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Capital structure decision making for SMMEs in the South African context

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Abstract

The **purpose** of this study is to explore how managers of SMMEs make capital structure decisions for their firms in the South African context.

The **study** is a qualitative and is grounded in interpretivism. The literature unpacked pecking order and trade off theories and together with taxation and profitability they were explored in research questions posed to SMME managers during semi-structured interviews.

The **findings** in this study is that SMME managers find the notion of taking up debt for the sake of the tax incentive to be counter intuitive, debt repayments become an expense that erode the firm's profitability and also exposes the firm to potential bankruptcy. The notion of borrowing without a business purpose, presents a challenge to managers. Business objectives thus present the most compelling determinant of capital structure decision making in this study. Pecking order theory is supported by the findings in this study. This study finds that the Trade off theory has no standing on capital structure decision making in SMMEs and managers explore alternative funding methods such as loan accounts.

The **implications** of this study include a call for academia to undertake descriptive studies to pursue these findings. Development of succinct business objectives will assist SMMEs bridge the gap between themselves and funding institutions.

Keywords

Debt, leverage, pecking order theory, SMME and trade off theory.

Declaration

I declare that this research project is my own work. It is submitted in partial fulfilment of the requirements for the degree of Master of Business Administration at the Gordon Institute of Business Science, University of Pretoria. It has not been submitted previously for any degree or examination in any other University. I further declare that I have obtained the necessary authorisation and consent to perform this research

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Acknowledgement

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Chapter 1: Introduction

1.1. The research problem

“But the reality would have been that any person starting a business, where do they access capital to start their business correctly? And that's the most difficult point: why do some business fail that should succeed? It's that they do not have readily available capital to let that business grow consistently.” – Medium size service firm manager (2016).

Small, Medium and Micro Enterprises (SMMEs) have been identified as the source of 90 percent of jobs created between 1998 and 2005 in South Africa (National Development Plan, 2011). The National Development Plan (NDP), South Africa's vision for 2030 document developed by the National Planning Commission highlighted the need to build research capacity to address the paucity of data available on SMMEs (NDP, 2011). The NDP proposes stimulation of the SMME sector through procurement, simplified regulation, support services and more importantly, stimulation through improved access to debt and equity finance. The NDP calls for the prominence of small and expanding firms and also notes the reluctance by credit providers to lend to SMME's due to high costs of services required to manage the risk of default. The Minister of small business recently stated that small business continues to face problems with access to funding from main commercial banks based on the lack of access to collateral and track record (Small business development department budget vote speech, 2016).

Ramjee and Gwatidzo (2012) found interrelation between firm characteristics such as profitability, asset tangibility, firm size, taxation, reputation and capital structure/leverage in listed companies. Macroeconomic variables such as inflation, GDP per capita growth, and the size of the economy have also been found to have an effect on leverage (Tesfaye & Minga, 2013). Tesfaye and Minga (2013) found positive correlations between these macroeconomic variables and capital structure in listed companies in Africa and have called for further studies in non-listed companies. This study will not attempt to survey further literature on macroeconomic variables; the main

reason is that studying these variables would require an analysis of cross-country differences in capital structure decisions. Frank and Goyal (2003) have concluded that these “internal” factors (macroeconomic factors) explain 30 percent of capital structure, thus attributing the remaining 70 percent to other factors such as firm characteristics and managerial factors.

Firm characteristics and their effect on leverage have been studied by Ramjee and Gwatidzo (2012), only taxation and profitability will be discussed further as the focus of this study is the manager or owner of the firm and their decisions around capital structure, in particular issues related to taxation and profitability. One of the key implications for capital structure determinants found by Tesfaye and Minga (2013) is that managers influence capital structures of firms by influencing firm level factors, it is for this reason that this study will focus on the role of managerial decision making with regard to the involvement of taxation and profitability as firm characteristics and decisions on capital structure. Table 1.1 below is compiled from the work of Ramjee and Gwatidzo (2012) and shows firm level characteristics and their correlation with leverage. Borgia and Newman (2012) argue that managerial attitudes and intentions determine the outcome of this relationship. This sets the scene for what this study intends to explore, the effect of intentions and attitudes of managers on capital structure decision making.

Table 1 Managerial influence on firm level characteristics

| Firm Level Characteristics | | Correlation with Leverage |
|----------------------------|--|---------------------------|
| Asset tangibility | | Positive |
| Size | | Positive |
| Age | | Positive |
| Growth | | Positive |
| Taxation | | Negative |
| Profitability | | Negative |

It was previously assumed that managers make rational finance and investment decisions in traditional finance frameworks (Ishikawa & Takahashi, 2010). However, currently it is accepted that the rational expectations theory and the efficient markets hypothesis do not hold, due to interference of psychological phenomena that prevent decisions makers from behaving in a rational manner (Shefrin, 2001). Shefrin (2001) labels these impediments (loss aversion, confirmation bias and frame dependence) as behavioral costs, losses in value associated with errors made by managers because of cognitive imperfections and emotional influences. These impediments are derived from the work of Tversky and Kahneman (1986). Ritter (2003) found these personal managerial characteristic variables (heuristics, overconfidence and mental accounting) have an effect on leverage decisions. Borgia and Newman (2012) found that in emerging economies, managerial aversion to external control and risk taking propensity has a huge influence on SMME capital structure.

Zwiebel (1996) concludes that managers voluntarily choose capital structure. This voluntary choice of capital structure is borne from the trade off theory of capital structure, which promotes balancing of costs and advantages of debt and equity. This theory has been developed from the seminal article by Modigliani and Miller (1958), the article gave rise to a world of research on capital structure decisions. The pecking order theory, initiated by Myers (1984) and Myers and Majluf (1984) proposes that firms will first choose internally generated funds to finance projects and then turn to debt before considering raising equity. An analysis of this phenomenon as well as the concept of asymmetric information, which purports that managers possess more information about the firm's future prospects than investors were applied to SMME's in a study by Daskalakis, Eriotis, Thanou and Vasiliou (2014).

Trade off theory and pecking order theories are applied in this paper's exploration of

managerial decision making regarding the two firm characteristics and leverage. Ramjee and Gwatidzo (2012) have found that both theories play a role in South African firm's capital structure decisions. The theories have been applied extensively in capital structure studies and the researcher intends to apply them to provide a framework upon which this study can be based and designed.

Loss aversion will be a managerial decision making bias of focus as it manifests in life experiences and is a social construct (Godoi, Marcon & Da Silver, 2005). Information asymmetry is closely associated with the pecking order theory and its role on capital structure will be explored as well.

1.2. The research purpose

There is abundance of literature on capital structure determinants both locally and internationally, but most focus on listed companies (Ramjee & Gwatidzo, 2012). South Africa's future economic growth path is predominantly in SMME's in terms of job creation according to the NDP (2011) and this raises the question of how this sector's capital requirements are determined to enable it to reach its potential.

The academic need for this study in SMMEs is brought forth by the limitations of previous capital structure studies that were restricted to listed companies (Tesfaye & Minga, 2013; Ramjee & Gwatidzo, 2012). The limitation of studies to listed firms is driven by better access to and credibility of their financial records, thanks to adherence to strict financial reporting requirements. SMMEs are different in this regard (Finmark, 2015).

The business need for this study is succinctly captured in the NDP document, raising a need for further research in debt and equity finance for SMMEs. The findings could provide insights to managers and credit providers that could reduce the provider's reluctance to provide debt due to risk of default by firms. Rovolis and Feidakis (2014) note that firm executives and policy makers should adjust their capital structure policies in response to the findings incorporated in capital structure studies. This study intends to contribute to capital structure literature through the exploration of managerial

decision making and its effect on the alignment of firm characteristics and leverage.

The author proposes to explore predominant factors influencing SMME managers in firm's capital structure decisions through exploration of managerial decisions around firm characteristics empirically shown to influence capital structure in South Africa and internationally. The study will focus on profitability and taxation as firm characteristics, the two characteristics have been found to have a negative correlation with leverage in South African listed firms (Ramjee & Gwatidzo, 2012). The study's exploration of SMMEs against the backdrop of managerial decision making should provide interesting insights, whether the findings turn out to be in-line with the Ramjee and Gwatidzo's (2012) study of listed firms or not. This provides the main theme of the study, which is the role of managerial decision making on capital structure. This managerial role will be explored through analysis of the study's finding in relation to the trade-off and pecking-order capital structure theories.

The study is structured as follows. Chapter 2 provides a review of literature on capital structure theories as well as description and discussion of definitions of SMMEs and factors that affect capital structure, in particular taxation and profitability as firm characteristics. Chapter 3 outlays the research questions that emerge from the literature and Chapter 4 the methodology utilized by the study, including its limitations. Chapter 5 will provide an outlay of the data collected and present the insights from the interviews, while Chapter 6 will provide the analysis of the study's findings and how they tie up with the literature studied.

Chapter 2: Literature review

2.1. Foreword to the Literature review

A developmental review of the field of behavioral finance indicate that much behavioral finance studies use work that demonstrates bias in decision making and human judgment to explain investor behavior (Kahneman *et al.*, 1982). Ishikawa and Takahashi (2010) state that psychology literature provides evidence that managers tend to be overconfident and thus irrationality should be considered to be an important factor in corporate financing decisions. Muradoglu and Harvey (2012) cover extensive work arguing that cognitive bias occur because people use heuristics as they lack the cognitive capability to make normative decisions.

Behavioral finance takes into consideration managerial choice and influence on capital structure; this is a deviation from the traditional leverage theories such as efficient markets and rational expectations theories mentioned in the preceding chapter. The discussions in this section will cover the review of SMMEs and development of capital structure literature. Two theories that emerge in the context of the behavioral finance will also be discussed, namely:

- Pecking order theory; and
- Trade off theory

2.2. Literature review on SMME

Key theme in this section for discussion is SMME funding challenges. SMMEs are key drivers of job creation (NDP, 2011) and they play an important role in the economic growth and job creation in many countries. In South Africa, SMMEs account for 91% of the formal business entities, contribute to about 57% of GDP, and provide almost 60% of employment (Finmark, 2015).

This research will base its definition of SMMEs from South Africa's amended National

Small Business Act 29 of 2004, which defines an SMME's as a small business that is separate and distinct, includes co-operatives and non-governmental organizations (NGOs) and is managed by one or more owners and may including branches and subsidiaries.

The number of employees, annual turnover and total gross asset value of the firm distinguish four categories of SMME's. The four categories are micro, very small, small and medium enterprises and the variations in the classification are depicted in Table 2.1 below and include the thresholds per industrial sector.

Table 2 Thresholds for the classification for micro, very small, small and medium enterprises

| | | | | | | | |
|--|----------------------|----------------|----------------|---------------|---------------|---------------|--------------|
| Retail and Motor Trade and Repair Services | Medium Very small | Small Micro | 200, 50, 20, 5 | 39.00 0.20 | 19.00 4.00 | 6.00 0.60 | 3.00 0.10 |
| Wholesale Trade, Commercial Agents and Allied services | Medium Very small | Small Micro | 200 50 20 5 | 64.00 0.20 | 32.00 6.00 | 10.00 0.60 | 5.00 0.10 |
| Catering, Accommodation and Other Trade | Medium Very small | Small Micro | 200 50 20 5 | 13.00 0.20 | 6.00 5.10 | 3.00 1.90 | 1.00 0.10 |
| Transport, Storage and Communications | Medium Very small | Small Micro | 200 50 20 5 | 26.00 0.20 | 13.00 3.00 | 6.00 0.60 | 3.00 0.10 |
| Community, Social and Personal Services | Medium Very small | Small Micro | 200 50 20 5 | 13.00 0.20 | 6.00 1.00 | 6.00 0.60 | 3.00 0.10 |

Lack of finance is one of the serious challenges to SMME survival in South Africa (Finmark, 2015). SEDA in its 2012 report acknowledged lack of access to finance as among the top three barriers to SME growth in the country (SEDA, 2012). The OECD (2009) also highlighted lack of access to external funding as one of the serious constraints to SMME growth. Finmark (2015) has identified age and size of the firm as some of the firm level factors and age, gender and educational level as individual level factors that play a role in whether SMMEs are granted external funding.

Chittenden, Hall and Hutchinson (1996) contend that as a result of the difficulties, SMMEs faced with accessing external funding firms tend to rely on internally generated

funds and this contributes to the constraint on their growth. Hartigh (2015) finds that 8 of 10 new businesses fail in the first two years and this is partly as a result of limited funding. The resultant reliance on internal funding thus creates a dilemma for the SMME manager/owner pursuing growth and performance and this study intends to uncover how managers navigate through this dilemma of balancing the use of internal funds and exploiting the benefits of debt where it applies.

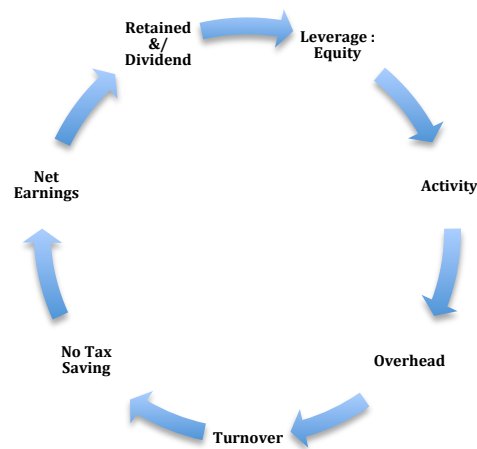
Given the critical role that SMMEs play in job creation, the sustainability and growth of this sector becomes a key ingredient for economic stability in any given country. Firer, Ross, Westerfield and Jordan (2012) believe that the role of capital structure in a firm is to maximize the firm's value. A firm with value will attract capital from debt providers as well as equity investors, thereby improve its chances of survival. These considerations shifts much of the focus on SMMEs to capital structure management.

2.3. Capital structure

The trade off theory (discussed below) highlights the tax interest shield that can be exploited by the use debt in the capital structure of debt, the bankruptcy risk of debt limits this tax exploitation. Thus, the option to avoid debt all together and loose out on the tax deduction benefit through the use of only equity in the capital structure equity seems a popular choice for many firms (Figure 2.1). This choice is also supported by the first prescript of the pecking order theory, which states that firms prefer own funds as a first choice in capital structure funding.

What the model on Figure 2.1 does not depict is the price of equity, which is the opportunity cost of ownership, what that money could be doing better elsewhere (Ward & Price, 2014). Ward and Price (2014) further believe that equity is more expensive due to the inherent risk of investments. The other loss in equity only capital structure according to the trade off theory is the lack of the tax deduction benefit.

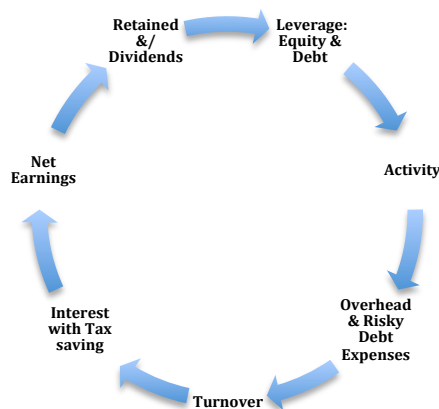
Figure 1 Equity only capital structures



Source: Deduced from Ward and Price (2014)

The introduction of debt into capital structure of a profitable firm is a key strategic driver that increases return on equity to investors (Ward & Price, 2014). An additional benefit of debt usage in capital structure is the tax interest shield that allows a deduction of the interest portion paid on the interest from the tax due by the firm, as depicted in Figure 2.2. These benefits come at a risk of bankruptcy should the interest and capital repayments fall behind.

Figure 2. Debt and equity capital structure



Source: Deduced from Ward and Price (2014)

2.4. Capital structure theories

Capital structure studies trace back to the seminal work of Miller and Modigliani (1958)

with their leverage irrelevance theory that concluded that in an ideal environment capital structure does not impact firm value. This ideal business environment theory was labeled MMI (Miller and Modigliani proposition I) and it excluded the impact of tax, inflation and transaction costs on capital structure transactions.

Academics criticised the MMI and questioned its validity given the fact that no business practically operates in an environment where tax, inflation and transactional costs have no impact (Meyers, 1984). MMII was a correction of MMI as a result of the criticism, the essence of the correction was that MMII stated that the impact of taxes advantages on debt financing were highly underestimated as compared to MMI, which ignored the effect of taxation (Modigliani & Miller, 1963).

Miller and Modigliani (1958) assert that there is realizable value in the tax deductibility of debt interest, lowering the cost of debt for firms. With increasing debt usage, the inherent risk is failure to meet the payments of the capital amount owing and interest, resulting in possible bankruptcy and higher interest payments which in-turn increases the cost of debt. Kolari and Zardkoohi (1991) assert that the “trick” is to take advantage of these debt interest deductible gains without allowing the debt interest rate to surpass those gains. They furthermore assert that higher tax rates create greater gains for firms through higher tax deductibility on interest payment.

Meyers (2001) asserts that higher profits have a negative correlation to debt, but high profitability implies a higher taxable income implying that it can benefit from trade-off theory as the risk of bankruptcy is lower due to the higher profits, which then creates a contradiction. Meyers (2001) further suggest two possible “financial tactics” to explain why managers prefer to keep debt low in the face of high profits: floating rate preferred shares and financial lease; these are proposed as counter explanations for a blame on managers as “excessively conservative”. Borgia and Newman (2012) looked at managerial factors that influence capital structure in an attempt to explain financing behavior of SMMEs in emerging economies, risk propensity and external control aversion emerged as key determinants of capital structure. This study will attempt to explore the possible managerial conservativeness as well as these emerging managerial factors that play a role in capital structure determination.

Two theories that play a significant role in the current behavioral finance studies are the pecking order theory and the trade off theory. Ramjee and Gwatidzo (2012) found that South Africa’s listed firm’s capital structure follow the prescripts of both these

theories in their studies of capital structure determinants, in keeping with financing behavior of other large listed firms according to Jalilvand and Harris (1984) as cited by Borgia and Newman (2012). This study intends to explore if South African SMMEs follow the same trend.

2.4.1. Pecking order theory

The Pecking order theory originated from a hypothesis by Donaldson in 1961 that management in firms preferred using internally generated funds as a source of new additional funding requirement. The hypothesis proceeds to state that choice of funding exclude external funding except for those occasions where additional funding was required (Meyers, 1984). Meyers (1984) infers from this hypothesis that firms tend to prefer internal financing to external financing of any sort, and further that when firms require external financing, they have a preference to debt over equity. An implication of this hypothesis is that it explains why events that decrease leverage (debt), such as new stock (share) offerings and equity-for-debt exchange schemes, are associated with a firm's decline in share price (Duc & Quan, 2002).

Relevant to this study however, is the implied reduction of the extent of information asymmetry. Information asymmetry is reduced as a result of involvement of intermediaries and new participants gaining proximity to the firm and its proprietary information such as financial statements (Duc & Quan, 2002). Frank and Goyal (2003) state that outside (new) investors will demand a higher rate of return on equity than the cost of debt. Duc and Quan's (2002) tests on the pecking order theory on publicly listed US firms over a twenty eight year period reveal that equity financing is not dominated in magnitude by debt financing despite this higher cost of equity. Frank and Goyal (2003) observed that firm's net share issues correlate more with the firm's financial deficits than does debt issues, they concluded that firm's financial deficit seems less important a factor in determining debt issues, overall implying that firms do not generally prefer debt over equity when external finances are sought to cater for financial deficits.

Frank and Goyal's (2003) rejection of the pecking order hypothesis is more so in high growth firms and smaller listed firms in the US, but Ramjee and Gwatidzo (2012) have found that South African listed firms follow the Pecking order hypothesis. Siefert and

Gonenc (2008) found conflicting results for support of the pecking order theory with support for the theory in US, UK and German firms from 1980 to 2004 and a rejection of the theory in Japanese firms from the 1980s to the 1990s. Other studies that have shown conflicting results in the application of the pecking order theory is Ni and Yu's (2008) study of Chinese listed firm's capital structure in 2004, where they found that while larger firms supported the pecking order theory, small and medium firms did not. These conflicting results point to the subjective role of manager's capital structure decisions in firms. Ross (1977) hypothesized that as managers possess more information about the firm's future prospects, their choice of capital structure sends a message to the market about their confidence in the performance of the company, thus presenting the relevance of the information asymmetry theory of capital structure.

Information asymmetry is described as the differences in information managers of a firm have about its prospects and the information other interested outside parties in the market have about the firm (Dierkens, 1986). Pecking order theory emphasizes information asymmetry (Rovolis & Feidakis, 2014). Dierkens (1986) further eludes that information asymmetry gives managers an advantage over the market in the prediction of firm-specific elements. At the core of information asymmetry is the finding that when managers issues debt into the firm it sends a positive signal about their confidence that the firm's future performance is adequate enough to cater for the debt and interest repayments (Dierkens, 1986). However, Fama and French (1998) presented a counter argument that increasing debt in a firm presents a reduction in profits due to the debt and interest payments and thus poorer future performance prospects.

Fama and French (1998) argue that profitable firms have lower leverage (debt/equity ratio), the same finding has been empirically tested in South Africa (Ramjee & Gwatidzo, 2012) and elsewhere (Daskalakis *et al.*, 2014). This presents yet another contradiction in these studies on capital structure theories, indicating that further studies on behavioral finance are still warranted. Duc and Quan (2002) posit that the preference of debt over equity is a general tendency and not a "hard" rule in regard to the choice of firm financing. The relevance of this studies to SMMEs is raised by Pissarides (1999) who observed that opacity of information and lack of transparency in SMMEs contribute to their difficulty in accessing finance, this underpins the importance of perceptions on information asymmetry for SMMEs who do not have a credible history of complying with accounting reports and transparency of their accounting

systems (Finmark, 2015). This lack of credible financial records is worst in smaller and non-registered firms (Finmark, 2015). This study intends to explore how SMME managers in the South African context make their capital structure decisions

2.4.2. Trade off theory

One of the major benefits of using debt in a firm's capital structure is the tax deductibility of interest payments (Kaplan, 1989). It is based on this premise that there is an expected gain for firms when using debt, this notwithstanding that additional funds would be required by the firm in the first place for some purpose and a further understanding that debt has that benefit of tax deductions as compared to other forms of external funding. Trade off theory is based on the proposition that capital structure is determined by a trade off between benefits and costs of debt (Tesfaye & Minga, 2013). The trade off theory in its static form predicts more debt acquisition for firms generating more profits as the possible bankruptcy costs are lower and the anticipated tax shield gains are higher (Kristoffer & Hambusch, 2014). Meyers (2001) also postulates that in an attempt to maximize the tax benefit, firms increase their usage of debt; this study intends to explore this detail further as some empirical studies have opposed this theory, revealing an inverse relationship between tax and leverage (Fama & French, 1998). Negash (2002) also found no relationship between JSE listed firm's tax rate and the extent of leverage, and these findings were corroborated by Ramjee and Gwatidzo (2012).

To counter for the weakness of the static trade off theory, in particular it's inability to explain the high profitability low debt ration correlation, a dynamic trade off theory model was conceptualized by Kane et al (1984) as cited in Kristoffer and Hambusch (2014). The financial complexity of this dynamic model (Kristoffer & Hambusch, 2014) renders the explanation and application near impossible and thus for the remainder of the study reference to the trade off theory will imply the static trade off theory. Literature of trade off theory often refer to a target debt ratios; this will be ignored in this study as its focus is the exploration of key determinants of capital structure and thus a view of a target debt ratio will be pre-empting debt ratios as a determinant.

There are two theories that go hand in hand with the trade off theory, first being the tax or bankruptcy theory, which purports that a firm should set a target leverage structure

aimed at maximizing value for the firm through balancing of debt and its costs (Graham & Harvey, 2001). The other theory is the agency theory, which highlights potential conflicts of interest between a firm's stakeholders, resulting in managers attempting to balance agency costs of debt against the benefits of debt (Harris & Raviv, 1991; Meyers, 2001; Jensen & Meckling, 1976). The relevance of these trade-off theories to this study is the exploration of the role they play in managerial decision making in capital structure, in particular the effect of these potential financial and information losses.

2.5. Decision-making theories

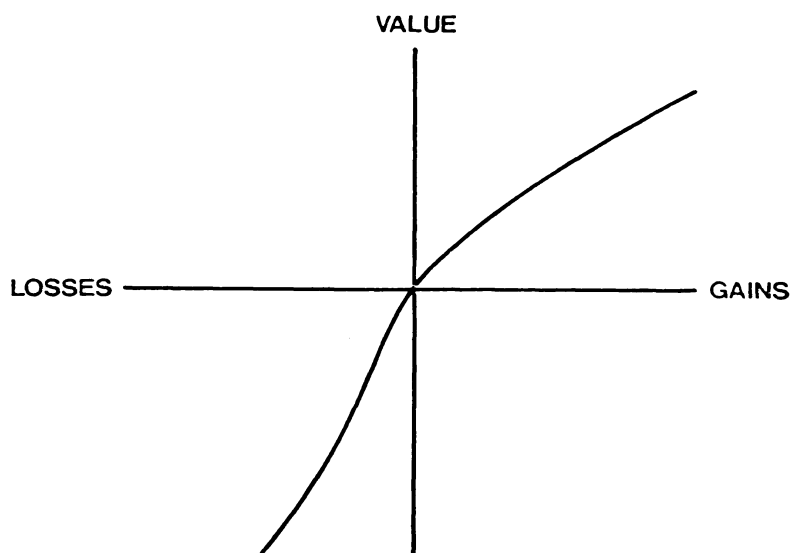
The prospect theory best demonstrates how managers override rational choices while making decision through loss aversion and frame dependence. The theory suggests that decision makers prefer definite outcomes over probable outcomes, leading to risk aversion when encountering sure gains and risk seeking behavior when facing likely losses (Kahneman & Tversky, 1979). The theory argues that one's risk attitude depends on one's own economic situation, and risk aversion ensues if it is regarded as positive and if it deemed negative, risk-seeking behavior prevails (Bovi, 2009). While testing dominant theories in behavioral finance, Algalith, Floros and Dukharan (2012) found data contradicting prospect theory, which states that when faced with gains, managers display a risk-averse behavior. They found evidence of risk seeking irrespective of gains or losses among investors in their empirical studies on dominant theories and assumptions in behavioral finance.

Kanheman and Tversky (1979), in their discussion of prospect theory, describe the process of choosing between options as comprising the framing, editing and the evaluation phase. Framing is described as the decision problem analysis and is controlled by the way a problem is presented as well as the habits, norms and expectations of the decision maker (Kanheman & Tversky, 1986).

Loss aversion is the basic notion that the response to loss is more extreme than the response to gains (Kanheman & Tversky, 1986). It is derived from the work of Markowitz (1952) and was modified by Kanheman and Tversky (1979). As a proposed value function defined on gains and losses, the curve is steeper and convex for losses, while concave for gains, as depicted in Figure 2.3. The shape of the curve depicts that choices that potentially result in losses are perceived as more severe than the equal-

potential winnings. This study intends to explore these aspects of the decision maker when making capital structure decisions as well as the finding by Due and Quan (2002) that managerial attitude towards risk has an effect on capital structure decisions.

Figure 3. The loss aversion curve



Source: Kanheman and Tversky (1986)

2.6. Profitability

Profit appears to be a key theme in behavioral finance theories; pecking order theory is set on the premise that retained profits are the first funding option available to managers (Frank & Goyal, 2003) and trade off theory is set on an inference of profits from which tax will be due that the benefits of an interest deduction can be realised (Meyers, 2001). Profit can be used as a proxy for financial performance using

accounting-based financial measures such as return on assets (ROA) and return on equity (ROE); these measures link back to capital structure in that the assets that must perform are funded by the capital structure. Equity represents funds invested in the business by owners and the ROE must cover the cost of the equity invested. Xiang and Worthington (2015) elude that profitability increases the likelihood to obtain external finance, even more than business objectives.

Dawar (2014) found a negative relationship between leverage and firm performance in India as an emerging economy. This finding is in contrast with similar studies on developed countries where a positive relationship is found (Hadlock & James, 2002). The present study seeks to uncover managerial attitudes around this trend in South African SMMEs, especially the link between firm performance and the trade off theory's assertion of tax-deductible debt interest benefit. Rajan and Zingales (1995) argue that the more profits a firm generates, the more there is a lesser risk of bankruptcy and thus the more leverage the firm should have to maximize the tax deduction, this holds true in support of trade-off theory, but numerous studies find the relationship between profit and debt to be negative (Ramjee & Gwatidzo, 2012).

2.7. Conclusion

Frank and Goyal (2003) succinctly expressed contrasting ideas on capital structure by stating that leverage (debt/equity ratio) will fall automatically, regardless of the impact of the trade off theory when firms earn profit and pay off their debts. Meyers (2001) summarises the trade off theory as placing emphasis on taxation but discounts it on the basis that it cannot account for the high-profitability-low-debt-ratio correlation. Meyers (2001) further summarises the pecking order theory as placing emphasis on information asymmetry leading to a hierarchy in preference of funding by the firms.

Meyers (2001) believes that managers will only chose equity when they perceive debt to be too costly or if additional debt might lead to financial distress. The emphasis, however, is that the decision is at the discretion of the manager and this is the basis for the purpose of this study - exploration of the determinants of capital structure decision making in SMMEs through analysis of two key behavioral finance theories, the trade-off and the pecking order theories. Profitability and taxation have been selected as the two firm-level characteristics of focus in this study and their selection is based on their

negative correlation with regard to leverage in a study of listed firms in South Africa (Ramjee & Gwatidzo, 2012), which is a source of contradiction for the application of the two aforementioned behavioral finance theories.

Chapter 3: Research questions

3.1. Introduction

The literature review in Chapter 2 outlined the key themes in capital structure, behavioral finance and their applicable theories. In the literature review SMMEs have been defined together with different options available for funding of a business enterprise. Profitability has been justified as the firm characteristic variable to focus on. The negative correlation of profitability to leverage has been discussed in the literature review; this negative correlation presents a contradiction to the trade off theory that is followed in South African listed firms (Ramjee & Gwatidzo, 2012) as profitability is associated with more taxation, providing a higher tax deduction benefit if debt was utilised. Managerial decision with regard to capital structure of firms has been widely studied and discussed in Chapter 2. The limitations of these studies is that they were undertaken in listed companies, and the relevant SMME studies were quantitative and did not explore the reasons behind the findings. This study aims to address some of the gaps that have emerged from the literature discussed through the following research questions.

3.2. Research questions

3.2.1. Research question 1

Is capital structure an important consideration for SMME managers?

Zwiebel (1996) concluded that managers choose capital structure of their firms voluntarily. The research question aims to explore if SMME managers make their capital structure decisions voluntarily and to determine the factors they take into consideration in making this consideration. Esperança, Matias and Gulamhussen (2003) are of the opinion that finding the optimal capital structure takes a lot of effort in the financial decision making process.

3.2.2. Research question 2

Do SMME managers consider taxation when deciding on capital structure?

Tax deductible gains of debt utilization presents one of the benefits for trade-off against costs in the Trade off theory (Tesfaye & Minga, 2013). This research question aims to explore the knowledge and attitudes of SMME managers towards this benefits and costs thereof.

3.2.3. Research question 3

During a profitable phase, do SMME managers consider utilising debt to counter higher taxes payable?

The research question aims to explore the contradiction between the negative correlation of profitability with leverage and application of the trade-off theory's trade off benefit on tax-deductible debt interest.

3.2.4. Research question 4

When external funding is sought, do SMME managers prefer debt or to raise equity?

Meyers (1961) refers to the preference of debt to equity when firms seek external funding, Ramjee and Gwatidzo (2012) purported that South African-listed firms follow this assertion of the perking order theory. The research questions aims to explore if South African SMMEs follow the assertion of the pecking-order theory.

Chapter 4: Research methodology

To explore the research questions outlined in Chapter 3, this study followed a qualitative exploratory approach using semi-structured interviews of managers in SMMEs to collect insights into decision making on capital structure. Saunders and Lewis (2012) are of the opinion that exploratory research is utilized when the researcher aims to discover general insights about a topic that is not well understood. In their study of capital structure in SMMEs, Daskalakis *et al.* (2014) highlighted a need for further insights into behavioral finance in capital structure determination. This study's findings could further contribute to the literature on determinants of capital structure of SMME's and form a basis for more descriptive studies relating to managerial decision making in capital structure of firms.

4.1. Research design

Insights into SMME managerial decision making on capital structure were explored through the application of the Trade off and Pecking order theories. The two theories have been applied in previous studies on capital structure determinants and were followed in listed companies in South Africa (Ramjee & Gwatidzo, 2012). The research explored the relative importance of leverage and profitability in SMME's. Saunders and Lewis (2012) recommend the use of qualitative methods to explore how and why things happen. Saunders and Lewis (2012) state that an exploratory research design is well suited to use with interviews in a qualitative study. This is opposed to a descriptive research designs that would be suitable for describing or quantifying observed phenomena without explaining their characteristics, and thus not appropriate for this study. This was a qualitative study, which explored insights into managerial decision making on capital structure of SMMEs.

The research philosophy was grounded in interpretivism, with the actors being surveyed in their own environment with the aim of understanding such an environment's characteristics (Saunders & Lewis, 2012). Given the research questions in Chapter 3 and their link to the literature review in Chapter 2, this was an inductive-approach research with emphasis on context of the research and the need to understand the meanings participants attach to events (Saunders & Lewis, 2012). The

approach was to draw specific conclusions from generalized observations.

4.2. Research strategy

The previous section on design describes this research as an exploration of SMME managerial decisions with regard to their capital structure choices. New insights drawn contributed to literature on determinants of capital structure and more detailed research can be done following insights uncovered from the research questions. Saunders and Lewis (2012) suggest that semi-structured interviews are suitable for this type of research study as the author could not pre-empt the answers and the questions were not rigid. Semi-structured interviews allowed the researcher to probe the participants for better understanding of answers provided, and the research objectives were explored more deeply.

4.3. Population

Saunders and Lewis (2012) describe a population as a complete set of subjects or group members. In this research the population comprised of SMME managers, with SMMEs falling within the range of firms employing between five and 200 employees (Small Business Act 29 Republic of South Africa, 2004). This population group was further defined by the position of individuals in those enterprises, as this study required financial decision makers in those firms, in particular decisions on issues of raising debt for the firm, transacting on equity and a degree of financial accounting understanding to make a decision on profit and taxation as firm characteristics. Ritchie, Lewis, Nicholls and Orsmton (2013) suggest that the population with relevant information to research questions is key and it is thus this study's choice of population. There was no reliable data source about the size of this study's population.

4.4. Unit of analysis

The unit of analysis was the individual as the study seeks to explore managerial decision making in SMMEs and its impact of alignment of firm characteristics and leverage. Zikmund (2003) described this as the "why" of the study. Due to time constraints and the diverse population, the study was structured as a cross-sectional research with SMME managers providing their current position and thinking on the

research questions; managers provided qualitative data as this research required analysis of decision making effects and thought processes.

4.5. Sampling method and size

A sample is described as an available subgroup of a given population that is most appropriate for the research objectives (Ritchie, Lewis, Nicholls & Orsmtom 2013). With the absence of reliable data on the whole population size, a non-probability sampling technique was applied (Saunders & Lewis, 2012). A purposive sampling methodology was employed for this survey as it was important for the researcher in this study to judge who will be in a position to answer the research questions fully to make logical generalizations. The sampling variety was homogeneous to allow greater depth in managerial decision making with minimal variations on data collected.

Purposive sampling in qualitative data collection is used for selection of a small sample (Saunders & Lewis, 2012) and this study performed interviews until data saturation was reached, as evidenced by lack of new insights and codes as the latter interviews were analysed for coding. The managers approached for the interviews are responsible for capital structure decisions in their firms, they represent a wide variety of perspectives on the topic given their different years of experience and the different sectors (Service or Manufacturing) they operate in and the different sizes of their operations in terms of employee head count ranging from Micro, Small and Medium enterprises. Daskalakis *et al.* (2014) are of the opinion that SMMEs of different categories determine their capital structure in similar ways; thus differentiation in size of the organization in the sample will not be considered further than the table below, which depicts the category of SMME managers interviewed.

Table 3: Profiles of interviewed participants and their companies

| Participant | Age | Company and sector | No. of Employees | Setting | Function |
|-------------|---------|--------------------|------------------|--------------------|-----------|
| 1 | 30 - 39 | Cavelli M and S | 120 | restaurant relaxed | Owner |
| 2 | 60+ | Amenities S and M | 50 | office relaxed | Owner |
| 3 | 50 - 59 | Chrysalis M | 32 | office nervous | Executive |
| 4 | 30 - 39 | Oncology center S | 18 | restaurant relaxed | Partner |
| 5 | 50 - 59 | Finico tech S | 11 | restaurant relaxed | Partner |
| 6 | 60+ | PGSI tribe S | 150 | office relaxed | Owner |
| 7 | 50 - 59 | Ebuhleni tours S | 5 | office anxious | Owner |
| 8 | 40 - 49 | Ubuntu kraal S | 7 | lobby anxious | Owner |
| 9 | 60+ | OTT tech S and M | 150 | office relaxed | Owner |
| 10 | 30 - 39 | Boutique S | 5 | office relaxed | Owner |

4.6. Data collection

This research collected primary data for the specific purpose of analysing the insights of SMME managers on their decision making on capital structure of their firms. To communicate the purpose of the study, a covering letter was forwarded to participating managers which included requests for permissions for interviews where they were sought. The method for data collection for this survey was semi-structured interviews, which were all face-to-face in different settings, including hotel lobbies, restaurants and their offices.

Saunders and Lewis (2012) further believe that the detailed exploration of participants' responses is the main purpose of these interviews. This study explored insights from SMME managers in decisions making around capital structure in general and responses to the research questions discussed in Chapter 3. The conduct of the

interviews involved printed checklists and consent forms (Appendix 2), pre-interview contacts and preparation, proper recording of the interviews and immediate word processing of the notes to assess for data saturation (Saunders & Lewis, 2012). The assessment used to assess for data saturation is depicted on the table below shows the diminished number of new codes from the last three interviews.

Table 4: Data saturation assessment

| New code | 8th interview | 9th interview | 10th interview |
|---------------------------|----------------------|----------------------|-----------------------|
| Alternate financing means | 0 | 0 | 1 |
| Equity considerations | 0 | 0 | 1 |
| Payback period | 0 | 1 | 0 |
| Sub contracting | 2 | 0 | 0 |
| Tax misperceptions | 1 | 0 | 0 |
| Total new codes | 3 | 1 | 2 |

4.7. Measurement instrument

In-depth, semi-structured interviews were conducted as the research instrument to explore managerial decisions making on capital structure in SMMEs with emphasis on profit as a firm characteristic. Pecking order and trade off theories were applied as the behavioral finance basis for this study, as described in the literature section in Chapter 2. Semi-structured interviews are ideal for asking relevant questions to a select number of respondents while allowing flexibility in questions asked and the responses to deepen understanding (Saunders and Lewis, 2012). The questions from the interview guide are outlined below with their corresponding research questions. The interview guide is available in Appendix 1.

Research question 1:

Is capital structure an important consideration for SMME managers?

| | |
|----|--|
| 1A | Do you have a predetermined capital structure ratio for your firm? |
| 1B | Is capital structure management a priority in your firm? Why? |
| 1C | In your experience, what is the most important factor regarding capital structure in your company? |

Research question 2:

Do SMME managers consider taxation when deciding on capital structure?

| | |
|----|---|
| 2A | What is your opinion on tax benefits of debt in your capital structure? |
| 2B | Is there a positive role debt plays in your company taxation? |
| 2C | Would an increase in your company's tax rate affect your capital structure? |

Research question 3:

During a profitable phase, do SMME managers consider utilising debt to counter higher taxes payable?

| | |
|----|---|
| 3A | Could you tell me about the role of profits on your capital structure? Why? |
| 3B | To counter taxation while profitable, would you consider acquiring debt? Why? |

Research question 4:

When external funding is sought, do SMME managers prefer debt or to raise equity?

| | |
|----|--|
| 4A | How do you fund your expansion or new capital acquisitions and why? |
| 4B | Have you had to or needed to raise additional funds by selling equity in the company? Why? |

4.8. Analysis approach

Primary data collected need to be analysed to answer research questions and to meet

the study's objectives (Saunders & Lewis, 2012). Collected data needed preparation for analysis and categorising, which was done through CAQDAS (computer-aided qualitative data analysis software) using ATLAS.ti. The collected qualitative data from the interviews, especially from audio recordings, was converted to text as interview transcripts and prepared for word-processing.

ATLAS.ti was used for analysis of the qualitative data; this categorized the data to look for patterns which were be used to test the study's propositions or relate to the research questions as this was an inductive research study with no defined theoretical framework. The transcribed interviews were loaded on ATLAS.ti in rich text format to allow for editing and first cycle-coding was applied using the in vivo and initial coding processes to draw insights and quotes that are relevant and of interest from the interviews.

A second cycle of coding was done to form groups that were categorized into themes and concepts that were used deductively to respond to research questions. New themes that emerged followed a different process; an inductive process was applied to the emerging insights for exploration of new themes that might contribute to the literature on capital structure in SMMEs.

4.9. Data validity and reliability

Saunders and Lewis (2012) describe validity as a measure of whether a research study's findings and conclusions are credible. To eliminate risks which may render this study's findings and conclusions invalid, the researcher applied purposive sampling to select a small sample of managers and owners of SMMEs who make capital structure decisions within their firms. To minimize unease or overfamiliarity during the interview process, the researcher stressed the importance of open and honest responses as confidentiality was assured and signed for on the consent form as per Appendix 2. A pilot test was undertaken before the start of the interview process, the feedback provided allowed for refinement of the questions in the interview guide. To ensure external validity, the participants of the study were sampled from different firms and sectors. The participants varied across age groups and were from different SMME size by employee headcount. Saunders and Lewis (2012) elude this spread allows the findings of this study some freedom to be generalized.

Reliability is defined as employment of procedures and methods in the research that

produce consistent findings, even on different occasions (Saunders & Lewis, 2012). To eliminate subject errors and bias, the researcher employed the use of an interview guide to assist with the semi-structured interviews as depicted in Appendix 1. The interview guide assisted with a list of questions asked without emphasis on the order. The guide assists with eliminating what Saunders and Lewis (2012) refer to as observer bias as well, which relates to different interpretations of the same data.

4.10. Limitations

The first limitation on this study's methodology related to interviews as a qualitative research strategy - their findings cannot be final or conclusive (Zikmund, 2003). A further contribution to this limitation was the limited number of questions permissible on semi-structured interviews due to high costs related to time and skills required of the interviewer (Zikmund, 2003).

As stated earlier, the non-probability sampling technique relevant for this study meant that the samples were not statistically representative of the population group (Saunders & Lewis, 2012). Judgment of the researcher is the main limitation of purposive sampling, even though the technique is reliant on it. Sampling bias is thus unavoidable. Further bias is presented by the subjective nature of the semi-structured interview process as the direction of the interview is at the interviewers discretion (Zikmund, 2003).

The coding limitations include that the data is coded using the researchers own analytical lens and this subjective process could result in loss of other insights that may be of value to the research assignment.

4.11. Ethical considerations

This study acquired the requisite ethical clearance (Appendix 3) of the Gordon Institute of Business Science's Ethics Committee that ensures the confidentiality of the participants and their firms. A further requirement of the committee was that every participant must sign a consent form (Appendix 2) that covers issues of anonymity, voluntary participation, consent for audio recording of the interview and information regarding the subject and context of the study.

Chapter 5: Research results

This chapter presents the findings of the research process outlined in Chapter 4 under data collection. The findings are from the interviews and the data analysis that followed.

5.1. Introduction

The researcher used the interview guide on Appendix 1 to keep the interviews in-line with the research theme; exploring factors that determine capital structure decision making in SMMEs within the South African context. Ten semi-structured interviews were conducted face to face over a two-month period. The interview process aimed to gain insights from managers and owners of different SMMEs on their approach and the thought processes behind their company's capital structures decisions.

Data was collected through the use of notes tabled during the interviews, as well as a voice-recording device that was used with the expressed permission from the participants. The notes included observations made by the researcher about the setting and the degree of comfort of the participant towards the interview. Most participants appeared relaxed, eager and interested throughout the interview process, two of the participants who appeared tense and guarded in the initial stages also warmed up to the interview and became relaxed and open. Table 5.1 shows the demographic details of the participants. The details did not reveal any notable patterns (such as differences in responses by age or company sector) and will thus not be expanded further in this section. The company names are displayed and the "M" and "S" symbols are for manufacturing and service sector respectively. The relevance of the number of employees is for SMME classification as depicted on Table 1.1. The setting highlights the environment where the interviews were held as well as the overarching initial approach of the participant to the interview.

Table 5: Study participants and company profiles

| Participant | Age | Company and sector | Function | No.of Employees | Setting |
|-------------|---------|--------------------|-----------|-----------------|--------------------|
| 1 | 30 -39 | Cavelli M and S | Owner | 120 | restaurant relaxed |
| 2 | 60+ | Amenities M and S | Owner | 50 | office relaxed |
| 3 | 50 – 59 | Chrysalis M | Executive | 32 | office nervous |
| 4 | 30 – 39 | Oncology center S | Partner | 18 | restaurant relaxed |
| 5 | 50 – 59 | Finico tech S | Partner | 11 | restaurant relaxed |
| 6 | 60+ | PGSI tribe S | Owner | 150 | office relaxed |
| 7 | 50 – 59 | Ebhleni tours S | Owner | 5 | office anxious |
| 8 | 40 – 49 | Ubuntu kraal S | Owner | 7 | lobby anxious |
| 9 | 60+ | OTT tech M and S | Owner | 150 | office relaxed |
| 10 | 30 – 39 | Boutique S | Owner | 5 | office relaxed |

The first question on the guide aimed to establish if capital structure was an important consideration for managers, whether the considerations were voluntarily made or they were made in response to other factors. One manager’s response validated this question, who proclaimed: *“Capital structure is probably the lifeblood of the business and how you structure it is vital.”* (Participant 4)

The next question aimed to establish managerial knowledge of the trade off theory and to explore the extent of the consideration of taxes as a consideration in capital structure determination as captured in this related statement about the risks of debt stating *“I think what you want to know is that having this conservative approach to financing obviously limits the growth, but it also limits the risks.”* (Participant 5)

Next, the role of profit in the determination of capital structure was explored within the context of the trade off theory as well. Finally managers were encouraged to share their insights on the hierarchy of preference of funding. The quote that summarized the importance of this question is the following: *“The thing is, overall you have to look at all that's available to you.”* (Participant 6)

The interviews closed off with a request for additional input from the participants on

relevant topics to the interview to source for additional insights that can be applied inductively to the study. The word cloud depicted in Figure 5.1 shows codes highlighted by occurrence from ATLAS.ti. The four items that stand out are counter arguments against the trade off theory, the stage of the business, leverage considerations as well as loan accounts. Insights from participants highlighting their thoughts on these codes and other findings are reported in this chapter in the manner prescribed below that consists of responses to research questions as set out in Chapter 3, then as emerging themes and finally with a section detailing SMME considerations.

Figure 4. Semi structured interviews code cloud



To ensure the reliability of the data, which Saunders and Lewis (2012) describe as a measure of consistency in results produced from a particular research design, data collected from interviews using an interview guide was transcribed and analysed using CAQDAS in a iterative manner throughout the interview process. There was no need for data transformation, data was collected on audio and the recordings were reviewed for accuracy before they data was transcribed. Qualitative data collection was the valid research method for this explorative study.

The following sections provide the results of the data results collected, first in-line with

the research questions and then an outlay of insights that featured strongly enough to warrant emergence of themes.

5.2. Research question 1:

Is capital structure an important consideration for SMME managers?

The literature section in Chapter 2 emphasised the importance of the manager's role in a firm's capital structure, this question explored whether SMME managers consider capital structure decisions an important role and to explore the factors they take into consideration when making those decisions. Table 5.2 and 5.3 below show details of the responses and the codes considered in determining the importance of capital structure to the participants as well as factors that were coded during the interview process.

This section of questions also served to set the tone of the interview with participants being asked broad, non-invasive questions that saw them ease off tension and relax as the interview proceeded.

Table 6. Research question 1: Summary of responses

| Research question 1: Summary of responses | 10 |
|---|----|
| Number of participants who affirmed capital structure is predetermined | 8 |
| Number of participants who expressed debt availability as a factor | 6 |
| Number of participants who mentioned cost of debt as a factor | 5 |
| Number of participants who commented on expectations on equity partners | 4 |

Table 7. Research question 1: Data structure

| First cycle coding | Second cycle coding | Themes |
|-------------------------------------|---------------------------------|--------|
| | | |
| ○ importance of leverage management | | |
| | | |
| ○ leverage considerations | Capital structure as a priority | |
| | | |

| | | | |
|----------------------------|--|----------------------------------|------------------------------|
| ○ leverage decision effort | | | |
| | | | Capital structure importance |
| | | | |
| ○ cost of money | | | |
| | | | |
| access to debt challenges | | Capital structure considerations | |
| | | | |
| ○ equity considerations | | | |

5.2.1. Capital structure as a priority

To gather a sense of whether capital structure is an important consideration participants were asked whether it is regarded as a priority for managers and whether it is predetermined. Participants overall agreed it is a priority and that it is predetermined, the following insights stood out:

- *“As part of decision making to buy a business, fifty percent of the time goes into deciding how you're going to get the money and fifty percent goes into the due diligence.” – Participant 1*
- *“I think it's predetermined with a start-up business, and that you do a forecast and you do planning based on where you see the business positioned.” – Participant 4*
- *“It's pre-planned and we don't operate in greed. So we won't bite off a chunk that we don't think we can chew.” – Participant 5*
- *“We do it well in advance and we try to do it like that. So at this stage where we are, not a lot of surprises and also since we started moving into Africa, our focus, our customers pay up front. So we're not squeezed for cash per say. So it doesn't take a lot of time currently.” – Participant 6*
- *“That takes a lot of my time, because most of the time I have just to balance things.” – Participant 8*
- *“So those are things you must clearly think about and it involves the cash flow of your company and what you must have a proper market analysis otherwise you cannot have a proper cash flow that you can put out.” – Participant 10*

Participants stressed upon the time it takes to apply their minds to capital structure and planning on information present. Participant six expressed that they plan for capital structure well in advance, but because they have cash, they are not paying much attention to capital structure. This raises an interesting question of whether it is a priority only when there is a need for cash.

5.2.2. Capital structure consideration

To gain a deeper sense of the importance of capital structure to managers, they were asked to provide insights into the factors that they take into consideration when making these determinations.

5.2.2.1. Availability of external capital

Availability and access to debt is a big concern to SMME managers as their insights below detail, it is a far bigger concern to managers than the monetary cost of debt and literature confirms that this is worst for small businesses. A few of the insights mentioned include:

- *“It’s far more onerous to get external funding.” – Participant 1*
- *“So my first prize would always be probably a 100% external finance-based. But then of course banks are not just dishing out money these days and opportunities come and you have a short window period.” – Participant 1*
- *“Opportunities come and you have a short window period. And often it’s that window period which prevents you from having the time to source a proper loan.” – Participant 1*
- *“Whereas if you get external financing it would typically be from a bank but it could also be venture capitalists or merchant banks or whatever, but a bank you need a business plan, you need financial projections, you need financial history, there’s credit checks that take place on you.” – Participant 1*
- *“I’m talking for every man on the street. So unless you had money available to*

invest in a business, then - and I'm talking about your own money or assets - where else can you raise capital.” – Participant 2

- *“It's not so easy initially to get people to trust you. Because you are selling something that's non-tangible until you have an invoice. So until you deliver you can talk the game, but until you've delivered, you're talking only. You have no security.” – Participant 2*
- *“I think small, medium businesses, availability of cash is very difficult.” – Participant 6*
- *“They always say it is much better to use other people's money, but as we know when the business is struggling to break-even it becomes difficult to raise that.” – Participant 8*
- *“If you want to find finance you must have a sellable and sustainable business plan.”- Participant 9*
- *“You must also put in a business plan and a cash flow plan otherwise you will not get finance from the banks and unless you can also give them sureties because they don't just accept a business plan, because unless you can put down a warranty which is acceptable to them or securities, they will not give you money, that is my experience.” – Participant 9*
- *“Small businesses will not easily get a bank loan, that is my experience. Unless you can give a warranty and once you start giving warranties and unless you are prepared to give a warranty.” – Participant 9*

The focus of most responses is centered on what the participants feel the banks will require making debt accessible to them, from intangibles such as trust to tangibles such as security and business plans. The issue of a long lead time to access debt when it is required features prominently, and in the previous section participants indicated that they spend considerable time planning for capital structure. These opposing considerations perhaps refer to a mismatch in the amount of time funders require to process applications and the amount of time participants feel they require to

plan their capital structure requirements.

5.2.2.2. Cost of capital

The cost of debt featured as a factor by a few participants, the emphasis for most participants was on availability. Some of the participants commented as follows:

- *“One must also realise that interest isn't the only cost that you experience with a loan. There are start-up fees, there are initiation fees, there's a quarterly appraisal commission, there's annual appraisal fees. So the cost of money becomes actually more.”* – Participant 1

- *“The most important factor is the availability of the capital and at what rate you're going to have to borrow that capital.”* – Participant 2

- *“Cost of capital is also a very important thing because you often have to weigh up your growth in terms of how much more funding you're going to need.”* – Participant 4

- *“You see a loan comes at a cost but so many businesses operate with loans.”* – Participant 9

The focus of participants' responses involves the transactional costs of debt, including the interest rate of the debt. These costs appear to be a deterrent to the acquisition of debt, but as participant four states, these costs have to be weighed up against objectives of the company that require funding, such as growth.

5.2.2.3. Expectations around providers of equity:

A section under research question 4 deals more directly with equity; this section is included here to highlight that when equity decisions are made as part of capital structure considerations, managers seem more concerned with losing control of the company while at the same time others seem concerned with equity partners who do not participate in the running of the company.

- *“I would prefer an investor who also brings something else to the business, you know, other expertise that could enhance the business not just on a financial level but also through that persons' expertise.” – Participant 4*

- *“If they're not active and sit in the passage like all our big directors, owners, then we're reluctant.” – Participant 5*

- *“It plays an important role because it determines the level of control that I have in the company. It also influences the decisions that are being made in the company.” - Participant 10*

Participants stress the two potential effects of an equity transaction, loss of control and possibility of passive investors that do not contribute anything else to the firm. Participants highlight the requirement for equity partners who bring in additional expertise or skills but at the same time there is no willingness share in the control of the firm.

5.3. Research Question 2:

Do SMME managers consider taxation when deciding on capital structure?

This section of questions saw participants becoming apprehensive and hesitant about their responses. Participants even volunteered alternate ways of dealing with tax instead of application of the trade off theory. Table 5.4 details the responses of participants. The trade off theory counter arguments stood out and the insights raised highlight the emphasis expressed about the topic. The significance of this is shown in the word cloud in Figure 5.1, showing how these counter arguments stood out.

Table 8. Research question 2: Summary of responses

| | |
|--|-----|
| Research question 2: Summary of responses | /10 |
| Number of participants who are familiar with debt and tax benefit trade offs | 6 |
| Number of participants who expressed a need for lower taxes | 7 |
| Number of participants who gave counter arguments to Trade off theory | 8 |
| Number of participants who raised a need for a business objective for debt | 4 |
| Number of participants who expressed a concern about debt bankruptcy | 6 |

Table 9. Research question 2: Data structure

| First cycle coding | Second cycle coding | Themes |
|--------------------------------------|----------------------------|------------------|
| ○ Trade off theory knowledge | | |
| | Establishing the need | |
| ○ need for lower taxes | | |
| | | |
| ○ bankruptcy | Cost of debt | |
| | | |
| | | Trade off theory |
| ○ tax misperceptions | | |
| | | |
| ○ trade off theory counter arguments | Trade off theory rejection | |
| | | |
| ○ tax saving alternatives | | |
| | | |
| | | |
| ○ business objective | Debt justified | |

5.3.1. Trade off theory knowledge

The trade off theory refers to benefits and costs of utilising debt in a company's capital structure and to source whether managers took advantage of these benefits, the study first established whether managers were aware of these trade offs, the following insights were noted:

- *“There's start-up fees, there's initiation fees, there's quarterly appraisal commissions, and there's annual appraisal fees. So the cost of money becomes actually more. However, all of that stuff is deductible.”*– Participant 1

- *“So the loan would create- one, the loan itself, to pay it off is an expense. But also the interest charged on the loan itself is tax deductible. So from those two I think you're already making a saving.”* – Participant 3

- *“It's a consideration I would make because then it makes that cheaper that actually getting an equity partner because then you get the tax deductibility on the interest that you're going to pay, so it's one of those important considerations I take into account when I'm looking at an expansion project.”* - Participant 10

Participants refer to the tax deductibility benefit of using debt as well as the potential costs of the debt, confirming the trade off as proposed by the trade off theory.

5.3.2. Taxation

The knowledge of trade off theory seemed limited to a few participants during the interviews, but the need for lower taxes emerged among seven of the ten participants, and the following insights emerged:

- *“I think that like you said when the business makes profit, there's a tax element involved and obviously within the limits of the law you'll want to*

lower that tax as much as possible. That's just being tax wise and tax efficient.” – Participant 1

- *“Most private businesses would like to reduce their tax burden.”– Participant 2*
- *“I would have to find ways in which to offset that tax burden. So that I'm not paying more tax.” – Participant 3*
- *“I've seen the benefit in that, in having the loan account so that you don't pay tax and that's a huge percentage that obviously has an impact on the business.” – Participant 4*
- *“So it's easy to verbally voice that it's not a problem. It is a problem if you have to pay too much tax.” – Participant 5*

The participants highlight their need to want to pay lower taxes. This need is expressed in different words such tax efficient, tax burden, too much tax, not paying tax and tax wise. The researched asked this question to assess if the sampled participants had a need for the tax-deductible benefit eluded to in the trade off theory.

5.3.3. Costs of debt

Having established that there is a need for lower taxes by participants, the researcher explored the aspect of the trade off theory that dealt with costs of debt or possible bankruptcy referred to in the literature. The following insights emerged:

- *“So if the business is not profitable and it's actually costing money, it means you have to draw more money from somewhere. So you go in the negative and the amount you owe becomes bigger, when you actually want it to become smaller.” – Participant 1*

- *“So as a policy we don't lend more money than we can afford to lose. So it's very conservative.” – Participant 5*
- *“If you need debt to survive, you're not going to survive. You're just going to become more desperate.” – Participant 6*
- *“You know if you borrow money for a business like this and something goes wrong where the business goes down, you will all go down! How will you pay the bank then.” – Participant 7*
- *“If you can't meet the repayment terms and depending on whether you had to give guarantees for repayment, it can put a lot of strain on you personally and it put a lot of strain on the expansion of your business.”- Participant 9*

The participants raise the potential for bankruptcy and the emotional stress of being in default with debt. The participants use different words to express bankruptcy; strain, go(ing) down, go in the negative and not going to survive. The words in themselves can be interpreted to mean different things, but within this context they imply risk of financial default on the payment of debt.

5.3.4. Debt aversion

Participants were assessed for underlying aversion to debt as the interviews continued, the researcher justified this as a means of assessing for undue bias in their responses to questions on debt. Only three participants displayed an aversion to debt and they had these interesting insights to share:

- *“Well, firstly you must appreciate that we don't like that and we don't like external financing.” – Participant 5*
- *“My view on debt was severely influenced by my previous work partners, and I have great respect for my partner that actually passed away, but it was like a family concern and a lot of debt, a lot of arrears, a lot of tax problems. And then I sort of vowed to myself when I took over the group and I formed the PGSI Group in 2001 that I will never (take on debt).” – Participant 6*

- *“So over many years, our focus is avoiding debt. We don't do debt easily, so we try to stay away. So most of our funding that we acquire is either we retain profits and put it away, or it's owner-funded.”* – Participant 6

- *“So I didn't want to involve myself with the bank, I was scared!”* – Participant 7

- *“You know if you borrow money for a business like this and something goes wrong where the business goes down, you will all go down! How will you pay the bank then.”* – Participant 7

Participants shared experiences and statements revealing their attitude towards debt. The words that highlighted this aversion include; dislike for external funding, focus on debt avoidance, and scared of getting involved with the bank. Managerial personal debt aversion among these participants has been inferred to their firm's capital structure with minimal debt, as literature predicts.

5.3.5. Trade off theory counter statements

Besides the concerns about the high potential costs of debt, a few participants raised insights that were analysed and considered as counter arguments to the trade off theory. A few of the notable insights are noted below:

- *“You know, if I must be honest with you capital structure is very limited in terms of how you can affect your taxes.”* – Participant 1

- *“If I believe strongly enough in the future of the business, I would use that profit to reinvest it, in other words and probably create debt through it, because yes, that would be... I would use that to expand the business, perhaps diversify into a different part of the market. Yes, I would use it. But the negative side of that is when you try and sell a business, to try and sell a business that for years hasn't*

shown a profit on the bottom line, people react to it in a negative way.” – Participant 4

- *“The risks of debt outweigh the advantages of tax savings to us.”– Participant 5*
- *“We wouldn't just go out and say let's take on debt so that we pay less tax.” – Participant 6*
- *“The thing about debt; the interest paid is not a tax deduction, it's an expense.” – Participant 6*
- *“What I'm saying is that when you look at what your requirements are from a very simple point of view, is that for your taxation, it doesn't necessarily give you that advantage that you think.” – Participant 6*
- *“I don't see why I should have a loan when I don't need it. I wouldn't go out and apply for a ten million Rand overdraft or ten million Rand loan when I'm not going to use it.” - Participant 10*
- *“So other ways of reducing your tax rate is that you invest into a new potential entity that sits with a current tax loss. What you then do is you restructure the business so that you can then utilize that tax loss. And that's one of the most effective ways of reducing tax.” – Participant 6*

Participants expressed the risks of debt and discounted the benefits of the tax interest shield, most notable being the statement that the risks outweigh the benefits. The observation notes highlight that participants were at their most apprehensive as they stated how they would not get debt just for the tax deduction benefit.

5.3.6. Business need for debt

No participant in the study expressed any benefit of debt to taxation except within the context of the knowledge of the trade off theory. The researcher noted the emergence of the need for business objectives guiding the need for debt. The pertinent insights include:

- *“I haven't thought about that. Because there hasn't been a need for a loan from just a practical day-to-day point of view.” – Participant 3*
- *“I suppose where I get stuck is, what would that debt be, for outside expansions?” – Participant 3*
- *“If you need debt to grow your business and you do it properly, at the end of the day you're going to have more money, more than enough to pay your debt plus you make extra profit. Then it makes sense.” – Participant 6*
- *“Most of the challenges of smaller type businesses I've been in, is that they try to fund cash flow rather than expansion to grow the business.” – Participant 6*
- *“For us at this stage what is very important is that we look at what we want to achieve, where we want to grow and what we want to grow.” – Participant 6*
- *“I don't see why I should have a loan when I don't need it. I wouldn't go out and apply for a ten million Rand overdraft or ten million rand loan when I'm not going to use it.” - Participant 10*
- *“Loans that we would go for would be for specific projects, we will not go for expansion, we would go to finance a project. Project is finished, you repay your loan or you repay your investor and you wait for another project, so your financing project by project and that I would say is the more easy thing to do.” – Participant 9*

Participants voice the need for some business objective for requiring debt. They argue that one cannot take on debt just for the sake of the debt interest benefit. The objectives mentioned include expansion, growth and project financing.

5.4. Research question 3:

During a profitable phase, do SMME managers consider utilising debt to counter higher taxes payable?

Research question 2 explores whether SMME managers follow the prescripts of the trade off theory given the benefits and risks that are associated with its application. This question focuses specifically on a profitable phase of a business, what the profits mean for the managers and what opportunities they present; the trade off theory refers to tax incentives from this profits and the pecking order theory refers to the use of available cash that stems from the profits generated in the company. The thoughts managers share on their approach to their firms during a profitable phase will help generate deeper insights on to the application of the two theories.

Table 10. Research question 3: Summary of responses

| | |
|---|-----|
| Research question 3: Summary of responses | /10 |
| Number of participants who emphasized importance of profits | 5 |
| Number of participants who mentioned opportunity costs of funds | 4 |

Table 11. Research question 3: Data structure

| First cycle coding | Second cycle coding | Themes |
|---------------------------|----------------------------|---------------|
| ○ importance of profit | | |
| | Role of profit | Profitability |
| ○ Opportunity cost | | |
| | | |

5.4.1. Role of profits

The pivotal role profits play in SMMEs became apparent during the interviews and an exploration of the use of debt during a profitable phase in a firm did not yield any notable insights, however insights on the role of profit in firm were expressed as follows:

- *“Okay so the role profit play in your capital structure is massive, because you can only repay- whether you have a bank loan or a loan from your uncle, you have to pay that off out of profits.” – Participant 1*

- *“You can only get paid your interest when you've made a profit.”–Participant 2*

- *“The negative side of that is when you try and sell a business, to try and sell a business that for years hasn't shown a profit on the bottom line, people react to it in a negative way.” – Participant 4*

- *“The first thing they look at is your bottom line and then we start explaining why there isn't much money on the bottom line because we've used it here, or we invest it, or we got burgled or you know, you always have to defend why your bottom line is not looking great. So yes, from that perspective, I always think I wish we could walk in there with a fabulous bottom line. But then they'd say why do you need the money, I guess.” – Participant 4*

- *“If you now increase your turnover or your profits to R200 with debt, obviously there's a huge benefit to shareholders because there's a deduction. Profit has increased.” – Participant 6*

- *“To put in your own capital you must be able to make a profit. Otherwise you don’t have capital to put in, your own money to put in unless you make a profit.”- Participant 9*

Participants show an appreciation for the role that profit plays in their firms and some further propose the importance of protecting the firms profit levels. Participants mentioned the following as part of the role that profit plays; debt repayments, provides return on equity for shareholders and is used as a performance measure.

5.4.2. Opportunity costs

When enquiring further about the role debt would play in a firm during a profitable phase, a theme emerged of the opportunity cost of the funds in the company. Managers shared insights on opportunities that can be pursued with profits generated by the firm. Some of the key insights included:

- *“For me, a big pressure between personal debt and let's call it family or partnership debt and a bank loan is really what opportunities do you have to do with any money that you have.” – Participant 1*
- *“You know, when you say please offer me an overdraft facility, maybe you max out that overdraft immediately to take advantage of another opportunity, knowing that you're in a profitable business that can always make the minimum repayment on the overdraft so that you haven't given the bank any reason to worry.” – Participant 1*
- *“If you tie up your own money it means that you don't have any more money to do something else with it, whereas if you use someone else's money, while it costs you interest, at least if you have personal money and another opportunity comes you can take advantage.”– Participant 1*
- *“You could use the debt to lower your tax obligation but also to have more money to do other things and to other projects.” – Participant 3*

- *“If I believe strongly enough in the future of the business, I would use that profit to reinvest it in other words, and probably create debt through it because yes, that would be... I would use that to expand the business, perhaps diversify into a different part of the market. Yes, I would use it. But the negative side of that is when you try and sell a business, to try and sell a business that for years hasn't shown a profit on the bottom line, people react to it in a negative way, so there's a fine balance to saying okay we want to sell the business in three years' time, for the next three years you should be showing a profit, otherwise whoever you present the business to, no matter what you tell them; but I have used the profit to expand, you know. They want to see a positive result in a business for it to be sellable. If that's what your plan is, then yes, you should.”* – Participant 4

- *“So what we have...you will find that that you are left with something so small that if reinvest it somewhere else or in a new thing then you won't be able to pay for whatever your accounts as time goes on.”* – Participant 8

- *“I would want to keep the loan kitty because it then opens up my thinking in terms of, I do have the money, what else can I do?”* – Participant 10

Participants seem open to utilising own funds for other opportunities if their current firms are profitable. Diversifying and expansion have been mentioned as possible opportunities that could be pursued if a firm was to take on debt while it was profitable. This tie in with business objectives mentioned earlier.

5.5. Research question 4:

When external funding is sought, do SMME managers prefer debt or to raise equity?

The literature in Chapter 2 states that perking order theory has two components; first part asserts that managers prefer to use funds available in the firm. The second part asserts that when external funding is sought managers prefer debt to equity. This research question explores the participant's approach to their external funding requirements and the factors that play a role in those decisions. Table 5.8 shows split

picture with own funding dominating the discussion, the insights below capture the wide array of responses with the general consensus in support of the theory.

Table 12. Research question 4: Summary of responses

| | |
|--|-----|
| Research question 4: Summary of responses | /10 |
| Number of participants who support the Pecking order theory | 5 |
| Number of participants who raised an aversion to debt | 3 |
| Number of participants who had own funds as first preference | 6 |
| Number of participants who had debt as first preference | 2 |
| Number of participants who raised asymmetry of information | 3 |
| Number of participants who had equity as first choice | 1 |

Table 13 Research question 4: Data structure

| First cycle coding | Second cycle coding | Themes |
|---------------------------------|-----------------------|----------------------|
| ○ Pecking order support | | |
| | | |
| ○ information asymmetry | | |
| | Perking order support | |
| ○ first preference | | |
| | | |
| ○ Cost of equity partners | | |
| | | |
| ○ misperceptions of debt | | Pecking order theory |
| | debt aversion | |
| ○ debt aversion | | |
| | | |
| | | |
| ○ Pecking order support counter | Pecking order counter | |

5.5.1. Approach to funding

The pecking order theory deals with managerial preference of utilization of funds in a firm, the theory purports that managers prefer to use internal funds and if need be they

prefer debt over equity. This research question explored how managers in SMMEs approached this aspect and the following insights emerged in support of the theory:

- *“Whenever we’ve sold equity it’s because of a strategic thing where we want to either exit the company or free our time up to go into another industry.”* – Participant 1

- *“We can either fund it as we’ve been funding everything else, from the professional fees, or the most efficient way that I think we would consider would be to get it finance (with reference to buying new equipment).”* – Participant 3

- *“In an ideal world, I would be happier to fund it from within the company.”* – Participant 4

- *“So when a company runs into cash flow challenges, it’ll first get approval to borrow money from their own market link with an agreement of payback.”* – Participant 5

- *“I also contribute towards an internal loan reserve so that if I need to expand in future I can use that money and I do not have to go seek money elsewhere. It’s just my approach to debt and to risk, that I try to have as minimal debt as possible. In cases where debt is unavoidable or debt makes sense, then I will acquire the debt.”* - Participant 10

Participants seem to have a wide array of funding options; from the “ideal” internal funding, borrowing money during cash flow challenges and the strategic sale of equity. The choice of words used by the participants around these three options is in line with the prescripts of the pecking order theory.

5.5.2. Own-funding preference

The researcher explored this phenomenon more in detail and participants were asked for further detail on what would be their first preference if funding was required. A

number of participants insisted on retained profits and shared the following insights:

- *“Well, firstly you must appreciate that we don't like that and we don't like external financing.”* – Participant 5
- *“If it's new equipment we try to do it on a cash basis.”* – Participant 5
- *“So over many years, our focus is avoiding debt. We don't do debt easily, so we try to stay away. So most of our funding that we acquire is either we retain profits and put it away, or it's owner-funded.”* – Participant 6
- *“I would buy more cars! But cash.”* – Participant 7
- *“So I will always contribute towards my own cash reserves so that if I have enough reserves, I can use those reserves as my loan to the company.”* - Participant 10
- *“Look private funding if you got your own funds, it is the less stressful because you don't have to manage repayments and people on your neck all the time.”* – Participant 9

The choice of using own funds is expressed in this section in different applications from buying equipment to avoidance of debt repayments.

5.5.3. Other funding preference

Other participants had different preference over additional funding requirements. Debt as Table 5.8 depicts, is the preferred additional source of funding despite the persistence of participants to use own funds. These insights were shared:

- *“I think first prize is always using someone else's money if the exchange rates at that time are good.”* – Participant 1

- *“If there was an expansion project then I would prefer debt.”* – Participant 3

One participant stated equity as their first preference; the reason provided is that they feel equity is key to growing into a big company and that is where they intend to be:

- *“I think of raising, ideally for me, raising equity.”* – Participant 2

Participants shared their preference for debt and equity in this section and those who preferred debt have put conditions to their choice.

5.5.4. Equity considerations

The researcher focused on equity as a funding mechanism for additional capital requirements. The pecking order regards equity as the last option managers consider for funding and this study’s findings are in support. The reasoning behind this phenomenon emerged in the following insights:

- *“Partnerships are also complicated because you have partnership agreements, you have to understand personality, understand their background, what they bring to the table, their credentials.”* – Participant 1
- *“Equity dilutes your control, which of course can become a major problem when it comes to all the changes you want in the company or your style of management.”* – Participant 1
- *“If that external investor somebody that’s just putting money into companies, or is it someone that could bring more than just funds? And for me, I would prefer an investor who also brings something else to the business, you know, other expertise that could enhance the business not just on a financial level but also through that persons’ expertise.”* – Participant 4
- *“We want active partners, not equity partners.”* – Participant 5

- *“I wouldn't want to run a company for someone else. So that's why I'm saying for me, control is important.”- Participant 10*
- *“About shareholding, that will give you a bit more lenience if share capital is put it because then you haven't got repayment terms but there will be expectations from the shareholders.” – Participant 9*

The participants express their different opinions on their equity considerations and the trend seems to be that some participants have participation expectations from equity partners while others do not want equity partners to diminish their control of the firm.

5.5.5. Information asymmetry

In addition to the insights above, these additional two succinctly highlight the notion of information asymmetry that plays an important role in why equity trails debt and own funds in capital structure funding. Literature ascribes the dominance of debt to equity to be a result of:

- *“If I believe strongly enough in the future of the business, I would use that profit to reinvest it in other words, and probably create debt through it because yes, that would be... I would use that to expand the business, perhaps diversify into a different part of the market.” – Participant 4*
- *“When you sit in the bank they tell you; we've got so much money that we don't have decent businesses to invest in. There's a huge mismatch there, so these guys sit with all the money and there's nothing out there for them to invest in. There's a reason for that. These guys on this side who need the money typically need it for day-to-day running, which is not attractive.” – Participant 6*

The first comment under this section highlights subjectivity of managerial thought about the firm, and how that guides his decisions. The second comment highlights the mismatch that the information asymmetry creates in the business environment.

5.6. Emerging themes

5.6.1. Introduction

A number of participants made reference to other means of funding than those aligned with the trade off and pecking order theories that dominate capital structure literature. Loan accounts stood out in the participants' responses on alternate finance in this study, as seen in Table 5.9. This is possibly because the researcher found the subject close to bank debt with a potential for application of the trade off theory and thus particular emphasis was paid to it. Some participants in this study discussed short-term finance as a factor and the researcher found that the context was either that it was regarded as a facility to cater for fluctuations in cash flow or in the same context as interest-bearing debt being discussed in this study, and as such it is not discussed further in this section.

Table 14 Alternate funding: Summary of responses

| Alternate funding: Summary of responses | | /10 |
|--|--|-----|
| Number of participants who mentioned short term finance | | 5 |
| Number of participants who made reference to loan accounts | | 8 |
| Number of participants who mentioned family borrowings | | 4 |

Table 15 Emerging themes: Data structure

| First cycle coding | Second cycle coding | Themes |
|---------------------------|----------------------------|---------------|
| | | |

| | | | |
|------------------------|--|-------------------------|-----------------|
| ○ sub contracting | | | |
| | | | |
| ○ short term financing | | | |
| | | alternate funding means | emerging themes |
| ○ loan account | | | |
| | | | |
| ○ family borrowings | | | |
| | | | |

5.6.2. Loan account

One interesting theme that emerged during these interviews on capital structure from a number of participants is about loan accounts, which in the researcher's view represent a bridge between own funds and debt, raising interesting inputs on issues of taxation and by inference the trade off theory. The loan account will receive detailed attention in Chapter 6. Key insights that were recorded include:

- *“On a less profitable year you lower the interest rate because there's no point in paying interest and getting yourself into a loss.” – Participant 1*

- *“From a tax perspective, actual fact, interest on the loan is a predetermined interest rate and you try go for the lowest interest rate. Whereas if it's your own finance and finance within a non-bank structure, you can actually determine the interest rate as long as it's within acceptable limits.” – Participant 1*

- *“Personal finance gives you more flexibility whereas the bank would issue an ITA 3 statement, which is a statement of your interest paid and that's all that you can deduct from tax.” – Participant 1*

- *“But personal interest on a loan agreement is just as tax deductible as a bank interest.” – Participant 1*

- *“What you would do is put your interest factor to your loan account. So your loan account would grow by your interest agreement.” – Participant 2*

- *“I've seen the benefit in that, in having the loan account so that you don't pay tax and that's a huge percentage that obviously has an impact on the business.” – Participant 4*

- *“I've seen the enormous benefit of the tax write-off against loan accounts, which is something which I was probably not even aware of before I got into this business and so the loan accounts, although they are excessive, we have not paid tax once since we've actually started this business because of the huge loan accounts.” – Participant 4*

- *“We don't really go external - they will come to me. And then I'll borrow them money against specific cash flow projections and income.” – Participant 5*

- *“So we had good agreements and good record with the suppliers. Obviously the Cuban thing hit us very hard and we've now had to look at other ways. As a result of this, obviously there's huge loan accounts to the companies.” – Participant 5*

- *“We considered that at some stage, but the auditors advised that it is better to use it as equity because of the way the company is performing. The tax implication is going to be worse if we use it as debt. I don't know how but that's what they said.” – Participant 8*

- *“So I will always contribute towards my own cash reserves so that if I have enough reserves, I can use those reserves as my loan to the company.” – Participant 10*

Participants share their knowledge that with loan accounts you have; flexible self determined interest rate payable, deductible tax interest shield, tax write-offs and the

availability of funds to loan to the company. Participant 8 mentioned that the use of equity for additional funding requirement was recommended by the firm's accountant, the logic behind this advice was not put provided.

5.6.3. Alternate funding mechanisms

Other concepts that the researcher found to be of value for SMME capital structure decisions. These insights also stood out because of the passion and enthusiasm that the participants displayed when discussing them, they include:

Creditor finance.

- *“Creditors are a very, very important source of financing.”* – Participant 9

Family finance

- *“A family member puts money into the business and there's a loan and you pay that loan, there's an agreed payback period, projective of course.”* – Participant 1
- *“We used our investments for getting the stock, and then the rest we borrowed from the family.”* – Participant 8

Sub contracting

- *“There are projects that perhaps I would... I wouldn't have the full capacity to work on, so we would work with an ownership structure with another company to say 'let's work on this, and this is the capacity that's required.' Then I'll bring mine, and they'll bring their contribution.”* – Participant 10
- *“You can run a business without capital. When you get jobs you can sub-contract someone who has the capabilities.”* – Participant 7

The alternate means of funding provided were spread between these four options. Sub contracting and credit finance form part of working capital financing, although they are effective cash flow management tools they do not form part of capital structure.

5.7. SMME considerations

The study's objective is the exploration of capital structure decisions for SMME's, some insights emerged that placed emphasis on the SMMEs within the context of capital structure. For prudence, the researcher labels these insights SMME considerations but the title is applied loosely as this study has not ascertained if these insights are unique to SMMEs. The insight below captures these two main considerations that have emerged from this study:

- *“But the reality would have been that any person starting a business, where do they access capital to start their business correctly? And that's the most difficult point: why do some business fail that should succeed? It's that they do not have readily available capital to let that business grow consistently.” – Participant 2*

Table 16 SMME summary of responses

| | |
|--|-----|
| SMME summary of responses | /10 |
| Number of participants who made reference to the lifecycle of SMMEs | 7 |
| Number of participants who made reference to growth factors of SMMEs | 4 |

Table 17 SMME data structure

| First cycle coding | Second cycle coding | Themes |
|--------------------------------|-----------------------|---------------------|
| ○ networks | | |
| | | |
| ○ sector differences | smme growth factors | |
| | | |
| ○ smme growth factors | | smme considerations |
| | | |
| ○ stage of the business | | |
| | | |
| ○ business size considerations | stage of the business | |
| | | |
| ○ payback period | | |

5.7.1. Stage of the business

Capital structure decisions seem intertwined with the lifecycle of the business; participants pay a great deal of attention to the start-up phase or the growth phase of the business, as depicted in Table 5.11. Some interesting insights that emerged were presented as follows:

- *“Because as long as your debt translates to an asset, as an asset that can be used like stock, then it's okay. That's good debt.” – Participant 1*
- *“I think it's predetermined with a start-up business, and that you do a forecast and you do planning based on where you see the business positioned.” – Participant 4*
- *“It's a bit of both, but definitely as a start up in the beginning it is predetermined.” – Participant 4*
- *“You need to ensure that you are with a partner who has the funding available to initially push into the business for the start-up and then you have to be able to have access to capital to roll the fund as required to buy raw materials.” –*

Participant 4

- *“So what I did is, the first time when we opened the business that’s when we needed money, so we had to apply of course for a loan to buy the buildings.” –*

Participant 8

- *“So to start up a new business and to secure funding is a challenge especially nowadays with the banks and the strict controls of government and the reserve bank that they’ve got on the banks, the cash flow of the banks and how they can lend out money, is very, very restricted.” – Participant 9*

The start-up phase of a business seem to receive the most attention from participants with regards to the lifecycle of a business. There is strong emphasis on planning and sourcing of funding.

5.7.2. Growth factors of the business

Growth is essential for the survival of any business, but because growth comes at a cost, it is linked to capital structure. Participants consider capital structure an important factor for growth in their firms. Here are some of the insights that emerged:

- *“There’s not a single business that I know that’s going to be a huge business, from being a small business, that hasn’t been financed through equity.” –*

Participant 2

- *“But the reality would have been that any person starting a business, where do they access capital to start their business correctly? And that’s the most difficult point: why do some business fail that should succeed? It’s that they do not have readily available capital to let that business grow consistently.” – Participant 2*

- *“I had the example again for you of the house auditor telling me that you can’t grow more than 12,5% a year because you can’t finance it.” – Participant 3*

- *“If that person brings expertise that is bigger than what we have currently in the business, I think it's very valuable and I also think that they have a big role to play then in expansion or diversification.”* – Participant 4

- *“The most important thing is actually to grow SMMEs. That's the most important thing.”* – Participant 5

- *“So I think what you want to know is that having this conservative approach to The most important thing is actually to grow SMMEs.”* – Participant 5

- *“That's the most important thing financing obviously limits the growth, but it also limits the risks.”* – Participant 5

Participants' insights in this section express their view on the growth of their business and the first insight by Participant 2 about equity and growth of a firm is pertinent and warrants further investigation in a separate study.

5.8. Conclusion

The code cloud on Figure 5.1 depicts the key findings in this study. Chapter 6 will provide a detailed link of these concepts and triangulate the findings back to literature in Chapter 2. The purpose of the study is to explore capital structure decision-making determinants for SMMEs in the South African context and this chapter detailed the findings of this study. The study's research questions, as provided in Chapter 3, and the interview guide in Appendix 1 were designed to explore insights into factors that SMME managers take into consideration when making capital structure decisions in their firms. The insights were shared in this chapter; this section will provide a review of whether the insights and data collected answered the research questions posed.

Leverage considerations cover broad aspects of determinants of capital structure for firms. Leverage considerations as well as leverage decision effort, which considered the effort participants put into deciding on their firm's capital structure, are well

highlighted on the code cloud in Figure 5.1. Overall, participants agree that they treat capital structure determination as a priority and they consider the risks and benefits of their choices. The conclusion from these findings answer Research question 1 and the answer is yes, capital structure is an important consideration for SMME managers.

The most prominent factor on the code cloud is the finding that participants in this study do not support one of the key theories in behavioral finance: the trade off theory. The trade off theory introduces benefits of a tax deduction through the use of an interest tax shield applicable when firms have interest-bearing debt within their capital structure. The participants in this study rejected the notion that the tax deduction is a factor enough for them to decide to use debt in their capital structure. The conclusion from this findings is that Research question 2 has been answered and the answer is no, managers do not consider taxation when deciding on capital structure.

The participants argued that a business objective or opportunity needed to be present for them to consider debt in their capital structure. The business objective consideration features prominently during the trade off counter arguments as well as during discussions on the stage of the business. Participants regarded the stage of the business as important decision factor. In the start up phase, firms are acquiring assets and this is a capital-intensive phase where capital structure decisions can make or break a business. At this stage the business is still relatively unknown and participants feel this makes external funding inaccessible and costly. When a business plateaus in its life cycle, it starts generating profits. Participants were apprehensive at the thought of raising debt at this stage of the business, such that the conclusion is that Research question 3 has been answered, and the answer is no, managers do not consider utilising debt to counter higher taxes payable during a profitable phase in the business.

Participants highlighted the costs of debt from a risk perspective in terms of bankruptcy as well as the financial cost of debt. Equity considerations were discussed and in keeping with the literature participants expressed a reluctance to use equity citing potential loss of control and possible lack of technical or tactical contribution by equity partners. A good argument for equity highlighted the important role equity plays in the growth of a firm. A few participants insisted on the use of own funds for expansion, when pressed for a need for additional funding past their own available funds a large majority chose debt. The conclusion therefore is that Research question 4 is answered

and the answer is that debt is preferred when SMME managers seek external funding.

One of the key topics from the emerging themes in this study is the concept of a loan account and most participants referred to the loan account within the context of other ways to save tax and to reduce the burden of interest payments on debt. The researcher regards the loan account as a kind of hybrid debt, or a bridge between own funds and debt. It is seen by the participants as providing debt benefits without the associated debt risk of bankruptcy as the owner of the firm is in control of the repayment terms, the rate of interest charges and is unlikely to institute liquidation against his own firm during financial distress unless as a last resort. The loan accounts topic will be processed inductively for evaluation of new possible frameworks. Subcontracting and credit finance will also partially reviewed in Chapter 6, the available time schedule cannot accommodate an inductive approach to three new themes.

The researcher notes that the data collected, analysed and presented in this chapter and the themes that have emerged are of relevance to the purpose of this study.

Chapter 6: Discussion

6.1. Introduction

This study intends to contribute to literature on capital structure; through the exploration of managerial decision making and the effect taxation and profitability as firm characteristics have on capital structure in SMMEs.

The results of the semi-structured, in-depth interviews in Chapter 5 provide a glimpse into the insights of firm managers on capital structure, particularly in relation to the role that taxation and profits play in their firm's leverage determination. In Chapter 3 the study introduced four research questions to address the areas in literature that have not been explored previously. The first question seeks to establish an understanding of whether SMME managers regard capital structure as a vital component of their firms and also to assess if the decisions around capital structure are made "off the cuff" or are well considered.

The second research question explored the role of taxation as one of the study's core variables within the framework of the trade off theory. In Chapter 5 the findings regarding the knowledge, the application and insights on the trade off were reported from the interviews. The third research question explored profits and their role in capital structure decisions of managers within the context of the trade off theory. The questions explored how managers perceived the notion of acquiring debt while profitable.

The fourth research question focused on capital structure within the context of the pecking order theory, the study explored whether SMME managers' decisions on capital structure are in line with the assertions of the theory as is the case for listed companies within the South African context (Ramjee and Gwatidzo, 2012). This chapter will analyse the results, shared insights and themes that have emerged in conjunction with the literature reviewed in Chapter 2 using the research questions to structure the discussion.

6.2. Discussion of results of Research question 1

Is capital structure an important consideration for SMME managers?

6.2.1. Capital structure as a priority

A manager's attention is divided between many areas of the business, some demanding more attention than others. To gain a sense of how important capital structure decisions are for SMME managers, we explored how much of a priority they afford capital structure decisions and the majority of them expressed its importance with one manager (Participant 4) exclaiming that *"capital structure is probably the lifeblood of the business and how you structure it is vital."*

Zwiebel (1996) concluded that managers choose capital structure of their firms voluntarily; this assertion is overwhelmingly supported by this study's findings with managers expressing insights into factors they consider when deciding on their firm's capital structure. High on the list of considerations is the availability of capital, followed by the cost of capital, and managers expressed how banks and other funding institutions make it *"onerous"* to access external funding with a multitude of requirements including warrantees, detailed business plans, credit checks and time.

6.2.2. Capital structure considerations

Regarding the cost of capital one participant related that *"the most important factor is the availability of the capital and at what rate you are going to have to borrow that capital"*. One interesting theme shared by a few managers is on the cost of equity in capital structure, with more managers not focused on financial cost of equity, but rather the dilution of control of the firm. One manager (Participant 4) succinctly stating that *"I would prefer an investor who also brings something else to the business, you know, other expertise that could enhance the business, not just on a financial level but also through that person's expertise."* Borgia and Newman (2012) referred to this concern on dilution of control as external control aversion and they have observed it in emerging markets SMMEs in keeping with this study's findings.

The overwhelming response from the managers interviewed support the notion of capital structure as an important consideration in their firms. This affirms that the insights the managers shared during the interview process are not taken lightly and have some credence as they regard the topic as important to them by inference.

6.3. Discussion of results of Research question 2

Do SMME managers consider taxation when deciding on capital structure?

6.3.1. Knowledge of trade off theory

In the quest to gain insights on managerial consideration of tax in their decisions around capital structure, the study explored if taxation in itself is an important consideration for managers of SMMEs, the study went further to explore if managers are aware of the trade-offs between the costs of debt and the tax deductible benefits of debt interest. Meyers (2001) describes the trade off as the debt levels that firms seek to balance the cost of potential financial distress of debt and its tax advantages, otherwise known as the interest tax shield. The majority of participants confirmed knowledge of the trade off benefits of debt interest payments and the potential cost of the debt.

6.3.2. Taxation

An even larger number of participants raised the need to want to pay lower taxes. This finding establish relevance of the research question, in that managers are aware that debt interest payments can lower their taxes and they have expressed that they do wish to pay lower taxes. The researcher intends to explore if participants had motivation to explore the benefit as described in the trade-off theory. Kolari and Zardkoohi (1991) are of the opinion that this tax gain is achieved through lowering of the cost of debt, as the firm's marginal tax rate multiplied by the debt interest rate is subtracted from the cost of the debt. Noulas and Genimakis (2014) found that tax incentives do not seem to constitute a significant capital structure determinant and the finding is in line with the position of the bulk of this study's participants.

6.3.3. Bankruptcy

One part of the trade-off theory is the costs of debt, and the monetary costs of capital were dealt with in the previous section under consideration of leverage. Kolari and Zardkoohi (1991) describe this cost as a potential failure of the firm to meet the debt obligation resulting in bankruptcy. The responses of the participants in this section explored the non-transactional costs of debt, in particular bankruptcy. The majority of

participants raised bankruptcy as a concern, and one participant (Participant 7) shared this aspect: *“You know if you borrow money for a business like this and something goes wrong where the business goes down, you will all go down! How will you pay the bank then?”*

Algalith, Floros and Dukharan (2012) found evidence contradicting prospect theory, but this study finds that the few participants who are risk averse tend to avoid the risks of debt in their firms.

6.3.4. Trade off theory counter statements

Contrary to the findings of Ramjee and Gwatidzo (2012), South African SMMs in this study do not seem to follow the Trade off theory. A significant finding from the participant’s insights shared on the question of the application of the trade off theory was that most of the participants felt uncomfortable with this section of questions and a few participants even provided counter insights to the trade off theory, such as: *“You know, if I must be honest with you capital structure is very limited in terms of how you can affect your taxes”* (Participant 1). Fama and French (1998) cited Miller’s (1977) hypothesis stating that there are no net tax benefits in using debt. Another participant discounted the benefits of the trade off stating: *“The risks of debt outweigh the advantages of tax savings to us”* and *“The thing about debt; the interest paid is not a tax deduction, it’s an expense”* (Participant 5).

In line with this study’s findings on the challenges participants experience with application of the trade-off theory, Meyers (2001) challenged the theory by stating that many firms with high profitability carry low debt ratios, and managerial action contrary to the theory cannot be blamed for what he terms “failure of an economist theory.”

6.3.5. Business need for debt

It is the position of most participants that there has to be a business need or requirement for debt to be considered, some expressing how it is inconceivable to take on debt with a tax saving in mind. One manager (Participant 6), said: *“We wouldn’t just go out and say let’s take on debt so that we pay less tax”*, while another said: *“I haven’t thought about that. Because there hasn’t been a need for a loan from just a practical day to day point of view.”*(Participant 3). Some of the managers went as far as asking for the interview to pause so they can collect their thoughts and try to respond to the question. One quipped *“I suppose where I get stuck is, what would that debt be for,*

outside expansion?” (Participant 3).

Xiang and Worthington (2015) in their empirical studies of Australian SMME’s finance-seeking behavior and outcomes, found that business objectives affect SMME financing decisions in a greater way than financial objectives. This finding might explain some of the frustrations the participants had with the proposition of the trade off theory that emphasizes a financial objective. Some of the participant’s insights are in-line with findings of studies that have refuted the application of the trade off theory in SMMEs (Xiang & Worthington, 2015). Debt aversion was explored as a managerial factor that may influence how participants make capital structure decisions, and very few participants had an aversion to debt and as such it is not regarded as a factor in the findings in this study.

6.4. Discussion of results of Research question 3

During a profitable phase, do SMME managers consider utilising debt to counter higher taxes payable?

6.4.1. Role of profits

The relation between profitability and debt is not in question in this study as numerous studies have empirically shown the negative correlation between the two variables (Ramjee & Gwatidzo, 2012). This study considered profits from the context of taxation being attractive and intended to explore if this was a factor to managers when they determined their firm’s capital structure. Profits are key in any organization, the participants overwhelmingly expressed that profits in their firms are reinvested in the business. The question of whether managers would consider using debt to reduce the tax exposure associated with profits, however, yielded similar negative findings to the previous section on the trade off theory.

Ramjee and Gwatidzo (2012) found that listed firms in South Africa finance their requirements with retained earnings and thus there is a negative relation between profitability and debt. Dewar (2014) found similar results in India, which is comparable as an emerging economy. A few participants commented on how acquiring debt during a profitable phase would erode the bottom line for shareholders and other potential investors saying: *“The negative side of that is when you try and sell a business, to try and sell a business that for years hasn’t shown a profit on the bottom line, people react to it in a negative way”* (Participant 4). The general tendency is the protection of profits

and thus lack of support for use of debt to maximize the tax benefit as the debt repayments are primarily regarded as an expense that erode profits (Fama & French, 1998)

6.4.2. Opportunity costs

An interesting theme of opportunity cost of money emerged during the interviews, one participant said that *“if you tie up your own money it means that you don't have any more money to do something else with it, whereas if you use someone else's money, while it costs you interest, at least if you have personal money and another opportunity comes you can take advantage (of it)”* (Participant 1). The findings were tied to the concept of utilising debt during a profitable phase, but no participant expressed that this idea might be enough to get them to take the debt to counteract the tax on the profits.

Ward and Price (2014) define the cost of equity as the opportunity cost of ownership of that stake, in this context the opportunity cost present what opportunities can be pursued if owner's equity was replaced with debt. This finding, the researcher feels, still relates to the need for a business objective for debt to be considered.

6.5. Discussion of results of Research question 4

When external funding is sought, do SMME managers prefer debt or to raise equity?

6.5.1. Approach to funding

The pecking-order theory states that firms prefer to fund their requirement with internally generated funds and that when additional funding is required, firms choose debt over equity finance (Meyers, 1984). This question focused on a scenario where managers are faced with a need for further funding, and some participants still insisted that they use internally generated funds besides the scenario set by the researcher. One participant (Participant 10) stated: *“I also contribute towards an internal loan reserve so that if I need to expand in future I can use that money and I do not have to go seek money elsewhere. It's just my approach to debt and to risk, that I try to have as minimal debt as possible.”* Participant 5 also stated that when their firm runs into cash flow challenges they first borrow from their own funds at market linked rate and (with) a

payback period. Seppa (2008) found that small firms in Estonia follow the pecking order theory, in keeping with this study's findings.

6.5.2. Own funding preference

These responses bear credence to the pecking order theory's first assertion that firms first consider internal funds and feel strongly about using this option. Participant 4 said: *"In an ideal world, I would be happier to fund it from within the company."* The key insight behind this was captured by Participant 9, who said: *"Look private funding if you got your own funds, it is the less stressful because you don't have to manage repayments and people on your neck all the time."* This finding is in line with evidence found by Daskalakis *et al.* (2014) in Greek SMMEs.

6.5.3. Debt funding preference

Own funding has emerged as the popular choice for managers; a few of them, however, expressed a preference for debt finance, with Participant 3 stating that for expansion projects, debt would be preferred. Participant 1 also said *"I think the first prize is always using someone else's money if the exchange rates (interest rate) at that time are good."* It is interesting to note that even when debt is noted as first prize, a condition is still attached to its consideration. This shared insight reverberates with the agency theory that debt motivates managers to be more efficient, citing the temptation of wasting excessive cash flow (Jensen & Meckling, 1976).

6.5.4. Equity consideration

One participant raised equity as a funding preference, stating: *"I think of raising, ideally for me, raising equity"* (Participant 2). Further enquiry into his assertion revealed that in practice he has raised debt to fund his business capital requirement; in an attempt to probe for the contradiction he stated: *"There's not a single business that I know that's going to be a huge business, from being a small business, that hasn't been financed through equity."* This contradiction presents an interesting observation on what the participant regards as a strategic decision to fund growth with external equity but in reality end up financing with debt. Dierkens (1986) alluded that when firms issue debt they send a positive signal about future performance, such a signal would prove most beneficial for a firm looking to attract external equity.

The study explored further why equity was the last preferred funding model and issues of interpersonal partnership difficulties emerged. Control dilution stood out as well as an expectation of non-financial contribution from the equity partner. This created an interesting phenomenon as we have here two contradicting positions on expectations of equity partners. Participant 1 said: *“Equity dilutes your control, which of course can become a major problem when it comes to all the changes you want in the company or your style of management.”* On the other end, another participant (Participant 4) said: *“If that external investor somebody that's just putting money into companies, or is it someone that could bring more than just funds? And for me, I would prefer an investor who also brings something else to the business, you know, other expertise that could enhance the business not just on a financial level but also through that person's expertise.”* Borgia and Newman (2012) found that managerial aversion to external control has an effect on capital structure decisions of SMMEs.

6.5.5. Information asymmetry

The contrasting insights on equity are explained by information asymmetry, as discussed in Chapter 2. The context discussed in this section differs from that in Chapter 2 relating to conflicting ideas about what managers expect from equity investors. Participants shared insights into the mismatch between information known internally by managers and information known by the external world about the firm. This becomes relevant as the mismatch of information between the managers in a firm and outsiders play a significant role in small firms failing to raise equity or debt (Carpenter, Fezzari & Petersen, 1994).

One participant (Participant 6) with experience of working in an accounting firm exclaimed that *“when you sit in the bank they tell you; we've got so much money that we don't have decent businesses to invest in. There's a huge mismatch there, so these guys sit with all the money and there's nothing out there for them to invest in. There's a reason for that. These guys on this side who need the money typically need it for day-to-day running, which is not attractive.”* Rovolis and Feidakis (2014) allude that information asymmetry emphasizes pecking order theory, in that managers are more keen to raise funds from options that require the least information exchange.

6.6. Emerging themes

During the course of the interviews participants made reference to alternate means of

raising funding for their firms that are not part of the traditional capital structure literature which predominantly focus on retained earnings, interest bearing loans and equity. Noulas and Genimakis (2014) in their study capital structure decisions of the CFOs of Greek listed firms, found that the CFO's follow alternate financing theories significantly more than they follow trade off theory and pecking order theory at 49.3%, 12% and 38.7% respectively. The importance of these emerging themes, even with the conservative frequency of response is captured in this quote,

"The thing is, overall you have to look at all that's available to you." (Participant 6)

6.6.1. Loan account

The loan account stood out of all the emerged themes, as it was highlighted in Chapter 5, it fits in a gap between own funds and debt and thus presents interesting permutations to cost of debt, risk of bankruptcy and potentially debt interest debt deductibility. Insights raised covered areas such as flexible repayments and interest charges, distributed reserves being loaned back to the company and confusion as to whether those loans are better off as equity or in a loan account. Seppa (2014) found that loan accounts *per se* carry no risk.

The following insight (Participant 4) is relevant with regard to the purpose of this study: *"I've seen the benefit in that, in having the loan account so (that) you don't pay tax and that's a huge percentage that obviously has an impact on the business."* This statement has huge ramifications for capital structure in that it implies that in having a loan account, any profits that you declare are not taxed as they are offset against the loan account. Being a loan account from the owner of the firms reduces the risk of effects of bankruptcy associated with other loan providers and it maximizes the benefits as all profits are offset against the loan account. This is opposed to normal debt (external) that is treated as a periodic expense with only the interest portion being offset against tax.

Seppa (2014) refers to loan accounts as inside debt and goes on to say that funding institutions regard it as quasi equity. The challenge raised is that loan accounts have been found to have a positive correlation to bankruptcy probability. Seppa (2010) argues that loan accounts are utilized in capital structure when the owners are unsure about the survival of the business. This phenomenon has been found to increase information asymmetry in firms.

6.6.2. Alternate funding mechanisms

Family finance is another mode of finance that emerged during the interviews. Participants made reference to it as a separate notion to traditional loans and own funding as captured by Participant 8 who said: *“We used our investments for getting the stock, and then the rest we borrowed from the family.”* The emphasis is placed on the words “our investments” and then the funds from family highlights how the funding is regarded as a separate source. Key difference that emerged is the importance of the agreed upon payback period and the emotional strive associated with that period not being honored as it was highlighted by the following statement (Participant 1): *“A family member puts money into the business and there's a loan and you pay that loan, there's an agreed payback period, projective of course.”* Lucey and Ciarán (2006) as cited Seppa (2013) allude to literature on funds from family and friends being referred to as internal funds of the firm.

Two additional themes that emerged (credit finance and sub-contracting) were presented which the researcher could only describe as non-capital funding in capital structure. The two models present an alternative to capital structure management by bypassing the need for capital funding by sub-contracting the obligations of the company that would require funding to a third party and negotiating a share of the profits when the task is completed. A shared insight was the following (Participant 7) *“You can run a business without capital. When you get jobs, you can sub-contract someone who has the capabilities.”*

The second model that emerged is credit finance, which is similar to a loan from a supplier of goods or services, the difference being that there is no exchange of funds for goods or services supplied for a set period of time, preferably until their sale proceeds (to end consumer) have been realised. One participant (Participant 9) in the medium service and manufacturing sector said: *“Creditors are a very, very important source of financing.”*

6.7. SMME considerations

6.7.1. Stage of the business

When participants were responding to the research questions on capital structure there was regular reference to the stage of the business, in particular the capital requirements of the early stages of a business enterprise. One interesting insight that

captured this was the following (Participant 9): “*So to start up a new business and to secure funding is a challenge especially nowadays with the banks and the strict controls of government and the reserve bank that they’ve got on the banks, the cash flow of the banks and how they can lend out money, is very, very restricted.*” This raises questions as to whether there is a difference in funding requirements for businesses in the start up phase compared to other stages of the business.

The financial growth lifecycle model alludes that firms undergo a linear sequential process as they develop and progress through different stages, and Ciaràn and Bhaird (2011) found that SMMEs correspond with this model and that firms in their early stages are largely dependent on owner and family funding. The lifecycle of the business is relevant for equity transactions as well, as Participant 4 stated: “*You need to ensure that you are with a partner who has the funding available to initially push into the business for the start-up and then you have to be able to have access to capital to roll the fund as required to buy raw materials.*”

6.7.2. Growth factors of SMME

Traditional finance models teach us that growth carries a cost; in corporate finance there is a concept of sustainable growth, where growth does not overtake available cash flow (Ward & Price, 2014). Participant 5 aptly commented: “*The most important thing is actually to grow SMMEs. That’s the most important thing.*” To match growth with cash flow requires capital structure management if the growth cannot be sustained by retained earnings.

6.8. Conclusion

The pecking order theory sets a proviso that when external funding is required, managers choose debt over equity; otherwise retained earnings are the first preference for managers. Trade-off theory makes no provisions and this creates the discord with managers as to the basic requirement of that debt. A possible model that can be drawn from the discussion on application of the trade off theory could focus on business objectives as drivers of capital structure, and then applying the trade-off theory to explain the choice between debt and equity when external funding is sought.



Chapter 7: Conclusion

7.1. Introduction

This research aimed to explore the factors SMME managers consider when they make capital structure decisions in the South African context. The research was motivated by the role that the SMME sector plays in the economy of the country and the impact that capital structure management has on a firm. Hartigh (2015) highlighted the shocking failure rate, especially among startups and this failure is attributed partly to capital structure issues. The role of the manager has been highlighted since the advent of behavioral finance theories that dominated capital structure decision making, deviating from traditional finance models that assumed financial decisions were made rationally (Shefrin, 2001). Muradoglu and Harvey (2012) argue further that managers lack the cognitive ability to make normative decisions.

It is for these considerations that this study chose the SMME manager as its focus point, as their decisions on capital structure affect the outcome and thus there are numerous studies on capital structure with varying results. Behavioral finance theories attempt to explain these decisions, but empirical studies in different settings also yield different results. One such study in Ramjee and Gwatidzo (2012) found support for the two dominant behavioral finance theories (Trade off and Pecking order) in listed South African firms on the Johannesburg Stock Exchange between 1998 and 2008 while studying dynamics in capital structure determinants. This study intends to contribute further to literature through exploration of the application of the two theories in SMMEs. Further empirical investigation of the findings can be instituted, in keeping with the research limitation notes by Ramjee and Gwatidzo (2012).

This chapter tables the main findings of the ten semi-structured interviews with capital structure decision-making managers of different SMME sectors, this review will be made in line with the research objectives and the response to the research questions as discussed in Chapter 6.

7.2. Summary of main research findings

In exploring the determinants of capital structure decision making of SMMEs in the South African context, the key findings are that SMME capital structure decisions are primarily determined by the business objectives of the firm. This is similar to the

findings in Australian SMMEs (Xiang & Worthington, 2015).

When firms are faced with the need for external funding managers prefer debt over equity, but own funds dominate the funding preference for firms, which is in keeping with the pecking order theory of capital structure. Ramjee and Gwatidzo (2012) find this to be the case for South African listed firms as well.

The trade off theory has been overwhelmingly rejected as a determinant of capital structure in South Africa SMMEs, this result is in keeping with findings from several studies. Of note, however, is the finding that this is in contrast with the studies in listed firms in South Africa (Ramjee & Gwatidzo, 2012).

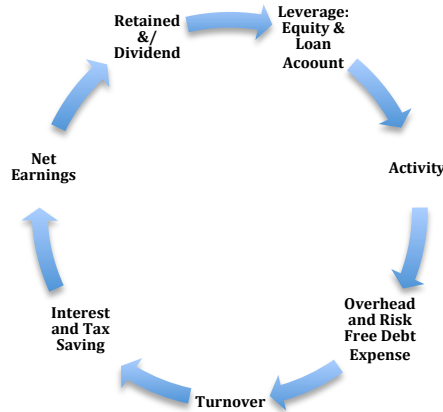
The study also finds that South African SMMEs consider alternate funding means in their capital structure decision. The key alternative means found in this study is the loan account. Seppa (2014) regards the loan account as internal funding but confirms it carries no risk. Other alternate funding means found considered in this study are not directly related to capital structure, but working capital funding means in the form of credit finance and sub contracting.

Capital structure decision-making is regarded as an important managerial consideration in SMMEs, Zweibel (1996) contends that managers choose capital structure of their firms voluntarily and this is in line with this study's findings. Participants in this study do not have full knowledge of the behavioral finance theories, but this study has found that they have an understanding of concepts imbedded in the theories.

7.3. Proposed framework

Following the review of leverage in Chapter 1, the discussion on behavioral finance theories in Chapter 2 and the discussion of the research findings in Chapter 6, the researcher proposes the model presented below in Figure 7.1. The benefits and costs of debt have been discussed in Chapter 2, this model presents a "hybrid" model where the benefits can be gained and adjusted for maximum benefit while at the same time minimizing the cost of debt from a bankruptcy and administrative point of view through the application of the loan account from the investors.

Figure 5. Proposed equity and loan account capital structure model



Source: Modified from Ward and Price (2014)

The loan account is treated like any interest-bearing loan, allowing the interest tax shield to be claimed by the firm (Ayers, Cloyd & Robinson, 2001). The risks, however, are mitigated as shareholders are not likely to liquidate their own company for default as quickly as the banks would and the interest payable can be adjusted with minimal effort to suit the needs and affordability for the firm. The obvious limitations of this model is that it will work where shareholders have excess capital to invest or loan to the firm, or if the firm is profitable and is able pay a dividend. The second limitation to this model is that although the tax risk of the firm may benefit from the interest tax shield, the loan providers will incur the tax payable on the interest that was charged to the firm as part of the loan account. This would present a challenge if that marginal tax payable by the loan providers in their personal capacity will surpass the tax payable by the firm. Seppa (2014) also raises a concern that loan accounts raise information asymmetries within firms, as funders view them (loan accounts) as a sign of poor business outlook by owners of firms.

7.4. Recommendations for business

The response to Research question 1 and the literature around capital structure emphasize the importance of capital structure. The recommendation from this study for managers to apply proper planning around capital structure at all stages of the business, from preplanning for start-ups to a coherent strategy around capital structure to align the company's capital requirements with its objectives for growth.

Research question 2 confirmed that managers do not consider taxation in their capital structure determination; the trend instead is planning capital structure around business objectives. There is no doubt about the value of the tax interest shield. A few participants feel that on its own it is not enough to consider as a capital structure determinant; the proposal therefore is for managers to exploit this tax benefit in conjunction with other business objective considerations.

Response to Research question 3 dealt with debt consideration during a profitable phase, the framework presented in the preceding section on the use of a loan account from shareholders, is being proposed to business owners as a means to exploit the interest tax shield with minimised risk of bankruptcy. This allows the firm maximum return on equity from capital structure in a profitable firm by applying leverage (Ward & Price, 2014) as well as through the tax deduction benefit (Miller & Modigliani, 1958).

The responses to Research question 4 are in line with the pecking order theory, that debt is preferred when external funding is sought. The recommendation is for managers to explore what participants referred to in the section on additional funding in Chapter 5. Sub-contracting and credit finance are within the managerial scope of control and can provide much needed relieve for working capital management and by inference additional capital requirements.

7.5. Limitations of the research

The first limitation of this study related to the choice of methodology and being a qualitative research, definitive conclusions cannot be drawn from them, except under extreme caution (Saunders & Lewis, 2012). The population studied is SMMEs within South Africa and thus the findings cannot be generalized to listed companies or similar companies in other countries. Chapter 4 outlays the rest of the methodology limitations of this study.

The second limitation of the study is that not all firm characteristics that have been empirically shown to have a correlation with capital structure were explored in this study; only taxation and profitability were reviewed in this study because of their negative correlation to leverage in previous studies. The implication of this limitation is that this study cannot claim to have explored the managerial capital structure decision making on firm characteristics.

The third limitation relates to the study's omission to explore managerial cognitive impairments to rational decision making in full. The study did a review of loss aversion

but excluded confirmation bias and frame dependence and thus the study's review of managerial decision making is limited.

The fourth limitation relates to the lack of differentiation of SMMEs by size, sector and whether the firm is owner managed or not. The implication is that the study lost an opportunity to explore whether these differences have a significant impact on how managers make their capital structure decisions.

7.6. Suggestions for future research

During the course of literature review and as the findings of this research unfolded, new research questions emerged. This explorative qualitative study design calls for validation of the findings through empirical quantitative studies (Saunders & Lewis, 2012); key amongst this is the finding on application of the static trade off theory given the controversy of its findings in different settings such as between listed and unlisted firms. Important suggestions for future research include:

- Quantitative studies of factors guiding the use of debt in firms. This is proposed to investigate if debt is utilized in firms for purposes of the interest tax shield benefit or for other strategic and operational reasons. Business objectives have featured as a consideration for SMME managers in this study and empirical studies of this phenomenon would prove beneficial.
- Participant 2 alluded to the importance of equity as opposed to debt funding as an essential factor for growth of the firm. Future research on the impact of equity funding on growth will contribute to the pecking order theory literature.
- The trade-off theory is based on the interest tax shield that debt presents (Miller & Modigliani, 1958). A study into the opportunity cost of the tax benefit of debt against other tax-saving strategies might help businesses make more informed decisions on application of different tax measures.
- A further exploration of the "hybrid model" of capital structure through the use of a loan account in a firm's capital structure could contribute greatly to the application of the trade off theory and other literature on capital structure.

7.7. Concluding remarks

SMMEs are key drivers of job creation within the South African context. They account for 60% of jobs in the market and 91% of all formal business. Most SMMEs are owner managed and thus the focus of this study was on managerial decision making. This study's contribution to SMMEs capital structure decision making is borne of the finance challenges in this sector, resultant lack of growth and the high failure rate that businesses experience due to improper capital structures, amongst other factors.

Behavioral finance theories have replaced traditional finance theories due to their inefficiencies in explaining capital structure decisions. The two key theories in behavioral finance present contradicting answers; while the pecking-order theory is more consistent in its application within SMMEs as in this study, the trade off theory, however, yields negative results in most SMMEs studies undertaken. This study found the same negative result for the trade-off theory application in SMMEs, but of importance is the finding that South African SMME managers instead consider business objectives when deciding on capital structure.

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Appendix 1: Interview Guide

Interview Guide

| No. | Questions to consider |
|-----|--|
| 1A | Do you have a predetermined capital structure ratio for your firm? |
| 1B | Is capital structure management a priority in your firm? Why? |
| 1C | In your experience, what is the most important factor regarding capital structure in your company? |
| 2A | What is your opinion on tax benefits of debt in your capital structure? |
| 2B | Is there a positive role debt plays in your company taxation? |
| 2C | Would an increase in your company's tax rate affect your capital structure? |
| 3A | Could you tell me about the role of profits on your capital structure? Why? |
| 3B | To counter taxation while profitable, would you consider acquiring debt? Why? |
| 4A | How do you fund your expansion or new capital acquisitions and why? |
| 4B | Have you had to or needed to raise additional funds by selling equity in the company? Why? |

Appendix 2: Consent Form

Consent form

Capital structure decisions for SMME's in the South African context

Researcher: Dr Mogori Thomas Mogashoa, student at *Gordon Institute of Business Sciences*

This study is conducting research on capital structure decisions for SMME's in the South African context. The study intends to uncover new insights into factors South African SMME managers consider in decisions around capital structure of their firms. Your experiences and views on the above-named topic will contribute immensely to the understanding of capital structure decisions for SMMEs.

The interview will last approximately 30 minutes. All data will be kept confidential and no comments will be linked back to you as a participant.

By signing below I confirm that: -

I agree to take part in the interview;

I understand what the research is about;

I have an opportunity to ask questions;

I understand that my participation is voluntary;

I can withdraw at any time without penalty or explanation;

I agree to the interview being audio recorded;

I agree to the use of anonymised quotations in publications.

Signature of Participant: _____ Date: _____

Signature of Researcher: _____ Date: _____

If you have any concerns or queries, please contact my research supervisor or me.
Contact details are provided below.

Supervisor : Dr Charlene Lew *Email*: lewc@gibs.co.za

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Researcher : Dr M T Mogashoa *Email*: 24237982@mygibs.co.za

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Appendix 3: Ethics approval letter

Dear Mogori Mogashoa

Protocol Number: **Temp2016-01318**

Title: **Capital structure decision-making for SMME's in the South African context**

Please be advised that your application for Ethical Clearance has been APPROVED. You are therefore allowed to continue collecting your data. We wish you everything of the best for the rest of the project.

Kind Regards,

Adele Bekker