EFFECTS OF DEBT FINANCING ON FINANCIAL PERFORMANCE OF SMALL AND MEDIUM ENTERPRISES IN NAIROBI CENTRAL BUSINESS DISTRICT

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DECLARATION

This research project is my original work and has not been submitted for examination in any other university.

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D61/77986/2015

As the university supervisor, I approved the Examination of this research project.

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ANOVA	Analysis of Variances
D/E	Debts to Equity Ratios
DF	Debts Financing
EEF	External Equity Financing
IEF	Internal Equity financing
LTF	Long Term Debts Financing
MBA	Masters of Business Administrations
NCBD	Nairobi Central Business District
NCC	Nairobi City Council
NPVs	Net present Values
ROA	Returns on Assets
ROE	Returns on Equity
ROI	Returns on investment
S.D	Standard Deviations
SMEs	Small Mediums Enterprises
STF	Short Term Debts Financing

ABSTRACT

There exists quite a lot of literature, empirical studies and theories on the optimal debt and equity mix on what is known as capital structure. There are studies that support use of more debt than equity, use of more equity than debt or use of a balance of the two in obtaining an optimal capital structure that would maximize the value of shareholders' wealth. The study objective was to investigate the effects of debt financing on financial performance of SMEs in Nairobi Business District in Kenya. The study employed random sampling and used a sample 85 SMEs around the Nairobi Business District (CBD). Data was collected by use of both secondary and primary data collection methods as information was obtained from financial reports published on websites of some of the SMEs; other SMEs had to fill a data collection form with data relevant for the analysis and making findings and conclusion for this study. There were a total of 72 respondents that duly provided information required for the analysis which represented 85% response rate. Data was analyzed by the use of SPSS software version 20 and output presented in form of graphs and tables. The study discovered a negative but statistically insignificant relationship between debt financing and financial performance of SMEs in Nairobi Central Business District. The regression model summary showed a coefficient of determination (R squared) of 0.042. The p value obtained was higher than alpha value of 0.05 and the F calculated was lower than critical F value, which enabled the study to accept the null hypothesis because there is no relationship. The study also showed that SMEs in Nairobi mostly financed their operations through equity and less of debt. The debt financing obtained was mostly short term debt which is considered more expensive.

It is recommended that owners and managers of SMEs should not shy away from investing in projects with positive NPV by use of debt, since the correlation between debt financing and financial performance is insignificant. This would mean that increase of debt financing would only adversely affect financial performance by a percentage of 4%.

CHAPTER ONE

INTRODUCTION

1.1 Background of the Study

Among the key managerial decisions is Capital structure choice that occupies the finance manager besides also making determination on the application of funds, that is, investment and dividend policies. All these decisions are geared towards maximizing the value of the firm (Karadeniz, et. al., 2012). The management of a firm is usually faced with a balancing act of deciding how much funds should be raised by owners/shareholders (equity) and how much should be raised externally from non-owners (debt). In making this decision the management typically takes into account the benefits and costs associated with each alternative source of financing. Sub-optimal selection of these capital components can run the firm into financial difficulties when it comes to the capacity to honor obligations due to the providers of funds (Sheikh and Wang, 2011). Similarly, despite the firms having a leeway on mixing debt and equity, managers always comes up with a mixing capital structure that will enhance the performance and increase the firm's market value.

The agency theory as developed by (Jensen andMeckling1976) is a widely used theory to explain the relationship fund between capital structure choice and performance of a firm. The basis of the theory is what exactly a firm's managers' and shareholders are not in tandem aligned if they are separate entities because managers as key decision-makers in a firm will try to increase their satisfaction rather than acting in the best interests of the owners of the firm who are the principal players in the relationship. Further, there will be a conflict between equity investors and debt-holders where the risk of default is high (Jensen and Meckling, 1976).

They theory proposes that as a firm's leverage is augmented, so is the agency cost which implies that conflict between equity holders and debt owners augments because shareholders are likely to adopt riskier investments to the detriment of debt financiers. This implies that a higher debt level, that is, higher leverage is negatively related to the performance of a firm (Soumadi and Hayajneh, 2012). Nonetheless, from a counter perspective, debt can affect the firms' performance positively. In this case, as further debts lead to increased interest expense, the risk of bankruptcy is increased. Therefore, a firm's capital structure choice is crucial for any working ground since a balance must be struck between ensuring highest return to the stakeholders on one hand and also checking the implications of the choice on the firm's ability to compete sustainably.

The levels of debt-equity mix have an important implication on the performance of the firms because it influences risk and return. But the beauty of this scenario is that unlike the other sources of risk such as investment choice and systematic risk, the management has the ability to influence the risk occasioned by the leverage choice (Skopljak and Luo, 2012).

The implication of this is that the management of a firm must appreciate how to test leverage levels when choosing financing options. As Hutchinson (2009) find out, as long as the firm's investment rate of return exceeds the cost of debt, then higher debt (leverage) positively influences a firm's performance. Therefore, the determination of an optimal capital structure choice is hinged upon the ability of the firm to generate returns that surpass the cost due to the debt providers. This will dictate the amount of debt the firm will be ready to hog at different times.

The Small and Medium Enterprises (SME) sector in a country has proved to be a fundamental segment especially for the developing economies. This is because the preponderance of economic activity in these economies is largely dominated by SMEs and hence they are the drivers of the economy (Boocock and shariff, 2005). In less developed economies, the critical role of SMEs is manifested in its development process and also comprises the biggest proportion of the business enterprises, and for this reason their key importance in the economic growth cannot be overemphasized (Mitchell and Reid, 2010). Authors Mac & Bhaird (2010) also added their voice by writing that the centrality of SMEs in the economic activity of any country has drawn the interest of academicians and policy makers. This is because in a country, SMEs are the bedrock of economic growth springboard in an emerging economy and is considered the industrial development backbone in most industrialized nations (Salehand Ndubisi, 2006).

1.1.1 Debt Financing

What defines the firm's capital structure has not been explicitly defined because various scholars have come up with various definitions in regards to capital structure. For example, Nirajini and Priya (2013) have the view about the definition of capital structure is led by how the organization is performing through various sources of funds, both short-term and long-term capital. Examples of long-term sources of financing include equity capital and reserves, preferred shares, bonds, and long-term bank loans, while short-term capital examples include bank overdrafts and trade creditors.

Myers and Brealey (2003) explain the capital structure as different securities mix. Further, Konchhar (1997) consider capital structure as the mix or blend of funds that a firm has employed and it has a bearing on the firm's operations.

Tong and Ning (2014) suggest that from the definitions of capital structure, it could be concluded that equity and debt form the footing of financing business operations. On the other hand, equity holders will end up being paid last after settling the interest on debt. Consequently, they are the highest risk bearers; possessing superior control on the firms overall actions and decision making. (Abor, 2005).From different findings across the world, on the subject of capital structure focusing on SMEs there is general consensus that these firms seem to face similar challenges as far as financing their operations is concerned. These challenges vary from difficulty in obtaining funds from the financial institutions and if they do access the same, the interest rate charged in most cases is high in comparison to the large corporate institutions.

Wang (2008) assert that lenders of funds consider SMEs to be less desirable clients because of the attendant high risk as a result of their possession of few assets (collateral) and low capitalization and in some of the cases high mortality rate. These SMEs characteristic also applies for the Kenyan SMEs as Karanja (2014) further point out that the diseconomies of scale associated with lending relatively small amounts makes it unattractive for commercial banks to lend to SMEs. The profit margins enjoyed by banks by lending to this segment are small because of the relatively high transaction costs when lending small amounts.

1.1.2 Financial Performance

The concept of performance has been difficult to define because of its multidimensional meanings. However, Murphy et al., (2006) had the view that performance measures are either financial or organizational. A known financial measure for performance includes profitability, assets return, and enhancement of shareholders' wealth. We also have operational based indicators of performance like market share and sales levels. These are considered to be broader measures because they are ultimately the drivers of financial performance (Hoffer and Sandberg, 2007). Ang, Cole and Line (2000) opine that the deciding on the most appropriate measure will depend on the objective of the firm. The choice of the measure will also hinge on the context's development of the capital markets. For instance, it will be indefensible to rely on market based performance measures in a context when the stock market is under developed.

According to Demsetz and Lehn (2005) the most popular measures of financial performance are derived from the firm's financial statements namely the statement of financial position and the income statement. Such financial ratios include, return on investment (ROI), return on assets (ROA), return on equity (ROE). Most studies have relied on these measures. In summary, Abu-Tapanje (2011) observed that organizational performance is determined by three specific areas of firms' outcomes which include: profit measured by the performance of a firm, ROA and ROI, product market performance and shareholder return, measured by total returns to shareholder and increased residual wealth.

1.1.3 Debt Financing and Financial Performance

A firm's capital structure being a mix of firm's different sources of financing including common stock equity (including reserves and retained earnings), preferred stock, bank loans, bonds as well as short term borrowings are applied in financing firm's operations in order to stimulate growth. Consequently, financing mix decision is a critical choice since it has an effect on the risk-return of the firm's profile (Watson and Wilson, 2002). Indeed, any sub-optimal financing mix choice may lead to increased capital cost and hence reducing firm value. A choice of an optimal capital structure on the other hand will result in reduced cost of capital and an increase in the firm's value.

The performance of a business is influenced by the financing mix choice. Jensen and Meckling (1976) reasoned that high capital structure debt has the beneficial effect of addressing agency conflict between managers and shareholders in the sense that it disciplines the management not into misusing funds since there are standing obligations in the form of interest and principal on debt to be repaid. This will lead to a more judicious management of the firms operations. In the same line Jensen (1989) argues that managers would rather replace equity with debt in order to stimulate free cash flows in the face of leveraged buyouts.

According to Eldomiaty and Azim (2008) leverage level has a positive outcome on financial performance. They argue the financial performance is related to the capital structure because high debt may initiate clashes between the firm owners and management due to selection of investment to be undertaken and equity, debt or hybrid the capital components will influence firms value (Myers, 2007). If we have

models that allow for predictions that are verifiable the rise in debt will lead to reduced agency costs of funds providers (that is, owners and debt holders) and this will therefore lead to performance improvement of the business, things were left as they were before. However, when the debt level is high the cost of debt will likewise increase, which also entails increased chances of financial distress (and bankruptcy) because of conflict between equity and debt providers. However, it is not easy to empirically determine the distinction between these two agency costs sources.

1.1.4 Focus on SMEs in Nairobi Central Business District

The highly reputable centre located in Kenya is Nairobi City which covers an area of 684 square kilometers that discloses the Kenyan Uganda railway birth and growth. In the year 1899 in May is when the rail reached Nairobi and in Kisumu deeply enrooted to the now so called Ugandan part. The subsequent growth of the city center was brought by shifting of the HQ of the railway by the then engineer sir Whitehouse George and Nairobi became the focal center of operation by the British colonial power. The migration of people from rural to urban and on growing of the population has brought about the higher demand of resources by people hence the growth and development of infrastructure (Olima 2001). The rank size distribution by the population is statistically shown that the populace will be distributed well in the term referred to as balanced by the geographers.

Many corporations made Nairobi city as the business headquarters and this include Coca cola, Kenya commercial Bank, Standard Chartered Bank, Safaricom, East African Breweries and Airlines such as Kenya Airways, British Airways. With the present of huge population in Nairobi due to several activities, small and medium

scale enterprise emerged daily to fulfilled the demand and facilitates trade since the city accommodate several political, Economical, social and educational centre which enrolled and educated majority on business dealing starting with small scale.

1.2 Research Problem

The common question that firms face in their financing decision is the determination of the correct mix of debt and equity financing that need to be adopted by a firm. The financing mix is critical because it has a bearing on the firms' performance (Abor, 2005). High levels of debt have implications in terms of benefits and disadvantages; the same too applies to equity. Therefore, the most important decision involves crafting a trade-off between the levels of debt and equity in order to settle at the most optimal mix of the two.

This optimal mix level is the one that gives the minimum cost of capital while maximizing the firms' value which is a measure of shareholders' wealth (Gleason et al., 2010). The key duty of deciding on the optimal debt-equity mix is vested upon the firm's management. They are under duty to make a choice that maximizes shareholder wealth as well as safeguard the firm's operational sustainability into the future. Mujahid and Akhtar, (2014) point that one straight impact of a capital structure decision is that it establishes the cost of capital, which by extension results in changes in a company's market value. This is to imply that financing mix choice has ramification on other variables like firm performance and profitability.

Majority of the industrialized nations owe their success to the small and medium enterprise sector (Easley and O'Hara 2014). SMEs are at the center of a country's employment generation goal, as well as economic stability. Su (2014) highlight that in countries like China which have industrialized fast, their growth has been fueled principally by the SMEs, with their accounting for 99.17% of the total firms, and accounting for 80% of employment opportunities, and 70% of innovations. Due to the important role that the SMEs therefore play in an economy, it is incumbent upon a countries political leadership and policy makers to identify ways in which the performance of the SMEs in their country, especially developing countries, to come up with appropriate policy directions that will shore up the growth of the sector.

Several studies have been undertaken regarding appropriate capital structure that a firm should adopt and also what its effect on performance in finance. Zeitun and Tian (2007) undertook a research to establish the role in establishing Capital structure and corporate performance on Jordan firms. The findings were that the financial crisis in Europe had positive effect on the Jordanian firm performance unlike the ntifadah in the West Bank and Gaza in September 2000 which significantly affected the firms financing opportunities. Zabri, Ahmad and Lea (2014) researched on the preferred financing options by managers and the accompanying financing mix complexion and the best performing SMEs in Malaysia. They found that SME managers' preference of equity against debt has an obvious interaction with the levels of short-term and long-term financing and equity employed. El-Maude, Ahmad, and Ahmad (2016) researched on financing mix and performance of firms in the Nigerian Cement Industry. They found that the performance of companies in the cement industry is not optimized by failure to use debts in their capital structures.

Locally, Karanja (2014), focusing on the Dairy sector, examined the effect of choice of financing on the performance of the Kiambu County SMEs. The study found that the debt asset ratio, liquidity and debt equity ratios affected positively the performance of the dairy firms in the district. In another study, (Maina and Mwasa, 2014) sought to evaluate the capital structure financial performance nexus focusing on the NSE listed organizations. They discovered that as much as the debt used by firm as finance source the poorer it will become.

The above results are varied and more importantly, the studies either concentrated in developed countries or in large firms here in Kenya. In addition, all the studies have utilized secondary data with limited use of primary data. However, there has been limited research works on smaller firms such as SMEs operating in Kenya to which limited keeping of financial statements is realized. Thus this study aimed at investigating the influence of debt financing on the financial performance of SMEs in Nairobi Central Business District?

1.3 Research Objectives

To establish the effect of Debt Financing on the Financial Performance of Small and Medium Enterprises in Nairobi Central Business District

1.4. Value of the Study

This research's findings will be helpful in informing policy framework that govern the operations of SMEs in a developing country framework in the sense that it will provide insightful information on how the financing mix influences firms' performance.

If the aspiration of the government is aimed at improving the efficiency of the SMEs, it should recognize internal organization decision that will influence the firm performance and come up with appropriate incentives to encourage the adoption of appropriate capitals structure decision. Furthermore, policymakers have to realize that capital structure per say, does not promote efficiency, but it should be accompanied by effective policy framework.

To the SMEs, the study will be significant to the managers of such institutions in that it will help them comply with good debt financing practices. The management of SMEs in Kenya will benefit from the findings that will help them enhance adoption of appropriate debt financing, which leads to sustained productivity and better performance. To academicians the study will be used as a basis for further studies on corporate financing of SMEs in Kenya. Researchers will too benefit from the outcome of this research and may enrich it further by plugging any limitations found in the study in their future researchers.

CHAPTER TWO

LITERATURE REVIEW

2.1 Introduction

In this chapter, the study details other researcher work on the structure and organization performance of SME's that has been undertaken in different contexts. The main sections covered in this chapter comprise; theoretical framework, empirical review, and a conceptual framework.

2.2 Theoretical Framework

There are several theories that have attempted to advance the reasons behind financing choice among firms despite the fact that the concept of a firms' financing structure is still a puzzle, yet to be determined. The various theories are being advocated to facilitate informed decision making. As a result, financing decision is very vital, especially in relation to performance of a firm as measured by profitability and value of the firm (Awunyo, 2012). The theories that bear the greatest relevance to this study are the Agency theory, pecking order theory and the trade off theory.

2.2.1 Agency Theory

Developed by (Jensen &Meckling, 1976), the agency theory is most used to explain the relationship between financial performance and capital structure of the firm. The arguments of this theory is that the interest of the firm's managers and owners are not in tandem aligned if they are separate entities because managers as key decision-makers in a firm will try to maximize their utilities rather than acting to suit their interests of shareholders and the firm who are the principal players in the relationship.

Muritala (2012) orate that one of the ways to mitigate agency costs is by employing more debt in the firm's financing. This by implication means that there is reduced need for equity in financing a firm's operations and hence reduced agency costs. But employing excessive debt also has the potential effect of causing even more agency costs due to an increase in the chances of financial distress. As the amount of debt employed increases the cost of financing from subsequent lenders goes up because of the firm's increased risk profile, this will lead to decreased return for the shareholders.

Typically the business owners try to make sure that the management delivers cash flows to them (in the form of dividends) in the absence of profitable investment opportunities where these funds could be committed to. This tendency of managers wanting to closely monitor the conduct of management decisions leads to increased agency costs. For the SMEs the agency conflict as far as the misuse of cash that flow free is concerned is low since the owners in most cases handle the cash and payment of dividends is determined by the owners.

Managers can be forced to be more efficient in the running of businesses by employing more debt in the financing of operations (Lubatkin and Chatterjee, 2004). These authors reason out that the outstanding debt repayment obligations would discipline the managers into being more prudent in the management and utilization of funds. Additionally, the managers will also be practical when making investment decisions such that they would rather distribute profits to the shareholders and as opposed to committing funds in projects with negative net present values (Onaolapo and Kajola, 2010). This will be made possible by the fact that the managers will be under pressure to pay interest expenses.

This will force the managers to direct funds only towards those activities that will guarantee the firm's ability to honor credit obligations. Therefore, high leverage leaves the managers with little cash to be spent on non-value adding discretionary spending.

2.2.2 Pecking Order Theory

The pecking order theory was originally developed by Donaldson in 1961 before it was subsequently enhanced by Myers and Majluf (1984). The developers of this theory state that firms come up with a hierarchy of preference in the capital components (from internal financing to equity). A firm raises funds in order of preference from various sources. The firm would exhaust the easily accessible source before going to the next and hence there is a hierarchy of preferences. Retained earnings are usually given the first choice, followed by the debt externally and finally issues of equity (Myers, 2001). This order will therefore define the order of preference of firm's shareholders.

Myers (1984) wrote that equity is not a desirable way of raising funds because of the perception among the investors that a firm management would only opt to issue shares when the firm's shares are overvalued by the market. Thus, investors tend to bid a price which is lower to the new equity issuance. As Awunyo (2012) discourse, most of the SMEs will not have accumulated much internal financing during the growth stage and therefore will opt to use debt financing for their operations unlike SMEs that will have operated for a longer period and retained adequate internal funding. These theories speak out that firms abide by the chain of command in business financing. In this case financing from retained earnings is given first priority.

If internal funds are exhausted the next best option is debt and financing equity is only embraced as the last resort. As a result, the type of debt a business decides on act as a sign of its need for exterior finance.

In summary, the pecking order theory, otherwise referred to as the information asymmetry theory, argues that business organizations would rather finance their investments using the internally available funds (retained earnings) because they are readily accessible. After the internal funds have been exhausted, the firm will go for the next easily accessible option which is debt financing. Finally, the firm would go for equity financing after it has exhausted the other available sources. The ranking is informed by ease of accessibility for each source and the level of information asymmetry generated by each source. Raising funds via equity issues would be the most expensive because of the higher levels of information lop-sidedness between the issuer and the investors. Therefore, the most optimal capital structure should be built of the basis of the hierarchical considerations highlighted.

2.2.3 Trade-off Theory

This theory was advanced by Myers (1984) that the choice of financing structure in a firm matters and affects its performance. According to this theory both debt and equity has associated benefits and costs. The best capital structure is the one that mixes debt and equity in a way that trades-off these benefits and costs in the most optimal manner (Margaritis & Psillaki, 2009). The theory points out tax shield advantage as the greatest benefit wrought by employing debt in financing. However, there are also costs associated with debt mainly the existence of bankruptcy cost.

Therefore, the best financing approach is the one that considers both ends of this double edged sword and hence settles on the most optimal debt levels. Myers (1984) note that as debt goes down the marginal benefit increases as the marginal cost increases, and therefore, for a firm to attain the most optimal value maximization it should put an eye on the tradeoff between the benefits and costs when determining how much debt against how much equity to employ. But according to Margaritis and Psillaki (2009) from an empirical perspective, this theory may only explain the existence on differences in debt-equity ratios between industries but its unable to explain the variations in this ratio for firms in the same industry. Therefore only when there is residual financing will a firm use external capital by using first retained earnings, followed by equity and debt as a final resting place.

This implies therefore that for SMEs, there is no clear optimal financing mix. It is to be noted that there are two forms of equity highlighted in this theory, the first one is retained earnings which is given the first preference, while the other one is new equity shares which is the least to preferred (Myers, 1984).As such its usage under this study becomes imperative as the paper focus on trend analysis of SMEs financial performance.

2.3 Determinant of Financial Performance in Small and Medium Enterprises

The financial structure of a firm will affect the leverage, liquidity, and cash flow position of the entity as well as its capacity honor credit obligations. The finance structure of a firm various referred to as leverage or gearing is measured using various indications some of which include the ratio of debt to equity, the ratio of debt to the

total assets, and also times interest earned. The ability of a firm to convert assets into cash is measured using liquidity measures such a current ratio, acid test ratio and interval measure. The sources and application of cash over a certain time are measured using the cash flow statement.

2.3.1 Leverage

A firms' leverage position shows the proportion of the firm's resources finance with debt as compared to the proportion financed using equity (Penman 2001). The use of debt financing by a firm generally puts the firm under a mandatory obligation to repay interest and principal periodically unlike the equity financing that does not have a mandatory call on cash paid occasionally to providers of capital or for liquidation of equity holders' capital interest. Therefore, equity holders are residual claimant on the earnings and assets of a firm after the interests of debt holders and other claimants are met.

Bromiley and Hendrickx (2012) noted that the equity holders are disadvantaged when a firm's earnings are less than the cost obligation due on debt. In this case the equity orders incur a loss that is equivalent to the association in the firm's earnings and the amount due to the debt holders. On the other hand, the debt holders are always assured of their full compensation whether a firm generates adequate earnings or not. This implies that the potential gains and losses to the equity holders are directly influenced by the level of debt employed. Therefore, for a highly leveraged firm, the bankruptcy risk increases during difficult economic times, but on the other hand, the higher the returns for equity holders during good economic times.

Hoskisson, Hitt, Johnson and Moesel (2008) further imagine that in strategic management studies, leverage can be utilized as a control variable since for highly leveraged firms, the managers have limited options when it comes to raising additional funds and may be forced to rely on raising the costly equity capital.

2.3.2 Liquidity

Liquidity is concerned with the capacity of a business organization to honor her credit obligations promptly without difficulties. The degree of as asset's liquidity is measured on the basis how it can be readily converted into cash (Brealey et al., 2011) and therefore under the liquidity quest, an organization needs to develop adequate and willingly available capital to support operations. Therefore, liquidity is among the indicators of performance of a firm's aspects, though it is not a sufficient measure by itself to conclusively measure a firm performance. The liquidity measurement of a firm can be done both in percentage terms with the absolute measures taking the form of an organization working capital that represents the correlation between the values of current assets and current liabilities – this difference is known as net working capital. Another absolute value that can be used is the interval measure.

This value shows the amount of time an organization is able to continue operating sustainably while relying on its liquid assets without generating any sales. Some common percentage measures that are used include the percentage change in working capital, changes in current and acid test ratios. Hoskisson, Hitt, Johnson and Moesel (2008) highlight that one weakness of financial statements based measures of liquidity is that they do not consider off-balance sheet credit access arrangements such as the available lines of credit and other credit arrangements.

Loans typically attract a higher cost of capital compared to the returns that can be generated on short term investments. Therefore, the best strategy is to use any surplus cash to offset any outstanding short term liabilities assuming that the capital can be readily replaced as per the borrowing agreements. The fact that a business could be having standby financing arrangement with lenders means that pure reliance on financial statement based measures of readily could lead to under-reporting a firm's actual liquidity strength.

2.3.3 Cash Flow

Cash flow is the bloodline for the firm's ability to honor the currently maturing financial obligations. It shows the firm's capacity to honor payments due to funds providers. The continued relationship between the firm and providers of funds is hinged on the firm's ability to pay what is due to the fund providers promptly. Brealey (2011) further notes that a typical business valuation method is valued based on projected cash flows in a firm.

There are varied cash flow measures which include net operating cash flows, cash flow return on equity (that is, cash flow expressed as a percentage of capital), and the periodic percentage growth rate of the operating cash flows. All these measures take into account the prompt availability of cash to meet obligations for the purposes of investment and financing activities as well as payments to investors (West and Jones, 2009). Cash flow is the immediate and most readily visible indication of a firm's value. For this reason cash flow is an important dimension in the measurement of a firm's performance.

The important question for researchers however is determining over what time period the cash flows should be measured. This is because cash flows might fluctuate significantly from year to year as dictated by investment activities and growth rates.

2.4 Empirical Studies

The area of a firms' capital structures has received quite attention among researchers locally and across the world. The result findings obtained from the studies as regard to performance of the firm financially and its structure, industry as well as the economy as whole has been mixed.

Deesomsak et al. (2008) in their research among the Malaysian manufacturing firms reported that the high capital structures debt negatively influences firm's financial performance as indicated by gross profit margin levels. The researchers used chi-square to measure longitudinal data. However, from data obtained in Singapore, Taiwan and Australia it was established a relationship that is negative in capital structure and firm performance.

Further, they found that firm size has a positive effect on leverage for all these countries apart from Singapore and they attributed this to the fact that the firms in this country have the government support and thus do not have financial distress. As opposed to the current study, the research by Deesomsak utilized secondary data from the manufacturing the large manufacturing firms and this deviates from the current study in that the researcher will use primary data to be collected from the SMEs. The researcher makes the assumption that the targeted SMEs in Nairobi do not keep proper books and hence it is better to use primary data.

Abor (2009) in Ghana Measures the outcome on capital structure and the firms' profitability. The study focused on the firms listed at the Ghana Stock Exchange. The researcher established ratio of short term and total assets debts has a favorable influence on profitability. It was opined that this was possibly due to low interest rates. The researcher reported that Ghanaian firms are largely financed using short term debt accounting for 85% of the total debt employed. In the case of long term financing, it was found to have a negative effect on the return on equity. Finally, total debt was found to positively influence profitability. The researcher also determined that most profitable firms employed more debt. The research by Abor used the large manufacturing firms that are listed in the GSE whose books are audited by reputable firms as opposed small and medium enterprises that might face challenges in keeping proper books.

Huang and Song (2009) did a research in Shangai Stock Exchange investigating the influence of capital structure on the performance of listed firms. The researchers established capital structure as measured using long term debt and total debt has a negative effect on performance as indicated by rate of return on assets. The authors suggested that the reason for this is that the Chinese market did not have a fully developed equity market and for that reason firms relied mainly on debt from banks. Another issue that came out is that in China most companies are controlled by the government and hence prefer equity financing in order not to dilute control. In addition, there is absence of strong shareholder rights protection laws. Furthermore, profitable firms need more debt to finance their growth.

China is developed and industrialized firms and even the firms that are considered as SMEs within their operation level differ in size and operations. Hence the current study will be a deviation from the study since it is being carried out in a developing country with unique financing problems.

Weill (2011) researched on the relationship that includes financial leverage and performance of a firm in (7) seven European countries. The study employs both market and accounting performance measure and leverage ratios, firm size, age and board size are regress. The researcher found out that leverage had an effect that is positive significantly on the performance of the firms in Spain and Italy, France, Norway, Germany and Belgium, but not significant in Portugal. A similar study was carried out by Li Meng et al. (2010) who find that higher debt has a negative influence on performance as measured by return on assets, but has a positive relation with return on equity.

San and Heng (2014) studied the influence of capital structure on firm performance in Malaysia. The study zeroed in on the firms in the construction industry with a focus on the 2007-2008 periods during which the country experienced a bad financial crisis. The research concluded the presence of relationship by performance and capital structure and the relationship was weak. This study used the rates of return on assets in financial performance and equity as a measuring agent. These results are also corroborated by Pratheepkanth (2013) who obtained similar results in a study done in Sri Lanka over the period 2005-2009 by using 10 firms over the period of 10 spanning from 2001-2009. He measures performance in a quadratic function, whereby performance forms the non-linear function of capital structure, as proxy by leverage ratio.

Locally, Adekmule(2012) carried out a study in Kenya focusing on pharmaceutical industries with an objective of evaluating the capital structure effect on financial performance. Capital structure was measured using debt ratio while firm's performance was measured using rate of return on assets and rate of return on equity. An evaluation of the relationship was done using the Ordinary Least Squares method. The research found out that the financial performance of a firm is negatively influenced by the debt ratio. This study did not however consider the possible mediating effect of internal cash flows on this relationship.

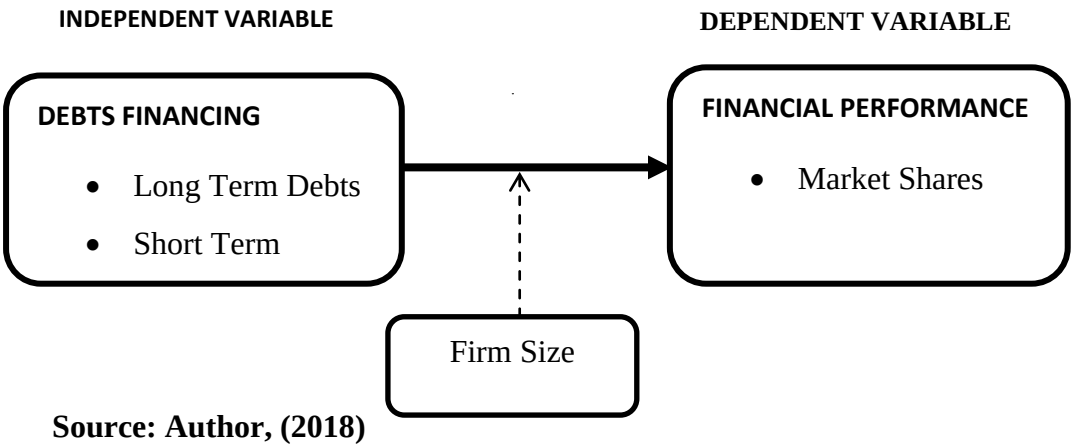
Another study in Kenya was undertaken by Kaumbuthu (2014).The study intended to find out the interplay between capital structure and the rate of return on equity. The research evaluated this relationship using the firms listed in the Nairobi Security Exchanges (NSE) Industrial and Allied sector over the period 2009 – 2013.

Debt to equity ratio was used to measure capital structure while the rate of return on equity was the performance measure. The relationship was estimated using a regression model. The gap in this study is that it only focused on only one sector of firms listed at the NSE (the non-financial firms). In addition, the research only focused on one dimension of financing decisions.

2.5 Conceptual Framework

The following diagram illustrates the relationships between the study variables. In this research the dependent variable is financial performance. The financial performance is expected to be elaborated by the firm's debts financing which is the independent variable. The operationalization of the two variables is illustrated below in Fig. 2.1.

Figure 2.1. Schematic diagram showing variable Relationships



Source: Author, (2018)

2.6 Summary of the Literature

The subject of how to realize an optimal financing for a firm has captured the discussion of finance managers and practitioners for a long time and can be traced back to the landmark publication by Modigliani and Miller (1958). The question that has been occupying the minds of finance people is whether there exists a unique (optimal) debt-equity mix that would maximize firm value or not and whether different components of capital have an influence on firm value in a similar manner or not. Varied polarized positions have arisen from the studies undertaken, such as that better performing firms are likely to place less reliance on debt due to access of retained earnings as compared to poor performing firms. Other empirical studies have concluded that firms that are growing at a faster rate need debt to finance their growth and hence would have higher debt to equity ratio (Kraus and Litzenberger, 1973; Li Meng et al. 2010).

From both the local and empirical evidence review in section 2.4, it can be said that the weight of available evidence overwhelmingly supports the view that capital structure positively influences firm financial evidence. However, it should also be noted that there is also a semblance of contrary evidence. This was more evidenced in firms in markets that are liberalized (Abor 2009, Bopkin and Arco, 2009; San and Heng, 2014). However, the studies also reveal that an evaluation of the relationship resulted in mixed results in those countries such as china in which the government has control majority of firms (Li Meng*etal*.2010; Zhao and Sun, 2012). The economic environment that existed over the study period also had an impact on whether or not capital structure affects performance and if so to what extent. For instance, as was evidenced in Singapore after the economic depression of 2008-2010 whereby firms that were highly levered were found to have been affected more than those that relied to equity financing.

However, from the reviewed studies, three distinguishing features come out and they present study. First are the sizes of the firms and the countries in which the studies were undertaken. All the studies apart from that of Karanja (2015) were based on listed firms in various countries stock exchanges and this definitely are large firms that meet the capital requirements threshold set. In addition, most of the studies were carried out in developed countries where their level of regulation and access to the capital market is better than in Kenya meaning that their use of different forms of capital structure will differ.

Secondly, the methodological approach that the studies adopted was that most of the studies adopted a longitudinal approach and conducted a regression analysis utilizing finance and accounting data which was panel in nature. Thirdly, the evidence provided in the empirical research on capital structure relation and performance of a firm are conflicting, as such necessitate further research despite those conducted in Kenya and across, as little need to be done to improve the researches to suit the Kenyan context given the differences in technological advancement, level of economic growth, politics, laws, leadership style and level of awareness that exists in the SMEs market.

CHAPTER THREE

RESEARCH METHODOLOGY

3.1 Introduction

This chapter explains the methodology that was used in this study. The key elements discussed here include the research design employed, the target populations by the study, data type (Sample), collection methods used, and the data analysis techniques used.

3.2 Research Design

The study adopted a descriptive design. This approach entails collection of data without tampering with the environmental setting. The choice of this specific design is that a descriptive research design objectively measures and reports relationships as they are (Cooper and Schindler, 2007). A further justification for the choice of descriptive design is that it allows the researcher to obtain results that are naturally out of the free interactions among the study variable without any manipulation.

3.3 Target Population

According to Lavrakas (2008) defines a populace or a population as any collection of distinct elements whether finite or infinite. Another writer, Hyngman (2008) defines population as the entirety of all the elements that one has an interest in. In this study, the population was made up of all the SMEs situated within the Nairobi CBD. Data obtained from the Nairobi City County business licensing section shows that there are 4265 registered SMEs operating in NCBD under classes 74 – 92 as at the end of the year 2016. This number formed the population of the study.

3.4 Sample

To determine the sample the researcher utilized systematic random sampling which accorded the same opportunity to all the respondents to be captured into the eventual sample. The researcher picked every 50^{th} SME in the list to be provided by the NCC licensing department. This enabled the researcher to arrive at 85 SMEs that will form the sample size.

3.5 Data Collection

The study used secondary data that was collected through self-administered data collection form. A data collection form is an important instrument for obtaining information as it provides a platform of getting first-hand information that might not be expressing in the financial data. In addition, the researcher also relied on published materials such as financial reports as well as books to design the data collection tool. The researchers used self-administration method hence enabling the respondents enough time to adequately answer the questions and seek any clarification during the data collection process.

An introductory letter explaining the purpose of the study was used as a proof that the study was being done for academic purpose only. Proper records of all data collection forms were kept for ease of follow up and also to ensure high response rate. The respondents were owners and managers of the small medium enterprises that are responsible for finances in the SMEs selected. The data collected was the total debt employed by the firm, profits or loss margin; the total debt was further brought to short-term and long-term constituents. The researcher also obtained data on total assets and total turnovers for all the firms.

3.6 Data Analysis

Data for this research was analyzed using descriptive statistics as well as using inferential statistics. The key descriptive statistics used included tabulation, diagrams, graphs, means, frequencies and standard deviation as well as maximum and minimum values. These statistics were useful in describing the data patterns. To estimate the relationship between variables, an inferential statistical model in the form of a regression model was used. The model took the following form:

$$\mathbf{Y = \beta_0 + \beta_1 X_1 + \beta_2 X_2 + \beta_3 X_3 + \beta_4 X_4 + \varepsilon}$$

Whereby the variables were as follows

Y = Performance of the SME measured by ROA

$\beta_0, \beta_1, \beta_2, \beta_3$, and β_4 represent the coefficients of debt financing option

X1 = Total Debt / Totals Assets

X2 = Long – term Debt / Total Assets

X3 = Short-Term Debt /Total Assets

X4 = Firm Size - Log (Total Assets)

$\boldsymbol{\beta_0}$= intercept term/constant term

$\boldsymbol{\varepsilon}$ = Error term/stochastic term

3.7 Test of Significance

The significance of the influence of the independent variable on the dependent variable was tested using one way ANOVA at 95% level of significance. This test determines if the relationship between variable is significant or unauthentic and it's applicable where there is more than one variable in the study.

CHAPTER FOUR

DATA ANALYSIS, RESULTS AND DISCUSSION

4.1 Introduction

This chapter presents the analysis of data collected on the effects of debt financing on financial performance of small and medium enterprises in Nairobi Central Business District. The Data was gathered using a self-administered data collection forms and review of the financial statements. The results of analyzed data and interpretations are presented in this chapter.

4.2. Response Rate

In the study, 85 respondents were contacted and 72 respondents from SMEs compiled and responded to self -administered data collection forms which was equivalent 84.71% of the studied SMEs population and the samples was adequate for the study. According to Mugenda (2003) a response rate of 50% is usually considered adequate, that of 60% is considered good while that of 70% is considered very well.

4.3. Descriptive Statistics

In this study, the variables were explained in form of the maximum, minimum, mean, standard deviation, kurtosis and skewness of data. These findings are presented in the table 4.1 below:

Table 4.1: Descriptive Statistics

	N	Minimum	Maximum	Mean	Std. Deviation	Skewness		Kurtosis	
	Statistic	Statistic	Statistic	Statistic	Statistic	Statistic	Std. Error	Statistic	Std. Error
ROA (Y)	72	-16.11	100.00	7.37	16.81	3.731	.283	16.901	.559
Total Debt/Total Assets (X1)	72	0	100.00	48.12	35.46	-.017	.283	-1.495	.559
Long Term Debt / Total Assets (X2)	72	0	91.59	15.90	27.64	1.668	.283	1.220	.559
Short Term Debt / Total Assets (X3)	72	0	97.11	32.22	34.06	.702	.283	-1.083	.559
Firm Size (X4)	72	16.23	25.44	20.94	2.18	-.563	.283	-.522	.559
Valid N (list wise)	72								

Source: Author, 2018.

The table 4.1 shows the summary of findings of the study variables. The financial performance represented by return on assets shows that the highest return on assets by the firms under study was 100% with the minimum being a loss of 16.11%. The mean is 7.37% with a standard deviation of 16.81% with positive skewness and a high kurtosis of 16.9. It generally shows that financial performances of SMEs in Kenya have high variance with both extremes of poor performers and very good performers. The majority however are good performers with a high kurtosis value.

The other variable is the ratio of total debt to total assets. Total debt is obtained by the total sum of short term debt and long term debt. The data collected had SMEs with the highest value of 100% showing that all assets of the firm are financed by debt, and the lowest value as 0%, which shows that the firm in that case did not finance any of its

assets by use of debt. The firm has zero debt. The mean level was 48.12% with a standard deviation of 35.46%. This shows that the distribution shows firms that are either highly leveraged or else lowly leveraged. The data is relatively flat and negatively skewed.

The other variable considered in the study was the ratio of total long term debts to total assets. This ratio recorded the maximum value of 91.59% and the minimum value being 0% with a mean of only 15.9% and a standard deviation of 27.64%. This shows that most SMEs had very little levels of long term debts. Those that were able to secure long term debt financed almost all the operations of the firm by the use of debt. This data is positively skewed and relatively flat.

The ratio of short term debt to total assets of the firm also showed that the minimum short term debt by an SME was 0% and the maximum was 97.11% with a mean of 32.22% and a standard deviation of 34.06%. The data is relatively flat and positively skewed. The data shows that most SMEs are able to secure short term financing that is relatively distributed across the SMEs.

The other study variable was firm size which was measured by natural logarithm of total assets. The largest firm had a natural log of 25.44 and the smallest firm had a natural log of 16.23. The mean registered a value of 20.94 with a standard deviation of 2.18. Data was negatively skewed with a flat but negative kurtosis.

4.4 Correlation Analysis

To test orders in relationship of variables, correlation analysis have been conducted.

Table 4.2: Correlation Analysis

	ROA (Y)	Total Debt/Total Assets (X1)	Long Term Debt to Total Assets (X2)	Short Term Debt to total Assets (X3)	Firm Size (X4)
ROA (Y)	1				
Total Debt/Total Assets (X1)	-0.12	1.00			
Long Term Debt to Total Assets (X2)	-0.13	0.44	1.00		
Short Term Debt to total Assets (X3)	-0.02	0.68	-0.35	1.00	
Firm Size (X4)	-0.16	0.10	0.21	-0.07	1.00

Source: Author, 2018

We are concerned with the relationship that exists between the independent variables and the dependent variable. The variables might be positively or negatively correlated or no correlation between the variables. Highly correlated variables have values equal to or closer to one while variables that are not correlated or show low levels of correlation have values that are either zero or almost equal to zero. In this study, all the variables are negatively correlated to the dependent variable meaning that an increase of the independent variable would lead to a decrease of the dependent variable, though the correlation is almost equal to zero which shows that there exist weak relationship between the independent variables and the dependent variable.

4.5. Regression Analysis

The researcher utilized a regression analysis to establish correlations between the studied variables. The data for independent variables and that of the dependent variables were brought together and used regression to establish how the causal variables influenced the independent variables.

The regression model used for the study:

$$\mathbf{Y = \beta_0 + \beta_1 X_1 + \beta_2 X_2 + \beta_3 X_3 + \beta_4 X_4 + \varepsilon}$$

Whereby the variables were as follows

Y = Performance of the SME as shown by ROA

β_1, β_2, β_3, and β_4 represent the coefficients of debt financing option

X1 = Total Debt / Totals Assets

X2 = Long – term Debt / Total Assets

X3 = Short-Term Debt /Total Assets

X4 = Firm Size - Log (Total Assets)

$\boldsymbol{\beta_0}$ = intercept term/constant term

$\boldsymbol{\varepsilon}$ = Error term/stochastic term

4.5.1 Regression Model Summary

Table 4.3: Model Summary

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate	Durbin-Watson
1	.205[a]	.042	.000	16.81	2.048

a. Predictors: (Constant), Firm Size (X4), Short Term Debt to total Assets (X3), Long Term Debt to Total Assets (X2)

b. Dependent Variable: ROA (Y)

The goodness of fit shown by the regression summary model in table 4.3 had a value of 0.042 shown by R^2 which is coefficient of determination. It can therefore be deduced that debt financing explain only 4.2 percent of the performance variations (ROA) of SMEs. It shows that the financial performance of SMEs in Kenya is predicted by other factors outside the model to the extent of 95.8%. The statistic for Durbin-Watson of 2.048 showed absence of auto correlation of predictor variables as presence of autocorrelation is shown by a value of Durbin Watson that is 4 and above.

4.5.2 ANOVA Table

The study further conducted ANOVA to test significance. It comprises of the computations that give rise to information pertaining levels of variance within particular regression models and hence forms a basis for the testing of significance.

Table 4.4: ANOVA TABLE

Model		Sum of Squares	Df	Mean Square	F	Sig.
1	Regression	839.491	3	279.830	.990	.403[b]
	Residual	19216.203	68	282.591		
	Total	20055.694	71			

a. Dependent Variable: ROA (Y)

b. Predictors: (Constant), Firm Size (X4), Short Term Debt to total Assets (X3), Long Term Debt to Total Assets (X2)

Table 4.4 above shown that the significance p value of 0.403 while the study was based on an alpha value of 0.05. This shows that the p value is greater than the significance level. We can therefore conclude that there is no statistical significant relationship between the study variables.

On the other hand the table shows a calculated F value of 0.99 while the critical F value at 0.05 significance level of 3 and 68 degrees of freedoms is 2.525. This shows that the critical F value is greater than the calculated F value, and therefore the calculated F value lies within the acceptance region. We therefore accept the null hypothesis states that there exists a relationship between debt financing and financial performance of SMEs in Nairobi Kenya.

The results therefore shown that there is a negative relationship between debt financing and financial performance of SMEs in Nairobi County Kenya, the relationship is not statistically significant and the model only explains about 4% of these variations.

4.5.3 Regression Coefficients

Table 4.5 shows the coefficients of the study variables that predict 4% of the dependent variable.

Table 4.5. Summary of Coefficients of Regression Model

Model	Unstandardized Coefficients		Standardized Coefficients	T	Sig.	95.0% Confidence Interval for B	
	B	Std. Error	Beta			Lower Bound	Upper Bound
(Constant)	32.992	19.650		1.679	.098	-6.219	72.203
Long Term Debt to Total Assets (X2)	-0.078	0.079	-0.128	-0.988	0.327	-0.235	0.079
Short Term Debt to total Assets (X3)	-0.037	0.063	-0.075	-0.588	0.559	-0.162	0.088
Firm Size (X4)	-1.108	0.937	-0.143	-1.183	0.241	-2.978	0.761

a. Dependent Variable: ROA (Y)

Source: Author, 2018

The coefficients β_0, β_1, β_2, β_3, and β_4 are given by 32.992, 0, -0.078, -.037, and -1.108 respectively. The error term is given by 19.65

The equation obtained after running regression analysis in SPSS is therefore

$Y=32.992 - 0.078X_2 - 0.037X_3 - 1.108X_4 + 19.65$

The study shows that if the above equation was used for any value of short term, long term debt and size of the firm, then we could be able to predict only 4% of the dependent variable which is financial performance of the SME. The relationship between these independent variables and the dependent is negative for each variable which shows that increasing the independent variable resulted to a decrease of the dependent variable but by a smaller margin.

4.6 Findings and Discussions

From the results, we can make various findings. We first make a finding that most SMEs in Nairobi County have low levels of long term debts. This is shown by the mean ratio of long term debt to total assets of 15.9%. When this value is compared to the short term loans ratio of 32.22% it shows a significant difference. This finding can be explained by the fact that lenders consider SMEs to be high risk clients. They are therefore not able to secure long term debts that make the level of long term financing to be low. On the other hand, most SMEs are only able to secure short term loans, from business partners, relatives and close friends. They lack collateral that would be required to secure long term financing. They are therefore left with the option of financing their operations, mostly through short term loans.

The mean of total debts to total assets is 48.2% which shows that 48.2% of the assets in SMEs in Nairobi are financed by debt and in most cases short term debts. The other 51.8% of the total assets are financed through owner's equity. This information shows that SMEs in Nairobi County are in most cases financed by use of equity rather than debt. It becomes difficult to obtain debt financing for SMEs in the capital market that leads the SME to revert to either short term loans financing or by use of equity. According to MM theory, use of equity financing means that the firm is not able to fully benefit from the tax shield element, and therefore reducing the value of the firm that would result to decrease in financial performance. The study has also found out that there is insignificant relationship between debt financing and financial performance of SMEs in Nairobi County. The study results show a p value of 0.403 that is greater than the alpha value of 0.05.

Although the study showed that the calculated value is less than the critical value and would therefore accept the null hypothesis. The study therefore concluded that there exist a relationship between debt financing and financial performance of SMEs in Nairobi County, but the relationship is not significant enough. In fact the regression model that tried to predict financial performance through debt financing had a coefficient of determination (R squared) of 0.042 that showed that debt financing only explained 4.2% of the variations in financial performance of SMEs. The other variations on financial performance are only explained by other factors that were not tested in the model. These results are in agreement with various empirical studies that showed insignificant relationship between the variables. A study by Schiantarelli and Jaramillo (1996) showed that long-term loans may lead to improvements in productivity albeit in small insignificant proportions.

In addition the findings also agree with a study by Moore (1995) who established that debts which are long term have an effect on managerial discretions. This is possible since they make access to the new funds a possibility. The findings of this study contradicted to the findings by Chepkemoi (2013) who established that capital structure affected SMEs performance in Nakuru Kenya. The theory by MM that try to suggest that debt financing increases the value of the firm is also contradicted by the findings of this study.

Similarly, findings showed that short term debts negatively affects SMEs performance through ROA and liquidity, the study of findings contradicts Garcia-Terul and Martinez-Solano (2007) who established that short term debts have a positive correlation with growth opportunities of the firm. In addition short term debts are not the best tools for SMEs financing. From the finding it is evident that both the short and long term loans have a negative effect of the financial performance of the SMEs.

The study finds a negative correlation between debt financing and financial performance of SMEs. This could be explained by the fact that SMEs in Nairobi mostly utilize short term debts for financing rather than long term debts. Short term debts attract high interest rates and penalties on default. It would therefore make sense that the more short term debt a firm has, the lower the profit it makes and hence dismal financial performance.

CHAPTER FIVE

SUMMARY, CONCLUSIONS AND RECOMMENDATIONS

5.1 Introduction

This section presented the summary, conclusion and recommendations in relation to the study objectives. The study aimed at establishing the effect debt financing on the financial performance of the SMEs in Nairobi County.

5.2 Summary of Findings

The study aimed at establishing the effect debt financing on the financial performance of the SMEs in Nairobi central district. The independent variable was debt financing. A total of 85 SMEs were sampled and data collected for 5 years time from year 2012 to 2016. Nevertheless, only 72 SMEs filled and returned the self- administered data collections forms.

The main findings of the study indicated that there exists a negative relationship between debt financing and financial performance of SMEs, however the relationship is insignificant as the p value was found to be greater than the alpha value. The model of the study had a coefficient of determination denoted by R squared of 0.042 which showed that the model of the study only predicted 4.2% of the variation is the dependent variable. The other 95.8% was predicted by other factors that were not in the model.

The correlation between dependent variable and independent variables were all negative, though closer to zero than they were closer to -1. This showed that increase in the independent variables (debt financing) led to decrease in dependent variable

(financial performance). The decrease in the independent variable was however weak, since the correlation was closer to zero, which denoted weak correlation between the variables.

The other findings that were made in the study were that SMEs in Nairobi Central Business area had low financing levels. Their total assets are mostly financed by equity. The debt financing of the SMEs is normally by use of expensive short term debts rather than long term debts. In average the study found out that debt finances about 48% of the total assets while 52% of the assets are financed by equity. The 48% of the assets financed by equity, long term debt finances only 16% while 32% was financed through short term debt.

5.3 Conclusions

Firm's total assets are characteristically financed with a combination of debt and equity, commonly referred to as the firm's capital structure. The capital structure decision is a critical financial decision taken by a firm because it directly impacts on the firm's financial performance. This study examined the effects of debt financing on the financial performance, as measured by ROA of SMEs in Nairobi Central Business District.

From the findings of the study, SMEs in Nairobi Central Business area finances their assets mostly through equity rather than through debt. They in fact use more of short term debt rather than long term debt. Short term debt attracts higher interest charges and increases risk of default that consequently increases their solvency risks. SMEs are therefore found to be high risk and most lenders shy away from advancing them

cheaper long term debt. SMEs are therefore left with no choice but to finance their operations by the use of high cost short term debt. There is therefore no wonder that the relationship between debt financing and financial performance is negative, meaning that the more SMEs take short term loans, the more they eat into their profitability which affects their financial performance albeit in relatively small proportion.

The study also concludes that the relationship between debt financing and financial performance is insignificant with debt financing predicting only 4% of the financial performance. This therefore communicates that although there exist a negative relationship, SMEs would not be adversely affected in their financial performance if they finance their operations through debt.

5.4 Recommendations

On the basis of the foregoing conclusions, the study presents the following recommendations to the SMEs, policy makers, lenders and scholars for review and consideration. Investors and managers of SMEs should work on their risk levels so as to convince lenders and would therefore able to secure long term debt financing which is less costly than short term debt financing. However, owners and managers of SMEs should not shy away from investing in projects with positive NPV by use of debt, since the relationship between debt financing and financial performance is negative, it is also insignificant. This would mean that increase of debt financing would only adversely affect financial performance by a meagre of 4%.

Government agencies engaged in availing funds to SMEs should avail such funds at the lowest possible rate or otherwise provide them at zero interest rate for the SMEs to realize sustained and robust financial performance. The government should understand that these SMEs though large in number and employ a bigger percentage of skilled labor, rarely secure long term loans, required to finance their operations.

The Kenyan Government funding programme for SMEs such as the Women enterprise Fund, Youth Development Funds and the Uwezo Fund should be tailored to meet individual SME borrower's needs besides the current group affiliation focus in order to improve the reachability and accessibility of the funds to many needy business operators. The National and County Governments should step in to act as guarantors of commercial loans obtained by SMEs from lenders as this will ensure that the SMEs experience sound and sustainable financial performance.

Based on the findings on short and long term loans the study recommends that there is need for capacity building among the SMEs particularly on business management which will have an overall effect on financial performance. The SMEs should put focus on reducing the time frame for loan processing and the borrowing cost. Through capacity building the government will have more gains from the SMEs through training, and skill acquisition which will give them a platform where they can reduce profitability by utilizing their loans and avoid being credit rationed. This is more important to Kenya mostly due to the issues of unemployment where the government will have a platform to implement measures to address the unemployment issues.

There is a recommendation that the banks should give a long term loans which will make the firms to be in a place where they can invest in machinery and equipment. It becomes difficult to pay loan of short term debt when it was used for the purpose on long term investments.

5.5 Limitations of the study

The study only focused on SMEs operating within Nairobi Central Business District. Therefore, the generalization of the results was limited and should be carried with caution. The respondents declined to provide information which they regarded as confidential. The study mitigated this by promising the respondents that the information will only be used academically. The model used considered a select few of the factors that can be considered when studying the subject of the study. There is room for improvement in the model by considering more factors can be included in the model. An increased duration is required for the researcher to collect more data and also to review other indicator variables of the study.

5.6 Suggestions for further Research

The study concentrated on a relatively small portion of the accessible population and the responses were only from SMEs in Nairobi Central Business District. A study on SMEs across various counties in Kenya could have provided more conclusive results on the effect of credit financing on financial performance of SMEs in Kenya. Further a research could be done on a sample which is bigger than the one used in this study for comparison purposes.

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APPENDICES

Appendix I: Letter of Introduction

Date……

To…….

Dear Sir/Madam,

RE: COLLECTION OF RESEARCH DATA

My name is Magot Daniel Deng and an MBA student in Business Administration – Finance option at The University of Nairobi. Currently, I' am carrying out a research on the "*Effect of debt financing on financial performance of Small and Medium Enterprises in Nairobi"*. I 'am in the process of gathering relevant data for this study. You have been identified as one of the collaborators and respondents in this study and kindly request for your assistance towards making this study a success.

I therefore kindly request you to take some time to respond to the attached self-administered data collection form. I wish to assure you that your responses will be treated with confidentiality and will be used solely for the purpose of this study.

I thank you in advance for your time and responses. It will be appreciated if you can fill the questionnaire within the next 5days to enable early finalization of the study.

Yours Sincerely
Magot Daniel Deng
Registration Number: **D61/77986/2015**

Appendix II: Data Capture Form

Items	Survey items	Variables	2012	2013	2014	2015	2016
Y	Ratio of either Net Income to Total Assets	Net Income					
		Total Assets					
X_1	Ratio of Total Debt to Total assets	Total Debt					
		Total assets					
		Ratio					
X_2	Ratio of long-term debt to Total Assets	Long-Term debt					
		Total Assets					
		Ratio					
X_3	Short –Term Debt to Total Assets	Short-term liabilities					
		Total Assets					
		Ratio					
Firm Size	Log of total assets	Total asset					
		Long-term (assets)					

Appendix III: Research Data

SMEs	ROA (%) (Y)	Total Debt to Total assets (%) (X_1)	Long-term debt to Total Assets (%) (X_2)	Short – Term Debt to Total Assets (%) (X_3)	Log of total assets (X_4)
SME 1	1.52	87.77	0.28	87.49	22.06
SME 2	1.56	87.23	1.24	86.00	21.93
SME 3	0.35	100.00	2.89	97.11	18.68
SME 4	0.32	100.00	3.24	96.76	18.46
SME 5	0.33	100.00	3.54	96.46	18.38
SME 6	100.00	100.00	4.27	95.73	18.32
SME 7	0.59	100.00	11.35	88.65	18.35
SME 8	0.67	64.20	5.59	58.61	21.53
SME 9	0.31	2.46	2.44	0.03	21.93
SME 10	-1.06	77.17	72.36	4.81	23.48
SME 11	0.11	81.15	79.65	1.51	23.54
SME 12	0.15	76.33	75.08	1.25	23.30
SME 13	1.34	67.90	67.10	0.80	22.67
SME 14	1.50	5.35	3.83	1.53	21.97
SME 15	0.16	84.14	79.76	4.37	24.03
SME 16	0.46	82.95	77.01	5.94	23.95
SME 17	1.47	81.36	5.59	75.77	23.73
SME 18	1.33	93.58	6.61	86.97	23.24

SME 19	1.18	98.83	91.59	7.24	17.21
SME 20	2.07	97.20	87.15	10.05	16.35
SME 21	1.58	48.47	35.35	13.12	22.62
SME 22	5.88	52.66	17.75	34.91	23.19
SME 23	1.07	86.18	78.26	7.92	21.89
SME 24	2.16	55.69	0.00	55.69	21.44
SME 25	4.16	60.46	0.00	60.46	21.28
SME 26	7.46	57.66	0.00	57.66	21.20
SME 27	-9.48	99.43	23.47	75.97	19.48
SME 28	24.16	79.18	37.77	41.41	18.75
SME 29	-16.10	27.58	8.50	19.08	16.23
SME 30	-7.21	26.22	0.00	26.22	16.29
SME 31	1.47	20.12	0.00	20.12	20.71
SME 32	0.50	15.01	0.00	15.01	20.59
SME 33	1.31	13.88	0.00	13.88	20.48
SME 34	2.50	62.12	60.67	1.45	23.10
SME 35	4.61	61.20	59.42	1.77	22.95
SME 36	3.76	65.21	63.22	1.99	22.65
SME 37	-3.08	1.08	0.00	1.08	17.53
SME 38	42.84	6.38	0.00	6.38	17.63
SME 39	26.49	1.07	0.00	1.07	16.97
SME 40	22.09	0.44	0.00	0.44	16.67
SME 41	-1.09	88.73	0.20	88.53	22.38
SME 42	-9.57	89.70	0.00	89.70	22.39

SME 43	-4.03	82.37	0.68	81.69	22.51
SME 44	5.81	62.84	0.00	62.84	22.31
SME 45	8.73	61.83	0.00	61.83	22.19
SME 46	6.88	68.24	0.00	68.24	22.04
SME 47	5.48	78.34	0.00	78.34	22.16
SME 48	1.35	79.78	0.00	79.78	21.50
SME 49	5.00	32.26	0.00	32.26	18.88
SME 50	3.25	24.03	0.00	24.03	18.56
SME 51	5.60	10.57	0.00	10.57	18.48
SME 52	9.59	16.20	0.00	16.20	18.58
SME 53	14.57	21.55	0.00	21.55	18.15
SME 54	7.31	47.43	0.00	47.43	21.31
SME 55	13.36	48.27	0.00	48.27	20.33
SME 56	9.30	47.83	0.00	47.83	20.40
SME 57	11.99	38.12	0.00	38.12	20.39
SME 58	0.58	0.00	0.00	0.00	21.76
SME 59	3.51	0.00	0.00	0.00	21.54
SME 60	2.27	0.00	0.00	0.00	21.29
SME 61	4.81	0.00	0.00	0.00	23.26
SME 62	4.84	15.63	11.04	4.59	23.20
SME 63	8.92	39.46	17.85	21.61	20.62
SME 64	7.71	0.00	0.00	0.00	21.45
SME 65	35.22	27.54	18.41	9.13	20.47
SME 66	4.05	21.53	17.36	4.17	25.44

SME 67	79.83	21.36	10.71	10.65	22.07
SME 68	9.85	0.08	0.01	0.07	22.78
SME 69	1.52	3.05	1.35	1.70	22.37
SME 70	20.60	0.00	0.00	0.00	21.28
SME 71	8.49	0.53	0.04	0.49	21.21
SME 72	14.18	9.44	2.12	7.32	21.44