Financing Challenges and Strategies for Small and Medium Enterprises in China

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Abstract. This study provides a comprehensive analysis of small and medium-sized enterprises' (SMEs) financing in China, highlighting their critical role in the national economy by contributing significantly to GDP, tax revenue, job creation, and exports. Despite their importance, SMEs face substantial financing challenges due to traditional banking systems' risk assessments, leading to a significant financing gap. The COVID-19 pandemic has exacerbated these challenges, threatening the survival of many SMEs. This research explores both traditional and innovative financing channels, including bank loans, equity financing, and digital platforms like Microconnect and Meituan. The difficulties SMEs face are also discussed, such as high loan rejection rates and the limitations of collateral-based financing which often push these enterprises towards high-cost alternatives or limit their access to necessary funds which hinder SMEs' daily operation. It assesses the role of government policy and inclusive finance in supporting SME financing and examines the effectiveness of current financial support mechanisms while identifying ongoing gaps and challenges. It argues that while digital platforms like Microconnect and Meituan offer valuable insights and solutions, the complexity of China's financing ecosystem and regional disparities present ongoing challenges. The study ends by highlighting the importance of SMEs to China's economy and the appeal for continued innovation and policy support to improve SMEs financing.

Keywords: Small and Medium-Sized Enterprises, Financing Channel, Microconnect, Inclusive Finance.

1. Introduction

In the dynamic pattern of China's economy, micro-enterprises are key participants, accounting for more than 98.64% of total enterprises and making significant contributions to GDP, tax revenue, job creation, and exports. Specifically, micro-enterprises contribute 60% of GDP, 50% of tax income, 75% of job creation, and 68% of exports [1]. Despite their economic importance, small and medium-sized enterprises (SMEs) often have limited foundations and capital, especially those in capital intensive industries. These businesses, characterized by long industrial chains and extended cycles for end-product formation, have high proportions of working capital tied up and substantial demand for it, along with longer turnover periods. Without the ability to maintain a continuous and healthy cycle of capital flow, the production development and operation growth of these enterprises and even the whole development of the industry can be severely impacted. Traditional banking systems typically evaluated these firms as high-risk due to a lack of collateral and proven performance records, leading to a significant financing gap that hinders the growth of firms and economic progress. COVID-19 creating severe challenges for their survival due to a combination of reduced operating income, inability to repay debts, and a general scarcity of funds to maintain operations for extended periods as evidenced by 86.22% of SMEs' account funds cannot survive for more than 3 months and annual unemployment rate increase from 5.3% in January to 6.0% in April 2020 [2]. Research by Shi Yi points to the prevalent financing difficulties of SMEs, highlighting issues such as low creditworthiness, inadequate national safeguards and policies, and credit discrimination by financial institutions [3]. The study suggests several measures to address these issues, including reducing financing costs, optimizing financing channels, and improving internal management systems to enhance corporate creditworthiness [3]. This study aims to gain an in-depth understanding of the current state of SME financing in China, examine the effectiveness of existing financial support mechanisms, and identify ongoing gaps and challenges. It seeks to answer key questions about the adequacy of current financing options available to SMEs, the role of government policy in bridging the financing gap, and the potential risks and challenges these businesses continue to face in accessing necessary funding, thus potentially contributing to the development of more effective financial support structures for these enterprises that are critical to the Chinese economy.

2. The Financing of SMEs

2.1. SMEs's Finance Channels

Under diversified pattern emerges incorporating both traditional and innovative channels. Traditional bank loans remain a common source, yet SMEs face challenges due to stringent requirements including collateral demands, high creditworthiness, detailed financial records, and guarantees, leading many to resort to informal credit sources. Financing needs of SMEs are typically characterized by small scale, high frequency, and urgency, which escalates the due diligence and monitoring costs for banks, although it can be compensated to a certain extent by raising interest rates, it will also lead to an increase in the financing costs of small and micro enterprises and may cause adverse selection and moral hazard [4].

Equity financing has gained prominence as a key financing avenue for SMEs, especially with the establishment of platforms such as the Beijing Securities Exchange, part of the central government's focus on developing "little giants"—small but technologically advanced companies. The BSE provides these SMEs with direct financing opportunities, enabling them to move up the value chain [5]. Moreover, venture capital, leasing and factoring, online lending, and crowdfunding have become increasingly important sources of SME financing. In 2020, SMEs garnered significant financing from various markets, including the STAR Market and the Shenzhen SME Board, highlighting the role of these platforms in SME financing [6].

2.2. SMEs's Financing Challenges

China's SMEs face several financing challenges. One notable issue is the high rejection rate for SME loan applications, which stood at 3.79% in 2020. This statistic reflects the difficulties SMEs face in meeting the standards of traditional banking institutions [6].

Firstly, the development uncertainties have heightened the financing risk premium for SMEs. SMEs mostly positioned at the end of the supply chain with low market entry barriers and fierce competition have lesser resistance to external shocks, including the significant impact of the COVID-19 pandemic.

Secondly, Information asymmetry has decreased the accessibility of financing for MSMEs compared to more established, larger enterprises with standard and transparent financial information. This limited disclosure makes it difficult for banks to accurately assess the credit, prospects, and fund utilization efficacy of SMEs, leading to more cautious lending.

Besides, the company's collateral is insufficient to meet the company's financing needs. At present, the financing of small, medium, and micro enterprises relies on indirect financing, mainly bank loans, and the amount of financing of the enterprise will continue to expand with the development of the enterprise, but the collateral or anti-risk means provided by the enterprise are constant, which means as a result, enterprises will run into bottlenecks when bank financing reaches a certain level.

Moreover, due to lower own capital and brand equity, SMEs have a lower bankruptcy cost, posing a higher risk of moral hazard related to bankruptcy and debt evasion. Public listing financing, involving various fees from investment banks and intermediary agencies, generally offers greater economies of scale than bank financing, making it a less viable option for most enterprises that cannot meet the initial financing requirements.

Lastly, the uneconomical scale further escalates the financing costs of SMEs. The operational flexibility translates into small-scale, high-frequency, and urgent financing needs, raising banks' due diligence and post-lending monitoring costs. While higher interest rates can offset these to some extent potentially leading to adverse selection and moral hazard.

3. Financing Solution of SMEs

3.1. Microconnect

Microconnect represents a novel method of financing for micro and small enterprises in China, aiming to overcome traditional financing barriers. DRC refers to the Daily Revenue Contract, which is the primary product for investment and transactions by Drip Irrigation Connect. It is a contract signed between investors and small and micro enterprises, stipulating the relationship between investment and daily revenue sharing over a certain period — investors exchange a current investment for a future percentage of the revenue from the small and micro stores for a set time. The investment amount is primarily based on the investor's portfolio needs, while the sharing duration mainly refers to the store's payback period and survival period, determined through negotiation by both parties. The determination of the daily revenue sharing ratio is negotiated based on the investment amount ratio, store profit margin, sharing duration, and repayment amount. Generally speaking, as an investor, Drip Irrigation Connect receives a higher daily sharing ratio with a larger investment proportion and higher store profit margin, and vice versa. As the sharing duration elapses and the repayment amount accumulates to a certain level, the daily sharing ratio also decreases in a stepped manner until it reaches zero. DRC is simple, flexible, and easy to mass-produce, suitable for small and micro enterprises. Small and micro enterprises, being the cells of the economic society, are small in size and numerous in number; they are present in all industries and everywhere; constantly metabolizing and renewing. Therefore, investment products suitable for small and micro enterprises must be highly simple in form, highly flexible in terms of agreement, can be mass-produced at a lower cost, and reliably executed.

DRC represents a distinct financing model that diverges from traditional equity and debt structures. In reality, a huge proportion of SMEs are unable or incompatible with equity or debt financing. For instance, there’s no shortage of examples like friends and family opening a small store together in real life, they can break even in a year and cease operations in 3 years. Such small businesses may not grow into IPO firms targeted by traditional capital markets but offer a very attractive return on investment calculated on a daily basis. This innovative financing method allows businesses to repay loans based on a portion of their income, without the need for traditional collateral or guarantees. This method is particularly popular in certain areas, such as direct-to-consumer e-commerce and SaaS companies, as it offers more flexible repayment arrangements and faster access to funds while avoiding equity dilution. This model has proven effective, as Microconnect has completed nearly 6000 investments in over 200 cities in China [7]. Furthermore, the platform has completed a $70 million Series B financing, further validating its inclusive financial market development approach [8]. Microconnect's digital capabilities play a core role in its operations, including automatic repayment systems and blockchain-supported transactions, clearing, and settlement systems. This technological integration ensures the efficiency of the investment and repayment processes, benefiting both investors and small and medium-sized enterprises [9].

3.2. Inclusive Finance

Inclusive financing can be defined as a financial tool that effectively and comprehensively provides services to all groups in society including SMEs. Its original intention is to emphasize the continuous improvement of financial infrastructure, improve the availability of financial services, and provide more convenient financial services at a lower cost to people from all walks of life, especially underdeveloped areas and low-income people. After 2005, the concept of inclusive finance was introduced in China and recognized by the Chinese government. Inclusive finance refers to based on the requirements of equal opportunity and the principle of business sustainability, through increasing policy guidance and support, strengthening the construction of the financial system, improving financial infrastructure, and providing appropriate and effective financial services at affordable costs to all social strata and groups in need of financial services [10].

Firstly, inclusive financing can reduce financing costs of SMEs by reducing asymmetry and transaction costs. Traditional financial institutions often need to conduct extensive investigations and evaluations to reduce risks when lending to SMEs. Inclusive finance can improve the efficiency of financial services through data science artificial intelligence and other technical ways to reduce financing costs. For instance, at present, China's digital inclusive financial business models are diversified, including online payment, online lending, Internet financial management, Internet insurance, etc. Within this framework, financial institutions and technology companies use digital technology as a tool to focus on specific businesses and provide inclusive financial services to vulnerable groups, small and medium-sized enterprises, and other key targets of digital inclusive financial services. China's DIF ecosystem is constantly evolving and improving. The financial infrastructure operates stably, its functions are more complete, the system is more complete, and innovative application scenarios continue to expand. Secondly, inclusive financing can expand financing channels and improve the financing environment. Traditional financial institutions often only provide loans to large enterprises, while small and medium-sized enterprises often have difficulty obtaining loans due to their small size and high risks. Inclusive finance can meet the different financing needs of small and medium-sized enterprises by providing a variety of financial products and services such as small loans, credit loans, and guaranteed loans. Inclusive finance can also promote competition in the financing market to enhance SMEs' financing environment. For instance, Meituan (a Chinese retail and technology company) provides a package service marketing plan and smart payment solutions. These include accurate online marketing tools, efficient on-time delivery infrastructure, cloud-based ERP systems, aggregated payment systems, and financial and supply chain solutions. Taking ERP as an example, many small and medium-sized stores do not have a store management system, resulting in serious fragmentation. Meituan's open platform connects all merchants and helps them improve operations and payments. Operators will be able to use a multi-channel settlement system for fast, agile, and secure account management. Meituan-Dianping has been involved in the catering industry for many years. By analyzing reservations and consumer spending in each region, combined with local demographic structure, it can predict their popularity and market size, helping it understand customer behavior, satisfaction, and services. Quality, and even comprehensively assess the performance of each restaurant and measure operational risks, thereby providing demand-side support to merchants. Identify the strengths and weaknesses of their operations and effectively resolve the information asymmetry problem between lenders and borrowers. Additionally, it will reduce the time required to verify customer credit information [11].

4. SMEs Financing Channel Challenges

4.1. Drip Irrigation Connect Challenges

Firstly, the franchise industry indeed has significant scale advantages and a rapid development trend, but these are primarily concentrated among the industry's leading companies. These leading enterprises demonstrate financing often do not need to rely on high-cost partners like "Drip Irrigation Connect," as they can directly establish cooperative relationships with financial institutions like traditional banks or Private Equity. Therefore, Drip Irrigation Connect's main service targets are likely those medium and small-sized franchise businesses that face more challenges in financing which may narrow the target market and have higher potential bankrupt risk. Secondly, for these medium and small-sized enterprises, the financing services provided by Drip Irrigation Connect bear risks akin to equity investments but only yield similar to debt investments. In this context, the core issue for Drip Irrigation Connect is how to effectively control and manage these high-risk investments. Without strong collateral or terms closely tied to the interests of the borrowing businesses, this risk management becomes particularly crucial. Moreover, Drip Irrigation Connect offers loans at relatively high interest rates, typically between 10%-20% annually, though the loan amounts are relatively small. This raises a question: Why wouldn't small business owners choose to resolve their capital issues through personal large cash loans? If their credit is good, they could entirely obtain loans at lower interest rates, possibly as low as 6%-8%, with rates below 15% being quite common, a significant portion of financing costs can be used for business operations and reinvestment. These traditional institutions typically have more robust risk assessment frameworks and may offer more secure terms, appealing to a broad customer base, including those with higher credit ratings. As a result, Drip Irrigation Connect encounters stiff competition, particularly when trying to extend credit to individuals with lower creditworthiness. To compete effectively, Drip Irrigation Connect must find a balance between managing risk and offering terms that are attractive to these under-served businesses. This often involves innovative credit products, like the Daily Revenue Contract, that provide financing based on daily revenue, thereby offering flexibility to SMEs. However, this innovation also comes with increased risk, particularly without the security of traditional collateral. The challenge for Drip Irrigation Connect is to mitigate these risks through strategic financial products and services that are tailored to the unique needs of SMEs with poorer creditworthiness, while also ensuring the sustainability and profitability of their business model.

Additionally, the role of diversified investment strategies in Drip Irrigation Connect’s risk management is worth questioning. Although diversification can reduce the risk of individual investments to some extent, if the projects within the investment portfolio are highly correlated, such diversification strategies may not be sufficient to effectively reduce overall risk. For instance, While Drip Irrigation Connect has strategically diversified its investments across various industries and geographical regions, including mainland China and Hong Kong, spanning from manufacturing to retail to technology sectors, it faces inherent risks associated with systemic crises, such as pandemics. Such global events can significantly impact revenues across nearly all sectors simultaneously, affecting the income on which Drip Irrigation Connect's returns are predicated. While the platform's revenue model is directly tied to the financial performance of its investee companies, a widespread economic downturn could pose a notable risk. In this way, contrary to its claims of robust risk diversification, Drip Irrigation Connect does not possess the level of diversity in its risk management strategy as advertised. This dependency underscores the importance of developing a resilient investment strategy that can withstand the volatility induced by systemic crises, ensuring sustainability and stability in the face of global economic shocks.

4.2. Inclusive Finance Challenges

Initially, the development of inclusive finance in China has made significant progress, involving a diverse range of service providers, extensive service coverage, and a high level of financial service penetration. In terms of policy and regulation, China has implemented a series of measures to promote inclusive finance, including monetary policy, tax policy, and regulatory policy, to reduce service costs and encourage technological and product innovation. However, these policies also face challenges in implementation, such as ensuring the applicability of financial products, managing loan risks, and ensuring the sustainability of financial services. Secondly, although the development of digital inclusive finance has a certain mitigating effect on the financing constraints of SMEs, there is a clear imbalance in the level of development between different regions. The development degree of digital inclusive finance in the eastern region is significantly higher than that in the central and western regions. Additionally, the impact of digital inclusive finance on enterprise financing constraints varies among different ownership entities and levels of financing constraints. For example, compared to privately owned enterprises lacking high-quality collateral assets, state-owned Enterprises, due to their stronger financial strength and abundance of high-quality assets, find it easier to gain support from financial institutions. Furthermore, according to OECD data, China's SMEs contributed over 60% to the total GDP, over 50% to tax revenues, 79% to job creation, and 68% to exports in 2020. With the support of inclusive finance, the total amount of Loans obtained by small and medium-sized enterprises reached approximately 36.9 trillion RMB in 2019, an increase of 10.17% compared to

2018. However, the loan application rejection rate for SMEs was 3.79% in 2020, indicating that there are still difficulties in obtaining financing [12].

5. Conclusion

In terms of limitations of specific solutions, while platforms like Microconnect offer insightful case studies, they may not fully capture the notably complex, multifaceted financing challenges encountered by Chinese SMEs, which feature a variety of models, each with its unique advantages and challenges. This complexity is further augmented by the presence of informal financing channels such as underground banking, which, alongside traditional practices of guanxi (private networks of influence) and particular rituals of reciprocity and favor, introduces distinct dynamics to the financing landscape. Besides, the emergence of Drip Irrigation Connect is undeniably built upon technological progress, requiring a sophisticated and real-time accounting system to facilitate the recovery of principal from daily business revenues. However, this aspect of leveraging advanced technology for seamless financial transactions has not been sufficiently highlighted in the discussion. Additionally, the traditional banking sector has also experienced technological upgrades in assessing SME assets. For instance, some banks have started employing artificial intelligence and machine learning algorithms to analyze SMEs' creditworthiness more accurately and efficiently. This tech-driven approach allows for a more nuanced assessment of potential risks and opportunities associated with lending to SMEs, moving beyond traditional financial metrics to include behavioral and transactional data analysis. Such innovations represent a significant shift towards more accessible and tailored financial services for SMEs, though the full extent of their impact remains to be fully explored within this research including industrial and geographical. SMEs financing in China is highly likely to continue evolving. Future research should aim to explore a broader range of financing solutions, including emerging technologies and the regulation policy that comes with it. Despite its limitations, the current research significantly contributes to the understanding of SME financing in China. It underscores the importance of innovative solutions like Microconnect and inclusive finance in addressing the financing gap faced by SMEs.

In summary, this study not only sheds light on critical aspects of SME financing in China but also paves the way for further exploration. Understanding the dynamics and complexities of SME financing is essential for formulating policies and establishing effective support mechanisms for these vital contributors to the Chinese economy.

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