

**IMPACT OF MICROFINANCE SERVICES ON FINANCIAL PERFORMANCE OF
SMALL AND MICRO ENTERPRISES IN KENYA**

BY

MARY WANJIKU MBUGUA

D61/71634/2008


**A MANAGEMENT RESEARCH PROJECT SUBMITTED TO THE SCHOOL OF
BUSINESS IN PARTIAL FULFILMENT OF THE REQUIREMENTS FOR THE
DEGREE OF MASTER OF BUSINESS ADMINISTRATION,**

UNIVERSITY OF NAIROBI

NOVEMBER, 2010

DECLARATION

This management research proposal is my original work and has never been presented for degree in any other university.

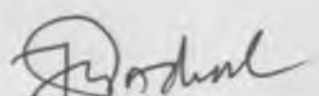
Signed..........

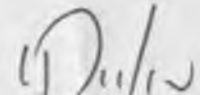
Date.....15/11/10.....

Mary Wanjiku Mbugua

D61/71634/2008

This management research proposal has been submitted with my approval as the university supervisor.

Signed..........

Date..........

Dr. Josiah O. Aduda

Lecturer

Department of Accounting and Finance

University of Nairobi

DEDICATION

This study is dedicated to my loving family, for their support, encouragement and patience during the entire period of my study and continued prayers towards successful completion of this course.

May God bless you all.

ACKNOWLEDGEMENT

This study has been made possible by a number of people and institutions to whom I am heavily indebted to and to whom I would like to express a lot of gratitude to. The list may be too long to complete. However, I would not forget to mention a few of the many who gave their input in the process of the study.

I would also like to express my sincere thanks to my supervisor Dr Josiah O. Aduda for having agreed to supervise this research paper, his patience in reading the drafts and occasionally guiding me, without which the research would not have been a reality.

I wish to thank my MBA colleagues and the academic staff of school of business, University of Nairobi who contributed to the success of this project. Special thanks the entire panellist who participated in my project proposal presentation, for their constructive criticisms, guidance and advice on areas that required to be improved on.

All Microfinance institutions and the small and micro enterprises who participated in my research for providing time and engagement, without their help this research project could not have been successfully written. Special thanks to Fednard Maliech who occasionally assisted in by introducing me to the SMEs customers.

I wish to extend my very special thanks to my loving family for their moral support, encouragement during the period of the study. To my friends you are all special in my heart and i am proud to have known you, the moral support and encouragement that you gave me was overwhelming.

Finally, i must also extend gratitude to my employer Chancery Wright Insurance Brokers for all the support i got throughout the period. All other people who contributed in the project in one way or another; I thank you all.

ABSTRACT

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

The purpose of the study was to establish the impact of microfinance services on financial performance of SMEs in Kenya. Survey method was employed in this study. The study population consisted of all SMEs in Nairobi. The study adopted systematic random sampling method with an interval of 50 SMEs. The sample size was 47 SMEs. The researcher used primary and secondary data. Primary data was collected through the use of semi-structures and structured questionnaires. Quantitative data was analyzed using descriptive and inferential statistics.

The study found that all SMEs borrow investment capital and they use it for the purpose in which they were borrowed, most of them do not have other source of financing other than from micro-finance institutions and they did not have other form of financing before they started receiving financing from microfinance institutions.. Based on the findings, the study concludes that SMEs got savings services, credit services and training services from SMEs. The SMEs mostly borrow investment capital and use the loan(s) for the purpose which they were taken. The study revealed that most of the SMEs do not have other source of financing other than that from micro-finance institutions. The study finally concludes that ROA increased with each consecutive loan showing that microfinance services enhance financial performance of SMEs in Kenya.

From the study findings, the study recommends that in order to enhance the impact of microfinance services on financial performance of SMEs in Kenya, the MFIS should train the borrowers on entrepreneurial skills so as to enhance their competence. The MFIs should also consider the performance of the business before allocating money to the business owners.

TABLE OF CONTENT

DECLARATION	ii
DEDICATION	iii
ACKNOWLEDGEMENT	iv
ABSTRACT	v
LIST OF FIGURES	viii
LIST OF TABLES	ix
ABBREVIATIONS	x
CHAPTER ONE	1
INTRODUCTION	1
1.1 Background to the study	1
1.2 Statement of the Problem	8
1.3 Objectives of the Study	9
1.4 Importance of the Study	9
CHAPTER TWO	11
LITERATURE REVIEW	11
2.1 Introduction	11
2.1.1 Characteristics of Microfinance institutions	11
2.2 Microfinance models	12
2.3 Empirical Evidence	18
2.4 Conclusion	23
CHAPTER THREE	25
RESEARCH METHODOLOGY	25
3.1 Introduction	25
3.2 Research Design	25
3.3 Population	26
3.4 Statistical sampling	26

3.5 Study Setting	26
3.6 Data collection.....	26
3.7 Data Analysis	27
3.7.1 Measurement of Variables.....	27
3.8 Data Reliability and Validity	27
CHAPTER FOUR.....	29
DATA ANALYSIS AND INTERPRETATIONS	29
4.1 Introduction	29
4.2 General Information	29
4.3 Impact of MFIs on SMEs.....	31
CHAPTER FIVE	45
SUMMARY, CONCLUSIONS AND RECOMMENDATIONS	45
5.1 Summary	45
5.3 Conclusion	46
5.4 Policy Recommendations.....	47
5.5 Limitations of the Study	48
5.6 Suggestions for further study	49
REFERENCES	50
APPENDICES.....	53
Appendix I: Letter of Introduction	53
Appendix II: Questionnaire	54
Appendix III: List of Registered MFIs In Kenya.....	57

LIST OF FIGURES

Figure 1: Level of education	30
Figure 2: MFIs services to SMEs	31
Figure 3: SMEs other sources of financing	32
Figure 4: Previous sources of finance before receiving from MFIs	33
Figure 5: Respondents use the loan(s)	34
Figure 6: Sales trend after receiving microfinance services	36
Figure 7: Profit trend after receiving microfinance services.....	37
Figure 8: Trend of working capital after receiving microfinance services	37
Figure 9: Trend of the Space occupied by businesses after receiving Mfl services.....	38
Figure 10: Trend of retained earnings after receiving MFI services	39
Figure 11: Trends of the assets after receiving MFI services.....	39
Figure 12: Trend of liability after receiving MFI services.....	40
Figure 13: Trend of capital after receiving microfinance services	40
Figure 14: Trend of ROA after receiving microfinance services	41

LIST OF TABLES

Table 1: Level of education.....	30
Table 2: Services tha SMEs get from microfinance institutions	31
Table 3: SMEs other sources of financing	32
Table 4: SMEs other form of financing before they started receiving finance from MFIs	33
Table 5: Respondents use the loan(s)	33
Table 6: Description of organization/ business before respondents started receiving microfinance services.....	34
Table 7: Description of organization/ business after respondent started receiving microfinance services.....	35

ABBREVIATIONS

CGAP	Consultative Group to Assist the Poor
GDP	Gross Domestic product
GOK	Government of Kenya
MFIs	Microfinance Institutions
ROA	Return on assets
SEDOM	Small Enterprises Development Organization of Malawi
SMEs	Small and Medium Enterprises

CHAPTER ONE

INTRODUCTION

1.1 Background to the study

Robinson (1998) defines microfinance 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 SMEs do not have access to other sources of financial assistance.

The term microfinance can also be defined as the provision of financial services to low income clients, including the self employed. Financial services generally include savings and credit; however, some finance organizations also provide insurance and payment services. In addition to financial intermediation, many MFIs provide social intermediation services such as group formation, development of self confidence and training in financial literacy and management capabilities among members of a group. Thus the definition of microfinance often includes both financial and social intermediation (Ledgerwood, 1999).

Microfinance is not simply banking, it is a development tool. Microfinance activities include: - Small loans generally for working capital, informal approval of borrowers and investments, collateral substitutes, such as a group guarantee or compulsory savings, access to repeat and large loans based on repayment performance, streamlined loan disbursements and monitoring and secure saving products (Ngehnevu and Nembo, 2010).

The services provided to microfinance clients can be categorized into four different categories these are:- financial intermediation or provision of financial products and services such as savings, credit, insurance, credit cards and payment system should not require ongoing subsidies. Social intermediation which is the process of building human and social capital needed by sustainable financial intermediation for the poor. Subsidies should be eliminated but social intermediation may require subsidies for a longer period than intermediation. Enterprise development services or non financial services that assist micro entrepreneurs include skills development, business training, marketing and technology. This will not require subsidy but will depend on the ability and willingness of the client to pay. Social services or non financial services that focus on advancing the welfare of micro entrepreneurs and this include education, health, nutrition, and literacy training. These services require ongoing subsidies and are always provides by NGOs or the state (Ngehnevu and Nembo, 2010).

There are different providers of microfinance services and some of them are; nongovernmental organizations (NGOs), savings and loan cooperatives, credit unions, government banks, commercial banks and non bank financial institutions. The target group of MFIs are self employed low income entrepreneurs who are; traders, street vendors, small farmers, hairdressers, artisans, blacksmith (Ledgerwood, 1999).

MFIs have the following characteristics: - Loans are usually relatively short, less than 12 months in most instances, and are generally for working capital with immediate regular weekly or monthly repayments. They are also disbursed quickly after approval, particularly for those seeking repeat loan. The traditional lenders requirements for physical collateral such as property are usually replaced by a system of collective guarantee where members are mutually responsible for ensuring that their individual loans are repaid. Loans application and disbursement procedures are

designed to be helpful to low income borrowers. They are simple to understand, locally provided and quickly accessible (Khan, 2008).

Baseline survey of 1999 defines SMEs as those non Primary enterprises (excluding agricultural production, animal husbandry, fishing, hunting, gathering and forestry), whether in the formal or informal sector which employ 1-50 people. Micro enterprises are those that employ 10 or fewer workers, while smallscale enterprises are those that employ 11-50 workers. According to this survey on a small proportion of SMEs employ 11-50 people

Small enterprises include a variety of firms, village handicraft makers, small machine shops, restaurants and computer software shops firms that possess a wide range of sophistication and skills and operate in very difficult markets and social environments. The owners may or may not be poor, some are dynamic, innovative and growth oriented while others are traditional lifestyle enterprises that are satisfied to remain small (Hallberg, 2000).

Microenterprises are normally family businesses or self employment persons operating in the semi- formal and informal sectors, most have little chance of growing into large scale firms, accessing bank finance or becoming internationally competitive. SMEs account of the majority of firms in developing countries and have a large share of employment, they are labour intensive, they are less efficient and pay low salaries and fringe benefits as compared to large firms and they lack job security because of their high mortality rates (Hallberg, 2000). Most activities characterized as SMEs are very small, majority of them operate in rural areas, they are owned and operated by women and they tend to be concentrated in a relatively narrow range of

activities such as knitting, dressmaking, retail trading etc and they are more likely than those headed by male to operate from home (Mead and Liedholm, 1998).

Financial performance is a subjective measure of how well a firm can use assets from its primary mode of business to generate revenues. The term is also used as a general measure of a firm's overall financial health over a given period of time, and can be used to compare similar firms across the same industry or compare industries or sectors in aggregation. Financial statements provide a picture of financial position and financial performance of a business. The financial statements are cash flow statements, the income statement, and the balance sheet. When taken together, they provide a picture of financial health of the business (Atril and McLaney, 2008).

A cash flow statement is a statement that shows cash movements i.e. cash in and cash out over a particular period. An income statement on the other hand shows the total revenues generated during a particular period and deduct from this the total expenses incurred in generating the revenue. The difference between total revenues and expenses will represent either profit or loss. While a balance sheet sets out the financial position of a business at a particular moment in time. It sets out the assets of a business on one hand and the claims against the business on the other hand (Ormiston, 2007).

Assets are resources held by the business and they must have the following characteristics for them to be treated as assets:- A probable future benefit i.e. the item must be expected to have some future value which can arise through sale or hire, the business must have exclusive right to control the benefit, the benefit must arise from a past event or transaction and it must be capable of measurement in monetary terms. Asset can further be classified into either current or fixed assets. Current assets are

those that are held for the short term while fixed assets are assets held for long term operations (Pendril, 2004).

A claim is an obligation on the part of the business to provide cash, or some other form of benefit, to an outside party. It normally arises as a result of an outside party providing funds in form of assets for use by the business. There are two types of claims equity and liability. Equity represents the claim of the owner(s) against the business while liability represents claims of all individuals and organizations other than owners. Liabilities are classified into either current or long term liabilities. Current liabilities are amounts due for settlement in the short term while long term liabilities are amount due for settlement in the long term (Foster, 2004).

The most common measure of financial performance is ratios. A ratio is simply a mathematical expression of an amount or amounts in terms of another or others. A ratio can be expressed as a percentage, as a fraction, or a stated comparison between two amounts. The computation of a ratio does not add any information not already existing in the amount or amounts under study. A useful ratio may be computed only when a significant relationship exists between two amounts (Wahid, 1994).

The most commonly used ratios are liquidity ratios, profitability ratios and investment ratios. Liquidity refers to an enterprise ability to meet its short term obligations as and when they fall due. They are used to assess the adequacy of a firm's working capital. The three basic measures are net working capital, current ration and quick or acid test ratios. Net working capital represents current assets that are financed from long term capital resources that do not require repayment in the short term, implying that the portion is still available for repayment of short term debt. Current ratio measures the debt paying ability of an enterprise. A high current ratio is assumed to indicate a

strong liquidity position while a low current ratio is assumed to indicate weak liquidity position. Quick ratio on the other hand tests the debt paying ability of an enterprise without having to rely on inventory and prepayments. The rule of thumb is for every shilling of current liability owed, the enterprise should have a shilling of quick assets available (Ormiston, 2007).

Profitability ratios evaluate the firm's earnings with respect to a given level of sales, a certain level of assets, the owner's investment or share value. Evaluating the future profitability potential of the firm is crucial since in the long run, the firm has to operate profitably in order to survive. The ratio is of importance to creditors, shareholders, suppliers, employees and other stakeholders. The ratios include gross profit margin, net profit margin, return on assets and return on equity. Investment ratios on the other hand help equity shareholders and other investors to assess the value of an investment in the ordinary shares of a company. The value of an investment in the ordinary shares in a listed company is its market value, and so the investment value must have not only the information in the company published accounts, but also to the current price. The ratios are earnings per share, dividend payout ratio, dividend yield and price earnings ratio (Foster, 2004).

Serving SMEs require distinct institutions and instruments, such as group based lending methodologies used by some microfinance institutions. Microfinance has grown out of the realization that people on low incomes are often excluded from access to financial services and the more an individual or a community is marginalized from financial services, the more likely it is that they will be socially excluded and this will lead to their overall civic marginalization. People in poverty can and do save and do not necessarily represent higher credit risk. Small savings and

loans can significantly contribute to the economic well-being of individuals and households (Richard, 2004).

The provision of financial services involves a number of specific products which include; soft loans which are interest free, interest bearing loans which could be low interest or above market rate but with no collateral, deposit savings account, rotating saving and credit associations , distress fund, financial counseling, debt management and advocacy and financial training. These products are not mutually exclusive. They are often used in conjunction with each other. Further there are a variety of different structures or institutional settings with which microfinance are associated. There are three major structures in which microfinance activities have developed. Within social and human services, and community organizations who are concerned with the economic, financial and social exclusion of their constituents. Within the banking sector in contexts associated with what is now termed as social banking while within various movements it is concerned with the revitalization of credit unions, friendly societies and mutual organizations (Guene and Mayo 2001).

People living in poverty, like everyone else need a diverse range of financial instruments to run their businesses, build assets, stabilize consumption, and shield themselves against risks. Financial services required by lower income people are working capital loans, consumer credit, and savings, pensions, insurance, and money transfer services. In recent years there has been a flourishing of microfinance institutions around the globe, particularly after United Nations caused the international year of Microcredit, 2005 In many ways microfinance has become an umbrella term which now covers notions of microcredit, micro-banking, micro-insurance and microenterprise, which represent less integrated approaches with similar intent, that is providing access to various financial services for people who

otherwise have little access to these activities through mainstream financial institutions (Burkett 2003).

1.2 Statement of the Problem

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

Various studies have been done on microfinance institutions, and despite the apparent benefits of microfinance inevitable controversy exists. The proponents of minimalist model argue that provision of training components can often be extremely costly. They argue that they do not know what is best for borrowers but the borrower may decide for themselves. They also argue that training is not essential to borrowers' eligibility or repayment performance on a loan. The proponents of integrated model on the other hand argue that microfinance programmes are designed to incorporate elements of social intermediation such as technical assistance, group organization, and non formal education activities designed to raise borrower's social and economic awareness and strengthen their leadership abilities. They argue that borrowers who would like to expand their enterprises or enter newer more dynamic fields face many constraints in addition to lack of capital. It is argued therefore, that credit is necessary

but not sufficient condition for them to enhance their business performance. Additional support such as training and technical assistance is needed to enhance their enterprises productivity (Khan, 2008)

However there are studies that show the positive effects of microfinance services e.g. Kuzilwa (2005) did a study on the role of credit for small business success. Ryan (1993) conducted a study on ex-post facto evaluation of one financial source of small businesses. small enterprises development organization Malawi. Mwindi (2002) did a study to establish the relationship between interest rates charged by MFIs to SMEs and performance of these SMEs in Kenya. Maghanga (2007) did a study on the perception of MFI loan borrowers on the effects of loans on their business and as a poverty alleviation tool.

However all the above mentioned studies focused only at the financial intermediation aspect of microfinance programmes, while microfinance programmes include also social intermediation such as development of self confidence, training in financial literacy and management capabilities. This study addressed this gap by looking at the impact of microfinance services on the financial performance of SMEs in Kenya.

1.3 Objectives of the Study

The objective of the study is to establish the impact of microfinance services on financial performance of SMEs in Kenya

1.4 Importance of the Study

The research will provide information to the MFIs. This will act as a basis upon which they will know the extent to which their services impact on the financial performance of SMEs. MFIs will therefore be in a position to provide the services in a way that will improve the financial performance of SMEs.

The findings of the study will provide information that the government can utilize in analyzing services offered by the micro financial sector to micro enterprises. The government will be able to know how the MFIs are assisting in poverty alleviation. The accessibility of credit and its sustainability by the poor will come into light. It will also help the government in its desire to create and facilitate favourable credit policies for microfinance institutions.

The research will provide valuable information to the academics regarding the micro financial sector. It will contribute to the general body of knowledge and form a basis for further research.

CHAPTER TWO

LITERATURE REVIEW

2.1 Introduction

This chapter contains the literature review, characteristics of MFIs, microfinance models which includes; group lending model, individual lending model, poverty alleviation model, financial sustainability model, minimalist model and integrated model. The chapter also describes the microfinance models, it contains the empirical evidence and a conclusion of the literature review where the research gap is highlighted.

2.1.1 Characteristics of Microfinance institutions

MFIs are concerned with provision of financial services to people who are economically poor and who therefore experience financial exclusion in that they do not have ready access to mainstream, commercial financial services. It is concerned with provision of financial services to poor people using means which are just, fair and sustainable as possible with the underlying goals being that of poverty alleviation (Burkett, 2003).

MFIs have a community and or a social agenda inherent in its purpose, mission and or goals and the provision of various financial services may be a means of achieving this purpose rather than an end in itself. The size of the transactions is relatively small compared to the typical transactions dominant in the mainstream financial services. It includes full range of financial services which poor people need access. It is not limited to provision of credit (Burkett, 2003).

Small and short loans, social collateral rather than financial collateral, access to larger amount of loan if repayment performance is positive, search and access to real poor and their business demand continuous monitoring of business, loan on higher interest rates due to expensive financial transaction and risk factor, easy way to access finance and therefore there is not much paper work and easy and short procedures, offer training services on business development, literacy training to borrowers so that they can come up with competence to daily business problems and solutions, health care, social services, and other skills training services to provide borrower a sustainable base for their business development (Ledgerwood, 1999)

MFIs have changed their operations substantially, resulting in an increased commercial orientation in provision of services/products. This has primarily been through elimination provision of subsidized lending programmes and the introduction and wide acceptance of commercial lending rates (Burkett, 2003).

2.2 Microfinance models

(i) Grameen lending model

The model is based on group peer pressure whereby loans are made to individual groups of four to seven. Group members collectively guarantee loan repayment, and access to subsequent loans is dependent on successful repayment by all group members. Payments are usually made weekly. The groups have proved effective in deterring defaults as evidenced by loan repayment rates attained by organizations such as Grameen Bank, who use this type of microfinance model. The model has also contributed to broader social benefits because of their mutual trust arrangement at the heart of group guarantee system and the group itself often becomes the building block to a broader social network (Ledgerwood, 1999).

(ii) Village Banking Model

In village banking model the group serves as financial intermediary. A group of thirty to forty forms a village bank, which they manage themselves and therefore assume some of the administration cost. The village bank borrows from an external source, usually a support institution and then on lends to individual bank members. Borrowers repay the village bank in regular instalments and at the end of the loan term the village bank repays the support institution. The amounts the village bank can borrow from support institution generally depend on the amount of member savings. Member's deposits form the foundation of banks internal accounts, which serve as security for the loans from the support institution (Ledgerwood, 1999). The village banking can also use its internal account to meet additional demand to credit from members as well as non- members or to finance community development activities. Accumulated savings and income earned by internal accounts may eventually capitalize an autonomous village bank. In this credit technology support institution, usually plays a critical role in helping to form and train the members of the village bank and provide access to external capital (Ledgerwood, 1999).

(iii) Group of Groups lending model

Group of groups is an approach used by Grameen bank (Bangladesh). Its replications and others, relies on social pressure from a wide network to reduce credit risk. As self selected group of five prospective borrowers are linked with four or five other groups from their village to form a centre. Prospective borrowers initially go through several weeks of training or induction, during which time group member begin to make small savings deposits. The weekly savings practice continuous during the client's relationship with the financial institution.

Loans for income generating activities are usually provided to individual's group members on a staggered basis, initially two of the five members. The group and the bank workers must approve their loan application. If this staggered format is used, after the first two members make weekly repayments for two months, two more members of the group are eligible for loans. The final member, usually the group leader, is eligible after they have made repayments for two months. If any member defaults the whole group becomes ineligible to receive subsequent loans. While in most groups of group approaches, members are not liable for the debts of a delinquent member, they often make payments for that member to maintain their own eligibility for future loans. The grouping of groups is designed to increase efficiency of managing very small loans and to increase the more internal account (Mohammed and Mohammed, 2007).

(iv) Minimalist Lending Model

Microfinance programmes provides loans only. The proponents of this model argue that provision of training components can often be extremely costly. The microfinance organizations do not wish to incorporate training assistance or follow up into their programmes because their underlying philosophy is that MFIs do not know what is best for borrowers but rather that borrowers may decide for themselves how best to use their money. Furthermore they argue that training is not essential to borrower eligibility or repayment performance on a loan and tend to see such assistance as superfluous and outside the scope of their expertise (Khan, 2008).

(v) Integrated Lending Model

Microfinance programmes are designed to incorporate elements of social intermediation such as technical assistance, group organization, and non formal

education activities designed to raise borrower's social and economic awareness and strengthen their leadership abilities. Proponents of this model argue that borrowers who would like to expand their enterprises or enter newer more dynamic fields face many constraints in addition to lack of capital. Thus, microentrepreneurs may face lack of access to markets, low technology levels, be literate or semi illiterate, and may lack training in business and related skills.

It is argued therefore, that credit is necessary but not sufficient condition for them to enhance their business performance. Additional support such as training and technical assistance is needed to enhance their enterprises productivity. The addition of training components have been justified as a means of guaranteeing effective use of credit and improvements in productivity and income for borrowers, as well as necessary to overcome a variety of non financial barriers that borrowers may encounter (Khan, 2008)

(vi) Individual lending Model

This is the simplest and the oldest credit lending model where small loans are given straight to the borrower. In most cases such loans are accompanied by socio-economic services like education and skill development. Individual loans are given based on a combination of personal guarantors, group savings accounts as well as co-signers and community recommendations to ensure repayment. The model is used when it may be difficult to promote group lending in regions where social ties are not necessarily high and also many entrepreneurs are individualistic, and may not be willing to work in groups and they may compete with each other and be unwilling to share confidential information with potential competitors (Khan 2008).

(vii) Women Empowerment Theory

Financial self sustainability paradigm. The main consideration in programme design is provision of financially self- sustainable microfinance services to large numbers of people, particularly micro and small – entrepreneurs. The focus is on setting of interest rates right to cover costs, to separate micro-finance from other interventions to enable separate accounting, to expand programmes so as to capture economies of scale, to use group to decrease cost of delivery. Gender lobbies argue that targeting women on grounds of high female repayment rates and contribution of women's economic activity to economic growth. In this paradigm it is assumed that increasing women access to microfinance services will in itself lead to individual economic empowerment, well-being and social and political empowerment.

Poverty alleviation paradigm. The main considerations are poverty reduction among the poorest, increased well-being and community development. The focus is on small savings and loans provision for consumption and production, group formation etc. This paradigm justifies some level of subsidy for programmes working with particular clients group or in particular context. Some programmes have developed effective methodologies for poverty targeting and or operating in remote areas. Gender lobbies in this context have argued for that targeting woman, because of higher level of female poverty and because of women's responsibility for household's well-being. Poverty alleviation and women empowerment are seen as two sides of the same coin. The assumption is that increasing women's access to microfinance will in itself increase household income which will then translate into improved well-being and enable women to bring about wider change in gender inequality.

Feminist empowerment paradigm; the underlying concern is gender equality and women's human rights. Microfinance is promoted as an entry point in the context of a wider strategy for women's economic and social political empowerment. The focus here is on gender awareness and feminist organization (Khan, (2008)

(viii) Financial Sustainability Theory

Long-term survival and sustainability is critical for an MFI in being able to reach its target clientele and cover administrative and other costs. While social goals of reaching the poorest and poverty alleviation are valid, sustainable standing on one's own feet is as true for low income households receiving microfinance, as for the microfinance itself. Sustainability for microfinance has internal and external implications. Internal in terms of deposit and savings mobilization, financial performance, staff motivation, loan administrative costs etc while external in terms of availability of funds for loan disbursement, grant for community organizing etc (Morduch, 2002)

(vix) Poverty Alleviation Theory

The pressing need for rural economy is to create jobs for a large unemployed and underemployed labour force. It is customarily argued that jobs can be created either by generating wage employment or by promoting self employment in nonfarm activities. Creation of employment requires investment in small working capital, unfortunately income from other sources is so low that they cannot generate investible surplus on their own. Thus obtaining credit becomes the only option available. Credit under certain circumstances can help the poor accumulate their own capital and thus improve their living standard through the income generated from the investments (Wahid, 1994).

2.3 Empirical Evidence

A number of studies have been conducted on microfinance services. Copstake et al (2000) did a study on the impact of microcredit on poverty in Zambia. The programme was not directed towards the poorest business operators but one third of the clients were below national poverty line. Those who graduated from their first to a second loan on average experienced significantly higher growth in their profits and household income, as compared with otherwise similar business operators. The borrowers also diversified their business activities more rapidly. However some borrowers were worse off particularly among the 50% or so who left the programme after receiving only one loan

Alarape (2007) conducted a study to examine the impact of owners/managers of small business participating in entrepreneurship programs on operational efficiency and growth of small businesses in Nigeria. The study was a cross – sectional analysis of the impact of exposure of owner manager of small businesses on their performance i.e. operational efficiency and growth rate. The data was collected from primary and secondary sources. Both descriptive and inferential statistics was employed for the analysis.

The findings were that small businesses whose owner managers had experience of participating in entrepreneurship programs exhibited superior managerial practice, had higher gross margin rate of growth than small businesses whose owner manager did not have super experimental learning. This had a practical implication that there is need to improve managerial practice of small businesses through exposure of owner/manager to entrepreneurship programs in order to enhance their performance and their transition to medium and large businesses.

Kuzilwa (2005) did a study on the role of credit for small business success: A study of the national entrepreneurship development fund in Tanzania. The objective of the study was to examine the role of credit in generating entrepreneurial activities. The study was a sample survey of businesses that gained access to credit from Tanzanian government financial source that had been approved by parliament to provide loans to SMEs. The government loaned out initial capital which was supposed to be loaned out to the initial borrowers and recovered with interest so that new businesses would borrow. All potential borrowers were supposed to go through special training as one of the preconditions for receiving credit. 7610 applications were received with only 20% being funded of the successful applicants 81% are in urban areas whereas 19% being from rural areas.

The study population was 250 clients and a cluster sampling was used to decide on the sample size of each design. 216 responded. The findings were that 87% of the businesses were started from funds other than loans from financial institutions, with majority using their savings. However, the large percentage of own funded start-up in the case of NEDF clients could also be as a result of policy fund, which targets ongoing business rather than funding start-ups. 72% of the sample attended the training before receiving the loans while 28% did not attend but were given loans.

All the respondents who attended the training found it to be very useful and said they would have attended it even if it was not a precondition to the loan. 74% of the respondent owned only one business. This indicates that majority of the operators are small and have not grown horizontally. All entrepreneurs used the loan for the intended purpose. Majority used the credit to fund business start-up and some investments were undertaken by existing firms. However success indicators were increase in demand for products , change in investment level, some entrepreneurs

invested part of the credit by expanding business space, creation of employment where the entrepreneur created own employment that paid more than other alternatives and increase in profit.

Ryan (1993) conducted a study on ex-post facto evaluation of one financial source of small businesses, SEDOM (Small Enterprises Development Organization of Malawi) in Malawi. A survey was undertaken on 50 firms that had received term loan from SEDOM. An assessment on the impact was done, by looking at whether or not the enterprises achieved the stated objectives of the scheme such as employment generation, technology employed and backward/forward linkages. The results showed that the scheme on the whole created 1873 jobs. It also showed significant backward linkages to agriculture sector were created as a result of loans received by manufacturing firms.

Mokogi (2003) did a study on implications of lending of microfinance institutions on micro and small enterprises in Kenya. The objective of the study was to determine the effect of MFI credit schemes on the performance of SMEs and to determine the rate of graduation of SMEs from borrowing from MFIs to borrowing from commercial banks. The study was a survey of all MFIs that provided credit to SMEs in Kenya and all the SMEs in Nairobi that had been financed by the MFIs over the years. A random sampling was used to ensure that all the MFIs had equal chance of being selected. Primary and secondary data was used. The primary data was obtained from MFIs and SMEs while the secondary data was obtained from relevant literature and records available in libraries, government offices and relevant offices of the MFIs and the SMEs. The response rate was 72% while 28% did not respond.

The findings were that SMEs financed by MFIs are micro enterprises mainly located in slum areas of Nairobi and other towns. The loans borrowed are used to boost working capital, purchasing fixed assets, personal consumption and other needs. The entrepreneurs have experienced tremendous growth in their businesses, increased fixed assets, increased net income, increased savings, number of employees and the space occupied by the business. The study also established that the more the number of loans taken the bigger the period of participation in the credit programs the higher the growth experienced by the SMEs.

Inziani (2006) did a study on informal finance as a source of funds for small and micro enterprises, a case study from Dandora slums in Nairobi Kenya. The objective of the study was to determine the level of startup capital for SMEs in Dandora, to determine the proportions of funds for start-up and expansion of SMEs that are sourced from informal markets, to determine whether the funds are fully utilized in the business and to identify the challenges faced by SMEs in Dandora slums in sourcing for funds. The study was a survey of all the small and micro enterprises operating in Dandora slums. Primary data was used and it was analyzed using descriptive statistics i.e. mean, percentages and frequencies. The findings were that informal financial markets are the main source of funds for SMEs, they represented 40% of sources of fund. The SMEs utilized the loans fully in the business. The study confirmed the results of baseline survey of SMEs in 1999 regarding their activities in businesses and also confirmed that the mortality rate among them were less than three years. (GOK Sessional Paper Number 2 of 2005). 60% of the businesses needed less than 10,000/= as capital with only 6% requiring over 100,000/= for start-up. It is clear from these findings that SMEs are small in size and in the nature of operations.

Maghanga (2007) did a study on the perception of microfinance loans borrowers on the effects of loans on their business and as a poverty alleviation tool, a case study of borrowers in Nairobi. The objective of the study was to establish the perceived effects of the microfinance loans by the recipient on their business, the perceived effectiveness of microfinance loans by the recipients as a poverty alleviation tool and how microfinance loan recipients perceive the effect of interest charges on their businesses.

The study was a survey of all SMEs in Nairobi who had been in any MFI credit scheme for at least four years. The sample size was 100 loan borrowers who had been in any MFI for a minimum of four years. He used primary and secondary data. The primary data was collected through semi-structured questionnaires using the drop and pick method in addition to attending group meetings and requesting those who met the research criteria to fill the questionnaire. Secondary data was used and it was obtained from relevant literature and respective MFIs offices. The findings of the study were that though the loans were perceived to have improved the businesses, the state of the business before entry into an MFI credit scheme was not bad. This is because they had the startup capital and they also felt they were not poor. The interest rate charged by MFI loans was perceived to have very little effect on the performance

Mwindi (2002) did a study to establish the relationship between the interest rates charged by microfinance institutions and the performance of micro and small enterprises in Nairobi. The study was a survey of all SMEs operating in Nairobi. Primary and secondary data was used. The primary data was collected through the use of a questionnaire which was administered to the SMEs entrepreneurs while the secondary data was obtained from relevant literature and records available. The study found that the interest rates charged by MFIs were high but they did not lower the

profits made by SMEs. It showed that there is a positive relationship between the interest rates and the profit by SMEs.

Mushumiyamana (2008) did a study to analyse the relationship between access to finance and business performance. The study sought to identify the constraints faced by women owned small businesses in accessing credit. The study was a survey of women who owned business in the Nairobi. Semi structured questionnaire was administered to women owned SMEs using a drop and pick method. The study showed that women were able to hire more employees and increase turnover.

2.4 Conclusion

Microfinance institutions have placed heavy importance on the lending methodologies in their success. However, group lending model has been the widely adopted by many MFIs throughout the world because of reasons such as the ability of borrowers to monitor the investment behaviour of one another during the course of a loan, making sure that each borrower only undertakes safe investment projects with the loan monies. Social cohesion that exists in some communities means that the sanctions that a borrower would receive from the group for defaulting results in each member wanting to repay faithfully, and the pressure between borrowers to repay means the group can expel non-paying members if they default, thus excluding them from continued access to credit.

Several studies have been conducted on credit from MFIs as a source of fund for SMEs outside Kenya and locally. For example Kuzilwa (2005) did a study on the role of credit for small business success: A study of the national entrepreneurship development fund in Tanzania. Ryan (1993) conducted a study on ex-post evaluation of one financial source of small businesses in Malawi. Alarape (2007) did a study to

examine the impact of owners/managers of small business participating in entrepreneurship programs on operational efficiency and growth of small businesses in Nigeria. Mokogi (2003), Inziani (2006) and Maghanga conducted local studies. Mokogi (2003) did a study on implications of lending of microfinance institutions on micro and small enterprises in Kenya, Inziani (2006) did a study on informal finance as a source of fund for small and micro enterprises, a case study from Dandora slums in Kenya while Maghanga (2007) did a study on the perception of microfinance loans borrowers on the effects of loans on their business and as a poverty alleviation tool, a case study of borrowers in Nairobi. However no study has been conducted locally on the effects of microfinance services on growth and development of SMEs in Kenya.

The studies that have been done only focused on credit offered by microfinance. The study differs from the local studies that have been conducted since they focus only on credit offered by MFIs and its impact on SMEs. However MFIs offer other services such as deposit savings account, rotating saving and credit associations, distress fund, financial counseling, debt management and advocacy and financial training. There is also no study that has covered the impact of the MFIs services financial performance of SMEs.

CHAPTER THREE

RESEARCH METHODOLOGY

3.1 Introduction

This chapter outlines the research methodology that will be used. This includes the target the research design, population, the sample size, data collection method data analysis, data reliability and the validity tests.

3.2 Research Design

Survey method was employed in this study. "A survey is an attempt to collect data from members of a population in order to determine the current status of that population with respect to one or more variables" A survey research is therefore a self-report study which requires collection of quantifiable information from the sample. A survey could be descriptive, exploratory or involving advanced statistical analysis (Mugenda and Mugenda, 2003).The method was important for getting information from SMEs regarding the effects of MFI services on the financial performance of SMEs.

There are several studies that have used the survey method for example; Ryan (1993) used the survey method to conduct an ex-post facto evaluation of one financial source of small businesses in Malawi, he surveyed 50 firms that had received loans from MFIs. Mwindi (2002) used the survey method to study SMEs operating in Nairobi that have been financed by MFIs. Kuziliwa (2005) used a sample survey of businesses that gained access to credit from Tanzanian government financial source that had been approved by the parliament to provide loans to SMEs. Inziani (2006) used a survey method to study SMEs operating in Dandora slums of Nairobi Kenya. Maghanga

(2007) used a survey to study the perception of MFIs loan borrowers on the effects of loans on their business and as a poverty alleviation tool, the study population was borrowers in Nairobi.

3.3 Population

Population refers to an entire group of individuals, events or objects having a common observable characteristic. A sample on the other hand refers to a small group obtained from the accessible population (Mugenda and Mugenda, 2003). The study population consisted of all SMEs in Nairobi. There are 235,000 SMEs in Nairobi according to the ministry of trade National trade policy, 2009. The sample was be a census survey of all SMEs in Nairobi.

3.4 Statistical sampling

The study adopted systematic random sampling method with an interval of 50 SMEs. The sample size was 47 SMEs.

3.5 Study Setting

The study setting was the SMEs in Nairobi, this is because they were accessible and most of them have their head quarters based in Nairobi.

3.6 Data collection

The researcher used primary and secondary data. Primary data was collected through the use of semi-structures and structured questionnaires. The questionnaire was administered through drop and pick method and the respondents were SME officials. Secondary data was obtained from sales and profit reports from the SMEs.

3.7 Data Analysis

The data was analyzed using content analysis to summarize the findings and make recommendations on the qualitative data. SPSS software version 17 was used to analyse the qualitative data in order to determine the relationship between provision of microfinance services and financial performance of SMEs. Quantitative data was analyzed using descriptive and inferential statistics. Descriptive statistics such as mode and mean was used. Descriptive statistics enabled the researcher to meaningfully describe measurements using few indices or statistics. Inferential statistics was used in order to generalize the results from the sample population. Regression analysis analyzed inferential statistics.

3.7.1 Measurement of Variables

The measurement of performance in this study was profitability ratios. Profitability ratios evaluate the firm's earnings with respect to a given level of sales, a certain level of assets, the owner's investment or share value. The profitability ratio that was adopted in the study was return on total assets (ROA) which measures how well management has employed available assets in generating profits from its assets. The return on assets is calculated as follows: $\text{Return on total assets} = \frac{\text{Profit after taxes}}{\text{Total assets}}$

3.8 Data Reliability and Validity

Saunders et al (200) defines reliability as the extent to which your data collection techniques or analysis procedures will yield consistent findings, while validity is concerned with whether the findings are really about what they appear to be about. In order to maintain reliability of the data collected, a standard structured questionnaire was used. A pilot test was conducted on the questionnaire. The pilot test enabled the

researcher to refine the questionnaire so that the respondents will have problem in answering the questions and there will be no problem in recording the data. It will also enable the researcher to obtain some assessment of the questions validity and the likely reliability of the data that will be collected.

The researcher will ask an expert to comment on the representativeness, suitability of questions and the structure of the questionnaire and this will help to establish content validity.

Data reliability will be assessed by using the test re-test method, which will entail administering the questionnaire twice to 3 respondents from SMEs. The data obtained will be correlated with the data that was obtained earlier using the same questionnaire. This will ensure the right data is collected and ambiguous questions are avoided. It will also eliminate the risk of collecting useless data.

CHAPTER FOUR

DATA ANALYSIS AND INTERPRETATIONS

4.1 Introduction

This chapter presents analysis of the data found on the impact of microfinance services on financial performance of small and micro enterprises in Kenya. The data targeted a sample of 47 SMEs from which 38 filled in and returned the questionnaires making a response rate of 80.8%. This response rate was good and representative and conforms to Mugenda and Mugenda (1999) stipulation that a response rate of 50% is adequate for analysis and reporting; a rate of 60% is good and a response rate of 70% and over is excellent.

4.2 General Information

The respondents were asked to state the kind of business that the respondents run. From the study findings, the respondents indicated that they run IT consulting, computer sales and services, export of handcrafts, supply of potatoes, internet services, butchery, supply of construction materials, milk products, skin hide, charcoal, chicken transport and potatoes. Some respondents had shops such as boutiques, beauty shops, cosmetic shops and hardware.

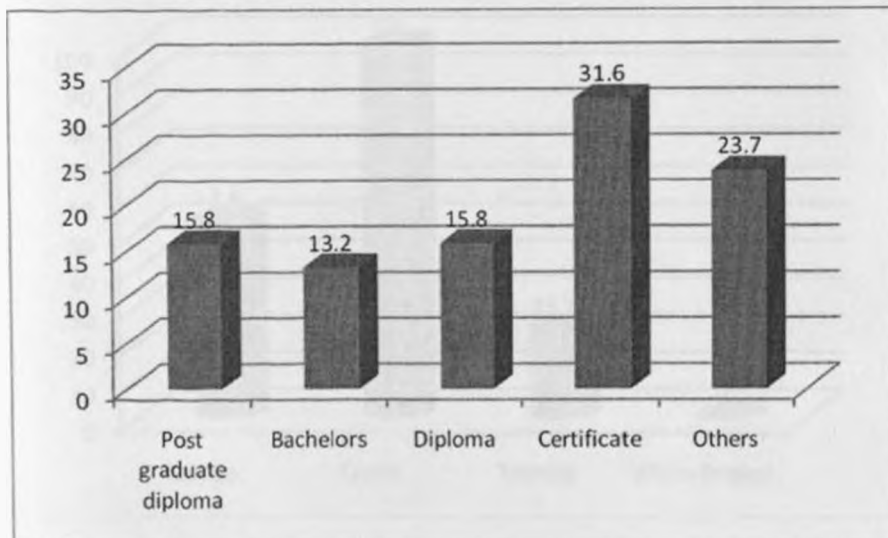
The respondents were asked to indicate when their organizations were established. From the study results, most of the organizations were established between 1995 and 2009. The study also sought to establish the positions that the respondents held in their organizations. From the findings, the respondents held positions such as directors and business owner/proprietor.

Table 1: Level of education

	Frequency	Percent
Post graduate diploma	6	15.8
Bachelors	5	13.2
Diploma	6	15.8
Certificate	12	31.6
Others	9	23.7
Total	38	100.0

The study also sought to establish the respondents' highest level of education. According to the findings, the majority of respondents had a certificate as shown by 31.6% of the respondents, 23.7% had other types of education such as high school, Those that had a post graduate diploma or a diploma were represented by a 15.8% each, while a small proportion of respondents as indicated by 13.2% had a bachelors degree as their highest level of education.

Figure 1: Level of education



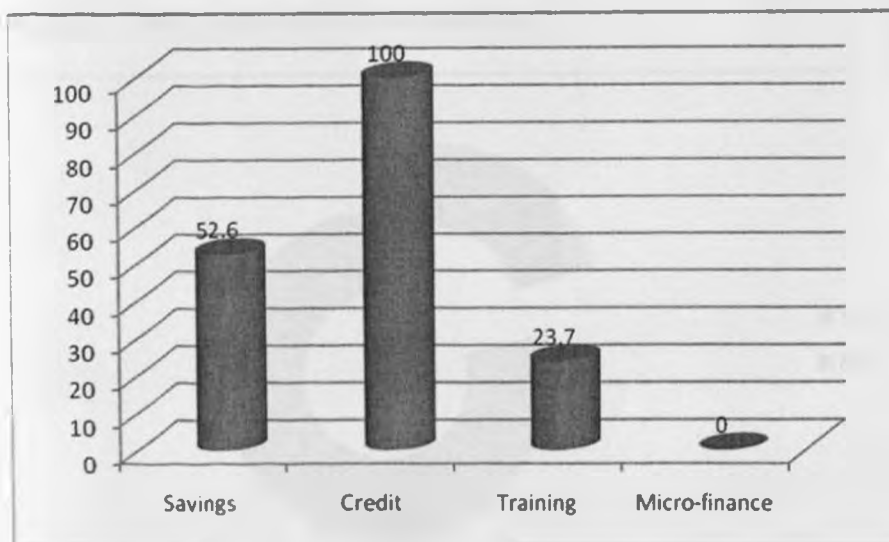
4.3 Impact of MFIs on SMEs

Table 2: MFIs services to SMEs

	Yes	No
Savings	52.6	47.4
Credit	100	0
Training	23.7	76.3
Micro- insurance	0	100

The respondents were required to indicate the services that they get from microfinance institutions. From the study 52.6% of the respondents indicated that they got savings services, all reported that they got credit services, 23.7% reported that they got training services while none of the respondents said that they got other micro insurance services.

Figure 2: MFIs services to SMEs



The study also sought to establish the kind of capital that the respondents borrow from the financial institutions. According to the study, all the respondents reported that they borrow investment capital.

Table 3: SMEs other sources of financing

	Frequency	Percent
Yes	8	21.1
No	30	78.9
Total	38	100.0

The study also required the respondents to indicate whether they have any other source of financing other than that from micro-finance institutions. According to the responses given, 78.9% of the respondents reported that there is no other source of financing other than that from micro-finance institutions while 21.1% of the respondents reported that they also access finance from banks, shylocks and personal savings.

Figure 3: SMEs other sources of financing

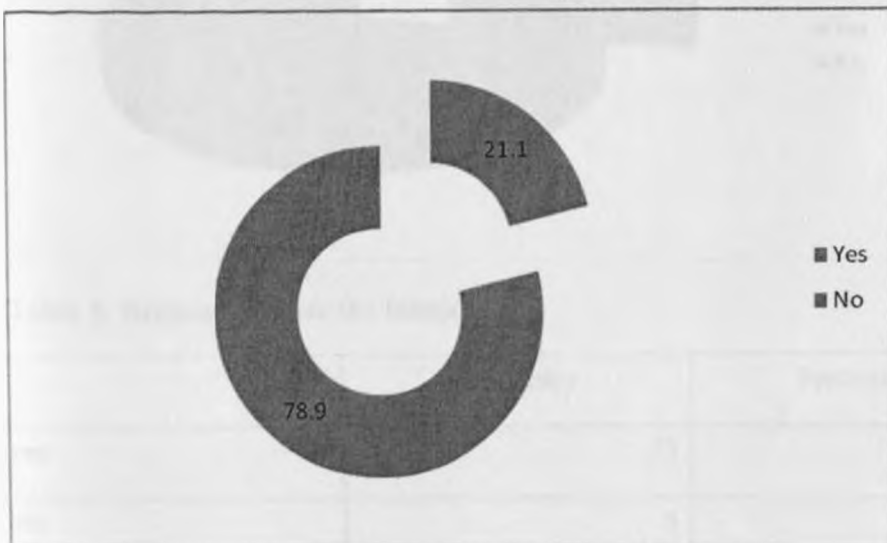


Table 4: Previous sources of finance before receiving from MFIs

	Frequency	Percent
Yes	11	28.9
No	27	71.1
Total	38	100.0

The respondents were also requested to indicate whether the respondents had other form of financing before they started receiving finance from microfinance institutions. From the results of the study, the majority of the respondents (71.1%) reported that they did not have other form of finance before they started receiving finance from microfinance institutions while 28.9% said that they had finances from personal savings and inheritance.

Figure 4: Previous sources of finance before receiving from MFIs

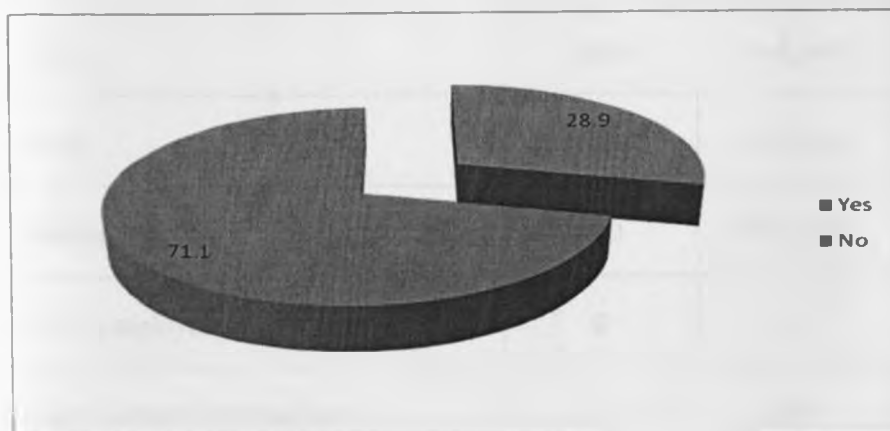


Table 5: Respondents use the loan(s)

	Frequency	Percent
yes	33	86.8
No	5	13.2
Total	38	100.0

From the results of the study, the majority of respondents as shown by 86.8% indicated that they use the loan(s) for the purpose in which they were taken while 13.2% said that they use them for other purposes.

Figure 5: Respondents use the loan(s)

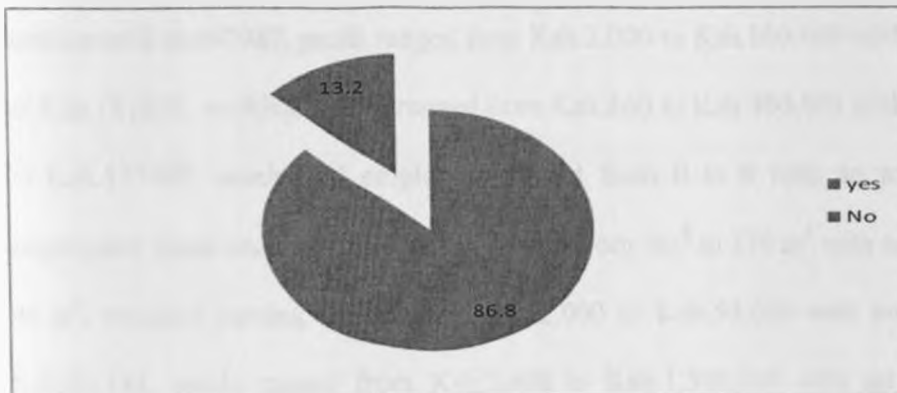


Table 6: Description of businesses before receiving microfinance services

	Minimum	Maximum	Mean
Sales	6,000	500,000	467987.7
Profit	2,000	100,000	181835.4
Working capital	800	400,000	137400
No of employees	0	8	2
Space occupied by business	0	270	96
Retained earning	2,000	50,000	46,184
Assets	2,600	1,500,000	308,461
Liability	1,000	300,000	85,000
capital base	5,000	1,500,000	177,307

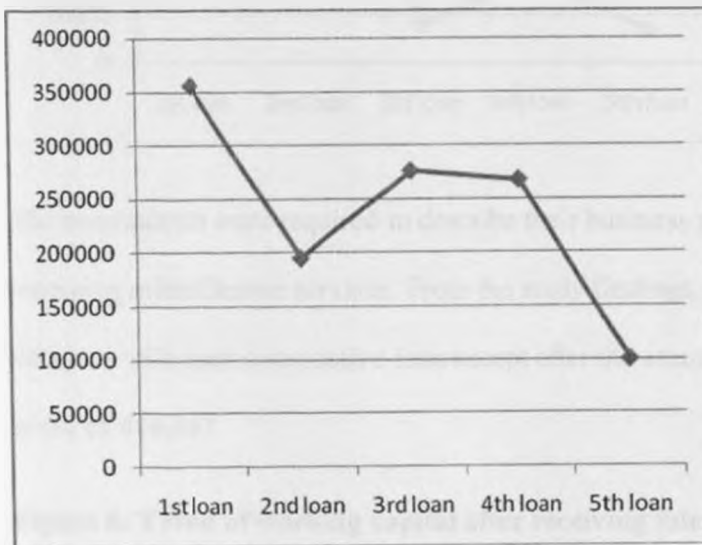
The respondents were also requested to describe the organization/business before they started receiving microfinance services. According to the finding, before they started receiving microfinance services, sales ranged from Ksh.6,000 to Ksh.500,000 with an average of Ksh.467987, profit ranged from Ksh.2,000 to Ksh.100,000 with an average of Ksh.181835, working capital ranged from Ksh.800 to Ksh.400,000 with an average of Ksh.137400, number of employees ranged from 0 to 8 with an average of 2 employees, space occupied by business ranged from 9m² to 270 m² with an average of 96 m², retained earning ranged from Ksh.2,000 to Ksh.50,000 with an average of Ksh.46,184, assets ranged from Ksh.2,600 to Ksh.1,500,000 with an average of Ksh.308,461, liability ranged from Ksh.1,000 to Ksh.300,000 with an average of Ksh.85,000 while capital base ranged from Ksh.5,000 to Ksh.1,500,000 with an average of Ksh.177,307. Further the technology used include dryers, broody, refrigerators, telephone, computers and e-mail while on enterprise stability, the respondents said that the enterprises were fairly stable.

Table 7: Description of businesses before receiving microfinance services

	After 1st Loan	After 2nd Loan	After 3rd Loan	After 4th Loan	After 5th Loan
Sales	355,554	194,959	275,751	267,502	100,005
Profit	153,846	416,667	40,000	90,000	35,000
Working capital	153,846	91,666	175,000	475,000	30,000
Number of employees	1	2	1	2	2
Space occupied by business	174	164	206	210	133
Technology used					
Retained earning	67,753	180,300	234,25	235,250	12,000

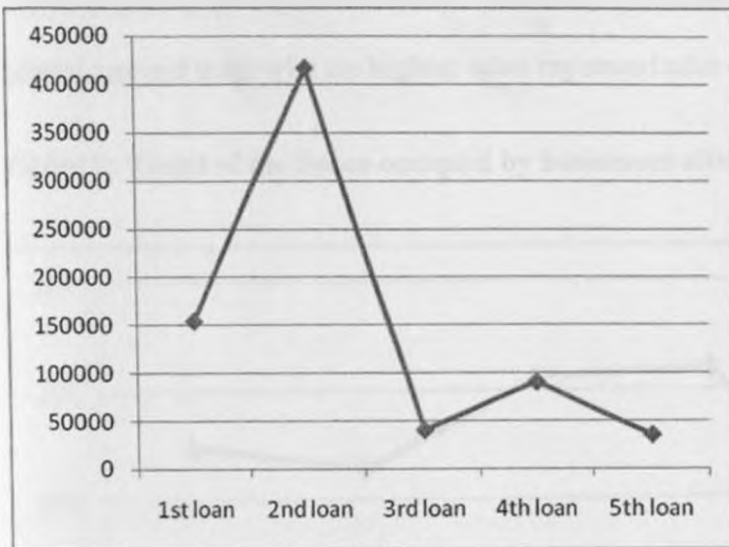
Enterprise stability					
Assets	523,077	744,667	291,250	205,000	60,000
Liability	270000	548333	173000	102500	40000
Capital	433077	650500	167500	202500	20000
ROA	0.29412	0.55953	0.13734	0.43902	0.58333

Figure 6: Sales trend after receiving microfinance services



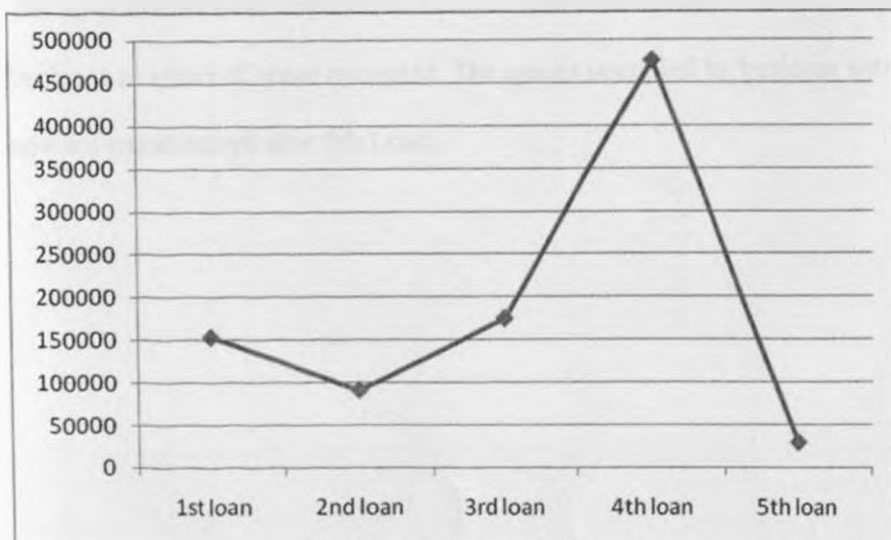
The respondents were required to describe their business sales after they started receiving microfinance services. From the study findings, sales registered a general decrease with each consecutive loan except after the third loan where there was an increase.

Figure 7: Profit trend after receiving microfinance services



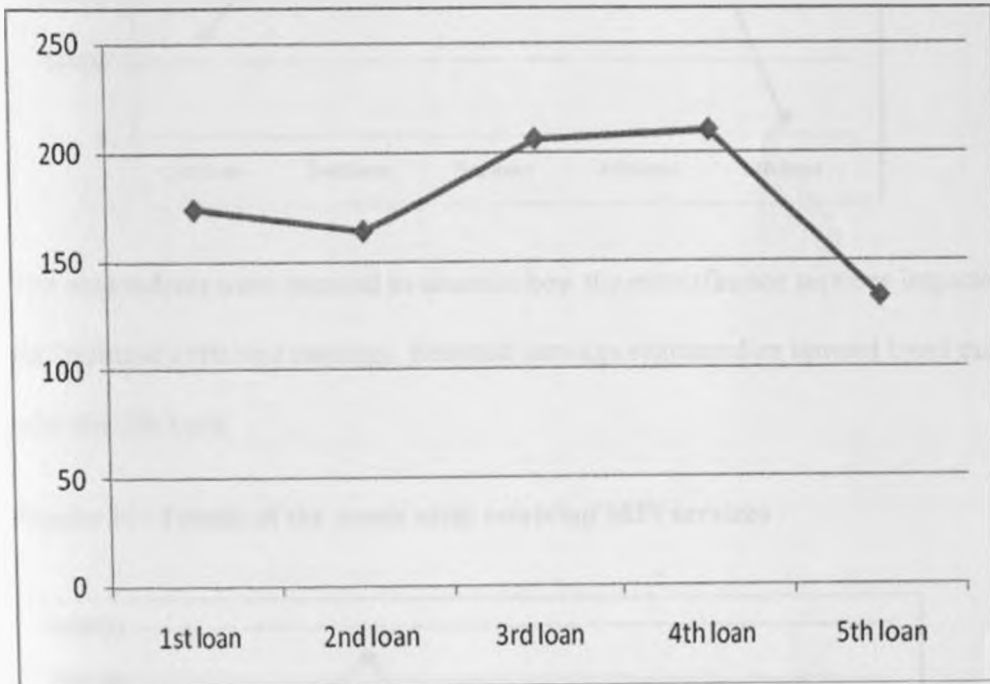
The respondents were required to describe their business profits after they started receiving microfinance services. From the study findings, profits registered a general decrease with each consecutive loan except after the second Loan which registered a profit of 416,667

Figure 8: Trend of working capital after receiving microfinance services



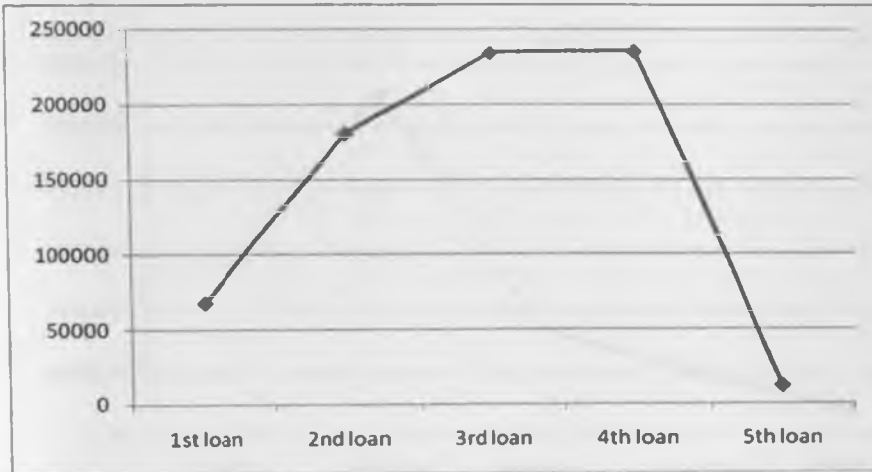
The respondents were required to describe their businesses' working capital after they started receiving microfinance services. The study found that working capital had a general upward trend with the highest value registered after 4th Loan.

Figure 9: Trend of the Space occupied by businesses after receiving Mfl services



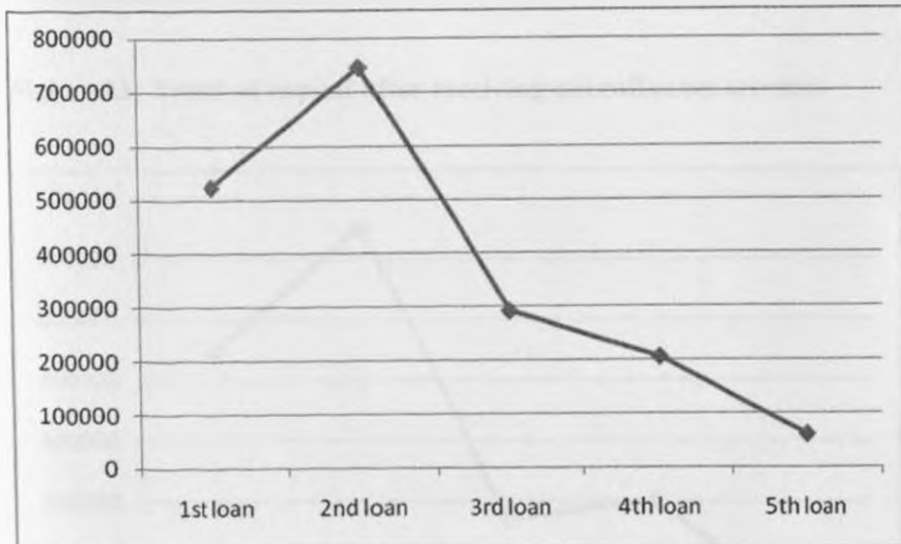
The respondents were required to describe how microfinance services impacted their business in terms of space occupied. The spaces occupied by business were on an upward trend except after 5th Loan.

Figure 10: Trend of retained earnings after receiving MFI services



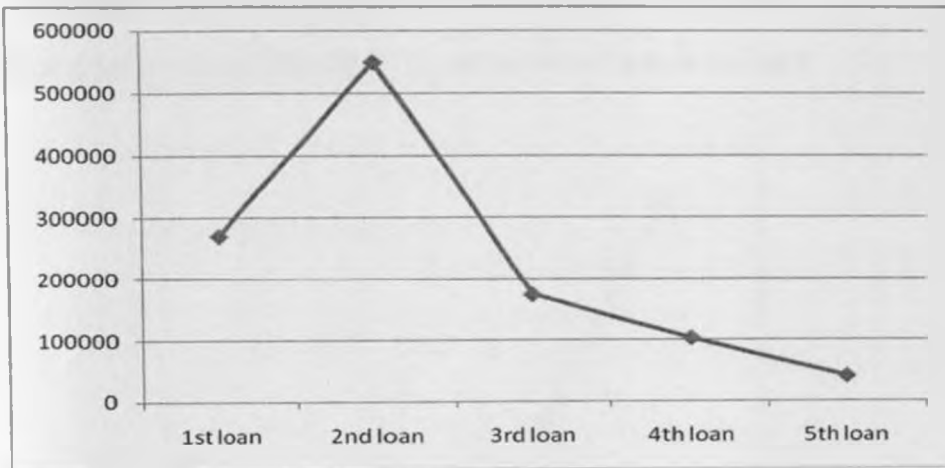
The respondents were required to describe how the microfinance services impacted on the business's retained earnings. Retained earnings registered an upward trend except after the 5th Loan

Figure 11: Trends of the assets after receiving MFI services



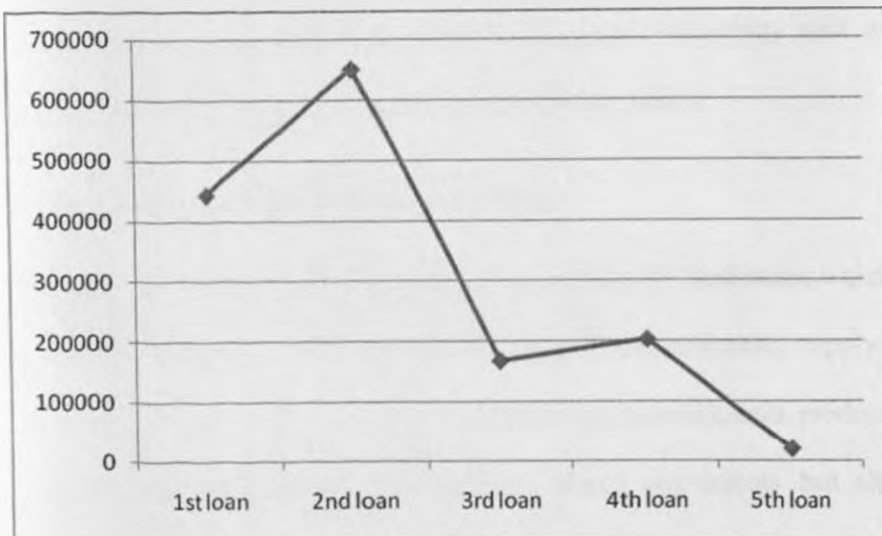
The respondents were required to describe how microfinance services have impacted the business assets. The findings were that there was an increase in assets after the first and the second loan followed by a decrease in the third, fourth and the fifth loan.

Figure 12: Trend of liability after receiving MFI services



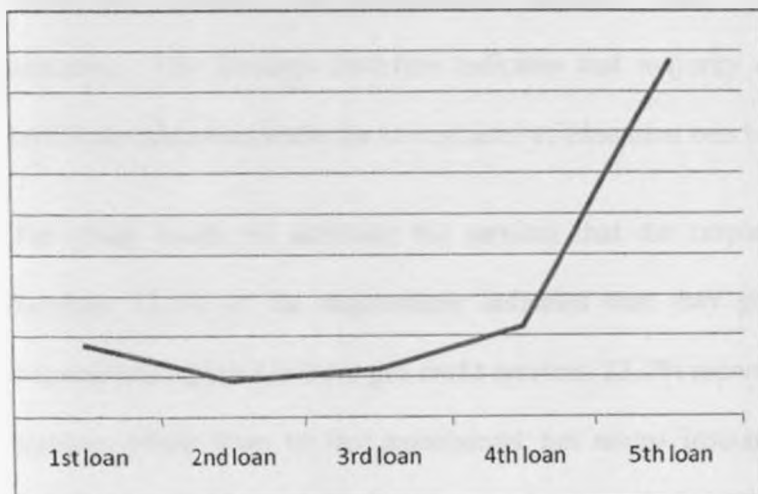
The respondents were required to describe their businesses after receiving MFI services in terms of changes in liabilities. The study revealed that there was an increase in liability after the first and the second loan followed by a decrease in the third, fourth and the fifth loan.

Figure 13: Trend of capital after receiving microfinance services



The study revealed that there was an increase in liability after the first and the second loan followed by a decrease in the third, fourth and the fifth loan.

Figure 14: Trend of ROA after receiving microfinance services



The study found out that there was an increase in ROA after the second and the third loan, followed by a decrease in the third loan, and an increase in the fourth and the fifth loan.

The study also revealed that there was an increase in the number of employees with each consecutive loan and that the businesses used technology such as computers, internet and email, bro dryers, water pumps among others.

4.4 Summary of Interpretation of the Study

The study found that most of the SMEs run small scale businesses which includes IT consulting, computer sales and services, export of handcrafts, supply of potatoes, internet services, butchery, supply of construction materials, milk products, skin hide, charcoal, chicken transport and potatoes. Some respondents had shops such as boutiques, beauty shops, cosmetic shops and hardware. Most of these SMEs were established between 1995 and 2009.

Majority of the respondents held positions such as directors and business owner/proprietor. 31.6% of these respondents had a certificate level of education, 23.7% had other type of education such as high school and primary school education, 15.8% had primary and postgraduate diploma while 13.2% had a bachelor's education. This findings therefore indicates that majority of the respondents had certificate education while the lowest level of education was bachelors education

The study sought to establish the services that the respondents got from MFIs. Services 52.6% of the respondents indicated that they got savings services, all respondents reported to have got credit services, 23.7% reported that they got training services while none of the respondents got micro insurance services. From the findings it is evident that all SMEs use MFIs as a major source of financing and as a source of investment capital.

Provision of credit being a source of financing to the SMEs the study sought to establish whether the respondents had other source of financing at the moment, whether they had other sources before they started receiving the services from the microfinance institutions and whether they use the loan for the purpose in which it was borrowed. 78.9% of the respondents reported that they did not have other source of financing other than that from micro-finance institutions while 21.1% of the respondents reported that they also access finance from banks, shylocks and personal savings. On the other hand 71.1% reported that they did not have other form of financing before they started receiving finance from microfinance institutions while 28.9% said that they had finances from personal savings and inheritance. This is an indication that SMEs have other sources of financing but MFIs is the major source of financing. However not all the loan is used for the purpose in which it was borrowed

since 13.2 % indicated that they used the loan for other purposes while 86.6% used the loan for the purpose in which it was borrowed.

The study found out that before the businesses started receiving microfinance services, had sales ranged from Ksh.6,000 to Ksh.500,000 with an average of Ksh.467,987, profit ranged from Ksh.2,000 to Ksh.100,000 with an average of Ksh.181835, working capital ranged from Ksh.800 to Ksh.400,000 with an average of Ksh.137400, number of employees ranged from 0 to 8 with an average of 2 employees, space occupied by business ranged from 0 to 270 m² with an average of 96 m², retained earning ranged from Ksh.2,000 to Ksh.50,000 with an average of Ksh.46,184, assets ranged from Ksh.2,600 to Ksh.1,500,000 with an average of Ksh.308,461, liability ranged from Ksh.1,000 to Ksh.300,000 with an average of Ksh.85,000 while capital base ranged from Ksh.5,000 to Ksh.1,500,000 with an average of Ksh.177,307. Further the technology used include dryers, broody, refrigerators, telephone, computers and e-mail while on enterprise stability, the respondents said that the enterprises were fairly stable.

The respondents described their business after they started receiving microfinance services. From the study findings, sales registered a general decrease with each consecutive loan except after the third loan where there was an increase, Profits had a general decrease trend except after the 2nd Loan which registered a profit of 416,667, working capital had a general upward trend with the highest value registered after 4th Loan, the number of employees registered a general growth with each consecutive loan, the space occupied by business also were on an upward trend except after 5th Loan, technology used was the same for all the loan disbursement, retained earning registered an upward trend except for the after 5th Loan, enterprise stability improved

with each consecutive loan, assets and liability were on a decrease trend which capital and ROA increased with each consecutive loan an increase in ROA shows that the owners of the business employed the assets well in order to generate profit and that microfinance services enhanced the financial performance of SMEs.

CHAPTER FIVE

SUMMARY, CONCLUSIONS AND RECOMMENDATIONS

5.1 Summary

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

The purpose of the study was to establish the impact of microfinance services on financial performance of SMEs in Kenya. Survey method was employed in this study. The study population consisted of all SMEs in Nairobi. The study adopted systematic random sampling method with an interval of 50 SMEs. The sample size was 47 SMEs. The researcher used primary and secondary data. Primary data was collected through the use of semi-structures and structured questionnaires. Quantitative data was analyzed using descriptive and inferential statistics.

The study found that all SMEs borrow investment capital and they use it for the purpose in which they were borrowed, most of them do not have other source of financing other than from micro-finance institutions and they did not have other form of financing before they started receiving financing from microfinance institutions. The SMEs mostly borrow investment capital and use the loan(s) for the purpose

which they were taken .SMEs also get services such as savings and training from microfinance institutions. The ROA increased with each consecutive loan showing that microfinance services enhance financial performance of SMEs in Kenya.

The study recommends that MFIs should introduce other loan packages such as school fees loans in order to prevent diversion of loans to other uses. The government should assist in training of small entrepreneurs since most of them do not have business management skills.

5.3 Conclusion

MFIs are concerned with provision of financial services to people who are economically poor and who therefore experience financial exclusion in that they do not have ready access to mainstream, commercial financial services. It is concerned with provision of financial services to poor people using means which are just, fair and sustainable for example they accept social collateral rather than financial collateral, access to larger amounts of loan if repayment is performance is positive, easy way to access finance in not much paper work, and easy and short procedures.

MFIs have a community and or a social agenda inherent in its purpose, mission and or goals and the provision of various financial services may be a means of achieving this purpose rather than an end in itself. The size of the transactions is relatively small compared to the typical transactions dominant in the mainstream financial services. It includes full range of financial services which poor people need access, this includes services such as savings, credit and training.

The SMEs mostly borrow investment capital since most MFIs finance businesses that already exist in order to hedge themselves against risk. Most of the SMEs do not have

other source of financing since they are usually regarded as risky by the formal financial institutions because they lack collateral and also the formal financial institutions see them as costly because of the nature of the transactions. However some SMEs have other sources of financing such as from personal savings and shylocks, friends and relatives.

The study revealed that the services received from the MFIs increased sales , profit , enhanced the working capital, the number of employees increased, the space occupied by business increased , retained earnings increased , enterprise stability improved and businesses used technology such as computers, internet and emails, bro dryers, and water pumps . The study finally concludes that ROA increased with each consecutive loan showing that the assets well used well to generate profit hence the study concludes that microfinance services enhance financial performance of SMEs in Kenya.

5.4 Policy Recommendations

From the study findings, the study recommends that in order to enhance the impact of microfinance services on financial performance of SMEs in Kenya, the MFIS should train the borrowers on entrepreneurial skills so as to enhance their competence. A large proportion of the owners of the business were found to be certificate holders and high school graduates, majority of them lack necessary business management skills. The government should invest in educating owners to ensure growth and development of their businesses which will result to improved financial performance.

The MFIs should consider introducing new loan products to cater for school fees, medical, insurance cover. This will discourage diversion of business loans to other uses. This will leads to higher impact experienced by the SMEs. However due

diligence must be exercised so that portfolio quality is not compromised through overburdening of SMEs with several loans which could be difficult to repay.

The study recommends that the MFIs partner with local authorities and other stakeholders so as to create awareness of the availability and the process of accessing microfinance loans. Since MFIs have poverty alleviation as its vision they should consider lending startup capital so that the welfare of the business and the borrower can be monitored.

The study recommends that the MFIs should consider changing their lending model since most of them use minimalist model of lending and they consider training as expensive to them. This service is important to the SMEs as evidenced by the study findings that majority of the respondents have are either certificate holders or form four graduates. Majority of the respondents also do not seek training services from the MFIs since the services are offered at a fee and therefore it should be made affordable since the MFIs will also benefit in terms of reduced default rate.

5.5 Limitations of the Study

A limitation for the purpose of this research was regarded as a factor that was present and contributed to the researcher getting either inadequate information or responses or if otherwise the response given would have been totally different from what the researcher expected.

Some research questions required the respondents to give very personal information, for example their sales, profit, the kind of business they do, their level of education, where they sourced funds from. This way a major problem because they felt that the

researching was seeking too much personal information and thus they tended to vague.

The level of illiteracy with most of the respondents was low and thus had an impact on the accuracy of interpretation and understanding of the issues in the questionnaire. For example, most of the respondent had confusion between working capital and capital base.

Most of the respondents were busy throughout and had to continuously be reminded and even persuaded to provide the required information. Time was also a limiting due to official duties

5.6 Suggestions for further study

The study recommends that further research should be done on the impact of MFIs on large businesses since their strategic approach and their financial footing is different from that of SMEs.

The study concentrated on the impact of microfinance services on financial performance of SMEs. Further research should be done to establish what the owners of the SMEs think should be done to assist them in preventing the high mortality rate that exists in the sector.

For the small and micro enterprises sector to grow small businesses need to link with the rest of the economy. Most of these businesses are so small that creating the link seems almost impossible. Further research should be done in this area to establish the best ways of linking small and micro businesses with large companies in the economy.

REFERENCES

- Alarape, A. (2007). Entrepreneurship programs, Operational efficiency and growth of small business. *Journal of Enterprising communities: People and places in global economy* , 1 (3).
- Atril, P. M. (2008). *Accounting and Finance for non-specialists*. Gosport harts, Great Britain: Ashford colour press.
- Burket.I. (2003). *Microfinance in Australia: Current realities and future possibilities*. School of social work and social policy, University of Queensland.
- Copstake, J. Bhalotra, S. and Johnson, S.J.(2000) *Assessing the impact of microcredit on poverty: A Zambian case study*. UK: University of Bath.
- Foster, G. (2004). *Financial Statement Analysis* (Second Edition ed.). Singapore: Pearson Education Limited.
- Guene. C. a. (2001). *Banking and Social Cohesion: Alternative Responses to a global Market*. Jon Carpenter, Charlbury, UK.
- Hallberg, K. (2000). *A market oriented strategy for small and medium- scale Entreprises*. Washington D.C: World Bank: International Finance Corporation.
- Hickson, R. (2001). *Financial Services for the poor - Thinking outside the Box*. Small Enterprise Development.
- Inziani V.R. (2006). *Informal finances as a source of funds for small and micro enterprises: Evidence from Dandora slums in Nairobi*. Unpublished research project, University of Nairobi.

- Khan, A. (2008). *Islamic microfinance: Theory and Practice*. 19 Street South, Birmingham. United Kingdom: Islamic Relief World wide.
- Kuziliwa, J. (2005). The role of credit form small business success: A study of the national entrepreneurship development fund in Tanzania. *Journal of Entrepreneurship* , 14, 131.
- Ledgerwood, J. (1999). *Microfinance Handbook: An institutional and financial perspective*, Washington, D.C. 20433, USA.
- Maghanga, M. (2007). *The perception of MFIs loan borrowers on effects of loans on their business and as a poverty alleviation tool*. Unpublished Research Project, University of Nairobi.
- Meed, D. A. (1998). The dynamic of micro and small enterprises in developing countries. *World Development* , 26, 61-74.
- Mohammed, A. a. (2007). *Impact of microfinance on living standards, empowerment and poverty alleviation of people: A case study of Microfinance in the Chittagong district of Bangladesh*. Unpublished MBA Report, Umee School of Business, Bangladesh.
- Mokogi, J. (2003). *Economic Implications of Lending of Microfinance Institutions on micro and small enterprises in kenya*. Unpublished Research Project.
- Morduch, J. (2000). The Microfinance Schism. *World Development* , 28 (4), 617-629.
- Mugenda, M. a. (1999). *Research Methods: Quantitative and Qualitative Approaches*. Nairobi, Kenya: Act Press, African Centre for technology studies (ACTS).
- Mushimiyimana, A. (2008). *Analysis of access to microfinance institutions loans by female enterpreneurs and Impact on their business in the Nairobi Business District*. Unpublished MBA, University of Nairobi.

- Mwindi, G. (2002). *The relationship between interest rates charged by MFIs to SMEs and Performance of these SMEs in Kenya*. Unpublished MBA Project, University of Nairobi.
- Ngehnevu, C. B. (2010). *The impact of Microfinance Institutions (MFIs) in the Development of SMEs in Cameroon: A case Study of Camccul*. Uppsala.
- Ormiston, L. M. and Fraser, A. (2007). *Understanding Financial Statements* (Ninth Edition ed.). United States of America.
- Pendrill, R. L. (2004). *Advanced Financial Accounting* (Seventh Edition ed.). England: Pearson Education Limited.
- Richard, R. (2004). *Financial Institution with a "Double Bottom Line": Implications for the future microfinance*. CGAP Occasional Paper.
- Robinson, M. (1998). The paradigm shift from credit delivery to sustainable financial intermediation. *Strategic issues in micro finance* .
- Ryan, P.R. (1993). *An evaluation of small enterprises lending: Evidence from malawi*. Development and project planning centre, University of Bradford.
- Saunders, M. Lewis, P. and Thornhill, A. (2003). *Research methods for business students*. 3rd Edition, Pearson Education Limited, Spain.
- Wahid, A. (1994). The Grameen Bank and Poverty Alleviation in Bangladesh: Theory evidence and limitations. *The American Journal of Economics and Sociology* .
- Wright, G. (2002). *Microfinance Systems: Designing Quality Financial Services for the poor*. London: Zed Books.

APPENDICES

Appendix 1: Letter of Introduction

Mary Wanjiku Mbugua,

University of Nairobi,

School of Business,

P.O Box 30197,

NAIROBI

Dear Sir/Madam

I am a master's degree student in the School of Business, University of Nairobi. In partial fulfilment of the MBA degree, I am conducting a study on "The impact of microfinance services on financial performance of small and micro enterprises".

You have been selected to form part of this study. To this end, i kindly request your assistance in completing the attached questionnaire.

This information and data required is needed for academic purposes only and will be treated in strict confidence.

A copy of the research project will be made available to you on request.

Thanks in advance

Yours sincerely,

Mary W. Mbugua
MBA student

Appendix II: Questionnaire

Section A

1 What is the name of your business/ organization? -----

2 What kind of business do you do -----

3 When was your organization established-----

4 What is your position in this organization-----

5 What is your level of education?

Masters degree ()

Post graduate diploma ()

Bachelors degree ()

Diploma ()

Certificate ()

Others ()

Section B

1 What services do you get from microfinance institutions?

Savings ()

Credit ()

Training ()

Micro insurance ()

Any other (specify) -----

2 What kind of capital do you borrow?

Start-up capital ()

Investment Capital ()

3 Do you have any other source of financing other than funds from microfinance institutions?

Tick where appropriate

Yes ()

No ()

If yes please specify -----

4 Did you have any other form of financing before you started receiving finance from microfinance institutions ? -----

Tick where appropriate

Yes ()

No ()

If yes please specify -----

5 Do you use the loan(s) for the purpose in which they were taken?

6 How would you describe your organization / business before you started receiving microfinance services in terms of the Following?

Sales -----

Profit -----

Working capital -----

Number of employees-----

Space occupied by business-----

Technology used -----

Retained earning -----

Enterprise stability -----

Assets -----

Liability -----

Capital base -----

7 How would you describe your organization / business after you started receiving microfinance services (Please provide a brief historical background in terms of the following)

	After 1st Loan	After 2nd Loan	After 3rd Loan	After 4th Loan	After 5th Loan	After 6th Loan
Profit						
Working capital						
Number of employees						
Space occupied by business						
Technology used						
Retained earning						
Enterprise stability						
Assets						
Liability						
Capital						

Appendix III: List of Registered MFIs In Kenya

1. AAR Credit Services
2. ADOC TIMO
3. Agakan Foundation
4. Barclays Bank of Kenya Ltd Microfinance Department
5. Biashara Factors Limited
6. BIMAS
7. Blue Limited
8. Canyon Rural Credit Limited
9. Chartis Insurance
10. CIC Insurance
11. Co-operative Bank
12. Chase Bank-Rafiki Deposit taking Microfinance Ltd
13. Equity Bank
14. Faulu Kenya DTM Limited
15. Fusion Capital Ltd
16. Greenland Fedha Limited
17. Jamii Bora
18. Jitegemee Credit Scheme
19. Jitegemee Trust
20. Juhudi Kilimo Company Limited
21. K-rep Bank Limited
22. K-rep Development Agency
23. KADET
24. Kenya Eclof
25. Kenya Entrepreneur Empowerment foundation (KEEF)
26. Kenya Post Office Savings Bank
27. Kenya Women Finance Trust
28. Microensure Advisory Service Limited
29. Micro Africa
30. Molyn Credit Limited
31. OIKO Credit
32. Opportunity Kenya
33. Pamoja Women Development Programme
34. Renewable Energy Technology Assistance Programme (RATEP)
35. Rupia Limited
36. Self Management Services Limited
37. SISDO
38. SMEP
39. Swiss Contract
40. Taifa Option Microfinance
41. U& I Microfinance Limited
- 42 Youth Initiatives Kenya
43. Yehu Enterprises Support
44. Remu Ltd
45. Orion East Africa Ltd
46. One Africa Capital Ltd