

FINANCIAL NEEDS OF SMALL AND MEDIUM SCALE CONTRACTORS IN SOUTH AFRICA

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Abstract

Purpose: The financing needs of contractors, especially emerging contractors, needs to be explored. In the case of the SMME contracting sector, a type of “finance-PLUS” arrangement, which sees the lender or an intermediary offer additional support service to emerging enterprises, would be worth exploring. The study then describes the problems and experiences that have been encountered by Small and Medium Contractors with regards to financial access.

Methodology: Interviews were conducted and a questionnaire was sent out to different contractors who have been successful in the business for more than five years and also contractors who are currently struggling and trying to maintain themselves. Conclusions will be drawn from the analysis and recommendations will be made for further research.

Findings: The research conducted shows that the major factor that impedes the establishment and success of businesses is the lack of capital, which is ascribed to lack of own funds and a lack of assets, especially fixed assets, which could serve as security to obtain loans and bank overdrafts. The study also found that although there are different initiatives that are in place to assist small and medium size contractors but the problems and challenges are still there.

Research limitations: The scope of this study only focused small and medium size contractors in the Built Environment.

Value: The paper shows that small and medium size contractors continue to be unsustainable due to lack of access to capital. Previously disadvantaged individuals do not have adequate access to formal financial institutions and, therefore, are forced to seek relatively expensive (and often inadequate) amounts of credit from alternative financial intermediaries, sometimes illegally.

Keywords: small and medium enterprise, entrepreneurs, finance, agencies, private sector, investment.

Introduction

As important as recent political changes in South Africa, is the fundamental restructuring of the economy. Not only is there a need for an economic transformation to support the political changes, but also evenly vital is the fact that the community must feel that it has equal access to the economic mainstream. Throughout the world, one finds that SMME's are playing a critical role in absorbing labour, penetrating new markets and generally expanding economies in creative and innovative ways. Small businesses have a major role to play in the South African economy in terms of employment creation, income generation and output growth. Small, medium and micro enterprises (SMMEs) account for approximately 60% of all employment in the economy and 40% of output.

During the first and second year of business, some contractors ought to see themselves heading for financial trouble, 90 % of business owners would say no when they are ask if they are heading for a

financial trouble (Business Day, 2001). Many business owners would like to know what signs to watch out for, if his or her business is in trouble financially. For many business owners, the phone call from his or her bank manager is the alarm bell that tells them that their finances are not in good shape. In most cases, entrepreneurs will be watching their bank accounts (often with that sinking feeling that comes with expenditure exceeding revenue) but will not always know what is going wrong. That is why there are other measures that they to employ – and these measures need them to have some knowledge about where their business's money is. All types of businesses need capital before they start operating and even after – for expansion. Capital is needed to buy equipment, stock and to pay salaries, water, lights, rent and telephone bills.

Building Industry plays, a pivotal role in social development .The contribution of the industry stands the domestic, commercial, industrial and public sectors in a lot of ways which determines the size of the construction industry. It provides housing, infrastructure and utilities. The demands on the industry however have become more complex with growing needs and in more complex social order. In order to meet these demands, the building industry must be innovative so that it can adapt and find solutions to social needs. Most interest groups and policy makers as being of critical importance to South Africa's ability to address the serious problems of unemployment acknowledge the growth and development of the small, medium and micro-enterprise (SMME) sector.

This problem is even more prevalent mainly in the areas of the previously disadvantaged. After the political transformation of 1994, government adopted the White Paper on the National Strategy for the Development and Promotion of Small Business in South Africa (White paper, 1995). The Integrated Small Enterprise Development Strategy presents the way forward for small enterprise development in South Africa over the next ten years (i.e. 2005 to 2014). It is the result of a thorough process of review (Review of Ten Years of Small-Business Support in South Africa, 2001); consultation, research and refinement and also takes into account the changing economic context. This process has built upon the successes of government in macro-economic development and applies the experiences and lessons of the last ten years relating to small-enterprise promotion, while responding to the concerns raised by stakeholders within government, the private sector, organised labour and civil society. In particular, the strategy aims to address government's special development goals to improve equity in terms of race, gender and geographical location.

Types and Sources of Finance for Small and Medium Size Enterprises (SMMEs)

The market segmentation of SMMEs provides the basis upon which to assess the adequacy of financial service provision, both in terms of the products available, as well as the geographic spread of service providers. (Provincial and Local Financial News, 1999).

The formal financial sector - namely, commercial and merchant banks, factoring houses, leasing finance companies and equity financiers - serves mainly the small and medium enterprises. Some smaller banks, as well as some local branches of large commercial banks, also occasionally serve very small enterprises. Parastatals that retail finance have similarly focused largely on small and medium-sized companies. Thus the survivalist and micro enterprise sectors are largely reached only by NGOs and family-based financing. This is true of both debt and equity finance. (Business Day, 2000).

The key objectives can be summarised as follows:

- To increase the contribution of small contractors to the growth of the South African Construction economy,
- To create an enabling environment for small contractors with a level playing field between big business and small enterprises, that reduces the disparities between urban and rural contractors and is conducive to entrepreneurship,

- To create sustainable long-term jobs in the small enterprise construction sector,
- To ensure equitable access and participation in term of race, gender, disability, age, geographical location and the built environment,
- To increase the competitiveness of the built environment sector and its enabling environment so that it is better able to take advantage of opportunities emerging in national, African and international markets,
- To assist political leaders, government officials, SMME finance practitioners and SMMEs themselves in establishing a consensus on creative financing strategies.

Evaluation of Existing Programmes

The key constraints faced by formal financial institutions, both debt and equity financiers, in making SMME investments can be summarised in two categories.

Factors relating to debt and equity - These factors include high overhead costs in general; the administrative cost of extending small loans to SMMEs; the high risk of business failure; an exaggerated risk perception of SMMEs on the part of bankers and institutional investors; and returns on SMME investments that are considered low relative to the risk and cost of making the investment (Absa News, 2000).

Factors relating to debt - These factors include an inability to accurately assess the level of risk inherent in an SMME transaction; the lack of collateral of SMMEs, especially previously disadvantaged entrepreneurs; and the cost of registering and realising collateral (Absa News, 2000).

For alternative financial institutions, there are similar constraints.

Factors common to group and individual lending - These factors include the cost of extending loans to SMMEs; returns on SMME investments that are considered low relative to the risk and cost of making the investment; and the cost of establishing new infrastructure.

Factors relating to individual lending - These factors include the cost of registering and realising collateral; and the risk of business failure.

In recognition of these constraints, Khula Enterprise Finance Limited and Ntsika Enterprise Promotion Agency were established in 1996. The institutions' mandates were to establish programmes that would absorb a portion of the risk and cost of making SMME investments, as well as increase the delivery capacity of alternative financial institutions. The overall aim was to provide private and non-governmental institutions with an opportunity to learn how to make these investments profitably. While significant strides have been made by the implementing agencies in meeting their mandates, more rapid progress is required, especially with respect to appropriate non-financial service provision.

Other programmes

The IDC had previously reorienting its loan programmes to include an increased emphasis on small and medium sized enterprises (SMEs) in the manufacturing sector and announced a cut in interest rates for small and medium-sized manufacturing enterprises. With its experience in industrial financing and the provision of subsidised credit, as well as its significant capital base, the IDC is in many respects an ideal institution for channelling subsidies to SMEs. However, the IDC defines SMEs as enterprises with assets below R60 million. In terms of the National Small Business Act, the enterprises with assets up to R18 million are defined as medium-sized (National Small Business

Act, 1996). Thus, effectively, the IDC is still targeting large enterprises. The IDC should thus be encouraged to consider smaller enterprises than are currently served.

The Department of Trade and Industry also offers a host of other programmes and incentive schemes. One programme specifically tailored to small and medium sized manufacturing concerns is the Small Medium Manufacturing Development Programme (SMMDP), designed to encourage investment by SMEs. The programme essentially offers a rebate on a portion of the investment incurred over a period. While there has been great interest in the programme, previously disadvantaged entrepreneurs in particular have had difficulty in accessing it, as they have largely been unable to obtain the finance for the initial investment. There is thus a need for greater cooperation between Ntsika, Khula, the IDC and commercial banks with the SMMDP programme, so that an integrated support package can be developed.

Expand market opportunities for specific categories of small enterprises

Efforts in this sphere have to happen through the government's procurement process and the possible addition of sector-preferential "set-aside" schemes. The dti also proposes the selection of a few products frequently used by government departments, to be manufactured by small-scale manufacturers (NEF, 2003). Seda is to provide a deal brokerage service for the acquisition of machinery and equipment from local and international suppliers further supplemented by Khula, IDC and NEF support programmes and other dti incentives. (The dti, 2002)

Localise small-business support through a grid of Seda-co-ordinate information and advice-access points

The mandate of Seda is to design and implement a standardised delivery network that reaches all regions of the country and integrates government-funded small-enterprise support across all tiers of government.

Co-fund minimum business-infrastructure facilities in local-authority areas across the country

Essentially the integrated strategy has to link up closely with current Local Economic Development (LED) efforts in all municipalities, with government prepared to help mobilise core funding. While the strategy stresses that in each area the optimal mix of private-public and public partnerships will be different, it is the integration of the different support clusters. This can, if underpinned by significant resources and strong leadership via the dti, assure a meaningful acceleration of the process of SMME growth. (The DTI, 2005)

Improving access to markets

Current interventions to promote market access

Efforts have in the past concentrated on three broad areas, thus:

- spreading information about domestic (local, regional, national) market opportunities through business information centres and sector-focused information material,
- introducing and gradually expanding an elaborate system of affirmative procurement among public-sector enterprises and departments, combining preferential procurement with support services for SMME suppliers and
- incorporating SME interests and concerns in negotiations and practical steps around export promotion, trade liberalisation and import controls.

Towards a New Policy Framework

The Role of government and implementing agencies on the Built Environmental Sector National

- The Khula Credit Guarantee Scheme should be revised and expanded significantly to facilitate greater access to finance for entrepreneurs.

- There should be more non-financial support services, better tailored to the needs of financial intermediaries, so as to facilitate greater access to debt and equity finance for entrepreneurs.
- A wholesale equity programme should leverage capital for smaller, early stage and start up equity investments.
- Possible tax incentives for institutional investors should be investigated, to enhance investment in SMMEs through the JSE and equity funds.
- A model of large-scale delivery of SMME financial services, especially for rural areas, should be established.
- There should be an investigation into a process for credit rehabilitation for borrowers with bad credit records listed with NCA (National Credit Act) in association with the Department of Justice.
- Regional business incubation programmes should provide an integrated support package of finance, targeted subsidies, training, counselling, marketing assistance, business premises and technology assistance. The possible role of the IDC in the development of such programmes must be investigated.
- Specialised capacity building support (training, workshops and conferences) should be provided based on local and international best practice in areas such as individual lending methodologies for alternative and formal financial institutions and small scale and start up equity investments for equity financiers.
- There should be a review of the impact of interest rates on SMMEs, and their contribution to business failure.

Provincial

- There should be a review of the mandates of Provincial Development Corporations, particularly with respect to their pricing policies, the SMME and industry sectors targeted the range of products and their suitability for the local context and provincial development strategies.
- The role of the SBDC in the respective provinces should be assessed, and regional management should be approached regarding the SBDC's fulfilment of targets.
- There should be an assessment of geographical areas in each province where there is a lack of SMME service delivery infrastructure as a basis to engage with Khula and Ntsika.
- Closer relationships with regional bank officials should be established, and provincial accounts placed with banks demonstrating the greatest commitment to SMME sector.

Local

- The Peruvian model of municipal banks should be considered as a means of better serving small contractors who are self employed.
- Information about bank services at the local level should be gathered by means of guidelines and survey questionnaire.
- Relationships with local bank officials should be established, and municipal accounts placed with banks demonstrating the greatest commitment to the SMME sector.
- Local SMMEs should be supported through the provision of advisory and information services.

Private Sector Contribution

Commercial banks

- Each financial institution should adopt targets for using the Khula Credit Guarantee Facility.
- Each institution should introduce a training scheme for staff and management, on SMME lending.

- Each institution should make financial contributions to non-financial support services such as mentoring and counselling.
- Each institution should clearly publicize its strategy for expanding financial services to unserved areas and should make full information available about services at branches.
- Each institution should establish a strategy on how its infrastructure can be shared by alternative financial institutions.
- Each institution should disclose information on lending to SMMEs, according to race, gender, geography, loan size and purpose.

Alternative financial institutions

- Alternative financial institutions should adopt Khula industry standards.
- Alternative institutions should enhance their efficiency and should lend at reasonable interest rate levels, within the constraints dictated by sustainability.
- There should be research into, and publication of, successful individual loan methodologies, through micro lender associations.
- A comprehensive data base should be established describing institutions serving the SMME sector and publish information about products, terms and conditions.
- There should be comprehensive disclosure of information on SMME lending.
- The alternative financial institutions should help establish their own ombudsman function to investigate and mediate disputes.
- Alternative financial institutions should consider innovative ways of sharing infrastructure and achieving economies of scale.

Equity financiers

- The major equity financiers, including the JSE and large institutional investors, should improve, and develop new, specialised equity funds for small-scale equity investments.
- The Venture Capital Association should be revitalised, and should publish literature (in all 11-eleven official languages) on equity products for SMMEs.
- The equity financiers should initiate an education campaign on how SMMEs can raise capital.
- The equity financiers should disclose information on SMME investments.
- The equity financiers should look into the establishment of new JSE vehicles listing SMEs.

Monitoring and Evaluation

- An annual report on small business financing should be jointly produced by the Reserve Bank of South Africa, the Financial Services Board and Ntsika Enterprise Promotion Agency.
- An annual round table discussion should commence between the Minister of Trade and Industry, the formal financial sector, institutional investors, NGO financiers and representatives of SMME borrowers, this should be done on a yearly base.
- Local and provincial government should provide ongoing reviews of the implementation of the policy in their respective areas.
- Private sector investment in socially and economically productive sectors should be monitored by the Department of Trade and Industry.
- Performance reviews of Khula, Ntsika and the SBDC should occur and be made public.
- There should be progress reports to MINMEC, Parliament and stakeholders.

Current Challenges

Overcoming the challenge of access to finance by emerging contractors is the aim of the current and on-going engagement between partners to the National Contractor Development Programme (NCDP) and the banking and financing sector.

Business Counseling and Aftercare

This Programme should be aimed at the provision of assistance to owners of SMME's on inter alia, General Management, Finance, Productivity, Appropriate Technology, advice, Business Plan Compilation, Book- keeping, Marketing and Personnel Related Matters.

Capacity building for infrastructure delivery for the Small Building Sector

This Programme should be aimed at enabling the small and emerging building contractors to participate in a meaningful way in the RDP Programme and should include:

- (a) Skills Transfer
- (b) Skills Training
- (c) Consultations/Management Training
- (d) Productivity

Conclusion

The government has a crucial role to play in creating the policy framework for development and to bring about a fair distribution of resources; government should not be the main agent for development. Government should rather create conditions conducive to entrepreneurial and private sector development. Given the vast development problems partnerships between the public and private sectors, NGO's (National Government Organisations), labour unions and all organs of civil society are essential. Let us apply our collective ingenuity to address South Africa's development problems and to make our country internationally competitive. This sector represents an important vehicle to address the challenges mentioned. Throughout the world, one finds the SMME's are playing a critical role in absorbing labour, penetrating new markets and generally expanding economies in creative and innovative ways. It is the author's view that with an appropriate enabling environment- SMME's should be seen as part of an integrated strategy to promote a diversified economy and where entrepreneurship flourishes.

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