THE EFFECT OF MICROFINANCE CREDIT ON THE FINANCIAL PERFORMANCE OF SMALL AND MEDIUM ENTERPRISES IN KIAMBU COUNTY, KENYA

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DECLARATION

I declare that this is project is my original work and has never been submitted for a degree in this university or any other university for examination/academic purpose.

Signature …………………………… Date………………………………………

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BY SUPERVISOR'S DECLARATION

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

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DEDICATION

All praises to the Almighty God, the most gracious, for giving me the strength and determination to complete this study.

To my parents Mr. and Mrs. James Waithanji for their sacrifice, encouragement and support

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ABSTRACT

Microfinance credit is a source of financial services for entrepreneurs and small businesses lacking access to banking and related services. Microfinance is “the provision of financial services to low-income poor and very poor self-employed people”. The research was aimed at investigating the effects of micro-finance credit on the financial performance of Small and Medium Enterprises (SMEs) in Kiambu County, Kenya. 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. 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 effect of microfinance credit on financial performance of SMEs in Kiambu. This research problem was studied through the use of survey design. Out of the 2,061 SMEs licensed, according to Kiambu County records by February 2013 this study randomly sampled 60 SME’s. The study found that there is a direct relationship of access to credit and financial performance of the companies. The study also concludes that the enterprises benefit from loans from microfinance institutions, the SMEs seek financial assistance from the MFIs due to interest rate, easy loan repayment and amount offered. There is need to provide an enabling environment for SME’s to grow and thrive, therefore there is a need to develop strategies to enhance increased access to microfinance credit by SME’s from commercial banks and microfinance institutions. It is important for the government to set up policies that will ease microfinance credit to SME’s.

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LIST OF ABBREVIATIONS

GOK	-	Government of Kenya
KIPPRA	-	Kenya Institute for Public Policy Research and Analysis
K-REP	-	Kenya Rural Enterprise Program
KSHS	-	Kenya Shillings
MFI's	-	Microfinance Institutions
NGOs	-	Nongovernmental Organizations
ROA	-	Return on Asset
ROE	-	Return on Equity
ROI	-	Return on Investment
ROS	-	Return on Sale
SME's	-	Small and Medium Enterprises

CHAPTER ONE
INTRODUCTION

1.1 Background of the Study

Microfinance is “the provision of financial services to low-income poor and very poor self-employed people”. These financial services according to Ledgerwood (1999) generally include savings and credit but can also include other financial services such as insurance and payment services. Galor and Zeira (2012) define microfinance as “the attempt to improve access to small deposits and small loans for poor households neglected by banks. Therefore, microfinance involves the provision of financial services such as savings, loans and insurance to poor people living in both urban and rural settings who are unable to obtain such services from the formal financial sector.

There are different providers of microfinance services and some of them are; nongovernmental organizations (NGOs), savings and loan cooperatives, credit unions, governmental banks, commercial banks and non bank financial institutions. The target groups for Microfinance Financial Institutions (MFIs) are self employed low income entrepreneurs (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, regularly, weekly or monthly repayments. They are also disbursed quickly after approval, particularly for those seeking properly 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 workers or fewer and small enterprises as those employing more than 10-15 workers. 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 owner 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 employed 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 labor 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).

Microfinance is a broad category of services, which includes microcredit. Microcredit is provision of credit services to poor clients. Due to the broad range of microfinance services, it is difficult to assess impact, and very few studies have tried to assess its full impact. Proponents often claim that microfinance lifts people out of poverty, but the evidence is mixed. What it does do, however, is to enhance financial inclusion (Frempong, 2007).

1.1.1 Microfinance credit

Microfinance credit is a source of financial services for entrepreneurs and small businesses lacking access to banking and related services. The two main mechanisms for the delivery of financial services to such clients are relationship-based banking for individual entrepreneurs and small businesses and group-based models, where several entrepreneurs come together to apply for loans and other services as a group (Diagne and Zeller, 2001).

Microfinance credit can play a pivotal role in economic growth. Banks and lending institutions provide the services that allow people to save and invest available assets and resources, which further supports and strengthen economic activity. Within underdeveloped communities, the role of microfinance institutions provides the credit access and financial services needed to develop income earning businesses. Within any society, microcredit financial services provide a means for people and businesses to obtain credit and manage available assets on a continuous basis (Copestake, Bhalotra, and Johnson, 2001).

Indeed, given asymmetric information problems (pre- and post-lending), high-risk environments and the presence of important transaction costs, banks are usually absent of the rural world in developing countries. There, credit-constrained households rely on informal money lenders for example landlords, local traders, small businessmen, who typically have more information on borrowers and accept as collateral goods or services that a bank would not. It has usually been observed that they charge high interest rate and that they fail to serve all potential borrowers (Ahmed, Adams, Chowdhury and Bhuiya, 2000).

Most microfinance programs make use of some form of group-lending schemes, such as peer selection and monitoring, regular public repayments and joint liability. With group lending schemes, explicitly uses joint liability, though it applies to any mechanism that implies some peer screening, monitoring or enforcement (Barnes, 2001). Under joint liability, individual borrowers have to form groups to apply and all group members are held collectively responsible for the repayment of each other's debt. Several authors have proposed various explanations for the new opportunities that this mechanism might offer (Coleman, 2006).

1.1.2 Financial performance of small and medium enterprises

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 firms 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. 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 ratio does not add any information not already existing in the amount or amounts (Wahid, 1994).The recommended measures for financial analysis that determine a firm's financial performance are grouped into five broad categories: liquidity, solvency, profitability, repayment capacity and financial efficiency (Maria, Florica and Catalina, 2002).

Liquidity refers to an enterprise ability to meet it's 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 assets that are finaced 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 repayments (Ormiston, 2007)

Profitability ratios evaluate the firms earnings with respect to a given level of sales, a certain level of assets, the owner's invetsment are 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 ratios is 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.It is important to remember that past and present financial information are not the only factors affecting a firm's financial performance rather measuring a group performance is more important than focusing on only one or two measures at the exclusion of others (Carton, 2004).

The common financial indicators of financial performance include: sales growth, return on investment (ROI), return on sales, return on equity (ROE), and earnings per share. The popular ratios that measure organizational performance can be summarized as profitability and growth: return on asset (ROA), return on investment (ROI), return on equity (ROE), return on sale (ROS), revenue growth, market shares, stock price, sales growth, liquidity and operational efficiency (Carton, 2004).

1.1.3 Microfinance Credit and Financial Performance of small and medium enterprises

Microfinance credit is important for the growth and development of Small and Medium-sized Enterprises (SMEs). However, access to microfinance credit is still a challenge to most SMEs, especially those in developing economies and it is also still a key issue both within the private and public sectors. Microfinance programs provide small-scale financial services to low-income individuals. Loans are designed to foster sustainable economic empowerment and capacity building for people in developing economies in order to enlarge capacity and increase their profits leading to financial performance. Unfortunately, microfinance and microcredit programs have come under criticism recently following out of control lending practices by unmonitored and irresponsible organizations. Lending that led to unmanageable debt for many individuals, microfinance's credit highly contributes to financial performance since owners of small and medium businesses with collateral can easily access credit for expanding their businesses (Diagne and Zeller, 2001).

Micro financing credit is a credible and effective instrument for poverty alleviation and as such its contribution to economic growth and performance of SME's (Akinyemi; cited in Onuba, 2008). Financing of small and medium scale enterprises are vital instrument for the alleviation of poverty in society. Therefore, SMEs play a crucial role in nation building, and providing them with the needed facilities would assist in bridging the gap between the rich and the poor (Ahmed et al., 2000).

Micro-finance activities usually involve; Small loans, typically for working capital, Informal appraisal of borrowers and investment, secure savings product. Micro-finance clients are typically self-employed, low-income entrepreneurs in both urban and rural areas. Clients are often traders, street vendors, service providers (hairdressers, tricycle operators), small restaurant operators, artisans and cottage industries. Usually, their activities provide a stable source of cash flow and income often from more than one activity (Aryeetey, et al., 1994).

1.1.2 Small and Medium Enterprises in Kiambu County

Kiambu County is the leading innovative commercial hub for SME's that shares its borders with five other counties; Nakuru to the west and Kajiado to the south, Nyandarua to the North and Murang'a County to the East (GoK, 2007). Most owners of SME's in Kiambu County invest mostly on agriculture and industries to sustain its economy. The managers and owners of these SME's access credit from microfinance institutions. However; this cannot be achieved without removing barriers that hinder SME's from accessing credit facilities from financial institutions. Despite these contributions of SME's, their major barriers to financial performance and development appear to be shortage of both equity financing and debt.

1.2 Research Problem

Small and medium enterprises cut across all sectors of the economy, providing a prolific source of employment, income, government revenue and poverty reduction. The sector comprises 98% of all businesses in the country, employs more than 4.6 million people (30%) and accounts for 18.4% of the country's GDP. Total capital employed in the sector is 28 billion (GOK, 2009). The sector provides goods and services; promotes competition, innovation and an enterprise culture and provides opportunities for the development of appropriate technological and managerial competencies. Most SME's in Kiambu County face difficulties in accessing credit facilities from financial institutions due to lack of collateral to obtain loans. This hinder growth and expansion of these SME's leading to poor performance of SME's and Kiambu County in general. SME's are a source of employment to the youth and women in Kiambu County; they form the basis of growth and development of an economy. Access to credit is one of the key drivers towards development of SME's.

Studies have been done in relation to microcredit and financial performance, a study by Diagne and Zeller (2001) was conducted in Malawi, the study concluded that access to microcredit is a major constraint for small scale entrepreneurs sector and a complicated challenge. Challenges shared by banks and other financial institutions include: the need to open new markets niches in the short or medium term, and transition to the "universal bank' principle, the need to expand credit activity to maintain or increase gross margin, and the need to link the future profitability of the bank with growth of lending to small scale entrepreneurs. Weller (2008) looks at financial constraints, the costs of credit and a number of contributions to the costs of credit, including sources and types of loans. The results showed that taste-based discrimination and structural discrimination may have persisted and possibly increased over time. Gaps in credit access and costs of credit have widened by race, remained high by income, but shrank by ethnicity. Part of the overall differences in credit access was a varying reliance on professional information when making decisions on debt.

Local studies by Muguchu (2013) found that there was a positive relationship between access to credit and ROA. Similary; Makena (2012) concluded that problems faced by SMEs were insufficient collateral (71.4%) and business proposal not acceptable (21.4%). on the same note the study identified that the most challenging stage of the loan process were; application and appraisal stage, loan approval stage and the period it took to process the loan. Owusu (2002) found that micro finance credit was the major source of capital for SME's. A positive correlation was shown between access to credit and financial performance of SME's.

From the above studies little focus has been laid on the impact of microfinance credit on the financial performance of SMEs in Kiambu County. This study is therefore geared towards answering the research questions: what is the relationship between microfinance credit on the financial performance of SMEs in Kiambu County, Kenya?

1.3 Objective of the Study

The objective of the study is to establish the effect of microfinance credit on the financial performance of Small and medium enterprises in Kiambu County, Kenya.

1.4 Value of the Study

This study will provide information which can be used to inform Microfinance institutions on the extent to which credit provided to the SMEs affect their financial performance, with a special emphasis on improving the entrepreneurs' welfare through their businesses specially focusing on the growth and development of entrepreneurs.

The study would be useful to the government in policy making regarding the financing of the Small and Medium Enterprises through microfinances and other financial institutions. The policy makers will obtain knowledge on the best mechanisms that should be adopted to finance the Small and Medium enterprises. This study is therefore to act as a guide in designing appropriate policies that will guide MFIs in financing the Small and Medium Enterprises.

The study would be of great importance to other researchers and academicians who can find it useful in providing information on the small and medium enterprises of microcredit financing on financial performance of SMEs in Kiambu County and in Kenya as a whole. It can also be of significant to researchers as it provides basis upon which further studies can be carried out on broad subject’s microcredit financing of SMEs.

It is hoped that this study will add to the available body of knowledge of microfinance specially the showing the effect of micro credit on the financial performance of SME’s. It will also increase the understanding of how to best empower entrepreneurs in the Small enterprise sector, so that they in turn can contribute more meaningfully to economic development.

CHAPTER TWO

LITERATURE REVIEW

2.1 Introduction

This chapter presents a review of literature on the effect of Microfinance credit on the financial performance of Small and Medium Enterprises. It includes the theoretical and empirical review of the study, the determinants of financial performance and the summary of the literature Review.

2.2 Theoretical Framework

The study is anchored by three theories namely: Microfinance Credit Theory, Credit Access theory and Theory of Financial Intermediation and other relevant theoretical literature which shows the impact of microfinance credit on the financial performance of SME's.

2.2.1 Microfinance Credit Theory

Microfinance in Kenya is now fully fledged sector. Dondo (1999) traced the history of MFIs in Kenya to the mid 1950s when the joint Loan Board Scheme was established to provide credit to indigenous Kenyans with small trading business loans. The Microfinance Institutions in sector in Kenya has grown since it inceptions in the 1970s and is one of the most established in Africa (Kashangaki et al, 1999). The birth of specialized microfinance in Kenya was in the 1980s when Kenya Rural Enterprises Fund (K-REP) and the Kenya Women Finance Trust (KWFT) were established. In the 1990s more MFIs emerged for example Faulu Kenya, Small and Medium Enterprise Program commonly known as SMEP and Jamii Bora

The concept of group lending is commonly heralded as the main innovation of microfinance and claims to provide an answer to the shortcomings of imperfect credit markets, in particular to the challenge of overcoming information asymmetries. Information asymmetries may lead to the distinct phenomena of adverse selection and moral hazard. In the case of adverse selection, the lender lacks information on the riskiness of its borrowers. Riskier borrowers are more likely to default than safer borrowers, and thus should be charged higher interest rates to compensate for the increased risk of default (Rahman, 2010).

Accordingly, safer borrowers should be charged less provided each type can be accurately identified. Since the lender has incomplete information about the risk profile of its borrowers, higher average interest rates are passed on to all borrowers irrespective of their risk profile. In moral hazard generally refers to the loan utilization by the borrower that is the lender cannot be certain a loan, once disbursed, is used for its intended purpose, or that the borrower applies the expected amounts of complementary inputs, especially effort and entrepreneurial skill, that are the basis for the agreement to provide the loan. If these inputs are less than expected then the borrower may be less able to repay it (Rahman, Davanzo and Sutradhar, 2006)

The standard model of lending commonly contains two mechanisms which address the issue of information asymmetries: assortative matching or screening to deal with adverse selection, and peer monitoring to overcome moral hazard. Early models were developed by Stiglitz (1990) and Swain, (2008).These models examined how group liability schemes resolve moral hazard and monitoring problems. Other models developed by   (Rafiq et al, 2009).

Gangopadhyay et al. (2005) were inspired by Stiglitz and Weiss (1981) and focused on adverse selection and screening mechanisms. Moreover, social ties among group members, i.e. social connections in the language of Anand and Kanbur (1993), also referred to as social capital; appear to play an important role in the context of group liability schemes in terms of enhancing repayment behavior, as theorized by Pisani andYoskowitz (2010)

2.2.2 Credit Access Theory

The credit theory was postulated by Stiglitz and Weiss (1981), they provided a framework for analyzing financial market inefficiencies. This framework provides that information asymmetry is the main cause of financial market malfunctioning in developing countries. Financial institutions that advance loans to economic agents are not only interested in the interest they receive on loans, but also the risks of such loans.

Most financial institutions screen and monitor borrowers more efficiently than other investors can. They are specialized in gathering private information and treating it. Managing money and deposit accounts, banks own highly strategic information on firms' receipts and expenditures as well as the way that firms develop (Kashyap, Stein and Wilcox, 1993).Despite this plethora of information, relationships between bankers and firms are not perfect. Banks suffer from informational asymmetries such that evolution of prices (interest rates) cannot clear the credit market. Finally, non-walrassian equilibrium arises with a fringe of unsatisfied agents (Pinaki, 1998).

In reference to Stiglitz and Weiss (1981) adverse selection and thus credit rationing still occurs if banks require collateral. They argue that low-risk borrowers expect a lower rate of return on average. Thus, they are less wealthy than high-risk borrowers on average after some periods. Low-risk borrowers are therefore not able to provide more collateral. Increasing collateral requirements may have the same adverse selection effect as a higher interest rate. Instead Walsh (1998) argues that banks only offer contracts in which they simultaneously adjust interest rates and collateral requirements. He proved that there is always a combination of interest rate and collateral requirements so that credit rationing does not occur (Jaffee and Russell, 1996).

The proponents of this theory argue that the most interesting form of credit rationing is equilibrium rationing, where the market has fully adjusted to the public whereby banks ration credit free, available information and where demand for loans for a certain market interest rate is greater than supply.Stiglitz and Weiss (1981) explains that credit rationing occurs if a financial institution charge the same interest rate to all borrowers, because they cannot distinguish between borrowers and screening borrowers perfectly is too expensive. Both assumptions are very simplifying and do not occur in this manner in the real world. Banks are usually able to distinguish their borrowers up to a certain degree.

2.2.3 The Theory of Financial Intermediation

According to the theory of intermediation, current theories of the economic role of financial intermediaries build on the economics of imperfect information that began to emerge during the 1970s with the seminal contributions of Akerlof (1970) and Spence (1973) and (Bernanke and Blinder, 1992).Financial intermediaries exist because they can reduce information and transaction costs that arise from an information asymmetry between borrowers and lenders. Financial intermediaries thus assist the efficient functioning of markets, and any factors that affect the amount of credit channeled through financial intermediaries can have significant macroeconomic effects (Spence, 1973).

There are two strands in the literature that formally explain the existence of financial intermediaries. The first strand emphasizes financial intermediaries' provision of liquidity. The second strand focuses on financial intermediaries' ability to transform the risk characteristics of assets. In both cases, financial intermediation can reduce the cost of channeling funds between borrowers and lenders, leading to a more efficient allocation of resources. Bernanke and Gertler (1995) analyzed the provision of liquidity and the transformation of illiquid assets into liquid liabilities by banks. In Adolfson (2002) model, depositors are risk averse and uncertain about the timing of their future consumption needs. Banks can improve on a competitive market by providing better risk sharing among agents who need to consume at different times. An intermediary promising investors a higher payoff for early consumption and a lower payoff for late consumption relative to the non-intermediated case enhances risk sharing and welfare. The optimal insurance contract in (Claus and Smith, 1999).Financial model is a demand deposit contract, but it has an undesirable equilibrium, in which all depositors panic and withdraw immediately, including even those who would prefer to leave their deposits in the bank if they were not concerned about the bank failing (Adolfson, 2002).

The proponents of this theory explain that the modern theory of financial intermediation, financial intermediaries are active because market imperfections prevent savers and investors from trading directly with each other in an optimal way. The most important market imperfections are the informational asymmetries between savers and investors. Financial intermediaries, banks especially, fill as agents and as delegated monitors' information gaps between ultimate savers and investors. They screen and monitor investors on behalf of savers to ensure the sustainability of financial intermediation, safety and soundness regulation has to be put in place (Bernanke and Blinder, 1992).

2.3 Determinants of Financial Performance

There are various determinants of financial performance of a firm:

2.3.1 Growth of the firm

Growth of the firms is an essential determinant of the firm, growth of the firm is attributable to increase in net assets. Firms are a collection of a certain number of resources that provide the means to successfully take advantage of those opportunities and grow (Pinaki, 1998). Formal there is no limit to the growth of the firms; it is the rate of growth what is limited in the short run but there is no limit to the size of the firm.

2.3.2 Size of the Firm

The other determinant of financial performance of commercial and services firm is the size of the firm. Large firms are more likely to manage their working capitals more efficiently than small firms. Most large firms enjoy economies of scale and thus are able to minimize their costs and improve on their financial performance (Kumar, 1995).Firm size is determinant of investment behavior and access to capital and liquidity management in SME's (Raheman and Nasr, 2007). Smaller firms exhibit larger degrees of information asymmetry between insiders and outsiders. In addition, these firms also face higher costs in issuing new equity (Sebastian 2010).

There are a number of ways that can be used in measuring the size of a firm. Sales turnover is one of the measures that can be used. Sales turnover (Sales revenue) is the money that you get from the sale of products and thus the costs of sales have not been deducted from this. Number of employees, is one of the simplest measures to know about the size of the firm, capital employed by a business may and can vary depending in the size of the business. A small business will need less capital to finance its investment, whereas, a large business enterprise will need a lot of capital to plan and finance the investments (Pandey, 2005).

2.3.3 Age of the Firm

Age is a key determinant of financial performance of the firm. The period of operation that a firm has been in operation highly determines the financial performance of the firm. Firms that have a vast experience in the market are able to gain economies of scale from the suppliers and other stakeholders of the firm as a result of good relationships and trust. Such a firm is more likely to perform better than a firm that is new in an environment. The firm might spend a lot of money before it gets adapts to the environment (Santalo and Becerra, 2008).

2.3.4 Liquidity of the Firm

Liquidity of the firm is a key determinant of the firm's financial performance Liquidity risk can be measured by two main methods: liquidity gap and liquidity ratios. The liquidity gap is the difference between assets and liabilities at both present and future dates (Pelg, 2006).

Liquidity ratios are various balance sheet ratios which should identify main liquidity trends. These ratios reflect the fact that firm should be sure that appropriate, low cost funding is available in a short time. This might involve holding a portfolio of assets that can be easily sold cash reserves, minimum required reserves or government securities (Santalo and Becerra, 2008).

2.3.5 Debt

Debt is a determinant of financial performance of SME's. Debt is funds borrowed from a financial institution at a certain percent of interest rates which should be paid within a specified period of time. It is appropriate for the firm to maintain a proper balance between debt and equity. The firms leverage decisions centers on the allocation between debt and equity on financing a firm (Raheman et al., 2007).

The emphasis on long-term finance and on the potentially adverse consequences when it is in short supply is somewhat at odds with recent theoretical contributions that emphasize the fact that the use of short-term debt may be associated with higher-quality firms and may have better incentive properties. In particular, the possibility of premature liquidation may act as a discipline device that improves firms' performance (Kashyap, Stein and Wilcox, 1993).

2.4 Empirical Studies

A number of studies have been conducted on microfinance. Owusu (2002) investigated on the various financing options for SME's in Ghana, a random sample of 10 formal and informal finance sources and 50 SME's in 6 selected small and medium industries in Kumasi, Accra and Tamale. A regression model was used for data analysis, the results of the regression analysis found that micro finance credit was the major source of income for SME's. A positive correlation was shown between access to credit and financial performance of SME's.

Idowu (2004) conducted a study on the impact of Microfinance on Small and Medium Enterprises (SMEs) in Ghana. Simple random sampling technique was employed in selecting the 100 SMEs that constituted the sample size of the research. Structured questionnaire was designed to facilitate the acquisition of relevant data which was used for analysis. Descriptive statistics which involves simple percentage graphical charts and illustrations was tactically applied in data presentations and analysis. The findings of the study reveal that significant number of the SMEs benefitted from the MFIs loans even though only few of them were capable enough to secure the required amount needed. Interestingly, majority of the SMEs acknowledge positive contributions of MFIs loans towards promoting their market share, product innovation achieving market excellence and the overall economic company competitive advantage.

A study was conducted in Europe by Kundid (2007), a cross-sectional survey of approximately 4500 was used in the study for the period ended 2010. A regression model was used for data analysis and the results of the study found that there was a positive relationship between microfinance credit and performance of SME's.

Wachira (2011) investigated the factors that influence the use of microcredit amongst the SMEs based at Mutindwa market of Buru Buru estate. Descriptive survey approach adopted in this research for primary data collection involved administration of a questionnaire to the SMEs. The study found out that there is a strong relationship between MFI loan use and the loan terms and conditions. MFls loans were noted to be popular because of their group lending model where security was by group guarantee demonstrating the fact that a majority of the loan consumers who are commonly women lacked tangible collateral. The study concludes that improving the lending terms and conditions especially through exploring a wide range of security options, pursuing a gender parity client-base and offering diversified business knowledge in favor of small-scale enterprises would provide an important avenue for facilitating their access to credit and accelerate the use of MF loans and the subsequent enterprises.

Makena (2012) was intended to identify the challenges faced by SMEs in accessing finance in Kiambu Town. The findings indicated that problems faced by SMEs were insufficient collateral (71.4%) and Business proposal not acceptable (21.4%). on the same note the study identified that the most challenging stage of the loan process were; application and appraisal stage, loan approval stage and the period it took to process the loan. Terms of coping mechanism used to manage challenges faced by SMEs in accessing finance, the study identified the following; saving and trying to reduce expenses, attending financial seminars, use of merry go rounds, borrowing from friends at zero interest rates, reducing credit period for the firm’s creditors, obtaining credit facilities from suppliers, ploughing back profits, offering stock as security, consulting with other SMEs owners, joining Sacco, using credit cards and overdrafts.

A cross sectional survey was carried out in Ghana by Ahiawodzi (2012),on effect of access to credit on financial performance of Small and Medium Scale Enterprises (SMEs) in the Ho Municipality of Volta Region of Ghana by using both survey and econometric methods. The survey involved a sample of 78 SMEs in the manufacturing sector from the Ho Municipality. Both survey and econometric results show that access to credit exerts a significant positive effect on financial performance of SMEs in the Ho-Municipality of Ghana.

A study was conducted by Nkeobuna (2012) to evaluate the relationship between microcredit and financial performance of SME's in Ghana. A sample of 65 SME's in the agricultural and financial services sector was conducted and a regression model was used for data analysis. The result of the analysis showed that there was a positive relationship between microcredit and financial performance of SME's.

Muthoka (2012) investigated on the link between microcredit and financial sustainability of SMEs, though repeatedly emphasized by donors and practitioners in conferences and summits, is a controversial area of empirical research. A multivariate regression model was applied to determine the relative importance of each of the variables with respect to financial self sustainability. The study found that the integrating gender awareness policies (gender equality and SME‘s human rights), creating ways for non-financial support and services (complementary services) to pay explicit attention to gender. The regression results imply that credit contribute more to the financial sustainability of SMEs followed by savings, while entrepreneurial development contributes the least to financial sustainability of SMEs.

Wekhoba (2012) investigated factors influencing microfinance credit accessibility in Kenya. In Kasarani district there has been a rapid increase of the number of MFIs licensed to operate from 2 in 2008 to 12 in 2010, most reporting increasing default rates, irregular loan repayments, client stagnation, pullout and an increase in number of loan applicants against a lower percentage of loan payments. Micro-credit has been found to have a limited application, being more relevant to the moderately poor than the destitute. Cross-sectional data was collected from a representative sample size of 46 respondents. This was sampled from 10 MFls currently operating in Kasarani district of Kenya which was the area of study. The finding shows that most MFls considers only growth oriented businesses or enterprises that have the, potential to grow, therefore agreeing with the argument that it's beneficial to a few and not the majority poor who are left with the choice of dependence on informal sources like relatives friends and community.

Mokua (2013) conducted an investigation on the extent to which collateral measures influence credit financing of small business enterprises in Kisii Town and to ascertain the extent to which management skills influence credit financing of small scale business enterprises in Kisii Town. The study employed the descriptive survey research design and employed questionnaire to collect data from160 SSB in Kisii town. The researcher sampled 160 SSB out of the population of 560 SSB using a simple stratified sampling technique. The study found out that the enterprises had inadequate funds. It was also revealed that the enterprises had stagnated in their financial status due to corruption in the municipality. It was also revealed that the enterprises had inadequate finances due to procedures that are too long to get the funding from financial institutions. The financial status of the enterprises is therefore affected in one way or the other.

2.5 Summary of the Literature Review

From the literature review, is evident that access to microcredit finance has a significant influence on financial performance of SME’s. Micro financing credit is a credible and effective instrument for poverty alleviation and as such its contribution to economic growth and performance of SME’s .Financing of small and medium scale enterprises is essential for creating employment and economic growth.

The literature review discussed above has shown that microfinance credit is important for growth and development of SME’s. It is important to note that restrictive credit requirements and guidelines in regulatory systems inhibit access to microfinance credit by borrowers. This is a constraint to financial performance of SME’s. This study is geared to determine the effects of microcredit finance on financial performance of SME’s.

CHAPTER THREE

RESEARCH METHODOLOGY

3.1 Introduction

This chapter outlines the research methodology used in the study. It involved the methods the researcher used to collect the data for the study. These included research design, target population, sampling procedures, data collection and analysis procedures with the expected results as a representation of the study.

3.2 Research Design

The study was conducted by the use of the survey design. Mugenda and Mugenda (2003) define 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 could be descriptive, exploratory or involving advanced statistical analysis.

There are several studies that have employed survey design for instance; 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 survey to study SMEs operating in Nairobi that have been financed by MFIs.

3.3 Population

Population refers to an entire group of individuals, events or objects having a common observable characteristic. The target population of this study comprised SME's operating in Kiambu County that are in various strata: financial services, trade and commercial services with specific attention to the owners and staff of these SME's. In

Kiambu County there are 2,061 SMEs licensed, according to Kiambu County records by February 2013. This study randomly sampled 60 registered SMEs of the 2,061 licensed.

3.4 Sample

A sample refers to a small group obtained from the accessible population (Mugenda and Mugenda, 2003). The study adopted a stratified random sampling, with a target sample of 60 registered SMEs within Kiambu County. To achieve the intended objective of the study random sampling was used to collect secondary data from SME's in Kiambu County.

3.5 Data Collection

Primary data was gathered through structured questionnaires. On the other hand secondary data was collected from newspapers, journals and magazines as well as other sources such as the MFI‘s annual reports. A semi-structured questionnaire was used to collect primary data. In order to ensure uniformity in response and to encourage participation, the questionnaire was kept short and structured with mostly multiple-choice selections in a likert scale. The questionnaires were preferred in this study because respondents of the study are literate and quite able to answer questions asked adequately. According to Mugenda and Mugenda (2003), questionnaires are commonly used to obtain important information about a population under study. The researcher obtained an introductory letter from the University to collect data then personally deliver the questionnaires to the respondents and has them filled in and then collect later: the drop and pick later method.

3.6 Data Analysis

A simple regression model was used for data analysis. The study focused on two key variables. Data collected was purely quantitative and was analyzed using a regression model. The study used a simple regression equation. The dependent variable is financial performance of SME's in Kiambu County which was measured using return on assets (ROA). The independent variable was access to credit which was measured through checking the loan book records from SME's. This is because the value for most SME's was measured in terms of financial records after access to credit.

3.6.1. The Analytical Model

The study used simple regression model of equation to establish the relationship between access to credit and financial performance of SME's in Kiambu County. The researcher used a five year period trend.

$Y=\alpha+\beta_1X_1+\beta_2X_2+\beta_3X_3 + \beta_4X_4 + \beta_5X_5\varepsilon+ \beta_6X_6 +e$

Y= SMEs financial performance as measured by return on assets

X_1= capital invested

X_2= Total assets

X_3 =the amount of outstanding debt

X_4= sales turnover of the SME

a, and b= regression constants

e= is the error term

3.6.2 Diagnostic Tests

A t-statistic test will be used to determine the significance of the independent variables in influencing performance of SME's.The t-test will be used to test the hypothesis that a particular coefficient is significantly different from zero or whether the estimated coefficient value occurred by chance in equation. The tests will be performed at both 95% levels of confidence. The R-squared (R^2) value ranging from '0' to '1' or the 'corrected R-squared' (R^2) which is adjusted for degrees of freedom indicates the explanatory power (goodness of fit) of the model.

CHAPTER FOUR

DATA ANALYSIS, FINDINGS AND DISCUSSIONS

4.1 Introduction

This chapter presents the analysis and findings with regard to the objectives of the study. The data targeted a sample of 60 SMEs from which 47 respondents were interviewed (filled in and returned the questionnaires) making the response rate of 78%. This response rate was overwhelming and conforms to Mugenda and Mugenda (1999) statement that a response rate of 50% is adequate for analysis and reporting; a rate of 60% is good and response rate of 70% and over is excellent.

4.2 General Information

The general information considered in this study was for the respondents to state the nature of their business. Some respondents indicated that they were in fashion sector, others in IT consulting, supply of agricultural inputs, supply of materials, transport, animal feeds, whereas others owned restaurants.

4.2.1 Distribution of Respondents by Gender

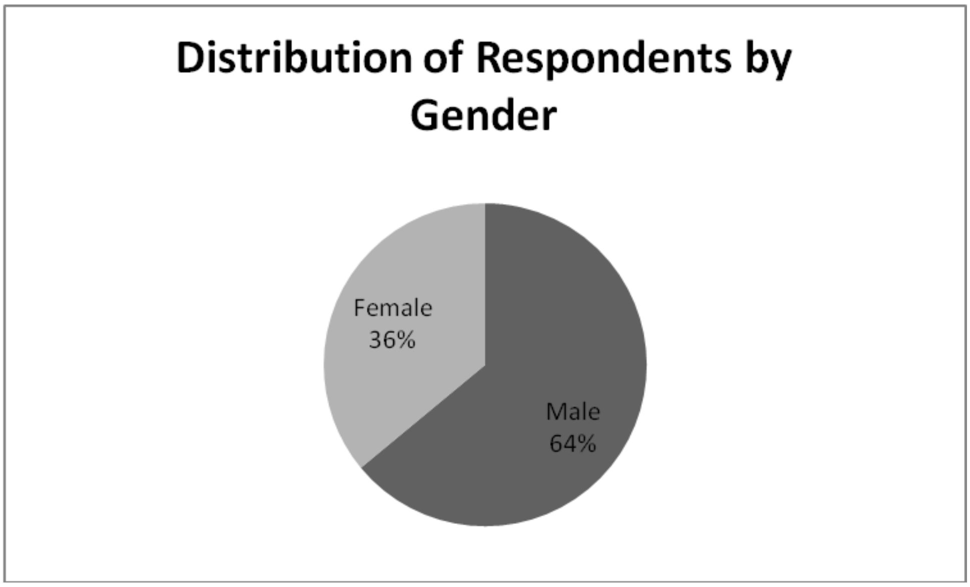
As can be observed from table 4.1 below, the interviewed population drew representation from both genders with 31% of the respondents being female and 69% male.

Table 4.1: Distribution of Respondents by Gender

Gender	Frequency	Percentage
Male	30	64%
Female	17	36%

Source: Research Findings.

Figure 4.1: Distribution of Respondents by Gender



Source: Research Findings.

4.2.2 Distribution of Respondents by Age

The study posed a question requesting the respondents to indicate their age brackets.

Table 4.2 shows the results of the findings on the age brackets of the respondents.

Table 4.2: Age Brackets of the Respondents

Age Bracket	Frequency	Percent
Below 20 years	2	4.3
Between 21-30	16	34
Between 31-40	18	38.3
Between 41-50	7	14.9
Over 50 years	4	8.5
Total	47	100

Source: Research Findings

According to table 4.2, 38.3% of the respondents were aged between 31-40 years, 34% of the respondents were aged between 21-30 years, 14.9% of the respondents were aged between 41-50 years, 8.5% of them indicated that they were 50 years and above, while 4.3% of the respondents were aged below 20 years. The study findings show that the respondents were well distributed in terms of age and that they are active in technological advancements and productivity and hence can contribute constructively in this study on the effects of microfinance credit on financial performance of SMEs in Kiambu County.

The study further sought to establish the highest academic qualifications attained by the respondents. The responses on this question are depicted in table 4.3.

4.2.3 Distribution of respondents by Level of Education

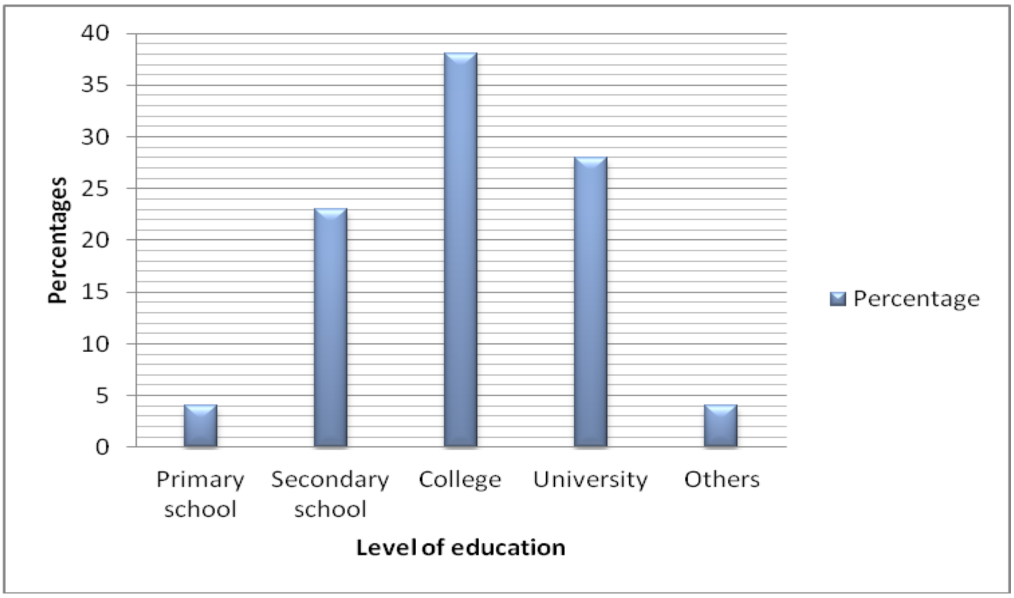
The study sought to ascertain the highest level of education for the respondents. This is shown in both tables 4.3 and figure 4.2 below.

Table 4.3: Distribution of respondents by level of education

Level of Education	Frequency	Percentage
Primary school	2	4
Secondary school	11	23
College	18	38
University	14	28
Others	2	4

Source: Research Findings

Figure 4.2: Level of Education



Source: Research Findings

Majority (38%) of the respondents reiterated that they had acquired Certificate/diploma, 28% University degrees, 23% of them had attained a secondary school only, another 4% of the respondents had primary school only, while 4% of them had acquired other form of education like village polytechnic.

4.3.1 Provision of Microfinance Services

The respondents were asked an open ended question whereby they were asked to state the services they receive from MFIs. The respondents stated the services listed in table 4.4 below.

Table 4.4: Distribution of Services Offered by MFIs

Services received from MFIs	**Frequency**	**Percentage**
Loans	47	100
Savings facilities	47	100
Training	23	50
Micro Insurance	10	21.84
Payment facilities	4	8.05

Source: Research Findings.

4.3.2 Distribution of respondents in respect to source of initial capital for their business

The respondents were required to indicate what was their major source for financing their business at the start-up point. The results are presented in table 4.5 below.

Table 4.5: Distribution of respondents in respect to sources of their initial capital

Source of initial Capital	Respondents	Percentage
Personal savings, friends and family	11	23.4
Loans from MFIs	31	65.97
Loans from banks	2	4.3
Other sources	3	6.33
Total	**47**	**100**

Source: Research Findings.

According to the findings, 11 respondents indicated that their initial capital was their own savings with assistance from friends and family members. This translated to 23.4% .31 of the respondents indicated that their major source was through loans from MFIs. Only 2 respondents said they obtained their initial capital from commercial banks whereas 3 respondents indicated their initial capital was from other sources.

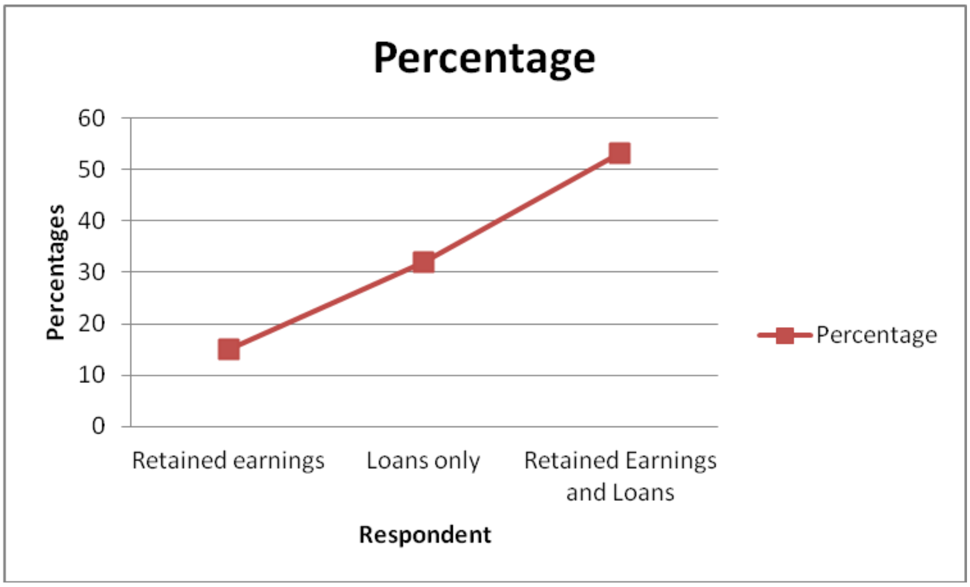
4.3.3 Distribution of respondents in respect to source of subsequent capital for their business.

Table 4.6: Distribution of financing additional capital requirements

Source of finance	Respondents	Percentage
Retained earnings	7	14.9
Loans only	15	31.9
Retained Earnings and Loans	25	53.2
Total	47	100

Source: Research Findings.

Figure 4.3: Distribution of respondents based on sources of financing



Source: Research Findings.

In terms of financing additional capital, 7 respondents said it was through retained earnings, 15 showed through getting further loans only and 25 said it was through both loans and retained earnings. This translated to 14.9% finding through borrowing alone, 31.9% through retained earnings and 53.2% through both retained earnings and borrowing. These results suggests that most SMEs are able to effectively and efficiently allocate the initial borrowed loans and thus with knowledge gained through training by MFIs, they are able to register positive results and also make savings. The low percentage of using loans only shows that business financial performance is sound thus SMEs are able to plough back profits to expand their business.

The study through this question intended to find out if MFIs offer similar services and from the findings, all the 47 respondents indicated that they got three main services namely the loans, saving facilities and training. Only 10 respondents indicated that they use micro insurance and 4 respondents said they use payment facilities provided by the micro finance institutions. This translated to 21.84% and 8.05% respectively. These findings suggest that most of the MFIs are offering credit accompanied by training in business skills and other relevant knowledge that enables young entrepreneurs to respond to business challenges. Also savings is equally being encouraged by MFIs through offering savings accounts especially amongst the deposit taking MFIS.

4.3.4 Distribution of respondents in respect to source of initial capital for their business

The respondents were required to indicate what was their major source for financing their business at start-up point. The results are presented in table 4.6 below.

Table 4.7: Whether the Enterprises benefit from Loans from Microfinance Institutions

Response	Frequency	Percentage
Yes	41	87.2
No	6	12.8
Total	47	100

Source: Research Findings.

Majority (87.2%) of the respondents indicated that their business enterprises benefit from loans from microfinance institutions, while only 12.8% of the respondents indicated otherwise.

The study sought to establish the reasons as to why the enterprises obtained loans from MFI‘s that made them to seek financial assistance from the MFI‘s.

Table 4.8: Reasons as to why the enterprises obtained loans from MFI's

Reasons	**Frequency**	**Percentage**
Easy loan repayment	14	30
Amount offered	13	27
Interest rate	20	43
Total	**47**	**100**

Source: Research Findings.

From the study, majority (43%) of the respondents indicated that their enterprises resorted to seeking financial assistance from the MFIs due to interest rate, 30% of the respondents indicated easy loan repayment, while 27% of them indicated that the amount offered triggered their enterprises to seek financial assistance from the MFIs. On others of the respondents indicated that business expansion and the need to increase production volume forced their enterprises to look for the financier. Other respondents indicated that their business enterprises sought for more than one financier to cover production cost, to improve on the performance of the business and to increase capital of the business.

The respondents were required to indicate the loan repayment period as per the conditions of MFI.

Table 4.9: Length of Time Allowed Repaying the MFI Loans

Loan Repayment Period	**Frequency**	**Percentage**
6 months to 1 year	3	6
Above 1 year to 5yrs	26	55
Above 5 yrs	18	39
Total	**47**	**100**

Majority of the respondents, shown by 55%, reiterated that the loan repayment period as per the conditions of the MFIs was between 1 and 5 years, 39% of them indicated over 5 years, while 6% of the respondents indicated that their enterprises were required to repay their loans within 6 months up to 1 year.

The respondents were required to indicate their opinion on the rate of the loan services offered by the MFI's.

Table 4.10: The rate of the loan services offered by the MFI's

Rating	**Frequency**	**Percentage**
Fair	3	6.1
Good	25	53
Excellent	19	40
Total	**47**	**100**

Source: Research Findings.

From the study, 54.5% of the respondents indicated that the loan services offered by the MFI's were good, 39.4% rated the loan services offered by the MFI's as being excellent, while 6.1% of them rated the loan services offered by the MFI's as being fair.

The respondents were further required to indicate whether they face any challenges as a loan beneficiary from the MFI's.

Table 4.11: Challenges faced by the loan beneficiary from the MFI's

Response	**Frequency**	**Percent**
Yes	33	70
No	14	30
Total	**47**	**100**

From the study, 60% of the respondents indicated that they face challenges as a loan beneficiary from the MFI‘s, as compared to 30% of those who indicated that they do not face any challenges as a loan beneficiary from the MFI‘s.

4.4 Entrepreneurial Development

The study sought to establish the extent to which various aspects of entrepreneurial development influence financial sustainability in the enterprises.

Table 4.12: Entrepreneurial Development that influence financial performance in SMEs

Aspects of Entrepreneurial Development	No extent	Little extent	Moderate extent	Great extent	Very great extent	Mean	Std. Dev.
Seminars	3.8	5.3	27.8	18	45.1	3.95	1.13
Workshops	11.3	0	18.8	20.3	49.6	3.9699	1.3081
Financial management counseling	7.5	0	13.5	34.6	44.4	4.1579	0.9280

Source: Research Findings.

Majority of the respondents indicated that Financial and management counselling influence financial sustainability in the enterprises to a great extent as shown by a mean score of 4.1579, workshops influence financial sustainability in the enterprises to a great extent as shown by a mean score of 3.9699 as well as seminars o a great extent as shown by a mean score of 3.95.

The study finally sought to establish the respondents level of agreement with various statements on the effect of microfinance on SME financial performance in Kiambu County.

Table 4.13: The Effect of Microfinance on SME Financial performance

Statements	Strongly dis	Disagree	Neutral	Agree	Strong agree	Mean	Std. Dev.
Microfinance institutions prefer SME members as they believe that they are better and more reliable borrowers	4.2	8.3	29.2	54.2	4.2	3.46	0.88
Microfinance institutions mainly benefit the SME who are already better off, whereas the poor SME are either neglected because of their low resource base, lack of skills and market contacts	0	0	54.2	41.7	4.2	3.50	0.58
Microfinance enables poor SME to become economic agents of change by increasing their income and productivity, accessing markets and information and decision making power.	6.3	12.5	18.8	31.3	31.3	3.68	1.25
The entire process of internal savings and credit is backed by financial and management counselling, promotion of new avenues of employment and motivation for enhancement of earnings from the ongoing activities	2.3	27.1	6.8	41.4	22.6	3.54	1.17
Increasing SME's access to microfinance will enable SME to make a greater contribution to household income and thus will translate into improved well-being for SME and enable SME to bring about wider changes in gender inequality	2.3	27.1	6.8	41.4	22.6	3.54	1.17
Increasing SME's access to microfinance will enable SME to make a greater contribution to household income and thus will translate into improved well-being for SME and enable SME to bring about wider changes in gender inequality.	0	4.2	45.8	37.5	12.5	3.58	0.77

Source: Research Findings.

Accordingly, the respondents agreed that microfinance enables poor SME to become economic agents of change by increasing their income and productivity, accessing markets and information and decision making power as shown by a mean score of 3.68, increasing SME's access to microfinance will enable SME to make a greater contribution to household income and thus will translate into improved well-being for SME and enable SME to bring about wider changes in gender inequality as shown by a mean score of 3.58, the entire process of internal savings and credit is backed by financial and 39 management counselling, promotion of new avenues of employment and motivation for enhancement of earnings from the ongoing activities as shown by a mean score of 3.54 and microfinance institutions mainly benefit the SMEs who are already better off, whereas the poor SME are either neglected because of their low resource base, lack of skills and market contacts as shown by a mean score of 3.50. However the respondents remained neutral on that microfinance institutions prefer SMEs members as they believe that they are better and more reliable borrowers as shown by a mean score of 3.46.

4.5 Financial Performance of Small and Medium Enterprises

The study required the respondents to give estimates of their assets, incomes and expenditures. Respondents were also required to attach copies of financial statements namely income statements and balance sheets where applicable.

4.5.1 Distribution of the respondents based on profitability/loss

The study showed that some respondents had recorded consistent profit with few recording losses. This is shown on the below tables 4.9a, 4.9b, 4.9c and figure 4.4.

Table 4.14: Distribution of respondents in respect to profitability

Years	Frequency		Percentage	
	Profits	Loss	Profit	Loss
2013	47	0	100	0
2012	44	3	93.62	6.38
2011	42	5	89.36	10.64
2010	38	9	80.85	19.15
2009	36	11	76.60	23.40

Source: Research Findings.

As can be seen from the above figure 4.4 all the respondents registered profits in the year 2013 thus there was no any respondent under the net profit class of below 0.Nevertheless, in the same cluster 3 respondents, 5 respondents, 9 respondents and 11 respondents didn't register any profits. This translated to 0%, 6.38%, 10.64%, 19.15% and 23.40% respectively for the years 2013, 2012, 2011, 2010 and 2009.This trend show that majority of respondents did incur losses in 2009 but their financial performance has been improving as the percentage of loss making respondents reduced over the five years period. The respondents financial performance based on the net profit margins was higher in the year 2013 followed by 2012, 2011, 2010 and 2009.This suggest that the SMEs up on using the Microfinance services namely loans, savings and training, they were able to show improved results possibly by having increased sales and corresponding reduced costs.

4.5.2 Distribution of Assets amongst the Respondents.

The respondents were required to give estimates of their fixed and current assets. They also attached their balance sheets. All of the respondents' fixed assets comprised of Motorbikes, Pick-ups and Machineries whereas current assets included cash at bank, inventories and account receivables. On the liabilities' side we had the long-term and short term liabilities.

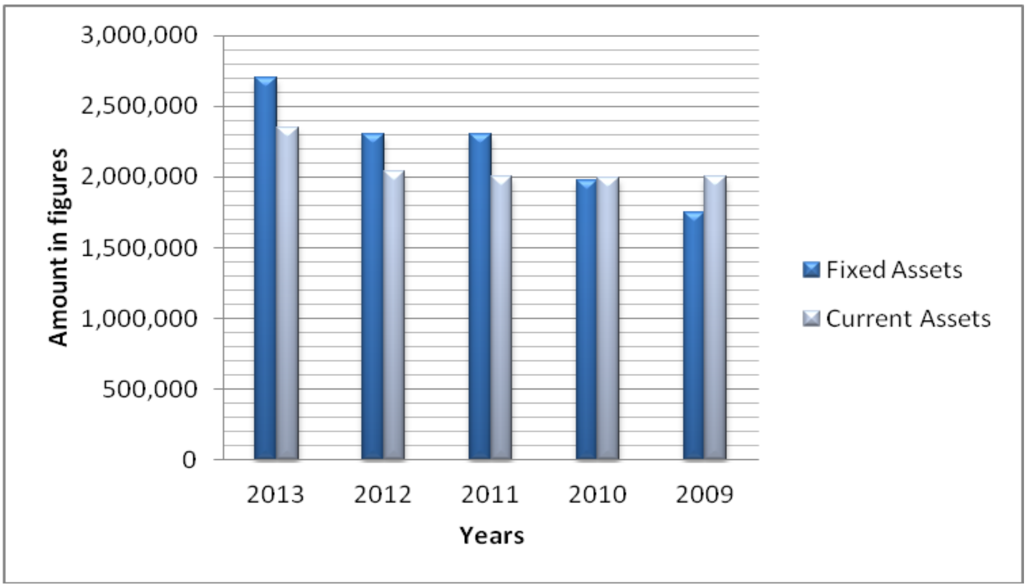
Table 4.15: Distribution of Assets for the five years period

	Years	**2013**	**2012**	**2011**	**2010**	**2009**
Fixed Assets	Minimum in Kshs	2,700,000	2,300,405	**2,300,405**	**1,980,000**	**1,750,550**
	Maximum in Kshs	6,340,000	**5,325,495**	**5,325,495**	**4,955,000**	**4,725,000**
	Average in Kshs (A)	4,452,00	**3,812,950**	**3,812,950**	**3,467,500**	**3,237,775**
Current Assets	Minimum in Kshs	**2,350,000**	**2,040,900**	**2,000,150**	**1,990,965**	**2,000,051**
	Maximum in Kshs	**4,497,320**	**4,290,000**	**3,967,553**	**3,578,038**	**3,750,000**
	Average in Kshs (A)	**3,423,660**	**3,165,450**	**2,983,852**	**2,784,502**	**2,875,026**
Total Assets	A+B	**7,943,660**	**6,978,400**	**6,796,802**	**6,252,002**	**6,112,801**

Source: Research Findings.

From table 4.15 above, there was a steady increase in both the fixed and current assets hence an increase in total average assets from the year 2009 to 2013.This suggests that there was growth that was occasioned by sound financial performance of the small and medium enterprises for the period studied. It is through the profits that the SMEs were able to expand their assets base. This information is also depicted in figure 5 below

Figure 4.4: Distribution of Assets for the five years period



Source: Research Findings.

Table 4.16: Distribution of Owner's Equity for the five years period

Years	2013	2012	2011	2010	2009
Minimum in kshs	3,325,425	3,325,425	3,325,425	3,325,425	3,325,425
Maximum in kshs	12,684,675	12,684,675	12,684,675	12,684,675	12,684,675
Average (A+B)/2	8,005,050	8,005,050	8,005,050	8,005,050	8,005,050

Source: Research Findings.

The respondents showed stable owners' equity with a minimum of Kshs 3,325,425 and maximum of shs12, 684,675 resulting to an average of Kshs 8,005,050.This is represented in table 4.16 above.

Table 4.17: Distribution of Retained Earnings for the six years period

Years	2013	2012	2011	2010	2009
Minimum in Kshs	4,435,051	4,030,2000	3,950,000	3,950,000	2,790,000
Maximum in Kshs	7,407,955	7,405,955	7,000,555	6,997,000	4,570,050
Average (A+B)/2	5,921,503	5,568,078	5,475,278	5,473500	3,680,025

Source: Research Findings.

Table 4.17 above shows that the respondents were able to plough back some of their earnings in form of retained earnings.

Table 4.18: Distribution of Sales and for the five years period

Years	**2013**	**2012**	**2011**	**2010**	**2009**
Minimum in kshs	6,349,600	5,290,770	4,340,550	3,400,350	2,740,000
Maximum in kshs	19,000,550	15,309,880	13,200,450	11,673,250	11,446,303
Average (A+B)/2	**12,675,075**	**10,300,325**	**8,770,500**	**7,536,800**	**7.093.152**

Source: Research Findings.

Based on the above schedule there was steady increase in volume of sales over the six years period.

Table 4.19: Distribution of Net Income and for the five years period

Years	2013	2012	2011	2010	2009
Minimum in kshs	3,150,820	2,050,085	2,170,485	1,200,170	1,305,007
Maximum in kshs	9,449,626	7,000,165	5,089,915	3,720,294	3,805,062
Average (A+B)/2	**6,300,223**	**4,525,125**	**3,630,200**	**2,760,232**	**2,553,535**

Source: Research Findings.

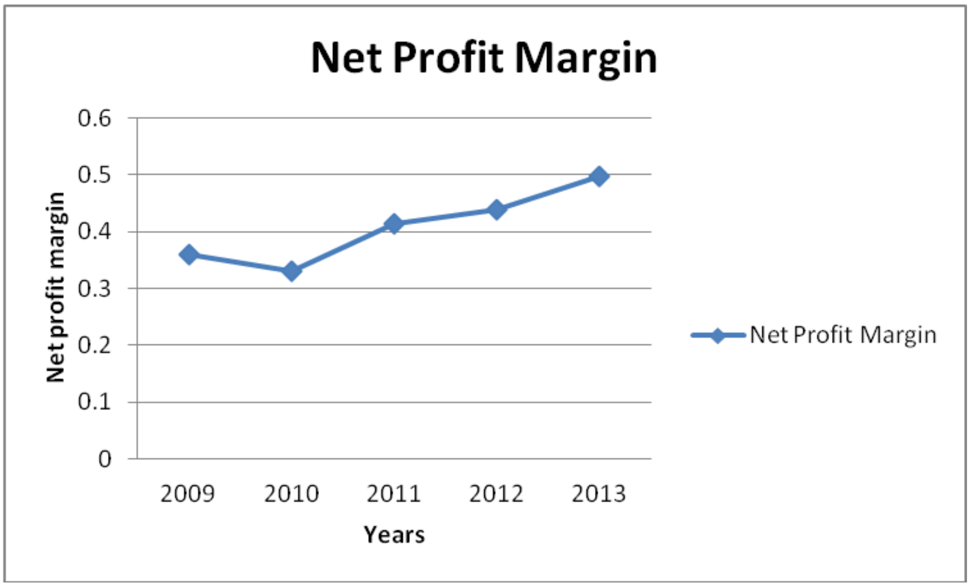
Based on the above schedule, there was an increase in net income for the five years period.

Table 4.20: Distribution of Net Profit Margins for the six years period

Years	2013	2012	2011	2010	2009
Minimum in Kshs	6,300,223	4,525,125	3,630,200	2,460,232	2,553,535
Maximum in Kshs	12,675,075	10,300,325	8,770,500	7,536,800	7,093,152
Average (A+B)/2	**0.497**	**0.439**	**0.414**	**0.33**	**0.36**

Source: Research Findings.

Figure 4.5: Trends of net profit margins over the five years



Source: Research Findings.

Based on the above figure, the study showed that there was an upward trend in net profit margins over the six years period. There was a slight decrease in years 2010 that was attributed to extraneous factors as this was the rates of interest were very high in Kenya.

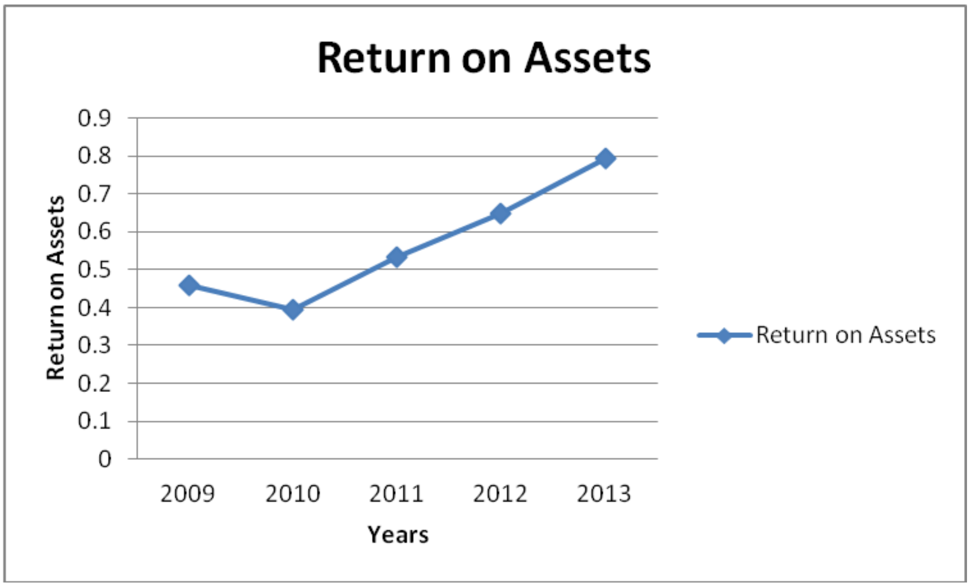
$$\text{Net Profit Margins} = \frac{\text{Net Income}}{\text{Net Sales}}$$

Table 4.21: Distribution of Returns on Assets for the five years period

Years	**2013**	**2012**	**2011**	**2010**	**2009**
Net Income	6,300,223	4,525,125	3,630,200	2,460,232	2,553,535
Total Assets	7,943,600	6,978,400	6,796,802	6,252,002	6,112,801
A/B (ROA)	**0.793**	**0.648**	**0.534**	**0.393**	**0.46**

Source: Research Findings.

Figure 4.6: Trends of return on asset (ROA) over the five years



Source: Research Findings.

Based on the above figure, the study showed that there was an upward trend in return on asset (ROA) over the five years period. There was a slight decrease in year 2010 that was attributed to extraneous factors as this was when the interest rates were very high in Kenya

Return on Assets (ROA) = $\frac{\text{Total Assets}}{\text{Net Income}}$

4.6 Inferential Analysis

To establish the relationship between the independent variables and the dependent variable of the study the study conducted inferential analysis which involved a coefficient of determination and a multiple regression analysis. Inferential analysis is utilized in this study to determine if there is a relationship between an intervention and an outcome, as well as the strength of that relationship. The inferential statistics analysis aimed to reach conclusions that extend beyond the immediate data alone between the independent variables in this study which included savings, credit and entrepreneurship development. The main focus was on the effect of microfinance on financial sustainability of SMEs in Kiambu, Kenya.

4.7 Multiple Regression Analysis

In addition, the researcher conducted a multiple regression analysis so as to determine the effect of microfinance credit on financial performance of SMEs in Kiambu County, Kenya. Multiple regression is a statistical technique that allows us to predict a score of one variable on the basis of their scores on several other variables. The main purpose of multiple regression is to learn more about the relationship between several independent or predictor variables and a dependent or criterion variable.

The coefficient of determination is a measure of how well a statistical model is likely to predict future outcomes. The coefficient of determination, r2 is the square of the sample correlation coefficient between outcomes and predicted values. As such it explains the extent to which changes in the dependent variable can be explained by the change in the independent variables or the percentage of variation in the dependent variable (Financial sustainability of SMEs) that is explained by all the three independent variables (savings, credit and entrepreneurship development).

4.8 Regression Analysis

In order to establish the relationship between independent and dependent variables, a multiple regression was conducted. The research study aimed at evaluating the relationship between microfinance credit and financial performance of SMEs in Kiambu County.

The study also revealed that 87.3% of financial performance in the SMEs could be explained by the variables under study. From this study it is evident that at 95% confidence level, the variables produce statistically significant values and can be relied on to explain financial performance in the SMEs sector in Kenya.

Table 4.22: Model Summary

Model Summary				
Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.934[a]	.873	.802	0.312
a. Predictors: (Constant), Microfinance credit (Million Kenya shillings)				

Source: Research Findings

In explaining the percentage of variation in the dependent variable (ROA) that is explained by the independent variables the researcher used coefficient of determination obtained from the model summary in table 4.1, to determine the extent to which changes in the dependent variable (ROA) can be explained by the change in the independent variable or the percentage of variation in the dependent variable that is explained by the variable (Microfinance credit).

From the analysis, the independent variable microfinance credit in this study contributed to 98.3% of the variation in financial performance of SME's in Kiambu County of SME's as explained by adjusted R2 of 87.3. The study conducted an Analysis of Variance, in order to test the significance of the model. The findings were as shown below:

4.8.1 Analysis of Variance

Analysis of variance shows the relationship between the two variables. This section shows you the p-value ("sig" for "significance") of the predictor's effect on the criterion variable. P-values less than .05 are generally considered "statistically significant. In this case the researcher will observe the relationship between liquidity and financial performance.

Table 23: ANOVA

Model		Sum of Squares	Df	Mean Square	F	Sig.
1	Regression	2.107	4	0.5268	5.2314	.000(a)
	Residual	3.122	31	0.1007		
	Total	5.229	35			

From the ANOVAs results, the probability value of 0.000 was obtained implying that the regression model was statically significant in predicting the relationship between microfinance credit and financial performance of SME's in Kiambu County and the predictor variables as it was less than α=0.05. By the help of the F-Test table (5%, 4) tabulated value was 3.472 which was less than F= 5.2314 as well indicated that the model was significant.

Table 24: Tests of Coefficients

Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.
		B	Std. Error	Beta		
1	(Constant)	1.215	1.013	002	3.145	.000
	Microfinance Credit	.001	.335	-.102	1.101	.005
	Outstanding Debt	.224	.103	.128	.725	.002
	Sales Turnover	.302	.657	.123	.345	.004
	Size of the Loan	.201	.768	.001	.789	.002
a. Dependent Variable: ROA						

Source: Research Findings

The researcher conducted a simple regression analysis so as to determine the relationship between financial performance of SME's in Kiambu County (dependent variable) and microfinance credit of SME's in Kiambu County. The following regression equation was obtained:

$ROA = 1.215+.001X_1+.224X_2+.302X_3+.201X_4$

From the regression model obtained above, holding all the other factors constant, financial performance of SME's in Kiambu County .The obtained regression equation further implied that there was a direct relationship between microfinance credit and financial performance of SME's in Kiambu County of SME's. The analysis was undertaken at 5% significance level. The criteria for comparing whether the predictor variables were significant in the model was through comparing the corresponding probability value obtained and $\alpha=0.05$. If the probability value is less than α, then the predictor variable is significant. Therefore, from the above analysis microfinance credit was significant in the model as its corresponding predictor variables were less than 5%.

4.9 Summary and Interpretation of Findings

From the findings obtained regression equation further implied that there was a direct relationship between microfinance credit and financial performance of SME's in Kiambu County. The analysis was undertaken at 5% significance level. Therefore, from the above analysis microfinance credit was significant in the model as its corresponding predictor variables were less than 5%.This shows that the model is a good predictor which is well explained by the coefficient of determination R^2=87.3%.These findings are consistent with these studies:

The study findings show that most SMEs borrow from MFIs their initial capital with 31 respondents stating that their initial capital came from MFIs. This translated to 65.97% leaving only 34.03% for other sources.4.3% of the respondents stated that they obtained initial capital from formal banking which clearly showed that MFIs caters for the greatest

proportion of financing SMEs in Kenya. The study findings also revealed that subsequent financing of SMEs comes from the MFIs with 31.9% of the respondents having borrowed from MFIs to cater for additional capital. Retained earnings with is the accumulation of profits was another source of funding additional capital and in fact when combined with borrowing from MFIs it comprised the largest source translating to 53.2% of all the respondents interviewed.

The study found that there was a strong positive relationship between credit and the financial sustainability of SMEs. This is similar to Hiedhues (1995) who stated that accessing credit is considered to be an important factor in increasing the development of SMEs. The study also established that the enterprises benefit from loans from microfinance institutions, the SMEs seek financial assistance from the MFIs due to interest rate, easy loan repayment and amount offered. The loan repayment period as per the conditions of the MFIs is usually little and the SMEs face challenges as loan beneficiaries from the MFI‘s. This concur with Navajas et al, (2000) that the main objective of microcredit according to is to improve the welfare of the poor as a result of better access to small loans that are not offered by the formal financial institutions. Diagne and Zeller (2001) also argue that insufficient access to credit by the poor just below or just above the poverty line may have negative consequences for SMEs and overall welfare. Access to credit further increases SMEs risk-bearing abilities; improve risk-copying strategies and enables consumption smoothing overtime. With these arguments, microfinance is assumed to improve the welfare of the poor.

The study found that there was a strong positive relationship between savings and the financial sustainability of SMEs. This agrees with Guichandut (2006) that more MFIs are becoming interested in the potential of savings, thanks partly to the global financial crisis which has become a big boost to the SMEs. The study further found that the SMEs do not have a long history of saving culture. The savings have an influence on the financial sustainability of the enterprises, amounts, most microfinance institutions offer savings services and savings influence financial sustainability. This agrees with Cheston and Kuhn (2001) findings that in an emergency, richer people might choose between dipping into their savings and borrowing. The choice for the great mass of the unbanked in the developing world is limited to whom to borrow from, often at great cost. That they can borrow at all is partly due to the rapid growth of microfinance, which specializes in lending small amounts to poor people (Guichandut, 2006).

The study found that there was a positive relationship between entrepreneurial development and the financial performance of SMEs. This is consistent with Guérin (2006) who observed that microfinance institutions need to supply services that fill the gaps and integrate the underserved group into the market. The study also established that financial and management counselling influence financial sustainability in the enterprises as well as workshops and seminars. Microfinance enables poor SME to become economic agents of change by increasing their income and productivity, accessing markets and information and decision making power, increasing SME‘s access to microfinance will enable SMEs to make a greater contribution to household income and thus will translate into improved well-being for SME and enable SME to bring about wider changes in gender inequality. This agrees with Cheston and Kuhn (2001) that in any country, there are underserved enterprises and households, ranging from the ultra poor who may not be economically active, to small growing enterprises that provide employment in their communities

The study found that there was a strong positive relationship between credit and the financial performance of SMEs. This is similar to Heidhues (1995) who stated that accessing credit is considered to be an important factor in increasing the development of SMEs. The study also established that the enterprises benefit from loans from microfinance institutions; the SMEs seek financial assistance from the MFIs. The loan repayment period as per the conditions of the MFIs is usually little and the SMEs face challenges as loan beneficiaries from the MFI‘s. This concur with Navajas et al, (2000) that the main objective of microcredit according is to improve the welfare of the poor as a result of better access to small loans that are not offered by the formal financial institutions. Diagne and Zeller (2001) also argue that insufficient access to credit by the poor just below or just above the poverty line may have negative consequences for SMEs and overall welfare. Access to credit further increases SMEs risk-bearing abilities; improve risk-copying strategies and enables consumption smoothing overtime. With these arguments, microfinance is assumed to improve the welfare of the poor

CHAPTER FIVE

SUMMARY, CONCLUSIONS AND RECOMMENDATION

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 scope of informal banking series specially credit services. According to the National Micro and Small Enterprises Baseline survey of 1999, there are close to 1.3million SMEs employing nearly 2.3million 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 this study was to establish the effects microfinance credit on financial performance of SME's in Kiambu County. The creation of SME's generates employment but these enterprises are short lived and consequently are bound to die after a short while causing those gained job positions to lose them and even go poorer than how they were. The purpose of the study was to find out the effect of microfinance credit on financial performance of SME's in Kiambu County.

The study employed a cross-sectional survey research design. The sample was picked from all business categories in Kiambu County. Simple random sampling was used to arrive at a sample of sixty (60) small and medium enterprises. Questionnaire was used as the principle tool for collecting primary data whereas the respondents provided financial statements in the case of secondary data. Data was analyzed using descriptive statistics and multiple regression approach. From the analysis the study revealed the following findings. The study found out that all SMEs borrow to increase their financial performance

5.3 Conclusions

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.

A large number of Kiambu residents derive their livelihood from the SME's. However in spite of the importance of this sector, experience shows that provision and delivery of credit services to the sector by formal financial institutions such as commercial banks and MFIs has been below expectation. This means that it is difficult for the poor to move out of poverty due to lack of finance for their productive activities. Small-scale loans can relieve capital constraints that might otherwise preclude cash-strapped entrepreneurs from investing in profitable businesses, while savings services can create opportunities to accumulate wealth in safe repositories and to manage risk through asset diversification.

As SMEs grow they require funds to finance growth in fixed asset and increase working capital. SMEs therefore require long-term credit in ever increasing amounts. SMEs needs funds so that they can purchase raw materials supplies and carry out activities that they need to facilitate the production process.

The study found that all SMEs borrow investment capital and they use it for the purpose in which they borrowed for, 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 study finally concludes that ROA increased with each consecutive loan showing that microfinance services enhance financial performance of SMEs in Kiambu County.

The regression results imply that microfinance credit contribute more to the financial performance of SMEs and hence higher return on assets.

5.4 Limitations of the Study

The limitation of this study is that it is utilized secondary data, which had already been obtained and in the public domain. Unlike the primary data which is firsthand information, despite that the secondary data was tested for precision and remained relevant since it reflected current macroeconomic conditions and financial soundness in the republic of Kenya.

The study adopted a multiple regression model with four variables: three dependent variables (microfinance credit, asset turnover and size) and one dependent variable (financial performance).Future researchers can adopt a similar model but investigate on other variables that may have an effect on financial performance of SME’s. Results and findings can be made and conclusions drawn.

Most of the financial statements are reaffirmed in the preceding years meaning that material misstatements of firms’ performance can create a window of opportunity for prior year's adjustments and this may not be brought to the attention of the public. This means the pattern depicted may affect the relationship established.

This study was carried out within a limited time frame and resources which constrained the scope and depth of the study. This necessitated the adoption of a sample design hence these findings cannot be used to make generalizations on the effect of microfinance credit and financial performance of SME's in Kiambu County.

5.5Policy Recommendations

There is need to provide an enabling environment for SME's to grow and thrive, therefore there is a need to develop strategies to enhance increased access to microfinance credit by SME's from commercial banks and microfinance institutions. It is important for the government to set up policies that will ease microfinance credit to SME's. These policies should be in line with both the owners of SME's and financial institutions in order to prevent putting hindrances to potential and credit worthy customers who seek to expand or start up a business. This will create a window for growth and development of the economy as a result of more job opportunities and increased flow of money circulation in the economy.

Financial institutions should ensure that they sensitize the owners of SMEs on best financial management practices. This will help the owners of SME's to account for loans borrowed. Lending institutions should also advise borrowers on how to appraise their projects for viability to ensure that they make wise decisions when investing in projects.

The study recommends that MFIs partner with the county governments and other stakeholders so as to create awareness of the avalibabilty 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 the central bank should set policies and procedures to prevent barriers that inhibit potential owners and managers of SME’s from accessing credit facilities. This will create a conducive environment for SME’s to growth and expand. It will also open up opportunities for jobs and this will enhance economic growth.

Financial institutions should also provide financial advisory services to individual proprietors when advancing credit to them; lower lending rates while improving service delivery and train people on risk management and financial management. The Government should also regulate financial institutions to ensure that the owners and managers of SME’s get access to information in order to make the right investment decisions.

5.6 Suggestions for Further Study

This study focused on SMEs in Kiambu County and therefore the findings of this study cannot be generalized to all the SME’s in the 47 counties in Kenya. The study recommends that further research could be conducted on SME’s countrywide to investigate on the effects of microfinance credit on financial performance of SMEs to find out whether there are commonalities or unique factors.

The concentrated on the SMEs, it is important to carry out similar study among large enterprises in order to find out the effect of credit on performance of these firms. Fure research should also focus on the different aspects of micro financing on the performance of SMEs.

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 a link seems almost impossible. Further research should be done in this area to establish the best way of linking small and micro businesses with large companies in the economy.

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APPENDIX I: LETTER OF INTRODUCTION

SIMON WAITHANJI WAKABA,

UNIVERSITY OF NAIROBI,

SCHOOL OF BUSINESS,

P. O. BOX 30197-00100,

NAIROBI.

RE: **THE EFFECT OF MICROFINANCE CREDIT ON THE FINANCIAL PERFORMANCE OF SMALL AND MEDIUM ENTERPRISES IN KIAMBU COUNTY, KENYA**

I am a Master degree student in the School of Business, University of Nairobi. In partial

fulfilment of the Master of Science in Finance degree, I am conducting the above underlined study. You have been selected to form part of this study. To this end, I kindly request your assistance in completing the attached questionnaires.

The information and data you will provide is for academic purpose only and will be treated in strict confidence.

Thank you in advance.

Yours sincerely,

SIMON WAITHANJI WAKABA,

APPENDIX II: QUESTIONNAIRE

BACKGROUND – PERSONAL INFORMATION

1. Name………………………………………… Optional

2. What is your Gender?

A	Male	
B	Female	

3. What is your age?

A	Below 20 years	
B	Between 21-30	
C	Between 31-40	
D	Between 41-50	
E	Above 50 years	

4. What is your highest level of education?

A	Primary school	
B	Secondary school	
C	College	
D	Others	

If other Specify…………………………………………………………………………

5 . How long have your business been operational?

Duration	**Option**
Less than 1 year	[1]
1-5 years	[2]
6-10 years	[3]
11-15 years	[4]
Over 15 years	[5]

PART II PROVISION OF MICROFINANCE SERVICES

6. Tell us about other valuable services you get from MFIs
…………………………………………………………………………………………
…………………………………………………………………………………………
…………………………………………………………………………………………

7. What was the major source of your start-up capital?

A	Personal Savings & Friends and relatives	

B	Loans from banks	
C	Other sources	
D	Others sources	

If other sources please state which source?
……………………………………………………………………………………..
……………………………………………………………………………………..
……………………………………………………………………………………..

8. What was the major source of financing additional capital?

A	Retained profits	
B	Loans and retained earnings	
C	Loans only	

9. Do you benefit from loans from microfinance institutions?

Yes [ ] No [ ] If Yes, how
…………………………………………………………………………………………
…

10. If you obtain loan from MFI‘s what made you to seek financial assistance from the MFI‘s

a. Easy loan repayment [ ]

b. Amount offered [ ]

c. Interest rate [ ]

Others state……………………………………

11. What is the loan repayment period as per the conditions of MFI?

a. 6 months-1 year [ ]

b. - 5 yrs [ ]

c. Above 5 yrs [ ]

12. In a scale of 1-5, rate the below in respect to training if any by MFIs. Note 1 =Less favourable; 2=moderately satisfactory;3= satisfactory;4=Very satisfactory and 5=Most satisfactory

Skills	**Most satisfactory**	**Very satisfactory**	**Satisfactory**	**Moderately satisfactory**	**Less satisfactory**
Basic business					

skills					
Capital investment decisions					
Business risk management					

PART III: FINANCIAL PERFORMANCES

13. Give us your estimates based on below table

Performance measure	2013	2012	2011	2010	2009
Turnover/sales					
Expenditure					
Surplus/deficit					

14. Has there been any change in your asset base? Please give us your asset estimates.

Performance measure	2013	2012	2011	2010	2009
Fixed assets estimates (kshs)					
Current assets estimate (kshs)					
Total assets estimates (kshs)					

(Please feel free to attach copies of financial statements where possible. It will be strictly
used for the purpose of the study)

15. In a scale of 1-5, rate the below in to your level of satisfaction that MFI services have contributed to your financial performance. Note 1 =Less favourable; 2=moderately satisfactory; 3= satisfactory;4=Very satisfactory and 5=Most satisfactory

Services	Most satisfactory	Very satisfactory	Satisfactory	Moderately satisfactory	Less satisfactory
How satisfied has your access to loan services contributed to your SMEs financial performance?					
How satisfied has your access to training contributed to your SMEs financial performance?					
How satisfied has your access to savings contributed to your SMEs financial performance?					

16. What percentage can you rate your SME performance?

Status	Most satisfactory (5)	Very satisfactory (4)	Satisfactory (3)	Moderately satisfactory (2)	Less satisfactory (1)
Financial performance					

APPENDIX III:

LIST OF MICRO FINANCE INSTITUTION REGISTERED WITH ASSOCIATION OF MICROFINANCE INSTITUTIONS

Jamii Bora Bank

Co-operative Bank

UNI Microfinance Bank

Kenya Women Finance Trust-DTM

Kiambere Road, Upper Hill Nairobi

Rafiki Microfinance Bank

Faulu Kenya Microfinance Bank

SMEP Microfinance Bank

Remu Microfinance Bank

Century Microfinance Bank

Sumac Credit Microfinance Bank

One Africa Capital Ltd

Pamoja Women Development Programme

Women Enterprise Solutions

Samchi Credit Limited

Milango Financial Services

Unaitas Sacco Society ltd.

Muramati Sacco Society Ltd

UNAITAS Sacco Society Limited,

Habitat for Humanity Kenya

Focus Capital Limited

Fort Credit Ltd

Vision Fund Kenya

AAR Credit Services

Jubilant Kenya Ltd

Fusion Capital Ltd

OIKO Credit

Bimas Complex

Letshego Kenya

Women Enterprise Fund

Habitat for Humanity Kenya