

Does Global Financial Crisis Affects Profitability of Entrepreneurial Sme's In Catching–Up Economy? (Nigerian Case)

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Abstract:

The paper investigated the empirical relationship between financial crisis (Economic meltdown) and profitability of entrepreneurial SME's in Nigeria by employing a survey method to carefully select (144) domestic entrepreneurial SME's from three industrial locations in manufacturing, retail trading and services as our sample model. Using fixed–effect regression model,. Our result demonstrated that during the economic meltdown accessing loans was the only option available for entrepreneurial SME's to service the scourge. There was a decline in income. Conclusion was drawn that global financial crisis constitute series threat to SME's in Nigeria

Keywords: Global crisis, economic meltdown, entrepreneurial, profitability.

INTRODUCTION

1.1 BACKGROUND OF THE STUDY

The genesis of global financial crisis also know as economic meltdown is traceable to United State of America and the United kingdom when the global markets come to abrupt static mood in July 2007(Avgouleas,2008). What began as a bursting of the U.S. housing market bubble transcend into a global economic crisis, leading to the worst global recession recorded aftermath the “Great Depression” that occur in 1930. The current global financial crisis is unprecedented in history of the modern world and mankind. It is having a severe effect on the financial position of millions of people and catastrophic impact on domestic entrepreneurial in the entire business world. The current crisis is rooted to the mortgage loan crisis, which became pronounced in the United State in the early 2004 and mod 2007 when it went hay – wire during early 2007. During early 2004 and before the hydra-headed monster called global financial crisis, the mortgage industries in the United State enjoyed an unprecedented boom whereby mortgage loan brokers dictate the pace by providing largesse to prospective buyers within adequate income or poor credit history into taking mortgage loans with little or no down payment. These loan called “home for all” programme which involves these subprime loans that were later re-packaged and resold to banks and other financial institutions which then created Collateral Debt Obligations (CDO) and sold these financial instrument to investors who unknowingly relied on the strength of the sellers rather than the risk rating of the underlying financial issues. It was at this instance in U.S in 2004, that the programme met its waterloo, as financing became more difficult; major global financial institutions had borrowed during the boom were not unable to service their due loans. Starting with credit squeeze, reduction in household demand, rise in unemployment and falling housing process in 2005 to 2006, the bubble finally ruptured, and heralded the sub-prime mortgage crisis within multiplier effect in 2007. The crisis resulted in unprecedented and major business failures, with consumer spending, income retrogressing, their purchasing power falling by trillions of dollars, and socio- economic activities taking negative turn considerably, and up surging the notion of European sovereign debt crisis decline and global recession era.

The financial crisis arose in the industrial countries, but has affected catching –up economies and emerging economies, through high interest rates sharp changes in commodity prices, reduction in investment,

trade, migration and remittances and other capital out flows, for most low- income countries like Nigeria, shocks that affects food prices or wage rates for unskilled workers, and likely to have affected food prices. The crisis did project the poverty level with declining trade, investment, and impact on the poor (Easterly, et al, 2009).

The current crisis is affecting Africa in dual capacity and these are , firstly there could be financial contagion and spillover for markets, this is because stock market in Africa have been showing volatility driven by a sell of by foreign investors. Secondly, there is an indirect effect of volatile and falling commodities prices particularly oil, on export revenue and the inflow of the capital into the region.

Many analysts were optimistic at the inception of the crisis that, the impact of the global financial crises in Africa would be negligible. Africa economic are among the least exposed to the global financial system of many world regions, and African banks hold few of “toxic assets” that helps sparked the crisis. Little wonder, as the financial crisis ballooned into a global economic recession, most analyst now conceded to the fact that Africa economic will be strongly affected; due to a contraction in global trade reduction in African commodity exports, strident financial conditions and a drop in foreign direct investment. The World Bank has warned that most African state are “highly exposed and vulnerable to the effects of the crisis” the IMF in a related opinion estimated that, average economic growth in African will slow from an average of over 6% per year over the past five years a historical high –to 15% in 2009. The crisis will increase unemployment, affects domestic entrepreneurial profitability, and increase poverty in Africa. No economy whether first world or emerging is so far insulated from the global crisis. The global financial crisis is already having huge impact on catching –up economies like Nigeria. The monetary policy committee (2009) has observed that the Nigeria economy is being imparted by exogenous factors such as the deepening recession of the industrialized economies, which is as a result of loan portfolio investment, decline in foreign aids and low Foreign Direct Investment.

1.2 The problem

The spread of global financial crisis to virtually all economies of the world today has brought the need to examine the implication of the trend in Nigeria. The financial crisis is already in the Nigeria economy even though the financial authorities have chosen to play a “blind loyalty” to the country by assuming that the country is insulated from its effects. In Nigeria the effect of the crisis was not felt until the mid – 2008. World economic interdependence gave room to the financial crisis in all economies of the world including Nigeria. The global financial crisis has crippled the financial sector in Nigeria and most economies in the world and this, by extension has affected the capital structure decision of domestic entrepreneurial SME’s in Nigeria. Another problem caused by the financial crisis is the psychological effect of the crisis on the domestic entrepreneurs’ profitability in Nigeria and all over the world. The recent crisis in the capital market has not given them hope as no one is interested in investing in stock any more. The government of different nations in the world has responded in different manners to the financial crisis. The initial response of the policy markers in Nigeria was meek and lukewarm. Either they did not understand the depth of the crisis or understand its magnitude. In general, they thought of the crisis only as a mere “piece of cake” on aberration, a “hiccup” they insisted that the fundamental of the financial system look impressively strong even when the capital market has been bleeding uncontrollably towards a downward turn. The response to this situation by the Minister of Planning in Nigeria was rather started insensitively; there is no problem in the nation’s capital market. What we are experiencing is just corrections and adjustments “shareholders are getting dividends and bonuses and there are happy “this was at a time when market capitalization had dropped from N12billion to less than N9 billion. When they finally accepted there was a crisis, they promised to take some unspecified drastic and unusual action to stem the global financial crisis from causing havoc in Nigeria in financial system (Minister of State Finance DT October 6, quoting the minister of State Finance) the question still remains if the entrepreneurial SME’s profitability is still a reality or insulated from the global financial crisis dilemma?

2.1 Impact of the Financial Crisis on the Nigerian Economy

The risk associated with the global recession and the volatility of commodity prices, which is the mainstay of the most developing countries like Nigeria further increased during the crisis due to the exposure of nascent economies to shocks in commodities prices. The Nigerian economy was exposed to the crisis via over dependence on crude oil for foreign exchange earnings and revenue and the crisis impacted all the sections of the Nigerian economy from the financial to the real economy. The global financial crisis had an impact on the capital market, the banking sector, foreign exchange and balance of payments as well as the real sector at inception, the potential effects of the global financial crisis on the Nigerian economy and financial market was downplayed. Analyst draw confidence especially from the strength of the economy's external balances, volume of external reserved and the strength of the Naira pre-crisis intensified, however, it became clear that there would be significant impact once the financial storm touched down.

The financial crisis crystallized into an economic slowdown as the collapse of confidence, biting credit crunch, deleveraging consumers and business depressed activity in the advanced economies. Emerging markets, many with export dependent growth models, had to contend with breaks in the speed of growth in their economies, owing largely to depressed demand from the advanced economies.

In Nigeria, Gross Domestic Product (GDP) grew at a decreasing rate during the crisis. The growth rate dropped from 6.4 percent in 2007 to 6.04 percent in 2008 but immediately rebounded despite the crisis. The oil sector GDP suffered the greatest fall at the peak of the crisis, touching a low of 6.19 percent growth rate in 2008. The Non-oil sector GDP growth fell from 9.46 percent in 2007 to 9.01 percent in 2008 and has falling till date with 7.89 percent recorded for 2012 (World Bank, 2012).

The crisis didn't spare the Nigerian stock exchange either as foreign investor's, who realized the danger posed by the on -coming financial turmoil, with drew their fund and took flight back to safety, depressing the stock market, as the All Share Index (ASI) shed more than 70 percent of its value between March 2008 and April 2009, (World Bank, 2008).

The level of poverty tripled between 2008 and 2009 with value erosion intensify organization. Inflation rose from 6 percent in 2007 to 15.1 percent in 2008 and remained at double digits till January, 2013 when it returned to single digit. The exchange rate showed that the Naira depreciation against the dollar by 25.6 percent (highest depreciation recorded since 2000 till date.) between 2008 and 2009, reflecting demand pressure. (African Development Bank, 2009).

1.3 Global Financial Crisis and Economic Conditions that affect Entrepreneurial SME's opportunities.

The existence of entrepreneurial occurs in any economic conditions. Many scholars have written unduly on entrepreneurial and its potency, thus, under scoring the quintessence, significance and relevant of this sub sector in the development of any given economy. The economic state of a country influences the form of tendency of entrepreneurial activity.

The conditions in any economy affecting the availability of entrepreneurial are the level of economic growth, stability of macro economic conditions, income level, employment levels, capital structure and profitability.

When a country experienced sustained economic growth and stable macro- economic conditions, there is the likelihood that entrepreneurial activity form manifested is of great value to the country (GEM, 2006). In such environment, low-innovations, low value entrepreneurship due to economic stability. Entrepreneurial activity have been found to be capable of making positive impacts on the economy of a nation and the quality of life of

the people. Studies have established its positive relationship with stimulations of economic growth; and empowerment of the disadvantaged segment of the population.

In time of harsh, economic conditions like during the global financial crisis, people tend to consider engaging in entrepreneurship by establishing entrepreneurial SME's often leading to initial upsurge in new business creation. This upsurge is often followed by a huge failure rate and decline in finding source leading to a decline in new business start up rate.

Income level serves as an indicator of prosperity. When income level in a country is high, it often translates to availability of funds which eases new business creation (Tom, Begley and Schock, (2004) opine that income per capital act as a driving force for a new business creation in a stable country with macro economic stability.

2.0 Review of Literature

Jawadi et al (2010) investigated the efficiency of central bank intervention policies within the current global financial crisis. Firstly, they discuss the major existing intervention of central banks around the world to improve liquidity restore investors confidence to ensure the efficiency of entrepreneurial SMEs and evaluate the short term efficiency of this policies in context of Nigeria. Their findings show strong repercussion from interest rate charges on banks, indicating that entrepreneurs are hoping on central bank intervention policies to run entrepreneurs SME's smoothly.

Olu and Tayo (2009) examined the impact of the global financial crisis on entrepreneurial SME's in Nigeria. According to them, the instability in foreign exchange and capital market, the hike in unfriendly borrowing from the banking sector, and deficit recorded in balance of payment as well as decline in external reserves cannot allow entrepreneurial SME's to thrive. They argued that the impact is more severe in Nigeria than in other countries in the region because of it almost to reliance on oil revenue to run its economy. Their findings confirmed that the inability of entrepreneurial SME's not to run smoothly have increased in poverty/poor household force here in Nigeria. The stock have increased the level of poverty and worsened household welfare over the period and it is expected to worsen in 2010 (Amba, 2011).

In his study Dike (2008) saw the new global financial and economic crisis as an added burden on poor nations as their economies are affected directly or indirectly. Dike said Nigeria might experience worst of crisis because it depends on foreign aids, and trade for its economic activities. He concluded that Nigeria Government should reduce waste and improve social environment with rapid development and protection of entrepreneurial SME's, service sector, develop infrastructure, job creation to reduce youth unemployment and under development in Nigeria. He further advocated massive investment in no-oil and agricultural, commitment to sustainable monetary and fiscal policies, and sufficient highly skilled personnel to supervise the needed reform and manage the affairs of the nation.

Research Hypothesis

H₀: The global financial crisis does not affect profitability of entrepreneurial SME's.

3.0 Methodology and Research Design

This research adopted cluster sampling method to select certain number and classes of entrepreneurial SME's needed for the study since the comprehensive list of SME's in the country is too large. A survey research method was used to collect data from Manufacturing Association of Nigeria (MAN) and Lagos Chamber of Commerce and Industry (LCCI). The multiple holistic case studies was considered as its support researcher's ability to isolate the defining characteristics of data set by cluster, even when such data are obtained through multiple sources (Deply and Gitlin, 1988). The survey was conducted in September, 2014. The study was conducted in Lagos State of Nigeria, by selecting three industrial locations (Lagos Island Isolo, and Ikeja), being typical areas in term of cluster of entrepreneurial SME's in Nigeria, availability of physical financial infrastructure as well as the commercial and economic nerve of Nigeria. The entrepreneurial SME's selected for the sample met the small and medium industries equity investment scheme definition for SME's having 10-300 workers. This study also required that selected firms must have been in existence for 5 years to get meaningful data. The data was selected for a 7 years period of 2007 – 2013. A comprehensive well structured questionnaire was developed and carefully administered to get data from the SME's on amount of

loan, sales, income generation, capital structure and interest rate. The study employed the fixed –effects method that involved specifying regression equation that incorporated profits as dependent variable, and loans, sales, income generation, capital structure and interest rate for the 144 firms that were randomly selected and sampled. The use of profitability to measure performance of firms is in consonant with profit or utility maximization assumptions that are the bedrock of many of economic theories (Rantamaki- Lahiten et al, 2007) as cited in Rantamaki-Lahiten et al, (2007), Penrose (1995) observed that managers try to maximize long runs profits, while Barney and Arikan (2005) regards firms as a profit maximizing entity. The fixed –effect regression model is expressed as: $PROFIT_{jt} = \text{profit before tax for firm } j \text{ at time } t$.

Table 3.1 Result of fixed–effect regression of the profitability of entrepreneurial SME’s dependent variable – profit.

Independent Variables	Coefficients	t- test	P-value
LOANS	0.0000000003	2.81	0.005*
SALES	0.0000000002	1.61	0.19
INCOME GENERATION	-0.153177	-0.741	0.459
CAPITAL STRUCTURE	0.0438390	4.77	0.000*
INTEREST RATE	0.771236	5.07	0.000*
R ²	0.768		
Chi ²	9576		
RSS	268.89031481		

Source: Author’s Computation from Study Sample Data

*Indicate significant at 5%

$a_1LOANS_{jt} + a_2SALES_{jt} + a_3INCOMEGEN_{jt} + a_4CAPSTRUC_{jt} + a_5INTRATE_{jt} + b_j + \text{lt} + \text{ej} + \text{eit} > 0;$

$a_2 > 0; a_3 > 0; a_4 > 0; a_5 < 0$

Where,

$PROFIT_{jt}$ = Profit before tax firm j at time t

$LOANS_{jt}$ = Amount of loan obtained by firm j at time t

$SALES_{jt}$ = Level of sales by firm j at time t

$INCOMEGEN_{jt}$ = Income generated by firm j at time t

$CAPSTRUC_{jt}$ = Size of firm capital structure decision j at time t

$INTEREST_{jt}$ = Interest rate at time t

b_j and lt = Intercepts coefficient, which allow for different unobserved firm specific factor and vector of time series dummies.

eit is the error component that varies over both individual firms and time.

A_0, a_1, \dots, a_5 are parameters to be estimated,

$J = 1, 2, \dots, 144$ and $t = 2007 - 2013$

Thus, theoretically, our a priori expectation concerning the coefficients of the variables are that LOANS, SALES, INCOME GENERATION and CAPITAL STRUCTURE carry positive signs, while the coefficient of interest variables, INTEREST RATE, is expected to carry a negative sign. The data for the dependent and independent variables used in analyzing the regression analysis were sourced through the primary data from the field survey, while data for the interest rate was collected from Central Bank of Nigeria statistical Bulletin.

The salient shortcomings of the study are the small size of entrepreneurial SME’s used as sample due to the unwillingness of some SME’s not to participate, lack of adequate data from government sources, and most importantly, inadequate information from owners- entrepreneurs over the worth of their firms. Another stream of challenges is lack of source to capture the extraneous variables socio-economic variables, such as, policy and reforms on SME’s which are factors that have positive relationship with profitability, though cannot be measured quantitatively. However, we make do those that have direct effects on the study.

4.0 DATA ANALYSIS, RESULTS AND DISCUSSION

The economic analysis was used to test the hypothesis of the relationship between the relationship between the profitability of entrepreneurial SME's and each of the performance indicators of loans, sales, income generation, capital structure and interest rate.

The coefficient of loan carries a positive sign, statically significant and confirms our priori expectations of economic theory. This implies that during the global financial crisis entrepreneurial SME's business operation was affected which resulted in them accessing loans from the bank. This further explains that, the loan assisted the enhancement of SME's profitability. This view was supported by McMahon et al. (1993) that loan is positively related to firm's profitability and that profits of SME's tend to increase with increasing amount of loans.

He further opine that the financing decision of firm's impact upon the profitability of an enterprise as stated by Keasey and Watson (1999), the use of banks financing is associated with higher business performance. The coefficient of sales carries a positive sign, in conformity with our a priori expectations of economy theory. This implies during the global financial crisis, SME's enjoy increase in sales and profit was high. The effect of the global financial crisis could no affect the increase in sales because according to Karem (2009) that profit maximizing firms need to strategize to maintain a high level of profitability requires that the firms must produce quality products which can easily be sold to generate revenues, especially through a combination of marketing strategic.

The coefficient of income generation carries a negative sign contrary to our a priori expectation.

This indicates that the rate at which SME's generate income during the global financial crisis was low. This is largely due to the hostile business environment like fluctuation of exchange rate, and high labour cost.

The coefficient of capital structure carries a positive sign and the variables is statistically positive to confirm our expectation. This implies that during the global financial crisis, the capital structure of SME's become bigger and more profit are expected to be realized. This view is supported by Teriba (2009) that SME's with large capital structure find it easier to borrow money from banks for expansion and hence be able to enjoy the economies of scales and increase profitability.

Surprisingly, and to our utmost dismay the coefficient of interest variable, although statistically significant, has a positive sign contrary to our a priori expectation. This implies that during the global financial crisis that the profits of SME's are on increase despite the increasing rate of interest. This is possible in Nigeria according to Mtango (2008), most Nigeria firms pass increased interest rates to the final consumer in form of hike in prices and enjoy higher profits.

5.0 CONCLUSION

There is no gain saying that, the global financial crisis constitutes a great threat to the existence of million of people all over the world and even a great shock to entrepreneurial SME's in Nigeria. The study has also contributed to our intellectual faculties on those factors that are key determinants to the profitability of SME's during the global crisis and how they behave as our a priori expectations of the economic theory. Our study agree the global financial and economic crisis was indeed an added burden on poor nations and catching up economies and even the entrepreneurial SME's were not insulated from the economic meltdown shock.

On the basis of the above results we therefore concluded that the entrepreneurial SME's profitability was shaken considering the variable we used and results presented.

The result demonstrated that there is interdependence between SME's profitability.

We strongly advocate that Nigeria government should concentrate on neglected sectors like agriculture, infrastructure and viable SME's.

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