

A narrative analysis of formal financial institutions' financing of new enterprises in South Africa

**Author:**Francis T. Asah¹ **Affiliation:**

¹Department of Management Practice, Faculty of Business and Economic Sciences, Nelson Mandela University, Port Elizabeth, South Africa

Corresponding author:

Francis Asah,
francis.asah@mandela.ac.za

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Background: South Africa needs more than one million new small and medium enterprises (SMEs) that can create approximately 10 million new jobs to reduce the unemployment rate below 10%, as new SMEs significantly contribute to economic growth.

Aim: This study explored how formal financial institutions (FFIs) perceive financing new SMEs, the credit approval rate for new SMEs, the credit criteria that influence the willingness of FFIs to finance new SMEs and the challenges experienced by FFIs in financing new SMEs.

Setting: This study focused on the eight largest FFIs in South Africa. Because external equity and venture capital are expensive and seldom available to new SMEs, new SMEs tend to rely on cheap debt from FFIs.

Methods: A qualitative research approach positioned in the interpretivist paradigm was used to achieve the research objectives. Data were collected from 16 participants using semi-structured in-depth interviews and analysed using the five-step process of content analysis by Terre Blanche, Durrheim and Kelly.

Results: The findings revealed that although FFIs perceive new SME financing to be highly risky, SMEs also provide potential business opportunities. In addition, equity contribution and credit profiles of new SME owners are the most important criteria that influence the willingness of FFIs to finance new SMEs.

Conclusion: With sufficient financial support from FFIs, South Africa's development issues can be addressed since the creation and sustainability of new SMEs is vital to the country's economic prosperity.

Contribution: This study contributes to the knowledge base on new SME financing in South Africa from a supply-side perspective.

Keywords: formal financial institutions; supply-side; qualitative; credit; new SMEs.

Introduction

The perspectives of Fajarika, Trapsilawati and Sopha (2024) and Joensuu-Salo, Viljamaa and Kangas (2023) on entrepreneurship acknowledge that if small and medium enterprises (SMEs) did not exist, it would be necessary to create them because they are a driving force in the creation of new jobs, poverty reduction and economic growth in every economy. New SMEs can be defined as SMEs that have been in existence for less than 42 months (Global Entrepreneurship Monitor [GEM] 2024; Small Enterprise Development Agency [SEDA] 2020). New SME creation, according to Asah (2019), is pivotal to the growth and sustainability of the South African economy and the stability of the country's socio-political environment, currently characterised by low economic growth and a high unemployment rate. FinMark Trust (2024) notes that South Africa needs more than one million new SMEs to create approximately 10 million new jobs to meet the National Development Plan of reducing the unemployment rate below 10% by the year 2030. Without the creation of new SMEs, Asah (2019) points out that South Africa risks economic stagnation. As such, the government of South Africa has designed support programmes such as SEDA and the National Empowerment Fund (NEF) to support new SME development with services such as business training, writing a good business plan and small business credits (SEDA 2020).

According to contemporary literature (Estrin, Korosteleva & Mickiewicz 2022; Jin & Liu 2024), Schumpeter was one of the earliest prominent economists to argue in 1934 that new SMEs are the engine behind the progress of capitalism. According to Estrin et al. (2022), the innovative activity of new SMEs feeds a creative 'destruction process' by causing constant disturbances to an economic system in equilibrium, creating opportunities for economic benefits not only for other

new SMEs but also for established firms. In adjusting to equilibrium, other innovations are spun off and new businesses enter the economic system. These new SMEs introduce new products, bring competitive pressure to bear on established businesses and develop new technologies (Bresser-Pereira & Oreiro 2024). In accordance with Schumpeter, new SMEs are the panacea to South Africa's development issues since the creation and sustainability of new SMEs are vital to the country's economic prosperity (GEM 2024).

Despite the noted importance of new SMEs highlighted precedingly, the creation rate of new SMEs in South Africa is ranked one of the lowest in the world. In recent years, the level of total early-stage entrepreneurial activity (primary measure of new business creation) in South Africa has been fluctuating from 17.5% in 2021 to 8.5% in 2022, and then up to 11.1% in 2023. This was below the average rate (11.4%) of all the efficiency-driven economies (developing countries), as well as the average for all middle- to low-income countries (13.2%), where South Africa belongs (GEM 2024). These statistics are consistent with the 2024 World Bank report on entrepreneurship, which states that South Africa has a lower-than-expected creation rate for new businesses, which is contrary to the situation in most developed economies, such as the United States of America and Europe, where entrepreneurship has flourished significantly in the past decades.

Besides the low creation rate of new SMEs, South Africa also experiences a high failure rate of these new SMEs. The GEM (2024) report on entrepreneurship advances that the prospect of new SMEs surviving beyond 42 months in South Africa is lower than in any other country sampled by GEM. Empirical literature emphasises that the high failure rate of new SMEs in South Africa at 75% implies that government and policy-makers should be seriously concerned about the state of entrepreneurship (Asah 2019; Asah, Louw & Williams 2020; Enaifoghe & Vezi-Magigaba 2023; Kruger, Dickason & Meyer 2020). Enaifoghe and Vezi-Magigaba (2023) conceptualise entrepreneurship as the creation and sustainability of new SMEs.

The creation and sustenance of new businesses in South Africa over the past decade (2014–2024) has been a considerable challenge for entrepreneurs. Literature reveals that the non-availability of formal sector financing is the most important constraint to the creation and development of new SMEs (Asah & Louw 2021; Asah et al. 2020; GEM 2024; Kruger et al. 2020; Turyakira 2018). Less than 20% of new SMEs in developing economies have access to formal sector finance (Mhlongo & Daya 2023; Turyakira 2018; World Bank 2024). In addition, limited access to credit from formal financial institutions (FFIs) is the most serious constraint to new SME development (Enaifoghe & Vezi-Magigaba 2023; Fajarika et al. 2024; GEM 2024; Mhlongo & Daya 2023). If new SMEs are the prime vehicle to help South Africa address its developmental challenges, and most new SME owners raise their start-up and running capital from personal or family

savings, which are often insufficient for growth and survival, then why is it that less than 20% of SMEs have access to financial support from FFIs in South Africa? Enaifoghe and Vezi-Magigaba (2023) observe that the lack of venture capital funds makes most new SMEs depend on bank loans and overdrafts for early-stage financing. Empirical studies (Asah & Hove-Sibanda 2024; Asah et al. 2020; Enaifoghe & Vezi-Magigaba 2023; Jin & Liu 2024) emphasise that the risk-averse attitude of FFIs is a prime reason why new SMEs struggle to access credit from them. Given the lack of empirical evidence from extant literature using qualitative methodology from a supply-side perspective in South Africa (Almansour, Almansour & Almansour 2019; Asah et al. 2020; Batrancea et al. 2022; Mmbengeni, Mavhungu & John 2021), this study seeks to investigate FFI financing of new SMEs in South Africa. With this research aim, the article explores how FFIs perceive new SMEs financing, the credit approval rate for new SMEs and the credit criteria that influence the willingness of FFIs to finance new SMEs in South Africa. The article also explores the challenges experienced by FFIs in financing new SMEs.

Literature review

Capital structure theories note that equity and debt are the two primary sources of external capital for new SMEs, as internal capital (owners' equity and retained earnings) is often insufficient for growth and survival (Riaz, Jinghong & Akhtar 2021). External equity (venture capital or the stock exchange) is usually expensive and not available to new SMEs because of the high transaction, flotation and other costs involved. The pecking order theory (POT) of Stiglitz and Weiss (1981) warns that new SMEs should avoid using external equity because it increases the weighted average costs of capital and might have a negative impact on the enterprise's performance. Because new SMEs usually obtain cheap external debt from FFIs as advocated by the capital structure theories (Enaifoghe & Vezi-Magigaba 2023; Riaz et al. 2021), most FFIs have become hesitant to lend to new SMEs.

While the static trade-off theory (STOT) of Modigliani and Miller (1958, 1963) advocates that new enterprises seeking finance should take absolute advantage of the tax shield and aim for 100% debt in their capital structure (taking into consideration the assumptions of this theory), POT argues that there is no well-defined optimal capital structure. Along with Jensen and Meckling (1976), STOT (also referred to as tax-based theory) suggests that the optimal capital structure of an enterprise is obtained when the net tax advantage of debt financing balances leverage-related costs such as transaction costs, financial distress and bankruptcy, while holding the enterprise's assets and investment decisions constant. Considering STOT, issuing equity will mean moving away from the optimum capital structure, which is, in effect, considered to be a wrong decision. Therefore, new enterprises rely heavily on credit from FFIs to finance their operations. Mmbengeni et al. (2021) also note that FFIs have become very risk-averse when considering financing new

SMEs in South Africa. Pecking order theory refers to this phenomenon as capital rationing.

Given that contemporary literature (Amoa-Gyarteng & Dhliwayo 2022; Batrancea et al. 2022; Enaifoghe & Vezi-Magigaba 2023) notes that the largeness, competitiveness and profitability of the SME sector present business opportunities that are of strategic importance to FFIs, the question which remains unanswered is: How do FFIs perceive investment in new SMEs in South Africa? Esubalew and Raghurama (2020), along with Jin and Liu (2024), argue that the financing gap (capital rationing) for new SMEs is caused by their lack of investment readiness. From the viewpoint of Amoa-Gyarteng and Dhliwayo (2022), FFIs are hesitant to invest in new SMEs because new SMEs are financially unstable. However, Jin and Liu (2024) challenge this view by arguing that information asymmetry is the main reason behind the capital rationing behaviour of FFIs. Batrancea et al. (2022) emphasise that FFIs are cautious about financing new SMEs because of the limited financial and credit information available to assess their credit merit and lending risk. According to Jin and Liu (2024), low levels of accountability for credit, a lack of credible collateral, a lack of transparency and market risks resulting from imperfect market conditions are some of the reasons why FFIs adopt credit-rationing behaviour. In addition, Asah et al. (2020) and Asah and Hove-Sibanda (2024) note that the availability of information arising from imperfections involved in new SMEs' lending and the opacity of borrowers also contribute significantly to the credit-rationing behaviour of FFIs in South Africa.

The World Bank (2024) advances that FFIs are not geared to finance new SMEs in developing countries such as South Africa because they have developed in an economy dominated by established and large firms. As such, they do not have the required skill set and tools to assess new SMEs. Furthermore, FFIs are not able to network effectively with new SME owners because of the poor quality of communication and low levels of understanding of these SME business owners (Amadasun & Mutezo 2025). Other challenges faced by FFIs in their credit decision-making process relate to assessing non-performing credit because of weak credit analysis and lending technologies (Bresser-Pereira & Oreiro 2024).

Asah et al. (2020) and Asah and Louw (2021) allude to the fact that inadequate financing of new SMEs in developing countries such as South Africa is primarily influenced by requirements determined and controlled by FFIs. According to SEDA (2020), these requirements are the reason for credit rationing and the high credit rejection rate. Credit rationing has left most new SMEs unable to understand what the FFIs' credit requirements are for financing a new SME, or which criteria FFIs use to assess a new business's creditworthiness. The current study sought to contribute to the body of knowledge on new SME financing by providing an insightful perspective from FFI credit and business managers to achieve the study's research objectives. A qualitative research

approach offers rich insights into the phenomena, which will help improve new SMEs' access to FFI finance and help to reduce the high failure rate of new SMEs in South Africa.

Methods

To achieve the objectives of this study, a qualitative research approach positioned in the interpretivist research paradigm (Collis & Hussey 2014) was implemented because it provided the researcher the opportunity to better comprehend the views of business and credit managers on how FFIs perceive new SME financing, the credit approval rate for new SMEs, the credit criteria that influence the willingness of FFIs to finance new SMEs and the challenges experienced by FFIs in financing new SMEs in South Africa. Adopting a qualitative approach for this study also helped the researcher to understand the perspective of the credit and business managers on why most new SMEs struggle to access credit from FFIs. The interpretivist research paradigm theorises that reality is subjective and is constructed through individual interpretations of and experiences within a phenomenon of interest. Given that credit policies of FFIs are formulated by business and credit managers based on their experiences and knowledge, it was therefore vital that the researcher provided insights into their experiences and knowledge of credit issues to better educate new SME owners.

Therefore, using a qualitative research approach enabled the researcher to conduct an in-depth enquiry into the financing of new SMEs by FFIs. The eight largest FFIs responsible for about 91% of all assets and about 85% of all liabilities in the commercial banking sector in South Africa were the focus of this study (Banking Association of South Africa 2023). Head office banks were the point of contact because they are responsible for enlisting all the requirements and policy documents that guide lending decisions for business and credit managers at the branch level. Furthermore, the business and credit managers at head office banks have more knowledge of and experience in drafting and instigating lending decisions.

The concept of 'information power' was used by the researcher to determine the sample size of the study. This means that when the sample size holds a larger information power, the sample size needs to be lower and vice versa (Bengtsson 2016). For this reason, interviewing head office credit and business managers would yield more insights than interviews with branch office credit and business managers. The eight FFIs employ about 106 business and credit managers in the Gauteng province. Purposive sampling was used to select participants from the eight FFIs at the head office banks. Purposive sampling is a non-probability sampling that involves the identification and selection of participants who are proficient, knowledgeable and well-informed about a phenomenon of interest. Identifying participants who possess the right knowledge and experience, according to Collis and Hussey (2014), is fundamental to the achievement of the study's objectives, which also contributes significantly to

a greater comprehension of the theoretical understanding of the study, leading to rich, focused data. Taking into consideration the requirements and code of practice governing credit lending in each FFI, interviewing more than one business manager and one credit manager from a single institution at the head office banks would normally lead to data saturation. Therefore, a credit and a business manager were interviewed from each institution, giving a total of eight business managers and eight credit managers who voluntarily accepted being interviewed.

Data collection

Data for this study were collected from November 2021 to May 2022 using face-to-face in-depth interviews (conducted in English). Each interview took about 45–60 min. The interview guide (research instrument) was divided into five sections. Section A contained the demographic characteristics of participants. Sections B, C and D focused respectively on how FFIs perceive financing new SMEs, the credit approval rate, the credit criteria and challenges experienced by FFIs in assessing credit applications from new SMEs. Section E focused on improving new SMEs' access to credit. The data collected were transcribed, analysed and then stored according to the ethical guidelines. The analysed data were also resubmitted to the participants to enhance the credibility and legitimacy of the findings.

Data analysis

The five-step process of content analysis, explained by Terre Blanche, Durrheim and Kelly (2006), was used. This involved familiarisation and immersion, in which the researcher became familiar with the data by listening to the interview recordings and then transcribing them word-for-word. This was followed by reading and re-reading each transcribed text, repeatedly listening to the audio recordings, making notes and developing portraits and reflective notes to gain an in-depth understanding of the diversity of the interviews. Recurrent themes were identified to inform the research of the frequency (the number of times a theme is mentioned), and these were ranked from the most important to the least important, as shown in Table 2 and Table 3. Themes were induced by identifying key words, chunks of text and recurring ideas relating to credit assessment, evaluation and approval, and were then grouped into themes and sub-themes. Coding (identifying and grouping aspects of the data that relate to the research problem) occurred simultaneously with developing categories. During elaboration, the themes were more closely explored, which allowed the researcher to revise the coding system and build a picture of the data as a whole, and interpretation and checking (examining the different themes for possible meaning and relationships) took place when analysing the data.

Qualitative research criteria and limitations

Reliability and validity are fundamental quality criteria in qualitative research. Therefore, the qualitative data analysis

was evaluated against the qualitative 'quality research criteria' (Collis & Hussey 2014) of credibility (internal validity), confirmability (objectivity), dependability (reliability) and transferability (external validity). A transparent and detailed description of the analysis and research process, backed by a sound research design and data analysis, contributed to the quality of the research findings. The researcher's immense knowledge of the subject and the participants' expertise contributed to the credibility and dependability of the research findings, as credibility establishes confidence (value and believability) in the findings and trust with the research participants, as noted by Bengtsson (2016). In addition, the researcher is experienced, well-educated and highly skilled in conducting research and interviews in both academic and professional settings. Adopting a reflexive approach enhances the trustworthiness of the research findings. Regarding transferability of the research findings, the study was conducted at the head offices of eight selected FFIs located in the Gauteng province. This means that the findings cannot be generalised to other FFIs operating in South Africa or to other developing countries.

Ethical considerations

Concerning research ethical clearance, written permission was first obtained from each FFI, and an ethics approval letter was later obtained from the Department of Management Ethics Committee at Rhodes University (Ref: 2018 MAN 01.03). In addition, all research participants signed a consent form. The participants were guaranteed anonymity, confidentiality and the possibility to withdraw from participating at any time.

Results

Interviews were conducted with eight business managers (PB₁ to PB₈) and eight credit managers (PC₁ to PC₈). Nine of the study participants (56%) were male (four business managers and five credit managers), while seven (44%) were female (three credit managers and four business managers). Moreover, 12 (75%) of the 16 participants had at least a bachelor's degree, nine (56%) were aged between 35 years and 40 years, and 13 (81%) had more than 10 years of banking experience. Complete demographic information is provided in Table 1. The research findings, aligned with addressing the research objectives, are presented in the following sections.

Perceptions of formal financial institutions regarding the financing of new small and medium enterprises

This study sought to explore how FFIs perceive the financing of new SMEs. To achieve this objective, participants were first asked whether they give credit to new businesses. The findings show that six of the eight FFIs in this study do not give out business credit to new businesses that have not had a business account with them for at least 5 years. Owing to the coronavirus disease 2019 (COVID-19) pandemic, the participants from these six institutions explained that their institutions had decided to temporarily suspend the

TABLE 1: Biographical information of participants.

Participant code	Nationality	Gender	Age range (years)	Ethnic group	Current position	Current position duration (years)	Highest level of education
PC ₁	South African	Male	35–40	Black person	Credit manager	5	Degree
PC ₂	South African	Female	30–34	Black person	Credit manager	3	Diploma
PC ₃	South African	Male	41–45	White person	Credit manager	7	Degree
PC ₄	South African	Male	35–40	Black person	Credit manager	6	Degree
PC ₅	South African	Female	35–40	Black person	Credit manager	6	Adv. diploma
PC ₆	South African	Male	41–45	Black person	Credit manager	4	Degree
PC ₇	South African	Female	35–40	Black person	Credit manager	6	Degree
PC ₈	South African	Male	35–40	Black person	Credit manager	6	Degree
PB ₁	South African	Female	35–40	Black person	Business manager	7	Degree
PB ₂	South African	Female	35–40	White person	Business manager	4	Degree
PB ₃	South African	Female	30–34	Indian person	Business manager	5	Postgraduate Degree
PB ₄	South African	Male	50–55	White person	Business manager	11	Matric
PB ₅	South African	Male	41–45	White person	Business manager	5	Degree
PB ₆	South African	Female	41–45	Black person	Business manager	8	Adv. diploma
PB ₇	South African	Male	35–40	Black person	Business manager	6	Degree
PB ₈	South African	Male	35–40	Black person	Business manager	4	Degree

processing or granting of credit to new businesses coming from other FFIs to seek credit from them. One of the participants noted:

‘At the moment, given the current economic climate and the impact of the pandemic, we have temporarily suspended credit to new businesses because a number of businesses banking with us have default payment, not once or twice for the credit they took before. Though some are struggling to pay, some have closed their businesses. Because of that, we cannot take more risk and give out more credit, especially to clients we do not know about their business dealings or financial well-being.’ (PC₂)

Another participant commented:

‘As a bank, we are experiencing lots of credit default from some of our clients. Some of them are complaining that business is not moving as before as the lockdowns has affected their businesses. So, for now, we are trying to support those businesses that have been with us over the years that are struggling so that they don’t close. So, we do not accept any credit applications for new businesses or businesses that have not been banking with us. They should look for credit from their banks.’ (PC₁)

In the following excerpt, consistent with the views of participant PC₁, participant PB₇ questioned why a new business would leave its bank and come asking for credit from another bank with which it has had no business dealings in the past:

‘I understand that many businesses are struggling now because of the pandemic. However, my job is to make credit decisions that does not put the bank at risk. Besides, why is it that some businesses as you say cannot get credit from the banks they have been dealing with in the past? That is to tell you that such businesses are either very risky or are not performing well, and that is why they cannot get credit from their banks.’ (PB₇)

The other two FFIs willing to process and grant credit to new businesses, including those from other FFIs, demand that the business accounts from the current bank be transferred immediately to their bank upon approval of the credit, as explained by one participant:

‘We are committed to supporting new businesses, but the business account must be open with us and the owners must be able to contribute at least fifty per cent of the start-up capital. However, in case the owner cannot provide fifty per cent of the start-up capital, then we are not interested. Because of the pandemic, times are hard, and our credit policy has changed. We are facing challenges with some of our business clients. We cannot therefore risk giving out more credit when we are not sure if the clients will be able to repay.’ (PC₃)

From the preceding findings, it is clear that FFIs perceive new SME credit financing in South Africa to be highly risky, especially in cases where the new SME is not an existing bank’s client. The findings also show that FFIs do not regard new SMEs who are not the financing bank’s clients as a priority when it comes to credit financing. They appear to be rather sceptical about giving such new customers access to credit finance for fear of them defaulting on payments or not being creditworthy. As such, some FFIs set conditions, such as requiring new SMEs to open an account with the financing bank and pay 50% of the start-up capital to help mitigate the risk of non-payment. Based on the participants’ views, and as supported by Turyakira (2018), it can be construed that new SMEs would find it hard to access credit from FFIs.

Credit approval rate for new small and medium enterprises

The findings generally reveal that the FFIs’ credit approval rate for new SMEs has significantly decreased because of the pandemic. Before the pandemic, FFIs were committed and motivated to give credit to new SMEs. One participant noted:

‘We are committed and confident in lending to SMEs because it is one of our institutional objectives that top management recommends. SMEs are a viable business opportunity for us and we believe that supporting more SMEs, they will be able to hire more people from the community and these people will come open accounts with us or other banks.’ (PC₃)

However, that has changed because FFIs are experiencing challenges as some of their clients have been asking for ‘grace periods’ (length of time to default payment without penalty),

while other clients have defaulted without any notice. Therefore, FFIs have resorted to tightening credit measures, as one participant highlighted:

'With the current economic climate, honestly, it is difficult for us to give credit to new businesses especially if the business does not have an account with us. So, to answer your question, I can honestly tell you that two or three new businesses out of say ten can successfully get credit from us.' (PB₃)

Another participant observed:

'We are more focused on supporting small businesses that have been doing business with us that are struggling. So, I have not approved any credit for a new business for the past three months. Hence, I cannot give you an estimate.' (PB₃)

While participant PB₅ refused to give an estimated number, another participant offered the following information:

'The approval rate for new businesses credit is quite low with us because we are facing challenges with our existing business accounts as some clients have missed payments lately; and as the credit manager, I have approved only two new business credit over the past two or three months maybe.' (PC₂)

Another participant stated:

'I can say five or less, maybe three or four out of twenty new business credit usually would get approval.' (PC₄)

Examining the findings, it can be understood from the participants' perspectives that at least two or three new SMEs (on average) out of 20 new businesses successfully have access to credit from FFIs. That translates to an average approval rate of approximately 15% or less. This finding is consistent with that of the World Bank (2024), which reports that less than 20% of new SMEs in developing nations have access to credit from FFIs. Next, one of the objectives of this study was to investigate the credit criteria, which are highlighted in the section 'Credit criteria that affect the willingness of formal financial institutions to finance new small and medium enterprises'.

Credit criteria that affect the willingness of formal financial institutions to finance new small and medium enterprises

The study further explored the credit criteria that influence the willingness of FFIs to finance new SMEs in South Africa. Table 2 provides a tabular summary of the participants' perspectives. In Table 2, participant codes are indicated in the left column, the credit criteria are in the middle column, and the frequency of citations of a particular criterion is given in the right column. For instance, in terms of equity contribution, while all the participants regarded this factor as being important, the importance was further enhanced by the frequency ($n = 16$) of mentions by the participants. The level of importance of each factor was therefore determined by the frequency of mentions rather than the number of participants.

As shown in Table 2, equity contribution ($n = 16$) was the most important criterion considered by FFIs that influences their

willingness to finance new SMEs. The ability and willingness to invest personal finances (equity contribution) in the business is an indication of the owner's commitment and confidence in the success of the business. The participants explained that FFIs have become very cautious when considering financing new SMEs, as stated by one of the participants:

'Our institutional policy recommend that we can only finance up to forty per cent of the equity of a new business, and as a credit manager, I have experienced that most new business owners come to us for credit thinking that because maybe they have a personal account with us, or they have a good business plan, we will finance their business idea. No, it does not work like that.' (PC₂)

Another participant offered a particular scenario:

'Say a client has a personal and a business account with us. If the client request business credit to support his business, we will consider the total amount he has in his personal and business account to determine the amount we can give him as credit.' (PB₅)

The credit profile of the business and/or owner(s) ($n = 16$) was the second most important criterion that influences the willingness of FFIs to finance new SMEs. This is because the credit profile provides pertinent information regarding the credit history and riskiness of the client, as one participant explained:

'The credit record of the business and the owners, using our credit model, will guide and inform our decision on the riskiness of giving credit to such client. Our credit model will also inform us if the client has any existing credit with another bank or if the client has default credit payment in the past, even if the credit did not come from us.' (PB₁)

Audited financial statements ($n = 16$) and annual turnover ($n = 16$) are quite important to FFIs as they are used to assess the performance and evaluate the creditworthiness of the business. One Participant elaborated:

TABLE 2: Participants' perspectives on the criteria influencing the willingness of formal financial institutions to finance new small and medium enterprises.

Participants	Requirements affecting the willingness of FFIs to grant credit	Frequency (n)
PC ₁ ; PC ₂ ; PC ₃ ; PC ₄ ; PC ₅ ; PC ₆ ; PC ₇ ; PC ₈ ; PB ₁ ; PB ₂ ; PB ₃ ; PB ₄ ; PB ₅ ; PB ₆ ; PB ₇ ; PB ₈	Equity contribution	16
PC ₁ ; PC ₂ ; PC ₃ ; PC ₄ ; PC ₅ ; PC ₆ ; PC ₇ ; PC ₈ ; PB ₁ ; PB ₂ ; PB ₃ ; PB ₄ ; PB ₅ ; PB ₆ ; PB ₇ ; PB ₈	Credit profile of business and owner	16
PC ₁ ; PC ₂ ; PC ₃ ; PC ₄ ; PC ₅ ; PC ₆ ; PC ₇ ; PC ₈ ; PB ₁ ; PB ₂ ; PB ₃ ; PB ₄ ; PB ₅ ; PB ₆ ; PB ₇ ; PB ₈	Audited financial statements	16
PC ₁ ; PC ₂ ; PC ₃ ; PC ₄ ; PC ₅ ; PC ₆ ; PC ₇ ; PC ₈ ; PB ₁ ; PB ₂ ; PB ₃ ; PB ₄ ; PB ₅ ; PB ₆ ; PB ₇ ; PB ₈	Annual turnover	16
PC ₁ ; PC ₂ ; PC ₃ ; PC ₄ ; PC ₅ ; PC ₆ ; PC ₇ ; PC ₈ ; PB ₁ ; PB ₂ ; PB ₃ ; PB ₄ ; PB ₅ ; PB ₆ ; PB ₇ ; PB ₈	Collateral	14
PC ₁ ; PC ₂ ; PC ₃ ; PC ₄ ; PC ₅ ; PC ₆ ; PC ₇ ; PC ₈ ; PB ₁ ; PB ₂ ; PB ₃ ; PB ₄ ; PB ₅ ; PB ₆ ; PB ₇ ; PB ₈	Comprehensive business plan	12
PC ₁ ; PC ₂ ; PC ₃ ; PC ₄ ; PC ₅ ; PC ₆ ; PC ₇ ; PC ₈ ; PB ₁ ; PB ₂ ; PB ₃ ; PB ₄ ; PB ₅ ; PB ₆ ; PB ₇ ; PB ₈	Business registration documents	10
PC ₁ ; PC ₂ ; PC ₃ ; PC ₄ ; PC ₅ ; PC ₆ ; PC ₇ ; PC ₈ ; PB ₁ ; PB ₂ ; PB ₃ ; PB ₄ ; PB ₅ ; PB ₆ ; PB ₇ ; PB ₈	Completed credit application form	9
PC ₁ ; PC ₂ ; PC ₃ ; PC ₄ ; PC ₅ ; PC ₆ ; PC ₇ ; PC ₈ ; PB ₁ ; PB ₂ ; PB ₃ ; PB ₄ ; PB ₅ ; PB ₆ ; PB ₇ ; PB ₈	Location of the business	7
PC ₁ ; PC ₂ ; PC ₃ ; PC ₄ ; PC ₅ ; PC ₆ ; PC ₇ ; PC ₈ ; PB ₁ ; PB ₂ ; PB ₃ ; PB ₄ ; PB ₅ ; PB ₆ ; PB ₇ ; PB ₈	Business experience	6
PC ₁ ; PC ₂ ; PC ₃ ; PC ₄ ; PC ₅ ; PC ₆ ; PC ₇ ; PC ₈ ; PB ₁ ; PB ₂ ; PB ₃ ; PB ₄ ; PB ₅ ; PB ₆ ; PB ₇ ; PB ₈	Ownership structure	6
PC ₁ ; PC ₂ ; PC ₃ ; PC ₄ ; PC ₅ ; PC ₆ ; PC ₇ ; PC ₈ ; PB ₁ ; PB ₂ ; PB ₃ ; PB ₄ ; PB ₅ ; PB ₆ ; PB ₇ ; PB ₈	Relationship with the bank	2

FFI, formal financial institution.

'For an established business, we ask for twelve months financials. As for a new business, we ask for six months financials. The financials help us understand the performance of the business, the estimated business turnover and if the business can be able to repay the credit.' (PC₆)

Offering collateral as security ($n = 14$) signals investment readiness of the owner(s) in the likelihood of success of the business. The participants noted that FFIs would consider collateral in the form of an investment account, life insurance, fixed assets such as buildings (excluding cars and empty land), surety and a contract letter. One participant stated:

'We also consider a contract letter to verify if the owner has already been awarded the contract. Then, we will do some verification checks with the department that has issued the contract and how they expect the project to be carried out, and when they expect the project to be finished. This information will help us to plan on how we are going to release the money the client is asking from us and how the client is requesting to pay back the money.' (PB₃)

Another participant commented that FFIs also consider granting credit if the investment constitutes collateral in itself, as captured in the following excerpt:

'If you are a start-up business and you come to us and you say I need funding to foot a kitchen and this has X amount of equipment, you do not need to give us collateral for that equipment because that equipment in itself is collateral. Even if you are in a growth phase or expansion phase and you say, "Here is my equipment plant that I want to purchase," that becomes collateral too. We still call for the financials, but you do not necessarily have to give us any of your personal property as collateral.' (PB₃)

A comprehensive business plan ($n = 12$) was also considered an important criterion influencing the willingness of FFIs to finance new SMEs. This is because having a comprehensive business plan enables FFIs to understand the new business owners' ability to articulate and manage a good business worthy of investment to investors such as FFIs. Other key criteria considered were business registration documents ($n = 10$) validating the legality of the business, and a completed credit application form ($n = 9$), only for new clients who do not have an account with the FFIs they seek business credit from, as noted by one of the participants:

'For all clients seeking credit from us, you do not have to complete the credit application form if you are banking with us because we already have your information on our database.' (PB₂)

Location of the business ($n = 7$) also influences the willingness of FFIs to finance new businesses. For instance, FFIs are less willing to finance new businesses in high crime areas or in cases where the new business is close to large franchises such as Checkers, Game, Pick n Pay, among others. This is because of the high risk involved in lending to such new businesses. One participant explained:

'The location of the business is also important to us because when your business is located in a high crime area, the risk of

lending to your business is very high because the business prone to looting. Likewise, if your business is located near a large established brand like Spar or Game, to us, it will be difficult for such a business to compete for sales.' (PC₄)

The business experience of the owner ($n = 6$) was another criterion considered by FFIs when financing new businesses. Being experienced in business enables the owner to articulate business opportunities and understand industry trends. One of the participants noted:

'Business experience of the owner is very important to us because to finance a business when the owner has no business experience is extremely risky. However, if the owner has been in business but working for someone else, say as a manager, and now wants to start his own business, then we will look at the performance of the business he was managing.' (PB₆)

Ownership structure ($n = 6$) of the new business was also important to FFIs because FFIs will not finance foreign-owned new businesses or if a foreigner is one of the directors of the new business. One participant stated:

'We do not finance new business owned by a foreign nationer. In case the business is a partnership and one of the directors is a foreign nationer, he must have a South African permanent resident permit with a South African identity document. If he is not a permanent resident, then we cannot consider such application.' (PC₂)

Relationship with the bank ($n = 2$) was the other criterion that influenced the willingness of FFIs to finance new businesses. This was explained by one participant:

'As a credit manager, we sometimes review credit application with written motivation from other colleagues why they feel a particular credit application should be reconsidered after the credit application was first denied. In such circumstance, we will then reassess the credit application noting the recommendation of the colleague. Some might be approved based on the recombination.' (PC₃)

Having a relationship with the bank is particularly important for new business owners, given the existence of information asymmetry between FFIs and new business owners. In such cases, FFI representatives might wish to offer some personal support (such as adding a recommendation letter) for a credit application to be approved.

Challenges experienced by formal financial institutions in financing new small and medium enterprises

The study explored the challenges experienced by FFIs in financing new SMEs in South Africa. Table 3 presents a summary perspective of the participants regarding such challenges.

According to the participants, lack of equity capital contribution ($n = 16$) was the most serious challenge experienced by FFIs when considering financing new SMEs. The participants noted that new SME owners are not investment-ready. For example, one participant detailed:

TABLE 3: Participants' perspectives on the challenges experienced by formal financial institutions.

Participants	Participants' perspectives on challenges experienced by FFIs	Frequency (n)
PC ₁ ; PC ₂ ; PC ₃ ; PC ₄ ; PC ₅ ; PC ₆ ; PC ₇ ; PC ₈ ; PB ₁ ; PB ₂ ; PB ₃ ; PB ₄ ; PB ₅ ; PB ₆ ; PB ₇ ; PB ₈	Lack of equity contribution	16
PC ₁ ; PC ₂ ; PC ₃ ; PC ₄ ; PC ₅ ; PC ₆ ; PC ₇ ; PC ₈ ; PB ₁ ; PB ₂ ; PB ₃ ; PB ₄ ; PB ₅ ; PB ₆ ; PB ₇ ; PB ₈	Lack of proper financial records	16
PC ₁ ; PC ₂ ; PC ₃ ; PC ₄ ; PC ₅ ; PC ₆ ; PC ₇ ; PC ₈ ; PB ₁ ; PB ₂ ; PB ₃ ; PB ₄ ; PB ₅ ; PB ₆ ; PB ₇ ; PB ₈	Lack of credible collateral	16
PC ₁ ; PC ₂ ; PC ₃ ; PC ₄ ; PC ₅ ; PC ₆ ; PC ₇ ; PC ₈ ; PB ₁ ; PB ₂ ; PB ₃ ; PB ₄ ; PB ₅ ; PB ₆ ; PB ₇ ; PB ₈	Poor credit history	13
PC ₁ ; PC ₂ ; PC ₃ ; PC ₄ ; PC ₅ ; PC ₆ ; PC ₇ ; PC ₈ ; PB ₁ ; PB ₂ ; PB ₃ ; PB ₄ ; PB ₅ ; PB ₆ ; PB ₇ ; PB ₈	Lack of business experience	8
PC ₁ ; PC ₂ ; PC ₃ ; PC ₄ ; PC ₅ ; PC ₆ ; PC ₇ ; PC ₈ ; PB ₁ ; PB ₂ ; PB ₃ ; PB ₄ ; PB ₅ ; PB ₆ ; PB ₇ ; PB ₈	Lack of entrepreneurship education	5
PC ₁ ; PC ₂ ; PC ₃ ; PC ₄ ; PC ₅ ; PC ₆ ; PC ₇ ; PC ₈ ; PB ₁ ; PB ₂ ; PB ₃ ; PB ₄ ; PB ₅ ; PB ₆ ; PB ₇ ; PB ₈	Poor business plan	4

FFI, formal financial institution.

'What I have realised over the years as a credit manager here is that most new business owners apply for business credit with very little they have to contribute. You can imagine someone applying for credit, say about two million rand, when the person does not even have half a million to invest in the business. That is unacceptable because the lending risk is too high.' (PC₂)

Another participant indicated:

'Our banking policy now demands that we can only finance fifty per cent of the total capital of any new business and the owners must have an account with us with the remaining fifty per cent. If the owner[s] does not have the fifty per cent, he must have at least thirty per cent, and then pledge a collateral worth the value of the total credit in addition.' (PB₁)

In the absence of proper financial records ($n = 16$), FFIs are unable to assess the performance of new SMEs, resulting in information asymmetry. One of the participants captured this situation in the following excerpt:

'Most often, we struggle to get proper financial records, especially for a new business or a client that deals with services and then they do not provide us with any financial records to control, then, we will turn our attention to the account they have with us. So, we will require a two-year management account. Another thing I would like to tell you is that some clients do not take time to keep their financials in order and that makes our job very difficult. Some want to do their financials only when they are preparing to apply for a loan.' (PC₄)

Lack of collateral ($n = 16$) as a challenge plays a significant role in the credit contracts between FFIs and new SME owners. Formal financial institutions accept investment accounts, life insurance policies and personal assets, excluding cars, as collateral, as one participant noted:

'As a matter of interest, we accept personal accounts, life insurance policy, fixed asset like business buildings that generate income, but we do not accept cars no matter the value, as collateral. We can also consider a contract agreement provided we are the only funding institution.' (PC₂)

Poor credit history ($n = 14$) of new SMEs is also one of the challenges that discourage FFIs from financing new SMEs as they are considered 'level one' clients (high risk). One participant stated:

'Like I told you before, level one clients are those clients seeking credit for the first time, and because they don't have any past

credit management experience, we consider them as the most risky clients. So, we are very cautious in our assessment of level one credit application.' (PB₄)

Lack of business experience ($n = 8$) is another factor that discourages FFIs from financing new SMEs, as a participant explained:

'From my experience, I have realised that a number of these new business owners are forced to do business because they cannot secure employment in the government or private sector. They do not even have any prior business experience. I can say they do not even have the passion for doing business.' (PC₄)

Lack of entrepreneurship education ($n = 5$) and poor business plan ($n = 4$) were additional factors mentioned as having an impact on FFIs' willingness to finance new SMEs. One participant noted:

'One thing I have realised with some of these new business owners is that they do not have that business qualification or let me say business knowledge. So, when you have such a client that cannot really convince you why he wants us to finance their business, it becomes easy for us to reject their credit application. Some of these people cannot even explain their own business plan properly.' (PC₂)

Discussion

The findings presented in the section 'Perceptions of formal financial institutions regarding financing of new small and medium enterprises' reveal that although FFIs are committed to supporting new SMEs in general. They perceive financing of new SMEs to be too risky. The findings also show that FFIs are very cautious of risk when considering financing new SMEs. From the participants' perspective, the pandemic has made lending credit to new businesses more challenging since FFIs consider the riskiness of new SME credit financing to outweigh the perceived benefits. This implies that FFIs strictly rely on their credit model when assessing credit applications and would reject or revise any credit application flagged by the credit model with intolerable risk. The findings of this study on risk cautiousness of FFIs are consistent with those of Stiglitz and Weiss (1981), who developed theoretical contributions about credit rationing, given that FFIs always want to mitigate the risk of granting credit to new SMEs, resulting in a high rejection rate and low availability of credit for new SMEs. Empirical studies by Weber (2018) and Mmbengeni et al. (2021) further acknowledge the credit-rationing behaviour of FFIs.

As detailed in the section 'Credit approval rate for new small and medium enterprises', this study's findings are consistent with the World Bank (2024) report on entrepreneurship, which concludes that less than 20% of new SMEs have access to finance from FFIs in developing countries like South Africa. According to the participants, at least three out of 20 new SMEs have access to finance from FFIs. This translates to an approval rate of at least 15%. Although slightly higher, these findings agree with those of Turyakira (2018) and GEM (2024), which reported low levels (less than 5%) of new SMEs having access to finance from FFIs.

The findings in the section 'Credit criteria that affect the willingness of formal financial institutions to finance new small and medium enterprises' further reveal that equity contribution is a key criterion that enhances the willingness of FFIs to grant credit finance to new SMEs. The willingness and ability of new SME owners to contribute up to 40% of the total equity signals their level of commitment and confidence in the envisioned success of their own business. Consistent with the participants' view, Asah et al. (2020) and Asah and Louw (2021) have found that FFIs prefer financing new SMEs with a sufficient owner's equity contribution because the owners are not likely to engage in risky investments, thereby reducing moral hazard for FFIs. In addition to equity contribution, the credit profile of the owner and business is used to assess the creditworthiness of the business and owners and the amount of risk in lending to such new business and owners. This means that should the SME and its owners have a good credit profile (not having defaulted on credit payments in the past), they stand a better chance of accessing more credit. Nevertheless, Amoah-Gyarteng and Dhliwayo (2022) agree that if the credit profile of either the business or the owners is bad (because of defaulting on credit payments in the past), then the approval of such credit will essentially depend on the collateral and audited financial statements presented. While pledged collateral may be repossessed by the creditor in a case of credit default, it also helps to limit the issue of moral hazard and increases the creditor's protection.

Another principal measure of the capacity of new SMEs to effect repayment of credit is the audited financial statements (Asah 2019; Asah et al. 2020). Consequently, new SME owners who are able to produce up-to-date information about their annual turnover and financial statements boost their chances of credit approval from FFIs. Moreover, FFIs consider the availability of a well-written business plan, a completed credit application and the business registration document to be some of the key criteria for lending credit to new SMEs. This is based on the fact that a well-written business plan indicates the owner's ability to articulate and explore business opportunities, business strategies, attract investors, make strategic decisions and manage a business (Jin & Liu 2024). A completed credit application form is needed when new SMEs seek credit from an FFI with whom they do not have an account. Meanwhile, the business registration document ensures that the business is registered and has a South African Revenue Service reference.

The findings demonstrate that additional key criteria for FFIs to lend credit to new SMEs are the location of the new SME, the business experience of the new SME owner, the ownership structure of the new SME and the new SME owner's relationship with the financing bank. New SMEs located in high-crime areas are particularly prone to assault, which increases the risk profile of the business. Because FFIs are risk-averse, businesses located in high-crime areas stand very little to no chance of securing any form of credit. New SME owners with high levels of business experience are the most likely to be successful in managing a business. Such experience, according to FFIs, reduces the risk of business

failure. Formal financial institutions are more confident to lend credit to new SME owners with extensive business experience because these skills allow businesses to transform themselves, improve their business performance and grow to become established and successful (Estrin et al. 2022). Regarding ownership structure, FFIs are not interested in financing new SMEs that are partially owned by a foreign national without a South African permanent resident permit or that have a foreign national as one of the directors. This is because FFIs often find it difficult to hold foreign nationals accountable in cases of credit default. Besides, as noted by Asah (2019) and Asah et al. (2020), some foreign nationals use different passports with different passport numbers and names. Having a longstanding debtor-creditor relationship is also very important because it reduces information asymmetry and increases confidence. As corroborated by Yadav et al. (2022), this implies that new SMEs with longstanding relationships with FFIs are most likely to access business credit because such relationships build trust.

With reference to the challenges faced by FFIs when considering financing new SMEs, the findings presented in the section 'Challenges experienced by formal financial institutions in financing new small and medium enterprises' suggest that FFIs mainly face new SMEs with insufficient equity capital. This is problematic since FFIs, as a matter of policy, can only finance 50% of the total start-up capital. To compound the problem, new SMEs seldom have audited financial statements that can convince FFIs of the prospects and performance of the business. For that reason, and to reduce lending risk, FFIs demand 60% of the total start-up capital, or at least 40% of the total start-up capital with pledged first-class collateral worth the value of the total collateral, which most new SMEs cannot yet provide. Consistently, contemporary literature (GEM 2024; Riaz et al. 2021) agrees that FFIs heavily rely on equity contribution and first-class collateral as primary requirements for funding. This is the primary reason why new SMEs cannot access credit from FFIs, coupled with the poor credit history of new SMEs because of their newness. Furthermore, since business plans of new SMEs usually contain both financial and business information, a poorly written business plan, a lack of business experience and entrepreneurship education make it difficult for FFIs to objectively evaluate the credit application (Meyer & Kruger 2020).

Conclusion

Managerial implications and recommendations

The creation and financing of new SMEs is of fundamental importance to the economic prosperity of South Africa, especially at this time of very low to no economic growth. They are a strategic source of economic growth, poverty alleviation and reduction of income inequality. New SMEs also contribute to employment, help diversify economic activity and make a significant contribution to exports and trade. However, lack of financial capital is a fundamental obstacle to their progress and survival. This study's findings reveal that although FFIs acknowledge new SMEs as potential business opportunities, they are risk-averse and always want

to mitigate the risk of granting credit to new SMEs. So, to improve the availability of finance from FFIs, new SME owners need to plan and save to be able to provide a reasonable amount of equity contribution. Without equity, it is practically impossible to get the required funding from FFIs, in view of corporate finance theory, which advocates that international best practice is a capital structure of 50% equity and 50% debt (Riaz et al. 2021). In addition, it is essential for new SME owners to have either business or personal assets to use as collateral, demonstrating their investment readiness.

A novel idea recently introduced in India could help FFIs reduce their demand for tangible collateral. Some FFIs in India have introduced the 'competency-as-collateral' scheme. This scheme integrates measures of managerial competency with the conventional credit risk assessment criteria. Modified evaluation systems built on the basis of this platform help new SME owners who would not have been eligible for credit under the conventional criteria to become eligible by allowing them to show their managerial competence as part of their collateral.

Formal financial institutions can also organise and communicate training programmes on the credit requirements to help new SME owners become investment-ready. Formal financial institutions can further create awareness of their financing requirements, especially the importance of equity contribution and collateral, through advertisements and communication with SME trade associations. Through seminars and workshops, FFIs can also motivate and educate new SME owners about the importance of business information and of writing a good business plan, and how such information can play a crucial role in the credit assessment and evaluation process. Knowing the importance of business information, it is the responsibility of new SME owners to undertake entrepreneurship education to be able to produce a comprehensive business plan that can attract investors such as FFIs.

Location of a business in relation to crime is a serious concern to FFIs, as most FFIs are hesitant to lend to new SMEs that are located in high-crime areas. The only way to reduce crime is for the government to make the legal system more efficient, especially by improving the speed of court judgment, so that those guilty of assault can be promptly arrested and punished. Formal financial institutions and the government should work in partnership with organisations such as Business Against Crime South Africa and Business Unity South Africa so that crime will not be an issue for FFIs to adopt credit rationing. Contemporary literature acknowledges that poverty is one of the many causes of crime. Therefore, supporting new SMEs is the gateway to address the issues of job creation, poverty and unemployment, in anticipation that crime will also reduce. The Small Enterprise Development Agency should regularly organise mentorship programmes for new SME owners on managing a new business in order to boost the business experience of new business owners. Such initiatives might help to reduce the high failure rate of new SMEs.

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