

## **Sources of Financing Start-Ups SMEs in Nigeria: A Study of Small and Medium Scale Enterprises in Yobe State**

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### **Abstract**

*Securing financing for start-up enterprises is crucial for the survival and expansion of small businesses, especially in developing economies. Small and medium-sized enterprises (SMEs) are seen as a driving force for growth in both developed and developing nations. This study focuses on the funding sources for launching small and medium-sized businesses in the Yobe state metropolis. It aims at examining the funding sources utilized by micro enterprises in Yobe State, the challenges related to these funding sources, and the preferred funding opportunities for micro enterprises in Yobe state. It advocates the need to adopt multifaceted approach in the quest to improve the financial ecosystem and proffers several means of doing so.*

**Keywords: Financial Start-Ups, Enterprises**

### **1. Introduction**

Start-ups are newly established entrepreneurial ventures that are in the developmental and market research phase. They typically have few employees, including the entrepreneur, and require an investment of less than fifty thousand.<sup>1</sup>

Securing financing for start-up enterprises remains a critical factor in determining the survival and growth of small businesses, particularly in developing economies. Small and Medium Enterprises (SMEs) are considered essential for growth in both developed and developing countries. The advantages of a vibrant start-up sector include the creation of employment opportunities, strengthening of industrial

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<sup>1</sup> H Ooghe, S Manigart and Y Fassin, "Growth patterns of the European venture capital industry," (1991) (6) *Journal of Business Venturing* 381–404

linkages, promotion of flexibility and innovation, and generation of export revenues.<sup>2</sup>

Despite the increasing number of start-up SMEs, business owners and sponsors still lack adequate information on how and where to raise funds to pursue their vision. Furthermore, Smallbone and Welter<sup>3</sup> noted an increasing recognition of the role that SMEs can play in wider social and economic restructuring. In Nigeria, the role of SMEs will be increasingly important as the nation strives to become a fully industrialized country.

Since the 1970s, there has been a growing interest in promoting small businesses in Nigeria due to the inability of the government and large organizations to employ the nation's population. This has led individuals to recognize that dynamic and growing small businesses can substantially contribute to various national developmental objectives. Notably, while the majority of businesses operating in Nigeria are SMEs, their contribution to the nation's GDP is only about 1%.<sup>4</sup> The limited contribution of SMEs to Nigeria's GDP can be attributed to the finance challenges faced by this sector, especially for start-ups. Some of these start-ups have little or no access to formal finance from commercial institutions, while some business owners believe their business cannot take off without formal funding or a bank loan. As a result, many viable business ideas in Nigeria do not materialize due to a lack of funding, either because they fail to meet the requirements of commercial banks or cannot demonstrate feasibility.

Although Yobe State has great economic potential for start-ups to thrive, the state still faces challenges in accessing funds for micro-enterprise growth. Against this backdrop, this research aims to shed light on alternative funding sources for start-up SMEs in Yobe.

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<sup>2</sup> C Harvie, and B Lee, "Best Asian SMEs: Contemporary Issues and Development – An Overview," In Charlie Harvie and Boon-Chyee Lee (eds) *The role of SMEs in National Economic in East Asia*, (UK: Cheltenham 2001) 1-20

<sup>3</sup> D Smallbone, and F Welter, "The Role of Government in SME Development in Transition Economies," (2001) (19) (4) *International Small Business Journal* 63-78

<sup>4</sup> E Gbandi and G Amissah, "Financing Options for Small and Medium Enterprises (SMEs) in Nigeria," (2014) (10) (1) *European Scientific Journal January* 327

### **1.1 Statement of Problem**

One of the primary challenges in starting a business often lies in securing the necessary funds. While an entrepreneur may possess a promising idea and a clear vision for transforming it into a successful venture, the inability to raise sufficient capital can significantly impede the launch of the business. The significance of small and medium-sized enterprise (SME) start-ups cannot be overstated, yet the failure rate of such start-ups remains notably high in Yobe. Access to finance stands out as a major constraint affecting the sustainability of start-ups in Nigeria. The lack of credit access for initiating or expanding start-up enterprises has been a persistent issue within the economy. Many start-ups tend to rely on personal resources of their owners or loans from friends and relatives to finance their ventures. It is worth emphasizing that obtaining capital for new entrepreneurial endeavours has consistently posed a challenge in Nigeria. Despite the successes achieved by numerous Nigerian entrepreneurs in the business sphere, it is evident that numerous entrepreneurial aspirations fail to materialize due to financial constraints.

### **1.2 Aim of the Study**

The principal objective of this study is to assess the available sources of finance for micro enterprises in Yobe State, located in the north-eastern region of Nigeria.

### **1.3 Objectives of the Study**

The objectives of this paper is to identify the financing sources utilized by micro enterprises in Yobe State; outline the various challenges associated with financing sources for micro enterprises in Yobe metropolis and identify the preferred financing opportunities for micro enterprises in Yobe metropolis.

### **1.4 Significance of the Study**

Given the escalating unemployment rates in Nigeria, fostering the growth of the SME subsector can play a pivotal role in mitigating unemployment and bolstering income generation. This study aims to offer pertinent recommendations based on its findings, particularly in the realm of financing micro enterprises in Yobe State, with the aim of

fortifying the institutional framework critical for funding the SME subsector. This is essential to ensure its sustainability and competitiveness within both the domestic and global economies.

### **1.5. Scope and Limitations**

The study focuses on evaluating the available sources of finance for start-up SMEs in Nigeria, specifically addressing micro-enterprises in Yobe State. While a comprehensive study covering all states in Nigeria would have been ideal, time and financial constraints led to the decision to concentrate solely on entrepreneurs in Yobe State. Consequently, the conclusions drawn from this research will be limited to the unique factors associated with this state, and may not be universally applicable to entrepreneurs in other parts of Nigeria.

### **1.6. Research Design and Methodology**

In terms of research methodology, a descriptive survey was employed for this study. Descriptive surveys aim to gather information from a representative group to draw inferences about the behaviors of the entire target population. This approach facilitates the rapid collection of data, is cost-effective, efficient, and provides an accurate means of assessing information about a population.<sup>5</sup>

### **1.7. Population of the Study**

The study's population comprises micro-enterprises operating in the retailing, food, and beverages sectors within Yobe State. Probability sampling techniques will be utilized, involving the selection of three local governments from each senatorial zone, totaling nine local governments out of the seventeen in the state. Thirty interviewees will be randomly selected in each local government, with ten interviewees representing each sector, resulting in a total of 270 respondents from across the state.

### **1.8. Sampling Technique**

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<sup>5</sup> WG Zikmund, BJ Babin and M Griffin, *Business Research Methods* (8th ed. Canada: South Western Cengage Learning 2010)

The sampling technique employed in the study involved the use of stratified sampling to categorize the target population, followed by the application of simple random sampling to select micro-enterprises from the trade, service, and manufacturing sectors. The use of random sampling was intended to ensure equal opportunities for all members of the target population to participate in the study. Micro-enterprises in each stratum were assigned random numbers, and those corresponding to the numbers drawn from the random table were included in the sample.

### 1.9 Method of Data Analysis

Regarding the method of data analysis, the data obtained from the questionnaires will be coded and analyzed using the Statistical Package for Social Science (SPSS) software. The data will undergo descriptive and inferential analysis to explore the relationship between the sources of financing and the growth of start-ups in Yobe State.

## 2. Literature Review

### 2.1 The financing needs of start-up SMEs

Timmons and Spinelli<sup>6</sup> emphasize the importance of developing financing and fund-raising strategies, understanding available alternatives, and securing funding. Winton and Yerramilli<sup>7</sup> note that defining the core market opportunity and the strategy for capturing it is essential before examining financial requirements, including asset needs and operating needs. Capital gaps also exist for companies undergoing significant transitions, such as ownership changes, as well as for SMEs aiming to improve their capital structures. Successful entrepreneurs anticipate their firms' investment requirements to effectively engage with potential funding sources. Zhou and Chen<sup>8</sup> highlight the necessity

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<sup>6</sup> AJ Timmons and S Spinelli, *New venture creation – Entrepreneurship for 21<sup>st</sup> century*, (Eight edition 2007)

<sup>7</sup> A Winton and V Yerramilli, "Entrepreneurial finance: Banks versus venture capital," Revised 28 October 2005, (2008) (88) *Journal of finance economics* 51 – 79

<sup>8</sup> H Zhou and X Chen, "Resource capabilities and new venture choice," <<http://74.125.77.132/search?q=cache:mgr4d29qtqpQ5:www.ceauk.org.uk/20>> accessed 20th August 2024

of physical resources for start-up SMEs to capitalize on business opportunities, emphasizing that lack of physical resources is a critical failure factor. Start-ups require resources such as fixed assets and working capital to gain a competitive advantage in the market.

## **2.2 The Impact of Financing Decisions on Small and Medium Enterprises (SMEs) Performance, Growth, and Survival**

In a study conducted to investigate the influence of debt on firm performance during the initial years post start-up; financing decisions were presumed to have no impact on product market outcomes under perfect financial and product market conditions.<sup>9</sup> However, when information asymmetry exists between firm insiders and external financiers, a significant financial market imperfection arises. Moreover, in markets with limited competitors, firms may engage in predatory practices to eliminate new entrants, provided that the benefits outweigh the costs.<sup>10</sup>

## **2.3 Overview of Micro Enterprises in Yobe state**

In Yobe State, the ancient city has a rich history of thriving in merchandising and small-scale industrial activities such as handcrafts, blacksmithing, and agriculture. With the advancement of modern economic activities, the state has experienced significant progress in commercial and industrial sectors, leading to the emergence of modern manufacturing activities and the establishment of market outlets.

Micro Enterprises are businesses with total assets (excluding land and buildings) of less than Five Million Naira and a workforce not exceeding ten employees. The Micro, Small, and Medium Enterprises (MSME) sector in Yobe State is robust and diverse, with an estimated 1.6 million businesses across various economic activities, contributing approximately 60-70% of output and employment. Historically, Yobe State played a pivotal role as a major entry port and the southern hub of the trans-Saharan trade route in the pre-colonial era.

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<sup>9</sup> F Modigliani and M Miller, "The Cost of Capital, Corporation Finance and the Theory of Investment," (1958) (48) (3) *American Economic Review* 261–297

<sup>10</sup> C Huyghebaert and Van de Gucht, "Incumbent Strategic Behaviour in Financial Markets and the Exit of Entrepreneurial Start-Ups," (2024) (25) (7) *Strategic Management Journal* 669 - 688

## 2.4 Main Sources of Financing Start-Ups in Nigeria

In the context of start-up financing in Nigeria, analysis of survey results revealed that 75.7% of respondents primarily relied on personal funds, while 20.3% sought financing from banks. Additionally, 2.7% of respondents utilized share capital, and 1.3% relied on supplier credit. Notably, below are the prevalent method for SME funding.

**2.4.1 Personal savings:** As highlighted by the National MSME (2012) Collaborative Survey; a potential business owner who is in a paid job and who has a plan to quit in the future must have a business plan with a strong financial model and save towards it. One of the benefits of this method of start-up funding is that the business does not carry any financial liability. However, the entrepreneur's personal standard of living may be compromised if the business does not make early profit.

**2.4.2 Trade credit:** This plays a significant role as an external financing source for SMEs, representing a substantial portion of SME debt in the US.<sup>11</sup> Trade credit allows firms to defer payment for goods or services, impacting the balance sheet as current liabilities for the firm and accounts receivable for the supplier.<sup>12</sup>

**2.4.3 Commercial Banks:** These are widely recognized source of funding, albeit with high interest rates, often ranging from 18% to 25% per annum. The Small Business Administration (SBA) in the US encourages banks and financial institutions to lend to SMEs and start-ups by providing loan guarantees of up to 90% to qualified borrowers.<sup>13</sup> Despite facing competition from larger businesses for funding,

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<sup>11</sup> AN Berger and GF Udell, "A more complete conceptual framework for SME finance," (2006) (30) (11) *Journal of Banking & Finance* 2945

<sup>12</sup> S Baños-Caballero, PJ García-Teruel and P Martínez-Solano, "Working capital management in SMEs," (2010) (50) (3) *Accounting and Finance*, (Accounting and Finance Association of Australia and New Zealand) 511-527

<sup>13</sup> A Abouzeedan, "Financing Swedish Small and Medium-Sized Enterprises: Methods, Problems and Impact," (2003) *ERSA conference papers ersa03p34*, European Regional Science Association

commercial loans are expected to remain a primary source of financing for SMEs in Sweden in the foreseeable future.

**2.4.4 Venture capitalists:** Venture capitalists serve as financial intermediaries, raising funds from investors to invest in high-risk, information ally opaque firms, typically young or start-up firms. They play a crucial role in determining the timing and type of investment, as well as in monitoring, screening, and contracting. They actively participate in the strategic planning and decision-making processes of the invested firms. The venture capital market encompasses various organizations, including public corporations, small business investment corporations, and private limited partnerships.

**2.4.5 Business angel:** This operates as an informal market for direct finance. Business angels, who are affluent individuals with extensive business experience, selectively invest in high-growth small and medium-sized enterprises (SMEs) without prior relationships.<sup>14</sup> This form of investment usually takes the shape of an equity contract, commonly involving common stock. While angels are typically individuals, they occasionally collaborate in small investment groups.

**2.4.6 Non-bank Financial Institutions:** These provide SMEs with a means to secure funding in both developing and developed nations. For instance, in Zimbabwe, loans from nonbank financial institutions represent nearly 30% of total debt and rank as the second most important source of funding for domestic SMEs.<sup>15</sup> In the US, a study by the Federation of Small Businesses revealed that 15,000 financial institutions, half of which were nonbank lenders such as credit unions, competed to lend to SMEs.<sup>16</sup> Furthermore, an earlier study in the US

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<sup>14</sup> J Madill, A Riding and GH Haines, 'Women Entrepreneurs: Debt Financing and Banking Relationships,'(2006)(19) *Journal of Small Business and Entrepreneurship* 121 - 142

<sup>15</sup> E Aryeetey and M Nissanke, *Financial Integration and Development Liberalization and Reform in Sub-Saharan Africa*, (1<sup>st</sup> edn, London: Routledge, 1998)

<sup>16</sup> S Goff and S Nasiripou, 'Non-Bank Lending on Rise for UK SMEs,' *Financial Times*, (2012)



found that nonbank debt accounted for almost \$40 billion of the \$350 billion total debt raised by new debt issuers firms during 1995–96.<sup>17</sup>

**2.4.7 Government Grant:** Governments at federal and state levels often offer financial assistance in the form of grants and tax credits to support start-up or expanding businesses.

**2.4.8 Government Initiative:** In Nigeria, the government has implemented various initiatives to support SMEs with capital. Notably, the Federal Government of Nigeria rolled out a N220 billion loan program aimed at assisting SMEs, with the Central Bank of Nigeria disbursing the fund at a single-digit interest rate. This initiative is a part of the government’s efforts to boost SMEs in Nigeria.<sup>18</sup>

## **2.5 Preferred Financing Opportunities for SMEs in Yobe State**

In Yobe metropolis, preferred financing opportunities for micro enterprises primarily revolve around several key sources discussed below.

**2.5.1 Microfinance Institutions (MFIs):** These institutions play a crucial role in providing accessible financial services to micro enterprises. They offer loans, savings products, and other financial services tailored to the needs of small businesses that often lack collateral or a formal credit history.

**2.5.2 Government Programs and Grants:** Various government initiatives provide financial support to micro enterprises. These programs often include low-interest loans, grants, and other financial incentives aimed at promoting entrepreneurship and reducing poverty.

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<sup>17</sup> D Elliott and Others, ‘Nonbanks, Banks, and Monetary Policy: U.S. Loan-Level Evidence since the 1990s, [October 25, 2019] *Proceedings of Paris December 2019 Finance Meeting EUROFIDAI - ESSEC*, <SSRN: <https://ssrn.com/abstract=3475427> or <http://dx.doi.org/10.2139/ssrn.3475427>> accessed 24<sup>th</sup> October 2024

<sup>18</sup> Daily Trust, 25th July; 2014

**2.5.3. Cooperative Societies:** Micro enterprises often turn to cooperative societies for financial support. These societies pool resources from members to provide loans and other financial services, which can be more accessible than traditional banks.

**2.5.4 NGO Support:** Non-Governmental Organizations (NGOs) frequently offer financial assistance, training, and technical support to micro enterprises. These organizations aim to empower small business owners and foster economic development at the grassroots level.

**2.5.5 Bank of Industry (BOI):** BOI provides tailored support and low-interest loan products to micro-enterprises, particularly in the informal and semi-formal sectors. They use intermediary channels to ensure last-mile delivery and program sustainability. BOI's initiatives include cluster financing, fintech digital lending, and MSME distributorship programs, which offer various financial products designed to meet the needs of micro businesses.

These financing opportunities, coupled with the support from various stakeholders, create conducive environment for micro enterprises in Yobe metropolis to thrive and contribute to the local economy.

## **2.6 Challenges Faced by SMEs in Yobe State**

Micro enterprises in Yobe metropolis face several challenges related to financing:

**2.6.1. Limited Access to Credit:** Many micro enterprises struggle to secure loans from formal financial institutions due to stringent collateral requirements and high-interest rates. Microfinance banks, although more accessible, still pose barriers due to their relatively high costs.

**2.6.2. Inadequate Government Support:** There is a lack of cohesive support from government agencies, which hampers the ability of micro enterprises to thrive. The coordination between various support agencies is often insufficient.

**2.6.3 Insurgency and Insecurity:** The ongoing Boko Haram insurgency has severely disrupted economic activities in Yobe State, affecting the stability and growth prospects of micro enterprises.

**2.6.4 Economic Policies and Regulatory Environment:** Inconsistent policies and regulatory frameworks can create an unpredictable business environment, making it challenging for micro enterprises to plan and grow sustainably.

Addressing these challenges require coordinated efforts from the government, financial institutions, and support agencies to create a more enabling environment for micro enterprises in Yobe metropolis.

### **3. Findings**

The study found that the primary sources of financing for start-up SMEs in Yobe State are diverse but predominantly centered around personal savings, family contributions, and microfinance institutions. Key findings include:

**3.1 Personal Savings:** This is most common source of funding, as many entrepreneurs rely on their own resources to start their businesses.

**3.2 Family and Friends:** Loans and contributions from family and friends are significant sources of initial capital for start-ups.

**3.3 Microfinance Institutions (MFIs):** These provide crucial support with more accessible financial products tailored to the needs of small businesses.

**3.4 Government Programs and Grants:** Various initiatives offer low-interest loans and grants, though access to these funds can be challenging due to bureaucratic hurdles.

**3.5 Cooperative Societies:** These play an important role in pooling resources and providing loans to micro enterprises.

**3.6 Challenges:** Major challenges include limited access to credit from formal financial institutions due to high collateral requirements and

interest rates, inadequate government support, insecurity from insurgency, and inconsistent economic policies.

#### **4. Summary**

The study reveals that securing financing for start-ups in Yobe State remains a significant hurdle. While personal savings and contributions from family and friends are the most accessible sources, reliance on these funds limits the potential for substantial business growth. Microfinance institutions and cooperative societies offer more structured financial support, but their reach and impact are often hampered by high costs and limited accessibility. Government programs, though beneficial, suffer from inefficiencies and limited reach. The business environment in Yobe State is further strained by security issues and unstable economic policies, which together constrain the development and sustainability of micro enterprises.

#### **5. Conclusions**

In conclusion, the study underscores the need for a multifaceted approach to improve the financial ecosystem for SMEs in Yobe State. This includes reducing collateral requirements and interest rates for loans, streamlining government support programs, enhancing the capacity of microfinance institutions and cooperative societies, and addressing the security issues and economic policy inconsistencies that impede business growth. By addressing these areas, it is possible to create a more enabling environment for micro enterprises to flourish and contribute significantly to the local economy.