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Influence of the Cost of Capital on the Financial Performance of SMEs in Turkana Central, Kenya.

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Abstract

The purpose of the study was to examine the impact of the cost of capital on the financial performance of SMEs in Turkana central, Kenya. The research was anchored in the Static Trade-off Theory and the Pecking Order Theory, Both of which provided a theoretical ground for understanding the balance between equity and debt financing behavior and the firm's financing Decisions. A mixed-methods research design was employed to examine the relationship between financial performance and the cost of capital, enabling the study to explain financial decisions among SME owners. The study population comprises 2,500 SMEs operating within five administrative wards in Turkana Central. Utilising Taro Yamane's (1967) sampling formula, a representative sample of 345 SMEs was selected through simple random sampling to ensure every business had an equal chance of selection. Primary data was collected using a structured questionnaire, which was pretested in a pilot study to assess validity and reliability, while supplementary qualitative data was collected through an interview schedule with selected SMEs respondents. The analysis incorporated both descriptive and inferential statistics to examine the influence of cost of capital on the financial performance of SMEs. The findings showed that, the regression model was statistically significant (linear regression, F (1322), and that the cost of capital influences financial performance (β = 0.237, P = 0.001). The study recommended that, SMEs should be encouraged to maintain comprehensive financial records. The study provided financial institutions, policymakers, and SME owners with ways to improve access to affordable credit for SMEs in Turkana Central.

Key terms: Business growth, cost of capital, financial performance, liquidity, small and medium enterprises, sustainability.

INTRODUCTION

The study aims to examine the impact of the cost of capital on the financial performance of SMEs in Turkana Central. Through this objective, the study hypothesises that the cost of capital does not significantly affect the SMEs' financial performance in Turkana Central, Kenya. Small and medium enterprises (SMEs) are recognised as key drivers of poverty reduction, employment creation, and economic growth. Despite their important contribution to national and local economies. Many SMEs continue to experience financial challenges that limit their sustainability and growth, affecting their long-term survival and financial performance. Turkana Central SMEs face inadequate financing, poor infrastructure, inadequate financial management skills, drought, limited markets, and political instability.

Although many financial initiatives, such as the enterprise development programme targeting women, youth and persons with disabilities and the Biashara fund (Eweet, 2020), have been implemented. The SMEs remained below expectations. Therefore, the empirical evidence on the relationship between the cost of capital and SMEs' financial performance in Turkana Central was limited. However, there was a need to examine the impact of the cost of capital on the SMEs' financial performance in Turkana Central. For the study, SMEs are businesses that fall within the classification provided by the SMEs Act, based on the number of employees, Annual turnover, and capital invested. Cost of capital refers to the cost of borrowing from a financial institution. Financial performance refers to how well the business performs financially, for example, maintaining liquidity, increasing sales, and generating profit.

Globally, the crucial role played by SMEs has led countries to develop economic pillars that recognise the SME sector as a vital catalyst (Verma, 2019). The goal was to promote socioeconomic growth and development through innovation, job creation, and entrepreneurship. Small and Medium Enterprises make up 95 per cent of businesses worldwide and significantly contribute to income generation and employment (Naradda et al., 2020). Most SMEs have grown steadily due to government policies, technological advancements, entrepreneurial skills, and access to credit from microfinance institutions. These have enabled the industry to compete in the international market, promoting economic growth and expansion. This could serve as an example of how a country's lending policies have affected the lending capacity of financial institutions. As Juznik Rotar et al. (2019) observed, in Europe, SMEs account for 30 per cent of employment, while large enterprises make up the rest and contribute more than half of the gross domestic product (GDP).

The field played a crucial role in Africa's development. In Uganda, Asiimwe (2017) postulated that small and medium enterprises contributed over 70 per cent to gross domestic product (GDP) and accounted for 90 per cent of job creation. In Kenya, Small and medium size enterprises substantially contributed to livelihoods and inclusive development. The industry accounted for 92 per cent of the new jobs generated each year. Kabeer (2021) stated that small and medium enterprises account for more than 93 per cent of the total labour force, thereby boosting the gross domestic product (GDP) by 40 per cent. The literature above demonstrates the role of SMEs in economic growth. This has been the trend in other African countries.

The authors Adian et al. (2020) argued for the dissimilarity in the impact of the COVID-19 pandemic on different firms, where grants rather than loans were needed for small and medium-sized enterprises. Although SMEs contributed to economic growth, they face challenges that threatened their sustainability and growth, including the inability to access affordable, timely, and sufficient credit. They also lack marketing skills, expertise in work resources, and promotional and advertising skills. Lack of access to credit, coupled with poor marketing skills, contributes to the underperformance of SMEs. All these are problems that affect the profitability, stability, and growth of SMEs in the area.

(Ayundibu and Houghton, 2017) asserted that policies, technology, and better access to credit had been used by the government to assist SMEs. They offered incentives, such as favourable loan terms and tax breaks, to help keep these businesses afloat. (Njagi, Maina, and Kariuki, 2017) reported that the financial performance of the SMEs in the county government has not been achieved. Turkana County was one of

them. Available empirical data on the impact of an optimal capital structure on the financial performance of SMEs in Turkana Central was scarce. Moreover, there was a financing gap for SMEs in Turkana Central. This has been reflected in the absence of business activity, a high poverty index, and low socioeconomic development, which has led to a high number of street children in the sub-county. As Wagah and Mwehe (2019) noted, most capital structure studies have been conducted in cities in Kenya, unlike Turkana Central, which is economically remote. This was why the research was conducted to examine the impact of capital structure on the financial performance of SMEs in Turkana Central.

The new lessons generated from this study provided insight into how capital structure decisions affect the financial performance of SMEs in Turkana's central region. This could help managers and business owners make decisions about the cost of capital for SMEs. The government addressed various constraints through government policies. Moreover, the study provided SME owners with recommendations for improving their challenges. Therefore, the results of this study was important to financial institutions as they could guide them in offering more targeted financial options to SMEs and promote the sustainability and growth of SMEs in the region.

LITERATURE REVIEW

According to Tuovila (2023), capital structure is the combination of equity and debt a firm uses to finance its operations. The seminal work of Miller and Modigliani (1958) explained that the firm's value was irrelevant, and many theoretical and empirical contributions expanded the literature on capital structure. After Miller and Modigliani, many people were fascinated and inspired to develop numerous theories. These capital structure theories primarily discussed the research on the firm's capital structure and financial performance. Majluf and Myers (1984) and Donaldson (1961) proposed the pecking order theory, which emphasised the hierarchy of a firm's financing preferences for capital raising. SME managers were observed to prefer internally generated sources of finance, as these were less risky and incurred lower information costs. If internal resources were insufficient, external financing options, such as debt and equity, were pursued, with debt preferred due to its lower risk. The theory was vital for SMEs in Turkana's central region, where they are more likely to rely on internal financing than on limited external finance. The study used the pecking-order theory to understand SMEs' financing preferences, given the problem of access to finance.

The trade-off theory proposed by Modigliani and Miller (1963) posited that SMEs carefully balance debt and equity levels to achieve tax advantages while avoiding excessive financial distress. The theory was important to SMEs because they need to balance the cost of debt with potential benefits, even amid limited financial resources. The trade-off theory was used in the study to examine the benefit of tax advantage (debt financing) and bankruptcy (potential cost) for SMEs in Turkana Central.

Small and medium-sized enterprises in the African perspective contributed to economic growth, poverty reduction and employment creation. Despite their contribution, one of the greatest obstacles was access to finance. Many African countries rely on informal financing sources due to collateral requirements, high interest rates, and strict lending. Many empirical studies in Africa have found that high borrowing costs slow economic growth, limit investment opportunities, and reduce profitability. However, debt financing exposed SMEs to repayment challenges, excess borrowing and limited opportunity for expansion. Many SMEs continue to rely on internal financing despite limited capacity to enhance business growth. Most studies are conducted in urban areas; less attention was given to rural areas like Turkana central, where business support was limited

SMEs are significant to the Kenyan economy, particularly in alleviating poverty and creating jobs. Most SMEs have been facing diminishing financial performance due to limited access to finance. The cost of capital was a fundamental to a firm's financing decisions. It represents the cost of equity and debt used to fund operations and investments. The cost of debt includes interest payments on borrowed funds, while equity refers to the returns shareholders demand. Cost of capital affects a business's profitability; a long repayment period and expensive loans increased expenses, making it hard for the business to survive. Moreover, choosing the right

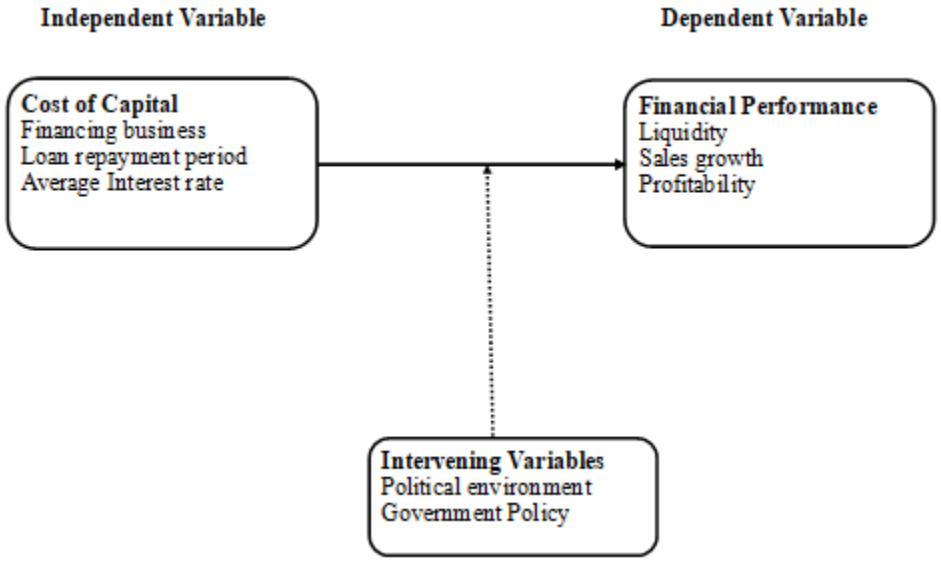
interest rate, financing sources, and a shorter repayment period could help the business maintain its financial health. This makes it hard for the business to survive. Firms must strike a balance in their capital structure to optimise financial performance. As Njagi, Maina, and Kariuki (2017) explained, excessive debt increased the risk of default, whereas reliance on equity can dilute ownership and increase financing costs.

Kamau (2023) observed that internal financing was the least expensive option, followed by debt, with equity being the costliest. He examined financial availability, finance cost, and business success in Kenya. The study evaluated business success through indicators such as market share, profitability, and growth, focusing solely on financial aspects. Therefore, firms must adjust their financing strategies to maximise asset returns and shareholder value. Motanya (2019) argued that financial managers must aim to minimise the cost of capital while achieving business goals such as stock price appreciation and profitability. By mobilising resources efficiently, firms can ensure sustainable growth and value creation. Small and medium enterprises contribute to poverty alleviation, create employment, and generate income, yet face financial constraints. Cost of capital was one of the constraints on the sustainability and growth of SMEs, due to a lack of collateral and high interest rates that reduce profitability.

Small and medium enterprises in Turkana Central face challenges, including high interest rates from financial institutions. This limits SME owners' ability to invest in business expansion. This study examined how the cost of capital in Turkana Central affected liquidity, profitability, sales growth, and SME financial performance.

Conceptual Framework

Conceptual framework outlining the influence of cost of capital on the financial performance of SMEs in Turkana Central Region include variables that contributed to the study's objectives. Independent variables in the conceptual framework include cost of capital. The dependent variable remains financial performance. Intervening variables included the political environment and government policy.



METHODOLOGY

The study adopted a mixed-methods research design, comprising a descriptive cross-sectional survey and an exploratory design to examine the relationship between the cost of capital and the financial performance of SMEs in Turkana Central. The descriptive design was appropriate for establishing the quantitative data, and the exploratory design involved the search for qualitative data, because there was limited empirical evidence on how the cost of capital

affects the financial performance of SMEs in Turkana Central. The quantitative approach was used to collect numerical data on SMEs at a single point in time to describe financial practices and to measure the relationship between the cost of capital and financial performance. The qualitative approach enabled the research to collect explanations from managers and SME owners about the challenges of accessing finance. Primary data was collected through questionnaires and interviews with SME owners and managers, while secondary data as from documentary guides and the SME library. The data was collected from the past five years (2017-2021).

Additionally, the study population comprised 2,500 SME companies registered as SME owners and managers within five administrative wards in Turkana Central. Utilising Taro Yamane's (1967) sampling formula, a representative sample of 345 SMEs was selected via simple random sampling from the target population. This technique was considered important because it gives individuals an equal chance of selection. These comprised the managers and SME owners who are directly involved in decision-making about the cost of capital and the financial performance of SMEs in Turkana Central. This was the most appropriate method because every SME had an equal and independent probability of being selected, thereby minimising selection bias and improving the representativeness of the sample.

The sampling process involved obtaining a sample frame comprising registered SMES in Turkana Central from the relevant county and business registration records. Each SME in the sampling frame was assigned an identification number. The required sample of 345 SMEs was then selected using a random selection procedure, such as computer-generated random numbers, ensuring that every SME had an equal chance of being included in the study.

Ethical Considerations

The researcher followed ethical guidelines, first seeking permission from Turkana University and the School of Postgraduate Studies to collect data, and then obtaining informed consent from the relevant authorities. NACOSTI will be essential for the research to be considered crucial. All study participants were respected, appreciated, and informed that their participation would be voluntary.

However, children under 18 years of age found in the shops acting on behalf of their parents were not contacted in the study, as they would not provide reliable and valid information. Informed consent was sought from all participants before data collection, without revealing the participants' names, to ensure involvement and confidentiality.

FINDINGS AND DISCUSSION

The findings show that the cost of capital was the main factor affecting the financial performance and decision-making of SMEs in Turkana Central, Kenya. This has been evidenced by introducing credit guarantee schemes, introducing affordable credit, improving financial management and reducing financial constraints. The findings aligned with capital structure theories, including the static trade-off, which suggests that the firm balances the benefits of debt against its costs. High borrowing costs increase financial distress, making SMEs less attractive to debt financing and reducing financial performance. The pecking order theory explains that firms prefer internal financing first, then debt and equity as a last resort. The study highlighted that interest rates encouraged SMEs to rely on internally generated funds. The cost of capital was measured using business financing sources, the loan repayment period, and the average interest rate, as explained below.

Business Financing Sources

According to the findings, the majority of respondents stated that loans from financial institutions finance their businesses (112, 34.5%), followed by employment income (96, 29.5%) and personal savings (62, 19.1%). Other notable sources of business funding include family and friends' support (14.8 per cent, 48), and only 1.9 per cent (6) stated farming.

The findings showed a high reliance on institutional loans, suggesting that the majority of SMEs across the country require or prefer external finance to support their operations and expansion. The finding corroborates earlier research that identified interest rates and the cost of capital as major financing concerns for SMEs.

The reliance on personal savings and salaries as other sources of funds also demonstrates the resource constraints of SME owners, who are often forced to turn to personal or informal sources due to limited access to investment capital or venture capital.

Finance from friends and family, while less prominent, remains a source of SME financing, underscoring the importance of social capital for entrepreneurship, especially in emerging economies. Farming as a source was minimal, indicating that it was not an important source of SMEs' startup or operating finance.

Overall, the evidence points to the need to increase financial access, especially through more affordable credit and SME-friendly financial instruments. Both financial institutions and policymakers need to consider tailoring lending models to better serve SMEs, especially those without significant collateral or long credit records.

Frequency of Business Financing Sources

	Frequency	**Percent**
Loans from a financial institution	112	34.5%
Employment Income	96	29.5%
Personal saving	62	19.1%
Family and friends support	48	14.8%
Farming	6	1.9%
Total	**324**	**100%**

Loan Repayment Period

From the findings, the majority of the respondents stated that the most commonly reported repayment period was 6 years, 35.5 per cent (115), followed by 4 years, 24.7 per cent (80), 8 years, 15.4 per cent (50), 3 years, 11.1 per cent (36), and 5 years, 21 per cent (6.5%). Less frequently highlighted repayment times included 7 years (13) and 2 years (9), with repayment rates of 4.0 per cent and 2.8 per cent, respectively.

The presence of shorter-term loans (e.g., 2 to 4 years) also implies diverse funding structures and requirements, where other SMEs may need quicker turnaround capital for expansion or working capital. Interestingly, only a negligible percentage (0.9%) reported 2-year terms, suggesting a preference for a manageable instalment plan over an extended period. These findings are in line with previous research that introduced interest rates and cost of capital as significant determinants of SME decision-making.

Longer payment terms can help mitigate the burden of high interest rates while continuing to secure the needed capital. The evidence points to the need for tailored financing products that account for SMEs' cash flow uncertainty and repayment capacity.

Frequency of the Loan Repayment Period

	Frequency	**Percent**
6 Years	115	35.5
4 Years	80	24.7
8 Years	50	15.4
3 Years	36	11.1
5 Years	21	6.5
7 Years	13	4.0
2 Years	9	2.8
	324	**100%**

Average Interest Rate

The analysis of interest rates charged on SME loans showed that the most frequently reported average interest rate was 16.60 per cent, as indicated by 46.3 per cent (150) of the respondents. Other commonly cited rates included 16.50 per cent (97), 29.9 per cent, 16.91 per cent (77), and 23.8 per cent. These values suggest that the prevailing interest rates for SME loans lie in a narrow range around 16.5 per cent to 16.9 per cent.

The results show that SMEs have been quoted slightly more than 16 per cent, and the majority are at levels just below 16.60 per cent. The comparatively high but stable range of interest rates may reflect lenders' risk profiles for SMEs, especially in markets with limited credit history or poor collateral.

Since interest rates have been identified as a crucial factor in SME investment levels, these statistics underscore the debt-servicing pressure on small businesses. Even minor differences in interest rates (e.g., 0.3% between 16.60% and 16.91%) can significantly impact small businesses, especially when lengthy repayment periods, such as the typical 6-year repayment period mentioned above, are involved.

These findings highlighted the need for supportive interest rate policies that drive SME growth, such as interest subsidies, risk-sharing arrangements, or low-interest alternative funding. Promoting financial literacy regarding the impact of interest rate movement on overall loan prices may also help SME owners make better borrowing decisions.

Frequency of Average Interest Rate

	Frequency	Percent
16.60%	150	46.3
16.50%	97	29.9
16.91%	77	23.8
	324	100%

Multiple Linear Regression

The study sought to investigate the impact of the cost of capital on SMEs' financial performance in Turkana Central, Kenya. The null hypotheses to be tested were: Ho_2: The cost of capital does not influence SMEs' financial performance. The cost of capital was also a satisfactory predictor, leading to the rejection of Ho_2.

Therefore, had a statistically significant effect on financial performance, p- value <0.05. Meaning the cost of capital affects financial performance. There was a relationship between the cost of capital and financial performance; e.g., high loan costs reduce SMEs' profits and business performance.

It was also discovered to have a significant positive effect (β = .237). The positive sign shows that SMEs that manage financing costs well can improve profitability, e.g., by balancing debt and equity. The R2 Value of 0.368 means that 36.8 per cent of the change in financial performance can be explained by the cost of capital. The remaining 63.2 per cent could be explained by other factors not included in the model, e.g., innovation management skills and market environment.

The results prove that the cost of capital significantly affects the financial performance of SMEs in Turkana Central. SMEs with a lower cost of capital will record higher profitability by efficiently managing resources. Therefore, the cost of capital negatively affects financial performance.

Regression Coefficients of the Influence of Cost of Capital on Financial Performance

Variable	*B*	*B*	*SE*	*P-Value*
(Constant)	1.341		.163	0.000
Cost of Capital	.237	.331	.035	0.001
R^2	.368			
F (1,323)				

Limitation of the Study

The study was restricted to Small and medium-sized enterprises in Turkana Central, Kenya. The study's findings were intended only for Turkana Central because of differences with other counties in access to finance, business environment, economic conditions, and infrastructure. To mitigate this limitation, the study employed a sampling technique to ensure the selected respondents were representative of SMEs operating in Turkana Central, Kenya. To enhance the validity and reliability of the research findings, consistent research procedures and standardised instruments were used. Future research was recommended to include enterprises from other counties and sub-counties to improve the research findings.

CONCLUSION AND RECOMMENDATIONS

Conclusion: The conclusion, based on the findings and the research objectives, is that a clearly defined and balanced cost of capital for SMEs also leads to better business financial performance, since low debt levels and judicious use of institutional loans can go a long way towards achieving profitability. Also, personal savings and retained earnings as sources of equity financing ensure more financial stability than external financing.

Recommendations: The research adds much to existing knowledge by providing empirical data on the relationship between cost of capital and the financial performance of SMEs in Turkana Central. Most studies on the cost of capital and financial performance have focused on urban areas, whereas rural areas such as Turkana Central face challenges including limited access to credit, high borrowing costs, and inadequate collateral. The findings contributes to the understanding of how the cost of finance affects the sustainability and profitability of SMEs. This provides practical evidence that can inform SMEs' financing Management. SMEs should keep accurate financial records by adopting an accounting system to track income, expenses, and profitability, thereby improving their access to loans and supporting strategic decisions. They also need to diversify their capital sources to avoid dependence on a single funding source. This can be achieved using a mix of equity, long-term loans, and reinvested profits, along with financial literacy training covering debt, budgeting, and investment appraisal.

For financial institutions, financing for SMEs should be simplified by creating user-friendly products that require minimal documentation, and credit should be made more accessible through policies that regulate SME lending rates. Additionally, financial institutions can offer advisory services by working with SMEs to help them manage funds efficiently, in conjunction with financial planning. Furthermore, formalisation should be promoted by offering preferential loan terms to SMEs with audited financial statements to ensure transparency and long-term business growth. Financial institutions have introduced stringent but reduced collateral requirements to encourage SMEs to borrow and expand their business operations. A long repayment period is favourable to SMEs as it allows them to generate more funds and pay the loan gradually, and a short repayment period increases SMEs' financial pressure if the business is required to repay.

Moreover, for government and development partners to increase access to credit for SMEs, it is necessary to diversify credit guarantee schemes that minimise lenders' risks, thereby creating more financial opportunities. Meanwhile, supporting financial infrastructure should involve encouraging the adoption of digital finance tools, including mobile lending platforms, bookkeeping tools, micro-insurance, and others, to boost financial inclusion and efficiency. Additionally, promoting capacity-building in business management and innovation can make

businesses more competitive and sustainable in the long term. The government introduced subsidised SME financing programs to encourage SMEs to access loans and to train them in business planning, financial literacy, and loan management.

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