EXOGENOUS CONSTITUENT AND CAPITAL STRUCTURE OF SMALL AND MEDIUM ENTERPRISE IN KITUI COUNTY, KENYA

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ABSTRACT

Small and medium-sized enterprises' development and operations depend majorly on the capital structure financing choice. Their capital structure choice is majorly influenced by various elements. Equity and debt capital are the major sources of Capital to most of Kenyan SMEs. Equity capital is a fund contributed by the shareholders, while Debt finances are borrowed from moneylenders. SMEs contribution to most of economies cannot be underrated, their contributions ranges from job creation, provision of quality goods and services at comparatively reduced prices and tax payment to the governments. Most of less developed countries encounters major economic problem such as persistent unemployment, rapid rise in inflation and dis-equilibrium in balance of payment which SMEs tend to work toward solving them to a given extend. Despite of all this contribution, the operation and performance of SMEs are adversely affected by the choice of capital structure. External contributes such as market conditions, cost of capital and investors attitude adversely influence the choice of capital structure. In 2017, the Kenya National Bureau of Statistics surveyed SMEs financing challenges. The study established that a few SMEs do not celebrate their second birthday while several of them do not manage to reach fifth birthday, which raised concerns on their sustainability. As a matter of quick fix an investigation to establish the cause massive failure of SMEs in Kenya was called to assist Kenyan get the root of this major issue. This study examined the effect of extraneous factors on SMEs Capital structure in Kitui County, Kenya. The done study was anchored on Signaling theory, Agency theory and Tradeoff theory. Descriptive research design was employed on the study, and questionaries administered to collect data from 150 SMEs. Data collected was analyzed using multiple regression analysis by use of SPSS and findings presented by tabulation, charts, and diagrams for easy visualization. The study established that external Contributes have got negative effect on the capital structure of SMEs. Training programs were recommended to correct this as many of entrepreneurs in these SMEs were found unaware of issues to do with capital structure. secondly the study recommended formulation of policies by government to control the operations of SMEs as most of them were operating informally such that to get the data which can assist in helping them stand was hard. Initiatives to motivate entrepreneurs was found to be best way to address and supply SMEs with required information which can assist them grow, the need to have structured way of information exchange and sharing was also found to be of great importance in entrepreneurial environments.

Keywords: Extraneous Factors, Capital Structure, Cost of Capital, Market Condition, Investors Attitude

INTRODUCTION

Developing countries in the world depends majorly on private sector to build their economies, world Bank report (2019). SMEs are believed to build economies of LDC by ensuring job creation and steady supply of consumer and non-consumer product at comparatively low price. World bank (2019) report project creation of 600Million jobs by the year 2030 forcing governments to put more effort in protecting SMEs interest. SMEs performance Index 2019 growth rate grew from 4.8% in 2017 to 6.3% in 2018.United Nation Goal 8 of sustainable development is based on promoting sustained, Inclusive, and sustained economic growth with full and productive employment and decent work for all., thinking of this we think of SMEs as goal 8 cannot be achieved without SMEs in Mind. World Bank report (2020) states that SMEs Represent 90% of business running in developing countries. Additionally, the report points out that the SMEs creates to a tune of 846,000 new jobs every year translating to 83.6% of the total employment creation they also contribute to a tune of 30% on GDP, hence facilitating economic growth and bridging the poverty gap as well as ensuring accessibility of goods and services the larger public.

The combination of Equity and debts makes up SMEs financing strategy, Debt capital are loans or bonds issued while Equity finance is expressed as the common stock. The Debt-to-Equity ratio is used to determine the capital structure. Debt capital is looked at as less risk to investors as compared to Equity Capital, however one need to strike the balance between the two sources of capital and come up with desired optimum capital mix which will maximize firm's efficacy and its operations.

Problem Statement

One of the key decisions in any investment venture is decision on capital. The capital structure decision carries the future of any entity in the world. An optimal capital structure is the best grouping of debt and equity financing that can be applied to maximize the market value of the business at the same time decreasing its cost of capital (Schauten,2010). Is there optimum capital structure? When does this combination of equity and debt finance reach optimal reach point, most of SMEs suffers losses and failure to penetration in market which are caused by either SMEs inability to pay their debt caused by the higher interest charged by lending institution or loss of control on the operation of SMEs by real owners caused by equity finance financing choice. One of the main conclusions of modern economics is that improvement of SMEs' capital structure depends majorly on financial status, however, the debate on which source of finance to improve the SMEs performance raises issues of concern, (Emad *et al*., 2014). Kenyan government beliefs an estimated number of SMES to collapse each year (Wellalage & Reddy, 2020). Adebayo, Alheety, and Yusoff (2019) documents that, there is link between the type of capital and performance of the SMEs and status of the economy in Urania. It was observed that tax rates influence the capital structure at a significant level. Adebayo, Alheety, and Yusoff (2019) explain the effect of the cost of equity on SMEs' financial performance in Nigeria, his study discovered that the performance of SMEs and the capital structure are interconnected. The choice of financing in SMEs in Saudi Arabia is influenced by the interest rates as commented by Al-Tit, Omri and Euchi (2019), this study also commended that the interest rates affect the issuance of debt to SMEs in Saudi Arabia, which influence the capital structure eventually. In Kenya, the market condition, cost

of capital and investor's altitude have been linked with SMEs' capital structure. In 2017, the Kenya National Bureau of Statistics surveyed SME financing challenges. The study found out that, nearly 400,000 SMEs fails to complete their second year in operation. Few SMEs manage to reach their fifth year in operation, which raises concerns on their sustainability**.** Alper *et al* (2019) state that the SMEs' performances in Kenya rely on the capital structure. The turnover tax imposed on the SMEs is another factor affecting the SMEs' capital structure in Kenya, as commented by the Musyoka (2019). The cost of capital for the starting small business becomes a major challenge (Mbuva & Wachira, 2019). Muturi and Njeru (2019), explain the relationship between lending and credit availability to SMEs in Kenya being affected by the borrowing power. for the SMEs to access credit facility, they must provide commitment or surety of payment in terms of collateral security. Since these SMEs are not stable enough to secure loans from the lending agencies, it becomes extremely hard for them to survive in the competitive business without the capital to finance their operations. Most of SMEs shareholder depends on them to finance their other domestic expenses, which also drains their capital. The government of Kenya have developed a mechanism through ministry of trade and cooperative to support SMEs' growth in all counties by ensuring favorable working condition and advocacy. This research attempted to fill this noticeable literature and conceptual gap by bringing light on the key external element affecting the Capital structure of 150 SMEs in Kitui County, Kenya.

Study objective

To examine effect of cost of capital, market condition and investors attitude on capital structure Small and Medium Enterprises in Kitu County, Kenya.

Research hypothesis

H $_{01}$ There is no significant effect of cost of capital on the capital structure of SMEs
H $_{02}$ There is no significant effect of market condition on the capital structure SMEs
H $_{03}$ There is no significant effect of investor's attitude on the capital structure SMEs

Theoretical Review

Agency Theory

Stephen Ross and Barry Mitnick in 1970s developed agency theory, theory explains two critical conflicts that arise in an organization and can influence its capital structure. There are different interests between directors and shareholders and secondly conflict between shareholders and creditors. Jensen and Meckling (1976), argue that directors sometimes may not function as per the shareholders' best interests. This is where conflicts arise in a firm, and it goes down from management through shareholders to the creditors. Managers take advantage of the profit made from the firm's they utilize for their personal gains at the expense of shareholders. Therefore, debt will provide the firms' shareholders with incentives to invest in a sub-optimal way. When investment yields good returns which are above the debt's face value, the benefits accrue to shareholders, and if the returns are below the value of the debt, then shareholders have limited

liability to walk away (Harris & Raviv, 1991). The servicing of the debt may affect the shareholders, according to Stulz (1990). Positively, debt payments force managers to pay interest consequentially lowering any potential overinvestment problem. Furthermore, when the debt is too high, it leads to overpayment of interest, and therefore, it becomes difficult to accept profitable projects, affecting the firm negatively through underinvestment. This theory clearly shows that the trade-off between the benefits and costs of debt determines the firm's capital structure. Myers (1977) argues that when a firm is in a bankruptcy state, shareholders have no incentive to invest more equity capital. This is because the benefits that will be realized at the end of the day will be directed to pay debt holders. The choice and attitude of the investor of the firm's shareholders as explained by the Agency theory may cause conflict because the manager interest is to maximize the profit while the investors or the shareholders focus is on the return on investment (ROI). The investor's attitudes are well explained by the Agency theory because their decision may affect the capital structure of the firm positively or negatively depending on their choice.

The Trade-off Theory

Eli Heckscher and Bertil Ohlin in 1900s developed the trade-off theory which states that the firm's current value of any possible financial crisis is balanced against interest tax shields' benefits. According to Chakraborty (2010), there should be an optimal capital structure to offset the cost of bankruptcy and the present value of interest tax shields. There are two categories of bankruptcy cost, which include direct expenditures and indirect expenditures. Direct cost bankruptcy is caused by a firm's price that goes bankrupt through legal and administrative expenses. In contrast, indirect cost bankruptcy occurs when a firm cannot service its debt obligation causing market value reduction (Baxter, 1967). These predictions show a firm position to secure a loan to finance its operations. Some firms have safe tangible assets, while others have risky intangible assets. Qiu and La (2010) argue that a business with safe tangible assets has high chances to borrow more because there is minimal exposure to financial distress. Contrary, a firm with unclear tangible assets is exposed to the economic crisis, and therefore it can borrow less. The third prediction of the trade-off theory talks about marginal tax rates.

The prediction associated higher the marginal tax rates, the high leverage levels. This is due to interest tax deductions. When the marginal tax rate is high, then there is a likelihood of a high debt ratio. In this situation, an organization with a low marginal tax rate will opt for more equity finance than debt capital. The theory shows how marginal tax affects the capital structure of the firm. The firm's decisions to opt for equity or debt funds depend on the marginal tax rates. The marginal tax is among the market conditions which will externally influence the capital structure. When the marginal cost is high the trade-off theory suggests focusing on the equity cost to adjust the firm's leverage.

Signaling Theory

This theory was described by Ross (1977), whereby it clarifies the choices of supervisors and shareholders. In this theory, troughs evaluate the firms' esteem to know if they can issue obligation or value. When the manager issues obligation when their firm is underestimated, but the firm is

overvalued at that point, managers will favor issuing value. The signaling theory states that when supervisors have interior data on trends of the organization, the manager signals data to the Market. The issue of obligation may be a commitment to supervisors to pay the intrigued in future. This commitment signals that the firm ventures the adequate cash streams to benefit their obligation. The information signaled by the firm will determine the accessibility of capital from financial institutions and shareholders. The promised interest payments are an obligation and therefore, are given more priority over the dividends. Ferris, Javakhadze and Rajkovic (2017) argue that the shareholders are the determinants of the firm's cash flows, and the debt payment may affect the share prices. This means the manager's choice to issue debt affects the firm since the commitment to pay the interest must be met. Failure to meet these commitments signals bankruptcy of the firm; thus, the shareholders are the last people to decide on the mechanisms of servicing the debt.

According to Barclay & Smith (1999), all the capital structure theories are more important, and therefore it’s not possible to choose one theory over another. For instance, signaling theory and trade-off theories have some truth when explaining financial decisions (Farma & French, 2005). When testing the signaling theory, it is impossible to measure managers’ proprietary information.

Empirical Literature Review

Cost of Capital and Capital Structure

According to Baas and Schrooten, (2006), the interest can be simple or compound interest; fixed or variable interest varies from one financial institution to another. According to Nassar (2016), large firms can negotiate the lenders' interest rates to reach favorable rates to acquire more debt. In addition to that, larger companies are safe compared to smaller companies, and therefore, loaning institutions are willing to give them more funds. This shows that the company size correlates positively with leverage. The growth prospect of the firm affects capital structure significantly. This is because the growth firm has high leverage compared to non-growing firms. The growth firms can get loans with minimal constraints. Nassar (2016) argue that growing firms add value to the firm, increasing its debt capacity. The firm's debt capital can be a loan from a bank, bonds, credit card debts, or personal loans. There is a price paid as a privilege of accessing those funds when using debt-equity. The cost of debt finance is the interest the lenders charge the firm to access the funds. In some situations, the interest rates charged can be fixed or variable. This leaves the firms in a challenging situation on the favorable decision to consider the debt capital rate. These interest rates are very competitive; making them varies from one financial institution to another. A financial institution charges a high-interest rate when the chances of repayment are low. Revolving loans such as credit cards are assigned high-interest rates because the repayment chances are not certain. This makes these loan types challenging to manage (Wehinger, 2014). Financial services also tend to charge high interest rates to firms or businesses they consider risky. This is due to the credit score of the organization or the individual. The variations in the charged interest affect the capital structure of the firm, and therefore it affects the firm's operations. On the other hand, debt capital has some benefits for the firm. When the interest rate rises, the interest payment cost is offset partially by the reduction of the firm's taxable income. According to Bandyopadhyay and Barua (2016) the cost of equity is the return of the business investment, enabling the management

to measure the requirements of the capital return. In most cases, the company uses the cost of equity as a threshold for the capital budgeting to determine the rate of return applicable (Ferris, Javakhadze & Rajkovic, 2017). The dividend policies have insignificant effect on the firm's value or the cost of equity, according to Bandyopadhyay and Barua (2016). In this argument, Bandyopadhyay and Barua (2016) relates how dividends are valued by investors than firms' future capital gains. If the firm's capital gains are taxed below the income from dividends, then increased dividends mean the reduced after-tax return of the shareholders who may have higher expectations of the pre-tax return rate. If the cost of equity increases, the firm may issue more debt relative to equity, consequently leading to a positive correlation between dividend payout and leverage (Herciu & Ogrean, 2017).

The relevance of dividend policy subsequently changes the market value of equity, thereby affecting the capital structure. Empirically many studies have carried out to test the hypothesis of this theory on the information. Herciu and Ogrean (2017), attempts to test the change in dividends and its implications on the profits and change in prices. The change in profits of a firm implies that there will be a change in benefits, and this has a significant signal to the market. The cost of equity by shareholders to keep the company at the peak is a capital structure factor. Shareholders expect a return on investments in terms of dividends. Conversely, the managers are looking on issuing debt to maximize the profits without considering the effect of debt on the dividends if the firm fails to honor contractual commitment to service the debt. The announcement of shares impacted stock prices as it was studied by Herciu and Ogrean, (2017). From this study, the increase in dividend increases considerably after the announcement of share prices. The study found out that the announcement of increased dividends has a positive change on the stock market prices regardless of the announcement of dividends before or after profits announcement. This implies that when announcing a change in dividends has a change in the prices of shares, the dividends' decrease has adverse effects on the returns.

Attitude of Investor and Capital Structure

The decision taken by the investors are directly linked to the firm's capital structure. There are external factors that influence the investor's attitude on purchasing shares from a firm. These factors are related to monetary policies and macroeconomic prospects in a given country. Liquidity is also another factor which can influence the decision of the investor. The main reason for an investment is to get returns. If the future of returns on investment would be certain then an investor would go for an investment with higher returns therefore the investors have to take risk in the decision making as described by Bandyopadhyay and Barua (2016). The attitude of the investor will depend on the risk of investment involved. Capital investment is very essential for the growth of the firm since they determine its value by influencing risk and profitability. The investment decision may involve expansion, asset acquisition or replacement, change of business marketing or production strategies is also a long-term investment. The investment decision causes some financial distress to many firms especially small-sized firms. The choice of the investors and the management is put to a dilemma because they don't know if there is optimal capital structure since the main object is wealth maximization and improving the performance of the form (Bandyopadhyay & Barua, 2016). Firm Managers use the status of the capital structure to pass message to the market and convince the investors. The firm can obtain financial assistance from

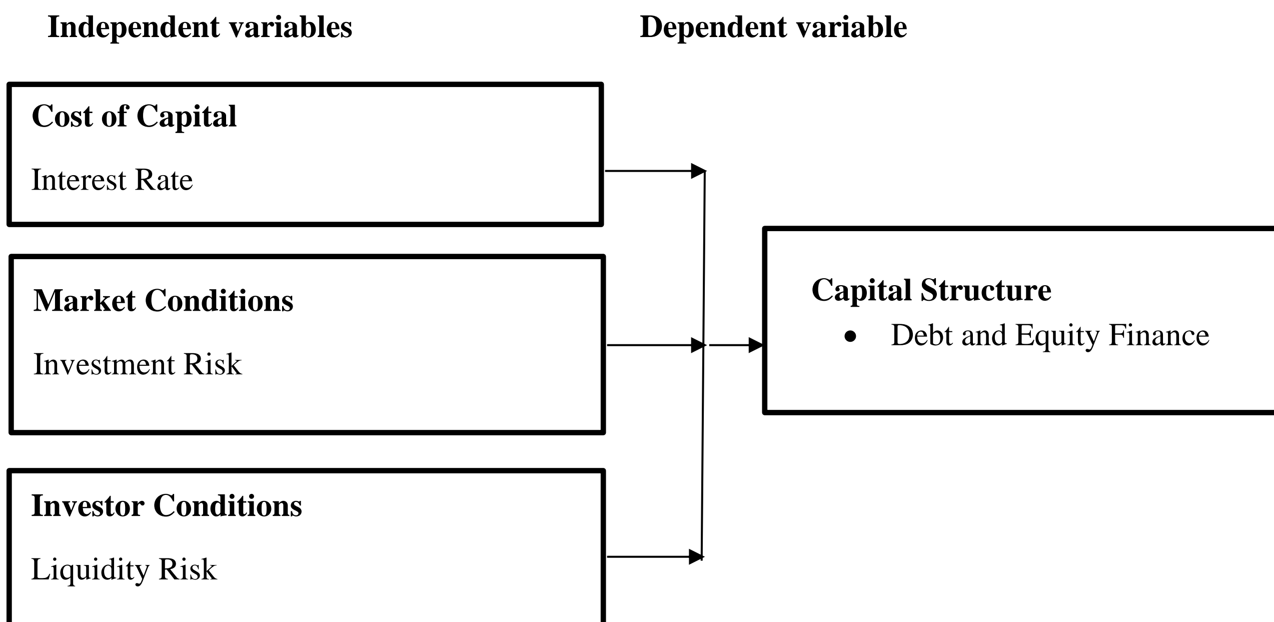
internal or external sources. The internal source includes the retained earnings, issuance of shares or loan stocks, while the external sources involve getting loans from the lending institutions. Investors are very considerate about liquidity when choosing an investment decision. One of the standard investment targets is liquidity and therefore when ignored can lead to suboptimal capital allocation. According to Dang et al., (2019), the attitude of the investor to purchase shares in a firm will depend on the liquidity measurement ratio so that liquidity risk can be evaluated. The investors normally check the forms liquid assets and compare them with the short-term liabilities. The firms with high debt obligations have liquidation risk (Ghasemi, & Ab Razak, 2016).

Market Condition and Capital Structure

Market condition is the situation of the market at a given time. The situation can also be as result of growth rate of the market. The business managers should always be updated of the changes in the market conditions and outside developments that have potential in affecting the business operations (Le & Phan, 2017). It is therefore very important to be ready to respond immediately at the same time changing plans to adjust to the changes. The changes in the market condition may affect the business capital structure positively or negatively depending on the condition. The market condition has correlation with the capital structure because it will determine the manager's choice of investment decision. The market conditions will determine the firm's capital structure because managers have the obligation to ensure that their stable adjustments to the prevailing market conditions. The manner in which business adjust or fail to adjust to their leverage due to market trends determines the sustainability of the business. The prevailing market condition such interest rates, governance and government policies influence the pattern of capital (Rani, Yadav & Tripathy, (2019). The choice of the investor to buy shares in a firm depends on the stage of the business cycle. Small and medium sized business which are not fully established and they are in dire need to for financial support may face numerous challenges to access finances because the risk of investment is high. The readiness of the investor to buy shares in a firm depends on the sustainability of the firm to be able to repay and adjust to its leverage. The taxation on the bonds and dividends is a factor of market conditions and discourage investors consequently affecting the capital structure. The changes in the market conditions in most cases affect the adjustments of the firm's debt with less impact of equity capital of the firm. The competition from other business is very important in determining the stability and performance of the firm. The competing firms may use different technology which is more efficient and time saving and therefore the manager is required to adjust to the market condition to remain in the business. When the competition is high it translates to reduced business hence affecting the capital structure.

Conceptual Framework

The structure exhibits the anticipated link between the predictor variables; (Market condition, Cost of capital and Investor's attitude) and the dependent variable (Capital structure). Figure 1 below clearly illustrates this.



Source: Researcher (2023)
Figure 1 Conceptual Framework

RESEARCH DESIGN

This is coherent and logical integration of the chosen strategy for different study components. The research design provides platform that answer research questions by incorporating all components of the study. A descriptive research method was employed to describe external elements affecting the capital structure of SMEs in Kitui County. According to Kothari (2004), a descriptive research design focuses on obtaining facts through surveying and enquiring, thus adding knowledge to the study topic. The population used was 150 SMEs in Kitui county, out of 150 the researcher come up with sample size to use on this study by exploring use of Krejci and Morgan, (1970) sample size determining formula.

$$\frac{n}{N} X\ 150$$

Where:
n = No. of SMEs in a Sub- County
N= Total No. of SMEs the County
Total Population was 150 SMEs operating in Kitui County with business permits licensed by the Kitui County Government

Data Analysis and Presentation

The study embarked on descriptive and inferential analysis of the collected data. Descriptive data analysis involves summarization of data by describing it in a meaningful way by use of graphs and tables. The inferential analysis is a way of estimating population parameters or characteristics by use of population sample. The process of making inferences and conclusions was guided by inferential statistics. In carrying out an inferential analysis, the study used multiple regressions to ascertain the external factors affecting the Capital structure of SMEs in Kenya. The researcher

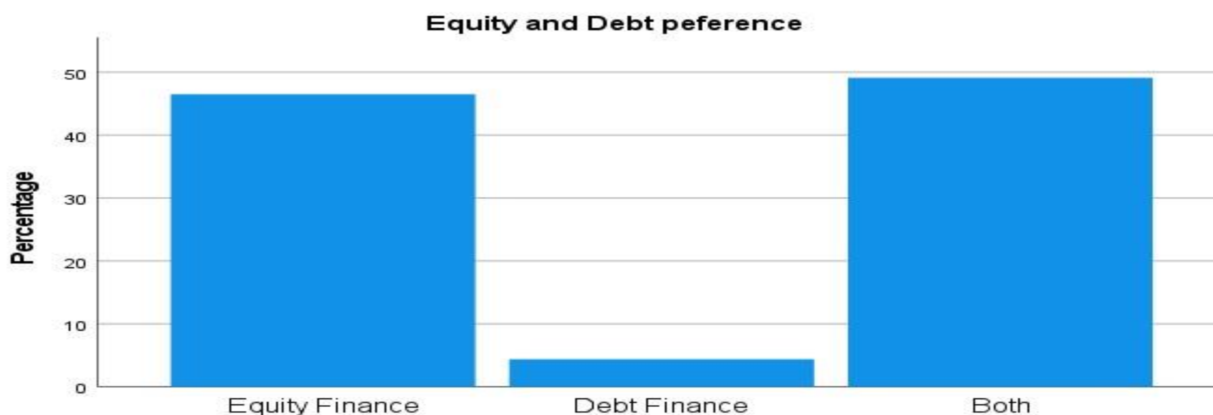
analyzed the data using SPSS, tabulation, charts, and diagrams were used to present the result. Multiple regression analyses were used where SMEs' capital structure was expressed as a function of the market condition, Cost of Capital, and Attitude of investor.

$CS = \beta 0 + \beta X1 + \beta X2 + \beta X3 + \alpha$ Where:
CS = Capital structure
β_0 = Slope of regression equation (constant)
X_1= Cost of capital
X_2= Market condition
X_3= Attitude of Investor
α= Residual Error

RESEARCH FINDINGS AND DISCUSSION

Equity and debt capital preference

To determine levels of preference between equity and Debt capital, data collected was run through SPSS and results obtained. 49.1% accounted for those who preferred both equity and debt finance for their business operations while 46.5% preferred equity finance. Only 4.4% of the respondents preferred debt finance in their business operation as presented in Figure 2 below.



Inferential Statistics

Table 1: Regression Summary

Model	R	R squared	Adjusted R	standard error of estimate.
1	0.341	0.116	0.92	0.93534

Predictors: (Constant), Investor's Attitude, Cost of Capital, Market Condition
Source: Study Data (2023)

This was done using multiple regression analysis to determine the significance levels. R of 0.341 clearly shows that 34.10% of independent variables affect Capital structure of SMEs while the remaining 65.9% can only be attributed to other factors outside this study, R squared of 0.116 means 11.6% of the variability observed market condition, cost of capital and investor’s attitude can be is explained by this regression model.

Table 2: Analysis of Variance

ANOVA TABLE					
Model	Sum of squares	DF	Mean of Squares	F	Significance
Due to Regression`	12.686	3	4.229	4.833	0.003
Due to Residual	96.236	110	0.875		
Total	108.921	108.921	113		

a. Dependent Variable: Capital structure
b. Predictors: (Constant), Investors Attitude, Cost of Capital, Market Condition
Source: Study Data (2023)

The regression model was also done using analysis of variance to establish levels of significance. The generated variance table shows that the population parameter has a 0.003 significance value which is below the significant level of (0.05) hence the model is significant. The computed F value (4.833) is higher than the F-critical 3.884 thus significant reject H0 on all factors affecting Capital structure and go for alternative H1 which state Cost equity, Investors Altitude and market condition have significant effect to the choice of capital structure to be employed by the firm.

Regression coefficients

The regression model enabled linking of the independent variable with dependent variable in this equation.

Table 3: Regression Coefficients

Model	Unstandardized Coefficient		Standardized Coefficient	T	Significant
Variables of study	B	Std. Error	Beta		
(Intercept)	-1.931	1.224		-1.577	.118
Market Condition	.857	.305	.289	2.810	.006
Cost of Capital	-.311	.227	-.141	-1.372	.173
Investor's Attitude	.407	.241	.170	1.690	.094
a. Dependent Variable: Capital Structure					

Source: Study Data (2023)

The regression model used was. $\mathbf{CS = -1.931 + 0.857X_1 - 0.311X_2 + 0.407\ X_3}$

When all independent variables are set to be constant at, the capital structure coefficient of SMEs in Kitui County turns to -1.931. This means that there is negative significant effect of external elements on capital structure of SMEs in Kitui County. Changes on variables interpretation - a poor

market working condition affect capital structure by 0.857 while a Positive investors' attitude would affect the capital structure by 0.407 and Market condition would have significant level of 0.006 while cost of capital had significant level of 0.173, and investor's attitude had 0.094 significant levels. This means that cost of capital and investors' attitude has a significance effect on the capital structure since significance level is more than 0.05 while market condition is insignificant since the significance level is less than 0.05. The residual error was assumed to be zero.

Recommendations

Cost of capital being one of the major external elements affecting SMEs capital structure, banks and money lending institutions should consider reviewing their security terms to accommodate and encourage SMEs access loans to boost their business operations. SMEs provide goods and services at affordable prices; create employment thus contributing gross domestic income. In this sense, this study recommends that both national and district governments ensure the full implementation of current policies for the SME sector, such as provision of incentives, protections of local SMEs from foreign business that suppress growth to ensure sustainability of this industry.

Additionally, the market conditions such as government policies and economic fluctuations affected majority of SMEs. Small and medium-sized enterprise industry being one of the sensitive industries to economic fluctuation, the current economic hardship orchestrated by the Covid-19 pandemic has hit SMEs hard affecting their capital structure. This study recommends that, the national and county governments should set up National agency to oversee and manage the establishments and operations of the SMEs in Kenya to formalize them.

Furthermore, majority of the SMEs consider the security of their business and thus they cannot undertake risky investments. The government should come up with training programs to SMEs to enable them to manage their businesses, be creative and innovative so that they can exploit the available business opportunities. This can be possible if both the County and National governments through the ministry of Trade and investment work together to facilitate these training programs.

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