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# SMEs Financing Constraints in Zimbabwe: The Case of Midlands Province

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***Abstract** - SMEs are dominant in Zimbabwe's business community. Acknowledging SMEs' role in the economy, it is indispensable for policy makers to make sure that all relevant support is given to SMEs. One major area of concern is lack of funding for SMEs business ventures. This study sought to unearth supply side, demand side as well as regulatory financing constrains that are negatively impacting on SMEs growth in Zimbabwe's Midlands Province. The study employed a qualitative research methodology in which questionnaires and interviews were the major data gathering tools. SMEs, SMEs associations, the Ministry of Small and Medium enterprises as well as various financiers participated in the study. Among a plethora of other constraints, excessive loan documentation requirements, collateral security issues, SMEs managerial inefficiencies, SMEs information opacity as well as high financing costs were found to be hindering SMEs financing. The study recommended the need for capacitating SMEs through training in bookkeeping and business management, SMEs adoption of trending innovative financing models such as crowdfunding as well as creation of an enabling environment for the establishment of alternate financing technologies, to mention but a few.*

***Keywords:** Collateral, Financing, Information Opacity, Relationship Lending, SMEs, Transaction Lending*

## 1. INTRODUCTION

Small to Medium Enterprises (SMEs) are non-subsidiary, independent business players that employ less than a given number of employees. This number varies across countries. The most common upper limit designating an SME is 250 employees, as defined, for example, by the European Union. However, some countries set different limits, as shown in the table below. In some countries, the sizes of financial assets or turnovers are used to define SMEs, in addition to (or instead of) employment thresholds. In Zimbabwe, Small enterprises are defined by turnover and assets less than $240,000.00 and $100,000.00 respectively whilst medium enterprises have turnovers and assets greater than thresholds for small enterprises but all less than $1 million (SME Association of Zimbabwe, 2020).

**Table 1: Employee Limits for Micro, Small, Medium and Large Enterprises**

| CLASS | WORLD BANK | RSA | EU | US | AUS |
|---|---|---|---|---|---|
| Micro | <10 | 0 | <10 | <6 | <20 |
| Small | <50 | <50 | <50 | <250 | <15 |
| Medium | <300 | <200 | <250 | <500 | <200 |
| Large | >300 | >200 | >250 | >500 | >200 |

***Source:** OECD (2005)*

SMEs dominate the global economy in general and the developing economies in particular. They play an indispensable role in the growth of economies through their contribution to employment creation, payment of taxes to the fiscus, production, spending and international trade, to mention but a few. The World Bank (2020) submit that SMEs account for the majority of businesses worldwide and are significant contributors to job creation and global economic development. SMEs represent about 90% of businesses and more than 50% of employment worldwide (World Bank, 2020). SMEs contribute at least 50% of Gross Domestic Product (GDP) in developing and developed economies (SME Association of Zimbabwe, 2020). However, despite all these salient statistics showing the importance of SMEs, at least 50% of SMEs lack funding. Among a plethora of ongoing matters of theoretical and empirical investigation is however the question of what determines access to finance for SMEs (Fanta, 2015). The Organisation for Economic Cooperation and Development (OECD) (2020) asserts that ensuring SMEs' access to finance in the appropriate forms and volumes is a prerequisite for their development and growth.

After a substantial structural transformation for the past couple of decades, SMEs have become dominant in Zimbabwe. However, access to formal financing for SMEs in Zimbabwe is an issue especially because of their operational sizes which make loan administration costly and unattractive to established financiers (Muzari and Jambwa, 2014). Financiers would actually prefer transaction lending to relationship lending. Transaction lending involves lending based on hard information about the borrower and examples include financial statement lending, credit scoring, asset based lending, fixed asset lending as well as cash flow lending. Relationship lending on the other hand relies on soft (usually qualitative) information about the borrower. However, transaction lending is not suitable for SMEs because of their incapacity to keep proper records and books of accounts. Financial organisations are usually reluctant to finance SMEs based on relationships due to costs and risks involved.

***Problem Statement***

The economy of Zimbabwe is currently dominated by small and informal players. The larger chunk of formal players in the Zimbabwean economy also constitutes SMEs. Capacity growths of individual SMEs may in the same way improve economic growth, all things being equal. In other words, today's SMEs are expected to be larger businesses in the future provided an enabling and conducive environment is available for SMEs' growth. The growth of SMEs in Zimbabwe is however stunted and financing constraints are among dominant causes of this stunted growth. It is against this background that this study intended to establish various SMEs financing challenges so that relevant and corresponding policy prescriptions or recommendations can be proffered.

***Objectives of the study***

The study specifically attempts to accomplish the following objectives:

- To unpack and justify the importance of SMEs in overall economic growth and development
- To ascertain supply side, demand side as well as regulatory constraints in SME financing in Zimbabwe
- To proffer policy recommendations that would likely ameliorate SMEs financing in Zimbabwe

## 2. LITERATURE REVIEW

SMEs contribute substantially to developing countries' economies although they remain with largely untapped potential due to a multitude of challenges, chief among them being lack of finance (Sachikonye and Sibanda, 2016). Many theories of SMEs exist and these include but not limited to The Theory of Technological Capabilities by Lall (2001), the Static Trade off Theory, Agency Theory, Growth Cycle Theory, Alternative Resource (or Bootstrapping) explanations and the Pecking Order Theory. Similarly, vast empirical literature on SMEs financing exists form studies done in Zimbabwe, Africa and the world at large. This section gives a synopsis of a few such empirical studies.

Munanga (2013) used a case study of Gweru urban to investigate financial challenges encountered by Zimbabwean retail SMEs operating in a multi-currency business environment. A total of 150 retail SMEs participated in the survey and were selected through convenience sampling. Financial challenges faced by retail SMEs in the multi-currency environment were found by the study to be liquidity inadequacy, high bank loan interest rates, high operating expenses as well as lack of trade credit. Among other recommendations, the study recommended the formation of strategic alliances and voluntary chains for SMEs.

Basing on findings from a survey of secondary data sources, Muzari and Jambwa (2014) published a discussion of small enterprises development constraints in Zimbabwe. Finance/credit was among a plethora of other small enterprises development constrains that were unearthed by the study. The study unpacked a series of factors making up the finance/credit constraints as including inadequate loanable funds, lack of incentives for banks to lend, stringent collateral requirements as well as negative perceptions of small-scale enterprises by lending institutions.

Using a case study of Zimbabwean SMEs, Njanike (2019) investigated the factors influencing SMEs growth in Africa's developing countries. Under the auspices of Zimbabwe Finscope Business Consumer Survey's 2012 data, the study employed a linear programming regression model in analysing factors influencing SMEs profitability in Zimbabwe and financial problem was included among other factors in the model. High SME financing costs by formal financial institutions, higher risk of default as compared to larger businesses and unclear financial statements were cited in the study as some of the possible impediments to SMEs financing.

Mudavanhu et. al. (2011) investigated the determinants of SMEs failure in Zimbabwe. Basing on data gathered in the Zimbabwean town of Bindura through interviews, questionnaires and focus group discussions, the study employed an Ordinary Least Squares (OLS) methodology to estimate the change in Return on Investment (ROI) function. Thus, the change in ROI function was used to proxy SMEs failure. Consistent with theory of technological capabilities by Lall (2001), unavailability of credit emerged as one of the determinants of SMEs failure in Zimbabwe. The study recommended the need for government to institute measures that would see SMEs getting lines of credit.

Inferring from a survey of at least 5 scores of randomly selected manufacturing firms in Ethiopia, Fanta (2015) established some demand side constraints to SME access to external finance. The sample of survey participants was drawn from the population of SME firms operating in Ethiopia's capital, Addis Ababa. Lack of collateralisable fixed assets, owners' reluctance to admit new business partners and lack of financial transparency were found to be among SME financing impediments in Ethiopia.

Beck (2007) investigated financing constraints of SMEs in developing countries through survey of related empirical research. Transaction costs and asymmetric information between SMEs and lenders were acknowledged in the study as major constraints to SMEs' access to external finance. The study recommended a comprehensive policy framework that combines market-developing policies (such as reforming the contractual and informational framework), market-enabling policies such as fostering competition and providing regulatory frameworks for leasing and factoring) as well as market-harnessing policies (such as the financial safety net that prevents imprudent lending booms and busts). The study emphasised government's role in spearheading reforms in the institutional environment, providing regulatory frameworks as well as fostering competition.

## 3. METHODOLOGY

The study employed a qualitative research methodology in a bid to gather views from relevant stakeholders. To capture both supply side and demand side constraints, interviews and tailor-made questionnaires were administered to SMEs as well as financing organisations through convenience sampling. Taking advantage of their rich experience with SMEs, seven officials from the Ministry of Small and Medium Enterprises as well as three officials from different SMEs associations were also part of participants in the study. Of the seven officials from the Ministry of SMEs, two were from the provincial office and five were from district offices. All interviews and questionnaires opened by requiring participants to confirm whether SMEs financing constraints exist before asking participants to state and elucidate on such constraints. Participants were also allowed to propose solutions to the stated financing constraints.

## 4. RESULTS PRESENTATION

To obtain a balanced and possibly unbiased analysis of SMEs financing constraints, four classes of stakeholders participated in the study. SMEs, SMEs associations, Ministry of SMEs and financiers were engaged through face to face interviews, telephone interviews as well as through questionnaires. As depicted in Table 2 below, 24 face to face interviews were executed, 18 telephone interviews were carried out, 23 hand-delivered questionnaires were returned and 11 questionnaires that were sent to respondents through the electronic mail were responded to, translating to a total of 76 successful respondents. Most research participants were SMEs themselves and some selected financiers. Only three and seven participants were from SMEs associations and the Ministry of SMEs respectively.

**Table 2: Research Participants by Class**

| **Class of Respondents** | **Number of research participants** | **Data Collection Instrument** | | | |
|---|---|---|---|---|---|
| | | **FFI** | **TI** | **HDQ** | **EQ** |
| SMEs | 36 | 14 | 6 | 16 | 0 |
| SMEs associations | 3 | 2 | 1 | 0 | 0 |
| Ministry of SMEs | 7 | 4 | 1 | 0 | 2 |
| Financiers | 30 | 4 | 10 | 7 | 9 |
| Total | **76** | **24** | **18** | **23** | **11** |

*KEY:* FFI=Face to face interviews; TI=Telephone Interviews; HDQ=Hand Delivered questionnaires; EQ=Emailed Questionnaires

**Source:** *Owner's compilation from primary data*

For convenience and in order to cover all selected participants in dispersed geographical locations of the Midlands Province, research questionnaire was administered through face to face interviews, telephone interviews, electronic mail and some were hand delivered to clients who completed the questionnaires on their own. Table 3 below reveals that total interviews/questionnaires administered were initially 80 although 3 hand-delivered questionnaires as well as a single emailed questionnaire were not returned, translating to a 95% response rate. The three unreturned hand-delivered questionnaires were all for some SMEs and an unreturned email questionnaire was for one of the financiers.

**Table 3: Questionnaire Administration Media Statistics**

| **Administration Media** | **Persons interviewed/Questionnaires administered** | | **Successful interviews/Questionnaires returned** | |
|---|---|---|---|---|
| | **Number** | **Share of total** | **Number** | **Response Rate** |
| Face to face interviews | 24 | 30% | 24 | 100% |
| Telephone interviews | 18 | 22.5% | 18 | 100% |
| Hand delivered questionnaires | 26 | 32.5% | 23 | 88.46% |
| Emailed questionnaires | 12 | 15% | 11 | 91.67% |
| Total/[Average] | **80** | **100%** | **76** | **[95%]** |

**Source:** *Owner's compilation from primary data*

The study found that supply side, demand side as well as regulatory SMEs financing constraints exist in Zimbabwe's Midlands Province. Demand side constrains arise from SME inherent characteristics (Fanta, 2015), supply side constraints emanate mainly from requirements as well as terms and conditions imposed by prospective suppliers of financial resources whilst regulatory constrains include impediments caused by inefficiencies in the governance, organisation and regulation of the SME business environment. Table 4 below gives a summary of supply and demand side financing constraints that were revealed by research participants.

**Table 4: Synopsis of SMEs Financing Constraints**

| SUPPLY SIDE CONSTRAINTS | DEMAND SIDE CONSTRAINTS | REGULATORY CONSTRAINTS |
|---|---|---|
| -High interest rates<br>-Excessive paperwork requirements<br>-High financing costs<br>-Unattractive tenure (too short) | -Lack of collateral security<br>-Information opacity<br>-Risk aversion<br>-High default risk<br>-Managerial inefficiencies<br>-Lack of viable projects<br>-Reluctance to dilute control and ownership of the business | -Lack of government support<br>-Lack of market development initiatives to support SMEs growth |

**Source:** *Owner's compilation from primary data*

### *4.1 Supply side constraints*

In circumstances where loans are available, demanders of loans indicated that nominal interest rates were too high. Loan providers in Zimbabwe set interest rates that are on the higher side, especially to compensate for high risk borrowers as well as high rate of expected inflation. SMEs and their associations indicated that they were constrained to borrow because interest payments were going to wipe away all expected profits from their projects.

Excessive paperwork requirements were also cited as a financing constraint. Banks and other financiers allegedly require their prospective clients to complete numerous forms and submit many documents for them to be able to successfully lodge their loan applications. SMEs and their representatives indicated that such excessive paperwork costed them so much money and time that they would end up not applying.

Financiers revealed that dealing with SMEs is associated with high financing costs. SMEs are risky and financing them requires gathering a lot if information. Survey participants indicated that in most cases costs of financing SMEs in Zimbabwe outweigh associated benefits. Information opacity and poor record keeping are some of the SMEs characteristics that lead to high financing costs by financiers.

Loan tenure is attractive and disadvantageous to borrowers and lenders respectively. Participants from the borrowing side indicated that tenure for SMEs finance is usually too short that the loan would not be of much benefit to SMEs. On the other hand, financiers indicated that SMEs are risky and giving longer tenures would be detrimental. Financiers indicated that some SMEs are short lived and giving loans with longer tenure might disadvantage financiers much.

### *4.2 Demand side constraints*

The importance of collateral security in orthodox financing theory cannot be overemphasised. SMEs are characterised with no assets or a few assets that are not collaterisable. The survey revealed that lenders are usually reluctant to lend without assets attached as collateral security as this poses much default risk.

SMEs are often unable or unwilling to provide sufficient, accurate, and reliable information to a financial institution. They typically cannot provide transparent and audited financial statements that financiers require. The statements they can provide are often non-transparent and unreliable. This therefore creates informational asymmetry since the financier will lack access to all the information that the SME knows about its business. This information asymmetry can and often does prevent the lending transaction from taking place since all parties involved in the transaction do not have access to all the information needed for their decision-making processes. Informational asymmetry, therefore, becomes the most serious obstacle for SMEs to obtain credit from formal financial institutions.

Seeking for external financing is considered by some organisations as too risky since the borrowing organisation may fail to meet its obligations and end up losing all assets to creditors. Risk aversion was found to be among demand side constraints as some economic agents were reluctant to borrow financial resources only to remain without possible financial risk.

The likelihood that SMEs fail to make full and timely payments of the principal and interest of the borrowed funds is termed default risk. Most adverse SMEs characteristics imply their high default risk. The study revealed that SMEs are perceived by potential lenders to have a high if not prohibitive default risk. Financiers would therefore like to deal with large and established entities whose default risk is low.

It was found in the study that most SMEs lack expected managerial efficiency. Such managerial inefficiency would negatively contribute to concerned SMEs' creditworthiness. Suppliers of finance would likely support SMEs with credible management and this gives a crude indication that supplied finances will be successfully be used to generate sufficient funds that will be used to pay back loans.

Financiers indicated lack of viable projects as one of the reasons why they are unwilling to finance SMEs. Financiers are interested in financing applicants with viable projects with higher probabilities of yielding attractive returns. With viable projects, financiers expect that project owners will be able to repay the borrowed loans using earned profits.

The study also found that most SMEs are reluctance to dilute control and ownership of the business. Such reluctance means that SMEs will not accept any financing which may affect business ownership and control. Thus, benefits form of financing such as equity financing usually take no part in SMEs financing despite their possible inherent benefits.

### *4.3 Regulatory constraints*

Faced with a daunting task of resuscitating the precarious economy with only meagre resources, the government of Zimbabwe was pointed in the study as not giving enough and expected support to SMEs. Some participants indicated that they have an expectation that the government would be playing a pivotal role in offering cheaper loans or seed capital to SMEs, offering grants, subsidies and tax holidays as well as generally creating an enabling environment for SMEs growth.

The Zimbabwean business environment also lacks innovative market development initiatives aimed at reducing asymmetric information between banks and SMEs. Participants from financiers suggested that the government's pro-growth policies should incorporate innovative market development initiatives that would improve information towards becoming perfect. This would reduce risk of lending to SMEs through the reduction of adverse selection and moral hazards.

## 5. CONCLUSION

The study sought to establish demand side, supply side as well as regulatory financial constraints for SMEs in Zimbabwe using the case study of the Midlands Province. A qualitative research methodology was employed and questionnaires were administered to both supply side and demand side SME financing stakeholders. Lack of collateral security, information opacity, risk aversion, high default risk, managerial inefficiencies, lack of viable projects as well as reluctance to dilute control and ownership of the business were identified as some of the possible SME demand side financing constraints. On the other hand, supply side constraints established by the study include high interest rates, excessive paperwork requirements, high financing costs and unattractive tenure. Lack of market development initiatives and government support were the regulatory constraints established by the study.

## 6. RECOMMENDATIONS

Globally, SMEs are regarded as significant drivers of economic growth and as such taking serious care of SMEs should be part of the macroeconomic policy if the economy is to realise a significant SMEs growth rate (Chivasa, 2014). Consolidating views from all stakeholders who participated in the study, the study proffers a number of recommendations for combating supply side, demand side as well as regulatory constraints of SMEs financing. Below are some recommendations that can generally be extracted from research findings presented under Sub-sections 4.1 to 4.3:

### *Innovative financing models*

Alternative financing models for SMEs have emerged globally and these include but not limited to crowdfunding, which is basically an internet based scheme for bringing together borrowers and lenders to interact on an online platform. SMEs in Zimbabwe can therefore adopt such financing models as crowdfunding and raise funds from multiple individuals through donations, presales/rewards, debt, or equity.

***SMEs training in bookkeeping and business management***

One reason for the reluctance of financial institutions and other financiers to fund SMEs in Zimbabwe is information opacity. The study therefore recommends that SMEs engage in record keeping and business management trainings that may be conducted by responsible stakeholders such as the Ministry of Small to Medium Enterprises, SMEs associations any other relevant stakeholders. These stakeholders ought to also take an active part in initiating training programmes.

***Establishment of Credit Guarantee Schemes (CGSs)***

The establishment of public and/or private CGSs may close a considerable gap in SMEs financing. The government may take a lead in establishing public CGSs and also create an enabling environment for the private sector to do the same.

***Establishment of innovative market development initiatives***

Secured transaction frameworks and credit information sharing platforms (e.g. credit registries or bureaus) are good examples of market development initiatives. Secured transaction systems, that is, the legal and institutional structures that govern how agents can create security interests over movable assets, would increase borrowing by firms that rely more on movable assets. Credit information sharing platform is another market development initiative that addresses the information gaps associated with SME lending. A credit information mechanism facilitates access by providing additional enhanced fact-based information on SME applicants. In addition, the credit reporting infrastructure is recognised as a public good that benefits both borrowers and lenders for a number of reasons such as mitigation of moral hazard and adverse selection problems as well as making it easier for financial regulators to assess and monitor systemic risks.

***Establishing pro-SMEs Legal and Regulatory Policies***

Establishment of legal and regulatory policies that encourage SMEs and banks to enter into lending relationships by providing tax incentives for SMEs to enter the formal sector or reducing banks' regulatory burdens would also go a long way in improving SMEs financing. In other words, the government of Zimbabwe should create an enabling environment for SMEs' access to financing and growth.

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