

**THE EFFECT OF FINANCING SOURCES ON THE FINANCIAL
PERFORMANCE OF TOP 100 MID-SIZED COMPANIES IN KENYA**

BY

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DECLARATION

This research project is my original work and has not been presented for a degree in any other University.

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DEDICATION

To my wife, our kids, and our future grand-children

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ABSTRACT

The objective of this study was to examine the effects of sources of finance on the performance of Top 100 mid-sized companies in Kenya. Descriptive cross sectional research design was adopted for this study. The target population for this study were the 100 SMEs (2013) in Kenya. Simple random sampling was used to select 30% of the top 100 companies. The sample size was therefore 30 SMEs. Primary data was collected through the use of questionnaires which were designed based on the study objective. Data was entered into SPSS and analysed using inferential statistics and regression analysis. The descriptive results showed that 77% of the firms had used personal income as a source of financing, 60% used bank loans, 57% used venture capital, 40% used leasing, 43% used sale of shares, 17% used government loans, and 13% used microfinance. All these sources were used by most firm to a low extent as financing options. The regression results show that personal income, bank loans, microfinance, and government loans had weak positive effects while venture capital, leasing, and sale of shares had weak negative effects on the financial performance of Top 100 companies in Kenya at 5% level of significance. The study concludes that the sources of finance do not affect the financial performance of Top 100 companies in Kenya. The study recommends the need for use of a mix of financing options to improve the financial performance of organisations rather than reliance on one form of financing. The study also recommends that the Government should be instrumental in offering loan facilities for businesses as currently very few mid-sized firms have used this method of financing.

CHAPTER ONE

INTRODUCTION

1.1 Background of the Study

The availability of finance has been highlighted as a major factor in the development, growth and successfulness of SMEs (Ou & Haynes, 2006; Cook, 2001). Financing methods employed by SMEs vary from initial internal sources, such as owner-manager's personal savings and retained profits (Wu, Song, & Zeng, 2008) to informal outside sources, including financial assistance from family and friends (Abouzeedan, 2003), trade credit, venture capital and angel financiers (He & Baker, 2007), and thence to formal external sources represented by financial intermediaries such as banks, financial institutions and securities markets (Chittenden, Hall, & Hutchinson, 1996).

SMEs are very significant to the economic success for most countries and their citizens and in recent times have been observed to employ an increasing proportion of the workforce of most countries. There is a fast growth in the number of privately owned small and medium-sized companies worldwide, however, this category of business is plagued by several issues that deter this growth. A key challenge for most SMEs is the problems of financing, according to Da Silva et al. (2007), all small firms live under tight liquidity constraints, therefore making finance a major problem for them.

According to Ogujiuba et al. (2004) generating an entrepreneurial idea is one thing but accessing the necessary finance to translate such ideas into reality is another. Many novel entrepreneurial ideas have been known to die simply because their originators could not fund them, and banks could not be convinced that they were

worth investing in. Finance, whether owned or borrowed, is needed to expand so as to maximize profit and given the nature of SMES, there is a need for financing.

1.1.1 Financing Sources

There are a number of sources of finance that a small and medium enterprise can choose from for their financing requirements. These include personal sources of finance, bank loans, micro-finance funds, venture capital funds, and leasing, among others. Most SMEs get funding from personal savings, informal lending schemes, savings collectors, and money lenders, rotating savings and credit associations and family members. This is further confirmed in a survey by USAID (2005) where 24 percent of the surveyed respondents agreed to use informal finance services.

Commercial banks constitute the main providers of financial services for enterprises. In Africa, they used to be dominated by foreign banks, but since the 1980s, a significant number of private-owned banks have developed in most countries. Commercial banks offer a wide range of financial services including savings, deposits, credits, transfers, insurance arrangements, and even leasing. The main lending mechanism is short-term working capital; however, the availability of other financial services depends on the nature of the deposits that are being used for funding, as well as the demand for it.

Given their profit-making principles, commercial banks find it difficult to provide financial services to SMEs because SMEs are considered high risk clients. Poor or incomplete business plans, when at all presented, make difficult the task of assessing the financial situation of such firms and their prospects for success. Second, transaction costs are inversely related to loan size, making lending in small amounts unprofitable. Third, restrictive financial policies impede commercial banks to set up

their own mechanism of loan recovery, therefore limiting how much they can lend and to whom (Mwangi, 2011).

The micro-finance industry has proved to be a reliable delivery vehicle for financial services to SMEs. They consist of licensed institutions, NGOs co-operatives as well as a large collection of associations ranging from women and youth clubs to loosely organized bodies. They offer savings, payments and insurance services to their clients. The strength of MFIs is that they serve the rural areas at low costs. Their service delivery is flexible, which makes it easy for weak SMEs to access financial services from them. Their weaknesses, though, lie in their weak operational and management information systems, poor internal controls, limited access to technical assistance, and dependence on donor funding (Mwangi, 2011).

Venture capital is equity investment provided by an outsider who is not the owner of the company. The concept behind venture capital is very simple. Instead of obtaining debt or bank finance, venture capitalists provide equity capital for other businesses, therefore sharing risks. It is a form of long-term investment for start-up and growing businesses that are seen as having a significant potential for economic growth (UNIDO, 2002).

The benefits of venture capital go beyond the provision of long-term finance. Since they share risks, venture capitalists, unlike banks, get actively involved in the functioning of the firm, from management to shop-floor operations. Given their knowledge gained from investing in other companies with similar growth challenges, venture capitalists or business angels can help their investees in overcoming the specific bottlenecks that hamper their performance. Following profit-making principles, venture capitalists seek high-return opportunities while minimizing risks.

In the developed world, „business angels“ have played a significant role in the success of small export-oriented high-tech firms, particularly in the fields of electronics and ICT (Mwangi, 2011).

Leasing has been an alternative means of financing capital investment of SMEs with minimum initial outlay. A lease is a contract between an owner of equipment (the lessor) and another party (the lessee) giving the lessee possession and use of a specific asset in return for payment of specified rentals over an agreed period. The lessee selects the equipment and the lessor purchases it for the former's use (Mwangi, 2011).

The development of stock markets is the most sophisticated phase in the evolution of any financial sector. In the last years, stock markets have been created through Africa partly due to stringent privatization policies and the establishment of capital market authorities. Some are country-specific while others are regional or pan-African. However, most SMEs cannot take advantage of the stock markets because of listing rules regarding disclosure requirements, which require companies to provide credible information to investors.

As described by the South African reserve bank (2004) in a report conducted by the Task Group of the Policy Board for Financial Services and Regulation, SMEs generally have four key funding requirements: i) initial infrastructure investments, ii) lumpy operations costs, iii) „next-step“ expansions, and iv) unexpected opportunities requiring quick access to funds. Despite what the funding requirement maybe, SMES often prioritize the source of financing from internal (cash flow or entrepreneur's own capital) to external, according to relative availability and (opportunity) cost (Ogujiuba et al., 2004). This is because for most firms, the internal funds are always insufficient

to undertake the required level of transactions for profitable projects hence the call for external finance to fill the finance gap.

Theoretically, a number of analytical paradigms have attempted to explain the complexities and practicalities involved in small-firm financing. As early as the MacMillan Report in 1931, there has been recognition that small firms suffer from what is termed the finance gap. This situation arises when a firm has grown to a size where the use of short-term finance is maximized, but the firm is not big enough to access capital-market funds. By contrast, in developing countries it is probable that such a finance gap arises at even earlier stages of the enterprise's lifecycle (South African reserve bank in a report conducted by the Task Group of the Policy Board for Financial Services and Regulation 2004).

1.1.2 Financial Performance

According to Brown (1996), performance measures must focus attention on what makes, identifies and communicates the drives of success, support organization learning and provides a basis for assessment and rewards. On the other hand, West and Fair (1996), define performance as a function of an organization's ability to meet its goals and objectives by exploiting the available resources in an efficient and effective way.

Performance encompasses three specific areas of firm outcomes: (1) financial performance (profits, return on assets, return on investment, etc.); (2) market performance (sales, market share, etc.); and (3) shareholder return (total shareholder return, economic value added, etc.) (Divenney et al., 2008). Performance is the ultimate dependent variable of interest for those concerned with just about any area of management: accounting is concerned with measuring performance; marketing with

customer satisfaction and market share; operations management with productivity and cost of operations, organizational behaviour with employee satisfaction and structural efficiency; and finance with capital market response to all of the above.

Performance is so common in organizational research that it is rarely explicitly considered or justified; instead it is treated as a seemingly unquestionable assumption (Devinney et al., 2005). The multidimensionality of performance covers the many ways in which organizations can be successful; the domain of which is arguably as large as the many ways in which organizations operate and interact with their environment.

The financial performance of mid-sized firm is measured through its profitability. There are various profitability measures that are used to measure the performance of organisations especially in SME studies such as Return on Assets (ROA) and the Return on Equity (ROE). In this study, return on assets will be used as a performance measure.

1.1.3 Effect of Financing Sources on Financial Performance

There is a strong relationship between access to finance and performance of SMEs. The inaccessibility of credit and capital is a major impediment to the development of SMEs, particularly because it prevents them from acquiring the new technology that would make them more productive and more competitive. Access to finance will provide assistance to SMEs in the area of accounting, financial management and entrepreneurship that complies with national accounting requirements and/or best practices, this will improve the performance of SMES (UNCTAD 2002).

Alexandra, (2006) noted that access to external funding helped to ease cash flow management, generate more institutional income, increase membership size and

promote training and capacity building . A survey conducted by FSD (2009) revealed that firms borrowed outside funds in order to increase membership size since individuals would be drawn to an institution with accessible funds for loans. A survey conducted by KUSCCO (2009) which indicated that majority of firms sought external credit in order to meet the demands of savings and withdrawals, loan disbursement and maintenance of operational expenses.

1.1.4 Top 100 Mid-Sized Companies in Kenya

Kenya's Top 100 mid-sized companies Survey ('Top 100 Survey') is an initiative of KPMG Kenya and Nation Media Group which ranks 100 best SMEs in a survey annually. The Survey seeks to identify Kenya's fastest growing medium sized companies in order to showcase business excellence and highlight some of the country's most successful entrepreneurship stories. From these surveys, hundreds of SMEs have been identified and these are the focus of the present study.

According to KPMG (2014), a "Top 100 Mid-sized Company" ('Top 100 Company') is one which ranks ahead of its peers in terms of revenue growth, profit growth, returns to shareholders and cash generation/liquidity. A Top 100 company has succeeded in progressively growing its market position in the industries in which it operates and over time. This growth has translated into both returns for its shareholders and a fairly sound financial position.

1.2 Research Problem

Firms depend on a variety of sourcing of financing both internal and external (Terungwa, 2012). The relationship among these sources and their effects on investment; however remain unclear in the literature. In the cases of SMEs, bank loan and credit is a major alternative of external funding. According to Valverde et al.

(2005) bank credit play a crucial role in providing external financing to SMEs. But in African context, this crucial sources of finance for SMEs is apparently non-functional (Kadri, 2012).

The Small and Medium Enterprises (SMEs) in Kenya account for 80% of employment and contributes about 40% to Kenya's GDP (Mwarari, 2013). This underscores the importance of this sector to the Kenyan economy. The biggest problem to the growth of SMEs has been financing as commercial banks shy away from financing them. The key issue affecting the SMEs can be group into four: unfriendly business environment, poor funding, low management skill and lack of access to technology (Onoivos, 2013). Among these, shortage of finance occupies a central position. Globally commercial banks which remain the biggest source of funds to SMEs have in most cases shied away because of perceived risks and uncertainties.

Studies on the effect of financing sources on performance of SMEs are limited. For instance, Memba, Gakure, & Karanja (2012) and Gikomo (2013) examined the impact of venture capital on growth of SMEs in Kenya while Ondieki et al. (2013) studied the effect of external financing on performance of SMEs. Another study by Mbugua (2010) examined the impact of microfinance services on financial performance of SMEs in Kenya. There is therefore a gap as concerns study on how source of financing affects performance of SMEs in Kenya. The present study attempts to address this gap by answering the following research question: what is the effect of sources of finance on the performance of Top 100 mid-sized companies in Kenya?

1.3 Research Objective

The objective of this study was to examine the effects of sources of finance on the performance of Top 100 mid-sized companies in Kenya.

1.4 Value of the Study

This study adds on to the growing literature on how sources of finance affect SME performance especially using data from Kenya. This is important as it brings in the perspective from an African emerging economy.

This work is to prove helpful to existing and potential entrepreneur of SMEs since this study lends assistance in the effect of sources of finance in the performance of a business in order to plan ahead.

The research work could also serve as a source of future reference to future researchers who may find it helpful in carrying out a research work of similar nature or related topic.

CHAPTER TWO

LITERATURE REVIEW

2.1 Introduction

This chapter presents a literature review on the effects of sources of finance on performance of organisations. First, a theoretical review is presented where relevant theories on the subject matter are shown. Then an empirical review of prior studies on the effect of source of funding on performance of firms is discussed. The chapter then concludes.

2.2 Theoretical Review

Two theories are reviewed in this study. These theories are the pecking order theory and the entrepreneurship theory.

2.2.1 Pecking Order Theory

The “pecking order theory” of financing says that firms and individuals will use personal funds before acquiring external debt and equity. Pecking Order Theory (POT) is a framework for examining firm financing that states that firms attempt to reduce information asymmetries and maintain ownership by first using internal financing, followed by external debt and equity (Myers, 1984; Berger & Udell, 2003). POT was originally devised to examine the financing of large corporations, but it has also been applied to small and medium-sized businesses.

Traditional finance theories are centered on agency conflicts between shareholders and debt holders. Up until the 1990s, the vast majority of finance studies focused on large corporations and publicly traded companies. Scholars began to realize that small firms, on the other hand, differ considerably from larger firms. Small and medium-sized businesses face different agency and information asymmetry challenges. For

example, they are not likely to be publically traded or incorporated, which limits the sources of financing available to them. And, because they are not required to share as much information as public companies, they are information opaque (Ang, 1991). Financing decisions for small and new ventures may also be more complex because they are closely linked to the personal wealth or contacts of the owner/manager. Consequently, agency problems may be more intense as shareholders and partners are often made up of family and friends (Ang, 1992).

The “pecking order” model of firm financing is one method firms might use to address these agency problems. According to this theory, firms do not aim for a target debt ratio. Instead, firms select from funding sources that minimize the cost of capital (Myers, 1984; Myers and Majluf, 1984). In the case of the small firm or entrepreneur, personal sources are used first, external debt next, followed by outside equity. Equity is acquired last because the entrepreneur presumably has more information than the investor. The presence of significant information asymmetries causes the investor to charge a higherrate of return on equity than on debt (Frank and Goyal, 2003). Indeed, information asymmetry costs may be much higher for small firms than for large, and the pecking order framework may therefore explain a great deal of financing behaviour by entrepreneurs (Scherr, 1993; Hall et al., 2000).

Some research seem to validate the view that SME owners/managers’ financing decisions are consistent with the “pecking order” theory (Sogorb and Lopez-Gracia, 2003; Watsonand Wilson, 2002). For instance, Watson and Wilson (2002) suggest that under these circumstances an owner(s)/manager will choose first – a personal source of finance; second – short-term borrowing; third – longer-term debt; and – finally, the least preferred, equity finance which might affect his/her control upon the business. Sogorb and Lopez-Gracia (2003) also suggest that owners/managers tend not

to sufficiently organise their finances in order to obtain an optimal capital structure (i.e. debt versus equity ratio) but prefer financing options that both ensure and maintain their control upon a business.

2.2.2 Trade-Off Theory

The term trade-off theory is used by different authors to describe a family of related theories. In all of these theories, a decision maker running a firm evaluates the various costs and benefits of alternative leverage plans. Often it is assumed that an interior solution is obtained so that marginal costs and marginal benefits are balanced.

The original version of the trade-off theory grew out of the debate over the Modigliani-Miller theorem. When corporate income tax was added to the original irrelevance proposition (see Modigliani and Miller, 1963) this created a benefit for debt in that it served to shield earnings from taxes. Since the firm's objective function is linear, and there is no offsetting cost of debt, this implied 100% debt financing.

To avoid this extreme prediction, an offsetting cost of debt is needed. The obvious candidate is bankruptcy. Kraus and Litzenberger (1973) provide a classic statement of the theory that optimal leverage reflects a trade-off between the tax benefits of debt and the dead weight costs of bankruptcy. According to Myers (1984), a firm that follows the trade-off theory sets a target debt-to-value ratio and then gradually moves towards the target. The target is determined by balancing debt tax shields against costs of bankruptcy.

2.2.3 Modigliani-Miller Theorem

The theory of business finance in a modern sense starts with the Modigliani and Miller (1958) capital structure irrelevance proposition. Before Modigliani and Miller, there was no generally accepted theory of capital structure. They start by assuming

that the firm has a particular set of expected cash flows. When the firm chooses a certain proportion of debt and equity to finance its assets, all that it does is to divide up the cash flows among investors. Investors and firms are assumed to have equal access to financial markets, which allows for homemade leverage. The investor can create any leverage that was wanted but not offered, or the investor can get rid of any leverage that the firm took on but was not wanted. As a result the leverage of the firm has no effect on the market value of the firm.

Their paper led subsequently to both clarity and controversy. As a matter of theory, capital structure irrelevance can be proved under a range of circumstances. There are two fundamentally different types of capital structure irrelevance propositions. The classic arbitrage-based irrelevance propositions provide settings in which arbitrage by investors keeps the value of the firm independent of its leverage. In addition to the original Modigliani and Miller paper, important contributions include papers by Hirshleifer(1966) and Stiglitz (1969).

A second kind of capital structure irrelevance is associated with multiple equilibria. In models of this kind, equilibrium conditions pin down the aggregate amount of debt and equity in the market. But the model does not specify how these aggregate quantities get divided up among the firms. The classic paper is by Miller (1977) in which consideration of both personal and corporate tax determines an economy-wide leverage ratio, but there are multiple equilibria in which debt is issued by different firms. A similar kind of firm-level capital structure irrelevance is found in Auerbach and King's (1983) paper.

The 1958 paper also stimulated serious research devoted to disproving irrelevance as a matter of theory or as an empirical matter. This research has shown that the

Modigliani-Miller theorem fails under a variety of circumstances. The most commonly used elements include consideration of taxes, transaction costs, bankruptcy costs, agency conflicts, adverse selection, lack of separability between financing and operations, time varying financial market opportunities, and investor clientele effects. Alternative models use differing elements from this list. Given that so many different ingredients are available, it is not surprising that many different theories have been proposed. Covering all of these would go well beyond the scope of this paper. Harris and Raviv (1991) provided a classic survey of the theory development as of the time it was written.

As an empirical proposition, the Modigliani-Miller irrelevance proposition is not easy to test. With debt and firm value both plausibly endogenous and driven by other factors such as profits, collateral, growth opportunities, etc., it is not easy to get a structural test of the theory by regressing value on debt. However, the fact that there are fairly reliable empirical relations between a number of factors and corporate leverage, while not disproving the theory, does make it seem an unlikely characterization of how real businesses are financed.

2.2.4 Entrepreneurship Theory

The entrepreneurial function implies the discovery, assessment and exploitation of opportunities, in other words, new products, services or production processes; new strategies and organizational forms and new markets for products and inputs that did not previously exist (Shane and Venkataraman, 2000). The entrepreneurial opportunity is an unexpected and as yet unvalued economic opportunity. Entrepreneurial opportunities exist because different agents have differing ideas on the relative value of resources or when resources are turned from inputs into outputs.

The theory of the entrepreneur focuses on the heterogeneity of beliefs about the value of resources (Alvarez and Busenitz, 2001).

Entrepreneurship – the entrepreneurial function- can be conceptualized as the discovery of opportunities and the subsequent creation of new economic activity, often via the creation of a new organization (Reynolds, 2005). Entrepreneurship is often discussed under the title of the entrepreneurial factor, the entrepreneurial function, entrepreneurial initiative, and entrepreneurial behaviour and is even referred to as the entrepreneurial “spirit. The entrepreneurial factor is understood to be a new factor in production that is different to the classic ideas of earth, work and capital, which must be explained via remuneration through income for the entrepreneurial with the shortage of people with entrepreneurial capabilities. Its consideration as an entrepreneurial function refers to the discovery and exploitation of opportunities or to the creation of enterprise.

Entrepreneurial behaviour is seen as behaviour that manages to combine innovation, risk-taking and proactiveness (Miller, 1983). In other words, it combines the classic theories of Schumpeter’s innovative entrepreneur (1934, 1942), the risk-taking entrepreneur that occupies a position of uncertainty as proposed by Knight (1921), and the entrepreneur with initiative and imagination who creates new opportunities. Reference to entrepreneurial initiative underlines the reasons for correctly anticipating market imperfections or the capacity to innovate in order to create a “new combination”. Entrepreneurial initiative covers the concepts of creation, risk-taking, renewal or innovation inside or outside an existing organization. Lastly, the entrepreneurial spirit emphasizes exploration, search and innovation, as opposed to the exploitation of business opportunities pertaining to managers.

SMEs are vital for economic growth and development in both industrialised and developing countries, by playing a key role in creating new jobs. Financing is necessary to help them set up and expand their operations, develop new products, and invest in new staff or production facilities. Many small businesses start out as an idea from one or two people, who invest their own money and probably turn to family and friends for financial help in return for a share in the business. But if they are successful, there comes a time for all developing SMEs when they need new investment to expand or innovate further. That is where they often run into problems, because they find it much harder than larger businesses to obtain financing from banks, capital markets or other suppliers of credit. This “financing gap” is all the more important in a fast-changing knowledge-based economy because of the speed of innovation. If SMEs cannot find the financing they need, brilliant ideas may fall by the wayside and this represents a loss in potential growth for the economy.

2.3 Determinants of Financial Performance

2.3.1 Size

The nature of the relationship between firm size and economic performance has received considerable attention in the literature and has provoked vigorous debate. Several arguments favour larger firm sizes in attaining higher performance. Large firms are more likely to exploit economies of scale and enjoy higher negotiation power over their clients and suppliers (Serrasqueiro and Nunes, 2008). In addition, they face less difficulty in getting access to credit for investment, have broader pools of qualified human capital, and may achieve greater strategic diversification (Yang and Chen, 2009). On the other hand, small firms exhibit certain characteristics which can counterbalance the handicaps attributed to their smallness. They suffer less from the agency problem and are characterized by more flexible non-hierarchical

structures, which may be the appropriate organisational forms in changing business environments (Yang and Chen 2009).

Existing empirical evidence has not been unambiguous, lending support to both a positive and a negative impact of firm size on performance. Yang and Chen (2009) compared the technical efficiency of SMEs with that of large firms and were inconclusive about the relationship when choosing different estimation methods. In a study on Portuguese companies Serrasqueiro and Nunes (2008) found that size is related positively to performance but only for the sample of SMEs and not for large firms. A similar finding by Diaz and Sanchez (2008) in the Spanish context suggested that SMEs were more efficient than large firms lending support to earlier studies that identified an inverse relationship between size and performance. These studies imply a relationship between firm size and performance that might not necessarily be linear, as illustrated in Barrett et al. (2010), Yoon (2004), and Risseeuw (1997), which conclude that company growth beyond optimal level can deteriorate performance.

2.3.2 Ownership Structure

Berle and Means (1932) warned that the growing dispersion of ownership of stocks was giving rise to a potentially value-reducing separation of ownership and control. As a consequence, they expected an inverse correlation between the diffuseness of shareholdings and corporate performance. This analytical framework is based upon the view that shareholder diffusion makes it difficult for them to act collectively and hence to influence management to any great extent. The inverse relationship between ownership diffuseness and firm performance was first challenged by Demsetz (1983), who supports the endogeneity of ownership structure.

Since Demsetz's (1983) work, numerous empirical studies investigating this issue have been published. In a seminal study, Morck et al. (1988) proposed a non-linear relationship between insider ownership and firm performance. By examining Future 500 firms for the year 1980 and using piecewise linear regression, they find a positive relationship between Tobin's Q and ownership structure for the 0 per cent to 5 per cent board ownership range, a negative relationship in the 5 per cent to 25 per cent range and a positive relationship for board ownership exceeding 25 per cent.

2.3.3 Age

It is not easy to find specific theoretical predictions for how firm age affects firm performance, because many theoretical models take firm size and firm age as representing the same fundamental concept. For example, Greiner (1972) presents his stages of growth model of organizational change in growing firms, in which size is linearly related to age. Other scholars have nonetheless made specific predictions about how firm performance changes with age.

The relationship between firm age and survival has also been investigated by many researchers (Mata and Portugal, 2004; Bartelsman et al., 2005), but the results have not been clear-cut. An early contribution coined the term liability of newness to describe how young organizations face higher risks of failure (Stinchcombe, 1965). More recently, however, authors have referred to the liability of adolescence (Fichman and Levinthal, 1991) to explain why firms face an initial 'honeymoon' period in which they are buffered from sudden exit by their initial stock of resources. Still others have identified liabilities of senescence and obsolescence (Barron et al., 1994) according to which older firms are expected to face higher exit hazards once other influences (such as firm size) are controlled for.

2.4 Empirical Review

Saeed (2009) investigated the impact of financial sources on firm growth in Brazil. The empirical results revealed that internal finance maintains positive relation with firm growth. Growth positively relates to the formal financial institutions while it is found insignificant to informal institutions. Furthermore, analysis strengthens the view that developed financial system is a very imperative factor for firm's growth in less developed countries.

Amjed (2011) explored the impact of debt financing on the profitability of the firms in Chemical Sector of Pakistan. OLS was applied to test the hypothesized relationship. The results were not consistent with previous studies conducted on capital structure. In contrast to literature, the results revealed significant negative relationship between long term debt and firms' performance and significant positive relationship between short term debt and the profitability.

Mallick and Yang (2011) used firm-level data covering over 11,000 firms from 47 countries over a recent period of 1997-2007 to examine the effect of different sources of financing on corporate performance. The results showed that firms with high debt-to-equity ratio tend to have lower returns to shareholders (profitability) and lower internal efficiency (productivity). The study found that retained earnings and equity financing improve performance, while debt financing by firms particularly in the form of bank loans leads to lower performance, although not so in the case of debt raised through issuing bonds.

Memba et al. (2012) examined the impact of venture capital on growth of SMEs in Kenya. The methodology adopted was collection of data before and after use of venture capital. The findings in this study revealed that venture capital has an impact

on growth of SME they finance. The study has demonstrated that use of venture capital can be profitable in Kenya even in an inauspicious political and economic climate. The study concluded that SME that use venture capital experience improved growth.

Kigomo (2013) studied the impact of venture capital financing on the growth of SMEs in Kenya and focused on Top 100 mid-sized companies. The study found out that there was a positive and significant relationship between growth in SMEs and venture capital financing. The study concluded that the effect of venture capital on growth of SME is real and practical, and that increased venture capital financing improves SMEs credit rating, marketing and distribution networks, improves technical expertise and management expertise/skills which in turn enhance growth in these firms.

Ondieki et al (2013) examined the effect of external financing on the financial performance of SACCOs in Kisii Central District using a sample size of 100 respondents. The study indicated that 88.9% of the sampled SACCOs had received external financing whereas the remainder 11.1% had not received any form of external financing. The findings showed that financial performance was influenced by financing and investment policies, and portfolio quality.

2.5 Summary of the Literature Review

This chapter has discussed two theories of financing in organisations. These theories are pecking order theory and entrepreneurship theory. For the SMEs, the most relevant theory of financing is the entrepreneurship theory as it explains that SMEs seek financing because of the need to produce goods and services or to expand. This theory will therefore be most relevant in this study. However, since the study will be

also focusing primarily on the top 100 mid-sized companies in Kenya, their large size might mean that the pecking order theory could apply to some of them. This needs to be investigated further using empirical data.

The empirical review has shown the studies on the effect of various types of financing on firm performance. As discussed, internal sources of financing and external sources of financing have different effects on performance of organisations. These results show mixed findings. Thus, there is a gap in literature as far as establishing how financing sources affect firm performance. The present study seeks to investigate this.

CHAPTER THREE

RESEARCH METHODOLOGY

3.1 Introduction

This chapter discusses the methodology that will be adopted by the researcher in carrying out the study. The chapter also presents the information on population, the methods used to sample it, the instruments used in data collection and procedures that will be used in data analysis.

3.2 Research Design

Descriptive cross sectional research design was adopted for this study. According to Cooper and Schindler (2014), a descriptive study is concerned with finding out the what, where and how of a phenomenon. Descriptive research design was chosen because it enables the researcher to generalise the findings to a larger population. Descriptive design method provides quantitative data from cross section of the chosen population. The descriptive research collects data in order to answer questions concerning the current status of the subject under study (Mugenda and Mugenda, 2003).

3.3 Population of the Study

A population is defined as the total collection of elements about which we wish to make some inferences (Cooper and Schindler, 2014). The target population for this study were the 100 SMEs (2013) in Kenya. Kenya Top 100 Mid-sized companies is a survey carried out annually to facilitate identification of the Top 100 companies survey participants are required to submit data on several financial indicators; such as business confidence outlook, growth, human resource policies, involvement in corporate social responsibility, and the role played by innovation in their operations.

3.4 Sample

Simple random sampling was adopted so as to give each item in the population an equal probability of being selected. The sample was selected from the population target of 100 possible respondents by taking a 30% sample of the target population in each stratum. Hence the sample size of the study was 30 SMEs.

3.5 Data Collection

The study collected primary data. This was collected using questionnaires designed based on the objective of the study. The questionnaires were administered using drop and pick later method to the premises of the firms sampled. The General Managers were the respondents in the study. A period of three weeks was given for the data collection process.

3.6 Data Analysis

The questionnaire responses were first cleaned, grouped into various categories and entered in the SPSS software to facilitate for analysis. Inferential statistics were employed to analyze the data using a regression model. The analysed data was then presented in frequency distributions tables and pie charts for ease of understanding and analysis. The regression model was used to establish the form of relationship between the dependent and the independent variable. The regression equation took the following form:

$$Y = \alpha + \beta_1 X_1 + \beta_2 X_2 + \beta_3 X_3 + \beta_4 X_4 + \beta_5 X_5 + \beta_6 X_6 + \beta_7 X_7 + \beta_8 X_8 + \varepsilon$$

The measurements of these variables are shown in Table 3.1.

Table 3.1: Measurement of Variables

Variable	Measurement
Y	Performance: measured as the ratio of income to total assets
X_1	Personal finance: measured as the level of agreement on personal financing
X_2	Bank loan: measured as the level of agreement on bank loan financing
X_3	Venture capital: measured as the level of agreement on venture capital financing
X_4	Micro-finance: measured as the level of agreement on micro financing
X_5	Leasing: measured as the level of agreement on leasing financing
X_6	Size of the firm: number of employees in the organisation
X_8	Age of the firm: number of years the business has been in existence

A correlation analysis was carried out between the independent variables. A correlation matrix shows the interrelationships within the independent variables under study. This helped show any serial correlations. A multiple regression analysis was then carried out. ANOVA and F-test show the fitness of the model used in the study. The coefficients show how each of the independent variables influence performance. The results of significance were interpreted at 5% level of significance. Both p-values and t-tests were be interpreted.

CHAPTER FOUR

DATA ANALYSIS, RESULTS AND DISCUSSION

4.1 Introduction

This chapter presents the results found from the data analysis. It therefore consists of the data analysis presentation and interpretation of findings. The objective of this study was to examine the effects of sources of finance on the performance of Top 100 mid-sized companies in Kenya. The study used primary data collected using questionnaires designed based on the objective of the study. Data was analysed using inferential statistics and regression analysis. The analysis was done as below.

4.2 Descriptive Analysis

The study sought to establish the various characteristics of the businesses. These results are shown in the following sections.

4.2.1 Duration of Operation

The study sought to establish the duration that the businesses had been in operation.

The results are shown in Table 4.1.

Table 4.1: Duration of Existence

Duration	Frequency	Percent
3 - 5 years	2	6.7
6 - 8 years	3	10.0
9 - 11 years	14	46.7
> 11 years	11	36.7
Total	30	100.0

Source: Survey Data (2014)

The results shown in Table 4.1 indicate that a majority (46.7%) of the businesses had been in operation for a period between 9 and 11 years, another 36.7% for more than 11 years, 10% for a period between 6 to 8 years and finally 6.7% for a period between 3 to 5 years.

4.2.2 Nature of Business

The researcher also sought to establish the nature of the businesses and the results are shown in Table 4.2.

Table 4.2: Nature of Business

	Frequency	Percent
Manufacturing	17	56.7
Retailing	2	6.7
Hotel and restaurant	7	23.3
Other	4	13.3
Total	30	100.0

Source: Survey Data (2014)

The results shown in Table 4.2 show that a majority (56.7%) of the businesses were in the manufacturing business, 23.3% in hotel and restaurant business, 13.3% in other businesses and the rest 6.7% in retailing businesses.

4.2.3 Sources of Finance

The study sought to establish the sources of finance that the businesses had used to finance their operations and the results are shown in Table 4.3.

Table 4.3: Sources of Finance

	Percent
Personal income	76.7%
Bank loan	60.0%
Venture capital	56.7%
Microfinance	13.3%
Leasing	40.0%
Government loan	16.7%
Sale of shares	43.3%

Source: Survey Data (2014)

The results presented in Table 4.3 show that the various sources of finance included personal finance (76.7%), bank loans (60%), venture capital (56.7%), sale of shares (43.3%), leasing (40%), government loans (16.7%) and micro finance (13.3%). These results show that the most common source of finance is personal income which means

that most business people use their personal savings to build and expand their businesses. The results also show that other sources of external financing such as bank loans, sale of shares, venture capital and leasing are also commonly used by firms. This is consistent with the results of Ondieki et al (2013).

4.2.4 Extent of Financing

The study further sought to establish the extent to which the respondents agreed that their businesses had been funded by the following sources of financing in the last 36 months. The results are shown in Table 4.4.

Table 4.4: Extent of use of Sources of Finance

	Mean	Std. Deviation	Median
Personal income	2.0667	.94443	2.00
Bank loan	2.2333	1.40647	1.50
Venture capital	2.4333	1.45468	2.00
Microfinance	1.2667	.73968	1.00
Leasing	1.7333	1.01483	1.00
Government loan	1.3000	.74971	1.00
Sale of shares	1.6667	.92227	1.00

Source: Survey Data (2014)

The results in Table 5 show that personal income scored a mean of 2.0667 and a standard deviation of .94, bank loans scored a mean of 2.23 and a standard deviation of 1.406, venture capital scored a mean of 2.433 and a standard deviation of 1.45, micro finance scored a mean of 1.26 and a standard deviation of .739, leasing scored a mean of 1.73 and a standard deviation of 1.01, government loans scored a mean of 1.3 and a standard deviation of .74, and sale of shares scored a mean of 1.667 and a standard deviation of .92. These results clearly show that bank loans are common sources of finance for these businesses as well as venture capital and personal income. These results are consistent with the results of Memba et al. (2012).

4.2.5 Opinion on Effect of Source of Financing on Performance

The study also sought to establish the extent to which the respondents agreed that the source of capital used have boosted their business performance. The results are shown in Table 4.5.

Table 4.5: Extent to which source of Capital Boosted Business Performance

	Frequency	Percent
Very low extent	1	3.3
Low extent	3	10.0
Moderate extent	7	23.3
Large extent	12	40.0
Very large extent	7	23.3
Total	30	100.0

Source: Survey Data (2014)

The results in Table 4.5 show that a majority (40%) of the respondents felt that the source of capital had boosted their business performance to a large extent, 23.3% to a very large extent, another 23.3% to a moderate extent, 10% to a low extent and another 3.3% to a very low extent. The results clearly show that the sources of finance used for the business boosted the performance of that business. This is in line with the results of Kigomo (2013).

4.2.6 Performance of the Businesses

The study sought to establish the various descriptive statistics of some of the variables used in the study. The results are shown in Table 4.6.

Table 4.6: Results of Descriptive Analysis

	Mean	Std. Deviation	Median
Sales	68,661.20	33,969.68	64,620
Profit before taxes	58,355.63	30,349.02	58,693.5
Number of employees	142.87	70.98	125
Total assets	439,044.57	186,274.96	464,320.5

Source: Survey Data (2014)

The results in Table 4.6 show that the mean sales for the companies were 68661.2 and a standard deviation of 33969.6. The results also show that the mean profit before taxes were 58355.6 and a standard deviation 30349.02. The mean number of employees were 142.87 and a standard deviation of 70.96. Finally, the mean total assets were 439044.56 and a standard deviation of 186274.95.

4.3 Correlation Analysis

Table 4.7 shows the results of correlation analysis. The correlation analysis was done for all the independent in the study. This analysis was carried out in order to determine whether there were serial correlations between the independent variables. As serial correlations are a problem when performing regression analysis, this preliminary test was carried out first.

Table 4.7: Correlation Matrix

	1	2	3	4	5	6	7	8
Personal income	1							
Bank loan	-.290	1						
Venture capital	.154	-.165	1					
Microfinance	-.247	.120	-.053	1				
Leasing	.129	.111	-.384*	-.320	1			
Government loan	.247	.000	.211	-.175	.183	1		
Sale of shares	-.154	.165	-.321	.251	-.165	.150	1	
# of employees	.001	-.219	.081	.238	.133	-.069	-.301	1
Age of business	-.553**	.113	-.138	-.054	.209	-.035	-.180	.303

Source: Survey Data (2014)

The results in Table 4.7 show that there were low correlation between the independent variables and therefore no serial correlations between the variables. But none of the variables was serially correlated. Therefore, all the variables were entered into the regression model for analysis and the results are shown in the next section.

4.4 Regression Analysis

Table 4.8 shows the regression analysis results. The table shows the coefficient of the variables, the p-values (in parentheses), the R, R² and F-statistic.

Table 4.8: Regression Results

	ROA
Constant	.352
Personal Income	0.191 (.530)
Bank Loan	0.156 (.500)
Venture capital	-0.37 (.895)
Micro finance	0.064 (.804)
Leasing	-0.57 (.838)
Government Loan	0.006 (.980)
Sale of Shares	-0.49 (.857)
R	.417
R ²	.174
F	.469 (.879)

Source: Survey Data (2014)

The results in Table 4.8 show that personal income had a weak positive effect on the performance of firms ($\beta = 0.191, p = 0.530$). The study found that bank loans had a weak positive effect on the performance of firms ($\beta = 0.156, p = 0.500$). The results also showed that venture capital had a weak negative effect on the performance of firms ($\beta = -0.37, p = 0.895$). The results show that micro finance had a weak positive effect on the performance of firms ($\beta = 0.064, p = 0.804$). The results reveal that leasing had a weak negative effect on the performance of firms ($\beta = -0.57, p = 0.838$). The study also revealed that government loans had a weak positive effect on the performance of firms ($\beta = 0.006, p = 0.980$). The results show that sale of shares had a weak negative effect on the performance of firms ($\beta = -0.49, p = 0.857$).

The study found that the independent variables had an average correlation with performance of the firm ($R = 0.417$). The results also show that the variables accounted for 17.4% of the variance in performance of the companies ($R^2 = 0.174$).

ANOVA results show that the F statistic was insignificant at 5% level. Therefore, the model was not fit to explain the relationships.

4.5 Discussion of Findings

The study examined the effect of personal income on the financial performance of Top 100 companies in Kenya. The descriptive results showed that 77% of the Top 100 companies had used personal income at one point of their lifetime as a source of financing. This method of financing was however being used to a low extent as shown by the mean of 2.07. The regression results revealed that personal income had a weak positive effect on the financial performance of Top 100 companies.

The study sought to determine the relationship between bank loans and the performance of firms. The descriptive analysis showed that 60% of the businesses had been financed through bank loans. Bank loans as a method of financing had been used to a low extent as shown by the mean of 2.23. The regression results show that bank loans had a weak positive effect on the performance of firms.

The study sought to determine the relationship between venture capital and the performance of firms. The descriptive results showed that 57% of the firms had been financed through venture capital. This method had been however used to a low extent by the firms as shown by the mean of 2.43. The regression results show that venture capital had a weak negative effect on the performance of firms.

The study sought to determine the relationship between microfinance and the performance of firms. The descriptive results revealed that only 13% of the firms had ever been financed through microfinance. This method of financing had been used to a low extent by the firms as shown by the mean of 1.27. The regression results show that microfinance had a weak positive effect on the performance of firms.

The study sought to determine the relationship between leasing and the performance of firms. The descriptive analysis results revealed that 40% of the firms had been financed through leasing. Leasing as a method of financing had been used to a low extent as shown by the mean of 1.73. The regression results show that leasing had a weak negative effect on the performance of firms.

The study sought to determine the relationship between government loans and the performance of firms. The descriptive results showed that 17% of the firms had been financed through a government loan. This method of financing was used to a low extent as shown by the mean score of 1.30. The regression results show that government loans had a weak positive effect on the performance of firms.

The study sought to determine the relationship between sale of shares and the performance of firms. The descriptive results showed that 43% of the firms had been financed through sale of shares. This method of financing was however used to a low extent as shown by the mean of 1.67. The regression results show that sale of shares had a weak negative effect on the performance of firms.

CHAPTER FIVE

SUMMARY, CONCLUSION AND RECOMMENDATIONS

5.1 Introduction

The main objective of this study was to examine the effects of sources of finance on the performance of Top 100 mid-sized companies in Kenya. This chapter presents the summary of findings, conclusion, recommendations, and suggestions for further research.

5.2 Summary of Findings

The study sought to determine the relationship between source of financing and performance of Top 100 companies in Kenya. The descriptive results showed that 77% of the firms had used personal income as a source of financing, 60% used bank loans, 57% used venture capital, 40% used leasing, 43% used sale of shares, 17% used government loans, and 13% used microfinance. All these sources were used by most firm to a low extent as financing options.

The regression results showed that the model accounted for 17.4% of the variance in performance of the companies ($R^2 = 0.174$). The ANOVA results showed that the F statistic was insignificant at 5% level, suggesting that the model was weak to explain the relationship between sources of finance and financial performance of Top 100 companies in Kenya.

The regression results show that personal income, bank loans, microfinance, and government loans had weak positive effects while venture capital, leasing, and sale of shares had weak negative effects on the financial performance of Top 100 companies in Kenya at 5% level of significance. Thus, the results show that the sources of finance do not affect the financial performance of Top 100 companies in Kenya.

5.3 Conclusions of the Study

The results show that personal income had a weak positive effect on the performance of firms. The study therefore concludes that the use of personal income as a source of financing for businesses does not influence the financial performance of mid-sized companies in Kenya.

The results show that bank loans had a weak positive effect on the performance of firms. The study therefore concludes that the use of bank loans as a source of financing for businesses does not influence the financial performance of mid-sized companies in Kenya.

The results show that venture capital had a weak negative effect on the performance of firms. This effect was however not significant and therefore the study concludes that venture capital does not influence the financial performance of mid-sized companies in Kenya.

The results show that micro finance had a weak positive effect on the performance of firms. The study therefore concludes that the use of micro finance as a source of financing for businesses does not affect the financial performance of mid-sized companies in Kenya.

The results show that leasing had a weak negative effect on the financial performance of firms in Kenya. The study therefore concludes that the use of leasing does not influence the financial performance of mid-sized companies in Kenya.

The results show that government loans had a weak positive effect on the performance of firms. The study therefore concludes that government loans does not influence the financial performance of mid-sized companies in Kenya.

The results show that sale of shares had a weak negative effect on the performance of firms. The study therefore concludes that the sale of shares does not improve the financial performance of mid-sized companies in Kenya.

5.4 Limitations of the Study

The researcher faced several limitations in the course of the study. First, the study was limited in terms of conceptual scope as it only focused on the effects of sources of financing of the top 100 companies in Kenya. The study was therefore confined to few sources of finance and therefore may not apply to all financing options.

The study was also limited since it only made use of primary data for analysis purposes. Some of the information needed was difficult to get from the respondents through the questionnaires. It may be important in the future to gather both primary and secondary data, if available.

The study also collected data from a sample of 30 firms out of the Top 100 companies. Therefore, the results are limited to the 30 mid-sized companies and thus may not apply to all other mid-sized companies in Kenya that are outside the Top 100 companies.

The model applied in this study was weak in explaining the effect of sources of finance on financial performance. It explained only 17% of the variance. To improve this in the future it may be important to change how the sources of finance are measured or to include more control variables in the model.

5.5 Recommendations of the Study

5.5.1 Recommendations for Policy and Practice

The sources of finance studied here did not significantly influence financial performance. This is due to the fact that these sources of finance were not extensively

used to finance business operations. Therefore, the study recommends the need for use of a combination of financing options that can help improve the financial performance of organisations.

The study also recommends that the Government should be instrumental in offering loan facilities for businesses as currently very few mid-sized firms have used this method of financing. Such available loans are for start-ups and it may be important to create such financing options for mid-sized companies too.

5.5.2 Suggestions for Further Research

The study suggests that a comprehensive study is carried out to evaluate these effects using different measures of firm performance as well as through the use of secondary data. Further, this can be done by using both primary and secondary data.

The study also suggests the need for the sample to be expanded beyond the Top 100 companies in Kenya. This way, it is possible to provide results that can be applicable to small and medium enterprises in Kenya.

Further studies should include more control variables in the study in order to improve the fitness of the model. The model can also be improved by changing the measurement of the variables in the model.

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APPENDICES

Appendix I: Research Questionnaire

Part I: General Information

1. How long has this business been in existence?

Less than 3 years []

3 – 5 years []

6 – 8 years []

9 – 11 years []

More than 11 years []

2. What is the nature of your business?

Manufacturing []

Retailing []

Hotel and restaurant []

Other service []

3. How many employees do you currently have?

.....

...

Part II: Sources of Finance

4. In the last 36 months, what sources of finance for your business have you used to finance your operations?

Personal income []

Bank loan []

Venture capital [] (An investor)

Micro-finance []

Leasing []

Government loan []

Sale of shares []

5. To what extent do you agree that your organisation been financed by the following sources of finance in the last 36 months? Check from 1 (strongly disagree) to 5 (strongly agree).

Source of Finance	1	2	3	4	5
Personal income					
Bank loan					
Venture capital – an investor					
Microfinance					
Leasing					
Government loan					
Sale of shares					

6. To what extent do you agree that the source of capital used have boosted your business performance?

- Very low extent []
 Low extent []
 Moderate extent []
 Large extent []
 Very large extent []

Part III: Performance

7. What was your sales revenue in the following financial years?

2013
 2012
 2011

8. How much did the business make in profit before taxes in the following years?

2013
 2012
 2011

9. In the last 12 months, how many permanent employees have you had?

.....

10. What was the value of your total assets at the end of the following financial years?

2013

2012

2011

The End