






“Interplay between capital structure choice and survival and growth of small, medium, and micro enterprises: A South African context”

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INTERPLAY BETWEEN CAPITAL STRUCTURE CHOICE AND SURVIVAL AND GROWTH OF SMALL, MEDIUM, AND MICRO ENTERPRISES: A SOUTH AFRICAN CONTEXT

Abstract

It is essential for small, medium, and micro enterprises (SMMEs) to become established, be sustainable and grow. These firms play a vital role in the economy of both developed and developing countries. Empirical studies have acknowledged the contribution of SMMEs to the economy, as well as to the gross domestic product. However, the failure rate of these firms has also been emphasized in the same studies. SMME survival is critical for economic growth, which is measured by increases in profits. Capital structure decisions are significant to the survival and growth of these entities. This study was conducted to examine the interplay between capital structure and SMMEs' survival and growth in a developing economy. A sample size of 103 SMMEs was chosen on a non-probability basis using convenience sampling within the eThekweni area, KwaZulu-Natal, South Africa. The statistical tool used for analysis in this study was the Partial Least Squares Structural Equation Modelling (PLS-SEM) 5.0 software. Capital structure was found to have a significant influence on the growth and survival of small, medium, and micro enterprises. The study concludes that utilizing retained earnings, personal savings, trade credit and funds from friends and family has a significant influence on the growth and survival of the firm. Debt and external equity financing, on the other hand, have an insignificant influence on the growth the firm.

Keywords

capital structure, developing economy, SMME growth,
SMME survival, sustainability

JEL Classification

G32, L21, L25

INTRODUCTION

Empirical studies have evinced that SMMEs across the world are engines in developing the economy, as these firms are perceived to be the hope for inequalities faced by these countries. South African SMMEs have also been found to be catalyst for substantial economic growth. The South African National Development Plan predicts that SMMEs will employ 90 percent of the country's employment quota by 2030 (Mokuoane, 2016). Despite the noteworthy economic contribution by SMMEs, it is challenging for these firms to thrive due to various challenges. Access to adequate finance for SMMEs have been found to be the greatest challenge, with these firms relying on informal sources of funds rather than formal sources.

Finance is a crucial matter for growing firms and the primary funds form a foundation from which other factors will be built on (Ngubane, 2015). According to Koropp, Grichnik, and Kellermanns (2013), access to adequate and suitable capital is one of the most crucial resources for a firm to grow and ensure the survival. Once growth stops, the firm

is likely to not survive. Therefore, the SMMEs survival is considered significant for economic growth (Shin, Park, Choi, & Choy, 2017), which, according to Okoye, Mbanasor, Okoye, and Nto (2013), is based on positive growth and increases in profits over three years.

It is for this reason that managing the capital structure in SMMEs is of paramount importance to ensure that strategic financing decisions pursued will aid growth and survival of these entities. This study, therefore, aims to ascertain factors influencing the capital structure for the survival and growth of these firms in a developing economy.

The next section unpacks the literature review, which is followed by the research methodology employed in this study. Subsequent to that, this paper discusses research findings and implications of this study, whilst the last section provides recommendations for SMMEs and for future research.

1. LITERATURE REVIEW

1.1. Theoretical framework and definition of key terms

As a point of departure, this study unpacks the theoretical framework that was pursued by first discussing relevant terms.

1.2. Capital structure

The advent of capital structure began with a seminal paper by Modigliani and Miller in 1958 known as the “irrelevance theory,” which concluded that the value of a firm remains unchanged notwithstanding the financial decisions made by firms. The main theories of capital structure are trade-off theory and pecking order theory. The pecking order theory posits that businesses have a preference in the type of financing; with internal financing utilized first preference, debt follows after and external equity as the last option (Trinh, Kabinaka, Kim, & Jung, 2017). The trade-off theory refers to balancing the benefits of debt through tax shields and the cost of debt (Serrasqueiro, Nunes, & Armada, 2016). Empirical research conducted on financing decision initiates from the capital structure theories, with a huge number of empirical studies focusing on large firms in contrast to small firms (Rao, Kumar, & Madhavan, 2019).

1.3. Survival

Survival has been considered to be critical for economic growth (Shin, Park, Choi, & Choy, 2017). According to A. C. Okoye, Mbanasor, B. C. Okoye, and Nto (2013), firm survival is dependent on pos-

itive growth. A. C. Okoye, Mbanasor, B. C. Okoye, and Nto (2013) also add that firm survival depends on firm size, firm age, the employment of highly-skilled workers and the leverage of the entity. Aigbavboa, Tshikudo, and Thwala (2014), however, found networking skills as being the most vital trait that an entrepreneur requires to achieve success, a skill vital for the survival of the firm. Liu and Pang (2015) mirror A. C. Okoye, Mbanasor, B. C. Okoye, and Nto (2013) proposing that firm survival tends to increase with firm age and firm size. Cant, Erdis, and Sephapo (2014) posited that most small firms in South Africa are survivalists, suggesting that their growth is limited, resulting in limited economic development and mildly alleviating poverty. It is, thus, not surprising that the National Small Business Amendment categorizes small businesses into survivalist, micro, very small, small and medium (ILDP, 2014). Ensuring that this sector is viable should be the goal of every government (Ngubane, 2015).

1.4. Growth

Despite growth being a vital indicator of a flourishing firm, measuring growth has its own challenges, since most countries are not consistent in the measurement growth or growth is not measured at all (Ngubane, 2015). Growth has numerous overtones such as sales turnover, value addition and expansion (P. Gupta, S. Gupta, & Krishnaswami, 2013). According to Sarwoko and Frisdiantara (2016), growth determinants include the personal value of the owner/manager (personality traits of an owner/manager, motivational growth, individual competence, and personal background). On the other hand, C. Tundui and H. Tundui (2012) revealed that

the growth of any firm regardless of size depends on the capital acquired at the firm's start-up. In addition to sustaining expansion, this amount can influence the capital structure and profitability of the entity. Blasco, Carrizosa, and Llopis (2016) further proposed that firm growth can be defined in various ways, such as employment, sales turnover, profit, productivity and added value. Blasco, Carrizosa, and Llopis (2016) and Wang (2016) defined 'high growth' as average employment growth of at least 20 percent per annum over three years. Omar (2016) acceded with Blasco, Carrizosa, and Llopis (2016) stating that the two most important indicators for measuring SMMEs growth are turnover and employment. Empirical studies by Moen, Heggeseth, and Lome (2015), Lekhanya (2016) and Kovač, Šesnić, and Krišto (2018) further propose that turnover and employment growth are frequently used indicators for measuring firm growth. In this study, growth and survival were measured using SMMEs turnover and number of employees.

1.5. The relationship between the capital structure and SMMEs growth and survival

Silva (2015) asserted that growth in a firm is an intricate phenomenon and one determinant cannot fully explain this phenomenon as "alterations in perspective and interpretations, effectiveness, empirical contexts, modelling and analysis approaches" are likely to be the causes of the difficulty in coherent determinants of firms' growth. Entrepreneurs have different growth objectives and may be at different stages in their own lifecycles (Bhaumik, Fraser, & Wright, 2015). Dimensions to measure the growth can be change in employees, sales and profit. Sales growth is used as the primary measure of growth in most empirical studies, since most firms require sales to survive and grow. Silva (2015) further indicated that small businesses have diverse needs and encounter various difficulties as compared to large firms, with access to finance being a crucial factor for these businesses. The capital structure decisions made at the initial stage of the business are extremely important to the survival and growth of SMMEs (Cole & Sokolyk, 2017). The study of Cole and Sokolyk (2017) discovered that entities utilizing business debt, as opposed to personal debt, are more likely to survive the first three years of operation and realize greater revenues. In

their study, it was revealed that firms are expected to utilize credit at start-up when they have larger revenue and more educated primary owners, while black-owned firms are significantly less likely to use credit. Bhaumik, Fraser, and Wright (2015) opposed Cole and Sokolyk (2017), arguing that the use of external finance is influenced by the owner/manager perceptions rather the owners' educational level and race.

Accessing finance is a challenge for many firms. Silva (2015) suggested that lack of collateral and astronomical interest rates with no flexibility in instalments with private banks is a major reason. Private banks are frequently being identified as inadequate source of finance. Newly established firms are limited in capital and due to this limit, these firms will rely more significantly on internal sources of funds such as retained earnings and capital. Banks would be the next source of financing that these firms will seek. A listing on a stock exchange can place firms in a strong position to bargain (Silva, 2015). Raising funds via stock exchanges represents the most popular and promising external long-term equity financing (Šestanović, 2015). A benefit for establishing stock exchanges for small firms is for these firms to obtain public equity capital. However, small firms, in contrast to large firms, encounter certain difficulties in raising funds using the stock exchange. Difficulties include high transaction costs, listing requirements and frequent vastly complex legal and regulatory frameworks (Šestanović, 2015). The lack of alternative stock exchanges for small firms has been experienced and it is becoming essential that small firms have a stock exchange (Jain, Shukla, & Singh, 2013).

The benefits of establishing a stock exchange for small firms is decreasing the asymmetric information on the market (Šestanović, 2015; Kovač, Šesnić, & Krišto, 2013; Jain, Shukla, & Singh, 2013). According to Kulkarni and Chirputkar (2014), listing SMEs on stock exchanges can add greatly to the creation and distribution of wealth in the economy. Bhaumik, Fraser, and Wright (2015) indicated that start-up firms rely on internal financing, trade credit and the least used finance, angel finance. However, recently, crowd-funding and accelerators are used as sources of funding. As firms grow, they become more likely to access external funds, such as debt, venture capital and public debt/equi-

ty. Bhaumik, Fraser, and Wright (2015) further reported that firms that are growth-orientated will be more likely to seek external funds. Silva (2015) postulated that these firms use external financing when starting up, although not as significantly as internal financing. Finance is a crucial matter for growing firms and the primary funds form a foundation from which other factors will be built on (Ngubane, 2015). According to Koropp, Grichnik, and Kellermanns (2013), access to adequate and suitable capital is one of the most crucial resources for a firm to grow and ensure the survival.

2. RESEARCH METHODOLOGY

This research focused on SMMEs operating within eThekweni area, in KwaZulu-Natal, South Africa. The methodology for this study was quantitative and cross-sectional in nature. The sample size of 103 respondents was chosen on non-probability convenience sampling. The Partial Least Squares Structural Equation Modelling (PLS-SEM) 5.0 was used.

Both convergent validity and discriminant validity were measured for the questionnaire. According to Forsberg (2017), convergent validity is a measurement used to examine the proximity between two related constructs, describing how two constructs converge, this is measured using average variance extracted (AVE). Sufficient convergent validity is acceptable with AVE being more than 0.5, but with the composite reliability being higher than 0.6 (Fornell & Larcker, 1981; Y. Huang, Wang, Wu, &

P. Wang, 2013). In Table 1, we find that AVE higher than the standard 0.5. The constructs of this study have convergent validity.

Discriminant validity on the other hand is performed to demonstrate that all the constructs are different from each other and is evaluated by considering the correlation amongst the constructs (Alkis, 2010). Using PLS-SEM 5.0 software, discriminant validity can be measured using Fornell-Larcker's criterion. The cronbach's alpha (CA) was performed for this study to confirm the reliability as well as the composite reliability (CR). The threshold of 0.7 which indicates a good reliability was met in the value of CR (Huang, Y. Wang, Wu, & P. Wang, 2013; Fornell & Larcker, 1981). Each dimensions CR are above the threshold indicating good reliability, however, CA was below the threshold. The CA and the consistent reliability coefficient (rho_A) with an asterisk were doubtful, being less than 0.7, but kept to maintain face consistency for the other factors (Henseler, Ringle, & Sinkovics, 2009). As shown in Table 2, the bold values diagonally exceed the inter-factor correlations. Therefore, it can be concluded they discriminant validity is acceptable.

3. RESEARCH FINDINGS

3.1. Descriptive statistics of demographic variables

Table 3 gives a summary of the descriptive statistics of respondents. The study found business owners in KZN had slightly more female owners

Table 1. Construct reliability and validity

Category of Questionnaire	CA	rho_A	CR	AVE
Capital structure of the firm (CapStrFirm)	0.490*	0.497*	0.796	0.662
Capital structure on survival and growth (CapStrSurGrth)	0.851	1.005	0.904	0.761
Financing information on the firm (FinInfoFirm)	0.741	0.877	0.826	0.548
Information on the firm (InfoFirm)	1.000	1.000	1.000	1.000

Note: * CA and rho_A less than 0.7.

Table 2. Discriminant validity

Category of Questionnaire	CapStrFirm	CapStrSurGrth	FinInfoFirm	InfoFirm
Capital structure of the firm	0.813	–	–	–
Capital structure on survival and growth	–0.302	0.872	–	–
Financing information on the firm	–0.078	0.069	0.740	–
Information on the firm	0.017	0.126	0.129	1.000

Table 3. Descriptive statistics of demographic variables

Demography	Characteristics	Percentage	Mean	Standard deviation
Gender	Male	46	1.54	0.50
	Female	54		
Age	Between 25 and less	8	3.02	1.06
	Between 26 and 35	24		
	Between 36 and 45	34		
	Between 46 and 55	26		
	More 55 and above	8		
Highest qualification	Matric	57	2.03	1.40
	Diploma	9		
	Degree	18		
	Professional qualification	4		
	No qualification	12		
Work experience	0-1 years	12	3.17	1.35
	1-2 years	25		
	2-4 years	16		
	4-5years	22		
	Above 5 years	25		

(54%) than males (46%). In addition, the study shows that the majority of respondents are middle-aged (44%) who had managerial experience before they undertook the current business. The study also found that the owners have somewhat a low level of academic qualification where more than half of them have a matriculation (58%).

Table 4 and Table 5 display SMMEs' capital structure choices when these entities were established. Sources of financing were measured using the following variables: retained earnings, personal savings, funds from friends and family, trade credit, debt and external equity financing. External equity financing included venture capital, private investors and government loans. Tables 4 and 5 show the level of importance of these financial sources at the initial stage of the firm and also once the firm was established.

As reflected in Table 4, personal savings is of the utmost importance financing choice at the initial stage of the firm. These findings concur with Fourati and Affes (2013) in that majority of SMME owners utilized personal savings at the

initial stage of the firm. Trade credit and funds from friends and family was preferred thereafter while debt and external equity were not preferred by these owners. Previous studies by Nawi (2015) and Fourati and Affes (2013) maintain that debt financing is utilized minimally, while external equity was found as being the least preferred source of financing. This assents with the findings of this study that debt and external equity financing was an insignificant source of financing at the initial stage of the firm.

Table 5 demonstrates the level of importance of the same aspects as Table 4, however, includes retained earnings.

As firms grow and mature, they may reinvest retained earnings back into the firm (Nawi, 2015). This is evident with the result from Table 5 in which we find that owners utilized retained earnings more than the other sources of finance. This indicates the importance of a firm remaining profitable, that is, generating retained earnings. The results of the study also reveal that personal savings and trade credit were preferred following

Table 4. Initial financing choice of firms

Financing choice	Not important at all	Not important	Neutral	Important	Very important
Personal savings	16%	0%	5%	17%	62%
Funds from friends and family	35%	9%	8%	28%	20%
Trade credit, lease, hire purchase	25%	13%	10%	35%	17%
Debt (loan)	50%	5%	14%	18%	13%
External equity financing	56%	12%	16%	11%	5%

Table 5. Financing choice of firms after being established

Financing choice	Not important at all	Not important	Neutral	Important	Very important
Retained earnings	11%	1%	4%	14%	70%
Personal savings	18%	0%	8%	31%	43%
Funds from friends and family	44%	12%	14%	10%	20%
Trade credit, lease, hire purchase	33%	12%	9%	31%	15%
Debt (loan)	53%	17%	6%	11%	13%
External equity financing	60%	7%	13%	8%	12%

retained earnings. Debt and external equity financing as shown to be the least preferred capital, which indicates the reluctance of owners to utilize these types of capital. Empirical studies reveal that internal financing is preferred over external financing as owners' fear using external financing may lead to loss of control over the firm (Borgia & Newman, 2012). Surprisingly, personal savings and funds from friends and family were still preferred by these firms after the firm was established.

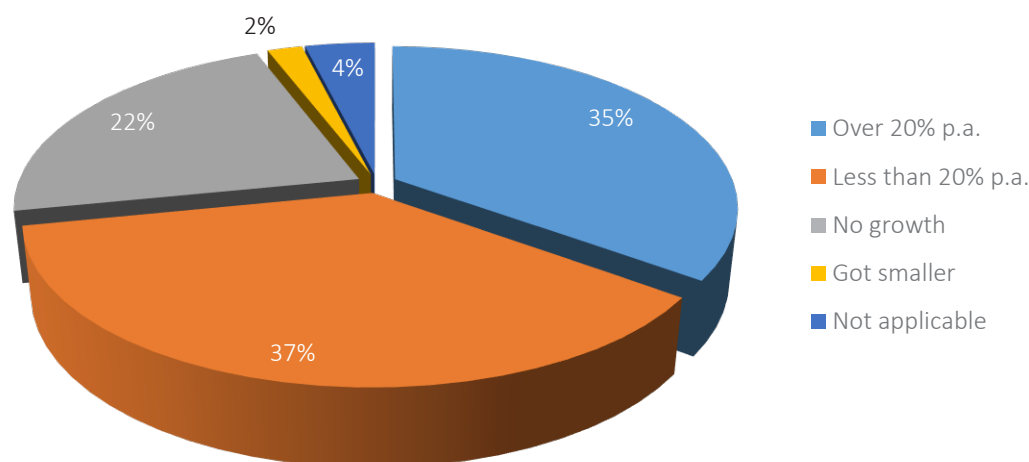
3.2. Findings on the growth of SMMEs

Figure 1 demonstrates the growth in employment for SMMEs firms. Omar (2016) speculates that an increase in employment indicates an increase in growth. The results reveal that the firm increased the employment during the operation of the firm, therefore, it can be interpreted that these firms have grown. The findings of the study indicate that owners utilize more retained earnings in the capital structure once the firm was established. By utilizing retained earnings, the firms grow substantially. The capital structure utilized by these SMMEs also included personal savings, trade credit and funds from friends and family.

Figure 2 specifies the future growth of the SMMEs firms. In Figure 2, the respondents revealed their expectations to grow the firm over the next two to three years. The findings divulge that owners have an expectancy for the turnover to grow, as a growth, especially in sales has a significant influence on the survival and growth of a firm (Lekhanya, 2016) and these results positively indicate owners' motivation to grow in the succeeding years (Bhaumik, Fraser, & Wright, 2015).

Figure 3 shows that a majority of the respondents (63%) grew over 20% per annum over the last three years. A further 30% of respondents grew by less than 20% per annum; and 3% of respondents had no growth. There was a minimal number of firms that had become smaller (2%); and 2% of the respondents stated that growth did not apply to their firm. The findings reveal that the firms have grown over 20% per annum over the last three years. The annually average growth rate of micro and small enterprises (MSEs) in the town was 5.3 percent (Hagos, Gebremichael, & Getie, 2014).

To achieve the aim which was to examine the interplay between the capital structure choice

**Figure 1.** Employment growth

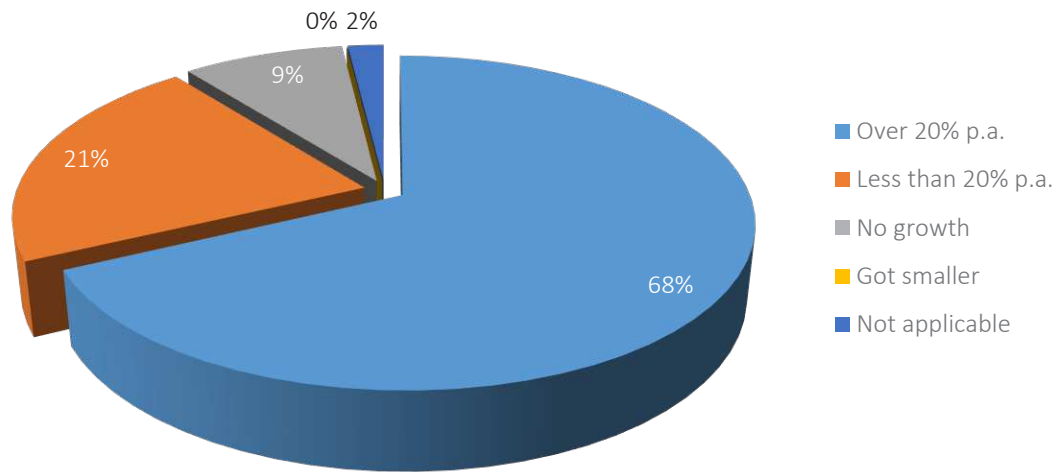


Figure 2. Future growth of firm

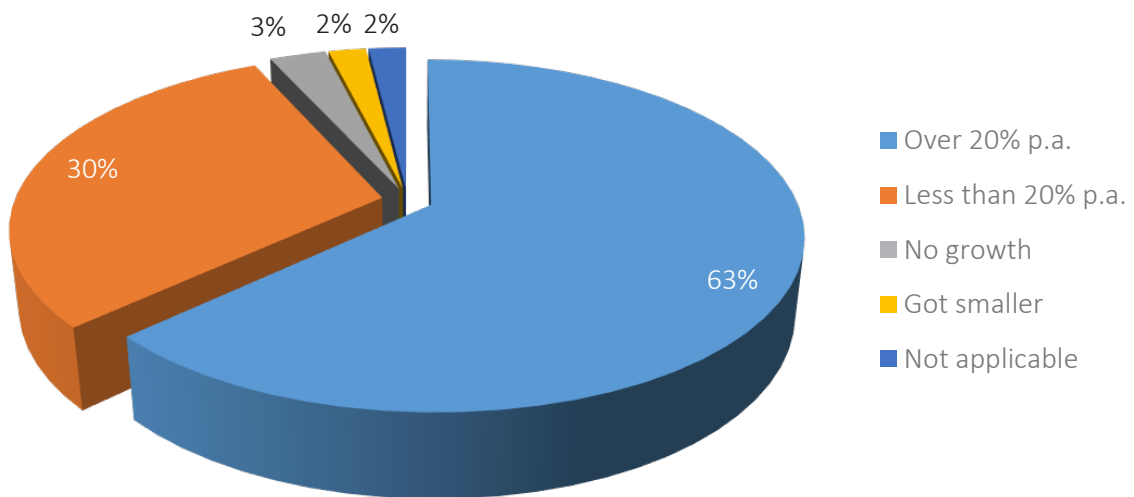


Figure 3. Growth over the last three years

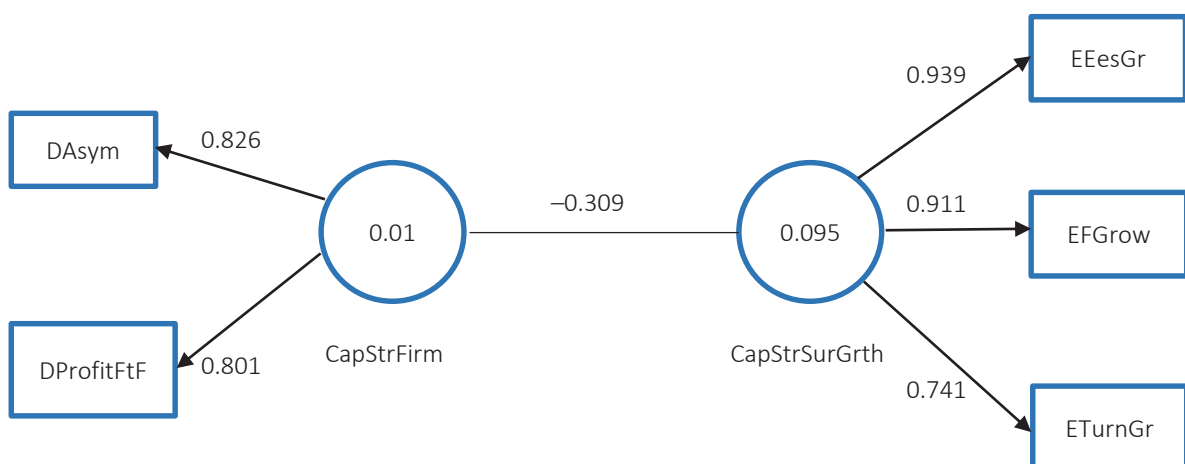


Figure 4. Empirical results of the research objective

and the survival and growth of SMMEs, this was modelled in a cause and effect manner and the structural model was assessed. Causal paths were then estimated to test the structural relationship. The value (0.095) shown in the oval CapStrSurGrth is variance (R^2) of the dependent factor CapStrFirm which indicates whether the model adequately suits the data. R^2 shows the amount of variance in the dependent factor that is explained by this objective and shows the predictive capability of the dependent factor CapStrFirm. The assessment of the impact of the capital structure (CapStrFirm) on the survival and growth of SMMEs (CapStrSurGrth) is to validate this objective's fitness, which is a measure of validity. Both R^2 and path coefficients (values on arrows) indicate the effectiveness of this objective and show how well this can be shown in a model perform, as seen in Figure 3 (Hulland, 1999). The overall fit and explanatory power of this objective were examined, together with the relative strengths of the individual causal path (values on arrows). Figure 3 shows the result of the structural model assessment, with the calculated R^2 values (explanatory power) and significance of individual paths summarised.

4. LIMITATIONS OF THE STUDY

The study was limited to the retail and wholesale SMMEs positioned in eThekweni area, KwaZulu-Natal, South Africa. Since this study concentrated on SMMEs in the retail and whole sector in the eThekweni area, the results could be generalized with care to other areas, as the conditions and characteristics may differ considerably.

5. IMPLICATIONS

Owners/managers must know the factors that impact the capital structure choice of the firm. Access to external financing requires formal financial in-

formation on the firm. Utilising these funds could reduce asymmetric information of SMMEs. This might lead to outside investors and lenders of debt having greater confidence in the firm. By SMMEs using internally generated funds, the growth of these firms stands out.

6. RECOMMENDATIONS

6.1. Recommendations for SMMEs

From Table 5, it was revealed that once the firm was established, retained earnings was the most importance source of financing. By utilizing this type of funds, there was growth in majority of the SMMEs. Debt and external equity financing were found to be the least source of financing and these funds has little to no impact on the growth of SMMEs. In order to continue utilizing retained earnings, owners/managers need to ensure that the firm generates sufficient internally generated funds if it wishes for the firm to grow, however, this may not always be possible, especially in SMMEs. The study recommends that owners/managers introduce debt capital to assist with the firm growth. This capital can alleviate the firm from depending on retained earnings and provide owners/managers financial assistance needed to grow and to survive.

6.2. Recommendations for future research

The current study was restricted to eThekweni area, KwaZulu-Natal. Therefore, this study recommends that future studies should include other parts of KwaZulu-Natal as well as other provinces to ascertain the type capital utilized by SMMEs and the significant of these types of capital on the survival and growth of the SMMEs. This study recommends future research to explore the impact of debt capital in relation to retained earnings on the growth and survival of the SMMEs.

CONCLUSION

This study investigated the influence of a capital structure choice on the growth and survival of SMMEs within a South African context. Capital structure was found to have a significant influence on the

growth and survival of SMME firms. The capital structure used by these firms include retained earnings, personal savings, trade credit and funds from friends and family. Debt and external equity financing were found to not have influenced the growth of the firm.

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