

Obstacles for the Sustainability of Business Start-ups: The Case of North Western Province in Sri Lanka

M.K. KULUPPUARACHCHI¹, A.M.T.P. ATHAUDA¹, and H.M.S.L. WIJEWARDANE²

¹*Department of Agribusiness Management, Faculty of Agriculture and Plantation Management, Wayamba University of Sri Lanka, Makandura, Gonawila (NWP), 60170, Sri Lanka*

²*National Enterprise Development Authority, No.561/3, Elvitigala Mawatha, Colombo- 05, Sri Lanka*

ABSTRACT

Small and Medium Enterprises (SMEs) form the backbone of the Sri Lankan economy and are essential in a competitive and efficient market. New SMEs play a vital role in the economy addressing the sustainable development of job creation, economic growth, competitive market pressure and the overall stimulation of the country's economy. The SME failure rate in Sri Lanka is quite as high as 45%. Therefore, the primary objective of this study was to examine both internal and external organizational factors which are acting as obstacles for the growth of new SMEs in Sri Lanka. Thirty four major variables were identified as obstacles through focus group discussions (FGDs) and a survey of literature. Principal Component Analysis (PCA) with varimax rotation was used to reduce the identified variables into five components. The most perceived obstacle was termed as finance which is largely internal to the firm with an Eigen value of 8.17 and a percentage variance of 24%, while the other obstacles determined by PCA were management (internal), market (external), infrastructure (external) and economic (external) in descending order. Even though, PCA emphasized finance as the most important obstacle for the growth of new SMEs in Sri Lanka, the study suggested that the new SME owners are equally in need of financial management knowledge.

KEYWORDS: Business start-ups, New small and medium enterprises, Obstacles, Principal component analysis

INTRODUCTION

Entrepreneurs are the change agents in economies. SMEs play a vital role in almost all economies in the world, especially in the developing countries like Sri Lanka. SMEs serve as stepping stones for large enterprises and most of the large enterprises have begun as SMEs at their inception. Many SMEs have gained recognition as a major player of employment, income generation, poverty alleviation and regional development (Anon, 2002). Furthermore, they play important roles in developing entrepreneurial skills and innovation and promoting economic growth and wealth creation. The Government of Sri Lanka recognizes SMEs as the backbone of the economy since they accounts for more than 75% of the total number of enterprises, providing 45% of the employment and contributing to 52% to the GDP (Anon, 2015).

At present, Sri Lanka doesn't have a generally accepted set of criteria for SMEs. Instead, different agencies use different criteria based on their objectives and hence there is no consistency. Turnover, wealth and number of employees employed have been identified as major criteria in defining SMEs. The industrial, trade and the service sectors have given rise to substantially different distributions, and, as such, different thresholds have been identified for each of those sectors to define micro, small, medium and large establishments. It is currently estimated that there are 1,019,681 business

firms of all sizes in Sri Lanka (Census and Statistics, 2015).

Statistics show that at least 99.8% of the firms are micro, small and medium enterprises having only 0.2% are large ones. It is vital for Sri Lankan SMEs to look beyond Sri Lankan boundaries in order to gain sustainability and growth. The study is based on the start-up culture of SMEs. There are specific reasons which cause business failure among the SMEs. It explores the fundamental question of why some businesses succeed while others fail under similar economic conditions. Most of the SMEs fail at their start-up stage itself.

At present, the government provides various services through a large number of public institutions which are directly involved in the development of SMEs in Sri Lanka. Even though, they provide various assistance with regard to loans, training, technology, marketing, and management, the principal issue in the SME sector is its poor performance against the large scale enterprises in the national economy (Priyanath, 2014). Contribution of the SME sector is paramount for the Government's efforts in the promotion of a balanced regional growth and development of the rural economy. The SME sector is an ideal platform for the government to build human capital to a level where the potential benefits of a state-led SME drive could be fully realized (Weerakkody, 2015). For an example, in 1983, 98% of small enterprises accounted for 48.6% of the total

employment and 31.1% of value added products. In 2008, 91.6% of small enterprises accounted for 29.6% of total employment and 20.3% of value added products (Priyanath, 2014). It is observed that the statistics show a downward trend in SMEs in Sri Lanka. The Sri Lankan entrepreneur is culturally different from his/her western counterpart. Social power is a key motivator for the Sri Lankan entrepreneur. Studies have suggested that entrepreneurial motivation in Sri Lanka is entrenched not in the need for individual achievement, but in a conscious or unconscious need to satisfy a sense of social intimacy. Studies have also recognized business failure upon the exit, bankruptcy, or liquidation of the enterprise. The rate of business failure among SMEs in Sri Lanka is 45% (Bandara, 2016).

According to statistics published by the Small Business Administration (SBA), at least 30% new establishments fail within the two years from its inception while 49% fails within five years (Jayasooriya, 2016). Business start-ups often fail because founders and investors surge forward without taking time to realize that base assumption of their business plan is wrong. They believe that they predict the future accurately, rather than trying to create a future of their own. Entrepreneurs tend to be single-minded with their strategies wanting the venture to be all about the technology or all about the sales, without taking time to form a balanced plan (Jayasooriya, 2016). It is crucial to overcome these shortcomings. New SMEs are seen as a significant component of the solution to Sri Lanka's development issues, but most of the new SMEs fail during the first few years of operation. The objective of this study is to identify major causes for such failures and to evaluate both internal and external environmental factors that stand as obstacles for the growth of new SMEs in Sri Lanka.

METHODOLOGY

Theoretical Framework

Consequent to a comprehensive survey of literature and several FGDs with SME owners, 34 obstacles were identified as major obstacles for the growth of new SMEs, which were broadly identified and categorized into five major components.

Data Collection

North Western Province (NWP) was the study area which is consisted of two districts, Kurunegala and Puttlam. Primary data were collected using a pre-tested structured questionnaire from a randomly selected sample of 152 newly registered coir based, milk based and broiler firms which are the most prominent

and established SMEs in the area. Collection of data was carried out during the period from 1st March to 9th April 2016 with the help of development officers of the National Enterprise Development Authority.

Data Analysis

The use of five point Likert scale enabled respondents to indicate their opinion on a variety of factors of the business environment that have an impact on the start-up of new SMEs. A pilot study had been carried out to pre-test the viability of the questionnaire while its reliability was ensured by using Cronbach's Alpha. The large number of internal and external variables related to the obstacles for the start-up of new SMEs made the analysis of data more difficult and complicated. The PCA was used to avoid grouping of highly correlated variables together, instead of dividing them into principal components and, as a result it brought a simplification to the analysis. Bartlett's test of sphericity (BTS) and the Kaiser-Meyer-Olkin (KMO) were accommodated to measure the sampling adequacy and used to determine the factorability of the matrix as a whole. High values (between 0.5 and 1.0) indicate factor analysis is appropriate (Olawale *et al.*, 2010). SPSS (version 16) statistical package was used for the analysis.

RESULTS AND DISCUSSION

Descriptive Analysis

The socio demographic characters of the sample revealed that majority of the SME owners were female (72.4%). This must be due to the type of business, milk based products and coir based products, which are dominated mainly by the female owners. The majority of the SME owners were between the range of 36-50 years of age (48.7%). This may be mainly due to the fact that younger generation prefers to employ in other occupations than being a SME owner. Further, it revealed that the most of the owners had completed both G.C.E. O/L and G.C.E. A/L examinations (40.1%) and the highest educational level provident was graduates with bachelors' degree (3.9%). The main reason is that more educated people prefer white collar jobs. However, young people with no proper educational background tend to join SME sector by their own dedication and commitment without staying unemployed. It was observed that more than half of the owners (54.6%) had not registered their businesses with relevant government authorities. This may be due to reason that the fear of the SME owners to get involved with such authorities. Thirty eight percent of the SMEs were between one to three years in operation and nineteen percent of

the SMEs were of less than one year. More than half of the owners had obtained loans (63.2%) while the majority had obtained loans from formal financial institutions (93.7%). Sixty eight percent of the loan obtained owners had provided government personnel as collaterals when obtaining loans from banks (Table 2).

Table 2. Descriptive statistics of the sample

| Parameter | Category | Percentage (%) |
|-----------------------------|----------------------|----------------|
| Gender | Male | 27.6 |
| | Female | 72.4 |
| Age distributions | Less than 20 | 0.7 |
| | 21-35 | 30.3 |
| | 36-50 | 48.7 |
| | More than 50 | 20.4 |
| Education level | Below Grade 10 | 13.8 |
| | Up to Ordinary Level | 40.1 |
| | Up to Advanced Level | 40.1 |
| | Graduates | 3.9 |
| | Diploma | 2.0 |
| Business registration | Registered | 45.4 |
| | Not registered | 54.6 |
| Time of establishment | Less than one year | 19.1 |
| | One to three years | 38.2 |
| | Four to six years | 15.1 |
| | More than six years | 27.6 |
| Loan obtained or not | obtained | 63.2 |
| | Not obtained | 36.8 |
| Sources of loan | Bank | 93.7 |
| | Family | 5.2 |
| | Friends | 1.1 |
| Collaterals to obtain loans | Land | 25.0 |
| | Government Personnel | 67.7 |
| | Building | 1.0 |
| | Vehicle | 6.3 |

Geostatistical Analysis

To ensure the appropriateness to use PCA, the KMO and BTS tests were carried out. BTS 2.700E3 and the level of significance $P=0.000$ indicated that data were appropriate for the purpose of PCA. The results showed that KMO measure of sampling adequacy was 0.797 which indicated that there were sufficient items for each component (Table1).

Table 1. Kaiser-Meyer-Olkin (KMO) and Bartlett's test

| | | |
|----------------------------------|--------------------|---------|
| KMO Measure of Sampling Adequacy | | 0.797 |
| Bartlett's Test of Sphericity | Approx. Chi-Square | 2.700E3 |
| | df | 561 |
| | Sig. | 0.000 |

The most Crucial Obstacle for New SMEs

The first component had an Eigen value of 8.17 and a percentage variance of 24.04% (Table 3). The component consisted seven statements. The statement of the highest factor loading was collateral/guarantee requirements

to obtain bank loans which is said to be too stringent (0.838). Usually bankers expect answers to five conditions when obtaining a loan, as; the amount of money requested, the way the money is being used for, the way the loan is collateralized, when the loan is going to be paid back and the way the loan is going to be paid back. If the owner fails to answer any of these questions properly, the red flag will be raised. Unwillingness of banks to lend money without collateral is the biggest problem. This is because SME owner suddenly thinks to obtain a loan from a bank even without a bank account or a business plan. Therefore, the bankers do not have the trust that the loan will be paid back within the given period of time and they ask for trustworthy collateral.

The other statements used to determine the extent of finance as an obstacle were, time consuming for process of loan application (0.833), lack of interest in obtaining loans from banks (0.792), too much restrictions from the money lenders (0.719), insufficient time for loan repayment (0.711), high interest rates for loans (0.664), and difficulty of access to finance (0.503) (Table 4).

The fact that the loan applications were time consuming since bankers take about three months for processing a loan. The lack of interest in obtaining loans from banks is due to various reasons such as scared to go to bank, scared to fill the forms, reluctance to take risks and high interest rates like 14% which is quite high for them. Component one was labeled as Finance.

The Other Critical Problems for New SMEs in NWP

Management, Market, Infrastructure and Economic were identified as the other most critical components.

Management: The component had an Eigen value of 3.42 and percentage variance of 10.06% (Table 3). The component consisted of 12 items. The item with the highest factor loading was poor knowledge about government rules and regulations (0.770). This may be because SME owners do not have much knowledge about government rules and regulations when registering and continuing their business.

The other statements included were poor application of information and communication technology (0.724), lack of awareness about quality certificates (0.661), lack of planning for the next stage of the business (0.642), lack of

Table 3. Variance explained

| Component | Initial Eigenvalues | | | Extraction Sums of Squared Loadings | | | Rotation Sums of Squared Loadings | | |
|-----------|---------------------|---------------|--------------|-------------------------------------|---------------|--------------|-----------------------------------|---------------|--------------|
| | Total | % of Variance | Cumulative % | Total | % of Variance | Cumulative % | Total | % of Variance | Cumulative % |
| 1 | 8.17 | 24.04 | 24.04 | 8.17 | 24.04 | 24.04 | 4.79 | 14.09 | 14.09 |
| 2 | 3.42 | 10.06 | 34.10 | 3.42 | 10.06 | 34.10 | 4.51 | 13.27 | 27.36 |
| 3 | 2.93 | 8.63 | 42.73 | 2.93 | 8.63 | 42.73 | 3.30 | 9.70 | 37.06 |
| 4 | 2.26 | 6.63 | 49.36 | 2.26 | 6.63 | 49.36 | 3.29 | 9.69 | 46.75 |
| 5 | 1.81 | 5.31 | 54.67 | 1.81 | 5.31 | 54.67 | 2.69 | 7.92 | 54.67 |

Table 4. Rotated component matrix

| Component | 1 | 2 | 3 | 4 | 5 |
|---|--------------|--------------|--------------|--------------|--------------|
| 1. Collateral/guarantee requirements to take bank loans are too stringent | 0.838 | | | | |
| 2. The process of loan applications is time consuming | 0.833 | | | | |
| 3. Not interested in obtaining loans from banks | 0.792 | | | | |
| 4. Too much restrictions from the money lenders | 0.719 | | | | |
| 5. The repayment of the loan is not enough. | 0.711 | | | | |
| 6. Interest rates are high | 0.664 | | | | |
| 7. Access to Finance is difficult | 0.503 | | | | |
| 8. Poor knowledge about government rules and regulations | | 0.770 | | | |
| 9. Application of ICT is low | | 0.724 | | | |
| 10. Lack of awareness about quality certificates | | 0.661 | | | |
| 11. Lack of planning for the next stage of the business | | 0.642 | | | |
| 12. Lack of information about new technology | | 0.620 | | | |
| 13. Lack of knowledge in business planning/management | | 0.618 | | | |
| 14. Lack of higher education | | 0.603 | | | |
| 15. Cost for obtaining quality certificates are high | | 0.546 | | | |
| 16. Poor account management | | 0.496 | | | |
| 17. Difficulty in obtaining information on markets | | 0.402 | | | |
| 18. Difficulty in obtaining business registration | | 0.358 | | | |
| 19. Bad credit history | | 0.308 | | | |
| 20. Insufficient government support | | | 0.704 | | |
| 21. High production costs | | | 0.680 | | |
| 22. Infiltrations are high | | | 0.657 | | |
| 23. Decline of demand for the products | | | 0.568 | | |
| 24. Nonpayment risk on credit sales | | | 0.566 | | |
| 25. Lack of novel business opportunities based upon new technologies | | | 0.523 | | |
| 26. Interruption of water supply | | | | 0.813 | |
| 27. Poor roads | | | | 0.790 | |
| 28. Breakdown of electricity supply | | | | 0.782 | |
| 29. Poor communication facilities | | | | 0.770 | |
| 30. Location of the business is less pivotal now | | | | 0.482 | |
| 31. Inflation is high | | | | | 0.684 |
| 32. High tax rates | | | | | 0.652 |
| 33. Deterrent rules & regulations of the government | | | | | 0.613 |
| 34. Political instability | | | | | 0.499 |
| Cronbach's Alpha | 0.889 | 0.845 | 0.774 | 0.812 | 0.728 |

information about new technology (0.620), lack of knowledge in business planning /management (0.618), lack of higher education (0.603), high cost for obtaining quality certificates (0.546), poor account management (0.496), difficulty in obtaining information on markets (0.402), difficulty in obtaining business registration (0.358) and bad credit history (0.308) (Table 4). The obstacle was labeled as management which is also internal to the firm.

Market: This component had an Eigen value of 2.93% and a percentage variance of 8.63% (Table 3). This component was consisted of six statements. Insufficient government support to find the market (0.704), high production cost (0.680), high Infiltrations (0.657), decline of demand for the products (0.568), non-payment

risk on credit sales (0.566), and lack of novel business opportunities based upon new technologies (0.523) (Table 4) were also included to measure the market component as an obstacle. This component is external to the firm and labeled as market which revealed that most of the SME owners are unable to find their target market. It was revealed that most of the SMEs have limited access to larger markets terms of market linkages, transport and information exchange.

Infrastructure: The component had an Eigen value of 2.26% and a percentage variance of 6.63% (Table 3). This component consisted of five items as; interruption of water supply (0.813), poor roads (0.790), breakdown of electricity supply (0.782), poor electricity

supply (0.782), poor communication (0.770), and location of the business is less pivotal (0.482) (Table 4). This component is also external to the firm. Expanding and constantly upgrading of infrastructure facilities, and thereby bridging the disparity in facilities between the rural and urban areas may prevent failures at start-up stage (Jayasooriya, 2016). Further, location is critical to the success of a business at the start-up stage whereas a good location may enable a struggling business to survive and thrive ultimately while a bad location could spell disaster to even the best managed enterprise. Some factors to consider are customer base, traffic, and accessibility, location of competitors, the history, community flavour and receptiveness to a new product.

Economic: The final component with least importance consisted of 1.81 Eigen value and a 5.31% of variance with four items (Table 3). The component was labeled as economic which consisted of high inflation (0.684), high tax rates (0.652), deterrent rules and regulations of the government (0.613) and political instability (0.499) (Table 4). The final component is largely external to the firm.

CONCLUSIONS

Study revealed that the most crucial obstacle for business start-up of new SMEs in NWP is largely internal to the firm. Surprisingly, the second most critical obstacle, management, is also internal. Though PCA extracted finance as the most important component, according to the FGDs, SME owners do not have much knowledge to manage their businesses. They do not have a plan for their business. However, they start the business and get stuck at the middle without being able to grow to the next stage of its life cycle. Hence, most of the enterprises get shut down and do not grow into large scale businesses. Many SMEs are of first time entrepreneurs, and they do not have sufficient bandwidth in all the functional areas. They are not able to estimate their own short-term and long-term needs accurately with all the uncertainties they encounter.

Sri Lankan SMEs have not made great progress in the past. They still struggle with tapping financial management. In most cases, SMEs are founded by entrepreneurs who are not managers themselves but they struggle to manage them due to the sole fact that they are the founders. Care must be taken often to study, organize, plan and control all activities of business operations. Most SMEs rely more on

mental records and therefore, unable to prepare proper or up-to-date financial statements that can be used as evidence of profit and loss earned/occurred and wealth of the business including the working capital.

This problem is even made worse where the entrepreneur, as the founder, manages without the required managerial skills. Therefore, the study suggests that it is needed to revisit the micro finance accessibility of SMEs and to formulate effective financial management plans through supporting SMEs in NWP within their early years from the inception to avoid failures.

ACKNOWLEDGEMENTS

The authors offer their sincere thanks to Dr. N. R. Abeynayaka and Mrs. G.H.I. Anjalee for the help given in statistical analysis, staff members of National Enterprise Development Authority and Mr. S. Eriyagama for the numerous help given for the study.

REFERENCES

- Anon. (2002). *National strategy for small and medium enterprise sector development in Sri Lanka*, Ministry of Enterprise Development.
- Anon. (2015). *National policy framework for SME development*. Sri Lanka, Ministry of Industry and commerce.
- Bandara, C. (2016). What causes SMEs to fail in Sri Lanka? Available from: <http://www.dailymirror.lk/101755> (Accessed 5 April 2016).
- Department of Census & Statistics. (2015). *Non-agricultural economic census, (2013/2014)*. Sri Lanka, Department of Census and Statistics.
- Jayasooriya, N. (2016). Why some companies fail? Available from: <http://www.ft.lk/article/49592> (Accessed 23 May 2016).
- Olwale, F. and Garwe, D. (2010). Obstacles to the growth of new SMEs in South Africa: A principal component analysis approach. *African Journal of Business Management*, 4 (5), 729-738.
- Priyanath, H.M.S. (2014). Government SME Development Programmes in Sri Lanka: A Review in the Lens of Transaction Cost Economics, *Sabaragamuwa University Journal*, 13 (2), 59-81.
- Weerakkody, D. (2015). SMEs will be critical to get Sri Lanka to the next level of growth. Available from: <http://www.sundaytimes.lk/130303> (Accessed 10 May 2016).