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Effect of Financing Structure on the Profitability of Micro and Small Enterprises in Nakuru Central Business District

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Abstract: Financing a business is among the steps towards achieving firm objectives. Having a proper financing structure is the key to the successful performance of an enterprise. Existing literature about financing structure and profitability of MSEs reveals contradicting results. This study sought to assess the effect of financing structure on the profitability of micro and small enterprises in Nakuru central business district (CBD).Specific objective was to establish the effect of retained earnings on the profitability of micro and small enterprises. The study adopted a descriptive survey research design. The target population was 1,249 MSEs located in the Central Business District. A systematic random sampling technique was used in the picking of the respondents; every K^{th} MSEs became part of the response group. Simple regression was applied in establishing the cause-effect of each of the independent variables to the dependent variable. The study revealed that there is a statistically significant relationship between the financing structure and profitability of MSEs. Retained earnings have a significant positive effect on profitability at a 5% level of significance. The study concluded that the financing structure significantly affects the profitability of micro and small enterprises in Nakuru central business district.

Keywords: Financing structure, Profitability, Micro and Small Enterprises.

I. Introduction

In Kenya, Micro Enterprise is considered as a business of between one and ten employees with an income of between Kshs 1million to 5million, Small businesses range between eleven to fifty staffs and income of between Kshs 5million to 50million while Medium businesses have between fifty-one and one hundred workers with revenue of between Kshs 51million -1billion. These businesses split around all segments of employment, (Sessional paper No 2 of Government of Kenya, 2005).

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

Studies have been carried out on the relationship that exists between financing structure and profitability. Studies such as the one done by Thuranira (2014) studying about retained earnings' effect on the stock return of companies listed at the Nairobi Securities Exchange. The result of this study concluded that retained earnings were not relevant in determining the value of Returns on stock earned. Salawu and Obafemi (2009) also examined the effect of

financing structure on the profitability of Nigerian firms listed at the stock exchange. The findings from the study indicated that the financing structure effect is insignificant on the profitability, but a positive relationship between profitability and short-term debt existed. Equity in financing structure has also a positive correlation with profitability.

Nyanamba, Nyangweso, and Omari, (2013) examined factors determining the structure of financing among Micro-Enterprises in Kisii town, Kisii County. It was concluded that factors affecting the structure of capital in micro-enterprises included capital market access, size, profitability, the attitude of creditors concerning the business, structure of assets, lending interest rates, age of the business, and attitude of the management toward risk. Wagana (2014) also examined the relation of financing structure on the financial performance of the top a hundred small and medium enterprises in Nairobi County. The outcome confirmed a negative relation of financing structure on the financial performance of SMEs.

1.2 Statement of the Problem

Existing studies on business enterprises has been much focused to financing structure and performance of small and medium enterprises with more emphasis on those listed at the stock exchange. Yegon et al. (2014) did study on the effects of capital on Firm' Profitability in the Banking Sector and found a significant positive relationship between short-term debt and profitability and a statistically significant negative relationship between long-term debt and profitability. They recommended that a business should consider using a financing structure having some debt, but not in totality. The Contribution of Githire and Muturi (2015) in a study on the effects of the structure of capital on the performance of firms in Kenya established that equity and long-term debt portray a positive and major effect on financial performance, whereas short term debt has a negative and major effect on financial performance. It recommended that firms should increase financing through equity for good financial performance.It is against this reason that this study aimed at adding more knowledge on the effect of financing structure on the profitability of Micro and Small Enterprises by looking at MSEs in Nakuru Central Business District. Using Descriptive statistics and inferential statistics, in-depth insight into the topic at hand was examined. Data was contextualized with a review of recent literature on financing structure and profitability in Nakuru central business district.

1.3 Hypothesis of the study

$H_0$1: Retained earnings have no significant effect on the profitability of MSEs.

II. Literature Review

This chapter gives an analysis of the critically reviewed literature on the topic under study. It first looks at the theoretical review, followed by an empirical review of existing studies conducted by other researchers in the same line, and a conceptual framework constructed.

2.1.1 Theory of capital structure Irrelevance

According to Modigliani and Miller (MM) hypothesis was proposed by Franco Modigliani and Merton Miller (1958). It forms the basis for modern financing structure thoughts and explains that financing structure is crucial in examining the worthiness of a business. It theorizes that the market value of a firm is determined by its earning power and by the risk of its underlying assets and that the value it has is not dependent on the way it chooses to finance its investments. It adds that a tax shield is witnessed in using debt and firms may decide on an all-debt structure. The theory stipulates that capital decisions by businesses are unrelated to the value of the business.

2.1.2 Pecking Order Theory

Donaldson in 1961 came up with the Pecking order theory which was then modified by Stewart Myers and Nicolas Majluf (1984). It proposed an alternative to explain why firms choose a certain financing structure. This theory is termed as the pecking order theory which is a preference order theory. It explains that there is an order of preference normally followed by management in funding a business. The theory clarifies why a bigger margin of external funding originates from debt and the reason majority of firms who are profitable borrow less.

2.2 Empirical Literature

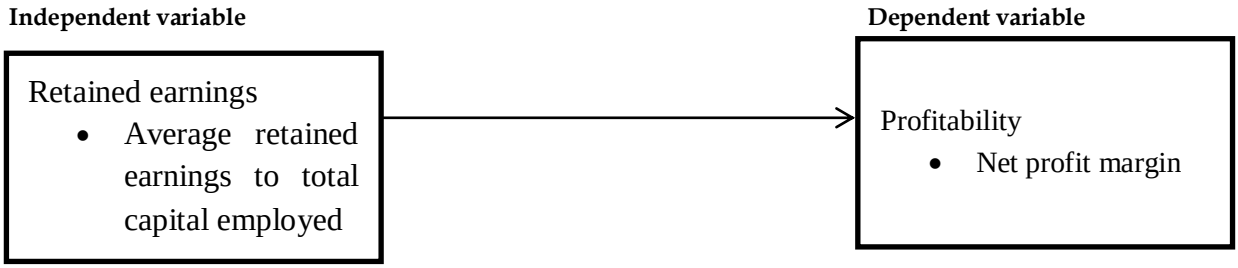
Studies have been done in consideration of structure of capital and profitability or/and performance of organization. Optimal capital structure is that in which its weighted average cost of capital is at minimum leading to maximization of worthiness of business. While some scholars observed positive effect of capital structure and profitability, others observed a negative effect, while still others observed a mix of negative and positive results.

2.2.1Retained earnings and Profitability

Thuranira (2014) studied about retained earnings effect on the stock return of companies listed at the Nairobi Securities Exchange. Results exhibited no significant relationship in returns on stock and retained earnings through a simple linear regression model. It was concluded that retained earnings were not relevant in determining the value of returns on stock earned. Muganda et al, (2016) concur that retained earnings financing affects the financial performance of small and medium enterprises significantly. This was in their study on the effect of business financing on the performance of small and medium enterprises in Lurambi sub-county, Kakamega where they used descriptive and inferential statistics.

2.5 The Conceptual Framework

This section presents conceptual framework that shows the hypothetical relationship between variables under study.



Independent variable **Dependent variable**

Figure 2.1: Conceptual Framework

III. RESEARCH METHODOLOGY

3.1 Research Design.

A descriptive survey design was used for this study to assess if the financing structure of micro and small enterprises affects profitability. This research design was chosen because of its high degree of represent activeness and the ease in which a researcher will obtain the participants' opinion, it involves gathering data that describe events and then organizes, tabulates, depicts, and describes the data collection

3.2 Target Population

This study was carried out in Nakuru central business district. The target population was 1,249 comprising all micro and small enterprises that were situated along Kenyatta Avenue and had been registered as of 1st July 2017 by Nakuru Municipality. The choice of this avenue was triggered by fact that it is located centrally within the town and a bigger number of micro and small enterprises stretch along this avenue (Municipal government of Nakuru, 2017).

3.3 Sampling and sample size

To arrive at a sample size used in the study, the researcher applied a sampling formula by Yamane (1967). When used, out of the target population of 1,249 MSEs, a sample size of 302 MSEs was obtained. In selecting the respondents for the study, the researcher employed a systematic sampling design by Madow and Madow (1944) where every Kth MSE along the avenue was identified to become part of the sample size. The respondents were the owners of these enterprises.

3.4 Data Collection Procedures

The study relied on primary data. Data was obtained from the owners of the MSEs sampled out as respondents. Data was collected by the use of structured questionnaires, with closed questions. Data covering a period of within 2011-2017 and for those businesses that kept their financial records were used.

3.5 Data Presentation and Analysis

A computerized data analysis package known as Statistical Package for the Social Science (SPSS)version 21was used for data entry and analysis. Simple regression was applied in establishing the cause-effect of each of the independent variable to the dependent variable. The result was for responding to the hypothesis under study. A regression model that guided the analysis was in the following form:

The first hypothesis; $H_0 1$: Retained earnings have no significant effect on the profitability of MSEs, was tested using

$$Y = a + \beta_1 X_1 + \epsilon$$

Where:

Y = Profitability, measured as a ratio of net profit margin

X_1= Retained earnings, measured as a ratio of average total retained earnings to average total capital used in the business.

a = Constant (y-intercept)

ϵ = Error term

β_1, β_2, and β_3 = The strength of the relationship between the variables.

Debt capital constituted the bank loan, trade credit, and bank overdraft for analysis.

The model significance was confirmed using the analysis of the variance (ANOVA) by the use of F statistics at a 95% confidence level. The coefficient of determination R^2 was used to show the contribution of the independent variable on the dependent variable.

In this study, the moderating variable, the size of the enterprise was not part of the analysis. It was held constant.

IV. DATA PRESENTATION, ANALYSIS, AND DISCUSSION

4.1 Correlation between retained earnings and profitability

Table 1: Correlation matrix

		Profitability	Retained earnings
Pearson Correlation®	Profitability	1.000	0.579
	Retained Earnings	0.579	1.000
Sig. (1-tailed)	Profitability	.	0.000
	Retained Earnings	0.000	.
		N=268, α= 0.05	

The study established the relationship that existed between retained Earnings and profitability in MSEs. According to the results in table 4.1, there existed a positive and statistically significant ($r = 0.579$; $p < 0.05$) correlation between retained earnings and profitability in MSEs.

4.2 Regression analysis between retained earnings and profitability

Simple regression analysis was used to examine the effect of retained earnings on the profitability and in testing the hypothesis. The hypothesis guiding this study was that $H_0 1$: Retained earnings have no significant effect on the profitability of MSEs in the Nakuru Central Business District. Results are presented in the table

Table 2: Effect of retained earnings on the profitability of MSEs.

	R	R Square	Adjusted R Square	Std. Error of the Estimate
Model	0.623[a]	0.388	0.266	0.3206

Predictors: (Constant). Retained Earnings

Dependent Variable: Profitability

	Unstandardized Coefficients		Standardized Coefficients	t	Sig.
	B	Std. Error	Beta		
Constant	2.423	0.456		5.313	0.046
Retained Profit	0.667	0.222	0.672	3.002	0.033

From table 4.13, the regression outcome, R-Square of 0.388 shows that as an effect, retained profit contributed to an extent of (38.8%) for the dependent variable which is the profitability of micro and small enterprises. The remaining percent of (61.2%)was attributed to the error term as well as other extraneous variables not covered by the study. Furthermore, the results inform of the existence of a positive statistically significant relationship between retained earnings and profitability of micro and small enterprises in the Nakuru central business district (β= 0.667, P<0.05).

V. CONCLUSION

It is therefore concluded that retained earnings positively influence the profitability of micro and small enterprises in Nakuru Central Business District and so it should always form a component of capital structure.

VI. RECOMMENDATION OF THE STUDY

Micro and Small enterprises should continue using retained earningsfor purposes of increasing profitability before they opt for debt capital. This is because any increase in Retained earningsleads to an increase in the profitability of micro and small enterprises

VII. SUGGESTION FOR FURTHER STUDIES

A further studycan be done by considering other components that make up the financing structure. A similar study could also be done on enterprises not covered by this study.

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