CAPITAL STRUCTURE AND FINANCIAL PERFORMANCE OF SMALL AND MEDIUM ENTERPRISES IN EMBU COUNTY, KENYA

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DECLARATION

This research project is my original work and has not been presented for a degree in any other university.

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ABBREVIATIONS AND ACRONYMS

CMA   Capital Market Authority

GDP   Gross Domestic Product

GoK   Government of Kenya

ILO   International Labor Organization

IOSC   International Organization of Security Commissions

KIPPRA   Kenya Institute of Public Policy and Research Analysis

ROA   Return on Assets

ROE   Return on Equity

SMEs   Small and Medium Enterprises

SPSS   Statistical Package for Social Sciences

POT   Pecking Order Theory

MM   Modigliani Miller

GP   Gross Profit

NP   Net profit

STDTA   Short Term Debt to Total Asset

TDTA   Total Debt to Asset

DEFINITION OF TERMS

Capital Structure: Capital structure defines the way an organization obtain funds to finances its assets through various combination of equity, debt or hybrid securities (Peek & Rosengren, 2000).

Equity: Equity financing is money acquired for business from owners themselves, other investors, friends' contribution or ploughed back profits (Tabitha &Karanja, 2016).

Financial Performance: It is a subjective measure of how well a firm can use it asset to generate revenues. Financial performance is a measure of profitability and liquidity among other valuable tools, which are used to evaluate the past financial performance and the current financial position of the company (Stewart, 2011).

Short Term Debt Finance: Short term debt is money owed to the lenders and has a maturity period of one year or less (Pandey, 2010).

Long Term Debt Finance: Long term debt is money owed to the lenders for a period of more than one year from the balance sheet date. Long term debt can be categorized as either as financial liability or as operating liability (Tabitha &Karanja, 2016).

ABSTRACT

Financial decisions affect the financial performance of Small and Medium Enterprises 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. Despite their importance Small and Medium Enterprises are characterized by slow growth rate and three out of five Small and Medium Enterprises fail in their first three years of operation. The continued poor performances have led to decline in growth and eventually death of the Small and Medium Enterprises. The growth of the Small and Medium Enterprises highly depends on the investment decisions made by the entrepreneurs and lack of access to external finances has created a financial gap that has fueled the challenges that Small and Medium Enterprises face. The objectives of the study were to determine the effect of equity finance, short term debt finance and long term debt finance on financial performance of the small and medium enterprise in Embu County. The study adopted a descriptive research design and simple random sampling technique. The target population of study was 300 Small and Medium Enterprises from which a sample size of 60 Small and Medium Enterprises was drawn. Pretest 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 determined 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 statistical package for social sciences. Data analyzed capture descriptive statistic which included mean, standard deviation and variance. Inferential statistic included Pearson's correlation and multiple regression. The study revealed that Small and Medium Enterprises 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 Small and Medium Enterprises. Equity offered a lifelong financing option with no or minimal cash outflow inform of interest. The overdraft agreements and trade credits were also found to affect business operations. This was because the short term debt finance adapted easily to the firm's financial need, they required no collateral in order to obtain the funds and they were repaid over a short period thus no or minimal interest rate was charged. The correlation between the short term debt and financial performance was found to be positive and statistically significant. The study further showed that use of bank loans had increased while lease agreement, mortgage and factoring did not play a significant role in the financial performance of the Small and Medium Enterprises. The relationship between long term debt and financial performance was found to be positively correlated and statistically significant. The study also noted that the performance of the Small and Medium Enterprises was largely affected by the source of finance and the liquidity position of the business. The study therefore recommends that Small and medium Enterprises should embrace angel investors as equity financiers since they provide the start-up capital to the Small and Medium Enterprises. 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 Small and Medium Enterprises. Reduction on loan processing time and cost of borrowing will encourage entrepreneurs from accessing long term loans, mortgage and lease.

CHAPTER ONE
INTRODUCTION

1.1 Background to the Study

Small and medium enterprises are crucial to Africa's growth contributing more than 45% to employment and 30% to gross domestic product (GDP). In high income countries, SMEs contribute nearly to 64% to the gross domestic product and 62% into employment (CMA, 2010).In 2014, 85 percent of jobs created were dominated by the SMEs [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 external 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).

Capital structure debate has for over a long period of time been widely discussed with issues on capital structure being put forth by Modigliani Miller in 1958. In Modigliani Miller first preposition model argued that capital structure is irrelevant in determining the value of the firm and its future prospect. Under this preposition Modigliani Miller assumed that the investors have homogenous expectations, there exist no transaction cost and taxes. This model assumed that the investors operate in perfect capital market. Modigliani Miller 1961 in the second preposition argued further that the value of the firm can be increased by changing the capital structure which is due to presence of tax shield benefit on debt financing. Modigliani Miller disregarded the existence of perfect capital market in which the businesses operates in.

The study of capital structure on financial performance has helped us since then to know the potential problems in financial performance and capital structure (Baker & Martin, 2011). According to Chepkemoi (2015) earlier studies on general small firm capital structure have presupposed small and medium sized enterprises to predominantly act in such a way as to maximize their financial wealth.

A consequence of this presupposition is that, these studies have assumed that SMEs in general desire substantial growth and consequently have a desire for external finance. Academic research has documented that there are differences in financing patterns between SMEs and large firms and analyzed possible causes of these differences (Eliane, 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, 2015).

1.1.1 Capital Structure

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 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 a firm's financial resources (Narayanan, 2008).

1.1.2 Financial Performance

Financial performance is a measure of the financial health of a business over a period of time. Financial health of a business can be determined by comparing similar firms across the same industry or sectors in aggregation to enable a business make a decision on how it can improve on the prevailing situation or sustain a desirable position. Financial performance can also be a measure of organization earnings, profit appreciation in value as evidenced by the rise in the entity's share price (Asimakopoulous, Samitas & Papadogonas, 2009). To determine the appropriate performance indicators, it is necessary to establish the constituents of good performance. To be useful performance indicators must be specific, measurable, accurate and relevant to organization (Ross, Westerfield& Jaffe, 2009).

Hamilton (2010) asserts that fund managers use financial information in forecasting the value of business. Firms relied on their tangible assets to drive their performance and firm-level strategy. The financial performance of business is highly dependent on business strategies and operations in market and non-market environments. An investment today will determine the firm's strategic position many years. Hamilton further states that these investments also have a considerable impact on the organization's future cash flows and the risk associated with those cash flows. Amidu (2007) further suggest that profitability depends on how efficiently scarce resources are utilized and it is a very decisive element in the businesses whose overall goal is to maximize their profit and wealth of the owners in the short or long term.

1.1.3 Capital Structure Verses Financial Performance

Modigliani and Miller in 1958 in their preposition created a fictional world without taxes, transaction costs, bankruptcy costs, growth opportunities, asymmetric information between insider and outsider investors, risk level preferences between different firms and individuals. They brought forth the argument that under perfect market conditions financing decision is irrelevant and there is no optimal debt to equity ratio (Stewart, 2011). As company's debt levels gradually increase so does the probability of financial distress and bankruptcy rises. High level of debt finance utilization in a business increases the risk of default in payment of the debt. In the event that the corrective measures are not put in place in time, the business will eventually go bankrupt.

The present value of financial distress cost is a reduction in value firm. In these respect, financial distress costs are therefore the opposite of interest payments tax savings. In other words it reduces firm's value just as the tax savings increases firms value (Ross, Westerfield, Jaffe & Jordan, 2009). Increased company leverage could lead to possibility of falling free cash flows and profitability. Suppliers also tighten their credit standard resulting to falling accounts payables and increasing net operating working capital which in turn reduces cash flows. Despite tax advantage of debt, increasing debt to equity ratio can bring grave consequences for the firm. Firms must therefore increase their debt to equity ratio with care bearing in mind the possibility of bankruptcy (Earnhardt & Brigham, 2009).

1.1.4 SMEs in Kenya

The importance of 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 of 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 with a view of finance the SMEs [Kenya Institute of Public Policy Research Analysis (KIPPRA), 2007].

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, poor infrastructure, poor production capacity, 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 mechanisms (Gok, 2009). SMEs lack of access to finance is a major constraint to their growth in Kenya (Atieno, 2009).

1.2 Statement of the Problem

An optimal capital structure is the one that best suit the situation in which the business operates in, that is it leads to reduction in cost of capital while maximizing the value of the firm. Lack of financial resources and poor business management practices are some of challenges that SMEs face. However, a number of SMEs are experiencing a declining performance and continuously report poor performance due to poorly thought out capital structure decisions. Their survival rate and growth rate are therefore extremely low. According to [Kenya National Bureau of Statistics, (KNBS, 2016)] micro, small and medium establishment that shut down were in wholesale and retail as well as in repair of motor vehicle and motor cycle repair which account for 73% of total closure. The main reason cited for the business closure was shortage of operating fund as reported by 30% of the businesses owing to increased operating expense, declining income and losses incurred.

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. Poor performance of the SMEs has 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.

1.3 General Objective

The broad objective will be to assess the relationship between capital structure and financial performance of SMEs in Embu County, Kenya.

1.3.1 Specific Objective

1. To establish the effect of equity financing on financial performance of SMEs in Embu county.
2. To assess the effect of short term debt financing on financial performance of SMEs in Embu county.
3. To establish the effect of long term debt financing on financial performance of SMEs in Embu county.

1.4 Research Questions

1. How does equity financing affect financial performance of SMEs in Embu County?
2. How does short term debt affect financial performance of SMEs in Embu County?
3. How does long term debt affect the financial performance of SMEs in Embu County?

1.5 Scope of the Study

The study laid emphasis on the impact of capital structure on financial performance of the SMEs in Embu County. The major focus was Embu town, because it had the largest number of registered SMEs compared to other towns within Embu County. The number of SMEs have continued to increase and thus resulting to vibrant growth. Embu town host many government and non-government organizations which seeks service or goods provision from the SMEs.

1.6 Significance of the Study

The knowledge on capital structure decisions is important to investors as it provides vital information to current and prospect investors on how capital structure affects the performance of companies, the consequences of such choices and how to evaluate the future performance of the firm. This research work is of benefit to the business community as it provides knowledge in the area of financial innovation and the investment opportunities at their disposal.

Financiers are keen on the performance of a company in order to get the assurance of adequate returns and timely repayment of the debts. The study findings would provide data that may help in determining their involvement with the SMEs.To the firm management team, the capital structure decisions impact on firm performance and as a result the management would be interested to know how the current choices affect the company financial performance, how any change in the capital structure affects the performance. To the academicians and scholars, the study is a contribution to the existing knowledge on capital structure determinant and it effect on financial performance of the SMEs.

CHAPTER TWO
LITERATURE REVIEW

2.1 Introduction

This chapter comprise of the research work done on capital structure, reviewing relevant literature on capital structure and its effects on financial performance of SMEs. It discusses theoretical review including theories on equity financing, long term debt financing, and short term debt financing on financial performance. Also included in this chapter is the conceptual framework, empirical literature, summary of the empirical literature and the research gaps identified.

2.2 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. This study adopted three theories namely: market timing theory, static trade off theory and agency cost theory.

2.2.1 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 such as fringe benefits employed in some kind of employment 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 (Calabrese, 2011).

2.2.2 Static Trade off Theory

This theory was first developed by Modigliani and Miller in 1958. It states that a target debt equity ratio is approached at the point where the advantage of debt is offset by the cost of prevailing market imperfections (Drodetz & Wenzenried, 2006). This theory has been used by different authors to describe a family of related theories.

In all these theories, a decision maker running a firm evaluates the various costs and benefits of alternative leverage plans. Often it assumed that an interior solution is obtained so that marginal cost and marginal benefits are balanced. This theory grew out of the debate over the Modigliani and Miller theorem when corporate income tax was added to irrelevance theory, this created a benefit for debt in that it served to shield earnings from taxes since the firm's objective function is linear and there is no offsetting cost of debt, this implied 100% debt financing (Caroline & Willy, 2015). This theory posits that there is an optimal capital structure which maximizes the firm's value and minimizes the cost of capital. It is a belief that the firm's value cannot be the same at different levels of capital structure (Ogebe, Ogebe & Alewi, 2013).

Firms would prefer debt over equity up to a point where the probability of financial distress and bankruptcy cost outweigh the tax benefit associated with debt (Gill, Biger, Mand & Shah, 2012). Debt has some influence on the risk of going bankrupt. The disadvantage of debt is that it increases the possibility of going bankrupt by producing cost for the organization which includes direct and indirect cost. Direct costs include administrative fees and legal fees. Indirect cost are cost which are not directly related to the possibility of going bankrupt (Jaffe, Ross & Westerfield, 2009). Debt is preferred due to its cost advantage of the tax shield benefit but on the other hand it exposes the business to chances of financial distress (Wanyoike, 2015). The possibility or default on debt increases with the increase in levels of debt beyond the optimal point. Should the firm default on repayment of the loan; the control of the firm will be shifted from owners to debt financiers who will try to repossess their investment through the process of bankruptcy (Anthony, 2013).

2.2.3 Agency Cost Theory
This theory suggests that the capital structure of firms is determined by agency cost which includes the costs for both debt and equity. In addition, when a firm issues debt, chances of investing in high-risk projects will be high. Managers or owners will invest in high risk project for the purpose of higher returns. The interest on the debt-finance does not increase no matter how much return is obtained from such high risk project. However, the debtors stand at risk if the higher risk does not produce favorable outcome.

If debtors anticipate investment in high risk project, a higher premium or interest will be required, which in turns increase the costs of debt. (Neuman, 2003). SMEs are less preferred candidates for external finance and are likely to be unsuccessful in their fund raising efforts (Canales & Nanda, 2012). Large SMEs are deemed to be more likely to use larger number of financing instruments including bank loans, state subsidized financing and equity, in comparison to smaller SMEs, which are more likely to use internal finance, flexible short term debts and trade credit financing. Larger firms have lower information asymmetries and can therefore access a broader range of financing sources, whereas smaller firms are more likely to use external finance (Artola & Genre, 2011).

2.3 Conceptual Framework

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

Equity Financing
- ❖ Angel investor
- ❖ Ploughed back profit
- ❖ Friends contributions
- ❖ Retained profit

Short term Debt financing
- ❖ Trade credit
- ❖ Account receivable financing
- ❖ Overdraft agreement

Long Term Debt Financing
- ❖ Bank loan
- ❖ Leasing
- ❖ Factoring
- ❖ Mortgage

Financial performance
- ❖ Profit margin
- ❖ Return On Equity
- ❖ Liquidity
- ❖ Sales growth

Independent variable   **Dependent variable**

Figure 2.1 Conceptual Frame work on Capital Structure and Financial
        Performance of SMEs in Embu County, Kenya

2.3.1 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 or 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 and the 'contentment hypothesis' argues that SMEs attach a greater utility value on connection and relationship than financial wealth. 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).

2.3.2 Short Term Debt Financing

Debt capital is typically raised with principle and interest payment and finite maturity period (Arnold, 2008). Debt financing is one of the firms most favorable source of funding due to many advantages that comes with it utilization. Short term debt financing has the following advantages; zero interest rate in some short term debt cases such as trade credit, lower nominal interest rate, short term debt is easy to adapt according to the firm's financial needs and lower cost of floatation as compared to long term debt (Arnold, 2008).

According to García & Martínez (2010) trade credit is a delay in the payment for goods or services after they have been delivered or provided as a result of an agreement between the supplier and the firm. Overdraft agreements are usually used to finance the business working capital or solve the business liquidity problem. It is usually unsecured, can be used without restrictions, raised very fast and therefore useful in solving immediate liquidity problems, financial constraint in the business are short lived (García & Martínez 2010). Account receivable represent funds received by the firm for goods and services which it has agreed to supply in future. The receipt increases the liquidity position of the business. Accrued expenses include taxes which are payable when business makes profit while accrued interest is paid periodically during the year while the borrowed funds are continuously used in the business (Pandey, 2010)

2.3.3 Long Term Debt Financing

Long term debt is money that is owed to lenders for a period of more than one year from the date of current balance sheet (Tabitha & Karanja, 2016). Long term debt financing include factoring, lease, mortgage and bank loan. Long term loans are more preferable source of debt financing among well-established corporate institutions. Mostly by the virtue of their asset base and collateral as a requirement of many deposit taking institutions such as industrial development banks, cooperative banks, commercial banks and other financial institutions, who grant medium term loans for a period of three to five years with an agreement on cost interest rate on principle amount (Munyuny, 2013). SMEs in their limited asset base have no potential of servicing long term loans as a major instrument of debt financing hence having it as a major constraint in borrowing funds to finance their operations. This in return limits sources of financing available to SMEs (Munyuny, 2013). Factoring is a financial service and not a loan where an enterprise sells its accounts receivables in the form of invoices to a factor at a discount in exchange for immediate cash and a range of services including credit protection, accounts receivable bookkeeping, collection services, and financing (Klapper, 2006; Vasilescu, 2010).

He and Matvos (2013) state that leveraging may increase the risk of bankruptcy and financial distress during temporary industrial and economy wide down turn, it will become increasingly difficult to attract more debt for investment purpose as creditors will charge high interest rate to compensate for high business risk. Debt capital is considered a double edged sword since an increase in debt means an increase in firm's risks and financial distress. First, debt can amplify the loss if a debt financed firm performs poorly. Secondly, funding with debt implies that firms have to bear the cost of financial distress, agency cost and financial risk. Therefore, debt management has been a crucial task for every business which aims to optimize the benefits of debt capital and minimize the risk it might bring (Brigham & Houston, 2007). Cecchetti, Mohanly and Zampolly (2011) concluded that moderate debt levels improves the welfare and enhance growth of the firm. High levels of debt will constrain the firm from undertaking projects that are likely to be profitable because of the inability to attract more debt from financial institutions.

2.3.4 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 gross profit margin, net profit 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.

2.4 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.

Shubita & Alsawalhah (2012) studied the effect of debt financing on performance of the firm. The study comprised of a sample of 39 Jordan companies revealed that significantly negative relation exist between debt and profitability. These showed that an increase in the debt position was associated with decrease in profitability thus the higher the debt the lower the profitability of the firm. Abdul (2012) researched on the relationship of capital structure decisions with firm performance of the engineering sector of Pakistan, the results showed that financial leverage measured by short term debt to total assets (STDTA) and total debt to total assets (TDTA) had a significantly negative relationship with the firm performance measured by Return on Assets (ROA), and return on equity (ROE) had negative but insignificant relationship with leverage. Firms in the engineering sector of Pakistan were largely dependent on short term debt but debts were attached with strong covenants which affected the performance of the firms. Ahmad, Abdullar & Roslan (2012) studied capital structure and effect on performance in Malaysia. The study established that short-term debt and long-term debt had significant relationship with ROA. It was also established that ROE had significant relationship with short-term debt, long-term debt and total debt.

Kamau (2010) conducted a study on the relationship between the capital structure and financial performance of insurance companies in Kenya. He 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. Chepkemoi (2013) studied the analysis of the effect of capital structure of small and medium enterprises, on their financial performance in Kenya. The result signified that there is a negative relationship between capital structure and profitability. 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.

2.5 Summary of Reviewed Literature

Many researchers have come up with a number of theories on the effect of capital structure on financial performance of firms. Market timing theory acknowledges that firms prefer equity financing when they perceive that its relative cost is low. Equity financing is important source of income and have a positive relationship to the performance of the business. SMEs prefer using internal equity, deferred income or retained earnings first before using new debt. Firms that use equity finance are able to make it performance better since there is direct control (Caroline& Willy, 2015).

Trade off theory argues that the firm should not use debt financing beyond a point where the cost of debt is higher than tax advantage. In the trade-off theory firms weigh the costs of borrowing against the benefits of debt financing. The cost of borrowing includes interest payments and bankruptcy cost. The benefit of debt financing includes the tax deductibility of interest payments and the discipline instilled on the management. The trade-off theory says that the value of the firm is equal to the value of unlevered firm plus the value of side effects, which include the tax shield and the expected costs due to financial distress (Brigham & Earnhardt, 2005). States that debt is cheaper than equity and as such a firm can increase the value by borrowing up to reasonable limit.

Agency theory suggests that the capital structure of firms is determined by the agency cost for both debt and equity. Amidu (2007) argued that small firms are often managed by very few managers whose aims and objectives is to minimize the intrusion in their businesses and that is why internal funds will lie in the first place of their preference. If internal funds are not enough, small firms will prefer debt to new equity mainly because debt means lower level of intrusion and lower risk of losing control

2.6 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 many studies have been carried out but there is no one specific to Embu County. There is very little that has been done to provide viable solution on option of financing which will enhance the financial performance of the SMEs. This study will therefore be conducted in order to fill the gaps in literature by studying variables on financial performance of SMEs in Embu County.

CHAPTER THREE
METHODOLOGY

3.1 Introduction

This chapter sets out various stages and phases that were followed in completing the study. Specifically the following subsections of research methodology were included; research design, target population, sampling technique, sample size, data collection instruments and procedures, pretesting of research tools and finally data analysis.

3.2 Research Design

A descriptive survey research design was employed in this study. A descriptive design was 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. It may be used to justify current practice and make judgment and also to develop theories.

3.3 The Target Population

The target population comprised of all SMEs in Embu County. Embu County has a population of 10,611 registered businesses units comprising of both formal and informal businesses according to County Enterprise Development Office (2015). The major focus was on the accessible population. The accessible population is that proportion of the population that the researcher can access easily and conveniently. The accessible population for the study was 300 registered SMEs in Embu town, this is because they had permanent establishment where they were easily located.

3.4 Sampling Technique and Sample Size

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

3.5 Data Collection Instruments

The study used self-administered questionnaire to collect primary data. The questionnaire consisted of open and close ended questions. A five step Likert scale was used for close ended questions.

Closed-ended questions in the questionnaire were used to help in standardizing and quantifying responses from the research. The open-ended questions in the questionnaire were meant to ensure that an in-depth data that is detailed and explorative of all aspects of the variables under study were obtained.

3.6 Data Collection Procedure

The questionnaires were administered by the researcher to the owners or managers of the selected SMEs. The target respondents were the business owner or managers who filled in the questionnaires. This is because they had vast and adequate knowledge about the business, considering their crucial role in management. Confidentiality of the collected information was emphasized by the researcher to the respondents. Secondary data was collected through financial statements of the firms.

3.7 Pretesting of Research Tools

To ascertain the validity and reliability of questionnaire, pretesting of the questionnaire was conducted. Mugenda (2003) states that, the pre-test sample is of characters ranging from 1% to 10% of the sample population. Therefore the pretesting of the questionnaire targeted 6 registered SMEs outside Embu town, which is the 10% of the sample size.

3.7.1 Validity

Content validity was used as validity test. Content validity is improved through proper assessment of the relevance of the content used in the questionnaire by an expert (Orodho, 2002).

3.7.2 Reliability Test

Cronbach alpha coefficient was used for reliability test where a threshold cut off point of 0.7 and above was used. Reliability is the ability of a research instrument to consistently measure the characteristics of interest over time. According to Orodho (2005) a reliability test of research instruments is one that consistently produces the expected results.

3.8 Data Processing and Analysis

Data collected from the primary survey was compiled, sorted, edited, classified and coded. A computerized data analysis package known as Statistical Package for the Social Science (SPSS) version 21was used for analysis.

Descriptive statistics tools including the mean, standard deviation mode and variance was used as shown in Equation 3.1. Tables, charts and graphs were used for purposes of presenting the findings of the study. The regression model for the study is as shown in the equation 3.1.

$$Y = \beta 0 + \beta_1 X_1 + \beta_2 X_2 + \beta_3 X_3 + \varepsilon \dots\dots\dots\dots\dots\dots\dots\dots\dots\dots\dots\dots\dots\dots\text{Equation 3.1}$$

Where:

Y is the financial performance, β_0 is the y-intercept (constant) whose influence on the model is insignificant, $\beta_1 \dots \beta_3$ is the slope which represents the degree with which firm performance Changes as independent variable changes with one unit variable, X_1 is equity component X_2 is long term debt component, X_3 is the short term debt component while ε represents error term. The model significance was tested using the analysis of the variance (ANOVA) by use of F statistics at 95% confidence level. The coefficient of determination R^2 was used to show the contribution of independent variable on the dependent variable.

Table 3.2 Statistical Analysis Table

Objective	Independent variable	Dependent variable	Statistical tools	Means of data collection
To establish the effect of equity financing on financial performance of SMEs in Embu county.	Equity finance	Financial performance	Mean Median Standard deviation Variance	Questionnaire
To assess the effect of short term debt financing on financial performance of SMEs in Embu county.	Short Term debt finance	Financial performance	Mean Median Standard deviation Variance	Questionnaire
To establish the effect of long term debt finance on financial performance in Embu county.	Long Term debt finance	Financial performance	Mean Median Standard deviation Variance	Questionnaire

CHAPTER FOUR

RESEARCH FINDINGS AND DISCUSSIONS

4.1 Introduction

This chapter gives an analysis and interpretation of the result. The study sought to determine the relationship between the capital structure and the effect it has on financial performance of the SMEs in Embu County. The data was collected by use of the questionnaires which were administered to the 60 SMEs that formed the sample size for the study.

4.2. Response Rate

The response rate was 68.3% which was attributed to by self-administering of 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.

4.3 Results of the Pretesting of Research Instrument

The study sought to determine the reliability of the research instruments. The results are as shown in Table 4.1.

Table 4.1: Cronbach Alpha for Reliability Assessments

Variables	Cronbach Alpha Values
Equity finance	0.791
Short Term Debt	0.772
Long Term Debt	0.781

The result of the cronbach alpha coefficient as shown on Table 4.1 for the different items was between the ranges of 0.772 to 0.791. The instrument therefore met the recommended threshold of value above 0.7.

4.4 Background Characteristics

The study sought to establish the background characteristics of the SMEs and respondents based on gender, age, position held and education level of the respondents.

4.4.1 Gender of the Respondents

The study sought to establish the gender composition of the respondents in Embu town. Figure 4.1 showed that 73% of the respondents were female while 27% were male. This indicated that many businesses were operated and managed by female entrepreneurs compared to the male counterparts.
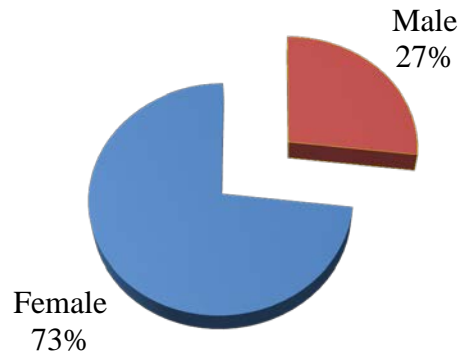

Figure 4.1: Gender of the Respondents

4.4.2 Age of the respondents

The study sought to determine the age composition of the respondents. Figure 4.2 revealed that the highest number (34%) of the respondent were between the ages of 36-45 years. Further it was also noted that 29% of the respondents were of between the ages of 26-35 years, while 27% of the respondents were above the age of 46 years. Only 10% were between the ages of 18-25 years. This acknowledged that many entrepreneurs' falls within the age bracket of 36 to 45 years of age as compared to the youngest entrepreneurs. This was attributed to by the government initiative in job creation through youth and women empowerment projects.
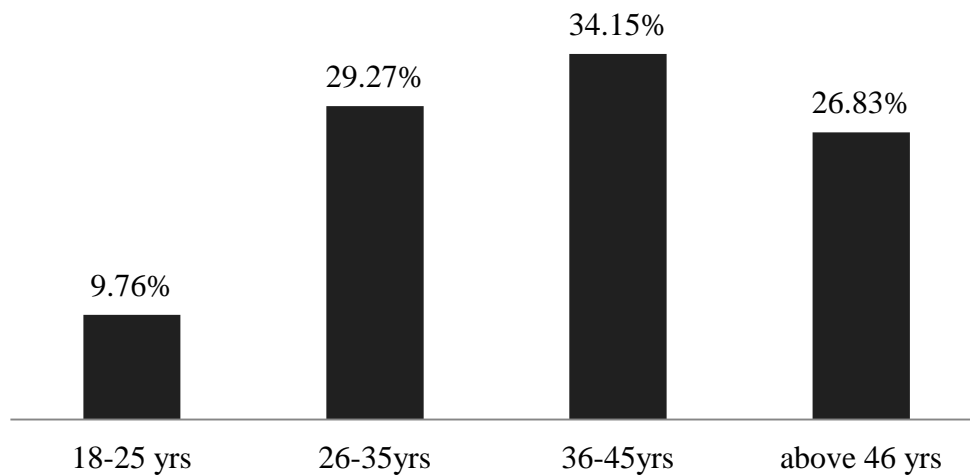
Figure 4.2: Age of the Respondents

4.4.3 Position Held by the Respondent

The study sought to establish the position held by the respondents. Figure 4.3 indicated that 59% of the respondents were managers and proprietors of the businesses, while 24% were proprietors and 17% were managers. This indicated that most of the businesses within Embu town were managed by the owners, while 17% of the respondents were employed to manage the businesses
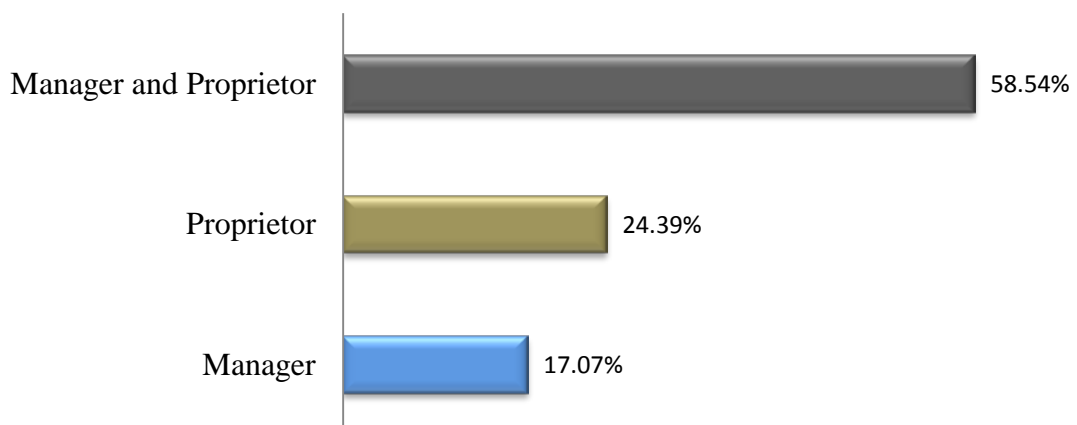

Figure 4.3: Position Held by Respondents

4.4.4 Education Background

The study sought to determine the education level of the respondents. Figure 4.4 revealed that the highest level of education attained by the respondents was bachelor's degree which represented 39% of the respondents, 33% had a diploma certificate, 24% had a secondary school certificate and 2% had primary and post graduate certificates

respectively. This indicated that the businesses are managed by the elite group of the society which understood the questions asked.
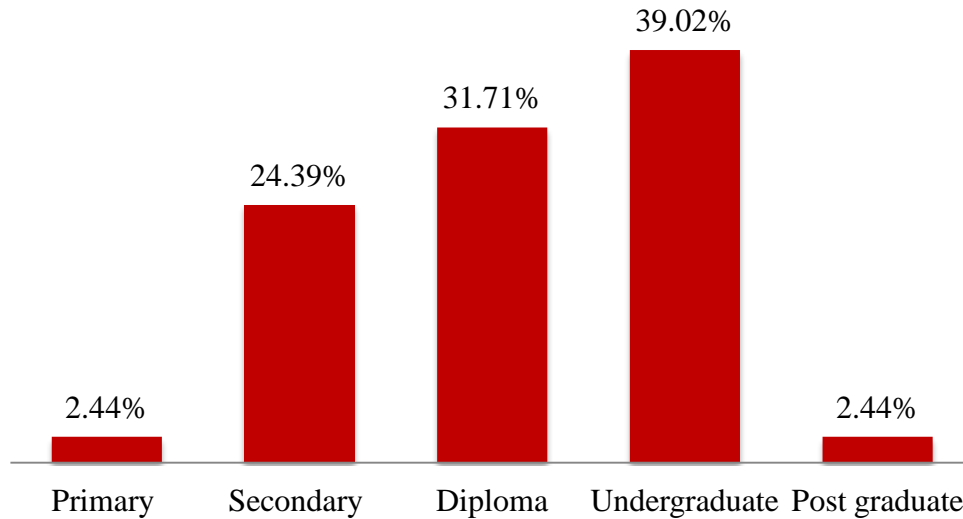

Figure 4.4: Education Level of the Respondents

4.5 Firm Characteristics
The study further sought to establish the firm characteristics which include the period of firm existence, category of business, legal status of business, number of employees, capital size of the firm and annual sales volume.

4.5.1 Period of Firm Existence

The study sought to establish how long has the business been in existence. Figure 4.5 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.
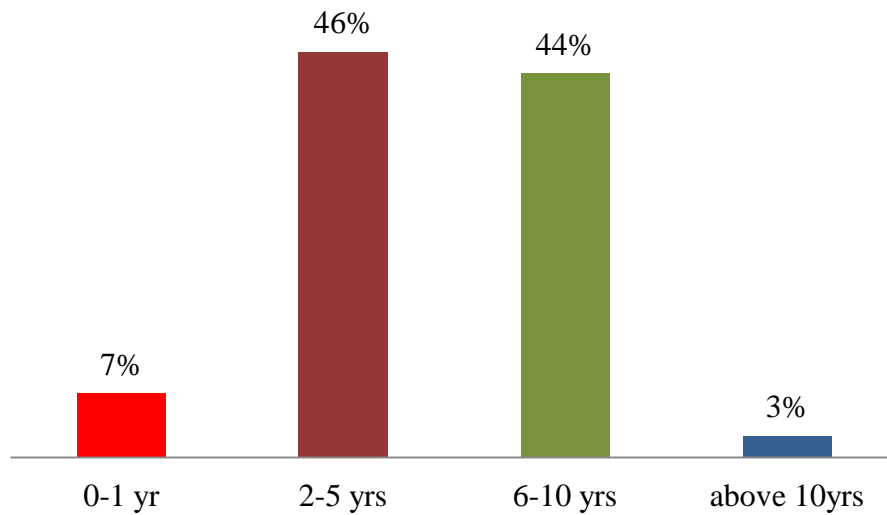
Figure 4.5: Period of Firm Existence

4.5.2 Category of the Business

The study sought to identify in which category the business units belonged to. Figure 4.6 revealed that 51% of the SMEs were in the service segment which comprised of hotels, beauty spa, cyber café, security firms, while 44% represent the trade industries which comprised of general shops, hardware shop, book stores and supermarkets. Manufacturing segment comprised of 5% which comprise of water processing and yoghurt processing firms. This indicated that many entrepreneurs in Embu town have higher preference for business units in service segment as compared to manufacturing sector.
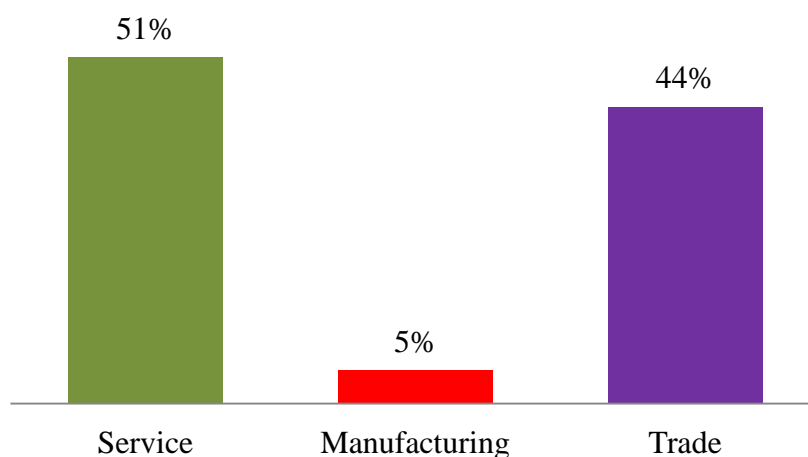

Figure 4.6: Category of the Business

4.5.3 Legal Status of the Business

The research study sought to determine the legal status of the businesses. From Figure 4.7 it 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.
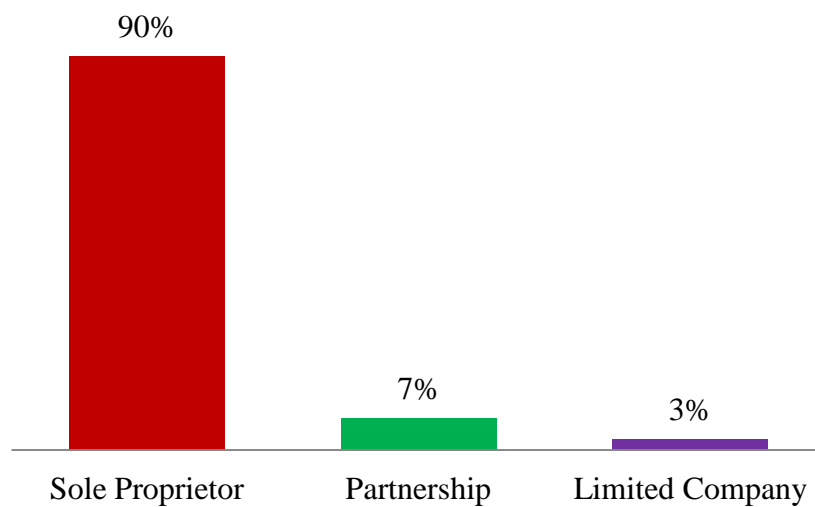
Figure 4.7: Legal Status of the Business

4.5.4 Number of Employees

The study sought to determine the number of employees on engagement. Figure 4.8 established that the firms with less than 5 employees were 84%, with 5-10 employees were 12% while those businesses with 10-15 employees were 2% and firms with above 15 employees were 2%. This outcome was due to the fact that most businesses were sole proprietor kind of businesses and managed by the owner or less than 5 employees.
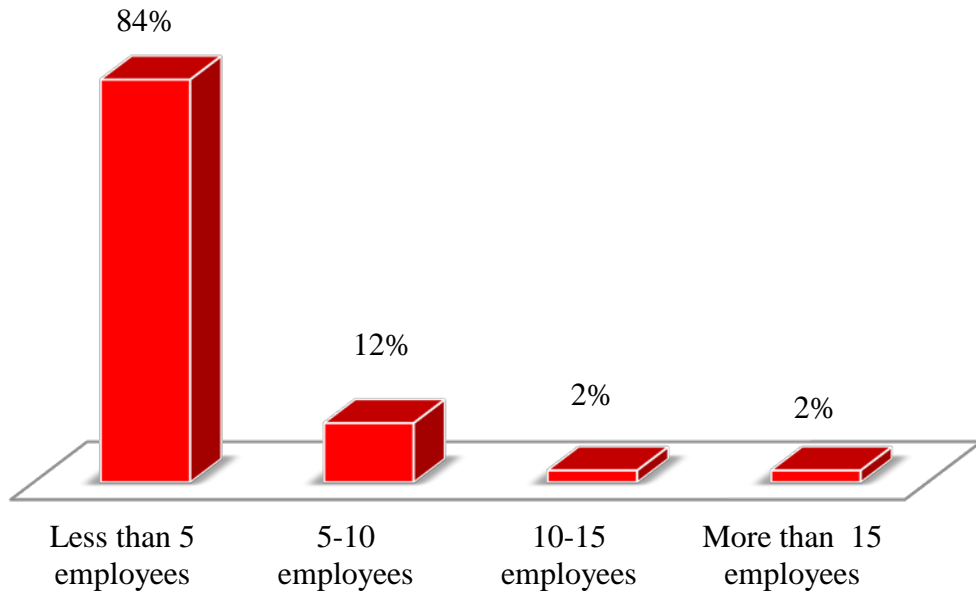
Figure 4.8: Number of Employees

4.5.5 Capital Size of the Firm

The study sought to establish the capital size of the firm. Figure 4.9 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 indicated 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 low levels of fixed assets such as land and buildings because the SMEs are operated on rented premises.
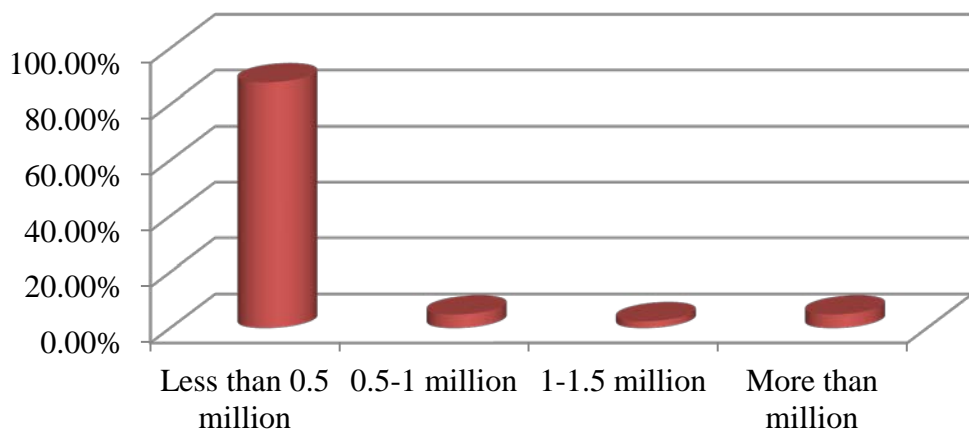
Figure 4.9: Capital Size of the Firm

4.5.6 Firms Annual Sales Turnover

The study sought to determine the annual sale turnover of the businesses within Embu town. From Figure 4.10 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.
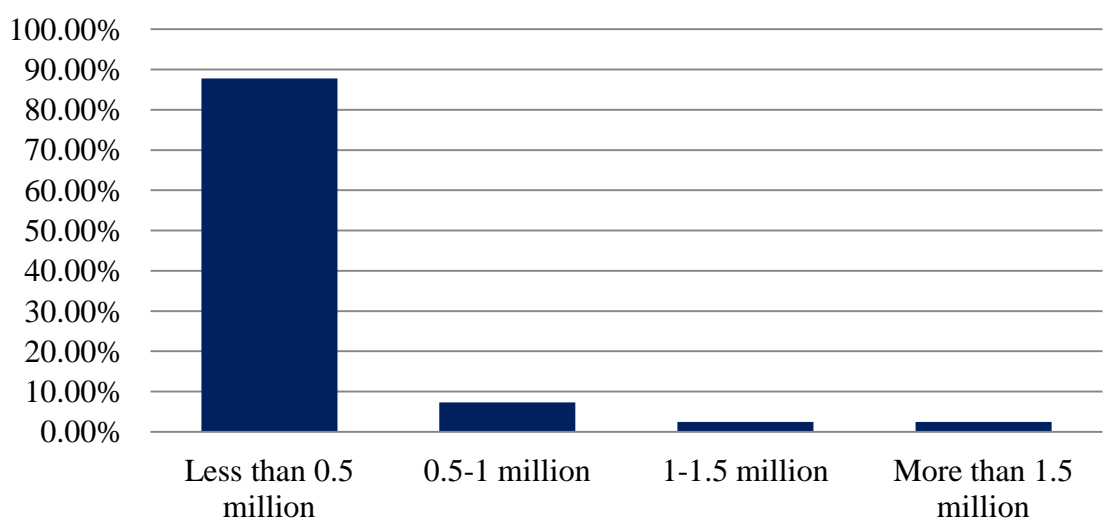
Figure 4.10: Firms Annual Sales Turnover.

4.6 Descriptive Statistics

This section gives analysis of the descriptive findings and discussion in relation to the capital structure and financial performance of the SMEs. The results were presented using the measure of central tendency and variation standard deviation. The result obtained were interpreted based on a 5 likert scale (5= strongly agree, 4= agree, 3= not sure, 2= disagree and 1= strongly disagree).

4.6.1 Equity Financing

The study sought to determine how various forms of equity finance options affect the financial performance of the SMEs. The study findings on Table 4.2 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 were neutral on (mean=3.20: std dev= 1.364) whether retained profits used to finance long term growth of the business actually affected the financial performance of the business. The respondents further disagreed (mean=2.68: std dev= 0.789) 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 to use the money to finance other business activities.

The findings concur with Bell and Vos (2009) asserts that the owners of the SMEs have strong preference for funding option which have minimal or no intrusion into the business. Many small businesses are established as family businesses which may not pursue growth strategies in the business but attach greater value on connections and relationship at the expense of financial wealth. According to Brettle (2003), German entrepreneurs ranked business angels as the most preferred and desirable fund provider. This was due to the fact that they play a very active role in the initial stages of business development by providing start-up capital. SMEs are opaque and for the external investor implementation and control of these ventures may be difficult and costly. These create problems to potential investors in valuing the venture and making investment decision on these ventures. This was evidenced by the strong preference of using contribution from friends and ploughing back of profit to run the business rather than use of angel investors.

Table 4.2: Descriptive Statistic 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	3.20	1.364	1.861
Angel investor as source of finance	41	1	5	2.68	.789	.622
Friends contribution	41	1	5	4.61	.737	.544

4.6.2 Short Term Debt Finance

The study sought to determine how various forms of short term debts affect the financial performance. The study findings on Table 4.3revealed that, the respondents (mean= 4.24: std dev = 0.943) agreed that the overdraft agreement affects the way business operates. Similarly they agreed to using credit financing as a source of short term debt (mean =3.54 std dev = 1.567). Respondents were not sure whether (mean=3.37 std dev= 1.260) use of accrued expenses to finance the business operations would influence financial performance of the business, nor use of deferred income (mean=3.22: std dev=1.314) would increase the working capital of the business.

This implied that overdraft agreement and credit financing were ideal when business had uneven sales structure because they helped reduce cash flow shortages. Likewise businesses were able to keep up with seasonal trends when they required more capital during certain period especially the festive season. Businesses that had poor credit records taking up short term loans and adhering to the repayment schedule were effectively able to boosting their credit worthiness over time.

The findings concur with Arnold (2008) that overdraft has more advantage compared to other forms of short term debt. Being part of short-term debt, the overdraft balance is not normally included in calculations of the business' financial gearing. Garcia & Martinez (2010) were in agreement that most of the larger firms in United States extended more trade credits to their customers during financial crisis. Companies that highly depend on short term loans reduce the amount of debt in long term. This is because the short term debt matures within a year.

Table 4.3: Descriptive Statistic on Short Term Debt Financing

	N	Min	Max	Mean	Std. Dev	Var
Trade credit financing	41	1	5	3.54	1.567	2.455
Use of deferred income to increase working capital	41	1	5	3.22	1.314	1.726
Overdraft agreement affect business operations	41	2	5	4.24	.943	.889
Accrued expense to finance its operation	41	1	5	3.37	1.260	1.588

4.6.3 Long Term Debt finance

The study sought to establish how long term debt finance affects the financial performance of the SME. The study as shown in the Table 4.4 revealed that the respondent agreed that there has been an increasing trend on usage of bank loans (mean= 4.76: std dev =0.489) to finance business operations. Further they disagreed on usage of factoring (mean = 2.41: std dev = 0.921), lease agreement (mean= 2.37: std dev = 1.135) and mortgage (mean=2.10: std dev=0.944) in financing of the business operations.

This implied that the use of bank loan in financing business ensured retention of ownership and control of the business. They were also secured on the assets of the business which acts as a collateral. Businesses with more tangible asset often got long term loans with ease as compared to businesses with intangible assets. Interest on debt provided a tax shield which reduced the amount of tax payable thus increasing the amount of funds required to finance other business activities.

The findings were in agreement with the findings of Cassar (2004) who concluded that the larger small firms rely more of long term debt and external financing including bank loans. Vera and Onji (2010) and Ono and Uesugi (2009) in their findings concluded that SMEs rely more on bank loans. Despite the fact that bank loans are more expensive as compared to other forms of finances, they generate more returns for the SMEs. SMEs tend to employ the funds more efficiently when they are monitored by

and answer to the banks on the utilization of the funds. Banks do not only provide the much needed finances to the entrepreneurs to establish new business or expand the existing businesses but also provide a variety of services including training (Abdulazis & Andrew, 2013).

This was in agreement with Trisha (2011) who found that Ghanaian SMEs had high preference to term loans due to their repayment structure which is in line with the business cash flows. As a result the payment date for this type of loan is structured in such a way that it coincides with the period when the business has made extra money to pay the loan.

Table 4.4: Descriptive Statistic on Long Term Debt Finance

	N	Min	Max	Mean	Std. Dev	Var
Use of lease agreement to acquire asset	41	1	5	2.37	1.135	1.288
Use of mortgage in business	41	1	5	2.10	.944	.890
use of factoring to finance operation	41	1	5	2.41	.921	.849
Use of bank loans have increased	41	3	5	4.76	.489	.239

4.6.4 Financial Performance of SMEs

The study sought to determine the financial performance of the SMEs. The findings revealed that on Table 4.5, 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. These findings

concur with Arnold(2008), holding cash provide some advantages such as provide the payment of daily expenses such as salaries, raw materials and taxes; due to the fact that cash flows are uncertain holding cash gives a safety margin for eventual downturns; ownership of cash guarantees immediate response to highly profitable investment.

Table 4.5: 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

4.7 Inferential Statistics

This section gives an analysis of the relationship between dependent and independent variables.

4.7.1 Correlation between Equity Financing and Financial Performance

The relationship between equity financing and financial performance was analyzed and results are shown on Table 4.6. 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 is because the SMEs in Embu desired to retain the control of the business. These findings concur with Garcia- Terul and Martinez- Solono (2007) who agreed that equity has a positive relationship to financial performance of the SMEs. They further agreed that small and medium size entrepreneurs' have strong preference for use of equity as a source of finance. Boating and Jones (2003) also noted a positive relationship between equity and financial performance. 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 (Ou & Hayne, 2006).

Table 4.6: Correlation between Equity Financing and Financial Performance

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

4.7.2 Correlation between Short Term Debt and Financial Performance

The analysis of the relationship between short term debt and financial performance is as shown in the Table 4.7. The correlation between short term debt and financial performance was found to be positively correlated (r = 0.552). The study further depicted that there is a statistical significance since the p value 0.00 is less than 0.05. This implied that a change in use of various forms of short term debt financing increased the financial performance of the SMEs.

Short term debt were repaid within a short period thus no or minimal interest was charged, no collateral required but the lender relied on credit worthiness of the borrower based on previous repayment records. Abor (2007) found that there is a positive relationship between short term debt finance and return on Asset of the SMEs in South Africa. The findings also concur with Abdullar and Roslan (2012) who agreed that there exist a significant relationship between short term debt and financial performance of Malaysian firms. However the findings do not concur with Shubita and Asawalhah (2012) that debt financing has negative relation between debt and profitability. SMEs preference for short term debt as a source of finance is due to the fact that they can be used to take care of the unexpected emergencies and they quickly adapt to the need of the firm.

Table 4.7: Correlation between Short Term Debt Financing and Financial Performance

		Short Term Debt
Financial	Pearson Correlation	.552[**]
Performance	Sig. (2-Tailed)	.000
	N	41

4.7.3 Correlation between Long Term Debt and Financial Performance

The correlation between long term debt financing and financial performance was analyzed in the Table 4.8. The correlation between the long term debt financing and financial performance was positively correlated (r = 0.536). The study also showed that there was a significant relationship between the two variable long term debt and financial performance since the p value 0.000 is less than 0.05. This implied that an increase in use of long term debt contribute to a significant increase in financial performance of the SMEs.

These findings were in agreement with Pelham (2000) who noted that long term debts have direct positive and significant relationship with financial performance of small businesses in Malaysia. The study further argued that long term debt provided more competitive advantage when compared with large firms. Dube (2013) concluded that debt financing have a positive impact on productivity of SMEs in Masvingo. The study further argued that this was due to adequate funding from the banks that lead to increased productivity. On contrary Chepkemoi (2013) noted that debt increases as firms profitability decreases.

Table 4.8: Correlation between Long Term Debt and Financial Performance

		Long Term Debt
Financial	Pearson Correlation	.536[**]
Performance	Sig. (2-tailed)	.000
	N	41

4.8 Regression Analysis model

Regression analysis was used to model the relationship between the predictor variable; long term debt, short term debt and equity and dependent variable financial performance. From Table 4.9 the regression shows that multiple regression models had a coefficient of determination R of 0.728. This indicates a positive correlation between the independent variable and the dependent variable. Further it indicates that R^2 for the model was 0.531. This means that 53.1% of the variation in the financial performance of the SMEs can be predicted by joint interaction of short term debt, equity and long debt term. Therefore other variables not covered by the study contribute to 46.9% of the variance.

Table 4.9: Regression Analysis Model

Model Summary			
R	R Square	Adjusted R Square	Std. Error of the Estimate
.728	.531	.492	1.07754

A. Predictors: (Constant), Long Term Debt, Equity, Short Term Debt

4.8.1 Analysis of Variance

F statistics was used to test whether the overall model was statistically predicting that independent variable (equity, short term debt, and long term debt) has effect on financial performance of the SMEs in Embu town. The overall significance of the model on Table 4.10 gave an F statistic value of 13.939 and a p value of 0.000 which is a value less than 0.005. This indicated that the overall model was a good fit.

Table 4.10: Analysis of variance

ANOVA					
	Sum of Squares	df	Mean Square	F	Sig.
Regression	48.552	3	16.184	13.939	.000[b]
Residual	42.960	37	1.161		
Total	91.512	40			

4.8.2 Regression Coefficients

Table 4.11 shows the regression coefficient for the study variables

4.11 Regression Coefficient

	Unstandardized Coefficients		Standardized Coefficients	T	Sig.
	B	Std. Error	Beta		
(Constant)	3.060	2.116		1.446	.157
Equity	.498	.160	.431	3.109	.004
Short Term Debt	.242	.131	.248	1.845	.073
Long Term Debt	.221	.144	.207	1.529	.135

According to the equation taking all other factors constant at zero financial performance will increase with 3.060 units. A unit increase of equity financing will lead to an increase in financial performance by 0.498 units. A unit increase of short term debt financing will lead to 0.242 increases in financial performance and a unit increase in long term debt will cause a resultant change of 0.221 increases in financial performance if all other factors are held constant. Further it was also noted that at 5% significance level, equity financing was statistically significant (p=0.004) a predictor with low p value is meaningful addition to the overall model. Short term debt and long term debt were insignificant (p=0.073; p=0.135 respectively) which was greater than 0.05.

$$Y = 3.060 + 0.498X1 + 0.242X2 + 0.221X3 \dots\dots\dots\dots\dots\dots..\text{Equation 4.1}$$

CHAPTER FIVE
SUMMARY, CONCLUSIONS AND RECOMMENDATIONS

5.1 Introduction

This chapter entails the summary of research findings, conclusions drawn from the study, recommendation and suggested areas for further research.

5.2 Summary

The study findings showed that, most of the business units were owned and managed by female entrepreneurs as compared to their male counterparts. The entrepreneurs in Embu town are mainly the youth. This could have been due to government programs aimed to empower the youth and women. The government funding of the SMEs through UWEZO Fund Women Enterprise Fund and Youth Fund has provided a stepping stone for the continued growth of the SMEs. However their intellectual capacity was relatively high since they hold an undergraduate certificate. Most of the SMEs were in there initial stages of existence while a few make it through to maturity. This revealed that despite the long period of existence the business units fail to transit to the next stage of growth. Although most of the SMEs in Embu town fall in the service and trade category few entrepreneurs also venture into the manufacturing segment.

5.2.1 Equity Finance

The study findings 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. Angel investors may also provide business management skills or supervisory role to the business. The relationship between equity finance and financial performance of the SMEs was found to be positively correlated and statistically significant. Equity financing is preferred in the initial stages of SMEs development. This is due to the financial shortage experienced by inability to secure loans with collaterals during the founding phase. Equity offers a lifelong financing option with no or minimal cash outflow inform of interest.

5.2.2 Short Term Debt Financing

The respondents agreed that overdraft agreements and trade credits affected business operations. However, they were indifferent in usage of, accrued expenses and differed income on financial performance of the SMEs. The correlation between the short term debt and financial performance was found to be positive and statistically significance. Short term debt as a source of financing by the SMEs offers solution to unexpected financial emergencies. This is because the short term debt finance adapt easily to the firm's financial need, they require no collateral in order to obtain the funds and they are repaid over a short period thus no or minimal interest rate is charged.

5.2.3 Long Term Debt Financing

The study showed that the respondents agreed that use of bank loans had increased while lease agreement, mortgage and factoring did not play a significant role in the financial performance of the SMEs. The relationship between long term debt and financial performance was found to be positively correlated and statistically significant. Financial institutions have incorporated SMEs financing as part of their core business. Government intervention in capping the interest rate has influenced more loan uptake for the entrepreneurs.

5.3 Conclusion

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.

The correlation between short term debt and financial performance is positive and significant. Overdraft agreement was the most preferred form of short term debt that had higher preference among other forms which include trade credit, accrued expenses and deferred income. Long term debt and financial performance of SMEs in Embu town had a positive relationship. The study also noted an increasing trend in the usage of the bank loan as a form of long term debt.

The performance of the SMEs was largely affected by the source of finance and the liquidity position of the business. The source of finance is also a vital factor in determining the financial performance of the SMEs.

5.4 Recommendation

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.

The financial institutions need to create awareness and educate the entrepreneurs on other products available to finance the SMEs. Lack on information has created the financial gap which has crippled the SMEs. Reduction on loan processing time and cost of borrowing will encourage entrepreneurs from accessing such long term loans, mortgage and lease.

5.5 Limitation of the Study

The study was limited by lack of adequate information from the entrepreneurs because most of them did not keep updated financial records. The study only considered the financial factors that affect the capital structure of the SMEs but did not consider other factors that determine the capital structure such as size, age, location of the business enterprise. The study was further limited by lack of cooperation from the respondents owing to their busy working schedule.

5.6 Suggested Areas for Further Research

The study noted that their exist variables that were not studied that could influence the financial performance of the SMEs in Embu town. The areas for further study include; financial literacy and how it affect the financial performance of the SMEs in Embu town. Government funding of the SMEs through revolving fund and its effect on the growth and development of SMEs in Embu town. Non-financial parameters like business location, ownership structure, improved infrastructures, competition and market share and how they influence the financial performance of the SMEs. Increase

in number of the financial institutions and how they influence growth and development of the businesses within the Embu County.

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APPENDICES

APPENDIX I: QUESTIONNAIRE

You are required to fill this questionnaire with utmost honesty, you name or business name should not appear anywhere in this questionnaire. The information obtained will be treated as confidential and will be used SOLELY on research only. Please tick or mark in the spaces provided.

PART A: DEMOGRAPHIC DATA

Please put a tick (√) against the answer of your choice.

1. Gender: Male   ( )   Female   ( )

2. Age

   18-25 years [____] 26-35 years [____] 36-45 years [____] Above 46 years [____]

3. To date, what has been your highest formal qualification? (Please tick one box only)

   i.   Primary Certificate   [ ]

   ii.   Secondary   [ ]

   iii. Diploma   [ ]

   iv.   Undergraduate   [ ]

   v.   Postgraduate   [ ]

4. Position of the respondent:

   Manager [____] Proprietor [____] Manager and Proprietor [____]

5. Category of the business
   Service   [____]
   Manufacturing [____]
   Trade   [____]

6. Please indicate the number of years this firm has been in operation.

0-1yr ☐   2-5 years ☐   -10 years ☐ Above 10 years   ☐

7. Tick the legal status of your business.

a) Sole proprietor   ☐

b) Partnership   ☐

c) Limited company   ☐

8. How many employees does this business have?

Less than 5 employees   ☐

5 -10 employees   ☐

10-15 employees   ☐

Above 15 employees   ☐

9. The firms' asset base in Kenya shillings

Less than 0.5million   ☐

0.5-1 million   ☐

1-1.5 million   ☐

Above 1.5 million   ☐

10. Annual sales volume

Less than 0.5 million   ☐

0.5 -1million   ☐

1- 1.5 million   ☐

Above 1.5 million   ☐

SECTION B

11. EQUITY FINANCE

Equity financing statement	5 Strongly Agree	4 Agree	3 Not sure	2 disagree	1 Strongly disagree
1 Firm normally refinance the business using ploughed back profits.					
2 Retained profits provide financing for the business's long term growth					
3 Angel investors are major source of financing in this firm					
4 Contribution from friends is used to finance the business					

12. SHORT TERM DEBT FINANCE

Short term Debt financing statement	5 Strongly agree	4 agree	3 not sure	2 disagree	1 Strongly disagree
1. Trade credit is applied the financing the firm					
2. Use of deferred income to increase working capital					
3. Overdraft agreement affect the way business operates					
4. The firm used accrued expenses to finance its operations					

13. LONG TERM DEBT FINANCE

Long Term Debt Finance statement	5 Strongly agree	4 agree	3 Not sure	2 disagree	1 Strongly disagree
1. The firm uses lease agreement to acquire asset.					
2. The firm use mortgage in					
3. The firm used factoring to finance its operations					
4. Use of bank loans have been increasing overtime					

14. FINANCIAL PERFORMANCE

Financial performance statement	5 Strongly agree	4 Agree	3 Not sure	2 disagree	1 Strongly disagree
1. The current profitability status increase after use of equity finance					
2. Firm liquidity position affect performance of the business					
3. High sales growth rate is due to use of debt finance					
4. Source of finance influence the financial performance of the firm					