Investment Decision and Profitability of Small and Medium Enterprises in Nigeria

[1]Bashir Umar Farouq &[2]Prof. Roselyn Gakure
[1]*Department of Social Sciences (CASSS) Kaduna Polytechnic*
[2]*Jomo Kenyatta University of Agriculture and Technology, Kenya*

Abstract

Nigeria has been one of Africa's growing economies. Small and medium enterprises (SMEs) play an important role in the economic growth in Nigeria SMEs contributes to economic development in various ways: by creating employment for rural and urban growing labor force, providing desirable sustainability and innovation in the economy as a whole. It is said that profitability is the most concerned goal of enterprises owners. However, with employment of investment decision, the impact on profitability still lacks investigation. Therefore, studying the relationship between investment decisions and profitability of small and medium enterprises could enhance the knowledge on the financial performance of SMEs. AIT will also enable government agencies to develop and design programmes and policies that will help the small and medium enterprises improve their performance in economic development of the country. A descriptive survey design will be used to analyse primary data. Advanced analysis will be conducted using correlation analysis to obtain final result of the study. Sample of 30 registered SMEs drawn from the target population in Kaduna State.

Keywords: Investment, Decision, Profitability, Small and Medium Enterprises.

Background to the Study

Resources of financing vary according to the rate of risk related to each fund based on the relationship between risk and return. Firm managers seek to reach a mixed capital structure that guarantees minimum cost to achieve the main goal of maximizing the corporation's wealth. The capital structure in the financial term means the way a firm finances their assets through the combination of equity, debt, or hybrid securities Saad (2010). The argument about the capital structure started in the early of 1950 Chakraborty (2010) Modigliani and Miler (1958) suggested that in the perfect market, financing strategies do not affect the value of the firm, but later they argue that firm value can be increased by changing the capital structure because of tax advantage of debts Modigliani and Miller (1963).

Since all firms' managers try to get the optimal capital structure with least possible cost, this led in 1984 for the picking order theory to emerge. The theory suggested that there is no an optimal capital structure for a firm, according to this theory, since there is asymmetric information between managers and investors. Therefore to minimize this asymmetric information, firms prefer to finance using retained earnings, debt, and equity respectively Mayers and Majluf (1984).

There are many studies and researches that argued the impact of the capital structure on the corporations performance, but a few of these studies found negative relationship between capital structure and performance Booth et al.,(2001); Deesomask et al, (2004); Huang And Song, (2006); Daradeniz Et Al., (2009); Chakraborty (2010) while several studies indicates a positive relationship between financing choices and firm performance Gosh et al,(2000); Hadlock and James,2002; Franck and Goyal (2003); Bergr and Bonaccors (2006). Moreover a number of studies find either poor of no significant relation between debt level and performance Tang And Jang,(2007); Ebaid,(2009).

Yet despite all this research, much is still unknown about how managers choose between debt and equity financing Harris And Raviv, (1991), Hovakimian, Opler, and Titman (2001) tested the hypothesis that firms tend to a target ratio when they either raise new capital or retire or repurchase existing capital. They found firms should use relatively more debt to finance assets in place and relatively more equity to finance growth opportunities.

Due to the importance of the issue and the impact of the financial structure choice of funding sources on the performance of companies, the previous studies and various research lead us to verify the relationship between the choice of financial structures and the performance of companies in emerging markets and in particular the Palestine financial market which is characterized as small and did not talk goes on its establishment 15 years and works under exceptional circumstances where the presence of the occupation and frequent closures and the inability of companies to communicate freely with the outside world because of the control of the occupation of the crossings, and at the same time there is next to the Palestine market developed markets such as the Israeli market and the large markets with long history, such as the Egyptian market. What distinguishes this study from other studies is that it used accounting and market measures to measure the performance. Unlike previous studies which argue that we can just only derive the range of the optimal capital structure, this paper yields the exact solution of non-financial industry's optimal capital structure in Palestine.

Statement of Problem

Small and medium enterprises (SMEs) are considered in all countries no after their level of development (Rejesh, Suresh and Deshmukh, 2008) small and medium enterprises play a very important role in Nigeria's economic growth, as they constitute 97.2% of the companies in Nigeria (Ministry of Trade and Commerce, 2011). However, Ismail 2005 found out that greater numbers of SMEs have very poor or mostly informal investment decisions; this had led to poor performance of many of these SMEs. Decision making is mostly not informed by sound analysis. Other researchers had also clearly shown that most successful SMEs are found to be making sound investment decisions, while majority of those that have failed to do so as a result of poor investments decisions among other reasons. A survey carried out by Okafor (2011) on six SMEs in South Eastern Nigerian to ascertain the level of attention to each of the component of financial management function had shown amazing results. The findings had shown that most SMEs are found to be taken informal investment decision which was not characterised by sound analysis.

Purpose of the Study

Investment decision is particularly important in small and medium enterprises. This is specifically true because it determine the success or otherwise of a business. In this context, the objective of the current research has been to provide empirical evidence on the relationship between investment decision and profitability of small and medium enterprises in Kaduna Nigeria. The main objectives were to determine whether they invest in long term projects, invest in non-current assets, the payback period, whether they evaluate the investment.

Significance

The relationship between investment decision and profitability of small and medium enterprises has not been studied in Nigeria. Therefore, it will contribute to fill the gap in knowledge, through studied in other countries. By their numbers alone, SMEs and entrepreneurial firms are a key segment and driver for most if not all national economies. Studies in this areas could help to yield high performance of SMEs which in turn can yield employment and contribute to the general health of the state region or the nation.

Literature Review

Brigham (1992) suggested that capital budgeting might be more important to a smaller firm than its larger counterparts because of the lack of access to the public markets for funding. Capital budgeting has attracted researchers over the past several decades. McMahon et al. (1993) claimed the earliest study of capital budgeting of SMEs was reported by Soldofsky (1964). During 1961, Soldofsky interviewed 126 owners of small manufacturing businesses in Iowa and the results were published in 1964.

Soldofsky (1964) found there was considerable variation in the methods of calculating payback period and in determining payback standards. In many businesses, required payback periods were flexible according to circumstances such as the variability of cash, planned product changes and business outlook. In the smaller enterprises, approvals for capital outlays tended to be given as required, whereas larger concerns were more likely to have annual capital budgets. Only four firms attempted to calculate some variation of the average cost of capital for use as a hurdle rate for capital projects. Most businesses seemed unaware of the link between their financing and investment decisions. On the positive side, it was quite clear that the evaluation of capital projects was heavily cash flow oriented.

Regarding capital project selection techniques, there were several surveys conducted by previous researchers such as Soldofsky (1964), Luoma (1967), Taylor Nelson Investment Services (1970), Hankinson (1979), Grablowsky and Burns (1980),Proctor and Canada (1992), and Block (1997). Soldofsky's (1964) study results shows around 58 percent of respondents used payback period methods whereas only 4.1 percent employed accounting rate of return technique.

Domination of payback period methods compared with other techniques in evaluating capital investment projects of SMEs was also found in the study of Louma (1967). Louma (1967) conducted a survey of small and medium-sized manufacturing businesses in the United States and found that more than 22 percent of SMEs used formal methods of capital investment evaluation.

Thirty years after the Louma's (1967) study, Block's (1997) survey of 232 small businesses in the USA indicated payback method remains the dominant method of investment selection for small businesses, whereas large corporations widely incorporate discounted cash flow models in financial analysis of capital investment proposals (Proctor and Canada, 1992). This is not evidence of a lack of sophistication as much as it is a reflection of financial pressures put on the small business owner by financial institutions. The question to be answered is not always how profitable the project is, but how quickly a loan can be paid back. Nevertheless, more sophisticated methods using discounted cash flow (IRR and NPV) have increased in use over time.

The predominance of the payback period method can be attributed to its simplicity, emphasis on liquidity, and response to external financing pressures. While other more complicated methods are not as popular. Similarly, Grablowsky and Burns (1980) found that the level of understanding and use of more advanced capital budgeting polices and techniques were very low. For example only 4.6 and 13.8 percent of respondents in the Grablowsky and Burns (1980) survey indicated they use the net present value and internal rate of return methods respectively. In the UK, Corner (1967) found remarkable differences in methods used for assessing capital projects between smaller and lager enterprises, the percentage use of different methods depending upon business size illustrated by Corner (1967).

Scott et al. (1972) examined the capital investment evaluation procedures of 35small manufacturing enterprises in the USA and the following are some principal findings: Eighty-four percent of respondents indicated that some investments were necessary in the short-run, regardless of their profitability.

Payback period was used to evaluate capital projects by 51 percent of respondents, while 30 percent reported use of some variation of accounting rate of return. Only 10 percent reported use of discount cash flow methods such as net present value (5 percent) and internal rate of return (2 percent). This finding is consistent with the Soldofsky (1964), Louma (1967), Corner (1967), and Grablowsky and Burns (1980) findings of a tendency in using simple and complicated methods of capital investment project evaluation.

Sixty-one percent of respondents indicated that they screened capital expenditures by comparing the expected rate of return on investment with the cost of capital or some cost of financing. Similarly, Block (1997) found that, of the 64 firms using discounted cash flow as the primary method of investment analysis, only 9 used a concept closely related to weighted average cost of capital as the discount or hurdle rate. The majority of firms used the cost of funding the specific project as the cut-off point. Others relied on such concepts as an arbitrarily determined cut-off point or historical rate of return. The reason for not using weighted average cost of capital is that smaller firms have difficulty in estimating the cost of equity capital. They were accustomed to relating cost to contractual obligations, and no other concepts such as opportunity cost related to retained earnings. Furthermore, smaller firms have less access to the public capital markets and fewer alternatives overall than larger firms and feel a less compelling need to measure the relative cost of each.

Methodology

A structured questionnaire was used to collect data from SMs. The researcher used random sampling and collected data from 30 small and medium enterprises. Correlation analysis and descriptive statistics calculations were done using statistical package for social sciences (SPSS), using the correlation analysis, correlation between investment decision and profitability of SMEs. Finally the results were discussed which can be applied to improve the SME sector.

Hypothesis

H_1: Cash for investment in long term projects enhance the profitability of SMEs
H_2: Investment in non-current assets enhance the profitability of SMEs
H_3: Evaluation of investment increases profitability of SMEs
H_4: Using payback period to assess investment increased profitability of SMEs

Analysis

Descriptive statistics (mean, standard deviation, minimum, median and maximum) for all the variables were calculated then segment wide means and standard deviation for all variables were found. Pearson's correlation coefficient was calculated for all the variables to identify the relation between investment and profitability of SMEs. Finally, regression method is to identify the impact of investment decision on profitability.

Findings

The findings revealed that few of the businesses have cash for investment in long term projects (Mean=2.7), these businesses vary from type and nature. Similarly the findings showed that the SMEs invests in non-current assets (Mean=2.54). However, the utilization of these non-current assets is doubted, as the findings showed low and improper utilization (Mean=2.42). This has a big effect on the utilization in generating sales which affects the overall profitability of the businesses. Though some of the SMEs may have cash for investment, majority of them invests without evaluating the investments (Mean=1.85). This puts the initial amount invested at stake as some of the businesses may not be viable. Few of the businesses use NPV (Mean=2.34), Payback period(Mean=2.21) clearing indicating that investment is made without consideration of viability as well as future returns.

Table 3D Investment Decision (Item Analysis) n = 335)

Item	Mean	Interpretation	Rank
Investment			
The business has cash for investment in long term projects	2.70	High	1
The business invests in non - current assets	2.54	High	2
The business utilizes fully the non - currents	2.42	Low	3
The business uses net present value to assess the investment	2.34	Low	4
The business uses Payback period to assess the investment	2.21	Low	5
The business invests without evaluating the investment	1.85	Low	6
The business invests in real estate	1.83	Low	7
The business reviews the investment projects after a certain period	1.81	Low	8
The business invests in shares on the stock exchange	1.74	Very Low	9
Average Mean	2.16	Low	

Source: Primary Data

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Legend (provide what is needed below)

Mean Range	Response Mode	Interpretation
3.26-4.00		Very High
2.51-3.25		High
1.76-2.50		Low
1.00-1.75		Very Low

(Interpret Table 3D)

The findings from Table 3D further revealed that, the investments made are not certainly reviewed after a certain period of time (Mean=1.81). This means that if the investment goes bad on the way there is no way to know how to bring it back on track and thus losing the initial investment. Similarly few of the SMEs invest in real estate (Mean=1.83) and very few of SMEs invests in shares at the stock exchange (Mean=1.74). This clearly shows that the nearly convertible investments are not priority for investments for SMEs as earlier researchers stated………

Conclusion

Investment Authority, SME Task force should put up trainings to SMEs owners on how to invest their funds. This more importantly concerns on how to choose and evaluate investments in which to invest in. For example more sensitization needs to be done on how to use investment analysis techniques like payback period, NPV, return on investments so as to maximize their wealth. Similarly SMEs owners themselves needs to pick interest and seek professional help on how to choose the best portfolio to invest their funds so as to obtain higher returns on investments.

Recommendations

1. The Ministry of Finance and Economic Planning should provide a favorable platform for SMEs to access financing that can enable them to run their businesses at a reasonable cost of financing. This is because currently the access to bank loans is difficult by SMEs and they end up using only internally generated funds.
2. The interest rates should be favorable; similarly the requirements to accessing such funding should also be reasonable not to push SMEs away.
3. The Nigerian Securities Exchange should also think about a way to moderate SMEs and raise funds through the stock exchange by floating their shares in a moderate market.

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