

Financing Preferences of Micro, Small and Medium Enterprises: An Empirical Research of Surat District

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Abstract

The Micro, Small and Medium Enterprises (MSME) plays an increasingly vital role in many economies, particularly in developing economies, highlighting the need for greater understanding of the financing behaviour of MSMEs. Financing behaviour here means the preferences of MSME owners in sourcing their funds, whether through personal investment or external credit.

This research aims to analyse the financing preferences of MSME through pecking order theory and to examine does there exists any association between the financing preferences of MSME, firm attributes and owner characteristics. Empirical data were collected from MSME owners of Surat district using a structured questionnaire. The data is analysed using descriptive and inferential statistics, including the Chi-square test. The findings indicate that MSME owners adhere to the pecking order theory, but no relationship was found between financing preferences and firm or owner characteristics.

These findings and insights of the study will help policymakers to develop tailored financial frameworks to enhance the sustainability and growth of MSMEs.

Keywords: Financing preferences of MSME, Firm characteristics, Pecking order theory, Surat

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Introduction

MSMEs are vital to economic growth, driving employment, exports, and innovation. But, they

often face financial hurdles such as high collateral requirements, complex procedures, and low financial literacy. As a result, MSMEs often prefer internal financing sources, such as personal funds, retained earnings, and reinvested profits, over

external credit options. Many studies support this trend, highlighting that MSMEs frequently rely on own funds rather than external financing (Al-Afifi, 2019). Sarkar & Ghosh (2024) further reinforce this perspective, noting that MSMEs commonly depend on personal investments, loans from family and friends, and traditional bank financing.

Understanding MSME financing preferences is vital for making decisions regarding capital structure, which directly impacts financial management and business sustainability. Identifying these preferences is essential as it helps determine financial requirements, assess growth potential, and enhance MSME contribution to GDP (Nendi & Koesharijadi, 2022).

The study explores MSME financing preferences in Surat district and examines the influence of owner (age, education, experience) and firm characteristics (size, sector, legal status, types of business activity) on these decisions.

Using the Pecking Order Theory as a framework, the research provides insights for MSME owners, financial institutions and policymakers. It shows the need for tailored financial schemes that support MSME growth and sustainability.

Literature Review

Financing preferences and pecking order theory

According to Myers (1984), the pecking order theory provide suggestion that firms rely on internal financing due to information asymmetry, and if external financing is needed, debt is preferred over equity. This idea was earlier witnessed by Donaldson (1961), who found that large business owners relied on internal funds unless external finance was unavoidable. Aabi

(2014) also noted that small firm owners avoid external financing unless necessary. Though widely accepted for large firms, the theory's relevance to MSMEs is debated due to their limited financial resources. Some studies support its relevance to MSMEs—such as Gebru (2009) in Ethiopia, Osei-Assibey et al. (2012) in Ghana, and Daskalakis et al. (2013) in Greece, showing MSME owners prefer internal funds and follow a hierarchical financing pattern.

Kuruppu & Azeez (2016) found that SME owners in Sri Lanka followed the pecking order theory, a finding supported by Nunez Huerta (2021) in Mexico and Mittal & Raman (2020) in India's National Capital Region. However, some studies challenge the theory's universal application. Wu Song & Zeng (2008) found it only partially explained SME financing, while Agha Jude & Adamou (2018) observed firms opting for bank loans over internal funds to retain control, driven by overconfidence. Verma et al. (2021) argued that neither the pecking order nor trade-off theory fully captures MSME financial behaviour. Most studies supporting the pecking order theory are from outside India, with few Indian studies and none focused on Surat district. Akyuz et al. (2006) found that Turkish MSMEs rely on internal funds due to high collateral and bank charges. Bebczuk (2010) noted SMEs face greater external financing barriers than large firms due to information asymmetry. Allen et al. (2012) noted SMEs rely on informal and internal sources due to limited access to formal funding. Adair & Adaskou (2015) added that MSMEs prefer internal funds to maintain control, turning to debt before equity when needed.

At the same time, some researchers claimed that in small businesses, the owner makes most decisions because they also control the business. So, managerial theories explain how these businesses choose their finances better than traditional theories (Ang, Cole, & Lawson, 2010; Hackbarth,

2008; Ruan, Tian, & Ma, 2011). The owner's role and demographic characteristics are key in determining a small firm's financing decisions (Baker et al., 2017; Ang et al., 2010).

Financing Preferences and Owner Characteristics

Age of the Owner:

The owner's characteristics - Age is one of the variable affecting the financing preference of the MSME firm. Some studies found younger owners prefer external finance, while older ones are less inclined (Vos et al., 2007; Bruine De Bruin et al., 2012). Others noted middle-aged owners have better access to bank finance due to greater financial knowledge (Wu et al., 2008; Abdulsaleh & Worthington, 2013). However, some researchers found no significant link between owner age and external debt use (Buferna et al., 2005; Rop et al., 2021; Osunsan et al., 2024). These studies suggest that the age of MSME owners does not have a strong association with financing preferences.

Education Level:

The education level of MSME owners influences financing preferences. Few researches suggests that higher education boosts confidence and increases the use of external finance (Storey, 1994; Osei-Assibey et al., 2010; Borgia & Newman, 2012) whereas less educated owners face more challenges (Belas et al., 2015). However, some research found a negative or no significant link between education and loan application or financing preference (Dung & Ngan, 2024; Rop et al., 2021; Abdesamed & Wahab, 2014).

Experience in the Business:

Experience, which is determined by years worked in an industry, also helps in obtaining external finance (Cole, 1998). Several studies report a positive association, suggesting that experienced owners are better at securing external finance (Nofsinger & Wang, 2011; Cassar, 2004; Wu et al., 2008). However, others found that experienced owners may avoid debt due to risk aversion (Scherr et al., 1993), while some studies found no significant relationship (Coleman & Cohn, 2000; Abdesamed & Wahab, 2014)

Based on literature review, this study proposes the following hypothesis:

Null Hypothesis: There is no significant association between the financing preferences and owner characteristics such as the age of the owner, education level and experience in the business

Alternative Hypothesis: There is a significant association between the financing preferences and owner characteristics such as age of the owner, education level and experience in the business

Financing Preferences and Firm Characteristics

Firm Size:

Firm size is a crucial factor in selecting financing (Gregory et al., 2005). Studies suggest larger firms

have better access to external finance due to greater transparency, lower risk, and more collateral (Berger & Udell, 1998; Burgstaller & Wagner, 2015; Mac an Bhaird et al., 2016). However, some research indicates a negative or no significant relationship between firm size and external debt usage, suggesting larger firms may rely less on

external finance (Coleman, 1998; Michaelas et al., 1999; Dung & Ngan, 2024; Abdesamed & Wahab, 2014).

Sector of the Business:

Silva & Carreira (2010) emphasized that the service sector, which lacks tangible assets, is unable to offer collateral for external debt finance. Compared to service enterprises, MSMEs involved in manufacturing and construction need more financing (D A Prihastiwati et al., 2021). However, Hamilton & Fox (1998) indicated that small firm owners often prefer internal sources and then tend to prefer external debt over equity, regardless of the sector of the business, which shows uniformity in financing preferences across the sectors.

Legal Status:

Legal status also plays a role in MSME financing preferences. Proprietorships and partnerships, with concentrated ownership, often prefer risk-averse

financing options (Lappalainen & Niskanen, 2012). MSMEs linked to group firms tend to use more inter-company and bank loans, while individually owned firms rely less on bank debt (Kumar & Rao, 2016). However, some studies found no significant link between legal status or managerial ownership and financing preferences (Rop et al., 2021; Brahmayanti, 2024).

Type of business activity:

The type of business activity also affects financing preferences. Studies show that industry-specific factors influence financing behaviour even after controlling for firm characteristics (Johnsen & McMahan, 2005). Industry differences impact how firms weigh debt and equity, supporting the trade-off theory in Asian contexts (Li et al., 2011). Kurniawan & Kodir (2015) also noted variations in financial access across industries. However, Sulistiyo et al. (2021) found no significant effect of industry type on access to external finance.

Based on the above literature review, this study proposes the following hypothesis:

Null Hypothesis:	There is no significant association between the financing preferences and firm characteristics such as Firm size, sector of the business, legal status and business activity
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Alternative Hypothesis:	There is a significant association between the financing preferences and firm characteristics such as Firm size, sector of the business, legal status and business activity
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Research Gap

Several previous research have explored the financing preferences of MSME and shown mixed findings—some linking preferences to owner characteristics, others to market dynamics. This research addresses the gap by assessing whether owner and firm characteristics genuinely affect MSME financing preferences, contributing to the ongoing debate on MSME financing behaviour. There is absence of region-specific research,

particularly in Surat district.

Research Objectives

- To study the financing preferences of Micro, Small and Medium Enterprises owners.
- To assess the association between the financing preferences and owner characteristics such as age, education level and experience in the business.
- To assess the association between the financing

preferences and firm characteristics such as firm size, sector of the business, legal status and business type.

Research Methodology

This study employs a quantitative method to study the financing preferences of MSMEs and assess the association between the financing preferences and firm and owner characteristics. Due to the difficulty of surveying a large number of MSMEs, this study focuses on MSME in the Surat district of Gujarat state only. The study area is significant as Surat has the second-highest MSME registrations in Gujarat. In Surat MSMEs drive provincial financial growth, especially in textiles, diamonds, and engineering, through employment, output, and exports. To gather data, owners and managers were interviewed with a structured questionnaire. The questionnaire was constructed in both English and Gujarati language, considering the comfortability of the firm owners. We contacted the MSME of major industrial areas in the Surat district via convenience sampling and administered the questionnaire to the 225 firm owners. However, only 97 agreed to participate in our survey, resulting in to 43% response rate. This response rate reflects a general hesitation of MSME owners

to discuss their business affairs. The data collected has been analysed using of MS Excel and SPSS v23.

Data Analysis & Discussion

The study used both descriptive and inferential statistics to analyze the data including the Chi-square test. The sample size is 97 which is more than 50 but less than 2000, then Shapiro-Wilk is still preferred, but Kolmogorov-Smirnov can be used for the normality test (Razali & Wah 2011). We examine the normality of the distribution for each variable (not reported) and find that the data is not normally distributed. Table 1 shows the normality test of financing preference.

Null Hypothesis: The Distribution is normal

Alt Hypothesis: The Distribution is Not Normal

As the p-value of the Normality Test is 0.000, which is less than the 5% level of significance, we reject the null hypothesis, which means that the data is not normally distributed.

So, in this case, a non-parametric test is applied for further analysis of the data.

Table 1: Test of Normality

Tests of Normality

	Kolmogorov-Smirnova			Shapiro-Wilk		
	Statistic	df	Sig.	Statistic	df	Sig.
Internal Finance	.417	97	.000	.603	97	.000
External Debt Finance	.376	97	.000	.696	97	.000
External Equity Finance	.540	97	.000	.165	97	.000

a. Lilliefors Significance Correction

Table 2: Sample Profile of MSME

A. Owner Characteristics		Frequency
Age of the owner	Below 30 years	14
	31-40 years	29
	41-50 years	33
	Above 50 years	21
Education Level	Below 10	5
	Class 10	6
	Class 12	27
	Graduate	43
	Post Graduate	11
	Professional Degree	5
Experience in the Business	Less than 5 years	25
	5 to 10 years	9
	10 to 15 years	9
	More than 15 years	54
B. Firm Characteristics		Frequency
Firm Size	Micro	49
	Small	32
	Medium	16
Sector of the Business	Manufacturing	65
	Trading	27
	Service	5
Legal Status	Sole Proprietorship	54
	Partnership	30
	Company	13
Business Activity	Textile	70
	Diamond	5
	Engineering	13
	Other	9

Table 2 describes the sample profile of 97 MSME from the Surat district based on firm and owner characteristics. Table 2 shows the owner's characteristics such as age, education level and experience in the business. As per the description in Table 2, most of the owners are from the age group of 41-50 years, which is 34%. The majority of the MSME owners have a graduation degree (44%),

followed by Class 12 (28%), and a majority have a high level of experience, such as more than 15 years (56%). The firm characteristics are firm size, sector of the business, legal status and business activity. As Table 2 shows, the majority of the firms are Micro enterprises (51%), and most of the enterprises are in the manufacturing sector (67%), followed by the trading sector (28%), while very

few are from the service sector (5%). Out of the total of 97 respondents, most are sole proprietorships (56%), and most of their business activity is textile-based (72%).

Objective 1: To study the financing preferences of Micro, Small and Medium enterprise owners

Financing Preferences of MSME

MSME can get finance from both internal and

external sources. These sources are Internal Finance, External Debt Finance and External Equity Finance. The first objective of this study is to study the financing preferences of Micro, Small and Medium Enterprises. The respondent was asked to rank the sources of finance for their business, where 1=First rank, 2=Second rank and 3=Third rank. Table 3 shows the preferred rank of the MSME owners of the sample.

Table 3: Financing preferences of MSME owners

Internal Finance	External Debt Finance	External Equity Finance	Total Number of Respondents
1	2	3	59
2	1	3	35
1	3	2	3
		Total	97

Table 3 shows that, out of a total of 97 respondents, 59 MSME owners gave the first rank to internal finance, the second rank to external debt finance and the third rank to external equity finance. Whereas 35 MSME owners prefer first rank to external debt finance, second rank to internal finance and third rank to external equity finance. While only 3 MSME owners gave priority to internal finance, second rank to external equity finance and third rank to external debt finance.

Thus, as per Table 3, we can find that out of the total respondents, the maximum number of respondents follow the pecking order theory as first priority to internal finance, followed by external debt finance and then only prefer external equity finance.

Objective 2: To assess the association between the financing preferences and owner characteristics such as age, education level and experience in the business

Null Hypothesis:	There is no significant association between the financing preferences and owner characteristics such as age, education level and experience in the business
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Alternative Hypothesis:	There is a significant association between the financing preferences and owner characteristics such as age, education level and experience in the business
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To assess the association between financing preferences and owner characteristics, the chi-square test is applied because both of these variables are categorical. In this study, the

financing preferences are internal finance, external debt finance and external equity finance, and owner characteristics are age, education level and experience in the business.

Table 4: Association between Financing Preferences and Owner Characteristics

Owner Characteristics		Financing Preference		
		Internal Finance	External Debt Finance	External Equity Finance
Age	Value	2.429	10.317	8.026
	df	3	6	3
	Significance	0.488	0.112	0.045
Education Level	Value	2.987	5.517	2.623
	df	5	10	5
	Significance	0.702	0.854	0.758
Experience in the business	Value	3.538	6.037	2.564
	df	3	6	3
	Significance	0.316	0.419	0.464

Table 4 shows the association between the financing preferences and the owner's characteristics. As per the analysis of the Chi-square test, p-values were found to be more than the 5% significance level except for the association between age and external equity financing. P-value of external equity finance is 0.045, which is less than the significance value of 0.05, which means the null hypothesis is rejected and the alternative hypothesis is accepted that there is a statistically significant association between age and external equity finance. While the other results of association show that the p-value is greater than the significance level of 0.05, which means that we fail to reject the null hypothesis, indicating that there is no association between the financing preferences and owner characteristics. Prior studies also showed there is no association between the age of the owner, education level and experience in the business and financing preferences (Buferna et al.,

2005; Rop et al., 2021; Osunsan et al., 2024; Abdesamed & Wahab, 2014; Dung & Ngan, 2024). This implies that firm owners' financing preferences could not be greatly influenced by their personal characteristics.

Objective 3: To assess the association between the financing preferences and firm characteristics such as firm size, sector of the business, legal status and business activity

Null Hypothesis:

There is no significant association between the financing preferences and firm characteristics such as firm size, sector of the business, legal status and business activity
Alternative Hypothesis: There is a significant association between the financing preferences and firm characteristics such as firm size, sector of the business, legal status and business activity

Table 5: Association between Financing Preferences and Firm Characteristics

Firm Characteristics		Financing Preference		
		Internal Finance	External Debt Finance	External Equity Finance
Firm Size	Value	0.662	1.179	0.671
	df	2	4	2
	Significance	0.718	0.882	0.715
Sector of the business	Value	5.578	7.268	2.361
	df	2	4	2
	Significance	0.061	0.122	0.307
Legal Status	Value	0.171	2.515	2.465
	df	2	4	2
	Significance	0.918	0.642	0.292
Business Activity	Value	2.805	4.411	1.194
	df	3	6	3
	Significance	0.423	0.621	0.754

To check the association between the financing preferences and firm characteristics, the Chi-square test was applied. Table 5 shows the association between the firm characteristics and financing preferences. The p-value of every firm characteristic and financing preference is higher than the significance value of 0.05. Therefore, considering this result, we accept the null hypothesis, which means there is no association between the financing preferences and firm characteristics. Prior studies also showed there is no association between financing preferences and firm characteristics such as firm size, sector of the business, legal status and business activity (Hamilton & Fox, 1998; Abdesamed & Wahab, 2014; Sulistiyo et al., 2021; Rop et al., 2021; Brahmayanti, 2024).

Research Findings

The study finds that MSMEs in Surat follow the pecking order theory, preferring internal finance, then external debt, and lastly external equity. Financing preferences show no significant association with owner or firm characteristics.

Conclusion

The findings of the research support the pecking order theory among MSMEs in Surat, suggesting internal financing is the most preferred due to cost and control concerns. Regardless of business size or ownership characteristics, this continuous preference emphasizes the necessity for financing options that fit the behaviour of MSMEs.

Recommendations

Financing Institutions should offer flexible loan products tailored to MSMEs' Financing

Preferences. The government should improve awareness and accessibility of subsidized credit scheme. Programs on financial knowledge can also help MSME make better financing decisions.

Scope for Future Research

Future research may be carried out in other regions with larger sample size and explore qualitative methods like interviews, case studies for deeper understandings into financing preferences.

Limitation

This study examines MSMEs' financial preferences and its relationship with the owner and firm characteristics in Surat district only, hence the findings of this study may not be generalised. Moreover, the data were collected through self-administered responses so it may involve biasness.

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