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Financing Preferences of Micro, Small and Medium Enterprises – Does Pecking Order Theory Explain?

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Abstract

Determining financial structure of Micro, Small and Medium Enterprises (MSMEs) is a complex task. The owners and managers either procure their own funds or avail credit in order to inject money into their businesses. This study intends to evaluate financing preferences of the small firm owners; also it aims to explore the financing behaviour of enterprises with respect to pecking order theory. The relationship between financing preferences and other independent variables such as education of the firm owner, gender of the firm owner and type of establishment ownership has been evaluated in the study. The data was collected from the 104 MSME owners of National Capital Region of India. Through structured questionnaire, responses were analysed with the help of chi-square test and multiple regression analysis. The study concluded that the MSMEs hold pecking order theory true and educated company owners are willing to prefer external mode of finance over internal funds. Also, the decision of opting for internal equity finance can be affected by the education of MSME owner and its ownership type. The research therefore tries to contribute to the better explanation of financing behaviour of enterprise owners.

Keywords: Entrepreneurial Financing, MSME, Financing Behaviour, Pecking Order Theory

Introduction

The Micro, Small and Medium Enterprises (MSMEs) encourage entrepreneurship and industrialisation and simultaneously play a role of catalysts in overall growth of economy. They also promote socio-economic development across the nation and significantly contribute to the gross output and national income. In India, "Micro, Small and Medium Enterprises Development (MSMED) Act, 2006" defines the entrepreneurial sector and provide business enabling environment to the entrepreneurs in the form of structural and legislative framework. Being the backbone of the country, the MSME sector is critical for the administration and therefore, immense attention is always given to this key area of the economy, in the form of legislation and institutional support; infrastructural and financial support, with numerous schemes and outreach programs.

MSMEs faces numerous problems, from initiation to survival, as explained by Yadav and Tripathi (2018), the obstacles such as product manufacturing and marketing related challenges, technological interventions and advancements, changes in bureaucracy and economic infrastructure, labour and raw material related shortages and many more; but insufficient and timely finance remains the most critical challenge for the entrepreneurs ofevery age and era (Nishanth.P & A., 2014; Kannan & Sudalaimuthu, 2014). While there is no denying of the enormous potential of this sector, it is also the need of hour to evaluate the ever occurring financing constraints of the MSMEs (Kumar & Rao, 2016). As Uma(2013) stated that when it comes to weaknesses of firms, lack of financial strength is one of the most fragile area of this industrial and service sector. Also argued by Cook (2001), finance plays a crucial role in progress of small enterprises and when it comes to source of finance, India's MSMEs are mostly self - financed or sometimes they depend on informal sources of external financing.

The lack of formal financing arises from the gap between MSMEs and financial intermediaries; factors such as huge administrative costs, inadequate collateral and lack of familiarity or participation within financial institutions together form the reasons behind existence of such finance gap (Kumar & Rao, 2016; Kannan & Sudalaimuthu, 2014). The finance gap can be explained as the difference between potential demand of formal credit and existing supply of formal credit (OECD, 2006). As per the report of IFC (2018) the constraints of demand side in formal lending can broadly be divided into three categories, namely 'High Information Asymmetry' which also includes the quality of financial literacy of the owners, 'Existing Debt' of MSMEs and 'Insufficient Collateral'. The financial markets of developing economies are generally found weak and inefficient as compared to developed economies, adding to that, the lack of information symmetry and existing debt makes it extremely difficult for financial institutions to provide funds easily (Gebru, 2009). As per Hamilton and Fox (2016), this deficiency of funds impacts the demand side and its capital structure in a crude way and then the owners of MSMEs have to finance their business or projects accordingly.

The decision of choice of financing depends on possibility and accessibility of various financing sources in the financial system; significantly, it also depends on preferences of the owners (Kuruppu & Azeez, 2016). The Indian MSMEs are mostly found dependent on informal finance and they generate credit heavily from the informal sources or personal networks (Sengupta, 2019). According to Bose (2013), the reason behind attraction of MSMEs towards informal lending options is because of absence of strenuous documentation and presence of trust and confidence in informal sources and therefore, MSMEs approach to such lending conveniently. Generally the small enterprise financing initiates from personal funds, retained earnings or monetary assistance from friends or family (Wu., Song, & Zeng, 2008). This kind of behaviour of small entrepreneurs can be linked to pecking order theory introduced and developed by Myers (1984), where a due order of preferred financing technique is explained

Financing Behaviour & Preferences of Micro, Small and Medium Enterprises

The decision of financing, of making a choice or combination of choices, to invest funds in the business idea, is the foremost critical area for any entrepreneur. As Ralph Waldo Emerson said “Money often costs too much”; therefore, the business managers and owners put maximum attention and effort while selecting the source of financing for their business (Thampy, 2010). In the recent history, there is constant developments of many different theories which directly or indirectly contribute to the explanation of SME financing behaviour, as summarised and explained by Johnsen and McMahon(2005); namely “Static Trade-off Theory, Agency Theory, Life-cycle Theory, Bootstrapping Explanations and Pecking Order Theory”. From the above mentioned financing theories, the paper focuses on Pecking Order Hypothesis (POH), the oldest among all and first proposed by Myers(1984), which probably also explains the financing decision making process of Indian MSME owners.

While classifying capital structure theories, Myers (1984) called pecking order theory as an orthodox framework, where it is believed that the firms shall always prefer internal financing over external financing and if the external financing is about making a choice between debt and equity, firms will favour debt over equity i.e. firms will prefer the security involving least risk. If we look at the literature on the pecking order, prior to Myers (1984), it can be found in the work of Donaldson (1961), where while studying the financing methods of business corporations, he found that the owners of business entities favoured internal funds for injecting money into growth and did not procure external funds till unavoidable circumstances. Pecking order theory also advocates that external sources of financing will not be prioritised, until internal funds are worn out or spent entirely (Abdulsaleh & Worthington, 2013). As confirmed by Aabi (2014) information asymmetries existing in the financial markets are particularly responsible for the framework of pecking order and its existence. Adding to this, the study by Holmes and Kent (1991) implies that small firm owners prefer internal source of finance in order to save their claim in ownership.

In empirical studies, the pecking order theory has been found standing true by many researchers; Gebru (2009) confirmed that pecking order theory holds true for MSMEs of Tigray state, the author concluded that the financing practices and choices of MSMEs majorly depends on various factors such as education, type of ownership etc. and the business owners prefer internal funds over external financing while funding their businesses. Zoppa and McMahon (2002) also confirmed that pecking order theory holds true for Australian manufacturing businesses. Similarly, after analysing samples obtained from 53 SMEs from Portugal interior region, Serrasquerio and Caetano (2014) indicated that debt and profitability are negatively related to each other and firms do prefer internal funds over external funds. Pecking order theory has its dominance in explaining and predicting financing behaviour of small enterprises sector and it can be confirmed from the numerous studies of Lemmon and Zender (2010); Beck, Demirgüç-Kunt and Maksimovic(2008); Frank and Goyal (2003).

The existence of information asymmetry between owners and lenders creates numerous hurdles for firms in obtaining external credit or finance for business initiation or growth(Biswas, Srivastava, & Kumar, 2018). From reviewing literature, it can be said that scholars have found significant effect of education level, gender of the entrepreneur, firm's age, size of the firm, structure of ownership, business sector, region of operation and number of employees on financing decision making process of MSMEs (Kuruppu & Azeez, 2016; Gebru, 2009; Kumar & Rao, 2016). In India, the enterprises are also found keen to borrow from friends and relatives, if they were to avail external credit; the inclination towards banks and government schemes or grants is proven somewhere less attractive for them (Kathuria & Mamta, 2012).

In our view, after having close interactions with entrepreneurs of urban areas, following are the research questions, we intend to investigate thoroughly from the perspective of demand side i.e. owners/managers of MSMEs – Does education, gender and ownership type influence the financing choices and preferences of MSME owners? Does capital structure and financing decisions of owners conform to Pecking Order Theory? Do MSME owners have a pattern of preferences while choosing from the external financing options available to them? What are the factors which affect the MSME owners' choice of internal equity finance?

Research Methodology

Research Data: The study is based upon the financing behaviour and capital structure preferences of MSMEs, the target population belongs to the micro, small and medium enterprises owners of urban areas of National Capital Region. After few brief discussions and dialogues, the firm owners and managers were interviewed with the help of set of self-structured questions, the questionnaire was constructed in both the languages, English as well as Hindi; considering the comfort ability of firm owners. The responses were collected from 104 firm owners and is analysed with the help of SPSS software.

Independent and Dependent Variables: The financing preferences of MSME owners is a dependent variable, where the respondents were asked to rank between 1 to 3, where 1 represented financing preference towards Internal Equity Finance, 2 represented financing preference towards External Debt Finance and 3 represented External Equity Finance. The independent variables are characteristics of MSME owners such as education, ownership type and gender. The summary statistics of variables is shown in Table 1.

Objectives and Hypotheses Development: The objective of this paper is to confirm whether MSME owners and their financing practices follow Pecking Order Theory. Apart from confirming pecking order theory, the study also aims to assess the relationship of financing preference with dependent variables.

The data is also tested on the following hypotheses:

1.HA0: There is no association between the financing preferences of MSMEs with respect to education of the MSME owner, gender of the MSME owner and type of MSME ownership.

HA1: There is an association between the financing preferences of MSMEs with respect to education of the MSME owner, gender of the MSME owner and type of MSME ownership.

2.HB0: Education of the MSME owner, gender of the MSME owner and type of MSME ownership does not affect the choice of internal equity financing.

HB1: Education of the MSME owner, gender of the MSME owner and type of MSME ownership does affect the choice of internal equity financing.

Data Analysis and Discussion

Table 1

Summary Statistics of Independent Variables

Variable	Mean	S.E. (Mean)	Median	Range
Gender(1=Male,2=Female)	1.16	0.036	1	1
Education (1=Higher Secondary, 2=Technical and Vocational, 3=Diploma, 4=Graduate, 5=Post Graduate)	3.92	0.16	5	4
Type of Industry (1=Manufacturing, 2=Service)	1.38	0.048	1	1
Type of Enterprise (1=Micro Enterprise, 2=Small Enterprise, 3=Medium Enterprise)	1.34	0.052	1	2
Type of Ownership (1=Sole Proprietorship, 2=Partnership, 3=Joint Hindu Family, 4=Co-operative, 5=Company)	1.53	0.113	1	4
Years of Existence of Firm (1=1 year to 3 years, 2=3 years to 5 years, 3=5years to 10 years, 4=10 years and more)	4.20	0.101	5	3
Registered Business (1=Yes, 2=No)	1.21	0.040	1	1

The responses collected from MSME owners are recorded and analysed on SPSS Software. The study is concluded on the basis of inferential and descriptive statistics. Non parametric test i.e. Chi-Square Test is applied, in order to determine the association between financing preferences with other independent variables (such as gender and education of the owners and type of firm ownership). The pecking order theory is confirmed with the help of a descriptive analysis of ranks, representing financing preferences of the firm owners. Multiple regression is also applied to anticipate the factors causing MSME owners to choose internal equity finance as their financing preference.

The Spearman's Rank Correlation (Table 2) indicates that education variable is positively correlated with type of enterprise variable (representing micro, small and medium enterprise classification) at the significance level of 0.05, since $r = 0.326$, $p = 0.015$. Similarly, education variable is also positively correlated with type of ownership variable at the significance level of 0.01, $r = 0.349$, $p = 0.009$. The medium enterprises are found to be owned by mostly educated owners, whereas least educated owners run their firms on financially low scale (micro enterprises); Also, highly educated owners run their businesses in the mode of company and least educated owners prefer sole proprietorship citing complete control and ownership reason.

Table 2
Spearman's Correlation

	indtype	owntype	yrex	entype	edu
indtype	1				
owntype	0.111	1			
yrex	-0.239	-0.101	1		
entype	-0.297	0.235	-0.81	1	
edu	0.087	0.349*	-0.311	0.326*	1

*(Notes: indtype= type of industry, owntype= type of ownership, yrex= years of existence, entype= type of enterprise, edu= education of the owner, *= positive correlation between the variables)*

Pecking Order Theory and MSMEs The respondents were asked to rank their financing preferences, considering they are choosing funds for a new business or a project or for the purpose of growth of the current business. Out of 104 respondents, 84 owners gave priority rank to 'Internal Equity Finance', second rank to 'External Debt Finance' and third rank to 'External Equity Finance'. While, 15 owners ranked 'External Debt Finance' as their first choice, 'External Equity Finance' as their second choice and 'Internal Equity Finance' as their third choice amongst financing alternatives. The remaining 5 owners were found giving response in a way, where they indicated to choose 'External Debt Finance' over 'Internal Equity Finance' and 'External Equity Finance'.

Almost one third of the sample population preferred Internal Equity Finance over External Debt or Equity Finance. The following Table 3 confirms pecking order theory behaviour of Micro, Small and Medium Enterprises; the firm owners are found inclined towards Internal Finance rather than any sort of External Finance.

Table 3

Preferred Ranks of Financing of MSME Owners

Internal Equity Finance	External Debt Finance	External Equity Finance	Number of Respondents
1	2	3	**84**
3	1	2	**15**
2	1	3	**5**

The Pearson Chi Square of cross tabulation of Education of the MSME owner and their Financing Preferences is 16.938, the p value obtained is 0.031 (Table 4) which is smaller than the chosen significance level (α=0.05); therefore we reject null hypothesis and conclude that there is significant association between education of the MSME owner and their financing preferences. The cross tabulation between 'Gender' of MSME owner and their financing preferences shows that the strength of female entrepreneurs is very less as compared to male entrepreneurs. The Pearson Chi Square is 1.580 and P=0.454 which is quite higher than the significance level (α=0.05). Therefore, considering this enough evidence, we accept the null hypothesis and conclude that there is no association between gender of entrepreneur and their financing preferences. It can also be explained as gender of the owner does not really impact the financing preferences of MSMEs.

Table 4

Pearson Chi Square Test

	Value	df	Significance
Education and Financing Preferences	16.938	8	**0.031**
Gender and Financing Preferences	1.580	2	**0.454**
Ownership Type and Financing Preferences	17.160	6	**0.009**

The entrepreneurs who run their organisations in the form of company are more keen to prefer external finance before internal finance; but the sole proprietors, they firmly believe in choosing finance internally first (Table 4). The Pearson Chi Square is 17.160 and at the significant level (α=0.05), P=0.009, hence we reject the null hypothesis and it can be said that there is significant association between 'Type of Ownership' and 'Financing Behaviour' of firms.

The decision of internal equity financing can be explained with the independent factors such as gender and education of the owner and the type of ownership of the firm. The multiple regression was conducted to anticipate the decision of procuring internal funds from education of the MSME owner, gender of the MSME owner and ownership type of MSME as shown in Table 5. These independent variables predicted that internal equity financing, $F(3,100) = 9.704$. $p < 0.0005$, $R2 = 0.225$ (Table 6). Out of all three variables, education and ownership type adds significance to the anticipation at $p < 0.05$ as shown in Table 7.

Table 5 Model Summary

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	0.475	0.225	0.202	0.474

Table 6 ANOVA

Model 1	Sum of Squares	df	Mean Square	F	Sig.
Regression	6.537	3	2.179	9.704	0.000
Residual	22.454	100	0.225		
Total	28.990	103			

Table 7 Coefficients

	Unstandardized Coefficients		Std. Coeff.		
Model	B	Std. Error	B	t	Sig.
Constant	0.530	0.216		2.455	0.16
Education of the Owner	0.097	0.028	0.310	3.508	0.001
Ownership Type	0.163	0.041	0.356	3.964	0.000
Gender of the Owners	0.067	0.129	0.047	0.520	0.604

Therefore, the data analysis assist us in forming three major inferences: 1. that the financing pattern of MSME owners confirms pecking order theory, which implies that before picking up finance from external sources, the owners prefer procuring the funds internally, may be from owner's funds or from retained earnings. Also, when it shall come to external finance, the owners will choose external loan-debt funds over external equity funds; this may be because either they are comfortable with loan interest rates or they do not want a contributor in equity. 2. There is a significant association between financing preferences and education of the owners, the well-educated MSME owners are found more willing to procure funds externally as compared to less-educated owners; similarly the association between financing preferences and MSME ownership type can be explained as in the sole proprietors do not seem keen to lend funds externally but the company owners may prefer external funds over internal equity funds. 3. The financing preference of internal equity finance gets affected by the education of the MSME owner and the type of ownership of the entity.

Conclusion

The paper stresses upon the financing behaviour and preferences of MSME Owners. The investigation is done to know and interpret entrepreneurial financing practices on the basis of various independent factors such as education, gender and ownership type. Also, the study confirms pecking order theory holds true for MSMEs. It has been found that owners who chose external financing as their priority, such owners belong to highly educated bracket, whereas people who are less educated, they all are inclined towards internal financing. It clearly depicts how education plays a crucial role in determining financing behaviour of entrepreneurs. The less educated owners run finance in their business conventionally that i.e. by relying on internal finance rather than external finance; therefore it is evident that the less educated firm owners follow the thumb rule of pecking order theory diligently; whereas those who do not prefer only internal financing options as a matter of priority, belongs to highly educated background. Same is the case with type of ownership of firms and their financing behaviour; the firms who run their business in the mode of company, they chose external choice of finance over internal choice of finance. Firms managed and owned by single owner or in partnership are reluctant to prefer external finance over internal finance. The companies are usually run by educated owners whereas it has been found that less educated entrepreneurs run their firms in the mode of sole proprietorship.

This paper also tried to find an association between gender of the owners and their financing preferences but the results depicts otherwise. There is no such relationship is found between the gender of the owner or how it influences financing behaviour of the firms. Lastly, the two factors that are education and ownership type significantly contributes to the decision making of internal equity finance. The confirmation of pecking order theory of MSMEs of National Capital Region of India can further be investigated in order to determine the reasons and causes of such behaviour which influences MSME owner's decision of preferring internal finance especially in the case of sole proprietors and micro enterprises.

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