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Effect of Capital Structure on Financial Performance of Small and Medium Sized Enterprise in Kenya

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ABSTRACT
Capital structure plays acritical role in determining the performance of a firm. The study investigated the effect between capital structure and financial performance of SMEs in hotel sector in Mombasa County and environs in Kenya. The study used profitability and liquidity as a measure of performance. SPSS software was used to analyze and generate reports for the study. Regression analysis, correlation coefficient, ANOVA, Chi-square tools and instruments were used. Regression coefficient showed B-0.021, beta -0.017n, t- 0.289 p- value 0.773. Therefore capital structure negatively and significantly affects the financial performance of SMES.

1. Introduction

To understand how company finances their operations it is necessary to examine the determinants of their capital structure decisions. Company financing decision involves a wide range of policy issue. At the private, they have implications for capital market development, interest rate, and security price determination and regulation. At the private, such decisions affect capital structure corporate governance and company development (Green&Murinde, 2008)

Capital structure refers to the firm's financial frameworks which consist of the debt and Equity used to finance the firm. Capital structure is one of the popular topics among the scholars in finance field. The ability of company carry out their stake holders needs is lightly related to capita structure. Therefore, this derivation is an important fact that we cannot omit, Capital structure in financial terms means the way a firm finances their assets through the combination of equity, debt or hybrid security (Saad, 2010).

The impact of capital structure on firm's financial performance remains a puzzling issue among financial scholars and corporate managers. According to (Zeitun and Tion, 2007) corporate capital structure is closely linked to financial performance. Umar et al (2012) show that capital structure negatively impacts firms financial performance, while Githuere & Muturi (2015) opined that long term liabilities constitutes money that is owed to lenders for a period of more than one year from the date of current balance sheet. They further noted preferred sources of debt financing among well-established corporate institutions.

The determination of a firms optimal financial structure is a difficult one since it involves an analysis of several factors, key among them risk and profitability (Shubita &Alsawalhah,2012). The decision becomes more difficult, in times when economic, social, technological and political environment in which the firm operates exhibits high degree of instability (Shubita &Alsawalhah, 2012). Capital structure, which also referred to as financial leverage or gearing, it's the proportion of a company's long term debt and preferential shares if any to ordinary share capital (ICAN,2009), with this definition, it can be described as the proportion of debt to business owners fund/Equity with regard to SMEs, as there are the major sources of finance for SMEs. This is consistent with the point of Nadada (2013) that the two principal sources of finance for SMEs in Nigeria are loans/ debt and equity (owners investment). SME capital structure typically follows pecking order theory behavior. However the theoretical underpinnings of the pecking order theory are doubled in the case of SMEs as SME managers highly value financial freedom, independence and control while the pecking order theory assumes firms desire financial wealth and suffer severe adverse selection cost in accessing external finance (Lopez-Garcia and Sogorb –Mira, 2008). Homes and Kent (1991) by proposing a restricted version of pecking order theory to explain SMEs capital structure, argue that SME, do not have easy access to equity, it is expensive and raising it implies a dilution of control of the firm. According to Damodram (2001), capital structure decision is the mix of debt and equity that a company uses to finance its business. Capital structure decisions represent of a business organization apart from investment decisions. It is important since it involves a huge amount of money and has long term implications on the firms. According to Gleason et al (2000), the utilization of different level of debt and equity in the firm's capital structure is one such firm specific strategy used by managers in search for improved performance. Hence most firms have strived to achieve an optimal capital structure in order to maximize the firm value. Previous research has established that small firm finance differs from large firm finance and that optimal capital structure rules are often not applicable to SMEs (Uzzi and Gillespie 1991, Rander Wijst 1989, Welsh

and While, 1981).In the finance literature the optimal capital structure, that is debt equity ratio which is defined as that which minimizes the overall cost of financing the venture (Moro et al, 2010).

According Modiglian and Miller (1963) firms should incorporate more debt in their capital structure in order to maximize the firms value which is manifested through profits, and efficiency in management. However, Harns (2011) warns of the danger of high amount of debt in the capital structure of firms which includes, Bankruptcy, liquidity, costs and in some cases corporation dissolution.

According to Brigham and Enhardt (2005) the mix of debt and equity used by a firm to finance investments in real assets is known as the firm's capital structure. Eriots, (2007) notes that the main objective of a finance manager is to maximize the wealth of shareholders and to minimize cost. According to Abor (2011) capital structure decisions are essential because of the fact that they have an impact on the ability of a business to compete effectively. Kajananthan, (2012) emphasize that capital structure decision is important because the profitability of a firm is directly affected by such decisions.

The determinants of a firm's capital structure comprise of those factors that influence its financing decisions, namely, asset structuring profitability, firm size, growth opportunities, uniqueness, business risk, ownership structure and control and enterprise age. The capital structure of SMEs as a whole is therefore looked at, which involves determining how much capital it is needed immediately over time and the combination of equity and debt that it will use to fulfil its entire financial requirement. The significance of asset structure underlined the importance of collateral in SMEs finance. Reviewed questionnaires from respondents handled by previous researchers confirmed that profitability, assets and size were important determinants of capital structure. Profitability was found to be important to the SMEs. The survey also found that while SMEs operated bank accounts, banks were the least preferred. Source of debt and there was no relationship between capital structure and industry sector growth (Codjia, 2012, Karadeniz, 2008).

2. Objective of the study

The objective for this study was to determine the effect of capital structure on financial performance of small sized enterprises in Kenya

3. Statement of the problem

Capital structure plays an important role in determining the success of any business (Madan, 2007). The importance of financing decisions cannot be over emphasized since many of the factors that contribute to business failure can be addressed using strategies and financial decisions that drive growth and the achievement of organizational objectives (Salaz et al, 2012). The finance factor is the main cause of financial distress (Slaza et al 2012).Financing decisions result in a given capital structure and suboptimal financing decisions can lead to corporate failure. A great dilemma for management and investors alike is whether there exists an optimal capital structure. The objective of all financing decisions is wealth maximization and the immediate way to measure the quality of any financing decision is to examine the effect of such a decision on firm performance (Salazar et al 2012)

A study of a firm's capital structure is important as it attempts to explain the security and financing sources used by companies to finance investment (Myres, 2001, Brigham, 2004). The difficult facing SMEs in Kenya are that of financing and to raise funds through debt. Although numerous research have investigated the determinants of capital structure, they primarily have used large firms a case study (Bennet &Dornely, 1993, Mazur, 2007, Parlak, 2010, Hatt, TImman &Wessels,1988 Zhang,2010). Financing used in the operation of a business determines its capital structure, which refers to the proportion of capital that comes from loans and equity that the companies acquire (Abor &Biekpe, 2009).

Most of the existing literature seeking to explain the relationship between capital structure and financial performance has focused mainly on developed countries. Example of German and France, Hall et al (2004), Eriots et al (2007) in Greek. It is important to investigate capital structure decision of small firms in Kenya. Thus the study sought to investigate the effect of capital structure on financial performance of SMEs in hotel industry in Kenya.

4. Theoretical Framework

4.1. Trade off theory

The trade theory suggests that managers weigh the benefit of debt financing against cost of borrowing (Karadeniz at el 2011). The cost of borrowing includes bankruptcy costs and interest payments. The benefit of the debt finance includes the discipline instilled on the management and the tax allowance on interest payments. Brigham and Eurhardt (2005) note that the tradeoff theory holds that the value of unlevered firm is equal to the value of levered firm plus the value of side effects ,which include the expected costs due to financial distress and the tax shield. When a firm has a zero or low levels of debt financing the like hood of bankruptcy is low. According to Baxter (1967) the extensive use of debt increases the chances of bankruptcy and this makes creditors to demand extra premium. Accordingly firms should not use debt beyond a point where the cost of debt is higher than the tax advantage. Therefore the tradeoff theory suggest that the optimal capital structure is the point where the marginal tax benefit is equal to marginal costs related with bankruptcy. According to the tradeoff theory, firms would prefer debt over equity up to the point where probability of finance distress and bankruptcy costs overweigh the tax benefit associated with debt (Gill at al, 2012)

4.2 The pecking order theory

The theoretical basis for research on the SMES finance originates from the corporate finance theory. The pecking order theory of financing hypothesis, the issue of information asymmetries whereby only firm manager is aware of the true value of the firm and the fact that the market is un aware of the true distribution of the firms income. Because investors assume that managers will only issue stock when they believe it to be overvalued, this implies that a new issue of stock will be taken as a bad signal, by the markets thus triggering a reduction in the share price. Myers (1984) extends this theory and states that firms will meet investment and financing requirement of the firm in a hierarchical fashion, preferring internal funds first, external debt next and external equity as a last resort. Literature provides a number of demand-side and supply-side reasons as to why firms prefer, internal sources of funding over external sources and Debt over equity. Stilitzand Weiss (1981) argues that supply side constraint exist when SMEs cannot obtain the debt financing they require at market interest rates, resulting in undercapitalization. This is viewed as an under investment problem, where equity clears the

market. Demand-side explanation as presented by Bolton (1971) and Lecornu *et al* (1996) are based on the well-established fact that SMES owners are extremely reluctant to relinquish control of their business e.g. SMEs owners will try to meet their financing needs from pecking order of first their own' money, personal saving and retained earnings, second short term borrowing, third longer term debt and preferred of all (Ciaran macan &Lucey, 2006). Studies on small business finance have frequently suggested the problem of scarcity of funds (Peer and Wilson, 1996, Laitinen, 1992). It is also observed that limited access to capital markets (Gopinath, 1995) appear to confine the finance of small business to internally generated funds. However there is a limit to which internally generated funds can contribute to the growth of the SMEs which bring to the fore the need for alternative source of capital for development of these enterprises.

4.3 Conceptual framework

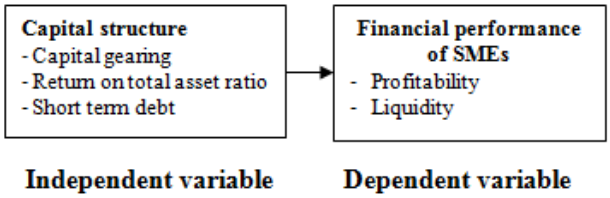

Figure 1. Conceptual framework.

5. Literature review

The analysis of capital structure which attempts to explain how companies choose a mix of securities and financing sources to finance their investments, has been an important area of research within a field of finance, Various imperfection, such as taxes, bankruptcy costs agency conflict, issues of asymmetric information and adverse selection have been pointed out as explanation for the use of debt financing and synthesized into the trade off and pecking order theory of capital structure. The extensive empirical evidence and tests can be found in the capital structure. As noted by Frank &Goyal,(2008), to understand the evidence, it is important to recognize the difference of the financing behavior between small private firms and large enterprises.

Roy and Mingfang (2000) state that an appropriate capital structure is critical decision for any business organization and that the decision is important because of the need to maximize returns to various organizational constituencies and also because of the impact such as decision has no organization's ability to deal with its completive environment. They further quote Modiglian and Miller, 1958,1963 emphasizing that there exists an optimal capital structure which balances the risk of bankruptcy with the tax savings of debt. However many later empirical researchers have been carried out only to disapprove this theoretical relationship they argue that there are other related characteristic such as future growth options, earning volatility, profitability and control, which affect a firms capital structure (Timan and Wessels,1988). In international dimension it has been observed that some of the determinants of capital structure include country norms, type and size of industry and also government control (Alwajjar and Taylor, 2008)'

6. Research Methodology

The research adopted a cross section survey research design. Both primary and secondary data for the period of five years for a sample size of 257 of SMEs in hotel sector in Kenya was used. For the analysis of data tools including statistical mean, standard deviation and regression coefficient were used. For the relationship and strength between the variable and financial performance, correlation coefficient was employed.

6.1 Sample size

A sample size of 320 respondents includes Director (owners), managers, accountants and credit officers of Hotels, tour safari and restaurants in Mombasa and environs in Kenya was selected. According to Saunders *et al* (2003), for a population of over 10000 a sample size of 385 is representative for calculation of sample of this group. This was determined according to a sampling formula of Saunders *et al*. (2003),

Methods of analysis in addressing the determinant of financing on financial pe

7. Multiple Regression Model

Completed questionnaires were edited and corded for completeness and consistency. The data then was analyzed using SPSS version 20 which generated qualitative reports of percentages and tables. A multivariate regression model was used to determine the relative importance for each of the variables with respect to financial performance of SMEs in Mombasa County in Kenya. The multiple regression analysis models on predicted level of independent variable to the levels of in dependent variable were chosen as the approach to analyze data.

Given the dependent variable the regression model was as follows;

$Y= \beta 0 +\beta_1 X_1 +\sum$

Where Y= Financial Performance of SMEs, (dependent variable)

$\beta 0$ = is the intercept (constant term)

β_1- β_1 = Coefficient of variables.

Table 1. Effect of Capital Structure on financial performance

Constructs	N	Mean	S.D
Capital structure decision is important because profitability of your firm is directly affected by such decisions	257	3.54	.922
Your firm is able to maximize the earnings per share when it uses debt finance due tax advantage	257	3.40	.943
Debt ratio and return on asset are among the important measures of capital structure of a firm	257	3.21	1.038
A high return on total asset is a measure of the effectiveness of a firm generating profits	257	3.16	1.011
You use short term debt to finance temporary shortages of cash due to fluctuations in sales	257	3.27	1.010
A business is said to be highly operationally geared when a large of its total costs are fixed cost	257	2.97	1.057
A sound and appropriate capital structure of your firm should have a return of capital which is satisfactory	257	3.36	.975
Short debt enables your firm to increase their after tax earnings by exploiting available tax shields	257	3.39	.937
Excessive use of short term debt finance is said to be highly geared affecting financial performance of your firm	257	3.14	1.029
A highly geared company may not lose control of its shareholders except if the gearing level exceeds 67%	257	2.98	.996

X1 = one independent variables in figure1

e= the error term normally distributed about the mean zero

The study sought to determine the effect of capital structure on financial performance of SMEs in Mombasa County, where the respondents were asked to indicate a scale of 1 to 5. Where 1 was strongly disagree, 2 disagree and 4 agree 5 strongly agree. The result in the above table revealed that respondents agreed that capital structure decision is important because profitability of your firm is directly affected by such decisions. This is revealed by a mean value score between 2.97 and 3.54 and a significant varied response of standard deviation between 0.922 and 1.057

Table 2. ANOVA on, capital structure.

Model	Sum of Squares	Df	Mean square	F	Sig
Regression	.103	1	.103	1.752	.187[b]
Residual	15.037	255	.059		
Total	15.141	256			

a. Dependent Variable: Financial performance

b. Predictors: (Constant), capital structure

The researcher performed ANOVA for capital structure as shown in the above table. The analysis revealed that there was insignificant level of 0.187, which leads to the conclusion that capital structure has effect on financial performance of SMEs as the value of significant with P-value of 0.187. The F value of 1.752 and P value of 0.187 showed that there is insignificant relationship between capital structure and financial performance of SMEs. This is consistent with the study of Charles et al (2014) on the effect of capital structure of firms profitability, who found out that there was no significant relationship between debt and the profitability of a firm.

Regression analysis was conducted to investigate the relationship between range of variables, which includes an error term, whereby a dependent variable is expressed as a combination of independent or explanatory variables and the unknown parameters in the model are estimated using observed values of the dependent and explanatory variables (Cooper and Schinder, 2006).

structure p = 0.773,.A multiple linear regression model for this study was conducted to describe the relationship between the dependent variable and the related independent variables, as expressed hereby $Y=2.381-0.021_{x1}$ .Where 2.381 is the constant shows independent variables of capital structure. Financial performance could be Y= 2.381. X_1-0.021 shows that one unit change in capital structure results in -0.021 units decrease in SMEs financial performance. The standard Beta coefficient gives a measure of the contribution of the variable to the model. A large value indicates there is a unique change in the independent variable has a large effect on the dependent variable. Further the study shows a negative and insignificant relationship between on financial performance. Hypothesis is accepted. The t value and significant values give an indication of the effect of the independent variable. A big t value and a small P value suggest that independent variable will have a large effect on dependent value.

The study conducted analysis of the Pearson's (r) correlation coefficient model between capital structure and dependent variable using SPSS to identify the relationships of capital structure, cost of capital, investment decisions and access to finance on the performance of SMEs in Kenya. The results of the analysis were represented in table 4 above as it was important to determine the strength and relationship between capital structure and financial performance.

Table 4. Correlations Analysis.

	CS	
C S	Pearson Correlation	1
	Sig. (2-tailed)	
	N	257
F P	Pearson Correlation	.083 1
	Sig. (2-tailed)	.187
	N	257 257

**. Correlation is significant at the 0.01 level (2-tailed).

*. Correlation is significant at the 0.05 level (2-tailed).

The results of the analysis were represented in table above was important to determine the strength and relationship between the variables as indicated by the Pearson's correlation coefficient r. The results indicated that there was a positive and insignificant relationship between capital structure (r = 0.083 p = 0.01) which is explained by a p- value of 18.7% and a correlation significant at 0.05 level (2 tailed) on financial performance of SMEs. This result implies that with 1% increase in the positive effect of capital structure there is 8.3 % increase which is a weak positive and significant relationship with financial performance of SMEs in Kenya. This is consistent with Maritala (2012) on optimal level of capital structure which enables a firm to increase its financial performance The result imply that capital structure. Insignificantly influenced financial performance of SMEs..

8. Test of hypothesis

$H0_1$. Capital structure has no significance effect on the performance of SMEs in Kenya Research finding show that capital structure had a coefficient of significant based on B_1= 0.021 p-value = 0.773 which is greater than 0.05, implying that we accept the null hypothesis stating that capital structure had no significant effect on financial performance and reject the alternative hypothesis which states that capital structure has significant effect on financial performance of SMEs. The effect of capital structure was stated by t- test value of -0.289, which pointed out that the effect of capital structure was less over – 0.289 of error associated by it. Further the effect of capital structure on financial performance of SMEs was stated by the Chi square value p-value of 0.313 which is more than the 0.05 value, therefore accepting the hypothesis and rejecting the alternative hypothesis, which states that' capital structure has significant effect on financial performance of SMEs.

9. Conclusion and Recommendations

The study investigated the effect of capital structure on financial performance of hotel SMEs in Mombasa County in Kenya. The study disused one of the most important issues of access to finance which is a particular problem for SMEs in Kenya and which affect many SMEs performance due to financial constraints. The paper employed measures of short term, capital gearing and return on asset. The results findings showed that we accept the null hypothesis stating that capital

Table 3. Regression Coefficient.

Model	Unstandardized	Coefficients	Standardized Coefficients	t	Sig.
	B	Std. Error	Beta		
Constant	2,381	0 .295		8.074	0 .000
Capital structure	0 .021	0 .072	-0.017	-.289	0.773

Dependable variable: Financial performance

structure has no significant effect on the performance of SMEs.

Regression results indicated that B =- 0.021, beta -0.01, t =- 0.289 and f 0.773. The correlation coefficient indicated a positive relationship between capital structure and financial performance explained at 18.7 % at a correlation significant at o.05n level (2 tailed) on financial performance *of hotel SMEs in Mombasa County and environ in Kenya.* This implies that with 1% increase in positive effect of capital structure there is 8.3 % increase which is a weak positive and significant relationship with financial performance of the SMEs studied.

Recommendations

Indeed capital structure is a significant determinant of business performance. This study therefore investigated the effect of capital structure on financial performance of SMEs in Mombasa County in Kenya. This study recommends further studies to be carried out on equity since it is long term which may improve long term financial performance of a firm. Also managers and owners of SMEs should maintain leverage levels to help the firm not lose control of its shareholders. Optimum capital structure should be maintained in order to maximize shareholder wealth. Further studies to be carried out on other variable like taxes , operating risk that may affect the financial of SMEs .

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