# Financing Issues and Solutions for Small and Mediumsized Enterprises (SMEs)

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**Abstract.** This study presents a systematic examination of financing challenges confronting Small and Medium-sized Enterprises (SMEs), with particular focus on the structural constraints and risk management deficiencies in their capital acquisition processes. Through an integrative methodology combining literature review and case study analysis, the research investigates prevalent financing channels including bank credit, equity financing, and bond issuance, while evaluating their respective efficacy for SMEs. The theoretical framework draws upon authoritative financial concepts from Encyclopedia Britannica to establish precise definitions of key financing mechanisms. Empirical findings demonstrate that SME financing difficulties predominantly stem from two interrelated factors: limited access to diversified funding sources and inadequate capacity to mitigate financial risks. Case analyses reveal how these constraints manifest differently across industries, with technology firms facing distinct challenges compared to manufacturing or service-sector SMEs. The study further identifies critical mismatches between existing financing solutions and SME operational realities, particularly regarding collateral requirements, credit assessment methodologies, and repayment structures. These findings contribute to ongoing academic discussions about SME financial inclusion by providing evidence-based insights into the root causes of financing gaps. The research concludes with policy recommendations for developing more adaptive financing ecosystems that account for SME heterogeneity while maintaining financial system stability.

**Keywords:** SME Financing, Financial Constraints, Risk Management, Capital Structure, Financial Inclusion

## 1 Introduction

Small and Medium-sized Enterprises (SMEs) are an important part of the global economy, especially playing a significant role in developing countries. By providing more than 50% of the jobs, they create employment opportunities for people in developing countries while simultaneously driving these countries' economic development. Although SMEs have great potential for development and a promising future, they still face many challenges and difficulties. The development of SMEs faces substantial barriers due to systemic financing challenges, particularly in three key aspects: inherent


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financing constraints, risk management deficiencies in capital acquisition, and restrictive financing environments. Empirical evidence from some researches confirms the predominant role of macroeconomic factors, showing that supply-side credit constraints, rather than demand fluctuations, constitute the primary determinant of SMEs' restricted access to bank financing [1]. This supply-constrained environment creates significant hurdles for SME growth and operational sustainability. The core of the financing dilemma lies in the structural inequality between SMEs and large enterprises, as well as the poor risk-resistance capacity of SMEs. This is manifested in that traditional financial institutions such as banks tend to favor large enterprises with high credit ratings and high collateral assets, while SMEs are small in scale, have poor financial transparency, and lack collateral, resulting in such a predicament. The core of the financing dilemma lies in the structural inequality between SMEs and large enterprises, as well as the poor risk-resistance capacity of SMEs.

Solving the financing problems of SMEs is crucial for their survival and equally important for economic development. Although there have been studies and discussions on the financing issues of SMEs, most of them are limited to a single financing channel and lack analysis of mixed financing methods. Therefore, this thesis aims to study the safe mixed financing model for SMEs and propose suggestions.

This article will separately analyze the financing methods of SMEs and present two case studies of such enterprises to explore the challenges faced by SMEs in financing and the feasibility of hybrid financing.

# 2 Financing Channels for SMEs

## 2.1 Introduction to Financing Channels for SMEs

Corporate growth and expansion invariably require significant capital investment. When internal funds prove inadequate for operational needs, debt payments, or strategic initiatives, businesses and governments must turn to external financing options like loans or equity offerings, as financial experts have documented [2]. The selection of appropriate financing channels represents a critical strategic decision that significantly influences enterprise development trajectories.

For SMEs, this decision carries particular weight due to their limited financing options and reduced risk-bearing capacity. These constraints require careful evaluation of the trade-offs inherent in each available financing method. Common SMEs' financing channels include equity financing, bank credit, and bond financing, each presenting distinct advantages and disadvantages that must be carefully weighed against specific business circumstances and growth objectives.

The complexity of this decision-making process stems from the fact that no single financing solution universally addresses the diverse challenges faced by SMEs. Rather, the optimal approach depends on multiple factors including the enterprise's growth stage, asset structure, risk profile, and long-term strategic vision. This necessitates a nuanced understanding of how different financing mechanisms interact with SME operational realities and market conditions.

### 2.2 Equity Financing

Equity financing, which involves raising capital through the sale of company shares, offers distinct advantages for SMEs. This approach provides access to stable funding while avoiding the pressures associated with excessive debt accumulation, as recognized by international financial institutions like the World Bank. By exchanging ownership stakes for capital, SMEs can secure necessary funds without incurring fixed repayment obligations that typically accompany debt instruments.

However, this financing method presents significant drawbacks for SME development. The dilution of existing ownership represents a fundamental concern, particularly when convertible securities are employed. This dilution lowers earnings per share and weakens the control of existing stakeholders. The implications of share distribution become particularly consequential at specific ownership thresholds. Minority shareholders gaining over one-third of total shares obtain veto power over major corporate decisions, while majority ownership exceeding 50% effectively transfers operational control. Most critically, when external investors accumulate more than two-thirds of shares, they assume complete authority over corporate governance, effectively marginalizing the original board of directors and determining the company's strategic direction. These control dynamics create inherent tensions between capital acquisition and operational autonomy that SMEs must carefully consider when evaluating financing options.

### 2.3 Bank Credit

Credit, defined as a transaction between two parties in which one (the creditor or lender) supplies money, goods, services, or securities in return for a promised future payment by the other (the debtor or borrower), remains one of the most prevalent and traditional financing methods for SMEs [3]. Unlike equity financing, credit financing allows SMEs to secure necessary funds without diluting ownership, thereby preserving managerial control while providing a stable and predictable source of capital.

However, despite its widespread use, bank credit financing for SMEs faces significant limitations. A primary challenge stems from SMEs' frequent lack of sufficient collateral—defined as a borrower's pledge to a lender of a specific asset used to secure loan repayment [4]. Many SMEs possess limited tangible assets that meet traditional lenders' requirements, restricting their access to secured loans. Additionally, SMEs often experience irregular cash flows, increasing the risk of default due to an inability to meet repayment obligations on schedule. These factors contribute to heightened credit risk perceptions among lenders, leading to stricter lending criteria, higher interest rates, or outright credit denials for SMEs. Consequently, while credit financing offers distinct advantages, structural barriers in risk assessment and collateral requirements continue to constrain its effectiveness as a reliable funding mechanism for smaller enterprises.

### 2.4 Bond Financing

Bond financing refers to a loan contract issued by governments or private enterprises, the terms of which legally obligate the borrower to repay the principal at maturity and make periodic interest payments (typically semiannually) at a predetermined rate [5]. As a conventional long-term financing instrument for businesses including SMEs, this financial vehicle plays a significant role in capital markets [5]. Compared to short-term debt instruments, bonds offer stable capital inflows and predictable repayment schedules, making them theoretically suitable for SMEs seeking sustained financial support.

However, despite these advantages, SMEs encounter significant barriers in accessing bond markets. The foremost challenge is the stringent issuance threshold, which excludes many SMEs due to their inability to meet high creditworthiness standards. Since bond investors prioritize low-risk assets, SMEs—often characterized by limited operational history, volatile earnings, and weaker financial transparency—struggle to achieve investment-grade ratings. Even if they issue bonds, the market may perceive them as excessively risky, leading to low demand, high yields (and thus high borrowing costs), or outright rejection.

Additionally, bond financing fails to align with the urgent funding needs typical of SMEs. The issuance process involves protracted regulatory approvals, credit assessments, and underwriting procedures, often exceeding six months. Given that SMEs frequently require rapid capital injections to seize growth opportunities or address liquidity shortages, the extended timeline renders bond financing impractical as a standalone solution.

### 2.5 Policy-based Financing

Policy-based financing represents a government-led mechanism to address market failures and promote strategic economic development [6]. By providing subsidized financing through specialized institutions, it targets enterprises aligned with national priorities while easing access for credit-constrained SMEs through favorable terms. However, research reveals significant trade-offs. Some researchers found excessive subsidies may crowd out private R&D investment due to managerial myopia, with each 1% subsidy increase reducing self-funded R&D by 0.3% [7].

The approach's sector-specific nature creates inherent limitations. As World Bank (2023) notes, financing remains restricted to priority sectors, potentially distorting broader market development [8]. While valuable for strategic goals, its effectiveness depends on careful design to avoid creating long-term dependencies or undermining market discipline. Successful implementations typically incorporate sunset clauses and performance-based disbursement to maintain accountability while gradually transitioning firms to commercial financing.

## 3 The Financing Challenges Faced by SMEs

SMEs encounter numerous challenges during the financing process. These problems have restricted the economic development of these enterprises and dampened their vitality. The difficulties mainly lie in three aspects: the government system, financial institutions, and the enterprises themselves.

### 3.1 Limited Financing Channels

The financing landscape reveals pronounced disparities between large enterprises and SMEs, with the latter facing significant structural barriers in accessing formal credit channels. Commercial banks typically impose stringent lending requirements on SMEs, including substantial collateral demands (particularly real property and capital equipment) and rigorous creditworthiness assessments based on quantitative scoring models, profitability records, and stress-tested debt service capacity [9]. These institutional constraints stem from legitimate risk management concerns but create a paradoxical outcome: the very mechanisms designed to ensure financial stability inadvertently push SMEs toward higher-risk financing alternatives. As a result, many SMEs become dependent on high-interest private lending, which both limits their growth potential and creates systemic risks as less-regulated credit markets expand. It highlights the need for more nuanced financing frameworks that balance risk mitigation with the unique operational realities of SMEs.

The financing challenges faced by SMEs reflect deeper structural imbalances in credit allocation systems. While large corporations benefit from diversified financing options and established banking relationships, SMEs encounter disproportionate barriers due to their limited collateral assets and shorter operational histories. Conventional credit evaluation methods, which rely heavily on standardized metrics like credit scores and historical financial statements, often fail to capture the actual viability of smaller enterprises. This mismatch between risk assessment methodologies and SME operational realities creates a financing gap that drives many smaller businesses toward alternative lenders. This dependence on high-cost borrowing raises financial vulnerability for individual firms while simultaneously creating macroeconomic risks through increased shadow banking activity. These systemic implications suggest that reforming SME financing requires both financial innovation in credit evaluation and policy interventions to bridge the institutional gaps in capital markets.

### 3.2 Excessive Financing Costs

The elevated financing costs borne by SMEs predominantly manifest through higher interest rates compared to their large corporate counterparts. This interest rate premium reflects fundamental risk differentials in the credit market, where SMEs typically demonstrate greater financial fragility as evidenced by three key factors: limited historical profitability, insufficient collateralizable assets (particularly real property and capital equipment), and elevated default rates that consistently exceed industry averages. Current data indicates SME default rates surpass the 1.8% benchmark common in corporate lending, compelling financial institutions to implement risk-based pricing models [10]. These models systematically incorporate several risk-mitigation mechanisms: higher interest margins to offset potential losses, more restrictive loan covenants to monitor borrower behavior, and additional fees for credit enhancement services. The resulting financing terms create a paradoxical situation where the enterprises most sensitive to capital costs face the highest borrowing expenses. By restraining SME growth, this pricing mechanism could simultaneously lead to market-wide inefficiencies when risk-adjusted calculations ignore the sector's positive externalities. Recent studies suggest this credit rationing phenomenon persists despite evidence that well-structured SME portfolios can achieve satisfactory risk-return profiles for lenders [11]. The systemic implications of these financing constraints warrant particular attention, as they may inadvertently reinforce cyclical economic vulnerabilities by limiting SME resilience during downturns.

### 3.3 Information Asymmetry

Information asymmetry represents a fundamental barrier to credit access for SMEs, creating persistent challenges in establishing trust with financial institutions. The opacity of financial information among SMEs often manifests through overstated revenue figures and inflated collateral valuations during loan applications [12]. This practice has fostered deep-rooted skepticism among lenders, who consequently impose more stringent verification procedures and higher risk premiums on SME loans. Historical banking experiences have shaped enduring perceptions of SMEs as high-risk borrowers, making financial institutions reluctant to extend credit even to creditworthy small businesses. Compounding this issue, many SMEs adopt short-term financing strategies focused on immediate capital needs rather than cultivating long-term banking relationships [12]. This transactional approach fails to address the underlying trust deficit and inadvertently reinforces banks' risk aversion. The resulting vicious cycle - where information gaps breed distrust, which then limits credit access, prompting further informational opacity - presents a significant structural barrier to SME financing. Empirical studies demonstrate that SMEs with greater financial transparency and established banking relationships achieve significantly better financing terms, highlighting the critical need for improved financial reporting standards and relationship banking models in the SME sector [13]. This trust gap hampers both individual enterprise growth and wider economic development by restricting productive capital allocation.

## 4 Case Study

### 4.1 Dual-Path Financing Strategy in Technology SMEs

The case of Shenzhen Jiguang Technology illustrates a common financing challenge faced by technology SMEs operating in China's dynamic consumer electronics market. When confronted with the dual pressures of substantial OEM prepayment requirements and intensified price competition from industry leaders in 2021, the company adopted an innovative hybrid financing approach that strategically balanced debt and equity instruments.

By first accessing Shenzhen's Science and Technology Innovation Network program, the company secured favorable debt terms including a 5 million CNY loan at 4.35% interest with a three-year maturity. This government-backed financing solution addressed immediate working capital needs while maintaining financial flexibility. Subsequently, the company engaged in a carefully structured equity transaction with strategic investors Shenzhen Innovation Investment and Gaorong Capital, exchanging a minority 15% stake for 12 million yuan at a 500 million CNY valuation.

This case highlights how technology SMEs can navigate growth financing challenges through balanced capital structure management. The successful implementation demonstrates the value of combining public sector financial support with strategic private investment, allowing the company to meet its capital requirements while preserving operational control and avoiding excessive financial leverage. The approach underscores the importance of timing financial decisions to align with both market opportunities and the company's developmental stage.

### 4.2 Financial Imbalance and Strategic Overreach

The demise of LeTV presents a cautionary tale of how financial mismanagement and aggressive expansion strategies can precipitate corporate failure. The company's financial troubles originated from a series of problematic financing decisions that created structural vulnerabilities in its capital structure. Beginning with its 2010 IPO that raised 730 million yuan for technological upgrades, LeTV embarked on an unsustainable growth path characterized by increasingly risky financial maneuvers.

The turning point came in 2015 when the company pursued an equity financing strategy that diluted nearly 80% of its ownership, generating substantial cash inflows but severely weakening corporate governance. This was followed in 2016 by a 3 billion CNY corporate bond issuance aimed at addressing mounting short-term liabilities, a clear indication of deteriorating financial health. By November 2016, when director Jia Yutian publicly acknowledged the funding crisis, the company's financial position had become untenable, culminating in its 2017 collapse and eventual 2018 delisting.

LeTV's failure stemmed from fundamental strategic and financial miscalculations. The company aggressively diversified into multiple markets without establishing adequate financial foundations, while its reliance on short-term financing instruments to fund long-term projects created dangerous asset-liability mismatches. These decisions eroded investor confidence and institutional trust, triggering a withdrawal of banking support that ultimately starved the company of operational capital. The case underscores how the interplay between aggressive growth strategies and imprudent financial management can lead to catastrophic business outcomes.

## 5 Inspiration and Suggestions

### 5.1 Inspiration

From the examples mentioned above, it is not difficult to see that first of all, a single financing channel is unable to meet the numerous financing needs of SMEs. The mixed financing model formed by combining bank credit and equity financing can control risks while avoiding excessive dilution of equity, which has an impact on the subsequent strategic development. It achieves a balance between funds and risks, meeting the financing needs of some SMEs. Secondly, the financing structure is a fatal trap for

SMEs. Choosing the wrong financing method can cause the enterprise to get into a difficult situation. Therefore, choosing a reasonable financing structure can balance the situation and avoid high risks or excessive dilution of equity. People should weigh the financing term, cost, and risk, and find a financing structure that suits the enterprise itself. This is what SMEs really need for financing. On this basis, it is suggested to improve the guarantee mechanism of the financing system to provide more opportunities for SMEs.

### 5.2 Suggestions

For the government, it is necessary to further develop the credit information system to prevent fraud among SMEs, and to alleviate the phenomenon of information asymmetry, so that SMEs can also have the same financing channels as large enterprises. Moreover, establishing special funds for financing of SMEs and encouraging them to adopt formal financing channels can help SMEs avoid huge debt pressures. For enterprises, establishing a transparent financial system helps reduce the various difficulties imposed by lenders when borrowing and enhances the trust of investors. Moreover, exploring diversified financing channels instead of overly relying on a single financing channel.

## 6 Conclusion

This study focuses on the core issues of financing for SMEs, systematically revealing that structural imbalances in financing channels constitute a critical bottleneck constraining SME development. The research identifies three major financing dilemmas faced by SMEs: credit rationing due to financial institutions' risk aversion, difficulties in direct financing caused by capital market access barriers, and mismatches between policy support and market demand. Through in-depth analysis of two representative cases in the technology sector, this paper demonstrates the pivotal role of hybrid financing strategies (organic integration of debt and equity financing) in addressing SME financing challenges, while proposing targeted policy recommendations and implementation solutions. The findings indicate that well-designed financing structures can effectively balance the tension between capital acquisition and retention of corporate control, providing financial support for the sustainable development of SMEs.

This study has several limitations that warrant improvement. First, the case selection was confined to two companies in the technology sector, failing to include SMEs from industries such as manufacturing and services, which exhibit distinct asset structures and cash flow characteristics. This limitation somewhat affects the generalizability of the conclusions. Second, the timeliness of the research data is constrained, as the case analyses were based on financing cases prior to 2021 and did not incorporate the impact of emerging innovative financial instruments such as green credit and ESG financing on the SME financing landscape.

Building on the current limitations, future research will prioritize three key directions. First, an in-depth exploration of the path dependency phenomenon among manufacturing SMEs regarding fixed-asset mortgage financing, analyzing the institutional factors and economic rationale behind it, and evaluating the applicability of alternative financing solutions such as supply chain finance and equipment leasing. Second, the development of differentiated financing assessment models for high-cash-flow enterprises, examining the efficiency boundaries of short-term financing tools like working capital financing and accounts receivable securitization. Third, a systematic evaluation of the impact mechanisms of ESG standards on SME financing costs, particularly the applicability conditions of innovative instruments such as green bonds and sustainability-linked loans at the SME level. These research efforts will contribute to the construction of a more refined and industry-adapted theoretical framework and practical guidelines for SME financing.

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