Access to finance: Small and Medium-Size Enterprises in Malaysia

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Abstract: Small and medium enterprises (SMEs) have become strength of economies overall the world. Despite increasing importance to the economy, SMEs still struggle with access in finance. An understanding the essential of capital structure is important to improve sustainability and contribution to Malaysian economy. This study aims to describe the overview of SMEs and barriers to access the financing in Malaysia. This conceptual study outcome are expected to provide insights to policy maker in making appropriate policy to facilitate equity capital since it provides a base for further borrowing, reduces businesses’ sensitivity to economic cycles, and provides SMEs with access to syndicates of private and institutional venture capital suppliers. There could be policies aimed at encouraging SMEs to access public equity capital through reduction of listing requirements and subsidizing flotation costs. This could assist SMEs to restructure their financing to rely less on debt to improve their liquidity.

Keywords - Capital structure, financing, SMEs

I. INTRODUCTION

Despite the importance of SMEs in a country’s economic development, the fact they face financing constraints is a reality. Many small firms report access to finance or cost of finance as major obstacles to their growth. Unlike large and publicly traded firms, SMEs have limited or no access to certain types of external financing such as long-term debt or issuing equity. Therefore, this study contributes to the literature by addressing the existing financing gap and attempts to diagnose the issue of access to finance and sources of finance accessible and available to SMEs. It is generally acknowledged that small businesses are able to borrow from formal financial avenues such as banks or informal avenues like family and friends to increase their capital. SMEs’ inability to gain access to bank loans could be due to high collateral requirements, high interest rates, and lack of relationship with bankers. There is no doubt that SMEs face increasingly large number of constraints and have less access to formal sources of external finance, thus accounting for the limited growth potential of SMEs.

1.1 Overview of Small and Medium-sized Enterprises (SMEs)

The relative importance of the SME sector varies greatly across countries. SMEs have been known to make significant economic contributions, both in the developed and developing countries. This is evident in a number of areas, including creating job opportunities, distributing income, alleviating poverty, providing training and upgrading entrepreneurship skills (Wahab & Abdesamed, 2012).

In Malaysia, the Ministry of International Trade and Industry (MITI) redefined SME as:

(i) A small scale firm “with less than 50 full-time employees, and with an annual turnover of not more than RM10 million” or

(ii) A medium scale company “with between 51 and 150 employees, and with an annual turnover of between RM10 million and RM25 million”.

Table 1: SMEs in Malaysia based on Sales Turnover and Total Number of Full Time Employees.

<table>
<thead>
<tr>
<th>Category</th>
<th>Microenterprise</th>
<th>Small Enterprise</th>
<th>Medium Enterprise</th>
</tr>
</thead>
<tbody>
<tr>
<td>Manufacturing, manufacturing- related services and agro-based industries</td>
<td>Sales Turnover less than RM300,000/ and having less than 5 full time employees</td>
<td>Sales Turnover between RM300,000 and RM15,000,000/ and having between 5 to 75 full time employees</td>
<td>Sales Turnover between RM15,000,000 and RM50,000,000/ and having between 75 to 200 full time employees</td>
</tr>
</tbody>
</table>

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1.2 Small and Medium-sized Enterprises (SMEs) in Malaysia

Small and Medium-sized Enterprises play an important role in Malaysia’s economic development in various sectors. In promoting and coordinating the development of SMEs, the National Development Council pursues the following guidelines (Hamid, Baharun & Hashim, 2006).

a) SMEs to assist in the development of a balanced economy, use of advanced technology and help in providing a more equitable distribution of income;

b) SMEs to complement as well as support the large scale industry, heavy industry and modern industry through a network of industrial linkages;

c) SMEs to produce quality and high value added products and services for both the domestic and export markets, as well as contribute significantly to the Gross Domestic Product; and

d) SMEs to increase productivity through the use of modern technology and management that would increase their competitiveness in the export market.

In Malaysia, the SME sector has been one of the main drivers of the nation’s economic growth (Hamid, et al., 2006). Table 2 shows its contributions towards the different sectors in the Malaysian economy.

Table 2: Number of Small and Medium-sized Enterprises in the Different Sectors in Malaysia in 2012

<table>
<thead>
<tr>
<th>Sector</th>
<th>Micro</th>
<th>Small</th>
<th>Medium</th>
<th>Total SMEs</th>
<th>Large SMEs</th>
<th>Total Establishments</th>
</tr>
</thead>
<tbody>
<tr>
<td>Manufacturing</td>
<td>21,619</td>
<td>13,934</td>
<td>2,308</td>
<td>37,861</td>
<td>1,808</td>
<td>39,669</td>
</tr>
<tr>
<td>Services</td>
<td>462,420</td>
<td>106,061</td>
<td>12,502</td>
<td>580,985</td>
<td>10,898</td>
<td>591,883</td>
</tr>
<tr>
<td>Agriculture</td>
<td>3,775</td>
<td>1,941</td>
<td>992</td>
<td>6,708</td>
<td>2,121</td>
<td>8,829</td>
</tr>
<tr>
<td>Construction</td>
<td>8,587</td>
<td>6,725</td>
<td>3,971</td>
<td>19,283</td>
<td>2,857</td>
<td>22,140</td>
</tr>
<tr>
<td>Mining and Quarrying</td>
<td>57</td>
<td>126</td>
<td>116</td>
<td>299</td>
<td>119</td>
<td>418</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>496,458</td>
<td>128,787</td>
<td>19,891</td>
<td>645,136</td>
<td>17,803</td>
<td>662,939</td>
</tr>
</tbody>
</table>

(Source: Department of Statistics, Malaysia, 2012)

The total number of establishments is 662,939 or 97.3 percent of SMEs in Malaysia as shown in Table 2. The services sector recorded the highest number of establishments comprising 90 percent, followed by the manufacturing and construction sectors with 5.9 percent and 3 percent, respectively. The agriculture sector registered 1 percent of the establishments and mining and quarrying constituted only 0.1 percent.

Further, SMEs are considered as important economic agents for Malaysia based on their GDP contribution of 35.9 percent, which is above the standard benchmark for a developing nation (Hafsah, 2015). SMEs contribution to overall GDP increased from 32.2 percent in 2010 to 35.9 percent in 2014 as shown in Table 3. Indeed, the SMEs in the construction sector recorded the highest growth, that is, 0.9 percent from 2013 to 2014, followed by 0.6 percent in the services sector and 0.5 percent in the agriculture sector.

Table 3: Contribution of SMEs to Overall GDP by Key Economic Activity (%)

<table>
<thead>
<tr>
<th>Year</th>
<th>2010</th>
<th>2011</th>
<th>2012</th>
<th>2013(^a)</th>
<th>2014(^b)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Percentage share to GDP</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Agriculture</td>
<td>4.3</td>
<td>4.3</td>
<td>4.1</td>
<td>4.0</td>
<td>4.5</td>
</tr>
<tr>
<td>Mining &amp; Quarrying</td>
<td>0.0</td>
<td>0.0</td>
<td>0.1</td>
<td>0.1</td>
<td>0.1</td>
</tr>
<tr>
<td>Construction</td>
<td>0.9</td>
<td>0.9</td>
<td>1.0</td>
<td>1.1</td>
<td>2.0</td>
</tr>
<tr>
<td>Manufacturing</td>
<td>7.2</td>
<td>7.4</td>
<td>7.4</td>
<td>7.5</td>
<td>7.8</td>
</tr>
<tr>
<td>Services</td>
<td>19.6</td>
<td>19.9</td>
<td>20.0</td>
<td>20.5</td>
<td>21.1</td>
</tr>
</tbody>
</table>

(Source: Small and Medium Industries Development Corporation, 2014)
1.3 Contribution and Development of Small and Medium-sized Enterprises (SMEs)

Small and medium scale enterprises (SMEs) are significant contributors to economic growth in both the developed and developing countries (Dube, 2013). Apart from producing goods and services and creating employment, SMEs are increasingly contributing towards export growth and the industrialization process in the emerging economies. SMEs have grown to be the largest cluster of industrial entities in most emerging economies, specifically impacting manufacturing productivity and employment in the case of Malaysia (Hashim, 2012). Growth of SMEs contribute towards reduction in poverty levels, removal of biases against labor-intensive production, creation of employment opportunities for the low-skilled workers and formation of linkages with small suppliers (Singh & Janor, 2013). A dynamic SME sector undoubtedly assists in employment generation, mobilization and utilization of resources and thereby, contributes to the growth of the national income of a country (Kumar & Gao, 2015).

SMEs form the basis of economic development in each country. They contribute immensely to the economic and social development. Aminu and Shariff (2015) stated that SMEs utilize the raw materials that do not require high level of technology to process, and this provides an effective means of mitigating rural-urban migration and resource utilization. SMEs use simple technology and recycle products and waste from large firms as inputs for their production processes. They account substantially for the national output through provision of raw materials for the usage of large firms. Table 4 indicates that SMEs contribution to overall GDP is projected to reach 50 percent in 2020. Malaysian SMEs expanded at a faster pace than the overall economy compared to in 1991 as their growth was supported by strong domestic economic activity, favorable labor market conditions and continued access to financing.

Table 4: SMEs Contribution to GDP (1991-2020) (Estimates)

<table>
<thead>
<tr>
<th>Year</th>
<th>Percentage of contribution to GDP</th>
</tr>
</thead>
<tbody>
<tr>
<td>1991</td>
<td>20 (RM4.3 billion)</td>
</tr>
<tr>
<td>2000</td>
<td>40</td>
</tr>
<tr>
<td>2020</td>
<td>50</td>
</tr>
</tbody>
</table>

(Source: Malaysia International Trade and Industry Report, 2012)

1.4 Challenges Encountered by Malaysian Small and Medium-sized Enterprises (SMEs)

Contribution of Malaysian SMEs to the economy has not reached a level on par with SMEs in most developing countries (Hamid et al., 2006). As with other businesses, SMEs continue to face domestic and external challenges such as shortage of skilled personnel, poor linkages, lack of market access, inadequate finance, unintended impact of policy instruments, competitions from foreign SMEs and technological constraints.

According to Bakar and Ahmad (2010), Malaysian SMEs encounter challenges in the light of changing global market, including networking at the firm and industry level, product innovation, branding and new technologies to enhance their competitiveness in the global marketplace. In the context of diverse businesses, SMEs have disadvantages in terms of capital and resources (Jayabalan, Raman, Dorasamy & Ching, 2009).

Malaysian SMEs are struggling with various trials in their process of internationalization and achieving economics of scale in a competitive market (Hashim, 2012). The internationalization challenges faced by Malaysian SMEs include lack of market knowledge, limited access to financial support, lack of infrastructure, technology and human capital, business competition and government policies.

The SME community has been traditionally perceived as a high-risk, high cost-of-service market segment. Major issues facing SMEs are insufficient working capital, slow loan approval processes, complicated procedures, mismatching of government programs and services due to lack of promotion, increase in interest rate and service fees charged (Muhammad, Ahmad & Shahnor., 2011).

The failure rate of SMEs in Malaysia is alarmingly high at 60%, given the challenges that pose a threat to their survival, such as lack of access to finance, lack of managerial capabilities and lack of information on potential markets (Chong & Mahmoud, 2012). Small businesses encounter five critical issues i.e. access to finance, lack of skilled human capital, business competition, access to technology and innovation infrastructure and non-conductive government policies (Saleh et al., 2008).
II. BARRIERS TO ACCESS TO FINANCING

Financing plays an important part in supporting firms to innovate, scale-up and adopt efficient production processes. However, most private financial institutions are reluctant to provide financing due to risk aversion and lack of expertise to evaluate the viability of new technologies. The requirement for collateral, particularly from new SME firms and start-ups, is also a barrier to access to financing (Unit, E.P., 2015).

2.1 Sources of Funds for Malaysian SMEs

Majority of small business owners or managers finance their start-ups and growth strategies using a combination of personal savings, retained earnings and external borrowing. As successful new start-ups develop and mature into established businesses, a need arises for further internal and external resources to sustain and accelerate growth (Hussain & Matlay, 2007). Internal resources continue to be a major source of finance as external financing could have an adverse impact on an owner’s or manager’s control of his or her firm. If the owners or managers and bank representatives develop close relationships, the small firms would be able to secure more debt and better repayment terms. Thus, changes in the capital structure of small businesses have considerable implications on their profitability and minimizing costs of capital.

According to Fourati and Affes (2013), novice entrepreneurs turn first to internal sources of finance. Subsequently, they seek external debts and finally equity finance. Entrepreneurs are known to have less than 38% chance of incurring a bank debt and less than 30% chance of having external equity in their capital structure. As shown in Table 5, most SMEs (55.9%) sourced their financing from internally generated funds or from shareholders for their operations in 2011. However, only 20.3% of overall firms were able to source their funds from financial institutions, including commercial banks, micro-credit organizations and development financial institutions.

<table>
<thead>
<tr>
<th>Sources of Financing (%)</th>
<th>Other Sources (Grants, financing from government, co-operative and leasing)</th>
<th>Family and Friends</th>
<th>Internal Funds or Shareholders</th>
<th>Microcredit, Banks and Financial Institutions</th>
</tr>
</thead>
<tbody>
<tr>
<td>Overall</td>
<td>30</td>
<td>14.3</td>
<td>55.9</td>
<td>20.3</td>
</tr>
<tr>
<td>Micro</td>
<td>28.8</td>
<td>15</td>
<td>58.1</td>
<td>16.2</td>
</tr>
<tr>
<td>Small</td>
<td>33.6</td>
<td>12.7</td>
<td>49.6</td>
<td>30.7</td>
</tr>
<tr>
<td>Medium</td>
<td>35.5</td>
<td>8.5</td>
<td>46.4</td>
<td>47.7</td>
</tr>
</tbody>
</table>

Source: Economic Census 2011: Profile of Small and Medium Enterprises, Department of Statistics, Malaysia.

On the supply side, there are several initiatives across countries to foster SME financing, including government subsidized lines of credit and public guaranteed funds (Singh & Janor, 2013). Financial institutions (FIs) which comprise banking institutions (BIs) and development financial institutions (DFIs) continue to be main providers of SME financing. In addition to FIs, SMEs have access to other sources of financing such as venture capital and private equity, factoring and leasing, Government funds, as well as micro financing and pawn broking. The diverse sources are further reinforced by a comprehensive framework covering guarantee schemes to enhance credit standing of SMEs without collateral and a debt restructuring avenue for firms facing difficulty in repaying their debt. Given that 90-95% of SME financing have been traditionally extended by FIs, efforts in recent years were focused on developing more avenues for risk capital. This is in line with the growing needs of the company where traditional form of financing offered by FIs might not be able to meet the needs of the more risky segment of SMEs, such as start-ups and SMEs in new activities which have high growth potential and are innovative in nature (SME Annual Report 2014/15).

III. THEORIES OF CAPITAL STRUCTURE

The theories suggest that firms select capital structure depending on attributes that determine the various costs and benefits associated with debt and equity financing (Abor and Biekpe, 2009). Several theories of capital structure have been highlighted in the literature:

Modigliani and Miller Theory (M&M) forms the foundation of capital structure theories (Kumar and Rao, 2015). The assumption of the Modigliani and Miller Theory (1958) is that firms have a particular set of expected cash flows. After selection of a certain proportion of debt and equity to finance the firm’s assets, the cash flow would be allotted among the investors. Investors and firms are assumed to have equal access to
financial markets, which allows for homemade leverage. Therefore, the leverage of the firm has no effect on the market value of the firm (Luigi & Sorin, 2009). M&M assumed that the market is perfect and has no influence on the value of a firm, investors have homogeneous expectations, it is a tax free economy and there are no transaction costs. However, this theory is inapplicable as it is based on restrictive assumptions and is inconsistent with the real world. Investors prefer to buy undervalued shares and sell at higher prices to earn income (Salim & Yadav, 2012). Hence, Modigliani and Miller (1963) revised their position by incorporating tax benefits as determinants of capital structure. To strengthen this argument, M&M explained that a firm that honors its tax obligation benefits from partially offsetting interest called tax shield in the form of payment of lower taxes. Thus, the firms are able to maximize their value by employing debt due to tax shield benefits associated with debt use (Ahmad et al., 2012). M&M theory was criticized due to some weaknesses and inapplicable assumptions. Nevertheless, it provided the foundation for other theories put forth that took into consideration the market imperfections. The M&M theory has been expanded into the pecking order theory and trade off theory.

Pecking order theory (POT) propounded by Myers and Majluf (1984) argued that firms prioritize their sources of financing and usually prefer internal financing. If external financing is needed then debt is chosen and equity would be the last resort. To avoid the underinvestment problem, managers seek to finance new projects using a security that is not undervalued by the market, such as internal funds and riskless debt. This is because a firm has more information than outsiders and information asymmetry investors demand more premiums for information-sensitive securities (e.g. equity). However, many profitable firms prefer debt financing for new projects since they have sufficient funds in the form of retained earnings.

Second theory is trade off theory (TOT) implies that leverage has positive relationship as contrary to the pecking order theory.. It assumes the presence of an optimal capital structure that maximizes shareholder’s wealth and simultaneously minimizes external claims to wealth. It considers the trade-off between benefits of interest tax shield of debt and cost of financial distress (Kumar & Rao, 2015). The advantage of borrowing allows companies to attain tax shield, that is, a company pays lower tax when it incurs more debt. Companies are most likely to use debt financing up to certain level until the cost of financial distress starts to surface (Saarani & Shahadan, 2013). A highly leveraged firm with a high debt ratio is always associated with the need for high returns. This is because the firm is exposed to bankruptcy risk if not managed well. This explains why highly leveraged firms require high returns to compensate for the risk. Incidentally, interest payment for debt is tax-deductible. An optimal capital structure could therefore be achieved by the firm to enjoy the maximum tax benefits.

The last theory is agency cost which provided by Jensen and Meckling (1976) is discussing the conflict the conflict of interest between principals (shareholder) and decision makers (agents) of firms (managers, board members, etc), this conflict stems from the differences in behavior or decisions by point out that the parties (agents and shareholders) often have different goals, and different tolerances toward risk. In this case, the managers whom are responsible of guiding the firm toward to achieve them personal goals rather than maximizing benefits to the shareholders. Hence, the main conflict that shareholder face is ensures that managers (agents) do not invest the free cash flow in unprofitable projects (Nassar, 2016). If the companies with high cash flow and profitability, increasing of debts can be used as a toll of reducing the scope for manager until resources of company may not be waste as a result of their activities (Negasa, 2016).

IV. CONCLUSION

Although Small and Medium-sized Enterprises (SMEs) in Malaysia greatly impact national economic development; however it is not easy to grow SMEs as local SMEs have limited access to funding. In fact, more than 50% sources of financing in SMEs are rely bank funds, many financial institution still find it risky to facilitate loan for potential SMEs. The situation causes SME development is slowly compare to listed companies. Therefore, if the SME funding problem remains unresolved, it will worsen economic development in Malaysia, as SMEs play a pivotal role in strengthening the national economy.

REFERENCES


