have adequate equity to fund these transactions. We are not saying you should not contribute to the equity capital for the company but mainly we rely on the forecast cash flow from the transaction that we are funding and from the total business."*

However, it appears that most business owners do not fully understand why credit should be accessed and this concludes in some misgivings if the application is not successful, as noted by one interview respondent below.

“I think we haven’t sold the reason for credit, credit is not just credit for the sake of credit, credit is credit to build and grow a business and if you give credit and that credit makes a business fail we still haven’t done our job.”

It also appears that fiscal constraints resulting from the government funding obligation does impact the extent of credit extension i.e. reduction in the amount of subsidies impact the number of applicants who can be funded at affordable rates by the institution.

4.4 Discussion relating to question 3

This research question sought to ascertain the factors deterring SMEs from accessing DFI funding. This was covered by research questions 6 and 9.

Responses to research question six quoted that some of the factors that serve as deterrent are collateral requirement by DFIs.

Perceived low risk appetite by DFIs was also another factor quoted as it results in applications being turned down if associated with high market risk. However, a major challenge was that it appears that there is no synchronisation between DFIs to direct entrepreneurs to a relevant DFI if the mandate of the DFI that was approached is found to be restrictive, as noted by one interview respondent below.

“Another challenge is that government’s DFIs work in silos and do not provide a link for the different mandates or overall interconnection. For instance, in my case the IDC could fund for further development but its mandate could not allow it to fund for piloting and commercialization. I struggled to find another DFI whose mandate is to fund that process which was the Technology Innovation Agency (TIA).”

Responses to question nine sought to determine the difference in the experience of respondents in dealing with DFIs and banks. A common factor quoted was that DFI staff or consultants do not appear skilled to assist in the application process and did not properly understand the requirements for an application to be successful, as noted by one interview respondent below.

"I went to SEFA four times and there were people in the office who did not even understand the application process, they were reliant on one person. For these individuals to protect themselves, they will give you incorrect information."

Requirements by the DFIs were often not clear from the beginning or appeared to change, which was in contrast with the bank where there is no goal-post shifting.

Another factor was that some of the solutions offered by DFIs, particularly SEFA, were not suitable for entrepreneurs as they resultantly struggle with working capital, and that revenue is often ceded to SEFA or payments are made directly to business suppliers which leave a challenge for other working capital requirements, such as labour or overheads, as noted by one interview respondent below.

"It is not the best way, in our case it was really tough on cash flow as I was struggling to pay my employees because money from my customer went to SEFA's account and I did not have money for working capital so I had to borrow money from family for that. I think they should minimise the potential impact on the business by allowing a higher percentage to be paid into the business for the business to have some form of working capital."

DFIs have extensive turn-around times on funding applications regardless of the amount being requested, which again differs to the banks' operations. These long turn-around times have a negative impact on the business, as noted by one interview respondent below.

"With IDC I applied on 28 April, I got my answer on 27 June after following up over and over again."

4.5 Summary of the results

The information gathered from participants supports the points noted in the literature review. Further to this, it appears that there is a gap in communication between SMEs and DFIs.

CHAPTER 5: DISCUSSION OF THE RESULTS

5.1 Introduction

This chapter delineates the important findings of the study; the findings are also connected with pertinent points that were revealed in the literature review, as was discovered in Chapter 2.

5.2 Determine the existence of the funding gap for SMEs in South Africa and the contributing factors thereof

This question in the study sought to determine whether there is a funding gap for SMEs in South Africa and intended to expose the contributing factors of this gap.

All respondents in the study indicated that there was a funding gap for SMEs in South Africa based on their experiences of attempting to source funding. This was consistent with the reviewed literature, specifically concerning the World Bank’s observation that the South African financial market lacked institutions to service the SME market (World Bank, 2013). The respondents’ feedback resonated with the World Bank’s statement, as most of the respondents—despite having approached commercial banks and DFIs—were not successful in accessing business credit for a myriad reasons, some of which included the lack of transactional history with a financial institution.

Another pertinent finding was that most of the respondents had used their personal funds to finance their business, which was again consistent (Jeffrey Lewis, 2001) which indicated that the majority of businesses surveyed in Johannesburg were financed from the owners’ personal savings. The surveyed business owners had similarly cited the lack of financing as a major constraint to SMEs’ growth.

As indicated above, approximately 70% of the respondents' businesses were primarily funded by owners' personal savings; these businesses had not been successful in securing funding from either DFIs or commercial banks. However, this is slightly below the 95% of businesses that were owner financed in South Africa, as quoted by the Global Enterpreneurship Monitor (2009).

This research question also sought to determine the factors that contributed to the existence of such a funding gap. Below are some of the factors that were found to contribute to the funding gap, especially concerning funding that was requested from banks.

1. **Lack of collateral**

   One of the factors that contributed to the existence of a funding gap, as quoted by Pretorius and Shaw (2004), was the lack of collateral which is required by financers. Some respondents quoted the lack of collateral as one of the reasons for the inability to secure funding from commercial banks and DFIs. It was found that requirements for collateral by banks were often unaffordable and that some of the government's support came with a requirement for some form of collateral. These actions did not assist SMEs as it appears that there are some similarities between the DFIs and the commercial banks. Only one respondent had managed to secure funding from a commercial bank, mainly because they could produce the collateral required by the bank, which confirms the point made by Pretorius and Shaw (2004) who observed that banks placed more emphasis on the availability of a security rather than the viability of the business based on the submitted business plan.

2. **Lack of transactional history with the bank**

   In the literature review, Cressy (2002) reported that banks primarily used transactional history in their decision to extend credit. This was congruent with the findings of this research study, as banks often require a minimum period of transactions on the business accounts before credit can be extended to the business and if the minimum period required is not met, the credit application is often rejected. One of the respondents noted that the bank extended credit after the business account had accumulated sufficient transactional information, whilst another one was rejected for not having adequate track records.

Based on these findings discussed above, SMEs in South Africa have a challenged with a funding gap. Therefore, they mainly resort to bootstrapping techniques to close such a gap.

Some of the respondents applied bootstrapping techniques to narrow the funding gap. This confirmed the observation by Lam (2010) who observed that capital reduction techniques can be applied to narrow the funding gap. Some of these techniques include selecting sectors with low capital requirements. Some of the respondents resorted to consulting, which is not capital intensive, in order to raise capital for desired business ventures that were more capital intensive. Generally, funding challenges were experienced by those desired business ventures.

5.3 Explore the government's intervention through DFIs and challenges faced by these institutions

This research question sought to determine certain funding interventions that the government had implemented through DFIs and also attempted to determine the challenges faced by the DFIs in extending such credit.

As already noted in the literature review, the South African government has put in place interventions to address funding challenges for entrepreneurs, these have included the establishment of DFIs such as SEFA and IDC, whose representatives were interviewed in this study. This is consistent with the suggestion by Chen (2005), who noted that governments should formulate targeted policies which create an enabling business environment (World Bank, 2007).

Lerner (1996) had also indicated that governments should provide subsidies for research and development. Some of the interviewees noted that the South African government provides subsidies for the research and development of innovative products through the Technology Innovation Agency.

A set of principles or criteria under which credit will be extended by DFIs is consistent with the recommendation by Lerner (2002). These criteria include the assessment of the commerciality of the business venture. However, despite these criteria, it was noted that one of the challenges faced by DFIs was that South African entrepreneurs had limited understanding of the circumstances under which credit should be extended and as such, they are often disgruntled even if the non-extensions of credit was predicated on sound or sustainability principles.

It was also observed that DFIs' requirements are mostly different from the commercial banks as they are not reliant on transactional history with the applicant. Rather, lending is based on future cash flows of the business based on the submitted business plan.

The South African government has implemented many interventions. However, it appears that there is a communication gap with applicants, especially unsuccessful applicants, particularly regarding reasons for non-extension of credit. This gap may be attributable to the level of understanding of reasonable circumstances under which credit may be extended following a fair process.

5.4 Understand the challenges faced by SMEs when accessing funding from DFIs

This question was intended to determine challenges that may be contributing to SMEs' inability to access funding from DFIs. This is based on the premise that DFIs' mandates are meant to close a market gap that may be created by the commercial bank's unwillingness to extend credit.

Below is a summary of some of the challenges that SMEs encounter when DFIs are approached for funding:

1. **Lack of integration among government's funding programs**
   Smallbone and Welter (2001) warned that governments should guard against lack of integration among its SME programmes. This research study found that there was no integration among DFIs mandated to assist SMEs with funding; this included the inability to direct SMEs towards other government funding solutions that might meet the specific requirements. It was observed that in instances where an institution like the IDC was approached for funding which is outside its mandate, the corporation did not refer the applicant to another DFI that might assist. A lack of proper coordination creates a wrong impression about government's funding solutions.

2. **Consultants at DFIs do not have good business appreciation**
   Most of the respondents noted that staff at the DFIs reflected poor understanding of their own processes or requirements. In most cases it was found that applicants would be sent back and forth for information that was not clearly communicated upfront. Such miscommunication often led some of the applicants to abandon their applications during the process as it was often found to be frustrating.

   The solutions that would be presented to the applicants would be found to be unsuitable for the business needs of the applicant. Through interviews conducted with the DFIs' representatives, it was found there are a variety of solutions that suit the varying needs of business. However, it appears that the consultants do not communicate such information to applicants after understanding the needs of each applicant, but rather employ a "one size fits all" approach.

3. Long turn-around times

It was found that, on average, DFIs response on funding application takes approximately two months, which is much longer than the average response time of a week from commercial banks. Long turn-around times on applications deter entrepreneurs from approaching such institutions as business deals or orders might be lost in the process.

4. Collateral requirement

It was noted that some DFIs have a requirement for collateral that is often not affordable to businesses. This appeared to be similar to the requirements listed by the banks, which creates a funding gap for SMEs.

5.5 Conclusion

This research study affirmed the existence of a funding gap for SMEs in South Africa. Furthermore, it identified that there are challenges faced by SMEs that approach DFIs for funding.

CHAPTER 6: CONCLUSIONS & RECOMMENDATIONS

6.1 Introduction

This chapter provides the conclusion of the findings of the research study. Recommendations for SMEs and government funding agencies are also made. This research reports concludes with suggestions for future studies.

6.2 Conclusions of the study

The main purpose of this study was to determine whether there was a funding gap for SMEs in South Africa and to ascertain the factors that contributed to such a gap. The study further sought to delineate the interventions made by government to close the gap through DFI. Furthermore, the study sought to garner a list of the challenges faced by SMEs when approaching DFIs for funding.

As emphasised in the literature review, a funding gap exists when the demand for funding exceeds the supply of such funding. Below is a summary of conclusions of the research problem and the sub-problems for the study.

6.3 Determine the existence of the funding gap for SMEs in South Africa and the contributing factors thereof

Based on the findings of this research, there is a funding gap for SMEs in South Africa. A variety of factors are found to be contributors to the gap, which include the lack of collateral as well as the lack of transactional history of the potential candidates with a financial institution.

Explore the government's intervention through DFIs and explain the challenges faced by these institutions

Though the government has implemented solutions through DFIs, small business owners should be educated about the circumstances under which credit can be extended to still allow for such business to flourish and be sustainable.

Understand the challenges faced by SMEs when accessing funding from DFIs

Business owners encounter a variety of challenges when approaching DFIs, which includes long turn-around times, as well as requirements that are similar to those of the banks, such as collateral requirement and inefficient processes.

6.4 Recommendations

Based on the findings of the study, it is recommended that the DFIs should ensure that only competent staff with appreciation for entrepreneurship is hired to assist SMEs. This will reduce the current challenge wherein SMEs are not properly assessed or guided for their applications to be honoured. Existing consultants should be trained to enhance understanding of DFIs' requirements as well as an explanation of the different lending solutions that are available to businesses.

The DFIs should review their processes to possibly reduce the turn-around times for applications as the current timelines appear to be too long to support sustainable SME businesses.

Though there are a number of DFIs that the South African government has established, there appears to be poor integration between the different mandates. There should be some focus to ensure that consultants at DFIs can refer applicants with other relevant DFIs if the specific applications cannot be serviced by the particular DFI which has been approached, particularly due to mandate restrictions.

Business owners should also invest time to understand the requirements of the DFI being approached and should ensure that their businesses can sustain the funding being requested. This will enable the business owners to engage with DFIs on a more informed basis if the solution being offered is not suitable to their requirements or is too rigid.

South African financial institutions should review their approach to SMEs and revise these to move from making considerations based on the availability of the security, instead of the viability of the business.

6.5 Suggestions for further research

The research study established that the South African government has implemented many initiatives to support SMEs. However, it appears that small businesses are not being reached in the desired numbers.

Based on the observed success of other governments' interventions, most notably in the UK and USA, it may be worthwhile for future studies to compare the South African interventions to those of developed countries or other developing countries, to extract some lessons for the South African DFIs.

This study also revealed that there appears to be some similarities regarding the requirements of commercial banks and those of state-owned DFIs. Future studies can explore the extent of such similarities in assessment criteria and whether this impacts the role that DFIs should play in the market.

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APPENDIX A

Threshold per sector

Sector or sub-sectors in accordance with the Standard Industrial Classification	Size or class	Total full-time equivalent of paid employees *Less than:*	Total annual turnover *Less than:*	Total gross asset value (fixed property excluded) *Less than:*
Agriculture	Medium Small Very small Micro	100 50 10 5	R 4.00 m R 2.00 m R 0.40 m R 0.15 m	R 4.00 m R 2.00 m R 0.40 m R 0.10 m
Mining and Quarrying	Medium Small Very small Micro	200 50 20 5	R30.00 m R 7.50 m R 3.00 m R 0.15 m	R18.00 m R 4.50 m R 1.80 m R 0.10 m
Manufacturing	Medium Small Very small Micro	200 50 20 5	R40.00 m R10.00 m R 4.00 m R 0.15 m	R15.00 m R 3.75 m R 1.50 m R 0.10 m
Electricity, Gas and Water	Medium Small Very small Micro	200 50 20 5	R40.00 m R10.00 m R 4.00 m R 0.15 m	R15.00 m R 3.75 m R 1.50 m R 0.10 m
Construction	Medium Small Very small Micro	200 50 20 5	R20.00 m R 5.00 m R 2.00 m R 0.15 m	R 4.00 m R 1.00 m R 0.40 m R 0.10 m
Retail and Motor Trade and Repair Services	Medium Small Very small Micro	100 50 10 5	R30.00 m R15.00 m R 3.00 m R 0.15 m	R 5.00 m R 2.50 m R 0.50 m R 0.10 m
Wholesale Trade,	Medium	100	R50.00 m	R 8.00 m

APPENDIX B

Interview Questionnaire

1. Interview questionnaire for Small Business Owners

1.1 Does your business qualify to be an SME as per the Small Business Act of 1996, as amended?

1.2 Please provide a background of your business.

1.3 How was/is your business funded?

1.4 Have you ever approached commercial banks or state-owned institutions for business financing?

1.5 If yes to the above, what was the outcome?

1.6 If the outcome was unsuccessful, what were the reasons provided for such or what were the contributing factors?

1.7 If the outcome was unsuccessful, how did you overcome the funding obstacle?

1.8 What are your views on a potential funding gap for small business owners in South Africa? Kindly discuss the demand and supply sides of financing.

1.9 What was your experience with the state institutions which you approached when compared to the experience with the commercial bank?

2. Interview questionnaire for DFI's representative

2.1 What is the main purpose of the institution as mandated by Government?

2.2 How has the institution fulfilled this mandate thus far, particularly relating to SMEs?

2.3 What is the process of evaluation for applicants, especially SMEs?

2.4 In your view, is the process different from that of a commercial institution? Provide reasons.

2.5 Do you think the process has the potential of rejecting viable business plans? Provide reasons.

2.6 Why do you think there are still small medium businesses that are still complaining about lack of business finance?

2.7 What do you think should be implemented to address the gap you identify, if any?

2.8 How do political and fiscal constraints influence the extension of credit to small businesses?