Pecking Order Theory Impact on UK Small- and Medium-Sized Enterprises' Financing

Abstract

Purpose - The paper examines pecking order theory (POT) impact on small- and medium-sized enterprises' (SMEs) financing in the UK.

Design/methodology/approach - The paper adopts a qualitative method based on semi-structured interviews of forty-five (45) owners/managers to examine the POT impact on SMEs' financing in the UK.

Research findings - 11% of owners rely on debt/equity primarily as their source of finance before internally generated funds. This suggests that the alternative POT approach is adopted in the financing of business activities. This manifests in three ways: first, because there is a tax shield on the interest paid on debt; second, because the internal source of finance is not enough to cater for capital investment; and third, because an expert may be required in the businesses, in terms of venture capitalists, to help support growth and expansion. The study assesses that 89% of owners/managers will use POT in their financing judgements.

Research limitations/implication - Due to the number of SMEs that are concentrated within the UK, the study adopted a non-probability sampling technique to collect data from owners/managers of SMEs.

Practical implications - The study extends the POT in assessing the combination of capital strands in SME financing. Further, it informs SME owners/managers of the alternative forms of financing available for their business activities.

Originality/value - The last study conducted on POT within the context of the UK was in 2011 by Zata-Poutziouris. This study is timely in adding to the study of SME financing using the POT approach within the context of the UK and to modestly contribute to the knowledge based on SME financing.

Keywords: investment approaches, pecking order theory, SME, SME financing, sustainability.

Paper type: Research paper

1. Introduction

Small- and medium-sized enterprises (SMEs) are widely recognised as the backbone of developed economies and are of considerable economic importance (e.g. Xiang and Worthington, 2015; Cheong *et al.*, 2020). For developed economies, the International Monetary Fund (IMF) (2020) operationalisation of an advanced economy is used herein, which at the time of writing comprises 39 economies (e.g. Australia, Italy, the Netherlands, UK and US). In the UK, the role that SMEs contribute in terms of employment, gross domestic product (GDP) and tax revenues cannot be underestimated. According to a report published by the Department for Business Innovation and Skills (BIS) (2019), SMEs in the UK contributed about 61% employment to the workforce in the private sector, with an average turnover of £2.2 billion. Despite the above statistics, which support SMEs' important role in the development of the UK economy, SMEs are still facing challenges in accessing finance to support their business activities. Covid-19 brought issues of their financing to the forefront, particularly difficulties in accessing finance. In the UK, the issue with SME financing was noted in a report known as the 'Macmillan Gap' (Johnman and Murphy, 2000). Historically, the lack of finance SMEs face has been included within the UK's 'public policy' (Hughes, 1997) since the 1970s, when SMEs started to emerge and gain ground, when the Bolton (1971) and Wilson (1979) reports reaffirmed the difficulties they were facing in accessing finance externally and emphasised a lack of supply of finance for SMEs, which prevented their 'growth and expansion' (Roland, 2016). A later report issued by the BIS (2012) states that an 'equity gap' exists in providing equity finance for SMEs and higher interest charges affect the finance that SMEs need to raise to expand their businesses (Carpenter and Peterson, 2002). Lodorfos *et al.* (2023) highlighted the value relevance of considering the business resilience for SMEs with various global contexts in normal or exceptional circumstances such as Covid-19. Also, Shubita *et al.* (2023) addressed the impact of mining activities as perceived by social communities as proxies of adopting sustainability approaches by the mining companies. In addition, Ceesay *et al.* (2021) addressed the value relevance of sustainability reporting in a larger context related to the top 100 public-listed companies in the London Stock Exchange (LSE). In the context of our studies, the value relevance of business sustainability and resilience is linked with the financial needs, and examines the POT impact on SMEs' financing in the UK. Previous studies on SME financing in the UK established that owners rely primarily on internal finance for their capital investments. These studies lack a comprehensive approach in reviewing the reasons why SME owners/managers adopt a POT strategy to raise finance to support their business activities. The POT establishes that there is a hierarchical order that SMEs follow in financing their business activities, starting from internal finance, followed by debt and equity. Previous empirical studies have tested the POT study from a quantitative point of view, which draws on 'averages' ('means') to show the financing behaviour of businesses (Cassar, 2003). They established that SMEs follow this order to raise finance to support their businesses, but they have not explored whether there is an alternative approach that SMEs use in financing their businesses in light of POT; whether they use debt/equity first, followed by internal funds. Myers and Majluf (1984) argue that capital structure theories require more development before they can explain the actual behaviour of businesses. Lemma (2015) further argues that more work needs to be done to understand this type of financing issue for SMEs. Thus, this study is in response to such absence and aims to understand why a particular type of financing decision may be selected (Hussain *et al.*, 2006; Cowling *et al.*, 2012; Fraser *et al.*, 2015).

Existing literature tends to focus on SMEs within a country/large geographical area or specific industry sectors. Consequently, there is a gap in the literature on research conducted for SME financing with a regional focus. Recent government policy on levelling-up highlights the need for investment in the northern belt, part of which is the Yorkshire and Humber region, focusing its attention on ensuring that SMEs within the region grow to contribute its fair share to national development. Therefore, this study and its focus on the context of the Yorkshire and Humber region in the UK is both timely and important as it aims to throw more light on the financing issues that SMEs face in the region.

The region has a population of over 5 million people, ranking alongside small countries like Ireland, Norway and Singapore. At the start of 2019, there were over 428,000 companies registered in the region (BIS, 2019). The region was ranked third in the UK for SMEs' exports with 43%, falling behind London and the south-east with 59% and 47% respectively, according to a poll by YouGov commissioned by Citrix (The Yorkshire Post, 2014). This points to the fact that the role SMEs in the Yorkshire and Humber region play is of significance to the UK economy.

The study finds that, in terms of financing capital investments, owners prefer to rely on debt/equity primarily as their source of finance before internally generated funds. They do this in three ways: first, because there is a tax shield on the interest they pay on debt; second, an internal source of finance is not enough to cater for the capital investment; and third, they may require an expert in their business in terms of venture capitalists to help support growth and expansion.

The sample cases were selected for differentiated replication, in that other studies may have focused on large SMEs, but the focus here is on the small size of SMEs. The study adopted a non-probability sampling method to help select the SME owners to be interviewed. This sampling method was used because of the size of the population (42,000) of SMEs in the Yorkshire and Humber region.

The contribution of the study is threefold. First, it contributes to the gap in the literature on POT study within the context of SME financing in the UK. The last study conducted on POT within the context of the UK was in 2011 by Zata-Poutziouris. Thus, this study helps expand the study of SME financing using the POT approach within the context of the UK. Second, the study fills the gap by adopting the inductive research approach through semi-structured interviews to explore how SME owners/managers finance their business activities. Third, the study informs SME owners/managers of the alternative forms of financing available for their business activities.

The structure of the paper is as follows: Section 2 discusses SME financing, POT and crowdfunding. In Section 3, the methodology of the study is presented. Section 4 looks at the results based on the qualitative study. Section 5 provides a discussion based on the findings and the contribution of the paper to the extant literature.

2. Literature review

2.1 SME financing

Beck (2013) argues that SME financing is the financial packages from institutions that are tailored for SMEs. Ganbold (2008) also asserts that access to finance is the supply of financial services by institutions without any 'price or non-price barriers'. The availability of external finance can lead to only few start-up businesses, allowing already established firms to access growth opportunities and allowing firms to invest in more efficient infrastructure and technology (Aghion *et al.*, 2007; Ayyagari *et al.*, 2011). Beck *et al.* (2006) argue that SMEs find it very difficult to attract external finance which impedes on their growth prospects, and that the help of financial and other institutions provides a platform to help curb the problem by using factoring and leasing tools. Furthermore, other studies have supported that firms in their start-up phase face more issues with accessing finance than firms in their developing and maturity stages since they have no track record of success and collateral to support their finance application (Berger and Udell, 1998; Ferreira *et al.*, 2011). In a similar light, Savignac and Sevestre's (2008) investigation of SMEs in France, points out that small and innovative firms face a higher interest rate on their loans than other firms, which reduces their demand for credit. Their results show that being innovative decreases SMEs' chances of obtaining finance. Kremp and Phillippon (2008) use data from French firms to establish a shift in the ownership structure of firms due to the lack of finance that individual firms face. Beck *et al.* (2008) surveyed 91 banks in 45 countries in 2008 and established that SMEs were not given the loans they requested because banks perceived them as riskier based on their size. However, Chandera and Setia-Atmaja (2020) establish that lending relationships reduce bank loan spreads and enhance SME financing.

2.2 The pecking order theory (POT)

Capital structure theories are one of the means that show how organisations choose the type, source and ratio of equity to debt of their capital structure to finance business activities (Frielinghaus *et al.*, 2005). There have been three main groups of capital structure theories in financing organisations: the Static Trade-Off Theory, Agency Cost Theory and POT (Sen *et al.*, 2009). POT helps to overcome some of the limitations of the other theories in the original capital structure view (Frielinghaus *et al.*, 2005). Previous studies (McNamara *et al.*, 2017; Jarallah *et al.*, 2018) have supported the POT in explaining SME financing. POT was first introduced by Donaldson in 1961 and was later modified by Stewart C. Myers and Nicolas Majluf in 1984. The theory arose based on asymmetric information ideas, as managers know more about their companies in terms of their prospects, risks and returns than investors. According to Martinez *et al.* (2019), POT describes a hierarchical order in terms of financing choices and has a central connection to the asymmetric information between lenders and companies. Companies tend to have more information on their future performance and survival than lenders. This results in the need for lenders to monitor companies, thereby increasing borrowing costs which encourage companies to adopt financing business activities from their funds in the first place.

Myers (1984) argues that companies prefer to rely on profits or reinvestment to avoid adverse selection problems from lenders. It is when these funds are depleted that they turn to bank debt, and lastly to the stock market. As the company performance improves, information asymmetry decreases, and there is an increase in financial access in terms of cost and the terms and conditions of finance. Under this theory, firms use a personal source of finance first because it is not subject to giving out information and is less expensive compared to the cost of capital from lenders. Secondly, a firm will turn to debt to raise capital once the internal sources have been exhausted (Myers, 1984). Firms prefer to issue debt because it is less expensive in comparison with new equity. Also, the cost of capital is tax-deductible. The last option firms will consider will be to issue expensive new equity. Since SME owners are, in most cases, the managers, unwilling to share inside information and/or relinquish control of the business to external investors, they use their internal income before considering borrowing elsewhere (Myers, 1984). This is supported by St-Cyr *et al*. (2000) and Minola and Giorgino (2011) who argue that young entrepreneurs prefer added services provided by venture capitalists, hence their quest for equity financing rather than debt. Further, various studies have established POT as the primary financing pattern of SMEs. Sogorb-Mira and Lopez-Gracia (2005) used panel data to study the financial behaviour of 6,482 SMEs from 1994-1998 in Spain. Similarly, Frank and Goyal (2003) used a dataset from CompStat comprising of SMEs from 1950-2003. Both studies reveal that those SMEs used POT financing. Conversely, other research supports that SMEs will prefer an alternative to pecking order theory (APOT) approach to finance their business activities. With such a proposal, firms will rely on internal funds, then equity before debt, whilst others will rely on equity and debt as their primary source of financing straightaway. Aghion *et al.* (2004) studied 900 firms from the LSE and found that firms with a high level of R&D tend to focus on using APOT. Similarly, Audretsch and Lehmann (2004) used data from 341 German-traded firms to establish that innovative firms use human capital rather than physical assets, and because of lack of collateral would prefer external equity over external debt financing.

Hogan and Hutson (2005), and Lucey and Bhaird (2006) both studied the financing pattern of SMEs in Ireland, and their results supported the POT for SME financing. Also, Sogorb-Mira and Lopez Gracia (2003) used panel data comprising of 6,482 SMEs in Spain from 1994-1998 to establish a similar financing trend. De Jong *et al.* (2011) used panel data from US firms covering the period from 1971-2001 to establish that SMEs adopted POT for their financing; this was supported by Zata-Poutziouris (2011), who argues through panel data from 1998-2008 of family-owned SMEs to establish that SMEs in the UK follow a similar approach. On the contrary, Koster and Rai (2008), in their analysis of 70

Indian enterprises, observe that firms that are managed by young entrepreneurs opt for a higher equity to debt ratio. This is further supported by Ullah *et al*. (2010), who argue in their research of 42 software firms and 41 biotech firms that the biotech firms support an APOT capital structure by focusing more on equity because of a lack of physical assets (collateral) to go in for debt. Bartoloni (2013) also established in Germany – from a dataset between 1996-2003 comprising of 2,591 SMEs – the use of POT in SME financing. Rossi (2014) further argues that SMEs in Italy adopt the pecking order in financing. They established this by using a dataset comprising 764 SMEs in Italy. Daskalakis *et al*. (2014) used the Hellastate database comprising 1,018 SMEs in Greece from 2003-2007. Their results show that the POT approach is widely used by all these SMEs. Further studies by Yazdanfar and Öhman (2015), who used the Affars database comprising of 15,897 SMEs in Sweden from 2009-2012, and Xiang and Worthington (2015), who used the Business Longitudinal database comprising of 2,732 SMEs in Australia from 2005-2006 support the use of POT by SMEs. But Minola *et al.* (2013) used data from 5,000 firms from the Kauffman Firm Survey to establish that most innovative firms follow the APOT. Research by Serrasqueiro *et al.* (2016) in Portugal from the SABI database, comprising of high-tech SMEs from 2000-2009; Balios *et al*. (2016) in Greece from the ICAP database from 2009-2012; Pacheco (2016) in Portugal from the SABI database of 3,164 SMEs from 2011-2014, also established the POT as a financing model adopted by SMEs. Also, Nunes and Serrasqueiro (2017) used the Social and Behavioural Instrument database from Portugal comprising of 177 SMEs; McNamara *et al*. (2017) used the Amandeus database from 2005-2011, and Jarallah *et al.* (2018) used panel data analysis from 1991-2015 to establish the same financing pattern they studied. But Cheong *et al.* (2020) argue that debt funding is not appropriate to SMEs in Malaysia; rather, alternative sources of finance – like access to non-bank credit sources and tax incentives – are.

Jansen *et al.* (2023) analysed 1,087 incremental financing decisions from 277 family firms to test the POT. The results indicated that family firms initially prefer internal finance, followed by debt, then family capital and then external capital. Further, Sumail and Akob (2022) studied manufacturing companies listed on the Indonesian Capital Market using regression analysis. They found that financing behaviours at young stages and waning stages tend to follow the POT. However, in the mature stages of the company, due to the behaviour of profitability, retained profit, free cash flow and size those companies' financial behaviour changes to trade-off theory (TOT). Choi (2023), in his study, used the ordinary least square (OLS) method to determine the capital structure of firms in the hospitality industry. The results show that firms rely significantly on internally generated funds, followed by debt, then equity finance. Lisboa *et al.* (2023) used an unbalanced panel data to sample 407 firms from the Portuguese civil construction sector from 2010-2019. They established that POT is prevalent in these firms, however, TOT also supports some established results. Additionally, Mendes *et al.* (2023), in their research to identify the determinants of the capital structure of SMEs in the tourism sector in Central Portugal, applied the economic model of linear regression to sample 606 SMEs. Their results disclosed that SMEs followed the assumption of POT more closely. However, there is an indication of the TOT assumption. They therefore concluded that POT and TOT are not mutually exclusive in explaining the capital structure decision of SMEs. Sulistianingsih and Santi (2023) collected sample data from 623 SMEs to test the POT using the structural equation model (SEM) partial least square (PLS). Their results indicate that SMEs which have a low level of financial literacy tend to have a high tendency for home bias decision and a high risk of preferences. Hence, their financial decisions to support their business activities do not follow the POT. Jaworski and Czerwonka (2023) studied the financial data of 2,820 SMEs in Poland operating between 2011-2018. They established that those SMEs behave in accordance with the POT. However, they also established that 24% of them exhibited the TOT approach in financing.

The support of the extant literature for POT for SME financing cannot be underestimated. Harris and Raviv (1991) assert that the only way to minimise the fall in share prices of SMEs would be for the company to finance new projects through less risky sources, such as its own internal finance or issuing debt securities. They only need to raise finance through the issuance of equity once the investment is completed and they need to pay off the debt. This therefore supports the POT approach. Chirinko and Singha (2000) argued that there are two forms of financing for SMEs: strong financing and weak financing. Strong financing occurs when an SME chooses only two sources of financing – namely, the use of internal sources of finance and the issuance of debt – and does not result in the issuance of shares for its financing needs. Alternatively, weak financing is when the SMEs have no problem with information asymmetry and therefore add the issuance of shares in their financing needs. Novo (2009) acknowledged two types of financing which are common to SMEs: self-financing and bank credits. They argue that since SMEs find it difficult to access the capital market, offering new shares to attract finance is not achievable. Also, since banks find it very difficult to trust SMEs, when such SMEs' profitability is high it gives them the greater capacity to be able to finance their business activities from internal sources. Further, Abrantes (2013) argued that SMEs are businesses that usually operate in less concentrated markets with high competition at their disposal, in addition to high risk and probability of high bankruptcy. As a result, they tend to reduce the debt level and finance their business activities from internal sources. The above assertion was also supported by Bharma *et al.* (2018), who argue that SMEs have a behaviour of financing their activities which usually use funds that have the lowest cost and less risk. Thus, they focus on internal finance to avoid the potential of information asymmetry, followed by debt and equity.

2.3 Crowdfunding

According to Allison and Anglin (2025), crowdfunding is an alternative way of financing a business compared with the traditional sources of capital. It involves a lot of people (the crowd) contributing funds to support new product ideas or growth initiatives. This type of financing has become attractive to SMEs – especially family-run businesses. There are three types of crowdfunding: reward based, equity based and debt based. Reward based is when people contribute to receive a reward; equity based is where people contribute in exchange for unlisted shares; and debt-based is where funds are given to attract some percentage of interest similar to loans from a bank. Allison and Anglin (2025) argue that reward-based crowdfunding is now popular and appeals to both SMEs and resource providers. With this type of finance, there is no exchange of debt or equity, however, there are resource providers who want to offer finance in exchange for future goods and services (Taeuscher *et al.*, 2021; Soubliere *et al.*, 2024). This type of funding helps entrepreneurs to identify and meet market needs which enable them to create new business opportunities (Wessel *et al.*, 2022; Primanti *et al.*, 2024). Further, Stevenson *et al.* (2022) argue that SMEs prefer reward-based crowdfunding as it gives them the opportunity to raise funds without diluting ownership (Troise *et al.*, 2023). However, Motylska-Kuźma (2020) and Rossi *et al.* (2023) argue that most SMEs use equity crowd financing as it enables them to meet their needs by getting the support they require to help them grow. According to Rossi *et al.* (2023), the crowd are not usually attracted to family firms though they can be safe investment opportunities.

The aim of the paper is to examine the POT impact on SMEs' financing in the UK. The objectives of the paper are: (i) to establish the impact of POT on SME financing; (ii) to establish whether there is an APOT in SME financing. The questions to be addressed in this paper are: (i) how does POT impact on SME financing? (ii) are there other alternatives to pecking order theory (APOT) that impact on SME financing?

3. Methodology

3.1 Research design

In this study, the inductive approach is applied through an interpretivism philosophical stand via semi-structured interviews of forty-five (45) SME managers/owners to help establish how they finance their business activities (Creswell, 2013); further details are listed in the Appendix. Conducting interviews using this approach helps gain rich information that may not be possible using a quantitative approach as in other POT studies (Basu and Bhola, 2016). This is the case in this study since the focal point is to explore the POT in SME financing. A qualitative study design could help establish why and how this approach is adopted by SMEs.

3.2 Sample process

The type of research conducted which results in establishing how SMEs finance their business activities is of a sensitive nature that not all SME owners were willing to answer. Hence the use of a non-probability sampling (criterion) method. A study conducted by Kaur and Gupta (2023 adopted a criterion sampling method to select a sample of 600 SMEs to establish why they selected a specific bank for their business needs. Further, Saumure and Given (2008) argued that non-probability (criterion) sampling focuses on the participants that are easily available and ready to be interviewed and provide the necessary information. Additionally, Poluan *et al.* (2024) used the criterion sampling method to collect data from 96 SMEs to establish the impact of financial literacy, financial technology and intellectual capital on their business operations. For this study, considering the number of SMEs located in the Yorkshire and Humber region and the sensitive nature of the interview questions being asked, the criterion method fits the research technique. Though the criterion sampling has its own flaws, the number of SME managers/owners interviewed for the study intended to minimise the disadvantages of the criterion sampling method.

The criterion-based sampling method was used to help select the SME owners to be interviewed. This method involves the selection of cases that meet a predetermined criterion of importance (Patton, 2002). The study adopted the criterion-based sampling method because of the number (42,000) of SMEs in the Yorkshire and Humber region. Considering the sensitive nature of the topic under investigation, a convenience sample was relied upon to include participants that were readily available while ensuring no conflict of interest by asking that all participants filling in the consent forms were willing to participate and had knowledge to provide. The following are the criteria adopted in selecting the samples: (i) SMEs which are in manufacturing, retail and service industries; (ii) SMEs which have been in business for more than five years; (iii) SMEs with turnover values above £250,000; and (iv) SMEs with assets values above £500,000.

3.3 Data collection

To address the issue of SME financing, first, company names were obtained from the Yorkshire and Humber region business website, which includes the names of businesses that have been registered with them, however not all the businesses were in that register. Second, calls were made to companies to introduce the researchers and ask permission for an appointment to be arranged for an interview. Some agreed they would call back to arrange the interview, which they did not do, and others that booked an interview subsequently decided they were not able to do it. This then resulted in a change in strategy, to adopt going to business owners to talk to them directly. This strategy worked well as the majority of the interviews were conducted on the spot with the business owners/managers. Third, a semi-structured interview was conducted to help understand how SME owners finance their business activities. The interview questions centred around four main themes: (i) SMEs explaining the sources and composition of finance; (ii) how SMEs raise finance to support their business activities; (iii) why SMEs raise finance in this particular way; (iv) to what extent the SME's business relies on external finance. Out of the forty-five (45) interviews conducted, only ten (10) interviews were officially arranged; the rest were all conducted on the spot with the owners and managers of the business. The interviews were all conducted in English and on the business premises. The sample case selected for differentiated replication in other studies may have focused on large SMEs, but the focus here was on the small size of SMEs. This sample was chosen because SMEs (less than 10 employees) in this category contribute about ninety-nine (99) per cent of all SMEs in the UK (BIS, 2019). Also, previous studies have mostly focused on SMEs with more than 10 employees (Serrasqueiro *et al.*, 2016; Yazdanfar and Ohman, 2016; McNamara *et al.*, 2017).

3.4 Data analysis

Since the interviews were related to financing, which is a sensitive topic, owners did not allow recording; therefore, the interviews were handwritten, transcribed, analysed and categorised into themes such as: how SMEs raise finance; why they raise finance in a particular way; reasons for raising finance; external finance reliance; difficulty in accessing finance; factors preventing the supply of finance; trade credits impact; personal savings; retained earnings; family finance; and invoice financing. All quotations below are respondents' comments to clarify to the readers the exact words of participants in order to differentiate them from the researcher's own words. The participants' business names were anonymised. Data analysis was carried out by going through all the transcripts on numerous occasions to provide meanings from the recordings and to ensure that the main salient points had been captured (Whitfield and Strauss, 1998; Rossiter 2008). The transcripts were then uploaded into Nvivo 11 to set up categories that would help in putting them into themes to enable answering of the research questions. Nodes needed for analysis of the interview scripts were created, taking into consideration the research questions the study wanted to address. Each interview script was analysed on a line-by-line basis to help identify themes and categorise them into nodes created; the nodes were further analysed into various themes. According to Welsh (2002) and Denzel and Lincoln (2011), Nvivo can help enhance the 'quality, rigour and trustworthiness' of the research. Alexander and Spencer (2019) also argue that one of the main features of using Nvivo is: "the use of hyperlinks to find connections and relations which would be very difficult and time-consuming if done manually".

4. Results

4.1 Explanation of composition of finance

Some participants would prefer to use their business profits (internal funds) as a secondary option rather than a primary one since they do not make enough profits. This does not follow the POT. Studies have shown that most firms do not follow the traditional POT but prefer to use internal funds first, then equity before external debt (Bartoloni, 2013; Minola and Cassia, 2013). However, based on this study, SME owners prefer to use debt first, then business profits, before relying on equity. These behaviours of SMEs are termed the APOT approach to their financing needs. Further, some SME owners/managers indicated in the interviews that they would always use trade credits, bank loans and overdrafts as their first option for supporting their business activities. This is because they do not make enough profit to rely on it to expand their business. In addition, with the use of bank loans and overdrafts, they can offset the interest on these loans as an expense against the income they generate in the business.

The APOT approach:

"I will consider raising finance through trade credits, bank loans and overdrafts." Owner/Manager - A manufacturing and service company in Hull

"Firstly, I will consider raising finance through trade credits, bank loans and overdrafts." Owner/Manager - A retail and service company in Grimsby, north-east Lincolnshire

4.2 How do SMEs raise finance to support their businesses?

The interviews also concentrated on establishing how SMEs raise finance to support their businesses. The combination of sources identified by the owners and managers were through personal savings, banks, business profits, buying of more stock, family members, sale of property and vehicles, selling of stock and personal equity in their properties. The combination of sources followed the POT and APOT strategies of SME financing. Amongst all these sources, the most frequent and primary source of finance is business profits. This was the case with SME owners/managers interviewed in the manufacturing, retail and service sectors. This finding is consistent with prior research (Serrasqueiro and Nunes, 2016; McNamara *et al.*, 2017; Jarallah *et al.*, 2018), who all argued that SMEs raise finance from personal savings, business profits, debt and equity. It was further noted in the interviews that no SME used only one method of finance to support their business. The combinations of the sources of finance ranged from personal savings and business profits, personal savings and bank loans, personal savings and family loans, business profits and bank loans, business profits and family loans. Some SME owners/managers stated that they sometimes raise finance through the sale of properties and other fixed assets, but still with the combination of business profits, bank loans and family loans to support their business operations.

The POT approach:

"*Firstly, I will rely on my own profits to support any expansion before relying on any bank loans and overdrafts and shares to raise funds." Owner/Manager - A manufacturing and retail company in Grimsby, north-east Lincolnshire, UK*

The APOT approach:

"Firstly, I will consider raising finance through trade credits, bank loans and overdrafts." Owner/Manager - A retail and service company in Grimsby, north-east Lincolnshire, UK

4.3 What are ways to raise finance other than the one suggested by the POT?

The interviews further sought to establish the reasons why SME owners adopt a particular way of raising finance to support their business. Below are some of the reasons given by those business owners/managers. These responses conform to the APOT strategy of raising SME financing.

4.3.1. High amount of capital needed to support business

A couple of SME owners/managers had to raise finance through the banks because they could not raise it from their savings and business profits due to the amount of money involved to support their capital expenditure. They went through the banks because they needed the funds to buy plant and machinery for their business, as at that time, they did not have the money and could not think of a better way of raising the finance. Others had also contacted their banks to raise finance for investment in their business because of the trust their banks had in their business and willingness to support any expansion. Some, in other instances, needed extra finance to buy more stock to meet rising demands from their customers. According to them, they had contacted their banks because their banks were comfortable with their needs and were willing to help them. Other SME owners/managers had contacted their banks because they had just started the business, and they needed enough funds to help them with their business needs. All these SME owners/managers stated that the banks were their first and last choice of raising finance at that time.

The APOT approach:

"I raise finance through the banks simply because I don't have the cash to buy more stock. Also, I have long-standing relationship with my bank who appear comfortable with my needs and are willing to help any time I approach them". Owner/Manager - A retail business in Hull, UK

"I have raised finance through the banks and private equity investors because I need the money to purchase plant and machinery for my business, which at that time, I did not have the sort of finance." Owner/Manager - A manufacturing and retail company in Hull, UK

4.3.2 High amount of interest on loans and overdrafts

Those businesses who had to raise finance from their personal sources, as well as through reliance on their business profits (POT strategy), did so because they did not want to pay high interest on any finance (which would affect the profits they make in the long run). The fear of paying a high amount of interest to financial institutions was the concern of some SME owners/managers which was why they would not go to the banks for loans and overdrafts. According to some of them, using their own money to support their business is cheaper, gives them peace of mind and puts them in control over their own business. For some, the high interest rates on loans and overdrafts could affect the length of time it would take to settle those loans and overdrafts. Others would also prefer to approach family members (who would not charge interest) to raise finance rather than going through the banks to incur interest and unnecessary bank charges.

Other participants did not like to approach the banks for anything because of their experience with them when they needed finance. Some SME owners/managers also did not like to contact their banks because they felt their banks would waste their time without giving them anything. Some of them also said that the banks would deliberately raise the interest rates on loans and overdrafts just to deter them from applying. The above findings highlight some of the reasons why SME owners/managers did not want to go to the banks for any form of finance (the issue of high interest rates). Therefore, some of them cannot expand their business activities.

The POT approach:

"I use business profits to support my activities because I don't want to pay interest to anyone and also be in debt as well. Better always to use your own finance than borrowing from people. This always gives me peace of mind." Owner/Manager - A manufacturing and service business

4.3.3 Fear of losing control of the business

Some SME owners/managers raised finance through business profits and personal savings because they did not want to relinquish control of the business to people who would control and dictate to them how to run it (POT strategy). The sense of security of the business was their major concern. They thought that when they used external finance for the business, it would give an opportunity to other people to control the running of their business. So, because of their fear of losing control, they preferred to use internally generated finance to sponsor their business needs. The findings from this study have shown that some SME owners may want finance to support their business growth but are not willing to do so because of the fear of losing control of the business to outsiders. The above statements support earlier research conducted by Curran (1986) and Jarvis *et al.* (2000), who state that SME owners prefer to maintain control of their business by refusing to apply for external finance.

The POT approach:

"Security! It puts me in control over my own affairs rather than relying on people who would come and dictate to me the way I need to run my business." Owner/Manager - A retail company in Hessle, East Riding of Yorkshire, UK

4.3.4 Proof of a successful business

Other SME owners/managers decided to raise finance by relying on their savings and business profits to prove to their banks that they are doing extremely well (POT strategy). This can lead to a lot of finance from their banks at a reduced interest rate which they may need for future capital investment in their business. They believe that having to do it on their own sends a positive signal to financial institutions, which gives an impression of good credit and the integrity of the business. They stated that most financial institutions would prefer to see that the business is successful in managing its affairs and is financially sound. In such cases, the banks would begin to offer money to businesses, even if it is not needed.

The POT approach:

"I raise finance in this way because of a good credit rating if needed and managing with integrity for the business. Financial institutions like it if you can finance your business activities and they will always come to your help if you are sound financially." Owner/Manager - A retail company in Grimsby, UK

4.3.5 Traditional way of raising finance

A couple of SME owners/managers view their ways of raising finance as traditional and straightforward. They would prefer to continue with tradition without changing their routine. Some said that they have raised finance historically through sales and retained earnings, and would prefer to stick to that (POT strategy). They also said they would prefer to use their own capital for their business needs rather than relying on bank loans and overdrafts. The SME owners/managers who have been raising finance through bank loans and overdrafts said they have always raised finance this way and would like to continue with the tradition. Others who have been doing it through their savings, family loans and business loans see it as a very simple and straightforward means of raising finance, and they would prefer to continue doing so.

The POT approach:

"We raise finance through sales and retained profits because historically that is how we have raised finance. We don't need to raise finance in other ways, such as bank loans and overdrafts. We always prefer to use our own capital for our business activities." Owner/Manager - A manufacturing company in Bridlington, UK

"I use my own savings, family loans or business loans because it is the simplest way of raising the finance you need to support your business ventures." Owner/Manager - A retail and service company in Hull, UK

4.3.6 Lack of trust in financial institutions

Some interviewees also stated that they would prefer to rely solely on business profits and personal savings (POT strategy). This is because they find it very difficult to trust financial institutions due to the way they have dealt with them in the past. They stated that it would be very difficult for the banks to win their trust again. They said further that banks are costly, and most of the time, unwilling to help. Also, even if they want to help, they demand a lot of unnecessary things from small businesses before they can help. In conclusion, it has been established that they raise finance through other means and would not want to contact the financial institutions for support because of the lack of trust that some owners/managers have in some financial institutions.

The POT approach:

"I raise finance through plough back profits because I don't trust the banks. They are very expensive to deal with and many at times they are unwilling to help. They demand a lot for any small help they want to offer you." Owner/Manager - A service business in Hull, UK

4.3.7 Fear of borrowing and being in debt

Some of the businesses never made it to step two of the POT, because they are afraid of borrowing and being in debt. Some of these SME owners said that they have made it their policy that they would always rely on business profits to support all their business needs (POT strategy). Even if their business profits were not enough for that investment, they would not borrow from anywhere but prefer to wait until they have raised enough finance internally for that project. Most SME owners/managers said that borrowing from any source would be their last resort which they would try to avoid. Some of them have vowed that if they cannot finance the project from internal sources, they will not push themselves into other means, which could create unnecessary pressure on their business. Some also stated that not borrowing money from any source gives them the peace of mind to focus on how they will build their business.

The POT approach:

"I rely on my own profits to support my business because I don't like borrowing money from anybody. I prefer to use my own money and not to owe anyone." Owner/Manager - A service business in Hull, UK

"We have always used our business profits to finance all our business needs. I have a simple policy that if I cannot afford it I will save up until I can be able to afford what I need to buy. There is no need to go borrowing." Owner/Manager - A manufacturing and service company in Hull, UK

5. Discussion and implication

The findings show that SME financing is mainly focused on business profits, personal savings, and borrowing from friends and families before going externally. It is further established that SME financing is shaped primarily by the POT approach. Alternatively, there are other businesses that will focus on debt and the use of equity to finance their business activities because of the large sums of money they require for that investment. To such businesses, this approach of financing is relevant for their business model, which helps them to expand quickly and meet customer demand, as well as being competitive in the market within which they operate. Some SMEs would prefer to use their own business profits as a secondary option, not a primary, since they do not make enough profits to support their business activities. To such businesses, the APOT is relevant to them.

Also, most SMEs use a different combination of sources of finance such as personal savings, business profits, buying and selling of stock, family members, and sale of property and vehicles. Further, some SMEs raise finance through banks because they cannot raise finance from savings and business profits to support their operations. For such businesses, they have gone to their banks because they needed the funds for capital investments.

Other SMEs would prefer to focus on personal savings because they do not want to pay high interest on loans and overdrafts from financial institutions. For such businesses, they would prefer not to lose their business because of defaulting on interest payments. Other SMEs may always prefer to rely on savings and business profits to prove to lenders that they are doing well. This can lead to them taking out loans from their banks at a reduced interest rate in the future. Other SMEs would also like to keep to their traditional way of raising finance through their retained profits and may not want to change that tradition.

Some SMEs also have trust issues with financial institutions because they believe that the banks increase interest rates on loans and overdrafts with a short notice period. This has prevented them from contacting banks to raise finance. Others also have a fear of borrowing, and they would not dare to borrow from any source even if they think they might need the funds to survive and grow the business.

6. Concluding remarks

The study extends the POT in assessing the combination of capital strands in SME financing by adopting the criterion-based sampling method to help select the SME owners to be interviewed. This sampling method was used because of the number (42,000) of SMEs in the Yorkshire and Humber region. The study was conducted within the context of this region in the UK. The study finds that, in terms of financing capital investments, 11% of owners/managers prefer to rely on debt/equity primarily as their source of finance before internally generated funds; thus, they follow the APOT. They do this in three ways: first, because there is a tax shield on the interest they pay on debt; second, internal source of finance is not enough to cater for the capital investment; and third, they may require an expert in their business in terms of venture capitalists to help support growth and expansion, whilst 89% of owners/managers rely on internal sources, then debt before equity, thus following the POT. Further, from the perspective of SME owners/managers, UK banks have some way to go to build trust within the UK SME community.

The study has some limitations, which are worth highlighting. Due to the number of SMEs that are concentrated within the eastern part of the UK, the study adopted the criterion sampling technique and adopted the cross-sectional time horizon technique for the data collection within the area chosen for the study, also assuming a longitudinal method of study was adopted that could have given another interpretation. Finally, the context within which the study was carried out, which is within the eastern part of the UK, also poses a limitation. A different contextual perspective to include SMEs across the UK could have provided different insights into this research topic. For further studies of SME financing, it would be interesting to adopt a TOT approach to establish its impact on SME financing within the UK and determine which one applies to SME financing in the UK. This will combine well with the findings adopting the POT.

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Competing interests

All authors declare that there is no conflict of interest.

Data availability

The anonymised version of the data used in the paper will be available upon request.

Ethical approval

The study was approved by the University of Hull upon collecting the data.

Informed consent

The informed consent was obtained from all participants as part of the ethics approval and data collection process.

Appendix

1. Details of Interview

Type of Business	No of Business	Type of Business %	Person Interviewed	Legal Status	
				Incorporated	Un-Incorporated
Retail only	21	47%	Business owner/Finance manager	11	10
Service only	11	24%	Business owner	3	8
Retail and Service	8	18%	Business Owner	6	2
Manufacturing and Service	2	4%	Business owner/Managing director	1	1
Manufacturing and Retail	3	7%	Business owner	1	2
	45	100%		22	23

(Full details of interview list are available upon request)

2. Details of SMEs who follow POT vs. APOT

SMEs	Total No	POT	APOT
Retail Only	21	19	2
Service Only	11	11	0
Retail and Service	8	7	1
Manufacturing and Service	2	1	1
Manufacturing and Retail	3	2	1
		40	5

3. Semi Structured Interview Questions

1. How do you raise finance to support your business activities?
2. What are the reasons behind raising finance in this way?
3. To what extent does your business rely on external finance to grow?
4. Have you considered using Venture Capitalist or Private Equity Investors before?

   a) If yes please elaborate: e.g. how you heard about them, how you approached them, how successful you were, the difficulties involved?

   b) If no, why? Haven't you heard about them or heard negative things about them……

5. Have you raised any finance from government agencies before and how easy was it?

6. Have you raised finance through the issue of debt before? Please tell me more about this experience.

7. Have you raised finance through the issue of equity before? Please tell me more about this experience of yours.

8. Will you agree that finance is a major issue for your growth and survival? If yes why? And if no what is a major setback for your growth and survival.

9. Does your business use invoice financing as a source of finance and why?

10. Does your business use trade credits as a source of finance and why?

11. How do you perceive the banks attitude towards small business like you? Is it negative or positive? And what in your opinion is that perception?