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THE EFFECTS OF EQUITY FINANCING ON FINANCIAL PERFORMANCE OF SMES IN UGANDA, A CASE OF SELECTED WHOLESALE BUSINESSES IN KAWEMPE DIVISION

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ABSTRACT

This study looked at the effect of equity financing on financial performance of SMEs in Uganda. Although equity financing is important in explaining the creation of SMEs, the extent to which equity financing affects the performance of SMEs is not well known. The study was guided by the following objectives, to examine the relationship between retained profits and the Return on Investment (ROI) of SMEs, to investigate the effect of Contributions from friends on return on assets (ROA) of SMEs and to examine the effect of Own Savings on the sales growth of SMEs. The research was carried out in Kampala district, Kawempe Division. Kampala was chosen because it is one of the regions with the highest concentration of businesses. The research adopted a descriptive survey design and targeted all small and medium enterprises in Kawempe division. Major focus was on accessible SMEs and the population was 70 registered SMEs in Kawempe Division. The sample was determined using simple random sampling. The study used primary data that was collected from the respondents using self-administered semi-structured open and close ended questionnaire. A five step likert scale was used for close ended questions. The collected data was refined, coded, and analyzed using STATA 12 and MS Excel to give more meaning to the findings of the study. The research findings indicated that 47% of the businesses were in the early stages of growth while 43% of the business units have exceeded the infancy stage of growth. The most preferred form of businesses in Kawempe Division 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. From the study it was evident that equity finance had a positive relationship to financial performance of the SMEs. SMEs prefer equity of own savings. This is because the entrepreneurs prefer to own risks at the same time avoiding any undesirable change in ownership. This is because most of the businesses are sole proprietorship forms of businesses which are controlled and managed by the owners.

Keywords: equity financing, sole proprietorship, small and medium enterprises and financial performance.

1.0 INTRODUCTION

The SMEs sector is increasingly viewed as an important engine for job creation, employment creation and economic growth. This has been necessitated by the increasing awareness within the government that large projects in the industrial sector are less likely to generate the requisite employment opportunities, given the high capital-intensity of output in the sector. The importance of finances has been viewed as a critical element for financial performance of small and medium-sized enterprises. Limit to finances hinder growth and development of these firms (Levy, 2015).

SMEs make up over 90% of business units in the world and account for between 50%-60% of the total employment while SMEs engaged in manufacturing account for between 40 and 80 per cent of manufacturing employment (Kennedy & Hobohm, 1999). It is estimated that SMEs employ 22% of the adult population in developing countries (Peter, 2001).

Despite the role played by SMEs, the World Bank Report (2018) suggests that one of the major causes of SMEs failure is limited access to 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.

According to Chepkemoi (2015) earlier studies on general small firm capital structure presupposed small and medium sized enterprises to predominantly act in such a way as to maximize their financial wealth. A consequence of this assumption is that, these studies assumed that SMEs, in general, desire substantial growth and consequently have a desire for external finance.

2.0 THEORETICAL FRAMEWORK

The study was based on four theories: The Static Trade-off Theory, The Pecking Order Theory, Signaling Theory and Market Timing Theory

2.1The Static Trade-off Theory

Under the Static Trade-off of Financing Strategy (also referred to as the Tax Based Theory), Baxter, (1967) and Altman, (2002), noted that optimal financing strategy is obtained where the net tax advantage of debt financing balances leverage related costs such as financial distress and bankruptcy, holding the firm's assets and investment decisions constant. In view of this theory, issuing equity finance means moving away from the optimum and should therefore be considered as not good. Myers (op. cit.) had found that firms adopting Static

Trade-off was regarded as setting a target debt-to-value ratio with a gradual attempt to achieve it. He however, suggested that managers will be reluctant to issue equity finance if they feel it is undervalued in the market. The consequence is that investors perceive equity issues to occur only if equity is either fairly priced or overpriced. As a result investors tend to react negatively to an equity issue and management is reluctant to issue equity.

2.2 The Pecking Order Theory

The Pecking Order Theory (also referred to as the Information Asymmetry Theory) was proposed by Myers (op. cit.), and Myers and Majluf op. cit. It states that firms prefer to finance new investment first internally with retained earnings, then with debt, and finally with issue of new equity. He argues that an optimal Financing Strategy is difficult to define as equity appears at the top and the bottom of the 'pecking order'. Internal funds incur no flotation costs and require no disclosure of the firm's proprietary financial information that may include the firm's potential investment opportunities and gains that are expected to accrue from undertaking investments. They pointed out that underpricing would be the best result of less information held by potential investor vis-a-vis management with respect to the expected cash flows from the firm's assets, both current and future. Considering this information asymmetry, investors would infer that the management would issue equity only when it is overpriced. Thus the newly issued equity might be sold at a discount. This would be regarded as a wealth transfer from existing investors to the new ones. This problem could be avoided if the firms use internally generated resources, such as retained earnings.

2.3 Signaling Theory

The impact of the signaling factor as already discussed in the Pecking Order Theory is the problem of the underpricing of equity. If a firm issues equity instead of debt for financing its new projects, investors will interpret the signal negatively. Since managers have superior information about the firm than investors, they might issue equity when it is overpriced.

2.4 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 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 (Colabrese, 2011).

Hovakimian (2006) revisited the view of Baker and Wurgler (2002), it argued that negative effects of past weighted average market to book ratios on capital structure was not merely due to the market timing effects, in fact this was due to past market to book ratios which was indication of growth and that was affecting the financing decisions. Alti (2006) among others postulated the IPO issuances as indicator of market timing, it was viewed that the firms went public in HOT market, implied the market timing behavior, however, analysis failed to show long run effects of market timing on capital structure.

2.5 Purpose of the study

The study seeks to examine the effect of equity financing on financial performance of SMEs in Uganda, A Case of Selected Wholesale Businesses in Kawempe Division

2.6 Objectives of Study

i. To examine the relationship between retained profits and the Return on Investment (ROI) of SMEs
ii. To investigate the effect of Contributions from friends on return on assets (ROA) of SMEs

iii. To examine the effect of equity financing; contribution from friends, Retained profits and Own Savings on Financial Performance

3.0 LITERATURE REVIEW

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 (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. 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).

To measure the success of an enterprise and to guide executives through the benefits realization process, an appropriate performance measurement model is needed. It is common practice to measure the performance of any business on a financial scale. Return on Investment (ROI) and Return on Capital Employed (ROCE) sales, profitability among others are the most common ways of measuring the financial success of a business (Kaplan and Norton, 2000; Kaplan and Norton, 1996).

3.2 Overview of SME

Small and medium-sized enterprises are a centerpiece of the world economy. This includes most developed economies such as Europe economy. This is due to their economies of scale and their financing operations and, in particular, from access to securitized lending and stock markets. However, SME limitations in financing their operations may seriously limit their expansion potential and, in particular when it comes to lack of risk capital and their innovation (Akhtar, 2005).

It is also estimated that SMEs constitute over 90 percent of total enterprises in most economies with a high rate of employment growth. They are also a vehicle for increased industrial production and exports (Copper et al 2005). However, there are challenges that they face. A recent study by Wanjohi (2005) reveal that most people in Kenya work in the agricultural sector with majority practicing subsistence farming while a very small number practice large-scale

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farming. Some people work as wage labourers in coffee farms or tea plantations where they are paid small wages and life become rather unbearable at times. There are all sorts of small businesses related to agricultural sector and finance is said to be the major challenge in whichever business one undertakes.

SMEs within the manufacturing industry have not seen much development since independence due to financial constraints. The informal sector is comprised of low scale artisans who mostly apply appropriate intermediate technology. This sector, given all conditions for growth can bring about industrial revolution in Kenya (Wanjohi, 2005).

Despite all the roles played by SMEs, the World Bank Report (2010) suggests that one of the major causes of SMEs failure is limited access to 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).

4.0 RESEARCH METHODOLOGY

A descriptive survey research design was employed in this study. A descriptive design is 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.

4.1 Study Area and Population

The target population comprised of all registered Wholesale Business in Kawempe Division. However, the major focus will be on the accessible population (Wholesale Business). The accessible population is that proportion of the target population that the researcher can access easily and conveniently. The accessible population for the study will be 85 registered Wholesale Business in Kawempe Division.

4.2 Sampling strategies

The researcher used a simple random sampling technique for the qualitative data. Simple random sampling technique is deemed suitable because each SME is chosen entirely by chance and each has an equal chance of being included in the sample.

4.3 Data collection methods

The study used primary data that was collected from the respondents using self-administered semi-structured open and close ended questionnaire. A five step likert scale was used for close ended questions.

4.4 Data Analysis

The collected data was refined, coded, and analyzed using SPSS and MS Excel to give more meaning to the findings of the study. Central tendency measures will be used and these

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included; mean, frequencies, percentages and Standard Deviation (SD). In order to establish relationships, and effects, Regression and Correlation models between variables were conducted.

5.0 RESEARCH FINDINGS

The study findings are presented in form of tables showing frequencies, percentages, mean scores, standard deviation and variance.

5.1 Equity Financing

The study sought to determine how various aspects of equity finance affect the financial performance of the SMEs. The findings are shown in Table

Table A: Shows Summary Statistics on Equity Financing

Statements	Observations	Min	Max	Mean	Std Dev	Var
Retained Profits	58	1	5	3.97	0.834	1.861
Own Savings	60	1	5	4.61	0.737	0.544
Contributions from friends	59	1	5	3.73	1.304	1.701

Source: Primary Data (2019)

The study findings revealed that the respondents agreed (Mean= 4.61: std dev = 0.737) that own savings and Contributions from friends (mean= 3.73; std dev= 1.304) was used to finance the business operations. Respondents also agreed (Mean=3.97: std dev= 0.384) that retained profits was used to finance long term growth of the business and actually affected the financial performance of the business. 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 use the money to finance other business activities.

Table B: Shows findings on the relationship between retained profits and the Return on Investment (ROI) of SMEs

Statements	Observations	Min	Max	Mean	Std Dev	Var
Increase in investment is as a result of use of equity	60	1	5	3.51	1.207	1.456
Liquidity position of profits affect performance and investment	60	4	5	4.44	0.502	0.252
Increase in investment is attributed to use of profits	60	1	5	3.71	1.327	1.762
Source of finance influence the investment and performance of SMEs	60	2	5	4.37	0.994	0.988

Source: Primary Data (2019)

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The findings revealed that Liquidity position of profits affect performance and investment (Mean = 4.44: std dev= 0.502) and Source of finance influence the investment and performance of SMEs (Mean = 4.37: std dev = 0.994) and affects their financial performance. Similarly respondents were in agreement that Increase in investment is attributed to use of profits (Mean =3.71; std dev = 1.327) and Increase in investment is as a result of 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 fall 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.

6.0 DISCUSSION AND RECOMMENDATIONS

6.1 The relationship between retained profits and the Return on Investment (ROI) of SMEs

The findings revealed that Liquidity position of profits affect performance and investment (Mean = 4.44: std dev= 0.502) and Source of finance influence the investment and performance of SMEs (Mean = 4.37: std dev = 0.994) and affects their financial performance. Similarly respondents agreed that Increase in investment is attributed to use of profits (Mean =3.71; std dev = 1.327) and Increase in investment is as a result of 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.

7.0 CONCLUSIONS

The research findings indicate that 47% of the businesses are in the early stages of growth while 43% of the business units have exceeded the infancy stage of growth. The most preferred form of businesses in Kampala Central Division 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.

From the study it was evident that equity finance had a positive relationship to financial performance of the SMEs. SMEs prefer equity of own savings. This is because the entrepreneurs prefer to own risks at the same time avoiding any undesirable change in ownership. This is because most of the businesses are sole proprietorship forms of businesses, which are controlled and managed by the owners.

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