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*A proposed Model for small and medium-sized
enterprises Capital Structure Decisions in
developing Countries Evidence from Egypt*

*A Dissertation Submitted in Partial Fulfillment of the
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DEDICATION

This dissertation is done at the first place for the sake of Allah's satisfaction and his Messenger Muhammed (*PBUH*).

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Thank you for your guidance throughout my academic career, your motivation and support and for your prayers for me all through my life.

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Abstract

The Purpose of this Thesis's to contribute to the academic research of determining the factors that affect the capital structure decisions of the Egyptian small and medium enterprises. Although the traditional theories of capital structure are useful in explaining the capital structure decisions of the companies, but it is showed that they mainly explained these decisions of large enterprises in developed economies, so the researcher tries to specify the main determinants of capital structure of SMEs in the Egyptian context. The study has been performed by investigating the capital structure of a sample of 27 SMEs that are listed in the Nile X index, the only index for the Egyptian SMEs. The data was collected over the period 2010 – 2016. The results showed evidence that some of managerial attitudes and characteristics are considered from the drivers of the capital structure decisions of the Egyptian SMEs. Aversion to external control has a negative impact on the willingness to seek external financing while managerial growth intentions and strength of the managerial relationships with others positively affect the leverage. Also, the results showed a limited evidence on the effect of corporate governance mechanisms on the capital structure, CEO duality positively affect the leverage. Firm specific factors and country specific factors are considered from the determinants of the capital structure decisions of the Egyptian SMEs.

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Chapter One

Introduction

Chapter one

Introduction

1.1 Introduction:

Small and medium enterprises or SMEs are the most dynamic, innovative and risk-taking sector in both developing and developed countries. They are getting recognized due to their contribution to the national economies. Their significant role has evolved over time and they become the drivers of economic activity and political stability in both mature and emerging economies.

SMEs are considered a backbone of the developing countries like Egypt due to both economic and social factors. SMEs enhance the economic growth, which helps in mobilization and utilization of resources and increases the national income of a country. However, social factors are more important because SMEs help in employment generation; they are the major job providers to a massive section of the society in labor intensive and capital scarce countries.

There are many definitions for SMEs, whether in Egypt or globally. The SME definition in Egypt depends on the correlation of two criteria which are the number of employees and the size of the invested capital, based on these criteria the law of investment number 230 for the year 1989 was formulated and approved by the parliament.

The Central Bank recently defines SMEs as that Small companies are the companies whose sales range between EGP 1 million to 50 million and their capital ranges between EGP 50,000 and EGP 5million for industrial facilities and less than EGP 1m for non-industrial ones. Employment in small companies is less than 200 individuals. While the medium companies are the companies whose sales range between EGP 50 million and EGP 200 million and which have fewer than 200 employees. Their capital ranges between EGP 5 million and EGP 15 million for industrial facilities and EGP 3 million to EGP 5 million for non-industrial ones.

Given the importance of Egyptian's SMEs, it is crucial to understand these firms' financing decisions. This justifies the motive of studying the capital structure of SMEs, and the factors that affect their capital structure decisions.

1.2) Literature Review:

Capital Structure and its compositions are one of the most prominent topics in the corporate finance. Since Modigliani and Miller (1958) and (1963) stated their famous irrelevance proposition and established the first theoretical framework attempting to explain firm capital structure choice, research on Capital structure theory has been of great interest to many researchers and scholars around the world. The main proposition of Modigliani and Miller theorem (1958), under certain assumptions which are violated in the real world, is that the firm market value is independent of its capital structure composition. Then in (1963) they presented a tax correction to the MM theorem, analyzing the tax

advantage of debt to the firm market value, but they explained that it does not necessarily mean that corporations should at all times seek to use the maximum possible amount of debt in their capital structure. Although debt is tax-advantaged in comparison to equity, it increases the firm's liquidity risk and the financial distress (Baxter, 1967) when the firm becomes unable to pay its bondholders what was promised to them.

Then in 1973, Kraus and Lichtenberger formally introduced corporate taxes and bankruptcy penalties into a single-period valuation model. This study is known as trade off theory (static trade off theory: as it assumes that the firm is fixed in terms of its assets and operations and it only considers possible changes in the debt-equity ratio in a single period of time). They stated that that firms borrow up to the point where the tax benefit from an extra dollar in debt is exactly equal to the cost that comes from the increased probability of financial distress. The trade-off theory claimed that every firm has a target optimal capital structure that balance the tax benefits and the bankruptcy costs to maximize the firm's value.

Kane et al. (1984) and Brennan & Schwartz (1984) introduced the first dynamic models to consider the tax savings versus bankruptcy cost trade-off, the main difference between the static and dynamic trade-off models is that dynamic tradeoff models emphasize the importance of time in capital structure decisions.

Jensen and Meckling (1976) identified the existence of the agency problem. They proposed that there are two kinds of agency costs - agency costs of equity and debt. The problems that arise between the owners and the agents when the desires or goals of the owners and agents are in

conflict lead to agency costs of equity. While the conflicts between shareholders and debt-holders lead to agency costs of debt. Accordingly, to the agency theory, the optimal financial structure of the capital results from a compromise between various funding options (equity and debt) that allow the reconciliation of conflicts of interests between the capital suppliers (shareholders and creditors) and managers.

According to Signaling theory, Ross (1977) showed how debt could be used as a costly signal to separate the good from the bad firms. The firms are able to signal its quality by using capital structure. Signal is a financing action by management that it is believed to reflect its view of the firm's stock value; generally debt financing is viewed as a positive signal that management believes the stock is "undervalued". While the stock issuing or equity financing is viewed as a negative signal that management believes the stock "is overvalued".

And because the managers, shareholders and bondholders don't have access to the equal information in the real world, and can't benefit from a fair share price which represents the firm's true value, the assumptions of MM theorem and of the trade-off theory are not met. Managers and external investors operate in a situation of information asymmetry.

An alternative approach to capital structure theory was then introduced by Myers and Majluf (1984) who followed the work of Donaldson (1961) which was the pecking order theory. This theory considered the role of information asymmetries (with regard to presently held assets and the investment opportunities) between firms'