

Analysis of the returns of small and medium-sized enterprises in Mongolia

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Abstract: This study analyses the profitability of small and medium-sized enterprises (SMEs) in Mongolia. SMEs play a crucial role in the Mongolian economy and are considered to be the stimulus of economic development in the country. The present paper investigates the factors that affect the performance of SMEs. It examines the relationship between returns, gender, age, education, bank advances, turnover volume, innovation, management experience, labour, interest rates, customer base, inflation and exchange rate based on data collected from 200 SMEs that have different capital structures. The equation specified profitability as the dependent variable and loans, sales, firm age, firm size and interest rates as independent variables. All data except interest rates which were derived from Central Bank data were gathered from a primary field survey. The conclusion to our study is that there is a strong positive correlation between sales growth, bank advances, business size and profitability.

Keywords: SMEs, Returns, Mongolia

1. Introduction

The role of small and medium-sized enterprises (SMEs) in the development process is very important not only in developing countries but also in developed countries. The development of SMEs is seen as accelerating the achievement of wider socio-economic objectives including poverty alleviation.

According to the SME Resource Centre, in most economies, Mongolia included SMEs comprise approximately 95% of all firms and employ about 50% of the workforce. In many sectors, SMEs are responsible for driving innovation and competition. Globally SMEs account for 99% of businesses and 40% to 50% of GDP. FSD (Financial Sector Deepening) Mongolia strongly believes that in Mongolia, SMEs have the potential to contribute significantly to economic growth and poverty reduction through increased production and employment.

There is no single, uniformly accepted, definition of a small firm (Storey, 1994). Firms differ in their levels of capitalisation, sales and employment. Hence, definitions employ measures of size (number of employees, turnover, profitability, net worth, etc.) In Mongolia, a business is considered to be an SME if: its yearly turnover ranges between TUG 5-20 million and 100-150 million; its

number of employees is 80-100; and its financing needs do not exceed about TUG 50 million.

There is consensus among policymakers and, business and economic experts that SMEs are the key drivers of the economy. A vibrant SME sector contributes to the economic basket by creating employment opportunities, generating high production scales and volumes, boosting the export sector and harnessing innovation and entrepreneurship skills. According to Sanusi, (2003), more than 98% of all industrial enterprises fall in the SMEs sector and account for the bulk of the labour force.

In the long run, profits are necessary for survival in a competitive business environment, but SME management may adopt grow or not to grow options. Long-term profitability derives from the relations between cost and revenue; which is a necessary but not sufficient condition for growth. While growth has been considered to be the most crucial measure in SMEs, it has also been argued that sound financial performance is multidimensional in nature and that measures such as financial performance and growth are diverse aspects of performance that need to be considered (Wiklund, 1999).

It has also been argued that firms grow in many ways and that a firm's growth pattern is related to age, size and industry (Delmar et al., 2003). Revenues may be held up by

entry barriers such as competitive pricing and costs pushed down by management ingenuity. In a 'life-style' SME, an owner may trade profitability today against profitability tomorrow. Dynamic pricing or sequential investment projects may require initially lower profits in order to obtain higher future pay-offs from greater market penetration. An SME manager's time preference is likely to determine the inter-temporal profit trade-off. Profitability is among the most crucial objectives of financial management because the main goal of financial management is the maximization of the owner's wealth (McMahon, 1995).

Hence the success or failure of SMEs, or any other business establishment for that matter, heavily relies on the realisation of profits. In the business cycle, a business is not usually profitable in the birth/establishment stage because this is the period of absorbing the costs emanating from the initial heavy capital outlay. However, as the business matures, profits become visible. An emphasis on profitability made Sabato (2005) suggest that small firms need to focus on the efficiency and profitability. For any establishment whether large or small, profitability is crucial for it remaining a sound going concern. A low-profit firm will lack the finance for expansion. Hence any compromise on profitability will have an adverse effect on the capitalisation of a business. However, a high-profit business may conclude the risk and rewards of expansion to be inadequate.

As is common practice, the cheapest source of financing operations is internal sources from retained earnings, which are traditionally ploughed back into the business. Without funding growth through retained earnings, the firm must rely on additional debt or equity finance. Markman, and Gartner (2002) stated that profitability and sustainable competitive advantages are attained by the use of growth as a measure of firm performance generally based on the belief that growth is a precursor. The relationship between growth and profitability is therefore an important consideration and to date there has been little agreement on the relationship between these two measures. Moreover, Sexton D. L. et al (2000) found that firm profitability was

correlated with sustainable growth, while Delmaret al., (2003) growth is not always highly correlated with sales growth and returns.

Recognising the importance of SMEs in economic development, the government in Mongolia has set up various programmes and institutions aimed at developing the SME sector. Despite the contribution of SMEs to the economy, they are vulnerable and very few manage to survive due to challenging factors such as finance, a lack of business plans, high taxation, a lack of business management skills, low sales, low profitability, the high costs of doing business, labour market barriers, poor market condition, high rental charges, and wrong pricing. While a range of financial and non-financial indicators have been suggested as measures of performance, prior research has tended to focus on variables for which information has been easy to gather (Cooper, 1995).

2. Characteristics of the Mongolian SME Sector

Until 2007, there was no official definition of SMEs in Mongolia. The SME law of 2007 provided a definition of SMEs which should help improve the consistency and effectiveness of government support programmes. The purpose is to set up policies for SME development and general measures to promote SMEs in order to ensure economic development.

The SME sector in Mongolia emerged as a result of the privatisation and breakup of large state-owned enterprises, very small firms that came as a consequence of the market liberalisation process in recent years. Since the transition to a market economy, the government of Mongolia has set up a new policy and proposed concrete measures to support national SMEs. The SME sector in Mongolia employs over 300,000 people which is around 30% of total employees and is accountable for approximately 40% of GDP, but contributes a mere 1.8% to the state budget in taxes.

Table 1. Table information.

Category	Sector	Number of employees	Annual revenue in TUG
Medium	Manufacturing	≥199	≥1.5 billion
	Wholesale trade	≥149	≥1.5 billion
	Retail trade	≥199	≥1.5 billion
	Services	≥ 49	≥1.0 billion
Small	Trade/services	≥ 9	≥250 billion
	Manufacturing	≥19	≥250 billion

Source: sme.gov.mn

3. SME Profitability

Profitability is one of the most important objectives of financial management because one goal of financial management is to maximise the owner's wealth (McMahon, 1995). Thus, profitability is very important in determining

the success or failure of a business. In the establishment stage, a business may not be profitable because of investment and expenses for establishing the business. When the business becomes mature, profits have to be produced.

Competitive performance is often measured by business volume (including sales, and profit) (Barth, 2003; Cheah et

al., 2007; Olutunla and Obamuyi, 2008), efficiency (productivity, return on equity, net profit) (Brooksbank et al., 2001; Davies and Walters, 2004), business growth and sustainable growth (Fu et al., 2002). Profit is especially important because it is necessary for the survival of a business.

4. Mongolian Financial System

The Mongolian financial sector comprises the banking sector and non-bank financial institutions, (NBFIs) such as, savings and credit cooperatives (SCCs), securities and brokerage firms and insurance companies.

Table 2. Structure of the financial sector, 2009-2011.

	2009			2010			2011		
	Number	Assets billion TUG	Percent age of total assets	Number	Assets billion TUG	Percent age of total assets	Number	Assets billion TUG	Percent age of total assets
Commercial Banks	15	4.215	95.6	14	6.214	96.3	14	9.223	96.4
Private	14	4.078	92.5	13	6.034	93.5	13	8.991	94.0
Domestic	9	2.534	57.5	9	4.489	74.4	9	6.489	72.2
Foreign (foreign ownership exceeding 50%)	5	1.544	35.0	4	1.545	25.6	4	2.502	27.8
State-Owned	1	137	3.1	1	180	2.8	1	232	2.4
NBFIs	459	195	4.4	465	237	3.7	467	340	3.6
Insurance companies	18	41	0.9	16	46	0.7	17	77	0.8
Life insurance	1	1	0.0	1	1	0.0	1	3	0.0
Non-life insurance	17	40	0.9	15	45	0.7	16	74	0.8
SCCs	217	45	1.0	179	49	0.8	170	59	0.6
Finance Companies/NBFIs	177	97	2.2	182	129	2.0	192	189	2.0
Securities firms/Broker firms	47	13	0.3	88	14	0.2	88	14	0.1
Total financial system	474	4.411	100.0	479	5.403	100.0	481	9.563	100.0

Source: Bank of Mongolia and Financial Regulatory Commission

Mongolia's banking sector comprises 14 commercial banks of which 13 are private domestic banks, and one is state-owned (i.e. the Bank of Mongolia the central bank). The small financial sector is held by NBFIs that are supervised by the Financial Regulatory Commission. The Mongolian banking system is highly concentrated, with three banks accounting for about 75% of market share (Khan Bank, Hadgalamj Bank and Turiin Bank).

Commercial banks remain the dominant institutions, with 96.4% of financial system assets in 2011 (Table 2). At the end of -2010, credit to the private sector accounted for 49% of GDP and deposits for 60% of GDP, compared with an average of 52% and 63% in the EAP region, respectively. Credit by NBFIs and SCCs has also increased, although it accounts for a small share (about 3%) of total financial sector lending, as NBFIs and SCCs remain small and underdeveloped.

The high cost of credit, has made most entrepreneurs resort to digging deeper into their personal savings, equity partners, friends and family to raise funds to run and grow their businesses; however, there is a reprieve. The decision to start any production type or enterprise depends on the availability of capital, viability of the business and return on investment. As Hallberg (2000) pointed out, government assistance strategies in both developed and developing countries often aim to achieve a combination of equity objectives (alleviating poverty and addressing social, ethnic and gender inequalities) and efficiency objectives (raising the productivity and profitability of firms). However, as Ojo, A.T. (2003) argues, all these SME assistance programmes have failed to promote the development of SMEs.

5. Objectives of the SME Fund

The government recognises the critical role that micro and small enterprises (MSEs) play in the development agenda. It also acknowledges that a significant barrier to the growth of MSEs, most of which are owned by young people, is access to affordable credit. Financial exclusion arising from a lack of credit access and cost challenges eclipses the potential in MSEs to grow their businesses. The fund, therefore, aims to meet the twin objective of addressing youth unemployment and encouraging the growth of MSEs as key drivers of economic growth and development.

Through the fund, the government seeks to empower about three million Mongolians in the informal sector and ultimately bring them into the formal sector. Through access to credit, MSEs are expected to expand their businesses, increase savings, and ultimately promote them to the formal banking system, thus reducing unemployment and poverty. The fund has a capacity building component that aims to enhance the financial management skills of MSE entrepreneurs and entrench best practices. Ultimately, it will address the financial sector's policy goals under Vision 2030 that include increasing financial access. It will also widen financial inclusion for the under-banked and unbanked in Mongolia. This will upgrade informal sector enterprises into the formal sector through access to financial services. The government aims to provide guarantees to groups and businesses that do not have access to credit by covering a share of the default risk of the loan. In the case of default, the lender recovers the value of the guarantee.

6. Theoretical Framework

Suppose that three sources of funding are available to firms: retained earnings, debt, and equity. Retained earnings have no adverse selection problem. Equity is subject to serious adverse selection problems, while debt has only a minor adverse selection problem. From the point of view of an outside investor, equity is strictly riskier than debt. Both have an adverse selection risk premium, but that premium is large on equity. Therefore, an outside investor will demand a higher rate of return on equity than on debt. From the perspective of those inside the firm, retained earnings are a better source of funds than is debt, and debt is a better deal than equity financing. Accordingly, the firm will fund all projects using retained earnings if possible. If there is an inadequate amount of retained earnings, then debt financing will be used.

The main problem for SMEs is finance because all smaller firms live under tight liquidity constraints (Da Silva et al., 2007). Finance, whether owned or borrowed, is needed to expand in order to maximise profit. When outside funds are necessary, firms prefer debt to equity because of the lower information costs associated with debt issues. For most firms, internal funds are always insufficient to undertake the required level of transactions for profitable projects. The financing deficit should normally be matched dollar-for-dollar by a change in corporate debt, which calls for external finance to fill the finance gap. When the sums borrowed are invested by the firm and the investment has proven a success, additional assets are created, which can again be used as security for further borrowing.

7. Statement of Hypothesis

Firms' returns are positively related to bank loans, business sales, firm age, firm size and interest rates. The dependent variable is returns. Thus:

Age is positively related to returns.

Returns are positively related to turnover volume.

Returns are positively related to innovation.

Firm age and education are positively related to higher returns.

Size of labour force is negatively related to returns

From the literature, the final goal of financial management is to maximise the wealth of the business owner and this general goal can be viewed in terms of two specific objectives: profitability and liquidity (McMahon, 1995)

O'Regan et al. (2006) argued that a definitive listing of organisational capabilities is not possible, but they list commonly agreed capabilities:

- Advertise/promote the product or service
- Deliver a broad product range
- Distribute products broadly
- Respond to swings in volume
- Make rapid design changes

- Compete on price
- Provide after-sales service
- Deliver products quickly
- Provide high performing products
- Deliver products on time
- Offer consistent quality
- Involve top management
- Involve line managers
- Adapt flexibly to unanticipated changes.

Robson and Bennett (2000) concluded that the company's strategic management emphasises the personal and leadership characteristics of the owner and entrepreneur. O'Regan et al. (2006) had a similar observation that ownership has important implications for the formulation and deployment of the corporate strategy, and for performance objectives such as short-term and long-term targets.

Several earlier studies (Batra, 1999, Lumpkin & Dess, 1999) argued that firm age has an influence on performance. Stuart, (2000) argued that organisational inertia in old firms tends to make them inflexible and unable to appreciate changes in the environment. Newer and smaller firms, as a result, take away market share in spite of disadvantages such as lack of capital, brand names and corporate reputation compared with older firms. (Kakani., et al. 2001).

Regarding firm age, older firms are more experienced, have enjoyed the benefits of learning, are not prone to the liabilities of newness and can therefore enjoy superior performance. Older firms may also benefit from reputation effects, which allow them to earn a higher margin on sales. By contrast, older firms are prone to inertia and the bureaucratic ossification that goes along with age. They might also have developed routines, that are out of touch with changes in market conditions, in which case an inverse relationship between age and profitability or growth could be observed. (Liargovas, and Skandalis, 2008)

This effect is related to owner-managers' education, relatively higher level of education have a greater ability to efficiently allocate resources to more productive lines of business and to select profit maximising inputs/combinations. They argued that a firm whose management has business entrepreneurial education is likely to perform better than those without managers with education.

8. Material and Methods

The study was carried out in Ulaanbaatar, Mongolia, which is an economic hub in terms of the characteristics of SMEs, availability of physical and financial infrastructure as well as economic resources. Two methods were used to identify SMEs, since no comprehensive listing of SMEs is available in the state. The first was the, listing of firms in Ulaanbaatar City. SMEs were sampled based on a survey of Mongol Bank of 2010 and a national baseline survey that clustered enterprises in the following order: micro

enterprises 1-9 employees; small enterprises 10-49 employees; medium enterprises 50-99 employees; and large enterprises 100 and above. The study employed the fixed-effects model that involved specifying a regression equation that incorporated returns as the dependent variable, and bank advances, sales growth, firm age, firm size and interest rates as independent variables for the 200 firms randomly selected.

The use of profitability to measure performance is in line with profit or utility maximisation assumptions that are the cornerstones of many economic theories (Rantamäki-Lahtinen et al. 2007). As cited in Rantamäki-Lahtinen et al. (2007), Penrose (1995) observed that managers aim to maximise long-run profits, while Barney and Arikan (2005) regarded firms as profit-maximising entities.

The fixed-effect regression model is specified as:

$$\text{Returns growth} = \beta_0 + \beta_1 \text{GNR} + \beta_2 \text{AGE} + \beta_3 \text{ED} + \beta_4 \text{BADV} + \beta_5 \text{TUVR} + \beta_6 \text{INN} + \beta_7 \text{MNXP} + \beta_8 \text{LBR} + \beta_9 \text{IR} + \beta_{10} \text{CB} + \beta_{11} \text{PRS} + \epsilon$$

where GNR is Gender; ED-Education; BADV-Bank Advances; TUVR-Turnover; INN-Innovation; MNXP-Management experience; LBR-Labor; IR-Interest Rates; CB-Customer Base; PRS-Premises; and ϵ -Error

$$\text{Returns growth} = 3.068 + 0.145 \text{GNR} + 0.0162 \text{AGE} + 0.115 \text{ED} + 0.191 \text{BADV} + 0.132 \text{TUVR} + (-0.058) \text{INN} + 0.110 \text{MNXP} + 0.029 \text{LBR} + (-0.192) \text{IR} + (-0.043) \text{CB} + 0.138 \text{PRS} + 0.483$$

Table 3. Regression analysis of the returns of SME.

Explanatory variables	Coefficients and std. errors	t-statistics
R(constant)	3.068** (1.008)	0.581
Gender dummy male=1;female=0	0.145 (0.248)	0.730
Age	0.0162* (0.925)	1.297
Education	0.115** (0.288)	-0.140
Bank advances	0.191** (0.060)	-1.199
Turnover	0.132** (0.003)	1.985
Innovation yes=1; no=0	-0.058* (0.301)	1.432
Management experience	0.110*** (0.626)	-0.554
Labour	0.029* (0.920)	1.123
Interest rates	-0.192 (0.383)	-0.310
Customer base	-0.043** (0.479)	-2.010
Premises dummy rent=1; owned=0	0.138 (0.352)	-0.472
Std. error of estimate	0.483	
F	4.501***	
R ²	0.675	
Adjusted R ²	0.497	
Standard Error of Regression	0.362	
Tolerance	>0.1	
Durbin Watson	1.98	

Source: Own calculations

Dependent variable here is returns: ***P < 0.01, **P < 0.05, *P < 0.1
SPSS software was used to generate, t-statistics, coefficients and standard errors.

Table 4. Correlation matrix.

Variables	1	2	3	4	5	6	7	8	9	10	11	12
1 Returns	1.00											
2 Gender	0.107	1.00										
3 Age	0.223	0.115	1.00									
4 Education	-0.062	-0.034	-0.445	1.00								
5 Bankadv	-0.026	0.110	0.023	-0.199	1.00							
6 Turnover	0.194	0.129	0.095	-0.165	0.186	1.00						
7 Innovation	0.177	0.056	0.143	-0.006	0.018	0.132	1.00					
8 Men exp	0.066	-0.091	0.442	-0.158	-0.080	0.053	0.130	1.00				
9 Labour	0.165	0.048	0.160	0.070	0.196	0.188	0.100	-0.091	1.00			
10 Interestrate	-0.047	-0.166	-0.135	0.081	-0.023	-0.020	0.060	0.005	-0.074	1.00		
11 Custobs	0.138	0.079	-0.088	-0.133	-0.046	0.192	0.013	-0.176	0.023	-0.091	1.00	
12 Premises	-0.038	-0.037	-0.140	0.147	-0.049	0.016	0.101	0.016	0.048	0.006	-0.078	1.00

Source: Author's calculation

Interest rates, r , were measured by the annual percentage rate appearing in each individual contract and loan amount, L , measured by the amount financed in the contract. Because the null hypothesis was based on the effect on returns, our a priori expectation for this relationship was a lagged inverse one. As interest rates increase, demand for credit should decline (or rise at a slower pace), as it becomes more expensive to borrow and more conducive to saving and withholding loan applications.

The data for other variables were derived from primary sources: inflation rates and foreign exchange rates were from the Central Bank of Mongolia, and interests rates were from what individuals were actually paying on their loan contractual obligations.

9. Data Analysis, Results and Discussion

The data collected were analysed by using a number of basic statistical techniques such multiple-regression to test the hypothesis of the relationship between profitability and firm performance and each of the performance indicators of returns, gender, age, education, bank advance, turnover volume, innovation, management experience, interest rates, customer base, inflation and exchange rate. As shown in Table 3, returns, gender, age, education, bank advance, turnover volume, management experience, labour and premise, were all positively and correctly signed as according to the hypothesis. The coefficient of age was

significant at the 10% level, which means that an older business seems to do well because of established customer relationships. The coefficient of turnover was significant at the 5% level which means a higher frequency of sales. Management experience was significant at the 10% level; because, this experience came about by virtue of most business owners doing the business for many years, sales were. The education coefficient was significant at the 5% level, while the coefficient of access to bank advances was also positive and significant at the 5% level. This finding implies that the more the business owner accessed credit, the more its business size increased with a variety of merchandise bought and more labour employed. This finding is also in line with those of various authors that credit is a veritable tool that can lead to increased output if properly applied (Ike and Chidebelu, 2003).

This finding implies that bank loans are positively related to firms profitability and that the profits of SMEs tend to increase with an increasing amount of loans. Firm size affects financial performance in many ways. Large firms can exploit economies of scale and scope and thus be more efficient compared with small firms. In addition, small firms may have less power than large firms; hence they may find it difficult to compete with the large firms particularly in highly competitive markets. By contrast, as firms become larger, they might suffer from inefficiencies, leading to inferior financial performance. For profit maximising firms, a strategy to maintain a high level of profitability requires firms to produce quality products that can easily be sold to generate more revenues, especially through effective and efficient marketing strategies. To achieve full sales potential, the product life cycle must be considered and the entrepreneurs must maximise profitability during the growth stage.

The coefficient of turnover carried a positive sign, confirming our a priori expectation from the economic theory. This means that profits tend to increase with an increase in turnover and that pricing strategy plays a crucial role here, with competitive pricing leading to higher turnover. However, the level of formal educational attainment was not found to be significant. It could be that experience acquired on the job may prove to be more relevant in affecting business operation than the acquisition of mere formal education. However, relevant formal education, it cannot replace experience in a particular enterprise. Examining the coefficient of individual characteristics showed that experience in business management is significant at the 1% level. This finding implies that profitability will increase as the business managers' experience in management increases. This is in line with economic theory that efficiency increases with an increase in managerial experience.

By contrast, innovation, interest rates, and customer base were negatively signed. Although innovation was negatively signed contrary to our hypothesis (+), it was significant at 10% which means that the degree of innovations is still low. Interest rates was correctly signed as per our hypothesis but

not significant.

The regression model was significant at the 1% level as shown by the F-statistic. This result implies that the whole equation shows the best fit. The R² of 0.6750 indicated that 67.5% of the variability in the output of returns is accounted for by the various independent variables used. Moreover, the F-ratio of 4.501 was significant at the 1% level. The standard error of regression of 0.362 and the Durbin Watson statistic of 1.98 imply minimal estimation error and auto-correlation, which are good attributes of econometric estimation results.

In Table 4, the highest positive (0.223) correlation occurs between turnover and age, while the lowest positive correlation (0.066) occurred between management experience and returns. In terms of negative relationships, the highest is that between returns and education (− 0.062) and the lowest is that between returns and bank advances (− 0.026).

10. Summary and Policy Implications

Ceteris paribus, the key driving force behind the operation of any entity is high returns and minimal costs. The study found there is much inefficiency in most Mongolian SMEs. The value chain should be clearly analyzed to unlock the potential of SMEs.

The government should implement policies that would promote cheaper sources of financing from the financial system and promote training programmes that would encourage innovation and new product development. This might encourage local production and reduce an overreliance on exports, which are the main source of merchandise in the supply chain.

The government, through the Ministry of Trade, Ministry of Finance and Ministry of Planning, should also form a joint committee that will interlink them on shared objectives to promote SMEs through the construction of public owned malls with subsidised facilities and, rents. Further, public private partnerships are necessary to accelerate the promotion and performance of SMEs especially given the effectiveness and efficiency that characterises the private sector.

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