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## **Assessing the Effect of Cost of Capital in Profitability of Co-operative Societies; A Case of Shinyanga Municipal SACCOs**

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### ***Abstract:***

*While Co-operative societies are made up of both internal and external sources of income, the extent to which the cost of capital affects their growth and development is questionable regarding different SACCOs in Shinyanga Municipal. Specifically, the study aimed at both identifying different sources and cost of capital and examining the effect of such cost of capital in profitability of SACCOs. As a case study design, the researcher used questionnaires, documentary review and interview to collect the data from 10 selected SACCOs in Shinyanga Municipal. The data were collected using both qualitative and quantitative approach. The findings revealed that, SACCOs in Shinyanga Municipal use debt in large proportion than equity to finance their activities. As a result, cost of capital (Weighted Average Cost of Capital) is very high and profit is low for debt financed but equity financed SACCOs have high profit due to low cost of fund. However, debt financed SACCOs provides various services to their members in large quantity than equity financed SACCOs although they exclude the very poor. It is recommended that, government should set regulations on proportional of debt and equity required for SACCOs and interest rate charged by financiers for them to be sustainable.*

***Keywords:*** SACCOs, Capital Structure, and Cost of capital

### **1. Introduction**

Co-operative societies are usually understood to entail organizations which provide financial services to their members who are micro-entrepreneurs and small business, collectively, they lack access to banking and related services due to the high transaction costs associated with serving. As part of Microfinance Institutions SACCOs play a key role in provision of financial services to low income earners especially in rural and urban areas. USAID, (2006) stated that SACCO is an abbreviation for Saving and Credit Cooperative. SACCOs are user-owned financial institutions that offer both savings and credit services to their members. SACCOs depend on capital as the components of permanent sources of financing used to buy mainly fixed assets (Kasilo, 2011). The capital structure of SACCOs can either be 100% equity or a composition of both Equity and Long-term Debt/borrowing or a 100% Long-term Debt/borrowing. However, many firms accept debt in their capital to either develop their activities or financing its operations. While in Tanzania SACCOs depend on the above sources of capital, the country legalizes the operation of SACCOs under Co-operative Societies Act No. 06 of 2013. Since 20<sup>th</sup> century there has been the traditional shift of developing SACCOs capital through member's contributions to largely rely on external source of funding due to growth of SACCOs's capital and demands of members. This has also been agreed by Pandey, (2010) stating that capital structure is influenced by future options of raising capital. However, it is reported that members' capital contribution was a challenge to SACCOs because it is contributed once at the time of joining (entrance fees) and buying shares (*Field Findings*). Moreover, upon the need of the SACCOs to increase their capital and a need to develop new products to their customer and meeting stiff challenges from their competitors, most of SACCOs have led to shift into external sources of fund. *Robb et al.* (2010) emphasizes that "thinking of co-operative capital, we think of investor capital whose only purpose is to maximize return and we forget the primary purpose of capital in co-operative societies which is to meet members and community needs". However, the statement implicates on the role of external sources of fund and their effect on SACCOs's member's needs, profitability and sustainability. Therefore, the current study will identify the sources and cost of fund used by SACCOs in Shinyanga Municipal and the effect of cost of capital on the profitability of SACCOs.

#### ***1.1. General Objective***

The general objective of this study is to assess the effects of cost of capital on profitability of SACCOs.

#### **1.1.1. Specific Objectives**

- i) To identify different sources and cost of capital used by SACCOs
- ii) To examine the effect of cost of capital in the profitability of SACCOs

### 1.2. Research Questions

- i) What are different sources and cost of capital used by SACCOs?
- ii) What are effects of cost of capital in the profitability of SACCOs?

## 2. Literature Review

### 2.1. Empirical Studies

Different sources of fund and their effects to SACCOs and other financial institutions are reported by different scholars (Wilson and McHugh, 1987; Sapundzhieva, 2011; Hannagan, 2008; Spiro, 1982; Tennent, 1976). For instance, Wilson and McHugh, (1987) identifies that debt (e.g. debenture and bank loans) as well as share capital (i.e. equity or preference capital) are among the most sources of fund of any enterprise. However, the proper balance of share capital and debt capital will be determined by enterprise's growth rate, stability of sales structure. While some enterprises are reported aggressive and other less aggressive following the amount of loan they may employ, it is found that cautious enterprises tend to have little debt and large current liquidity resources unlike aggressive enterprise which often employ large amount of debt in an effort to grow quickly (ibid). The suggestion is that Financial Manager should use the best financial mix that suit the profile of the company and which keeps the Weighted Cost of Capital (WACC) as minimum as possible. While such suggestion may prevail, SACCOs should keep their external financing minimal taking into consideration that their source of capital are mainly shares, savings, deposits and retained earnings. Sapundzhieva, (2011) also adds that, Microfinance Institutions (MFIs) have three main sources to fund their growth: debt, equity, and deposits. In addition to understanding the landscape and source of funds, it is important for both funders and MFIs to assess the relative cost and terms of debt. However, the source of funds has its own implications for the structure, pricing and terms of loans.

Other scholars (Spiro, 1982; Tennent, 1976; Myers, 2003) emphasize on the effect of cost of capital on the SACCOs profitability. For instance, while Spacio, (1982) believes that a friendly success of a financial firm is largely depending on the debt-to-equity ratio of the Balance Sheet, its significance is remarkable as the lender will be less likely to recover any of the loans extended in case of depts. But also, the larger the debt, the larger the cash flow required. Tennent, (1976), adds that no management should seek additional funds from outside sources without first ensuring that there do not exist in the company already, funds which could be more profitable redeployed. Such funds are almost always cheaper than negotiating new external sources. More important is also considered by Brealey and Myers (2003) who stated that debt financing has one important advantage under corporate income tax system. The interest the company pays is the tax-deductible expenses. Thus, return to bondholders' escapes taxation at the corporate level.

Contrary, to the above studies, the effect of cost of capital on SACCOs or financial institution profitability is reported by caution as Hannagan, (2008) advises that Equity capital is considered most expensive to be afforded by the company. However, this may not be the case when the company balance sheet is health. The author cautions that it is better to estimate the effect of capital by assessing the capital structure of the firm using Gearing (also called Leverage) which is an indication of the relationship between the long-term debt and the equity (Equity is ordinary share capital plus the reserve). While equity is considered as expensive, external financing is more expensive from conditions attached to the loans, interest charged, collection and follow up of the loans. Therefore, with high gearing ratio the risk of failure for a SACCOs is high (source).

### 2.2. Agency Theory and Pecking Order Theory

Berle and Means (1932) initially developed the agency theory and they argued that there is an increase in the gap between ownership and control of large organizations arising from a decrease in equity ownership. This particular situation provides a platform for managers to pursue their own interest instead of maximizing returns to the shareholders. Due to this theory, Lubatkin and Chatterjee (1994) suggested that 'increasing the debt to equity ratio will help firms ensure that managers are running the business more efficiently. Hence, managers will return excess cash flow to the shareholders rather than investing in negative NPV projects since the managers will have to make sure that the debt obligations of the firm are repaid. Hence, with an increase in debt level, the lenders and shareholders become the main parties in the corporate governance structure. This mean that leverages firms are better for shareholders as debt level can be used for monitoring the managers, thus debt improves accountability and efficiency use of resources by managers'.

More is explained by Pecking Order Theory (**Source**) that companies with higher earnings should take less debt, as they require less of funding requirements due to funding met by the internal resources. A high profit making company can generate internal cash to fund their new projects. A balance between risk and return met by capital structure is known as the most favorable capital structure. A sound capital structure aims at minimizing the risk and maximizing the profit margins. This theory is positive for a small SACCOs but for the growing one it needs more fund to be able to meet with members' demands. Growth of the SACCOs determine the type of capital structure the organization can have as long as they are in position to pay for such debt and maintain shareholders' return. Borrowing might be of high risk but with higher earnings the risk is neutralized. Both Agency Theory and Pecking Order Theory were used to guide the study as they establish a good link between the performance of SACCOs in relation to their capital, the theories also explain on the behavioral performance of the company regarding cost of capital and sources of capital and also how different sources of fund can be managed by any organization in attaining their goals.

## 3. Methodology

The study was a cross section design which allowed the collection of data from Shinyanya SACCOs as a case study. To achieve the design, the study adopted both explanatory and descriptive approach. The target populations of the study were SACCOs available in

Shinyanga Municipality. Different sampling designs were used to arrive into a representative sample. For instance, the sampling techniques used includes simple random sampling used to selected members and SACCoSs so that the respondents can get different views from different members; Purposive sampling used to select chairpersons, managers, accountants and co-operative officers in order to get enough information about capital, costs and policies governing SACCoS. Stratified sampling was also used in selection of members and managers who were divided into stratum depending on need and importance of the respondent.

The distribution of respondents with the total of 70 respondents showed that there were 42(60%) male respondents and 28 (40%) female respondents. As shown in a table 1 is the distribution of respondents according to their position in SACCoSs.

Position	Frequency	Percent
Members	37	52.9
Chairperson	10	14.3
Accountant	11	15.7
Board Member	1	1.4
Co-operative Officer	4	5.7
Manager	7	10.0
<b>Total</b>	<b>70</b>	<b>100.0</b>

Table 1: Category of Respondents  
Source: Research Findings (2013)

Data were collected using questionnaires, interview, group discussions and documentary review of laws (Co-operative Societies Act and Rules) and SACCoSs' policies. The researcher used questionnaires as a major tool of collect primary data to ensure members provide reliable information freely without ambiguities. The questionnaires were issued to members, managers and co-operative officers to collect information about sources of fund, costs of funds, and management funds. The interview and discussions served as a complementary tool of collecting primary data specifically on challenges relating to costs of funds and accessibility of funds. Also, Co-operative policies, Act No 6 of 2013 were reviewed on capital structure requirements for the SACCO.

Data collected were analyzed by the use of Statistical Package for the Social Sciences (SPSS) in categorizing respondents, identifying sources of fund and cost of funds. Excel was also used to show the capital structure of visited SACCoS in Shinyanga, profitability trend, cost of capital and the relationship between cost of capital and profitability. Also, STATA package was used to show the relationship between some variables such as capital and profitability, cost of capital and profitability.

#### 4. Analysis and Discussion of Findings

##### 4.1. Sources and Costs of Capital/Fund in SACCoSs

##### 4.1.1. Sources of Capital for SACCoSs

Savings and Credit Cooperative Societies (SACCoSs) have different sources of capital depending on the capacity and management of it. Based on the findings, 33.8% of respondents felt that SACCoS fund is formed of entrance fee, 13.5% believed fund to be formed of penalties on late repayments of loans and 37.8% felt that SACCoS fund was formed of loan interest. Printing documents such as policies, rules and regulations and selling them is among the sources of fund for some SACCoSs. While writing, different projects are not commonly considered as sources of fund, only 1.4% of respondents thought it as a source of fund for SACCoS.

Sources of Fund for SACCoSs	Responses	
	No	Percent
Entrance fee	25	33.8%
Penalty	10	13.5%
Interest received	28	37.8%
Projects contribution	1	1.4%
Printing and selling documents	10	13.5%
<b>Total</b>	<b>74</b>	<b>100.0%</b>

Table 2: Sources of Fund for SACCoSs  
Source: Research Findings (2013)

Similarly, the findings revealed that, the sources of fund of the SACCoSs depend on policies, financial strategies of the respective SACCoSs and member's willingness to support them. Also, it was found that entrance fees, penalties and interest are commonly sources of fund in almost all SACCoSs visited.

Interest received from loans is the major contributor in all SACCoS visited. This is probably due to SACCoSs members are low income earners and they depend on loan for various family and business activities and therefore from loans they pay interest rate. It has been also found that different loans offered to members range between 18% to 25%. Entrance fee also contribute a lot in the sources of fund, but it is paid only once by the member and it requires new member in order to generate more fund.

#### 4.1.2. The Capital Structure of the studied SACCoSs in Shinyanga Municipality

From findings, capital structure of various studied SACCoSs in Shinyanga municipality is formed by either debt only or equity only or combination of debt and equity. Combining both SACCoSs with their capital structure, the findings revealed that, many SACCoSs depend on debt financing rather than equity financing. Even for those which are Equity only financing SACCoSs their capital is very small compared to those which are financed by both debt and equity.

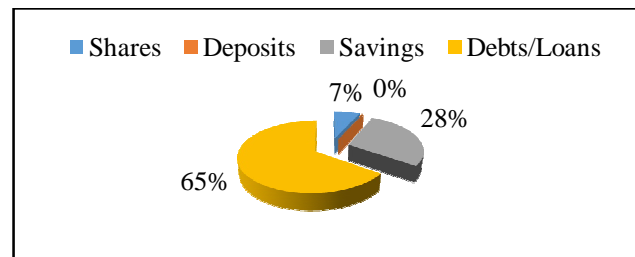


Figure 1: Capital Structure of SACCoSs in Shinyanga Municipal  
Source: Research findings, (2013)

Figure 4.1 shows the capital structure of SACCoSs in Shinyanga municipal. The loans hold an average of 65% of total capital structure for all SACCoSs followed by savings which constitute a proportion of 28%. Others are shares forming a 7%; and very small part 0.1% for deposits.

Each firm has an optimal level of debt and equity at which it can operate most efficiently and profitably. As per findings above; the capital structure of most microfinance institutions in Shinyanga municipal depend on debt financing rather than internal sources of fund (equity financing). Debt financing is an expensive source of fund for SACCoSs because they pay interest of 16% on the loan provided and for short term loans they pay interest of 11% on flat rate method. Debt financing requires minimum operating expenses in order to be profitable because, this loan is charged out to members at 18% up to 25% only. Therefore, this interest rate should be used to cover operating expenses and remain with profit. According to Kasilo, (2011) 'the larger the Debt Equity Ratio the more the risk shareholders assume.' This has also been supported by Abor, (2005) who state that 'long-term debts are relatively more expensive, and therefore employing high proportions of them could lead to low profitability.'

Equity financing (shares, savings, deposits and reserves) are the cheapest sources of fund for SACCoSs. In Shinyanga, few SACCoSs provide interest on shares and it ranges between 0-5% per year (Co-operative Societies Act No. 6 of 2013). Abor, (2005) also found out that short-term debt tends to be less expensive, and therefore increasing short-term debt with a relatively low interest rate will lead to an increase in profit levels. The results also show that profitability increases with the control variables (size and sales growth).

According to the findings, SACCoSs choose external financing because it is easily available and therefore meet the needs of members in time. The findings have been shown that members need enough capital and due to limited amount of shares and savings they can't meet those needs and therefore they decide to borrow from external sources which are easily available such as loans from commercial banks. Although may be expensive but its fund which is easily available. However, Kumburu, et al, (2014) argued that there is current inadequate evidence to show that sourcing SACCoS' capital from other financial institutions has benefited the members. Co-operative officers advise that, SACCoSs' capital structure should be formed of shares, 10% savings, 20% retained earnings, grants from different donors and debt which is proportion to their assets. But many SACCoSs they have loans more than 50% and small amount of shares and savings.

#### 4.2. Effect of Cost of Capital/ Interest on Profitability

##### 4.2.1. Cost of Capital

Capital is the term used by firms for funds needed for investment purposes (not for day to day operating needs). This capital carries a cost because the investors want a return on their investment (shares, bonds, bank loans, etc.). Each of these sources carries a different cost based on the required rate of return of each provider of these funds (Pandey, 2010).

Source	Amount	Average Cost
Total shares for all studied SACCoS	181,918,224	3%
Total deposits	2,836,250	3%
Total Savings	785,407,593	0%
Total Debts/Loans	1,817,697,643	16%
<b>Total</b>	<b>2,787,859,710</b>	

Table 3: Cost of Capital for Each Source  
Source: Research findings

According to the findings (Table 4.2) shows that Shinyanga municipal provide constant interest rate on share, it does not grow but remains constant at that rate. For loans/credit the interest charged is 16% -25% in case of long term loans. Deposits are provided with

2-4 interest/return specifically on fixed deposits but no return/interest is provided on savings. While such instances exist, Co-operative Societies Act No.6 of 2013 states that, the return on savings, shares and deposits should not be more than 5% of the amount.

4.2.2. Proportion of each Source of Fund and Calculation of WACC

As per field findings about capital structure of SACCoSs (Figure 4.2), the proportion/percentage of each source of fund in optimal capital structure shows that debt proportion is higher (65.2%) followed by savings which is 28.17%. Therefore, the average cost of capital can be calculated by using Weighted Average Cost of Capital (WACC). According to Pandey, (2009) WACC measures the weight of each cost of capital in relation to its proportion/percentage in total optimal capital structure as follow:

$$WACC = (WT_d \times AT k_d) + (WT_p \times k_p) + (WT_s \times k_s)$$

Whereby;

WTd =Weight of debt, ATkd= After tax cost of debt,

WTp= Weight of preferred stock, kp = Cost of preferred stock,

WTs=Weight of equity and ks = Cost of equity

But since our capital structure is formed by only debts/loans and equity (shares, savings, deposits, retained earnings) therefore, calculation of WACC will be as follows:

$$WACC = (WT_d \times AT k_d) + (WT_s \times k_s)$$

Source	Amount	Proportion (%)	Cost	WACC
Shares	181,918,224	6.5%	3%	0.20%
Deposits	2,836,250	0.1%	0%	0.00%
Savings	785,407,593	28.2%	0%	0.00%
Debts/Loans	1,817,697,643	65.2%	16%	10.43%
<b>Total</b>	<b>2,787,859,710</b>		<b>WACC</b>	<b>10.63%</b>

Table 4: Calculation of WACC  
Source: Research findings (2013)

Therefore, Weighted Average Cost of Capital is 10.63% for all sources of capital structure. This cost shows in average the cost which is incurred by SACCoSs by having different sources of funds and it shows that, debt/loan financing has high costs and therefore affect the weighted average cost of capital but for internal sources of fund seem to be the cheapest sources (Table 4).

4.2.3. Profitability of SACCoSs

• Profitability for Equity on SACCoSs

Equity only financing SACCoSs their profitability increases year after year, this is because they pay little or non-interest or return from their sources of fund. Little interest on share, deposits or savings is provided to them but people use SACCoSs as the place of safety for their money. Therefore, the profitability trend for equity on SACCoSs is always increasing as shown in the figure bellow.

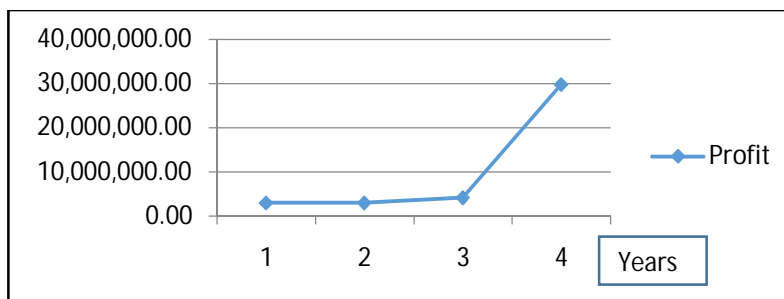


Figure 2: Profitability Trend for Equity only SACCoSs  
Source: Research Findings, (2013)

As per correlation coefficient results, equity only SACCoSs has 0.5(50%) linear relation between profit and capital. This means that as capital increases the amount of profit for equity SACCoSs also increases from one year to another although not at increasing rate. This means that, increase in capital in equity only SACCoS increases profit also although not that much due to the fact that the capital is small from members' savings, deposits, etc. and so does the profit generated. Also, the same profit is required to cover other operating cost of SACCoS and the remaining profit (retained earnings) is the only amount increasing the capital of the SACCO.

• Profitability for Debt/Equity Financed SACCoSs

The figure below shows the relationship between capital structure and profitability for debt/equity SACCoSs. It was found that debt/equity financed SACCoS have small profit in comparison to amount of capital they have. The profit is less than 100Million while

capital is more than 2 billion. Also, as per correlation coefficient results, it shows that, there is minimum linear relationship of 0.68 which is 68% between performance of debt financing SACCoS and its profitability. Hence, as per findings profit for debt financed SACCoS has positive effect on the performance of debt/equity financed SACCoS of 68%. This means that, increase in debt financing will require high payment of interest and therefore will reduce profit of the SACCO and therefore the performance of the SACCO will also be affected by 68%. Therefore, debt increases cost and reduces profit which results to poor performance of the SACCO.

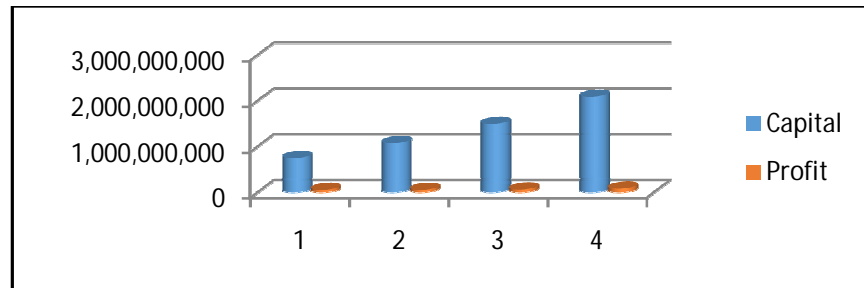


Figure 3: Capital Structure and Profitability for Debt/Equity SACCoS  
Source: Research Findings, (2013)

Figure 3 shows the relationship between capital and the profit for debt/equity financed SACCoS of Shinyanga municipal. The profit generated is so small compared to the amount of capital available in the business. Therefore, debt financed SACCoSs their efficiency and growth of profitability is affected by debts and therefore the profit is not satisfactory. According to the findings, many members from this type of SACCoSs argued that, their profitability is average although activities are performed well.

4.2.4. Relationship between Interest/Cost of Fund and Profitability of visited SACCoS

For debt financing SACCoSs, the findings show that, as the capital increases the interest rate/cost of capital also increases, but the profitability of the SACCoSs was increasing at decreasing rate. For the year 2008 to year 2009 the profitability was high compared to cost (profit was 8.1% while interest was 7.8% for the year 2008 and for the year 2009 profit was 5.6% and interest was 5%) but for the year 2011 the interest paid was much higher compared to profitability- it was 88% more than profit generated in percentage term as the profit was 4.6% while interest was 10.7%. Therefore, for debt/equity financing SACCoSs, they use more of their fund generated to pay interest for their borrowed fund rather than increasing the shareholders’ welfare.

Correlation coefficient results show a positive relationship between debt and cost of fund which is 0.6 (60%) relations. This means that, as debt increases so does the cost of capital. Increase of debt in the SACCoS increases the interest/cost and reduces profitability of the respective SACCO.

For equity, only SACCoSs there is small relationship of 0.4 (40%). This means that increase in equity capital does not directly cause increase in cost/ interest because interest charged for equity (internal sources) is very small or sometimes it is not there. Therefore, cost of capital affect equity only SACCoSs by only 40% different from how it affects debt financed SACCO.

Year	Capital	Interest	Profit
2008	750,410,499	58,810,521	61,008,376.25
2009	1,076,114,666	53,497,585	60,571,438.25
2010	1,497,966,987	159,595,239	69,628,460
2011	2,088,100,709	212,868,325	113,248,523.60

Table 5: Relationship between Cost of Fund/Interest and Profitability of visited SACCoS  
Source: Research Findings, (2013)

Figure 4 summarizes the relationship between the interest and profitability for debt financed SACCoSs. The debt financed SACCoSs had 3% interest on shares and 16% was interest on loan making a total of 19% cost of capital. the profit for these SACCoSs increases but at a decreasing rate as shown;

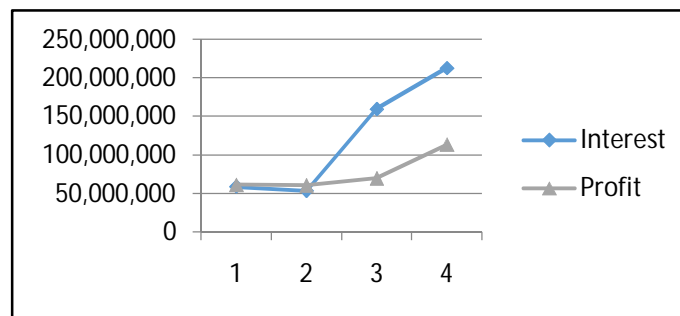


Figure 4: Relationship between Interest and Profit for Debt/Equity SACCoSs  
Source: Research Findings, (2013)

Also, it shows that (Figure 4) for year 1 (2008) and year 2 (2009) profit was high in relation to interest charged where by profit was 8.1% and interest was 7.8% and for year 2 profit was 5.6% but interest was 5%. For the 3<sup>rd</sup> year interest increased for more than 100 Million while profit increased for 10 million only. Therefore, change in interest rate affect profitability of SACCoSs.

According to the manager of Biashara SACCoSs, the cost of fund decreases as they borrow more because profit is generated although at small rate and capital increases. Therefore, borrowing is used as the means to increase profit of the SACCoSs and therefore increase capital from retained earnings.

#### 4. Conclusion

Microfinance Institutions especially SACCoS were established to attain economic, social and agricultural sustainability of the majority poor (low income earners) who can't access fund from commercial banks and other lenders because they can't meet certain conditions. SACCoS were originally required to use internal sources of funds to meet members needs such as savings, deposits, retained earnings, etc. but due to growing demands of members they had to change their sources of fund which led to positive and negative outcome. From the study, the following were discovered;

- Entrance fee, penalties, interest received on loans, loans or borrowing from commercial banks, printing and selling various documents such as policies and accounting books and projects are the commonly sources of fund in SACCoSs.
- Borrowing has high proportion in capital structure of 65% than equity which is 35%. Weighted Average Cost of Capital (WACC) (average of cost of funds) for most debt/ equity financing SACCoSs in Shinyanga municipal is 10.63% while their profitability ranges from 8% to 4% only. For equity financed SACCoS the cost of fund ranges from 0-5% while profit generate ranges from 10-15%
- Debt financed SACCoS provides more loan products and at large quantity, also they reach large number of clients although the cost per loan product is high and therefore the reach high income earners. But for equity financed SACCoS they reach few members with small amount of loan provided and there are few loan products offered but they are issued at low cost which enable them reach the majority poor which is the major goal of SACCoS.

Therefore, cost of fund for debt financed SACCoS is higher than Internal Rate of Return (IRR)/profitability and large amount of income generated is used to pay debt. Due to this high cost of fund, SACCoSs do not help the low-income earners, which is among their mission but serve average earners and non-poor due to high cost services. Equity only SACCoSs have small cost but their capital is at a minimum level associated with a very small rate of development and growth but they generate enough profit. More is that the efficiency of SACCoS is not only affected by the capital structure but also by poor management. Debt financed SACCoS may have high debt but reach a large number of people.

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