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Unlocking Potential: Exploring Financing Choices Among Small and Medium Enterprises

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Abstract
This study investigates the financing preferences of small and medium enterprises (SMEs) in Pakistan and determines their adherence to the hierarchy of financing sources as proposed by the Pecking Order Theory. The study employs a robust methodology, utilizing a sample of 202 Pakistani SMEs and collecting data through structured self-administered questionnaires. Rigorous robustness checks are conducted to ensure data reliability and consistency. The findings reveal a discernible financing hierarchy within Pakistani SMEs, confirming the principles of the Pecking Order Theory. Retained earnings emerge as the overwhelmingly preferred 1st choice for financing, followed by debt financing in 2nd place and external equity in 3rd place. This hierarchy aligns with the theory's emphasis on internal equity, the intermediate role of debt financing, and the last resort nature of external equity. The study's limitations include data availability and the potential for variable changes over time. However, its findings offer valuable insights into SME financing preferences in Pakistan and their adherence to the Pecking Order Theory. The study also provides avenues for future research into additional factors that influence SME financing preferences and their effects on financial performance and growth.

Keywords: SME Financing, Pecking Order Theory, Small and Medium Enterprises, Financing Preferences, Internal Equity.
JEL Classifications: G32, G24, M21, L26, O16, P24.

Introduction:
Small and Medium Enterprises (SMEs) constitute a dynamic and intricate sector within the global economic landscape, often serving as engines of economic growth and innovation (Gherghina et al., 2020). In a similar vein, the Pakistani SME sector mirrors this significance, contributing significantly to employment generation, export earnings, and overall economic vibrancy (Ikram et al., 2020). An understanding of SME financing is imperative, as it profoundly influences their survival, expansion, and innovation capacity (Rao et al., 2023). Amidst the myriad complexities associated with SMEs, one prevailing question endures: How do these enterprises finance themselves and to what extent do their financing preferences conform to established financial theories? This question serves as the pivot of our inquiry.

Finances for small and medium enterprises seem plentiful, but access and adequacy of these funds are limited and fragmented (Abdullah and Ab. Manan, 2009).The financial structure of large listed firms is explained using various financial theories. It is, however, unclear whether these arguments apply to other firms, particularly small and medium enterprises. Financial theories can be questioned when assessing the influence of institutional settings on costs and availability of financing alternatives, and the relative impact of various institutional settings can be examined.

Studies on small and medium Enterprise financing choices are explained in terms of firm characteristics (firm size, age, asset structure, profitability; to name a few) without taking into account owner/manager characteristics. (Mac an Bhaird, 2010) and (Roxas, 2008) emphasized the importance of understanding the beliefs of managers and their relationship with financial practices of the firm. Regarding financing for entrepreneurs Firms' financing choices are explained by the pecking order finance method. For financial decision making, the favoured hierarchy of enterprises is explained by this capital structure hypothesis. Before using any kind of external funding, they place the utmost priority on the use of internal finance (i.e., the impacts of depreciation and retained earnings). The decision of which financial purchase to make is based on the industry the company is in and the owners' or managers' desire to share ownership with investors (i.e. start-up, growth or steady). In the setting of small and medium-sized enterprises, the financial environment is characterized by many options that can affect business performance and growth trajectory. SME's preferred methods of financing play an important role in their long-term viability (Baker et al., 2020; Z. Wang et al., 2023) Many studies have been conducted on SMEs' financial strategies, including internal and external financing sources (Han et al., 2021; K. Wang et al., 2023)

the Pecking Order Theory offers a framework which helps in explanation of the financial decisions made by SMEs. The hypothesis states that a firm's financing decisions show a hierarchy. According to (Myers, 1984), the order often includes a propensity towards internal equity first, then debt, and finally external equity. The availability of financing for SMEs is not an issue as the sources of finance seems abundant, however the main issue is the accessibility and adequacy of those funds which were found to be limited and fragmented (Abdullah & Manan, 2009).

In case of entrepreneurial finance Pecking order financing approach explains financing preferences of firms. This capital structure theory explains the preferred hierarchy of firms for financial decision making. They give highest preference to use of internal financing (i-e. effects of depreciation and retained earnings) before resorting to any form of external funds. The choices of financial acquisition depend on the willingness of business owners/ managers to share ownership with investors, and the life cycle stage of the firm in an industry (i.e. start-up, growth or stable). UNCTAD (1995, 2001) Despite the numerous challenging factors that impact the survival and growth of Small and Medium Enterprises (SMEs) in both developed and developing countries, financing decisions are considered among the most crucial factors. (Qerimi et al., 2023) asserted that the emphasis on large companies has led researchers to overlook, or inadequately study, small and young firms that lack access to public markets. They noted, "Various theories have been developed to explain financing preferences, focusing on large, listed firms. The issue of whether these findings are valid for other firms, especially SMEs, is still debatable and requires further study."

The essential question emerges: What are the financing preferences of SMEs?

The objectives of this study are:

i. To comprehensively examine the financing preferences of Small and Medium Enterprises (SMEs) operating in Pakistan.
ii. To ascertain the extent to which the financing choices of SMEs in Pakistan align with the principles of the Pecking Order Theory.
iii. To identify and evaluate the multifarious determinants shaping the financing preferences of SMEs in Pakistan.
iv. To explore the wider economic implications and policy imperatives arising from the financing preferences of SMEs within the Pakistani context.

The study aims to identify the factors influencing financing from the entrepreneur's perspective, contributing to the development of the financial sector, particularly in relation to Small and Medium Enterprises (SMEs). This research holds significance for policymakers, given that a substantial portion of the economy comprises SMEs, accounting for 90% in the case of Pakistan. Through this study, policymakers can analyze the various types of financing utilized by SMEs and understand their preferences. Furthermore, the study fills a critical gap in the existing literature, particularly in the context of Pakistan, providing valuable insights for researchers. It offers an accurate understanding of how managers of SMEs evaluate and choose financing options for their firms. Additionally, the research contributes to the improvement and formulation of policies within both government and private agencies involved in funding SMEs.

Literature Review:

An SME's funding decisions are also influenced by the sector in which it operates. In this section of the study, existing studies will be discussed related to financing preferences of small and medium enterprises. In literature it is well known that Bank debt and other private loan sources are important sources of funding for small businesses. Though, it is difficult to acquire debt financing for privately held small firms due to agency problem and information asymmetry both. The capital structure theories suggest that firm's selection of capital structure depend upon characteristics that determine the various benefits and costs associated with equity and debt financing. However, these theories have been developed by focusing on the financing preferences of large, listed firms Research on whether these findings apply to Small and Medium Enterprises has received very little attention. Zingales (2000) stated in this study that, the researchers focused on large companies as compared to young and small firms as these SMEs lack access to the public markets. (Abor & Biekpe, 2009)conducted a study on Ghanian SMEs and found that the in case of SMEs capital structure can be affected by various factors such as ROA, firm size, age, growth and asset's structure. He also found that the major source of financing in SMEs of Ghana is short term debt. While locating private investors proves to be more challenging than securing venture capital funds, the process of finalizing a deal with private investors is notably less time-consuming. In comparison to funding from venture capital funds, investment from individual investors is more cost-effective. Both venture capital firms and individual investors enhance the value of their investments by cultivating a collaborative relationship with the projects they sponsor. Entrepreneurs perceive these collaborative partnerships as a valuable aspect of the deal (Beck et al., 2005)

A study conducted on Greek firms revealed reluctance to utilize external sources of finances and a tendency to avoid generating capital through external equity. Greek firms predominantly relied on internal sources or internally generated funds. In terms of debt financing, firms expressed an intention to utilize more debt, specifically long-term debt, than they currently do.

Consequently, there exist limitations in accessing long-term debt financing(Daskalakis et al., 2013). In the realm of grant financing, it is advisable for micro and small firms to receive enhanced information and encouragement to actively participate in state grants and co-financed programs. Thus, an informational gap in grant financing is evident.the study by (AKYUZ & OPUSUNJU, 2020)and Block et al. (2009) investigated the financial preferences of micro and small- to medium-sized business owners in Turkey's forest products industry. The owners of these companies favor internal financial sources over excessively expensive capital from the external market for their initial and ongoing facilities, based on some of the financial characteristics and capital structure of these sectors that have been identified. However, as with financial capital, other people's social capital can be devalued if the venture fails or used opportunistically. For this reason, the entrepreneur cannot use other people's social capital unless they have a relationship of mutual obligation and trust with the owners of the capital. Therefore, the social capital that business owners can probably borrow is limited.

H0: There is no evident deviation from the Pecking Order Theory in Pakistani SMEs' funding preferences.

*H1: Pakistani SMEs' finance preferences are strongly influenced by the Pecking Order Theory***.**

Methodology:

To quantitatively assess the alignment of SME financing preferences with the Pecking Order Theory and the moderating impact of agency costs, information asymmetry, and firm-specific characteristics, we propose a simplified research equation/model:

$$F = \beta 0 + \beta 1(Retained\ Earnings) + \beta 2(Debt\ Financing) + \beta 3(External\ Equity) + \beta 4(Agency\ Costs) + \beta 5(Information\ Asymmetry) + \beta 6(Firm - Specific\ Characteristics) + \varepsilon$$

Where:

- F is the overall funding preference score.
- Retained Earnings, Debt Financing, and External Equity are binary variables indicating the preference of each SME for these financing options (1 for preference, 0 for non-preference).
- Agency Costs, Information Asymmetry, and Firm-Specific Characteristics are continuous variables representing the level or impact of these factors on financing preferences.
- $\beta 0$, $\beta 1$, $\beta 2$, $\beta 3$, $\beta 4$, $\beta 5$, $\beta 6$ are the coefficients that represent the effect of each variable on SMEs' financing preferences.
- ε is the error term accounting for unexplained variance.

The research equation/model allows for quantitative analysis to test whether SME financing preferences significantly align with the Pecking Order Theory (the coefficients $\beta 1$, $\beta 2$, and $\beta 3$) and assess the moderating effects of agency costs, information asymmetry, and firm-specific characteristics on these preferences (the coefficients $\beta 4$, $\beta 5$, and $\beta 6$). The Pecking Order Theory's degree of reflection in Pakistani SMEs' financing preferences is assessed using this model, which also takes into account the impact of multiple factors on these preferences. The survey data was analysed. Self- administered questionnaire was collected from a sample of Small and Medium Enterprises of Haripur and Abbottabad. The questionnaire contained a total of 23 questions including key variables and demographic questions. Most survey items were adapted from pre-validated research work to increase the construct validity of the survey items.

to measure financial preferences of SMEs. A convenient sample of 200 SMEs is used. The main reason is to use non-probability sampling technique i.e., convenient sampling is that this sampling technique required relative less cost and less time required which enables to get data relatively fast and inexpensive.

Results and Discussions

Table 01 provides important demographic information about the sample of Small and Medium Enterprises (SMEs) that are the subject of the investigation.

Nature of Business: The variety of business activities that the SMEs in the study participate in reflects the diversity of the SME landscape. It is noteworthy that 44.6% of SMEs are engaged in retail trading, demonstrating a sizable presence of companies centred on the selling of goods to customers. 4.5 percent of the population, or SMEs, who participate in foreign commerce, are active in exporting operations. A considerable portion of the sample (23.8%) belongs to the manufacturing sector, highlighting the value of industrial output for the SME sector. Additionally, 13.9 percent of the sample's firms are service-oriented, showing the range of services, that SMEs provide. At 5.9 percent and 7.4 percent, respectively, real estate and farming make up a smaller but still significant portion of the sample, indicating their existence in the SME sector.

Age of Company: The sample's SMEs' age distribution reflects a diverse setting. A significant number of relatively recent entrants into the SME sector are present, as indicated by the fact that 34.7% of SMEs have been in operation for 1 to 5 years. 37.1 percent of the sample falls within the age group of 5 to 10 years, showing the significance of mid-aged SMEs. Additionally, 16.8% of the SMEs have been operating for 10-15 years, and 11.4% have surpassed 15 years in business, suggesting the presence of well-established SMEs in the sample.

Owner-Manager: The majority of SMEs in the sample (89.1%) are owner-managed, underscoring the hands-on involvement of owners in the day-to-day operations and management of their businesses. A smaller proportion (10.9%) indicates businesses with separate ownership and management roles, where the owner may not directly manage the operations.

Table 01: Sample Demographics

Kind of organization	Frequency	Percentage
private limited company	52	25.6
public limited company	3	1.5
partnership	31	15.3
sole proprietor	69	34.0
family-owned business	47	23.2
Total	202	99.5
2. Nature of business		
retail trading	90	44.6
Export	9	4.5
Manufacturing	48	23.8
Service	28	13.9
real estate	12	5.9
Farming	15	7.4
Total	202	100.0

3.Age of company		
1-5years	70	34.7
5-10years	75	37.1
10-15years	34	16.8
more than 15 years	23	11.4
Total	202	100.0
Owner- Manager		
Yes	180	89.1
No	22	10.9
Total	202	100.0

Table 02 provides critical information regarding financing sources, bank credit utilization, and the reasons why the sampled Small and Medium Enterprises (SMEs) do not seek bank loans the results show the demographics of the small and medium enterprises used in the study. The table shows that among 202 SMEs 44% were involved in retail trading, 24% were involved in manufacturing business. 37 % of the businesses were operating for 5-10 years while 34.7% were operating for 5-10 years. 89% of the businesses were having a manger to deal with business while 11% were not having managers.

Table 02: Source of Finance

Sources of Finance	Frequency	Percentage
owner financing	149	73.8
private institutions	25	12.4
Bank	6	3.0
equity finance	22	10.9
Total	202	100.0
Credit availed from bank		
Yes	26	12.9
No	176	87.1
Total	202	100.0
If not availed, why?		
do not like loan	106	52.5
high interest rate	67	33.2
no collateral to pledge	28	13.9
Others	1	.5
Total	202	100.0

The results show that 78% of the businesses used owner financing, 12% used debt from private institutions, 3% from banks and 11% equity financing. The results also suggest that majority SMEs do not for financing from banks due to lack of collateral, high interest rates. Table 03 reveals insights into the financing preferences of small and medium-sized enterprises (SMEs) in the context of the Pecking Order Theory, which posits a hierarchy of funding sources. **SME's** were asked about their preference in choosing financing options. 77% of the SME's ranked retained earnings (internal equity) as their 1st choice while making decision about financing preferences. 12% chose debt financing as their 1st option and remaining 10% opted for equity finances. 21%%

of the small and medium businesses chose retained earnings as 2nd preference. 66 % chose debt as 2nd option while making financing decision while 12% opted equity as 2nd preference. Only 2% of the SME's selected internal equity as their last option 76 % of SME's selected equity as a third option while making decision about financing preferences. 22% chose debt financing as their last option. The reason for selecting equity as 3rd option was that SME's don't want to dilute their ownership/ control. The results show that there is a clear hierarchy between the first three financing sources preferred.

Table 03: Financing Preferences

Preferences	Retained earnings		Debt		Equity	
	Frequency	percentage	Frequency	percentage	Frequency	percentage
1st preference	156	77.2	24	11.9	22	10.9
2nd preference	43	21.3	134	66.3	25	12.4
3rd preference	3	1.5	45	22.3	154	76.2
Total	202		202		202	100.0

Conclusion:

The study is conducted to study the financing preferences of the small and medium enterprises using firm specific variables and availability of sources of finance. A sample of 200 SMEs was selected from Haripur and Abbottabad by using convenient sampling. The main results of the study are in 3 folds Retained earnings (internal equity), Debt financing and External equity. The results show that majority of the SME's used internal equity for the financing needs in operations or at the time of startup. They do not go for banks due to lack of collateral to pledge or due to high interest rates. The businesses selected debt financing as their 2nd preferences and results suggested that most of them go for either short term financing or they take finances from social capital. Majority SME's ranked external equity as their 3rd preferences while making financing decisions as they do not want to dilute their ownership/ control of the firm. There is strong evidence from the findings that small and medium firms follow the pecking-order financing approach, which can be explained by the relatively high agency costs of debt and the fear of losing control in the case of external equity (funds outside the family). The following are the limitation of the study. The sample size used was very small so for generalizability of the study it should be conducted on a larger sample. The sample was restricted to selected cities. This study, although limited in scope, tries to contribute to lack of understanding and knowledge. Nevertheless, Small and medium enterprises financing is vast area, and small firms are indeed important. Thus, it is important to understand small firms on the same level that we already understand large firms.

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