Asian Business Research Journal
Vol. 9, 91-96, 2024
ISSN: 2576-6759
DOI: 10.55220/25766759.206

Capital Sources for Small and Medium Enterprises in Somalia and the Effect on Their Performance: A Case Study of Mogadishu Based Businesses

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Abstract
The study intended to determine the source of capital for small and medium enterprises in Somalia, and how it affects the performance of the SMEs. The study used venture capital, saved Capital, family and friend capital, angle investor capital, interest-charging capital as the independent variable, while performance of SMEs was the dependent variable. The sample of the study was drawn from the population of small businesses in Mogadishu, Somalia. Cochran's formula was used to calculate the sample size. The standard deviation of the study was 0.5 with confidence level of 95%. The Z value of 5% confidence level is 1.96 therefore, (1.96)2 (0.5) (0.5) / (0.05)2 = 385. Pearson's Product Moment (PPM) was used to measure the strength and the direction of the relationships between each of the dimensions of factors affecting the performance of small businesses. Linear regression was also used to determine the relationship between the independent and dependent variables. The result of the study indicated strong significant positive relationship between saved capital and business performance, 0.421 with p-value of less than 0.05. Angle investors have significant relationship with business performance, 0.385 with p-value of less than 0.05. There is no significant correlation between venture capital, interest charging capital, and the capital from family and friends against business performance.

Keywords: Empowerment, Initiative, Interrogating, Nafa Scheme, Re-defining, The Gambia, Theory, Women, Youth.
JEL Classification:

1. Introduction

The term ' Financial capital' is an economic resources measured in terms of currency used by business entrepreneurs to buy the materials that they need to make a product or provide services in the sector of the economy upon which their operations are based. On the other hand, Capital in businesses is the financial resources that businesses can utilize to fund their operations like machinery, cash, equipment, and all the other resources required by the business to function, produce product, distribute, and sell to the different customers. Capital is vital resources of financing across all types of businesses in order to operate and produce goods or services. Large businesses can issue stock or bonds to investors in order raise capital and buy equipment, trademarks, patents, brand names, buildings, and land to generate revenue and create wealth for their investors. Small businesses, on the other hand, depend on saved fund, angel Investors, venture Capital, small Business Loans, government Grants, crowd-funding, microloans, invoice Factoring, credit Cards, and free loans from family and friends.

Source of capital is very crucial for businesses because it determines the cost and other factors that contribute the profitability of the business. The ease of obtaining capital for investment does not only contribute the profitability of businesses, but rather improves the economic growth of that country generally. The cost of capital is equally important for the survival and profitability of any business. A company's investment assessments for new projects should always consider that it generates a return that exceeds the firm's cost of capital used to finance the project. Otherwise, the project will not generate a return for investors and may consume the assets of the production, causing the collapse of the business.

Somalia is a country in the horn of Africa ravaged by civil war in the last 35 years, but their economy is thriving and transcends many peaceful countries in the world. Banks are also operational, lend out billions of non-cash dollars to businesses as well as individuals, yet the majority of entrepreneurs in this nation does not know or use interest charged capital. The interesting question is what is the leading source of capital for small and medium enterprises in Mogadishu without borrowing an interest-charging fund. The study will answer this question by studying the source of capital for small and medium enterprises in Mogadishu.

2. Theoretical Review

A theoretical review refers to the broad analysis and synthesis of the literature in order to identify research gaps, adopt new approach of testing existing theories, build new ones, and postulate a research agenda. A theoretical framework must establish an understanding of the theories and concepts that is germane and applicable to the topic of the research at hand.

2.1. Pecking-Order Theory of Capital Structure

Pecking-Order Theory of Capital Structure theory proposed by Myers and Mailuf (1984) is centered on the proposition that financing follows a hierarchy and that, firms prefer internal over external financing and debt over equity (Frank, Goyal, & Shen, 2020). The fundamental factor is the asymmetry of information: The more asymmetry of information, the higher the costs of the sources of financing. Kim, Lee, Park, and Waggle (2021) studied firms in Europe and US to understand factors that determine their capital structure. Financial flexibility was the factor that most significantly drove capital structure, suggesting a "pecking order" model application. Standard issues that are pragmatic in the application of Pecking order theory are: (a) Debt is encouraged when firms experience loss or insufficient profits (b) Debt is encouraged when equity is undervalued. Current theory that contends that firm's trade off of the costs and benefits of leverage is associated with tax effects, bankruptcy, and agency costs, in order to generate a target capital structure for the firm. There is a vivid justification why the theory of pecking-order theory is relevant to this study as it provides crucial information about sourcing cheapest fund for the business.

3. Empirical Review

Literature review is a compilation, classification, and evaluation of what other researchers and scholars have composed on a particular topic. A literature review usually forms part of a research thesis but it can also stand alone as a self-contained review of writings on a subject. In this section, we will review the common sources of capital for small and medium enterprises. Shimasaki (2020) researched Sources of Capital and Investor Motivations in USA. The researcher found that capital sources has investing limitations, certain expectations for returns, and deferring motivations that drive their funding decisions.

Ou, and Haynes (2004) examined the importance and uses of equity capital by small firms in USA. The study utilized the data collected in 1993-1998 about small business finance surveys. The study established the importance of public issue market (IPOs) and the role of venture capital in promoting growth of small businesses. The study also stated that very small number of businesses used external equity, while majority used internal equity. Internal equity is the major financing sources for most of small firms. Majority of firms relied on internal sources like owner's capital, owners' loans, and the retained earnings. Few businesses relied on external borrowing from financial institutions. The study concluded that this is the "pecking order" of borrowing from internal sources to financial institutions for small businesses.

Brown, Rocha, and Cowling (2020) researched the sources of finance for businesses during pandemic covid-19 crises in United Kingdom. The study found that small and large businesses preferred internal capital and venture capital due to low cost of these resources as well as low volume of business at that period of time. The researcher indicated that depending interest earing capital at times of crises is very dangerous, as businesses may not generate enough profit to pay these costly finances. In case of default, the lenders will go after the assets of the businesses causing its collapse. Exposito, and Sanchis-Llopis (2018) researched on Innovation and business performance for Spanish SMEs. The study used 400 small businesses in Madrid and found that interest charging financial institutions topped the list of lenders followed by saved and venture capitals. The researchers reasoned this outcome at the abundant availability of this kind of finances, though it is very expensive.

Ahlstrom, Bruton, and Yeh (2007) researched the source of capital for Chinese firms and found that venture capital tops the list followed by bank loans, private firms, and bond markets. The study stated that venture capital is preferred due to ease of availability, low cost, and the fact that these contributors of the capital are also partial owners of the business and will anticipate profits generated by the business. Rita, and Huruta (2020) researched financing access and SME performance in Indonesia. The research assessed the influence between access to cheap financing and performance through the mediation of entrepreneurial-oriented finances in Batik SMEs, Indonesia. The structural equation modeling (SEM) was used to analysis the study, and the result of 265 SMEs revealed that entrepreneurial-oriented finance has an influence between cheap financing access and SME performance. A positive direct effect is found in the relationship between financing access and entrepreneurial-oriented finance as well as entrepreneurial-oriented finance and SME performance. In order to improve business performance, it is not enough to only rely on financing access. Entrepreneurs should also improve their ability to obtain and utilize funds to develop their businesses.

Gbandi, and Amissah (2014) researched financing options for small and medium enterprises in Nigeria. The study examined the financing options available for SMEs and used; debt financing, equity financing through venture capitals, and angle financing. The study found that venture capital and angle financing were preferred by small business in Nigeria due to flexibility and lower cost than debt capital from financial institutions. The study concluded that funding SMEs is very critical for the growth and development of the economy. Khalid, and Muturi (2021) investigated 'Effect of Financial Management Practices on Financial Performance of Manufacturing Firms in Bosaso, Somalia.' The target population of the study was 64 registered Manufacturing firms operating in Bosaso. The study used structured questionnaire to collect the data and utilized SPSS to analyze it. The study showed that the management of working capital did not influence the financial output of manufacturing companies. Financing decisions have also been found to have significant relationship with capital-output of manufacturing companies. The study recommended that business owners should collect enough information about the cost and other requirements before deciding the sources of finances.

3.1. Hypotheses of the Study

A hypothesis in a scientific context is testable statement about the relationship between two or more variables or a proposed explanation for some observed phenomenon (Chukhrova, & Johannssen, 2019). Another definition by Jun, Birchfield, De Moura, Heer, and Just (2019) also described hypothesis as and educated guess about a possible solution to a prediction or mystery that can be tested to prove or disprove.

H_1: I got my finance through venture capital

Venture capital is a finance usually provided by investors to businesses to partake the profit generated by the business. Sometimes venture capital can be provided in the form of technical or managerial expertise. The investors are part of the owners and there is no obligation to repay the investors if the business does not generate profit. The shortcoming of this finance is that major business decisions require the consent of the fund providers and this may delay important decisions for the business. Getting venture capital is lengthy and complicated process.

H_2: I Got My Finances Through Saved Capital

Saved capital is the resources saved before or after starting a business in order to operate the business in terms of buying the machinery and pay expenses to generate profits (Fidow, 2021). Internal sources of capital is the cheapest of all finances since it do not involve interest or transaction costs, but the problem is that it is not always sufficient. There is also evidence from a study by Northwestern Mutual Insurance Company that saving is related to increased happiness of business owners. On a related note, the Consumer Federation of America found a strong relationship between spending and saving.

H_3: I got my finances from family and friends

Family and friends finances are the funds without charges received from relatives and friends for the purpose of investment. Loans from family and friends are very convenient for a capital of starting a business, since interest and other charges are not involved. Family members some times contribute capital for someone to start business, but the shortcoming is that it is not always adequate and the contributors can demand at any time. Lee, and Persson (2012) indicated that the family and friend capital is altruistic, while non-family finances are source of risk for the business. The study added that the drawback of family finances is that it leaves risk in the entrepreneur's social sphere and exposes his social relations to negative feedback effects, both of which deter risk-taking.

H_4: I got my finances from angle investors.

Angel investors are also called informal investors, private investors, or business angels. These are affluent entities that inject capital for both startups and operating businesses. The return-rate for such investors depends on the profits generated by the business as calculated by the owner. Unlike debt capital, the return rate of the angle investor is not fixed and is not paid incase of the collapse of the business. Angle investors some times get more than the interest rate in the market, but it is very risky because investors are not involved in business decisions and has to accept whatever the management of the business declares. Most Muslim businessmen are shy of interest and depend angle investor capital.

H_5: I got my finance from Interest charging capital

Financial institutions are the entire establishments that facilitate monetary transactions, such as loans, deposits, and mortgages. Both deposit and non-deposit taking financial institutions charge interest at different rates depending the riskiness of the borrower. In a capitalistic economic system, financial institutions are vital for regulating the economy, ensuring fair financial practices, and facilitating prosperity. Main kinds of financial institutions are central banks, commercial banks, internet banks, credit unions, savings and loan associations, investment banks, brokerage firms, insurance companies, and mortgage companies.

H_6: My average annual profit is ……………..….%

Profit is a financial gain, especially the difference between the amount earned and the amount spent in buying, operating, or producing something. It is also described as the financial benefit realized when revenue generated from a business activity exceeds the expenses, costs, and taxes involved in sustaining the activity in question. The aim of any business entity is to exceed break-even point (BEP) and generate profit for the organization.

3.2. Methodology

Research methodology is the specific procedures and techniques that are used to identify, process, and analyze information about a topic (Pandey, & Pandey, 2021). This study used descriptive correlation research design to investigate how source of capital affects on the performance of small and medium enterprises in Somalia. A descriptive correlation research design was pragmatic for this research because it tested the effect and causes of independent variables on the dependent variable. The method adopted to collect the sample obviously has large implications on the results and the conclusion of the study. The sample of this study is drawn from the population of small businesses in Mogadishu. Cochran's formula was used to calculate the sample size. The standard deviation of the study was 0.5 with confidence level of 95%. The Z value of 5% confidence level is 1.96 therefore, $(1.96)^2$ (0.5) (0.5) / $(0.05)^2$ = 385. Pearson's Product Moment (PPM) was used to measure the strength and the direction of the relationships between each of the dimensions of factors affecting the performance of small businesses. Linear regression was also used to determine the relationship between the independent and dependent variables. It was selected because of its efficiency and ability to obtain good results using relatively small data sets. Each hypothesis was tested independently resulting in the acceptance or rejection of the null hypothesis.

4. Results

Female respondents were 61.3% and 38.7 were males. Twenty seven percent of the respondents had no formal education but have the ability to read and understand the questions in Somali language, 28% have completed secondary school, 4% were bachelor's degree holders, and only 2% have master's degree. In terms of age, 49% were in the age bracket of 30-39. The average profit for the SMEs was 14.6%

Table 1. General information.

Gender	**Male** **Female**	**38.7%** **61.3%**				
Position of the respondents	Owner employed	69.4% 30.6%				
Age of the respondents	Below 20=6%	20-29=17%	30-39=49%	40-49=21%	50-59=5%	Over 60 =2%
Level of education	Without formal education 27%	Primary 39%	Secondary 28%	Bachelors degree 4%	Master's degree 2%	
Annual average profit	14.6%					

4.1. Correlations

Correlation coefficients are used to measure the strength and direction of relationship between two variables. There are several types of correlation coefficient, but this study used Pearson's correlation.

Table 2. Pearson's correlation between independent and dependent variables.

Constructs		Business performance
I got my finance through venture capital	Pearson Correlation Sig. (2-tailed) N	0.190 0.134 373
I Got My finances through saved capital	Pearson Correlation Sig. (2-tailed) N	0.421 0.039 372
I got my finances from family and friends	Pearson Correlation Sig. (2-tailed) N	0.087 0.155 376
I got my finances from angle investors	Pearson Correlation Sig. (2-tailed) N	0.385 0.045 359
I got my finance from interest charging capital	Pearson Correlation Sig. (2-tailed) N	0.087 0.650 361

There is strong significant positive relationship between saved capital and business performance, 0.421 with p-value of less than 0.05. Angle investors have significant relationship with business performance, 0.385 with p-value of less than 0.05. There is no significant correlation between venture capital, interest charging capital, and the capital from family and friends against business performance.

4.2. Regression Analysis and Hypotheses Testing

The study sought to establish the effect of the source of capital on the performance of small businesses in Mogadishu, Somalia. The findings are hereby presented.

Table 3. Regression results.

Model	R	R^2	Adjusted R^2	Std. error of the estimate	Durbin Watson
1	0.386	0.149	0.127	5.071	1.97
2	0.573	0.328	0.213	7.321	2.01
3	0.303	0.092	0.165	8.140	1.87
4	0.586	0.343	0.301	7.831	2.00
5	0.179	0.032	0.106	1.310	1.85

The study findings revealed that saved capital explained 32.8% of performance (R^2=0.328) with p value of less than 0.05. Angle investor variable explained 30% of the SME performance in Somalia.

4.3. Coefficients

Multiple linear regression was conducted to determine the magnitude and direction of the relationship between the independent and the dependent variables. The result is listed in the table below.

Table 4. Coefficient.

Model		Unstandardized coefficients	Standardized coefficients	Beta	T	Sig.
		B	Std. error			
1	Constant Venture capital	3.07 2.81	0.135 1.25	 0.083	2.43 2.24	0.08 0.07
2	Constant Saved Capital	9.75 5.78	0.941 0.35	 0.192	5.13 3.87	0.021 0.000
3	Constant Family and friends	2.98 4.19	0.238 0.234	 0.093	3.42 2.89	0.175 0.242
4	Constant Angle investors	8.95 6.15	0.318 0.321	 0.23	2.65 3.04	0.032 0.041
5	Constant Interest charging capital	3.87 5.19	0.189 0.231	 0.13	4.12 3.15	0.319 0.47

The multiple linear regression results of the study showed that, saved capital variable was significant in predicting small business performance, β =0.083, t(372)=2.24, p< 0.05. Angle investor variable was also significant in predicting business performance, β = 0.230, t (359) = 0.304, p< 05.

5. Discussion

In respect to the first research question of venture capital on the performance of small businesses in Mogadishu, Somalia, the study found that venture capital was not significantly correlated with the performance of SMEs in Mogadishu, r(373) = 0.190, p >0.05. The regression indicated that venture capital explained 15% of the variance, (R^2=0.149). The reason is that venture capital is not widespread among small businesses because venture capital requires extensive process and paperwork that small business cannot afford. Venture capital did not significantly affect the performance of SME in Mogadishu, Somalia.

In respect to the second research question on the effect of saved capital on the performance of SMEs in Somalia, the study found that the variable was significantly correlated with the performance of SMEs in Somalia, r (372) =0.421, p <0.05. The results of the regression indicated that saved capital explained 32.8% of the variance, (R^2=0.328). Saved capital significantly affected the performance of small businesses in Mogadishu, Somalia.

In respect to the third research question on the capital from family and friends, the study found that the variables was not significantly correlated with the performance of SMEs in Mogadishu, r(376) =0.087, p >0.05. The results of the regression indicated that capital from family and friends explained 9.2% of the variance,

(R^2=0.092). Capital from family and friend did not affect significantly the performance of SMEs in Mogadishu, Somalia. Although capital from family and friends exist, it is negligible and very difficult to start a business without using additional capital.

In respect to the fourth research question on angle investors, the study found that the variable was significantly correlated with the performance of SMEs in Mogadishu, r(359) =0.385, p <0.05. The results of the regression indicated that capital from angle investors explained 34.3% of the variance, (R^2=0.343). Angle investor capital is enormous in Somalia because people trust each other impressively, though very risky for both sides. The other reason why this investment is popular among Somalis is that many people do not have business idea or cannot start business of their own and prefer angle investment.

In respect to the final research question, Interest charging capital was not significantly correlated with the performance of SMEs in Mogadishu, Somalia, r(361)= 0.087, p > 0.05.The results of the regression indicated that capital from interest charging explained 3.2% of the variance, (R^2=0.032). As majority Muslim community that avoids interest (Riba), very few unreligious Muslims dare to borrow from interest charging banks or other entities. Another reason why interest-charging capital is not significant in this research is absence of commercial banks and other loan paying entities that charge interest. The few who got this kind of capital got from neighboring countries like Kenya and Ethiopia.

5.1. Recommendation

Small businesses are the economic backbone of this war-ravaged country called Somalia, and entirely anything that affects positively should be encouraged, while those that affect negatively should be avoided by all means. The city of Mogadishu is recovering from civil war and limited financial institutions are available. The few lenders who are accessible do not offer cash, since interest on loans are not allowed by Sharia law. Getting customers for interest-charging finances in a 100% Muslim community is difficult if not impossible. It is also a taboo to apply such capital for business and many to be customers shy away this capital and that is the reason that this source of capital is not widespread in this city.

Saved capital is the main finances for SMEs in Mogadishu, but the problem is that it is not sufficient causing the businesses to operate under capacity. The main problem is the fact that majority of businesses shy away to borrow interest-charging loans. The government or the non-governmental organizations (NGOs) should provide free loan or a loan that the provider gets a share of the profit if there is any. "Angle investor capital" is widespread in small businesses in Mogadishu. This capital is involved a lot of trust and many investors avoid this kind of investment. Those who are ready to invest always apply "don't put your eggs in one basket" approach and invest small ratio of their investment, causing insufficient capital. The government should formulate rules and regulations to increase the trust of angle investors and tab the capitals from this source.

Capital from family and friends was not significantly correlated with the performance of small businesses, yet some of them utilized this capital. This capital is the cheapest and less risky than all the other sources of capital, but it is very difficult to get sufficient amount for investment in this sources. The business people should be encouraged to seek this source of capital before scheduling other sources of capital. Interest bearing capital is abundantly available both locally and the neighboring countries, but the problem is that 99% of the community are religious Muslims and interest is prohibited in Islam. There are Sharia law compliant banks in Mogadishu but they don't give out cash, but only other assets. There is one product under which cash loan is allowed, where the borrower gets cash, invests, and shares the profits or loss with the lender. This is too risky and depends a lot of trust on the side of the borrower, and the banks are always disinclined to apply this product. The government should arrange insurance for the banks to mitigate their loss incase of default or incase borrowers incur losses instead of profits. This will help those with genuine business ideas to get capital, while shielding the banks from cheats.

5.2. Limitations of the Study

Somalia is large country, 3 times the size of United Kingdom (UK), and the data was from the capital city of Mogadishu alone. The business people in this city are also sensitive due to long time civil war and clandestineness. This caused some respondents refusing the questionnaire or not answering some of the questions. Some of the questionnaire distributors avoided certain areas because their rival tribesmen dominated that areas and this created unstandardized distribution of the questionnaires within the city. Finally, illiteracy, lack of understanding, and refusing to take the questionnaire was high in the whole project.

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