THE EFFECT OF MICRO FINANCE SERVICES ON FINANCIAL PERFORMANCE OF SMALL AND MEDIUM ENTERPRISES IN NAIROBI COUNTY

BY

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DECLARATION

I declare that this research project is my original work and has not been submitted for examination for a degree in this or any other university

Signed:……………………………Date:……………………………

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This research project has been submitted for examination with my approval as university supervisor.

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DEDICATION

To my beautiful family, you have been my inspiration to work harder and aim higher.

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LIST OF ABBREVIATIONS

ANOVA	: Analysis of Variance
CBK	: Central Bank of Kenya
K-REP	: Kenya Rural Enterprises Fund
KWFT	: Kenya Women Finance Trust
MFIs	: Micro Finance Institutions
ROA	: Return on Asset
ROE	: Return on Equity
SMEs	: Small and Medium Enterprises

ABSTRACT

Microfinance institutions are vital to the development of economy. Financial institutions avail the products for the SMEs to invest and expand their businesses which in turn boosts the economy. In communities that are underdeveloped, these institutions play a key in their growth as they avail funds to the SMEs who need them for expansion. This study investigated the impact of SMEs among the SMEs in Nairobi County. The researcher used a descriptive research design. The targeted population consisted of the 2,340 SMEs operating in Nairobi County and using stratified random sampling a sample of 234 respondents was selected. This study used secondary data obtained using a data collection sheet. The data was obtained for a period of three years from 2014 to 2016. To analyze the collected data, the regression model was adopted. The findings established that the relationship linking microcredit and financial profitability of SMES is positive and insignificant while correlation linking micro savings and financial performance of SMEs in Nairobi County was also positive and insignificant. The results also show correlation linking micro insurance and financial performance of SMEs was positive and significant while the association linking microfinance training and profitability of SMEs in Nairobi County was also positive and significant. The study concluded that microcredit and micro savings do not significantly affect the financial performance of SMES in Nairobi County The study concluded that micro insurance and the number of microfinance trainings significantly affects SMEs in Nairobi County financial performance. The study recommended that SMEs owner and managers can utilize microcredit as a source of finance which they can use to expand their enterprises. The study also recommended that SMEs owners and managers should always save some money with microfinance institutions since cash savings can be used to secure microcredit. Further, the study owners and managers of SMEs should use the microfinance insurance services to transfer risks, which might be affecting the SMEs. Finally, the study recommended that the owners and managers of SMEs should attend microfinance trainings and other forms of training since training so that they can get skills, which will help them to manage their enterprises.

CHAPTER ONE: INTRODUCTION

1.1 Background to the Study

Microfinance is an important tool in reducing income inequality, giving citizens from a lower socio-economical class a chance to participate in the economy. In addition, its involvement has indicated an upward trend in incomes of both individuals and the government. However, on its own it cannot eradicate poverty in a country. The availability of microfinance services which include deposit savings facilities, loans to clients, emergency fund, financial advice, credit associations debt management and advocacy, rotating saving and financial training in basic skills of running small businesses hugely affect the profitability of SMEs (Mbuta & Nkandela, 1998).

The theories that this study will anchor on are microfinance credit theory and joint liability theory. These theories will be used in this study to elaborate the contributions of microfinance services to SMEs. Poor people lack organized credit facilities since microfinance institutions have little means of determining the credit worthiness of clients, enforcing repayment, or monitoring how the funds are put to use. Recently, most development organizations have embarked on using group lending as a means of offering credit to the neediest people.

On average, SMEs in developing countries provide over 70% of jobs to the formal markets to the host country's citizens (Ayyagari, *et al.*, 2011). They are also known in eradicating poverty through provision of funds to the small and micro enterprises hence increased production, social mobility and innovation. Nonetheless, these institutions are faced with numerous challenges especially those situated in less developed nations such as Kenya.

The stakeholders have frequently made efforts in eliminated some of these constraints which have led to huge amounts of money being spend yearly on various programs in order to boost their growth. Nonetheless, extensive consultations have shed light on the challenges these institutions face day in day out in their operations which have resulted in stakeholders successfully addressing the barriers in the SMEs, hence rendering the stakeholders without the direction on how to implement the necessary programs, strategies and policies to implement. There is need to determine the contribution of microfinance services to SMEs in order to assist in steering investments to the most efficient and effective practices. Therefore, the study aimed to establish the impact of micro finance services on the financial performance of Small and Medium Enterprises in Nairobi County.

1.1.1 Microfinance Services

According to Wambugu, (2007), MFI provides avenue that avails funds to small and micro institutions which entail very small savings, micro insurance, and micro leasing which support extremely poor individuals in growing and establishing their businesses which is in line with main objective of microfinance institutions of poverty alleviation. It is mainly practiced in less developed nations where small enterprises face numerous challenges in accessing cheaper and flexible finances. To many authors, the term is usually taken to refer to availing funds to small businesses and micro entrepreneurs who lack access to banking or related services since such range of clients suffer high transaction costs and interest rates.

Micro-financial services to include savings, credit, insurance and payment service (Ledgerwoods, 1999). Galor and Zeira (2012) refer MFIs as institutions which avail funds to the poor population in the society who find it difficult to access them in the commercial banks. Both agree that microfinance is an important part of a growing economy especially one whose majority of its people are poor.

There are numerous institutions which provide financial assistance including; NGOs, SACCOs, state banks, commercial banks as well as NFIs. They usually target the section of population who are self-employed and business people who have low returns due to low capital injected into their businesses (Ledgerwood, 1999). MFIs have unique characteristics as opposed to other financial institutions which include: -the amount lend has a short repayment period usually below a year which are repaid weekly to reduce the probability of default among the borrowers who earn low income. The MFIs disburse the funds immediately especially for those not applying them for the first time. The banks and other lenders ask for collateral when advancing loans to the borrowers in order to ensure they can recover the amount borrowed in times of default. These loans are designed to help the low income earners to elevate from poverty. The process involved in accessing the loans is less complicated as compared to other lenders where the process is complicated and cumbersome (Khan, 2008).

Another micro finance service to SMEs is financial training. This is the most vital part as the funds could end up being invested in sectors where the capital will never be recovered or being used for personal purposes. These institutions train their clients on how to invest and expand their businesses as well as keeping proper books of accounts which is also an important factor to financial prosperity. Wright (2000) in his study revealed that the funds directed towards training is waste of resources which could have been used for other developmental schemes as well as improving the service delivery of the MFI itself.

Under this study, Micro finance services will have operationalized using, Microfinance credit services (Credit received per year), Microfinance saving services (Amount of savings, Micro insurance (Amount paid for insurance) and Micro finance training services

1.1.2 Financial Performance

According to Bran, and Woller, (2010), defined financial performance as the efficiency with which a firm uses its resources in generating revenues. Papadaki, and Chami (2002) define performance as revealing the health of a firm as well as its going concern, and also used for comparing firms in the same industry. There are various ratios which are used for measuring the performance of firms.

Firms are mostly concerned with their profitability, as profitability serves as the main driver for firms engaging in businesses as firms constantly making losses will in the end be insolvent. The notable measures of financial performance in companies are ROA, ROE and net margin on sales. It also serves as the measure of how well a firm is performing in the corporate world. The use of equity and debt impact the common performance measures in different ways. A given firm with relatively high use of debt will have higher interest expense and therefore lower net margin. On the other hand, a relatively lower use of equity would result in a proportionately higher return on equity. Therefore, if a corporate entity were to use relatively less debt and more equity, the opposite would be true (Liebrand, 2007).

Many firms use past and present financial performance as the only measures of how well the firm is performing but they focus on the performance of other firms in that industry (Carton, 2004). The main ratios used as proxies for financial performance include: growth of sales, ROI and ROS, ROE as well as the dividends earned by the shareholders(Carton, 2004). This study will use net profit as a measure of financial performance.

1.1.3 Microfinance Services and Financial Performance

Micro finance services have direct impact on the performance of the SMEs. When SMEs access funds at high rates even if they are having high turnover, they will end up using the earned revenues in repaying the loans (Bowen, Morara, & Mureithi, 2009). The products produced by SMEs face high competition from large and established institutions hence finding it hard to penetrate market hence default rate is high. The little they make goes to repaying loans hence retained earnings are quite low making expansion in the SMEs difficult hence their stagnation and sometime collapse. This calls for the stakeholders to provide interest free loans to these enterprises in order to realize growth.

Microcredit is another way of increasing the performance of SMEs as it encourages them to make savings from which they will be allowed to borrow according to their borrowings. This benefit both the SMEs and lending institutions as the financial institutions have funds to loan to the borrowers and the SMEs are eased with the burden that comes with the loans. In less developed nations, SMEs are synonymous as they are the major drivers of the economy by availing funds for many start-ups and those small enterprises wishing to expand their businesses.

MFIs are on the forefront in poverty eradication around the world due to their primary objective of lending to the poor in the society which in turn boosts the GDP of a nation (Akinyemi; cited in Onuba, 2008). SMEs not only play economic role in the society but social one as youth who are majority owners of these SMEs are always occupied hence don’t have time to engage in criminal activities which provides a conducive environment for growth of businesses. This shows the role of the SMEs in the society hence well governed SMEs are vital in job creation, bridge the gap that exists between the haves and have not in the society as well as providing conducive environment for businesses (Ahmed et al., 2000). Madole, (2013) in their study of the effect of MFIs on profitability of SMEs in Zanzibar found that; the role of financial institutions aimed at SMEs success is a very important. Quaye and Obli (2011) did a study on significance of MFIs on profitability of SMEs in Ghana. The study found out that micro these institutions play an important and positive role in SMESs development.

1.1.4 Small Scale and Medium Enterprises (SMEs) in Nairobi County

Like in many developing countries, SMEs are vital to the economic growth of this nation as they provide employment to over 85% of the total labor force. Under the constitution promulgated in 2010, it opened opportunities for the SMEs to thrive through creating opportunities which never existed in the previous Acts and by creating devolved system which opens new markets for their products. The performance of SMEs in the counties heavily relies on the structures and the laws aimed at boosting their performance.

Nairobi County government has come up with different programs aimed at supporting as well as financing SMEs. These enterprises make substantial contribution to the economic growth and development of Nairobi County because they create job opportunities and help in curbing unemployment situation within and without the county. Job creation and output growth as an important contribution of SMEs is widely accepted in both developed and developing countries (Mbuta & Nkandela, 1998).

Nairobi County is well served by microfinance institutions. However, as in many other parts of country, the MFIs in the county have fallen short in removing the financial barriers of the SMEs sector has not been satisfactory. The appraisal processes of assessing delayed loan disbursement, creditworthiness, and the approach by government to preferential rates of interest, have reduced the amount of credit that is available to the small and medium size enterprises and how well the available funds are utilized. The overall outreach by the microfinance sector that is generally weak, alongside some push for formal sector to reduce their scale, has threatened and raised concerns that the SMES are likely to continue to lacking access to basic, cheaper and important financial services (Atieno, 2001).

The government has been in the forefront indicating great concerns for the development of the SMEs because of their contribution to socio economic factors that are plaguing the developing countries. However, the maximum potential and benefits of the micro business in the development process have not been achieved due to many setbacks. This lead the Central Bank of Kenya (CBK) as part of its reform agenda to initiate policies aimed at bringing credit closer to the door steps of the very poor in the society.

1.2 Research Problem

Microfinance services play vital part in growth of economy (Mutuku, 2010). They avail the products that allow SMEs in saving funds which they mobilize and in turn lend to the SMEs for investment hence boosting the performance of the economy. In communities that are underdeveloped, the MFIs play a key role in availing the funds that are much needed by SMEs (Kemei, 2011). SMEs are available in various sectors whereby they employ majority of youth and women, source of income to poor, and income for the government as well as poverty alleviation. It covers a huge percentage of all businesses in the country, give approximately 4million people jobs. The poor need financial support in form of financial products stabilization, and consumption and shield themselves from risks. Microfinance comes with the premise which poor population in the society are able to access hence uprooting them from the poverty.

In Kenya, the government really supports the SME sector as a way of providing jobs to the youth. Although the SMEs contribute greatly to the economy, majority of them experience financial challenges (Ngugi, 2009). One main problem of SMEs in Kenya that still exists and defies logic is funding. Most SMEs in Kenya face barriers in gaining access to finances as a result of their limited assets. This hinders expansion and growth of these SMEs leading to their poor performance (Makena, 2011).

Ojo (2009) examined the effects of microfinance on entrepreneurial development in SMEs in Nigeria, the study revealed major differences in the number of entrepreneurs who used products and services offered by MFIs and those who do not. The study also found out a significant impact of microfinance services in enhancing productivity but not entrepreneurial development. Dyar, Harduar, Koenig, and Reyes (2006) examined the effect of inequality in MFIs in China where they revealed many advantages are associated to providing microfinance to women than men, despite lack of convincing evidence on whether this significantly reduces gender inequality in the society. Microfinance gives women greater economic power, stronger social and political empowerment and better living standards.

A study by Bran and Woller (2010) explored the impacts of MFIs in Asian countries. They revealed that MFIs have provided better social environment even more than it does to the economy. Idowu (2004) undertook a study on the effects of Microfinance on SMEs in

Ghana. Their findings show many SMES have benefitted from the funds advanced to them in form of loans even not all of them were able to access the funds.

Mbugua (2010) studied the impact of MFIs on SMES profitability. The study found out that micro finance services actually enhance the performance of SMEs in Kenya. A study aimed at determining the challenges faced by SMEs in Kamukunji District in Nairobi County by Koech (2011) discovered that the factors that affect growth included cost, collateral requirements, capital access, capital market, capital management and cost of registration. Ngugi, (2009) studied financial challenges that were faced by Small and Medium Enterprises (SMEs) and the study indicated that inadequacy access to finance is key obstacle to Small and Medium Enterprises growth. Wachira (2011) studied the influence of the wider use of microcredit by the SMEs based at Mutindwa market of Buru Buru estate. The study established existence of relatively strong correlation linking the loan terms and conditions and loan use. No study that is known to the researcher had focused on the contributions of MFIs on SMEs in Nairobi County therefore this study will be carried out with the intention of bridging this gap and give a keen focus on the contributions of microfinance services on the SMEs in Nairobi County. To achieve the research objective, the research question which is: what is the impact of micro finance services on the financial performance of Small and Medium Enterprises in Nairobi County?

1.3 Research Objective

To establish the effect of micro finance services on financial performance of Small and Medium Enterprises in Nairobi County.

1.4 Value of Study

The findings provide vital insights that can inform the owners of the SMEs the extent to which they can finance their enterprises through loans to boost their profitability by improving their welfare through their businesses specially.

The mandate of policy making will benefit on matters that relates to the financing of the SMEs owned by the poor through microfinance and other financial institutions. The study will provide deeper and better knowledge that policy makers can consider in their efforts to better the performance of the SMEs. Hence, the research is an important tool that will act as a guide in coming up with the best policy for financing microfinance institutions.

To other researchers and academicians, the study would be of great importance. It will be important to the researchers who wish to embark on advanced studies on the subject matter. The study will also provide critical source for literature review hence contributing to the theory.

CHAPTER TWO: LITERATURE REVIEW

2.1 Introduction

This review will highlight theories and work that has been carried out by other scholars in the past concerning the phenomenon under study**.** It will bring forth the gap that exists in the topic under study despite the previous researches that have been carried out by other scholars. This chapter reviewed some of the literature on correlation that exist between and microfinance services and small scale and medium enterprises (SMEs) will also be discussed.

2.2 Theoretical Review

There are different theories that try to explain the relationship between microfinance services and small scale and medium enterprises (SMEs). Two of those theories, microfinance credit theory and joint liability theory will be used in this study to elaborate the contributions of microfinance services to SMEs.

2.2.1 Microfinance Credit Theory

Microfinance Credit Theory was propagated by Dondo in 1999. According to the theory, the concept of lending to groups instead of lending to individuals is viewed as the solution to default rate which is common in these institutions as well the problem that arises due to information asymmetry as it's the main cause of adverse selection. Adverse selection problems arise where the lender is unable to separate the safe from risky borrowers. This forces the lenders to charge high rates for their loans in order to recover their funds from those who default which makes the capital expensive especially to the poor (Rahman, 2010).

Dondo (1999) conducted a study to trace the history of the MFIs in the country which were established in early 1950s with their main objective being lending to small enterprises. The sector has experience success as it's currently on of the leading in the continent (Kashangaki et al, 1999). It has led to the growth of the MFIs spread across the country.

This theory is relevant to this study since it informs Microfinance services which is the independent variable in this study. The institutions have experienced growth due to their ability to screen the borrowers separating risky from safe ones**.** Their management have increased their operations to include other financial activities like deposit taking which boosts the firm's incomes.

2.2.2Joint Liability Theory

Joint Liability Theory was propagated by Ghatak in 1999. The theory argues that the reason why the poor find it difficult in accessing credit is because financial institutions have little avenues to screen their clients, enforcing repayment or following up to ensure the funds are used for investment purposes. In the recent past, many non-profit making organizations and development organizations have made use of group lending to provide credit to the poor. Group lending is intended to reduce default rate among the borrowers by ensuring the ones who fail to repay their loans are repaid by the group members (Banerjee *et al.* 1994, Diamond, 1984; Varian, 1990).

To overcome the prohibitively high fixed costs which in turn creates barriers in providing small loans, formal lenders use group loans. Group lending under joint liability offers a wonderful solution and barrier of lending to those without collaterals. This problem protects borrowers from getting rid of agency costs that arises from information asymmetries between the parties or by the lenders in the credit market which is prevalent in under developed nations (Ghatak & Guinnane, 1999).

Joint Liability Theory is relevant to this study since it informs Microfinance services which is the independent variable in this study. Many microfinances have adopted group lending schemes, where the client is a group of people who form the groups through peer selection. The SMEs shift the burden of screening and monitoring to members as there is joint liability of the advanced amount (Barnes, 2001). Groups are formed by individual borrowers to qualify for credit facilities and all other group members will be held collectively liable for each other's debt.

2.3 Determinants of Financial Performance of SMEs

The main determinants of performance of SMEs whether they are solely brought in by services of MFIs or not (Cheston & Kuhn 2002). The main determinants of financial performance of SMEs include Credit services, savings services, micro insurance, training services, age of the business as well as size of the business.

2.3.1 Microfinance Credit Services

In development of SMEs, accessing credit is becoming increasingly important factor. It is argued that credit increases income levels, increasing employment opportunities especially to the youth and thus poverty reduction. Moreover, being able to access credit facilities, the poor get to solve their cash flow problems and more importantly engage in activities such as the improvement of farming technology that in turn leads to an increased agricultural output (Hiedhues, 1995).

According to Buckley, (1997) the measures of success of any micro-credit programs are high loan repayment rates, greater market reach and financial sustainability but it does not consider the impact it bears on micro enterprise operations. In addition, (Burger, 1989) concluded that microfinance does not increase income or increase jobs but rather tends to stabilize and preserve income. According to Navajas *et al*, (2000) the top most agenda of micro-credit programs is to uplift the wellbeing of the poor through poverty alleviation as a result of suitable and easier access to cheaper funds which are not offered by other formal lenders.

2.3.2 Microfinance Saving Services

The efforts of smoothening consumption are not possible if there is nowhere money can be safely stored as well as being able to accurate capital sufficient in starting small businesses. When one does not have any other source of income or in the case of an emergency, people have an option of choosing between exhausting their savings and borrowing. The limitations evident in developing countries and due to the fact that majority remain delinked from the financial sector reduces the choices that the poor have (Cheston & Kuhn, 2001).

Savings accounts that are aimed at cultivating a culture of savings amongst the poor people are offered by many larger microfinance institutions (MFIs). A well-known example is the Grameen Bank in Bangladesh. However, the industry remains heavily dominated by credit facilities that are aimed at advancing credit to the poor individuals consequently, the ability to save through the MFI is mostly driven by the need for credit. Of the 165 MFIs studied in 2010 by the Microfinance Information Exchange, all institutions offered credit while only 27% offered savings products. Majority of scholar's state that there should be a balance between saving and borrowing (Guichandut, 2006).

2.3.3 Micro Insurance

Microfinance also has been in the limelight upon safeguarding poor individuals from the extreme risks that characterizes their everyday lives. Micro Insurance, loans, and savings helps in ironing out income or cash flow fluctuations ensuring that consumption levels are maintained even during thin periods (Brockhaus, 2001).

Many group lending programs normally offers an insurance of guarantee scheme where each member is expected to give a certain percentage of the loan amount to the insurance fund. if a member dies, the fund will be used to clear amounts due and used to assist the deceased member's family with the required resources to cater for the burial and other costs (Brockhaus, 2001).

2.3.4 Microfinance Training Services

Many writers have portrayed microfinance as means of SMEs financial self-sustainability. Bengston explained that micro financing for the poor individuals is designed to make their micro enterprises even more economically paying thus contributing to financial empowerment in their families, in political and social spheres. The reason for giving assistance to microfinance and the targeting their programs is that microfinance is a vital means and entry area for empowering poor individuals (Cheston & Kuhn 2002).

2.3.5 Age of the Firm

Another important factor that determines financial performance of the firm is its age. The length of time that the business has operated determines how that business performs in financial terms. This is because such firms have wider experience in the market and are able to enjoy benefits that accrue from economies of scale. According to Santalo and Becerra (2008) as a consequence of good name and good businesses practices build overtime with the suppliers and other stakeholders, the business will probably experience a better performance compared to newly established firms in a market. The proprietors will end up spending huge amounts of money before adapting to the new environment.

2.3.6 Size of the Firm

Small businesses bear bigger information asymmetry as compared to their bigger counterparts. Furthermore, such businesses experience increased costs when floating new capital (Sebastian 2010). On the other hand, large businesses are known to be very good in managing their working capitals in a more efficient manner than small businesses. They enjoy economies of scale and thus improving on their financial performance as a result of minimized costs (Pandey, 2005).

There are a couple of ways that are mostly used in determining current the size of a business. One of the measures is sales turnover where you from the sales of the firms' products before deducting the cost of sales. The other measure is number of staff that the firm has which is the easiest method of determining how large the firm is. Another approach to measuring the size of the businesses is to determine the amount of capital that has been employed by the business. Capital employed normally varies depending on how large a firm is. A small firm requires small capital to fund its investing activities, while large businesses will require a lot of funding for planning and financing its investment activities (Kumar, 1995).

2.4 Empirical Studies

Copstake, et.al (2000) conducted a research to determine the impact of MFIs on poverty reduction in Zambia. The study did not focus on the very poor enterprises but a portion of those who were living below a dollar a day. Loans were given on a graduated scale such that those who successfully cleared their first one graduated to a second one and on average the SMEs recoded significant higher growth in their profit business size by diversification and in turn increased household income. The study also compared other small businesses that did not seek financial services of MFIs and concluded that their growth was relatively lower as compared to the ones that took advantage of these services. Since this study did not concentrate on the very poor, this created a contextual gap.

Idowu (2004) studied the effects of MFIs on SMEs (SMEs) in Ghana. The results revealed that a good number of SMEs did benefit from MFIs loans but on the other hand, a handful of SMEs were not able to secure the amounts they required. In addition, the study also indicated that many SMEs were appreciative of the big contributions by MFIs in promoting their market outreach, innovations in coming up with new products to satisfy their markets and by putting the SMEs in a competitive edge with other bigger businesses in the general market. This study was conducted in Ghana and thus presenting a contextual gap.

Olu, (2009) studied the effect of microfinance on promoting entrepreneurship of SMEs in Nigeria. The study made use of questionnaire as its major tool of primary data collection.

The study showed that MFIs are critical tools of entrepreural development since they offer services that are accessible by many small businesses. The study further revealed that reforms that were put in place by the state through various legislations will make MFIs compete favorably with other players in the sector. The study concluded that MFIs are directly correlated to the economy performance of Nigeria. The study findings showed that the activities of MFI contribute greatly in the direction of the economy of Nigeria in general.

Nilsson (2010) sought to establish the impact of MFIs on growth of SMEs in Cameroon. To achieve the objective of the study, the researcher used a case study approach that comprised the Cooperative Credit Union League in Cameroon. The study findings revealed that MFIs are a vital instrument to many developing economies since they are able to satisfy the financial needs of the very poor individuals of the society. Though this study focused on the effect of MFIs on growth of SMEs, it was not conducted in Kenya and thus presenting a contextual gap.

Bran and Woller (2010) conducted a study on effects of microfinance in India. They also revealed that microfinance has contributed greatly by bring better economic, psychological and social empowerment, though it states that the psychological and social empowerment benefits the poor more than the economic empowerment. The other results from the study further revealed that the impact of microfinance is reduction of poverty by improving rural savings, self-confident, skill development, self-worthiness, awareness about environment, managerial ability in decision making process, commendable in courage, peace in the family and group management. As a consequence of participating in microfinance, there is evidence of a greater improvement in managerial skills, social empowerment and psychological well-being. This study concentrated on the effects of MFIs in general and thus presenting a conceptual gap. The current study will specifically focus on the impact of micro finance on SMEs. Further, the study focused on India economy and thus presenting a contextual gap.

Koech (2011) conducted a study to establish the factors hindering the development of SMEs in Kenya. Case study approach was used in this study and mainly targeted Small and Medium Enterprises (SMEs) in Kamukunji. Structured questionnaires were adopted as the main instrument for collecting data. Analyzing data was done with the aid of SPSS to obtain the frequencies as well as mean. The barriers to development of SMEs were established to include cost, limited access to capital and collateral requirements.

Wachira (2011) conducted an investigation to establish the factors that greatly influenced the use of micro-credit among SMEs at Mutindwa market (Buruburu estate). Primary data was the preferred method for data collection through the use of questionnaires. The study concluded that there existed a direct correlation linking MFIs loan terms and conditions such that those MFIs that offered more friendly terms attracted more clients. This study looked at only one variable that is micro credit and thus presenting a conceptual gap. A part from micro credit, this study will focus on micro saving services, micro insurance and micro finance training as some of the variables impacting on financial performance of SMEs.

Cooper (2012) on a study about the impact of micro-finance services on the growth of SMEs in Kenya, he concluded that SMEs heavily depend on micro financing for their development and growth. The researcher used self-developed questionnaires and quantitative analysis in data collection and data analysis respectively. A big percentage of SMEs were found to have been seeking microcredit to finance their operations. The study further revealed that the contributions by microfinance services have greatly improved and changed their economic conditions of SMEs which experienced growing revenue. Though the SMEs have enjoyed easy access to affordable micro-credit, the study also established that they were still went through thorough screening before they could qualify to be advanced loans. It also revealed that micro insurance services are not common to most SMEs in Nairobi and therefore MFIs engage in awareness to Small and Medium Enterprises. The study concluded that microfinance services have greatly contributed to the growth of SMEs in Kenya. Though this study was conducted in Nairobi, it used only 50 SMEs as a unit of observation and thus presenting a methodological gap. The current will use 5,311 SMEs operating in Nairobi County.

Memba et al. (2012) carried out study on the impact of capital on the development of SMEs in Kenya. It used a sample of 100 SMEs that had been financed by venture capital from MFIs in Kenya. Primary data was the preferred method of data collection through the use of questionnaires. The study concluded that SMEs experienced much greater growth in assets, profits and number of employees after using the financial service. The study also stated that poor performance by SMEs can be attributed to lack of finance in most developing countries. The study further recommended that other SMEs should take advantage of the facility as they will experience similar growth and lead the country in achieving vision 2030.

Mwewa (2013) conducted a research on the impact of MFIs on growth of SMEs in Machakos County. The study acknowledged the contributions of SME sector in the improved economy of Kenya. It stated that the sector contributed to the GDP increase from 14% in the early 90's to 19% in early 2000. The study concluded that the growth in sales was greatly influenced by microcredit availed by MFIs in the county since there was a direct association linking microfinance services and the SMEs growth. Additionally, the study also revealed that microcredit and training were leading in the growth of the small businesses.

2.5 Conceptual Model

A conceptual model gives an idea of the association between and influence amongst the variables informing the investigation and helping in achieving the set goals. Kothari (2004) describes an independent or explanatory variable as the variable presumed to give rise to variability in the dependent variable, whereas a dependent variable is described as a variable that ought to be explained. The main aim of a conceptual model is to particularly classify and give a detailed account of the idea closely connected to the investigation and give a representation of the association between them. Similarly, a framework would help the researcher describe exactly the abstract idea, give a representation of the terrain of the research or conceptualize the extend, arrange according to associations among concepts, and establish gaps in the written works. This is graphically represented in figure 2.1 below.

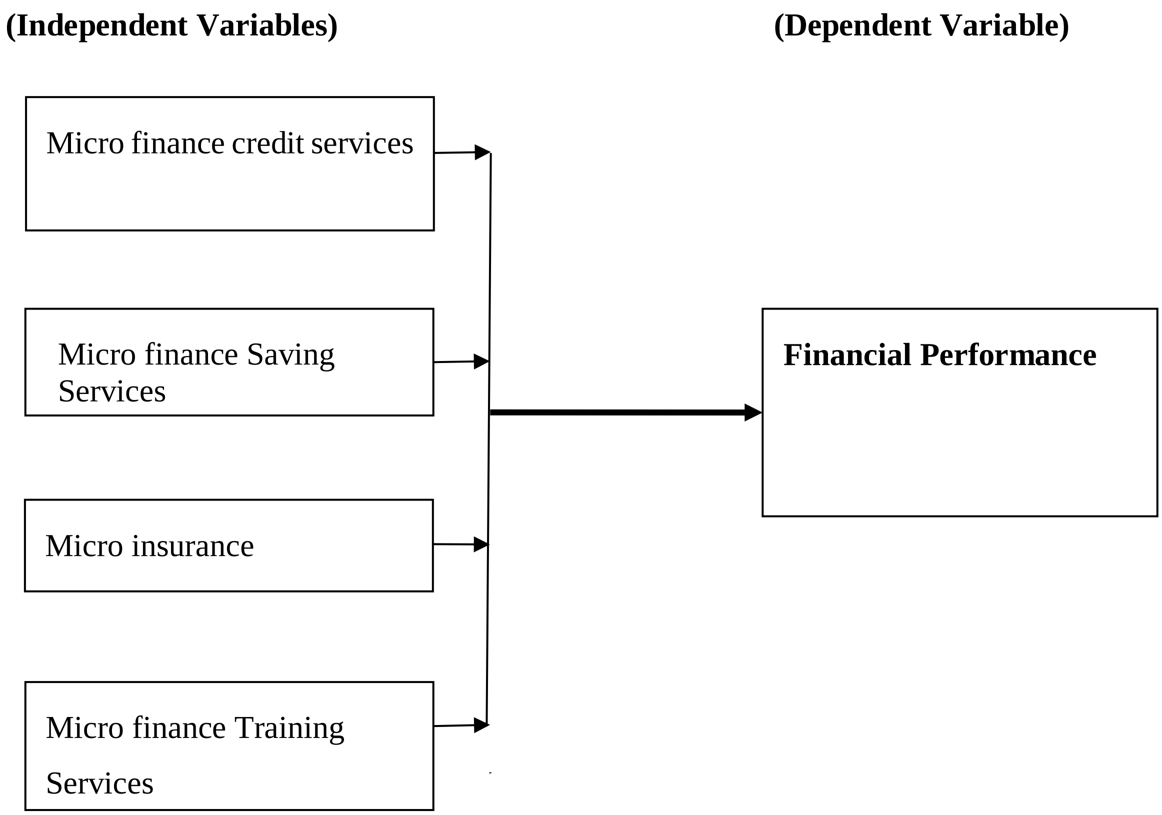

Figure 2.1: Conceptual Framework

2.6 Summary of Literature Review

Nilsson (2010) carried out a study to establish the influence of micro finance institutions (MFIs) on the growth of small and medium size businesses (SMEs) in Cameroon. Though this investigation focused no establishing the marked effects of micro finance institutions (MFIs) on the process of developing the small and medium size businesses, it was conducted in Cameroon and thus presenting a contextual gap. The current study will be conducted in Kenya. Idowu (2004) carried out a study on the effects of Microfinance on Small and Medium Enterprises in Ghana. Though this study focused on the impact of micro finance institutions (MFIs) on small and medium size businesses (SMEs), it was carried out in Ghana and as a result introducing a contextual gap since such a study has not been carried out in Kenya.

Bran and Woller (2010) conducted a study to determine the impacts of microfinance in India. The research showed that microfinance did bring in a greater way better psychological, social and economic empowerment and stated that poor people enjoyed both the psychological and social empowerment than economic empowerment. This research focused on the effect of microfinance in general and thus presenting a conceptual gap. The current study will specifically be looking at the effects of microfinance on SMEs in Nairobi County.

Further the study focused on India economy and as a result presenting a contextual gap. The current study will be conducted in Kenyan Economy. Cooper (2012) on a study about the effects of micro-finance services on the growth of SMEs in Kenya that aimed to investigate 50 SMEs in Nairobi concluded that SMEs mostly rely on micro financing for growth. Though this study was conducted in Nairobi, it used only 50 SMEs as a unit of observation and thus presenting a methodological gap. The current will use 5,311 SMEs operating in Nairobi County.

Koech (2011) conducted a study to find out the financial barriers that that make it difficult for in the process of growing the SMEs in Kenya. This study focused on the economic restrictions that inhibit the process of growing and expanding SMEs in Kenya and thus presenting a conceptual gap. The current study will look at the marked effects of MFIs products on the financial performance of Small and Medium Enterprises so as to bridge the existing gap. Wachira (2011) in the study undertook an enquire the contributors to the use of microcredit amongst the SMEs based at Mutindwa market of Buru Buru estate. This study looked at only one variable that is micro credit and thus presenting a conceptual gap. A part from micro credit, this study will focus on micro saving services, micro insurance and micro finance training as some of the variables impacting on financial performance of SMEs. Therefore, this study will be conducted so as to fill the identified research gaps stated above.

CHAPTER THREE: RESEARCH METHODOLOGY

3.1 Introduction

This chapter gives a detailed plan designed to achieve the goals of the research by establishing the effect of microfinance services on the Financial Performance of Small and Medium businesses. The chapter gives the research methodologies under the main subsections namely; the research design, target population, sampling procedure and sample size, research instruments, data analysis procedures.

3.2 Research Design

Research design gives a generalized plan and arrangement of the study so devised in the mind of the researcher as to secure convincing solution to research questions. A descriptive study involves establishing the rate at which something occurs over a given period of time or the connection involving the variables (Cooper & Schindler, 2003). In this study, the researcher adopted a descriptive research approach. Descriptive study will be suitable for this study, because the researcher intends to gather detailed facts by means of descriptions and is important in establishing variables and logical conclusions.

3.3 Population

Population is the whole set of elements, events or objects with a homogeneous noticeable feature. The targeted population consisted of the 2,340 SMEs operating in Nairobi County (SMEs Report, 2015). Stratified sampling was employed since SMEs in Nairobi are not homogeneous. Business categories are the stratus from which the sample was selected. The study was conducted in the Central Business District (CBD) which is home to about 810 (34.62%) SMSEs, Kamukunji Sub-County with about 610 (26.06%), Starehe Sub-County with about 510 (21.79%) MSEs and Makadara Sub-County with 410 or 17.52% (SMEs report, 2014). The ranking in percentage is based on the total number of SMEs in Nairobi County which is 2340 SMEs. The four sub-counties were chosen because they host half of the total number of MSEs in Nairobi County.

Table 3.1: Population

Study location	Target population
CBD	810
Kamukunji	610
Starehe	510
Makadara	410
Total	**2340**

Source: Author

3.4 Sample

Sample size is a specified number of elements or situations drawn from the population which is carefully chosen as being suitable in representing the entire population with the appropriate features. A sample can therefore be considered as a smaller portion acquired from the population. According to Mugenda and Mugenda (2003) since the population is huge, the fisher et al, (2003) formula was employed.10% of population was used. This is according to Kothari (2004) who argued that 10% or more of a population is acceptable for a descriptive study. Hence, stratified random sampling was employed in selecting the 234 respondents. The 234 respondents were distributed proportionately according to the owner-managers of SMEs' population in each sub-county.

Table 3.2: Sample size

Study location	Target population	Sample frequency	Percentage (%)
CBD	810	81	10%
Kamukunji	610	61	10%
Starehe	510	51	10%
Makadara	410	41	10%
Total	**2340**	**234**	**10%**

Source: Author's computation

3.5 Data Collection

This study used primary data which was collected using a data collection sheet. The data collection sheets were administered to the managers of the sampled small and medium enterprises in the respective locations. The data collection sheet obtained data on financial performance and on the Credit received per year (loan amount), estimated amount of savings, Amount paid for microfinance insurance and number of trainings by microfinance's. The data was obtained for a period of three years from 2014 to 2016.

3.6 Diagnostic Tests

The study checked for normality using skewness and kurtosis. The study also checked for multicollinearity using correlation analysis and the variance analysis and the variance inflation factors. Finally, the study checked for independence of observations (serial correlation) using the Durbin Watson statistic.

3.7 Data Analysis

Data analysis includes using of reasoning in understanding the data presented with the intention of establishing fairly accurate trends and giving a summary the appropriate details disclosed in the research(Griffin, 2010). Descriptive statistics record the main features on association between the study variables.

3.7.1 Analytical Model

The multiple linear regression model which was used was as follows;

$$Y = \beta_0 + \beta_1 X_1 + \beta_2 X_2 + \beta_3 X_3 + \beta_4 X_4 + \epsilon$$

Where,

Y= Financial Performance measure using return on assets, which is the ratio of net income to total assets

X_1= Microfinance credit services (microcredit) measured using the natural log of the credit received per year

X_2= Microfinance saving services (micro saving) measured using the natural log of the amount of savings

X_3= Micro insurance using the natural log of the amount paid for insurance

X_4= Micro finance training services measured by the number of trainings

Є= Error term

In the above equation, β_0=the term that remains constant whereas the coefficient β_i=1…4 will be used to measure how sensitive the dependent variable (Y) to unit a change in the independent variables X_1, X_2, X_3 and X_4. ϵ is the error term, which expresses the unaccounted-for variations in the model.

3.7.2 Test of Significance

The analysis of variance (ANOVA) was used to check accuracy and to disclose the entire model importance. In specific, a comparison was done between the calculated f statistic and the tabulated f statistic. To establish whether or not the overall model was significant, a critical p value of 0.05 was also be used.

CHAPTER FOUR: DATA ANALYSIS, RESULTS AND INTERPRETATION

4.1 Introduction

The chapter analyzed data and the discussion of the results. The chapter entails the response rate results, descriptive result, correlation and regression findings and the results interpretations.

4.2 Response Rate

The sample of this study was 234 SMEs in Nairobi County and collected secondary from the SMEs from a period of 3 years from 2014 to 2016. From the 234 sampled SMEs only 152 respondents to the issued data collection sheets. The 152 SMEs made up a response rate of 64.96% and generated 456 data points, which were adequate to run a regression model.

4.3 Descriptive Statistics

Table 4.1 Descriptive Statistics

	ROA	Microcredit	Micro savings	Micro insurance	Microfinance training
Mean	.0585	12.0350	13.0230	12.5571	2.8618
Std. Deviation	.08678	9.66292	1.78631	1.75987	1.75931
Skewness	.072	.060	-.065	-.159	.591
Kurtosis	1.369	.726	-.149	.289	-.382
Minimum	-.140	.000	6.670	5.970	.000
Maximum	.640	21.730	18.030	18.000	7.000

Source: Research findings

The descriptive results on table indicate that the average return on assets for the sampled SMEs is 0.0585 with minimum and maximum values of -0.140 and 0.640 respectively. The findings also show that the average microcredit in terms of natural log (Ln) is 12.0350 with minimum value of 0.000, which indicate some SMES had not borrowed any amount from microfinance institutions and a maximum value of 21.730 respectively. The results further indicate that average micro saving in terms of natural log (Ln) is 13.0230 with minimum and maximum values of 6.670 and 18.030 while the mean value of micro insurance 12.5571 with minimum and maximum values of 5.970 and 18.000 respectively. The findings also show the average number of microfinance training is 3 with a minimum of 0.00 which indicates that some SMEs had not been trained by microfinance with other receiving a maximum of seven trainings. The kurtosis and skewness value indicates that the data was normally distributed since all the skewness and kurtosis values lie with the range of negative and positive one.

4.4 Correlation Analysis

Table 4.2 Correlations

	ROA	Microcredit	Micro savings	Micro insurance	Microfinance training
ROA	1				
Microcredit	.003	1			
Micro savings	.059	-.012	1		
Micro insurance	.204**	.002	.015	1	
Microfinance training	.143**	.008	.209**	.049	1

**. Correlation is significant at the 0.01 level (2-tailed).

Source: Research findings

The correlation results on table 4.2 indicate a weak and direct association linking microcredit, micro savings, micro insurance, microfinance training and financial performance of SMEs in Nairobi County.

4.5 Regression Analysis

4.5.1 Model Summary

Table 4.3 Model summary

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate	Durbin-Watson
1	.246[a]	.060	.052	20.08859	2.039

a. Predictors: (Constant), Microfinance training, Microcredit, Micro insurance, Micro savings

b. Dependent Variable: ROA

Source: Research findings

The regression summary on table 4.3 indicates independent variables contributes 6% of the variation in the dependent variable as indicated by the coefficient of determination value of 0.060. The Durbin Watson statistics of 2.039 lies within the range of 1.25 and 2.5 indicates that there is no autocorrelation.

4.5.2 Analysis of Variance

The results of ANOVA below indicate that the regression model is fit and significant as indicated by the p value of 0.000, which is less than the significance value of 0.05. The findings also revealed the model is a good prediction of the correlation linking **the variables.**

Table 4.4 ANOVA

Model		Sum of Squares	df	Mean Square	F	Sig.
	Regression	11701.307	4	2925.327	7.249	.000[b]
1	Residual	18201.744	451	403.52		
	Total	193703.050	455			

a. Dependent Variable: ROA

b. Predictors: (Constant), Microfinance training, Microcredit, Micro insurance, Micro savings

Source: Research findings

4.5.3 Coefficients

Table 4.5 Coefficients

Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.	Collinearity Statistics	
		B	Std. Error	Beta			Tolerance	VIF
	(Constant)	1.041	1.594		.653	.514		
	Microcredit	.005	.097	.002	.055	.957	0.998	1.002
1	Micro savings	.011	.017	.030	.633	.527	.956	1.046
	Micro insurance	.108	.025	.198	4.328	.000	.998	1.002
	Microfinance training	.101	.037	.127	2.723	.007	.954	1.048

a. Dependent Variable: ROA

Source: Research findings

The results of the regression coefficients indicate that the association linking microcredit and financial performance of SMES is positive and insignificant while correlation linking micro savings and financial performance of SMEs in Nairobi County is also positive and insignificant. The results further show that the association linking micro insurance to financial performance of SMEs is positive and significant while the correlation linking microfinance training to financial performance of SMEs in Nairobi County is also positive and significant. The collinearity statistics indicate that the all variance inflation factors are less than 10, which is an indication there is no multicollinearity.

4.6 Interpretation of the Findings and Discussion

The findings revealed an insignificant and direct correlation linking microcredit and financial performance of SMEs. This finding means that microcredit have a week impact on the financial performance of SMEs in Nairobi County. A study by Idowu (2004) revealed that a good number of SMEs did benefit from MFIs loans but on the other hand, a handful of SMEs were not able to secure the amounts they required. MFI contribute greatly in the direction of the economy of Nigeria in general. According to Hiedhues, (1995) being able to access credit facilities, the poor get to solve their cash flow problems and more importantly engage in activities such as the improvement of farming technology that in turn leads to an increased agricultural output.

The findings revealed an insignificant and direct association linking micro savings and financial performance of SMEs. This finding means that micro savings have a week impact on the financial performance of SMEs in Nairobi County. However, Cheston and Kuhn (2001) supports that savings accounts that are aimed at cultivating a culture of savings amongst the poor people are offered by many larger microfinance institutions.

The findings revealed a significant and direct association linking micro insurance and financial performance of SMEs. This finding means that micro insurance has a significant impact on the financial performance of SMEs in Nairobi County. According to Brockhaus (2001) micro insurance, loans, and savings helps in ironing out income or cash flow fluctuations ensuring that consumption levels are maintained even during thin periods. Cooper (2012) also revealed that microfinance insurance has greatly improved and changed their economic conditions of SMEs which experienced growing revenue.

The findings revealed a significant and direct correlation linking microfinance training and financial performance of SMEs. This finding means that microfinance training has a strong impact on the financial performance of SMEs in Nairobi County. Mwewa (2013) also concluded that the growth in sales was greatly influenced by microcredit, micro insurance and training provided by MFIs in the county since there was a strong positive association between the microfinance services and the SMEs growth. Additionally, the study also revealed that microcredit and training were leading in the growth of the small businesses.

CHAPTER FIVE: SUMMARY, CONCLUSION AND RECOMMENDATIONS

5.1 Introduction

This chapter presents the summary, the conclusions, the study recommendation, the study limitations and the suggestions for further research.

5.2 Summary

The microfinance credit theory and joint liability theory were used in this study to elaborate the contributions of microfinance services to SMEs. The researcher adopted a descriptive research approach. The sample of this study was 234 SMEs in Nairobi County and collected secondary from the SMEs from a period of 3 years from 2014 to 2016 and from the 234 sampled SMEs only 152 respondents to the issued data collection sheets. The 152 SMEs made up a response rate of 64.96% which was adequate for the study.

The descriptive findings established that the average return on assets for the sampled SMEs was 0.0585 and that the average microcredit in terms of natural log (Ln) was 12.0350 with minimum value of 0.000, which indicated that some SMES had not borrowed any amount from microfinance institutions. The results further established that average micro saving in terms of natural log (Ln) was 13.0230 while the mean value of micro insurance 12.5571. In addition, the findings found that the average number of microfinance training was three with a minimum of 0.00, which indicated that some SMEs had not been trained by microfinance with other receiving a maximum of seven trainings. The correlation findings established a weak and positive correlation between microcredit, micro savings, micro insurance, microfinance training and financial performance of SMEs in Nairobi County.

The regression summary established independent variables contributed about 6% of the variation in the dependent variable while the ANOVA results revealed the model was fit and significant. The results of the regression coefficients established that the correlation linking microcredit and financial performance of SMES is positive and insignificant while association linking micro savings to financial performance of SMEs in Nairobi County was also positive and insignificant. The results also show that correlation linking micro insurance and financial performance of SMEs was positive and significant while the association linking microfinance training to SMEs performance in Nairobi County was also positive and significant.

5.3 Conclusions

The research findings revealed an insignificant and positive relationship between microcredit and the small and medium enterprises in Nairobi county financial performance. Based on this finding this study concludes that microcredit does not have a significant impact on the financial performance of SMEs in Nairobi County.

The findings of the research revealed an insignificant and direct association linking micro savings and financial performance of SMEs. Based on this research finding the study concludes that micro savings has a weak impact on the financial performance of SMEs in Nairobi County.

In addition, the study findings revealed a significant and direct association linking micro insurance and financial performance of SMEs. As per this finding, this study concludes that micro insurance has a significant effect on the financial performance of SMEs in Nairobi County.

Finally, findings of the research revealed a significant and positive association linking microfinance training and financial performance of SMEs. Based on this finding the study concludes that microfinance training has a strong correlation to the financial performance of SMEs in Nairobi County.

5.4 Recommendations

The conclusions made by the study are microcredit does not have a significant impact on the financial performance of SMEs in Nairobi County. However, recommends that SMEs owner and managers can utilize microcredit as a source of finance which they can use to expand their enterprises.

It further concluded that micro savings have weak impact on the financial performance of SMEs in Nairobi County. The study nonetheless recommends that SMEs owners and managers should always save some money with microfinance institutions since cash savings can be used to secure microcredit.

The research findings the study concluded that micro insurance have strong impact on the financial performance of SMEs in Nairobi County. Therefore, recommends that the owners and managers of SMEs should use the microfinance insurance services to transfer risks, which might be affecting the SMEs.

Based on the research findings the study concluded that microfinance training has a significant impact on the financial performance of SMEs in Nairobi County. Thus, recommends that the owners and managers of SMEs should attend microfinance trainings and other forms of training since training so that they can get skills, which will help them to manage their enterprises.

5.5 Limitations of the Study

This study was carried out in Nairobi County and covered SMEs within the Central business district and three other sub counties in Nairobi out of the 17 sub counties within Nairobi County. The findings therefore are based on the sampled SMES and the selected sub counties in Nairobi County.

The study also sampled all forms SMEs including wholesalers, retailers, restaurants, supermarkets among others. The findings, conclusions and recommendations thus are not specific to a particular type or segment of SMEs in Nairobi County.

In addition, the study used secondary data which was collected using a data collection sheet and covered a period of three years between 2014 and 2016. Secondary data is quantitative and historic in nature hence it may not cover the current happenings and the qualitative aspects that influence financial performance of SMEs in Nairobi County.

Further, the study considered microfinance training, microcredit, micro insurance, micro savings as the independent variables. The findings therefore are limited to the considered research variables since there are other microfinance services which affect SMEs in Nairobi county financial performance.

5.6 Suggestion for Further Research

This study concentrated on the demand side of microfinance services and collected data from small and medium owners and managers in Nairobi County. The study recommends a study on the effect of microfinance services on SMEs from the supply sides where views of microfinance institutions managers will be sought.

The research also recommends another study can also be carried on the factors that affect SMEs in obtaining microfinance services in Nairobi County. A similar study can also be carried out on the other sub counties in Nairobi County which were not covered by this research.

The regression model established that microfinance training, microcredit, micro insurance, micro savings account for 6% of the variation in SMEs in Nairobi county performance in financial terms. This is an indication there are other microfinance factors that influences SMEs performance. This study recommends an additional research on the additional factors which the study did not consider.

This study used secondary data and did not obtain the views of SMEs managers and owners. The study therefore recommends an additional research where data can be obtained from the SMEs owners and managers using questionnaires as opposed to secondary data which is historic.

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APPENDICES

Appendix I: Data Collection Form

I am a student of Master of Science in Finance at University of Nairobi. I am conducting a study on the impact of micro finance services on the Financial Performance of Small and Medium Enterprises in Nairobi County. Please fill up the data collection form and return. The information acquired for this purpose will be treated with utmost confidentiality and will be consumed for academic reasons only. Will be highly grateful for your cooperation.

	2016	2015	2014
Net profit/ loss			
Total Assets			
Credit received per year (loan amount)			
Estimated amount of savings			
Amount paid for microfinance insurance			
Number of trainings by microfinance's			

Thank You