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An Assessment of Capital Structure Decisions by Small and Medium Enterprises in Kenya

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Abstract
Many theories and empirical research that explain the determinants of capital structure, originated in the developed economies. These studies focus on large firms that issue complex financial securities for both debt and equity. Very little research has been carried out to establish the determinants of capital structure in emerging and the less developed countries. This research was done to establish whether the determinants of capital structure identified in the developed world are the same determinants of capital structures of Small and Medium Enterprises in developing countries. The study establishes that age, profitability, size, growth opportunities and tangible assets of the business greatly determine the leverage of the business. The study's significance lies in the provision of newevidence on the determinants of capital structure of small and medium enterprises in developing countries with a special focus on Kenyan firms.
Keywords: Capital structure, Small and Medium Enterprises, Kenya.

1.1 INTRODUCTION

Corporations mainly raise capital through debt and equity. According to Brigham and Ehrhardt (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. Debt financing encompasses term loans, commercial paper, corporate bonds among others while equity financing refers to the funds provided by the owners. Baker and Martin (2011) point out thatcapital structure is one of the most important decisions made by financial managers. This is because the mix can have an effect on the overall cost of capital of a business and hence its value.A firm can be able to create value for its shareholders when its earnings are more than the cost of investment. Eriotis (2007) notes that the main objective of a finance manager is to maximize the wealth of shareholder's and to minimize cost. Therefore, capital structure decisions provide firms with an effective tool of minimizing their overall cost of capital.

According to Abor (2007), 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) emphasizes that capital structure decision is important because the profitability of a firm is directly affected by such decision. This is due to the fact that high leverage imposes discipline to managers and reduces the agency costs. This increases the profitability of a firm as managers are forced to act towards meeting the interest of the shareholders. Besides, capital structure decisionsare vital elements of firms' financial strategies. Consequently, business organizations are obliged to choose a mix of debt and equity that will enable them to generate more wealth and at the same time to maintain stability. Nonetheless, capital structure decisions vary among firms as they try to set a mixture of debt and equity that would enable them to optimize on their overall market value (Al-Najjar and Hussainey, 2012).

Karadeniz at el (2008) note thata number of studies have identified various factors that determine capital structure decisions by firms. These factors include, size of the business, growth opportunities, asset tangibility, profitability and age of a business. However, Upneja and Dalbor (2009) observe that though much research on the area of capital structure has been done, the conundrum on how firms make capital structure decisions is still considered as one of the most noteworthy unsolved problem in finance. Al-Najjar and Hussainey (2011) emphasize that it is still unclear what drives capital structure decisions particularly by small and medium enterprises (SMEs). Therefore, this paper tries to assess the determinants of capital structure decisions by SMEs in Kenya.

1.2 The Research problem

Many theories and empirical research that explain the determinants of capital structure, originated in the developed economies. These studies focus on large firms that issue complex financial securities for both debt and equity. On the other hand, very scanty research has been carried out to establish the determinant of capital structure in emerging and in the less developed countries. The little research done in the developing countries does not explain whether the conclusions from theoretical and empirical research carried out in developed economies are appropriate for developing countries and in particular to Small and Medium Enterprises (SMEs). Rajan and Zingales (2000) emphasize that a lot of attention on capital structure has been directed toward large firms, ignoring the small firms, which are equally important. According to IFC (2006), there is a positive

relationship between a country's overall level of income and the number of SMEs. In addition, SMEs represent an important source of innovation. They are a major market for goods and services provided by larger corporations. The conclusions from these studies were that there were some common features in the capital structures of firms in different countries. However the studies do not provide specific information on the determinants of capital structures of SMEs in developing countries. The unresolved question is whether the various theories and studies are useful in understanding the capital structure of SMEs in the developing countries. Therefore it is important to understand the factors that determine this combination and have a better grasp on the variables that influence capital structure decisions of SMEs, which may in-turn help in improving future policy decisions. It is against this background that this study re-focuses attention to study the capital structure of small and medium enterprises and bridge the information gap -are the determinants of capital structure identified in developed world the same determinants of capital structures of SMEs in developing countries.

1.3 Main Objective

The primary objective of the study was to assess the determinants of capital structure of SMEs in Kenya.

1.4 Specific Objectives

1. To identify the determinants of capital structure of SMEs in Kenya
2. To examine the relationship between the size and leverage of SMEs
3. To establish the relationship between the age of SMEs and leverage.
4. To determine the relationship between the availability of tangible assets and leverage of SMEs.
4. To determine the relationship between leverage and profitability of SMEs.

1.5 Research Hypotheses

H_{01}: There is no statistical significant relationship between SME's size and leverage.
H_{02}: There is no statistical significant relationship between the age and leverage of SMEs.
H_{03}: There is no statistical significant relationship between the availability of tangible assets and leverage of SMEs.
$H_{04:}$ There is no statistical significant relationship between growth opportunities and leverage of SMEs.
H_{05}: There is no statistical significant relationship between profitability and leverage of SMEs.

2.0 LITERATURE REVIEW

2.1 Theoretical review

2.1.1 Modigliani and Miller theory

According to Modigliani and Miller's proposition I (1958), the value of the firm is not affected by the way the firm finances its real assets. This implies thatthe proportion of debt financing is irrelevant in determining the value of the firm.Addae at el (2013) observes that MM theory was based on the argument that capital structure decision has no effect on a firm's market value, cost of capital and profitability.However, this theory received a lot of criticisms because it assumed a world free of taxes which was unrealistic (Gill at el, 2012). Subsequently, this led to the development of MM proposition I with taxes. According to Brigham and Ehrhardt(2005), MM proposition I with taxes holds that levered firms have a higher value as compared to the unlevered firms. This is due to the tax advantage on debt that leads to increasing returns on equity hence shareholders value.

2.1.2 Trade-off theory

The trade-off theory suggests that managers weigh the benefits of debt financing against the costs of borrowing (Karadeniz at el, 2008). The cost of borrowing includes bankruptcy costs and interest payments. The benefit of debt financing includes the discipline instilled on the management and the tax allowance on interest payments. Brigham and Ehrhardt (2005) note that the trade-off theory holds that the value of unlevered firm is equal to the value of a 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 zero or low levels of debt financing, the likelihood 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 risk premium. Accordingly, firms should not use debt beyond a point where the cost of debt is higher than the tax advantage. Therefore, the trade-off theory suggests that the optimal capital structure is the point where the marginal tax benefit is equal to marginal costs related with bankruptcy. According to the trade-off theory, firms would prefer debt over equity up to the point where probability of financial distress and bankruptcy costs overweigh the tax benefit associated with debt (Gill at el, 2012).

2.1.3 Agency theory

According to Abor(2007), agency theory focuses on the behavioral relationship between the shareholders or owners (principals) and the managers (agents). Managers are employed by the shareholders to perform tasks on their behalf. Addae at el (2013) note thatmanagers may resist high level of debt if they feel that it places their jobs and income at a risk.Conversely,owners prefer riskier projects because they might generate high returns..

Therefore, corporate policy financing decisions can offer shareholders with a means of minimizing value-reducing behavior of the management and hence reduce the agency costs. Specifically, the selection of management leverage dividends and ownership can lessen agency costs arising from the firm's 'nexus of contracts'. Brigham and Ehrhardt (2005) argue thatthis convergence of interests between management and shareholders reduces the agency costs. This is because managers are inspired to follow value maximizing behavior. Nonetheless, management reduces the diversification of their personal portfoliowhen their equity share in the firm is increased. On the other hand, a firm can reduce the agency costs by increasing its reliance on debt financing (Gill at el, 2012). This reduces the need for equity financing, and thus, avoids the related agency costs. However, the ability of a firm to increasingly depend on on debt financing is restricted due to higher agency costs of debt that result from the possibility of the business facing bankruptcy.

2.1.4 Pecking Order theory

According to Karadeniz at el (2008), the pecking-order theory relies upon the notion of asymmetric information between investors (outsiders) and managers (insiders) which guides managers in their preference for raising funds. According to this theory, firms prefer funds from sources with the lowest degrees of asymmetric information (Brigham andEhrhardt, 2005). This is because the cost of borrowing rises with increase in asymmetric information. Myers (1984) emphasizes that the Pecking order theory holds that firms prefer to finance new investment, first with internally generated finances like retained earnings, followed with debt, and finally with an issue of new equity.

2.2Empirical Determinants of Capital structure

2.2.1Profitability

There is a general belief that highly profitable organizations are likely to use more debt. The relationship between leverage and profitability of a firm has been one of the most controversial issues. According to the pecking order theory, firms prefer to use retained earnings first, then debt financing and finally equity financing by selling shares in the stock market. This implies that profitable firms tend to use more internal than external financing, implying a negative relationship between the use of debt financing and profitability. This is consistent with empirical literature and findings by Harris and Raviv, (1991); Rajan and Zingales, (1995); Booth at el (2001). on the other hand, profitable firms use more debt to take advantage of the tax shield benefit. In addition, firms that are profitable and have stable sales are capable of meeting the interest payments with some degree of certainty.

2.2.2 Firm Size

The size of a firm has a major impact on its capital structure. Large companies tend to be more diversified. This is because theydo not have high failure rate and they have stable cash flows. Additionally, large firms have tangible assets which can be used as collateral to obtain debt financing (Ezeoha and Botha, 2011). Thus large firms are capable of taking on more debt. According to Ferri and Jones (1979) large firms have easier access to the markets and can borrow at better conditions. Smaller firms, on the other hand, experience difficulties in raising long-term finances due to unavailability of tangible assets to use as collateral; they have less stable cash flows and lack the necessary management skills. In addition, small companies are believed to have bigger bankruptcy costs in relative terms. Therefore the size positively related to leverage in a firm .

2.2.3Firm Age

Younger firms need finances for growth and expansion. Ezeoha and Botha (2011) note that small firms are typically less creditworthy, less profitable, and less diversified than older firms. They have higher probabilities of financial distress or bankruptcy. The trade-off theory predicts that younger firms should use less debt than large firms suggesting a positive relation between firm age and leverage. Informational asymmetry between insiders and outsiders for young firms are more pronounced because they do not have well established track records. According to the pecking-order theory such firms should prefer internal equity to private debt, implying a positive relation between firm age and leverage.

2.2.4 Growth Opportunities

Companies with growth opportunities finance their growth with equity rather than with debt, because equity financing reduces the chance of the firm been forced into bankruptcy by creditors. Jung et al (1996) suggest that firms should use equity to finance their growth because such financing reduces agency costs between shareholders and managers. According to Myers (1977), companies with growth opportunities invest sub-optimally and therefore creditors are unwilling to lend for long horizons. Therefore, these companies result to using short-term financing. Also, according to the pecking order theory, growth firms with strong financing needs will issue short-term securities due to informational asymmetries. This suggests that there is a negative relationship between growth opportunities and leverage.

2.2.5 Asset Structure (Tangibility)

Firms with valuable tangible assets which can be used as security, tend to use more debt. The availability of tangible assets has a major impact on the borrowing decisions of a firm because they are less subject to

information asymmetries and they have greater value than intangible assets in case of bankruptcy (Khrawish and Khraiwesh, 2010). The cost of borrowing can be prohibitively high when firms do not have collaterizable assets; hence their availability increases firms borrowing opportunities. Bradley at el (1984) found that the asset structure of a firm was positively related to debt. Furthermore, Marsh (1982) provided indirect evidence of firm's tangible assets and the debt. His time series study and report suggested that larger firms with a larger tangible asset base tended to use more debt. Other empirical studies that explains a positive relation between availability of tangible assets and the level of debt includes Rajan and Zingales (1995); Krempet al (1999); Delcoure (2007). These studies demonstrate that there is a positive relationship between the availability of tangible of assets and use of debt.

3.0 RESEARCH METHODOLOGY

3.1Scope and study population

The study employed survey research design. This involved collecting primary data on small and medium firms in Kenya, using structured questionnaires. The design was selected because similar studies like Titman and Wessel (1988), which focused on determinants of capital structure, used the same design.

3.2 Sample and Data collection

To obtain a representative sample, a survey sample of thirty businesses was selected using simple random sampling. This ensured that each business on the list has an equal and independent chance of being selected.Data was collected from both secondary and primary sources. The secondary data derived from the annual financial statements. For the primary sources, the data was obtained using self-administered structured questionnaires, whereby the respondents were asked to complete questionnaires themselves. In some cases one-on-one interviews were done to extract some important information.

3.3 Data Analysis

The data obtained from the respondent was tabulated for analysis and interpreted with the help of the regression model. It helped establish the relationship between the dependent variable (leverage) and the independent variables; size, age, profitability, growth and asset structure (tangibility). The regression analysis was employed on cross-sectional data from 2008 to 2013.
The regression equation used was:

$$LEV_{it} = \alpha + \beta 1\ Profitability_{it} + \beta 2 Tangibility_{it} + \beta 3 Size_{it} + \beta 4 Growth_{it} + \beta 5 Age_{it} + \varepsilon_{it}$$

Where:

Variable	Definition and measurement
Leverage	This is the dependent variable and can be described as the mix of debt and equity in a firm. It is measured by debt to total assets ratio.
Size	It is measured by the Natural logarithm of total assets.
Age	Which measured by natural logarithm of firm age.
Profitability	Which is measured by EBIT divided by Total assets
Asset Structure	Which is measure by Fixed Assets plus Stock divided by Total Assets
Growth opportunities	Which is measured by Intangible Assets divided by Total assets
α	is the intercept of the equation
β	is the slope coefficient for independent variables.
ε	Error Term

4.0 Results and Discussions

According to the results in table 1, most of the respondents (78%) indicated that the size of the business determined its leverage to a great extent while 3 % of the respondents revealed that the size of the business did not determine leverage of a business. Size had a mean of 4.53 with a standard deviation of 1.042.Table 1 shows that 86% of the respondents indicated that the age of business determined its leverage by a great extent while 6% and 5% of the respondents indicated that age determined the leverage of a business by a low extent and by a moderate extent respectively.Age had a mean of 4.60 and a standard deviation of 1.037. This implies that age of a business determined the leverage of SMEs in Kenya by a large extent. Furthermore, the results of the study indicate that most of the respondents (16) perceived that profitability determined the leverage of a business by a

moderate extent.

Table 1: Extent to which Size, age Profitability, Asset structure and growth opportunities determine leverage

	No extent	Low extent	Indifferent	Moderate extent	Great extent	Mean	Std Deviation
Size	1	2	0	4	23	4.53	1.042
	3%	5%	0%	14%	78%		
Age	1	2	0	2	26	4.60	1.037
	3%	6%	0%	5%	86%		
Profitability	0	5	7	16	2	3.50	0.861
	0%	16.7%	23.3%	53%	7%		
Asset structure	2	2	1	3	23	4.67	0.844
	5%	5%	3%	11%	76%		
Growth opportunities	1	0	0	3	26	4.77	0.774
	3%	0%	0%	11%	86%		

The results in table 1 further show that seventy six percent (76%) of the respondents indicated that the tangible assets in the business determined the leverage of the business to a great extent. Asset structure had a mean of 4.67 and a standard deviation of 0.844. This suggests that the asset structure determined the leverage of small and medium enterprises in Kenya by a great extent. Moreover,the study results revealed that majority of the respondents (86%) indicated that growth opportunities determined the leverage of the business to a great extent while 11% revealed that growth opportunities determined the leverage of the business to a moderate level. On the other hand 3% indicated that growth opportunities determined the leverage of the business to a low extent.

Table 2Pearson correlations analysis and 2-tailed tests

		Age	Size	Assets	Growth opportunities	Profitability	Leverage
Age of business	Pearson Correlation	1	.349(*)	.074	.418(*)	.070	-.090
	Sig. (2-tailed)		.035	.662	.010	.682	.597
Size of the business	Pearson Correlation		1	.090	.537(**)	.086	.111
	Sig. (2-tailed)			.594	.001	.612	.511
Tangible assets	Pearson Correlation			1	.085	-.019	-.122
	Sig. (2-tailed)				.619	.912	.471
Growth opportunities	Pearson Correlation				1	.081	.057
	Sig. (2-tailed)					.632	.736
Profitability	Pearson Correlation					1	.059
	Sig. (2-tailed)						.727
Leverage	Pearson Correlation						1
	Sig. (2-tailed)						.
	N	37	37	37	37	37	37

* Correlation is significant at the 0.05 level (2-tailed).
** Correlation is significant at the 0.01 level (2-tailed).

According to the results in table 2, there is a negative correlation between age of the business and leverage. This means that an increase in the age of the business will lead to a decrease in leverage used. This was shown by a factor of -0.9. However, the study noted that there was no statistical significant relationship between the two variables. This suggests that increase in age of a business does not significantly lead to an increase or decrease in leverage as shown by P value of 0.597 (P>0.05). Table 2 above further shows that there exists a weak relationship between the size of the business and leverage as shown by a Pearson correlation value of 0.111. However, the relationship between the two variables was not statistically significant as shown by the P valueof 0.511.

The results in table 2 indicate that there is a negative correlation between tangibility of business assets and use of leverage as depicted by a Pearson correlation value -0.122. The degree of significance of the relationship between the two variables was 0.47. The P value was greater than 0.05 and this means that there is no statistical significant relationship between tangibility of business assets and leverage. Further, the study established that growth opportunities and profitability had a weak, positive relationship with leverage with a Pearson correlation value of 0.507 and 0.509 respectively. However, the relationship of these variables with leverage was not statistically significant as shown by their significance levels of 0.736 and 0.727 respectively.

Table 3; Regression Analysis

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.227(a)	.052	-.101	1.02628

According to the results in table 3 above, the correlation coefficient value was 0.227. This shows that there is a weak correlation between the independent variables and the dependent variable. Furthermore, the results in table 3 indicate that the independent variables explain only 5.2% of the variations in the dependent variable (leverage) as shown by the co-efficient of determination value of 0.052.

Table 4 ANOVA Test

Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	1.782	5	.356	.338	.886(a)
	Residual	32.651	31	1.053		
	Total	34.432	36			

a. Predictors: (Constant), to what extent does age of the business determine the leverage (use of credit to increase profits) of the business, To what extent does profitability determine the leverage of the business, To what extent do tangible assets in the business determine the leverage of the business, To what extent does the size of the business determine the leverage of the business, To what extent do growth opportunities determine the leverage of the business.

b. Dependent Variable: Leverage

The results in table 4 show that the overall significance of the model was 0.886 with an F value of 0.338. This implies that there is no statistical significant relationship between the independent variables (age, size, growth opportunities, tangible assets and profitability) and leverage (P>0.05).

Table 5 Regression Coefficients

Model		Unstandardized Coefficients		Standardized Coefficients	T	Sig.
		B	Std. Error	Beta		
1	(Constant)	2.346	1.541		1.523	.138
	profitability	.003	.011	.051	.291	.773
	growth opportunities	.113	.480	.051	.235	.816
	tangible assests	-.008	.011	-.127	-.722	.476
	size of the business	.201	.290	.146	.692	.494
	age of business	-.223	.280	-.156	-.799	.430

a Dependent Variable: rating the leverage

According to table 5 above, the significance value on the relationship between size of the business and leverage was 0.494. This value was higher than the p value of 0.05. As a result, this study fails to reject the first null hypothesis and concludes that there is no statistical significant relationship between size of the business and leverage. Furthermore, the degree of significance of the relationship between the age of the business and leverage was 0.430.Therefore, this study fails to reject the second nullhypothesis and concludes that there is no statistical significant relationship between leverage and size and age of business(P>0.05)

The results in table 5 show that the level of significance on the relationship between asset structure and leverage was 0.476. This value was higher than the p value of 0.05. Consequently, this study fails to reject the third null hypothesis and concludes that there is no statistical significant relationship between asset structure and leverage. Additionally, the significance value on the relationship between growth opportunities and leverage was 0.816. Thus, this study fails to reject the fourth null hypothesis and concludes that there is no statistical significant relationship between growth opportunities and leverage. Finally, the degree of significance on the relationship between profitability and leverage was 0.138. Accordingly, this study fails to reject the fifth null hypothesis and concludes that there is no statistical significant relationship between profitability and leverage.

5.0 Summary and conclusions

The aim of the study was to assess the determinants of capital structure decisions by SMEs in Kenya. The study results revealed thatmajority of the respondents indicated that the size of the business, age of the business, availability of tangible assets and growth opportunities determined the leverage of SMEs by a great extent. However, profitability determined the leverage of SMEs by a moderate extent. The results from the correlation analysis showed that there is a negative correlation between age of the business and leverage. However, there was no statistical significant relationship between age of the business and leverage. This means that the age of a business has no significant impact in determining the capital structure of SMEs. Furthermore, the correlation results showed that size of the business, availability of tangible assets, growth opportunities and profitability had a positive relationship with leverage. This means that these variables determine firm leverage among SMEs in Kenya. Therefore, the results of this study suggest that capital structure decisions of SMEs in Kenya are determined by factors which are similar to those identified in previous literature.

6.0Limitations and Recommendations

The sample for this study was small and the study was limited to SMEs in Kenya. Consequently, the results of this study can only be generalized to SMEs similar to those which were included in the sample. Additionally, this study uses factors that influence capital structure decisions that have been identified from previous studies. As a result, future studies should consider other variables like taxes and operating risk that may potentially influence capital structure decisions of SMEs. Moreover, further research should be conducted in other mature and developing countries in order to aid comparability of the results.

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