American Journal of Research in Business and Social Sciences
Vol. 1(1), pp. 1-8, May 2021
AJRBSS-21-005
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ISSN: 2768-5462
https://www.mprijournals.com/

Full Length Research

Commercial Banks Evaluation Strategies of Financing Entrepreneurial Start Ups in Malaysia

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Abstract: Small and medium sized firms especially the technology businesses have been widely acknowledged to find it difficult to raise adequate financing for growth and expansion. This is despite the general knowledge that financing is very significant to growth and survival of every new venture which eventually help in speedy and rapid economic development of every nation. The aim of this investigation is to shed more light on the selection criteria traditional lending institutions adopt in screening a few of the young firms they grant loans to, and how the monitor their investments against perceived risk and of unexpected business failure. The research methodology adopted in this study is through a qualitative approach by interviewing 25 senior managers of commercial banks out of 30 interview schedule/request letters sent out to randomly selected commercial lending institutions in Malaysia. Conventional lending organizations in Malaysia are very strict in evaluating potential young firms for financing probably as a result of the perceived high risk nature of the sector.
Keywords: Debt Financing; Young Firms; Selection Criteria; Qualitative Research, Malaysia
Cite This Article As: Ajagbe, M. A., Oke, A. S., Jinadu, O. M. & Kabir, A. (2021). Commercial Banks Evaluation Strategies of Financing Entrepreneurial Start-Ups in Malaysia. American Journal of Research in Business & Social Sciences, 1(1), 1-8.

1.0 Introduction

There have been a wide acknowledgement of the fact that Small and Medium Enterprises (SMEs) constitute about 99.2% of overall business establishments in Malaysia and are a source of employment for more than 56% of the overall working population and are a significant source of growth for the country (SME Info Mag, 2012; Abdullah et al., 2012). There was also a recognition that it will continue to play a substantial role in the country's New Economic Model (NEM) which envisions transforming Malaysia from a middle-income economy to a high-income knowledge-driven society as anticipated by the year 2020 (Massa & Testa, 2008; Abdullah et al., 2012). Furthermore many authors have emphasized that technology small and medium-sized enterprises (SMEs) have been assumed to be a major influence in the economic development, employment and creation of new innovations (Massa & Testa, 2008; Abdullah et al., 2012). Economists also argue that despite the heavy concentration of R and D expenditure in large firms, new ventures have consistently accounted for a vast majority of the important inventions and innovations. However, they reported that inability to access adequate funding for either growth or expansion has been one of the major constraints facing TBF. It is argued further that technology small firms play a major role in innovation and industrial development. By virtue of their numerous size and significant economic and social contribution, small and medium sized enterprises should be considered as an important engine to economic development of every nation. Not minding, their importance, small and medium sized enterprises are still generally perceived as higher credit risk by financial institutions, hence, limiting their access to formal financing sources (Mason & Testa, 2008; Wonglimpiyarat, 2011)

In view of the foregoing, it is expedient to highlight that financial and investment policies play an increasing important role in entrepreneurial venture and economic development. The financial and investment policies are among the important operational priorities in developing countries to support investment by local firms, especially technology based firms, and transnational corporations investing in these countries (Wonglimpiyarat, 2011).

The intent of this study is to obtain a clearer insight into the important criteria conventional lending organizations adopt in selecting some the young firms they finance and also examine how they monitor their investments in these companies among a few other issues. The findings of this study would be of immense benefit to conventional financial managers, public policy makers and other stakeholders and further enrich academic literature as there is little study on this subject in Malaysia.

2.0 Literature Review

2.1 Definitions of Start Ups Firms

Several researchers have defined the term Start Ups Firms considering a variety of parameters. Among them is (Yip et al., 2009), who viewed TBFs as , those companies in which their sales revenue is generated through the use of at least 51 percent of technology based operations e.g. internet, electronics,mechanical,automobile,clean energy, biomedical, communications, telephone, fax companies and so on. Meaning that, the main trust of their business relies heavily on the use of high technology. One of the main features of technology based firms is that they have a high level of business internationalisation (Mason & Brown, 1994). It was further reported that new ventures are much more likely to engage in global

markets than non-high growth small and medium sized firms. Other characteristics of TBFs include above-average levels of productivity growth (Mason & Brown, 1994), strong levels of innovation (Coad, 2009), strong levels of export-orientation (Parsley & Halabisky, 2008) and a high level of internationalization. They most popular of high tech firms was revealed by (Yip et al., 2009) as the young firms, an inventive design which has been nurtured into a high technology organization. The most successful of these companies as they mentioned become the popular and most talked about giants such as Microsoft, Netscape, Face book, Amazon.com, Sun Microsystems to mention a few.

2.2 Commercial Banks Financing for Start Ups

Authors have emphasized that the savings of founders, as well as the assets of family and friends of new venture firms usually form the basis of initial capital (Tyebjee & Bruno, 1984; Ismail et al., 2011). However, while financing requirements differs by industry (Mason & Harrison, 1994), for most of tech firm's internal equity and profits alone are not sufficient to meet the huge financial needs for development and progression to the next growth stage.

The economic recession in the United Kingdom in the recent past resulted in the majority of the traditional lending institutions to adjust and become more cautious in their lending decisions. Further evidence was shown that commercial banks in UK has to tighten their lending criteria which then resulted to an exaggerated effect on technically small organizations (BOE, 1995). This policy led to key changes in the way banks initially evaluate firms for funds.

2.2.1 Overdraft facilities; There have been a more reduction in the rate at which short term overdraft facilities are granted to small and the medium enterprises, this is rather because of the constant use of these facilities by mostly undercapitalized firms as an alternatives for equity rather than working capital. Second, financial institutions are now asking for more security for loans and there is the need to raise additional equity finance beyond what the originally could raise from personal sources and this is due to the renewed importance placed on the level of gearing (Mason & Harrison, 1994). More evidence in previous literature further revealed that commercial banking institutions have three main assessment criteria they adopt in determining the appropriate firms to allocate funds to.

2.2.2 Risk assessment: The lessons learnt from the recent financial crisis encouraged banks to develop a more sensitive risk pricing strategy and has resulted in the better quality proposals now receiving lower margins (BOE, 1995). Bank managers have resulted to considering the better businesses to be the ones with large size as against the smaller businesses, hence they are becoming more comfortable assessing businesses based on their size.

2.2.3 Profitability in lending; Past research pointed out that it has become increasingly unprofitable lending to small businesses because of the attendant low margins and high losses encountered by banks and other lending institutions (BOE, 1995). In a further confirmation from one of the banking gurus in the United Kingdom, Sir Brian Pearse, former chairman of midland bank, "*asserted that the banks have probably broken even on lending to small businesses in the last three decades*". This view was also supported by other banking giants such as accountants, bankers and other financial managers who cautioned that growth firms should seek for finance from other sources such as venture capital companies, business angels and other equity financing companies (BOE, 1995; Ismail et al., 2011).

2.2.4. Prospect Based Lending: Considering a new thinking by banks that availability of collateral security may be a secondary factor in lending to small businesses. Banks are increasingly looking at making their lending decisions based on the analysis of the borrower's business plan and cash flow as very important (Mason & Brown, 2011). Although they consider this new strategy as very expensive in that they bank need to commit lots of resources to their staff in order to ensure proper monitoring of their investment with the small business borrowers, recruitment of more high quality personnel, training of personnel and cost involved in carrying out due diligence and business evaluation will definitely increase bank charges.

2.3. Reasons Conventional Lending Institutions do not Fund Young Firms

2.3.1 Lack of Qualified Personnel in the Industry; The need to finance technology ventures require that commercial banks officials be more knowledgeable in the specific sectors in which they invest, including a familiarity with the specific technologies, processes and market involved (VCIF, 2008). However, the commercial banks staffs do not always possess this knowledge and may therefore not be able to provide the technology based firms with the industry-specific technical, production, marketing expertise and facilities which are vital for its success (Mason & Harrison, 1994). Indeed, empirical studies from various countries have found that technology firms usually require that investors provide other value added activities apart from financial support which unfortunately they are not in a position to do.

2.3.2. Collateral Security: More common reasons include a lack of tangible collateral security. Although a venture capitalists view a good idea whose time has come as representing intangible collateral. But to traditional and the very conservative lending institutions new ideas are not always very attractive to them, they prefer to deal with that which is old and tested (VCIF, 2008). However, investee companies may find it difficult to raise debt finance as they are required to provide sufficient collateral and it's even more complicated in situations where they are expected to provide asset- backed collateral at "Carcass value" prices to ensure the loan is realistically covered (Ajagbe et al., 2012).

2.3.3. Distinguishing between Good and Bad Investments: As a result of the inability of commercial banks to recruit enough personnel that will cater for the various areas of specialization of technology businesses, it has been very cumbersome for them to understand and evaluate technologies that are considered good investments. In view of this shortcomings coupled with the high risk nature of potential investments they have chosen to stay away from financing this category of investee firms.

2.3.4 Risky Investments: The degree of risk involved in technology investment as reflected in the innovativeness of the products and processes, the specificity and size of capital inputs required, the often intangible nature of capital base, the financial inexperience of the founders and the attitudes, practices and imperfections in the capital markets (Massa & Testa, 2008). The financial experience of the owners showed that majority of innovative entrepreneurs all over the world especially in America were at their early twenty's, hence they mostly do not possess the managerial and financial ability to manage such a venture, and also they do not even possess a higher education or professional qualification (an MBA) needed at that level.

3 Methodology

3.1 Research Design

This research is based on field study carried out in Malaysia. The data were gathered and assembled using 25 interviews with senior managers in charge of investment with prominent commercial banks in a manner consistent with grounded theory research design (Strauss & Corbin, 1990; Abolghasemi et al., 2012). The researcher also ensured that commercial bank officials who have served with the organization for at least five year period and well versed/experienced in investment are interviewed. The commercial banks interviewed were initially identified from the list of registered financial institutions in Malaysia found on the internet. Request for interview with our university letter-head paper was sent to 30 randomly selected commercial banks headquartered in Kuala Lumpur and other part of the country, among which we were able to secure acceptance from 25 through referrals. The response rate showed over 83%. The researcher ensured that respondents were selected across geographical locations in the whole country and that commercial banks who have made investments across sectors are interviewed this actions is geared towards ensuring effective representativeness and generalizability of findings. The interviews were tape recorded, transcribed and analyzed through content analysis. We asked the bank officials to discuss…………

4.0 Summary of Interview Schedule and Responses

4.1 **How do you monitor your investments?**

Financial executives were asked questions on how they monitor their financial investments in technology young firms they grant loans to: The bank manager responded "*we monitor our investments by been very close to the business we finance by carrying out frequent on-site visit and observation of the financial operations of the companies we fund"*. Majority of those we discussed with agreed that the best way to monitor investment/loans awarded to new ventures is by asking to be furnished with financial review and status of their company and this is done on a quarterly basis. One of the executives says "*we carry out constant review of the financial status of the company*". Another puts it this way "*we mandate new venture owners to provide us with bankers performance report on a quarterly basis"*. All the managers involved in the discussions confessed that the best way that commercial banks monitor their loans is that they impose terms and conditions that new venture managers must abide by in order to minimize risk exposure. To achieve this they agreed that they usually expect that venture owners will cooperate with the bank by making their books available to carry out yearly and half yearly audited accounts and financial statements with full and transparent disclosure of information. A few of the terms and conditions are that they provide flexible loans with tighter terms and conditions to reduce risk exposure, impose third party guarantee against the risk, provide smaller structure with progressive disbursement schedule, impose higher than usual loan rate with higher pledging assets (fixed assets) and fixed repayment amount.

4.2 **What are the important criteria your bank adopt to select new ventures for financing?**

Considering what traditional lending institutions look for in potential investee companies before loans approval. The analyses of responses from the interviewees are summarized into five main sub headings for easy understanding and explanations; (i) track record with satisfactory profit record, potential for profitability, healthy balance sheet with surplus assets position, credibility of client in all aspects including financial compliance with rules and regulations, loan amount, repayment period and break-even point (ii) prospect and long term planning which is justifiable and feasible with availability of resources on hand (iii) Provide adequate collateral security; traditional lending institutions like commercial banks will only finance technology based firms who are able to show enough collateral security commensurate to the value of cash they are asking for. One of the respondents replied that *"our bank shall give special preference to technology new ventures who have received initial grants from government as seed capital or early staged fund or who may have the backing of reputable retired business angels such lawyers, accountants, bankers, politicians and are known in the community and are longtime friends to the commercial bank they should have the support of reputable venture capital firms as co-investors"*. (iv) Background information, credibility and strong management teams. According to the senior manager of one of the top commercial banks in Malaysia he says "*In our bank, the educational level of the new venture owner does not matter to us in granting loans to the business, what is important to us is the ability of the investee firms management to meet up the bank's loan requirement"*. (v) Geographical location of the business is another important criteria adopted by banks in selecting a firm to fund. The firm must be located at a reasonably near distance to the bank. In the case of finance it is argued that greater geographic distance between small business borrowers and their banks will reduce in person visits due to the high costs of travel by bank staff, particularly time costs, there by exacerbating information asymmetries which, in turn, increases the risk of adverse selection leading to higher default rates and loan losses. The responses gathered in respect of the geographical location of investee firms are almost the same from all the respondents, but one of the respondents particularly emphasized that "*although our bank have branches in almost all the commercial cities in the country, but since we consider a whole lot of other criteria other than location in our evaluation criteria, we may also choose to finance if other options out-way the geographical location of the venture."*

5. Findings and Conclusions

From this study, the researcher finds that the important selection criteria adopted by conventional money lenders such as commercial banks and other financial institutions mostly consider the following significant factors in selecting new ventures they fund in Malaysia; (i) track record with satisfactory profit record, potential for profitability, healthy balance sheet with surplus assets position, credibility of client in all aspects including financial compliance with rules and regulations, loan amount, repayment period and break-even point (ii) prospect and long term planning which is justifiable and feasible with availability of resources on hand (iii) Provide adequate collateral security. (iv) Background information, credibility and strong management teams. (v) Geographical location of the business is another important criteria adopted by banks in selecting a firm to fund.

Findings from responses confirmed the fear nursed by traditional lenders in Malaysia and this is consistent with the general perception from investigation carried out by past authors (Mason & Harrison, 1994, VCIF, 2008; Mason & Brown, 2011; Ajagbe et al., 2012) in other part of the world which indicate that financial managers from conventional lending

institutions are very careful or almost unwilling to commit their fund to new venture businesses. As it is a wide knowledge that these groups of investors are managing funds in trust for stakeholders. Public sector officials are advised to adequately safe guard such funds to be made available to technology new ventures in case of such situations as business failure. Although during the course of our interview, we found that a few of Malaysian banks have been very active in promoting the venture capital concept by forming new companies to handle that responsibility. This may be an alternative strategy adopted by Malaysian banks to help grow technology business firms, even though most of these commercial banks have one way or the other some percentage of government funds in their investment capital. There evaluation criteria adopted by conventional lending institutions in Malaysia is not that different from what is obtainable in other part of the world. However, commercial banks in Malaysia have been very instrumental to the growth of new ventures in the country over the years. But that notwithstanding, they government can still help both new ventures and commercial banks by; (i) Provide more friendly import duty, tax rebates, subsidies and sales tax exemption on machinery and equipment purchased by technology new ventures for their operation. (ii) Provide grants to be used by banks to support technology ventures and provision of guarantor responsibility to early-stage tech firms, (iii) close monitoring on the progress of technology new firms formed and render help when necessary, (iv) establish agencies to evaluate and recommend high tech firms to commercial banks for financial support. (v) encourage local financial institutes to offer short-term flexible loan facilities to cater for eligible companies,(vi) assist to source for external investors (local and overseas) to participate in this new venture. Above all commercial bank managers are also advised to be patient enough to look at the potential of the company's products and services and evolve strategies to help bridge the financing gap.

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