

A study of the factors affecting to the capital structure of the
small and medium enterprises in Sri Lanka

By

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Declaration by the Candidate

The work described in this thesis was carried out by me under the supervision of Prof. Dr. Kennedy D. Gunawardana and a report on this has not been submitted in whole or in part to any university or any other institution for another Degree / Diploma.

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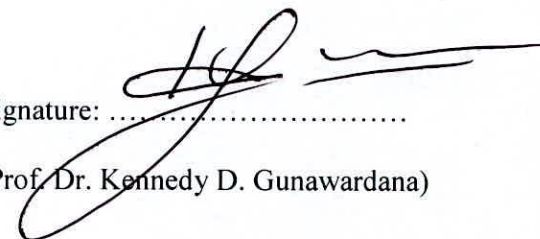
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ABBREVIATIONS

SME	Small and Medium Enterprise
SMEs	Small and Medium Enterprises
LTD	Long-term debt ratio
STD	Short-term debt ratio
GLS	General Least Square
AST	Assets Structure
PROF	Profitability
GROW	Growth

**A STUDY OF THE FACTORS AFFECTING TO THE CAPITAL
STRUCTURE OF THE SMALL AND MEDIUM ENTERPRISES IN
SRI LANKA**

Kulathunga P.G.K.N.

ABSTRACT

This study investigates the determinants of capital structure in small and medium enterprises in Sri Lanka. This is an essential issue to study in this development era in Sri Lanka. The multiple linear regression models are used to estimate the relationship between capital structure, which is measured by long-term and short-term debt ratios, and firm level characteristics as size, assets structure, and firm risk towards variation in profitability, growth and profitability. This study shows that the most of SMEs in Sri Lanka use more short-term debts over long-term debts with high liquidity and long-term solvency positions. The findings of the study suggest that size and profitability strongly influence on both short term and long term debt ratios. Assets structure also influence in determining debt ratio. However firm risk towards variation in profitability and growth provide weaker evidence on influencing both debt ratios. The results of the study implies that size, profitability and assets structure affect in determination of capital structure in small and medium enterprises in Sri Lanka. The results support pecking order theory implying small and medium enterprises prefer more, to use internally generated funds for future investments and size of the firm making limited access to long-term debts suggesting the policy makers to provide an environment to retain sufficient amount of internally generated funds within the firm.

1. INTRODUCTION

This study investigates the factors affecting to the capital structure in small and medium enterprises (SMEs) in Sri Lanka.

Small and medium enterprises are an important sector in any economy and it is said that the SME are the strategic sector in achieving development in any economy. Moreover, SMEs play a major role in providing employment opportunities, contributing the GDP, doing innovations to help the alleviation of poverty in any economy ignoring the factor that the economy is developed or developing. SMEs are more labor sensitive and use many local resources than large enterprises, so SMEs better fit for countries such as capital scare developing countries. Therefore, most people like to introduce the SME sector as the backbone of any economy in the world. Moreover, development of the SME sector provides better protection to large and multinational corporations.

In this development era of Sri Lanka, the importance of the SME sector has increased more than ever before. In addition, it has been identified as the strategic sector of promoting growth and social development in Sri Lanka. Especially, the SME sector in Sri Lanka provides opportunities for employment and income generation in rural areas to alleviate poverty. The SME sector in Sri Lanka contributes a considerable amount to the GDP. In Sri Lanka, more than 80-90% of the establishments are SMEs and more than 40% of the employment opportunities are provided by SMEs as well as the industrial value addition by SMEs is also more than 20%. Moreover, SMEs in Sri Lanka are involved in wide range businesses including agricultural, mining, manufacturing, construction and services including information technology and communications.

1.1. Problem Statement

What are the existing capital structures in the SME sector in Sri Lanka and its impact to the growth of the firm?

1.2. Problem Justification

Capital is one of the major factors in achieving higher growth of a firm. Most of the large companies have started their business either in a medium or small scale. In addition, they have become large-scale businesses by managing their capital structure properly to achieve higher growth of the firm. Therefore, it is very essential to know how to manage capital structure properly to achieve future improvement. The value of the firm is dependent on the capital structure. Capital structure can exist in several ways. It may exist with owners' capital only or 50% owners' capital and rest from debt, etc., thereby getting maximum benefits, so that the firm needs to decide optimum capital structure. If there is a large portion of external debts in capital structure, it gives a high gearing ratio to the firm and this makes problems in controlling the power of the firm. Therefore, any firm needs to maintain a low gearing ratio to protect the controlling capacity of the firm. But, to fulfill the financial requirements to achieve higher growth, the firm might have to obtain external debts. Therefore, the capital structure decision is a critical decision for the firm when the firm tries to achieve future development.

Though there are many SMEs in Sri Lanka. However, it is very difficult to find the details of existing capital structure of SMEs including how SMEs maintain their gearing ratio, whether they are using external debts for their financial requirements or are they using only the owners' capital to fulfill the financial requirements and whether the capital structure decision has affected the growth achievement, etc. Therefore, existing capital structures in SMEs and impact of it for the growth of the firm are unexplored. To

manage the capital structure properly in SMEs, the identification of the existing capital structures and their impact to the growth of the firm is essential.

1.3. Objectives

- I. To find out the existing capital structure patterns among SMEs
- II. To find out the factors affecting the capital structure
- III. To find out the relationship between capital structure and firm base characteristics

The main objective of this study is to find out the existing capital structures in SMEs in Sri Lanka and the factors that affect to SMEs' capital structure. In addition to this, the study is going to identify the effects of firm base characteristics (e.g. size of the firm, profitability of the firm) to capital structure decisions of a firm as well as to find out whether there is any significant relationship between them.

1.4. Significance of the Study

Though the SME sector is an important sector in the economy in Sri Lanka, there are many constrains for the performance of the SMEs. Especially the volatile exchange rate, high interest rate and illiquid financial markets are major fiscal difficulties in the country yet to be understood properly for the SME sector when proposing solutions. A major issue is the difficulties they faced when they access the capital for future development requirements. Many SMEs in Sri Lanka face capital structure issues such as lack of knowledge in capital structure, difficulties in accessing financial markets, etc. (Gamage, 2003). Therefore, many SMEs use owners' capital to fulfill day-to-day financial requirement without having proper professional advice. Even most of the financial institutions are not much aware about the capital structures of SMEs due to no

empirical evidence of the SMEs. Because of that, many financial institutions refrain from providing financial support to SME which leads to restriction of the future development of SMEs.

In addition, studying and finding empirical evidence on capital structure in SMEs is very helpful to identify key issues in capital structure. Knowing the existing capital structures, key determinants of capital structure as well as the relationship between capital structure and firm base characteristics are very useful to make better financial decisions to firms and to policy makers to develop policies.

It is very difficult to find empirical evidence of capital structure in Sri Lanka for any type of firms. Sri Lanka has given little attention to study in capital structure theories. Because there are differences in financial institutions and financial markets between developing and developed countries, it is very essential to fill the gap literature in capital structure in SMEs in transitional economic perspective or developing countries perspective. Therefore, based on the gap existing literature in capital structure in SMEs in Sri Lanka, this study focuses to explore the factors affecting to the capital structure in SMEs.

1.5. Scope of the study

Small and Medium (SME) scale firms in the western province that has a total assets value of less than Rs. 50 Mn. and which are preparing audited financial statements are included in this study. The study also uses three years audited financial statements between 2007 to 2009 of SMEs. Policy makers, bankers, financial institutions and SMEs are the beneficiaries of this study.