EQUITY FINANCING AND FINANCIAL PERFORMANCE OF SMALL AND MEDIUM ENTERPRISES IN EMBU TOWN, KENYA

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ABSTRACT

Capital structure comprise of a mix of debt and equity. Managers used various combinations of debt and equity that increases the net worth of business at the same time reduces the cost of obtaining finance. Financial decisions affected the financial performance of SMEs but vary from one firm to another. This is due to the limited access to finances and ability of the manager to fully utilize the resources available. SMEs are of significance to the economic development of any state regardless of the development status. Despite their importance SMEs are characterized with slow growth rate and three out of five SMEs fail in their first three years of operation. The continued poor performances have led to decline in growth and eventually death of the SMEs. The growth of the SMEs highly depended on the investment decisions made by the entrepreneurs and lack of access to finances has created financial gaps that have fueled the challenges that SMEs face. The study therefore analyzed the effect of equity financing on financial performance of SMEs in Kenya. The study adopted a descriptive survey research design. The target population of study was 300 SMEs from which a sample size of 60 SMEs was drawn. Pretesting of the research instrument was done to determine the reliability of the questionnaire by use of Cronbach alpha coefficient. Content validity of the questionnaire was used to ensure that the questionnaire answered the research questions. The primary data was collected using self-administered questionnaire while secondary data was obtained from audited financial statements and analyzed by use of SPSS. Data analyzed capture descriptive statistic which included mean, standard deviation and variance. Inferential statistic included Pearson's correlation and multiple regressions. The study revealed that SMEs had greater preference for contribution from friends and ploughing back profit as a source of equity finance. Angel investors as a form of equity financing has not gained acceptance as a source of finance. From the study it was evident that equity finance had a positive relationship to financial performance of the SMEs. Equity offered a lifelong financing option with no or minimal cash outflow inform of interest. The study also noted that the performance of the SMEs was largely affected by the source of finance and the liquidity position of the business. The study therefore recommended that SMEs should embrace angel investors as equity financiers since they provide the start-up capital to the SMEs. Angel investors also provide managerial and book keeping skills to the entrepreneurs thus enhancing the accountability and efficient use of the financial resources at hand. The financial institutions need to create awareness and educate the entrepreneurs on other products available to finance the SMEs.

Key Words: *capital structure, equity, financial performance*

INTRODUCTION

The significance of Small and Medium Enterprises in Kenya was first acknowledged in the International Labor Organization report on Employment, Income and Equity in Kenya in 1972. The report underscored SMEs as an engine for employment and income growth. SMEs create about 85 percent of Kenya's employment [Government of Kenya (Gok, 2009)].

Despite the role played by SMEs, the World Bank Report (2010) suggests that one of the major causes of SMEs failure is limited access to finances. Business organizations aim to improve on their production and operations efficiency and to increase their profit margin. A number of factors may influence efficiency and effectiveness of business operations including capital structure. The capital structure of a firm is a mix of debt and equity that a firm uses to finance business. The finance manager is therefore concerned with a capital structure that increases the profit margin at least cost (Ehrhardt & Brigham, 2013).

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Academic research has documented that there are differences in financing patterns between SMEs and large firms and analyzed possible causes of these differences (Elaine, Angelo, Ana & Ricardo, 2005; Howorth, 2001; Mac & Lucey, 2010). The existence of fixed costs due to external financing, smaller firms choose to refinance less frequently than larger firms because they are more affected by these fixed costs in relative terms. Hence, small firms choose to operate at a higher leverage level at a refinancing moment to compensate for less frequent rebalancing. This argument explains why smaller firms, if they have some debt, are more levered than larger firms. In addition, as the time period between restructurings is longer for small firms, on average, they have lower leverage ratios (Chepkemoi, 2013).

Capital structure represents the proportionate relationship between the different forms of long term financing (Varaiya, Kerin & Weeks, 2007). Making appropriate decision on the financing option may look simple, but sometimes it require time. Management is often faced with dilemma on whether to obtain funds from internal sources (retained earnings) or external sources which include loans from financial institutions, trade credit, and issuance of equity shares. The creation of a capital structure in any organization influences the governance structure of a firm which, in turn, has direct impact on strategic decisions made by the managers (Mwangi, Makau & Kosimbei, 2014).

Management has numerous capital structure choices that they may adopt at their discretion. The choice of the type of capital structure to be adopted may not mean value maximization but may be for the protection of the management self-interest, especially in businesses where the decisions are dictated by the managers and the voting power of the shares they own (Dimitris & Psillaki, 2008). Funds used for firms operations may be generated internally or externally. When raising funds externally, firms choose between equity and debt. Most of the effort of financial decision making process is centered on the determination of the optimal capital structure of a firm (Narayanan, 2008). Capital structure decisions affect all businesses, but they vary from one business to another based on financial requirement for the business success primarily depends on the ability of the finance manager to effectively manage firm's financial resources (Narayanan, 2008).

Equity Financing

Equity financing comprise of retained profits, own savings, contribution from board members, contribution from partners and friends, deferred income and cash flows of the business (Kongmanila & Kimbara, 2007). Angel Investors (business angels) are wealthy individuals who place equity in business that they believe have high growth and return prospects and are interested in supporting the entrepreneur (Ibrahim, 2008). Many successful large companies which attracted venture capitalists or public equity relied first on angels (Ibrahim, 2008). Equity financing is important source of income and have a positive relationship to the performance of the business. Firms that use equity finance are able to make it performance better since there is direct control and because equity holders are residual claimant they have to ensure that resources are allocated efficiently (Caroline & Willy, 2015).

Many small firms are established as family business which may not pursue growth strategies. Moreover, if SMEs have unconstrained choice between external debt and internal resources, they will choose not to use debt financing because of a desire to retain control and independence (Bell & Vos, 2009). They further conceded that the owners of SMEs may show strong preference for the funding options, which have minimal or no intrusion into the business that is retained earnings and personal savings (Bell & Vos, 2009).

Financial Performance

Operational performance measures growth in sales and growth in market share this provide a broad definition of performance as they focus on the factors that ultimately lead to financial performance. The most common used performance proxies are the GP margin, NP margin and operating ratios (Munyuny, 2013). Pandula (2011) explains that firms' performance has a great influence on access to credit; research implies that greater profits as well as sales are associated with greater access to financing. Firms with increasing sales and sales turnover have less constraint on credit while poor performing firms have been found to have limited access to financing particularly by banks.

SMEs in Kenya

The importance of micro and small enterprise (SMEs) sector to the Kenyan economy has been widely recognized. The SMEs sector is crucial to the government's effort in reducing poverty as it employs nearly 6.8 million Kenyan and the new jobs created, 89% were in the small sector firm. The Kenyan government is aware of the crucial role private sector plays in her economic development. This has made it to initiate finance scheme such as youth and women fund and Uwezo fund with a view of finance the SMEs [Kenya Institute of Public

Policy Research Analysis (KIPPRA, 2007)]. SMEs contribute positively to economic growth, employment and poverty alleviation (Fatoki & Asah, 2011).

In the recent years the performance of the SMEs has continued to decline in Kenya. Virtually most small enterprises had collapsed leading to closure of some of the SMEs that were producing 40% of the employment in Kenya. Other SMEs were auctioned while some were merged or acquired signifying questionable financial performance due to lack of proper management of debt acquired (GoK, 2009). SMEs continue to face challenges such as overlap and inconsistencies in legal and sectorial policies, lack of clear boundaries in the institutional mandate, lack of suitable legal framework, outdated council by-laws, unavailability of land and worksites, exclusion of local authorities in policy development, lack of access to credit, lack of central coordination mechanism, lack of devolved coordination and implementation mechanism (Gok, 2009). SMEs lack of access to finance is a major constraint to their growth in Kenya (Atieno, 2009).

STATEMENT OF THE PROBLEM

An optimal capital structure is the one that best suit the situation in which the business operates in, that is have reduction in cost of capital while maximizing the value of the firm. However, a number of SMEs are experiencing a declining performance due to poorly thought out capital structure decisions. Their survival and growth rates are therefore extremely low. When wrong mix of finance is employed, the performance and survival of business enterprise may be seriously affected. The continued poor financial performance has led to closure of medium sized enterprises. This have led to shorter life expectancy, which means that these businesses do not develop fully to large enterprises or even companies. The ownership of the SMEs is basically a family owned enterprise which means decisions are internally made with little or no external influence. These encourage intergenerational transfer of problems from one generation to another.

OBJECTIVE OF THE STUDY

The objective of this study was to establish the effect of equity financing on financial performance of SMEs in Embu town in Kenya.

SIGNIFICANCE OF THE STUDY

The study intended to add value to the following; the knowledge on capital structure decisions will be important to investors because it will provide vital information to current and prospect investors on how capital structure affects the performance of the business and the consequences of such choices. The financiers of the SMEs will be interested with this information since they will be able to evaluate SMEs performance, this will enable them to determine the best equity-debt mix and how their choice affect the business financial performance. To the academicians and scholars, the study will form the basis for future research study. This study will add value to the body of knowledge in areas of capital structure determinant and its effect on financial performance of the SMEs in Kenya.

THEORETICAL REVIEW

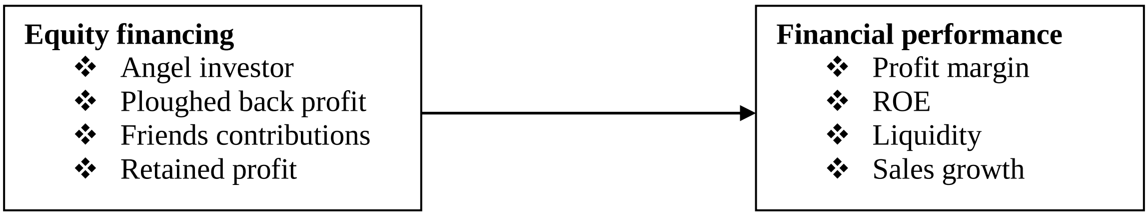
Theories of capital structure try to explain what happens to the overall cost of capital and the value of the firm when the proportions of the funds that make up the capital structure are varied. The study was guided by market timing theory.

Market Timing Theory

According to this theory firms prefer equity when they perceive that its relative cost is low otherwise debt finance would be appropriate (Salomon, Ondiek, & Ruto, 2013). Barker & Wurgler (2002) observed that managers or business owners will use those financial tools that appear to be more favorable in the moment they need financing. Managers or business owners seek equity finance even when growth opportunities do not exist, so that such cash flow can be used for perquisites rather than for enhancing firms' value. Manager wants free cash flows to invest in unprofitable project that generate cash so that salaries or perquisites may be enhanced rather than service debt (Colabrese, 2011).

Conceptual Framework

According to Young (2009) conceptual framework is a diagrammatical representation that shows the relationship between dependent variable and independent variable. This study will be guided by equity financing as independent variable while financial performance was the dependent variable.



Independent variable *Dependent variable*

Figure 1: Conceptual Framework

EMPIRICAL LITERATURE

Studies have been done in regard to effect of capital structure on firm performance both locally and internationally. Heshmati (2008) in his study on dynamics of capital structure of Micro and small firms in Sweden found that listed companies have easier access to the equity market compared to smaller companies because of low fixed cost thus indicating a negative relationship between firm size and debt levels. Shubita and Alsawalhah (2012) in a study of the relationship between capital structure and profitability of industrial Jordan companies suggested that firms with high profits depend heavily on equity as their main financing option. Kihinde (2012) studied relationship between capital structure mix of SMEs and overall performance of firms in Nigeria. The study revealed that most of the SMEs have all equity finance structure and have less debt finance compared to equity finance. It also revealed that the earnings survival and performance of the SMEs is strongly influenced by capital structure mix.

Kamau (2010) conducted a study on the relationship between the capital structure and financial performance of insurance companies in Kenya. The study found that there was a weak relationship between financial performance and capital structure hence, debt and equity ratios accounted for a small percentage of financial performance. Birundu (2015) examined the effect of capital structure on the financial performance of small and medium enterprises in Thika sub-County, Kenya. In his findings there was no significant effect of capital structure, asset turnover and asset tangibility on the financial performance of SMEs in Thika sub-County, Kenya. Karanja (2014) carried out a study on effect of capital structure on financial performance of Kenyan SMEs. The study concluded that capital structure has significant impact on the financial performance.

Research Gaps

From the review of relevant literature it is evident that research in the area of capital structure has been done both internationally and locally. Heshmati (2008) studied dynamics of capital structure of micro and small firms in Sweden, Shubita and Alsawalhah (2012) studied the relationship between capital structure and profitability, Mahamed and Jaafer (2012) studied the effect of debt financing on performance of the firm, Abdul (2012) studied the relationship of capital structure with performance of firms in Pakistan, Salama (2015) studied the impact of capital structure on performance of SMEs in Tanzania, Kamau (2010) studied relationship between the capital structure and financial performance of insurance companies in Kenya, Chepkemoi (2013) studied analysis of the effect of capital structure on the financial performance of SMEs in Nakuru town. Birundu (2015) studied the effect of capital structure on the financial performance of SMEs in Thika Sub County. From the survey of relevant literature it is evident that many studies have been carried out in regard to capital structure. However there is no specific study on equity financing and financial performance of small and medium enterprises in Embu town, Kenya. This study will therefore be conducted in order to fill the gaps in literature by studying equity financing and financial performance of small and medium enterprises in Embu town, Kenya.

RESEARCH METHODOLOGY

Research Design

A descriptive survey research design was employed in this study. A descriptive design is selected because of its high degree of representativeness and the ease in which a researcher will obtain the participants' opinion. According to Burns & Grove (2009) descriptive research is designed to provide a picture of a situation as it naturally happens.

The Target Population

The target population comprised of all 10,611 registered small and medium enterprises in Embu County. However the major focus was on the accessible population. The accessible population is that proportion of the target population that the researcher can access easily and conveniently. The accessible population for the study was 300 registered SMEs in Embu.

Sampling Technique and Sample Size

The study used simple random sampling technique. Neuman (2003) indicated that 10 to 20% of the accessible population is an adequate sample size in descriptive study. The sample size was therefore 60 SMEs which was 20% of accessible population.

Data Collection Instruments

The study used self-administered semi-structured open and close ended questionnaire for the collection of primary data. A five step likert scale was used for close ended questions.

RESEARCH RESULTS

Response Rate

Response rate refers to number of the questionnaires completely filled by the respondents against the questionnaires administered. The study administered 60 questionnaires out of which 41 questionnaires were collected fully filled and returned. The response rate was 68.3% which was attributed to by self-administering the questionnaires and respondents were also assured high level of confidentiality. According to Mugenda & Mugenda (2003) a response rate of 50% is considered adequate, 60% is good and 70% is excellent. The response rate was therefore considered to be good and reliable.

Period of Firm Existence

The study sought to establish how long has the business been in existence. From the result of the study it was revealed that majority (46%)of the businesses have been in existence for a period of 2-5 years, while 44% of the businesses have been in operation for a period of 6-10 years. Businesses that have been in operation for a period of less than a year are 7% and those above 10 years of operation are 3%. This indicates that 46% of the businesses are in the early stages of growth while 44% of the business units have exceeded the infancy stage of growth.

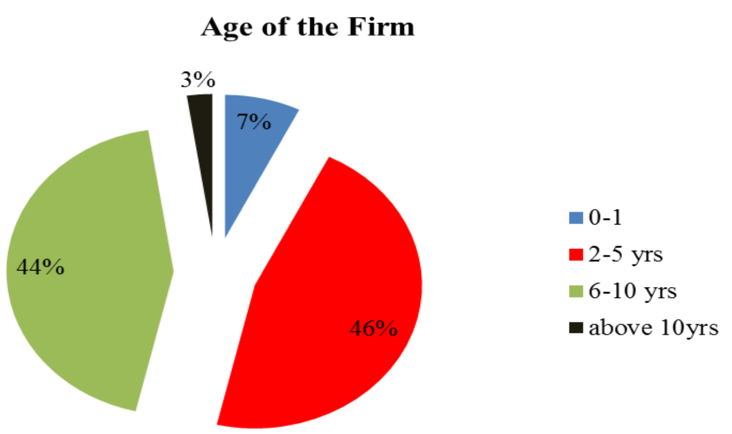


Figure 2: Period of Firm Existence

Legal Status of the Business

The research study sought to determine the legal status of the businesses. It was revealed that 90% of the businesses were formed through sole proprietorship while 7% represent partnership kind of business and limited companies represent 3% of the businesses. The most preferred form of businesses in Embu town was sole proprietorship. This could be highly attributed to the ease in legal requirement during formation, capital requirement and exercising full control of the business while least preferred form of business was limited company.

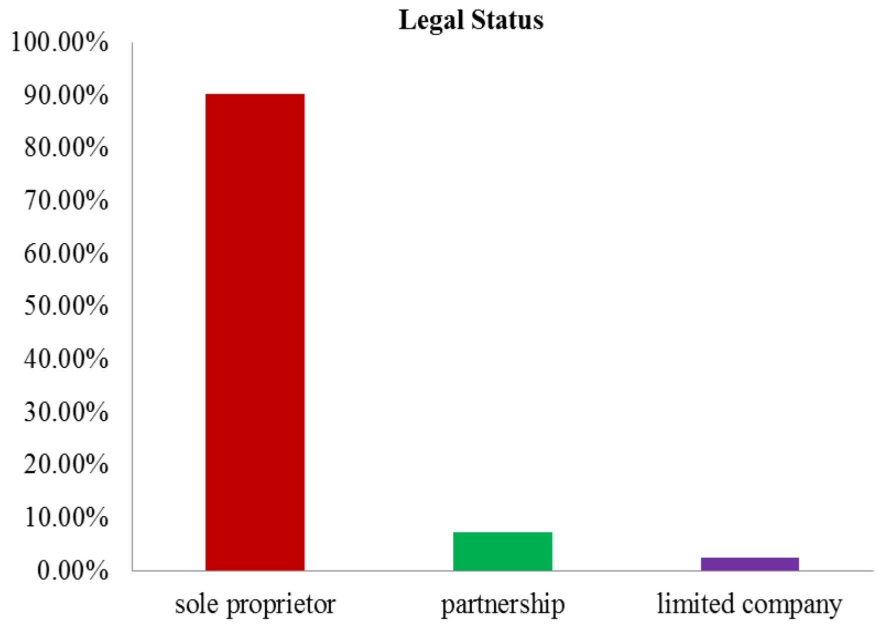


Figure 3: Legal Status of the Business

Capital size of the Firm

The study sought to establish the capital size of the firm. It established that majority (88%) of the business enterprises' had an capital base of less than 0.5 million shillings worth, 5% had an asset base worth between 0.5 to 1 million shillings and more than 1.5 million shillings. Businesses with a capital base of 1.0 to 1.5 million shillings represented 2%. This indicates that many businesses in Embu town have a capital base of less than 0.5 million shillings due to their size of operation and legal status of the business. The small size capital base was attributed to due to low levels of fixed assets such as land and buildings because the SMEs are operated on rented premises.

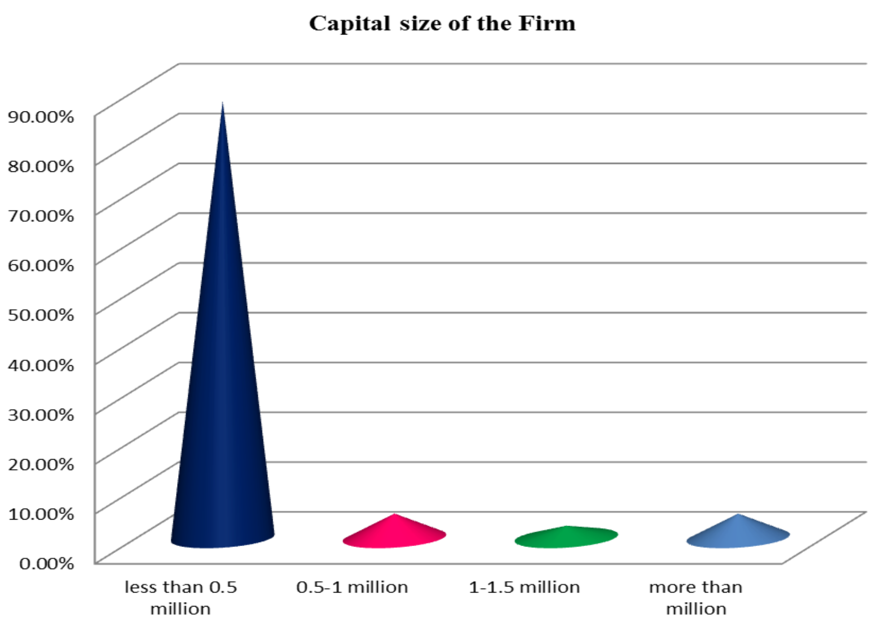


Figure 4: Capital Size of the Firm

Firms Annual Sales Turnover

The study sought to determine the annual sale turnover of the businesses within Embu town. From the findings it was established that the 88% of the businesses reports annual sales volume of less than 0.5 million shillings, 7% of the enterprises report annual sales of 0.5 to 1 million shillings while 3% reports annual sales turnover of more 1 to 1.5 million shillings and 2% report annual sales turnover of more than 1.5 million shillings. This indicate that the larger percentage of the business units report less than 0.5 million shillings annual sales turnover

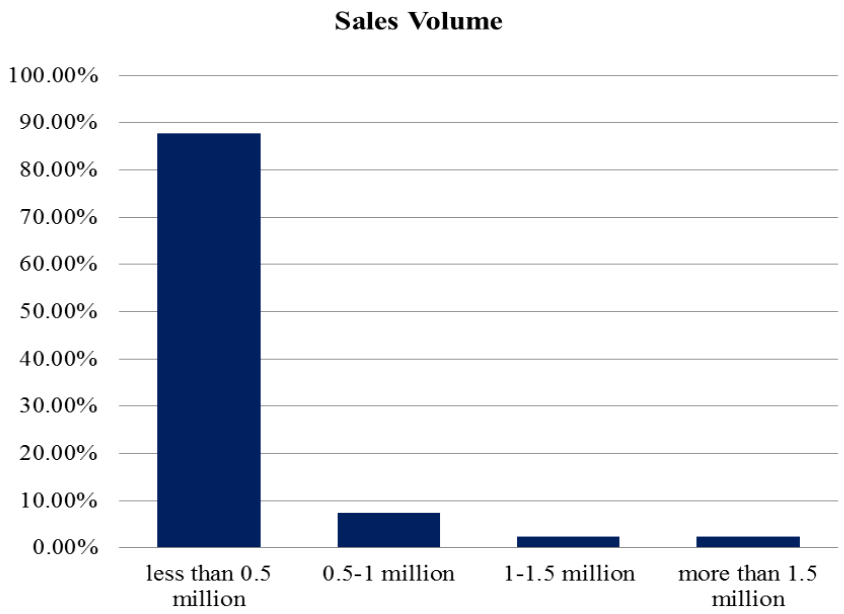


Figure 5: Firms Annual Sales Turnover.

DESCRIPTIVE STATISTICS

This section gives analysis of the descriptive findings and discussion in relation to the objective of the study.

Equity Financing

The study sought to determine how various aspects of equity finance affect the financial performance of the SMEs. The findings are shown in Table 1.

Table 1: Descriptive Statistic Summary on Equity Financing

	N	Min	Max	Mean	Std. Dev	Var
Ploughing back profit	41	1	5	3.73	1.304	1.701
Retained profit as a source of finance	41	1	5	3.97	0834	1.861
Angel investor as source of finance	41	1	5	2.68	.789	.622
Friends contribution	41	1	5	4.61	.737	.544

The study findings revealed that the respondents agreed (Mean= 4.61: std dev = 0.737) that contribution from friends and ploughing back profit (mean= 3.73; std dev= 1.304) was used to finance the business operations. Respondents also agreed (Mean=3.97: std dev= 0.384) that retained profits was used to finance long term growth of the business and actually affected the financial performance of the business. It was further disagreed (Mean=2.68: std dev= 0.789) upon that angel investors were not an option for equity as a source of finance. This implied that use of equity as a source of finance helped the entrepreneurs to retain the control of the business. Also it does not have any additional financial burden and obligation to the business inform of interest. This allowed the entrepreneur use the money to finance other business activities.

Financial Performance of SMEs

The study sought to determine the financial performance of the SMEs. The results are presented in Table 2.

Table 2: Descriptive Statistics on Financial Performance

	N	Min	Max	Mean	Std. Dev	Var
Increase in profit is as a result of use of equity	41	1	5	3.51	1.207	1.456
Liquidity position affect performance	41	4	5	4.44	.502	.252
Increase in sales attributed to use of debt	41	1	5	3.71	1.327	1.762
Source of finance influence performance	41	1	5	4.37	.994	.988

The findings revealed that liquidity position (Mean = 4.44: std dev= 0.502) and source of finance (Mean = 4.37: std dev = 0.994) affects the financial performance of the SMEs. Similarly respondents were in agreement that increase in sales was attributed to use of debt (Mean =3.71; std dev = 1.327) and increase in profits was due to use of equity (Mean = 3.51, std dev = 1.207). This implied that SMEs financial performance was highly influenced by source of finance used in financing it activities, increased use of equity and debt finances since it improved the liquidity position of the SMEs. They were able to settle obligations when they fell due. A liquid firm or business unit is one that holds enough liquid assets and cash together with the ease to raise funds quickly from other sources to enable meet payment obligations and financial commitments as and when they arise.

INFERENTIAL STATISTICS

Correlation between Equity Financing and Financial Performance

The relationship between equity financing and financial performance was analyzed and results are presented on Table 3. The relationship between equity financing and financial performance of the SMEs was found to be positively correlated (r = 0.656). The study also noted that there was a significant relationship since the p value 0.000 is less than 0.05. This implied that equity financing of the SMEs yielded an increase in financial performance. This also shows that SMEs in Embu desired to retain the control of the business. Equity financing is preferred in the initial stages of the SMEs development. This is due to financial shortage experienced by inability to secure loans with collaterals during founding phase. Equity offers long term financing with minimal cash out flow inform of interest.

Table 3: Correlation between Equity Financing and Financial Performance

		Equity
Financial performance	Pearson Correlation	.656**
	Sig. (2-tailed)	.000
	N	41

CONCLUSIONS

From the study it was evident that equity finance had a positive relationship to financial performance of the SMEs. SMEs prefer equity contribution from friends. This is because the entrepreneurs prefer to share risks with less risk averse investors at the same time avoiding any undesirable change in ownership. Angel investors has not gained acceptance with the entrepreneurs in Embu town. This is because most of the businesses are sole proprietorship forms of businesses which are controlled and managed by the owners.

RECOMMENDATIONS

The study acknowledged the use of equity in financing as a source of finance. Contributions from friends and ploughed back profits have minimal or no money burden to the SMEs. The study recommends that SMEs should embrace angel investors as equity financiers since they provide the start-up capital to the SMEs. Angel investors also provide managerial and book keeping skills to the entrepreneurs thus enhancing the accountability and efficient use of the financial resources at hand.

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