RELATIONSHIP LENDING AND CREDIT AVAILABILITY TO SMALL AND MEDIUM MANUFACTURING ENTERPRISES IN NAIROBI KENYA

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DECLARATION

This project is my original work and has not been presented for award of any degree in this or any other university.

Signature _____ Date: _____

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This project has been submitted for examination with my approval as University of Nairobi supervisor.

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DEDICATION

This research project is dedicated to all my family members and friends for their inspiration, support, encouragement and understanding throughout the research period.

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ABSTRACT

In developing countries and Africa in particular, small businesses (SMEs) lack access to capital and money markets. Despite efforts by financial institutions and public sector bodies to close funding gaps, Small and Medium Enterprises (SMEs) continue to experience difficulty in obtaining capital. It was expected that with the presence of relationship lending, such businesses would be assured of survival.

The objective of the study was to investigate the impact of relationship lending on credit availability to manufacturing SMEs in Kenya. The study used a descriptive research design. The study targeted SMEs involved in manufacturing business in Nairobi Metropolis. The study selected a sample of 10% of Manufacturing SMEs in Nairobi Metropolis. The study collected both primary and secondary data. The questionnaire had both open and close-ended questions. The researcher administered the questionnaire individually to all respondents. Descriptive and content analysis techniques were employed. Descriptive statistics were used to summarize the data. This included percentages and frequencies. The study also conducted a multiple regression analysis.

The study established that most of manufacturing SMEs in Nairobi were public limited companies with ten to twenty employees. These institutions had relationships with commercial banks which extended loans to them at high interest rate. There was no Government involvement in funding of the SMEs sampled. Even NGOs involvement was insignificant.

It was also established that there was a positive relationship between credit availability to manufacturing SMEs in Nairobi and relationship lending them the commercial banks. However, this relationship was so insignificant to be of any economic beneficial to manufacturing SMEs in Nairobi. Finally, it was concluded that other factors such as market conditions played significant role in ensuring credit availability to manufacturing SMEs.

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ABBREVIATION

ASCAS	Accumulating Savings and Credit Associations
FSD	Foundation for Sustainable Development
IMF	International Monetary Fund
KAM	Kenya Association of Manufacturers
KNBS	Kenya National Bureau of Statistics
OECD	Organization for Economic Co-operation and Development
PECC	Pacific Economic Cooperation Council
ROSCAs	Rotating Savings and Credit Association
SACCOs	Savings and Credit Cooperative Societies
SMB	Small to Medium Business
SMEs	Small and Medium Enterprises
NGOs	Non Governmental Organizations

CHAPTER ONE

INTRODUCTION

1.1 Background of the Study

According to Hatten (2008) the term SME (Small and Medium Enterprises) is used in the European Union and other international organizations to designate companies that have a limited, specified number of employees, while the United States typically uses the term "SMB" (Small to Medium Business) instead. Classification as an SME is based on the number of employees, generally between 10 and 100, depending on the country in which the business is set up (Norlaphoompipat, 2008). In Kenya, a micro-enterprise is defined as having no more than 10 employees; a small enterprise with 11-50 employees; and a medium/large enterprise with more than 50 employees, as indicated by National Micro and Small Enterprise Baseline Survey (1999).

Relationship lending exists if a firm has close ties to a financial institution. As Dollinger (1999) posits, it is common practice in credit financing for close ties to exist between firms and banks. The relationship lending influences the credit availability to SMEs. William, James and Susan (2005) define credit availability as the amount of credit to which a borrower has access at a given time. This study aims at investigating relationship lending and credit availability to SMEs in developing countries where focus will be SMEs in Nairobi, Kenya.

1.1.1 Relationship Lending and Availability of Credit to SMEs

Small business lending by financial intermediaries can be categorized into at least four main distinct lending technologies – financial statement lending, asset-based lending, credit scoring, and relationship lending. These technologies are deployed to address the types of problems that can lead to either credit rationing or over-lending

(de Meza, 2002). The first three lending technologies are often referred to as transactions-based lending, under which the lending decisions are based on "hard" information that is relatively easily available at the time of loan origination and does not rely on the "soft" data gathered over the course of a relationship with the borrower.

Financial statement lending places most of its emphasis on evaluating information from the firm's financial statements. The decision to lend and the terms of the loan contract are principally based on the strength of the balance sheet and income statements. Financial statement lending is best suited for relatively transparent firms with certified audited financial statements. Thus, it is likely the technology of choice in bank lending to large firms (Boot & Thakor, 2000). However, some small firms with long histories, relatively transparent businesses and strong audited financial statements also qualify for financial statement lending.

Under asset-based lending, credit decisions are principally based on the quality of the available collateral. This type of lending is very monitoring-intensive and relatively expensive. Generally, the collateral is accounts receivable and inventory, and requires that the bank intensively monitor the turnover of these assets. Asset-based lending is available to small firms of any size, but is expensive and requires that the firm have high-quality receivables and inventory available to pledge. Small business credit scoring is an adaptation to business lending of discriminant analysis and other statistical techniques long used in consumer lending. In addition to using information from the financial statements of the business, heavy weighting is also put on the financial condition and history of the principal owner, given that the creditworthiness of the firm and the owner are closely related for most small businesses (Mester,

1997). In the United States, the use of small business credit scoring is generally limited to small micro-business loans of up to $250,000. Small business credit scoring is still a relatively new phenomenon. It was not widely used prior to the introduction of Fair, Isaac's model in 1995, and as of January 1998, 37% of a sample of the largest banks in the United States still had not adopted small-business credit scoring (Frame et al., 2001).

The other lending technique is relationship lending. Elsas (2003) defined relationship lending as a long-term implicit contract between a bank and its debtors. He further noted that due to the information production and repeated interaction with the borrower overtime, the relationship bank accumulates private information and thus establishing close ties between the bank and the borrowers. While Boot (2000) defines relationship banking as the provision of financial services by a financial intermediary that: Invests in obtaining customer specific information, often proprietary in nature and evaluates the profitability of those investments through multiple interactions with the same customer over time or across products.

Under relationship lending, the lender bases its decisions in substantial part on proprietary information about the firm and its owner through a variety of contacts over time. This information is obtained in part through the provision of loans (Petersen & Rajan, 1994; Berger and Udell, 1995) and deposits and other financial products (Nakamura, 1993; Cole, 1998; Mester, L. et al., 1998; Degryse & van Cayseele, 2000). Additional information may also be gathered through contact with other members of the local community, such as suppliers and customers, who may give specific information about the firm and owner or general information about the business environment in which they operate. Importantly, the information gathered

over time has significant value beyond the firm's financial statements, collateral, and credit score, helping the relationship lender deal with informational opacity problems better than potential transactions lenders.

1.1.2 SMEs in Kenya

In the study carried in Nairobi on the characteristics of small scale manufacturing enterprises, Nyambura, (1992) observes that the emergence of local entrepreneurs in food processing has been hampered by attitude and lack of accessibility to key factors of production. Locally produced goods by small enterprises were perceived as inferior hence low demand, which contributed to their performance. According to a World Bank (2005) report on the current situation of the micro, small and medium enterprise competitiveness project there has been decline in the efficiency of capital and factor productivity in the sector. Some of the constraints noted for example by the Kenya's Ministry of Labour Permanent Secretary, Nancy Kirui (Daily Nation 22.4.2005) include unfavourable regulations, poor work sites, poor infrastructure, inadequate access to finance, access to markets, technology and poor coordination.

The development of the small enterprise sector in Kenya is highlighted in the Sessional papers No. 1 of 1986, Sessional paper No. 2 of 1992 and the sixth National Development plan (1989-1993) as a primary means of strengthening Kenya's economy. The sector includes all enterprises employing 1-50 workers. The Government of Kenya recognizes the important contribution of the sector to the country's industrialization process. This sector creates the breeding ground for the small industries. The employment trend of the small enterprise is noticeable. In 2003 total employment in Kenya (outside small scale farming and pastoralism) was

estimated at 7.3 million persons. The growth in employment was almost entirely attributable to the increase in employment in the SMEs, KNBS (2004).

According to the IMF (2001) report on Poverty Reduction Strategy in Kenya, the potential of SMEs in both employment creation and raising incomes for many Kenyan families makes them an element in the poverty reduction strategy.

The importance of the sector to creation of jobs is underscored. According to KNBS (2007), the improved performance in the various sectors of the economy was affected in the creation of new jobs in both the modern and informal sectors. Overall, the economy generated 469,000 new jobs in 2006-2007 financial year, which was an increase of 5.7 % from the previous year. KAM (2009) notes that one of the major challenges that SMEs face in the course of doing business in Kenya is inadequate business information. Others include: lack of and/or inadequate managerial training and education and skills, lack of access to credit both for start up and expansion of the business, unfavorable national policy and regulatory environment.

1.2 Statement of the Problem

In Developing Countries and Africa in particular, small businesses (SMEs) lack access to capital and money markets. Investors are unwilling to invest in proprietorships, partnerships or unlisted companies. As risk perception about small businesses is high. So is the cost of capital. Institutional credit, when available, requires collateral which in turn makes the owner of the unit even more vulnerable to foreclosure (Senthiles & Nilforoushan, 2003).

Despite efforts by financial institutions and public sector bodies to close funding gaps, Small and Medium Enterprises (SMEs) continue to experience difficulty in obtaining capital. These funding gaps relate to firm size, risk, knowledge and flexibility. In

addition, SME borrowing requirements are small and more collateral may be required than SMEs can pledge (FSD, 2008). Further, the financial institutions may lack expertise in understanding SMEs and also flexibility in terms and conditions of financing that are required by SMEs, PECC (2003). Small firms have traditionally encountered problems when approaching providers of finance for funds to support fixed capital investment and to provide working capital for the firm's operations. The presence and nature of a "finance gap" for small firms has been debated for decades. Berger and Udell (2002) prescribes relationship lending to SMEs by arguing that any agency costs associated with production of soft information will be controlled through flatter organizational structure to monitor loan officer behavior.

In Kenya, many SMEs continue to struggle with the challenge of lack of access to capital for their expansion which contributes to their failures. As a result, various local studies have been done on SMEs in Kenya. Nyambura (1992) carried out an investigation into the characteristics of small scale manufacturing enterprises of Gikomba market. The study found that access to business information service, such as access to information on customer service, business expansion and diversification and technology and providing access to linkages affected the growth of SMEs and thus recommended that there should be increased support for learning visits to improve the information flow from business associations and for attendance at trade fairs and business exhibitions. Wanjohi (2009) investigated the appropriate financing for the SME sector in Kenya and found that the enterprises face high cost of credit, lack of access to finance, lack of access to long-term credit for small enterprises, restrictive lending offered by commercial banks, insufficient financing and lack of information on where to source for finance. Wanjohi recommended that the financial institutions should adjust their tight regulations and credit policies and the means of determining

the creditworthiness of the SMEs and the credit appraisal. Other studies include Ndung'u (2007) who did a study on availability of credit to small traders in Kenya and found that lending to the SMEs was not only administratively costly, but was highly risky because of their limited saving propensity and inability to come up with sufficient traditional collateral as a guarantee for loans, while Nkungi (2008) in his study on contribution of SMEs to economic growth in Kenya found that Microfinance Institutions have pioneered innovations which have challenged the traditional bank lending methodologies. It is expected that with the presence of relationship lending, such businesses would be assured of survival, yet no study has ever focused on this issue especially in the local context. It was against this background that the researcher aimed at filling the existing academic gap by investigating relationship lending and credit availability to manufacturing SMEs in Kenya. To this effect, the study sought to answer the following research questions: To what extent does relationship lending ensure the availability of credit to SMEs in Kenya? What is the effect of relationship lending on firm performance?

1.3 Objectives of the Study

The objective of this study was to investigate the impact of relationship lending on credit availability to manufacturing SMEs in Kenya.

1.4 Significance of the Study

1.4.1 SMEs Sector

The findings of this study would be of great significance to SMEs sector. By using analyzed results, entrepreneurs in the sector would be in a better position to understand role of relationship lending in ensure the availability of credit and be conversant with best solutions in regards to business growth and sustainable

profitability. Additionally, since the study would draw attention to the role of relationship lending in ensuring the availability of credit to SMEs, the study will provides use of adaptive and creative strategies which would be consistent with current economic and competitive environmental realities. The institution through various stakeholders would facilitate development of operational policies that will ensure rapid growth of the sectors hence immense contribution to the economy.

1.4.2 Financial Institutions

Financial institutions would be able to understand the impact of relationship lending on credit availability. Thus they would be in a position to make sound decisions on transaction costs, lending interest rates and on what lending technology they can deploy to capture a bigger market share. The study of transaction costs in credit markets provides a foundation for the design of policies and institutional arrangements that lower transaction costs.

1.4.3 Scholars and Researchers

Like any other research the findings would be used as a reference as far as further studies are concerned and spark off further research in relationship lending and transaction costs with specific interest in commercial banks. The researcher would be able to understand how the interest rates charged on loans are impacted by the transaction cost and relationship lending factors and how effective as an institution they can be in reducing exchange hazards, that is, opportunistic behavior of borrowers.

CHAPTER TWO

LITERATURE REVIEW

2.1 Introduction

This chapter builds on the background, statement of the problem and research objective identified in the previous chapter. The chapter begins with reviewing characteristics of SMEs and thereafter theories associated with relationship lending are analyzed. This is then followed by analyzing some of the empirical studies undertaken by various scholars in this area of study. Finally bank–firm relationship is examined in detail before summarizing and concluding the chapter.

2.2 Characteristics of SMEs

The following are the characteristics of SMEs according to McMahon (2001):-

2.2.1 Dependence on a Small Group of People

Many SMEs are quite small and have very few employees. This limited staff is required to complete all necessary tasks including innovation, production, marketing, sales and accounting for the entire business; for example, the owner of the business may also be the manager who oversees all the areas of the company (McMahon, 2001). This can be a disadvantage if employees do not have the required skill sets to perform multiple tasks well; however, this type of business structure promotes long-term stability rather than focusing on short-term results.

2.2.2 Relationships

Most SMEs focus on a small number of products and services; this limited focus lets such companies establish strong relationships with their business partners, which in turn provides stability for the SME. An SME typically make necessary changes to their services or products to suit their clients' needs; the downside of this is that the

SME relies very heavily on existing partnerships and may suffer financially if a relationship is terminated.

2.2.3 Simplicity

The SME is a simple business structure, which allows the company to be very flexible and make necessary changes quickly without such requirements as addressing board members or stockholders for approval. This flexibility, however, does not necessarily mean that the company is observing state or national regulations that a board or legal team of a larger organization would review prior to putting such changes into place.

2.2.4 Small Size

The small size of the business can be an advantage when it comes to specialization and filling niche markets with products. However, size can be a disadvantage when it comes to obtaining financing for the business. Many SMEs rely on personal assets of owners and management to finance the company. Limited funds also affect marketing and the ability to reach new markets with their products due to budget limitations.

2.3 Theoretical Review of Relationship Lending and Credit Availability

The theoretical foundations of relationship lending are found in the modern literature of financial intermediation that acknowledges the special role of banks in alleviating the informational asymmetries in the credit markets. This study is grounded on financial intermediary theory, credit rationing theory and the moral hazard theory.

2.3.1 Financial Intermediary Theory

The Theory of Financial Intermediation describes four economic functions of deposit-taking financial institutions: financial intermediation information specialist, delegated monitors, and payment and financial services provider (Leland & Pyle, 2002). Gorton

and Pennacchi (2001) explained that, banks as financial intermediaries are in a position to obtain confidential information, and access privileged information both on the demand and supply side of the market. The current financial intermediation theory builds on the notion that intermediaries serve to reduce transaction costs and informational asymmetries.

As developments in information technology, deregulation, deepening of financial markets, etc. tend to reduce transaction costs and informational asymmetries, financial intermediation theory shall come to the conclusion that intermediation becomes useless (Scholtens & Wensveen, 2003). It posits that a large number of securities are needed for it to hold except in special cases. Leland and Pyle (2002), suggests that an intermediary can signal its informed status by investing its wealth in assets about which it has special knowledge. The reality is that the financial systems in many countries have undergone a dramatic transformation in recent years.

According to Hay and Morris (1979), the role of the financial intermediary is essentially seen as that of creating specialized financial commodities. These are created whenever an intermediary finds that it can sell them for prices which are expected to cover all costs of their production, both direct costs and opportunity costs. Financial intermediaries exist due to market imperfections. As such, in a 'perfect' market situation, with no transaction or information costs, financial intermediaries would not exist. In financial markets, information asymmetries are particularly pronounced. Borrowers typically know their collateral, industriousness, and moral integrity better than do lenders. On the other hand, entrepreneurs possess inside information about their own projects for which they seek financing (Leland & Pyle, 1977).

2.3.2 Credit-Rationing Theory

Traditionally credit-rationing problem is represented within new-Keynesian (Stiglitz & Weiss, 1981) analytical framework based on asymmetrical information. They explain why economic agents have conflicting relations where borrowers mislead lenders, obliging them to take measures such as credit rationing. Interests of the bank and the borrowers are not always conflicting, especially in case of cooperative and commercial banks, given their ownership structure and historical background. This fact allows us to employ alternative post Keynesian (Wolfson, 1996) framework where it is believed that uncertainty does not allow overcoming informational opacity in ultimate terms.

Moreover, according to new-Keynesian approach of exogenous money, banking institutions are conceptualized as pure financial intermediaries, while in post-Keynesian endogenous money perspective they create money by making loans. Given the fact that in Europe cooperative and commercial banks are primary credit organizations (OCDE, 2005), their role is to some extent crucial as compared to commercial banks. According to Stiglitz and Weiss (1981), credit rationing refers to a situation where within a group of loan applicants with equal characteristics, some of them receive a loan and some do not even if they offer to pay a higher interest rate.

In the situation where available offer cannot satisfy the demand for credit, bank will tend to raise interest rate in order to equilibrate the market (Chick & Dow, 1988). Bank is therefore obliged to ration credit demands on quantitative basis: some individuals obtain credit while others do not even if they are ready to assume the same conditions as accepted borrowers. Asymmetry of information thus does not play crucial role when efforts are made to explain credit rationing (Lavoie, 1992). Lending

relationship has to do with the future expectation to deal with the same customer, and therefore, duration may be undervaluing the strength of relatively new relationships.

2.3.3 The Moral Hazard Theory

The theory of moral hazard proposed by Jensen and Meckling (1975) argued that bondholders should require an indenture to eliminate opportunities for the stockholders and managers to shift wealth from bonds to stock. Moral hazard is a situation where the behavior of one party may change to the detriment of another after the transaction has taken place. The costs of surveillance to monitor the firm's compliance with the indenture are an agency cost which is passed to the shareholders or managers. The more restrictive the indenture and the larger the potential transfer, the higher agency costs are likely to be. It has long been recognized that a problem of moral hazard may arise when individuals engage in risk sharing under conditions such that their privately taken actions affect the probability distribution of the outcome

Jensen and Meckling (1975) suggest that those costs outweigh the present value of the interest tax shields at some level of debt financing. When a loan is shared among multiple lenders, as is the case of syndicated loans, there is an additional element of moral hazard between the lead lender, who is expected to be focal in monitoring the loan (Holmstrom & Tirole, 1997), and other members of the syndicate.

Even if a firm is assessed as an acceptable credit risk, after making the loan the lender must expend resources in monitoring the borrower given the firm's incentives to invest sub-optimally (borrower moral hazard). However, the information frictions caused by adverse selection and moral hazard can be mitigated if the lending is done by a single private lender such as a bank (Diamond, 1984, Ramakrishnan & Thakor, 1984, Fama, 1985). These risk mitigation benefits are further magnified if the lending

bank has had a strong past relationship with a borrower directly producing borrower-specific durable and reusable information (Boot, 2000). With posting collateral, the borrower makes himself vulnerable if a bad state occurs; that is, he would then have to forfeit the collateral. This makes collateral effective in combating moral hazard and adverse selection problems.

2.4 Empirical Literature

2.4.1 Local Studies

Relationship lending exists all over the world and is regarded as a potentially vital instrument linking interests of borrowers with those of lenders. According to a survey on the access to financial services in Kenya, FinAccess Study, (FinAccess, 2006), only 19% of Kenyans (SMEs) have access to formal financial services through commercial banks and Postbank. An additional 8% of Kenyans are served by Savings and Credit Cooperative Societies (SACCOs) and Micro Finance Institutions (MFIs), while 35% depend primarily on informal financial services such as Rotating Savings and Credit Association (ROSCAs) and Accumulating Savings and Credit Associations (ASCAS). This brings to about 62% the population that is financially included while 38% of Kenyans classified as financially excluded. This implies that more effort is required to improve access to financial services and products.

Ndung'u (2007) argued that lending to the SMEs was not only administratively costly, but was highly risky because of their limited saving propensity and inability to come up with sufficient traditional collateral as a guarantee for loans (Ndung'u, 2007). Formal financial institutions thus tended to concentrate their lending on investment opportunities and transactions that had high or more assured rates of returns. Nkungi (2008) contends that Microfinance Institutions have pioneered

innovations which have challenged the traditional bank lending methodologies. These alternative financial services providers have emerged with new, innovative, and pro-poor alternative modes of financing the poor, low income households and SMEs in the rural and urban areas of Kenya. They have indeed played a key role in providing increased access to financial services and products to the underserved or un-served segments of the Kenyan population. Undeniably, providing financial services to the poor, low income households and SMEs can go a long way in alleviating poverty.

2.4.2 International Studies

James (1987) examined the average stock price reaction of firms that publicly announce a bank loan agreement. He finds a positive abnormal price reaction after a bank loan announcement which indicates that bank loans reveal positive information about the future value of the firm. Numerous contributions have expanded on these results (Dahiya, Puri & Saunders 2003, Billett, et al. 2006, Gande & Saunders 2005). Generally, these event studies find a favorable impact of bank loan announcements on borrowers' stock returns, which contrast to the insignificant or negative response of investors to the announcement of other forms of financing.

Using event studies analysis, Dahiya, Saunders and Srinivasan (2003) analyze the other side of the coin: the effect of the announcement of firm financial distress on bank's stock price. Fan, Titman and Twite (2006) show that, in countries with strong legal systems and creditor protection rights, firms tend to exhibit lower leverage but higher long term debt to total debt ratios. Diamond (2004) states that in emerging markets where the financial benefits from pursuing legal enforcement are too small, creditors might engage in what is called lender passivity. Instead of relying on weakly enforced legal protection of creditor rights or on higher interest rates, a passive lender

will employ non-price mechanisms, such as the maturity of loans, to effectively control credit risk in such environments.

Cole (1998) examines the effect of the existence of a bank-firm relationship on the probability of being granted a loan using a U.S. sample of small businesses. He finds that financial intermediaries are more likely to extend credit to firms with which they have a pre-existing relationship as a source of financial services, but that the duration of the relationship is unimportant. He also finds that the likelihood to grant credit is inversely proportional to the number of credit entities with which companies work. The long-term credit availability is also sensitive to the development level of a country's financial and legal institutions

A growing branch of the empirical literature on the value of relationship lending examines the role of lending relationships in determining the loan contract terms and the availability of credit to borrowing firms. There seems to be a wide consistency between studies that a close bank-firm relationship provides the borrower with greater availability of credit. However, there is little consensus about their impact on loan contract covenants, like interest rate or collateral requirements. Angelini, Di Salvo and Ferri (1998) use a dataset of 1095 Italian firms in the year 1995 and find evidence in favour of bank capture theories. With banks other than cooperative banks, lending rates in Italy tend to increase with the duration of the relationship.

Elsas and Krahnen (1998) use credit-file data of 200 medium-sized German firms. For each loan relationship, they know the banks own assessment of its status as a house-bank or not. They find that loan pricing is alike for house-banks and normal banks, that is, there is no evidence for intra or inter-temporal price differentiation related to house-banking. Harhoff and KÄorting (1998) use survey data on 1509 German SMEs

to examine the role of lending relationships in determining the costs and collateral requirements for external funds as well as the availability of credit, measured as the percentage of early discounts on trade credit taken. The proxies of strength of relationship are duration, the number of lenders and qualitative response in which firm managers indicate to what extent they consider their bank relationship as being characterized by mutual trust.

D'Auria, Foglia and Marullo-Reedtz (1999) examine a panel dataset of Italian bank-firm relationships during the period 1987-1994, corresponding to 2300 large and medium-sized firms. They find that a main bank (measured as percentage of loans from main bank over total firm loans) provides credit at a lower interest rate and that increasing the number of bank relationships decreases the interest rate. Cosci and Meliciani (2002) also provide evidence from Italy. They find that the number of bank relationships has a positive effect on credit availability but has no effect on interest rates. With data of 18,000 loans supplied by one of the largest Belgian banks, Degryse and Van Cayseele (2000) find an increase in the interest rate and a decrease of collateral with the duration of relationship.

Firms that contract more financial products from the same intermediary benefited from reduced costs but were asked for more guarantees. Chakraborty, Fernando and Mallick (2002) adopt a different approach to measure how bank-borrower relationships affect availability of credit. For each firm, they compare the credit limit in lines of credit from different banks with which they have a different duration of relationship. Using the same dataset, Chakraborty and Hu (2006) investigate how the duration and scope of the bank-borrower relationship affect the decision to secure a loan. They find that the likelihood of collateralizing a line of credit decreases with the

length of the bank-borrower relationship and with the number of lenders. Firms with an extended relationship with a bank obtained a reduction in both the cost and the use of personal guarantees. In addition, these firms are more likely to have loan terms renegotiated during a credit crunch.

Using a quite different dataset, Athavale and Edmister (2004) examine the pricing of a sequence of loans provided by the same bank in the U.S. By using a survey of 296 firms conducted in 2000 in Belgium, De Bodt, Lobez and Statnik (2005) examine the determinants of credit rationing probability. They find a positive relationship between credit availability and the duration of the lending relationship. An increase in the number of banks leads to an increase in the probability of credit rationing; however, this effect is stronger or weaker depending on the size of the lender and of the borrower. Hernandez and Martinez (2006) examine the effect of bank relationships on debt terms of 184 Spanish firms in year 1999. SMEs that work with fewer financial intermediaries obtain debt at a lower cost. Additionally, financial institutions show a clear tendency towards raising the use of personal guarantees as the relationship progresses.

2.4.3 Bank-Firm Relationship

The strength of the customer-bank relationship can be approximated by the number of institutions providing finance for the borrower or the duration of the relationship (Jimenez & Saurina, 2004). Giannetti (2009) and Elsas (2003) emphasize the duration of a bank borrower relationship as the most common proxy for relationship lending and reflects the degree of relationship intensity over time. Further still the intensity of a relationship is measured by the number of financial institutions that the firm borrows from, in which the intensity is highest if a firm uses only one bank (Jiangli,

2004). In this regard, the number of bank relationships captures the possibility for bank to realize the economic benefit associated with the relationship (Giannetti, 2009).

While Ongena and Smith (1998) point out the duration as a measure of the strength of a bank relationship. That as the duration lengthens, the bank gets an opportunity to observe, learn and utilize the private information about its customer. However when a firm has a relationship with several banks, none of them can monopolize their information on the borrower's quality (Jimenez & Saurina, 2004). Using the number of bank relationships as an indicator for the presence of relationship lending is based on the premise that maintaining an exclusive bank relationship promotes the development of close ties between bank and borrower.

Exclusivity induces a lower degree of direct competition between banks, allows for unique access to valuable information, and eases the realization of the economic benefits associated with relationship lending, like for instance (efficient) renegotiation of loan contracts. However, exclusivity of a bank relationship is neither a necessary nor a sufficient condition for relationship lending. First, Holmström and Tirole (1997) have shown that only a fraction of funds needs to be financed by a monitoring lender to deter the borrower from moral hazard. The remaining funds can be raised from the market or uninformed arm's-length banks. Second, the building block of theory is access to valuable private information and its accumulation over time.

Since valuable information is likely to be distributed by the borrower in a strategic way, this can be accomplished even in the context of multiple bank relationships (though possibly harder), and, most importantly, it does not have to happen at all. The scarcity of long-term credit availability in developing market economies is recognized

as an obstacle to their growth. Caprio and Demirguc-Kunt (1997) find that non-financial firms in such markets consider the scarcity of long-term credit as one of the most important impediments to their operations. They show that firms that grew faster than predicted, exhibited higher levels of long-term debt to total assets.

A number of empirical studies support the argument that banks use shorter loan maturities to enforce monitoring through more frequent renegotiations of loans and to mitigate informational asymmetries between the creditor and opaque or risky borrowers. Strahan (1999) finds that safer, larger, and more profitable companies receive loans with greater maturity times. Ortiz-Molena and Penas (2008) report a negative and monotonic relationship between borrower risk and maturity and show that more opaque and risky companies receive shorter maturity loans. More recent research explores the credit availability and cross-country variation in the maturities of bank loans in the emerging markets. It reveals an important risk factor that affects the supply of credit in general and loan maturities in particular - the legal risk of debt.

The authors find that the strength of creditor's rights affects non-financial firms' debt structure. The importance of creditors rights protection in bank lending decisions, including the credit rationing and the maturity of loans, is further supported by Demirgüc-Kunt and Diamond (2004), Qian and Strahan (2007), and Bae and Goyal (2009). González and González (2008) find that higher bank concentration acts as a substitute for creditor's protection. Giannetti (2003) finds that the existence of creditor protection rights is very important in determining the availability of long term debt for companies operating in industries exhibiting high volatility of returns. Not all types of financial institutions are equally likely to offer relationship loans.

Cole, Goldberg and White (2004) use U.S. survey data to look at the loan approval process across banks of different sizes. They find that large banks base their decisions on standard criteria obtained from financial statements - what the authors call a cookie cutter approach. In contrast, hard information has less explanatory power for the approval decisions of small banks. This is consistent with small banks basing their decisions more heavily on soft information. With a different approach, Berger et al. (2005) examine the effect of bank size on the characteristics of the bank- borrower relationship, such as duration and distance between the borrower and the lender among others. They show that small banks, because of their organizational structure, have a comparative advantage in collecting soft information with respect to large banks.

2.5 Chapter Summary and Conclusions

Changes in the economic environment in which banks and small businesses operate – such as domestic and cross-border consolidation of the banking industry – have heightened concern about the availability of credit to small businesses. Although relationship lending has been the subject of considerable recent research interest, the process of relationship lending is not well understood. A clear understanding of how the relationship lending technology works and how the organizational structure of the bank affects its ability to deliver this service are needed to assess how recent changes in the economic environment are likely to affect the availability of credit to small businesses.

From the foregoing literature review, relationships permit smoothing the loan interest rate over the duration of the relationship and over the interest rate cycle. Another benefit of relationship lending that has been highlighted in the literature is that

repeated lending from a bank provides credible certification of payment ability. This permits borrowers to build a reputation that would allow eventual borrowing through public markets. Continuing relationships lending are associated with lower loan rates, less stringent collateral requirements, and a lower likelihood of credit rationing.

There is substantial evidence that banks are specialists in providing contractual flexibility and reducing the costs of financial distress for borrowing firms. As a consequence of the important contribution of relationship lending on credit availability, there is dire need to investigate the extent to which relationship lending contributes to availability of credit to SMEs in developing countries like Kenya. This study therefore came in handy with an aim of investigating relationship lending and credit availability to SMEs in Kenya

CHAPTER THREE

RESEARCH METHODOLOGY

3.1 Introduction

Research methodology is a general approach to studying a research topic. This chapter, therefore, explores how the research was carried out. It sets out various stages and phases that were followed in completing the study. It involves a blueprint for the collection, measurement and analysis of data. In this stage, most decisions about how research was executed and how respondents were approached, as well as when, where and how the research was completed. Specifically the following subsections were included; research design, population, sample, data collection, data analysis and finally reliability and validity.

3.2 Research Design

This study used a descriptive research design. A descriptive research design attempts to describe or define a subject, often by creating a profile of a group of problems, people, or events, through the collection of data and tabulation of the frequencies on research variables or their interaction, (Cooper and Schindler, 2006). It is concerned with describing the characteristics of a particular individual, or of a group. In this case, the research problem was to investigate impact of relationship lending on credit availability to SMEs in Kenya with specific focus on SMEs in Nairobi. A descriptive research defines questions, people surveyed, and the method of analysis prior to beginning data collection. Thus, this approach is appropriate for this study, since the researcher intended to collect detailed information through descriptions and is useful for identifying variables and hypothetical constructs.

3.3 Population

According to KAM (2009), there were 745 registered active manufacturing SMEs in Kenya. Out of this figure, 410 were in Nairobi Metropolis. The study targeted SMEs involved in manufacturing, business in Nairobi Metropolis. Mugenda and Mugenda, (2003), state that the target population should have some observable characteristics, to which the researcher intends to generalize the results of the study.

3.4 Sample Population

The study used simple random sampling technique in coming up with the sample of the study. Simple random sampling technique is used as it minimizes sampling error as each element in the target population is accorded equal (unbiased) probability of being selected.

Using probabilistic sampling each population member has a known chance of being included in the sample. Statistically, in order for generalization to take place, a sample of at least 30 must exist (Cooper and Schindler, 2003). Moreover, larger sample minimize errors. Kotler (2001) argues that if well chosen, samples of about 10% of a population can often give good reliability. Other literatures have shown that sample size selection to a great extent is judgmentally decided. The study selected a sample of 10% of Manufacturing SMEs in Nairobi Metropolis.

3.5 Data Collection

The study collected both primary and secondary data for the purpose of investigating relationship lending and credit availability to SMEs in Kenya. Primary data was collected using a questionnaire. The questionnaire had both open and close-ended questions. The close-ended questions provided more structured responses to facilitate tangible recommendations. The closed ended questions were used to test the rating of

various attributes and this helped in reducing the number of related responses in order to obtain more varied responses. The open-ended questions provided additional information that might not have been captured in the close-ended questions. The questionnaire was carefully designed and tested with a few members of the population for further improvements. This was done in order to enhance its validity and accuracy of data to be collected for the study.

The researcher administered the questionnaire individually to all respondents of the study. The researcher exercised care and control to ensure all questionnaires issued to the respondents were received. To achieve this, the researcher maintained a register of questionnaires, which were sent, and which were received. The questionnaire was administered using a drop and pick later method. Secondary data was obtained from annual reports of the organizations and from the ministries concerned as well as secondary sources like the websites, journals and other published reports.

3.6 Reliability and Validity

3.6.1 Reliability

Reliability of the questionnaire was evaluated through administration of the said instrument to the pilot group. A construct composite reliability co-efficient (Cronbach alpha) of 0.6 or above, for all the constructs, was considered adequate for this study. The acceptable reliability coefficient is 0.6 and above (Rousson, Gasser and Seifer, 2002). Cronbach Alpha was used to test the reliability of the research instrument.

3.6.2 Validity

According to Mugenda and Mugenda, (2003), validity is the accuracy and meaningfulness of inferences, based on the research results. One of the main reasons for conducting the pilot study was to ascertain the validity of the questionnaire. The

study used both face and content validity to ascertain the validity of the questionnaires. Content validity draws an inference from test scores to a large domain of items similar to those on the test. Content validity is concerned with sample-population representativeness.

3.7 Data Analysis

Before processing the responses, the completed questionnaires were edited for completeness and consistency. The data was then coded to enable the responses to be grouped into various categories. The data collected was mainly quantitative, however some qualitative data was collected from the open ended questions to enhance and uncover any convergent and divergent views. As such, descriptive and content analysis techniques was employed. The content analysis was used to analyze relationship lending and credit availability to SMEs in Kenya with specific focus on manufacturing SMEs in Nairobi. Descriptive statistics were used to summarize the data. This included percentages and frequencies. All quantitative data on relationship lending and credit availability to SMEs in Kenya were measured in real values by normalizing.

Descriptive statistics were used to measure the quantitative data which was analyzed using the SPSS. Tables and other graphical presentations as appropriate were used to present the data collected for ease of understanding and analysis. The researcher used the data with an aim of presenting the research findings in respect to relationship lending and credit availability to SMEs in Kenya. This generated quantitative reports through tabulations, percentages, and measure of central tendency. In addition, the study used inferential statistics that involved determination of coefficient of correlation and multiple regression analysis. The regression equation was:

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

Whereby the variables were identified as follows

Dependable variable Y = credit availability (measured as the proportion of debt finance in the capital structure),

Independent variable X_1= duration of relationship of SME with a lender (in years). According to Peterson and Rajan (1994) and Berger and Udell (1995), duration is the most commonly used proxy for relationship lending. The basic idea is that duration reflects the degree of relationship intensity overtime.

Independent variable X_2 = Number of financial partners. Using number of financial partners as an indicator of presence of relationship lending is based on premise that maintaining an exclusive bank relationship promotes the development of close ties between the financier and borrower, Houston and James (2001)

Independent Variable X_3= credit terms (measured in terms of Number of conditions imposed by lender to an SME such as collaterals, Guarantors, financial statements etc). The less the conditions imposed, the more likely the presence of relationship lending

Independent X_4= transaction costs (Interest Rates, valuation of collaterals, credit processing fees, monitoring costs). The higher the transaction cost, the more likely the relationship lending. Relationship lending is associated with costs. One such costs is exogenous monitoring costs, Gale and Hellwig (1985)

While β_1, β_2 and β_3 are coefficients of determination and ε is the error term.

CHAPTER FOUR

DATA ANALYSIS AND INTERPRETATION OF FINDINGS

4.1 Introduction

The purpose of this research was to investigate relationship lending and credit availability to SMEs in Nairobi Kenya. The study identified the research problem in chapter one, the available literature was reviewed in chapter two, while chapter three explained the methods that the study used to collect data. This chapter presents analysis and findings of the study as set out in the research methodology. It highlights the findings of the study based on the data collected from respondents. The chapter is organized under sub-sections guided by the research questions. The study employs various statistical tools (SPSS & MS. Excel) for extracting the relationship lending and credit availability to SMEs in Nairobi. The data was gathered mainly using a questionnaire as the research instrument. The questionnaire was designed in line with the objectives of the study.

4.2 Data Presentation

4.2.1 Response Rate

Response rate refers to the extent to which the final data set includes all sample members and it is calculated as from the number of people with whom interviews are completed divided by the total number of people in the entire sample, including those who refused to participate and those who were unavailable. The study targeted 41 respondents from the manufacturing SMEs in Nairobi. The questionnaire return rate results are shown in Table 4.1.

Table 4.1: Response Rate

Response	**Frequency**	**Percentage**
Responded	33	80.5
Not responded	8	19.5
Total	41	100

Source: Author, 2012

From the study, 33 of the sample respondents filled in and returned the questionnaire contributing to 80.5%. This commendable response rate was made a reality after the researcher made personal calls and visits to remind the respondent to fill-in and return the questionnaires as well as explaining the importance of their participation in this study. This commendable response rate can be attributed to the data collection procedure, where the researcher personally administered questionnaires and waited for respondents to fill in, kept reminding the respondents to fill in the questionnaires through frequent phone calls and picked the questionnaires once fully filled. This response rate was good and representative and conforms to Mugenda and Mugenda (1999) stipulation that a response rate of 50% is adequate for analysis and reporting; a rate of 60% is good and a response rate of 70% and over is excellent. The 8 questionnaires that were not returned were due to reasons like, the respondents were not available to fill them in at that time and with persistence follow-ups there were no positive responses from them. The response rate demonstrates a willingness of the respondents to participate in the study.

4.2.2 Length of Time that the Business Enterprises have been in Existence

The respondents were required to indicate the length of time that their business enterprises had been in existence. The results are shown in table 4.2 below.

Table 4.1: The Length of Time that the Business Enterprises have been in Existence

Duration of Existence	Frequency	Percent
1 – 5 years	11	33.3
6- 10 years	10	30.3
11- 15 years	6	18.2
16 – 20 years	5	15.2
More than 20 years	1	3.0
Total	33	100.0

Source: Author, 2012

From the study, 33.3% of the respondents indicated that their enterprises had been in existence for a period of 1 to 5 years, 30.3% of the business enterprises that were surveyed had been in existence for 6- 10 years, 18.2% of them had been in existence for 11- 15 years, 15.2% of them indicated that they had been operating in the country for 16 – 20 years, while only 3.0% of the respondents indicated that their enterprises had been in existence for a period of more than 20 years.

4.2.3 Legal Business Ownership of Business Enterprises

The study required the respondents to indicate the type of ownership of the business enterprises they work with. The results are as depicted in table 4.3.

Table 4.2: The Legal Business Ownership of Business Enterprises

Ownership	Frequency	Percent
Sole trader	7	21.2
Private limited company	17	51.5
Partnership	9	27.3
Total	**33**	**100.0**

Source: Author, 2012

According to the results, majority (51.5%) of the respondents indicated that their enterprises were private limited companies, 27.3% of the enterprises were partnerships, while 21.2% of the respondents worked in sole trader owned enterprises.

4.2.4 Number of Employees Working in the Business Enterprises

The study also sought to establish the size of the companies in terms of number of employees. Table 4.4 shows the results.

Table 4.3: Enterprise Sizes by Number of Employees

Number of Employees	Frequency	Percent
Less than 10	8	24.2
11-20	15	45.5
20- 30	5	15.2
30- 40	3	9.1
40 – 50	2	6.1
Total	**33**	**100.0**

Source: Author, 2012

The results in table 4.4 above show that 45.5% of the business enterprises had between 11 and 20 employees, 24.2% of them had less than 10 working employees, 15.2% of the enterprises had between 20- 30 employees, 9.1% of the respondents worked in enterprises which had between 30-40 employees while 6.1% of the respondents indicated that their enterprises had between 40–50 employees.

4.2.5 Business Activities of the Manufacturing Enterprises

The study further sought to establish the various business activities that the participating enterprises involved in. The respondents indicated that their enterprises involved in various activities such as animal feeds manufacturing, biscuits/foods color/packaging, cake baking and event catering, car parts, bolts and screws, steel items manufacturing, food mincing and packing, fresh fruit juice manufacturing,

furniture making and interior decoration. Other enterprises involved in garment manufacturing such as shoes, jacket, bags etc, machines and hardware, making of doors, chairs and tables, manufacturing of paints, metal melting, paints and chemicals, plastic manufacturers, printing services such as printing of posters, brochures, magazines, spare parts, tiles manufacturing and welding of chairs and tables. The study was concerned in establishing the link between relationship lending and credit availability to SMEs in the manufacturing sector. As such the study was interested in finding out the estimated value of the total assets in the business enterprises. The surveyed business enterprises had total assets ranging between KShs. 150,000 and KShs. 32 million. It was however noted that majority of them had total assets worth between KShs. 2 million and KShs. 10 million.

4.2.6 Relationship Lending and Credit Availability

This theme comes from the main objective of the study which sought to investigate the impact of relationship lending on credit availability to manufacturing SMEs in Kenya.

4.2.7 Borrowing of Funds from External Sources

The respondents were required to indicate whether their enterprises had ever borrowed funds from external sources. Table 4.5 shows the results in this area.

Table 4.4: Whether the Enterprises had ever Borrowed Fund from External Sources

Response	Frequency	Percent
Yes	31	93.9
No	2	6.1
Total	33	100.0

Source: Author, 2012

According to the results, 93.9% of the respondents were in agreement that their enterprises had borrowed funds from external sources, while 6.1% of them had never borrowed funds from external sources.

4.2.8 Institutions where Firms Borrow Funds From

The respondents were requested to indicate where the institutions borrowed funds from. Table 4.6 depicts the results.

Table 4.5: Sources of Fund for Firms

Financial Institution	Frequency	Percent
Commercial banks	31	93.9
Micro Finance Organizations	2	6.1
Total	33	100.0

Source: Author, 2012

From the study, 93.9% of the respondents indicated that their firms obtained funds from commercial banks, while 6.1% of the enterprises obtained funds from micro finance organizations.

4.2.9 Current Total Loan for the Enterprises

The study sought to establish the current total loan of the business enterprises that were surveyed. Majority of the businesses did not disclose the total loan of the business enterprises. However, among the businesses that disclosed their total loan it was found that the loan was ranging between KShs. 15,000 and KShs. 8 million. Majority of the business enterprises had a total loan of less than KShs. 2 millions, while only a few of them had a loan of more than KShs. 8 millions.

4.2.10 Number of Financial Institutions that have provided Services to the SMEs

The study further sought to establish the number of banks/financial institutions that

have provided the business enterprises with their services in the last three years.

Table 4.6: Number of Financial Institutions that have provided Services to the SMEs

Number of Financial Institutions	Frequency	Percent
Only 1	24	72.7
2-3	8	24.2
4-5	1	3.0
Total	**33**	**100.0**

Source: Author, 2012

According to the results in table 4.7, an overwhelming majority (72.7%) of the respondents indicated that their enterprises had only 1 bank/financial institution that had provided them with their services in the last three years, 24.2% of the enterprises had 2-3 banks/financial institutions that had provided them with their services in the last three years, while 3.0% of the enterprises had 4-5 banks/financial institutions that had provided them with their services in the last three years.

4.2.11 Reason that Forced the Enterprises to look for more than One Financier

The study required the respondents to indicate some of the reasons that forced their enterprises to look for more than one financier. Majority of the respondents indicated that business expansion and the need to increase production volume forced their enterprises to look for more than one financier. Other respondents indicated that their business enterprises sought for more than one financier to cover production cost, to improve on the performance of the business, to increase capital and to increase capital of the business. This implies that most of the business engaged in more than one financier in order to cater for the business both financially and in provision of quality product or services to their clientele which could be boosted by the financial stability of the organization.

4.2.12 Timely Provision of Loans by the Financiers

The respondents were requested to indicate whether all the financiers provide loan at the time the enterprises request for. Table 4.8 shows the results on this question.

Table 4.7: Whether all the Financiers Provide Loan at the Time Request for

Response	Frequency	Percent
Yes	23	69.7
No	10	30.3
Total	**33**	**100.0**

Source: Author, 2012

From the study, 69.7% of the respondents indicated that all the financiers provide loan at the time the enterprises request for, as compared to 30.3% of those who indicated that not all the financiers provide loan at the time the enterprises request for.

4.2.13 Cases of Default on Loan Repayment

The study required the respondents to indicate whether their enterprises had ever defaulted on loan repayment.

Table 4.8: Whether the Enterprises had ever Defaulted on Loan Repayment

Response	Frequency	Percent
Yes	9	27.3
No	24	72.7
Total	**33**	**100.0**

Source: Author, 2012

Majority of the respondents reiterated that their enterprises had never defaulted on loan repayment, shown by 72.7% of them, while 27.3% of them indicated that their enterprises had ever defaulted on loan repayment

4.2.14 Reasons for Loan Default by the Enterprises

Upon indicating that their firms had defaulted in loan repayment, the respondents were further required to indicate the reason for the default. The respondents indicated that their firms defaulted to repay the loans due to low sale volume which was expected to raise the profit which in turn could cover the loan, lack of adequate funds, low return on asset, inflation and low sales.

Table 4.9: Length of Time that the Enterprises have been doing Business with Financiers

Duration in Years	Frequency	Percent
0-1 years	2	6.1
2-3 years	9	27.3
4-5 years	15	45.5
more than 5 years	7	21.2
Total	**33**	**100.0**

Source: Author, 2012

From the study, 45.5% of the enterprises had been doing business with their major financiers for duration of 4-5 years, 27.3% of them enterprises had been doing business with their major financiers for duration of 2-3 years, 21.2% of the respondents indicated that their enterprises had been doing business with their major financiers for more than 5 years, while 6.1% of them indicated that had been doing business with their major financiers for 0-1 years.

4.2.15 Rating the relationship between the Enterprises and their Financiers

The respondents were required to rate the relationship between their enterprises and their financiers. The results were presented in table 4.11 below.

Table 4.10: Rating the Relationship between the Enterprises and their Financiers

Rating	Frequency	Percent
Fair	2	6.1
Good	18	54.5
Excellent	13	39.4
Total	**33**	**100.0**

Source: Author, 2012

From the study, 54.5% of the respondents indicated that the relationship between their enterprises and their financiers was good, 39.4% rated the relationship between their enterprises and their financiers as being excellent, while 6.1% of them rated the relationship between their enterprises and their financiers as being fair.

4.2.16 Conditions Required to be Fulfilled for an Enterprise to get a Loan

The study sought to establish the various conditions that the enterprises were required to fulfill for them to get the current or the last loan given. Majority (58%) of the respondents indicated that the enterprises were required to provide collateral for the loan, 27% were required to produce their financial statements while others (15%) indicated that the enterprises were required to provide guarantors before the loan could be processed.

Table 4.11 Conditions Required to be Fulfilled for an Enterprise to get a Loan

Requirement for loan process	Frequency	Percentage
Collateral	19	58
Guarantors	5	15
Financial statements	9	27
Total	**33**	**100**

4.2.17 Loan Repayment Period

The study further sought to establish the repayment period that was provided for the enterprises to start paying the loan offered. Majority (72.7%) of the enterprises were required to repay the loans acquired within a period of 1 to 3 years, while others (27.3%) were required to repay the loans within a period of more than 3 years.

Table 4.12: Loan Repayment Period

Response	Frequency	Percent
Yes	24	72.7
No	9	27.3
Total	33	100.0

4.2.28Ability of SMEs to meet set terms to Access Loan

The study also sought to establish whether the enterprises were in a position to meet all set terms in order to access loan from your financier(s).

Table 4.13: Whether the Enterprises were in Position to meet all Terms to Access Loan

Response	Frequency	Percent
Yes	30	90.9
No	3	9.1
Total	33	100.0

Source: Author, 2012

According to the results in table 4.14, 90,9% of the respondents unanimously indicated that their enterprises were in a position to meet all set terms in order to access loan from their financier(s), while 9.1% of them did not. On what was the purpose of the enterprises current/last loan, the respondents indicated that their enterprises obtained loans for fixed asset financing, increasing working capital and refinancing (loan repayment).

4.2.20 The Largest Amount of Loan Obtained by the Enterprises

The respondents were requested to indicate the largest amount of loan that the firms had ever borrowed. The results are shown in table 4.13.

Table 4.14: Largest Amount of Loan that the Firms had ever Borrowed

Amount of Loan	Frequency	Percent
0-100, 000	1	3.0
101,000- 1, 000, 0000	9	27.3
1,000,000- 5,000,000	23	69.7
Total	**33**	**100.0**

Source: Author, 2012

From the results, 69.7% of the respondents indicated that their enterprises had borrowed between KShs. 1,000,000- 5,000,000, another 27.3% of the enterprises had borrowed between KShs. 101,000- 1, 000, 0000, while 3.0% of them borrowed less than KShs. 100,000.

4.2.21 Percentage Charged as Interest in the Current Loan

The study sought to establish the percentage charged as interest in the current loan obtained by the enterprises.

Table 4.15: The Percentage Charged as Interest in the Current Loan Obtained

Interest Charged on Loan	Frequency	Percent
Less than 10%	1	3.0
11-15%	16	48.5
16-20%	11	33.3
over 20%	5	15.2
Total	**33**	**100.0**

Source: Author, 2012

Accordingly, 48.5% of the enterprises were charged an interest rate of between 11-15% on the loan obtained, 33.3% of them were charged an interest rate of between 16-20%, another 15.2% of the respondents indicated that their enterprises were charged an interest rate of over 20% on the loan, while 3.0% of the enterprises were charged an interest on less than 10% on the loan obtained.

The respondents were required to indicate their level of agreement with the various statements relating to credit availability. A scale of 1- 5 where 1- strongly disagree, 2-Disagree, 3-Neutral, 4-Agree and 5-Strongly agree was provided.

Table 4.16: Agreement with Statements on Credit Availability

Credit Availability	**Mean**	**Std. Dev.**
Our firm has experienced problems in accessing credit	3.0606	1.14399
Financial institution charges prohibitive interest on credit	4.1818	.84611
The credit processing costs and other charges are unrealistic	3.8788	.78093
Lack of acceptable collateral is a major obstacle in accessing credit	4.7576	11.15244
We have a particular person whom we consult on the finance matters from our financier	3.1515	1.50252
My firm has established a personal relationship with the lending institution which enhances credit availability	3.8788	1.74567
Duration of my relationship with my financier determines whether I can access credit	4.0303	1.28659
The credit availability to my organization is to a large extend determined by my relationship with loan officer/ bank manager	3.0909	1.64628
Big Banks lack appropriate structure for dealing with SMEs	4.0303	5.33552

Source: Author, 2012

Majority of the respondents strongly agreed that lack of acceptable collateral is a major obstacle in accessing credit as shown by a mean score of 4.7576. The

respondents further agreed that financial institution charges prohibitive interest on credit as shown by a mean score of 4.1818, duration of my relationship with my financier determines whether the enterprises can access credit as shown by a mean score of 4.0303, big banks lack appropriate structure for dealing with SMEs as shown by a mean score of 4.0303, the credit processing costs and other charges are unrealistic as shown by a mean score of 3.8788 and the firms have established a personal relationship with the lending institution which enhances credit availability as shown by a mean score of 3.8788. The respondents indicated neutrality that the enterprises have a particular person whom they consult on the finance matters from their financier as shown by a mean score of 3.1515, the credit availability to my organization is to a large extend determined by relationship with loan officer/ bank manager as shown by a mean score of 3.0909 and the firms have experienced problems in accessing credit as shown by a mean score of 3.0606.

4.2.22 Inferential Analysis

To establish the relationship between the independent variables and the dependent variable the study conducted inferential analysis which involved coefficient of correlation, coefficient of determination and a multiple regression analysis.

4.2.23 Coefficient of Correlation

To compute the correlation (strength) between the study variables and their findings the study used the Karl Pearson's coefficient of correlation (r). From the findings, it was clear that there was a positive correlation between credit availability and number of financier as shown by a correlation figure of 0.583, it was also clear that there was a positive correlation credit availability and duration of relationship of SMEs and financier with a correlation figure of 0.5140, it was also clear that there was also a

negative correlation between credit availability and credit terms with a correlation value of -0.7460 and a negative correlation between credit availability and transaction cost with a correlation value of -0.6210. This shows that there was positive correlation between credit availability and duration of relationship of SMEs and number of financier while there is a negative correlation between credit availability and credit terms and transaction cost.

Table 4.17: Pearson Correlation (Sig. 2-tailed)

	Credit Availability	**Number of Financiers**	**Duration of Relationship**	**Credit Terms**	**Transaction Costs**
Credit Availability	**1**				
Number of Financier	.5830	1			
	.0032				
Duration Relationship	.5140	.3421	1		
	.0021	.0014			
Credit Terms	-7460	.1240	.0621	1	
	.0043	.0120	.0043		
Transaction Cost	-6210	.3420	.0000	.1660	1
	.0172	.0031	1.000	.0031	

4.2.24 Coefficient of Determination

The coefficient of determination was carried out to measure how well the statistical model was likely to predict future outcomes. The coefficient of determination, r^2 is the square of the sample correlation coefficient between outcomes and predicted values. As such it explains the extent to which changes in the dependent variable can be explained by the change in the independent variables or the percentage of variation in the dependent variable (credit availability) that is explained by all the four

independent variables (duration of relationship of SME with a lender, Number of financial partners, credit terms and transaction costs).

Table 4.18: Coefficient of Determination Model Summary

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.733(a)	.537	.369	.213

a Predictors: (Constant), Credit availability (measured as the proportion of debt finance in the capital structure), duration of relationship of SME with a lender (in years), Number of financial partners, credit terms (measured in terms of Number of conditions imposed by lender to an SME such as collaterals, Guarantors, financial statements etc) and transaction costs (Interest Rates).

The four independent variables that were studied (duration of relationship of SME with a lender, Number of financial partners, credit terms and transaction costs) explain only 53.7% of the credit availability to the manufacturing SMEs in Nairobi as represented by the R^2. This therefore means the four independent variables only contribute about 53.7% to the credit availability to the manufacturing SMEs in Nairobi while other factors not studied in this research contribute 46.3% of credit availability to the manufacturing SMEs in Nairobi.

4.2.25 Multiple Regression Analysis

The researcher further conducted a multiple regression analysis so as to identify the factors that affect credit availability to the manufacturing SMEs in Nairobi. Multiple regression is a statistical technique that allows the study to predict a score of one variable on the basis of their scores on several other variables. The main purpose of multiple regressions is to learn more about the relationship between several

independent or predictor variables and a dependent or criterion variable. The researcher applied the statistical package for social sciences (SPSS) to code, enter and compute the measurements of the multiple regressions for the study.

Table 4.19: Coefficients of Multiple Regression Analysis

Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.
		B	Std. Error	Beta		
1	(Constant)	.329	.291		1.131	.282
	Duration of relationship of SME with a lender	.070	.069	-.252	-1.010	.334
	Number of financial partners	.051	.085	-.131	-.606	.557
	Credit terms	-.204	.088	.555	2.329	.040
	Transaction costs	-.201	.067	.662	2.983	.012

a Dependent Variable: Credit Availability

The regression equation, $Y = \beta 0 + \beta_1 X_1 + \beta_2 X_2 + \beta_3 X_3 + \beta_4 X_4 + \alpha)$ become:

$$Y = 0.329 + 0.070X_1 + 0.051X_2 - 0.204X_3 - 0.201X_4$$

Where Y is the dependent variable (Credit availability to an SME), X_1 is the duration of relationship of SME with a lender, X_2 is the number of financial partners an SME had at a given time, X_3 is credit terms (Collateral and other requirements) and X_4 transaction costs (interest rate).

The above variables were derived as follows:

Credit availability was measured as a proportion of finance debt to total assets

Duration of relationship of an SME with a lender was measured as a number of years that an SME had been doing business with a financial institution.

Number of financial partners: this was taken as the number of financial partner providing service to an SMEs at a given time.

Credit terms- these are conditions other than interest imposed by lenders to SMEs such as asset security, collateral deposit, guarantors etc.

Transaction costs- these are financial cost such as interest rate.

From the regression equation established, taking all the factors (duration of relationship of SME with a lender, number of financial partners, credit terms and transaction costs) constant at zero, the credit availability for manufacturing SMEs in Nairobi would be 0.329. Further, if all the other variables are kept constant, a unit increase in duration of relationship of SME with a lender will lead to a 0.070 increases in credit availability for manufacturing SMEs in Nairobi. A unit increase in number of financial partners will lead to a 0.051 increases in credit availability for manufacturing SMEs in Nairobi, a unit increase in credit terms will lead to a 0.204 decrease in credit availability for manufacturing SMEs in Nairobi, while a unit increase in transaction costs will lead to a 0.201 decrease in credit availability for manufacturing SMEs in Nairobi.

The above analysis infers that loan terms (collaterals and cost of credit) have a greater impact on credit availability to SMEs than relationship with lenders. Hence, credit availability to SMEs in Kenya is more dependent on market forces rather than relationships between lenders and SMEs.

4.3 Summary and Interpretation of Findings

The study found out that most of the manufacturing SMEs in Nairobi were registered as private limited liability companies. This is contrary to the popular perceptions that these organizations exist as sole proprietorship firms. It was also established that most

these firms were fairly young with 33.3 % having been in existence for a period of less than five years. Generally, more than half of all SMEs sampled were found to have been in existence for less than ten years. As mentioned above, the findings of the study showed that manufacturing SMEs in Nairobi were small institutions with majority of them having ten to twenty employees. Capitalization of these firms ranged from two to ten million Kenya Shillings. These organizations were mainly engaged in manufacturing of food items, hardware, loose tools, motor vehicle parts, furniture and related products.

Another outstanding finding of the study was that most the manufacturing SMEs sampled had access to credit. However, the credit accessed was inadequate and was mainly used to boost working capital. As a result there was a significant financing gap for capital projects necessary for business expansion. These firms had borrowed loans ranging from 150,000 to 8 million Kenya shillings. Commercial Banks were the most preferred institutions of lending with 94% of respondents admitting having borrowed from them. Half of the institutions sampled agreed of having a good relationship with these commercial Banks. This was confirmed by 70 % of respondents who agreed of having being given their loans within a reasonable time.

The study established that access to credit by manufacturing SMEs in Nairobi was restricted through unreasonable conditions that were imposed by lenders. For instance 58 % of the firms sampled had to provide a collateral as a security for the loan applied. Others were required to provide guarantors or financial statements.

Other factors hindering access to credit were said to be high interest rates, unrealistic cost of processing credit and shorter repayment period. The study found that half of

the firms sampled were charged an interest rate of between 16% and 20 % with the loan repayment period being between one to three years

The study also found that 72.7% of SMEs in Nairobi were obtaining financial services from a single institution at a time. Those who had more than one financier at a time did so in order to access more credit. The relationship of most of these firms with their current financier had been going on for a period of between four to five years.

The study established that most of manufacturing SMEs in Nairobi were fairly good borrower with only 27% of them having had problems with loan repayment. The poor loan repayment was attributed to low sales, poor prices of goods produced and inflation.

There was a general an agreement amongst the respondents that a personal relationship existed between them and their financiers. This was confirmed by respondents' assertion that access to credit was significantly influenced by the length of time they had been in business with their financiers. However, most of the commercial banks did not assign a specific person (Relationship Manager) to deal with business pertaining to a particular SME.

Through regression analysis, the study established that there was positive correlation between availability of credit and duration of time that the manufacturing SME had a business relation with a financier. However, this relationship was insignificant as portrayed by the small magnitude of the coefficient of the variable representing duration of time in the equation. This finding supports the earlier claim by most of SMEs sampled that they had fairly good relationship with their financiers. This finding also support Peterson and Rajan(1994) and Berger and Udell (1995) who

asserted that duration of relationship between a lender and a borrower was a good measure of existence of relationship lending.

The regression analysis also portrayed a positive relationship between availability of credit to a manufacturing SME in Nairobi and the number of financial institutions that the SME had at a given time. As with duration of time, this relationship was not significant enough to have a major impact on the performance of manufacturing SMEs in Nairobi. This finding contradict the earlier study of Houston and James (2001) which found that an exclusive bank relationship promote development of close ties between the borrower and the lender. This relationship should have resulted in better lending terms and hence adequate credit availability to a firm.

The analysis of the data through regression analysis found a very significant negative relationship between availability of credit to manufacturing SMEs in Nairobi and both the value of interest charged and the number of conditions imposed.

In conclusion, the study established existence of relationship banking between the Manufacturing SMEs in Nairobi and their lenders. However, this relationship did not provide significant benefits to these SMEs. This was deduced from result of the regression analysis which showed that a unit increase in the duration of relationship with the financiers did not result in a significant increase in credit availability. However, a unit increase in either number of conditions imposed or interest rates charged significantly reduced credit availability to SMEs.

From the above analysis, it is apparent that the study does not fully agree with findings of Elsas (2003), Boot (200), Berger and Udell(1995) which found significant relationship between relationship lending and credit availability to participating firms.

CHAPTER FIVE

SUMMARY, CONCLUSION AND RECOMMENDATION

5.1 Summary

The objective of the study was to investigate the impact of relationship lending on credit availability to manufacturing SMEs in Kenya. This study used a descriptive research design. The study targeted SMEs involved in manufacturing business in Nairobi Metropolis. A sample of 10% of Manufacturing SMEs in Nairobi Metropolis was selected. The study collected both primary and secondary data. The questionnaire had both open and closed-ended questions. The researcher administered the questionnaire individually to all respondents. Descriptive and content analysis techniques were employed. Descriptive statistics were used to summarize the data. This included percentages and frequencies. The study also conducted a multiple regression analysis.

The study established that there was existence of relationship lending between the manufacturing SMEs in Nairobi and their lenders. However, this relationship did not provide significant benefits to these SMEs. This was deduced from both regression and coefficient of determination analyses. Both analyses showed that a unit increase in the duration of relationship with financiers did not result in a significant increase in credit availability. However, a unit increase in either number of conditions or interest rates significantly reduced credit availability to SMEs. It was therefore concluded that relationship lending existence between manufacturing SMEs in Nairobi and Commercial Banks. However, there were no significant benefits from this relationship in terms of increased credit availability. Credit availability was mainly affected by market conditions such as interest rate and inflation.

As mentioned above, the main drivers of availability of credit to SMEs were mainly market (interest rates, securities) conditions rather than relationships with lenders. Therefore relationship lending had insignificant impact on credit availability to SMEs

5.2 Conclusions

Most of the Manufacturing SMEs in Nairobi were body corporates engaged in production of garments, food items, loose tools and furniture .These institutions were fairly young with most of them having been existence for less than ten years.

These firms obtained their credit mainly from commercial banks which charged them exorbitant interest rates. The credit obtained was manly used as working capital and therefore there existed a financing gap for infrastructure and expansion financing.

There was none or little intervention by the government in the area of financing manufacturing SMEs in Nairobi. This had contributed to a situation whereby commercial banks exploited the vacuum by extending short term credit to SMEs at usury rates.

The four independent variables that were studied contributed only 54 % of the possible factors contributing to credit availability to manufacturing SMEs in Nairobi. Therefore, other factors need to be studied

There was relationship banking between the Manufacturing SMEs in Nairobi and their lenders. However, this relationship did not provide significant benefits to these SMEs. This was established by the regression and coefficient of determination analyses. Both these analyses showed that a unit increase in the duration of relationship with the financiers did not result in a significant increase in credit

availability to an SME. However, a unit increase in either number of conditions or interest rates significantly reduced credit availability to an SME.

Finally, it can be concluded that the main drivers of availability of credit to manufacturing SMEs were money market (interest rates, securities, inflation) conditions rather than relationships with lenders. Therefore relationship lending had insignificant impact on credit availability to SMEs

5.3 Policy Recommendations

The study recommends urgent market intervention by the Government and donor organizations. Government should revamp institutions such as Kenya Industrial Estates by providing them with funds which can be extended as long term loans to SMEs at affordable terms. In addition, more donors should be encouraged to venture into this important sector by providing affordable long term credits to SMEs.

Commercial banks should also evaluate their relationships with manufacturing SMEs with a view of establishing those organizations that have histories of repaying their debts promptly. This should be achieved by assigning relationship managers to SMEs. In addition, commercial banks through use of credit reference bureaus should identify SMEs that are low risk borrowers. These should be rewarded through better terms of credit.

The government, through the Central bank, should review the policy governing interest rates with a view of shielding small lenders from effects of exploitative interest rates. If need be, the Government should re –introduce interest rate control regime to protect small vulnerable borrowers.

Finally, more need to be done in creating awareness of benefits that can accrue from relationship lending. This campaign should be spearheaded by the major players in money and capital markets such as the Central Bank, Capital Markets Authority and Nairobi Securities Exchange Market.

5.4 Limitations of the study

The researcher had a difficult time convincing the respondents to allow him access to their premises. Some of the possible respondents completely denied the researcher access to their premises while others allowed him after a lengthy discussion over the phone. This was very expensive in terms of time wasted and money spend on telephone calls

Some of the respondents did not act on the questionnaire promptly. This made the researcher to make follow up either by physical visit or by making telephone calls. This was not only physical exhausting but was also expensive in terms of money spend on fuel and telephone calls.

The dependent and independent variables were derived from data collected through a questionnaire. Such kind of data is highly subjective since it is based on the memory of the responded and in most cases can be exaggerated or underestimated depending on the respondent perception of the interviewer use of the data.

Some of the respondents were suspicious of the motive of the researcher. Some of them even asked the researcher whether he was from the revenue authority. This suspicion made some respondents to refuse to co-operate while others accepted to fill the questionnaire on condition that they will not be certify the questionnaire with their official stamp.

5.5 Suggestions for Further Studies

From the study, it was apparent that there was little Government participation in funding manufacturing SMEs in Nairobi. From the foregoing, the study suggests that a study be carried to establish the role of the government in ensuring credit availability to SMEs in Kenya.

The study also suggests that a research be carried out to determine the role played by NGOs in determining credit availability to SMEs in Kenya. Such study will assist the Donor Community to identify funding gaps in different types of SMEs with a viewing filling the gap.

The study also recommends that a research be undertaken to establish the impact of relationship lending on credit availability to companies quoted in Nairobi Securities Exchange. This if done, will complement the findings of this study in enriching body of literature on relationship lending in Kenya

Finally, the study recommends a study to be undertaken to determine factors affecting credit availability to all SMEs in Kenya. This will answer paradox of the 47 % other factors impacting credit availability to SMEs that were not covered by this study.

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APPENDICES

Appendix I: Introduction Letter

Dear Sir/Madam,

REF: REQUEST TO CARRY OUT DATA COLLECTION.

I am a student at UON pursuing a Masters degree in Business Administration. As a requirement in fulfillment of this degree, am carrying out a study on the '**RELATIONSHIP LENDING AND CREDIT AVAILABILITY TO SMALL MEDIUM MANUFACTURING ENTERPRISES IN NAIROBI KENYA**'.

You have been chosen as you are well positioned to provide reliable information that will enable the study achieve its objectives. I intend to research the above though the use of questionnaire.

Any assistance accorded to me in my noble cause and information given shall be treated as confidential and will be used purely for the purpose of this research and a final copy of the document shall be availed to you upon request. Your cooperation will be highly appreciated and thank you in anticipation.

Yours Faithfully,

KIAMA PETER WANJOHI

Appendix II: Questionnaire

Kindly answer all the questions by ticking in the appropriate box or filling in the spaces provided.

PART A: GENERAL INFORMATION

1. Indicate the name of your SMEs (optional)……

2. How long has your business been in existence?

   1 – 5 years [ ] 11- 15 years [ ] More than 20 years [ ]

   6- 10 years [ ] 16 – 20 years [ ]

3. What is the legal business ownership of this firm?

   a) Sole trader [ ] c) Private limited company [ ]

   b) Partnership [ ]

   Any other (specify.....

4. How many employees work in this firm?

   Less than 10 [ ] 11-20 [ ] 20- 30 [ ]

   30- 40 [ ] 40 – 50 [ ]

5. What does your business deal with (manufacturing product)?

   ……

   What are the estimated value/total assets in your business?

   ……

PART B: CREDIT INFORMATION

1. Has your firm ever borrowed fund from external sources?

Yes [ ] No [ ]

2. If your answer in (1) above is yes, indicate appropriately where your firm borrowed funds from (Tick all that applies).

Commercial banks [ ] Micro Finance Organizations [ ]

Government [ ] NGOs [ ]

3. What is current total loan of your business?……

4. How many Banks/Financial institutions have provided you with their services in the last three years?

Only 1 [ ] 2-3 [ ] 4-5 [ ]

5-7 [ ] More than 7 [ ]

5. What are some of the reason that forced you to look for more than one financier?

i. ……

…

6. Do all financiers provide loan at the time you request for?

Yes [ ] No [ ]

If no in (6) above, explain why? .....

7. Have you ever defaulted on loan repayment

Yes [ ] No [ ]

If the answer in (7) above is Yes, what was the reason for the default……

8. For how long have you been doing business with your current major financier?

0-1 years [ ] 2-3 years [ ]

4.5 years [ ] more than 5 years [ ]

9. How would you rate the relationship between you and your financiers?

Fair [ ] Good [ ] Average [ ]

Poor [ ] Excellent [ ]

10. What conditions were required to be fulfilled in order to get the current/ last loan?

Collateral [ ] Guarantor [ ]

Financial statements [ ]

Others (Specify)……

11. What was the repayment period?

Below 1 year [ ] 1- 3 years [ ]

Above 3 years [ ]

12. Are you or were you in position to meet all set terms in order to access loan from your financier(s)?

Yes [ ] No [ ]

13. What was the purpose of your current/last loan?

Fixed Asset Financing [ ] Working Capital [ ]

IPO Financing [ ] Refinancing (Loan repayment) [ ]

Other (Specify)…… ……

14. What is the largest loan your firm has ever borrowed?

0-100, 000 [ ] 101,000- 1, 000, 0000 [ ]

1,000,000- 5,000,000 [ ]

15. What percentage were you charged as interest in your current loan?

Less than 10% [ ] 11-15% [ ]

16-20% [ ] over 20% [ ]

16. Kindly indicate your level of agreement with the following statement relating to credit availability. Use a scale of 1- 5 where 1- strongly disagree, 2-Disagree, 3-Neutral, 4-Agree, 5-Strongly agree

	1	2	3	4	5
Our firm has experienced problems in accessing credit					
Financial institution charges prohibitive interest on credit					
The credit processing costs and other charges are unrealistic					
Lack of acceptable collateral is a major obstacle in accessing credit					
We have a particular person whom we consult on the finance matters from our financier					
My firm has established a personal relationship with the lending institution which enhances credit availability					
Duration of my relationship with my financier determines whether I can access credit					
The credit availability to my organization is to a large extend determined by my relationship with loan officer/ bank manager					
Big Banks lack appropriate structure for dealing with SMEs					

17. In your own opinion what would you suggest to enhance credit access to SMEs?

.....

.....

.....

THANK YOU FOR YOUR COOPERATION!!!

Appendix III: List of Enterprises that Participated

1.Abadare steel and hardware

2.Apex agencies

3.Bencon agencies

4.Braulic equipment and services

5.Chafa enterprises

6.Comet paints

7.Danland engineering works

8.Dovewax industries

9.Graphic line ups ltd

10. Hemco feeds
11. Hydraulic equipment and services
12. Jamarie enterprises
13. Joshwana enterprises
14. Kema E.A
15. Kizuri limited
16. Magic juice
17. Molor paints & chemical
18. Morrison engineering
19. Orchid juice ltd
20. Pambridge agencies
21. Parown furniture
22. Riara Tex Prints and Garment ltd
23. Signal press
24. Soko sweets ltd

25. Sunchet paint
26. Sweety and spicy food factory
27. Syntax business solution
28. Truffood ltd
29. Tumaini enterprises ltd
30. Victoria graphic
31. Warren enterprises ltd
32. Whamah enterprises