EFFECTS OF EQUITY AND DEBT FINANCING ON SME PREFORMANCE IN MALAYSIA

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Abstract

This study is to examine and verify the existence of relationship between the source of capital via equity and debt financing, and the performance of small and medium enterprise (hereafter SME) in Malaysia. The study is run based on of postal survey using cluster sampling method. It comprises of 177 samples of Malaysian SMEs involving in manufacturing and agriculture sectors. Subsequently, two research hypotheses are developed and analysed. It is found that equity financing has significant positive relationship on the business performance, while debt financing is insignificant. The study suggests that SMEs in Malaysia to employ equity financing as a source of business capital, for its potential (capability) in affecting the performance of business.

Keywords: Equity financing, debt financing, business performance, small and medium enterprise (SME)

1.0 INTRODUCTION

SME constitutes a large portion of overall business system and provides sizeable contribution to economy, social and politics of developed and developing countries. SMEs represent more than 90 percent of the entire business entities in most countries (EU-SME, 2010/2011). In Malaysia, SMEs represent 97.3% (DOSM, 2013) of the entire business entities and contribute to the increment of GDP from 28.1 percent in 2003 to 31.9 percent in 2010 (SME report 2010/2011) and 32 percent in 2012 (SME report 2011/2012). However, the performance of SMEs is still perceived as moderate achievement (Shuhymee, 2010). This can be seen through the contribution of SMEs to Malaysian GDP in comparison with SMEs in developed countries, where the contribution of SMEs to GDP in developed countries such as Japan (53 per cent), German (53 per cent), United Kingdom (51 per cent), South Korea (49 per cent) and Singapore (49 per cent) show a much better performance (SME Report, 2009-2010).

In addition, financial resources are seen as imperative and if not managed properly can cause low-performing and non-competitive firms (Brigham Houston, 2004). Therefore, the issue of capital resources has posted significant challenges to SMEs in many countries including Malaysia (Mohd Khairuddin, 2007). However, empirical research exploring the problem of business capital financing sources that affect the performance of SMEs in Malaysia is still limited (Mohd Khairuddin, 2007, 2010). In addition, majority of earlier research use secondary data in examining the connection (Wan Murshidah, 2005; Zuraidah, 2009)

Furthermore, findings of the previous studies with different methodologies are inconsistent. This research examines the relationship between sources of financing business capital (debt and equity financing) with business performance amongst SMEs consisting of 177 firms from manufacturing and agriculture in Malaysia using primary data. The findings of this study reveal that equity financing is significant with business performance while debt financing is found to be insignificant. That means funding business capital in the form of equity financing is capable of providing positive impact on business performance of SME firms in Malaysia.

This research paper is further divided into several sections. Next section discusses about the literature review highlights by previous researchers and the formation of hypotheses of the study. The third section describes about the review of methodology and measurement of variables. The fourth section of the report is on the findings of the studies and the final section discusses about the analysis of the findings and conclusions of the study.

2.0 LITERATURE REVIEW AND HYPOTHESIS FORMATION

Financial resources are part of the internal sources which can affect the performance of the business and is one of the key elements highlighted by Barney (1991) in the RBV theory (Basic View of Sources). Additionally, a source of business financing or capital structure is an element of the financial resources (Dollinger, 2003). Sources of financing business or business capital consists of two large branches, namely the financing in the form of equity and debt (Chakraborty et al. 2010)

Equity financing is a business capital financing methods that does not require repayment and does not charge any interest on funds advanced but offers to investors a form of ownership in the business (Daniel et al., 2010). Equity financing comprises of sources such as venture capitalists, angels, family/friends equity contribution and other external resources (Fraser, 2005). Equity financing can also consist of a source of own savings, contributions of the Board, the contribution of partners, property of the omission, deferred income and cash flows of the business (Kongmanila and Kimbara, 2007). Meanwhile, sources of financing debt financing is a method of debt capital involving interest-based instruments (Rosli et al., 2010) and is comprised of a number of resources such as bank loans, family/friend loans, and secured loans, credit cards and other credit (Fraser, 2005).

Sources of financing in equity and debt are an important source of income and have a positive relationship to the performance of the business. In fact there are SME firms that use both financial resources to finance their businesses. However, SMEs prefer using internal equity, deferred income (retained earnings) first, then use the new debt financing before using external equity financing when loan limit is maximum (Vos, 2007; Ou and Haynes, 2003). A firm uses external equity financing when the costs of getting more debts become expensive, or if a firm has better knowledge of information on its own value than the market or if a firm has the opportunity to improve its profit performance (Myers Majluf, 1984).

In addition, prior research investigating the relationship of debt and equity financing on the business performance of SMEs show varied results and are inconsistent. Studies by Fu et al. (2002) on SMEs in Taiwan find out that equity financing shows significantly positive relationship, while debt financing showed negative relationship. However, a study by Kongmanila and Kimbara (2007) on 160 firms SMEs in Vientiane Capital City, Lao PDR shows both equity and debt financing are significantly positive over the performance of the business. In Malaysia, a number of studies that examine the relationship between sources of capital i.e. equity and debt financing over the performance of firms by Chin Ai Fu (1997), Wan Murshidah (2005) and Zuraidah (2009) also show inconsistent findings.

In general, the findings of earlier studies of the relationship of equity and debt financing, to business performance are mixed and inconsistent. In addition, studies that employ primary data and the data on agricultural sector are limited. Thus, this study examines relationships and the influence of independent variable of equity and debt financing to the independent variables i.e. business performance of SMEs in Malaysia and suggests the following hypothesis to the test.

Hypothesis 1: Firms' equity financing have a significant relationship with the business performance of SMEs in Malaysia.

Hypothesis 2: Firms' debt financing have a significant relationship with the business performance of SMEs in Malaysia.

3.0 METHODOLOGY

3.1 Sample and data collection

The samples consist of SMEs in the manufacturing and agriculture sectors in Malaysia. Manufacturing sector has been employed as a sample and tested in previous studies by Mohd Khairuddin (2002), Alexandra (2006), Azizi (2010), and Shuhymee (2010) and proved to give good response. Taking the lead by Shuhymee (2010), this study includes the agricultural sector which is believed of not being explored regarding SME issues in Malaysia. The samples cover all states in Malaysia. The selection of the samples takes into account the scope of the review, budget and time limitation to complete the study. In this regard, a total of 177 SMEs are used as samples.

This study collects primary data via questionnaires in the form of self-administered completed by respondents. Data collection is by post and this technique proved to be helpful to get the number of respondents in short period, possesses high secrecy feature (Sabitha, 2005) and saves cost and efficient (Sany Sanuri, 2007). In addition, this technique also gives an advantage to researchers in terms of logistics; where it is also efficient in dealing with a large number of respondents who live faraway and at different locations (Cavana et al., 2004; Sabitha, 2005).

3.2 Measurement variables Independent Variables

3.2.1 Review

The independent variable in this study is the business performance of SME firms in Malaysia. The instrument used for the assessment is subjective and self-report. The instrument consists of 8 items, adopted from various dimensions such as business growth performance, financial performance and overall performance of Azizi (2010) and Shuhymee, (2010).

3.2.2 Independent Variables

Independent variables consist of equity financing and debt financing resources. This research uses a total of 3 items questionnaire adapted by Fraser (2005), which conducts financial study on SMEs in the United Kingdom. This questionnaire is adapted and modified to suit local respondents and the study to measure equity and debt financing variables. The scale of measurement is based on ratios. Items within the questionnaire include funding resources of firm internal equity, external equity and debt. This questionnaire has also exceeded the minimum requirement of pre filtration tests and pilot study and gets good response during the actual field study.

4.0 FINDINGS

The results of the descriptive analysis is provided in table 4.1, which reports that equity financing variables have the mean of 6.67 (above the mean ratio; 5.00), on the other hand, the mean value for debt financing variable is 3.32 (below the level of the mean ratio; 5.00). It demonstrates that SMEs in Malaysia are also more likely to operate using the equity financing to fund their business compared to the debt financing. Furthermore, the results of the descriptive statistics analysis on business performance variables shows the mean of 5.21 (above the Likert's mean; 3.50). The results also indicate that the majority of SMEs in this study have high business performance.

Table 4.1 – Descriptive Statistics

Variables	Mean	standard deviation	Min	Max
Performance	5.2140	0.74441	3.38	7.00
Equity Financing	6.6780	1.86573	1.00	10.00
Debt Financing	3.3295	1.86315	0.00	9.00

N=177

The results of the correlation analysis in table 4.2 shows that correlation results at the confidence level of 99 percent. Independent variable i.e. equity financing is found to be positively correlated with dependent variables i.e. business performance ($r = .273$, $p < 0.01$), while debt financing negatively correlated with business performance variables ($r = -.295$, $p < 0.01$). This explains the equity and debt financing sources are significantly correlated with business performance and free from the effects of multicollinearity. This finding supports the view that the use of equity financing can improve business performance while the use high debt financing can lead to low business performance.

Table 4.2 - *Correlation Analysis Between Variables*

Variables	Performance	Equity Financing	Debt Financing
Performance	1.00		
Equity Financing	.273.**	1.00	
Debt Financing	-.295**	-.858**	1.00

**. Significant at 0.01 level
N. 177

Multiple regression analysis is carried out by the 'enter solution' process. Table 4.3 shows the multiple regressions analysis results performed using independent variables of equity financing and debt financing, and business performance as the dependent variables. Equity financing (value of p =. 000) found to be significantly positive related with the dependent variable (performance). While debt financing resource variables are found to be insignificant in relation to the performance of the business (value of p =. 99). Thus, the hypothesis 1 (H1); equity financing is significantly related with business performance is supported. While the hypothesis 2 (H2), debt financing is significantly related with business performance is rejected. This study has shown that the use of equity financing for SMEs in Malaysia is capable of influencing and improving business performance.

Table 4.3 - *Regression Results*

Variables	R	R^2	Adjusted R^2	Error	F	Sig.F	Beta
Equity	.273	.075	.069	.71459	14.112	.000	.273
Debt	.298	.089	.078	.71115	8.474	.102	-.231

Dependent Variable: Performance

5.0 DISCUSSION and CONCLUSIONS

The first hypothesis is a study to determine the relationship between equity financing and business performance. Multiple regression results demonstrates that equity financing is positively related with business performance (β =. 273, $p < 0.01$).This is consistent with the findings of Jordan et al. (2005) and Fu et al. (2002) who conducted a surveys on SME firms in England and Taiwan. Several other studies such as Fraser (2005), Mesquita and Lara (2003) also reported similar findings. However this finding contrasts with the findings of Jung et al. (1996), Mohamad Khan (1994) and Ahmad Farid (1980) who report significant negative relationship between equity financing and business performance.

However, the findings of this study is in accordance with the review of Myers and Majluf (1984) who propose that SMEs use of equity financing to improve the performance of the business as the cost of debt financing is high. According to them again, the firms' use of high debt financing would have to incur additional premium costs and thus affects the profitability of the firm. Therefore, this study recommends that SMEs should always self-check for the internal value of the firm (internal sources) before going for external capital resources (capital market).

In addition, the findings of the study also were able to elaborate on that equity financing is capable of enhancing business performance. This finding also indicates that operators of SMEs in Malaysia are getting wiser in managing their sources of financing, comparable to the approach taken by SMEs in developed countries such as discovered by Vos et al. (2007) and Fraser (2005). In his study, Fraser (2005) finds that SMEs in England use equity financing in the form of deferred income to improve their business performance. On the other hand, the use of debt financing may affect business profitability because of interest charges (Ballentine et al. 1993).

In addition, SMEs have problem in acquiring loans from banks because of their business performance (Shuhymee 2010), face serious financial problems (Mohd Khairuddin 2007), provide incomplete business plans (Schmid, 2001) and unsecured (OECD, 2006). This steers them to rely more on equity financing, and avoid over-reliance on bank loans. Bank loans also involve long waiting process, uncertainty of bureaucratic process and possibility of loans disapproval. In addition, advisory services and Government supports such as SME Corp. has helped SMEs to become more competitive.

The findings of this study explain that debt financing source has no effect on the business performance of SMEs firms in Malaysia. The findings are consistent with Carpienter studies (2006) whose research on 243 firms in Canada. A review by Kyereboah-Coleman (2007) on the Micro Finance institutions Ghana also demonstrates that short-term and long-term debt financing are not significant to business performance.

Therefore, the findings of the study provide understanding and new knowledge to the field of resource management that examining the relationship of equity financing and the performance of the business in the context of SMEs in Malaysia. Furthermore, the study also underlines the use of internal resources (equity financing) in improving business performance for SMEs.

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