THE RELATIONSHIP BETWEEN ACCESS TO MICROFINANCE SERVICES AND FINANCIAL PERFORMANCE OF MICRO, SMALL AND MEDIUM SIZE ENTERPRISES IN EMBU TOWN

BY

WARUI, PHYLLIS WAGIO

REG. NO.: D61/75295/2009

A RESEARCH PROPOSAL SUBMITTED IN PARTIAL FULFILMENT OF THE REQUIREMENTS FOR AWARD OF THE DEGREE OF MASTER OF BUSINESS ADMINISTRATIONOFTHE UNIVERSITY OF NAIROBI

OCTOBER 2011

DECLARATION

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

Signature: .... Date: ....4/11/2011....................

PHYLLIS WARUI

D61/75295/2009

This research project has been submitted for examination with my approval as the University Supervisor.

Signature: .... Date: ....4/11/2011....................

MR. MWANGI MIRIE

Lecturer, School of Business

University of Nairobi.

ACKNOWLEDGMENT

This research project is dedicated to my family who always inspired me in every step to accomplish this study. I am eternally grateful for your love, encouragement and support in all my endeavours.

I would like to pass my appreciation, gratitude and thanks to my supervisor, Mirie Mwangi. His valuable suggestions and ideas in every step of my work helped me a lot to prepare this thesis.

Above all, my profound gratitude goes to God Almighty who gave us the enabling capacity both mentally and physically as well as the opportunity to be alive for the completion of this work to the glory of God.

ABSTRACT

Micro, Small and Medium size enterprises are constrained by a number of factors which include among others difficulty in accessing credit facilities. In a bid to improve MSMEs access to credit there has been a significant growth of MFIs. The researcher was carried out with the objective of finding out the relationship between access to microfinance services and financial performance of the micro, small and medium size enterprises in the busy town of Embu in Eastern province of Kenya. To achieve the stated objective a quantitative historical research design was used, primary data was collected using a data collection sheet on the financial performance of the MSMEs in Embu town. Out of the 50 MSMEs identified for our sample, 31 responded, representing 62% response rate. The research also used any available information from the secondary sources which was the financial statements of the organisations visited. The research quantified access to microfinance services in terms of the loans disbursed to the MSMEs while financial performance concentrated on organisation profitability measured in terms of Return on Assets(ROA). Descriptive analysis as well as regression analysis to analyse the data collected and found that there was only a very small positive relationship between the amount of loans disbursed and ROA while there was a stronger relationship to other control variables such as turnover and age of the business. There was a negligible negative relationship between the ROA and size of the business. Although the MFIs do have an impact on the financial performance of MSMEs, it is very small and may not form a strong case for their increased presence especially in rural town such as Embu town. Perhaps it is not enough to just disburse funds and the MFIs may need to equip the recipients more with business skills in order to run successful enterprises.

ABSTRACT

Micro, Small and Medium size enterprises are constrained by a number of factors which include among others difficulty in accessing credit facilities. In a bid to improve MSMEs access to credit there has been a significant growth of MFIs. The researcher was carried out with the objective of finding out the relationship between access to microfinance services and financial performance of the micro, small and medium size enterprises in the busy town of Embu in Eastern province of Kenya. To achieve the stated objective a quantitative historical research design was used, primary data was collected using a data collection sheet on the financial performance of the MSMEs in Embu town. Out of the 50 MSMEs identified for our sample, 31 responded, representing 62% response rate. The research also used any available information from the secondary sources which was the financial statements of the organisations visited. The research quantified access to microfinance services in terms of the loans disbursed to the MSMEs while financial performance concentrated on organisation profitability measured in terms of Return on Assets(ROA). Descriptive analysis as well as regression analysis to analyse the data collected and found that there was only a very small positive relationship between the amount of loans disbursed and ROA while there was a stronger relationship to other control variables such as turnover and age of the business. There was a negligible negative relationship between the ROA and size of the business. Although the MFIs do have an impact on the financial performance of MSMEs, it is very small and may not form a strong case for their increased presence especially in rural town such as Embu town. Perhaps it is not enough to just disburse funds and the MFIs may need to equip the recipients more with business skills in order to run successful enterprises.

Table of Contents

DECLARATION i

ACKNOWLEDGMENT ii

ABSTRACT iii

ABBREVIATIONS viii

CHAPTER ONE 1

INTRODUCTION 1

1.1. Background of the Study 1

1.2. Statement of the Problem 8

1.3. Objectives of the Study 10

1.4. Importance of the Study 10

CHAPTER TWO 12

LITERATURE REVIEW 12

2.1. Introduction 12

2.2. Theoretical Literature 12

2.3. Empirical Studies 25

2.4. Summary 28

CHAPTER THREE 29

RESEARCH METHODOLOGY 29

3.1. Introduction 29

3.2. Research Design 29

3.3. Population 30

3.4. Sample 30

3.5. Data Collection 30

3.6. Data Analysis 31

3.7. Data Validity and Reliability 32

CHAPTER FOUR 33
DATA ANALYSIS, FINDINGS AND INTERPRETATION 33
4.1. Introduction 33
4.2. Demographics information of the respondents 33
4.3. Statistical Analysis 39
4.4. Regression Analysis 40
4.5. Summary of Key Findings and Interpretations 42
CHAPTER FIVE 43
CONCLUSIONS AND RECOMMENDATIONS 43
5.1. Introduction 43
5.2. Conclusions and Recommendations 43
5.3. Limitations of the Study 46
5.4. Suggestions for Further Research 47
REFERENCES 49
APPENDIX I: RETAIL MFIS REGISTERED WITH AMFI 54
APPENDIX II: MICRO, SMALL AND MEDIUM SIZE ENTERPRISES SAMPLED 56
APPENDIX III: DATA COLLECTION SHEET 58
APPENDIX III: LETTER OF INTRODUCTION 59

List of Tables

Table 1: Source of startup capital....37

Table 2: Amount of loans from MFIs....38

Table 3: Statistical analysis of the sample....39

List of Figures

Figure 1: The critical triangle in achieving economic sustainability of microfinance 13

Figure 2: Gender of respondents 34

Figure 3: Age of respondents 35

Figure 4: Type of businesses 36

ABBREVIATIONS

AMFI - Association of Microfinance Institutions

CBK - Central Bank of Kenya

ECLOF - Ecumenical Loans Fund

GDP - Gross Domestic Product

IMF - International Monetary Fund

KPSOB - Kenya Post Office Savings Bank

KSTES - Kenya Small Traders and Entrepreneurs Society

KWFT - Kenya Women Finance Trust

MDGs - Millennium Development Goals

MFs - Microfinance

MFIs - Microfinance Institutions

MSE - Micro and Small Enterprises

NGOs - Non Governmental Organizations

POT - Pecking Order Theory

PRSP - Poverty Reduction Strategy Paper

ROI - Return on Investment

ROSCAs - Rotating Savings and Credit Associations

SHG - Self-Help Groups

MSMEs – Micro, Small and Medium Size Enterprises

SMEP - Small and Medium Enterprise Programme

CHAPTER ONE

INTRODUCTION

1.1. Background of the Study

Nearly one half of the world's population lives on $2 a day or less, often unable to meet even their most basic human needs (UNDP, 2009). To enhance international development, the United Nations Organization (UNO) announced the millennium development goals, aimed to eradicate poverty by 2015. In this regard, microfinance is the form of financial development that has its primary aim to alleviate the poverty. Governments, donors and NGOs around the world responded enthusiastically with plans and promised to work together towards the realization of these goals. In the recognition of microfinance, the UNO celebrated the year 2005 as a year of micro-credit, as a result this financing instrument is perceived worldwide as a very effective mean against hunger and poverty, mainly in developing countries (Barr, 2005).

Microfinance is defined as a development tool that grants or provides financial services and products such as very small loans, savings, micro-leasing, micro-insurance and money transfer to assist the very or exceptionally poor in expanding or establishing their businesses. It is mostly used in developing economies where Micro, Small and Medium Size Enterprises (MSMEs) do not have access to other sources of financial assistance (Robinson, 1998). In addition to financial intermediation, some Microfinance Institutions(MFIs) provide social intermediation services such as the formation of groups, development of self confidence and the training of members in that group on financial

CHAPTER ONE

INTRODUCTION

1.1. Background of the Study

Nearly one half of the world's population lives on $2 a day or less, often unable to meet even their most basic human needs (UNDP, 2009). To enhance international development, the United Nations Organization (UNO) announced the millennium development goals, aimed to eradicate poverty by 2015. In this regard, microfinance is the form of financial development that has its primary aim to alleviate the poverty. Governments, donors and NGOs around the world responded enthusiastically with plans and promised to work together towards the realization of these goals. In the recognition of microfinance, the UNO celebrated the year 2005 as a year of micro-credit, as a result this financing instrument is perceived worldwide as a very effective mean against hunger and poverty, mainly in developing countries (Barr, 2005).

Microfinance is defined as a development tool that grants or provides financial services and products such as very small loans, savings, micro-leasing, micro-insurance and money transfer to assist the very or exceptionally poor in expanding or establishing their businesses. It is mostly used in developing economies where Micro, Small and Medium Size Enterprises (MSMEs) do not have access to other sources of financial assistance (Robinson, 1998). In addition to financial intermediation, some Microfinance Institutions(MFIs) provide social intermediation services such as the formation of groups, development of self confidence and the training of members in that group on financial

literacy and management (Ledgerwood, 1999). There are different providers of microfinance (MF) services and some of them are; nongovernmental organisations (NGOs), savings and loans cooperatives, credit unions, government banks, commercial banks or non bank financial institutions. The target group of MFIs are self employed low income entrepreneurs who are; traders, seamstresses, street vendors, small farmers, hairdressers, rickshaw drivers, artisans blacksmith etc (Ledgerwood, 1999). Microfinance is a form of financial development that has primarily focused on alleviating poverty through providing financial services to the poor. Most people think of microfinance, if at all, as being about micro-credit i.e. lending small amounts of money to the poor. Microfinance is not only this, but it also has a broader perspective which also includes insurance, transactional services, and importantly, savings (Barr, 2005).

1.1.1. Access to Microfinance services

Financial inclusion or broad access to financial services is defined as an absence of price or non-price barriers in the use of financial services. Improving access then means improving the degree to which financial services are available to all at a fair price. It is easier to measure the use of financial services since data of use can be observed, but use is not always the same as access. Access essentially refers to the supply of services, whereas use is determined by demand as well as supply (Demirguc-Kunt, 2008). Users of financial services can be distinguished from nonusers, and there are important distinctions among nonusers. Those who do not use financial services for cultural or religious reasons or because they do not see any need including enterprises without any promising investment projects. These nonusers have access, but they choose not to use

financial services. From a policy maker's viewpoint, nonusers do not really constitute a problem because their lack of demand drives their nonuse of financial services.

On the other hand are the involuntarily excluded who, despite demanding financial services, do not have access to them. There are several different groups among the involuntarily excluded. First, there is a group of firms that are considered unbankable by commercial financial institutions and markets because they do not have enough income/collateral or present too high a lending risk. Second, there might be discrimination against certain groups based on social, religious, or ethnic grounds. Third, the contractual and informational framework might prevent financial institutions from reaching out to certain groups of firms because the outreach is too costly to be commercially viable. Finally, the price of financial services may be too high or the product features might not be appropriate for certain firms. While the first group of involuntarily excluded cannot be a target of financial sector policy, the other three groups demand different responses from policy makers.

Theoretically a problem of access to credit for firms exists when a project that would be internally financed if resources were available, does not get external financing. This happens because there is a wedge between the expected internal rate of return of the project and the rate of return that external investors require to finance it. This wedge is mainly introduced by two well-known constraints that hamper the ability to write and enforce financial contracts, namely, principal-agent problems and transaction cost (Stiglitz, 1990).

Although access is not easy to measure, financial depth (total loan outstanding) can be seen as an approximate indicator with direct and indirect effects on financing firms. Greater depth is likely to be associated with greater access for firms. Demirguc-Kunt, Beck and Martinez Peria (2007) identified geographic and demographic penetration, average size, number of deposits and average size of deposits. Although those indicators cannot be precise measurement of access to finance, those can be good proxy indicators of measuring accessibility of financial services.

1.1.2. Micro, Small and Medium Size Enterprises definition and performance

The term MSME covers a wide range of definitions and measures, varying from country to country and between the sources reporting MSME statistics. Although there is no universally agreed definition of MSME some of the commonly used criteria are the number of employees, value of assets, value of sales and size of capital as well as turnover. Among them the most common definitional basis used is employees because of the comparatively ease of collecting information and here again there is variation in defining the upper and lower size limit of an MSME. In developing countries the number of employees and size of asses or turnover for MSME tend to be much smaller compared to their counterparts in developed countries due to their relative size of business entities and economies. (Ayyagari et al, 2003). Currently the MSME Department of the World Bank uses the following definitions: microenterprise up to 10 employees, total assets of up to $10,000 and total annual sales of up to $100,000; small enterprise up to 50 employees, total assets and total sales of up to $3 million; medium enterprise up to 300 employees, total assets and total sales of up to $15 millions.

A firm is defined as an administrative organisation whose legal entity or frame work may expand in time with the collection of both physical resources, tangible or resources that are human nature (Penrose, 1995). The purpose or goal of any firm is to make profit and grow. The term growth in this context can be defined as an increase in size or other objects that can be quantified or a process of changes or improvements (Penrose, 1995). The firm size is the result of firm growth over a period of time and it should be noted that firm growth is a process while firm size is a state (Penrose, 1995). The growth of a firm can be determined by supply of capital, labour and appropriate management and opportunities for investments that are profitable. The determining factor for a firm's growth is the availability of resources to the firm (Ghoshal, Halm and Moran, 2002).

1.1.3. Context of Study

The potential of using institutional credit and other financial services for poverty alleviation in Kenya is quite significant. About 18 million people, or 60% of the population, are poor and mostly out of the scope of formal banking services. According to the National Micro and Small Enterprise Baseline Survey (Central Bureau of Statistics, 1999), there are close to 1.3 million MSMEs employing nearly 2.3million people or 20% of the country's total employment and contributing 18% of overall GDP and 25% of non-agricultural GDP. Despite this important contribution, only 10.4% of the MSMEs receive credit and other financial services. The formal banking sector in Kenya over the years has regarded the informal sector as risky and not commercially viable.

According to the Poverty Reduction Strategy Paper (PRSP), Ministry of Finance and Planning (2001), a large number of Kenyans derive their livelihood from the MSMEs. Therefore, development of this sector represents an important means of creating employment, promoting growth, and reducing poverty in the long-term. However, in spite of the importance of this sector, experience shows that provision and delivery of credit and other financial services to the sector by formal financial institutions, such as commercial banks has been below expectation. This means that it is difficult for the poor to climb out of poverty due to lack of finance for their productive activities. Therefore, new, innovative, and pro-poor modes of financing low-income households and MSMEs based on sound operating principles need to be developed. Alongside the explosion of the microfinance industry in absolute terms, there has been a steady growth in private financing for MFIs. The bulk of microfinance funding is still provided by development-oriented international financial institutions and NGOs. Yet estimates place demand for unmet financial services at roughly 1.8 billion individuals.

According to the Central Bank of Kenya (Bank Supervision Report, 2008), the exact number of microfinance business practitioners operating country wide is largely unknown. AMFI reports that their membership serves over 4 million clients with an outstanding loan balance of over 300 million USD. These institutions and figures do not include SACCOs, which the Central Bank estimates number in excess of 5,000, at least 3,500 of which are active. The Central Bank expects that at least 200 of these will become registered under the Microfinance Act, and estimates that as of December 2008, SACCOs in aggregate account for 3.3 million accounts worth 2.2 billion USD, and had

1.5 billion USD in loans outstanding. Major players in the MFI sector include Faulu Kenya, Kenya Women Finance Trust (KWFT), Pride Ltd, Wedco Ltd, Small and Medium Enterprise Programme (SMEP), Kenya Small Traders and Entrepreneurs Society (KSTES), Ecumenical Loans Fund (ECLOF) and Vintage Management (Jitegemee Trust). The Kenya Post Office Savings Bank (KPSOB) is also a major player in the sector but only to the extent of providing savings and money transfer facilities. With the increasing number of MFIs sprouting all over the country this study seeks to find out if there is any impact they are making on the financial performance of SMEs. It is expected that with the increased provision of credit facilities to the MSMEs, they are better able to perform in terms of profitability and expansion of their businesses.

Embu town is a major trading centre in Eastern Kenya. For a long time, it was the main economic center for the Embu and Mbeere communities, as well as other communities from central Kenya. Embu has an elevation of 1,350 metres and is itself located on the foothills of Mount Kenya. Having been founded in 1906 by the British settlers for administration and agricultural purposes, it is now the provincial headquarters of the Eastern province, hosting major public provincial offices including Embu Provincial General Hospital. The town of Embu stretches across a radius of about only 10 km in size (Population of Local Authorities, Government of Kenya, 1999). Among the 43 retail MFI registered with AMFI, there are 10 that have a branch office in Embu town. This raises the question thereof whether with such a high number of MFI, the SME in the town who are among the target market for the MFIs can boast of any changes in financial performance that can be linked to the services provided by the MFIs.

1.2. Statement of the Problem

In Africa, the failure rate of MSMEs is 70% to 80% out of every 100 companies due to lack of skills and access to capital among other reasons (Brink, Cant & Ligthelm, 2003). It is typical of MSMEs in Africa to be lacking in business skills, track record and collateral to meet the existing lending criteria of risk averse banks (World Bank, 2000). The unequal access to finance by MSMEs and large enterprises has undermined the role of MSMEs in the economic development of most African countries like Kenya.

In Kenya, there is a widespread concern that banking systems are not providing enough support to new economic initiatives and in particular to the expansion of MSMEs and agriculture sector (Sacerdoti, 2005). It is argued that faster economic growth will not be possible without a deepening of the financial system and in particular, more financial support from the banking sector to the MSMEs. Banks remain highly liquid and reluctant to expand credit other than to the most credit worthy borrowers which in most cases excludes the MSMEs. While Micro Finance Institutions (MFIs) have expanded vigorously in Kenya, the size of their credit remains limited, so that their support is not on the scale needed for many small projects. Also, the interest rate on micro-credits is very high, due to large administrative costs in relation to their scale of operations.

MSME advocates increasingly point to the contribution of MSMEs to private sector–led economic development and poverty reduction in terms of job creation, innovation, higher productivity, and greater social equality. They argue that this is the case because MSMEs represent a large segment of the private sector; contribute significantly to employment

and gross domestic product (GDP) and provide the only employment and income source for many poor households, disproportionately so for women. Others argue that insufficient attention has been paid to conducting impact assessments to verify these claims. MSME finance is very practical on the grounds of deepening and broadening financial sector development to build inclusive financial systems that work for the majority of the population and thereby facilitate pro-poor, private sector–led growth. However, it is also important to identify the key constraints to access to finance by MSMEs and how to correct financial policies that often inadvertently restrict MSMEs in order to establish a neutral and level playing field for all financial institutions and products.

Accessing credit is considered to be an important factor in increasing the development of MSMEs. It is thought that credit augment income levels, increases employment and thereby alleviate poverty. It is believed that access to credit enables poor people to overcome their liquidity constraints and undertake some investments. However, the lack of access to credit to start or expand small scale enterprises has often plagued this sector of the economy. Most MSMEs tend to rely on the personal resources of their owners, and or loans from friends and relatives to fund the enterprises. The expectation has been that, after the initial take off of the small scale enterprises, the business should be able to raise funds from the formal sector especially MFIs or banking industries to expand its operations. This study will investigate the relationship between the access to microfinance and the financial performance of MSMEs in Embu town.

1.3. Objectives of the Study

The purpose of this study is to assess the relationship between access to microfinance services and financial performance of micro, small and medium size enterprises in Embu town.

1.4. Importance of the Study

The 1990s saw growing enthusiasm for promoting microfinance as a strategy for poverty alleviation. The microfinance sector blossomed in many countries, leading to multiple financial services firms serving the needs of micro entrepreneurs and poor households. These gains, however, tended to concentrate in urban and densely populated rural areas.

Today, practitioners and donors are increasingly focusing on expanded financial services to the poor in frontier markets and on the integration of microfinance in financial systems development. The recent introduction by some donors of the financial systems approach in microfinance - which emphasizes favourable policy environment and institution-building - has improved the overall effectiveness of microfinance interventions. But numerous challenges remain, especially in rural and agricultural finance and other frontier markets. The microfinance industry and the greater development community share the view that permanent poverty reduction requires addressing the multiple dimensions of poverty. For the international community, this means reaching specific Millennium Development Goals (MDGs) in education, women's empowerment, and health, among others. For microfinance, this means viewing microfinance as an essential

element in any country's financial system. It will be interesting to discover through the research the actual impact that these efforts have had on individuals in Kenya. The outcome of the study could also be helpful for donors willing to fund MFIs or MSEs as well as generating future research in the field of microfinance sector.

Further, the research will be a useful guide to researchers seeking to expound on the same issues in Kenya in other regions. Scholars and academicians will find this study a useful guide for the same as it will recommend on areas for further research.

UNIVERSITY OF NAIROBI
LOWER KABETE
LIBRARY

element in any country's financial system. It will be interesting to discover through the research the actual impact that these efforts have had on individuals in Kenya. The outcome of the study could also be helpful for donors willing to fund MFIs or MSEs as well as generating future research in the field of microfinance sector.

Further, the research will be a useful guide to researchers seeking to expound on the same issues in Kenya in other regions. Scholars and academicians will find this study a useful guide for the same as it will recommend on areas for further research.

UNIVERSITY OF NAIROBI
LOWER KABETE
LIBRARY

CHAPTER TWO

LITERATURE REVIEW

2.1. Introduction

This chapter presents the literature review. First, a theoretical review is provided focusing on the theories related to Microfinance. Secondly, the empirical review of the studies done on how access to microfinance has impacted the financial performance of micro, small and medium size enterprises.

2.2. Theoretical Literature

Poverty is the major problem in most developing economies. In these economies, it is argued that among others absence of access to credit is presumed to be the cause for the failure of the poor to come out of poverty. Meeting the gap between demand and supply of credit in the formal financial institutions frontier has been challenging (Von Pischke 1991). In fact, the gap is not aroused merely because of shortage of loan-able fund to the poor rather it arises because it is costly for the formal financial institutions to lend to the poor. Lending to the poor involves high transaction cost and risks associated with information asymmetries and moral hazards (Stiglitz and Weiss 1981). Nevertheless, in several developing economies governments have intervened, through introduction of microfinance institutions to minimize the gap then allow the poor access credits.

There are different arguments concerning how to evaluate the performance of microfinance institutions. Zeller and Mayer (2002) indicated that there is what is called Critical Micro-finance Triangle that we need to look at to evaluate Micro-finance institutions based on their objective.

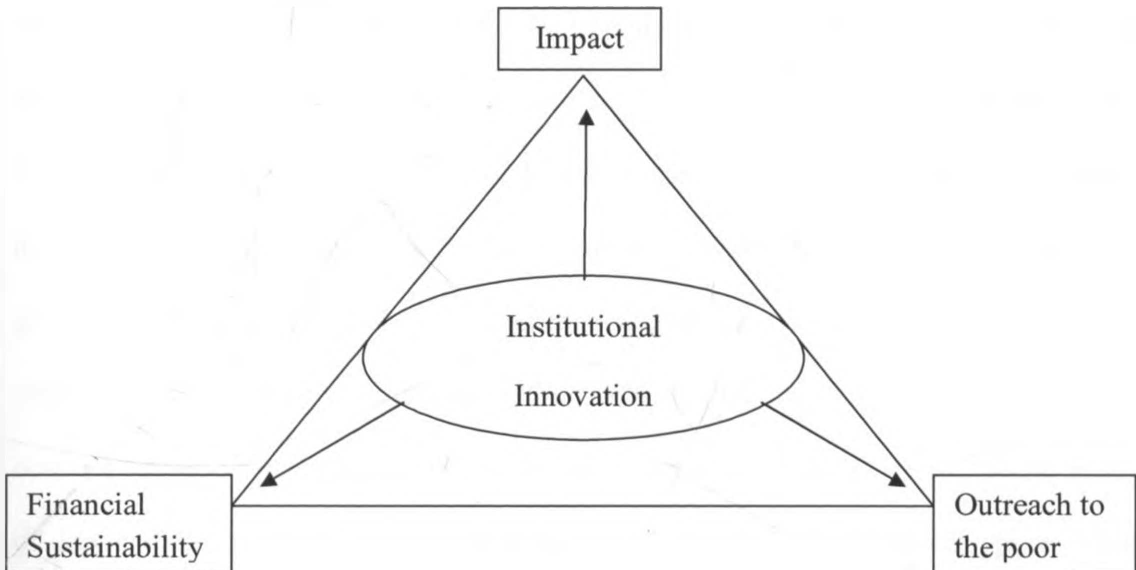

Figure 1: The critical triangle in achieving economic sustainability of microfinance

The triangle corners represent outreach to the poor, financial sustainability and welfare impact. And performance criteria are required for each objective and all three must be measured thoroughly to evaluate micro-finance performance Meyer (2002). Further he indicated that the inner circle in the figure represents MFI innovations in technology, policies, organization, and management that affect how well each objective is met. The outer circle represents the environment within which micro finance operates that also affects performance. This environment broadly includes the human and social capital possessed by the poor, the economic policies of the country, and the quality of the financial infrastructure that supports financial transactions. Improvements in the environment make it easier for MFIs to reach the three objectives Meyer (2002).

2.2.1. Measuring Outreach to the Poor

Outreach at glance means the number of clients served. Meyer (2002) noted that outreach is multidimensional concept. In order to measure outreach we need to look in to different dimensions. The first is simply the number of persons now served that were previously denied access to formal financial services. Usually these persons will be the poor because they cannot provide the collateral required for accessing formal loans, are perceived as being too risky to serve, and impose high transaction costs on financial institutions because of the small size of their financial activities and transactions. Women often face greater problems than men in accessing financial services so number of women served is often measured as another criterion. Although difficult to measure, depth of poverty is a concern because the poorest of the poor face the greatest access problem. Some measure of depth of outreach is needed to evaluate how well MFIs reach the very poor. Finally, the variety of financial services provided is the criterion because it has been shown that the poor demand and their welfare will be improved if efficient and secure savings, insurance, remittance transfer and other services are provided in addition to the loans that are the predominant concern of policy makers.

Navajas et al. (2000), similarly, indicated that there are six aspects of measuring outreach: depth, worth of users, cost to users, breadth, length and scope. Where, depth of outreach refers to the value the society attaches to the net gain from the use of the micro credit by a given borrower. This measure is to identify the poor clients. Because, the poor are the one who fail to get access to get credit from formal financial institutions since they fail to signal that they can repay their loan (Conning, 1997). And, worth of outreach

to users refers to how much a borrower is willing to pay for a loan (Navajas et al., 2000). Similarly, cost of outreach to user refers to cost of a loan to a borrower, (Navajas et al. 2000). These costs to users might consists of prices like interest rates and various payments that they have to pay, which could be revenue to the lender, and other loan related transaction costs like expenses on documents, transport, food, taxes, etc. Finally, breadth of outreach is the number of users, length of outreach is the time frame in which a microfinance organization produces loans and scope of outreach is the number of type of financial contracts offered by a microfinance organization. It is argued that length of a loan matter, because if the microfinance institutions support the poor only in the short run it will hamper the social welfare of the society in the long run. In the case that when the client of the microfinance institution knows that he/she will not receive additional loan in the future they would have no incentive to borrowers to repay their loan.

2.2.2. Financial Sustainability

The other indicator of performance of a micro finance institution is its financial sustainability. Different literatures noted that financial sustainability is one of the areas that we need to look at to assess the performance of micro finance institutions. Meyer (2002) noted that the poor needed to have access to financial service on long-term basis rather than just a onetime financial support. Short-term loan would worsen the welfare of the poor (Navajas et al., 2000).

Meyer (2002) also stated that the financial unsustainability in the MFI arises due to low repayment rate or un-materialization of funds promised by donors or governments.

According to Meyer (2002), there are two kind of sustainability that we could observe in assessing MFIs performance: Operational self-sustainability and financial self-sustainability. Operational self-sustainability is when the operating income is sufficient enough to cover operational costs like salaries, supplies, loan losses, and other administrative costs. And financial self-sustainability (which he referred as high standard measure) is when MFIs can also cover the costs of funds and other forms of subsidies received when they are valued at market prices. Meyer (2002) indicated measuring financial sustainability requires that MFIs maintain good financial accounts and follow recognized accounting practices that provide full transparency for income, expenses, loan recovery, and potential losses. There also are some dispute on the link between financial sustainability and outreach to the poor. According to some (Christen et al. 1995; Otero and Rhyne 1994), cited in Meyer (2002), outreach and financial sustainability are complimentary this is because as the number of clients increase MFIs enjoys economies of scale and hence reduce costs which help them to financial sustainable.

Hulme and Mosely (1996) argued that there is inverse relationship between outreach and financial sustainability. Here the argument is higher outreach means higher transaction cost in order to get information about creditworthiness of clients and hence make MFI financially unsustainable. Including credit in the production function can be used to assess impact of MFIs. But, Scholars like Adam (1988) critic that it is wrong because this kind of assessment involves complications; probably it could be difficult to sort out loan effects from technical assistance. Regarding indicator of financial sustainability, Khandker et, al. (1995) pointed out that loan repayment (measured by default rate) could

be another indicator for financial sustainability of MFIs; because, low default rate would help to realize future lending.

2.2.3. Welfare Impact

Welfare impacts of the services of MFIs are also argued to be another indicator to evaluate the performance of the institutions. As indicated at the beginning of this paper, one way or another, the objective of MFIs is reducing poverty which implies that we need to access the impact of the microfinance programs on reducing poverty to evaluate their performance. As defined in World Bank (2000/01) report poverty is viewed as lack of money, lack of adequate food, shelter, education and health and the poor are vulnerable to ill health, economic dislocation and natural disaster. According to Meyer (2002) this perspectives of poverty can be used to access the impact of the MFIs on those who receives the services. Meyer (2002) also noted that assessment of impact of the MFIs on their clients is a very difficult and controversial way of evaluating the institutions performance. This is because of the methodological difficulties and high costs involved in conducting robust studies, it has been argued that the most important evidence of impact should be whether or not MFI clients continue to use the services. If they do, they must value the benefits received more than the costs of obtaining them. Impact analysis, therefore, should focus on understanding the impact on MFIs of programs offering services to the poor rather than impacts on the clients of such services. A counter argument is that most of the industry requires substantial amounts of public funds at least in the form of start-up costs if not in the form of long-term subsidization. These funds have opportunity cost (they have alternative uses for society) so policy makers need

evidence as to whether or not clients are receiving direct measurable benefits from microfinance. If not, the fund should be allocated to other means to fight.

2.2.4. Determinants of Capital Structure by MSMEs

Capital structure is defined as the specific mix of debt and equity a firm uses to finance its operations. Four important theories are used to explain the capital structure decisions. These are based on asymmetric information, tax benefits associated with debt use, bankruptcy cost and agency cost. The first is rooted in the pecking order framework, while the other three are described in terms of the static trade-off choice.

MSMEs have some important aspects that are considered when taking decisions on their financial structure. A firm's history is a more important factor in determining the capital structure than its characteristics. The cost of debt to equity is compared; the increase in risk and the cost of equity as debt increases is also compared before taking the decision. The advantage of debt by MSMEs due to tax reduction is also considered. The costs of capital remain unchanged when there is a deduction in taxes and interest charges. This indicates that using cheaper debt will be favourable to the business than using equity capital due to increase risk (Modigliani and Miller, 1958 and 1963). Firms would seek a good portion of their capital structure as debt to a certain level so as to take these tax advantages. An over reliance on debt as capital by MSMEs will have a negative effect in the business activity in that it will increase the probability of the firm to go bankrupt (Myers, 1984).

Myers (1977) determines the capital structure of MSMEs. The pecking order theory (POT) was used to explain why firms will choose a particular capital structure than the other. The POT stipulates that MSMEs average debt ratio will vary from industry to industry because these industries have varied asset risks, asset type and the requirements for external capital (Myers, 1984). Firms in one industry will have certain aspects that are common to most than to firms in a different industry (Harris and Raviv, 1991). The decisions are made taking into consideration information asymmetry, agency theory, and the signaling theory. The signaling theory describes signs and the effectiveness or how a venture will progress in an uncertain environment (Busenitz et al., 2005). The main idea behind this theory is that there is an information signal that alerts the stakeholders of what is happening in the business (Deeds et al., 1997). The success of a business in the future is determined by the availability of information to the firm. The stakeholders of a business require signals to find the way of the asymmetry of information between what is known and what is unknown (Janney and Folta, 2003). The outsiders get to know about a particular venture based on the signals it sends out. These signals need to be favourable because it is from it that potential investors will be informed and thus show the intention to invest in the venture. The cost of equity will be high when poor signals are noticed by outsiders and this will restrain potential investors (Busenitz et al., 2005). Firms get access to venture capital when they have a good goodwill (Prasad, Bruton and Vozikis, 2000). Good signals to the outsiders of a firm can be described as equal to due diligence with reduced time and input (Harvey and Lusch, 1995).

New businesses have problems in getting a favourable position in the market. Their existence is determined by their size and age. If it continues to exist, it means it is capable of maintaining its size or it is expanding. This of course goes with time and when they continue to exist, it means resources are acquired or unlimited (Freeman, 1982). This process of gaining stability and to survive makes the firm to gain legitimacy and thus can be trusted as a successful business since it emits positive signals (Singh, Tucker and House, 1986). Firms with unlimited resources at the infancy stage are easy to go bankrupt and die in this early stage (Aldrich and Auster, 1986; Carroll and Delacroix, 1982; Freeman, Carroll and Hannan, 1983; Romanelli, 1989; Singh, Tucker and House, 1986; and Stinchcomb, 1965). Firms that are young and small are incapable of getting the available resources for the proper functioning of its business activities and they are always associated with external organisations in a vertical manner for support (Stinchcomb, 1965). The integration of the young firm with a well established one gains ground for available resources such as funding and legitimacy (Hannan and Freeman, 1984; Singh et al., 1986). Businesses employing this approach to gain legitimacy are at risk since they are not independent. The other activities will have an influence in the outcome of the other. Its competitors along with others get to know the inner dependent firm which the competitor will use it as its strength. They get to know the weaknesses of the opposing firm but at the same time they will enjoy the benefit of transaction cost. The reduction of costs is due to the fact that they integrate with others to realise their objectives. This is done by gaining the inside of the quality of work, production and ideas within its top level. It is realised that there is no target equity mix and this is due to the fact that there exist two different kinds of equity. The two are at extremes meaning one at

the top and the other at the bottom of the pecking order. These differences are caused by the costs of information asymmetry.

External sources of funding have more moral hazard problems and consequently the demand for own or internal finances are of paramount to the firm (Myers, 1984). This moral hazard is explained by the fact that MSMEs are very close entities; that is owned and or controlled by one person or few people (Watson and Wilson, 2002). Ang (1991) POT emphasizes on the use of owned capital rather than outside capital by MSMEs and also explains why SMEs are denied or has a hindering factor in seeking for external sources of finance. World Bank (2000) reiterates the fact that MSMEs are more likely to be denied new loans for their businesses than larger firms when in need. They consider SMEs to lack the skills to manage risk and the high transaction costs in lending to them compared to the amount that is borrowed (Hallberg, 1994).

2.2.5. Financial performance of MSMEs

Financial performance is commonly used as an indicator of a firm's financial health over a given period of time. The financial performance of a firm can be defined or measured in various different ways. Each of these different measures captures a slightly different aspect of financial performance. Some such as profitability gauge return while others like sales growth and market share growth gauge the growth of a firm. Some measure profitability (return on investment, return on equity), some liquidity (quick ratio, current ratio), and still others solvency (gearing). Some measures are indicators of commercial

success (growth, market share) while others are indicators of financial success (profitability). In this regard it can also be argued that different firms have differing financial goals and therefore one financial performance indicator need not measure the success rate as perceived by the firm itself. In this study financial performance will be measured by the development of profits. Many firms are maximizing their profit making the development of profits a suitable indicator for financial performance.

According to the Economic Survey (2006), the MSME sector contributed over 50 percent of new jobs created in the year 2005. Despite their significance, past statistics indicate that three out of five businesses fail within the first few months of operation (Kenya National Bureau of Statistics, 2007). According to Amyx (2005), one of the most significant challenges is the negative perception towards MSMEs. Potential clients perceive small businesses as lacking the ability to provide quality services and are unable to satisfy more than one critical project simultaneously. Often larger companies are selected and given business for their clout in the industry and name recognition alone.

Starting and operating a small business includes a possibility of success as well as failure. Because of their small size, a simple management mistake is likely to lead to sure death of a small enterprise hence no opportunity to learn from its past mistakes. Lack of planning, improper financing and poor management have been posited as the main causes of failure of small enterprises (Longenecker, *et al.,* 2006). Lack of credit has also been

identified as one of the most serious constraints facing MSMEs and hindering their development (Oketch, 2000; Tomecko & Dondo, 1992; Kiiru, 1991).

Education is one of the factors that impact positively on growth of firms (King and McGrath, 2002). Those entrepreneurs with larger stocks of human capital, in terms of education and (or) vocational training, are better placed to adapt their enterprises to constantly changing business environments (King and McGrath, 1998). Infrastructure as it relates to provision of access roads, adequate power, water, sewerage and telecommunication has been a major constraint in the development of MSMEs (Bokea, Dondo & Mutiso, 1999).

MSMEs usually face a comparatively uncertain environment and entrepreneurs often have a short-term time horizon. Therefore the decision to implement technology depends on the intuition of the entrepreneur which is subject to his training and experience as well as to his optimism or pessimism with respect to policy changes and economic conditions in the future. Therefore the adoption decision is determined not only by enterprise characteristics but also by characteristics of the entrepreneur and the environment the enterprise operates in. This explains why not all potential users introduce the different ICT technologies at the same time despite its advantages. Technology adoption research for MSMEs shows in almost all cases, especially in network technologies that the diffusion of an innovation starts slowly with a few early adopters. As the benefits of the new technology can be observed by others, the diffusion and the speed of penetration

increases. When most potential adopters have the new technology the speed of diffusion decreases again until the saturation level is reached, where entrepreneurs might not see a benefit of the new technology but fear to have a disadvantage if they don't use it (Müller-Falcke 2001).

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

2.3. Empirical Studies

Schiffer and Weder (2001) show that MSMEs find accessing financing more difficult than larger firms. They rank all the obstacles firms face in doing business and find that financing is a top problem for MSMEs, which rate it higher than larger firms.

Beck, Demirgüç-Kunt, and Maksimovic (2002) further clarify how financial constraints affect firms of different sizes. Their study of 4,000 firms in 54 countries offers evidence that large firms internalize many of the capital allocation functions carried out by financial markets and financial intermediaries. They conclude that financial constraints affect the smallest firms most adversely and that an incremental improvement of the financial system that helps relax these constraints will be most beneficial for MSMEs. The 2005 World Development Report (World Bank 2004c) indicates that small firms obtain only 30 percent of their financing from external sources, whereas large firms meet up to 48 percent of their financing needs through external financing.

Oketch et al (1995) conducted a study on 16 financial institutions to determine the demand and supply of credit to the MSME sector. The study revealed that the demand and supply for credit have been on the increase since 1991. It also revealed that the demand has only been met by 16% of what is required. The study also revealed that although financial institutions lend to prime borrowers with collateral security, there is need for these institutions to increase their lending to MSMEs.

Diagne and Zeller (2001) argue that insufficient access to credit by the poor just below or just above the poverty line may have negative consequences for MSMEs and overall welfare. Access to credit further increases MSME's risk-bearing abilities; improve risk-copying strategies and enables consumption smoothing overtime.

However, not all studies have fully supported the fact that increased access to microfinance services has led to increased enterprise performance. Dia (1996) showed that additional capital is often not required to carry out a successful business and that lack of capital can be compensated through creativity. Kallon (1990) found that the amount of capital needed to start a business is significantly negative when related to the rate of growth for the business.

In his study, Buckley (1997) concluded that there was little evidence to suggest any significant and sustained impact of micro finance on beneficiaries in terms of micro entrepreneurs graduating to higher or more sophisticated operations, increased income flows or level of employment. The main argument that was adduced was that improvement in access to micro finance and markets was not sufficient unless there was an accompanying change in the undertakings themselves i.e. changes in techniques and/or technology.

Roth (1997) in his study on microfinance and successful enterprise was critical of the microfinance evangelists who created a vision of the rural poor as a collection of budding

entrepreneurs, waiting for salvation from credit agencies, which on receipt of credit, will develop successful micro enterprises and leave poverty forever. To respond to a potential demand for a good or service, a rural micro-entrepreneur may need access to one or more of the following transport, communications, power, water, storage facilities, and a legal system for enforcing contracts and settling disputes even much more than financing. Apart from infrastructure, micro entrepreneurs need access to information about market trends and skills to run their macro enterprises. Roth cited Weber (1958) who argued that hard work, skills and enthusiasm are essential ingredients for an enterprise to be successful.

Amanda et al (2007) found that although MFI and even commercial banks made a commendable effort towards financing of smaller enterprises, the enterprises continued to encounter the 'challenge of smallness' and discriminatory treatment by the bank officials who preferred to deal with larger enterprises. Another interesting conclusion from the study indicated that the MFI have different target markets, operate under varying methodologies and often lack the capacity to diversify their lending products and offer business support for their clients. The study also MFIs offered limited support for business owners who wished to grow their enterprises beyond the micro level.

Hospes, Musinga and Ongoayo (2002) carried out a study on the effect of MFIs services on businesses in Kenya and focused on KWFT. The study established that KWFT clients were able to start several enterprises through the lending and with additional funding

more enterprises were established but could not relate the use of microfinance services to financial performance parameters such as revenue development or profitability development. Similarly Muganda(2010) in a comparative study to estimate the impact of microfinance programs on business performance and individual well being in Kenya and South Africa, there was no conclusive evidence on the relationship between use of microfinance services and the performance of the enterprises they serve.

2.4. Summary

From the studies it is evident that most MSMEs have little access to finance, which thus hampers their emergence and eventual growth. Their main sources of capital are their retained earnings and informal savings and loan associations, which are unpredictable, not very secure and have little scope for risk sharing because of their regional or sectoral focus. Access to formal finance is poor because of the high risk of default among MSMEs and due to inadequate financial facilities. Accessing credit is considered to be an important factor in increasing the development of MSMEs. One such channel of providing financing for these small businesses is through increased access to finance by informal financing institutions such as MFIs. However, the studies done so far have not shown any substantial relationship between the increased access to financing and performance of the MSMEs.

CHAPTER THREE

RESEARCH METHODOLOGY

3.1. Introduction

This chapter highlights the methods used by the researcher to undertake the research. These methods include research design, target population, sampling design, data collection procedures and data analysis procedures.

3.2. Research Design

The research design outlines the methods for data collection, measurement and analysis (Cooper & Schindler, 2001). According to Saunders, Lewis and Thornhill (2007), a research design can be named in terms of time horizons, choice of methods, or strategies used to collect data. This study adopted a historical correlation method of research design estimated the returns on assets for selected MSMEs. Nyandemo (2007) stated that correlation method describes in quantitative terms the degree to which variables are related and explores the relationship between variables. Quantitative historical research design is therefore considered suitable for this study due to the nature of the investigation where the researcher used historical quantitative data.

3.3. Population

Population refers to an entire group of individuals, events or objects having a common observable characteristic (Mugenda and Mugenda, 2003). Further, the authors note that researchers define the population to which the results would be generalized – the target population. The population of study is all retail MFIs that have registered with the Association of Microfinance Institutions of Kenya. As at September, 2010 there were 34 retail MFIs that had registered with AMFI.

3.4. Sample

According to Trochim (2005), sampling is the process of selecting units (people, organizations) from a population of interest so that by studying the sample we may fairly generalize our results back to the population from which they were chosen. The study covered a sample of 5 MSMEs that have been in existence for the last 5 years from each of the 10 MFIs that have a branch office in Embu town from where we shall select.

3.5. Data Collection

The study used secondary data for information regarding set up of MFIs, their organization; outreach and desired impact (required for furthering & supporting the analysis of findings from primary data) are the typical kinds of secondary data that would be used in the study. The study also used primary data collected using a data collection

sheet to collect data from MSMEs on the performance variables as assets, loans, turnover, personnel and profits.

3.6. Data Analysis

The data was analysed using regression analysis. The MSMEs profitability will be measures using the return on assets. Fraser and Fraser (1991) argued that ROA and ROI are the best measures of profitability. Beck and Martinez Peria (2007) presented size of loans among factors as indicators of banking sector outreach. Although this indicator cannot be precise measurement of access to finance, those can be good proxy indicator of measuring accessibility of financial services. The study uses a regression model to establish the relationship between the financial performance of the MSMEs and access to microfinance services provided by the MFIs in form of loans. The regression equation that will be analysed is:

$$PERF = a + b\,(ACCESS) + c\,(CONTROL) + d$$

Where a, b, c and d are constants

PERF — is the financial performance in terms of profitability of MSMEs variable measured as ROA

ACCESS — is the microfinance access variable measured as the loan value borrowed from MFIs

CONTROL represents all control variables of age of MSME measured by number of years in existence and enterprise size measured by the total assets and turnover.

The analysis for the variables will also be done to show the mean values, the median, the percentiles, and the standard deviations. The results will be presented in tables and charts.

3.7. Data Validity and Reliability

Validity and reliability of the data collected is to ensure good quality research. According to Trochim (2005) Reliability has to do with the quality of measurement. In its everyday sense, reliability is the consistency or repeatability of your measures. Validity concerns that whether the concept really measures the aimed concept (Bryman, 2004).

Pre-testing of the data collection instruments will be carried out in National Cereals and Produce Board. Pre-testing of the instrument will enable the researcher to access the clarity of the instrument and its ease of use; Mugenda and Mugenda (2003) suggests that pre-testing allows errors to be discovered as well as acts as tool for training a research team before the actual collection of data begins. They further argue that effective revision is the result of determining participant interest, discovering if the questions have meaning for the participant, checking for participant modification of a question's intent, examining question continuity and flow, experimenting with question-sequencing patterns, collecting early warning data on item variability and fixing the length, and timing of the instrument.

CHAPTER FOUR

DATA ANALYSIS, FINDINGS AND INTERPRETATION

4.1. Introduction

This chapter provides the empirical findings gleaned from the collected data. It provides demographic information of the respondents and the statistical analysis of the information collected from them. This is followed by the interpretation and discussion about our findings.

4.2. Demographics information of the respondents

The study focused on the impact of access to microfinance services in the financial performance of MSMEs business in Embu town. We had a data collection sheet that we provided to members who own small businesses. Out of a total of 50 businesses where we provided the data collection sheet, only a total of 31 were answered, there was no response from 13 and 6 did not contain all the relevant information for the study. This represents a 62% response rate. According to Babbie (2002) any response rate of 50% and above is adequate for analysis.

4.2.1. Gender of respondents

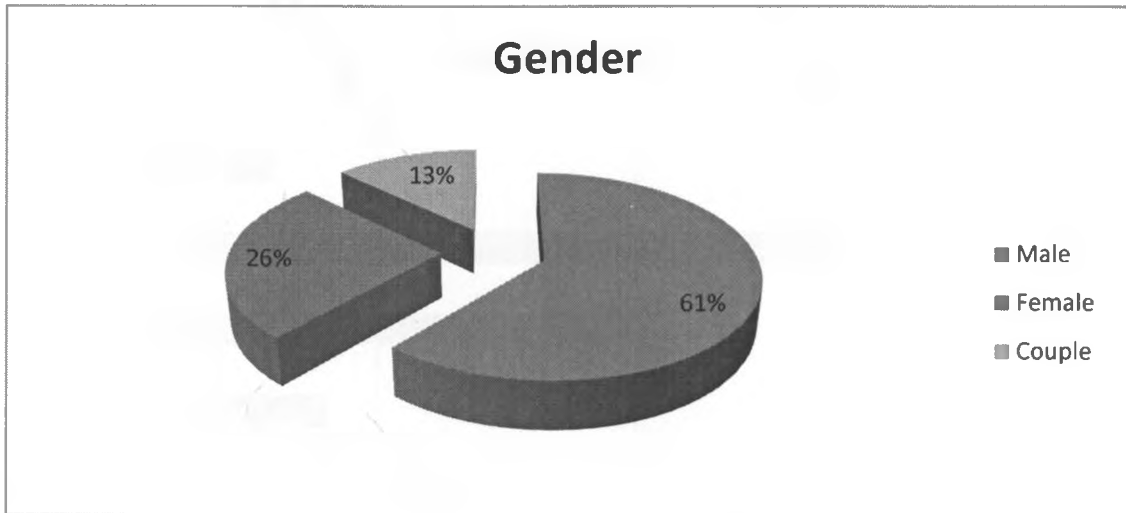

Figure 2: Gender of respondents

Figure 4.1 above shows the gender of the business owners who responded. From the findings 61% of the respondents were male while 26% were female. 13% of the businesses whose owners responded were owned by both spouses. This information is interesting as we had earlier indicated in our literature review of the target market for MFI are mostly women and other underprivileged members of society yet from those who have accesses the services women are fewer compared to their male counterparts.

4.2.2. Age of respondents

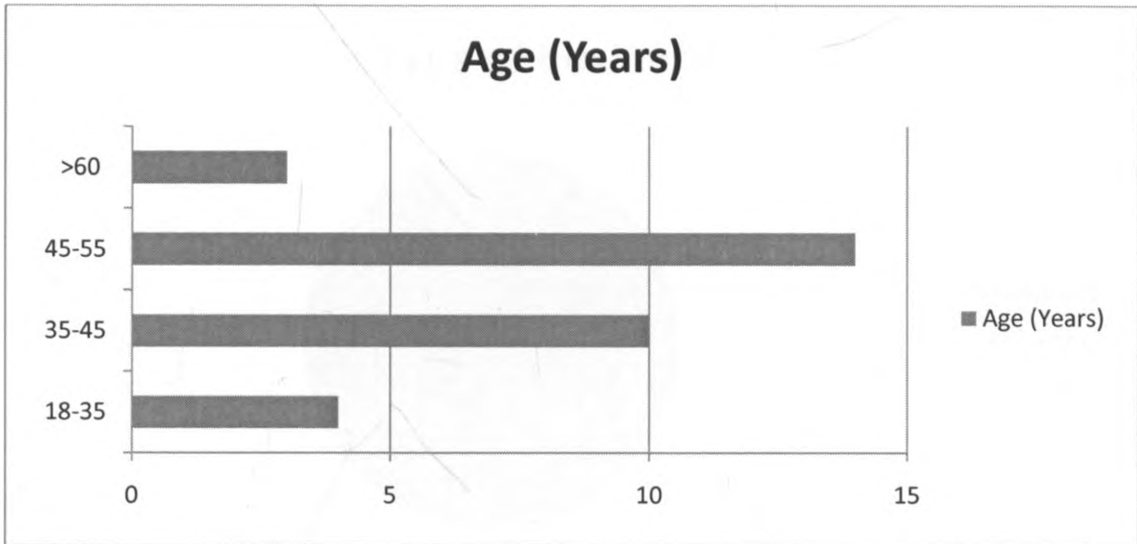

Figure 3: Age of respondents

From the analysis of the age of the respondents, the largest number 45% of the respondents are between 45-55 years. In total, the higher number of the respondents about 55% is above the youth age threshold of 35 years according to the Ministry of Gender and Youth Affairs yet one of the key target groups for the MFIs are the youth who are not in a position to afford collateral which may be asked for by the mainstream bank.

UNIVERSITY OF NAIROBI
LOWER KABETE

4.2.3. Type of businesses

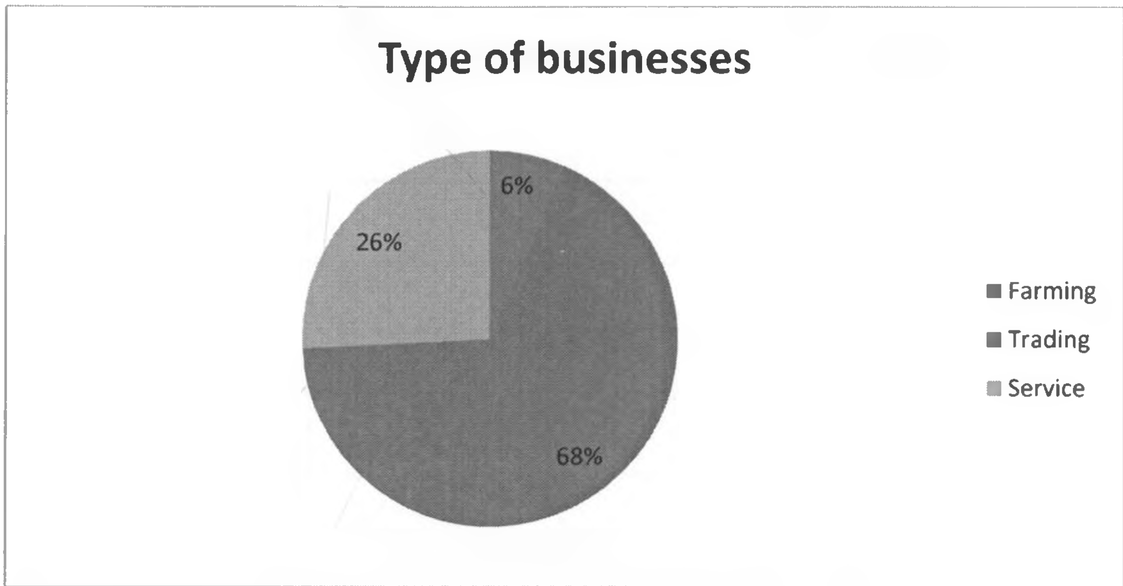

Figure 4: Type of businesses

From the analysis of the highest number of businesses in Embu Town 68% engage in trading activities which range from small scale manufacturing plants, clothing, bookshops, tailoring and cosmetics shops. There were only few agricultural related shops 6% despite the area being considered an agricultural town. This was attributed to the fact that with the town's activities increasing, more people are moving there are the agricultural businesses moving their businesses closer to the farmers in the smaller town centres as opposed to the bigger ones such as Embu town. Business owners are therefore focusing more on the needs of the population settling within the town and hence the increase in the demand for trading items.

4.2.4. Source of Start Up Capital

Source	Frequency	Percentage (%)
Personal Savings	11	35%
Friends or Relatives	2	6%
Loan from MFIs	10	32%
Other Sources	8	26%
Total	**31**	**100%**

Table 1: Source of startup capital

Table 1 above shows the source of startup capital of the respondents. 32% of total respondents took loans from MFIs to start up their businesses while the rest of them either borrowed money from friends and relatives 6%, from their personal savings or other sources such as mainstream banks 8%. It implies that although MFIs is the major source of initial capital and is playing a significant role in helping poor people to start their own business, they are yet to establish themselves as the first stop for financing for small enterprises. From our analysis, most businesses started off from the savings of the owners especially for the older businesses since the MFIs did not exist about10 years ago and where they did, they were still too expensive for the small business owners.

4.2.5. Amount of Loan Taken From MFIs

In the table 2 below, we analyzed the loans granted to individuals on five different bands covering a range of KShs.100, 000 and KShs.200, 000. Majority of granted loans, around

94% are within KShs.500, 000 which implies that MFIs basically emphasize on micro-credit and focus on the smaller enterprises. Only 2 out of the respondents got loans above KShs.500, 000 which shows the limiting criteria and ceilings of loan offered by MFIs. Indirectly, the result shows the lack of sufficient funds to expand the businesses due to less amount loan offered by MFIs. This could be one of the ways that the MFIs are managing the risk by keeping the loan given to borrowers given their profile low but it does not seem to solve the risk challenge. Organizations lending to micro-enterprises should explore further alternative forms of collateral such group credit guarantees and personal guarantors to try mitigate such risk so as to enable MSMEs to borrow more amounts which can be used towards business expansion.

Amount (KShs.)	**Frequency**	**Percentage (%)**
0 - 100,000	12	39%
100,001 - 300,000	8	26%
300,001 - 400,000	1	3%
400,001 - 500,000	8	26%
>500,000	2	6%
Total	**31**	**100%**

Table 2: Amount of loans from MFIs

4.2.6. Employment

The respondent businesses have collectively increased their level of employment by 55% over the last five years from an average of 1.8 employees to an average of 2.8 employees presently. With the growth having started slowly and increased significantly in 2009 by about 30%. For most businesses, this was pointed out as the year they experiences the highest growth and hence the willingness and ability in terms of costs to take on more staff.

4.3. Statistical Analysis

Measure	Mean	Std deviation	Coefficient of variation
Age of borrowers(Years)	45.03	12.29	0.27
Age of business(Years)	7.24	6.31	0.87
Number of employees	2.10	0.27	0.13
Debt ratio	0.74	0.85	1.15
ROA	0.28	0.31	1.11
Borrowing from MFI(Kshs)	182,258.00	180,299.00	0.99
Profitability(Kshs)	203,453.00	176,907.00	0.87
Turnover(Kshs)	1,086,515.00	2,198,687.00	2.02

Table 3: Statistical analysis of the sample

From the analysis above, the average age of borrowers from the MFI is about 45 years with the majority of the borrowers being male. The Businesses have been in operation on average for 7 years and have 2 employees on average. The debt ratio on average is 0.74 for the sample size tested, implying that for every unit of debt in the business, the owner has put in 0.74 unit of equity. The return on assets is 28% on average for the sample tested while the average borrowing from MFIs for the sample businesses tested was KShs.182, 258.

4.4. Regression Analysis

The researcher conducted a regression so as to determine the relationship between the return on investment and various independent variables including debt component of MFIs, age of the business and size of the business.

The regression model was as follows:

$$Y_t = \alpha_0 + \alpha_1 D_t + \alpha_2 A_t + \alpha_3 S_t + \alpha_3 T_t$$

Where:

Y is the profitability of the MSME measured by the return on assets over time t

D_t is the LN of the amount of loan accessed from the microfinance institutions over time t

A_t is the number of years the business has been in operation over time t

S_t is the LN of size of the business measured by the total assets over time t

T_t is the LN of the size of the turnover of the business over time t

The regression equation will be as follows:

$$Y = 0.28 + 0.09D + 0.25A - 0.12S + 2.22T$$

From the regression equation established, taking all other factors constant at zero, the profitability growth is 0.28 for the sample selected or 28%. The data findings analysed also shows that taking all other independent variables at zero, a unit increase in the loan provided by the MFI leads to a 0.09 or 9% increase in the ROA. This shows there is a positive relationship between ROA and availability of loans from the MFI but not as great as anticipated especially compared to other factors such as age of the business which resulted in 0.25 increase in the ROA meaning overtime the MSMEs tend to do better regardless, this may be attributed to establishment of clientele and learning by the business owners who gain experience over time and are hence better able to manage their businesses. Also, having greater influence is turnover towards the profitability of the businesses, a unit increase in turnover led to 2.22 increase in the return on assets. Most MSME covered in our sample about 68% engage in trading activities where they sell small items and hence their leverage would come in making huge amounts of sales in order to increase the profit level as they have more or less been able to manage their costs. Interestingly, there was a negative relation to the assets with a unit increase in the value of assets causing a 0.12 decrease in the ROA. On further discussion, we discovered that most businesses prefer to maintain very low levels of assets to avoid fixed costs that arise from having fixed assets such warehousing, insurance and depreciations or obsolescence which the business owners are not able to cover from the sales that they

make. The businesses are able to achieve relatively higher return on investments from managing their costs hence will want to avoid anything that inflates such costs.

4.5. Summary of Key Findings and Interpretations

Microfinance has a major target on women as well as other underprivileged groups. Some MFI have adopted a specified focus on women such as KWFT and Pamoja Women which lend specifically to women and Youth Initiatives Kenya that lends to the youth. Such efforts have resulted in increased involvement of such groups in economic activities as indicated by the 26% female borrowers in the study. About 55% of the borrowers were above 35 years of age indicating the beneficiaries of the MFI services were not youth bracket. These percentages are not satisfactory and additional efforts are needed to include such groups in the economic development of the nation.

The granting of loans or credit to MSMEs is still a major problem as many of the MSMEs are unable to access such funds. Also there is the problem of information between the loan provider and the loan receiver as to the availability, cost and mode of assessing such fund. The study revealed that most borrowers borrowed only a small amount of money from the MFIs because they were only eligible to access such amounts given the criteria set by the institutions and also because they were reluctant to take out large amounts that they may not be able to repay. Such small amounts can only have so little impact on the growth of the MSMEs hence lower impact.

CHAPTER FIVE

CONCLUSIONS AND RECOMMENDATIONS

5.1. Introduction

This chapter presents the conclusions drawn from the findings highlighted and recommendations made thereto. The conclusions and recommendations drawn were focused on addressing the objective of this study which was to try and establish the relationship between access to microfinance services and the financial performance of micro, small and medium size enterprises in Embu Town.

5.2. Conclusions and Recommendations

The MSMEs sector is, without doubt, the key to unlocking the economic potentials of the country and in particular the rural areas. The MSMEs are mostly owned and run by "small" people especially small and micro scale enterprises for local markets and using mostly materials from the locality of the businesses. From the study, it can be interpreted that MFIs affect the creation of employment. It was found from the study that most of the family members of borrowers contributed to run the business directly or indirectly. Apart from the superior employment generating capacity indicated by a steady increase in number of employees in this and potentiality of the MSMEs, there are the added advantages of their being flexible and easily adapt to changing market opportunities and conditions.

The industrial development of Kenya depends on the degree of attention given to the micro, small and medium scale sector. In spite of the abundance of natural resources, many of its citizens are living under abject poverty with a slow economic development. The development of MSMEs and its effective promotion have not been approached seriously hence the lack of their impact in the economy. In Kenya, the government instituted various programs aimed at developing MSMEs sector. Most of the programs were not given the appropriate backing and as such the impact of the programs could not be felt in the economy. Access to credit continues to pose a major problem to MSMEs sector in Kenya. The traditional financial institutions have not been able to meet the credit needs of the MSMEs. Since the introduction of economic reforms, more MSMEs have been forced to the informal institutions for credit. But the supply of credit from the informal institutions is often so limited to meet the credit needs of the MSMEs.

Microfinance institutions are an asset to the developing and transition countries. The services they provide are tailored to meet the needs and aspirations of the local inhabitants and emphases are towards the poor. The products and services put forth to the members are not by itself a solution to the numerous problems affecting the poor. These problems range from business skills, lack of financial intermediation services, and the lack of markets, technology etc. These institutions provide a focal point that makes users financially comfortable with their hard work and commitment. It should be noted that microfinance does not serve or solve all the problems of the poor but it serves as a means of helping them to boost their economic activities or augmenting their status.

Microfinance schemes often are of paramount importance when the targeted problem is in its initial stage and not when it has emanated. Funding is only a portion of what is needed to boost an enterprise activity in the rural areas and who are incapable of getting the necessary assistance from a commercial bank. There are many other services such as capacity building for the business owners in order to equip them with the necessary skills to run successful businesses. MFIs also need to create more awareness on some of the other services that they offer such as insurance and medical cover which most respondents do not currently know about.

Expansion for most MSMEs continue to be a huge challenge and policy makers such as government who are key on the growth of the sector could support through the establishment of support agencies, associations which could be charged with among other activities looking for markets for the MSMEs both locally and internationally through exports. MSMEs also must be profitable in order to grow and be able to attract more external finance.

Different MFIs serve specific target markets and their ability to meet the credit needs of certain enterprises, especially those requiring large amounts of credit as they grow, is limited. MFI lending is confined to specific activities and at lower levels of income, thus limiting its use and confirming the argument that the nature of credit markets is such that the lending units are unable to meet the needs of borrowers interested in certain types of

credit. The result is that a credit gap is created that captures those borrowers who cannot get what they want from the informal market, yet they cannot gain access to the formal sources because of restrictive lending practices. An important conclusion for improving access to credit is that given the wide and established branch network of commercial banks, improving their lending terms and conditions in favour of small-scale enterprises would significantly facilitate the accessibility of small-scale enterprises to financing. There is also need to expand the capacity of MFIs to enable them to increase their potential to lend to MSMEs.

5.3. Limitations of the Study

The study was restricted to Embu town and hence can only be generalized for a similar rural town and not to an urban setup such as Nairobi. The sample covered 5 MSMEs from the each 10 retail MFIs that have a branch in Embu town which may fail to represent other MSMEs that are in Embu but are served by MFIs without a branch office in Embu town. Relevant theories in the literature review chapter were not easy to come by because no established theories have been particularly defined in the financial impact of microfinance field yet. Most of the studies used focused more broadly on the microfinance model.

Another problem encountered in the field had to do with reluctance to cooperate due to suspicion that disclosing information may lead to increased taxation of their corporate profit and other compliance problems. In addition some of the respondents adopted nonchalant attitudes towards providing information as they did not perceive possible

benefits to them and their businesses.

Finally, the accuracy of the analysis heavily relied on the data provided by the MSMEs visited and yet most had major book keeping shortcomings. Some enterprises did not have accounting records and we had to rely on the verbal information given by the respondents.

5.4. Suggestions for Further Research

The current study was based on a small sample size taken from rural Embu town of Kenya. Therefore, the results can only be generalized to other similar rural towns of Kenya especially in the analytical terms. Further research done on a bigger scale with large sample size could shed light on how microfinance activities affect the financial performance of micro, small and medium size businesses in Kenya. Another area that has not been investigated is difficulties if any that the borrowers face to repay the loans. These areas should to be studied by future researchers in the field.

Another area which is not covered in our study is the supply gap of MFIs. Actually, to what extent the MFIs are capable to deliver their service to the poor people. Further research could be conducted in this area and for finding the reasons for the gap between demand and supply in terms of micro finance services.

benefits to them and their businesses.

Finally, the accuracy of the analysis heavily relied on the data provided by the MSMEs visited and yet most had major book keeping shortcomings. Some enterprises did not have accounting records and we had to rely on the verbal information given by the respondents.

5.4. Suggestions for Further Research

The current study was based on a small sample size taken from rural Embu town of Kenya. Therefore, the results can only be generalized to other similar rural towns of Kenya especially in the analytical terms. Further research done on a bigger scale with large sample size could shed light on how microfinance activities affect the financial performance of micro, small and medium size businesses in Kenya. Another area that has not been investigated is difficulties if any that the borrowers face to repay the loans. These areas should to be studied by future researchers in the field.

Another area which is not covered in our study is the supply gap of MFIs. Actually, to what extent the MFIs are capable to deliver their service to the poor people. Further research could be conducted in this area and for finding the reasons for the gap between demand and supply in terms of micro finance services.

In the course of the research it was clear that the MSMEs did not have outstanding profitability and they indicated various reasons including lack of adequate business knowledge to grow their businesses, some of the other services being offered include capacity building and further studies could be done to establish the need and impact of such other services on the performance of the businesses.

REFERENCES

Adams, D. and Picshke, J. D (1992) "Microenterprise Credit Programs: Déjà vu" World Development, Vol. 20.

Aldrich, H. E. and Auster, E (1986). "Even Dwarfs Started Small: Liability of Age and Size and Their Strategic Implications." In Staw and L.L. Cummings (eds.) Research in Organizational Behavior, Vol. 8, JAI Press.

Ayyagari, M, Thorsten B, and Demirgiic-Kunt A.(2003). "Small and Medium Enterprises across the Globe. A New Database," Policy Research Working Paper 3127, Washington, D.C.: World Bank. 2 US Small Business Administration, March, 2008.

Barr, Michael S. (2005), "Microfinance and Financial Development", The John M. Olin Centre for Law & Economics Working Paper Series, University of Michigan Law School.

Baumol, W. (1967) Business Behaviour, Value and Growth. New York, Harcourt-Brace.

Bokea, D and Dyer, J (2003) The Agricultural Bank of Mongolia: From Insolvent State Bank to Thriving Private Bank.

Brink A, Cant M & Ligthelm A Problems experienced by small businesses in South Africa. A paper for the Small Enterprise Association of Australia and New Zealand 16th Annual Conference, Ballarat, 28 Sept-1 Oct, 2003.

Buckley, G. (1997) "Micro finance in Africa: Is it either a Problem or the Solution?" World Development, Vol. 25 No 7.

Burger, M. (1989) "Giving Women Credit: The Strengths and Limitations of Credit as a tool for Alleviating Poverty" World Development Vol. 17 N07.

Busenitz, L. W; Fiet, J. and Moesel, DD. (2005), "Signalling in the venture capitalist New venture team funding decisions: does it indicate long term venture outcomes?" Entrepreneurship Theory and Practice, Vol. 29.

Central Bank of Kenya: Bank Supervision Report (2008).

Central Bureau of Statistics, International Centre for Economic Growth (ICEG) and Rep-Holdings Ltd; National Micro and Small Enterprise Baseline Survey (1999).

Copestake, J. (2002) Inequality and the Polarizing impact of microcredit: Evidence from Zambias Copperbelt. Journal of International Development, Vol 14.

Deeds, D. L., Decarolis, D., and Coombs, J. E. (1997), "The impact of firm specific capabilities on the amount of capital raised in an initial public offering: Evidence from the biotechnology industry", Journal of Business Venturing, Vol. 12, No 1.

Demirgüç-Kunt A., Beck. T, Honohan P. and World Bank(2008), Finance for all. Policies and Pitfalls in Expanding Access.

Diagne, A and M. Zeller (2001) "Access to Credit and its impacts in Malawi" Research Report No.116 Washington DC, USA: International Food Policy. (IFPRI).

Fadahunsi, O. (1997) "The Challenge of Promoting Entrepreneurship and Small Business: The Common Wealth Experience." In Fadahunsi Olu and Tunji Daodu edts., Small and Medium Enterprises Development: Policies, Programmes and Prospects. West African Management Development Institutes Network (WAMDEVN).

Freeman,J., Carroll G. R. and Hannan, M. T. (1983). "The Liability of Newness: Age Dependence in Organizational Death Rates." American Sociological Review.

Harris, M. and Raviv, A. (1991). "The theory of capital structure". Journal of Finance.

Harvey, M.G. and Lusch, R.F. (1995) "Expanding the nature and scope of due diligence". Journal of Business Venturing, Vol. 10.

Heidhues, F.(1995) "Rural Finance Markets-An Important Tool to Fight Poverty". Quarterly Journal of International Agriculture Vol.34 No.2.

Hospes,O, Musinga,M and Ongoaya,M (2002) an Evaluation of Microfinance Programmes in Kenya as supported through the DUTCH Co-Financing Programme: With a focus on KWFT, Netherlans Co-Financing Programme. International Food Policy Research(IPFR).

Hulme D. and Mosley P. (1996) Finance against Poverty Vol. 1 Routledge, London.

Janney, J. J. and Foita, T. B. (2003) "Signalling through private equity placements and its impact on the valuation of biotechnology firms". Journal of Business venturing, Vol. 18.

Kallon, K.M. (1990) The Economics of Sierra Leonean Entreprenuership. University Press of American, Lanhan,MD.

Kirakowski, J.(1998) Questionnaires in Usability Engineering.

Kothari, S. and Shanken, J. (2003) Time-series coefficient variation in Value-Relevance Regressions: A Discussion of Core, Guay, and Van Buskirk and New Evidence, Journal of Accounting & Economics.

Kuter, U., and Yilmaz, C. (2001) Survey Methods: Questionnaires and Interviews.

Ledgerwood, J. (1999) Microfinance Handbook, Sustainable Banking with the Poor. Institutional and Financial Perspectives: Published in USA, World Bank (IBRD).

Longenecker, J (2006) Small Business Management: An Entrepreneurial Emphasis.

Ministry of Finance and Planning (2001) Poverty reduction strategy paper for the Period 2001–2004. Ministry of Finance and Planning, Government of Kenya.

Modigliani, F. and Miller, M (1963) "Corporate income taxes and the cost of capital: A correction". American Economic Review.

Mosely and Hulme (1998) Impact Assessment Methodologies for Microfinance: Theory, Experience and Better Practice.

Müller-Falcke, D.. 2001. Adoption of Information and Communication Technologies by Small-scale Enterprises in Developing Countries. International Small Business Series No. 27.

Mugenda (2003) Research Methods: Quantitative and Qualitative Approaches, Africa Centre for Technology Studies (ACTS), (1999, Revised 2003).

Myers, S.C.(1977) "Determinants of corporate borrowing". Journal of Financial Economics, Vol 5.

Myers, S.C. (1984) "The capital structure puzzle". Journal of Finance, Vol 39.

Myers, S.C. (2001) "Capital structure". Journal of Economic Perspectives, Vol 15.

Myers, S.C. and Majluf N.S.(1984). Corporate financing and investment decisions when firms have information that investors do not have. Journal of Financial Economics Vol 13.

Nappon, D. and Huddlestone B. (1993). Rural infrastructure priorities for food security and sustainable development: The case of Central Africa.

Nissanke M. and Aryeetey E. (1995) Financial integration and development in sub-Saharan Africa. Report prepared for the African Technology Department, AFTPS,Washington, D.C.: The World Bank.

Oketch, H., Abaga, A. and Kulundu, D. (1995) The demand and supply of micro and small enterprise finance in Kenya. KREP, Nairobi.

Population of Local Authorities (with towns), Government of Kenya, 1999.

Prasad, D., Bruton, G. D., and Vozikis, G. (2000) Signalling value to business angels: The proportion of the entrepreneur's net worth invested in a new venture as a decision signal, Venture capital, Vol. 2, No.3.

Robinson, M. (2003). The microfinance revolution: Sustainable finance for the poor. Vol. 1. Washington D.C.: World Bank.

Robinson M. S (1998): The Paradigm Shift From credit Delivery to Sustainable Financial Intermediation, In Mwangi S Kimenyi, Robert C Wieland and J D Von Pischke (eds), 1998, Strategic Issues in Microfinance. Ashgate Publishing: Aldershot.

Roth J. (1997) The Limits of Micro Credit as a Rural Development Intervention: Prepared for the Institute for Development Policy and Management-Manchester University.

Sacerdoti, E. (2005) Access to Bank Credit in Sub-Saharan Africa: Key Issues and Reform Strategies. International Monetary fund (IMF) Working Paper WP /05/166, August.

Saunders, M.L.P. & Thornhill, A (2009) Research method for business students. Pearson education limited Harlow England.

Schiffer, M and Weder, B (2001) Firm Size and the Business Environment: Worldwide Survey Results.

Singh, J. V., Tucker, David J. and House, Robert J. (1986). Organizational Legitimacy and the Liability of Newness. Administrative Science Quarterly, Vol 3.

Stiglitz J. (1990) Peer monitoring and Credit Markets. The World Bank economic Review Vol. 4.

Stinchcomb, A.L. (1965). Social Structure and Organizations. In J.G. March (Ed.). Handbook of Organizations.

Strong, M (2008) Beyond Microfinance: Entrepreneurial Solutions to Poverty Alleviation

Todd, H (1996). Women at the Center: Grameen Bank Borrowers after One Decade. New York: Westview Press.

Trochim, W.M. (2005) Research Methods Knowledge Base – Survey Research.

UNDP, Human Development Report 2009.

Von, Pischke, J. D. (1991) Finance at the Frontier: Debt Capacity and the Role of Credit in the Private Economy. World Bank Economic Development Institute. Washington DC.

Zeller, M., Meyer, Richard L.(2002), "The Triangle of Microfinance – Financial Sustainability, Outreach, and Impact", Published for the International Food Policy Research Institute, The Johns Hopkins University Press, Baltimore and London.

Zeller, M. and Sharma M. (1998), "Rural Finance and Poverty alleviation" Washington, DC. USA: International Food Policy Research Institute (IFPRI).

Sacerdoti, E. (2005) Access to Bank Credit in Sub-Saharan Africa: Key Issues and Reform Strategies. International Monetary fund (IMF) Working Paper WP /05/166, August.

Saunders, M.L.P. & Thornhill, A (2009) Research method for business students. Pearson education limited Harlow England.

Schiffer, M and Weder, B (2001) Firm Size and the Business Environment: Worldwide Survey Results.

Singh, J. V., Tucker, David J. and House, Robert J. (1986). Organizational Legitimacy and the Liability of Newness. Administrative Science Quarterly, Vol 3.

Stiglitz J. (1990) Peer monitoring and Credit Markets. The World Bank economic Review Vol. 4.

Stinchcomb, A.L. (1965). Social Structure and Organizations. In J.G. March (Ed.). Handbook of Organizations.

Strong, M (2008) Beyond Microfinance: Entrepreneurial Solutions to Poverty Alleviation

Todd, H (1996). Women at the Center: Grameen Bank Borrowers after One Decade. New York: Westview Press.

Trochim, W.M. (2005) Research Methods Knowledge Base – Survey Research.

UNDP, Human Development Report 2009.

Von, Pischke, J. D. (1991) Finance at the Frontier: Debt Capacity and the Role of Credit in the Private Economy. World Bank Economic Development Institute. Washington DC.

Zeller, M., Meyer, Richard L.(2002), "The Triangle of Microfinance – Financial Sustainability, Outreach, and Impact", Published for the International Food Policy Research Institute, The Johns Hopkins University Press, Baltimore and London.

Zeller, M. and Sharma M. (1998), "Rural Finance and Poverty alleviation" Washington, DC. USA: International Food Policy Research Institute (IFPRI).

APPENDIX I: RETAIL MFIS REGISTERED WITH AMFI

1. AAR Credit Services
2. ADOK TIMO
3. Agakhan Foundation Microcredit Programme
4. Biashara Factors
5. BIMAS
6. Blue Limited
7. Canyon Rural Credit Ltd
8. ECLOF - Kenya
9. Faulu Kenya DTM Ltd
10. Fusion Capital Ltd
11. Greenland Fedha Ltd
12. Jamii Bora
13. Jitegemea Credit Scheme
14. Juhudi Kilimo
15. KADET
16. Kenya Entrepreneur Empowerment Foundation (KEEF)
17. Kenya Women Finance Trust DTM Ltd
18. K-rep Development Agency
19. Micro Africa Ltd
20. Molyn Credit Ltd
21. One Africa Capital Ltd
22. Opportunity Kenya

23. Orion East Africa Ltd
24. Pamoja Women Development Programme
25. Remu Ltd
26. Renewable Energy Technology Assistance Prog.(RETAP)
27. Rupia Ltd
28. Select Management Services Ltd
29. SISDO
30. SMEP
31. Taifa Options Microfinance
32. U&I Microfinance Ltd
33. Yehu Enterprises Support Services
34. Youth Initiatives – Kenya (YIKE)

APPENDIX II: MICRO, SMALL AND MEDIUM SIZE ENTERPRISES SAMPLED

1. Agriput Enterprises
2. Auto Fancy Emporium
3. Bachu School Supplies
4. Batana Wholesalers
5. Beekay Suppliers Ltd
6. Boma Drycleaners Ltd
7. Business Initiatives & Management Assistance Services (BIMAS)
8. Capital Hill Pharmacy
9. City Centre Bookshop
10. Economic Credit Traders Ltd
11. Embu Farmers Sacco Society Ltd
12. Embu Highway Transporters Ltd
13. Famous Bookshop
14. Gandhi Brothers
15. Highway Court Hotel
16. Izaak Walton Inn
17. J Maina Electrical Appliances
18. Jaribu Credit Traders Ltd
19. Joint Tyres Distributors Ltd
20. Kindaruma Ltd
21. Kinswa Specialised Services Ltd
22. Minni Inn Ltd
23. Mt Kenya Business Machines Ltd

24. Mugo Holdings Ltd
25. Njoka Tanners Ltd
26. Owoods Hotel
27. Peterson Commercial Stationers
28. Prime Lodge Embu
29. Skyline Security Ltd
30. Sparko General Store
31. Tebere Provision Store Ltd

APPENDIX III: DATA COLLECTION SHEET

Name of Organisation: ……………………………………………………………..………….

Year Established: ………………………………………………………………………..

Gender of Owner: ……………………………………………………..…………..

Age of Owner: ……………………………………………………..…………..

Type of Business: ……………………………………………………..…………..

	2006	2007	2008	2009	2010
Loan borrowed from MFI					
Total Borrowings					
Total Equity					
Total Assets					
Turnover					
Operating expenses					
Number of staff					

APPENDIX III: LETTER OF INTRODUCTION

UNIVERSITY OF NAIROBI
SCHOOL OF BUSINESS
MBA PROGRAMME

Telephone: 020-2059162
Telegrams: "Varsity", Nairobi
Telex: 22095 Varsity

P.O. Box 30197
Nairobi, Kenya

DATE......28 SEPTEMBER 2011.....

TO WHOM IT MAY CONCERN

The bearer of this letter.......PERIS PHYLLIS WAGIO WARUI..........

Registration No.......D61/75295/2009...................

is a bona fide continuing student in the Master of Business Administration (MBA) degree program in this University.

He/she is required to submit as part of his/her coursework assessment a research project report on a management problem. We would like the students to do their projects on real problems affecting firms in Kenya. We would, therefore, appreciate your assistance to enable him/her collect data in your organization.

The results of the report will be used solely for academic purposes and a copy of the same will be availed to the interviewed organizations on request.

Thank you.

JUSTINE MAGUTU
ASSISTANT REGISTRAR
MBA OFFICE, AMBANK HOUSE