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Analysis of Formal and Informal Sources of Entrepreneurial Financing on the Performance of MSMEs in Lagos, Nigeria

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Abstract

Micro, Small and Medium Enterprises (MSMEs) have been recognised as one of the drivers of economic growth in developed and developing economies. It contributes significantly to employment generation and Gross Domestic Products (GDP). However, in view of the current financial crisis experienced by many economies, due to outbreak of COVID-19 pandemic, many economies have witnessed significant decline in finance flow to MSMEs, thus creating a funding gap for their operations. The study analysed the effect of formal source of finance (Bank Loan) and informal source of finance (Trade Credit) on the performance of MSMEs. The study's objectives are to examine the effect of Bank Loan (BL) on profitability of MSMEs and effect of Trade Credit (TC) on sales turnover. Survey research design was employed on registered MSMEs in Lagos State with a sample size of six hundred and sixty-five (665) determined using Cochran's formula from the population of registered MSMEs in Lagos State. Data were obtained through Primary sources with the use of structured questionnaire using simple random technique. Analysis was done using descriptive and inferential statistics. The results showed that TC had $\beta = 0.891$; $R^2 = 0.828$; t-value = 35.642; $p < 0.05$ while BL with $\beta = 0.775$; $R^2 = 0.638$; t-value = 33.894 and $p < 0.05$; respectively. This revealed that TC has stronger effect on MSMEs' performance than BL indicating that MSMEs make more profit through TC than BL. The study recommends that, financial policy that ensures availability and accessibility of loans to MSMEs through Deposit Money Banks should be developed as well as creating awareness for alternative micro credit schemes that could cushion the effect of Covid-19 on the performance of MSMEs.

Background to the Study

There has been a significant reduction in equity and debt finance flows to MSMEs as a result of the current financial crisis faced by many countries. (Bhaumik, Fraser & Wright, 2015). Consequently, there are concerns that these financing gaps may be hindering enterprise performance as a result of an on-going economic recovery especially due to outbreak of Covid-19 recently experienced globally. It has been identified in literatures that one of the problems associated with the entrepreneurial decision-making strategy on the adequate choice of external source finance to enhance business performance is to identify the right financial sources either formal or informal (Bhaumik, Fraser & Wright, 2015; Chemmanur & Fulghieri, 2010). In addition, there has been extant literature on entrepreneurial finance, its methodology and approach to business enterprise which could enhance business performance, however, there is a gap that less attention has been given to various techniques of financing business enterprise and financial options that are available for the entrepreneurs to adequately finance their business operations to achieve optimum performance (Maleki, 2015).

In Nigeria, MSMEs constitute 90% of businesses, 84% employment and contribute 48% of the national Gross Domestic Products (National Bureau of Statistics (NBS) & Small and Medium Enterprise Development Agency of Nigeria (SMEDAN), 2019; Olukanni, 2020). MSMEs have also been described as the engine room for economic transformation and industrialization (SMEDAN, 2019). According to Price Water Coopers (2020), contributes 96% of the total businesses in Nigeria; 50% to GDP; 76.5% employment, 32.1% financing gap for MSMEs.

Despite the contributions of MSMEs to Nigeria economy, challenges such as inadequate working capital, intense competition from large enterprises, difficulties in accessing raw materials, low-capacity utilization, inadequate managerial skills, low literacy level of the business owners, unconducive business environment, political instability among others hinder the development and performance of MSMEs (Olukanni, 2020; SMEDAN, 2019; Ayedun & Asikhia, 2018). Most of these businesses find it difficult to access the funds as a result of insufficient collateral and bureaucratic processes when applying for laons. (Olukanni, 2020; Ayedun, 2019). Notwithstanding all these challenges which are enormous before the outbreak of the current pandemic that affected the performance of MSMEs, the financing of businesses becomes more worrisome. The lockdown as result of Covid-19 became "new normal" which eventually hinder most of these MSMEs to experience business failure as a result of inability to access required finance for the business, unable to access needed raw materials for production which eventually make some of them to shut down operations, thus affecting their performance.

One of the major sources of financing for small business enterprises is Trade credit (Ayedun & Ashikia, 2018). The problem of inconsistent track record of profitability by small businesses and inadequate assets that can be used as security have been addressed by past researchers (Bitler *et. al.,* 2001; Laitinen, 2017; Odebunmi, Afolabi, Agboola & Adekunle, 2017; Osano & Languitone, 2016). Trade credit as a strategy of increasing sales turnover by many suppliers have discovered that smaller enterprises that are usually cash constrained do not have adequate capital to make payment on purchase and are essential to collect their goods. (Coleman, 2005). Consequently, the flow of goods from the supplier is unpredictable and this affects the sales turnover of the entrepreneur. The cost of transaction of trade credit which is relatively high (supply side) that is available to enterprises negatively affects the volume of stocks to be released to the entrepreneur as well as the sales turnover. This is as a result of cost associated with ascertaining the credit worthiness of less established business enterprise as well as information asymmetry (Chemmanur & Fulghieri, 2010; Coleman, 2005; Cowton & San-Jose, 2016; Fatoki & Odeyemi, 2010). The challenge of short-term tenor associated with trade credit is also a hindrance to effective performance of MSMEs. The tenure of trade credit availed to business enterprises ranges between 1-3 months. Wilson and Summers (2002) posit that trade credit is considered to be a costly financing source if payments were not made within the given credit window of "2/10 net 30". It implies that 2% discount payment within 10- day discount period, the net period ends on 30 days. The gap identified in the literature as regards trade credit is that its effect on sales turnover was only considered and addressed from the supply side. However, the effect of trade credit on sales turnover on the demand side (entrepreneur) has not been properly addressed, thus necessitating the research question that how does trade credit influence the sales turnover of MSMEs in achieving enterprise performance? Is it causing a decrease, increase or no effect on the sales turnover of the business enterprise?

The financing gap being experienced by MSMEs to boost their performance has been a challenge, also, access to finance by entrepreneurs has become a serious issue as they have to rely on Deposit Money Banks (DMB) and other financial institutions for investment financing. This constraint is more pronounced among the very small enterprises, with 59% of small enterprises reporting difficulties in accessing finance. About 35% of medium firms and 11% of the large enterprises are facing difficulties with access to credit (CBN, 2014). As a result of high rate of default, liquidity crunch and absence of collateral by MSMEs, Deposit Money Banks do not want to lend to MSMEs unlike other sectors (Mordi, Anyanwu, Adebusuyi, Odey & Amoo, 2014). Records have shown that the DMBs prefer to lend to other sector of the economy than MSMEs sector and this usually has negative effect on enterprise performance. The statistics from the Central Bank of Nigeria (CBN) report (2017) show that Deposit Money Banks' (DMBs) loans and advances to MSMEs' sector have been on the decline over the years in Nigeria. The issues of high interest rate on commercial banks' loan, liquidity, information asymmetry, bureaucratic credit process have negative effect in accessing bank loans to support their performance and profitability (Akinola, 2013). The study sought to analyse the effect of formal sources of finance (Bank Loan) and informal source of finance (Trade Credit) on the performance of MSMEs. The study's objectives were to; examine effect of Bank Loan (BL) on profitability of MSMEs and effect of Trade Credit (TC) on sales turnover.

Hypotheses

Cole (2010); Cunat and Garcia- Appendini (2012) affirmed the significant relationship between trade credit and firm's liquidity. Supporting this view, Beck, Pamuk, Uras and Ramrattan (2015); Coleman (2005); Fatoki and Odeyemi (2014), established a positive relationship between managerial competencies, business size, availability of business plan and previous relationship on access to trade credit by MSMEs. The firm's owner characteristics by Coleman (2005); working capital, demand cost and inventory decision by Luo and Shang (2014); Socio-economic characteristics have a positive relationship on sales. In addition, a positive relationship has been established between trade credit and credit worthiness of an entrepreneur for bank loans (Burkart, Ellingsen & Giannetti, 2011; Garcia-Appendini & Montoriol-Garriga, 2013; Fabbri, Maria & Menichini, 2010; Saito & Bandeira, 2010; Yano, Shiraishi & Hu, 2013). A positive effect of trade credit on private firms' performance have been established by Sun and Sun (2011) measured by return on asset. On the other hand. Collombatto, Melenik and Monticone (2011) established a negative relationship between trade credit and perceived risk. Also, a negative relationship has been established between trade credit and business policies and regulations (Breza & Liberman, 2013). As a result of these conflicting findings from various studies, it is thus hypothesised that:

Hypothesis One: Trade credit does not have effect on sales turnover of MSMEs.

Bank loans have been found to be consistently associated with positive long-term outcomes (Shaffer & Sokolyk, 2013), bank size and credit flow to business of different categories (Berger, Frame & Miller, 2005; Morris, Basat, Das, Ramachandran & Koshy, 2001; Sufians & Habibullah, 2010), bank competition and credit availability for MSMEs (Banerjee, Cole & Duflo, 2013; Carbo-Valverde, Rodriguez-Fernandez & Udell, 2009; Thampy, 2010), bank loans, age and size of the business (Olotula & Obamuyi, 2008; Venkatesan & Nagarajan, 2012). Also, informal sources of financing such as credit cards and trade credit from banks have been found to be positively affect the working capital of MSMEs (He & Baker, 2007). Corroborating this position, Abiodun, Peter and Utomi (2015) showed that there exists a positive relationship between banks' investments and financing working capital policies and profitability of MSMEs. However, Durkin, McGowan and Babb (2013) identified that the relationship between small businesses and their banks appears to be much damaged resulting in low profitability with the use of bank loans (Bhattacharya, Faiz & Zohir, 2000). Supporting this position, Shahchera and Taaheri (2015) found a negative and significant coefficient of loans to MSMEs on banks' profitability. The efficient use of bank loans as a measure of profitability of MSMEs has not been properly investigated. Thus, it is hypothesized that:

Hypothesis Two: Bank loans do not have significant effect on the profitability of MSMEs.

Review of Literature

Alhabeeb(2015) defines Entrepreneurial finance as the application of fundamental financial principles and theories in the domain of businesses. The author further stated that Entrepreneurial finance involves adopting those principles and theories for planning, starting up, operating, growing and sustaining, valuing and harvesting businesses. The need to raise capital to actualise business objectives have been realized by many business owners (Maleki, 2015). Thus, investors, banks, business angel, a venture capital fund trade credit and other sources of financing must be sought for by business owners. (Chen, 2010; Moghadam, Salamzadeh & Yousefiyar, 2014). The underpinning theory of this study is Resource-Based-View (RBV). The proponents of RBV are Wernerfelt (1984); Hamel and Prahalad (1989); Barney (1991) in his work on firm resources and sustained competitive advantage. According to the theory, an organisation must have distinctive, and non-substitutable resources to have a sustainable competitive advantage, and everything internal to the organisation must be included in this resources that enables them to achieve greater organisational performance. Asikihia (2016) notes that RBV is one of the strongest theoretical foundations used to explain MSMEs performance. Supporting this position, Jurevicius (2013) also states that the RBV is a model that sees resources as key to superior firm performance. The author further stated if an organisation shows distinctive and non-substitutable attributes, it enables the organisations to achieve sustainable comparative advantage.

Empirical evidences by Burkart, Ellingsen and Giannetti (2011); Garcia-Appendini and Montoriol-Garriga (2013); Fabbri, Maria and Menichini (2010); Saito and Bandeira (2010); Yano, Shiraishi and Hu (2013), trade credit, to ascertain credit worthiness of businesses revealed that, there is a positive significant effect on the availability of trade credit is used by banks as a certification of the creditworthiness of a firm (Garcia-Appendini & Montoriol-Garriga, 2013), the use of trade credit is related to the nature of the transacted goods (Burkart, Ellingsen & Giannetti, 2011). Fabbri, Maria and Menichini (2010) found that firms may be using trade credit as a way to foster sales and also find some evidence of trade credit given and trade credit taken being strongly correlated. Supporting this view, Yano, Shiraishi and Hu (2013), in their studies, found that trade credit has a positive effect on entrepreneurial investment, while development of bank finance has low impact on promotion of private investment. Saito and Bandeira (2010), also found that trade credit can be used to denote the quality of a firm and a means of facilitating accessibility to bank loans as trade credit seems to be a substitute for bank loans. This corroborates the findings of Alphonse, Ducret and Severin (2006) who established that registered organisations use bank loans and trade credit as two major formal sources of financing.

Furthermore, Fraser, Bhaumik and Wright (2015); Kerr and Nanda (2009); Tang (2014); Wilson (2014) carried out a study on the use of bank loans and trade credit in enhancing the profitability. A positive significant effect was established that MSMEs make use of make use of trade credit as a substitute for bank loans. Subsequently, Kerr and Nanda (2009), found that enterprise plays a linking role in a country's financial market performance to its economic growth.

Similarly, empirical evidence showed that finance contributes to a reasonable extent to the success of MSMEs. (Asikhia, 2010; Mbaegbu & Gbandi, 2014; Ogujiuba *et al.,* 2004). In Nigeria, majority of MSMEs do not have sufficient capital to sustain their businesses due to their inability to access funds and may lead to the death of businesses. Mbaegbu and

Gbandi (2014), in their correlational study on commercial bank's credit to MSMEs and sustainable development in Nigeria, found a positive correlation the percentage of commercial banks' credits and the GDP rate over a period of two decades.

Methodology

Survey research design was adopted in analysis the effect of formal source of finance (Bank Loan) and informal source of finance (Trade Credit) on the performance of MSMEs. Primary data were collected from registered MSMEs in Lagos State with a sample size of six hundred and sixty-five (665) determined using Cochran's formula from the population of 3,224,324 registered MSMEs in Lagos as at 2017 (SMEDAN Report 2019). Administration of structured questionnaire on the respondents using simple random technique. Data were analysed using descriptive (mean, frequencies) and inferential Partial Least Square (PLS-2.0 M3) statistics.

Results of Findings

From the data collected for this study, responses on awareness of trade credit as informal finance source for MSMEs in Lagos Nigeria showed that 90.5% were aware of trade credit which suggested that the MSMEs owners were not ignorant of existence of TC. However, few of the respondents (9.5%) disagreed with the use of TC. Responses from the respondents on issue of getting TC from suppliers as external financing source for their businesses showed that an average of 71% of the MSMEs accessed trade credit from suppliers, while 29% claimed that they have not been using TC to boost their sales turnover. This established that most of the MSMEs in Lagos State Nigeria are getting financial support in form of trade credit from the manufacturers or the suppliers in enhancing business performance. In Nigeria, it was found that the average credit window of TC offered by suppliers is 30-90days. Majority of the respondents agreed that TC has improved their businesses greatly. This corroborated the result of Yano and Shiraishi (2012) that MSMEs have the opportunity to thrive as a result of access to TC. The findings also showed that increase in volume of sales turnover as a result of trade credit had availed them the opportunity to access bank loans because of improved transactions with the banks and inventory turnover.

Table 1: Descriptive Analysis of the effect of TC on SL

Variable	N	Minimum	Maximum	Mean	Std. Dev.
TC	665	1.00	6.00	4.2788	1.17170
ST	665	1.00	6.00	4.0255	1.20342

Source: Researcher's Field Survey (2020)

The result of the descriptive analysis in this study revealed that variable trade credit had mean of 4. 279; SD of 1.172; sales turnover had mean of 4.0255; SD of 1.20342. In line with the rating scale, the result indicated that the MSMEs partially agreed with the effect of trade credit on sales turnover, revealing that it partially has high influence on sales turnover. On the effect of bank loans on the profitability of MSMEs, majority (69.8%) of the respondents have business relationship with Deposit Money Banks, while 30.2% did not have relationship with banks which may be attributed to size of the business, low literacy level and lack of collateral. The results further revealed that 53.9% of them have accessed loans from banks at one time or the other. On the contrary, 46.1% stated that they have not accessed loans from banks as a result of interest rates on bank loans which are not moderate and affordable. Furthermore, the study found that bank loan is a good alternative formal source of finance for MSMEs as a result of strong capital base of the DMB. Although, the study affirmed that it is not cheaper to finance MSMEs through bank loans with 53.1% of the respondents supporting this view, while 46.9% of them considered it to be a cheaper financing source. This could be attributed to higher interest rates and other administrative costs attached to it. Information gathered from this study revealed that 54.5% of the MSMEs agreed that financial support from banks had improved their profitability. On the contrary,45.5% of the respondents claimed that financial support from banks has no effect on profitability of the business. The findings showed that bank loan (BL) on profitability (PR) showed a moderate effect of loans on profitability of MSMEs. Majority of entrepreneurs have business relationships with the banks and have accessed loans from them to improve business performance. Although, it was generally agreed that interest on loans is relatively high and loan processes are cumbersome. As a result of high cost of funds attached to bank loans and other conditions, the profitability level of MSMEs is being affected.

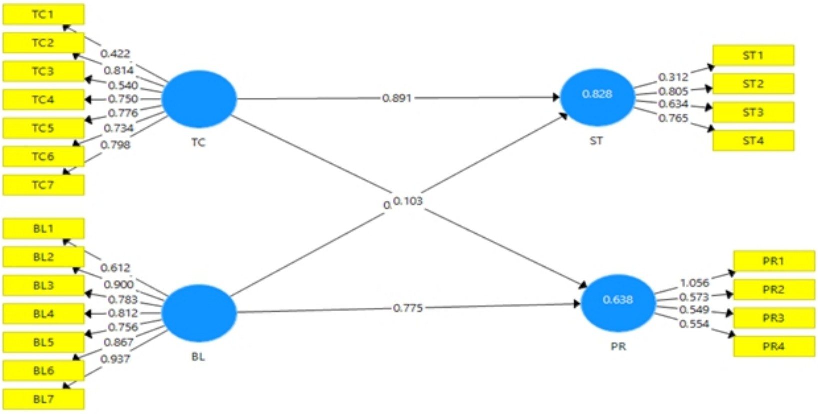
Table 2: Descriptive Analysis of effect of BL on PR

Variable	N	Minimum	Maximum	Mean	Std. Dev.
BL	665	1.00	6.00	3.4835	1.46000
PR	665	1.00	6.00	3.6385	1.33520

Source: Researcher's Field Survey (2020)

Findings on the effect of bank loans on profitability of MSMEs in Nigeria showed that bank loan had a mean value of 3.4835; SD of 1.4600 while profitability had a mean value of 3.6385 and SD of 1.33520. This showed that there is a moderate effect of bank loans on profitability of MSMEs. The result for the test of hypotheses using Partial Least Square (M3) is represented below:

Figure 1: PLS M3, 2020



Source: Survey Research, 2020

The results revealed that the effect of Trade Credit (TC) on independent variable, Sales Turnover (ST) demonstrated evidence of significant effect with ((β =0.891; R^2 = 0.828; t-value = 35.642; $p < 0.05$). The p-value signifies that the model using the predictor did a good job of predicting the outcome of the variables. It also showed a significant effect of TC on ST. Since the t-value was greater than or equal to 1.96 at 5% significant level as the decision rule for this study with their p-values ($P <0.05$), therefore, hypothesis $H0_1$ is rejected. The result indicated that the higher the volume of trade credit, the higher the sales turnover.

Table 3: Results of Hypothesis I: Effect of Trade Credit on Sales Turnover

Hypothesis	Beta	Std. Error	R^2	T-Statistics	P-Value	Decision
TC -> ST	0.891	0.021	0.82848	35.642	0.000	Supported

Source: Researchers' Field Survey Results, (2020)
Note: * P<0.05, Indicates the item is significant at 5% significant level

Test of hypothesis two; the effect of Bank Loan (BL) on Profitability (PR) revealed a positive significant effect among the variables with (β = 0.775; R^2 = 0.638; t = 32.894; $p < 0.05$). The result revealed that 63.8% of the variation in Enterprise Performance (EP) of MSMEs is explained by the variation in bank loan. Therefore, 36.2% of variation in enterprise performance is described by other factors not in the model. It was obvious that the above hypothesis met the decision criteria earlier set for this study and thus, showing evidence of significant positive effect since $p < 0.05$ which signifies that the model using bank loan did a good job of predicting the outcome of the variables.

Table 4: Results of Hypothesis II

Hypothesis	Beta	Std. Error	R^2	T-Statistics	P-Value	Decision
BL -> PR	0.775	0.025	0.63843	32.894	0.000	Supported

Source: Researcher's Field Survey (2020)
Note: * P<0.05, Indicates the item is significant at 5% significant level.

Since the t-value of 32.894 was greater than 1.96 at 5% significant level as the decision rule for this study with their p-values (P <0.05), thus, hypothesis $H0_2$ is rejected that, bank loan does not have significant effect profitability of MSMEs. The result indicated that the greater the volume of loans available to MSMEs, the higher the profitability of the business enterprise.

Discussion

Trade credit could be regarded as a reliable informal source of enterprise finance that could be harnessed by MSMEs in Nigeria. The results emphasised the position of Abdulaziz and Worthington (2013); Fatoki and Odeyemi (2010) that TC is a good alternative source of finance for enterprises as a result of agreement for a delay in payment for goods and services. In addition, the results corroborated the findings of Nguyen (2011) who found provision of TC has a significant influence on growth of sales turnover, and business enterprises that benefit more from trade credit realise higher growth rate and sales turnover. The results further emphasised the position of Krugon, Nagaraju and Narayanan (2014) who found that it has become customary for manufacturers to provide TC to retailers as part of enhancing the sales turnover. With the relatively strong contribution of trade credit to sales turnover. However, there is need for the MSMEs to consider negotiation for favourable terms of payment with their suppliers as emphasised by Lamptey, Frimpong and Morrison (2017). Suppliers of trade credit are somehow conscious about the cost of extending trade credit to MSMEs, and as a result, they tend to spread the cost on the terms of payment in order not to run at a loss. It is thus, expedient for the MSMEs to properly understand the terms and conditions associated with TC. This corroborated the findings of Cunat and Garcia-Appendini (2012) who found suppliers offer TC that allows buyers to delay payment for a specific period of time as a means of financing their businesses. The findings also corroborated the findings of Coleman (2005) that in the absence of collateral by small businesses and inconsistent credit history, sales turnover is These another avenue of accessing financial support from the bank. findings suggest that, considering the economic and financial situation of many developing economies for Post-Covid- 19, the MSMEs can explore use of TC for enhanced performance.

This study further revealed that banks loans contribute significantly to the performance of MSMEs in Lagos, Nigeria. This corroborated the empirical work of Olotula and Obamuyi (2008); Venkatesan and Nagarajan (2012). They also found that for high profitability, increase in the volume of loans availed MSMEs. In addition, it emphasised the work of Dana, Mertens and Mensah (2017) in their study of MSMEs financing and bank's profitability and found that bank loans have positive significant contribution to MSMEs profitability. This position was further emphasized by Mbaegbu and Gbandi (2014) who in their correlational study on bank's loan to MSMEs and sustainable development, established a positive linear relationship between percentage of commercial bank's loan and GDP rate over a period of two decades which indicated that as the percentage of credits to MSMEs increased, the GDP rate also increased.

The empirical results further emphasised the findings of Bruton, Khavul and Chavez (2011); De Castro, Khavul and Bruton (2014); Fatoki and Odeyemi (2010) who found that existing businesses and start-ups entrepreneurs try to access loans from banks as a result of information asymmetry, higher interest rates, inadequate collaterals and cumbersome credit policies. As a result of the above position, it was established that MSMEs are not finding it easy to get financial supports from banks in order to enhance their performances.

In addition, bureaucratic process of accessing loans from banks could be attributed to the organisational structure and the quality of manpower put in place by most deposit money banks, which serves as a control measure to guide against assets loss or high rate of default. This also emphasised the work of Khartik and Varghesa (2011) who observed that profitability level of a business enterprise depends on utilisation of manpower resources. Other factor that could be responsible for the variation in the level of performance of MSMEs using bank loans is the low level of profitability by banks when dealing with MSMEs.

Conclusion and Recommendations

As emanated from this study, it could be recommended that, financial policy that ensures availability and accessibility of loans to MSMEs through Deposit Money Banks at acceptable terms and conditions should be developed by Nigerian Government that could cushion the effect of Covid-19 on the performance of MSMEs. Since many of the MSMEs made use of trade credits than bank loans, the Government of Nigeria should create more awareness about the releases of some intervention funds for MSMEs through CBN and Bank of the Industry (BOI) For example, MSMEs survival funds, MSMEs intervention funds, Trader's Money, fashion funds for operators in the fashion industry, start-up funds for National Youth Service Corps (NYSC) through BOI among others. Furthermore, the formal financial sector needs to further sensitize the operators in the MSMEs sector on the need for them to establish a financial relationship with Nigerian Banks. Although, majority (69.8%) of the MSMEs claimed to have relationship with any of the Nigerian banks, there is a need to improve on this result because evidence of their business activities with banks in terms of their sales turnover from statements of accounts are also important requirement for accessing funds from the government. It is also a basis for establishing credit worthiness of an entrepreneur for a trade credit from their suppliers. Further studies should focus on other sources of financing such as cooperative, micro-credit agency, venture capital, private equity, crowdfunding, business angel among others to support MSMEs' financing in Nigeria as Post Covid-19 measures.

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