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SPECIAL FEATURES OF CAPITAL STRUCTURE OF SMALL FIRMS IN TOURISM INDUSTRY- AN EXPLORATORY STUDY

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ABSTRACT

Small and Medium Enterprises (SMEs) across the world differ on the parameters of definitions as well as the set of challenges faced. Out of the challenges faced, the major challenge seems to be finance related, especially in developing economies. This paper seeks to study the capital structure of SMEs and the preferred sources of finance for the long term and short term needs in tourism sector. The concurrence with existing theories and emergence of new sources is examined with the reasons for the same. Two case studies, of small firms, in medical tourism and business tourism have been reviewed in context of extant theories. Market timing theory could be used in conjunction with pecking order to explain the order of preference. The managerial implications could be to improve flow of finance to the SME sector, by elimination of bottlenecks.

Key words: SME financing in tourism, Sources of SME finance in tourism.

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1. INTRODUCTION

SMEs across the world differ on the parameters of definitions as well as the set of challenges faced. As compared to large enterprises they encounter more obstacles of various kinds, most of them being financial and economic. (Ayyagari et al, 2007; Beck & Kunt, 2006). Lekhanya and Mason 2014 investigated environmental, financial and infrastructural factors that influence the success or otherwise of Small and Medium Enterprises (SMEs) in rural areas and found that access to finance and skill shortages are major factors affecting their success.

However, the definition of SMEs in India differs across manufacturing and service sectors, based on the quantum of investment in plant and machinery in these two sectors. The prescribed quantum of investment in plant and machinery is much less in service sector. Hence, this paper seeks to understand and differentiate the factors affecting financial structures of SMEs, with particular reference to Tourism sector, which is a predominant part of service sector. Tourism being the largest segment in service sector in Goa, the study focuses on exploring the nuances in financial structures in this sector.

As of 2015-16, the number of passengers who arrived in the state on the basis of e-tourist visas was recorded to be 80,928. Moreover, the state recorded a total of 541,480 foreign tourists from over 141 countries across the globe. Medical Tourism is one of the emerging tourism and hospitality segment.Tourists seek specialised medical treatments mainly ayurvedic, spa and allied therapies. The primary purpose is achieving, promoting or maintaining good health and a sense of wellbeing. (Report on Goa by Indian Brand Equity Foundation, February 2016)

2. OBJECTIVES OF THE PAPER

Objective of the paper is to study the capital structure of SMEs in tourism sector, to trace the special features, if any. The preferred sources of finance for the long term and short term needs will be particularly studied. The concurrence with existing theories and emergence of new sources is examined with the reasons for the same.

3. METHODOLOGY

Methodology employed is extensive literature review coupled with an exploratory research. The literature review states the extant theories explaining the preferences of the firms generally. These were supplemented with the analysis of the case studies of small and medium firms. Case study is deemed be a suitable approach to gather initial comprehensive data on the subject longitudinally. It can also provide detailed insight into the niche area of SME financing, for unearthing the special features, as compared to generic traits.

4. LITERATURE REVIEW

Detailed literature review is stated in the following sequence:

- SME TAXONOMY
- THEORETICAL BACKGROUND
- FINANCING OF SMES

4.1. SME- Taxonomy

The abbreviation "SME" is used in the European Union, World Bank, United Nations and World Trade Organization (WTO). International scenario reveals that different countries have their own definitions of SMEs. The differences in the definitions of SMEs across nations and regions, accentuates the need to validate the research findings in any country for their generic applicability.

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Firms differ in their levels of capitalisation, sales and employment. Hence, definitions which employ measures of size (number of employees, turnover, profitability and net worth) when applied to different sectors may lead to different classifications. In India, the firms are classified based on investment in plant and machinery, separately for manufacturing and service sector.

Table 1 - Table of present definition of SME in India in manufacturing and service sector as per MSME Act 2006

Nature of activity of the Enterprise	Investment in plant and machinery excluding land and building for enterprises engaged in manufacturing or production, processing or preservation of goods	Investment in equipment excluding land and building for enterprises engaged in providing or rendering of services (loans upto Rs 1 crore)
Micro	*Not exceeding Rs. 25.00 Lakhs*	*Not exceeding Rs. 10.00 Lakhs*
Small	*More than Rs. 25.00 lakhs upto Rs. 500.00 lakhs*	*More than Rs. 10.00 lakhs upto Rs. 200.00 lakhs*
Medium	*More than Rs. 500.00 lakhs upto Rs. 1000.00 lakhs*	*More than Rs. 200.00 lakhs upto Rs. 500.00 lakhs*

4.2. Theoretical background

Different theories used for analysis of financing are stated below in brief:

Table 2 Theories of Capital Structure

Sr No	Theory	Contributors	Highlights
1	Modigliani-Miller Capital Structure Irrelevance	Modigliani and Miller(1958)	• The value of the firm is independent of how the firm is financed under perfect competition conditions. • the firm value of a company is dependent on its earning power and the risk of its underlying assets • Also known as Capital Irrelevance theory
2	Trade off Theory of Capital Structure Leverage	Kraus and Lichtenberger (1973)	• Leverage enhances firm value by balancing the cost and benefits • Capital structure which balances tax benefits and bankruptcy Costs optimises firm value

Contributors	Highlights
Jenson and Meckling(1976)	• Arise when there is conflict of Interest among firms' management ,debtors and shareholders • Controlling agency costs –balancing stakeholder's interest further optimise firm value.
Myers and Majluf(1984)	• Cost of Financing increases with asymmetric information • Firm Financing Preference: o Internal Funds o Borrowings(debt) o Equity(shares)
Akerlof, Spence and Stiglitz (2001)	• Information asymmetries affect sourcing decisions from capital markets • Financers and SMEs have imperfect information about each other • Informational asymmetries raise cost of external finance and risk perception
Baker and Wurgler(2002)	• Decision of finance depends upon market conditions • Market timing contrasts with trade off and pecking order theory

E financing, less stress has been laid on the conjuncti
preferred to test the pecking order or the trade-off mode
ave been tested in fragmented fashion, across varyi
pez-Gracia and Sogorb-Mira (2008) showed that t
related to variations in the debt level, thereby confirmi
on-listed Spanish SMEs. Bhaird and Lucey (2010) fou
nanner roughly consistent with pecking order theory a

that there were no major differences between the capital structure of service and manufacturing SMEs. Serrasqueiro (2011) found greater informational asymmetry for non-listed service SMEs relative to unlisted manufacturing SMEs, thus suggesting a greater likelihood of observing pecking order behaviour in the service sector relative to manufacturing.

SMEs find it difficult to access long term bank financing for many reasons including collateral requirement, credit history, credit worthiness, networking/relationships and transaction costs. This is supported by Scholtens (1999), Schiffer and Weder (2001 Beck et al. (2006); Beck and Demirgüç-Kunt (2006). The criteria used by financiers are mainly the success factors that relate directly to functional management skills, namely planning of the enterprise, knowledge of competitors, being mainly market-focused, quality work enjoying priority, client service, financial understanding, financial management, knowledge and skills with regard to the enterprise and the utilisation of experts. Success factors that relate to personal characteristics that are used as financing criteria by financiers are creativity, innovation and commitment to the enterprise. (Nieuwenhuizen & Kroon 2003). Five factors have been identified by Bhalla and Kaur 2012 towards decision making criteria by the banks. These are loan characteristics, financial and collateral backup, margin money and earlier track record, entrepreneurial characteristics, skills and purpose of loan.

The capital structure of SMEs in Vietnam is positively related to growth, business risk, firm size, networking, and relationships with banks; but not related to tangibility (Nguyen & Ramachandran, 2006). Ngoc & Nguyen, 2009 stated that liaison of SME with customers and government promotes use bank loans while liaisons with suppliers and social ties reduces use of bank loans further supporting use of venture funds over debt. Informational asymmetry, financial reporting (unavailable and unreliable financial data) and credit risk add to the problems of SMEs and financial institutions are reluctant and prudent in providing finance (Yigui Ma & Shumin Lin, 2010). International accounting standards improves informational asymmetries (Barth, Lin and Yost 2011). Substitution effect and rent extracting behavior encourage venture capital over bank finance (Berger and Schaeck 2011). Improving political affiliation allows greater access to long term fund while entertaining and gift giving improves short term debt (Guariglia, Newman, & Du, 2013). In Ghana and Nigeria, the size of the firm, age of the firm, ownership type and relationship banking have a positive impact on a decision to extend credit to small firms in West Africa. (Boateng & Abdulrahman, 2013)

Thus, having regard to the multiple factors unearthed by different researchers from varied regions, having wide ranging definitions of the SME concept itself, the researchers explored the field by conducting two case studies, one each in medium and service sector. The factors gathered from the literature were proposed to be reviewed against the case studies conducted.

5. CASE STUDIES

CASE STUDY 1

VEDD AYURVED BHAVAN (SMALL FIRM IN MEDICAL TOURISM)

Tourism sector

Tourism is the largest segment in the services sector. It has also emerged as a main destination for Medical Tourism /Heath care supported with major hospitals like Apollo, Manipal, and Wockhardt having its presence in the state.

It has ample scope for natural wellness centres in Goa as the infrastructure is readily available. It is a best substitute for Kerala which is a major Tourist Destination supported by its Ayurveda wellness centres.

Introduction:

Ved Ayurved Bhavan is pure, traditional Ayurvedic clinic and panchakarma centre where all Ayurveda treatments, rejuvenation programs suited to specific constitution & lifestyle are based on the ancient principles of Ayurveda. It provides the thorough diagnosis together with the professional treatments by a caring staff & with proper Ayurveda oils & herbal medicines.

The owners are into wellness industry basically into service sector since 2011 with branches in Kolhapur, Pune and Goa. Its Goa based clinic caters to both domestic as well as foreign clients. It also offers training in yoga, stress management, lifestyle management to individual and enterprise employees as well.

Business Environment:

Ved Ayurved Bhavan boasts of loyal client both India and abroad. There is a significant awareness among foreigners towards Indian traditional medicinal system. The owner finds them more dedicated and devoted to Indian science. He ventured into consulting during his internship days in Pune and nearby villages. Over the time when his confidence built up, he started permanent clinic in Pune initially.
Next idea was to expand business and market it globally so that it could generate

awareness and revenue from international clients. Goa was considered as the right place. In July 2011 they started operations in Goa. Owner states that the main hurdles are during starting the business. Despite Governments interventions/assistance, he feels that finance still remains a very big issue for a newcomer like him.

Initially they approached banks with project reports that they had made from their requirements. Some of the Banks they approached were Corporation bank, ICICI, SBI. They found the banks were approachable but had lot of formalities and always asked for collateral security. After providing healthy collateral security the banks agreed but the rate of interest was 13-16% with lot of hidden charges and delays in processing loan application.

The initial cost for entire setup came around to 17 -18 lakhs in 2009-10. Another quick option the banks offered /suggested them was to avail a personal loan again asking for IT returns and collateral in the form of Fixed deposits, Gold or Property assests. The rate of interests also was too high for personal loan. Personal loan rate of interest was around 12% and business loans 18%+ . Such rate of interest was viewed as not affordable and the venture funds were viewed favourably due to ease of getting finance and lack of paper work. Bank options were not perceived as useful as lot of policies don't support a new business.

Instead they approached one of the relatives and his friend and briefed them about the venture. They were very optimistic as they themselves had business knowledge about prospects in Goa. They had earlier helped him to search for premises in Goa.

They got the funds from them initially for the start, to be returned in the form of EMI or lump sum basis to them. They were also open to profit sharing basis. Such flexibility would not be possible with bank funding or any other sources initially. Thus, he borrowed funds through the venture fund. The initial start-up funds required were 17-18 lakhs in 2009.They started as a joint venture and resorted to profit sharing mechanism.

With the start of the clinic the business flourished well and cost of operating was less because lot of purchases were done keeping in view the needs of all other clinic. Like the brand being Ved Ayurved Bhavan the labels, posters, stationary bills of all other clinics were same .Only the VAT accounts and other accounts were maintained at different places.

As with the growth of business various banks approached for current accounts but the owner chose Corporation bank and ICICI bank as both are nearest and provide prompt facilities compared to others. Another reason for choice of ICICI bank was that they have a merchant account with them for a point of sale machine which helps them realising the payment from customers through the ATM/Credit cards, hence can manage their delayed payments without worrying to manage credit from customers.

At present, besides consulting, the firm is having a distributorship of major Ayurveda medicines in north Goa. Their working capital needs increased as compared to initial times but now they were eligible for short term loans from banks as they have proper accounts and IT returns. In others words they have improved their credibility.

The working capital needs are higher as compared to setup cost today. Major portion of funds is required for buying medicines. Rolling operations is main tasks as there are delayed payments from customers. Amount of payment to pharmacies is large and credit duration for is less (1 month) and cash conversion from sales usually takes 3-6 months. Buying in bulk is considered better.

Options for working capital finance were short term loans or cash credit facility.

Summary of Financing

Table 3 Financing Options

Initial Set up Cost	• 17-18 lakhs
Finance Option	• Venture Funds
Working Capital	• Cash Credit facility with corporation bank, Pilerne branch (50,000 approx.)
Bank Accounts	• Current account with Corporation bank for agency sales(distributor) • Current account for clinic for consulting and sales on the OTC sales
Other accounts	• Merchant account with ICICI bank for Point of Sale(POS)

CASE STUDY 2
ABC RESTAURANT CUM CANTEEN (NAME CHANGED)

Introduction

ABC is a food Start Up delivery service operating in South Goa. It was started in February 2016 by the owner. It also has a Restaurant cum Canteen called XYZ operating in a major industrial area.

ABC is a food packaging and delivery service. Currently it is catering meals to Industrial Estate area and nearby places around few beaches in Goa.

Industry Background

In India, the size of the food market in 2014 was around Rs 23 trillion. As per consultancy Boston Consulting Group , It is expected to touch around Rs 42 trillion by 2020, along with a three-fold increase in average income of household from 2010-2020.

The tiffin sector caters to a demand of 2.5 lakh customers daily and there are only seven to eight organized players and over 90 percent unorganized players.

Inside Story

A hotel management graduate started the service in early 2016. Prior to ABC he worked for major five stared hotels across the country.

While working in Goa, he could not find economic and hygienic meals and tiffin service that was willing to cater to a single meal without a month-long subscription. He found food needs of business tourists, which are substantial part of working class people in Industrial Estate and ventured out to set up his own start up. Thus, he realised that visitors to the Industrial Estate and business tourists could not get good meals.

He initially launched his business with start-up capital of 8-10 Lakhs and grown very significantly within a year. Eventually it started a 24 x 7 meal ordering service.

The XYZ provides services from 9AM to 8PM and ABC from 8PM to 3PM.

"We offer freshly prepared home like daily meals for lunch and dinner, tea and snacks for parties and meetings through various food vendors. Meals are delivered in hygienic packaging," the owner said

They got a canteen contract which is centrally located and convenient to all Industries nearby. The Restaurant is named ABC and operates as a Restaurant cum canteen.

Apart from breakfasts, lunch and meals, it supplies tea snacks to the industries nearby on fixed contract. Some employees working in industrial area demanded supply of lunch, meals to their Offices as the restaurant sitting area would be crowded during Lunch hours. They provided supply of meals to customers on monthly subscription basis also. They later extended the services to neighbouring areas and nearby beaches in southern Goa.

The Start-up Capital required for the setup was around 8-10 lakhs. Funding was obtained partly from his personal Savings and borrowing from friends. They did not go on to bank funding because it required more time and paperwork and loss on the interest money.

Personal Borrowings was good options as the business had good cash flows from start of operations. Later they expanded for service delivery and had technological expenses in Branding, Website and Warm Food Keeping Equipment's.

The Suppliers are paid from the day to day earnings. The food is affordably priced and accommodates all working classes. The monthly Subscription business is good as it lowers our costs and economical for customers. The Quality food at economic Prices is their USP.

Thus, the business did not depend on organised sector for funds at all.

6. Cross Case Analyses

The capital structure in above cases is analysed on the basis of the following criteria:

a. The composition of the Capital Structure: The firms studied above rely on the owner's capital than institutional finance.
   i. Equity/Owner's Capital: Here the study states that the entrepreneurs depend on the own funds and if needed seek debt.
   ii. Debt: The debt was sought in the nature of Term Loan by one of the firms studied special from banks. Thus banks did form a part of the consideration set.
   iii. Working Capital: One of the firms studied had working capital finance arranged through Public sector bank. The other, being in the hotel business could use internally generated funds, as the sales were cash sales predominantly.

b. Source of capital: The sources from where the firms reviewed have raised finances are the Banks, Financial Institutions, and Friends and Relatives, especially for long term needs. They are aware of the Governmental schemes too but they feel it is not timely or reliable source. Hence, Financing through Government Institutions is the least preferred source. For working capital needs, the preferred source is public sector banks, when required.

c. Special characteristics identified-Following special features have been identified:

- Difficulties in obtaining finance are much acute at the start-up stage. As the firm reaches growth stage, the financers rate the firms higher in their credit ratings and are willing to offer finance.
- Case studies have thrown light on sources not highlighted in the theories or literature such as venture capitalists, who in India are predominantly the friends and relatives, as compared to professional angel investors. They have also pointed towards emerging sources such as venture capital.
- Private Sector banks are preferred for special services like merchant bank accounts. Hence, add-ons are now preferred by SMEs over vanilla accounts.
- Venture capital is preferred as it offers flexibility of repayment like profit sharing arrangements.

7. CONCLUSION AND FUTURE RESEARCH PROSPECTS

The research on factors affecting the capital structure has progressed into specific issues relating to SME financing, particularly related to obtaining debt form formal institutions. The current research has explored that SMEs need external financing primarily for their long term and also for short term needs as the owners' capital seems insufficient. The Government financial institutions and banks seems to need much coordination with SMEs to be in sync with their demands, as SMEs have complaints relating to timeliness and general apathy towards their requirements. Private Banks seem to be preferred due to the need for merchant banking services, for the day to day business requirements.

Market timing theory could be used in conjunction with pecking order and information asymmetry to provide suitable backgrounds to explain the order of preference. Financing of SMEs do follow the pecking order of preference for own funds over debts. But they are not averse to profit sharing arrangements with venture capitalists, in order to overcome the difficulties faced in obtaining debt. Hence, Market Timing theory could rightly explain the choice of venture capitalists as preferred emerging sources of finance. This emerging source in market seems to be a preferred source due to flexibilities and lack of formalities coupled with timeliness.

The future research could test the preferences along with the reasons on a wider sample quantitatively. This could have much social significance, due to the role of SMEs in employment generation and equitable distribution of wealth. The preferences, along with theoretical background explaining the same, could largely enrich the extant literature. The managerial implications could be to improve flow of finance to the SME sector, by elimination of bottlenecks.

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