IMPACT OF FIRM AND OWNER CHARACTERISTICS ON ACCESS TO FORMAL EXTERNAL FINANCING AMONG SMEs IN NORTH CENTRAL NIGERIA

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IN PARTIAL FULFILMENT OF THE REQUIREMENTS FOR THE AWARD OF DOCTOR OF PHILOSOPHY (Ph.D.) DEGREE IN FINANCE

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MARCH, 2019

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CERTIFICATION

This is to certify that this Ph.D. research thesis has been read and approved as meeting the requirements of the Department of Accounting and Finance, College of Humanities, Management and Social Sciences, Kwara State University, Malete, Kwara State.

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DECLARATION

I hereby declare that this thesis titled Impact of Firm and Owner Characteristics on Access to Formal External Financing among SMEs in North Central Nigeria is my own work and has not been submitted or presented by me and to the best of my knowledge, by any other person for any course or qualification at this or any other academic or research institution. I also declare that the information provided herein are mine and those that are not mine are properly acknowledged.

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…… ……...

Lukman Adebayo Oke Date

DEDICATION

This thesis is dedicated to my Parents, Alh and Alh. Abdurrauf Oke; my wife, Dr. (Mrs) Khadijah Karatu; and my children, Khaalid, Ikraam, Abdurrafeeq and Maryam.

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ACKNOWLEDGEMENTS

Thanks to Almighty Allah, who elevated me to this status of His prestigious mercy and enabled me put together, this lucubration that has availed me a lot of benefits and galvanized me into the realm of the academe.

Thereafter, I tender my gesture of respect and salutation to my amiable parents. I pray Allah to recompense them with good and grant them mercies as they were merciful to me when I could not distinguish right from left. They are indeed uncommon parents.

My enculturation into the academia was not without an escort. With the luculent comments and pacifying remarks of my supervisor, Prof. M. A. Ijaiya, I was accompanied through this academic adventure that changed my perception about life. Despite his more important schedules, he found time to make a metamorphosis of my research proposal into a laudable and fabulous PhD. Thesis. Sir, I acknowledge your impactful mentorship.

In the company of valiant and supportive hunters, a dog, they say kills monkeys. With appreciable closeness and sufficient dedication, Dr. Sanni Mubaraq, my mentor, turned deaf ears to the shin dies of my phone calls and considered the shindigs of my incessant inquisition a necessity for the achievement of success in this work. He spared his leisure to painstakingly vet this work and offered uncommon suggestions. I would not have expected a better compassion and consideration from scholars of his calibre. “Allah assists a servant in so far as he continues to assist his brother”. With sincere reverence, I pray for the veracious personality of Dr. E. O. Imoloame under whose leadership as the HOD and with whose mentorship I pursed this program to a meaningful conclusion.

Under the tutelage of Prof. M. N. Nassar; Prof. Kenneth Adeyemi, Prof M. Odedokun and a host of other amiable lecturers in the Department Indeed, they are worthy of

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erudition. Also to my colleagues in the Department of Accounting and Finance, Kwara State University, Malete, I appreciate your unflinching supports.

If I were a loner, the program would have offered a boredom that is full to the brim. The intimacy of Ismail Daud, A. B. Uthman, Sulaiman Hakeem, Oloyin, Mr Jimba, Balqees, Alhaja Mahmud and other classmates whose awesome ideas exterminated the inherent academic fatigue is acknowledged. Voracious of good results, we studied together in a paradoxical world of critics, jokes, nostalgia, quarrels, awe, happiness and thanks to the Almighty. In the end we were availed of gorgeous friendship. I pray for all to have a meaningful conclusion of this program.

It will be outwardly hypocritical to overlook the contribution and perseverance of my one and only soul mate , my beloved and uncommon wife, the mother of my blessed children, the gift of my life and the one regarding whom I will ceaselessly thank Allah. Dr (Mrs) Khadijah Karatu. She is indeed one in a million. I pray that Allah blesses her children and assist her beyond her request. My chidren, Khaalid, Ikraam, Abdurrafeeq and Maryam I appreciate your understanding throughout the programme. I pray Allah enrich you with beneficial knowledge and grant you long life with sound health.

Definitely, I cannot acknowledge all. I only seek Allah, the Lord of worlds to reward all and sundry in relation to their contribution to my success. In the end, I thank Allah, the Lord of the world.

Lukman Adebayo Oke

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ABSTRACT

The paucity of finance to SMEs, widely reported in the literature has continued to undermine the contribution of the sector to economic growth. This scourge has partly been blamed on the SMEs' observable characteristics which include firm factors and owner's profile. However, the dearth of comprehensive research in this area portends the need for further studies especially in the North Central Nigeria where the problem is reportedly endemic. Against this backdrop, the study examined, from both SMEs and banks' perspectives, the impact of firm and owner characteristics on access to formal external financing in the North Central Nigeria. The specific objectives of the study were to: (i) examine the nature of access to finance among SMEs in the North Central Nigeria; (ii) evaluate impact of firm specific characteristics on access to bank finance among SMEs in the North Central Nigeria; (iii) investigate if owner characteristics influence access to bank finance among SMEs in the North Central Nigeria; (iv) examine the firm specific factors influencing credit status of SMEs in the North Central Nigeria; (v) assess the owner factors determining credit status of SMEs in the North Central Nigeria; and (vi) determine the firm and owner characteristics influencing banks' credit approval for SMEs in the North central Nigeria. Data were drawn from the primary source through the adaption of World Bank and OECD Financial literacy questionnaires to elicit responses from the sampled SMEs owners/ managers and bank loan officers in study area. A sample of 280 SMEs and 207 loan officers were drawn from the population of 1030 SMEs and 448 banks respectively. Descriptive statistics, binary logit regression model with Marginal effect, ordered logit with average partial effect and Kruskal Wallis H were employed in analyzing the data. The findings of the study were:

- *(i) external credits are relatively less utilized for startup, working capital and acquisition of non-current asset due to the risk averse behaviour of banks in North central Nigeria;*
- *(ii) firm size, firm age, incorporation status, industry, financial information, firm location and firm collateral which are significant at 0.1,0.1,0.05,0.05, 0.01, 0.1 and 0.1 respectively, are the firm specific characteristics impacting on access to bank finance among SMEs. Whereas financial stability is insignificant at 0.01;*
- *(iii) owner's gender, owner's networking and relationship with bank are the owner characteristics influencing access to bank finance among SMEs, significant at 0.05, 0.1 and 0.1 respectively, and that owner's age, education, experience, financial literacy and personal wealth do not have significant influence on access to bank finance among SMEs in the region;*
- *(iv) firm size, industry, financial information, firm collateral and financial stability which are significant at 0.01,0.01,0.01,0.0, 0.01and 0.1 respectively, are the firm specific characteristics influencing the probability of not being credit constrained among SMEs in the region. Whereas firm age, incorporation status and firm location are insignificant;*
- *(v) owner's gender, owner's age, education, financial literacy, owner's networking and relationship with bank are the owner characteristics influencing the probability of not being credit constrained among SMEs in the region, significant at 0.01, 0.01, 0.01, 0.01, 0.01 and 0.05 respectively, and that owner's experience and personal wealth do not have significant influence on probability of not being credit constrained among SMEs in the region; and*
- *(vi) all the study's firm and owner's characteristics, which are all significant at 0.01, are the factors influencing banks' credit approval for SMEs in the North Central Nigeria*

The study concluded that SMEs in the North Central Nigeria encounter serious paucity of finance as they are virtually oblivious of, or not fully exploring all firm and owner related factors influencing their access to formal external finance from financial institutions. The study recommended that SMEs should fully explore all firm and owner factors, at individual level, for improved access to financial market. Also, they should synergise by forming strong alliance and solicit credits as a consortium rather than as individual units to facilitate better access and at relatively cheaper costs.

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CHAPTER ONE

INTRODUCTION

1.1 Background to the Study

Active participation of Small and Medium Enterprises (SMEs) in the financial market, through easy access to financial products and services, does not only enhance their growth but also leads to financial development which is widely recognized as an important determinant of economic growth.

SMEs occupy a center stage in the transformational activities of most national economies, developed and developing world over. This is not unconnected with the fact that SMEs are no doubt important catalysts for employment generation, poverty reduction and economic growth and development. Small and medium scale enterprises (SMEs) are lifeblood of most economies world over especially in Sub-Sahara Africa (SSA). On the average, SMEs represent over 90 percent of the enterprises and account for 50 to 60 percent of employment in most African countries (Ahiawodzi & Adade, 2012). For instance, in Tanzania, the contribution of SMEs to Gross Domestic Products (GDP) is ranked about one third and the sector represents 98 percent of the total Tanzanian enterprises which is estimated at approximately 2.7 million (Kira, 2013).

Similarly, Maina (2006) reported that SMEs in Kenya employ about 5.1 million people representing 74 percent of the total employment level and that 88 percent of the total jobs at any time are created by the sector. The sector also contributes approximately 24.5 percent to the Kenyan GDP. In Rwanda, more than 123,000 SMEs operate in the private sector, accounting for 98 percent of all businesses and 84% of private sector employment (Kira, 2013). In Uganda, 90 percent of the private businesses are dominated by SMEs and the sector contributes about 75 percent of the GDP and creates employment of

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approximately 2.5 million people in the country (African Development Bank, 2011). Also, Ntsika Enterprise Promotion Agency (2002) revealed that South African SMEs contribute 56 percent of private sector employment and accounts for 36 percent of the national GDP.

In Nigeria, about 80 percent of the country's labour force is employed by SMEs (Adelaja, 2007). It has equally been documented that SMEs provide 70 percent of the industrial sector employment and 60 percent of the agricultural sector employment (Odubanjo, 2001 and Usman, 2001 cited in Lawal & Ijaiya, 2007). According to Ahiawodzi and Adade (2012), SMEs have been described as efficient prolific job creator, the seed of big businesses and the fuel of national economic engine. As a matter of fact, the role of SMEs in the economic growth and development cannot be down played.

The Small and Medium Scale Enterprises (SMEs), since Nigeria's independence in 1960s and up to this current disposition, have been receiving necessary attention for playing very essential role towards fostering accelerated economic growth, development and stability (Ariyo, 1999). They represent the largest proportion of the businesses in the country and world over and they equally play tremendous roles in employment generation, provision of goods and services, creating a better standard of living as well as immensely contributing to gross domestic products (GDP) of many countries (Organisation for Economic Cooperation and Development (OECD, 2000). Also, Nnanna (2002) cited in Lawal and Ijaiya (2007) opined that the earlier view that SMEs belonged to the past has changed because the contributions of SMEs to industrial and economic growth of many countries have attracted global recognition.

The importance of contributions of SMEs around the world, and in particular Nigeria, has motivated greater supports for SMEs. For a developing economy, like Nigeria,

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whose economy is basically SME-driven, any investment in this sector is very crucial and deserves special consideration given the dominance and pervasiveness of SMEs couple with the fact that the bulk of economic activities are generated by this vibrant subsector.

Nevertheless, ability of the SME sector to contribute immensely to any economy is a function of its performance and growth (Olutunla & Obamuyi, 2008). Improved firm's performance ensures higher earnings, increment in sales volume, creation of employment and wealth maximization (Kira & He, 2012). However, firm performances can be unattainable if SMEs fail to access and easily use financing to support their investment opportunities (Mohamed, Sadek, Ghee, Abdullahi, Ismail, & Mustapha, 2015).

Finance is to business what blood is to human. Apparently, there exists a plethora of consensus that access to finance can transform the posture and performance of the SMEs sector, especially in the developing economies (Fatoki & Odeyemi, 2010; Kira & He 2012; Kira, 2013; Musamali & Tarus, 2013; Zarook, Rahman & Khanam, 2013; Solari, Morini-Marrero & Hernandez-Estarico, 2014). Access to finance stems from equity based finance, access to banking services, access to Non-Bank Financial Intermediaries (NBFIs), access to capital market to access to public (government) sector support incentives (Policy Board for Financial Services and Regulation 2001). Fatoki and Odeyemi (2010) also recognized trade credit as an integral aspect of external finance which the business enterprises ought to access. In fact, they see trade credit as playing a dominant role in the new venture creation process.

The implication of this is that the ability of SMEs to live up to performance and growth expectation depends heavily on the extent of financial access of the sector.

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Acknowledging the aforementioned fact, SMEs financing has been in the forefront of development agenda in Nigeria (Mordi, Anyanwu, Adebusuyi, Odey, Amoo, Mbutor, Adebayo, Akpan, Igue, Ibeagha, Belonwu & Zimboh, 2014). Broadly speaking, two categories of institutions have been actively involved in the credit delivery to SMEs in Nigeria, namely; the private sector-led institutions and the public sector-led institutions (Mordi *et al*, 2014). The private sector-led institutions are dominated by the Deposit Money Banks (DMBs) and the Micro Finance Institutions. The public sector-led institutions are dominated by specialized sectors' government intervention institutions established with a view to improving credit access by various SMEs. These comprise the various agencies and funding scheme established to support the private sector efforts in credit delivery to SMEs. These include inter alia, The Small Scale Industries Credit Scheme (SSICS), The Bank of Industry (BOI), The Bank of Agriculture (BOA), The World Bank SMEs I and II Loan Scheme, National Economic Reconstruction Fund (NERFUND), Small and Medium Enterprises Equity Investment Scheme (SMEEIS), N200 Billion Small and Medium Scale Enterprises Credit Guarantee Scheme (SMECGS), N200 billion Manufacturing Restructuring/Refinancing Facility, N200 billion Commercial Agricultural Credit Scheme (CACS) and The Nigerian Incentive-Based Risk Sharing System for Agricultural Lending (NIRSAL).

The formal private sector-led and public sector-led SMEs financing efforts become necessary given the limitations of informal finance such as money lenders and rotating credit and savings association, and semi-formal finance (cooperative societies, credit unions and so on), in providing external finance for business expansion (Ayyagari, Demirguc-Kunt, & Maskimovic, 2012; Solari, Morini-Marrero & Hernández-Estárico, 2014). Other external financing options such as corporate bonds and organised securities

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markets are typically out of reach for SMEs as their accessibility is only for larger firms requiring longer term funding (Beck, Demirguc-Kunt, & Martinez Peria, 2008).

When it comes to formal external financing to the higher end of SME market segment, banks, especially DMBs, MFIs and specialized banks, have a prominent role to play as key and dominant players in the financial system. Accordingly, the Nigerian banking sector underwent tremendous reforms including consolidation in December, 2005. One of cardinal rationales for bank consolidation is the need to promote credit delivery to the SMEs so that they can generate economic activities for the national economic growth (Mordi *et al*., 2014). Yet, SMEs are still plagued with myriads of problems, the major of which is finance. Finance is a major problem that has inhibited the growth of SMEs. Calomiris and Hubbard (1990) noted smaller companies encounter more restrictions on credit than their larger counterparts. Also, in accordance with Beck *et al*. (2008), small firms often experience more financing obstacles than medium and large enterprises. Smaller, younger and domestic—as opposed to foreign-owned—enterprises report more financing obstacles even after controlling for other firm characteristics.

Even after consolidation exercise, available information shows that credit delivery to SMEs has reduced significantly, due largely to the risk perception of the suppliers of formal finance including DMBs, MFIs and specialized banks. The SME subsector is very risky given their lack of formal financial history and adequate collateral; hence they are generally averse to extending credit to SMEs (Mordi *et al*., 2014). Some of the constraints of inadequate SMEs financing include inadequate collateral to secure loans from private credit institutions, poor feasibility studies and lack of equity contribution, among others. Also in line with the above reason, Ogunjiuba, Ohuche and Adenuga (2004) opined that the SMEs subsector's performance have fallen below expectation as a

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result of poor access to finance coupled with the risk-averse behaviour of Nigerian banks in funding SMEs.

Extant studies including firm–level data from the World Bank Enterprise survey over the years, reveal that financing inadequacy is a greater obstacle for SMEs than it is for large firms, particularly in the developing world, and that inaccessibility to finance constrains the growth of the SMEs sector more than that of large companies (Schiffer & Weder, 2001; Beck, Demirguc-Kunt, Martinez, 2008).

Apart from the macroeconomic environment, the legal and regulatory environment, the state of the financial sector infrastructure and the banks' internal limitations in terms of lending capacity and technology (Beck *et al*., 2008; Luper, 2012), banks also consider the SME-specific factors especially their landscape in terms of number, size, industry or sector of operation, collateral adequacy, the inadequacy of proprietary information on SMEs and so on (Beck *et al*., 2008). These SME- specific factors are important in gauging credit worthiness or magnitude of risk of the fund seeking SMEs. They are thus, seen as important determinants of asymmetric information and by extension SMEs' credit constraints. Hence, the extent to which these SME-specific characteristics explain access to formal bank finance and credit constraints by SMEs in the North Central Nigeria is the central thrust of this study.

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1.2 Statement of the Problem

The paucity of external finance to Nigerian SMEs, widely reported in research literature is a major problem to contend with. Notwithstanding the Nigerian banking sector reforms including consolidation since 2006, which implies that the Nigerian banks are now more capitalised and financially robust, available evidence shows that credit

delivery to SMEs has continued to plummet significantly. In spite of the supposed positive effect of bank consolidation, the loan portfolio of the Nigerian banks is more channeled to large companies and multinational institutions than the SME subsector (Ekpu, 2015). To corroborate this, World Bank statistics of 2014 shows that only 9.5 percent of Nigerian SMEs had a loan or line of credit in their books and SME lending made up only 5 percent of total deposit money banks' lending.

The situation is more worrisome in the North Central Nigeria where the World Bank survey (2014) reveals serious paucity of finance to SMEs in the region. For instance, the statistics of firms with a bank finance stand at 4.5 percent and 1.6 percent for Kwara state and Niger state respectively. Also, the proportion of investment finance by banks stands 7.0 percent and 1.6 percent for Kwara state and Niger state respectively. In terms of working capital financing, only 6.7 percent and 4.2 percent of the firms in those two states have access to bank financing.

This credit rationing phenomenon can be blamed on information asymmetry between the lenders and SME borrowers. This asymmetric information generates agency problems of adverse selection and moral hazard which thus impact on the availability of credits and capital structure of SMEs even in liberalised financial markets (Mordi *et al.*, 2014). Accordingly, SMEs observable characteristics (firm and owner) are crucial in resolving partly, information asymmetry problems for more improved credit delivery to SMEs (Beck, Demirguc-Kunt, & Martinez Peria, 2008; Mordi *et al.*, 2014).

Generally, due to their nature, most SMEs lack attractive firm and owner characteristics which are used by the formal external finance providers including banks, to gauge their credit worthiness.

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Vast majority of SMEs lack sellable firm characteristics for formal external financial access. For instance, in terms of firm age, younger firms experience hardship and prohibitive costs in accessing external financing from lenders as firm age reflects the persistence of firms to unpleasant economic circumstances (Le & Nguyen, 2009; Chandler, 2009). Also, because firm size is an inverse proxy for the probability of bankruptcy, SMEs might encounter financial challenge than their large counterparts (Honhyan, 2009). Similarly, the scourge might be explained with respect to incorporation status as large chunks of SMEs are unincorporated. In that regard, many SMEs may encounter paucity of external finance as incorporation is perceived to enhance financial credibility and formality of operation (Dietmar, Stahl & Woywode 1998 and Cassar, 2004).

More so, industry reflects how risky or profitable the fund seeking firm is (Barbosa & Moraes, 2004). Consequently, as the risk degree or level of profitability is the yardsticks for accessing external finance, SME firms in the high risk or less profitable industry experience more financial challenge. There is perceived bane on access to external finance as a result of poor financial information and inadequate collateral. This informs the risk averse behaviour of most banks due to the difficulty in resolving information asymmetry (Hyytinen & Parajarinen, 2008).

On the other hand, SMEs have been described in several empirical literature with financing challenges primarily due to the profiles of their owners, both social demographic and entrepreneurial. For instance, with respect to demographic characteristics, a number of studies (Abor, 2008; Pencil, 2015; Bellucci, Borisov & Zazzaro, 2009) have shown that external finance providers are age bias or gender bias in their credit delivery to SMEs. Similarly, the SMEs' financial constraint has been

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