THE FINANCIAL SUPPORT STRUCTURE OF SMALL AND MEDIUM - SCALE ENTERPRISES (SMEs) IN GHANA: A COMPARATIVE STUDY OF CAPITAL MARKET FINANCE AND BANK FINANCE

AIDOO, JACOB BENSON

A Thesis Submitted to Asia e University in
Fulfilment of the requirements for the
Degree of Doctor of Philosophy

October 2017

ABSTRACT

The introduction of capital market in Ghana with the establishment of the Ghana Stock Exchange (GSE) in 1989 was received as an initiative that provides an alternative avenue for businesses to raise long term capital to finance their operations and list on the exchange. The Government was also expected to divest its interest in the over 300 state-owned enterprises (SOEs) at the time through the GSE to boost activity on the stock market. After 25 years of capital market operation, a large number of medium and large scale companies still operate outside the formal capital market and mostly depend on bank finance in spite of limited access to credit which has been identified as critical factor constraining business growth in Ghana. The low utilization of capital market finance has implication for the number of companies listed on the GSE. With 11 companies listed in 1990, the number increased to 37 in 2016, giving an average of one listed company per year. To this end, the main purpose of the present study was to explore factors that influence the decision of companies to raise funds from the capital market for their operations. The study relied mainly on primary data, and structured questionnaires employed as data collection instrument. Simple random sampling technique was adopted to select 400 respondents and binary logistic regression used as the estimation technique. The results show a positive and significant relationship between loss of control, credit availability, knowledge about capital market, and capital market finance. It also revealed a negative and significant relationship between growth stage of the firm and capital market finance. The results further show that SMEs are over dependent on bank finance due to the constraint they face in accessing other forms of external finance. Based on the results, the study recommends intensive education and awareness creation programmes for potential issuers on the benefits of capital market finance.

APPROVAL PAGE

I certify that I have supervised / read this study and that in my opinion it conforms to acceptable standards of scholarly presentation and is fully adequate, in quality and scope, as a thesis for the requirement for the degree of Doctor of Philosophy.

Prof Dr Ravindran Ramasamy
Graduate School of Business
Universiti Tun Abdul Razak
Supervisor

Examination Committee:

Assoc Prof Dr Anbalagan Krishnan
Deputy Vice Chancellor
Asian Metropolitan University
Examiner

Dr Hamdino Hamdan
Assistant Professor, Kulliyyah of Economics &Management
International Islamic University Malaysia
Examiner

Prof Dato' Dr Sayed Mushtaq Hussain
School of Management
Asia e University
Examiner

Prof Dr Juhari Ali
Dean, School of Arts, Humanities & Social Sciences
Asia e University
Chairman, Examination Committee

This thesis was submitted to Asia e University and is accepted as fulfilment of the requirement for the degree of Doctor of Philosophy.

Assoc Prof Dr Wan Sabri Wan Hussin
Dean, School of Management
Asia e University

Prof Dr Siow Heng Loke
Dean, School of Graduate studies
Asia e University

DECLARATION

I hereby declare that this thesis submitted in fulfilment of the PhD is my own work and that all contributions from any other persons or sources are properly and duly cited. I further declare that the materials has not been submitted either in whole or in part, for a degree at this or any other university. In making this declaration, I understand and acknowledge any breaches in this declaration constitute academic misconduct, which may result in my expulsion from the programme and/or exclusion from the award of the degree.

Name of Candidate: Aidoo, Jacob Benson

Signature: Date: 5TH October 2017

ACKNOWLEDGEMENTS

My sincere thanks go to the Almighty God for the strength, wisdom and companionship offered me during the lonely journey of this academic pursuit, which by his grace is brought to a successful completion.

I also express my deepest gratitude to my committed Supervisor, Professor Dr Ravindran Ramasamy for his invaluable comments, guidance and time spent to read the several drafts both of the pilot and main study. I was stunned by the way he transmitted his feedback which nullified the effect of the great distance between our respective physical locations. I owe him tons of thanks for his understanding, care and constructive feedback which greatly improved the thesis.

Additionally, I wish to thank Professor Dr Siow Heng Loke, Dean of School of Graduate Studies and his team of Professors for their insightful research workshops on the various chapters of a thesis, especially on research methodology and literature review which shaped my thoughts throughout the entire process of the study.

I am also grateful to Dr Leo Fredericks, who intervened when the appointment of my supervisor delayed due to a change of Advisor for the Ph.D. Business Administration programme. My heart-felt appreciation also goes to the staff at the Administration, Finance, E-library, and other non-academic staff of the University.

I also wish to acknowledge Mr. Robert Quaye, Mr. Samuel Tawiah Baidoo, Mr Frank Anane and all others who helped in diverse ways to bring this work to a successful end.

TABLE OF CONTENTS

Content **Page**

LIST OF TABLES

LIST OF FIGURES

CHAPTER ONE

INTRODUCTION

1.1 Introduction

This chapter presents the general overview of the study. Specifically, it discusses the background of the study, statement of problem, objective of the study, research questions, significance of the study, scope and limitation, contribution of the research, definition of terms and organization of the remaining chapters.

1.2 Background of the Study

The capital market plays a key role in the financial system of every economy. It provides the medium through which long-term capital is mobilized for investments crucial to sustained corporate and economic growth. This view is supported by academic literature provided by researchers such as Schumpeter (1934), King and Levine (1993), Levine and Zervos (1996), Bencivenga *et al.* (1996), Mishra *et al.* (2010), Paramati and Gupta (2011), Osamwonyi *et al.* (2013), Adusei (2014), Jalloh (2015), Ofori- Abebrese (2016) and Faris (2017) who have argued that there is a positive relationship between stock market development and economic growth. However, the direction of causality of the relationship is a subject of debate among researchers (Luintel and Khan, 1999; Hondroyiannis *et al.,* 2005; Yartey, 2006; Paramati and Gupta, 2011; Chow and Fung 2013; Osamwonyi *et al.,* 2013; Adusei, 2014; Deyshappriyya, 2016) implying the two are positively inter-dependent and the level of development of one affects the other. The capital market therefore is an important source of the financing critical to the health of business and the economy.

Formally defined, the capital market refers to the buying and selling of capital investments, usually equity or debt instruments used by businesses in the production of goods or offering of services for their growth and development. Acquah-Sam and

Salami (2013) refer to the capital market as "the market in which corporate equity and long-term debt securities are issued and traded to raise capital for growth of businesses and economy".

The absence of formal capital market in Ghana therefore, meant businesses depended on internal capital, augmented by short term bank borrowings to serve the working capital needs of the enterprises. This was the situation after the owners have used their personal savings and borrowings from relatives as start-up capital to create the business. This system of financing inhibits growth of businesses as short – term borrowings granted by the banks cannot be used sustainably to finance long term expansion projects. Osei (1997) points out that the business sector in Ghana has depended on short-term financing such as bank overdraft to finance long-term projects which is unsustainable. Quartey *et al*. (2017), Dinh *et al.* (2010) and Ardic *et al.* (2012) attribute the situation to limited access to finance which poses a particularly strong barrier to business growth and expansion. This was the condition of most businesses in Ghana in the 1960's and 1970's which led to the participation of the state in the establishment of corporations in a bid to accelerate industrialization to foster economic growth and development.

The state's involvement in business did not pay off as most of the state-owned enterprises had failed leading to near collapse of the economy by 1983 (Boadi *et al.*, 2017), giving rise to the need for an alternative model that would be able to mobilize and allocate long-term private capital for Ghana's economic growth and development. To reverse the internal debt burden on the economy arising from deteriorating performance of state-owned enterprises, which also reduces the credit worthiness of the economy, the government sought to increase the role of the private sector to foster economic growth, following the belief of Mwaura (2007) that resources are likely to be managed more efficiently by the private sector.

This belief was operationalised with the liberalisation of the financial sector under government’s Financial Sector Adjustment Programme (FINSAP) which included the establishment of a capital market as part of the overall 1988 macroeconomic adjustment program, after the Ghanaian economy had performed woefully in the 1980’s (Sowa, 2003). The development of a well-functioning capital market and a stock exchange was also seen as an initiative that would facilitate the divestiture of about 300 state-owned enterprises (SOEs) in diverse business sectors of the economy (Osei, 1997). According to Hinson and Abor (2004) the aim of the adjustment programme was to create an enabling environment for SMEs to contribute to the growth of the economy.

The broad objectives for establishing the capital market were to maximise government and business financing opportunities, provide investment opportunities for prospective local and foreign investors, contribute to poverty reduction and increase employment opportunities and prepare the way for privatisation of SOEs (Acquah-Sam and Salami, 2013).

The government of the day therefore revisited the initiatives by past governments to establish a stock exchange that would provide the facilities and framework for a functioning capital market through which private capital would be mobilized. It is worth mentioning that the first recommendation to establish a stock exchange in Ghana was made in 1969, but was not implemented. In February 1989, the government of the day set up a 10 - member national committee chaired by a former governor of Bank of Ghana to consolidate all previous work done on the stock exchange project and draw up the modalities for actual establishment of the exchange. The work of the committee resulted in the establishment of the Ghana Stock Exchange in July 1989 as a company limited by guarantee. Even though the Stock Exchange Act, (Act 384) was passed in 1971 and Accra Stock Market limited incorporated in 1971, the market could not take off due to factors such as political and macroeconomic instability and lack of government support (Osei, 2005). Government attempted again and established the National Trust Holding Corporation (NTHC) in 1976 as a nucleus of a capital market to provide an Over- The-Counter (OTC) market for the trading of equity stocks and debentures. The establishment of NTHC was also meant to facilitate the implementation of the "Investment Policy Decree" (1975) of the government which required foreign companies operating in Ghana to sell not at least 40 percent of their equity holdings to indigenous Ghanaians (Osei, 2005). The OTC market was met with less enthusiasm as it served only the few foreign companies and excluded indigenous and small firms. The need for a functioning stock exchange was thus not satisfied until the Ghana stock Exchange was established in July 1989.

The Ghana Stock Exchange started trading in November 1990 with 11 companies listed by introduction and three (3) Licensed Dealing Members (Acquah-Sam and Salami, 2013). The number of listed companies increased to 37 after two decades in 2016. The Ghana Alternative Market (GAX) established in 2013 for SMEs also had 4 companies listed as at December 2016.

The low number of listings on the Ghana Stock Exchange has been contributed to by the government's divestiture programme which emphasised privatisation through strategic investor financing rather than through the stock exchange (Ziorklui, 2001). Out of about 300 state-owned enterprises as pointed out by Osei (1997), only seven (Ashanti Goldfields, Cocoa Processing Company, Produce Buying Company, Ghana

Commercial Bank, Ghana Oil Company, Social Security Bank and Agricultural Development Bank) had been divested through the stock exchange by the end of 2016.

There are also a number of medium and large scale companies outside the formal capital market which depend mostly on the banks for their financing in spite of the identification of access to credit and cost of credit as the most critical factors constraining the growth of businesses in Ghana (AGI Business Barometer Report, 2009-2013). The situation mirrors that of Mozambique where 55.9 percent of respondents in a study on SMEs, indicated that access to finance was the biggest constraint to doing business (Rand and Schou, 2012).

As pointed out by Yartey and Adjasi (2007), stock markets contribute greatly to financing investments of corporate entities, and hence the growth of listed companies. Whilst at a point in time, decreasing reliance on bank credit became pronounced in the United States of America (USA) as companies turned to the securities markets to fulfil their short term and long term financing needs (Saidenberg and Strahan, 1999), the situation in Ghana appears to be the reverse. The Ghana situation appears to support the view held by Jacklin and Bhattacharya (1998) and Allen and Gale (1999) that the banking industry has developed at the expense of the capital market. This system denies business enterprises the appropriate mix of short term and long term financing (Song and Thakor, 2010) needed for growth and economic development.

1.3 Statement of Problem

The study focuses on understanding the causes of the low utilization of the capital market by companies in Ghana to raise capital for their businesses as they do with bank finance. Private enterprises play a vital role in the development of economies. As production units, they require capital to purchase factors of production to carry out their operations.

In Ghana there are only a few companies that use the capital market to raise financing for their operations. For instance, out of the 100 elite companies that made it to the list of the “Ghana Club 100 Companies” (Yearly official list of top 100 companies in Ghana compiled by Ghana Investment Promotion Centre) between 2000 and 2016 only 18 percent on the average, are listed on the stock exchange (see Table H2 in Appendix H). There are also dozens of other private companies under the umbrella of Association of Ghana Industries (AGI) which do not source funds on the capital market. In an economy where venture capital and private equity markets are undeveloped, the alternative left for businesses is the use of internal capital and bank borrowing to finance their operations. This practice does not promote growth and survival as pointed out by Clementi and Hopenhayn (2006) and Haltiwanger *et al.* (2013) that smaller firms that raise funds from the capital market are more likely to grow faster than their larger counterparts, and stressed that this applies across different firm age groups.

Singh (1997) reports that stock markets contribute significantly to both domestic and external liberalisation of economies of successful developing countries. This is supported by Jalloh (2015) who points out that stock markets have the potential to expedite economic growth in Africa. It is also asserted that stock markets provide a vital source of capital in countries where there is financial repression resulting from high interest rates, the evidence suggesting that capital market could offset such repressions.

In spite of the increasing recognition of the contribution of the SME sector to developing economies and the proportion of total bank loans disbursed to the private sector (excluding households and public enterprises loans) of between 75.7 percent and 78.3 percent from 2012 to 2016 (Bank of Ghana [BOG], 2016a) access to capital has been a major impediment to their growth (Cook and Nixon, 2000; Beck and Cull, 2014;

Rand and Schou, 2012). It is reported that SMEs in Ghana employs about 61 percent of domestic labour force, account fo 70 percent to GDP and contribute about 92 percent of businesses in Ghana (Abor and Quartey, 2010). This is supported by Amuakwa-Mensah and Marbuah (2015) who report that in spite of the critical role the banking sector plays in economic growth, low financial intermediation limits availability of loanable funds to businesses which results in high bank lending rates in Sub-Saharan Africa, compared to other parts of the world. A growing SME sector has the potential to mitigate the rate of unemployment faced by developing economies. As pointed out by Mullineux (1997), the SME sector is the largest employer of labour force rather than the multinational corporations.

The lack of access to capital compels SMEs in Ghana to borrow from the banks at sector average interest rates which range between 32.5 percent and 33.5 percent per annum (Bank of Ghana [BOG], 2016b). This is informed by the risk-free Government Treasury bill rates of 22.77 percent to 24.65 percent per annum (Bank of Ghana [BOG], 2016c). The non – bank financial institutions such as savings and loans companies and micro-finance institutions (MFIs) charge much higher rates ranging between 5 percent and 7 percent per month (Boateng, 2014). According to him despite the high interest rates charged by MFIs, they also charge a processing fee of least 3 percent and apply short repayment periods which SMEs complain about. He further states that SMEs source 85 percent of their working capital from MFIs. The dependence on bank finance persists in spite of the high cost and limited access to credit by industry, which are cited as the two most critical factors that limit the growth of businesses and threaten their survival. The reality of this predominant source of financing for companies in Ghana is that businesses become financially repressed, cost ineffective and unable to compete in the market (Allerano *et al*., 2012; Midrigan and Xu, 2014). According to Osei (1997) firms in the business sector even use short term bank loans to finance long term projects. This is risky based on the maturity matching concept as such firms need to secure appropriate mix of short term and long term capital to fund their operations. The high cost of short term finance restricts growth and limits expansion of the productive sector of the economy, reduces employment opportunities and tax revenue for the government and inhibits poverty reduction through income transfers from employment and owners (Prasad *et al.*, 2001).

The dwindling tax revenue from the private sector necessitates the short-term high government borrowing from the banks to finance budget deficits which increases interest rates and crowds out the private sector. It is therefore in the interest of the government to develop the capital market to provide long-term financing, which is relatively cost effective, to enable the private sector play its role as the engine of growth of the economy. The low utilization of the capital market by capital-generating companies has implication for the stock exchange either through listing after initial public offerings or listing by introduction for liquidity and subsequent capital raising. The growth in the number of companies listed on the Ghana Stock Exchange averaged one (1) listing per year from 1991 to 2016 (i.e. 11 companies in 1990 to 37 in 2016).

The slow growth in the number of companies listed on the Ghana Stock Exchange has led to the perception of the marginal contribution of the Ghana capital market to the economy. Azarmi *et al.* (2011) have argued that the stock market as an initial source of equity finance is necessary and has a strong positive supportive effect on growth of SMEs. It is therefore evident that the choice of the source of capital has an effect on performance and growth of the private sector.

The problem the study seeks to understand therefore, is the motivation for the seeming preference for bank finance by companies in Ghana as opposed to capital market finance, which affects their growth and prevents the SMEs particularly, from achieving their economic potential. The research will explore the constraints which have led to the low utilization of the capital market alternative, the results providing relief to the SMEs from the constrained access that bank finance presents. This position is confirmed by Didier *et al.* (2015) who assert that empirical evidence suggests a strong positive association between capital market financing and firm growth, particularly small firms, across many countries.

The study also provides the opportunity to fill an essential research gap on factors that influence capital market finance by SMEs in Ghana, which to the best of the author's knowledge has not been adequately explored in existing literature, a problem which limits our understanding of the situation and available solutions.

1.4 Research Objectives

The objective of the study is to provide an understanding of the research problem by finding answers to the stated research questions. Specifically, the study sought to;

1. Identify the factors that influence the decision of companies to issue shares or bonds on the capital market to raise long-term funds.
2. Identify specifically the factors that have inhibited the growth in the number of the capital-generating companies listed on the stock market.
3. Examine whether the companies are being overly dependent on bank finance as they rely predominantly on bank finance amidst complaints about limited access and haggling over high cost of borrowing.

The study will therefore seek to identify the factors that are preventing industry from utilizing the capital market for raising long-term financing for sustainable operation of their businesses.

1.5 Research Questions

To realise the objectives of the research, the study will investigate the under-stated research questions to identify the factors that influence capital market financing. Specifically the study seeks to provide answers to the following questions:

1. What factors influence the companies' decision to issue of shares or bonds on the capital market to raise long-term capital?
2. What factors inhibit the growth in the number of the companies listed on the stock market?
3. Are the companies being overly dependent on bank finance and what factors are accountable if indeed they are?

1.6 Significance of the Study

The results of the research will identify factors that account for the low utilization of capital market by companies in Ghana. The study seeks to highlight this phenomenon and recommend to industry and policy makers, measures to deal with the impediments identified and pave the way for companies to use the capital market to raise equity or debt capital for their businesses. This will encourage public participation in the capital market in particular and deepen the financial system in general which will promote economic growth in the long run (Caporale *et al.*, 2004; Ofori-Abebrese, 2016; Faris, 2017).

The evidence that the research will gather will lower the apprehension of financial sector policy makers as discovered by Rioja and Valev (2014) surprisingly that, in spite of the investment low-income countries make in stock markets, they do not contribute much to capital growth because companies rarely use the capital market to raise funds for their businesses.

The research will also contribute knowledge to the financing decisions of private companies as they will be provided with a vital source of alternative financing that could relax the financial repression that they may face as a result of high bank interest rates and enable them grow (Allerano *et al.*, 2012; Midrigan and Xu, 2014). The capital market will therefore complement bank finance (Song and Thakor, 2010) and provide liquidity which is important for promoting capital growth, productivity improvement and economic growth, (Osamwonyi *et al.*, 2013; Adusei, 2014). When the capital market functions well, it accelerates economic growth (Ofori- Abebrese, 2016; Faris, 2017) by providing a boost to domestic savings and increased investment (Singh, 1997) which expands opportunities for investment funds and reduces the pressure on few listed securities which promote stable stock market. The study provides evidence that will determine whether the SMEs are overly dependent on bank finance or there are real factors that hinder their access and use of the capital market to raise funds for business operations.

1.7 Scope and Limitation

The research aims to investigate why medium to large scale companies are not using the capital market to raise long term financing for their businesses. The secondary capital market will not be investigated and evaluated to the extent that it does not affect the offering of securities by the companies to the public. The activities of the banks and their loan financing models will also not be investigated. The financing of state owned enterprises which have not raised capital on the capital market will also not be investigated. The study does not include financial data such as sales, net profit, assets and liabilities which could have been used to measure directly growth, profitability and leverage of the respondent firms from their financial statements. This is due to the lack of empirical data on private companies due to the fact that they are not required to