A SURVEY OF THE CHALLENGES OF FINANCING SMALL AND MICRO ENTERPRISES (SMEs) IN NAIROBI

BY

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A MANAGEMENT RESEARCH PROJECT SUBMITTED IN PARTIAL FULFILMENT OF THE REQUIREMENTS FOR THE DEGREE OF MASTER OF BUSINESS ADMINSTRATION

SCHOOL OF BUSINESS

UNIVERSITY OF NAIROBI

2011

DECLARATION

I declare that this project is my original work and has not been submitted to any University for examination.

Signed .... Date: ....

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D61/70186/2009

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

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DEDICATION

To my spouse Dorcas, our beloved children Cynthia, Whitney and Seth.

ACKNOWLEDGEMENT

I would like to acknowledge the invaluable guidance of my supervisor, Dr. Josiah Aduda who has guided me throughout the stages of this research paper.

Am also grateful to Mr. Mirie Mwangi for his guidance as the moderator. My thanks also go to all lecturers in the school of Business, University of Nairobi for having provided practical and mind challenging lectures.

Thanks to my spouse and our children who were supportive and understanding during the period of this research. Without their support I would not have come this far with this project.

My appreciation goes to my employer The World Bank Group for allowing me time off to study my MBA and work on this project. The employer was understanding during the entire period of my study. My appreciation also goes to my colleagues at the work place who acted as my back-up during my absence as I undertook my studies.

I would like to appreciate the moral support and encouragement from my parents. They acted as role models to motivate me to work harder.

My appreciation goes to my neighbours at home. The long hours I spent studying, they reduced on their noise to provide a quiet and conducive environment to study and prepare for my MBA.

I would like to thank my spiritual parents, my church reverend and his wife, our pastor for praying for me and encouraging me to remain faithful to God and work hardest. They encouraged me to be sincere in my studies and be patient till the end of my MBA.

Lastly but not least I would like to thank my classmates in MBA class for the team work they showed during class and group discussions. The interaction with these special and hard working students enabled me to have different perspectives of situations.

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LIST OF ABBREVIATIONS:

CBOs:	Community Based Organizations
CDF:	Constituency Development Fund
IFC:	International Finance Corporation
***GDP*:**	Gross Domestic Product
GOK:	Government of Kenya
IDA:	International Development Association
K-REP:	Kenya Rural Enterprise Programme
MDGs:	Millennium Development Goals
MFIs:	Micro Finance Institutions
NGOs:	Non-Governmental Organizations
SAPs:	Structural Adjustment Programs
SMEs	Small and Micro Enterprises
WB:	World Bank
WSP-AF:	Water and Sanitation Program

ABSTRACT

In the past five years there has been efforts made by SMEs in ensuring that they remain relevant and competitive. To remain competitive in the market the latest technology has to be applied, staff be equipped with the relevant skills, modern tools for projects monitoring and evaluation used. The SMEs need financial resources to facilitate all these operations in the organisation. Most SMEs do not have sufficient funds of their own to finance their projects hence have to source from outside. The process of accessing these funds has not been easy, there have been numerous hurdles that have to be overcome before funds are secured.

The purpose of this research was to identify the main challenges encountered by SMEs in the course of raising finances for their operations with the view of recommending ways of dealing with these challenges.

Data was collected via questionnaires with forty (40) SMEs based in Nairobi. All the SMEs were targeted hence no sampling was applied. Data was collected and analysed using SPPS version 17.

The findings were that SMEs face several challenges in the course of seeking funds to finance their projects. Most of these challenges are conditions that are within the control of SMEs. The SMEs can overcome these challenges by adopting specific strategies in their operations. It was also noted that a few challenges are from external forces that SMEs have little or no influence. It was concluded that the SMEs need to carry out a SWOT(Strength, Weaknesses, Opportunities and Threat) analysis and change their operations to remain effective and efficient, to influence the external parties by ensuring constant availability of information that may influence third parties perception for better.

Specific main challenges identified include; lack of sufficient past financial records, lack of modern accounting system, lack of proper tools of monitoring and evaluating the projects, negative attitude toward SMEs by commercial banks, bias evaluation and rating of SMEs by potential lenders, lack of well trained staff, misclassification of SMEs as NGOs by some partners, lack of collateral, inability to service loans and lack of tools to evaluate projects that need to be implemented.

CHAPTER ONE:

1.0 INTRODUCTION:

1.1 Background to the study:

The size of a business may be defined in terms of the numbers of employees, the turnover, or capital invested in the business. Different authors and researchers have defined SMEs variously depending on their respective objectives. Using employees as the basis of definition, the GoK defines an SME as one employing 0-50 persons. A small business is one that is actively managed by its owner(s), highly personalized, largely local in its area of operation and largely dependent on internal sources of capital to finance its growth (Banmback, 1998).

These (SMEs) organisations usually have limited coverage and mainly focus on the immediate community and have a relatively limited access to finance. Donors include those organizations that avail financial resources and assist in building capacity among the community. In Kenya the main donors include the World Bank (WB) and International Finance Corporation (IFC). These are Britton wood institutions with head quarters in the United States of America but have regional offices that partner with the member countries for issuing loans and grants (Proparco's magazine, 2009 issue 1).

K-REP Bank has been used as the link through which the donors channel the funds to the beneficiaries. The target of these loans is rural and peri-urban communities that either want to develop new projects or expand existing ones. Investments will finance technical and financial management systems. Technical support will entail the building of capacity and know how while financial support will include record keeping and computations to determine the quantitative and the cost benefits of the project. Financing in this context refers to both the mobilization of resources and the mechanisms for channelling funds to community projects. Such quantitative analysis will be useful in determining the financial viability of the project. Post implementation period covers the time the project is implemented into future date. The key criterion in K-REP Bank's assessment of projects for financing is the borrower's ability to repay the loan in the project's post-implementation phase. A viable project therefore should have:

(i) Strong demand for their products/services,

(ii) Adequate and sustainable source of raw materials and legal rights to access the resources,

(iii)Good governance structures, and

(iv) A solid post-implementation operational and financial plan. In addition to demand and supply criterion, communities need skills and resources to effectively run and maintain projects once they commence operations (Parker et al, 1994).

The management of some of the community projects is outsourced in order to enhance the efficiency of the systems and make them commercially viable. Outsourcing entails the use of outside entities such as consultancy firms or experts to perform specified duties on behalf of the community project at a fee. The community served consist mainly of the surrounding families, schools, churches and businesses. In the rural and poor urban informal settlements where most of the small enterprises are based are inhibited by mostly poor people with low income. The average income of such poor people is less than a dollar per day. Such poor neighbourhood has attracted subsidies from various organisations including the government, the donor community and non-governmental organisations (NGOs). Subsidy here comes in the form of reduced prices for electricity, water, food, school fees and other public goods/services (Wanyungu, 2000).

The government intervention in the local communities can be traced to both direct and indirect manner. Direct subsidy includes the construction of social amenities such as roads, installation of electricity lines in the community centres by using the Constituency Development Funds (CDF). The indirect subsidy is done when the government for example give tax holidays to organisations operating in poor hardship areas serving the poor. Tax holidays are when the organization that makes profit is exempted from paying government taxes for a specified period of time. This will act as an incentive for such organizations in some hardship, poor regions. By the government reducing or eliminating the taxes on the services/goods provided by the organisation serving the poor the organizations will be able to provide such services at a lower and affordable price. A good subsidy is based on an assessment of genuine need, it accurately targets the intended beneficiaries, it is simple to administer and low cost, it avoids creating perverse economic incentives that might for example, encourage customers to waste resources. An organization that receives subsidy is expected to pass onto the community the benefits by charging lower amounts for services rendered (Oketch et al, 2000)

Reforms refer to the changes in which the services are rendered in order to be effective in line with the changes in the environment. There are three areas of reform that are important: Firstly decentralization of service delivery. This is where local governments lead oversight role while allowing responsibility for service delivery to be delegated to community organizations. Secondly, community-driven development where communities do more of the planning. Hence there is capacity building for the community organizations. Thirdly we have private sector participation. Hence the private sector management of commercial utilities and service delivery by small independent providers. The idea here is to increase efficiency and coverage by changing the incentives to focus directly on consumers and improved services. . Financing of small and micro enterprises should be based on the following principles: Use of public funds for the improvement of social goods/services, training, community mobilization; prioritization of hygiene and sanitation in the society innovative marketing of sanitation solutions for households and communities and enforcement of public Health by-laws. Structural Adjustment Programs (SAPs) entails fundamental changes in the manner in which the given entity carries out its activities in its pursuit of achieving its goals. SAPs were introduced by the government in Kenya in the 1980's. Community based organizations (CBOs) include those organizations that are in direct contact with the people at the grass root. Such organizations are more vibrant in rural and urban poor settlements (Smart lessons, November 2010).

Micro-Financial Institutions (MFIs) are the financial intermediaries that provide a link between the savers and users of the funds in the market. Most MFI's generally offer loans for income generating activities to individuals and business organizations. Self help groups are those groups of individuals with a common interest that come together for a common course such as having an objective of running a business in the community. Such self help groups may have great ideas but lack the financial resources and the capacity to start, operate and sustain the given project. The MFIs will be at hand to provide financial support in the form of loans; the World Bank may provide grants and also assist in capacity building. Due to lack of access to sufficient credit, the informal groups may resort to use of informal financial routes such as 'harambee' to raise funds for major expansions and repairs of the project. Funds raised in this manner can be unpredictable and irregular. A harambee refers to the informal collection of funds from the beneficiaries of the project in the community with the help of a few invited guests such as the politicians and business people. In Kenya, Community-based organizations (CBOs) are important in providing services to the rural and urban poor. Seed financing is funding invested for the research, assessment and initial development of a product or business concept. Start-up financing is provided for product development and initial marketing to companies that are in the process of formation, or that has been in business for a short time, but have not yet sold their product commercially. Taken together, seed and start-up financing, are commonly referred to as early-stage financing. Expansion financing is often done in successive rounds (Smart lessons, November, 2010).

1.2 Statement of the problem

SMEs that rely on public funding for capital investment often fall short in mobilizing resources and are, therefore, unable to sustain improvement in service delivery. One of the critical constraints faced by SMEs is finance, access to credit and limited capacity. There is shortage of funds for development, operation and maintenance of SMEs. MFIs products in Kenya must overcome two serious constraints: the short tenure of most credit facilities and very high interest rates. Despite the SMEs sector drawing a lot of interest for various finance partners (like the government with the youth fund, 'maendeleo ya wanawake', CDF and donors like the IFC loans, IDA grants), the problem of accessing sufficient funds to finance operations is experienced by most SMEs (Wanjohi and Mugure, 2008).

Small business enterprises have traditionally encountered problems when seeking financing from banks to support their fixed capital investments as well as working capital for their operations. Most new small business enterprises are not very attractive for mainstream banks, with their rigid lending regulations (Tangoe et al, 2005).

Lending to small firms is difficult because of the problems of information asymmetry. The SMEs do not have full disclosure of the relevant financial information to all interested parties. By having a predetermined budget, plan and expectations, the effective and efficient deployment of resources and effort, continuous monitoring and evaluation of the projects are necessary to enable success of the projects. (Elijah, 2007)

It was emphasized that "the major banks have never really liked small business customers" and that banks are quite often ambivalent toward such clients. The fact that predicting how well a start-up business will perform, or if in fact it will survive, is difficult, and has offered one of the main reasons why banks are sceptical of their small business clientele (Murray and Wallbridge, 2000).

The reason why the informal sector flourishes in Kenya is the operations of business without much restriction or regulation, the entrepreneur's flexibility in meeting customer needs and the goods and services provided depended on demand as perceived by entrepreneurs (McCormick, 1998).

Despite the billions of money channelled to development assistance each year, there is still a minimum actual impact on the small businesses projects.

Lack of credit has been identified as one of the most serious constraints facing SMEs and hindering development. Many SMEs may use inappropriate technology due to lack of sufficient funds to buy the appropriate one. Even in cases where credit is available the SMEs may lack the freedom of choice because the lending conditions may force the SME to purchase heavy equipment that can serve as collateral for the loan. Such machine may not necessarily be priority (Oketch et al, 2000).

Financial constraints remain a major challenge facing SMEs in Kenya (Wanjohi and Mugure, 2008). Small organizations have little access to finance, which hampers their emergence and eventual growth. The main sources of capital are retained earnings and informal savings which are unpredictable. Access to formal finance is poor because of the high risk default among small businesses and due to inadequate financial facilities (Kauffman, 2005).

1.3 Objective of the study:

The objective of the study was to establish the challenges of financing small and micro enterprises (SMEs) in Nairobi.

1.4 Significance of the study:

The government of Kenya will be interested in this study so as to align its policies to enable the achievement of the millennium Development Goals and vision 2030. The study will identify the problems that SMEs face in their bid to offers products/services to the people of Kenya. This revelation will be used by the government to determine policy changes to strengthen the SMEs. The study may be used by the government to set-up subsidies; tax holidays to encourage SMEs have extra resources hence reduce the financial burdens.

The donor community especially the World Bank and IFC will be keen to find out how their funds are being utilized and the impact on the ground. The donors will be keen in establishing how effective the funds are being used and well accounted for. Based on the findings and conclusion the donors may opt to change the strategies, increase/reduce funding and to determine the priority areas to focus on.

The MFIs will be interested in knowing the financial management systems used by the SMEs, this will enable the MFIs to tailor make their financial products to suit their clients. The MFIs will be interested in knowing the characteristic of the successful borrowers so that they are in a better position to make informed financial decisions.

The academicians will use the study to gain deeper understanding of the challenges facing the SMEs and try to suggest some ways to solve the challenges.

CHAPTER TWO:

2.0 LITERATURE REVIEW:

2.1 Introduction:

The sources of literature reviewed included books, journals, reports, thesis, websites, and publications by professional bodies. In this chapter we review the arguments put forth explaining why small enterprises fail in their infant stages, the different management styles that used in organizations, and the how public goods /services are applied. There is an attempt to find out what the main problems the SMEs and hence set the scene for possible solutions.

2.2 Key theory guiding this study:

Dividend theory:

Dividend is the distribution of firm's value to shareholders. Most investors be they individuals or corporate usually spend with an expectation of some return. The lenders of funds expect some interest in return while the borrowers use the funds to generate extra money after paying off the cost of the funds. Those who spend their efforts in any enterprise will expect some form of benefit The MFIs will expect to earn interest on the loans advanced to the SMEs. The SMEs can only manage to repay the principle and interest if they utilise the funds wisely. The IFC loans to SMEs through the MFIs will be issued at an interest. The MFIs will be expecting to generate income from the loans to the SMEs (Tajirian, 1997).

The income will be in the form of interest on loans. On the other hand the SMEs will use the funds to expand and grow into more efficient and effective organization. When the government spends money on public goods and services on its citizens in terms of construction of good roads, power lines, and other essential infrastructure, the government expects these services to improve the standards of living and provide an incentive for increased investments in the country. When the economy is robust with economic activities the GDP will go up and the businesses will make more profits hence pay more taxes to the government. The investors (SMEs) included will be motivated to increase operations in a thriving economy. These increased activity levels will mean the SMEs will be obtaining more funds from the MFIs, banks and the public to finance their increased operations. Paying out some cash dividend today reduces the risk of future payoff uncertainty (Linter, 1956).

When the MFIs and banks increase their lending to the SMEs, the lenders will expect to earn more amounts of money in the form of interest on the loans. On the other hand the SMEs will be using the increased funding to expand and cover large regions. With a larger market size the SMEs will be targeting to generate more money and save costs as a result of the economies of scale due to bulk production. The increased funds can also be used to invest in the latest technology. By using the modern technology in the business processes the SMEs will be very efficient in the operations. Such efficiencies coupled with high quality products/services will result into overall reduction in costs hence increase in the profits generated. There is a significant relationship between the dividend ratios to the value of the firm (Bitok, 2004).

2.3 Previous studies relevant to this current study:

One of the most significant challenges is negative perception towards SMEs. Potential clients perceive small businesses as lacking the ability to provide quality services and are unable to satisfy more than one critical project simultaneously (Amyx, 2005).

Education is one of the factors that impact positively on growth of firms. Majority of those who run SMEs are ordinary lot whose educational background is lacking. Hence they may not be well equipped to carry out managerial routines for their enterprises (King et al, 2002). Lack of planning, improper financing and poor management have been identified as the main causes of failure of small enterprises (Longenecker et al, 2006).

It was found out that among challenges facing SMEs include; capital constraints hampering market expansion, limited access to market information with only a small number of small businesses surveyed having access to communication technologies such as telephone and fax machines, variations in incomes between urban and rural-based small business, women-led small businesses had a lower income than those lead by men (Mureithi, 2005).

The following were identified as SME challenges in a previous study: lack of business knowledge and skills, poor culture of enterprise, and the lack of available working capital; lack of education and training hence cannot take advantage of the competitive environment; industrial policies and incentives favour large businesses; difficulties in raising finance, lack of knowledge on government regulations, insufficient physical and institutional support infrastructure, and a lack of technical and managerial business skills (Bigsten et al, 2003).

Banks are reluctant to lend SMEs since they (SMEs) lack reliable financial statements validated by auditors, lack well organized and well managed structures, SMEs are understood to be to be fragile in terms of organization and forward-looking vision. Banks will need to closely supervise the SMEs to fulfil the advisory role. The banks fail to carry out supervision effectively due to banks having other many mainstream clients, lack of time due to large number of SMEs (Proparco's magazine, 2009).

Lack of forward-looking vision is another obstacle leading to financial difficulties in SMEs. Too many firms were born on an impulse on the part of the entrepreneur, without any in-depth analysis of the market or competition. This often leads to disillusion in terms of turnover and, consequently, repayment capacity for bank loans. Too many budding SMEs make a very sketchy analysis of their potential and growth rates and consequently handicap their future, even if their businesses do get off to a perfect start (Proparco's magazine, 2009).

The following have been identified to course financial failure to SMEs: Lack of capital, increased taxes, low sales, management problems, negative cash flow, poor record keeping, family situations, inadequate control of inventory, lack of business plan, faulty product concept (African Studies Quarterly, 2006, http://www.africa.ufl.edu/asq/v8/v8i4a3.htm).

A survey which tracked bank borrowing by manufacturing firms in developing African countries found that among firms which wanted a loan, small firms had substantially worse chances of getting one because the lenders are biased towards small firms (Bigsten et al, 2003).

The behaviour of financial institutions is not the only reason that SME have problems accessing financing. Constraints on the 'demand side' also have an impact. Indeed, while SME advocates loudly lament the inaccessibility of external finance, bankers and venture capitalists often decry the shortage of 'bankable' or 'investable' firms. In this connection, the following factors play a significant role: When the quality of the projects submitted for financing is poor, below the minimum standards, the bankers have a reason to reject the financing proposals. Even when the projects have intrinsic quality, the SME may be unable to make best use of the available opportunities. This relates to the SME's limited ability to convincingly articulate business ideas and also the unwillingness of many small entrepreneurs to spend a lot of time in dealing with financial institutions. This is a problem to do with equity financing. The SMEs are unwilling to relinquish control over the company to outsiders (Berggren et al, 2000).

The economic downturn of the late 1970s and rapid increases in unemployment provided an immediate spur to interest in an entrepreneurial economy (Birch, 1979). It was noted that in the 1980s aid increased dependency in the sub-Saharan Africa. Conditionality of the donors 'self-imposed rights' to connect demands for changes in social-political systems to more financial inducements (David and Aders, 1999).Entrepreneurs may either adopt conservative financial policies and restrict expansion or plan their expansion to minimize risk (Penrose, 1959)Observers blame rigidities in the Kenya banking system for the inability of small enterprises to borrow (Kabwegyere, 1977).

Firms with different profiles are likely to be financed with different combinations of debt and equity there is no universal optimum in respect of capital structure, although it seems that small firms rely on short term debt with little or no third party external equity (Berger and Udell, 1998).The rural entrepreneurs are reluctant to use land to secure business loans due to their risky circumstances (Ngethe and Wahome, 1987).

A quick insight into financial management detailed that organizations should have procedures, such as accounting policies, cash management, budgeting and budgetary control, travel, procurement of goods and services, payroll, reporting requirements (Jacobs, 2004). Simply increasing knowledge of financial management principles does not insure that a person will be a more effective financial manager. Knowledge must be applied (Gorham et al, 1998).

SMEs need systems such as clear guidelines and codes of ethics as means of minimising corruption. The organizations should have transparency and honesty so that they gain the trust of the community and avoid running the risk of being rejected. Mismanagement cannot be pushed under the carpet too long. The poor marginalized people are now becoming aware of the corruption tactics used by management of utilities. The powerful voice of the ordinary people is surely but steadily making an impact on public opinion and decision-making (Kameri, 2000).

Small businesses are typically much more informally opaque than large corporations because they often do not have audited financial statements to yield credible financial information on regular basis. Also, these firms usually do not have publicly traded equity or debt, yielding no market prices or public ratings that might suggest their quality (Berger and Frame, 2007).

A particular concern for policy makers is whether or not small businesses have access to adequate credit. After all, a lot of small firms are relatively young and have little or no credit history. Lenders may also be reluctant to fund small firms with new and innovative products because of the difficulty associated with the evaluating the risk of such products (Craig et al, 2006).

Despite the importance of the small enterprise sector, experience shows that provision and delivery of credit and other financial services to this sector by formal financial institutions, such as commercial banks has been below expectation. The Kenyan Government's Draft session paper of January 22nd 2004 on "Development of micro and small Enterprises (MSEs) for wealth and employment creation for Poverty reduction" recognizes that there has been limited access to financial services by MSEs mainly due to lack of tangible security and inappropriate legal and regulatory framework (Omino, 2005).

There is a deep-seated feeling that, commercial banks do not in practice, recognizes the SME segment and in the most cases, they either define their customer either as a corporate or as an individual client (Shultz and Prince, 1994).The type of financial institutions and its policy will often determine the access problem. Where credit duration, terms of payment, required security and the provision of supplementary services do not fit the needs of the target group, potential borrowers will not apply for credit even where it exists and when they do, they will be denied access (Parker and Torres, 1994).

There is need to develop appropriate institutions for the delivery of loans to small-scale as demonstrated in the study where it was established that the banks supports the view that high interest rate credit can help keep away the influential non-target group from a targeted credit programme (Joyce, 1978).

The success or failure of Community Based Organizations (CBOs) is based on competence of the change agent or lack of participation by the community. He observes that to avoid donor or government dependency, capacity building on individuals and community is critical to success of any project (Lotz, 1977). It was argued that development agencies supporting enterprises development should have an entrepreneurial culture that promotes strategic thinking as opposed to formal methods of planning (Gibb, 1999).

The poor performance of development agencies is attributed to lack of strategic thinking required for re-positioning within a dynamic environment. This is because the SMEs sector is constantly changing with new opportunities and challenges emerging (Harper et al, 1998).It was argued that finance is a key element for SMEs to succeed in their drive to build production capacity, create jobs and contribute towards poverty reduction (Mwangi, 2001).

The requisite concentration on financial services ignores the significant non-financial constraints that inhibit growth of SMEs. As a result, the impact of credit on enterprise development has been questioned, as portfolios remain dominated by trade and simple processing business that offer little scope for increased productivity (Ndwiga, 2007)

From the various literature reviews it is apparent that there are numerous factors that determine, affect and influence who, how much and by whom the financing of SMEs is done. Various variables determine the success/failure of the projects financed by micro-financial institutions and donor communities. From the literature reviews, there is need to further find out why despite the willingness of the various players and availability of resources; SMEs have failed to keep the country's MDGs on track for provision of essential services especially in the third world countries specifically in Africa. Despite presence of numerous NGOs and donors in the poor countries why do we still have problems of lack of basic services in the 21st century (Gorham, 1998).

There is need to find out what is really missing to make a difference for the millions of funds used up and yet the results are below the expectations. In this study there is an attempt to determine underlying reasons for success/failure of the SMEs in as far as financing is concerned. In addition to determining what actually happens in the raising finances, an attempt is made to explore the effective ways of going about the entire process from raising the funds, to utilization, managing, accounting, evaluating, and reporting of the entire project. From the literature review it is apparent that despite numerous attempts by the donor community and the government to avail credit the SMEs, there seem to be other issues that affect the SMEs financing other than access to funds (Gorham, 1998).

Availing the credit facilities has not solved all the financial issues facing SMEs. Other external factors beyond the control of SMEs have been found to greatly influence the performance of the SMEs. Rapid changes in technology has brought about new opportunities such as ease of sharing experiences as found on the internet in similar past projects in any part of the world, better management tools to manage the projects, availability of latest and low cost technology for processes. These technological changes have also brought in new challenges such as systems hacking (Gorham, 1998).

In short we can say that most SMEs have common challenges. These challenges mainly include; firstly lack of finances to carry out their operations without constraints. The sources of the funds are limited and sometimes have conditionality that is not friendly to the SMEs. Very few financial institutions are willing to finance SMEs. The lenders do not see much financial benefit from lending SMEs as the SMEs are not seen to be commercial entities but rather some charitable organizations formed to assist the poor. Therefore SMEs do not attract financial lenders. Secondly the SMEs have limited access to credit facilities mainly due to lack of security. Lack of acceptable security to guarantee the loans will hinder access to funds by the SMEs. Most of the SMEs are owned by individuals or groups of individuals who in most cases do not have assets to be used as security. Most of these SMEs are located in the poor neighbourhoods (Gorham, 1998).

Most credit facilities available in the market for SMEs are for relatively short periods, up-to three years only. Three years is a very short period for an organization to obtain credit, make investments and generate profit sufficient to pay off costs and retain some for development. The interest rates charged are quite exorbitant to be able to make a reasonable return and save for future expansion of the organization. Most SMEs are seen to engage in very risky ventures thus making it very difficult to secure funding from the commercial banks (Gorham, 1998).

Thirdly the SMEs lack capacity to fully utilize the funds, there is a limitation of the skilled personnel to administer the financial management. They have simple structures that limit the use of innovation. Having funds alone without the knowledge on how to best invest will not solve the financial management problem. There has to be appropriate personnel in the organization to implement the financial strategies, keep track, monitor progress and make any needed corrective actions. Fourthly the SMEs have very limited access to latest technology. This is because the technological changes needs to be adopted but at a cost. In turbulent technological environment, it is not possible for SMEs to keep on embracing each latest technology. New technology may result into more efficiency in operations. Using latest technology will increase the efficiency and hence increased output. This will make the SMEs have a higher benefit as compared to the costs associated with the provision of the goods and services (Gorham, 1998).

The economic literature on enterprise financing has identified three main obstacles that may prevent SMEs from obtaining adequate financing. These obstacles are as follows:

The intrinsic high risk associated with small-scale activities; The SMEs are regarded as facing more uncertain competitive environment than larger companies. SMEs are also less equipped in terms of human and capital resources to withstand economic adversities hence variable rate of return and higher rates of failure. Inadequate accounting system which undermines the accessibility and reliability of information.

The existence of marked informal asymmetries between small businesses and lenders, or outside investors; Privilege information within the SMEs may not be accessible to the lenders and outside investors. This will result into the lender not being able to clearly identify and differentiate between high quality and low quality companies and projects. The lenders may not be able to assess whether the enterprise is utilizing the funds in an appropriate way. Hence the need for collateral by the lenders of the funds.

The existence of sizeable transactions costs in handling SMEs financing; despite the relatively small amount of funds sought, the costs incurred are fixed e.g administrative costs, legal fees, costs related to acquisition of information.

Lack of collateral: Some SMEs are new hence may not have collateral even in the form of track records of financial performance, small SMEs may have a limit to access only small loans due to their current operation scale.

Institutional and Legal Factors in developing countries (Kenya included) still have highly concentrated and uncompetitive banking sectors. Hence restrictive government regulations which leads to conservative lending policies and/or high interest rates. Insufficiently developed legal systems effectively prevent the development of certain financing instruments including the use of collateral. There are problems with enforcement. Due to information infrastructure being largely undeveloped there is lack of credit bureaus and other mechanism for collecting and exchanging information on payment performance (Gorham, 1998).

2.4 Summary of Literature Review:

From the literature review it can be concluded that SMEs have limited resources in terms access to affordable finances, skilled personnel, latest technology, best management systems. A combination of the problems above means that the SMEs cannot be effective and efficient in its operations. Unlike previous studies, in this study there is an attempt to find out what conditions, circumstances; factors put the SMEs in difficult situations. There is a gap in that it is not clear why after having MFIs, donor community who have the resources; the SMEs still are experiencing financial difficulties. Despite the advancement in technology why some SMEs are still not utilizing previous experiences and knowledge, they are experiencing similar hardships every year.

Justification for this current study: How this study differs from previous studies:

Mwaka (2006) focuses her study on the financial structure and growth of SMEs. The study assesses the growth of SMEs but fails to deal with the challenges these SMEs face in raising funds. Wanyungu (2000) focuses on the financial management practices of SMEs in Nairobi and yet failed to tackle the issue of challenges faced by SMEs in accessing funds. Mueni (2006) looks at the linkages between MFIs and commercial banks. The study does not address the challenges faced by the SMEs when seeking finances from MFIs and commercial banks. From the literature review, there is need to further carry out a study on the challenges that SMEs face in the course of financing their projects. This is because the earlier studies dwelled on the operations of the SMEs but has not tackled the financing challenges facing SMEs especially in Nairobi.

CHAPTER THREE:

3.0 RESEARCH METHODOLOGY:

3.1 Introduction:

This chapter will discuss the research methodology used, the research design, the population of the study, the sample and sampling techniques, data collection methods and the data analysis and presentation methods applied.

3.2 Research design:

The study will be descriptive. Descriptive means observing the behaviour of a subject without interfering. Facts will be gathered to describe the present status of the challenges in finance in the sampled SMEs. The study will involve observing the sampled SMEs to establish the main financing challenges. It will involve review of available literature and information (James, P.K, 1997).

3.3 Population:

The study population will consist of all the 83 registered SMEs in Nairobi. (List attached in appendix 2, source: Ministry of Trade and Industry as at July 1, 2010).

3.4 Sample selection:

The study will select 30 SMEs. Computer generated random sampling technique will be used to select the sample from the population. The justification for using the random sampling technique is to ensure that each SME in Nairobi an equal chance of being selected. Different SMEs have different issues and to enable a broader field for greater representation of the population all SMEs are given equal probability of being sampled.

3.5 Data Collection:

The data will be both primary and secondary. The secondary data will be mainly from magazines, newspapers, journals, earlier thesis, and internet. The primary data will be collected by use of questionnaire. Sample questionnaire attached in the appendix. The questionnaire have both closed and open-ended questions. The closed ended questions are to enable the researcher to collect quantitative data for statistical analysis. The open ended questions on the other hand are intended to elicit qualitative respondent's views on the challenges facing SMEs in financing their projects. The drop and pick later method of data collection will be used. The researcher will be available to make clarifications on questions that correspondents may not find to be clear. The researcher will also be available to assist the respondents who are illiterate by administering the questionnaires orally.

3.6 Data Analysis:

There will be factor analysis to capture the mega financial challenges that SMEs face. Factor Analysis is a statistical method used to describe variability among observed variables in terms of a potentially lower number of unobserved variables. The data collected will be analysed by using the SSPS version 17. The result of the five point Likert scale will be used to analyse the variables. From the analysis the mode, the mean enable the researcher to identify the main challenges that SMEs face in their financial management at all levels of the project cycle. The standard deviation will be useful in determining the extent of deviation from the average. Percentages and frequencies inform the study on how often the various challenges recur and the level of importance placed on them by the SMEs during the financing process. Pie charts and bar graphs of the various challenges will provide at a glance the pattern of the common challenges faced by most SMEs.

3.7 Data Reliability and Validity:

The data collected will be from credible sources, respected sources, generally available and accessible, verifiable sources. The data will be tested for accuracy to detect any possible errors, bias and manipulations, the data will be subjected to validity tests to ensure that they are valid for the intended study by ensuring that they are timely and relevant. Tests will be carried out to confirm the accuracy. Data from different sources will be compared to confirm discrepancies and consistencies. The data collected will be analysed and the results compared to the theoretical expectations, any material variations will necessitate further research to enable gathering more evidence preferably from a different source to enable us make a conclusion.

CHAPTER: FOUR

4.0: FINDINGS AND DATA ANALYSYS

4.1 *Introduction:*

The research objective was to identify the main challenges encountered by SMEs in the course of raising finances for their operations. This section presents the findings and analysis from the primary data that was gathered from the respondents. Summaries of data findings together with interpretations have been presented by use of percentages, frequencies, charts, bar graphs, mean scores, standard deviations. SPSS version 17 was used in the analysis of the data.

4.2 *Profiles of the respondent SMEs:*

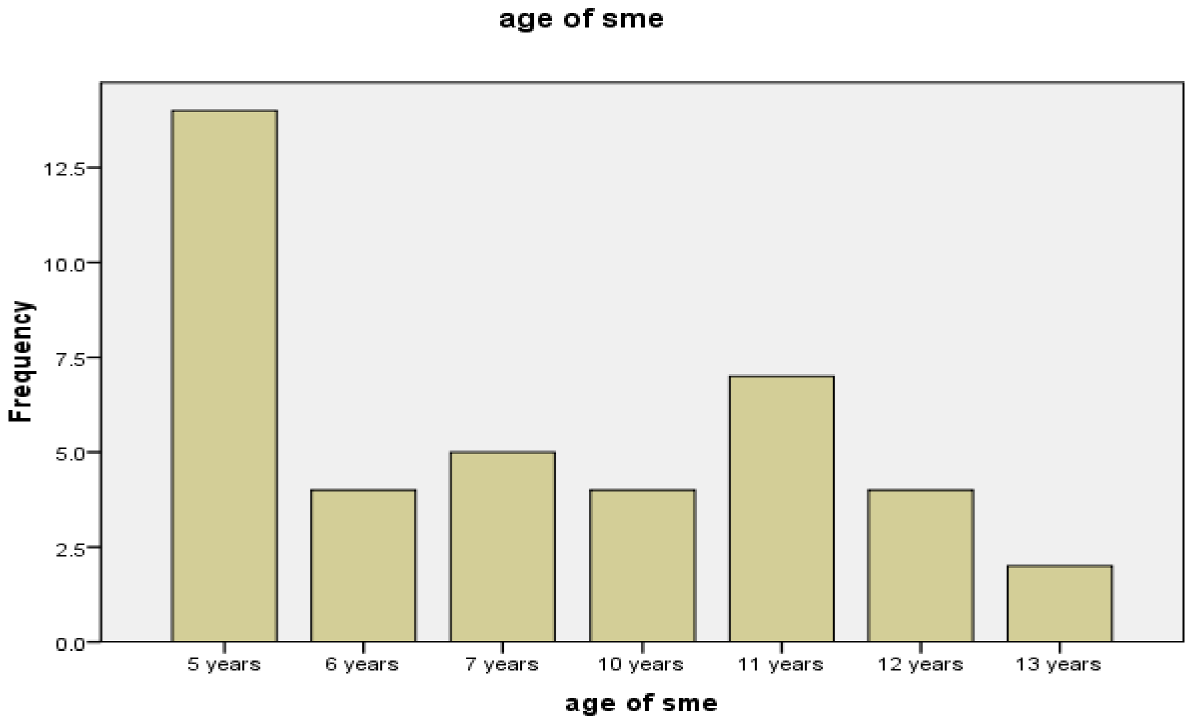
The study used a census survey of eighty three (83) questionnaires which were sent out to various respondents (SMEs) in Nairobi. Out of the eighty three questionnaires, forty were dully answered and used for analysis, this represents 48 percent response rate.

Table 4.2.1: Age of SME

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	5 years	14	35.0	35.0	35.0
	6 years	4	10.0	10.0	45.0
	7 years	5	12.5	12.5	57.5
	10 years	4	10.0	10.0	67.5
	11 years	7	17.5	17.5	85.0
	12 years	4	10.0	10.0	95.0
	13 years	2	5.0	5.0	100.0
	Total	40	100.0	100.0	

Source: Research Data

Majority (67.5%) of the SMEs under this study are less than ten years old. This partially explains why there is scarce experience in excess of ten years among the SMEs management. With passage of time the SMEs either transform into different form of organisation or phase out.



Source: Research Data

The SMEs in the study were analysed in terms of the age where the majority (57.5%) were found to be below seven years old. Such young SMEs will make it difficult for one to get history of financial history for credit rating.

Table 4.2.2: No. of employees per SME

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	1	1	2.5	2.5	2.5
	2	3	7.5	7.5	10.0
	3	5	12.5	12.5	22.5
	4	3	7.5	7.5	30.0
	5	8	20.0	20.0	50.0
	7	4	10.0	10.0	60.0
	9	4	10.0	10.0	70.0
	10	4	10.0	10.0	80.0
	11	3	7.5	7.5	87.5
	12	2	5.0	5.0	92.5
	13	1	2.5	2.5	95.0
	15	2	5.0	5.0	100.0
	Total	40	100.0	100.0	

Source: Research Data

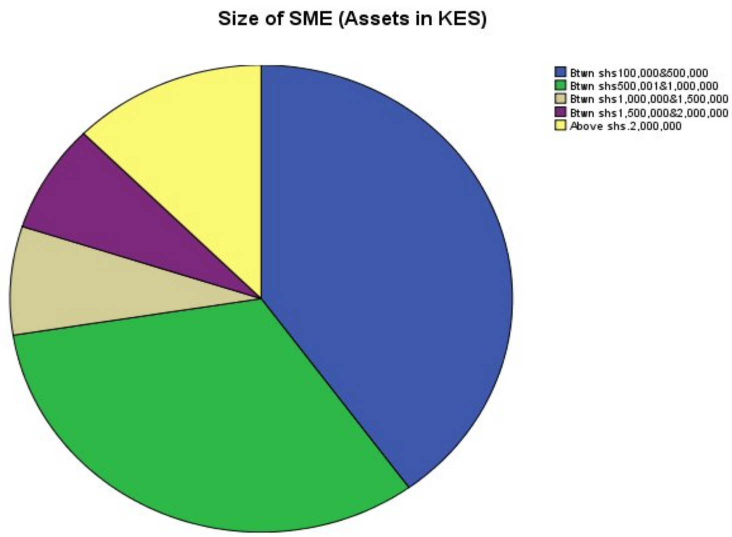
70 percent of the SMEs interviewed have between three and ten employees. This low number of employees indicate that the owners of the SMEs are not willing to invest a lot in human resources, do not want to lose control over the SME.

Table 4.2.3: Size of SME (Assets in KES)

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	Between shs100,000&500,000	16	40.0	40.0	40.0
	Between shs500,001&1,000,000	13	32.5	32.5	72.5
	Between shs1,000,000&1,500,000	3	7.5	7.5	80.0
	Between shs1,500,000&2,000,000	3	7.5	7.5	87.5
	Above shs.2,000,000	5	12.5	12.5	100.0
	Total	40	100.0	100.0	

Source: Research Data

Most SMEs interviewed (72.5%) control less than KES 1,000,000. Such small sizes will limit the ability to acquire additional funds from lenders due to lack of security in the form of assets.



Source: Research Data

In terms of size as per the assets held by SMEs, 72.5 percent of those interviewed control assets valued between KES 100,000 and 1,000,000.

Table 4.2.4: Sources of Finances for SMEs

		Micro-Financial institutions	Commercial banks	The government	The IFC/World Bank group	The community	The proprietors	Well wishers	NGOs
N	Valid	29	36	35	17	27	29	8	4
	Missing	11	4	5	23	13	11	32	36
Mean		4.2759	4.0833	3.1143	2.0588	2.0741	2.2759	2.7500	1.0000
Std. Error of Mean		.13946	.08333	.19129	.15975	.14047	.30952	.52610	.00000
Median		4.0000	4.0000	3.0000	2.0000	2.0000	1.0000	3.5000	1.0000
Mode		4.00	4.00	3.00	2.00	2.00	1.00	4.00	1.00
Std. Deviation		.75103	.50000	1.13167	.65865	.72991	1.66683	1.48805	.00000
Variance		.564	.250	1.281	.434	.533	2.778	2.214	.000
Minimum		2.00	2.00	1.00	1.00	1.00	1.00	1.00	1.00
Maximum		5.00	5.00	5.00	3.00	4.00	5.00	4.00	1.00
Sum		124.00	147.00	109.00	35.00	56.00	66.00	22.00	4.00

Source: Research Data

The SMEs that were interviewed indicated that they get their finances mostly from MFIs, commercial banks, the government the community and the proprietors. The SMEs have preference to specific lenders for reasons ranging from ease of accessibility, speed of processing loans, amount that can be provided as loans to cost of the loans amongst others.

Table 4.2.5: Main lenders for the past three years

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	0	2	1.1	3.1	3.1
	Micro-Financial Institutions (MFIs)	26	13.9	40.6	43.8
	Commercial Banks	27	14.4	42.2	85.9
	The Government	5	2.7	7.8	93.8
	The IFC/World Bank Group	1	.5	1.6	95.3
	The Community	2	1.1	3.1	98.4
	The Proprietors	1	.5	1.6	100.0
	Total	64	34.2	100.0	
Missing	System	123	65.8		
Total		187	100.0		

Source: Research Data

From the study it can be confirmed that there are several potential sources of funding to SMEs in Nairobi. The SMEs have all these sources to choose from.

Table 4.2.5: Main lenders for the past three years

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	0	2	1.1	3.1	3.1
	Micro-Financial Institutions (MFIs)	26	13.9	40.6	43.8
	Commercial Banks	27	14.4	42.2	85.9
	The Government	5	2.7	7.8	93.8
	The IFC/World Bank Group	1	.5	1.6	95.3
	The Community	2	1.1	3.1	98.4
	The Proprietors	1	.5	1.6	100.0
	Total	64	34.2	100.0	
Missing	System	123	65.8		

Table 4.2.6: Level of reliability for the SME projects operations

		Micro-Financial Institutions (MFIs)	Commercial Banks	The Government	The IFC/World Bank Group	The community	The Proprietors	Well wishers	NGOs
N	Valid	32	35	32	29	18	24	11	5
	Missing	4	1	4	7	18	12	25	31
Mean		4.4375	4.4000	3.3125	2.1034	1.7222	1.7500	1.1818	2.0000
Std. Error of Mean		.09977	.10208	.13043	.13450	.21090	.20189	.12197	.44721
Median		4.0000	4.0000	3.0000	2.0000	1.5000	1.5000	1.0000	2.0000
Std. Deviation		.56440	.60391	.73780	.72431	.89479	.98907	.40452	1.00000
Variance		.319	.365	.544	.525	.801	.978	.164	1.000
Minimum		3.00	3.00	2.00	1.00	1.00	1.00	1.00	1.00
Maximum		5.00	5.00	5.00	4.00	4.00	5.00	2.00	3.00
Sum		142.00	154.00	106.00	61.00	31.00	42.00	13.00	10.00

Source: Research Data

MFIs were preferred by SMEs due to various reasons amongst them being that; they are easily accessible, have relatively low interest rates, process loans fast, have SMEs interest at heart, sometimes provide training to SME management. Commercial banks were preferred because; their loans are repayable over longer period, have many branches for ease of access, can provide loans of high amounts. NGOs were preferred because; they offer large amounts of funds, the amount given may not be repayable, no interest is levied on principal amount.

Table 4.2.7: Average amount of credit applied per year

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	Below KES 100,000	35	87.5	87.5	87.5
	Between KES 500,000 and 1,000,000	5	12.5	12.5	100.0
	Total	40	100.0	100.0	

Source: Research Data

Those SMEs informed that on average the total amount borrowed in loans was below KES 100,000 per year. This implies that the SMEs have not been getting huge amounts in loans for financing their projects for the period under study.

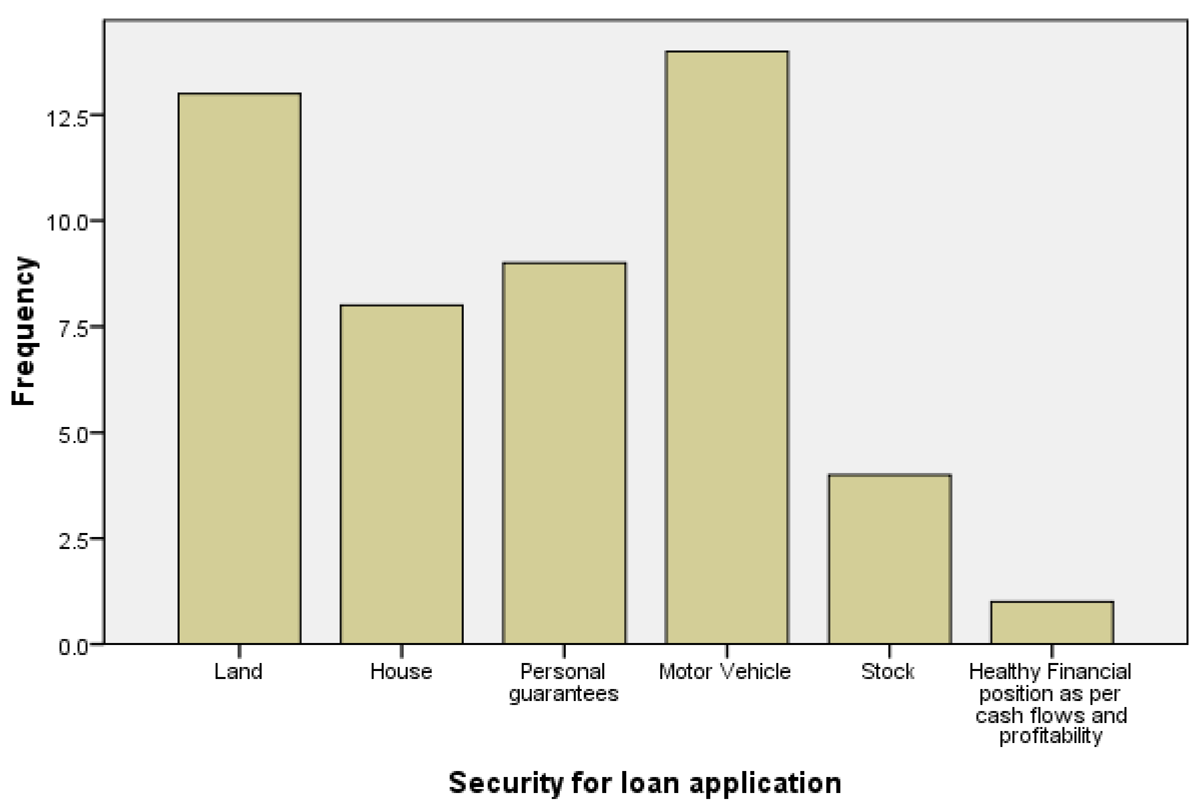
Table 4.2.8: Security for loan application

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	Land	13	7.0	26.5	26.5
	House	8	4.3	16.3	42.9
	Personal guarantees	9	4.8	18.4	61.2
	Motor Vehicle	14	7.5	28.6	89.8
	Stock	4	2.1	8.2	98.0
	Healthy Financial position as per cash flows and profitability	1	.5	2.0	100.0
	Total	49	26.2	100.0	
Missing	System	138	73.8		
Total		187	100.0		

Source: Research Data

Security to secure loans for SMEs is one of the headache that the management has to face. This is because due to relative small size of the SME, they do not control huge valuable assets that can be used as security. The total frequencies is greater than the number of correspondents due to the fact that they (correspondents) prefer more than one type of security. Despite the fact that the value of each asset is relatively 'small' in financial terms, SMEs use several assets at one to get substantial loans. SMEs have access to various assets that they use in combination as security for the loans applied. From the table 4.2.8 it can be concluded that SMEs are flexible in their choice to type(s) of security(ies) used for loan applications.

Security for loan application



Source: Research Data

The main securities that SMEs avail for loans include; motor vehicles, land, personal guarantees and house. These are assets directly controlled by the SMEs hence easily exchanged as security for loans.

Table 4.2.9: Types of Financial records maintained

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	0	1	.5	.6	.6
	Cash Book	33	17.6	21.4	22.1
	General Ledger	31	16.6	20.1	42.2
	Petty Cash	31	16.6	20.1	62.3
	Miscellaneous payments book	25	13.4	16.2	78.6
	Miscellaneous Receipts book	18	9.6	11.7	90.3
	Asset register	4	2.1	2.6	92.9
	Stocks Movement register	8	4.3	5.2	98.1
	Accounts receivables ledger	2	1.1	1.3	99.4
	Accounts payables ledger	1	.5	.6	100.0
	Total	154	82.4	100.0	
Missing	System	33	17.6		
Total		187	100.0		

Source: Research Data

All SMEs interviewed confirmed that they maintain at least some form of financial records in form of; cash book, petty cash, general ledger, miscellaneous payments and receipt books. Financial records are critical for auditing to verify the financial position and credit reference too.

Table 4.2.10: Specific information and documents are requested by the provider(s) of the funds:

	Frequency	Percent	Valid Percent	Cumulative Percent
Land title deed	35	18.7	18.7	18.7
Moto vehicle log book	33	17.6	17.6	36.4
Copy of leasehold deed	15	8.0	8.0	44.4
Copy of audited Financial statements	5	2.7	2.7	47.1
The name of the external auditors if any	10	5.3	5.3	52.4
The list of top management with their qualifications & experience	6	3.2	3.2	55.6
The period the SME has been in existence	30	16.0	16.0	71.7
The size and structure of the SMEs	30	16.0	16.0	87.7
The estimated total cost of the project to completion	15	8.0	8.0	95.7
Records of current and previous projects	8	4.3	4.3	100.0
Total	187	100.0	100.0	

Table 4.2.10: Specific information and documents are requested by the provider(s) of the funds:

	Frequency	Percent	Valid Percent	Cumulative Percent
Land title deed	35	18.7	18.7	18.7
Moto vehicle log book	33	17.6	17.6	36.4
Copy of leasehold deed	15	8.0	8.0	44.4
Copy of audited Financial statements	5	2.7	2.7	47.1
The name of the external auditors if any	10	5.3	5.3	52.4
The list of top management with their qualifications & experience	6	3.2	3.2	55.6
The period the SME has been in existence	30	16.0	16.0	71.7
The size and structure of the SMEs	30	16.0	16.0	87.7
The estimated total cost of the project to completion	15	8.0	8.0	95.7
Records of current and previous projects	8	4.3	4.3	100.0

Source: Research Data

Lenders Seek a lot of information for use in determining whether, how much, when to lend the SMEs. The various documents provided by the SMEs will provide the much needed information.

Table 4.2.10: Specific information and documents are requested by the provider(s) of the funds:

	Frequency	Percent	Valid Percent	Cumulative Percent
Land title deed	35	18.7	18.7	18.7
Moto vehicle log book	33	17.6	17.6	36.4
Copy of leasehold deed	15	8.0	8.0	44.4
Copy of audited Financial statements	5	2.7	2.7	47.1
The name of the external auditors if any	10	5.3	5.3	52.4
The list of top management with their qualifications & experience	6	3.2	3.2	55.6
The period the SME has been in existence	30	16.0	16.0	71.7
The size and structure of the SMEs	30	16.0	16.0	87.7
The estimated total cost of the project to completion	15	8.0	8.0	95.7
Records of current and previous projects	8	4.3	4.3	100.0

Table 4.2.11: Specific information and documents are requested by the provider(s) of the funds:

	Observed N	Expected N	Residual
Land title deed	35	18.7	16.3
Moto vehicle log book	33	18.7	14.3
Copy of leasehold deed	15	18.7	-3.7
Copy of audited Financial statements	5	18.7	-13.7
The name of the external auditors if any	10	18.7	-8.7
The list of top management with their qualifications & experience	6	18.7	-12.7
The period the SME has been in existence	30	18.7	11.3
The size and structure of the SMEs	30	18.7	11.3
The estimated total cost of the project to completion	15	18.7	-3.7
Records of current and previous projects	8	18.7	-10.7
Total	187		

Source: Research Data

Different documents supplied by the SMEs provide different information. By obtaining different information the lenders will be in position to evaluate the financial position of the SMEs.

4.3 *Challenges that SMEs face in regard to financing:*

The specific challenges that SMEs face in the course of financing their projects are; Lack of collateral security, lack of audited financial records, poor banking history, lack of proper management structure, lack of budgets, lack of business plans, lack of resources to install modern accounting systems, lack of tools to evaluate projects, negative attitude of the commercial banks toward SMEs, misclassification of the SMEs as NGOs by some partners, lack of well trained and qualified staff, inability to service loans, lack of funds to invest in latest technology .

Table 4.3.1: Specific challenges that SMEs face in financing their projects:

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	Lack of collateral	5	4.1	4.1	4.1
	Lack of sufficient past financial records	20	16.5	16.5	20.7
	Lack of well trained and qualified staff	9	7.4	7.4	28.1
	Inability to generate sufficient returns on investments to pay off principal & interest	3	2.5	2.5	30.6
	Lack of resources to install a modern accounting systems to monitor projects	12	9.9	9.9	40.5
	Lack of the tools to evaluate projects that needs to be implemented	10	8.3	8.3	48.8
	Negative attitude of the Commercial banks towards SME's	17	14.0	14.0	62.8
	Bias evaluation and rating of SME by the potential lenders	10	8.3	8.3	71.1
	Misclassification of the SME as an NGO by some partners	11	9.1	9.1	80.2
	Inability to service loans	7	5.8	5.8	86.0
	Lack of a detailed management information systems	4	3.3	3.3	89.3

Lack of sufficient funds to hire qualified finance staff	6	5.0	5.0	94.2
Lack of funds to train existing staff on the latest technology and skills	7	5.8	5.8	100.0
Total	121	100.0	100.0	

Source: Research Data

Most of the challenges that SMEs face are factors that they (SMEs) can influence. They are factors that the SMEs can change gradually and overcome them in the long run.

Table 4.3.2: Default in loan repayments one SME

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	Reason: Natural calamities	1	.5	50.0	50.0
	Resolution: scaled down/cancelled project	1	.5	50.0	100.0
	Total	2	1.1	100.0	
Missing	System	185	98.9		
Total		187	100.0		

Source: Research Data

Most SMEs that were interviewed did not disclose that they ever defaulted in the loans advanced. Either the SMEs are very carefully when taking loans to make sure that they do not default or they are not honest in claiming non-default.

Table 4.3.3: Key factors considered before funds are released to the SMEs:

	Observed N	Expected N	Residual
The ability to repay the loan	18	16.3	1.7
The amount of the loan applied	24	16.3	7.7
Previous history with the lenders(s)	6	16.3	-10.3
Availability of security	24	16.3	7.7
Size of the SME (in terms of assets)	24	16.3	7.7

Table 4.3.2: Default in loan repayments one SME

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	Reason: Natural calamities	1	.5	50.0	50.0
	Resolution: scaled down/cancelled project	1	.5	50.0	100.0
	Total	2	1.1	100.0	
Missing	System	185	98.9		

The nature of the project to be financed	18	16.3	1.7
The availability of financial records	10	16.3	-6.3
The viability of the proposed projects	26	16.3	9.7
The nature of the security available	11	16.3	-5.3
Other competing loan applicants	2	16.3	-14.3
Total	163		

Source: Research Data

In some cases the numerous documents (such as log book, title deed) may not be available hence delay in loan processing, it may also be difficult to anticipate which document will be requested for the first time loan application. Some SMEs felt that some of the information being requested is confidential and hence the management felt uncomfortable to divulge to third parties.

Table 4.3.4: Problems experienced when asked to provide information/documents

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	The SME does not have the document ready	12	6.4	28.6	28.6
	The document is with the third party	8	4.3	19.0	47.6
	The information requested is confidential	8	4.3	19.0	66.7
	Only partial information is provided	7	3.7	16.7	83.3
	There is no accurate information	2	1.1	4.8	88.1
	More time is needed for getting the information	4	2.1	9.5	97.6
	There is fear that the information/documents given may be misused	1	.5	2.4	100.0
	Total	42	22.5	100.0	

Missing	System	145	77.5		
Total		187	100.0		

Source: Research Data

Due to lack of proper accounting records by SMEs they always find it difficult to supply in time all documents needed by the potential lenders.

4.5 *Summary and interpretation of the findings:*

From the findings of this study, the following have been determined and concluded:

Most SMEs lack collateral for raising finances from financial institutions. This has led to failure by SMEs to obtain loans for their operations. Even those SMEs that had some form of collateral, these were not easily acceptable in exchange for the loans from the lenders. Majority of the SMEs lack audited financial statements. This lack of audited financial records reduced the credibility of the records that the financiers are meant to rely on when assessing the credit worthiness of the SMEs during loans processing.

The management of the SME has had a huge bearing on the success of the SME. SMEs structure, budget and business plans have heavily been considered when SMEs loans applications have been assessed. The SME is as good as its management and employees' experience and qualifications, level of technology. The level of technology applied in the SMEs affects its strengths/weaknesses that greatly influence its success in financial matters.

The history of the SMEs tells a lot about the current and possible future of the SME. What the SME has experienced in the past acts as an indication of what the SME is capable of doing. Where an SME has had a smooth financial operation. A healthy financial indicates good financial planning and wise investment. The SMEs use past experiences for future engagements. Lessons about previous financial management will act as a reference point. Indeed there is a school of thought that a manager that has run down a business is the best manager, meaning that such a manager will most likely know when the current business is on track or it is Tambling and take the necessary steps.

The ability of the SME to repay the loan if known in advance will influence the chances of whether and how much credit will be given to the SME. SMEs that appear to have the ability to service their loans will easily win the interest of financiers to advance a loan. On the other hand in cases where the SME has the indication that they are likely to default on repayment will appear unattractive for potential lenders. The lenders will demand a higher interest rate being a reflection of the high level of risk to give credit. The repayment period will tend to be shorter for those SMEs that are unlikely to service their loans smoothly.

The project being financed may determine whether the loan application will be successful or not. In cases where in the judgement of the potential lenders the project is not viable, feasible, the chances of success in the loan appraisal become slim. An attractive project proposal will interest the potential lender to advance the loan on the hope that the success of the project will make it easier for the SME to generate sufficient returns and service the loan without much stress.

SMEs that are newly established find it more difficult to convince the potential financiers that they have the manpower, experience, goodwill to use the funds borrowed and service the loans without failure. Lack of previous reference, history makes such new SMEs difficult to sell in the market. On the other hand, old well established SMEs wind it easier to sell themselves in the market to the potential lenders. This is because there is previous experience that can be referred to. The old SMEs can proof their ability and good will in sound financial management.

SMEs offer varied products and services. The SMEs tend to specialise in a few services/products. The type of services/products rendered by the SME influences the likely success of financing. Some nature of services/products that are commonly demanded in the market make the SME easy to sell and attract funding faster. For products services that are not on high demand, the SME attraction to potential financiers is reduced.

Lack of resources to evaluate and monitor projects may hinder sound management practices. Lack of sufficient tools to evaluate potential projects may result in poor choice of projects. Poor selection of projects will reduce the chances of success of the SME.

Negative attitude by commercial banks towards SMEs affects the rating of SMEs by the financial institutions. Bias evaluation and rating of SMEs causes misclassification of SMEs for financing purposes.

CHAPTER: FIVE

5.0: SUMMARY AND RECOMMENDATIONS:

5.1 *Summary:*

The main aim of this study was to get insight into the main challenges that SMEs face in financing their projects. The study sought to identify the main challenges that SMEs in Nairobi encounter. This chapter contains the conclusion of the results from the study, recommendations, limitations of the study and suggestions for further research. The study met its objective of identifying the key challenges that SMEs face in financing their projects. The field survey was carried out by administering questionnaires to the SMEs in Nairobi. For those SMEs that accepted to be interviewed were enthusiastic about stating the various challenges that they face.

Apart from the primary data collected by using questionnaires, secondary data was also used to collaborate the information obtained. Previous studies carried out in this area of SMEs financing were also used to clarify facts and the data to ensure objectivity in the process. By using the internet the data collected was compared with similar studies to confirm consistencies. Using different sources to obtain data proved that the intention of getting as much information as possible was achieved since the different sources complemented each other.

The data collected was analysed by using SPSS version 17 to present the various challenges that SMEs face. Tables, charts, percentages and frequencies were generated from the analysis. These graphical presentations provided a clear view of the challenges faced by SMEs. Different attributes of the SMEs such as the size in terms of assets, number of employees were analysed.

The whole population region of Nairobi was explored to ensure that the data collected is a fair representation of the entire population. The various different types of businesses like the shops, saloons, stationery shops, chemists among others were interviewed to ensure that a cross-section of all industries involved in SMEs were adequately covered. Nairobi region has a very high concentration of SMEs hence confirmed that all types of SMEs can be located in this study area.

5.2 *Conclusion:*

The findings indicate that the majority of the challenges that SMEs face are factors that the SMEs themselves can influence to change in their favour, the SMEs are unwilling to relinquish control over the company to outsiders (Berggren et al, 2000). The choice of sources of finances is entirely made the SME's management. The level of technology that the SME uses, the financial management tools and accounting modules are decisions that are within the SME management. Depending on the choices and decisions made by the SME management, this may lead to different challenges in managing and financing their projects. The experience and exposure of the staff managing the SME's projects will have a huge implication on the success or failure of the project. It can also be said that a few factors are externally controlled beyond the direct control of the SMEs. Small firms have substantially worse chances of getting loans because the lenders are biased towards small firms (Bigsten et al, 2003).

It was generally coming out that new SMEs, new products, and new clients had to work harder to proof that they are capable as compared to the old well established SMEs. Good will takes time to be build and once established may on the other hand take a very short time to be eroded. For the risk averse investors in the market every slightest indication of availability of risk is taken serious and carefully evaluated before decision is made to commit any finances for the organisation. The Lenders tend to be reluctant to fund small firms with new and innovative products because of the difficulty associated with evaluating the risk of such products (Craig et al, 2006).

Information is important to financial success for the SMEs. It is easier for SMEs that have successfully applied for loans in the past than new SMEs in the market since previous experience by the SME and the lenders will play a critical role in terms of availability of history of loan repayment. Most lenders would like to know the financial history and present circumstances to be predict the likely future. In cases where it information is not readily available, the perceived risk tend to be high. This converges to the conclusion that finance is a key element for SMEs to succeed in their drive to build production capacity, create jobs and contribute towards poverty reduction (Mwangi, 2001).

5.3 *Policy Recommendations:*

SMEs to obtain access to sufficient and sustainable funds to their projects, have to overcome the typical challenges and hurdles common in SMEs financing. The SMEs have to remain focussed, embrace the latest technology, own some valuable assets, invest in qualified staff , maintain professionalism and market themselves to remain competitive.

The SME need to have experienced staff in the top management. The decisions made at management level will affect what activities will be implemented during the project's financing and management. It will be easier to ensure that quality is maintained in all stages of the project management where those who are in charge of implementing are qualified with the relevant tools, knowledge and skills. Where the original documents such as log books and title deeds are with other third parties, the lenders should consider accepting certified true copies of the originals.

The SME need to get clearly from the beginning of the loan processing all the requirements and list of documents that are likely to be requested and ensure that these are made available. The previous experience should always serve as a lesson so that subsequent loan processing become easier and more of routine. There is need for objective formula of assessing credit worthiness in the financial market. This consistence will enable the SMEs to learn from previous experiences and also from other successful SMEs and adopt to get the requested funding at competitive cost.

In the dynamic environment, the SMEs need to carry out SWOT (Strength, Weakness, Opportunities and Threats) analysis in order to improve performance and remain effective and efficient. The SMEs need to re-strategize to remain competitive and appealing to the potential lenders since access to formal finance is poor because of the high risk default among small businesses (Kauffman, 2005).

The SMEs need to get organised in such a way that it is easier for potential lenders to evaluate them. There should be clear guide lines and rules that SMEs must follow in such areas as disclosure of financial information for credit rating, history of the owners, the list of all the items that the SMEs deal in and the other business associates that the SME may engage with during the course of business. Availability of such information will make it easier to evaluate the SME's credit worthiness and avoid general bias conclusions about SMEs financial capabilities. Policy makers in financial markets need to carter for the SMEs too alongside other entities. The traditional view of SMEs as institutions denied access to financial services does not survive. Success of SMEs financially largely depends on the strategies adopted.

5.4 *Limitations of this study:*

The results of this study were drawn from the respondents of only 48 percent of the SMEs targeted. The results may have been different if 100 percent of SMEs targeted had participated.

Another limitation of this study is that the period of focus was only upto five years only, had the period been extended to a longer term say twenty years, the trend in the evolution of the challenges could be different.

This study was limited by respondents' attitudes. This was most severe in respondents' failure to adequately respond to the unstructured questions. This can be seen in the sense of the proprietors being reluctant to release information considered sensitive or private. Lack of full disclosure may lead to loss of critical information about the SME finances.

5.5 *Suggestions for further research:*

A comparative study should be done from the financier's point of view to establish the main reasons for making it very difficult for SMEs to access and service the funds from them. The risks and perceptions that the sources of finances have against the SMEs. The financiers could provide some new perspective on the whole issue of the financial management practices adopted by SMEs and how these impact on how they are perceived.

A study should be carried to establish whether SMEs which get external financing are more successful as compared to those that do not have access to external financing. Some SMEs heavily rely on funds from third parties for financing their projects while some prefer ploughing back their earnings and entrepreneurs' funds . There has to be reasons to why the two options of financing is preferred to the other. There are benefits and pitfalls for each option selected.

A study on why different sources of financing are preferred by each SME. Each SME has their own reasons as to why particular source(s) of finance is (are) preferred to the other(s). Such a study will bring out the various implications of the different available sources of finance to SMEs.

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APPENDIX 1 – QUESTIONNAIRE

Section A: Background of the SME:

1. What is the name of your SME? ---

2. Where is the SME registered office located?--

3. How old is the SME? --

4. What is the size of the SME in terms of :

- Assets (Ksh) --

- Number of employees --

Section B: SME main products/ services offered:

5. What are the main services/products offered by the SME?

- --

- --

- ---
- ---
- ---

6. Of the services/products offered above, which one(s) are the key (i.e. the primary, main, reason for your existence) ones that you concentrate on? Why?

- ---
- --

Section C: Financing the SME's operations:

7. For each of the listed sources of finances, indicate the level of importance to your projects' operations (where 1 represents the least important where as 5 represents the most important)

	1	2	3	4	5
• Micro-Financial Institutions (MFIs)---------	( )	( )	( )	( )	( )
• Commercial Banks-----------------------------	( )	( )	( )	( )	( )
• The Government-------------------------------	( )	( )	( )	( )	( )
• The IFC/World Bank group------------------	( )	( )	( )	( )	( )
• The community--------------------------------	( )	( )	( )	( )	( )
• The proprietors--------------------------------	( )	( )	( )	( )	( )
• Well wishers-----------------------------------	( )	( )	( )	( )	( )
• NGOs--	( )	( )	( )	( )	( )
• Any other(s) please specify-------------------	( )	( )	( )	( )	( )

8. Assuming that all sources listed in 7 above are willing and ready to finance your project(s), which one will you select)? Why or why not?

- ---

- --

- ---

- ---

9. Have you been unable to raise finances? Please explain briefly.

----

10. On average, how much credit do you apply for per year? (Please select):

- Below Ksh 500,000 ---------------------------------( )
- Between Ksh 500,000 and 1,000,000--------------( )
- Between Ksh 2,000,000 and Ksh 5,000,000------( )
- Over Ksh 5,000,000----------------------------------( )

P. Please rank by ticking the following in the order of importance as far as challenges your organization faces in regard to financing: (1 – least important and 5 is most important):

	1	2	3	4	5
(a)Lack of collateral security----------------------------	( )	( )	( )	( )	( )
(b)Lack of Audited Financial records------------------	( )	( )	( )	( )	( )
(c)Banking History---------------------------------------	( )	( )	( )	( )	( )
(d)Type of product/services offered-------------------	( )	( )	( )	( )	( )
(e)Management structure/budget/business plan------	( )	( )	( )	( )	( )

(f)Any other(s) please specify -------------------------( ) ( ) ( ) ( ) ( )

<u>12. What are the key factors/characteristics considered before funds are released to the SME? (Please tick the ones that apply)</u>

- The ability to repay the loan---------------( )
- The amount of the loan applied -----------( )
- Previous history with the lender(s)--------( )
- Availability of security----------------------( )
- Size of the SME (in terms of assets)-------( )
- The nature of the project to be financed---( )
- The availability of financial records -------( )
- The viability of the proposed project(s)---( )
- The nature of the security available--------( )
- Other competing loan applicants-----------( )
- Any other(s) please specify-- --

13. What specific information and documents are requested by the provider(s) of the funds? (Please tick the ones that apply):

- Land title deed---( )
- Motor vehicle log book---( )
- Copy of leasehold deed---( )
- Copy of Audited Financial statements for the recent year(s)-----------------------------( )
- The name of the external auditors if any--( )

- The list of the top management with their qualifications and relevant experiences.---( )
- The period that the SME has been in existence---( )
- The size and structure of the SME.---( )
- The estimated total cost of the project to completion---------------------------------------( )
- Records of current and previous projects ---( )
- Any other(s) please specify--( )

14. When requested to provide the information/documents above do you experience the following (Please tick where applicable):

- We do not have the document ready --( )
- The document is with a third party being held for another charge--------------( )
- The information available does not seem sufficient ------------------------------( )
- We feel that the information requested is confidential ----------------------------( )
- We provide only partial information --( )
- We do not have accurate information --( )
- We ask for more time to prepare information--( )
- We fear that the documents/information to be given out may be misused------( )
- We are of the opinion that the information being requested is not necessary---( )
- Any other(s) please specify--

15. What do you think about the difficulties above?

----

16. What are your recommendations on how to resolve the issues in 14 above?

----

17. Do your subsequent funds applications have your feedback incorporated when loans are being appraised in future applications according to your judgement? (Do you think previous experience on loan applications influence the subsequent applications and outcome?)Please explain.

----

18. Do you encounter similar hurdles in your loans applications every year? Please elaborate.

----

19. Does the SME have any security?

- Yes ---------------
- No ----------------

20. If yes, what security do you often offer for the loan application? Please mark the one(s) that you offer:

- Land -----------------------------( )
- House-----------------------------( )
- Personal guarantees-------------( )
- Motor Vehicles------------------( )
- Stock------------------------------( )
- Healthy Financial position as depicted by cash flows and profitability----------------( ).
- Any other(s) please specify--

21. What were your main lenders for the past three years (Please tick the one(s) applicable)

- Micro-Financial Institutions (MFIs)-----( )
- Commercial Banks--------------------------( )
- The Government-----------------------------( )
- The IFC/World Bank group----------------( )
- The community------------------------------( )
- The proprietors-------------------------------( )
- Well wishers----------------------------------( )

- NGOs---( )
- Any other(s) please specify--- --

22 Of the listed lenders, which ones do you prefer. Why. Please explain.

----

23. For the various sources of funds, list the lender name(s) and the interest rate charged in the following format:

Name of Lender Average interest rate per annum (%) for the last three years

(a)-------------------------------- -----------------------------------

(b)-------------------------------- ------------------------------------

(c)-------------------------------- -------------------------------------

(d)--------------------------------- --

24. Please state any other costs incurred by the SME in the process of obtaining finance:

- --
- --
- ---
- ---

- ---

25. What is the turn –around- time for the loan application?----------------------------------

26. Have you ever had a loan application declined (in part or in total)? Please explain circumstances.

----

27. If yes for 26 above, what action did you take?

----

28. For the funds that the SME has successfully secured, how do you utilize, account for them to ensure that they are used for the intended purpose?

----

29. What types of financial records do you maintain in accounting and managing for the funds? (Please tick where applicable)

- Cash book-------------------------------- ( )
- General ledger----------------------------( )
- Petty cash book--------------------------( )
- Miscellaneous payments book---------( )

- Miscellaneous receipts book-----------( )
- Asset register-----------------------------( )
- Stocks movement register--------------( )
- Accounts receivables ledger-----------( )
- Accounts payables ledger--------------( )
- Shareholders register------------------- ( )
- Any other(s) please specify--

30. Have you in the past three years had to default repayment of a loan? Please tick as appropriate

Yes---------------( )

No----------------( )

If yes what were the reasons for default? Please select the ones that apply:

- The project was not successful--( )
- The repayment period was too short---( )
- There were too many loans to be repaid at the same time---------------------( )
- Negative economic environmental changes------------------------------------( )
- There was no much pressure from the lender-----------------------------------( )
- Interest rates charged were too high---( )
- Natural calamities like drought, floods, earth quacks affected business----( )
- The funds were diverted to non planned and non profitable use-------------( )
- Too much money had been borrowed than what we could manage---------( )

- We were overwhelmed by the drastic increase in activities------------------( )
- There were no proper financial records---( )
- Any other(s) please specify--

----

31. How did you resolve the problems in 30 above (Please tick all that are applicable)?

- Approached another potential financier-------------( )
- Scaled down on the project----------------------------( )
- Postponed the project implementation--------------( )
- Cancelled the project-----------------------------------( )
- Restructured the project-------------------------------( )
- Did nothing about it------------------------------------( )
- Sold all the organization assets to raise funds------( )
- Sought legal advice-------------------------------------( )
- Laid off some staff--------------------------------------( )
- Any other(s) please specify--

----

32. Please tick all the challenges that you face in financing among the list below:

(a)Lack of collateral for a loan ---( )

(b)Lack of sufficient past financial records --( )

(c)Lack of well trained and qualified staff --( )

(e)Inability to generate sufficient returns on investments to pay off principal & interest---( )

(f)Lack of resources to install a modern Accounting system to monitor projects------------( )

(g)Lack of the tools to evaluate projects that needs to be implemented -----------------------( )

(h)Negative attitude of the Commercial banks toward SMEs----------------------------------( )

(i)Bias evaluation and rating of SME by the potential lenders----------------------------------( )

(j)Misclassification of the SME as an NGO by some partners----------------------------------( )

(k)In ability to service loans --( )

(l)Lack of a detailed management information system--( )

(m)Lack of sufficient funds to hire qualified finance staff---------------------------------------( )

(n)Lack of funds to train existing staff on the latest technology and skills--------------------( )

(o)Any other(s) please specify--

----

33. For each of the listed sources of finances, indicate the level of reliability for your projects operations (where 1 represents the least reliable where as 5 represents the most reliable)

	1	2	3	4	5
• Micro-Financial Institutions (MFIs)---------	( )	( )	( )	( )	( )
• Commercial Banks-----------------------------	( )	( )	( )	( )	( )
• The Government--------------------------------	( )	( )	( )	( )	( )
• The IFC/World Bank group-------------------	( )	( )	( )	( )	( )

- The community----------------------------------( ) ( ) ( ) ( ) ( )
- The proprietors----------------------------------( ) ( ) ( ) ( ) ( )
- Well wishers--------------------------------------( ) ( ) ( ) ( ) ( )
- NGOs--( ) ( ) ( ) ( ) ( )
- Any other(s) please specify--------------------( ) ( ) ( ) ( ) ( )

Filled in by (Designation)--

THANK YOU VERY MUCH FOR TAKING YOUR TIME TO PROVIDE THE INFORMATION.

APPENDIX 2: List of SMEs in Nairobi (Based in the major shopping centres and industrial area)

List of SMEs in Nairobi:

1. Adega Creations Ltd
2. Aflowama Company Ltd
3. Afso Exporters.
4. Afya na Faida
5. Agnes Fashions & Design
6. Agnes Kwamboka Matoke
7. Agys Snacks enterprises
8. Ajosina Sea Food/Handicrafts
9. Al-Ekhiaas Agency

10. Aozora Enterprises

11. Brenmer Services

12. Burhani Bakers (Nairobi)

13. CC warbucks Enterprises

14. Charliah Enterprises

15. Cheleann Art & Crafts

16. Chicken Choice Ltd

17. Chiras (K) Ltd

18. Coyote Services Ltd

19. Crossroad Merchants

20. Emarc Maritime Supplies

21. Fineno Enterprises

22. Flora E.A limited

23. Freimann Enterprises

24. Gealtie Enterprises Ltd

25. Geenfileds Fina Foods Ltd

26. Harvesters products

27. Home Delish

28. Irich Company Limited

29. Jajua Handcaft dealers

30. Janes Traders

31. Jawan Impex Suppliers

32. Jekez Enterprises

33. Jolex Services Investments Ltd

34. Kilimanjaro Spty Fishing Flies

35. Kirinyaga Flour Mills Ltd

36. Lamarie enterprises

37. Ledama African Curios & Craft

38. Ledemamangola enterprises

39. Lisamu Enterprises Ltd

40. Lycan Enterprises

41. Maika Agencies

42. Marnel Jinja Fishing flies

43. Mary W. Macharia

44. Mega Exporters & importers

45. Melona Products Ltd

46. Melvin Marsh International Ltd

47. Mifra Services Ltd

48. Miromi Company Limited

49. Moliv Distributors

50. Nadis Services Limited

51. Nature’s tastes

52. Ngong Amaranth Foods

53. Obesh Enterprises

54. Opija Agency

55. Quarterly General Supplies & Promotion

56. Regie Flowers

57. Richkasey Enterprises

58. River-Walk Beauty & Design Products

59. Sagi Enterprises

60. Samaki Enterprises

61. Sceptre & ORB limited

62. Shammah Wings Agencies

63. Shawn-Ethans Mushrooms

64. Silmart Enterprises Limited

65. Sky Tea Ltd

66. Sky Trail Travel & Tours

67. Soy Africa Ltd

68. Street Bins Ltd

69. Supa Cosm Products Ltd

70. Tasha Enterprises (K) Ltd

71. Teeny Fashions Ltd

72. The Mount of Olive

73. Thomas Bernardo House

74. Top Supplies 2000

75. Twins Catering (K) Ltd

76. Vasams Enterprises

77. Vihakama Enterprises

78. Wadan Soya Foods &Snacks

79. Wem Integrated Health Services

80. Willmark Diesel Services & Electric Ltd

81. Wima Flowers Ltd

82. Wima Suppliers

83. Windave Enterprises

UNIVERSITY OF NAIROBI
SCHOOL OF BUSINESS
MBA PROGRAM – LOWER KABETE CAMPUS

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

P.O. Box 30197
Nairobi, Kenya

DATE. JUNE 06, 2011 ....

TO WHOM IT MAY CONCERN

The bearer of this letter .. MAURICE BARASA WANYAMA ....

Registration No: ... D61/70186/2009 ....

is a Master of Business Administration (MBA) student of the University of Nairobi.

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 if you assist him/her by allowing him/her to collect data in your organization for the research.

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.

UNIVERSITY OF NAIROBI
SCHOOL OF BUSINESS
MBA OFFICE
P. O. Box 30197
NAIROBI

DR. W.N. IRAKI
CO-ORDINATOR, MBA PROGRAM

APPENDIX 3: INTRODUCTORY LETTER

University of Nairobi

School of Business

P.O. Box 30197 – 00100

Nairobi

March 31, 2011.

To whom it May Concern:

Dear Sir/Madam,

Ref: Request for data – Challenges faced in Financing SMEs in Nairobi.

I am a post graduate student at the University of Nairobi, School of Business undertaking research in Small and Micro Enterprises financing with specific reference to the challenges faced in financing SMEs in Nairobi.

Your participation is essential to this study and will enhance our knowledge of the challenges faced in financing SMEs. The information required is strictly for academic purposes and will be treated in the strictest confidence

Your kind assistance in providing requested information will be highly appreciated.

Yours faithfully,

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