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EFFECT OF EQUITY FINANCING ON PERFORMANCE OF SMALL AND MEDIUM SCALE ENTERPRISES IN BUNGOMA COUNTY KENYA

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Abstract

The study sought to investigate the effect of equity financing on the performance of SMEs in Bungoma County Kenya. Under the empirical literature review, the study discussed current and relevant studies to the topic. Under the theoretical literature review, pecking order theory was discussed. Descriptive and inferential research designs were then used. The study area was Bungoma County located in western Kenya with an approximate size of 2207KM2. The target population was 4721 licensed SMEs retail shops operating in the county while simple random sampling technique was used to select a sample of 368 SME retail shops. Data was collected using structured Likert scale questionnaires to obtain opinions from SMEs managers and owners. A pilot study was then conducted to test the reliability and validity of the data collection instruments. Descriptive and Inferential data analysis were then used. The descriptive statistics revealed that majority of the SMEs use equity financing in their capital structure. Similarly, it was *revealed that SMEs had been witnessing an increase in performance measured by return on equity, return on assets and return on capital employed. For inferential statistics, the correlation results showed that equity financing had a positive association with performance. The regression model was also statistically significant signifying that the variable equity financing explains the changes in performance of SMEs. The study concluded that equity financing have a statistically positive and significant effect on the performance of SMEs. The study recommended the government through the Micro and Small Enterprises Authority to make policies that will guide the SMEs on the way to increase the use of equity financing as well as the management and owners of SMEs to seek for strategies to increase their use of equity financing.*

Keywords: Equity Financing, Performance, Small and Medium Scale Enterprises, Retained earnings, Personal Savings, Contributions from friends

INTRODUCTION

Capital structure is the mixture of debt and equity that the firm employs to finance its business operations (Aziz & Abbas, 2019). It is the proportionate relationship between debt and equity. Equity consists of fully paid-up shares, retained earnings, contributions from friends, personal savings and share premium whereas debt is made up of long-term debt. The idea of modern capital structure remained undiscovered until when Modigliani and Miller (1958) article was published on capital structure irrelevancy theory. It was discovered that a firm's market value is defined by its earning potential and the risk of its underlying assets since the value of the firm is independent of the way it chooses to finance its investments. They therefore affirmed the irrelevance of debt-equity ratio on the value of the firm. Since then, numerous scholars have studied the effect of capital structure on performance on a global, regional, and local level but capital structure remains thorny amongst many companies as it has led to the fall of many corporations worldwide. The puzzle around capital structure is still therefore unresolved.

Globally, the Sable (2013) explored how the capital structure of black-hole venture capital firm in the United States of America (USA) drag down the company shares prices where it was revealed that a poorly constructed capital structure attests to haphazard and careless company financing, a condition that can make an otherwise interesting company completely un-investable thus leading to decline in share prices and profitability in the long run. Similarly, the European Public Real Estate Association UREA (2015) report on how capital structure can be used to gauge firms' foundation highlighted that real estate enterprises' capital structures can be used as a barometer of their overall value. Regionally, Beck, Maimbo, Faye and Triki (2011) stipulated that African capital structure has a tendency of being financed with equity capital and more so personal financing and contribution from friends. Poor infrastructure and lack of established financial systems make it difficult for businesses and more so SMEs to access debt financing the reason why they have poorly performed although there is an increasing trend for firms getting loans. Locally, the Novo Nordisk Kenya (2020) annual report demonstrated that a key instrument for enhancing a company's performance is capital structure alignment. It stipulated that long term debt and equity financing if well managed can aid the company to attain long term shareholders value.

Statement of the Problem

The KNBS (2017) report revealed that approximately 400000 micro small and medium enterprises do not celebrate their second birthday with only a few celebrating their fifth birthday. Additionally, Douglas, Muturi and Ochieng (2017) revealed that the SME mortality rate in Kenya is at 70%. This is so despite the vital role that SMEs play through employment creation and contribution to economic growth as evidenced in the 2020 national survey report of the central bank of Kenya where SMEs employs over 30% of the working population, contributed 33% to the country's GDP and constituted 98% of all businesses in Kenya. The high failure rate of SMEs is as a result of many challenges including but not limited to lack of funding and wrong mix of the capital structure which needs careful planning (Guzman, Palacios & Carrilo, 2016). Li, Niskanen and Niskanen (2019) revealed that poor capital structure mix negatively affect SMEs performance thus recommending for more studies to be done in order to find the optimal capital structure level for SMES in Finland. Kariuki, Maina and Njagi (2017) on the other hand researched on the effect of equity financing on performance of SMEs in Embu thereafter recommending for further studies to be done in other counties as well as with the inclusion of debt finance as an element of capital structure.

Empirical studies on capital structure have widely been done but inconsistent findings have been found leaving the puzzle of capital structure effect on performance unanswered (Chahenza, 2017). Ajibola, Wisdom and Qudus, (2018) revealed that capital structure has a positive impact on financial performance while Ongombe and Mungai (2018) revealed that debt-ratio as well as debt-equity ratio have insignificant effect on performance. Most studies done focused on large corporations where secondary data can easily be collected from published annual reports forgetting SMEs which do not keep proper books of accounts as it is with Musah, (2017) and Ajibola, Wisdom and Qudus, (2018). Most studies done did not conduct pilot studies to test the validity and reliability of their data collection instruments as evidenced in the works of Odero and Mutswenje (2021) and Nicodemus and Wamugo (2017). Moreover, most studies done focused on developed nations as it is with the work of Rahman, Sarker and Uddin (2019) which was done in Bangladesh, the work of Nguyen & Nguyen (2020) done in Vietnam, the work of Iqbal, Farooq, Sandhu and Abbas (2018) done in Pakistan and many others. There is therefore a need for a study to be done in developing countries such as Kenya with the main focus on devolved functions such as Bungoma County.

Objective of the Study

To examine the effect of equity financing on performance of SMEs in Bungoma County Kenya.

Research Question

What is the effect of equity financing on performance of SMEs in Bungoma County Kenya?

Scope of the Study

The objective of the study was to examine the effect of equity financing on the performance of SMEs in Bungoma County Kenya. The independent variable of the study was equity financing while the dependent variable was performance. The study focused on Bungoma County as the study area. This is a county located in the western part of the country with an approximate size of 2207KM.^{2}

LITERATURE REVIEW

Empirical Review

Iqbal, Farooq, Sandhu and Abbas (2018) in their study investigated the effect of capital structure on the financial performance of SMEs in Pakistan. Return on equity was one of the independent variables employed. The study applied a casual research design. The target population was 61 companies in Pakistan out of which 15were small, 28 were medium and 18 were commercial enterprises. Regression model was used to analyze data. Their study revealed that there was a strong positive relationship between equity financing and the financial performance of SMEs in Pakistan. The study therefore used the same variable for the SMEs in Bungoma County Kenya to come up with a conclusion which applies to Kenyan context.

Mayasa (2020) conducted a study on the impact of capital structure on performance of small and medium enterprises in Tanzania. Equity financing was one of the independent variables affecting performance. The study adopted causal research design and the target population was 2868 registered SMEs in six regions from Small Industries Development

Organization (SIDO) in 2020. The findings of the study revealed that equity financing had statistically negative influence on the performance of SMEs in terms of ROCE and ROE while there was a statistically significant positive influence on the performance of SME in terms of ROA. His study relied only on secondary data thus the researcher in his study used primary data which is more original with limited manipulations.

Odero and Mutswenje (2021) in his study investigated the effect of capital structure on financial performance of micro financial institutions in Nairobi city county Kenya. Equity financing was one of the independent variables of the study. The target population of the study was all the 14 successful microfinance companies as recognized by the Kenya Microfinance Act as of 2020 which represented a census survey for the period of 5 years (from 2014-2018). To analyze the results, Stata was used. There was descriptive and inferential statistics execution. After data analysis, the inferential statistics revealed that equity financing had as statistical negligible sway on the financial return of micro finance institutions ($p=0.155>0.05$). The shortcoming of their study was that they did not conduct a pilot study to test the validity reliability of their data collection instruments.

Theoretical Review

Pecking Order Theory

The theory was hypothesized by Myers and Majluf (1984). It explains the preferred order of funding using all sources of funds (retained earnings, long term debt and stock) in order to have high performance thus capital structure is relevant. The theory asserts that there is irregular information between the insiders of a company and the outside investors. Managers therefore know the true position of the firm as far as its value is concerned compared to outside investors. According to Myers (1984), organizations prefer internal to external funds due to no flotation costs of internal funds. Firm will therefore finance their projects using retained earnings when funding is required before considering any other source of capital. When the retained earnings remain inadequate, then debt is employed. It is only in risky cases when organizations use new stock. Therefore, the order of monetary sources preferred is the internal financing from profits (retained earnings), then debt and then the chosen stock is the last choice. The theory forecasts that the issuance of equity (common stock) is the alternative source of financing. Organizations would prefer internal financing of retained earnings because there are no floatation costs as is the case of external financing. It is only at the point when the reserved incomes are not enough when an organization may choose debt funding as its second option (Bhama, Jain & Vadav, 2017).

Since its publication, various empirical studies have been done trying to critique the theory of which mixed results have been attained some supporting while others have found otherwise findings. Lemmon and Zender (2007) in their study found supporting evidence for pecking order theory while Leary and Roberts (2010) found the contradicting evidence for pecking order theory. The theory was therefore relevant to the study as it provided the order of preference when sourcing the various capital structure components and more so when a firm should apply equity financing in its capital structure to attain and eventually realize high performance which was in line with the study topic where the researcher indented to find out the of equity financing on performance of SMEs in Bungoma County Kenya.

Figure 1: Conceptual Framework

Independent variable		Dependent variable
Equity Financing (EF) Retained earnings. Personal savings Contributions from friends	→	**Performance (P)** Return on equity Return on assets Return on capital employed

RESEARCH METHODOLOGY

The study applied descriptive and inferential research designs. The study area was Bungoma County located on the western part of Kenya with an approximate size of 2207KM.^{2}The target population was 4721 licensed SMEs retail shops operating in the county as per the integrated development plan 2018-2022 report of the County government of Bungoma. Simple random sampling technique was then employed to select a sample of 368 SME retail shops from the population. The sample size was arrived at by the use of Yamane, (1967) formula. Data was collected using structured Likert scale questionnaires to obtain opinions from SMEs managers and owners with regards to the study variables. A pilot study was conducted using 20 respondents which were randomly selected from the study area to test the reliability and validity of the data collection instruments. Descriptive and Inferential data analysis was then used to analyze the data. Normality and Multicollinearity tests were performed before the inferential data analysis was performed. The Statistical Package of Social Sciences (SPSS) version 28.0 was then used to generate measures of central tendency including mean and standard deviations. Correlation and Regression analysis was also generated.

The linear regression model used is as laid below

$Y=\alpha + \beta 1X1 + \varepsilon$

Where:

Y= Performance SMEs.

X1=Equity Financing.

α= the constant term.

ANALYSIS AND FINDINGS

Response Rate

Table 1: Response Rate

	Frequency	Percent
Returned	315	86
Unreturned	53	14
Total	368	100

The researcher had administered 368 questionnaires. However, those that were filled completely and returned were 315 translating to a response rate of 86%. This was a good response rate that was adequate for the study.

Pilot Study

A pilot study was conducted in order to test the reliability and the validity of the questionnaire.

Reliability Test

The reliability was tested using Cronbach Alpha where a value that is equal to or greater than 0.7 was considered reliable. The results were as in Table 2. According to the results, all variables depicted a Cronbach Alpha value above 0.7. Therefore, the questionnaire was reliable.

Table 2: Reliability Test Results

Variable	Cronbach's Alpha
Equity financing	0.834
Performance	0.812

Validity Test

The validity was tested using Kaiser-Meyer-Olkin (KMO) and results were as in Table 3. The results showed that the KMO values were all above 0.5 hence validity was confirmed.

Table 3: Validity Test Results

Variable	KMO
Equity financing	0.508
Performance	0.5

Descriptive Statistics for Equity Financing

Table 4: Descriptive Statistics for Equity Financing

	N	Mean	Std. Deviation
Our firm has been using retained earnings in its capital structure to finance its operation	315	4.17	1.056
Our firm has been using Personal Savings to finance its operations	315	4.14	1.039
Our firm has been using contributions from friends to finance its operations	315	4.18	0.984
Valid N (list wise)	315		

From the results tabulated in Table 4, the statement that our firm has been using retained earnings in its capital structure to finance its operation attracted a mean of 4.17 and a standard deviation of 1.056. The statement that our firm has been using Personal Savings to finance its operations had a mean of 4.14 and a standard deviation of 1.039. Additionally, the statement our firm has been using contributions from friends to finance its operations had a mean of 4.18 and a low deviation of 0.984. This indicated that the majority of the respondents affirmed to the statements implying that equity financing has been adopted among the SMEs in Bungoma County. The findings were similar to those of Iqbal, Farooq, Sandhu and Abbas (2018) who found that there was a strong positive relationship between equity financing and the financial performance of SMEs in Pakistan. The results were also similar to those by Mayasa (2020) where there was a statistically significant positive influence on the performance of SME. As a result, equity financing is an important component of capital structure in any business, particularly SMEs in Bungoma County.

Descriptive Statistics for Performance

Table 5: Descriptive Statistics for Performance

	N	Mean	Std. Deviation
Our firm has been witnessing an increase in Return on Assets	315	4.38	0.736
Our firm has been witnessing an increase in Return on Equity	315	4.35	0.785
Our firm has been witnessing an increase in Return on Capital Employed	315	4.37	0.76
Valid N (list wise)	315		

Table 5 results revealed that the mean for the statement our firm has been witnessing an increase in Return on Assets was 4.38 and the standard deviation was 0.736. It was also revealed that the statement our firm has been witnessing an increase in return on equity attracted a mean of 4.35 and a standard deviation of 0.785. Finally results revealed that the statement our firm has been witnessing an increase in return on capital employed had a mean of 4.37 and a standard deviation of 0.76. The results revealed that the SMEs in Bungoma County had been performing well with increasing performance in terms of ROA, ROE and ROC. The findings were similar to those by Iqbal, Farooq, Sandhu and Abbas (2018) and Odero and Mutswenje (2021) who found that there is a significant relationship between capital structure and financial performance in terms of ROA, ROE and ROCE. It is therefore evident that when SMEs adopt equity financing in their capital structure their performance is able to change positively in terms of ROA ROE and ROC.

Correlation Results

Table 6: Correlation Matrix for Equity Financing and Performance of SMEs in Bungoma County Kenya

		Equity financing	Performance
Equity financing	Pearson Correlation	1	
	Sig. (2-tailed)		
	N	315	
Performance	Pearson Correlation	.661**	1
	Sig. (2-tailed)	0	
	N	315	315

The results of correlation showed that equity financing has a positive relationship with performance (r=0.661). Therefore, the use of equity financing by SMEs will lead to a positive change in their performance. It can therefore be concluded that when equity financing increases in the capital structure performance of SMEs increases too.

Regression Results

Table 7: Model Summary for Equity Financing and Performance of SMEs in Bungoma County Kenya

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.465a	0.216	0.214	0.487123

The model summary results revealed that the R square was 0.216. This meant that the variable equity financing explain 21.6 percent of performance.

Table 8: ANOVA for Equity Financing and Performance of SMEs in Bungoma County Kenya

	Sum of Squares	df	Mean Square	F	Sig.
Regression	4.009	1	4.009	13.827	.000b
Residual	90.741	313	0.29		
Total	94.75	314			

The ANOVA showed that the overall model was significant (p=0.000).

Tale 9: Regression Coefficients Equity Financing and Performance of SMEs in Bungoma County Kenya

	Unstandardized Coefficients		Standardized Coefficients	t	Sig.
	B	Std. Error	Beta		
(Constant)	3.853	0.124		31.145	0
Equity financing	0.107	0.029	0.206	3.719	0.000

From the regression coefficient results, it was revealed that the relationship between equity financing and performance was positive and significant (β1=0.107 p=0.000). This means that a one-unit increase in equity financing would results in 0.107 increase in performance of SMEs. The findings concurred with those of Iqbal, Farooq, Sandhu and Abbas (2018) and

Odero and Mutswenje (2021) who found that there was a strong significant and positive relationship between equity financing and the financial performance of SMEs in Pakistan and Kenya respectively. However, the findings partly disagreed with those of Mayasa (2020) who established that equity financing had statistically negative influence on the performance of SMEs in terms of ROCE and ROE while there was a statistically significant positive influence on the performance of SME in terms of ROA.

The model hence becomes:

Y=3.853 + 0.107X1

Where:

Y= Performance of SMEs.

X1=Equity Financing.

CONCLUDING REMARKS

Summary

The descriptive statistics results established that majority of the SMEs in Bungoma County had been making use of equity financing in terms of retained earnings personal Savings and contributions from friends. Moreover, the study found that equity financing has a positive correlation with performance of SMEs. Similarly, it was established that equity financing has a positive and significant relationship with performance.

Conclusion

From the findings, the study concluded that equity financing has a positive and significant effect on the performance of SMEs. The study concluded that increasing the use of equity financing such as using retained earnings or personal savings as well as contributions from friends will enhance the improvement in the performance of SMEs.

Recommendations

The study found that equity financing has a positive effect on the performance of SMEs. The study therefore recommends the management and owners of SMEs in Kenya and particularly those in Bungoma County to seek for strategies to increase their retained earnings as well as savings. This will ensure that there is enough capital for the expansion of their businesses. The study also recommends the government through the Micro and Small Enterprises Authority to make policies that will guide the SMEs on the way to increase their retained earnings and savings.

Limitation of the Study

The limitation of the study was that it involved only one county, hence the future research studies on the same topic can add other counties in order to compare the findings as to how equity financing affect the performance of SMEs which can give more generalizable findings to be applicable in the entire country Kenya.

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