Capital Rationing and SMEs Profitability in Nigeria

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ARTICLE INFO

Keywords: Capital Rationing, SMEs, Investment, Profitability

Received: 22, March
Revised: 21, April
Accepted: 30, May

This research paper examined the effect of capital rationing on SMEs profitability in Nigeria. The study discussed the existing literature, empirical review, nature of capital rationing and its implications on investment, and financial performance of SMEs. The paradoxical nature of capital rationing, its challenges and potential use of capital were discussed. The study adopted descriptive research method while findings and recommendations were highlighted.

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INTRODUCTION

Firms aiming to sustain operations, pursue growth opportunities, and ultimately generate profits must have access to capital as fundamental prerequisite for business survival. However, the Nigerian small and medium enterprises (SMEs) struggle with limited access to capital hence hindering their growth prospects and overall stability. The persistent problem of capital rationing, where inadequate accessibility hampers investment activities remain a noteworthy challenge for many businesses, particularly in Nigeria (Adu and Uchehara, 2024).

Capital rationing presents challenges to SMEs profitability in which deliberate approach can change it into a channel of more proficient capital allocation. Capital rationing is a widely recognized occurrence in Nigeria's business environment, with SMEs bearing the burden of constant challenges in accessing sufficient money. The funding landscape for these enterprises is weighed down by obstacles that obstruct development, investment in vital areas like technology and training, and financial stability during economic downturns (Adu and Williams, 2024).

Globally, firms face constraints on financial capital through capital rationing which crash their capability to secure external finance for investment projects and operational needs. In Nigeria, this incident is particularly widespread in small and medium enterprises (SMEs) bearing the burden of these limitations by constituting over 90% of registered businesses.

The constraints compelled by capital rationing range from deficient capital markets, information asymmetry between firms and investors, and the high costs of raising funds externally). Such restrictions essentially institute a budget ceiling, restraining firms from surpassing allocated capital. Remarkably, these challenges become worse in Nigeria due to factors like high lending rates, strict collateral requirements, and weak capital markets, collectively hampering the financing alternatives available to businesses (Ahmed and Malik, 2015).

Regardless of involvements by development finance institutions, the mitigation of capital access challenges remains inadequate in Nigeria. Statistics specified that Nigerian firms receive only about 11% of the required funding from the banking system, emphasizing the enormity of the gap in capital accessibility (World Bank, 2013). Firms, most especially SMEs rely heavily on internal funding further restraining their capacity for growth and development (Adu, 2023).

Objectives

This study examined the effect of capital rationing on SMEs profitability while specific objectives are to:
1. Analyze the impact of capital rationing on SMEs investment decisions.
2. Determine the negative effect of capital rationing on capital allocation.
3. Examine the effect of capital on alternative sources of funding.
LITERATURE REVIEW

Concept of Capital Rationing

Capital rationing is a common phenomenon in Nigeria’s business environment, particularly for SMEs. Capital rationing occurs when firms have limited access to funding, which hinders their ability to invest and expand. The effects of capital rationing on firms’ profitability are multifaceted and complex.

Capital rationing affects firms’ investment decisions, particularly in terms of capital budgeting. Firms must prioritize investment projects based on their expected returns and available funding. Capital rationing limits firms’ capacity to undertake profitable investment projects, which can hinder their growth prospects (Adu, 2023). Capital rationing can also affect firms’ operational efficiency. Firms may be unable to invest in technology and training, which can limit their capacity to improve productivity and reduce costs. This can lead to lower profitability and competitiveness in the long run.

Capital rationing can also jeopardize firms’ financial performance during economic downturns. Firms may be unable to maintain solvency during periods of low demand or economic recession, which can lead to bankruptcy or insolvency (Odit and Chittoo, 2008). Capital rationing affects firm profitability in Nigeria through some negative and positive impacts some of these are:

- **Negative Impacts of Capital Rationing**
  - Missed growth opportunities: rationing forces firms to forgo profitable investment opportunities, negatively impacting returns. Average capital investment is just 30% of total requirements (Emmanuel, Babajide and Adepeju, 2020). The missed opportunities hinder sales growth and market share gains.
  - Constrained operations: limits on working capital also hinder inventory purchases, production, marketing capabilities, and other functions needed to maximize profits. Almost half of Nigerian SMEs report capital shortfalls severely hindering operations (Sanusi, 2003).
  - Higher costs: financing shortfalls push firms toward higher-cost informal financing sources, increasing expenses and squeezing margins. Around 55% of Nigerian SME financing comes from such expensive informal sources (World Bank, 2013).
  - Closures and failures: insufficient capital precipitates firm distress, closures, and bankruptcies. An estimated 20-50% of Nigerian SME failures result from inadequate financing (Udeh, Nwanneka and Onwuka, 2019). Survival rates in the first 5 years are just 20-30%.
  - Inefficient allocations: information asymmetry between firms and capital providers can result in inefficient capital allocation to less-productive uses. This dynamic undermines overall economic efficiency.

- **Positive Impacts of Capital Rationing**
  - Stimulates innovation and creativity: facing constraints, managers find new ways to minimize capital needs and get the best source for their buck. This spurs innovation.
  - Disciplined project selection: rationing requires strict prioritization of the most promising investments expected to deliver the highest risk-adjusted returns.
Implications of Capital Rationing on Firms’ Profitability

Capital rationing has far-reaching implications for firms’ profitability in Nigeria. It hinders firms’ capacity for expansion, impedes investments in technology and training, and jeopardizes financial stability during economic downturns. Consequently, many promising firms fail to achieve their full potential.

Partnerships and alliances: to pool financing, firms forge mutually beneficial partnerships and strategic alliances. This also enables synergies and risk-sharing (Adu, 2023).

Policy Reforms

Increased Lending Support: advocate for financial institutions to actively increase lending to firms, ensuring accessibility and affordability of credit to facilitate growth and sustainability.

Tailored Financing Initiatives: encourage the development of financial products and services tailored to the unique needs of firms, fostering a more responsive and supportive financial ecosystem.

Capacity-Building for Firms: promote initiatives that enhance financial literacy and managerial skills among firms, empowering them to navigate capital constraints and make informed decisions regarding funding opportunities (Adu, 2023).

METHODOLOGY

The descriptive method of research was adopted for this study by conducting an extensive review of existing literature on capital rationing and its impact on SMEs profitability in the Nigerian business context.

RESULT AND DISCUSSION

Policymakers play a pivotal role in addressing the supply-side constraints contributing to capital rationing. Structural reforms in the banking sector, fostering the development of the capital market, and implementing targeted financing support for SMEs through development banks are essential interventions. Improving information availability, transparency, and creating a supportive business environment with appropriate incentives further contribute to creating an enabling ecosystem.

CONCLUSIONS AND RECOMMENDATIONS

In conclusion, the intricate dynamics of capital rationing cast a substantial impact on the profitability of firms operating within the Nigerian business landscape. As evidenced by both the challenges outlined and the potential benefits highlighted in this position paper, it is evident that capital rationing is a multifaceted phenomenon that demands a strategic approach for both firms and policymakers.

Nigerian firms, particularly SMEs, face a substantial hurdle in their quest for profitability due to the pervasive nature of capital rationing. The challenges manifest in limited expansion opportunities, constrained investments in crucial areas like technology and training, and financial instability during economic...
downturns. However, it is crucial to acknowledge that within these challenges lie opportunities for strategic decision-making.

Firms in Nigeria can mitigate the adverse effects of capital rationing by making disciplined financing and investment decisions. This involves prioritizing projects with the fastest payback and highest returns, utilizing internally generated funds, exploring alternative financing options, adopting technology for enhanced efficiency, and fostering networks and partnerships to access financing at lower costs. By embracing these strategies, Nigerian firms can navigate the constraints of capital rationing, maintaining and even maximizing their profitability trajectories.

In essence, the conclusion drawn is that while capital rationing imposes significant challenges, a balanced and strategic approach can help firms maintain profitability in the face of these constraints. By adopting a multifaceted strategy that combines firm-level initiatives and policy reforms, Nigeria can navigate the complexities of capital rationing, fostering an environment where businesses can thrive, contribute to economic transformation, and ultimately realize their full potential.

Strategic Project Prioritization: advise firms to prioritize projects with the fastest payback and highest returns, maximizing profitability within the constraints of capital rationing. Optimal Use of Internal Funds: encourage firms to rely on internally generated funds to finance projects, reducing dependence on expensive external capital and enhancing financial resilience.

Exploration of Alternative Financing: suggest exploring alternative financing options such as leasing, venture capital, and asset-based lending to diversify funding sources and increase flexibility. Adoption of Technology: recommend the adoption of technology to improve capital efficiency, enhance productivity, and ultimately boost profitability in the face of capital constraints.

Network and Partnership Building: Emphasize the importance of building networks and partnerships, enabling firms to collaboratively access financing at lower costs and share resources. Capital Market Development: call for initiatives that foster the development of the capital market, allowing firms to raise funds through diverse instruments like bonds and equity, thereby expanding their financing options.

Targeted Financing Support for SMEs: push for the implementation of targeted financing support and credit guarantee schemes for SMEs through development banks, addressing the unique challenges faced by these enterprises. Information Availability Improvement: Urge policymakers to improve information availability, minimizing information asymmetry between firms and investors, and enhancing transparency in the financial ecosystem.

Supportive Business Environment: Advocate for the creation of a supportive business environment with appropriate incentives and protections to bolster the confidence of firms and investors alike. With this comprehensive set of recommendations, stakeholders can collectively contribute to alleviating the challenges posed by capital rationing, empowering firms, promoting entrepreneurship, and fostering Nigeria’s economic transformation.
FURTHER RESEARCH
This research still has limitations so further research needs to be done on this topic “Capital Rationing and SMEs Profitability in Nigeria”.

REFERENCES