EXTERNAL ELEMENTS AFFECTING CAPITAL STRUCTURE OF SMALL AND MEDIUM ENTERPRISE IN KENYA: A CASE OF KITUI COUNTY, KENYA

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ABSTRACT

For quite some time, small and medium-sized enterprises' development and execution depend majorly on the capital structure financing choice. The choice of capital structure for SMEs is majorly influenced by various factors which mostly hinder their success. The operations of the small and medium-sized enterprises operate with equity or debt capital. The equity finance is sourced from the shareholders where the business owners ordinarily contribute to their business's success or it can be from retained earnings. In contrast to an equity fund, Debt financing is cash which is borrowed from moneylenders. The lenders ordinarily are commercial institutions, and the borrowed money has predetermined cost and maturity time. The capital structure of SME may either be under or over financed by either of the two sources of capital or be overall underfinanced by both, which may result to operational challenges. Small and medium-sized enterprises have a significant contribution to the country's economy by contributing immensely in terms of taxes, job creation, provision of quality goods and services at comparatively reduced prices. Despite this contribution, the operation and performance of SMES are adversely affected by the choice capital structure. Some of the external elements that influence capital structure include market conditions, cost of capital and attitude of the investor. The main reason for an investment is to get returns. If the future of returns on investment would be certain then an investor would go for an investment with higher returns therefore the investors have to take risk in the decision making. In 2017, the Kenya National Bureau of Statistics surveyed SME financing challenges. About 400,000 SMEs do not celebrate their second birthday according to the study. Few SMEs manage to reach their fifth birthday, which raises concerns on the sustainability of those businesses. This calls for an investigation to establish whether these external factors have an effect on the capital structure of small and medium-sized enterprises. This study examined the impact of external factors on small and medium-sized enterprises' Capital structure in Kitui County. Throughout the study theories of capital structure such as Signalling, Agency and Trade-off theories were used to analyze the external factors on capital structure. The recommendation from this research can be used by the decision makers to make policies which address the challenges facing SMEs in Kenya. The research design was descriptive to collect data from 150 SMEs in Kitui County using a structured questionnaire. Data analysis was done using multiple regression analysis in SPSS and findings presented by tabulation, charts and diagrams. From the study findings the government should come up with training programs to SMEs to enable them to manage their businesses, be creative and innovative so that they can exploit the available business opportunities. This can be possible if both the County and National governments through the ministry of Trade and Social services work together to facilitate these training programs. The government should provide annual or bi-annual benchmarking workshops for Kenyan SMEs with other SMEs in developed countries so that they can learn new ideas and technologies to

enable them improve their business performance.

Key words: Cost of Capital, Market Condition, Capital Structure, Equity and Debt Financing.

INTRODUCTION

The development of every developing nation depends majorly on the private's sector of the economy. According to World Bank report 2019, developments of economies especially in countries which are developing are boosted by the SMEs. Most of the businesses and job creation are facilitated by the SMEs in such that 90% of the businesses are from formal or informal SMEs and 50% of the employment in the world is created by the SMEs. The World Bank report points out that, SMEs will have created approximately 600 million jobs by 2030 and therefore the governments should put priority in development of the SMEs. Despite of most jobs being generated by SMEs most of the SME's operations are struggle due inadequate capital. In Morocco, SMEs developed project that has been supporting the development of women-owned SMEs to access finance inform of short-term loans. In Nigeria, Development Finance Project has been supporting the establishment of Development Bank of Nigeria, an institution that provides financial support and credit guarantees for all eligible SMEs (World Bank, 2019). In Kenya, the available data from Kenya SMEs finance survey 2019 indicates that approximately 90% of businesses which are registered under the companies' registrar are SMEs. The reports also point out that Kenya's Gross Domestic Product (GDP) is projected at 6.1 per cent with 3 per cent being contributed by the SMEs by 2020. Moreover, SMEs have a significant contribution to the country's economy by contributing immensely to taxes, job creation, provision of quality goods and services at comparatively reduced prices. According to Kenya SME performance Index 2019 the SMEs growth rate grew from 4.8% in 2017 to 6.3% in 2018 a growth index of 1.4%. Additionally, the report points out that the SMEs created 846,000 new jobs in 2018 in the informal sector which is 83.6% of the total employment created. The report attributes 30% contribution of the SMEs to the GDP of Kenya's economy. This helps to bridge the poverty gap and normalize accessibility of goods and services to the larger public. Despite this contribution, the operation and performance of SMEs are adversely affected by the capital.

The SMEs capital structure comprises of Debt capital and Equity finance that is used to finance its operations. Debt capital is loans or bonds issued while Equity finance is expressed as the common stock. The Debt-to-Equity ratio is used to measure the capital structure. In Debt capital, investors take less risk because the first claim is business assets in the case of bankruptcy. Wehinger (2014) explains how this makes the investors accept a lower rate of returns leading to a lower cost of capital when debt finance is compared to equity finance. On the other hand, equity investors take more risks. This is because they get the residual value after the repayment of debt investors. Due to the high risk, the return rate is also high; hence the cost of equity seems to be higher than the cost of debt (Gathogo & Ragui, 2014). There are benefits attached to the structure of the company whereby it amplifies Return-On-Equity.

This measures the business's performance in terms of asset turnover, earnings, and debt. Capital structure gives greater control and flexibility to a firm. The capital structure of SMEs is greatly affected by external factor such as market condition, Cost of capital and Investor's attitude. The environment business is operating in mostly determines it success or failure, various organization operates on environment which tend to be dynamic and being pulled up and downward by market forces, for the SMEs success in market one need to constantly learn and evaluate the conditions at any given point, some of condition that may affect capital structure choice include, competition from other firms, government policies and restriction imposed by the potential investors and lenders. Investor altitude also play great role on determination of capital structure of SMEs, how do investor see these SMEs is it a positive or a negative view, based on economic surveys which mostly indicate collapsing of SMEs in a short run most of investor flew from investing to SMEs which finally scales down the choices of capital structure of SMEs to only owner's capital.

In the other hand cost of capital greatly affect investor choice for the type of capital to employ, some of the component of cost of capital include interest charged by the lenders, interest is mostly expressed in percentages (Mac & Lucey, 2010). Interest is the cost of fund acquired from lending institutions; lending institutions earn income from funds lent out to borrowers. These interest rates are very competitive; making them varies from one financial institution to another. A financial institution charges a high-interest rate when the chances of repayment are low. Revolving loans such as credit cards are assigned high-interest rates because the repayment chances are not certain. This makes these loan types difficult to manage (Wehinger, 2014). Financial services also tend to charge high-interest rates to firms or businesses they consider risky. This is due to the credit score of the organization or the individual. According to Mac and Lucey (2010), businesses with a high credit score are assigned a low-interest rate. Financial institutions have interest rates which can be fixed and variable. Fixed interest rates do not change throughout the repayment time of the loan. The interest rates which are variable change with the prime rate. The increase in the rate increases the payment of the loan. The return rate of any given investment is explained by the cost of equity for it to convince an investor to invest in a firm. This is a crucial component of stock valuation in a business. This is because to convince an investor; the equity investment is expected to grow by at least the equity cost (Botosan, 1997). This calculates cost equity sensitive if there are changes to the dividends' growth rate because it does not consider the investment risk. The Capital Asset Pricing Model (CAPM) is as well sued to get the cost of equity, which is useful in that; it explicitly accounts for the investment riskiness. As Alan and Gaur (2018) documents, all companies can apply this model regardless of the growth rate of the dividends. The CAPM most rely on the past performance of the company to predict future firm values. Moreover, taxation is one source of income that the Kenyan government applies to offer its citizens public services. Tax income in Kenya has improved significantly over the last decade, which is an average of 22% of the economy size. This has enabled the government to fund half of the national budget (Wairimu, 2015).5 Because of its benefit, debates on tax policy and decision-making are an important issue for the public, businesses and the economy because of the varied impact on each of these companies. Therefore, the strategy and effectiveness of the tax system imply some inequality, and it is government's

role to make sure that a fair system of taxation is applied to ensure equitable income allocation to citizens.

Kenya's tax system imposed in the new constitution of 2010 shows a two-tier government system that includes national government and 47 county governments. Corporate income tax is charged to companies that live at a flat rate of 30% for registered business companies (Wairimu, 2015). The government has introduced a turn-over tax which has seen to be underperforming. These tax rates have a direct influence on the capital structure, according to Smatrakalev (2014) or the informal sector, which in most cases, comprises SMEs. The SMEs encounter these external factors affecting capital structure in their operations. The major pressing issues are the financing of their daily operations. The government of Kenya has tried to assist the SMEs and other development agencies and donors, but the challenges remain unsolved. To maintain their operations and meet customer and market demand, these SMEs are forced to seek financial institutions' assistance. Accessing financial assistance creates another challenge to the SMEs. According to Deloitte Kenya Economic outlook 2016 documents, the SMEs' growth is hindered by the inadequate capital. The capital structure of any organization determines its success greatly. The issues of financial institutions and interest rates raise some questions in my mind. Are the interest rates exorbitant among the financial institutions? What requirements are needed to acquire the services from the financial institutions? These questions put the SMEs at crossroads on whether to depend on equity funds, assistance from friends and well-wishers, family savings, support from donors or financial institutions to finance their operations. This study investigated the impact of external factors on Small and Medium-sized Enterprises' capital structure in Kitui County.

Problem Statement

The capital structure of SMEs in Kenya comprises of Debt and equity finance, for the success of the SMEs in market the combination of two must reach optimal. An optimal capital structure is the best grouping of debt and equity financing that can be applied to maximize the market value of the business at the same time decreasing its cost of capital (M.B.J Schauten,2010).When the combination has no optimal reach point, most of SMEs suffers losses and failure of penetration to market which may be caused by either SMEs inability to pay their debt caused by the higher interest charged by lending institution or loss of control on the operation of SMEs by real owners caused by on equity finance. One of the main conclusions of modern economics is that improvement of SMEs' capital structure depends majorly on financial status. However, the debate on which source of finance to improve the SMEs performance raises issues of concern in accounting and finance (Emadet al., 2014) SMEs make a great contribution to the creation of employment at the same time boosting Kenya's economy.

In Kenya, many small businesses are estimated to collapse each year (Wellalage & Reddy, 2020). Adebayo, Alheety, and Yusoff (2019) documents that, there is link between the type and performance of the SMEs and status of the economy in Urania. He observed that tax rates influence the capital structure at a significant level. Adebayo, Alheety, and Yusoff (2019)

explain the effect of the cost of equity on SMEs' financial performance in Nigeria. His study discovered that the performance of SMEs and the capital structure are interconnected. The choice of financing in SMEs in Saudi Arabia is influenced by the interest rates as commented by Al-Tit, Omri and Euchi (2019). Their study found out that the interest rates affect the issuance of debt of SMEs in Saudi Arabia, which influence the capital structure in the long run. In Kenya, the market condition, cost of capital and investor's attitude have been linked with SMEs' capital structure. In 2017, the Kenya National Bureau of Statistics surveyed SME financing challenges. The study found out that, nearly 400,000 SMEs fail complete their second year in operation. Few SMEs manage to reach their fifth year in operation, which raises concerns on their sustainability**.** Alper et al. (2019), state that the SMEs' performances in Kenya rely on the capital structure. The turn over tax imposed on the SMEs is another external factor on the SMEs' capital structure in Kenya, as commented by the Musyoka (2019). The cost capital for the starting SMEs and small businesses is a major challenge (Mbuva & Wachira, 2019). Muturi and Njeru (2019), explain the relationship between lending and credit availability to SMEs in Kenya being affected by the borrowing power. To get access to loans for the SMEs, they must provide commitment or surety of payment in terms of collateral security. Since these SMEs are not stable enough to secure loans from the lending agencies, it becomes very hard for them to survive in the competitive business without the capital to finance their operations. Additionally, these small enterprises owners depend on them to finance other domestic expenses, directly affecting the business capital structure. The government of Kenya is working very hard to support SMEs' growth in all counties by the provision of the favorable working condition under the Ministry of Industrialization and Trade. These SMEs lack mandatory documents to proof such as registration documents, operational inventory of books of account, banking/credit history and valuable collateral security which can guarantee those loans. Similarly, tax rates affect the relative composition of debt such that, an increase in corporate tax translates to increased leverage. Such situations leave the SMEs at the verge of collapsing due inadequacy of operational capital.

The capital structure, which comprises of long-term debts, retained earnings and equity capital are significant to overall performance of SMEs. The capital structure of an SME can be under finance or over financed by either two sources of capital. SMEs' operation becomes a challenge when it is both underfinanced by both sources of capital, which is stated as over below optimal capital. The underfinanced SMEs may face great challenge by being competed out by their stable counterparts. The study will mainly concentrate its effort to unearth how the external environment affects the SMEs' capital structure, which finally affects the industry's success. In most cases, equity capital finance the business's initial operation than from their retained earnings and loans can be used to supplement the growth of the business. Suppose the business cannot access loans or extra equity funds from the shareholders. In that case, the business operations are strained because the capital structure depends on these funds, as mentioned above. Research on the previous studies shows that very little have been done on the external factors affecting SMEs' capital structure in Kenya. A study on challenges facing the financing of SMEs in Kangemi Harambee market, Nairobi County

found out that high cost of loan repayment and unwilling attitude of the people to act as guarantors hindered the performance of SMEs (Gichuki et al., 2014).

This research attempted to fill this noticeable gap in the literature and bring light on the key external element affecting the Capital structure of 150 SMEs in Kitui County. The study, therefore, sought to answer the research question: What are some of the external elements affecting the capital structure of SMEs in Kitui County.

Study objectives

General objective

To find out the effect of external elements on capital structure of small and medium-sized Enterprises in Kitui County.

Specific objectives

This study focused on the following explicit objectives:

i. To determine the effect of cost of capital on a Capital structure of small and medium enterprises in Kitui County, Kenya

ii. To establish the effects of market condition on a capital structure of small and medium enterprises in Kitui County, Kenya

iii. To establish effect of investors attitude on a capital structure of small and medium enterprises in Kitui County, Kenya.

THEORETICAL REV1EW

Agency theory

Agency theory explains two critical conflicts that arise in an organization and can influence its capital structure. There are different interests over directors and shareholders and secondly conflict between shareholders and creditors. Jensen and Meckling (1976), argue that directors sometimes may not act as per the shareholders' best interests. This is where conflicts arise in a firm and it goes down from management through shareholders to the creditors. Managers take advantage of the profit gained from the firm's they utilize for their personal gains at the expense of shareholders. Therefore, debt will provide the firms' shareholders with incentives to invest in a sub-optimal way. When their investment yields good returns, which are above the debt's face value, the benefits accrue to shareholders, and if the returns are below the value of the debt, then shareholders have limited liability to walk away (Harris & Raviv, 1991). The servicing of the debt may affect the shareholders, according to Stulz (1990). Positively, debt payments force managers to pay interests consequentially lowering any potential overinvestment problem. Furthermore, when the debt is too high, it leads to overpayment of interest, and therefore, it becomes difficult to accept profitable projects,

affecting the firm negatively through underinvestment. This theory clearly shows that the trade-off between the benefits and costs of debt determines the firm's capital structure. Myers (1977) argues that when a firm is in a bankruptcy state, shareholders have no incentive to invest more equity capital. This is because the benefits that will be realized at the end of the day will be directed to pay debt holders. The choice and attitude of the investor of the firm's shareholders as explained by the Agency theory may cause conflict because the manager interest is to maximize the profit while the investors or the shareholders focus is on the return on investment (ROI). The investor's attitudes are well explained by the Agency theory because their decision may affect the capital structure of the firm positively or negatively depending on their choice.

Signaling theory

This theory was described by Ross (1977), whereby it clarifies the choices of supervisors and shareholders. In this theory, troughs evaluate the firms' esteem to know if they can issue obligation or value. When the manager issues obligation when their firm is underestimated, but the firm is overvalued at that point, managers will favour issuing value. The signaling theory states that when supervisors have interior data on trends of the organization, the manager signals data to the Market. The issue of obligation may be a commitment to supervisors to pay the intrigued in future. This commitment signals that the firm ventures the adequate cash streams to benefit their obligation. The information signaled by the firm will determine the accessibility of capital from financial institutions and shareholders. The promised interest payments are an obligation and therefore, are given more priority over the dividends. Ferris, Javakhadze and Rajkovic (2017) argue that the shareholders are the determinants of the firm's cash flows, and the debt payment may affect the share prices. This means the manager's choice to issue debt affects the firm since the commitment to pay the interest must be met. Failure to meet these commitments signals bankruptcy of the firm; thus, the shareholders are the last people to decide on the mechanisms of servicing the debt. According to Barclay & Smith (1999), all the capital structure theories are more important, and therefore it's not possible to choose one theory over another. For instance, signaling theory and trade-off theories have some truth when explaining financial decisions (Farma & French, 2005). When testing the signaling theory, it is impossible to measure managers' proprietary information.

Empirical Review

Cost of capital and capital structure

The interest rate in economics is the privilege of borrowed money or the price paid in exchange for borrowed funds (Nassar, 2016). According to Baas and Schrooten, (2006), the interest can be simple or compound interest; fixed or variable interest varies from one financial institution to another. According to Nassar (2016), large firms can negotiate the lenders' interest rates to reach favorable rates to acquire more debt. In addition to that, larger companies are safe compared to smaller companies, and therefore, loaning institutions are willing to give them more funds. This shows that the company size correlates positively with

leverage. The growth prospect of the firm affects capital structure significantly. This is because the growth firm has high leverage compared to non-growing firms. The growth firms can get loans with minimal constraints. Nassar (2016) argue that growing firms add value to the firm, increasing its debt capacity. The firm's debt capital can be a loan from a bank, bonds, credit card debts, or personal loans. There is a price paid as a privilege of accessing those funds when using debt-equity. The cost of debt finance is the interest the lenders charge the firm to access the funds. In some situations, the interest rates charged can be fixed or variable. This leaves the firms in a challenging situation on the favorable decision to consider the debt capital rate. These interest rates are very competitive, making them varies from one financial institution to another. A financial institution charges a high-interest rate when the chances of repayment are low. Revolving loans such as credit cards are assigned high-interest rates because the repayment chances are not certain. This makes these loan types challenging to manage (Wehinger, 2014). Financial services also tend to charge high-interest rates to firms or businesses they consider risky. This is due to the credit score of the organization or the individual. The variations in the charged interest affect the capital structure of the firm, and therefore it affects the firm's operations. On the other hand, debt capital has some benefits for the firm. When the interest rate rises, the interest payment cost is offset partially by the reduction of the firm's taxable income. According to Bandyopadhyay and Barua (2016) the cost of equity is the return of the business investment, enabling the management to measure the requirements of the capital return. In most cases, the company uses the cost of equity as a threshold for the capital budgeting to determine the rate of return applicable (Ferris, Javakhadze & Rajkovic, 2017). The dividend policies have insignificant effect on the firm's value or the cost of equity, according to Bandyopadhyay and Barua (2016). In this argument, Bandyopadhyay and Barua (2016) relates how dividends are valued by investors than firms' future capital gains. If the firm's capital gains are taxed below the income from dividends, then increased dividends mean the reduced after-tax return of the shareholders who may have higher expectations of the pre-tax return rate. If the cost of equity increases, the firm may issue more debt relative to equity, consequently leading to a positive correlation between dividend payout and leverage (Herciu & Ogrean, 2017).

The relevance of dividend policy subsequently changes the market value of equity, thereby affecting the capital structure. Empirically many studies have carried out to test the hypothesis of this theory on the information. Herciu and Ogrean (2017), attempts to test the change in dividends and its implications on the profits and change in prices. The change in profits of a firm implies that there will be a change in benefits, and this has a significant signal to the market. The cost of equity by shareholders to keep the company at the peak is a capital structure factor. Shareholders expect a return on investments in terms of dividends. Conversely, the managers are looking on issuing debt to maximize the profits without considering the effect of debt on the dividends if the firm fails to honor contractual commitment to service the debt. The announcement of shares impacted stock prices as it was studied by Herciu and Ogrean, (2017). From this study, the increase in dividend increases considerably after the announcement of share prices. The study found out that the announcement of increased dividends has a positive change on the stock market prices regardless of the announcement of dividends before or after profits announcement. This

implies that when announcing a change in dividends has a change in the prices of shares, the dividends' decrease has adverse effects on the returns.

Attitude of investor and Capital structure

The decision taken by the investors are directly linked to the firm's capital structure. There are external factors that influence the investor's attitude on purchasing shares from a firm. These factors are related to monetary policies and macroeconomic prospects in a given country. Liquidity is also another factor which can influence the decision of the investor. The main reason for an investment is to get returns. If the future of returns on investment would be certain then an investor would go for an investment with higher returns therefore the investors have to take risk in the decision making as described by Bandyopadhyay and Barua (2016). The attitude of the investor will depend on the risk of investment involved. Capital investment is very essential for the growth of the firm since they determine its value by influencing risk and profitability. The investment decision may involve expansion, asset acquisition or replacement, change of business marketing or production strategies is also a long-term investment.

The investment decision causes some financial distress to many firms especially small-sized firms. The choice of the investors and the management is put to a dilemma because they don't know if there is optimal capital structure since the main object is wealth maximization and improving the performance of the form (Bandyopadhyay & Barua, 2016). Firm Managers use the status of the capital structure to pass message to the market and convince the investors. The firm can obtain financial assistance from internal or external sources. The internal source includes the retained earnings, issuance of shares or loan stocks, while the external sources involve getting loans from the lending institutions.

Investors are very considerate about liquidity when choosing an investment decision. One of the standard investment targets is liquidity and therefore when ignored can lead to suboptimal capital allocation. According to Dang et al., (2019), the attitude of the investor to purchase shares in a firm will depend on the liquidity measurement ratio so that liquidity risk can be evaluated. The investors normally check the forms liquid assets and compare them with the short-term liabilities. The firms with high debt obligations have liquidation risk (Ghasemi, & Ab Razak, 2016).

Market Condition and Capital Structure

Market condition is the situation of the market at a given time. The situation can also be as result of growth rate of the market. The business managers should always be updated of the changes in the market conditions and outside developments that have potential in affecting the business operations (Le & Phan, 2017). It is therefore very important to be ready to respond immediately at the same time changing plans to adjust to the changes. The changes in the market condition may affect the business capital structure positively or negatively

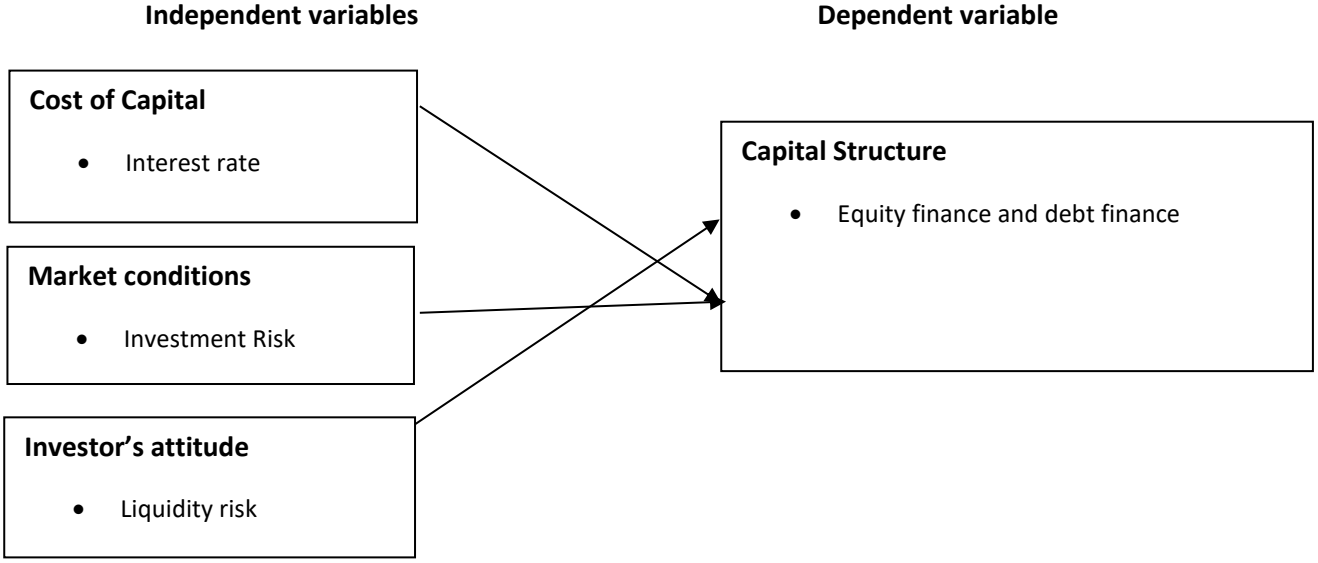
depending on the condition. The market condition has correlation with the capital structure because it will determine the manager's choice of investment decision.

The market conditions will determine the firm's capital structure because managers have the obligation to ensure that their stable adjustments to the prevailing market conditions. The manner in which business adjust or fail to adjust to their leverage due to market trends determines the sustainability of the business. The prevailing market condition such interest rates, governance and government policies influence the pattern of capital (Rani, Yadav & Tripathy, (2019). The choice of the investor to buy shares in a firm depends on the stage of the business cycle. Small and medium sized business which are not fully established and they are in dire need to for financial support may face numerous challenges to access finances because the risk of investment is high.

The readiness of the investor to buy shares in a firm depends on the sustainability of the firm to be able to repay and adjust to its leverage. The taxation on the bonds and dividends is a factor of market conditions and discourage investors consequently affecting the capital structure. The changes in the market conditions in most cases affect the adjustments of the firm's debt with less impact of equity capital of the firm. The competition from other business is very important in determining the stability and performance of the firm. According to Amjed and Shah (2016), the competing firms may use different technology which is more efficient and time saving and therefore the manager is required to adjust to the market condition to remain in the business. When the competition is high it translates to reduced business hence affecting the capital structure.

Conceptual Framework

The structure exhibits the anticipated link between the predictor variables; (Market condition, Cost of capital and Investor's attitude) and the dependent variable (Capital structure). Figure 2.l below clearly illustrates this.



Source: Researcher (2021)

Figure 2. 1 Conceptual Frame work (Researcher, 2021)

Research Design

This is coherent and logical integration of the chosen strategy for different study components. The research design will provide a platform that will provide answers to research questions by incorporating all components of the study. A descriptive research method has described external factors affecting the capital structure of SMEs in Kitui County. According to Kothari (2004), a descriptive research design focuses on obtaining facts through surveying and enquiring, thus adding knowledge to the study topic.

Target Population

This is the number of people the researcher anticipates to obtain information from. Cooper and Schindler (2009) explain a population as a total collection of factors that the researcher is interested in when it comes to drawing conclusions and inferences. In this study, the target population was 150 SMEs operating in Kitui County with business permits licensed by the Kitui County Government.

Sample

This is the number of participants to be used in the study. The sample size was obtained using the Krejcie and Morgan, (1970). The sample size of the study in each sub-county is obtained using the following formula.

$\frac{n}{N}\ X\ 150$ Where: **n** = No. of SMEs in a Sub- County

N= Total No. of SMEs the County

	Sub county	**Number of SMEs**	**Sample size**
1.	Kitui West	53	32
2.	Kitui Central	88	53
3.	Kitui South	35	21
4.	Kitui East	9	6
5.	Mwingi North	11	7
6.	Mwingi West	20	13
7.	Mwingi Central	29	18
Total		**245**	**150**

Source: Researcher (2021)

Tab1e 1: Sample distribution

Collection of data

The researcher focused on the 150 SMEs in Kitui County, Kenya. The targeted respondents were SMEs managers and shareholders of the 150 SMEs. The study utilized primary data in coming up with inferences on the population of the study. The research mechanism that was adopted in collecting data is the use of a structured questionnaire, which consisted of three sections; General information, SMEs Background information, and Variable sections. The decision to use the questionnaires arises from the familiarity of usage by most people. In terms of the cost considerations, the questionnaires are relatively cheap in comparison to

interviews. Primary data was gathered using structured questionnaire; this relied on the Likert scale of l to 5, the purpose of which is to assign numerical values to answers (Kothari, 2004). In the administration of questionnaires, drop and pick techniques was utilized.

Data Analysis and Presentation

The study embarked on descriptive and inferential analysis of the collected data. Descriptive data analysis involves summarization of data by describing it in a meaningful way such as graphs and tables. The inferential analysis is a way of estimating population parameters or characteristics by use of population sample. The presentation of the essential characteristic of the variables used was done through Descriptive statistics. In contrast, the process of making inferences and conclusions was guided by inferential statistics. In carrying out an inferential analysis, the study used multiple regressions to ascertain the external factors affecting the Capital structure of SMEs in Kenya. The researcher analyzed the data using SPSS; tabulation, charts, and diagrams were used to present the result. The proposed study utilized multiple regression analyses where SMEs' capital structure was expressed as a function of the market condition, Cost of Capital, and Attitude of investor.

$$\mathbf{CS = \beta_0 + \beta_0 X_1 + \beta_2 X_2 + \beta_3 X_3 + \alpha}$$

Where:

CS = Capital structure

$\boldsymbol{\beta_0}$ = Slope of regression equation (constant)

$\mathbf{X_1}$= Cost of capital

$\mathbf{X_2}$= Market condition

$\mathbf{X_3}$= Attitude of Investor

RESEARCH FINDINGS AND DISCUSSION

Descriptive Statistics

Market condition and capital structure

The study sought to know the how market condition affects the capital structure of SMEs by requesting to know extent to which issues related to market condition affect their business. The extent was measured using Likert scale of 1 – 5. It was established that 52.6% of the respondents agree and 45.6% strongly agree that SMEs industry is sensitive to economic fluctuations due to their financial status while 0.9% were neutral, and 0.9% disagreed. The indication of the respondents on what extent they agreed on how government policies and practices impact on the choice of financing for SMEs, majority of respondents agreed accounting for 52.6% and 46.5% agreed strongly while 0.9% was neutral and .9% of the respondents disagreed. Majority of the respondents 75.4% agreed and 6.1% strongly agreed that the market condition including competition for capital determines the choice of capital for investment while 18.4% indicated neutral. The study also sought to know how the stage of the business cycle influences the business pattern of capital and a readiness of investor to

purchase shares where 66.7% and 10.5% agreed and strongly agreed respectively while 21.1% were neutral and 1.8% disagreed as shown below.

Tab1e 2: Descriptive Analysis on market condition

Market condition	Strongly Disagree	Disagree	Neutral	Agree	Strongly agree
SME industry is sensitive to economic fluctuations due to their financial status	0.0%	0.9%	0.9%	52.6%	45.6%
Government policies and practices have direct impact on the choice of financing for SMEs	0.0%	0.0%	0.9%	52.6%	46.5%
The market condition including competition for capital determines the choice of capital for investment	0.0%	0.0%	18.4%	75.4%	6.1%
The stage of the business cycle influences the business pattern of capital and a readiness of investor to purchase shares.	0.0%	1.8%	21.1%	66.7%	10.5%

Source: Researcher (2021)

Cost of capital and capital structure

To understand the extent to which cost of capital affect the capital structure of small and medium-sized enterprises in Kitui County the researcher used Likert scale of 1 – 5. The findings established that 71.9% of the respondents indicated agree, while 17.5% indicated strongly agree and 8.8% indicated neutral. The rest 1.8% indicated Disagree that Interest rate charged on various capitals affect the capital structure choice. It was also found out that 48.2% of the respondents indicated strongly agree while 36.8% indicated Agree, 6.1% Neutral, and 5.3% strongly disagree. The remaining 3.5% indicated Disagree that it is very expensive to acquire equity capital as compared to debt finance. To find out if the rate of interest charged on loan depends on credit risk on Loan issued out, it was established that 64% of the respondents indicted Agree, while 22.8% indicated Neutral and 8.8% indicated strongly agree. The remaining 4.4% of the respondents indicated Disagree. To establish respondents' views on if investor consider various tax imposed by government on their capital decision choice, it was found out that 57.9% indicated Agree, while 30.7% indicated Neutral and 11.4% strongly agreed.

Tab1e 3: Descriptive Analysis on Cost of Capital

Cost of Capital	Strongly Disagree	Disagree	Neutral	Agree	Strongly agree
Interest rate charged on various capital affect the capital structure choice	0.0%	1.8%	8.8%	71.9%	17.5%
It is very expensive to acquire equity capital as compared to debt finance	5.3%	3.5%	6.1%	36.8%	48.2%
The rate of interest charged on loan depends on credit risk on Loan issued out.	0.0%	4.4%	22.8%	64.0%	8.8%
Investor consider various tax imposed by government on their capital decision choice.	0.0%	0.0%	30.7%	57.9%	11.4%

Researcher (2021)

Investor's attitude and capital's structure

To know the extent in which investor's attitude affects the capital structure of SMEs in Kitui County, it was measured using Likert scale of 1 – 5 that is Strongly disagree, Disagree, Neutral, Agree, strongly agree in that order respectively. The findings established that 49.1% of the respondents indicated Neutral, while 23.7% indicated Agree, 7% indicated strongly agree and the remaining 4.4% of the respondents indicated strongly disagree on that they would go for the best possible return even if there were risk involved. Furthermore, 50.9% of the respondents indicated Agree, while 44.7% indicated strongly agree, and the remaining 4.4% of the respondents indicated neutral on that to reach their financial goal, they prefer an investment with less risk and fast growth rate. The findings also established that 66.7% of the respondents indicated Agree, while 21.1% indicated Neutral, and 9.6% indicated strongly agree. The rest of the respondents (2.6%) indicated disagree on that when looking for high investment growth, they are willing to accept the possibility of greater liquidity risk to achieve this. Additionally, 66.7% and 28.1% of the respondents strongly agreed and agreed respectively, while 3.5% of the respondents indicated neutral and the remaining 1.8% indicated disagree on that they consider safety of their investment even if it means forgoing the whole investment process. The findings are as shown below.

Tab1e 4: Descriptive Analysis on Investors attitude

Investor's attitude	Strongly Disagree	Disagree	Neutral	Agree	Strongly agree
I would go for the best possible return even if there were risk involved	4.4%	15.8%	49.1%	23.7%	7.0%
To reach my financial goal, I prefer an investment with less risk and fast growth rate.	0.0%	0.0%	4.4%	50.9%	44.7%
When looking for high investment growth, I am willing to accept the possibility of greater liquidity risk to achieve this	0.0%	2.6%	21.1%	66.7%	9.6%
I consider safety of my investment even if it means forgoing the whole investment process	0.0%	1.8%	3.5%	28.1%	66.7%

Source: Researcher (2021)

INFERENTIAL STATISTIC

Model summary

This was done using multiple regression analysis to determine the significance level. It was found out that an adjusted R=0.341 and the square of R had a value of 0.116 which means 11.6% of the capital structure is attributed to market condition, cost of capital and investor's attitude. The rest (89.4%) attributed to capital structure may be due to other factors which are not covered in this study.

Tab1e 4: Model Summary

Regression Summary				
Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.341[a]	.116	.092	.93534
a. Predictors: (Constant), Investor's Attitude, Cost of Capital, Market Condition				

Source: Study Data (2021)

Analysis of Variance

The regression model was also done using analysis of variance to establish significance. The generated variance table shows that the population parameter has a 0.003 significance value which is below the significant level of (0.05) hence the model is significant. The computed F value (4.833) is higher than the F-critical 3.884 thus significant.

Tab1e 6: ANOVA

ANOVA[a]						
Model		Sumof Squares	Df	Mean Square	F	Sig.
1	Regression	12.686	3	4.229	4.833	.003[b]
	Residual	96.236	110	.875		
	Total	108.921	113			
a. Dependent Variable: Capital Structure						
b. Predictors: (Constant), Investors Attitude, Cost of Capital, Market Condition						

Source: Study Data (2021)

Regression coefficients

The regression model has enabled linking of the independent variable with dependent variable in this equation

$$\mathbf{CS = \beta_0 + \beta_0 X_1 + \beta_2 X_2 + \beta_3 X_3 + \alpha}$$

Tab1e 7: Regression Coefficient

Regression Coefficients[a]						
Model		Unstandardized Coefficients		Standardized Coefficients	T	Sig.
		B	Std. Error	Beta		
1	(Constant)	-1.931	1.224		-1.577	.118
	Market Condition	.857	.305	.289	2.810	.006
	Cost of Capital	-.311	.227	-.141	-1.372	.173
	Investor's Attitude	.407	.241	.170	1.690	.094
a. Dependent Variable: Capital Structure						

Source: Study Data (2021)

The regression model which formed was

$$\mathbf{CS = -1.931 + 0.857X_1 - 0.311X_2 + 0.407\ X_3}$$

If the independent variables were rated zero according to the regression model equation formed, the capital structure of SMEs in Kitui County would be -1.931. The study shows that there is negative and significant effect on external elements of capital structure of SMEs in Kitui County. The implication of this is that increased unit on the market condition reduces

the capital structure by 0.857 while a unit increase in the investors' attitude would affect the capital structure by 0.407. Market condition had a significant level of 0.006 while cost of capital had significant level of 0.173, and investor's attitude had 0.094 significant levels. This means that cost of capital and investors' attitude has a significance effect on the capital structure since significance level is more than 0.05 while market condition is insignificant since the significance level is less than 0.05. The residual error was assumed to be zero.

CONCLUSSIONS AND RECOMMENDAT1ONS

Conclusion

The results of data analysis revealed that the cost of capital had negative coefficient of -0.311 and a P value > 0.05. This shows that the increase of cost of capital will have negative impact on the capital structure of SMEs in Kitui County. The analysis also showed that the market condition had a coefficient .0857 and P value < 0.05. this shows that an improve in market conditions such as government policies, competitions and taxation will definitely lead to improved levels of capital structure of SMEs significantly in Kitui County. Additionally, investor's attitude had a coefficient of 0.407 and P value > 0.05. This implies that investors' attitude has a significant effect on the capital structure because if the attitude towards a given investment is negative then the capital structure of SMEs will be affected negatively in Kitui County.

Recommendations

From this study majority of the respondents prefer use of equity capital in their business operations. The study findings also revealed that majority of SMEs in Kitui County depend on equity capital as current source of capital for their business operation. This is because they face challenges when accessing capital from the financial institutions due to strict measures and conditions like collateral securities and processing costs.

The banks and money lending institutions should consider reviewing their security terms to accommodate and encourage SMEs access loans to boost their business operations. SMEs provide goods and services at affordable prices; create employment thus contributing gross domestic income. In this sense, this study recommends that both national and district governments ensure the full implementation of current policies for the SME sector, such as provision of incentives, protections of local SMEs from foreign business that suppress growth to ensure sustainability of this industry.

Additionally, the market conditions such as government policies and economic fluctuations affected majority of SMEs. Small and medium-sized enterprise industry being one of the sensitive industries to economic fluctuation, the current economic hardship orchestrated by the Covid-19 pandemic has hit SMEs hard affecting their capital structure. This study also recommends that, the national and county governments should set up National agency to oversee and manage the establishments and operations of the SMEs in Kenya

Furthermore, majority of the SMEs consider the security of their business and thus they cannot undertake risky investments. The government should come up with training programs to SMEs to enable them to manage their businesses, be creative and innovative so that they can exploit the available business opportunities. This can be possible if both the County and National governments through the ministry of Trade and Social services work together to facilitate these training programs.

The study also recommends that, the government should provide annual or bi-annual benchmarking workshops for Kenyan SMEs with other SMEs in developed countries so that they can learn new ideas and technologies to enable them improve their business performance.

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