Analysis of the Relationship Between Financing Channels and Enterprise Characteristics of Small and Medium-Sized Enterprises

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Abstract. Small and medium-sized enterprises (SMEs) are essential drivers of mass innovation and entrepreneurship. They play a crucial role in boosting employment, stimulating economic growth, fostering technological advancement, and promoting social harmony, thereby holding considerable strategic significance for the national economy and social development. Nevertheless, SMEs currently face several financing challenges, including restricted financing channels, elevated financing costs, and inadequate policy support. This paper examines the characteristics of various types of SMEs and assesses the advantages, disadvantages, and suitability of the financing channels available to them. The findings indicate that SMEs continue to face numerous obstacles; however, they should select appropriate financing methods tailored to their specific characteristics, while primarily relying on internal funds and bank loans as their main sources of capital.

Keywords: Small and medium-sized enterprises, financing channels, characteristic selection, internal financing, bank loans

1 Introduction

Small and medium-sized enterprises (SMEs) play a crucial role in the economy; however, their financing difficulties have long impeded their development. Due to factors such as small scale, low financial transparency, and lack of collateral, SMEs often face challenges related to expensive and difficult financing. During the financing process, elements such as company size, years of operation, and industry attributes directly influence the choice of financing channels. SMEs with varying characteristics must often weigh considerations such as financing costs, risk tolerance, and the urgency of their financing needs when selecting financing channels. Therefore, this study aims to explore the relationship between SME characteristics and financing channels, elucidate the pervasive nature of financing difficulties, and conduct an in-depth investigation into how SMEs can navigate these challenges while effectively selecting and utilizing financing options. The goal is to provide both

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theoretical foundations and practical recommendations for optimizing the financing strategies of SMEs.

2 Overview of Domestic and International Research

2.1 Different Types of Financing Channels

SMEs can obtain financing through various methods. Scholars have classified financing channels from several perspectives, distinguishing between internal and external financing[1]. Among these, mortgage loans are regarded as the primary channel for addressing the short-term financing needs of micro and small enterprises[2]. Government subsidies, tax incentives, self-funding, and equity financing also significantly foster innovation within enterprises. However, over time, the motivational effects of these financing channels tend to weaken, while reliance on bank loans may inhibit enterprise innovation[3]. At the same time, new types of loans are also emerging, and some scholars have proposed that fintech can use the endogenous asset of enterprise reputation cost as a class of collateral assets, effectively reducing the threshold for SMEs to obtain loans and improving financial inclusion[4]. With the rapid evolution and widespread application of technologies such as big data, cloud computing, and the Internet of Things, internet finance, including P2P lending, third-party payments, and crowdfunding, has also gained prominence [5]. Scholars note that crowdfunding can alleviate information asymmetries, disperse risks, and lower financing thresholds, making it particularly compatible with SME financing [6].

2.2 Current Financing Situation of SMEs

SMEs continue to face challenges related to expensive and difficult financing, driven by complex underlying reasons, including internal factors and multiple external influences [7]. Currently, bank loans remain the primary financing channel for these enterprises, with shareholder reinvestment following in second place, and the introduction of new shareholders as a distant third [8]. Scholars attribute the financing difficulties to three main factors: the characteristics of the enterprises themselves, the financial market, and monetary policy, particularly in the context of innovations in monetary policy tools [9]. Additionally, the limited financing channels available to SMEs in China, coupled with the underdeveloped credit guarantee and re-guarantee systems, are significant contributors to their financing challenges [10]. In terms of financing avenues, SMEs have substantial needs that are often difficult to satisfy, exacerbated by limited options and high costs [11].

2.3 Environment's Impact on SME Financing

Reforms can significantly influence SME financing by lowering thresholds or expanding available channels. The LPR reform has leveraged the role of financial institutions, enhancing the position of SMEs in securing bank loans and reducing financing costs [1][12]. Digital finance also supports SME financing primarily through pathways for information identification, cost transmission, and marketization, thereby alleviating funding constraints [13]. From an inclusivity perspective, digital inclusive finance can guide governments in formulating policy frameworks that stimulate the supply of digital financial services and promote improvements in SME financing issues [14]. In addition to the impact of digital finance, the growth of shadow banking has provided assistance to SME financing as well. Scholars believe that the development of shadow banking can reduce SMEs' sensitivity to internal cash flow, thereby mitigating financing constraints to some extent [15]. Simultaneously, social capital serves as an important funding source for SMEs. As a form of "unique information" circulated between banks and enterprises, social capital effectively alleviates adverse selection for fund providers and mitigates moral hazards faced by enterprises, thereby reducing credit default risks and improving the credit rationing phenomenon caused by information asymmetry among SMEs [16].

3 Theoretical Foundations

3.1 Theory of Information Asymmetry

Information regarding a company is often predominantly held by the financing party, while investors generally acquire relevant data through public and voluntary disclosures. The investors' understanding of the financing party is contingent upon the amount of information accessible to them, which may introduce bias into their analysis of the company's current circumstances, thus resulting in significant investment risks. Consequently, investors are likely to engage in risk-averse behaviors, leading to the inclusion of restrictive clauses or the establishment of contingent agreements, both of which contribute to increased financing costs. To mitigate the negative impacts associated with this issue, SMEs should proactively disclose pertinent information as much as possible, thereby reducing information asymmetry and, consequently, lowering financing cost, particularly for those companies in the startup phase or operating in high-risk sectors such as technology and pharmaceuticals.

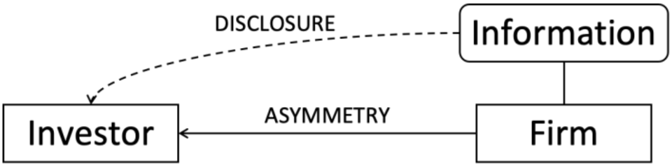

Fig. 1. Theory of Information Asymmetry

3.2 Principal-Agent Theory

Conflict of interest frequently arises between shareholders (the principals) and management (the agents); the objectives of management do not always align with those of shareholders, especially when tensions emerge between short-term profits and long-term development. Therefore, shareholders must design incentive mechanisms or enhance supervisory management to improve the efficiency and direction of resource utilization within the firm. Small and medium-sized enterprises (SMEs), due to their limited scale, often lack robust governance structures to regulate managerial behavior, resulting in diminished control for investors. To bolster investor interest and confidence, companies should proactively negotiate and implement both incentive and supervisory mechanisms.

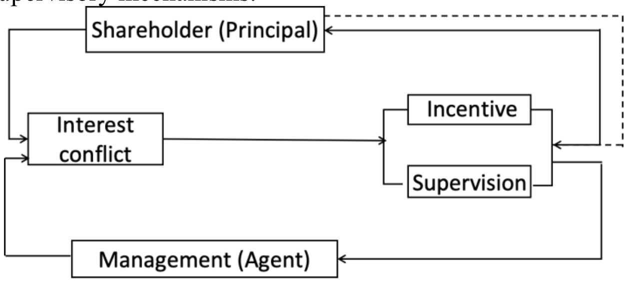

Fig. 2. Principal-Agent Theory

3.3 Theory of Financing Preferences

Due to variations in financing costs stemming from information asymmetry and differing risk-return ratios, companies generally prefer to utilize internal earnings first, followed by debt financing, with equity financing considered only as a last resort. Small and medium-sized enterprises (SMEs) often encounter significant challenges in accessing capital markets and typically rely on internal funds or bank loans. However, these sources are frequently insufficient in amount or duration, thereby constraining expansion and growth, particularly in high-risk industries.

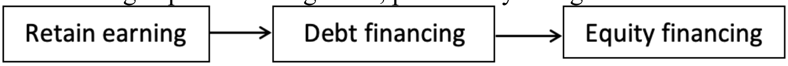

Fig. 3. Theory of financing preferences

3.4 Resource-Based Theory

A company is essentially a collection of diverse resources, and the differences in resources among companies result in variations in their competitiveness. Investors determine whether to invest in a company based on an assessment of its competitive strength. To attract greater investment, companies must create and possess scarce and inimitable resources, such as intellectual property and technological innovations, thereby establishing intangible assets that facilitate the financing process.

4 Phenomenon Analysis

4.1 Financing Channel Classification

Throughout their development, small and medium-sized enterprises (SMEs) have access to a variety of financing channels; however, their options are comparatively limited when placed alongside those of large enterprises. Based on the sources and nature of financing, these channels can be categorized into the following types:

Regarding internal financing, there are two primary channels. The first category includes corporate profits, allowing companies to reinvest earnings generated from operations for internal capital accumulation. The second category consists of self-owned capital, referring to funds directly provided by business owners or shareholders, making it the most straightforward financing method. Although internal financing offers a high degree of autonomy and is free from external funding pressures, its capital is often insufficient to meet the substantial funding needs necessary for rapid expansion or innovation.

In terms of external financing, the options primarily include debt financing, equity financing, bank loans, venture capital, angel investment, government subsidies and loan guarantees, as well as internet finance and P2P lending, each with specific applicability as follows:

Table 1. External Financing Channels and Their Applicability

Types of External Financing	Applicability
Debt Financing	Issuing bonds for fundraising is suitable for larger small and medium-sized enterprises (SMEs), with financing costs lower than equity financing; however, it requires the company to possess a certain credit rating.
Equity Financing	Selling shares to external parties in exchange for funds is common among rapidly growing companies, such as technology-based SMEs, but may face risks of shareholder dilution and control dispersion.
Bank Loans	Traditional financing methods primarily rely on bank credit assessments. SMEs frequently encounter difficulties in securing loans due to insufficient collateral and low credit ratings, which complicates financing.
Venture Capital	This type of financing mainly targets innovative SMEs, particularly those in the early stages of high-potential high-tech enterprises. However, investment risks are relatively high, and investors need to consider multiple factors, usually demanding significant returns and equity control.
Angel Investment	Investors provide early-stage direct investments in startups with significant potential, a form of private investment that primarily depends on the company's future development prospects. Like venture capital, investors must also consider the possibility of investment failure.
Government Subsidies and Loan Guarantees	Governments provide subsidies, tax incentives, or loan guarantees for SMEs through policy measures to encourage their

	development, although this approach carries considerable uncertainty.
Internet Finance and P2P Lending	A novel type of financing method that relies on the internet. SMEs seek individuals willing to lend based on specific conditions, helping to share the loan risk. While obtaining funds can be relatively quick, the associated risks are also higher.

4.2 Characteristics of Enterprises

Enterprises exhibit a wide variety of characteristics, among which factors significantly influencing financing methods and channels include size, development stage, industry type, and ownership structure.

Enterprise size is generally determined by the number of employees and annual revenue. The scale directly affects the company's cash flow status, the quantity of collateral available, and its risk-bearing capacity. The life cycle of a company typically includes the startup phase, growth phase, and maturity phase, with differing business stability and growth potential at each stage.

Industries can broadly be categorized into manufacturing, services, technology-based enterprises, etc., with substantial differences in resource requirements, especially in terms of talent and capital investment, resulting in varying attractiveness for different types of funding. Ownership structure includes state-owned enterprises, private enterprises, and joint ventures, leading to significant differences in exposure to funding from various political backgrounds.

In addition, internal management structures and innovation capabilities also have a considerable impact on the financing channels available to the enterprise.

4.3 The Impact of Enterprise Characteristics on Financing Channel Selection

According to the theory of information asymmetry, uncertainty in information leads banks to require companies to provide higher collateral or risk premiums. Due to the lack of comprehensive financial statements and information disclosure mechanisms, small and financially opaque SMEs face significantly high financing costs, particularly for those in emerging industries characterized by volatility and higher uncertainty in development. At the same time, equity investors demand a higher proportion of equity or control rights, further reducing the application of equity financing. To secure funding, SMEs often have to turn to internet finance, government subsidies, loan guarantees, and venture capital, a trend particularly evident in small, startup technology companies. According to the "2023 Statistical Report on Loan Direction of Financial Institutions," by the end of 2023, 2.212 million technology-based SMEs received loan support, with a loan rate of 346.8%, an increase of 2.1 percentage points compared to the end of the previous year. This indicates that the government has lowered the barriers to loans and increased the amounts available for borrowing, enabling technology-based SMEs to take on lower risks and secure more funds.

During the startup phase of SMEs, management is typically handled by the entrepreneur, making agency issues relatively negligible. However, as the company develops through the growth and maturity phases, the need for external funding inevitably arises. To ensure liquidity and manage risk levels, most of this funding is derived from equity financing. From 2016 to 2017, the rapidly emerging CATL conducted four rounds of private equity financing, securing 16 billion in investments. Equity financing can accompany company growth, providing capital gains in return as the company expands. However, this also brings about agency problems. The primary investors are venture capitalists, who impose higher standards on corporate governance through incentive constraints, leading to increased compliance costs. According to the "2020 Survey Report on the Financing Status of Chinese SMEs," over 60% of SME owners are reluctant to pursue equity financing due to concerns about losing control of their businesses.

When selecting financing channels, companies generally prioritize internal financing, followed by debt financing, and finally equity financing. Based on 2018 data on SME financing, internal financing comprised over 50% of total financing for SMEs, while equity financing accounted for less than 10%. However, due to limited operational profits, insufficient fixed assets, and a strong desire to protect control rights, these three financing methods often prove less effective for SMEs compared to large enterprises. In contrast, internal financing typically offers better value for money. For instance, in 2013, Laoganma's tax contributions exceeded 500 million without any debt, with nearly two decades of expansion funded entirely by its own profits.

According to resource-based theory, the core resources of an enterprise dictate its competitive advantage and capacity for financing. Companies with unique resources are more likely to secure long-term external financing. Since most SMEs are relatively resource-poor, firms with core technological capabilities, especially technology-based SMEs, are more likely to attract venture capital and angel investment, as these investors are more interested in medium- to long-term value. Conversely, SMEs lacking technological advantages or brand recognition often rely solely on internal funds and bank loans for financing. According to data from the Qianhai Capital Research Center, approximately 70% of venture capital allocated in 2020 targeted technology SMEs with innovation advantages.

5 Conclusions

5.1 Conclusion

Small and medium-sized enterprises (SMEs) typically encounter significant challenges related to difficult and expensive financing, which stem from complex and varied underlying causes, including limited size, low financial transparency, and lack of collateral. The analysis reveals that different types of SMEs must make informed decisions regarding financing channels that align with their specific characteristics, including company size, development stage, industry type, and ownership structure. Emerging financing avenues such as digital finance, government support, and internet finance are increasingly becoming vital sources of funding for SMEs, particularly for technology and innovation-driven firms. However, concerns about the dilution of control associated with equity financing result in a lower proportion of equity funding, leading these enterprises to rely predominantly on internal funds and bank loans as their main financing methods.

5.2 Recommendations

To better address financing challenges, the following recommendations are put forth for SMEs:

(1) Increase Financial Transparency and Information Disclosur. To mitigate the costs associated with information asymmetry, SMEs should proactively disclose financial information and business development plans, particularly during the startup phase or in high-risk industries. This approach can reduce investment risks for investors, thereby lowering financing costs.

(2) Enhance Core Competitiveness to Attract Long-Term Investment. SMEs should effectively manage internal business activities to increase revenue and capital, thus enhancing investor confidence. Additionally, companies should prioritize investment in research and focus on accumulating intellectual property to develop core technologies and unique resources, which can attract long-term investment and venture capital support.

(3) Diversify Financing Channels to Reduce Reliance on Single Sources. SMEs should avoid dependence on a single financing channel, particularly bank loans. By exploring options such as venture capital, internet finance, and government loan guarantees, SMEs can successfully broaden their financing channels and attain timely and secure access to funds.

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