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RESEARCH ARTICLE

The Impact of Sources Financing on SME Lifecycle: Insights from Somalia

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ABSTRACT

This study was conducted purposely to determine the effect of financing source on the small and medium enterprises development stages in Mogadishu Somalia, especially how formal and informal finance affects SMEs stage. A total of 300 employees of SMEs was selected as the target populations of the study. A total of 290 were collected and become valid response out 300 questionnaires. To analyze the data, multiple regressions were used to test the hypotheses since there were multiple independent variables and different dependent variables. Structural Equation Modeling (SEM PLS) were used to analyses the relationship. From the findings of the study, there is a positive relationship between informal financing and the first two stages of business cycle (Start-up, Survival), while there is a positive relationship between formal financing and rapid growth and peak stages. Moreover, this finding suggests that these businesses prioritize informal funding sources in their early phases, placing a strong emphasis on self-financing and financial support from friends and family. But after surviving from the first experimental phase, the entrepreneurs gain enough courage to find financial support from other funding sources, such as business angels and seed investments. This study is crucial for entrepreneurs seeking knowledge on financing requirements and will aid future researchers in gaining fresh insights into small business financing. The study recommends entrepreneurship and training centers to offer beneficial training and financial counseling to small business owners, thereby fostering competition and enhancing their efficiency in the business sector.

INTRODUCTION

Scholars have approached the topic of small and medium-sized enterprises from various perspectives, delving into their operational framework, influencing factors, and economic function. Karadag, (2015) stated that SMEs are crucial for economic growth, job creation, and innovation, for both developing and advanced economies, making them global actors in socioeconomic development, playing a significant role in creating new jobs and driving economic growth. Over the past three decades, there has been a significant shift from large enterprises to small and medium-sized enterprises (SMEs), with SMEs playing a crucial role in economy and development (ref). For instance, within the Organization for Economic Co-operation and Development (OECD), SMEs account for over 95% of registered enterprises and account for over half of total private sector employment (Lukacs, 2005). In the Eurozone, SMEs make up 98% of all enterprises, providing 67% of total employment and 58% of gross value added (EC, 2012). While in China, Small and Medium

Enterprises (SMEs) are responsible for employing 80% of the urban population and contributing 60% of the country's GDP (Sham, 2014). Similarly, SMEs, or small and medium enterprises, are the driving force behind Africa's growth, accounting for over 95% of all firms in the Sub-Saharan Africa region (Muriithi, 2017).

In Africa, SMEs face numerous challenges such as power shortages, lack of capital, poor management skills (Kulmie, et al. 2023), inadequate information, and corruption (Kulmie, 2023). Most African governments provide little support to SMEs, neglecting their vital economic role and neglecting their development as pillars (Muriithi, 2017). In most developing countries the shortage of capital is the major barrier for promoting an industrial culture. So, as a small business industry requires relatively less capital per unit and relatively less infrastructures, it justifies the promotion of this vital sector (Beck & Demirguc-Kunt, 2006) Despite these shortages, the development of Small business in developing countries like Somalia has great potential to generate maximum social economics benefited to the country with a low level of investment. Therefore, SMEs have great potential to mobilize and divert financial resource in the economy, which would otherwise have been used for consumption in purpose for a useful Investment purpose in rural areas. Another argument says that SMEs can be an aid to promote balanced regional development (Abouzeedan 2003). Moreover, financial capital is one of the most important resources required for enterprises to form and subsequently operate.

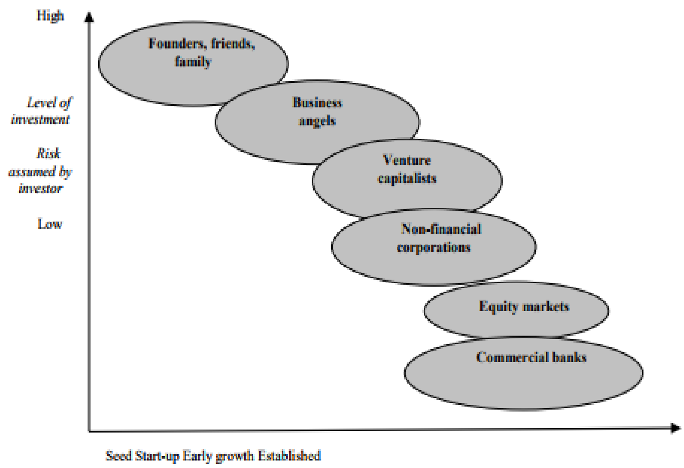
Therefore, the most important steps in starting an entrepreneurial venture is to ensure an adequate financing source. According to Kotha and George (2012), showed that entrepreneurs with previous experience in startups are able to raise more funds (from both formal and informal sources) compared to entrepreneurs without any experience. Therefore, making capital decisions and the use of debt and equity at start-up have been shown to have important implications for the operations of the business, the risk of failure, firm performance, and the potential of the business to expand. Although, the previous studies have paid little effort to take a look at knowing how the business owners have been financing their businesses and which sources of finance is suitable to their business levels that can contribute meaningfully to their business performance. Therefore, the main focus of this study is to search into dimensions of financing sources such as Personal Saving, family and friends, commercial banks and lending institutions (Microfinance institution) which Hou et al. (2020) grouped under two headings; informal and formal sources and their effect on business lifecycle.

LITERATURE REVIEW

Business Cycles

According to Maurya (2012), start-up companies go through three stages of development. The first stage is the problem identification which investigates whether the market even has a problem that needs to be solved. Such a case, the idea/problem is not the most important element. This idea it can be quite cheap, but its implementation can be expensive. It is important to match the solution to the associated problem, as well as to search if the start-up wants to develop something that the customers/users need and whether they are willing to pay for it. The second phase is Product/Market which has to answer the question of whether the implemented idea is really what the users need. After the first phase, in which it is necessary to investigate the existence of the problem, the purpose of solving the problem and the possibility of building a prototype or a partial solution, in the next phase it is essential to test and analyze different metrics to determine the extent to which the new product addresses specific customer issues.

The third phase is Scale and it involves the expansion and growth of start-up companies, which leads to an increase in the number of employees, an increased market shares or to higher income. The ideal time for finding the source of funds is after phase 2 (Product/Market Fit), or once the market has been tested to see the potential for future start-up growth (scaling follows in the third stage). Therefore, after the second phase, the start-up's founders; as well as potential investors, have the same goal - the expansion of the business. In the expansion phase, the most common available sources of finances are venture capital funds and loan funds. At the buyout stage, private equity funds play an important role.



Source: Vasilescu (2009).

Informal Source

Using Informal financing does not require serious paper works. Getting these Sources of financing provides financial assistance with or without demanding serious collateral security from SMEs' owners; rather, it may base it on words of mouth or with simple agreement. Beside personal saving and contribution, most of informal source comes from friends, relatives and business angels (Mason, 2005). Most studies agreed that incidence of informal investment was higher among firms in the manufacturing, wholesale or retail and knowledge-based sectors (Hirsch, 2011, Kihimbo, 2012, Scherr, 1993). For instance, a study conducted in Canada Found that both business angels and friends or relatives contribute significantly under informal source towards SMEs performance in Canada to the tune of 15 and 25% respectively. In terms of financial comparison, the study revealed that the contributions of both angel-financed and those financed by friends and family are larger than other SMEs financial sources. Therefore, it might say that informal investment has indeed spurred growth for these SMEs. The same case may be found in SMEs operating currently in Somalia, especially SMEs operating in Bakara Market.

This is in align with Gbandi and Amissah (2014) which shows that informal finance sector (IFS) provides more than 70% of the funds to the SMEs. This implies that entrepreneurs should try to collect their initial funds from those people who are closest to them such as friends and family (informal sources of financing) before they turn to external investments such as business angels, various funds or banks (Kihimbo, 2012). This is the "first line" of investors and it is often called "Fools" because they invest their money into start-up companies even though the available data shows that a great number of start-up companies stop doing their business within the first three years of business. However, before they become larger and more powerful investors, it is important to note that initial investment should come from entrepreneur him/her self. This indicates that the entrepreneurs believe in their ideas and that their family and closest friends are also ready to take the risk and invest in their business idea. Potential risks of such a financing are disagreements that may occur in the families or between friends if the project fails in the end (Saeed, 2009). Seed investments are one of the initial investments that contribute start-up companies in expanding their business. In recent years, Start-up companies avail in technology development with rapid growth potential due to the nature of their business often explore seed investments in order to accelerate their growth and develop of their products (BrezakBrkan, 2010).

Formal Source

The formal source of finance comprises commercial banks, merchant banks, savings banks, bank of industry, and Development banks. This refers to those financial institutions that are formed by law to carry out financial business activities and at the same time are saddled with the responsibilities of helping in growth, development, and survival stages of SMEs by providing facilities after fulfilling a certain criterion like collateral security which is commonly used (Hou et al., 2020). Borrowers prefer formal loans to informal loans and would be forced to finance from informal sector only when they cannot get access to formal sector.

According to Beck, Demirgüç-Kunt and Pería (2008), most banks, independently of their country of operation or ownership type, have set up separate departments to manage their relations with SMEs. This shows that banks have a special role to play in making the dreams of business' owners come to reality and that SMEs have some benefits that they should enjoy with the formal institutions. But most of SMEs are refused to get these benefits from the banks as a result of the unrealistic collateral security demanding from them and these have been seriously affecting the survival of the industry especially in developing country like Somalia. Despite this, Financial Inclusion Experts Group or SME Finance Sub-Group 2010 and SAEEED (2009) emphasized that formal source of finance remains an important source of SMEs growth and development and they have contributed significantly to business sustainability. Again, findings from Kihimbo, Ayako, Omoka, and Otuya (2012) agreed with the significance of formal financial source to the business operations. Moreover, Business angels are investors who help entrepreneurs to realize their business ideas.

Another study conducted in the UK which proved that business angels have a major role in funding high-tech start-ups in their early stages. One of the reasons for that is the governmental support through tax exemption of their investments. In contrast, venture Capital investments are unlike of bank loans because Venture capitalists seek for a corresponding part of the ownership in the company, while banks enter into a financing for an exactly determined time period and with precisely defined interest rates. Another difference is venture capital (VC) funds don't affected by company`s cash flow and it does not create any costs, while bank loans are always time-limited and during the entire repayment time they burden the company`s cash flow (Collins, 2014). General speaking, Firms' financial positions are important for understanding business cycle fluctuations.

METHODOLOGY

Study Variables and design

The success of SMEs is significantly influenced by the availability of finance, which can come from internal sources like personal savings, informal external sources like family and friends, trade credit, venture capital, and angel financiers, and formal external sources like banks and financial institutions. several studies examined the nature of SMEs and their sources of financing, however, this study attempts to establish a relationship between financing sources and SMEs development stages. Several studies have utilized the lifecycle model to comprehend the financial issues of SMEs. In this case, financial sources were considered as the independent variables (x) and SMEs business cycle as the dependent variable(y). The survey research design was used to enable the researchers to have a comprehensive overview of the variables under examination. This study is quantitative in nature and adopts a cross-sectional research design. Using the Smart PLS 2.0 software package (Ringle et al., 2005), Partial least squares structural equation modeling (PLS-SEM) technique was employed to analyze the data. In order to achieve research objectives, several research questions and hypotheses were formed:

H_1: There is significant relationship among informal finance and formal finance and business startup stage

H_2: There is significant relationship among informal finance and formal finance and business survival stage.

H_3: There is significant relationship among informal finance and formal finance and business Rapid growth stage

H_4: There is significant relationship among informal finance and formal finance and business Peak stage

Regresion Models

To examine the effect of both informal and formal financing on business cycles, researcher used the following models:

M1: *Startup stage=* $b_0+b_1PS+b_2FF++b_3CB+b_4MI$

M2: *Survival stage=* $b_0+b_1PS+b_2FF++b_3CB+b_4MI$

M3: *Rapid Growth stage=* $b_0+b_1PS+b_2FF++b_3CB+b_4MI$

M4: *Peak=*$b_0+b_1PS+b_2FF++b_3CB+b_4MI$

Startup, Survival and Rapid growth stages are the indicators of business cycle (dependent variable), whereas PS (Personal saving), FF (Family and Freinds), CB (Commercial bank loans) and MI (Microfinance Institution) are independent variables which indicate the financing sources of the firm.

Study Framework

In present study all measured items are borrowed from the existing literature. Moreover, a slightly modification was made in the wording of the item. The framework that evolved from this effort delineates the four stages of development and two sources of finance shown in Figure 1. Each stage is characterized by an index of size, diversity, and duration and capital structure.

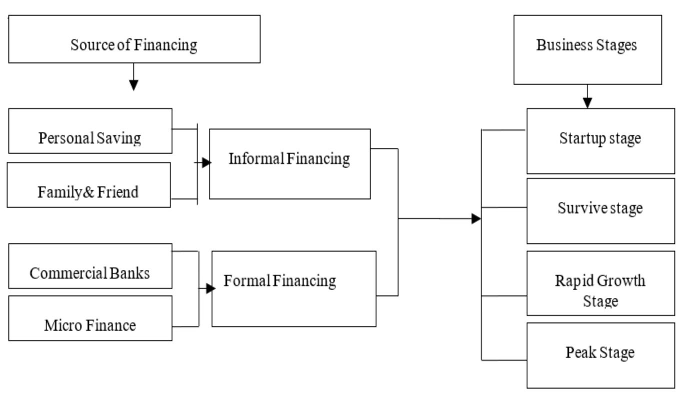


Figure 1: Conceptual framework of the study

RESULTS AND DISCUSSIONS

Demographic Information

The above table shows that 86.7% of small and medium enterprises are owned by a male while 13.3% of them are female. On the age of the respondents, age category of 20-30 years is most predominant age of small and medium owners, followed by 31-41 years old business owners, while above 41 years old are minority groups owning in small business. This statistic shows us that people within age bracket 20-31 take a lead in establishing SMEs in Mogadishu. In terms education background, the above table shows that 56.7% were university graduates, followed by 33.3% secondary graduates. Also, it shows that 43 % of SMEs are in the startup stage while 26% of them are in rapid growth stage, followed by 20% of Survival stage. This result deduced that most of SMEs operating in Mogadishu are in the startup stage. Finally, the table shows business life cycle. It shows that 46.7% of the SMEs are less than 3 years, followed by 33.3% of them are Between 4 up to 6 years. It can be deduced that most of them are in the initial life cycle.

Table 1 Demographic Variables of the respondents

Variables	Frequency	Percentage
Gender		
Male	52	86.7%
Female	8	13.3%
Age		
20-30 years	32	53.3%
31-41 years	20	33.3%
41 and above	8	13.3%
Education		
Secondary	20	33.3%
Bachelor	34	56.7%
Postgraduate	4	6.7%
Business Stage		
Start-up stage	26	43.3%
Survival Stage	12	20%
Rapid growth	16	26.7%
Peak	4	6.7%
Business Life cycle		
Less than 3 years	28	46.7%
Between 4 up to 6	20	33.3%
7 up to 10 years	10	16.7%

Regression analysis of Models

According to Table 2, there is a significant positive effect of either formal and informal finance on startup stage (β ¼ 0.654, p<0.005). Therefore, H1 is supported. Similarly, there is significant positive and direct effect of formal and informal finance on growth stage (β ¼ 0.698, p<0.005), Survival (β ¼ 0.632, p<0.005) and peak (β ¼ 0.3256, p<0.005). These results support H2, H3 and H4.

Table 2. Result of Structural model path coefficient (Direct relationship)

Model 2 Survival					
Hypothesis	***Relationship***	***B***	***SE***	**t- value**	**Decision**
H1	FF & IF → Startup stage	0.654	0.034	15.456	Support
H2	FF & IF → survival stage	0.632	0.065	12.324	Support
H3	FF & IF → growth stage	0.698	0.085	11.767	Support
H4	FF & IF → maturity/peak stage	0.32567	0.054	14.921	Support
P <0.005					

Table 3. Regression analysis of Model 1

Model 1 Startup stage			
Variables	**Coefficient**	**F- Statistics**	**Std.Error**
PS	0.001	0.005354	0.000338

FF	0.0269	0.004328	0.005662
CB	0.4521	0.003451	0.061213
MI	0.5678	0.002351	0.086745
C	0.0185	0.08935	0.010986
R^2= 0.637 F statistics 5.921 P-value = 0.0212			

Table 3 presents the first Model of the study. It shows that the personal saving variable is significantly related, and a one-unit increase in personal saving leads to an improvement in the start-up stage. As well as, Family and friends' contribution is significant at this stage. This finding rejects earlier submissions Nkamnebe (2008) that entrepreneurs look for credit from other sources like friends and tribal association than from MFIs. Note that the R^2value of this model is 63%, which measures the extent to which the independent variables can predict the dependent variable. This positive relation between Personal saving and startup stages will motivate others to start a business with their own savings. Also, as evidence from other research confirms, start-up companies first reach into their own financial savings.

Table4.Regression analysis of Model 2

Model 2 Survival			
Variables	**Coefficient**	**t- Statistics**	**Std.Error**
PS	0.3513	0.006057	0.000338
FF	0.0269	0.03254	0.005662
CB	0.0423	-0.13561	0.005681
MI	-0.67	0.32567	0.078923
C	0.0487	0.06354	0.044289
R^2= 0.75 F statistics 4.355 P-value = 0.0055			

Table 4 indicates the second Model of the study. It deduced that family and friend's contribution and bank loans variables are significantly related, that means both informal and formal finance play leading role of financing in this stage at 0.0269 and 0.0423 at 5% significance level. Note that the R^2 value of this model is 75%, which measures the extent to which the independent variables can predict the dependent variable.

Table 5. Regression analysis of Model 3

Model 3Rapid growth stage			
Variables	**Coefficient**	**t- Statistics**	**Std.Error**
PS	0.201	0.02311	0.000338
FF	0.422	0.04512	0.005662
CB	0.026	0.00379	0.007846
MI	0.531	0.76921	0.003986
C	0.0235	0.078125	0.087954
R^2=0.55 F statistics 6.951 P-value = 0.0231			

The above table presents the third Model of the study. This model explains rapid growth stage and its financial needs. The result of the model shows that formal finance in particular commercial bank loans is significant variable related to this stage. Therefore, this result concurs with previous literature which showed as much as entrepreneurs get experience and business growth they start getting external finance especially debt financing. Note that the R2 value of the study is 55%, which measures the extent to which the independent variables can predict the dependent variable.

Table6.Regression analysis of Model 4

Model 4Peak			
Variables	**Coefficient**	**t- Statistics**	**Std. Error**
PS	0.531	0.07125	0.000338
FF	0.632	0.09687	0.005662
CB	0.035	0.00231	0.001445
MI	0.133	0.05487	0.002587
C	0.0359	0.04895	0.06789
R^{2}= 0.35 F statistics 5.925 P-value = 0.0684			

Table 6 shows the regression analysis of the two sources of finance and how they were related to the small and medium enterprises (SMEs) stages. The results show that formal source of finance in particular, (Commercial banks loan) plays leading roles of financing SMEs in the state with .035 at 5% level of significance. This result shows that Bank Loans are the most accessible source of finance to SMEs due to getting good credit history and business experience. This result is in align with Financial Inclusion Experts Group 2010 and SAEED, (2009) that formal source of finance remains a reliable source of small and medium enterprises (SMEs) performance both in terms of growth and development.

CONCLUSION AND POLICY IMPLICATIONS

This paper has examined the small business stages and its financial needs. It is well known that finance is an inevitable too for SMEs growth and development. Therefore, the study affirmed that any stage of business has different need of finance. By doing this, the researcher used regression models to examine the relationship between source of finance and business cycle. From findings of the study, the researcher found that at start-up stage of each business needs self-financing and assistance of family and friends. But after they pass the first stage of development, founders gain enough courage to find financial support from other funding sources, such as business angels, either bank loans or other business debt financing, and seed investments, although the level of development of the company and the experience of managers are not necessarily associated with the financing method. In conclusion, most start-up companies prefer informal financial sources with emphasis on self-financing and financial assistance of friends and family. Evidence from previous literature showed that most start-up companies fail because they cannot implement the product in the way they planned to, they work on the implementation of the wrong product for too long and in doing so spend a significant amount of money – both for marketing and sales, just to sell the wrong product (Nobel, 2011). After analysis this statement can be true in Somali context. Therefore, this study suggests that potential entrepreneurs should learn how to do the business feasibility study. This will help them to remain focused. As well as, the researcher recommends establishing center for entrepreneurship and training for mentoring the young business owners.

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