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Capital Structure And Financial Performance Of Small And Medium Enterprises In Embu County, Kenya

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Abstract:*Small and Medium Enterprises constitutes the backbone of many economies in the world since they create jobs and contribute positively to their respective economies which Kenya is not an exception. In Africa there are a few studies on the link between capital structure and SMEs financial performance. The few studies in record focuses on capital structure and profitability of quoted companies, capital structure and financial performance of errand services SMEs and international joint ventures. In addition, the effect of capital structure on financial performance of large firms have been examined by a number of studies with smaller firms attracting less attention. Very few if any studies have examined the effect of capital structure on financial performance of SMEs. Hence, inadequate finance knowledge and inconclusive literature thus the need for more empirical work. This warranted a further investigation hence the current study. The specific objectives of the study were: to establish the effects of equity capital, debt capital and Retained earnings on financial performance of SMEs. The study adopted descriptive design. The target population was 95 SMEs and by use of stratified random sampling technique a sample of 29 respondents was established. Descriptive analysis and multiple regression analysis were used in data analysis. Data was presented in tables graph and pie charts. Preliminary diagnostic tests were done before running the regression analysis. The study established that: Equity capital and Debt capital has a significant effect on financial performance of the SMEs studied due to a p-value of 0.021 and 0.020 respectively with the significance level being 0.05. However, retained earnings was found not to have a significant effect on financial performance of the SMEs studied since the p-value was 0.797. Among the three variables Equity capital had greatest proportion in terms of contribution towards capital structure due to its advantage to the firm. Debt capital was found to be more risky than others while retained earnings proved difficult to raise and maintain. The study therefore concludes that generally, capital structure has a collective significant effect on financial performance of SMEs in Embu County, Kenya.*

Key Words: Leverage, capital structure, financial performance, debt capital, equity capital.

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I Introduction And Background

Capital structure is the composite of borrowed fund and owner's fund that adds up to total capital employed of the business organization (Friend, 2008). Corporate managers needs to be cautious when determining the ratio of borrowed fund and owner's fund. Capital structure decisions are of great significance when considering the factors that affect performance of a firm (Rajan, 2005). Among the many decisions accomplished by financial managers the one rated as most significant is on capital structure (Berger, 2006). The composition of capital employed can affect the firm's value and optimality of financing cost. The management core objective is to maximize equity owner's wealth, cutting cost to the minimum and acting within the legal frames governing the establishment of the firm. To ensure minimum cost of capital is maintainable, the determining factor will be an optimum capital structure. Current and prospective investors tend to gather and analyze firms' information to understand the operations. Agency costs, according to agency theory can be reduced by ownership and optimal capital structure (Jensen & Meckling, 2006). Therefore, a lot of care and attention need to be given when making decisions on capital structure.

With a combination of various sources of capital like ordinary shares, preference shares and long-term fund a number of considerations requires to be put in place as far as optimum capital structure is concerned. This combination of sources of capital makes it difficult for a firm on realizing the goal of utilizing funds economically. Therefore, it is progressively relied that a firm need organize its capital structure for an optimum use of funds and to be in a position that enhance dealing with upcoming situation (Pandy 2009). Management and owners keeps on making decisions on proportions of debts versus equity as they try to get answers to the following questions; so as to get higher returns, should they go for more debts?. To reduce risk of high gearing, should the firm use more equity finance?. A rise in value of a firm by restraining managers to work at

shareholders interest reduces agency costs outside equity by high leverage or low equity/asset ratio. The two major types of liabilities are equity and debt and the holders represent the two classes of firms investors. Different levels of risks, gains and influence have an association for each of the two liabilities. Debt owners have no control over the firms operations, they earn fixed rate of interest according to the terms and conditions of the investment contract. Ordinary shareholders are the last claimant and bears nearly all the risks though they have greater influence to the firms operations. Retained earnings on the other hand is part of equity fund that is generated internally only when a firm makes profit and in a position to retain some of the earnings for future use. Therefore, a firm that makes no profit cannot raise any retained earnings (Abor, 2005). The study focused on three independent variables that includes equity capital, debt capital and retained earnings that forms part of capital structure (Ebaid, 2009).

As an abstract measure, financial performance is how current assets of a firm can be utilized optimally in the course of normal business activities and raise income for the business (Baxter, 2007). Financial performance is a sign of the financial stability for a given period of time for a firm, and can be used to compare firms in the same line of operations or to compare industries or sectors in total to enable a business plan on how they can improve the conditions at stake with an aim to achieve the business objectives (Berger, Oliver & Pua, 2007). Financial performance can be determined by a number of ways, though all should be considered as one. Items in the income statement like turnover, inventory levels, cost of sales, operating income and expense as well as cashflows from operating activities can be used. Additionally, the analyst or investor may wish to find more from financial statements and seek out margin growth rates or a decline in debt (Brush, Bromiley & Hendrickx, 2000). Financial and non-financial indicators can be used by a firm to determine its performance. On issues pertaining employees turnover, waiting and delivery time, referral rates on customers and their satisfaction are termed as non-financial measures while sales revenue and earnings before tax are financial measures (Marr, 2008). Acknowledging some problems that may arise by using one measure or the other, entrepreneurs of today have embraced the idea of using both of them. Combining non-financial and financial measures assist in determining the next course of action.

Over the years the performance of Kenyan SMEs has been diminishing. Most of the SMEs that contributed 40% employment in Kenya were closed down due to inability to operate small enterprise (GOK, 2009). Financial performance of SMEs over the years has been questionable since some have been auctioned and others merged or acquired. From 2001 to 2002, the SMEs performance declined by 56% (Kenya Economic Survey, 2003). Industrial economists also have given a report that small industries have high liquidity risks despite they also enjoy higher growing rate than big industries (OECD, 1997). Due to poor management of short term loan, trade credit and long-term loans, SMEs have continuously experienced some difficulties in improving their financial performance. The cause could be failure by SMEs not using appropriate debts in their normal operations and if this is not dealt with, it might cause financial distress and business failure (Pindalo, 2006). However, the much availability of debt facilities and the strict procedure of raising the limited available equity finance has caused many SMEs to turn to debt as a source of finance (Githaiga 2015). This fact is theoretically and practically acceptable from the debt providers' perspective owing to the perceived high risk of moral hazard problems among small and medium enterprises. Debt is an important factor for the free flow of cash in the operation of the SMEs.

The study sought to establish the significance of independent variables (Equity, Debt and Retained earnings) in explaining financial performance of SMEs. The research was conducted in Embu County. The purpose of the survey was to establish the effect of capital structure components (equity capital, debt capital and retained earnings) on financial performance of SMEs in Embu County. Embu County was preferred as a study context due to competitive advantages in business activities and the notable tremendous growth. The target population of the study was SMEs that have been in operation since 2012, having gone through a five years business cycles (2012- 2016).

II Research Problem

Empirical literature on the link between capital structure and financial performance of SMEs in developing countries remains scanty, limited and unclear. Capital structure is associated with the capacity of the business being able to meet the interest of investors (Boodhoo, 2009). SMEs in the commercial sector are vital to nearly all economies in the world, particularly to those in evolving countries those that their main challenges are employment and income distribution (Maina, 2014). SMEs promote to the output and creation of "decent" jobs; looking at the dynamic front, they act as start-up for the larger firms of the future, are the following and critical step up for expanding micro enterprises, they provide absolutely and often significantly to total savings and investment, and they play part in the development of appropriate technology (Elimuti and Kathawala, 2009). In Africa, there is limited empirical evidence the effect of capital structure on financial performance of SMEs. Abor (2005) studied on the relationship between capital structure and profitability of quoted companies in Nigeria, Kamau (2013) looked at the impact of capital structure on financial performance of errand service

SMEs within Nairobi County. Boateng (2004) studied on the determining factor on capital structure in international joint ventures. Nevertheless, not a single study focused on how the capital structure and SMEs performance and more so on commercial sector irrespective of how they are influenced by financial challenges plus macro-economic factors.

Unlike in big firms where debt-equity ratio has been investigated by a good number of researchers, a few have shown interest on small firms. The financial strategies of big registered companies regularly vary from smaller firms for the reason that, they raise finance through long-term borrowing or issuing equity shares through stock exchange market (Githaiga, 2015). The livelihood of Embu County community is based on agriculture and business oriented activities. Among the major crop that has hit the market is Miraa and a big number of people are in small and medium sized business. Quite a good number of these businesses have been raising finance through equity capital, Debt capital and retained earnings. Based on the available information it is obvious that results from the study of the effect of capital structure on financial performance not yet done conclusively and needs further practical work study. The study was therefore motivated by this gap in finance knowledge and sought to answer the question. Is there impact of SMEs capital structure decisions on financial performance in Embu County?

III Objectives Of The Study

The specific objectives of the study were:

(i). To establish the effect of equity capital on financial performance of SMEs in Embu County, Kenya.

(ii). To establish the effect of debt capital on financial performance of SMEs in Embu County, Kenya.

(iii). To determine the effect of retained earnings on financial performance of SMEs in Embu County, Kenya.

***The study formulated and tested three null hypotheses in view of each specific objective at a significance level of 0.05.**

IV Significance Of The Study

The relationship between capital structure and financial performance is greatly recognized in the financial literature. So as to determine the problems, a study focusing on factors that affect the relationship between capital structure and financial structure was of paramount importance. Today the business environment that SMEs operate in is quite hostile and competitive. Therefore, of great importance, are the research findings available when choosing the optimum capital structure that will enhance a sound financial performance of SMEs. To managers and owners the study will be of benefit as they carry out financial analysis to determine how far the firm has achieved its core objective. It will also promote valuable knowledge to the area of micro-enterprise policy in general. Study findings on the effect of capital structure on financial performance will equip the managers and owners with relevant knowledge. Also it can further enhance efficient financial policies that will see the firm possess competitive advantage. Lastly, these study findings will significantly contribute towards the aspect of SMEs financing, capital structure and financial performance.

V. Review Of Literature

1. Theoretical Review

The study considered the three theories which are pecking-order, trade-off, and agency theories. According to the Pecking Order theory, firms develop an order ranking when it comes to capital required to finance business operations. Due to lack of adequate information and a good link between future investors and firms, the preference will be as follows; debt better than equity, retained profit preferred to debt, and short term loan superior than long-term loans. The pecking-order theory depends on the idea of asymmetric information involving outsiders (investors) and insiders (managers), this helps managers in selecting the best source of finance. This theory argues that, sources with the minimum levels of asymmetric information attracts firms requiring funding since the borrowing expenses increases with this metric. The adverse selection model influenced the ranking, according to (Myers and Majluf's, 1984). On the other hand, a variety of sources including taxes and agency conflicts have stemmed the ranking. The theory suggests that, bigger size lets a firm to accumulate retained earnings, and so smaller amount of debt is necessary. According to Myers (1984), bigger firm size lowers the problems of information asymmetry among the managers/owners and creditors, allowing firms to get debt on more good terms. For the intention of this study, theory on Pecking Order is of paramount importance as is intended for the assessment of financing performance of the SMEs along the life cycle. An assumption of the theory is that, older firms have a superior ability to retain and accumulate earnings, and so the demand to go for external financing to solve their financing needs will be less than in the situation of younger SMEs. The possibility of old SMEs reserving profits over time is significant, so the older SMEs lessen the alternative to borrowing

Trade-off theory came from the research done by Kraus and Litzenberger (1973), who properly initiated the tax benefit related to borrowed finance and financial distress costs into a state preference model. It suggested that, balancing of cost and benefits are the main factors in deciding the amount of borrowed fund and owners' equity to use. According to the theory debts and equity capital are normally the two sources of finance to a firm and debt finance has an advantage of tax on interest though there is floatation cost, also non-bankruptcy and bankruptcy costs that forms financial distress costs, (e.g. labor turnover, unfavorable credit terms from suppliers, conflict between shareholders and creditors etc.).The minimal gain of additional long-term fund drops as it rises, whereas the minimal cost rises, thus a firm enhancing its total worth focuses on this counterbalancing at the time of deciding how much to raise from each source (Harris, 2010). Focusing on the trade-off theory the optimal capital mix would occur where there is a counterbalance between tax benefit and marginal costs related to bankruptcy. Consequently, debt would be more preferred to equity by firms up to a point where cost of bankruptcy starts to be significant. A further recommendation to the firms was that, they should not use long-term fund to a level that the debt costs exceed the tax shield benefit. The tax shield benefit may be reduced by an increase in anticipated cost of bankruptcy due to rise in long-term financing. This theory connects to this study since firms assess borrowing costs alongside the advantages of long-term financing. Costs of bankruptcy and paid interest makes the borrowing cost. Advantages of long-term financing are the allowance of interest paid from tax and the management self-control out of the terms and conditions of the financing.

Agency theory focuses on the behavioral relationship between the owners (principals) and those others (agents) who are contracted by the owners to execute duties on behalf of the principal. Jensen and Meckling (1976) further go into detail on this concept by recognizing two foremost conflicts between parties to a company, firstly, shareholders disagrees with owners, and secondly, owners differ with the creditors. In the first case, managers are enticed to pursue the profits of the firms they oversee to their own individual gain at the disadvantage of the shareholders. In the latter case, debt imparts shareholders with the enticement to invest sub-optimally. Managers may perhaps avoid extreme level of leverage if they sense that, it puts their jobs and income at stake. Alternatively, shareholders, can spread company certain risks and/or prefer riskier projects. According to Smith and Warner (2009) dilution of claim and asset substitution can cause more agency conflicts amongst shareholders and bondholders. Chen (2009) asserts that by increasing reliance in debt financing can help firms in lowering their agency costs. The demand for financing through owners' equity reduces together with related agency costs. Nevertheless, a corporation's capability to progressively depend on long-term funding is restrained owing to debts high agency costs ensuing from the likelihood of the firm dwindling into financial distress. This theory is imperative for this survey because, the choice of dividends, leverage and management ownership can alleviate costs of agency resulting from firm's contract relationship. The managers of SMEs can raise their stake of ownership in the firm and bring into line their interests with those of shareholders, ensuing in a coming together of interests among shareholders and managers. Even by enhancing the firm equity share, the diversification of individual portfolio is lowered by the management.

2. Empirical Review

The study reviewed various studies drawn from different industries and different countries as captured hereunder. Bhaduri (2002) studied European poultry states to find out how capital structure is influenced by business risk and found that business risk is among the key factor that has influence on firms capital structure. From the study he established that debt is about honoring payments done on regular basis, firm with high debt equity ratio may have difficulties in meeting financial obligations to their creditors leading to related costs like expensive financing, opportunity costs etc. Dividend payments signifies stable financial status and hence higher borrowing capacity, most probably there will be a correlation that is positive between leverage and divided payment. Furthermore, capital markets will monitor firms that have a reputation arising from paying a stream of dividends. The investigation established that there exists a relationship amid institutional ownership and dividend payments that is positive. Nevertheless, the presence of institutional ownership alleviates the requisite for dividends as an indicator of good performance. A study carried by Myers and Majluf (2004) in German banking sector aimed at finding out how liquidity is influenced by agency cost. It discovered that when borrowing exceeds creditors threshold there exists a negative relationship. As a result, liquidity and borrowed fund relationship is expected to be negative. For established investors high-level of liquidity is expected to be a positive indicator.

Ebaid (2009) examined how the choice of components of capital structure influences the firms performance in Egypt. Gross profit margin, Return on asset and equity were used to evaluate performance. Capital structure was assessed by comparing current liabilities, long-term fund against asset, and debts to assets ratio. Relationship between performance and leverage was established by use of Multiple regression analysis. It revealed an insignificant effect of capital structure on the firms performance. A research done in Kenyan pharmaceutical industries to find out how the capital structure influenced the performance, Adekunle (2009)

compared debt against equity as an alternative to capital formation whereas ROE and ROA were used to assess the performance of firms. A study on how measures of financial performance are influenced by debt equity ratio revealed a significant negative effect.

During the period between 2004 and 2008, Kaumbuthu (2011) tried to establish the relationship of industrial return on equity to capital structure and related sectors in the Nairobi stock market. Performance focused on return on equity while composition of capital took the place of debt equity ratio. By using the regression analysis to establish the influence of debt equity to return on equity ratio, a negative relationship was found. Investigation focused on only one sector of the companies quoted in Nairobi Securities Exchange and gave consideration to only one aspect of financing decisions. Therefore, these study findings cannot be generalized to include some other more sectors. To establish the effects of firms decisions on financing to financial performance, non-financial firms quoted in the Nairobi stock market were all included by the current thesis. On the impact of capital structure to financial performance of quoted companies in the Tehran Security markets was further carried out by Saeedi and Mahmoodi (2011). The study revealed a positive correlation between performance market measures and capital structure while between return on asset and capital structure the relationship is positive but on return on equity and capital structure no notable relationship. According to Mahmoodi and Saeedi (2011) findings, different measures of performance may be affected by financial leverage.

VII. Methodology

The study adopted the causal research design and targeted SMEs in Embu County, Kenya. The SMEs targeted were those in retail business selling products and services directly to individual consumers for their own use with a goal of earning a profit. Stratified random sampling method was used to single out SME's for the survey whereas purposive sampling was used to select respondents who were to fill the questionnaires. Stratified random sampling entails subdividing the population into mutually exclusive parts called strata, based on the categories of one or a combination of relevant variables. From each stratum a simple random sample is then drawn and these sub samples are put together to form a complete stratified sample (Cooper, 2006). A sample of 29 SMEs from the target population of 95 SMEs in Embu County was selected for the study, depending on the size of each stratum.. From each stratum, purposive sampling was used to select two respondents from each sampled SME (a manager and proprietor) hence a sample size of 58 respondents. This study utilized both secondary and primary data. A period of five years was preferred which was from 2012 to 2016. The data was mainly extracted from financial statements. Organization statements and newsletters were reviewed by the investigator so as to get firms secondary data on capital formation of these organizations.

The questionnaires were administered by delivering and collecting afterward from the selected respondents. An introduction letter was developed stating the study purpose and sent to the manager/proprietor. Moreover, the purpose of the study was further explained to the individual respondents through telephone calls and also requesting for financial statements. High level of confidentiality was also guaranteed. This enhanced integrity in collected data. SPSS version 20 software of data analysis was applied to examine the quantifiable data. Further, an analysis of quantitative data was done through use of inferential and descriptive statistics. Descriptive analysis (means and Standard deviations), correlation analysis as well as Multiple Regression Analysis methods of data analyzes were used. Figures and Tables were used in presentation of Quantitative data. The study also used qualitative data attained from questions that were open ended. The presentation of data was then done in a prose form.

$$Y = B_{0+} B_1X_1+B_2X_2 + B_3X_3 +\varepsilon$$

Where y = Financial Performance

B_o = Intercept

X_1 = Equity Capital

X_2 = Debt Capital

X_3 = Retained Earnings

B_1-B_3 = Regression Coefficients

ε = Error Term

VIII. Results And Findings

The results findings were summarized and presented in the tables below. For purposes of descriptive statistics, means and standard deviations were used. Results were interpreted to form the basis of key findings.

1. Descriptive Analysis

The section presents output and interpretation on descriptive analysis which is in the form of means and standard deviations.

Table 1: Equity Capital

The study sought to establish the familiarity of the SMEs as regards the equity capital, eight items were used.

	Mean		Std. Deviation
	Statistic	Std. Error	Statistic
SME relies on equity capital to run	2.69	.227	1.473
SME has less liability burden	2.98	.217	1.405
Equity preferred to loan since is cheaper	3.50	.244	1.581
Reserves are maintained to ensure continuity	2.31	.254	1.645
Equity capital has advantages than all	2.69	.242	1.569
Equity capital alone is enough to finance a business	2.98	.254	1.645
Members receive flexible dividends from savings	3.30	.259	1.736
Firm minimizes average cost of capital	3.36	.279	1.805

Source: Research data, 2017

In view of Table 1 above, the study sought to establish the familiarity of SMEs as regards the equity capital. The highest scoring item had a mean of 3.50 while the lowest mean score was 2.31. The distribution of the means is normally distributed. Overall, the average score for equity capital familiarity appears to be average and hence there is need to put more emphasis on how to raise and increase to a level that it commands largest share in capital structure. According to the Likert scale, score of 5 indicated strongly agree, 4 agree, 3 neutral, 2 agree and 1strongly disagree. Hence, results in Table 1. indicate that most of the respondents were in agreement or neutral or disagreed to the selected items on equity capital.

The study also found that majority of the respondents agreed with the statement that; equity capital is preferred to debt equity since it is cheaper, members receive flexible dividends from their savings and with the use of equity, firms minimizes the weighted average cost of capital. Moreover, the respondents were neutral to many of the attributes, this means they were neither agreeing nor disagreeing. This aspect therefore calls need for further analysis. The study findings shows that equity capital is highly recognized as major source of finance, this is due to the fact that, an item on; equity capital alone is enough to finance a business scored average. On whether the equity capital is at maximum, majority said "NO", this shows the SMEs preferred to wait as they hope to develop a way to raise more equity capital instead of going for debt capital or retained earnings.

Table 2: Debt Capital

The researcher sought to determine the knowhow and usability of debt capital by SMEs as shown in Table 2.

	Mean		Std. Deviation
	Statistic	Std. Error	Statistic
SMEs relies on loan to run	3.31	.247	1.600
Borrowing short term reduces risk of running	3.64	.233	1.511
Borrowing long term reduces risk of investment	2.93	.134	.867
Debt preferred due to lower information disclosure	2.93	.232	1.504
SME matches maturity of its debt to asset life	2.43	.210	1.364
Issues long-term debt to min finance in bad times	2.55	.260	1.685
Firm considers credit rating before it borrows	3.29	.249	1.612
Firm limits its debt	2.74	.221	1.432

Source: Research data, 2017

In view of Table 2 above, the study investigated the extent to which the SMEs prefer short term debts and also their knowhow and usability on debt capital. The results of the study shows that, the highest score for debt capital is 3.64 while the lowest score is 2.43. This shows a high deviation from the mean. This indicates different views towards debt capital. The study shows that, SMEs concentrated their responses to the middle which is neutral. This indicates that most of the SMEs don't appreciate the use of debt capital either due to lack collateral that can qualify them access debt capital or fear the risks that accompany debt financing. Many agreed the aspect that short-term debts reduce the risk of bankruptcy. With regards to matching debts with the life of its assets the SMEs disagreed, this was either due to lack of experience with debts capital as generally SMEs have

less accumulated wealth that really don't attract lenders. These being SMEs their knowledge and accessibility of debt capital requires an enhancement. The study found that the respondents are neutral and this affects the growth and success of their business to a great extent that there is a significant effect of debt capital on financial performance of SMEs.

Table 3: Retained Earnings

The study sought to determine how SMEs manage the retained earnings.

	MEAN	STANDARD DEVIATION
Retained earnings should be used for owner consumption	3.40	1.432
Retention ratio is irrelevant when declaring dividends	2.62	1.637
Retained earnings is kept in bank for future use	2.74	1.345
Retained earnings should be reinvested	2.95	1.637
Reserves ensures continuity	2.88	1.811
Retained earnings are cheapest source of finance	2.86	1.601
Retained earnings lowers gearing ratio	3.07	1.759
Better delay than issue new securities for investment	2.67	1.525

Source: Research data, 2017

Results in Table 3 above present findings on various statements on Retained Earnings. The highest mean score was 3.4 whereas the lowest was 2.6. This is an indication that there are challenges on management of retained earnings by SMEs. Before the respondents responded to the Likert scale items, the study framed some questions with an intention to find out whether the respondent understands what is retained earnings, its use and factors that affects retained earnings. From the study the study established that, the SMEs understands and knows the factors and uses of retained earnings. This therefore enhanced the findings and interpretations of the Likert scale results. Study findings found that retained earnings is the best source of finance which is ranked first fallowed by equity capital. It is the cheapest source with very minimal risks, however the problem is how to raise it.

With all the knowledge that, retained earnings is money set aside from profit, this becomes difficult since every time profit is realized, the chances of retaining part of it proves difficult due to continuous and never finished financial obligations. The items on retained earnings is profit and should be used for owner consumption scored highest (agreed), this is evident that raising retained profit for use is a challenge. Being a risk free source of finance there should be more emphasis on training SMEs on the developing and management of retained earnings as this affects their financial performance

2 Regression Analysis

The study adopted multiple regressions where dependent variable (Y) was financial performance whereas the independent variables were Equity capital (X_1), Debt capital (X_2) and Retained earnings (X_3). The statistical package for social sciences (SPSS version 20) was used to compute measurements of multiple regression analysis. Preliminary diagnostic tests (normality, multicollinearity and heteroscedasticity) were conducted to ensure that the data was fit for purposes of running regressing analysis: their results were in the affirmative and the output is presented in 3 tables as captured below:

The results of correlation coefficients and coefficient of determination are captured in Table 4 below.

Table 4. Model Summary

Model	R	R^2	Adjusted R^2	Standard error of the estimate
1	0.683	0.466	0.423	0.203

Source: Research data, 2017

Table 4 above displays the results of multiple regression where the dependent variable was financial performance and independent variable were equity capital, debt capital and retained earnings. The degree of association between financial performance and equity, debt and retained earnings is shown by correlation coefficients (R). The findings indicate that, there was a strong positive correlation between financial performance and Equity Capital, Debt capital and Retained Earnings collectively of 0.683.

Coefficient of Determination (R^2) in the study indicate how the variability in dependent variable (Y) is caused by changes in independent variables (X_1, X_2, X_3). The results of adjusted R square indicates that 42.3% of changes in financial performance is explained by the capital structure components collectively (equity, debt and retained earnings) while the other is beyond the scope of the study.

Table 5 tests the goodness of fit of the model by interpreting the p-value at a significance level of 0.05.

Table 5. Analysis of Variance (ANOVA)

Model	Sum of Squares	Df	Mean Square	F	Sig.
Regression	1.265	3	0.422	10.538	0.000[b]
Residual	1.521	38	0.040		
Total	2.786	41			

Source: Research data, 2017

a. Dependent Variable: Financial Performance.

b. Predictors: (Constant): Equity Capital, Debt Capital, Retained Earnings

Table 5 above presents output on goodness of fit of the model by interpreting the p-value . In view of the output, the P-value (0.000) is less than 0.05 significance level, an indication that the model was statistically significance, hence, the overall model was of a good fit.

The study presents results (in Table 6 below) on beta coefficients and p-values showing significance of each predictor variable in explaining financial performance.

Table 6: Coefficients

Model	Unstandardized Coefficients		Standardized Coefficients	t	Sig.	interpretation
	B	Std. Error	Beta			
(Constant)	2.473	.327		7.571	.000	significant
Equity Capital	-.248	.103	-.513	-2.414	.021	Significant
1						
Debt capital	.273	.113	.506	2.422	.020	significant
Retained Earnings	-.022	.084	-.041	-.259	.797	Insignificant

Source: Research data 2017

The above table 6 was used in interpreting the beta and the p-value of the independent variables (Equity capital, Debt capital and Retained earnings) and also display regression analysis results which were used to formulate the regression model of the study. The focus was mainly on the unstandardized coefficients, as the section includes a Y-intercept term (beta zero) as well as a slope term (beta one). For the Y-intercept to equal to zero, standardized coefficients were based on re-scaling of the variables.

The regression function is extracted from table 6 above as follows:

$Y=2.473-0.248X_1+0.273X_2-0.022X_3$

The beta coefficients explain a one unit contribution of each predictor variable in explaining the dependent variable. The regression equation has been developed from the unstandardized coefficients which includes the y-intercepts term (beta zero) as well as a slope term (beta one). Unstandardized coefficient beta of 2.473 shows that the financial position will be at that level when all other factor (Equity capital, Debt capital and Retained earnings) are held constant. The study found that all other Independent variables being held at zero, a unit increase in equity capital will lead to a 0.248 decrease in financial performance all else constant; a unit increase in debt capital will lead to an 0.273 increase in financial performance all else constant while a unit increase in retained earnings will lead to a 0.022 decrease in financial performance all else constant.

The statistical significance of individual capital structure components on financial performance can be explained by the p-values. Of all the three independent variables, two have a p-value that is less than 0.05. In particular, Equity capital has 0.021, hence the study rejects the null hypothesis that equity capital does not have a significant effect on financial performance. A p-value, (0.020) on Debt capital. The study finds that debt capital has a significant effect on financial performance. Hence, a null hypothesis that debt capital does not have a significant effect on financial performance is hereby rejected. The p-value of SME relying on retained earnings to run the business was 0.797, this is greater than 0.05. Hence, the null hypothesis that a retained earnings does not have a significant effect on financial performance is hereby accepted.

The findings indicated a strong positive relationship of 0.683 between variables. Also revealed 45.4% capital structure of SMEs can be explained by independent variables. The researcher used stratified sampling technique to reach at 29 SMEs. The study found that a retained earnings was the cheapest source of finance. The study findings indicated a strong positive correlation (R=0.683) which is above the average 0.5. There was also a variation of 46.6% on financial performance of SMEs in Embu County due to changes in equity capital, debt capital and retained earnings. The statistical significance of individual capital structure components on financial performance was explained by the p-values. Out of the three independent variables, two had a p-value that was less than 0.05. Equity capital had 0.021, hence the study rejected the null hypothesis that equity capital does not have a significant effect on financial performance. Debt capital had a p-value of 0.020, hence the null hypothesis that debt capital does not have a significant effect on financial performance was rejected. The p-value of SME relying on retained earnings to run the business was 0.797, this is greater than 0.05. Hence, the null hypothesis that retained earnings does not have a significant effect on financial performance was accepted.

Ebaid (2009) examined how the choice of components of capital structure influences the firms performance in Egypt. On the preferred capital, equity capital proofed to be preferred by many respondents (about 61.9%) as compared to debt capital, however many SMEs cannot afford enough equity capital and relies on debt capital. Githaiga (2015) states that, the abundance of loan facilities plus the demanding approval requirements of the scantly available equity fund have led many of the SMEs to resort to debt. Comba (2013) asserts that by increasing reliance in debt financing can help firms in lowering their agency costs. The demand for financing through owners' equity reduces together with related agency costs. On the source of equity capital, majority got their equity capital from employment. Retained Earnings has proved to be the best source of capital. Myers and Majlufs (1984) argue that adverse selection implies that retained earnings are better than debt and debt is better than equity. The similarity independent variables were tested negative since all the three VIF were between 1 and 10. The pattern in the distribution graph indicated the error term was the same across all values of the independent variable. The sets of data were normally distributed and had a relationship. The analysis of variance had p-value of less than 0.05 indicated that the model was of good fit

IX. Conclusion And Recommendations

1. Conclusions

The statistical significance results as per the p-values of equity capital, debt capital and retained earnings were 0.021, 0.020 and 0.797 respectively. A p-value of less than 0.05 shows that a variable has a significant effect while greater than 0.05 shows insignificant effect. Therefore, equity capital and debt capital has a significant effect on financial performance while retained earnings does not have a significant effect. The study found that a good number of respondents appreciate the concept of equity capital and prefer it as a source of finance as it is not redeemable and it is permanent source of finance. The owner controls the business and enjoys profits whenever it's high and bears the risk alone. This therefore shows equity capital forms higher proportion of capital structure hence has a significant effect on financial performance of SMEs. Debt capital has a negative effect on the performance of SMEs due to its fixed interest that must be paid where the firm makes profit or not. The study concludes that, firms with good asset base attracts lending financial institutions hence boosting their performance as they are able to face challenges that are in business cycles. However, the study refutes high rate of borrowing as this can have negative effect to the financial performance of a firm especially when gearing ratio exceeds limit. The study found that, debt capital has a significant effect on financial performance. From the study findings, retaining earnings was well appreciated irrespective of not having a significant effect on financial performance due to challenges of raising it. It stands a chance of being the best source of finance for expansion because it is the cheapest and painless method of raising additional capital. It is money set aside from profit, therefore for any business to raise retained earnings it must make profit and have a good retention policy. Many businesses have therefore preferred equity and debt capital in financing their operations. The researcher concludes that retained earnings have insignificant effect on financial performance of SMEs.

2. Recommendations

From the study findings and conclusions, several recommendations are noteworthy. Management of SMEs should ensure that the capital structure of the firm is always at optimum. The firm cannot only survive on equity capital due to its low risk, also cannot wholly depend on debts due to high risk, more so retained earnings is only realized after making profit. They should develop an investment policy that will enable them maintain an optimum capital structure. The lending institution should develop structured ways of financing SMEs so as to boost their financial performance which may improve their lending business. Lending institution need to develop products like asset financing that are tailor made to the SMEs. The Government benefits indirectly from the operations of SMEs, have great impact towards the economy, when they thrive it's to the benefit of the

government. They pay tax and provides employment to many people, these are some the factors that facilitate economic growth. SMEs need things like proper security, good infrastructure and business friendly policies that can enhance the growth of their business. To the researchers I would recommend them to research on how cost of capital affects capital structure of the firm. They will establish on how one would arrive at optimum capital employed after mixing all the available sources of capital. This might help one understand the relationship between cost capital and financial performance of a firm. The study recommended that an entrepreneur should go for a capital mix that will give an optimum capital structure hence a sound financial performance. Also more training to SMEs is needed to ensure proper utilization of available finance.

X. Contribution To Knowledge

The study findings indicated that equity capital, debt capital and retained earnings have significant effects on financial performance of SMEs. This will help SMEs and other businesses on determining the optimum capital structure of their firms. The study findings will also enhance the knowhow of the business communities on how they can improve their financial performance. The study findings can work for both small and large business since an optimal capital structure is a major factor towards a healthy financial performance. These findings can also be of great relevance to financial institution, they need to know that even SMEs can contribute towards their financial objective (profit maximization). The governments need to put more focus to the SMEs, this is supported by the fact that SMEs contributes significantly to the economy by paying taxes and creating jobs. The researchers need also to utilize the study in comparing the results of their study on capital structure and financial performance as well as support their findings on founded similarity as they carry out their own.

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