# THE PECKING ORDER THEORY AND START-UP FINANCING OF SMALL AND MEDIUM ENTERPRISES: INSIGHT INTO AVAILABLE LITERATURE IN THE LIBYAN CONTEXT

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*The Pecking Order Theory states that internal financing is preferred when available; and, if external financing is required, debt is preferred over equity. Thus, this paper aims to test the application of The Pecking Order Theory as an exploitation of start-up financing of Small and Medium Enterprises in Libya.*

The firm life cycle is divided into four different stages. Each stage has its own prescribed characteristics. The different stages of the firm lifecycle are Birth or Startup stage, Growth stage, Maturity Stage and finally the Decline or Revival stage. The startup stage is considered to be the starting point where the entrepreneur tries to convert an idea

into a business opportunity. In the startup stage founder and the key personnel are the main employees of the firm followed by small funding requirements.

Access to finance for startup firms has always been an issue of debate within the circle of Economists and Researchers. Issues related to the capital structure decision have attracted lot of attention, because of the reason that these issues are primarily dominant in small size and young firms. Capital structure has been defined as the mixture of debt and equity used to finance the business activities of a firm (Myers, 1984). The ability to gain adequate access to financial capital enables SMEs to establish and subsequently operate effectively. The capital structure decisions of SMEs therefore have important implications for their performance, their ability to succeed, their risk of failure and their potential for future development.

Several major financial theories have been developed to explain the capital structures that firms adopt (Johnsen and McMahon, 2005). Pecking Order Theory (POT) is more suitable to identify the SME capital structure compared to other theories even though it is developed for large corporations (Mlohaolas [et al.], 1998; Osei-Assibey [et al.], 2011).

However, there is a lack of such studies in Libyan context, particularly in SMEs. Therefore, this study attempts to fill this gap in the finance literature addressing the research question, "To what extent does the POT appear to explain financial structure of SMEs in Libya?". Thus, the objectives of this study are two-fold: first, to investigate the financing preference of SMEs in Libya at start-up stage; second, to examine whether the POT can explain such financing preferences of SMEs in Libya at start-up stage. The study is organised as follows; Section two discusses the research methodology. Section three is devoted to a review of the relevance of POT for start-up SMEs. Section four dials with literature on SMEs start-up finance in Libya and application of POT. The last section concludes the paper.

The research is based on the structured review of the literature. The first part of literature review includes the selection of most relevant articles on SMEs access to finance at start-up stage in Libya. A comprehensive literature search of published academic, peer reviewed professional literature using a variety of databases including journal articles, conference papers and thesis, both published and unpublished, was conducted. The main sources were the Internet. Once the articles are selected it is followed by the next step, which is the analysis of the selected articles. Based on the definitions of POT, the results of such studies will be analysed to find out various components that are available to answer the research questions of the paper. Furthermore, the results gathered from the analysis will be merged to give a meaningful interpretation and help in more structured literature review.

However, the main limitation of the literature review, as a study methodology, is that it relies on information which has already been researched (secondary information), and if there is none, then specific questions on the new study might not be adequately answered. Secondly, owing to different objectives and methodologies (and study designs) of previous studies, the data might not be in the right format or specific enough to answer the current study. Because of these limitations, a literature review is always conducted in preparation for primary and more detailed research (NCR, 2011). Thus, this research aims to provide a theoretical framework for the research followed by other researchers in future.

Financing decision at start-up stage of SMEs, selecting one or more sources of finance mainly depends on available financial sources in the financial system, preferences of owners and accessibility to finance. This decision is one of a vital decision for any firm regardless of the size, industry, etc. This is because business continuity has a direct relationship with firm finance and its effect on ability of taking competitive advantage. As a result, financing decisions are imperative for SMEs similar to large enterprises as SMEs are functioning as backbone of any country specially a developing country like Libya.

SMEs can use different types and sources of financing methods especially informal sources, which differ from traditional or formal sources of finance, namely equity and debt.

Johnsen and McMahon (2005) briefed five capable theories which is more relevant in SME financing, which named as Static Trade-off Theory, Agency Theory, Growth Cycle Theory, Alternative Resources (Bootstrapping) Explanations and Pecking Order Theory (POT). POT to date remains essential part of corporate finance. It is considered as one of the most influential theories. The Pecking Order Model developed by Myers (1984). According to this model firms prefer internal funding over external funding. In case firms require external funding, they would prefer debt over equity. Traditional methods represent a logical sequence for start-up companies to start raising money, and most start-up companies enter the entrepreneurial world in this way. If the start-up project founders do not have their own financial resources (prefer internal funding) and cannot independently raise the start-up without external investments they usually turn to the traditional financing sources such as: 3F (i. e. Friends, Family and Fools), business angels, bank loans and venture capital investments. Equity is generated as last resort .

The POT sought mainly to explain the observed financing practices of large publicly traded corporations. However, it was soon recognised that the theory may also relevance of SMES and apply to the financing practices of non-publicly traded SMEs that might not have the additional financing alternative of issuing external equity finance. Scherr et al. consider the POT to be an appropriate description of SMEs' financing practices, because the 'Pecking order hypothesis is in keeping with the prior findings that debt is by far the 4 largest sources of external finance for small business'. In addition, Holmes and Kent suggest that in SMEs 'managers tend to be the business owners and they do not normally want to dilute their ownership claim'. Thus, the issue of external equity finance, and the consequential dilution of ownership interest, may be further down the pecking order. The theory's application to SMEs implies that external equity finance issues may be inappropriate. In relation to the owner-manager's control over operations and assets, if the POT holds, then internal equity finance will be preferred, because this form of finance does not surrender control. When external financing is required, obtaining debt rather than equity finance is favoured, because this places fewer restrictions on the owner-manager.

A growing number of researchers have sought to establish whether the pecking-order theory can assist in explaining the capital structures adopted by SME. This study attempts to contribute to the existing literature focusing the debate on capital structure and financing behavior of SMEs from a developing country perspective and examines the capital structure and financing patterns that represents by Libyan SMEs based on POT.

**Definition of SMEs in Libya.** Understanding the SMEs and its contribution to the economy is not complete without identifying the still unresolved question of what really constitutes SMEs. There is no universally agreed definition of SMEs. Generally, there are two common approach to defining the SMEs. The first is a functional definition in which the small businesses are distinguished from the larger ones on the basis of suspected or proven characteristics. For example, Ang (1991), suggest that a business is classified as small if it possesses most of the following characteristics: a) it has no publicly traded securities; b) the owners have undiversified personal portfolios; c) limited liability is absent or ineffective; d) first generation owners are entrepreneurial and prone to risk taking; e) the management team is not complete; f) the business experiences the high cost of market and institutional imperfections; g) relationships with stakeholders are less formal; h) it has a high degree of flexibility in designing compensation schemes. The second approach to the definition of a small business employs some quantitative measures, such as number of employees, sales turnover, level of output or capital assets.

However, in Libya, the Ministry of Manpower, Training and Employment (MMTE) adopted the second approach in defining the SMEs in Libya. It establishes a national standard for SMEs, which stated that: "private productive or service businesses and instruments for economic and social development, accommodate the strengths of youth, and which includes professional administrative, and technical specifications which are suitable to operate efficiency". The MMTE classified SMEs in Libya as shown in the table 1.

*Table 1*

**Libyan classification for productive, service, and commercial businesses**

| Business | Size of employment | Size of fixed assets |
|---|---|---|
| Small | No more than 25 | Less than 2.5 Million Libyan Dinars |
| Medium | 26–50 | Less than 5 Million Libyan Dinars |
| Large | More than 51 | More than 5 Million Libyan Dinars |

*Source*: MMTE Report of 2004 (reported in Hajjaji, 2012).

Finally, it is worth to mention that there is a large number of SMEs in the Libyan economy, though the exact size of the sector is unknown. This is due to the fact that most SMEs in Libya have conducted their business outside the formal economy to avoid taxation and other fiscal and regulatory considerations. Currently the SME sector is dominated by the production of food products, wood products, and metal for construction. Some SMEs also engage in the production of clothing, ceramics and bricks, grain milling and press and publication goods.

**Importance of SMEs in Socio-Economic Development in Libya.** In general, there is a growing recognition that SMEs can be a vital resource to combating some of the challenges facing the region by contributing to job growth and the economy, and bridging some of the regional economic development imbalances that have emerged within developed and developing countries.

However, it is generally acknowledged that there is substantial evidence that SMEs face large growth constraints and have less access to formal sources of external finance, potentially explaining the lack of SMEs contribution to the country's economic growth.

Accordingly, SMEs are very important to Libyan economy because of the fact that the economy of Libya suffers from lack of economic diversification in its activities. The government has proactively created the national programs for SMEs in 2008 to promote a vibrant SME sector. However, although 96 % of the enterprises in Libya are SMEs, their contribution to the GDP of the country is only 4 %. This is supported by UN's report of 2008. It stated that: "the contribution of SMEs to the Gross Domestic Product (GDP) is estimated to be less than 10 percent in most African counties". The main aspects of this disadvantaged position is due to: 1) the Libyan economy is heavily dependent on the exports of oil for state revenue; more than 96 % of exports are from the oil sector (Eltaweel, 2012, UN, 2008), and 2) the financial difficulties for these enterprises to have accessed for bank loan successfully (Zarook [et al.], 2013 a, b).

**Literature on SMEs Start-up Finance in Libya.** By reviewing the available literature on SMEs start-up finance in Libya, one can say that in Libya, bank lending to SMEs Firms is relatively low. Falah (2006) reported that only 4 % of Libyan SMEs borrow money from banks. Moreover, Eltaweel (2011) and Elmansori and Arthur (2013) found out that loans from banks represent only 11 and 8 %. Wahab and Furthermore, Abdesamed (2012) examined the issue of financing SMEs in the startup phase and when they were

established as businesses. They found that 81.6 % of startup firms used informal sources of finance and among these; 60.5 % preferred personal savings, whereas only 17.1 % preferred formal sources of finance. Moreover, 71.1% of the mature businesses were still using informal financing such as personal savings (25 %); family subsidies (25 %); trade credit (15.8 %) and their own profit (5.3 %); whereas 27.6 % were relying on bank loans. Table 2 gives a description of this trend.

*Table 2*

**Source of Finance of SMEs in Libya**

| Source at the Startup stage | Percentage | Source after the Startup stage | Percentage |
|---|---|---|---|
| Personal Saving | 60.5 | Personal Saving | 25.0 |
| Family Loan | 3.9 | Family Loan | 25.0 |
| Friend Loan | 9.2 | Trade Credit | 15.8 |
| Active Partner | 2.7 | Firm Profit | 5.3 |
| Inactive Partner | 5.3 | – | – |
| **Bank Loan** | **17.1** | **Bank Loan** | **27.6** |
| Total | 98.7 | Total | 98.7 |
| Missing System | 1.3 | Missing System | 1.3 |
| Overall Total | 100 | Overall Total | 100 |

*Source*: Abd Wahab and Abdesamed (2012, p. 1538–1539).

Abdulsaleh stated that: "overall, the three most common sources of funds used by SMEs in the sample to finance business start-up were as follows: owner-managers' own savings, venture capital and bank finance. Just a above half of enterprises in the whole sample has used the own savings of their owner-managers as the primary source for start-up capital". Moreover, regarding to the source for post start-up, he stated that: "a cross the sample financing source generated internally (retained earnings and personal saving) were the most preferred source for ongoing finance... when it comes to external sources banks and trade credit from suppliers were found to be the most preferred other sources of finance (equity finance and government assistance) were found to be least". However, Abdulsaleh and Worthington (2018) found out that bank loans in Libya are largely made on the strength of the relationship between the bank and the SME rather than the financial statement-, asset-, or credit scoring based approaches to bank lending found in more developed economies with stronger banking sectors.

Samawi et al. also confirmed such fact by saying that: "When asked about sources of finance, 75 % of respondents said that they had started their businesses by using informal finance, which is consistent with the 73 % of Libya SMEs that were found to rely on informal sources of funding in a study by Falah (2006). Most had used their personal and family savings at startup".

The above results of literature clearly consistent with the pecking order theory of capital structure and suggest that SMEs Start-up (even post start-up) finance in Libya tends to finance their expansion with debt over equity after exhausting their internal resources. This conclusion was supported by Masoud (2014) who stated that: "the empirical finding of this study contribute towards a better understanding of financing decisions of these firms can be explained by the determinants suggested by much of extant the empirical literature. Specifi-

cally, it is found that liquidity and profitability are negatively and significantly related to the leverage ratios, which is consistent with pecking order theory. This implies that firms prefer to finance investment with internally returned funds before issuing debt".

This study attempts to contribute to the existing literature focusing the debate on capital structure and financing behavior of SMEs from a developing country perspective and examines the capital structure and financing patterns that represents by Libyan SMEs based on Pecking Order Theory. Based on the literature review, it can be more or less concluded that financing businesses from personal savings, family and friends have been considered as very significant source for providing seed capital for most start-ups and expansion, as it remains the popular choice for SMEs in Libya. Moreover, when it comes to external sources banks and trade credit from suppliers were found to be the most preferred and equity finance was found to be least.

Although this study does not provide empirical evidences of SMEs but at least this study will contribute in addition of literature review and knowledge regarding SMEs in Libya. However, as the main limitation of the literature review, as a study methodology, is that it relies on information which has already been researched (secondary information), an empirical study is recommended to provide more support to findings of this study.

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