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Formal and Informal Financing as Source of Funds of Carinderia Owners

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ABSTRACT

This study explores the role of formal and informal financing as a source of funds of carinderia owners in Rizal Province, Philippines. Amidst the COVID 19 pandemic, carinderias remain relevant as evidenced by an increasing number of households are engaged in this business since the quarantine protocols began. Descriptive research method was used which includes surveys and various fact-finding inquiries. The study suggests the following major conclusions: a) carinderia owners prefer borrowing from informal sources for convenience; b) financing plays a big role as a source of funds for a carinderia business; c) the financing that offers lower interest rates and flexible payment terms are preferred financing option; d) carinderia owners are likely to shift to the financing that offers lower interest rates; and (e) the ability of the owners to properly manage expenses and do budgeting is significant for the carinderia sustainability. The study recommends four major action plans to build a sustainable carinderia, namely Capital (Maintain), Profit (Allocate), Cash Flow (Manage) and Financing (Expand).

Keywords: *Formal and Informal Financing, Funds of Carinderia Owners*

I. INTRODUCTION

The Philippines is one of the developing countries in Southeast Asia which has a large informal sector comprised of micro-enterprises and many poverty-stricken people. Many of these are small vendors operating in public markets and large families which have very limited resources. To make their ends meet and survive, they rely heavily on various financing sources (Kondo, 2003). It is no doubt that informal financers called loan sharks or “5-6” are usually the source of financing for these people. The term "loan shark" has been commonly used to describe those who lend money at higher interest rates and charges than the law allows. Moreover, they are persons or unregistered private lending businesses that lend money without the permission or regulation of the government. These lenders do not require collaterals or much documentary requirements, and do not impose credit limits from potential borrowers, allowing them to loan as much money as they want. It is also more convenient and faster than formal financing such as bank loans because there are no contractual agreements in this type of loan. According to the World Bank’s Global Findex Database for 2014, it is alarming to note that 10% of Filipinos seek loans from informal lenders. This is comparatively high compared to the worldwide average of just 5%.

One of the micro-enterprises that rely on the accessibility of the loan sharks is the carinderia business as there is a ready market for it in the Philippines. According to Business Diary Philippines (2018), a carinderia is a local eatery selling and serving affordable viands for the masses. It is also known as a “turo-turo” wherein customers just point and inform vendors what they want to eat at a cost. It offers a variety of food that are often priced at lesser price tags than those offered in traditional restaurants. The Spaniard Wenceslao E. Retana traced the etymology of carinderia in the 1920s to curry that is kari in Tagalog. This is the root word of the native dish called Kare-kare. Most streets in the Philippines where schools and offices are located have carinderias surrounding them. Even those highly developed urban areas and private properties have some sort of modern carinderias in the form of larger eateries. The carinderia is the predecessor of the fast food concept in the Philippines (Philippine Daily Inquirer, 2011).

Legal forms of financing such as pawnshops, banks, lending companies, and even cooperatives are widely available to aid small-time entrepreneurs like the carinderia owners finance their businesses due to lack of funding. Since these sources of financing are usually regulated by government bodies, borrower rights are usually protected. Formal agreements are established between the borrowers and lenders, interest rates are not usurious, and sanctions are implemented if borrower rights are abused. However, the aforementioned reasons are also the same reasons why small-time entrepreneurs often resort to informal financing like borrowing from family and friends and the “5-6” lenders. Besides the convenience and quick loans that these financers offer, various documentary requirements like valid identification details, proof of income and collateral are not required to be submitted which the carinderia owners find hard to complete, and they can borrow any amount of money they want. As joblessness and population growth continues, they tend to resort to small businesses in the informal service sector like the "5-6" lending scheme in hopes of making their lives better despite the usurious interest rates and its impracticality to their daily business operations.

II. LITERATURE REVIEW

Three main capital structure theories are used to set the background literature, namely irrelevance theory, trade-off theory and pecking order theory. A Venn diagram is also illustrated to show the interdependence of capital, micro, small and medium enterprises, and sustainability to come up with a sustainable MSME like a carinderia. Having the right amount of capital will allow establishment of an MSME (carinderia) but it needs financing to be sustainable which can be provided by a continuous source of cash flow. Having all three will then result to a sustainable MSME (carinderia).

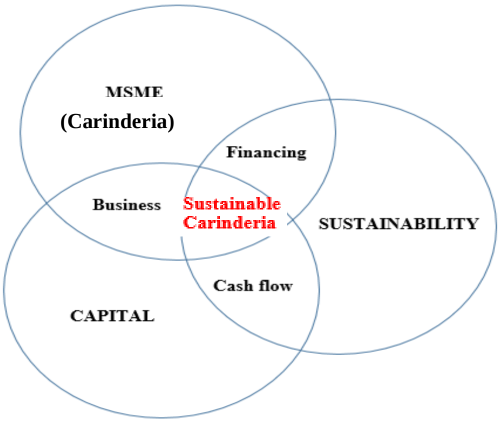

Figure 1. Interdependence of MSME, Capital and Sustainability

MSMEs play a fundamental role in contributing to the overall economic performance of countries. Small businesses play an important role in community development by encouraging private investments into lagging areas and spreading the benefits of economic growth to people and places too often left behind. Private small businesses and micro-enterprises produce jobs and create new opportunities that build the community and promote social activities in various rural and small towns through their capital investments which in turn builds the economy. By creating job opportunities, adding flexibility and industrial diversification, and making use of resources they may otherwise be drawn into the development process, the micro, small and medium enterprises (MSMEs) sector speeds up the competitive strength of a national economy (Seleshi, 2001). For instance, in 2004, MSMEs contributed 6.2% of employment in the US, 22.3% in China, 80% in India, 67% in Japan, and 70% in the European Union (Tegegne & Meheret, 2010). It also generated substantial employment and output in many countries (Nichter & Goldmark, 2009). Studies in five African countries, namely Botswana, Kenya, Malawi, Swaziland, and Zimbabwe found that MSMEs create nearly twice more job opportunities than what the registered, large-scale enterprises and the public sector do (Mead & Liedholm, 1998). Hence, the economic contribution of small business to economic growth and job creation is now well recognized and established in the literature (Samwel, 2018).

In this regard, it is but necessary that MSMEs be provided with wide access to financing and right capital structure. The foundation of modern theory of capital structure was established by the capital structure **irrelevance theory** of Modigliani and Miller (1958). Based on assumptions related to the behavior of investors and capital market, Modigliani and Miller illustrate that firm value is unaffected by the capital structure of the firm. It is said that transaction cost, bankruptcy cost and taxation do not exist because securities are traded in perfect capital market, and all relevant information are available for insiders and outsiders to take the decision. This preposition also argues that the value of levered firm is same as the value of unlevered firm. Therefore, managers can disregard capital structure and they can freely select the composition of debt to equity (Abeywardhana, 2016).

Another theory is the **trade-off theory** which shows the importance of limiting indebtedness because tax benefits are being counterbalanced by the risk of experiencing financial difficulties due to the directly proportional increase of costs. The theory states that the point where the benefits and costs of indebtedness are in balance is the optimal ratio between indebtedness and equity which maximizes the company's value (Shyam-Sunder and Myers 1999). In Figure 2, Arnold (2008) explains how the value of the firm is affected by the increase in debt capital in the capital structure. Based on the illustration, WACC of the firm declines as debt capital increases until the firm reaches the optimal gearing level and cost of financial distress increases along with the debt level.

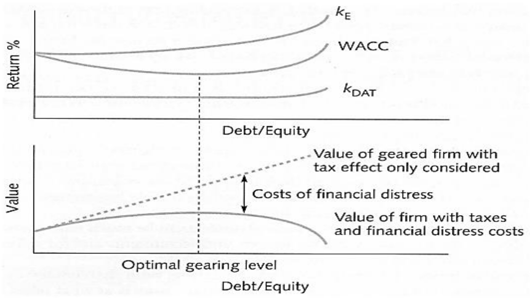

Figure 2. Debt Capital and Value of the Firm

The last capital structure theory is the **pecking order theory** (Myers 1984; Myers and Majluf 1984) which assumes that investors know they could address an information asymmetry issue, for example, the managers' attempt to issue risky securities when they are overvalued. At the same time, there could be inability to finance certain profitable investments through the capital market since managers know that shareholders will try to limit this risk. Briefly, the pecking order theory argues that in case the internal funds are unsatisfactory, if external sources are more expensive than the internal ones, and if attracting capital is more expensive than debt, the capital structure will be affected. Many companies now are trying to finance their new projects through internal resources, because of the fear of market aversions or because the available information does not provide certainty, instead of aiming to find the optimal combination of debt and equity (Frank & Goyal, 2009). This makes the pecking order theory a greatly accepted capital structure theory.

To become sustainable, the authors believe that MSMEs should have the right capital structure, easy access to financing and continuous cash flow especially that there are several issues facing small business leaders such as lack of sale, investment, financial assistance, talent, visibility, and information to make strategic decisions (Warner & Zheng, 2013). Broadly, corporate sustainability is the ability of an organization to maintain practices over the time (Catlin, Luchs, & Phipps, 2017). Corporate sustainability is also the balance between the economic, social, and environmental goals of an organization (Hansen & Schaltegger, 2016). It involves profitability, long-term growth, innovation and creativity, and competitive advantage over the others. The sustainability of a firm is the ability of the company to meet the needs and requirements of current stakeholders while developing continuous investment and managerial strategies to ensure future profitability, social well-being, and environmental protection (Pantelica et al., 2016). Additionally, a firm is sustainable if it continues to exist regardless of market threats and internal change (Banker, Mashruwala, & Tripathy, 2014).

Conceptual Framework

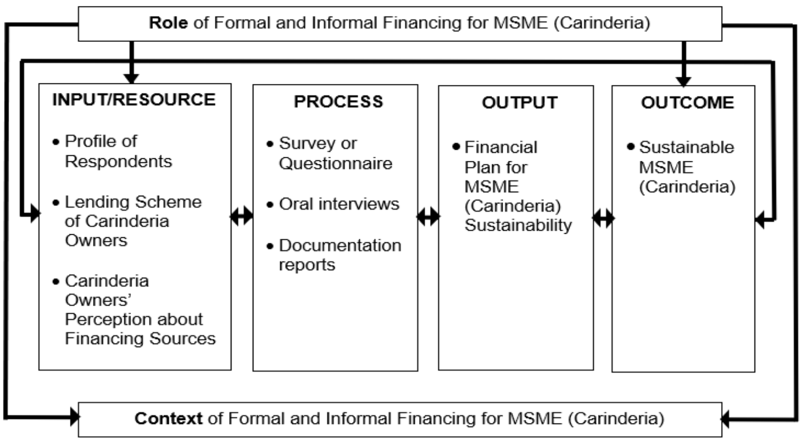

Figure 3. Debt Capital and Value of the Firm

The study focuses on formal and informal financing as source of funds of the carinderia owners in Barangay San Lorenzo Ruiz, Taytay, Rizal. Figure 3 shows how the study was conducted to have an assessment regarding their financing practices and be able to answer the research questions.

The input contains the respondents' profile as there will be an assessment of the respondents in terms of sex, age, civil status, educational attainment, number of household members, number of household members who are earning, business monthly sales and frequency of borrowing. Distribution of survey questionnaires, oral interviews, and reference to documentation reports were made to gather data from the respondents regarding their perception about the various formal and informal financing practices in terms of as to source of funds, as to borrower circumstances, and as to general opinion. The responses were then processed in order to assess the respondents' perception about the role and significance of formal and informal funding for the carinderia business. Through the employment of different statistical tools and methodologies, namely frequency and percentage, ranking, weighted mean, one-way analysis of variance (ANOVA) and independent sample T-test, interpretation and analysis of the results was done to assess the gathered responses and determine whether the relationship is significant or not.

Based on the results of the data interpretation and analysis, a financial plan for MSME sustainability was produced. This will then be used to benefit carinderia owners and other Filipino entrepreneurs to make their businesses sustainable, local and national government to offer sustainability programs to encourage MSME growth and provide rich source of reference for the academe.

III. RESEARCH METHODS

The descriptive research method was used in the conduct of this study. Descriptive research aims to gather, analyze, classify and tabulate data about the prevailing conditions, processes, trends and cause-effect relationships in the chosen field of study without researchers' control or manipulation over the environment. The method includes surveys and fact-finding enquiries of different kinds in order to describe prevailing conditions and interpret how they work the way they do (Calderon, 2010; Jackson, 2009). The descriptive research techniques performed were survey method and content analysis. Survey method was used to collect respondents' demographic data and their practices on financing their carinderia businesses in San Lorenzo Ruiz, Taytay, Rizal. The results were then analyzed and evaluated.

The study focuses on carinderia owners who do the actual budgeting and financing decisions as respondents of the research. Since there are no data available regarding the total number of carinderia owners in San Lorenzo Ruiz, Taytay, Rizal due to the fact that many of them do not secure business permits, the authors conducted convenience sampling where the respondents will be chosen on the basis of their convenient accessibility. All former and present carinderia owners around the said location that the authors can access are target respondents of the study which accounted to 85-90% of the total population. The chosen research locale of the study is also known as San Juan which is the largest and most populous barangay and is the center of Taytay municipality and its local industries. Furthermore, the municipality is already working hard to achieve city status which is tantamount to more investment and business opportunities, and more visitors in the area. Thus, it is no wonder that lots of MSMEs like carinderias are starting to flourish in this barangay.

IV. FINDINGS AND CONCLUSIONS

After the data gathered had been interpreted and evaluated, and based on the research findings, the study concludes that carinderia owners in Brgy. San Lorenzo Ruiz, Taytay, Rizal lack financial literacy. Specifically, it suggests that:

1. Carinderia owners are mostly female, aged 41-50, married, HS graduate, with 4-6 household members and 1-2 who are earning, less than 2 years or new in the business, and with maximum of Php 20,000 monthly sales. In addition, 66% of the respondents resort to borrowing whether formal or informal. It can be concluded that the monthly sales from majority of carinderia owners are not enough to meet their business needs which would cause them to resort to financing.
2. Most carinderia owners practice informal financing through either borrowing from "5-6" or loan sharks or from personal funds with primary consideration on speed and convenience of the financing practiced. It can be concluded that carinderia owners prefer borrowing from informal over formal sources due to speed and convenience.
3. Based on the assessment of carinderia owners on formal and informal financing for a carinderia business, it shows that they agree with formal and informal financing as a source of their funds (fast way to borrow money, just interests and charges, convenient credit terms, few documentary requirements and convenient collaterals), strongly agree in terms of borrower circumstances (accessible, secured, faithful, friendly and non-discriminating and strongly recommended), and agree that there is still a high demand for financing for a carinderia business. It can be concluded that formal and informal financing still play a significant role as source of funds of carinderia owners. However, the carinderia owners in the barangay are not aware that these informal financing sources charge higher interest rates and charges than formal sources which is not surprising given that only few resorts to formal sources. This can be an indication of poor financial literacy among the carinderia owners.
4. An equal number of carinderia owners said that they will either shift or not shift to another kind of financing. Majority indicated that the primary factor they would consider when shifting is the interest rate. In addition, most carinderia owners indicated lower interest rates and flexible payment terms as their comment/suggestion for lenders. It can therefore be concluded that if offered lower interest rates, carinderia owners are most likely to shift to another kind of financing given that the financing option which offers lower interest rates and flexible payment terms (shorten or lengthen terms/ change schedule of payment depending on the situation) is the preferred financing source.
5. Most carinderia owners that are at least 3 years already in the business suggested that to survive, one must learn to manage expenses and do proper budgeting. Therefore, the ability of the business owner to make wise financing/budgeting decisions is relevant to creating a sustainable carinderia business.

V. RECOMMENDATIONS

In view of the findings and conclusions, the authors hereby recommend the following to create a sustainable carinderia as depicted in the figure below:

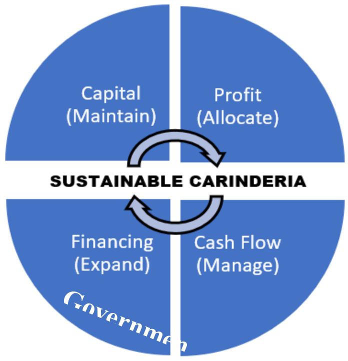

Figure 4. Financial Plan for a Sustainable Carinderia

1. **Capital (Maintain).** The authors suggest that initial capital for a carinderia business should come from own savings/funds of the owner to avoid paying penalties and charges for the starting capital/ investment which is more likely to reduce imprest/maintaining capital balance. This will also allow the owner to have full control of the business given that a carinderia business does not require a large amount of capital and to avoid paying interests/charges for the initial investment out of the profit that the business would generate.
2. **Profit (Allocate).** The authors suggest the 50/20/30 budget rule in budgeting which was popularized by Senator Elizabeth Warren in her book, All your Worth: The Ultimate Lifetime Money Plan. 50% of the profit (net of costs and taxes, if any) should be used to cover the needs and obligations of the owner, 20% of the profit should be for the wants or things which are not absolutely essential and at least 30% of the profit should go directly to savings (could be a bank account) which could be used by the owner for emergency purposes, and for liquidity and retirement reasons.
3. **Cash Flow (Manage).** The authors do not suggest allowing customers to eat now, pay later. There is a big possibility that the money that should have been collected from a defaulting customer will be left unaccounted, and this would result to a reduction in starting capital which will surely affect how the profit generated by the business would be allocated to compensate for the money uncollected. The authors also suggest buying in bulk to get discounts especially that turnover of ingredients is fast and minimizing wastage/leftover foods because in a financial standpoint, this would equate to expenses incurred for buying ingredients that are not recouped (losses).
4. **Financing (Expand).** The authors would still recommend financing but only for expansion purposes like addition of product offerings, delivery services (especially now that the country is experiencing an outbreak) and branch expansions. It is suggested that carinderia owners resort to borrowing from cooperatives instead of banks and informal sources like “5-6” or loan. The government can also play a significant role by tapping the Committee of Livelihood of each barangay to be aggressive in publicizing information about various microfinancing institutions that can offer help to microenterprises for their funding needs and can also hold various financial literacy trainings and seminars for these business owners to learn about proper funding/budgeting.

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