# A SURVEY OF THE FINANCIAL CONSTRAINTS HINDERING GROWTH OF SME's IN KENYA: THE CASE OF KAMUKUNJI DISTRICT IN NAIROBI COUNTY

BY

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# DECLARATION

I, the undersigned, declare that this is my original work and has not been submitted to any other college, institution or university other than the University of Nairobi for academic credit.

**Signed:**       **tj<v|ec-**                    **Date:**      **OfrlvilaOH**

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**SUPERVISOR'S DECLARATION**

This project has been presented for examination with my approval as the appointed supervisor.

**Signed:**       **•<[>- '**                   **Date:**      **/                    Q-,  Zj&i'f**

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# DEDICATION

This study is dedicated to my loving parents, Mr. and Mrs. Koech and my fiancee Edgar who have continuously inspired me and supported my efforts throughout this study.

# ABSTRACT

The Small and Medium Enteiprise (SME) Sector has continued to play an important role in the Kenyan economy. The sector's contribution to the Gross Domestic Product (GDP) has increased from 14% in 1993 to about 20% in 2007. Many entrepreneurs have limited ways to grow their business into large enterprises. There are many constraints hindering their growth , so it is important for an entrepreneur to fully understand all financial constraints.

The purpose of the study was to identify the financial constraints hindering growth of SMEs in Kamukunji District. A quantitative, descriptive design was used to study sixteen types of businesses in five locations of Kamukunji District.Structured questionnaires were used to collect the data from 100 businesses.Business owners completed all the questionnaires that included background, growth and financial constraints of the businesses. The findings identified cost, capital market and capital access as the highest contributing factors to constraining SMEs growth into large business enterprises. Further findings indicated that profits and sales were the factors that were found to influence business growth.

This study expands our understanding on the implications of cost, capital market, capital access, profits and sales to business growth. The results will guide microfmance institutions to coming up with better loan facilities to these SMEs, and to the government, better planning and providing of information to small and medium enterprises.

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# CHAPTER ONE

# INTRODUCTION

## 1.1 Background to the Study

Small businesses are generally regarded as the driving force of economic growth, job creation, and poverty reduction in developing countries. They have been the means through which accelerated economic growth and rapid industrialization have been achieved (Hams and Gibson, 2006; Sauser, 2005; Van Eeden,et al, 2004; Arinaitwe, 2002; Kiggundu, 2002; Yusuf and Schindehutte, 2000; Monk, 2000; Goedhuys and Sleuwaegen, 2000; Birch, 1981, 1987). While the contributions of small businesses to development are generally acknowledged, entrepreneurs face many obstacles that limit their long-term survival and development. Research on small-business development has shown that the rate of failure in developing countries is higher than in the developed wolid (Arinaitwe, 2002). Scholars have indicated that starting a business is a risky venture and warn that the chances of small-business owners making it past the five-year mark are very slim. They should develop both long-term and short-term strategies to guard against failure (Sauser, 2005; Monk, 2000).

It is in the realization of the important role played by the SME Sector that the government has put measures to promote the development, growth and competitiveness of the sector. In particular, the role of government is to create a conducive business environment for private sector growth and competitiveness. It is in this context that the government developed and implemented the Private Sector Development Strategy (PSDS).

The purpose of the PSDS is to catalyze the provision of an enabling environment which will enhance Private Sector growth and competitiveness. This is to be achieved through two strategic objectives namely: to create a conducive business environment for private sector growth and by alleviating major constraints and to enhance the growth and competitiveness of the private sector, especially, the SME.

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The Ministry of Industrialization is also implementing the SME Competitiveness Project that aims to increase productivity and employment in participating SMEs. The objective of the project will be achieved by strengthening financial and non-financial markets to meet the demand of SMEs; strengthening institutional support for employable skills and business management; reducing critical investment climate constraints on SMEs.

The Enterprise Centre seeks to meet the needs of the Small and Medium Enterprises in four key areas, first, Capacity building in business management: through the six month certificate in Entrepreneurship Management Course; secondly, Value added services: that includes business counseling, networking meetings, business diagnostics, mentoring, exhibitions and corporate retreats; thirdly, Business Club: that provides members with access to value added services at discounted rates and finally Knowledge Hub: that provides access to resources (such as conferences; annual awards and SME bulletins; SME Toolkit; and industry research) to facilitate their operations. As can be observed from its focus areas, the centre will contribute immensely to the support and development of the Development SME Sector.

In the light of these support and incentive programs, it would seem reasonable to expect that small businesses would grow and flourish in Kenya. The study explores the constraints to small-business graduating into large business despite all the programs established to help them succeed.

## 1.1.2 Meaning of Small and Medium Enterprises

There is no commonly accepted definition of a small- scale business. The same business could be defined as small, medium or big by different people. A business that may be described as medium in Europe could be described as big in Kenya (Storey J and Stokes 1978). Numerous efforts have been made by academicians and policy makers to define small and medium enterprises (SME's). According to the National baseline Survey of 1999 and sessional paper no. 2 of 2005, there are various criteria used; number of employees, degree of legality and amount of capital. According to the number of employees, small and enterprises (SME's) can be defined as per the number of employees engaged by enterprises. A distinction is made between small enterprises, which employ

between 10-50 workers of which in all cases the owner is included. According to the degree of legality, SME is based on enterprises that are essentially non-primary businesses i.e. non-farm business activities excluding agricultural production, animal husbandry, fishing, hunting and gathering and forestry.

According to the amount of capital, SME's include farm based activities that involve some form of processing before marketing. Ministry of Research and Technical Training and Technology (1997) takes SME's in the broadest sense to include enterprises having 1-50 employees, enterprises (small enterprises) in the non-structured or informal sector of the economy engaging in manufacturing. MRTTT also includes non-manufacturing enterprises, largely those that provide services and meet the set criteria.

## 1.1.3 Defining EJusiness Growth

There are many different definitions of business growth and ways of measuring this growth(Barringer et al,2005;Delmar et al,2003;Delmar and Wiklund,2008).Business growth is typically defined and measured using absolute or relative changes in sales,assets,employment,productivity,profits and profits margins(Delmar 1997;Davidson et al,2005;Allinson et al,2006) measures possess particular advantages and disadvantages in understanding the phenomenon of growth(Delmar 1997) but overall these variations render systematic knowledge accumulation and comparison problematic.Although related,there is no necessary connection between the different growth measures(Delmar et al,2003).

Firm growth varies widely depending on business age, size and industry(Penrose 195 9). There fore, sales growth need not correspond to or underpin other dimensions of growth in which policymakers might also be interested; for instance, sales can increase while employment and/or profits fall. This is partly related to contextual or structural issues such as sector or age of business but also to the strategic choices made by principal decision-makers within the firm. Firms might, for example, expand sales at the expense of profit margins by reducing prices or by outsourcing work with no impact on employment.

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Following earlier work that suggest sales and or employment growth is a better measure of new and small business performance than accounting based measures such as profit,return on investment or market share(Brush and VanderWerf,1992).Sales data are usually readily available and business owners themselves attach high importance to sales as an indicator of business performance(Barkham et al; 1992).In practice, sales growth is also easier to measure compared with some other indices and is much more likely to be recorded. Sales are a good indicator of size and, therefore, growth.Sales may also be considered a precise indicator of how a firm is competing relative to their market. Business owners themselves often treat sales as a key motivator and indicator of performance rather than for example, job generation.

## 1.1.4 Small Manufacturing Firms in Kenya

The small enterprise sector in Kenya is exploding because there are very few formal rates that neither keep up with inflation nor signal relative scarcity of capital. When investors cannot entrust their savings to financial institutions, they tend to opt for entrepreneurship (Hart, 1973).Many African investors are either illiterate or semi-illiterate; consequently, the management of large and complex organizations is difficult so that operations of such investor tend to be limited to small enterprises. A further motivation for operating small firms is the avoidance of registration-related costs and red tape, as well as taxation.

A large proportion of the entrepreneurs of the small firms is young and well educated but deficient in technical and vocational training. Entrepreneurs with technical or secondary education perform better in terms of output growth. Constraints facing the enterprises are many but the main ones include credit, demand and technology, with inadequate credit being widely cited as a major constraint (Baah-Nuakoh et al, 2002).

The sector is a mixture of self-employment outlets and dynamics enterprises involved in an array of activities that are concentrated in urban areas but that are also evident in rural areas in Africa. The activities absorb many people who otherwise would be unemployed, the SME's or Informal Sector provided 78% of total employment and contributed over 57% of the new jobs created in 2005/06 according to the Economic Survey of 2007.In

2'imbabwe, there were 845,434 small firms in 1990 providing employment to approximately 1.6 million people. Most small enterprises in Zimbabwe were involved in Manufacturing while the rest engage in trading, services, construction and transportation (Gemini, 1994).

Sole proprietorships forms the majority of enterprises of which an important proportion are female-owned and operate from homes. Indeed, as many as a half of the very small businesses are female-owned. Many are also one-person operations and although the proportion of female ownership varies across activities, it is especially small within manufacturing. Thus, although women own a significant proportion of all small enterprises taken together, men dominate small manufacturing activities. Female-owned small enterprises are more likely to operate informally than male-owned small enterprises. They also start smaller, use less start-up capital, grow slower if at all, have more limited access to credit and more often operate from less permanent premises (Kimuyu and Omiti, 2000).

Employment in the small enterprise sector makes it possible for unskilled rural migrants to acquire skills needed for survival in the more challenging urban environment. The sector also attracts skilled persons who have been retrenched from formal sector jobs and is often viewed as a second-best option for people unable to find or keep jobs in the modern sector. In the recent past, employment growth in the enterprise sector far outpaces growth in the large modern sector (Aboagye, 1996).Many small enterprises however require skills that school leavers often lack, so that the small enterprise sector on its own is unlikely to solve Africa's daunting unemployment problem (Ongile and McConnick, 1996).

A significant proportion of small manufacturers in Kenya is unregistered and therefore operates informally. The majority of those that start informally remain unregistered and do not perceive such registration as beneficial. They therefore prefer to operate informally. Some register well after start-up, however, late registration is motivated by a felt need to put the manufacturing operations on a legal footing. Some of the enterprises that keep books of accounts do so primarily for tax puiposes.

Many small manufacturing firms operate from rented premises due to failure of operations. Purchase of land from the open market is expensive for these small enterprises that are generally undercapitalized. Renting is however problematic in most of Africa due to problems in enforcing contracts. Evictions from such premises are common and arbitrary (Moyo et al, 2002).

## 1.1.5 SME's Growth and Financial Constraints

For a long time in Kenya, promotion of SME sector has been duly recognized as a viable and dynamic strategy for attainment of national goals such as job creation, poverty alleviation and development between diverse sectors.These are the cornerstones of a strong national industrial base and domestic structures that are central to the Kenya government's vision of achieving newly industrialized country status by the year 2030 (Mullei and Bokea,1999).

The Small and Medium Enterprise (SME) Sector has continued to play an important role in the economy of this country. The sector's contribution to the Gross Domestic Product (GDP) has increased from 13.8 per cent in 1993 to about 20 per cent in 2007. The Small and Medium Enterprise Sector (SMEs) or Informal Sector provided 78% of total employment and contributed over 57% of the new jobs created in 2005/06 according to the Economic Survey of 2007. The sector therefore plays a key role in employment creation, income generation and is the bedrock'for industrializing the Country in the near future.

In Kenya, there are about 2.2 million micro, small and medium enterprises (Strategic Business Advisors (Africa) Ltd. - SME BankingSector Report, 2007), of which 88 percent are non-registered. Of this non-registered group, only 23 percent have bank accounts, and onlylO percent have ever received credit from any formal source.
Financial Constraints has been attributed as one of the main constraints facing SME's in Kenya.The nature of credit markets, which are segmented and incomplete, is one major explanation. Market segmentation implies that demand for and supply of financial services, do not interact. Due to the risky and inter-temporal nature of credit trade, the information requirements and enforcement problems for lenders are high, resulting to

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agency costs, which affect the outcome of credit programmes towards SME's.As a result firms may prefer to seek funds from external sources but fail due to the high costs of loan application.On the supply side, most formal financial institutions consider SME's uncreditworthy.The slow growth of SME's has been attributed by some researchers to the lack of access to financial resources(Nkurunziza,2005).

## 1.2 Statement of the Problem

The potential contribution of small businesses to employment and income in Kenya has been generally recognized. The Small and medium Enterprise Sector (SMEs) or Informal Sector provided 78% of total employment and contributed over 57% of the new jobs created in 2005/06 according to the Economic Survey of 2007.

Prior research has shown that a number of factors constraint the growth of small-businesses, especially a lack of capital or financial resources, Okpara (2007). Lack of credit has also been identified as one of the most serious constraints facing SMEs and hindering their development, Oketch (2000).

Oketch et al (2002) indicates that small firms, that are limited resources may be constrained from joining any networks or having contacts, due to the costs involved in such associations. Financial constraint remains a major challenge facing SMEs in Kenya (Wanjohi and Mugure, 2008). However, the degree to which limited financial resources alone are a major obstacle is still debatable. According to the financing theories especially trade off theory (Kraus and Litzenberger, 1973) people should weigh between the costs and benefits of a financing source before they decide on one.

Studies by Dia (1996), Godsell (1991), Hart (1972), and Harper (1996) found that additional capital is often not required and can be overcome through creativity and initiative. Kallon (1990) found that the amount of capital needed to start a business is significantly negative when related to the rate of growth for the business. He also found that access to commercial credit did not contribute to entrepreneurial success in any significant way, and, if it did, the relationship would be negative, Kallon (1990). Schiffer and Weder (2001) that found small firms consistently report higher growth obstacles than

medium-size or large firms. Beck, et al (2006) show that size, age and ownership are the most reliable predictors of firms' financing obstacles.

From the literature search very little research has been conducted on the extent to which financial constraints hinder growth of SME's in Kenya. Studies on other countries may not apply to the Kenyan business environment. This study will thus fill the gap by examining the constraints to growth of SME's in Kenya. The study contributes to additional empirical evidence on constraints facing SME's development in Kenya.

## 1.3 Objectives of the Study

To analyze the financial factors that constrains SME's growth in Kenya.

## 1.4 Importance of the Study

The study will be of significance in the following ways:

It will enlighten the micro finance institutions in understanding constraints faced by SME's in order to implement better and effective programs.

It will also be of importance to the government, it will assist in setting up specific management policies that will enhance effectiveness and sustainability of SME's in Kenya.

The study will also be of significance to Scholars and practitioners in understanding the level of SME's development in Kenya, which plays a significant role in providing ancillary services to multinational corporations.

Finally, this study will contribute to the future development of this area of research, particularly in a developing country like Kenya.

# CHAPTER TWO

# LITERATURE REVIEW

## 2.1 Introduction

This chapter looks at the importance of theory in academic writing and the various developments in theory. Section 2.2 explains the financing theories, section 2.3 explains the financial constraints that affect the growth of SME's and finally section 2.4 gives the empirical evidences both locally and globally are explained.

## 2.2 Financing Theories

## 2.2.1 Pecking Order Theory

The theory states that firms avoid external financing while they have internal financing available and avoid new equity financing while they can engage in new debt financing at reasonably low interest rates.Murray and Goyal (2005). According to the theory, the most preferred source of finance is internal source which is the retained earnings or personal savings for informal sector entrepreneurs. The second preferred source is debt this is followed by internal equity and external equity.

According to Cosh and Hughes (1994), the Pecking Order Theory, with its emphasis on the desirability of the use of funds generated within the business rather than funds raised externally, can readily be applied to SMEs. Indeed SMEs seem to face a more extreme version of the Pecking Order Theory described as a "constrained" Pecking Order Theory by Holmes and Kent (1991) and a "modified" Pecking Order Theory by Ang (1991) because they have less access to external funds, debt as well as equity than do large enterprises.

The Pecking Order Theory suggests that use of external funds is very much related to profitability on the basis that SMEs, particularly if they are not stock exchange listed, will make use of internally generated funds as a first resort, i.e. those which make use of external funds will be those with a lower level of profit. Growth is likely to lead SMEs

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that do not have sufficient internal resources to borrow although if the pecking order is constrained by lack of external funding of any kind, SMEs might restrict their growth to fit the availability of internal funds. Myers (1984) refers to the importance of asset type in providing collateral for borrowing in a situation of information asymmetry. Given the "lumpiness' of many investments, it is more likely that smaller firms will need to borrow than large when faced with investment opportunities. It can also be deduced from the pecking order theory, given the importance of retained funds that newer firms will have less time to accumulate resources and so will need to borrow more than older firms.

### 2.2.2 Trade off Theory

According to the trade-off theory, businesses should gear up to a point where the benefits of tax relief are balanced by potential costs of bankruptcy. At this point the weighted average cost of capital (WACC) should be minimum and the value of the business should be at maximum. Up to moderate levels of gearing, the tax advantages of loan finance will cause the WACC to decrease as more gearing is introduced, as predicted by MM's (after tax),Kraus and Litzenberger (1973).

Beyond moderate levels, bankruptcy risks to the equity shareholders and the introduction of real risk to lenders will push up the returns required by each group, making WACC a very high figure at high gearing levels. The moderate level is the point at which the balance is struck between the tax advantage, on one hand, and the bankruptcy cost and rising cost of borrowing on the other.

An emerging area in finance theory is right- financing theory whereby investment banks and corporations can enhance investment return and company value over time by determining the right investment objectives, policy framework, institutional structure, source of financing (debt or equity) and expenditure framework within a given economy and under given market conditions.

### 2.2.3 The Modigliani and Miller Hypothesis under Corporate Taxes

The original M and M propositions (Modigliani and Miller, 1958 and 1963) highlighted the important issues involved in financial structure decisions namely: the cheaper cost of debt compared to equity; the increase in risk and in the cost of equity as debt increases; and the benefit of the tax deductibility of debt. They argued that, in the absence of taxes, the cost of capital remained constant as the benefits of using cheaper debt were exactly offset by the increase in the cost of equity due to increased risk.

With taxes and the deductibility of interest charges they concluded that firms should use as much debt as possible. Myers (1984) described the compromise "static trade-off" theory in which firms would use a good deal of debt to take advantage of tax deductibility but not too much to avoid the increasing likelihood of costly bankruptcy.

## 2.3 Financial Constraints

### 2.3.1 Cost

Transaction costs and information asymmetries drive the variation in access to finance across firms of different sizes. Take first transaction costs. Fixed transaction costs in credit assessment, processing and monitoring result in decreasing unit costs as the size of the loan increases. These fixed transaction costs exist at the transaction, client, institution and even financial system level. Assessing an individual loan request entails costs that are at least partially independent of the loan amount. Maintaining a client relationship over time and across different financial products, including loan, deposit and saving, services, implies costs that are partly orthogonal to the number and amount of financial transactions with the client. At the level of the financial institution, fixed costs range from brick-and mortar branch installations over computer system to legal services and are again partly independent of the number of clients or the size of their loans. Fixed costs might eve arise on the financial system level in the form of regulatory costs and the costs of payment and settlement systems, which are up to a point independent of the number of transactions, clients and institutions in the system.

These fixed transaction costs drive a wedge between funding costs of financial institutions and the lending rate they charge borrowers. In a world of uncertain returns on investments, higher transaction costs and the resulting higher lending costs can increase the likelihood that borrowers cannot pay due to too high of a repayment burden. Rather than increasing the interest rate to the market clearing rate, financial institutions might ration at a lower interest rate than the market equilibrium rate because higher interest rates would lead to lower expected repayments. High transaction costs do therefore not only increase the cost of borrowing, but can also restrict access to external finance for some borrower groups.

While transaction costs are restraining for all borrowers, there are arguments that they are even more constraining for small and medium enterprises. Their diverse characteristics and their relative opaqueness increases assessment and monitoring costs. Unlike other credit categories, such as consumer credit or mortgage lending. SME lending is still considered a high-cost lending product. More specifically, unlike other lending products that can be reduced to simple transactions, SME lending often still depends heavily on relationships between borrowers and lenders (Berger and Udell, 1998, 2006).

## 2.3.2 Lack of Access to Capital Market

Weston and Brigham (1981) provided arguments to explain SME capital structure using a lifecycle approach. A major element in this explanation is the combination of rapid growth and lack of access to the capital market. SMEs were seen as starting out using only owners' resources. If they survived the dangers of under-capitalisation they were then likely to be able to make use of other sources of funds such as trade credit and short-term loans from banks. Rapid growth at this stage could lead to the problem of illiquidity that would follow from an over-reliance on short-term finance. The over-reliance on short-term finance would result from the lack of availability of long-term funds, such as debentures or equity issues that, in turn, would be due to the SME not having a stock market quotation. In other words, the SME at this stage would be facing the classic finance gap.

The growing SME would, therefore, have to choose between reducing its growth to keep pace with its internally generated funds, acquire a costly stock market quotation, or seek that most elusive form of finance - venture capital. The implications of this analysis for the financial structure of SMEs that grow rapidly are clear, namely higher levels of short-term debt, less, if any, use of long-term debt, and, in cases where short-term debt is substituted for unavailable equity issues, higher total debt. Access to the capital market in the form of a stock market flotation should enable SMEs to restructure their financing so as to rely less on debt, particularly short-term debt and thereby improve their liquidity. Growth after flotation would be likely to have less impact on capital structure because of the ability to raise finance in a balanced way, including long-term debt and equity, rather than having to rely on short-term debt.

### 2.3.3 Collateral Requirement

In addition to transaction costs, the outreach to small and medium enterprises is constrained by default risk. Default risk can be either borrower-specific or systemic. In the following, we will focus on the borrower-specific risk and more specifically on risks arising from asymmetric information between borrower and lenders. If the debtor is privy to information about her project or her effort and the lender may only secure this information at a prohibitively high cost, this can lead to two different sources of risk: adverse selection and moral hazard. Adverse selection refers to difficulties of choosing good credit risks ex-ante, while moral hazard refers to the inability of the lender to effectively enforce the agreed credit contract ex-post. Although such risk can be compensated by increasing the interest rate, this would increase adverse selection and moral hazard. As the interest rate rises, this will attract riskier borrowers to the pool and will entice borrowers to undertake riskier project with a higher probability of default.

The impossibility to use interest rates as screening technology entices lenders to use noninterest screening devices such as collateral, warrants or assessment based on audited information. In its ultimate consequence, however, lenders will ration credit rather than allow the interest rate to rise to the market-clearing level, Stiglitz and Weiss (1981).

## 2.3.4 Capital Management

Education and skills are needed to run small and medium enterprises. Research shows that majority of the lot carrying out small and medium enterprises in Kenya are not quite well equipped in terms of education and skills. Study suggests that those with more education and training are more likely to be successful in the SME sector (King and McGrath 2002). As such, for small businesses to do well in Kenya, people need to be well informed in terms of skills and capital management. SMEs in ICT appear to be doing well with the sprouting of many commercial colleges offering various computer applications. Further, studies show that most of those running SMEs in this sector have at least attained college level education (Wanjohi and Mugure, 2008).

## 2.4 Empirical Literature Review on Constraints to SME's Growth

## 2.4.1Global Empirical Literature Review

Africa's small manufacturing firms not only graduate but also systematically grow and experience growth spurts. The odds for and the rate of such growth and its spurts vary with firm age and size, registration status, business heritage, location, gender, age and, to some extent, the race of the proprietor. An assortment of other firm and proprietor attributes shape growth and its spurts, too (Mullei, 2003).

Micro and small scale enterprises in Africa do grow as some literature asserts. Firms owned by persons with vocational skills and business experience gained from years of exposure to similar enterprises-indicating that the owners understand different aspects of a business, production processes and markets before start-up-should generally show greater inclination to grow. Ultimately, the growth of a firm results from a deep knowledge of markets of interest to the firm, as evidenced by relationships between entrepreneurs and key market players. Firms also grow when their owners/managers value expansion, seize opportunities and overcome growth obstacles. When growth is not perceived as beneficial and barriers are un-surmountable, firms tend to stagnate.

Mullei (2003) demonstrated the importance of registration as a lever for firm growth and growth spurts and shows that while growth spurts take place over time and are therefore

lifecycle, young and small firms are generally more likely to grow and enjoy faster growth rates than old ones.

Small manufacturing firms in Africa transform, so that they move from one to another institutional threshold. Nevertheless, these firms neither share uniform transformations nor are the depths of the transformations symmetric across countries. Some entrepreneur-specific and firm-specific factors shape the structure and depth of such transformation of firms. In respect to firm-specific factors, the age of a firm increases odds for the transformation of firms, so that increasing the life expectancy of small manufacturing firms probably holds a key for industrial transformation in Africa. On a different tangent, while general education seems worthless from the viewpoint of firm transformation, technical skills drive firm transformation as does experience gained through either operating similar activities or working for firms in the same line of business (Mullei,2003).

Frank and Goyal (2003) tested the pecking order theory on the basis of what a broad cross-section of U.S. businesses actually did (rather than what managers said that they felt) during the period of 1980 to 1998. They found that the business behaved exactly in line with the trade-off theory and not as they would have been predicted. Bunn and Young (2004) taking similar approach to Frank and Goyal, but using UK data, found clear support for the trade off theory.

Liedholm et al., (1994), in their study on small enterprise employment growth in rural Africa found that an average of about 27% of enteiprises surveyed experienced growth. About 23% of jobs occurred through net firm expansion, while the rest came from new starts. Countries included in the study were Botswana, Kenya, Malawi, Swaziland and 2'imbabwe. Using data generated from baseline surveys, the percentage of enteiprise that grew in each of the countries was as follows: 19% in Botswana; 35% in Kenya; 23% in Malawi; 17% in Swaziland; and 20% in Zimbabwe. An average of about 1% of the smallest firms were observed to have graduated (i.e., grew from employing 4 or less people to over 10 workers). The authors concluded that while small enterprises formed a

dynamic part of rural African economies, a high percentage of new firms disappeared within the first three years of operation.

Ramachandran and Shah (1999) examined the link between minority entrepreneurship and firm performance in sub-Saharan Africa. They found that the educational attainment of firm managers influenced the performance of firms. Among the group of firms owned by Africans, a higher growth rate occurred for those firms which had managers with secondary or university levels of education. The authors observed that, generally, firms owned by non-indigenous Africans began with large sizes and grew faster than firms owned by indigenous Africans. The study focused on Tanzania, Kenya, Zimbabwe and 2'ambia and used 1992 and 1994 data from the Regional Program on Enterprise Development.

Liedholm (2002) investigates the determinants of survival and growth of SMEs in Africa and Latin America. Firms located in urban and commercial areas are more likely to survive and human capital also plays a crucial role. Again size and growth are central features in describing firm dynamics. Sector, location and gender also play a significant role in determining enterprise growth. In particular, it is shown, that enterprises run by male entrepreneurs grow more rapidly than those run by females.

Recent studies have begun to shed light on the types of biases that might arise from the use of employment as a measure of expansion rather than alternative indicators such as changes in sales, output, or assets. Parker's (1994) analysis of the growth in Kenyan SMEs, for example, indicated that net increases in real sales were almost double the growth in employment. A similar pattern was detected in the Jamaican Quarterly Panel Survey of SMEs (Gustafson and Liedholm 1995), where the change in real sales was twice the change in employment. Such findings highlight the lumpy nature of employment, which appears to increase with a lag after a sizeable growth in real sales, and indicate that the employment growth measures provide a lower-bound estimate of net firm expansion.

The high overall growth rates exhibited by the existing (surviving) SMEs are one of the most striking findings to emerge from the various surveys. Key determinants of small

enterprise growth would be the age and initial size of the enterprise. "Learning models" of enterprise growth along with empirical evidence from the United States and the developing world support an inverse relationship between these two variables and enterprise growth. Sector would be another important determinant of enterprise growth. From the theoretical perspective, it is likely that firms in different sectors would face different product demands and encounter different cost structures on the supply side. The empirical evidence of sectoral differences in growth rates is quite extensive (Liedholm and Mead 1999).

Another variable likely to affect the growth of existing enterprises would be location. Complementary enterprises grouped close together or enterprises located close to the final demand sources might be expected to grow more rapidly than their more isolated counterparts. Enterprises of this type would more likely to be found in urban areas, particularly in commercial districts away from the home. Initial empirical evidence from Africa has indicated that urban enteiprises typically grow more rapidly than their rural-based counterparts (Liedholm and Mead 1999).Various socioeconomic variables relating to the entrepreneur might also be expected to influence enterprise growth. Economic theory suggests, for example, that increases in "human capital," such as through increases in the experience or education of the entrepreneur, should lead to increases in enterprise growth. The empirical evidence of this relationship, however, has been mixed (Liedholm and Mead 1991). In addition to "human capital," proprietor gender might also be thought to be an important determinant of enterprise growth. Downing and Daniels (1992), for example, posit that female entrepreneurs in Africa are more risk averse and thus less like to grow in comparison with their male counterparts. Initial empirical evidence would tend to support this view.

Country is another key determinant of the growth of small enterprises. In addition to marked differences in their political, cultural, and historical context, countries differ widely in their overall economic conditions, particularly in their aggregate levels and changes in per-capita output. Empirical evidence on the wide differences in country growth rates has already been presented. The relationship between these key variables and enterprise growth has been analyzed recently by several scholars. McPherson (1992)

examined this relationship by applying formal statistical methods to the baseline enterprise data generated from several African countries. Parker (1994) used similar techniques to examine this relationship in Kenya, while Cabal (1995) extended the analysis to the Dominican Republic baseline data. In these studies the individual contribution of each of the key variables thought to influence growth can be specifically determined while holding the effects of the other variables constant.

To provide an added perspective on these studies, similar statistical techniques were used to examine the determinants of enterprise growth in the six African countries with countrywide baselines: Botswana, Kenya, Lesotho, Malawi, Swaziland, and Zimbabwe. The data from these countries were analyzed by estimating an ordinary linear ordinary least squares regression of growth. The growth measure used as the dependent variable was an absolute one: the annual jobs generated since startup per enterprise. Except for age and initial size, all the independent variables to explain growth were entered as dummy variables. Because data from only the "surviving firms" were examined, the possibility of sample selection bias was investigated by using the Heckit model. Fortunately, the bias turned out to be insignificant in this case.

The influence of specific government rules and regulations on the SME growth is the subject of some debate. Snodgrass and Biggs (1996), for example, argue that most governmental regulations fail to reach the smallest firms; that is, as these firms increase in size, however, they become more visible and more subject to government regulation and taxation, thus introducing a disincentive to expand beyond a certain threshold. Desoto (1989) has described the high transactions costs associated with registration in Peru. Yet, MSEs enumerated in our African or Latin American surveys rarely mention direct governmental controls or taxation as problems of central concern and were rarely cited as a binding constraint for these enterprises (Liedholm and Mead 1999). Indeed, recent from Africa indicates that taxes, when measured in terms of taxes actually paid by firms, were regressive by enterprise size and that registration and other governmental regulations did not inhibit the growth of MSEs in the countries studied(McPherson and Liedholm 1996).

## 2.4.2 Local Empirical Studies

Clothing and textiles is one of the SME activities with potential for the country's industrialization and it is a major SME activity in urban Kenya (Ouma, 2002; McConnick et al., 2002). For instance, the Regional Programme on Enterprise Development (RPED) study on manufacturing firms in Kenya, found that the textiles sector provides twenty-six percent of manufacturing employment and is characterized by a high proportion of small sized activities (Aguilar and Bigsten 2002).The sector, like other MSE activities in the country, faces constraints of lack of access to financial services.

Lack of access to financial services is one of the main constraints facing SME's in Kenya. Studies on the informal sector have indicated that despite the proliferation of SME's activities, many of them not grow (McCormick, 1992). Most are characterized by a small size of activities and employees. The slow growth of firms has been attributed by some researchers to the lack of access to financial resources (Nkurunziza, 2005).

Finance is a key input in the development and growth of business enterprises. One of the reasons why firms form linkages and relations with one another are to access finance (McCormick and Atieno, 2002).Credit contributes to enterprises development in a number of ways. Access to external resources allows for flexibility in resource allocation and reduces the impact of cash flow problems on firm activity (Bigsten et al., 2000). Firms with access to funding are able to build up inventories to avoid stocking out in periods of crisis, while in conditions of macroeconomic instability, use of credit increases growth of surviving firms. Firms without access to bank funding have also been found to be vulnerable to shocks (Nkurunziza, 2005).

Issakson (2004) argues that credit can be seen as a constraint to enterprise development due credit allocation process, which locks out firms with viable projects and the weak legal institutional framework for enforcement of contracts, forcing lenders to either rely on social networks or deny loans to potential borrowers. The information asymmetry existing in these markets creates a need for institutional and contract arrangements, which ensure contract enforcement.

In their study of financial constraints to Kenyan manufacturing firms, Issakson and Wilhborg (2002) observe that most firms obtain their loans from friends and relatives, with most informal borrowing occurring among informal firms with African owners. However, informal loans do not play a major role in substituting bank loans. Most firms above the small size are able to obtain trade credit, with a higher proportion of formal firms being able to obtain trade credit than the proportion of informal sector firms. Among the informal sector firms however, more are able to obtain trade credit rather than loans.

Finance affects firm growth in different ways. At the micro economic level, there is a widely held view that the slow growth of firms is the result of lack of access to financial resources. Neoclassical literature indicates that as firms are rationed out of credit, they may b forced to curtail investments. At the same time, empirical studies reveal that, for firms that survive macroeconomic instability, access to credit increases firm growth. Nkurunziza (2005) argues that the use of bank credit can affect firms' growth through profitability. Kenyan firm studies indicate that the use of credit increases firm growth, with firms citing access to credit as one of their main constraints.

Migiro and Wallis also sought to establish how often the manufacturing SME operators used different sources of information to access finance. The aggregate results indicated that 227 (60%) of the respondents very often use family and friends to obtain information on external sources of finance, while customers 154 (41%); local suppliers 152 (40%); competitors 87 (23%) and the Department of Trade and Industry 15 (4%) were also used. In conclusion it was observed that Kenya had weak enterprise finance information system that could not support, in particular, the information needs of small business enterprises. The findings revealed that general knowledge and awareness of finance options available to SMEs in Kenya were poor. This was said to be due to a lack of understanding of what was available, due to fragmented financial information, and lack of targeted awareness and educational schemes with a view to raising the profile of finance issues among the SMEs. The study suggested that SME operators need information on available bank

loans, sources of business finance, SME loan schemes, information on venture capital and on angel finance.

In developing countries where firms suffer from poor infrastructure, lack of information, and lack of finance, as well as weak institutions, linkages are even more important. One potential benefit from linkages is access to finance. By easing such financial constraints, linkages therefore can contribute to the process of industrialization. Since small firms are frequently constrained by lack of investment and working capital, linkages between producers and suppliers may lead to credit that in turn reduces the requirements for working capital. Other linkages like belonging to group lending schemes may also provide access to new sources of finance. Studies have advocated for linkages between formal and informal financial markets as an important strategy for increasing the flow of financial services to the small scale entrepreneurs (Braverman and Huppi, 1991).

Recent research on business systems (Oketch et al., 2002) indicates that small firms that are limited resources may be constrained from joining any networks or having contacts, due to the costs involved in such associations. This, in turn, limits the extent to which they can influence the support mechanisms like policies, legislation and infrastructure that affect their businesses. Small firms therefore, face a number of constraints, which are institutional in nature, but their weak organizational ability and limited or nonexistent linkages, limit the extent to which they can address such constraints.

Small manufacturing firms in Africa graduate from one size category to another during their lifetimes. In the process, a significant proportion of firms that start very small, graduates to higher size categories. Across-country comparison shows greater incidence of graduating in Ghana, perhaps in response to better macroeconomic out turns in recent years relative to Kenya and Zimbabwe. Further, founders of firms seem better able to nurture their enterprises into graduation than secondary owners who acquire businesses through either inheritance or purchase (Mullei, 2003).

 Female-owned firms perform relatively badly with respect to graduation as do African owned firms relative to those owned by persons of other race. Proprietors' gender and

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race therefore influence the graduation prospects. The graduation is not lifecycle in nature, since young firms are just as likely to graduate as old ones. Management arrangements also count, with the owner-manager management mode common among small manufacturers seemingly undermining the graduation process. Formalization of firms, however, seems to tip the balance in the direction of graduation (Mullei, 2003).

Female-owned firms, owned by Africans are less likely to graduate than firms owned by members of other races. This observation hints at racial differences in the reasons of going into business, ways in which start ups are financed, differences in corporation strategies and experience that translate into the poorer performance for African firms. These results also mimic other findings that suggest that African firms are likely to perform badly on account of lack of focus and dissipation of managerial capability, limited business experience and poor human capital attributes (Kimuyu, 1999).

## 2.5 Summary

Finance affects firm growth in different ways. At the micro economic level, there is a widely held view that the slow growth of firms is the result of lack of access to financial resources.

As with many developing countries, there is limited research and scholarly studies about the SME sector in Kenya. The 1999 National Baseline Survey conducted by Central Bureau of Statistics, ICEG and K-Rep Holdings provides the most recent comprehensive picture of SMEs in Kenya. Mead (1998) observes that the health of the economy as a whole has a strong relationship with the health and nature of small and medium enterprise sector. When the state of the macro economy is less favourable, by contrast, the opportunities for profitable employment expansion in SMEs are limited. This is true especially for those SMEs that have linkages to larger enterprises and the economy at large. Given this scenario, an understanding of the dynamics of SMEs is necessary not only for the development of support programmes for SMEs, but also for the growth of the economy as a whole. Given the importance of small businesses to the Kenyan economy and the exposure to risks owing to their location, there was need to conduct an empirical enquiry to investigate the financial constraints facing SMEs in Nairobi.

# CHAPTER THREE

# RESEARCH METHODOLOGY

## 3.1 Introduction

Research methodology refers to the analysis of principles of methods, rules and techniques. It involves the systematic study of methods which are to analyze a specific study .Section 3.2 explains the research design that was used on the study, section 3.3 gives the target population, section3.5 explains the methods that was used to collect data and finally section 3.6 and 3.7 explains methods that was used to analyze the data and data reliability and validity respectively.

## 3.2 Research Design

The study is regarded as an exploratory study since it focuses on identifying financial constraints to SME's growth into large business enterprises, with questionnaires as the main instrument of collecting data. (Kathuri and Pals, 1993) assert that survey research usually uses questionnaires in order to determine the opinions, attitudes, preferences and perceptions of groups of people of interest in the research. This instrument was found to be more accurate in this type of survey given the minimal intellectual sophistication of the subjects. It also saved time on part of the researcher.

## 3.3 Population

The research targeted the SME's within Kamukunji district, 100 Small and Medium Enterprises were sampled using stratified sampling. 100 small and medium entrepreneurs were selected using simple random sampling procedure from each stratum which is the business category, as shown from the table below.

**Table 1:** Sample Size Selected from each Category

| Business Category | Business Code | Sample Size | Percentage % |
|---|---|---|---|
| 1 | 110,115 | 24 | 24 |
| 3 | 315,335,365,380 | 12 | 12 |
| 4 | 415 | 8 | 8 |
| 5 | 515,524,527,546,549,552 | 10 | 10 |
| 6 | 610,615,630,635 | 12 | 12 |
| 7 | 735,740,760 | 10 | 10 |
| 8 | 815,825,830 | 24 | 24 |
| **Total** | | 100 | **100** |

Source: Author's computation

## 3.4 Sampling Design

The researcher intended to use stratified sampling in selecting respondents. The population was segregated into several mutually exclusive subpopulations or strata herein referred to as business categories as shown in Table 1 (see appendix). The research applied proportionate stratification that was based on the stratum's share of the total population to come up with the sample in each stratum. 100 small and medium entrepreneurs were selected using simple random sampling procedure from each stratum. Questionnaires were administered to all entrepreneurs selected.

## 3.5 Data Collection

Sampled small entrepreneurs in the informal sector were visited in their business premises. Primary data was collected based on a structured questionnaire that was administered to the respondents. The questionnaire consisted of both open ended and closed ended questions covering issues on the constraints to SME's growth into large business enterprises. Once the completion of the questionnaires was through, they were collected in readiness for data analysis. Due to limited intellectual sophistication of the subjects, questions were clarified and even translated to Kiswahili as deemed necessary. Field editing was conducted before departure from the field.

## 3.6 Data Analysis

Gay( 1992),observed that data analysis involves organizing, accounting for and explaining the data, that is making sense of data in terms of respondents definition of the situation noting patterns,themes,categorizes and regularities.

Data was analyzed using exploratory factor analysis and descriptive analysis in accordance with the objectives of the study. Factor analysis was used to rank factors considered in order of importance, while descriptive analysis used frequency distribution and percentages. The statistical package for social sciences (SPSS) was used to analyze the data.

## 3.7 Data Reliability and Validity

A research has high validity if the study only contains what one wants to study and nothing else. Validity is subdivided into three subgroups: construct-, internal- and external validity. Construct validity refers to data collection procedure. The primary data collection was directed towards the SMEs entrepreneurs, who are the mostly faced with growth constraints.

 Internal validity which is a link between theory and empirical research was ensured as the study tries to discover which factors mostly influence constraint to SME's growth by considering existing theories. External validity establishes the domain to which a study's findings can be generalized. Respondents were chosen randomly and the study sample was fairly representative.

Reliability demonstrates that operations of study for example data collection procedures can be repeated with the same outcome. The researcher utilized a quantitative method in form of a questionnaire and considered that the same procedure is easily applicable to another similar sample of SMEs and render same results if directed towards the same sample group. Therefore, the study fulfilled reliability criteria. However, answers of respondents were exposed to subjectivity and may distort the responses.

# CHAPTER FOUR

# DATA ANALYSIS, RESULTS AND DISCUSSION

## 4.1 Introduction

This chapter shows findings of the study and discusses these findings in length. The study targeted the SME's within Kamukunji district, 100 Small and Medium Enterprises were sampled using stratified sampling. 100 small and medium entrepreneurs were selected using simple random sampling procedure from each stratum which is the business category, as explained in chapter 3. Section 4.2 shows summary statistics, section 4.3 explains factors influencing and affecting the growth of SMEs, section 4.4 discusses the results and section 4.5 summarizes the chapter.

## 4.2 Summary Statistics

### 4.2.1 Nature of Business

Sixteen forms of businesses in Kamukunji District were sampled. Restaurants/hotels had the most respondents (14%) followed by Boutiques (13%) and beauty shops (11%) down to general shops (1%). Table 4.1 shows the various natures of businesses that were sampled:

**Table 4.1** Nature of Business within Katnukunji District

| Nature of business | Frequency | Percent | |
|---|---|---|---|
| Bar | 2 | (2.0 | |
| barber shop | 6 | 6.0 | |
| Beauty shop | 11 | (ll.O | |
| Boutique | 13 | 13.0 | |
| Chemist | 4 | 4.0 | |
| dry clcaner | 4 | 4.0 | |
| ilFumiture | 2 ** | 12.0 | |
| Garage | 10 | 10.0 | [ |
| general shop | 1 | 1.0 | |
| Hardware | 7 | 7.0 | |
| Restaurant | 14 | 14.0 | j |
| Salon | 6 | 6.0 | |
| shoe selling | 5 | 5.0 | |
| Tailoring | *2* | 2.0 | |
| timber supply | *6* | 6.0 | |
| 'Welding | 7 | *h.o* | |

Source: Author's Computation

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### 4.2.2 Forms of Business Ownership

Table 4.2 shows the various forms of ownership. Sole proprietorship had the lion's share of 82% followed by partnership (18%). Companies and other forms of ownership had no respondents.

**Table 4.2** Forms of Business Ownership within Kamukunji District

| Form of ownership | Frequency | Percent |
|---|---|---|
| Sole proprietorship | 82 | 82.0 |
| Partnership | 18 | 18.0 |
| Total | 100 | 100.0 |

Source: Author's Computation

## 4.2.3 Location of Business

Eastleigh had the highest number of businesses sampled since it is termed as 'Dubai' of Nairobi. Of the sampled respondents, 47% were from Eastleigh, followed by Gikomba (19%) and Bahati had the lowest number of businesses sampled (10 %.)

**Table 4.3** Location of Business

| Location of business | Frequency | Percent |
|---|---|---|
| Eastleigh | 47 | 47.0 |
| Jua Kali | 13 | 13.0 |
| Bahati | 10 | 10.0 |
| Jerusalem | 11 | 11.0 |
| Gikomba | 19 | 19.0 |
| Total | 100 | 100.0 |

Source: Author's Computation

### 4.2.4 Gender of Business Owners

The businesses in Kamukunji are dominated by males (by 76%). Females only share a quarter (24%) of the businesses in the area, as shown below.

**Figure 4.2** Gender of Business Owners

**Sex of business owners**
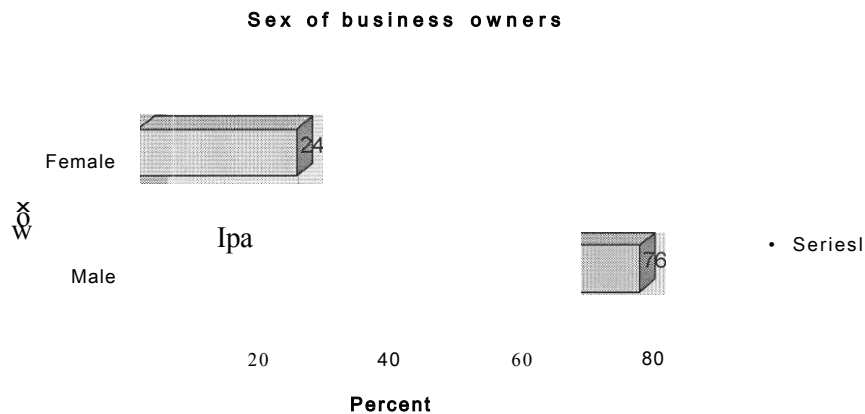


Source: Author's Computation

### 4.2.5 Methods of Financing Business

The study sought to find the various ways in which the businesses in Kamukunji were financed. The outcome was that 79% of the businesses in the area were financed through business income, 19% through MFI (loans) and 2 % through friends and relatives.

**Figure 4.3** Method of Financing Business

**Method of financing the business**



Source: Author's Computation

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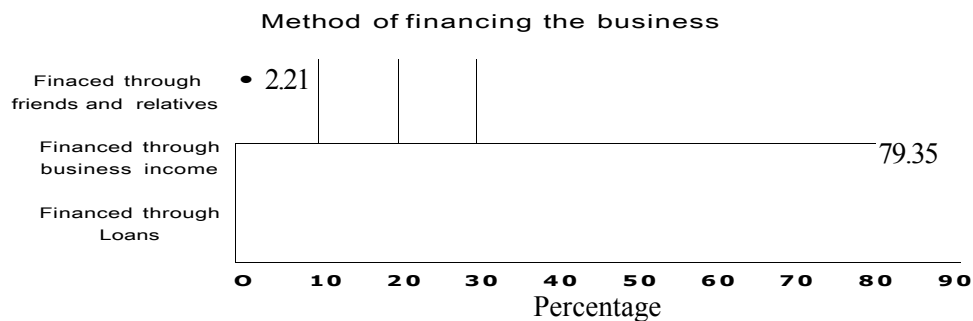
### 4.2.6 Business Value and Employment

The mean value of the businesses in Kamukunji is KSh 933,663, mean yearly savings is KSh 205,508, average monthly sales is KSh 298993, median number of permanent employees is three and the number of temporary employees is zero.

**Table 4.4** Assets and Employment for SMEs within Kamukunji

|  | Value of business assets | Yearly savings | Average monthly sales | No of full time employees | No of temporary employees |
|---|---|---|---|---|---|
| N | 98 | 59 j | 100 | 100 | 100 |
| N Missing | 2 | 41 : | 0 | 0 | 0 |
| Mean | 933663 | 205508 | 298993 | 3.48 | .63 |
| Median | 600000 | 120000 | 250000 | 3 : | 0 |

Source: Author's Computation

### 4.2.7 Business Growth Status of SMEs within Kamukunji

Figure 4.4 shows growth status of SMEs within Kamukunji. Two thirds of the businesses (68%) experienced growth in the past two years.

**Figure 4.4** Business Growth Status within Kamukunji

## Growth status



- Experienced growth
- Did not experience growth
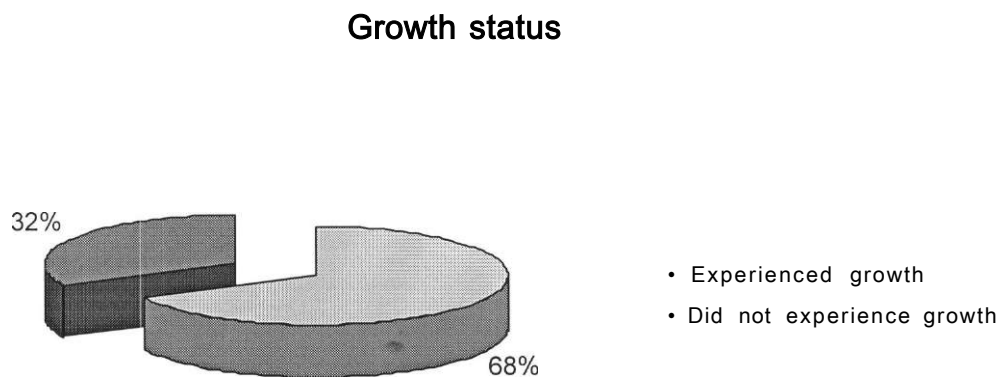
Source: Author's Computation

Table 4.5 indicates the mean percentage of growth in each area. The highest growth was experienced in sales (7%) followed by employment (5%). There was no growth in new branches/businesses.

**Table 4.5** Average Percentage in Growth

|  | N | Mean |
|---|---|---|
| Growth in sales | 100 | 7.36 |
| Growth in employment | 100 | 4.88 |
| Growth in new branches/businesses | 100 | .00 |
| Growth in technology improvement | 100 | 1.00 |
| Growth in skills improvement | 100 | .20 |

Source: Author's Computation

To know what contributed to this growth, five factors were identified, mainly loans, new markets, new products, re-investment of profits and technology. Loans contributed the highest percentage (37%), followed by new markets (34%) and the least was technology (2%). Figure 4.5 shows how each factor contributed in form of a chart.

**Figure 4.5** Factors Contributing to Business Growth
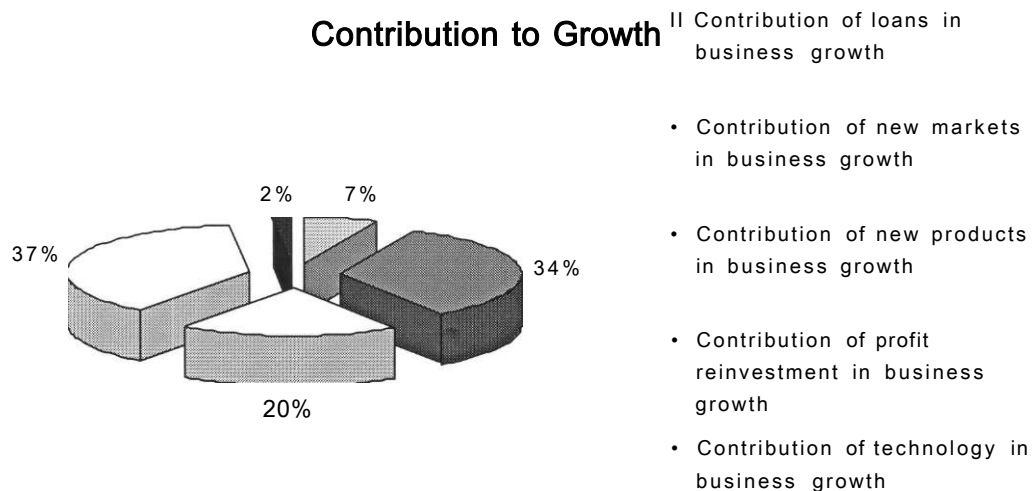


Source: Author's Computation

## 4.2.8 Business Assets Disposal

Figure 4.6 shows how assets were disposed in the past 6 months, 93% indicated no assets disposed while only 7% were disposed.

**Figure 4.6** Business Assets Disposal
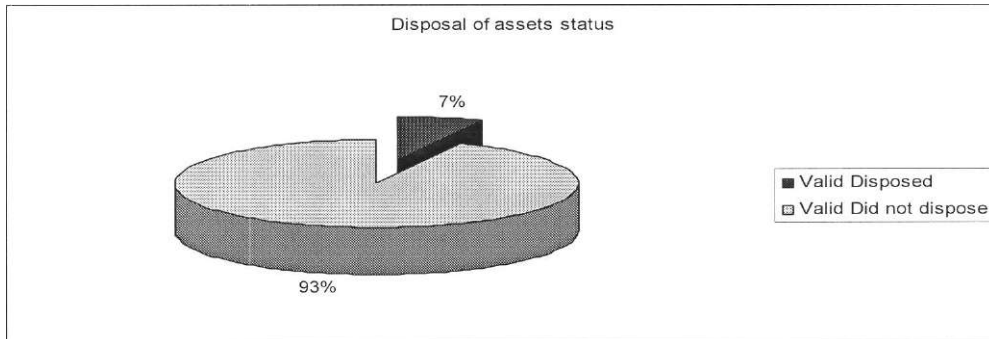


Source: Author's Computation

## 4.2.9 Income from Business Enterprise

Table 4.6 describes expenditure and estimated profits. The average amount spent on inputs was KSh 197,590 and estimated profit was KSh 71,827.

**Table 4.6** Income from Business Enterprise

|  | Mean |
|---|---|
| Amount spent on inputs | 197590.16 |
| Amount spent on salaries | 85441.89 |
| Amount spent on rent | 12095.00 |
| Amount spent on telephone | 1648.50 |
| Amount spent on transport | 3337.37 |
| Estimated profits | 71827.59 |

Source: Author's Computation

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### 4.2.10 Use of Business Profits

Table 4.7 shows how profits were used in the past two years, 40% was used for business expansion and 39% was saved. No profit was used to purchase land and only 0.4% was used to start another business.

**Table 4.7** How Profits were used

|  | N | Mean (%) |
|---|---|---|
| Percentage of profits used to purchase assets | 100 | 5.35 |
| Percentage of profits saved | 100 | 38.50 |
| Percentage of profits used for business expansion | 100 | 39.95 |
| Percentage of profits used to purchase land | 100 | .00 |
| Percentage of profits used as working capital | 100 | 1.60 |
| Percentage of profits used to start another business | 100 | .35 |

Source: Author's Computation

## 4.3 Factors Influencing and Affecting the Growth of SMEs

This section looks shows the factors that were found to influence business growth within Kamukunji district. It also describes the factors affecting growth of SMEs into large business enterprises.

### 4.3.1 Assessment of Overall Business Growth

A question was designed to identify the factors that contributed to business growth. Growth in workforce (14%) and in product line (17%) contributed very low to the growth of business. Moderate contribution by all factors was observed. Table 4.8 shows the outcomes.

**Table 4.8** Assessment of Overall Growth

| | Growth in sales | Growth in workforce | Growth in profits | Growth in business size | Growth in product line |
|---|---|---|---|---|---|
| N | 100 | 100 | 100 | 100 | 99 |
| Missing | 0 | 0 | 0 | 0 | 1 |
| Very low | 0 | 14 | 0 | 6 | 17.2 |
| Low | 13 | 43 | 17 | 15 | 8.1 |
| Moderate | 67 | 39 | 60 | 48 | 35.4 |
| High | 19 | 4 | 23 | 30 | 38.4 |
| Very high | 1 | 0 | 0 | 1 | 1 |

Source: Author's Computation

Figure 4.7 shows a graphical representation of extent to which these factors contributed to business growth.

**Figure 4.7** Factors Contributing to Business Growth



## Contribution to business growth
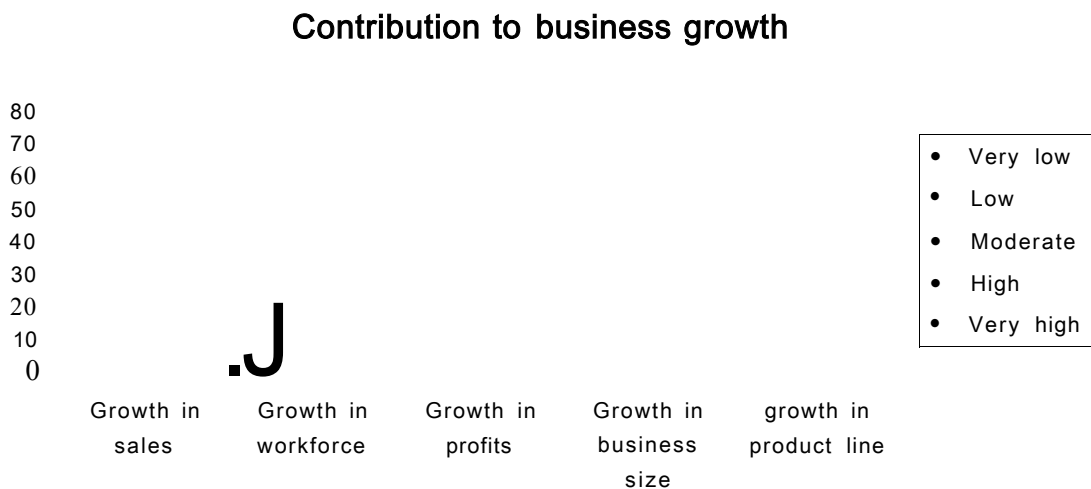
Source: Author's Computation

## 4.3.2 Factor Analysis Results for Factors Influencing SME's Growth

The study showed the contribution of each factor to the growth of business, and therefore factor analysis was used to assess this. Factor analysis was assessed to confirm whether it would apply to these data.

Table 4.9 shows an abridged version of R-Matrix. The top half of this table contains the Pearson correlation coefficient between all pairs of questions whereas the bottom half contains the one-tailed significance of these coefficients. This correlation matrix is used to check the pattern of relationships. There is no coefficient which is greater than 0.9. There are significant values less than 0.05, for Growth in business size and Growth in profits, which means there is singularity in the data and we might eliminate the two questions. The determinant of the correlation matrix is 0.527 which is greater than the required value of 0.00001, which means multicollinearity is not a problem in this data.

**Table 4.9** Correlation Matrix for Factors Influencing SMEs Growth(a)

|  |  | Growth in sales | Growth in workforce | Growth in profits | Growth in business size | Growth in product line |
|---|---|---|---|---|---|---|
| Correlation | Growth in sales | 1 | 0.184 | 0.415 | 0.071 | -0.168 |
|  | Growth in workforce | 0.184 | 1 | -0.02 | 0.251 | 0.384 |
|  | Growth in profits | 0.415 | -0.02 | 1 | 0.069 | -0.13 |
|  | Growth in business size | 0.071 | 0.251 | 0.069 | 1 | 0.357 |
|  | growth in product line | -0.168 | 0.384 | -0.13 | 0.357 | 1 |
|  |  |  |  |  |  |  |
| Sig. (1-tailed) | Growth in sales |  | 0.033 | 0 | 0.241 | 0.048 |
|  | Growth in workforce | 0.033 |  | 0.42 | 0.006 | 0 |
|  | Growth in profits | 0 | » 0.42 |  | 0.248 | 0.1 |
|  | Growth in business size | 0.241 | 0.006 | 0.248 |  | 0 |
|  | growth in product line | 0.048 | 0 | 0.1 | 0 |  |

 a Determinant = .527
Source: Author's Computation

The Kaiser-Meyer-Olkin Measure of Sampling Adequacy and Bartlett's Test of Sphericity were tested. The KMO statistic varies between 0 and 1. The value of 0 indicates that the sum of partial correlation is large relative to the sum of correlations, indicating that factor analysis is likely to be inappropriate. A value close to 1 indicates that patterns of correlations are relatively compact and so factor analysis should yield

distinct and reliable factors. For these data, the value is 0.517 so we are confident factor analysis is appropriate for these data.

Bartlett's measure tests the null hypothesis that the original correlation matrix is an identity matrix. For factor analysis to work, some relationships between variables are needed, and if the R-Matrix were an identity matrix then all correlation coefficients would be zero. Therefore we want this test to be significant (i.e. have a significant value less than 0.05. A significant test tells us that the R-Matrix is not an identity matrix; therefore, there are some relationships between variables we hope to include in the analysis. For these data, Bartlett's test is highly significant (p<0.001), and therefore factor analysis is appropriate.

**Table 4.10** KMO and Bartlett's Test result for Factors influencing SME's Growth

| Kaiser-Meyer-Olkin Measure of Sampling Adequacy. | | .517 |
|---|---|---|
| Bartlett's Test of Sphericity | Approx. Chi-Square | 61.141 |
| | df | 10 |
| | Sig. | .000 |

Source: Author's Computation

Communalities indicate the amount of variance in each variable that is accounted for. Extraction communalities are estimates of the variance in each variable accounted for by the components. The communalities in this table are all high, which indicates that the extracted components represent the variables well.

**Table 4.11** Communalities for Factors influencing SME's Growth

| | Initial | Extraction |
|---|---|---|
| Growth in sales | 1.000 | .730 |
| Growth in workforce | 1.000 | .568 |
| Growth in profits | 1.000 | .651 |
| Growth in business size | 1.000 | .510 |
| growth in product line | 1.000 | .701 |

Extraction Method: Principal Component Analysis.
Source: Author's Computation

For the initial solution, there are as many components as variables, and in a correlations analysis, the sum of the Eigenvalues equals the number of components. The second section of the table shows the extracted components. They explain nearly 63% of the variability in the original two variables, so we can considerably reduce the complexity of the data set by using these components, with only a 37% loss of information.

**Table 4.12** Total Variance Explained Results for Factors influencing SMEs Growth

| Component | Initial Eigenvalues | | | Extraction Sums of Squared Loadings | | |
|---|---|---|---|---|---|---|
| | Total | % of Variance | Cumulative % | Total | % of Variance | Cumulative % |
| 1 | 1.669 | 33.386 | 33.386 | 1.669 | 33.386 | 33.386 |
| 2 | 1.489 | 29.789 | 63.175 | 1.489 | 29.789 | 63.175 |
| 3 | .796 | 15.927 | 79.102 | | | |
| 4 | .604 | 12.086 | 91.188 | | | |
| 5 | .441 | 8.812 | 100.000 | | | |

Extraction Method: Principal Component Analysis.
Source: Author's Computation

The first component is most highly correlated with Growth in product line, Growth in workforce and Growth in business size. Growth in product line is a better representative, however, because it is less correlated with the other two components. The second component is highly correlated with Growth in sales and Growth in profits, where growth in profits is a better representative. Therefore, two components were found to explain growth in SMEs.

**Table 4.13** Component Matrix for Factors influencing SMEs Growth [a]

| | Component | |
|---|---|---|
| | 1 | 2 |
| Growth in product line | .805 | -.231 |
| Growth in workforce | .728 | .194 |
| Growth in business size | .694 | .168 |
| Growth in sales | .010 | .854 |
| Growth in profits | -.101 | .800 |

Extraction Method: Principal Component Analysis,
(a) components extracted.
Source: Author's Computation

Figure 4.8 shows, clearly, the classification in components in a Component Plot as explained above.

**Figure 4.8 Component Plot for factors influencing SMEs growth**
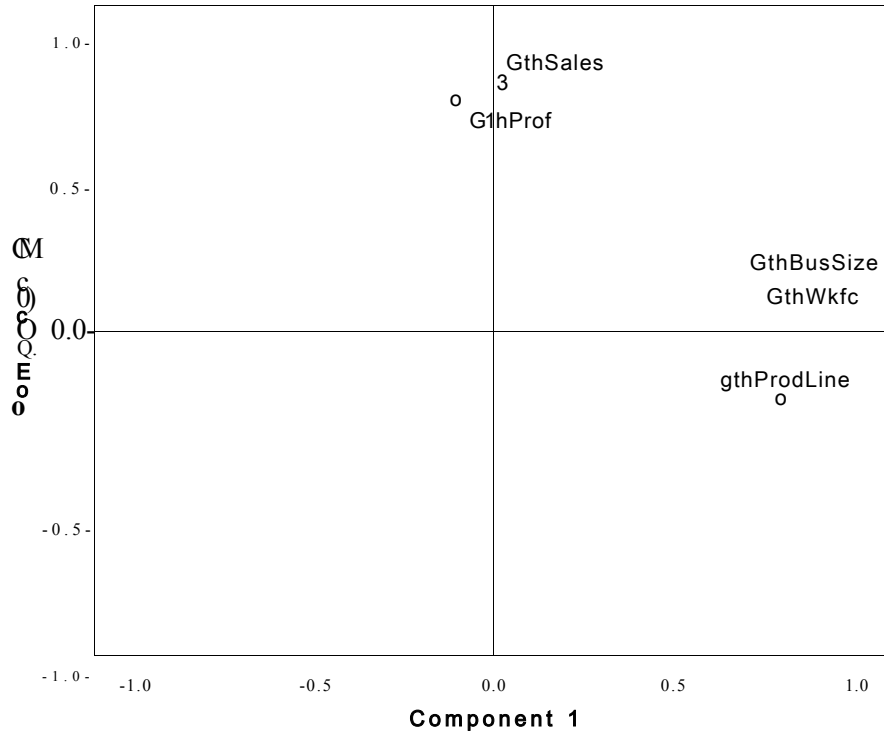


Source: Author's Computation

From this factor analysis, it is evident that the factors that greatly influence SMEs growth are profits and sales.

### 4.3.3 Factors Affecting SME's Growth into Large Business Enterprises

This study sought to find the extent to which financial factors constraint SME's growth into large business enterprises. It came up with seven factors with a scale of very high, high, medium, low and no effect. Cost and information access had the highest effect (65% and 53% respectively.) Capital market 44%) and capital management (35%) had the highest effect of high and only cost of registration had the highest (8%) of no effect to SMEs growing into large businesses. Table 4.13 shows this.

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# Table 4.13 Factors Affecting SME's Growth into Large Business Enterprises

| | Effects of cost in SMEs growth into large businesses | Effects of capital market in SMEs growth into large businesses | Effects of information access in SMEs growth into large businesses | Effects of capital access in SMEs growth into large businesses | Effects of collateral requirement in SMEs growth into large businesses | Effects of capital management in SMEs growth into large businesses | Effects of cost of registration in SMEs growth into large businesses |
|---|---|---|---|---|---|---|---|
| | 100 | 100 | 100 | 99 | 100 | 100 | 100 |
| Missing | 0 | 0 | 0 | 1 | [o | 0 | 0 |
| Very high | :65 | 27 | 17 | 52.5 | 1 17 | 4 | 7 |
| High | 34 | 44 | 20 | 32.3 | 1:25 | 35 | 17 |
| Medium | 1 | 28 | 41 | 12.1 | 133 | 46 | 40 |
| Low | 0 | 1 | 16 | 3.0 | [19 | 12 | 28 |
| No : Effect | 0 | 0 | 6 | 0 | \|6 | 3 | 8 |

Source: Author's Computation

Figure 4.9 shows a graphical representation of the extent to which financial factors constraint SME's growth into large business enterprises.

**Figure 4.9** Extent to which Financial Factors Constraint SMEs Growth



Extent to which financial factors constraint SMEs growth
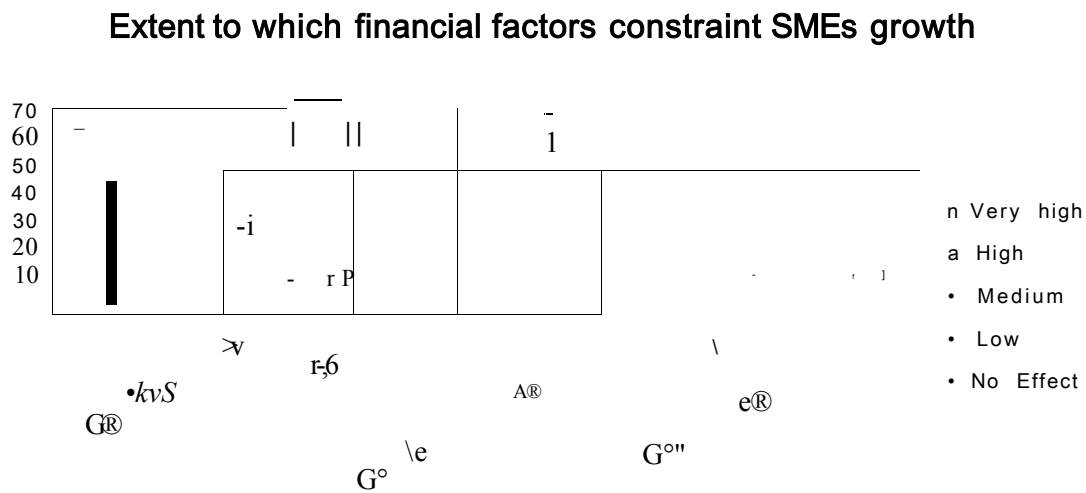
Source: Author's Computation

## 4.3.4 Factor Analysis Results for Factors Affecting SME's Growth into Large Business Enterprises

Factor analysis was done to determine how each factor contributes and their distribution/classification. Factor analysis technique was tested to determine whether it is appropriate for these data using KMO and Bartlett's statistic. The value of KMO is 0.754 and Bartlett's test is highly significant (p<0.001), so factor analysis was appropriate for these data.

**Table 4.14** KMO and Bartlett's Test Results for Factors Affecting SME's Growth

| Kaiser-Meyer-Olkin Measure of Sampling Adequacy. | | .754 |
|---|---|---|
| Bartlett's Test of Sphericity | Approx. Chi-Square | 93.929 |
| | df | 21 |
| | Sig. | .000 |

Source: Author's Computation

The communalities in this table are all high, which indicates that the extracted components represent the variables well.

**Table 4.15** Communalities for Factors Affecting SMEs Growth

| | Initial | Extraction |
|---|---|---|
| Effects of cost in SMEs growth into large businesses | 1.000 | .537 |
| Effects of capital market in SMEs growth into large businesses | 1.000 | .615 |
| Effects of information access in SMEs growth into large businesses | 1.000 | .370 |
| Effects of capital access in SMEs growth into large businesses | 1.000 | .463 |
| Effects of collateral requirement in SMEs growth into large businesses | 1.000 | .529 |
| Effects of capital management in SMEs growth into large businesses | 1.000 | .197 |
| Effects of cost of registration in SMEs growth into large businesses | 1.000 | .818 |

Extraction Method: Principal Component Analysis.
Source: Author's Computation

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The first component is most highly correlated with Effects of capital market in SMEs growth into large businesses, Effects of collateral requirement in SMEs growth into large businesses, Effects of cost in SMEs growth into large businesses, down to Effects of capital management in SMEs growth into large businesses. Effects of capital market in SMEs growth into large businesses is a better representative, because it is less correlated with the other two components. The second component is highly correlated Effects of cost of registration in SMEs growth into large businesses.

**Table 4.16** Component Matrix for Factors Affecting SME's Growth

|  | Component | |
| --- | --- | --- |
|  | 1 | 2 |
| Effects of capital market in SMEs growth into large businesses | .754 | -.214 |
| Effects of collateral requirement in SMEs growth into large businesses | .719 | .109 |
| Effects of cost in SMEs growth into large businesses | .684 | -.263 |
| Effects of capital access in SMEs growth into large businesses | .655 | -.184 |
| Effects of information access in SMEs growth into large businesses | .539 | .282 |
| Effects of capital management in SMEs growth into large businesses | .375 | .238 |
| Effects of cost of registration in SMEs growth into large businesses | .160 | .890 |

Extraction Method: Principal Component Analysis.
Source: Author's Computation

Figure 4.10 clearly plots the components. Cost of registration in SMEs growth into large businesses is on its own group, capital management, Information access, and Collateral requirements group together, whereas Capital access, Cost and Capital market are in their own groups.

**Figure 4.10 Component Plot for Factors affecting SME's growth**
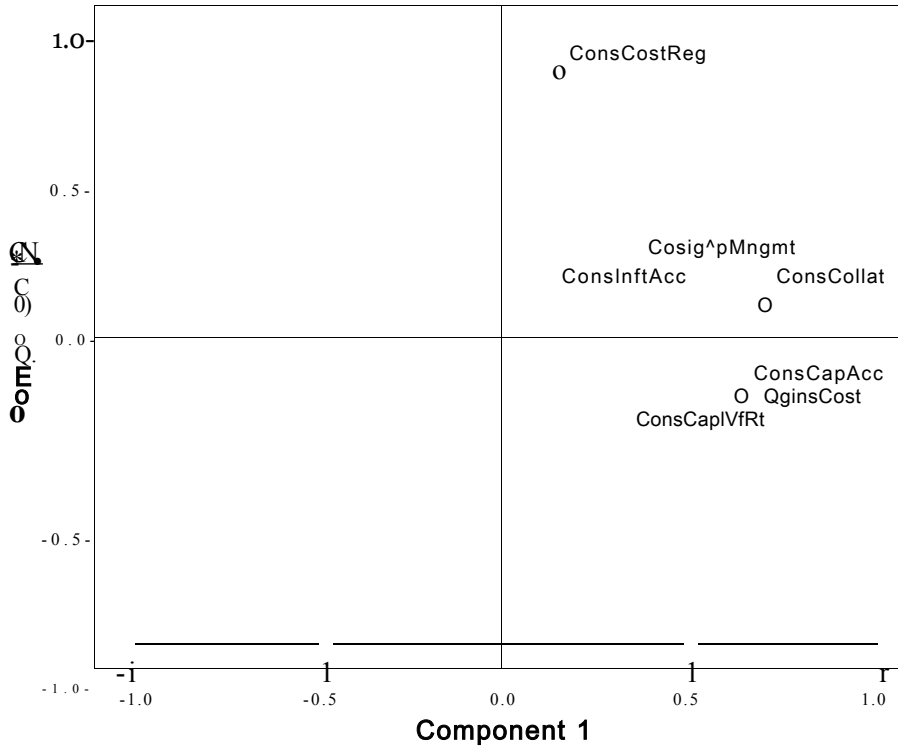


Source: Author's Computation

The factors that were found to mostly affect growth of SMEs into large business enterprises are capital market, cost and capital access.

## 4.4 Discussion of Results

The research found that most of the business owners are male (76%) and form of ownership is sole proprietorship (82%). The businesses that were financed through income from businesses were 79%, 19% through loans and 2% through friends and relatives.

The mean business value in Kamukunji was found to be KSh 933,663, with yearly savings of KSh 205,508. SME's were found to offer employment in good numbers with a median of 3 permanent employees and 1 temporary employee per business.

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There was found to be a significant growth in these businesses, with 68% of them experiencing growth. The areas that greatly experienced growth were sales with 7 % and employment, experiencing a growth of 5%. This growth was attributed to reinvestment of profit (contributing 37% of growth), new markets (34%) and introduction of new products into the market (20%). Loans contributed to business growth with 7% and new technology with a negligible growth of 2%.

Inputs were found to take the highest in expenditure followed by salaries and transport. The average estimated profit per month was found to be KSh 71,827, 40% of these profits were used in business expansion and 36% of the profits were saved. The rest was either used to purchase assets (5%), as working capital (2%) or to start another business (0.4%).

Correlation analysis was done to determine correlation between factors influencing SME growth. Correlation usually ranges between -1 and 1, with increasing relationship within that scale of -1 and 1. The correlation between sales and workforce is 0.184 which means there was a slight positive relationship. The factor with greater relationship to sales is profits, indicating that they greatly depend on each other. The other factors which have high positive correlation are business size and product line, with a correlation of 0.357.

When factor analysis was done, it was noted that profits and sales were the factors that influence business growth, whereas capital market, cost and capital access were the factors that were found to affect growth of SMEs into large business enterprises.

## 4.5 Summary

The data collected was useful in answering the research question: what factors influence/affect SMEs growth into large business enterprises? From the analysis of data collected, profits and sales were the factors found to influence SMEs growth into large business enterprises. What this means to entrepreneurs is that they should capitalize in sales and profits. This is evident in that 37% of business financing was found to be from

reinvesting profits. Sales and profits go hand in hand. One cannot make much profit with fewer sales. SMEs have taken this challenge by way of cheap marketing. Social sites have been used to create awareness by these SMEs, therefore increasing sales and profits, hence leading to growth.

Capital market, cost and capital access were the factors identified to affect growth of SMEs into large business enterprises. This is an opportunity to microfmance institutions and banks. These institutions should come up with attractive loan packages to SMEs, or better the existing packages to attract more loan intake to grow these businesses. Loans were found to contribute only 7% to business growth, and 19% to business financing, hence the need of these financial institutions to rethink their strategy to attracting SMEs to take up more loans.

Information access, capital management and collateral requirements affected, in a smaller way, to SMEs growth. These are factors that can be looked into and capitalized to realize growth in business. By use of digital social advertising/marketing, use of the availed Government Portal, reducing collateral requirements among other things, SMEs would realize growth. Banks and MFIs should, and are, avail information access to the SMEs. They are actively marketing their loan products, facilitating opening of accounts without necessarily visiting a branch and easing loan undertaking time.

# CHAPTER FIVE

# SUMMARY AND CONCLUSIONS

## 5.1 Introduction

This chapter provides a summary and conclusion of the study. Section 5.2 gives the summary of key findings, section 5.3 provides the research conclusions, 5.4 explains limitations of the study and section 5.5 gives recommendations for further research.

## 5.2 Summary of Key Findings

The objective of the study was to find out financial constraints to growth of SME's in Kenya. In order to realize the objectives of the study, survey design was adopted to facilitate the collection of original data necessary for the study. The target population included small and medium enterprises within Kamukunji district in Nairobi, Kenya, and five regions were identified which include, Eastleigh, Gikomba, Jua Kali, Jerusalem and Bahati. Primary data was collected using structured questionnaires. Data collected was first edited in order to check for completeness. Thereafter, it was coded and formatted before being analyzed to obtain percentages and frequency distribution tables.

The study found that most of the business owners are male (76%) and form of ownership is sole proprietorship (82%). In financing of the businesses, 79% were financed through income from businesses, 19% through loans and 2% through friends and relatives. The mean business value in Kamukunji was found to be KSh 933,663, with yearly savings of KSh 205,508. SME's were found to offer employment in good numbers with a median of three permanent employees and one temporary employee per business.

There was a significant growth in these businesses, with 68% of them experiencing growth. The areas that greatly experienced growth were sales with 7% and employment, experiencing a growth of 5%. This growth was attributed to reinvestment of profit (contributing 37% of growth), new markets (34%) and introduction of new products into

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the market (20%). Loans contributed to business growth with 7% and new technology with a negligible growth of 2%.

Inputs were found to take the highest in expenditure followed by salaries and transport. The average estimated profit per month was found to be KSh 71,827. Of these profits, 40% was used in business expansion, and 36% of the profits were saved. The rest was either used to purchase assets (5%), working capital (2%) or to start another business (0.4%).

With regard to growth, it was noted that sales and profits had the highest growth as compared to the other factors. In order of contribution to SME's growth is growth in sales, growth in profits, growth in business size, growth in workforce, and growth in product line.

## 5.3 Conclusions

The following conclusions were made with reference to the study. First, factors contributing to the growth of SME's were identified. These factors are: sales, workforce, profits, business size, and product line. In order of contribution to SME's growth is growth in sales, growth in profits, growth in business size, growth in workforce, and growth in product line. They were, however, found to group into three components, first one comprising of growth in sales and profits, second one having growth in business size and workforce, while the third one comprising of growth in product line. This grouping is important in narrowing down to specific factors affecting growth.

Secondly, seven factors affecting SME's growth were identified, and measured with a scale of very high, high, medium, low and no effect. In order of contribution, the factors influencing growth are: capital market, cost, capital access, collateral requirements, information access, capital management, and cost of registration. It was however noted that these factors, when further analyzed, grouped into three, the first group having cost of registration, second group having capital management, information access, and collateral requirements. The third group had capital market, cost and capital access. It

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would be of interest to study these groupings and effect of each group to SME's growth into large business enterprises.

Cost, capital market and capital access had the highest contribution to constraining SME's growth into large business growth. Taking into considerations the mode of financing business, the highest percentage (79%) of the businesses was found to be financed via business income. Loans contributed 19% and family and friends contributed 2% towards business financing. The only factor that can be optimized here is loans, therefore, relating the first component with the second one where we have collateral. But since collateral is not contributing much to hindering business growth, is it that there are no micro financiers, banks or any other loan access point to finance the businesses, or is it that the SME's are contented with the current state? It is therefore recommended the availability of loans towards SME's growth to be studied further to derive its position in SME's growth. It is also recommended that business financiers, through loans, consider reducing collateral requirements to facilitate SME's to have easy access to loans.

Cost of registration was found to have minimal effect in constraining SME's growth into large business enterprises. This might be because registration is needed only once. How would this factor affect business growth if registration costs were done away with? Would the businesses benefit or lose? Would there be unfair competition? It is recommended that scrapping of business registration and a further study to be done to check its effects. Of the profits earned, 39% were put into savings. How would his have affected business growth if the amount was used for business expansion? It is recommended to the SME's to consider increasing the amount used for business expansion and reduce saving. This would go a long way in realizing SME's growing into large business enterprises.

## 5.4 Limitations of the Study

This research did not go without challenges. The research was marred by various unexpected interferences which sometimes ended into premature discontinuation. These interferences were caused by respondents who needed to attend to their businesses like

serving customers. Some respondents opted not to respond to some questions, increasing the number of missing values. Some respondents treated us with suspicion because they thought perhaps we were spies from the government. This may have led us to lose some important information

Language barrier, especially in Eastleigh, was one of the limitations. We had to interpret the questions which sometimes took a lot of time to get information from the respondents. It was evident that some respondents expected compensation for the information they diverged. Some even asked openly whether they would get 'something' for their information.

## 5.5 Recommendations for Further Research

To sum up this research, areas that may need further research are looked into. Sales and profits had the highest contribution to business growth. How should these factors be harmonized? Studies need to be done to establish whether these two interrelate and whether sales affect profits.

New products seemed to have an insignificant effect to business growth. Is it that there are no new products coming into the market? Further study need to be done to establish the effect of new products on business growth.

Loans contributed 7% to business growth and 19% to business financing. Collateral was found not to contribute much to business growth. Is it that banks do not require collateral to offer loan facilities? How does collateral affect loan take up by these SMEs? Would reduction in collateral requirements increase loan take-up? This is recommended for further research.

In conclusion, this study can be termed as a success because it was able to address not only the research question but also the research assumptions and objectives. This study proved that cost, capital access and capital market were the major factors affecting SME's growth into large business enterprises. However, if recommendations for this

study are implemented, there would be considerable growth in SME's into large business enterprises.

# APPENDIX

## Appendix 1

## REFERENCES

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# Appendix 2

## TARGET POPULATION

| Business Category | Business code | Description | Total count |
|---|---|---|---|
| 1 | 110 | Medium Trader Shop or Retail Services | 15,774 |
| | 115 | Small Trader, Shop or Retail Service | 53,293 |
| 3 | 315 | Small Transportation Co. | 2,249 |
| | 335 | Small Petrol Filling | 790 |
| H | 365 | Small Storage Facility | 813 |
| | 380 | Small Communications Co. | 158 |
| | 415 | Small agric. Producer/Processor/Dealer | 2,201 |
| 5 | 515 | Medium Lodging House With Restaurant Or bar | 258 |
| | 518 | Small Lodging House With Restaurant/Bar | 205 |
| | 524 | Medium Lodging House | 305 |
| | 527 | Small Lodging House Basic Standard | 397 |
| | 546 | Small Restaurant With Bar | 917 |
| | 549 | Large Eating House; Snack Bar; Tea House | 522 |
| | 552 | Medium Eating House; Snack Bar; Tea House | 1,010 |
| 6 | 610 | Medium professional services firm | 437 |
| | 615 | Small professional services firm | 5,166 |
| | 630 | Medium financial services | 406 |
| | 635 | Small financial services | 443 |
| 7 | 735 | Small private health facility | 52 |
| | 740 | Doctor/ Dentist/Physiotherapist | 871 |
| 1 | 760 | Small Entertainment Facility | 63 |
| 8 | 815 | Small Industrial Plant | 644 |
| | 825 | Medium Workshop, Services-Repair Contractor | 2,907 |
| | 830 | Small Workshop Service Repair Contractor | 8,727 |
| Total | | 98,608 | |

Source: Nairobi City Council, Licensing Department

# Appendix 3

## QUESTIONNAIRE

This questionnaire is meant to collect information on constraints to SME's graduating into large business enterprises. Kindly answer the following questions by writing a brief answer statement or ticking in the spaces provided as will be applicable.

BACKGROUND

1. Name of the business
2. Nature of the business
3. Tick the form of ownership
Sole proprietor (   )                          Partnership   (   )
Company      (   )                          Other specify
4. Location of business
5. When established
6. Gender of the entrepreneur          Male (   )                Female (   )
7. What is the main objective of your business

GROWTH
1. How is your business financed? Indicate in percentage
MFI (loan)_____%
Business Income_____%
Friends and Relatives_____%
Others (Specify)_____%
2. What is the value of your business of total assets
3. How much savings have you made from the last one year ksh
4. What is the average monthly sales ksh
5. How many full time employees do you have?
6. How many temporary/casuals employees do you have?
7. Has your company experienced growth in terms of sales, assets, new branches, size etc in the last two years?
Yes (   )                    No (   )

Please indicate the percentage of growth if any in each of the following areas

| Area of Growth | Last 2 years | Last1 year | Last 6 months |
|---|---|---|---|
| Sales | | | |
| Employment | | | |
| New branches/business | | | |
| Technology improvement | | | |

["Skills improvement

8. What attributed to the growth above, tick as appropriate
Loans(   )
New markets (  )
New products (  )
Re-investment of profit (   )
Technology (   )
Other Specify
9. Have you disposed any assets in the last
Six months    Yes ( )                   No ( )
What was the proportion of asset disposed
One year    Yes ( )                   No ( )
What was the proportion of asset disposed
Two years    Yes ( )                   No ( )
What was the proportion of asset disposed

10. Income from business enterprise

| Item | Last 2 years | Last 1 year | Per month |
|---|---|---|---|
| How much sales do you make | | | |
| How do you spend on inputs | | | |
| How much do you spend on salaries | | | |
| How much on rent | | | |
| How much on telephone | | | |
| How much on transport | | | |
| Total cost | | | |
| Estimated profits | | | |
| | | | |

11. How did you use the profits for the last two years (in percentage)
Purchased assets                          %
Saved                                     %
Business Expansion                        %
Purchased land                            %
Used as working capital                   %
Started another business                  %
Other (specify)                           %
12. Please give your assessment of the overall growth of your business using the response scale below
Scale: 1.Very low     2.Low        3.Moderate        4.High             5.Veryhigh
Sales growth for the last 2 years
Growth in workforce

55

Increase in profits
Increase in business size
Increase in product line

FINANCIAL CONSTRAINTS
1. How you would rank the following asthe financial constraints hindering growth of business enterprise, starting with the most important as 1 to the least important as 5
-Cost

- Lack of access to capital market

- Information access

- Collateral requirement

- Managerial Experience

- Cost of registration

- Capital access

2. Please indicate the extent to which the followingfinancial factorsconstraint SME's growth into large business enterprises

| Factors | Very high | High | Medium | Low | No Effect |
|---|---|---|---|---|---|
| Cost | | | | | |
| Capital market | | | | | |
| Information access | | | | | |
| Capital access | | - | | | |
| Collateral requirements | | | | | |
| Capital Management | | | | | |
| Cost of registration | | | | | |
| | | | | | |
| | | | | | |
| | | | | | |

3. In your own opinion, what would you recommend to be done in order to eliminate constraints to graduating into large business?

THANK YOU FOR YOUR RESPONSES