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بِوَسِيْلَةِ اِسْلَامِ اَنْبَا وَاِيْجَابِ مَلِيْسِيَا

STUDY ON FINANCING AND FINANCIAL  
PERFORMANCE OF SMEs IN MALAYSIA

BY

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## ABSTRACT

The experience around the world suggests that small and medium-sized enterprises (SMEs) have played an important role in the industrialization and development of an economy as they make-up over 98 percent of all enterprises. Typically, the SMEs are generally under-capitalized. Hence, they need financing throughout their stages of development. Realizing the importance of financial assistance to the SMEs, Malaysian public and private sectors had provided various financing schemes and programs specifically meant to cater their needs and requirements. Nevertheless, most facilities are in the form of debts (Islamic and conventional alike) and little are in the form of equity. Hence, they are left with limited financing choices but debts. This had caused them to be generally financially leveraged. Will the abundant availability of debt in the SMEs' financial structure give favourable impact to the SMEs financial performance is something that this study try to investigate. Specifically, the study examined the methods of financing utilized by the SMEs, their perception towards such methods and the relation between the enterprises' external financing with their financial performance (ROA and ROE). Primary and secondary data of the study were acquired from survey and the SMEs financial statements. The methods of data analysis employed on the survey and published data were descriptive, factor analysis and OLS regression. Descriptive and factor analysis were used to examine SMEs financing preference and perception. OLS regression on the other hand, was employed to estimate the relationship among the variables under study. The samples covered those SMEs operating in the area of Klang Valley. Consistent with many previous findings, the study found that internally generated funds (i.e. savings or retained earnings) were the main source of capital. Banks' credits were sought when external financing are required. Interestingly, quite a number of enterprises preferred to have Islamic financing (eg. *Qarḍ Ḥasan*, *Murābaḥah* and *Bay' bithaman ājil*) and a significant number of them are ready to apply profit/loss-sharing (PLS) equity financing (*Mushārahah* and *Muḍārahah*) if they are given the opportunity. The study also found that Malaysian SMEs were generally highly leveraged (high level of debts) irrespective of their sizes and age. This high leverage in the SMEs financial structure was found to have significantly negatively related to the enterprises' financial performance (ROA). The findings of this study send an alarm to the relevant parties and authorities such as entrepreneurs, banks and policy makers that over abundance of debts may pose problem to the SMEs. It was proposed that the offering of PLS equity financing facility to be given premier attention as it might give more benefits to the enterprises than debt-based facilities.

## ملخص البحث

تثبت التجارب التي حصلت في أنحاء العالم أن الشركات الصغيرة والمتوسطة الحجم تلعب دورا كبيرا في تطوير وصناعة الإقتصاديات لأنها تمثل 98% من كل المؤسسات التجارية. ومع ذلك فإن هذه الشركات لم يتم استغلالها كما ينبغي، ومن ثم يحتجن إلى تمويل في كل مرحلة من مراحل تطورها. إدراكا لأهمية المساعدة المالية لهذه الشركات فقد قامت قطاعات العامة والخاصة في ماليزيا توفير نظم وبرامج تمويلية متعددة مخصصة لتغطية حاجاتهم ومتطلباتهم. وبالرغم من ذلك، يكون أغلب هذه التسهيلات تعطى على شكل الديون (إسلاميا كان أو تقليديا) وقليل منها على شكل الأسهم. ولذلك أصبحت خياراتهم التمويلية قليلة غير الديون، وهذا جعلهم غالبا معرضين لضغط مالي. ستبحث هذه الدراسة ما إذا كان توافر الديون في هيكل التمويل لمثل هذه المؤسسات يعطي أو يؤثر إيجابيا على أداء مالي لهذه الشركات. وفي هذه الدراسة تبحث كذلك عن أساليب التمويل أو مناهجها المستخدمة بهذه الشركات على وجه التحديد، حيث كانت ملاحظتهم وإدراكهم لهذه المناهج والعلاقة بين التمويل الخارجي للشركة وأدائها المالي (العوائد على الأصول والعوائد على الأسهم). وقد تم جمع معلومات أولية وثانوية عن طريق دراسات ميدانية والحصول على كشف الحسابات لهذه الشركات. وكانت الأسلوب التي اعتمدت في تحليل هذه الدراسة والبيانات المنشورة وصفية ودراسة استقصائية وOLS. وقد تم استخدام أسلوب تحليل العامل والوصفي في تحليل التمويل المفضل للشركات ونظرتهم تجاه ذلك. وتم استخدام OLS في تحديد علاقة المتغيرات في الدراسة. وأخذت الدراسة كنموذج الشركات العاملة في منطقة Klang Valley. ووجدت الدراسة وفقا مع نتائج دراسات سابقة أن الأموال الداخلية (التوفيرية والأرباح غير موزعة) هي المصدر الرئيسي لرأس المال. ويتم طلب التمويل المصرفي عند الحاجة لتمويل خارجي. ومن المثير أن هناك كثير من المؤسسات التجارية التي تفضل التمويل الإسلامي (القرض الحسن والمرابحة وبيع بثمن أجل) وعدد كبير منهم مستعدون للمشاركة و المضاربة إذا أعطيت فرصة. ووجدت الدراسة بصفة عامة أن الشركات الصغيرة والمتوسطة الحجم الماليزية مضغوطون أكثر ( مستوى عالي من المديونية) بغض النظر عن حجمهم أو عمرهم. ووجدت أن هذا الضغط الكبير في هيكل تمويلي لهذه المؤسسات له علاقة سلبية على الأداء المالي (العوائد على الأصول) لهذه المؤسسات. وهذه النتيجة تبعث إنذارا إلى جهات ذات الصلة أي جهات إشرافية وأصحاب المشاريع والبنوك وصناع قرارات السياسية مفادها أن توفر الزائد للقروض يمثل مشكلة لشركات الصغيرة والمتوسطة الحجم. ومن المقترح هنا أن عرض تمويل حسب المشاركة لا بد له أن يعطي إهتمام أكبر لأنه مفيد لشركات أكثر من تسهيلات المبنية على الديون.

## APPROVAL PAGE

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## DECLARATION

I hereby declare that this dissertation is the result of my own investigations, except where otherwise stated. I also declared that it has not been previously or concurrently submitted as a whole for any other degrees at IIUM or other institutions.

Siti Khadijah bt. Ab. Manan

Signature.....

Date.....

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**AN ANALYSIS ON THE FINANCING AND FINANCIAL  
PERFORMANCE OF SMALL AND MEDIUM SIZED ENTERPRISES  
(SMEs) IN MALAYSIA**

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I dedicate my love to:

Husband; Ahmad Khalid b. Ismail,

Kids; Aiman, Asma', Husna, Humaira, Munawwar, Mujahid

and my parents Hj. Ab. Manan and Hajjah Khamisah.

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## LIST OF ABBREVIATIONS

ABI	Agricultural Bank of Iran
AITAB	Al-Ijārah Thumma Al-Bay <sup>c</sup>
AIM	Amanah Ikhtiar Malaysia
ANOVA	Analysis of Variance
APEC	Asia Pacific Economic Cooperation
ASEAN	Association of South East Asian Nation
BA	Bankers' Acceptance
BBA	Al-Bay <sup>c</sup> Bithaman Ājil
BIMB	Bank Islam Malaysia Berhad
BITMB	Bank Industri dan Teknologi Malaysia Berhad
BMMB	Bank Muamalat Malaysia Berhad
BNM	Bank Negara Malaysia
BPIMB	Bank Pembangunan Industri Malaysia Berhad
BSN	Bank Simpanan Nasional
CCM	Companies Commission of Malaysia
CGC	Credit Guarantee Corporation
DAGS	Direct Access Guarantee Schemes
DFIs	Development Financial Institutions
DOS	Department of Statistic
DTAR	Debt Over Total Asset Ratio
ECR	Export Credit Refinancing
et al.	( <i>et alia</i> ): and others
etc	( <i>et cetera</i> ): and so forth
EXIM Bank	Export-Import Bank of Malaysia

FDP	Franchise Development Program
FGCM	Financial Growth Cycle Model
FGS	Flexi Guarantee Scheme
FFS	Franchise Financing Scheme
FIs	Financial Institutions
GDP	Gross Domestic Products
GSP	Global Supplier Programme
IBGS	Islamic Banking Guarantee Scheme
IBS	Islamic Banking System
IBs	Islamic Banks
ICT	Information and Communication Technology
i.e.	that is
ILP	Industrial Linkage Programme
IOFC	Islamic Offshore Financial Center
JBIC	Japan Bank for International Cooperation
JEXIM	Export-Import Bank of Japan
KFH	Kuwait Finance House
KMO	Kayser-Meyer-Olkin
LC	Letter Of Credit
LSDV	Least Squares Dummy Variables
LTD	Long-Term Debts
MARA	Majlis Amanah Rakyat
MATRADE	Malaysian External Trade Development Corporation
MAVCAP	Malaysian Venture Capital Management Bhd
MBC	Malaysian Biotechnology Corporation Berhad
MIDA	Malaysian Industrial Development Authority
MDV	Malaysia Debt Venture Berhad
MDeC	Multimedia Development Corporation

MECD	Ministry of Entrepreneur and Co-operative Development
MIDF	Malaysian Industrial Development Finance
MITI	Ministry of International Trade and Industry
MNCs	Multi-national Corporations
MOSTI	Ministry of Science, Technology and Innovation
MSA	Measure of Sampling Adequacy
MTD	Medium-Term Debts
MTDC	Malaysian Technology Development Corporation
n.d.	no date
NEP	New Economic Policy
NPGS	New Principal Guarantee Scheme
NPLs	Non-Performing Loans
NPV	Net Present Value
OECD	Organization of Economic Cooperation and Development
OECF	Overseas Economic Cooperation Funds
OLS	Ordinary Least Squares
OMs	Owner-Managers
P.B.U.H.	Peace Be Upon Him
PC	Principal Component Analysis
PLS	Profit Loss Sharing
PUNB	Perbadanan Usahawan Nasional Berhad
PNB	Perbadanan Nasional Berhad
PROSPER	Project for Bumiputera Entrepreneurs in Retail Services
R & D	Research and Development
ROA	Return on Assets
ROE	Return on Equity
ROI	Return on Investment
SBA	Small Business Administration

SEAP	SME Expert and Advisory Panel
SEGS	Small Enterprises Guarantee Scheme
SIB	Sudanese Islamic Bank
SMEs	Small and Medium-sized Enterprises
SMIDEC	Small and Medium-Industry Development Corporation
SMIDEX	SMIDEC Annual Showcase
SPSS	Statistical Package for Social Sciences
SRL	Sequential Response Logit
STD	Short-term debts
TBSFs	Technology-Based Small Firms
VC	Venture Capital
VDP	Vendor Development Programme
YTN	Yayasan Tekun Nasional

# CHAPTER ONE

## INTRODUCTION

### 1.1 INTRODUCTION

The 21<sup>st</sup> century is the era of global economy in which industrialization plays a very significant role to lift one's economy to be at par with the global market. Industrialization process involves a transition of one's economy from the traditional agricultural-based to an industrial-based economy. In this regard, the experience around the world suggests that the small and medium-sized enterprises (later termed as SMEs) have played an important role in the industrialization and development of a country's economy. Since the SMEs constitute a major percentage of the economy across the globe, developed and developing alike, they have been acknowledged as the primary contributor to the growth and development of an economy.

SMEs are said to have contributed significantly in terms of increasing the Gross Domestic Products (GDP) and play a significant role in creating jobs and employment opportunities. Besides, they also made valuable contributions in regional income generations, savings, trainings, stimulation of competition, aiding large firms, and introduction of innovations and as a seed-bed for growth (Mohd Khairudin, 2005). In many parts of the world, SMEs accounted for the majority of business establishment. Figures of the SMEs in the Asia Pacific Economic

Cooperation (APEC) region indicated that they make-up over 98 percent of all enterprises (refer Table in Appendix 1) (Hall, 2002).

As far as their contribution to economy is concerned, SMEs in these APEC countries provide quite a significant percentage of employment. The said enterprises for instance provide 87.9 percent jobs in Peru, 66 percent in Australia, 59.4 percent in Hong Kong, 69.9 percent in Japan, 78.7 percent in Korea, 65.2 percent in Mexico, 60 percent in New Zealand, 69.5 percent in Philippine and 43.1 percent in Singapore (Hall, 2002). They also generate about 50 percent of sales or value-added to the respective countries (Hall, 2004).

Similar figures are obtained in Europe and the United States (US). As reported in Mulhern (1995), there were 17 million enterprises in European Union of which 99.9 percent were SMEs and only 0.1 percent was large firms. In the US, there are about 20 million small businesses constituting 97 percent of US enterprises that employed 75 percent of the workforce and accounted 45 percent of the US Gross Domestic Products (GDP) (Nickels, Mchugh and Mchugh, 2005). India as one of the new emerging robust economies in Asia also gives similar figures. There are over 3 million SMEs in India, representing over 90 percent of industrial units and contributing about 35 percent of industrial outputs (Raju, 2005).

Statistics on SMEs in Malaysia also show a similar fact. The Census of Establishment and Enterprises 2005 had reported that the SMEs made up over 98

percent of the total business establishment (Small and Medium Industries Development Corporation [SMIDEC], 2006). These enterprises contributed quite significantly to the economy of the country<sup>1</sup>. Realizing the important role of the SMEs, the government of Malaysia consistently gives financial support for the progress and development of the enterprises. Funds are made available via various schemes and programs, and credit guarantee facilities are introduced to make the funds easily accessible to them. Beside, debt resolution scheme has been set up to facilitate the restructuring of SMEs which are viable but being burdened with non-performing loans (NPLs).

Nevertheless, the abundance of loan facilities plus the demanding approval requirement of the scantily available equity funds has led many of the SMEs to resort to debt. This phenomenon is theoretically and practically acceptable from the loan providers' perspective owing to the perceived high risk of moral hazard problems among small and medium enterprises. The Islamic financing facilities are no less different as Bank Negara Malaysia (BNM) Annual Report for the year 2000 to 2005 showed that more than 98 percent of funds extended by Islamic banks in Malaysia were in the form of debt-based financing (Bank Negara Malaysia [BNM], 2001 - 2005).

While debt is necessary for the free flow of cash in the operation of the SMEs, over proportion of debt in their financial structure may pose problem to

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<sup>1</sup> Further discussion on SMEs in Malaysia and their contributions to the economy of the country is captured in chapter three.