THE RELATIONSHIP BETWEEN MICROFINANCE SERVICES AND THE FINANCIAL PERFORMANCE OF SMES IN NANDI DISTRICT

BY:

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DECLARATION

This is my original work and has not been submitted to any institution or university for examination.

Signed: .... Date: 14/11/2011..............................

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This research project has been presented for examination with my approval as university supervisor

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DEDICATION

This project is dedicated to my parents Mr. & Mrs. Chepkwony and my siblings for their encouragement and inspiration to me. May the Lord, God Almighty bless you all abundantly.

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This management research proposal could not have been successful without the invaluable contributions and support of people who I owe gratitude. Though I will not be able to list all those who were of help to me during the process of my studies and research, I would like to acknowledge with appreciation, the following people who made this research possible, but above all, I thank the Almighty God for His favour and blessings throughout my studies, and in my entire life. Thank you Lord

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Mr. and Mrs. Chepkwony, my parents, who have shaped my life and supported my decisions. My siblings and siblings in-law, for your love, care and prayers all through my studies.

To all my friends, for your understanding, support and confidence in me.

ABSTRACT

The purpose of this study was to determine the relationship between microfinance services and the financial performance of SMEs in Nandi County. Despite the apparent success and popularity of microfinance, no clear evidence yet exists that microfinance development have positive impacts. While there are tales and other inspiring stories purported to show that microfinance can make a real difference in the lives of those served, rigorous quantitative evidence on the nature, magnitude and balance of microfinance impact is still scarce and inconclusive (de Aghion and Morduch, 2010).

The causal research design was used to carry out this study. The target population of this study was all the medium and small enterprises in Nandi County. These are the enterprises that deal with agricultural and other related activities that are registered and have a physical office in Nandi County. The simple random sampling method was applied to select a sample of 53 SMEs. The study used both primary and secondary data. Primary data was collected using semi-structured questionnaire to the owner/managers of the selected SMEs. Secondary data was taken from articles and from small and medium size enterprises, as well as website of major MFIs in the region: Faulu Kenya and Kenya Women finance Trust. The study utilized the SPSS software Version 18 to do the analysis as this involved quantitative analysis. A regression analysis was also performed on the variables to determine whether microfinance services have an effect on performance of SMEs in Nandi County.

LIST OF ABBREVIATIONS

MSMEs	Micro, small and medium enterprise
LSE	Large scale enterprise
SME	Small and medium enterprise
LDC	Lesser developed country
MFI	Microfinance institution
US	United States
UK	United Kingdom
KWFT	Kenya Women Finance Trust
UNCDF	United Nations Capital Development Fund
NGO	Non-governmental Organization

TABLE OF CONTENTS

Declaration i
Dedication ii
Acknowledgements iii
Abstract iv
List of abbreviations v
CHAPTER ONE: INTRODUCTION 1
1.1 Background to the problem 1
1.2 Statement of problem 4
1.3 Objective of the study 6
1.4 Significance of the Study 6
CHAPTER TWO: LITERATURE REVIEW 8
2.1 Introduction 8
2.2 Theoretical Review 8
2.3 Empirical Studies 12
2.4 Chapter Summary 16
CHAPTER THREE: RESEARCH METHODOLOGY 17
3.1 Introduction 17
3.2. Research Design 17
3.2 Population of Study 17
3.3 Sample and sampling Design 17
3.5 Data collection 17
3.6 Data analysis 18
3.7 Data validity and reliability 19
CHAPTER FOUR: DATA ANALYSIS AND PRESENTATION OF FINDINGS 20
4.1 Introduction 20
4.2 General Information 20
4.3 Accessibility of Financial Services 24
4.4 Impact of Microfinance Services on SMEs 27
4.4.1 Access to MFI loans 28
4.5 Regression results 29
4.6 Summary and interpretation of findings 31

CHAPTER FIVE: SUMMARY CONCLUSIONS AND RECOMMENDATIONS.........34
5.1 Summary..34
5.2 Conclusions..35
5.3 Policy Recommendations...36
5.4 Limitations of the study 37
5.5 Recommendations for Further Research...38
References...39
Appendix I:Questionnaire to NandiCounty members who own small businesses 43

CHAPTER ONE: INTRODUCTION

1.1 Background to the problem

Muganga (2010) defines microfinance as the provision of financial services to low-income individuals and households, as well as micro, small and medium enterprises (MSMEs), using specially designed methodologies that will ensure sustainability for the lenders, and lead to improvement in the standard of life for the consumers, while ensuring a triple bottom-line of "developing the person: positively impacting lives: and leading to economic development of the region" as it facilitates large numbers of clients with relevant financial services at affordable prices" - provides an enormous potential to support the economic activities of the low income people and thus contributes to poverty alleviation.

The World Bank categorizes companies with fewer than 50 employees as small, and those with fewer than 250 as medium (World Bank, 2006). SME definition is based on number of employees, sales volume, or loan size. Number of employees and sales volume seem to be the most widely used criteria, present in 50 and 41 economies; respectively (World Bank, 2010). Small and Medium enterprises are defined as enterprises in the non-financial business economy that employ less than 250 persons. The complements of the SME-sector – enterprises that employ 250 or more persons are large scale enterprises (LSEs). Within the SME-sector, the following size classes are distinguished: micro enterprises, employing less than 10 persons (including self-employed), small enterprises, employing at least 10 but less than 50 persons (including self-employed), and medium-sized enterprises that employ between 50 and 250 persons (including self-employed) (World Bank, 2010). Throughout the world, small businesses are excluded from formal financial systems. Exclusion ranges from partial exclusion in developed countries to full or nearly full exclusion in lesser developed countries (LDCs).

Absent access to formal financial services, the SMEs have developed a wide variety of informal, community-based financial arrangements to meet their financial needs. In addition, over the last two decades, an increasing number of formal sector organizations (non-government, government, and private) have been created for the purpose of meeting those same needs. Microfinance is the term that has come to refer generally to such informal and formal arrangements offering financial services to the poor and small businesses. Microfinance has existed, although mostly in the shadows and unseen by casual observers.

since the rise of formal financial systems, and indeed probably predates them. It has only been within the last four decades, however, that serious global efforts have been made to formalize financial service provision to the poor. This process began in earnest around the early to mid-1980s and has since gathered an impressive momentum. Today there are thousands of Microfinance institutions (MFIs) providing financial services to an estimated 1 - 2 billion of the world's poor (Christen et al., 2005). What began as a grass-roots "movement" motivated largely by a development paradigm is evolving into a global industry informed increasingly by a commercial/finance paradigm.

The rise of the microfinance industry represents a remarkable accomplishment taken within historical context. MFIs provide similar products and services to their customers as formal sector financial institutions. The scale and method of delivery differ, but the fundamental services of savings, loans, and insurance are the same. Notwithstanding, to date most efforts to formalize microfinance have focused on enterprise lending (loans for enterprise formation and development) which remain by far today the dominant product offered by MFIs (Woller, 2008). This, however, has slowly begun to change. Increasingly today MFIs have begun to offer additional products, such as savings, consumption or emergency loans, insurance, and business education. Nourse (2009) reviews the context and rise of microfinance products and argues there is a need for savings and insurance services for the poor and not just credit products. He goes on to argue that MFIs need to provide tailored lending services for the poor instead of rigid loan products. Supporting this latter assertion of Nourse (2009), Eyiah (2010) develops a model of small construction management contractors and MFIs in developing countries that provides a tailored lending structure for microenterprise contractors. Similarly, Woller (2008) argue that MFIs need to be more client-focused, including offering a mix of financial products tailored to the varied needs and wants of poor consumers and small and micro businesses.

Micro credit is most often extended without traditional collateral. If physical collateral were a requirement for borrowing, most MFI clientele would be unable to participate due to their extreme poverty level. Because borrowers do not have physical capital, MFIs focus on using social collateral, via group lending. Group lending encompasses a variety of methodologies, but all are based on the principal of joint liability. In essence, the group takes over the underwriting, monitoring, and enforcement of loan contracts from the lending institution (Wenner, 2005). Under joint liability each group member is made responsible for the loans of

other group members. If one member defaults, the other group members are required to cover the loan from their own resources, and if they do not, they lose access to future loans. It is thus in each member's interest to ensure that the other members pay.

Within the lending function of microfinance, it is useful to divide loans into enterprise loans and consumption/emergency loans. As mentioned above, the loan programs typical of MFIs almost entirely consist of enterprise loans. Nonetheless, significant unfulfilled market demand also exists for consumption and emergency loans (Woller, 2008). Thus far, we have defined and reviewed the first five areas of microfinance. As a general rule, MFIs work toward a double bottom-line—financial and social—unlike the typical formal financial institution which works solely toward a financial bottom-line. MFIs have been found to have mixed impacts to SMEs in various studies. The difficulty and cost inherent in assessing impact are such that most MFIs do not try to assess social impact; nonetheless, donors and policymakers have a legitimate interest in assessing the social and financial returns to their investments. Some knowledge of impact is therefore necessary for MFI management and other stakeholders (e.g., donors and policymakers) to assess overall program effectiveness (Information on financial performance alone gives an incomplete picture of program performance). Analyzing four programs in Bolivia, Mosley (2010) shows that assets and income of SMEs increased with use of MFI services, but also that MFI services may increase vulnerability if borrowers over-leverage. Bolnick and Nelson (2010) find that MFI participation had a positive impact on enterprises that were typically small, labor intensive and growing, although the impact was far from uniform across sectors and target variables. Copestake et al. (2011) find that borrowers who were able to obtain two loans experienced high growth in profits and household income compared to a control sample, but borrowers who never qualified for the second loan were actually worse off due to MFI collection mechanisms.

Wydick (2009) in a study in Guatemala finds that rapid gains in job creation after initial credit access were followed by prolonged periods of stagnant job creation by SMEs. Dunn (2001) finds that program clients' enterprises performed better than non-client enterprises in terms of profits, fixed assets, and employment. Finally, Anderson et al. (2008) analyze 147 MFIs and finds that microfinance participation increased environmental awareness and common pool resource stewardship. The supply and demand for finance for small-scale businesses in developing countries significantly impacts their growth and development

(Cook, 2010). Cook notes that much research had been done regarding the US and the UK, and that much of the developing countries research focused on gathering information on the characteristics of small-scale businesses. Cook investigated the relationship between finance and small-scale businesses in developing countries. Cook begins by noting that small-scale businesses hold many advantages for developing countries. They encourage entrepreneurship. There is a greater likelihood that small businesses will utilize labour-intensive technologies, which has an immediate positive impact on employment generation. In addition, these small-scale businesses can usually be established quite quickly, producing quick returns on operations. The development of small- scale businesses has been seen as an accelerator of wider economic and socio-economic objectives, which includes poverty alleviation. Making financing available to small-scale businesses in developing countries has been an aim of governments and several interested donor agencies, however, they have been able to achieve little. Eyiah (2010) theorizes that this is due, in part, to the banks' perceptions that the risk and transaction costs involved in dealing with small businesses are too high. However, with the mushrooming of MFIs in poor urban and rural areas, small business are growing at a high rate which is attributed to the services these enterprises are getting from MFIs and other bottom of the pyramid lending institutions.

Nandi County is in the heart of Nandi district that is in Kenya's' Rift-Valley province. It has a population of approximately 752,965. The constituencies within the Nandi County include Tinderet, Aldai, Nandi Hills, Emgwen North, Emgwen South and Mosop. The major town includes Kapsabet (capital). Over the years, Nandi has been famous for being the home town of the famous athletes. The main economic activities include Agriculture, Small scale business and Tea farming. The Nandi people are the majority in the county and form the second most populous group of the Kalenjin speaking communities. Nandi County is located in the highland areas of the Rift Valley Province with the Nandi hills making it a proper training area for local and international athletes. The facts that even the international athletes train in the area, has been a great boost for the tourism industry of Nandi and Kenya as whole. (www.guide2kenya.com)

1.2 Statement of problem

Despite the apparent success and popularity of microfinance, no clear evidence yet exists that microfinance development have positive impacts (de Aghion and Morduch, 2010). There have been reviews examining impacts of microfinance. These reviews concluded that, while

tales and other inspiring stories purported to show that microfinance can make a real difference in the lives of those served, rigorous quantitative evidence on the nature, magnitude and balance of microfinance impact is still scarce and inconclusive (de Aghion and Morduch, 2010). Overall, it is widely acknowledged that no well-known study robustly shows any strong impacts of microfinance (de Aghion and Morduch, 2010). Many microfinance institutions in Nandi County have aimed to support Kenya's SMEs with micro-financing, but it is unclear whether their administrative practices support their efforts or create additional hurdles for rural firms in need of financing for the development of their businesses. The specific questions that shall guide the research in this project are: Do SMEs have access to the financial resources they need for developing their businesses? Are microfinance institutions providing funding to developing rural small businesses in Kenya in an acceptable way and on reasonable terms?

Various studies have been done in Kenya on SMEs and how they are influenced by microfinance services. A study by Amanda et al, (2007) on access to financial services by women owned businesses in Kenya established that access to financial services ranked as the biggest hindrance to small and medium enterprises. Previous studies have shown that a number of factors hamper the growth of small businesses, including lack of capital or financial resources, however, the degree to which limited financial resources alone are a major obstacle to business development is still controversial. For example, findings show that additional capital is often not required to carry out a successful business activity and that lack of capital can be compensated through creativity and initiative (Diagne, 1996). Kallon (1990) found that the amount of capital needed to start a business is significantly negative when related to the rate of growth for the business. He also found that access to commercial credit did not contribute to entrepreneurial success in any significant way, and if it did, the relationship would be negative. This section discusses the various studies carried out in Kenya regarding microfinance and small and medium enterprises and how they are linked.

A study by Amanda et al. (2007) on access to financial services by women owned businesses in Kenya established that access to financial services ranked as the biggest hindrance to small and medium enterprises. However, the study indicated that microfinance institutions had come up to solve that challenge with little success. The study by Amanda et al. further indicated that microfinance sector is highly segmented and disconnected. MFIs target different market niches and operate under different methodologies and organizational

missions. Another study carried out on effect of MFIs services on businesses in Kenya was carried out by Hospes, Musinga and Ongoayo (2002). This study was an evaluation of micro-finance programmes in Kenya as was supported through the Dutch co-financing programme. The study was a focus on KWFT. This study established that KWFT clients were empowered by microfinance services to undertake a variety of enterprises ranging from small trade through hawking and different shops of service provision including running of private clinics, schools, hair salons and sale of bathroom and toilet services in slum areas. Another study which has been carried out on microfinance impact on businesses was by United Nations Capital Development Fund (2003). This study was a case study of Nigeria, Kenya, Malawi and Haiti. This study was aimed at establishing the impact that MFI services had on individuals, communities and enterprises. In terms of enterprise assets, some impact was found in Nigeria. For Malawi and Haiti no impact on enterprise assets could be observed. For Kenya, where the findings relied on qualitative research, there was not enough data to make a determination, though results pointed to a positive impact. A study by Muganga (2010) was aimed at estimating the impacts of microfinance programs on business performance and individual wellbeing in Kenya and South Africa. This was to see if microfinance was indeed achieving its goals. Since the small loans provided are designed to increase entrepreneurship within the poor, we would expect to see an increase in the overall number of small businesses and entrepreneurship activity in the regions studied. The study however was not conclusive in this aspect as business performance did not show any correlation to use of microfinance services. The current study therefore was aimed at finding out the case in Nandi County since earlier studies have come up with mixed results.

1.3 Objective of the study

The general objective of the study was to determine the relationship between microfinance services and the financial performance of SMEs in Nandi County.

1.4 Significance of the Study

The findings of this study will be useful to various stakeholders such as government, public, researchers and academicians and NGOs. In trying to justify why the current study is important, it is vital to mention that researchers have found this area of study very important to the development of the socio-economic activities in developing countries and their contributions to the development of small and medium size businesses in Kenya. Extensive

research has also been carried out on the role of the financial management aspects. This research will therefore focus on the impact of microfinance development on the performance of SMEs which has not been exploited in terms of its contributions to the development of small and medium size businesses and particularly in the farming domain.

A study of this nature is equally very important because it is going to enlighten the government on the role microfinance institutions are playing towards realization of vision 2030.This study will also enlighten the public on the role microfinance is playing in the SMEs sector since it is in partnership with some international NGOs and with the government. In addition, the results of the study will serve as a source of information for people that need to know the role of MFI in development of small and medium enterprises.

Researchers will also benefit from this research in that this research will provide a platform for extensive research to be done on other microfinance institutions in developing countries. Microfinance as a whole provides the rural population a means to have access to financial services in their localities to boost their living standards in a sustainable manner in line with the millennium development goals of alleviating poverty in developing countries. They can contribute in the fight against poverty by improving the agricultural sector which is the main source of living to the inhabitants of such developing nations. It will pave a way forward for potential NGOs wishing to help in the sustainable development of SMEs to understand the difficulties they may come across and how they can succeed in their endeavors.

CHAPTER TWO: LITERATURE REVIEW

2.1 Introduction

This chapter examines both theoretical and empirical literature on microfinance institutions, their services and the impact of those services on the development of SMEs. In the section, the author discusses theories supporting microfinance activities, findings from earlier studies on effects of microfinance services on development of small and micro businesses and ends with a summary.

2.2 Theoretical Review

This section provides a discussion of the different theories that support the link between microfinance services and development of small businesses. The theories discussed are the social capital theory, joint liability theory, quasi-hyperbolic preference theory and the business constraint model.

2.2.1 Social Capital Theory

The theory of social capital in its present form and associated meanings was popularized amongst others by Bourdieu (1977). Social capital refers to the institutions, relationships, and norms that shape the quality and quantity of a society's social interactions. There are many possible representations of social capital. Broadly social capital can be seen in terms of five dimensions: first, networks-lateral associations that vary in density and size, and occur among both individuals and groups; second, reciprocity-expectation that in short or long term kindness and services will be returned; third, trust-willingness to take initiatives (or risk) in a social context based on assumption that others will respond as expected; fourth, social norms-the unwritten shared values that direct behavior and interaction; and fifth, personal and collective efficacy-the active and willing engagement of citizens within participative community (Bourdieu, 1977). These five dimensions manifest themselves in various combinations and shape the interaction amongst the members of a group, organization, community, society or simply network and can be studied through various perspectives.

Increasing evidence shows that social cohesion is critical for societies to prosper economically and for development to be sustainable. Social capital is not just the sum of the institutions which underpin a society: it is the glue that holds them together. This theory will be used in this study to explain the recent expanded role of microfinance to small business

development. In this regard, the recent flourishing of microfinance as a development strategy is related to the developments in application of social capital theory (Morduch, 2000). While the idea of rotating credit groups is as old as commerce itself its rise to mainstream prominence as a development strategy, like social capital, coincides with the recent resurgence of neoliberal economic ideology. Microfinance programs have proliferated rapidly in the 1990s with the restructuring of previously strict banking systems and the devolution of rural credit delivery to a new set of financial institutions specializing in banking with the poor.

The all inclusivity of development entailed in microfinance is now commonly justified through efficiency and empowerment arguments that draw on the principles of social capital theory. Small entrepreneurs in many rural agrarian societies typically lack the collateral, literacy, numeracy, and freedom of mobility necessary to compete for credit from conventional institutional sources. At the same time, small entrepreneurs spend disproportionately more of their incomes on household welfare than bigger businesses (Kabeer, 1994). Thus extending credit for small-scale enterprise will likely have beneficial outcomes for all household members, poor communities, and lenders themselves (Morduch, 2000). The dominant model of microfinance – the group lending model pioneered by the Grameen Bank in Bangladesh – socializes the costs of lending to the poor by providing them access to credit on the basis of "social collateral" obtained through membership in borrower groups. Here social capital helps correct for imperfect information about borrowers lacking in formal credit and employment histories and substitutes for collateral by ensuring against default through social sanction and peer enforcement. As the World Bank (2011) social capital web page puts it, "poor but closely-knit communities pledge their social capital in lieu of the material assets that commercial banks require as collateral.

For SMEs, the theory goes, participation yields not only an economic payoff in increased access to financial services, but also an empowerment payoff in new forms of bridging and linking social capital that emerge from participation in networks of borrower groups (Servon, 1998). As one scholar recently put it in a study of the Grameen Bank in Bangladesh, borrowers' interaction at "center meetings" (during which borrower groups convene to repay their loans) facilitates their ability to establish and strengthen networks outside their kinship groups and living quarters. Donors thus consider microfinance to be a "win–win" approach

to development because investors can mobilize bonding social capital to enhance the financial viability of banking with SMEs and the poor.

2.2.2 Joint Liability Theory

This theory was coined by Ghatak and Guinnane (1999). The first wave of theoretical work on microfinance focused exclusively on joint liability. The term joint liability can be interpreted in several ways, which can be lumped under two categories. First, under explicit joint liability, when one borrower cannot repay his/her loan, group members are contractually required to repay in his/her stead. Such repayments can been forced through the threat of common punishment, typically the denial of future credit to all members of the defaulting group, or by drawing on a group savings fund that serves as collateral. Second, the perception of joint liability can be implicit. That is, borrowers believe that if a group member defaults, the whole group will become ineligible for future loans even if the lending contract does not specify this punishment.

One form in which this can happen is if the microfinance organization itself chooses to fold its operations when faced with delinquency. Ghatak and Guinnane (1999) review the key mechanisms proposed by various theories through which joint liability could improve repayment rates and the welfare of credit-constrained borrowers. These all have, in common, the idea that joint liability can help alleviate the major problems facing lenders — screening, monitoring, auditing, and enforcement — by utilizing the local information and social capital that exist among borrowers.

In particular, joint liability can do better than conventional banks for two reasons. First, members of a close-knit community may have more information about one another (that is, each other's types, actions, and states) than outsiders. Second, a bank has limited scope for financial sanctions against poor people who default on a loan, since, by definition, they are poor. However, their neighbors may be able to impose powerful non-financial sanctions at low cost. An institution that gives SMEs and the poor people the proper incentives to utilize information about their neighbors and to apply non-financial sanctions to delinquent borrowers can do better than a conventional bank.

2.2.3 Quasi-Hyperbolic Preference Theory

Fischer and Ghatak (2009) proposed an alternative theory based on present-biased, quasi-hyperbolic preferences in order to capture the belief of many microfinance practitioners that clients benefit from the fiscal discipline required by a frequent repayment schedule. Their work is motivated by a pervasive sense among practitioners that frequent repayment is critical to achieving high repayment rates. This belief is captured well in the following observation by Muhammad Yunus. Yunus (2008) observed that it is hard to take a huge wad of bills out of one's pocket and pay the lender. There is enormous temptation from one's family/business to use that money to meet immediate consumption needs. Borrowers find this incremental process easier than having to accumulate money to pay a lump sum because their lives are always under strain, always difficult.

The model that captures this is stark in order to highlight one particular effect: if borrowers are present-biased, frequent repayment can increase the maximum loan size for which repayment is incentive-compatible. Intuitively, when borrowers are present-biased, the immediate gain to defaulting on any large repayment is subject to significant temptation. When these payments are spread out, the instantaneous repayment burden at any time is smaller and thus less subject to temptation (Fischer and Ghatak, 2009). Frequent repayment also means that at the time of the first payment, the rewards (typically access to future credit) are further away from the repayment decision and thus more heavily discounted. On the other hand, so, too, is some of the repayment burden. When borrowers are subject to frequent repayment, they cultivate discipline which they can apply in business with positive benefits.

On balance, frequent repayment relaxes the incentive compatibility constraint for present-biased borrowers. But these benefits do not come without costs. Frequent repayment imposes an opportunity cost of meeting attendance on borrowers and direct costs on the lender. It might also distort the investment incentives of borrowers toward projects that generate consistent, if meager, returns. The optimal frequency balances these costs against the positive incentive effects.

2.2.4 Business Constraint Model

The study also adapted Ansoff's (1965) framework for classifying the types of decisions needed to start and maintain a successful business and analyzing common problems faced by small business owners. This framework categorized small business constraints as

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administrative, operating, strategic, and exogenous. Administrative constraints focus on the organizational structure and its capability to obtain and develop necessary resources. These problems include personnel, finance, and management issues. Operating constraints deal with issues of allocating resources in an efficient manner and are more common in the functional areas of a business. Examples include marketing, operations, and inventory management.

Strategic constraints involve the ability of small business owners to match their product or service with the demands of the external environment (Harris and Gibson, 2006). This requires that business owners understand the nature of their business and the needs of their customers. Business owners with strategic issues will need assistance with general management and marketing issues. Another area that has been identified in the literature, which is particularly important to small businesses in Kenya, is the area of exogenous constraints. These constraints include financial issues, infrastructure issues, technology, and demand conditions.

2.3 Empirical Studies

Previous studies have shown that a number of factors hamper the growth of small businesses, including lack of capital or financial resources, however, the degree to which limited financial resources alone are a major obstacle to business development is still controversial. For example, findings show that additional capital is often not required to carry out a successful business activity and that lack of capital can be compensated through creativity and initiative (Diagne, 2001). Kallon (1990) found that the amount of capital needed to start a business is significantly negative when related to the rate of growth for the business. He also found that access to commercial credit did not contribute to entrepreneurial success in any significant way, and if it did, the relationship would be negative. This section discusses the various studies carried out in Kenya regarding microfinance and small and medium enterprises and how they are linked.

A study by Amanda et al. (2007) on access to financial services by women owned businesses in Kenya established that access to financial services ranked as the biggest hindrance to small and medium enterprises. However, the study indicated that microfinance institutions had come up to solve that challenge with little success. The study by Amanda et al. further indicated that microfinance sector is highly segmented and disconnected. MFIs target

different market niches and operate under different methodologies and organizational missions. The majority of Kenyan MFIs, especially the non-bank ones, often lack the financial and institutional capacity to diversify their lending products and offer business support programs to their clients. Larger and formalized enterprises may have access to commercial banks and licensed non-bank financial institutions. There is virtually no provision between these two extremes. The study further noted that even though well-delivered microfinance is a great poverty reduction tool, it offers only limited support for women who wish to grow their enterprises beyond the micro level. Women business owners who have outgrown the maximum loan limits from microfinance institutions have great difficulties obtaining loans as small as Kshs 1 million from commercial banks.

The study by Amanda et al. (2007) further indicated that commercial banks provide the widest range of services, but until recently, they were not interested in servicing Small and Medium Enterprises (SMEs) because of the perception of the higher credit risk and the high transaction costs. With an improved macroeconomic framework and lower interest rates, more banks are recognizing the potential of lending to SMEs and are developing products to target this growing sector. For example, Equity Bank provided financial literacy training and same-day emergency loans for SMEs at the time of that study. Equity bank's product range and marketing strategy directly targeted small and medium entrepreneurs. The study however observed that despite some positive trends by the banks and microfinance institutions in reaching out to the SMEs, small and medium entrepreneurs reported that they continued to encounter 'challenge of smallness' when they approached a traditional financial institution. Discriminatory treatment by bank officials who prefer dealing with larger entrepreneurs and business people and often do not take SMEs seriously was frequently cited in that study. This study however will go a step further and seek to establish how microfinance services offered my MFIs affect the performance of SMEs.

Another study carried out on effect of MFIs services on businesses in Kenya was carried out by Hospes, Musinga and Ongoayo (2002). This study was an evaluation of micro-finance programmes in Kenya as was supported through the Dutch co-financing programme. The study was a focus on KWFT. This study established that KWFT clients were empowered by microfinance services to undertake a variety of enterprises ranging from small trade through hawking and different shops of service provision including running of private clinics, schools, hair salons and sale of bathroom and toilet services in slum areas. Some clients

according to this study were involved in agro-based production and marketing while a few undertook manufacturing of clothing items and food processing. While a few of the businesses were operated in formal commercial places with business buildings and facilities, a majority of them took place in informal sites including the homestead or just under a tree, while many were mobile with no fixed abode.

This study by Hospes, Musinga and Ongoayo (2002) established that a sample survey undertaken as part of this assessment had a large proportion of clients who did not have business structures. The study also found that the majority (65.9%) of KWFT clients held only one business, that is, the businesses funded by KWFT. A significant number (34.1%) however owned more than one business with a few (2.3%) having up to three businesses.

Further analysis in this study showed that ownership of more than one business was higher among clients who had received more loans than those with fewer loans. This would suggest that as clients expand their capital base through increased access to financial services, they tended to diversify their sources of livelihood by starting other businesses. A small or medium entrepreneur running a clothing shop for example, decided to use his/her next loan to start trading in cereals just outside his/her shop. A client doing tailoring may decide to diversify by starting a hairdressing unit within his/her shop. According to this study, on average, enterprises run by KWFT clients had been in existence for 8.2years. About half (49.2%) of the enterprises were however fairly young having been in operation for no more than five years by the time of that study with a significant percentage (17.2%) being only two years old or less. This study by Hospes, Musinga and Ongoayo (2002) did not relate use of microfinance services with business performance but rather gave a descriptive analysis of clients of microfinance services. Rather than having a description of clients of microfinance services, this study will go a step further and relate use of microfinance services with performance of SMEs.

Another study which has been carried out on microfinance impact on businesses was by United Nations Capital Development Fund (2003). This study was a case study of Nigeria, Kenya, Malawi and Haiti. This study was aimed at establishing the impact that MFI services had on individuals, communities and enterprises. In terms enterprise assets, some impact was found in Nigeria. For Malawi and Haiti no impact on enterprise assets could be observed. For Kenya, where the findings relied on qualitative research, there was not enough data to make a

determination, though results pointed to a positive impact. The findings demonstrated the influence of the macroeconomic situation on impact. Further, the study concluded that the programmes in Nigeria and Kenya, which operated in diversified economics, demonstrated positive impact in levels of enterprise income. However, the programmes in Haiti and Malawi, operating under seemingly more narrow or less-diversified economies, which additionally experienced sharp declines in the general macroeconomic environment over the past two years before this study, showed no impact in levels of enterprise income as a result of participation in the UNCDF-supported MFI.

This study by UNCDF (2003) was a case of only those enterprises that had benefited from UNCDF-supported MFIs. The current study is aimed at findings the impact of microfinance services regardless of the institution providing the services. This study will therefore provide more rich data since it will rely on all enterprises in Nandi County and the microfinance services they get.

A study by Muganga (2010) was aimed at estimating the impacts of microfinance programs on business performance and individual wellbeing in Kenya and South Africa and Kenya. This study was a comparative study of the situation in the two countries. The study established that as the overall amount and number of loans to the poor increase, there was a direct positive relationship with the recipient's income over time. Presumably, the intent behind this form of lending is to provide the very poor with the same opportunities afforded to the other economic classes. Thus, if utilized effectively, microfinance is a tool that the poor can use to pull themselves out of poverty. Muganga's study also aimed at testing if that is what is truly taking place in the developing economies. This was to see if microfinance was indeed achieving its goals. Since the small loans provided are designed to increase entrepreneurship within the poor, we would expect to see an increase in the overall number of small businesses and entrepreneurship activity in the regions studied. The study however was not conclusive in this aspect as business performance did not show ant correlation to use of microfinance services. The current study therefore is aimed at finding out the case in Nandi County since earlier studies have come up with mixed results.

2.4 Chapter Summary

The link between microfinance and SME development Accessing credit is considered to be an important factor in increasing the development of SMEs. It is thought that credit augment income levels, increases employment and thereby alleviate poverty. It is believed that access to credit enables poor people to overcome their liquidity constraints and undertake some investments such as the improvement of farm technology inputs thereby leading to an increase in agricultural production (Hiedhues, 1995). The main objective of microcredit according to the reviewed literature 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. This chapter has reviewed the theoretical and empirical literature on microfinance services, SMEs and the effect of microfinance services on SME development. In the section, the writer has also provided the gap that this study seeks to fill which justifies the current study. The following section discusses the methodology that was used in this study.

CHAPTER THREE: RESEARCH METHODOLOGY

3.1 Introduction

This chapter presents the research methodology that was adopted in this study. The chapter highlights the research design, the research approach and research strategy, as well as the data collection and analysis techniques.

3.2. Research Design

The causal research design was used to carry out this study. According to Cooper and Schindler (2006), a causal study is designed to establish the influence of one variable(s) on another variable(s) which depicts causation. Causal research is typically structured with a clearly stated objective of discovering associations and causal relationships among different variables. The causal study was necessary to generate detailed information regarding the key aspects in order to develop profiles of those aspects: how microfinance services cause SMEs to grow or improve their performance.

3.2 Population of Study

The target population of this study was all the medium and small agrarian enterprises in Nandi County. These are the enterprises that deal with agricultural and other related activities that are registered and have a physical office in Nandi County. These SMEs were selected due to the fact that Nandi County is an agricultural center whose major growth indicator is development in agriculture. The target population comprised the 105 SME registered in Nandi County as at 31st July 2011 (Nandi County Council, 2011).

3.3 Sample and sampling Design

The simple random sampling method was applied to select a sample of above 30 (Mugenda and Mugenda, 2003). Due to the small size of the total population and the heterogeneous aspect of the population, a sample equal to 50% of the population was selected using simple random sampling. This constituted 53 SMEs. Simple random sampling was applied since the population consisted of subjects who had similar properties (Yin, 2003).

3.5 Data collection

The study used both primary and secondary data. Secondary data was obtained from articles, financial reports and websites of SMEs in Nandi County

Primary data was collected using semi-structured questionnaire to the owner/managers of the selected SMEs. The questionnaire was the chief data collection instrument. The questionnaire was distributed to the owner/managers of each SME since he/she is the one who must be involved in all interactions with microfinance institutions. The owner/managers are also the one who are in a position to provide performance information of the SMEs. This resulted to a total of 53 questionnaires being distributed to all the targeted SMEs in Nandi County. The questionnaire was designed to the specific objectives of the study. The questionnaire was divided into three sections; A, B and C. Section A addressed the general information about the SME and microfinance services. Section B addressed the specific objective dealing with challenges faced by SMEs in Nandi County while section D dealt with questions about performance benefits to SMEs as a result of microfinance services.

After designing the questionnaire, the researcher tested for effectiveness on 3 senior employees from the SMEs. Respondents were required to critique the questionnaire on content, design and validity. This pretest was done to detect and correct any weaknesses in the questionnaire. After the pretest, the researcher made any amendments that were deemed necessary. The researcher distributed the final questionnaire to the owner/manager through contact persons in Nandi County. An introductory letter accompanied the questionnaires so as to give authenticity to the research and explain the purpose of the survey. The researcher requested the questionnaires to be filled and collected as arranged and communicated probably within a week.

3.6 Data analysis

The study utilized the SPSS software Version 18 to do the analysis as this involved quantitative analysis. The data and information obtained through the questionnaires was first checked for completeness and consistency. The questionnaires found correctly filled and fit for analysis were coded and all the data entered into statistical package for social sciences and analyzed based on descriptive statistics. The descriptive statistics that were used included mean scores, percentages and ratios. Percentages were used to analyze the use of microfinance services by SMEs in Nandi County. A regression analysis was also performed on the variables to determine whether microfinance services can predict good performance in SMEs in Nandi County.

The Regression model was of the form:

$$Y = \beta_0 + \beta_1 X + \varepsilon$$

Where Y = Performance of SMEs measured using ROA

X = Usage of microfinance services by SME measured through amount of loans for the last two operating years

ε = Error or random term

β_0 and β_1 = Constants

The analyzed data was then presented using tables, pie charts and bar graphs for easier interpretation.

3.7 Data validity and reliability

Triangulation technique was used for improving the validity and reliability of research or evaluation of findings. Patton (2001) advocates the use of triangulation by stating that triangulation strengths a study by combining methods. This can be attained by using several kinds of methods or data including both qualitative and quantitative approaches. By selecting complement methods, the researcher was able to offset the weakness of one method with the strength of another. Validity was tested by cross checking data from questionnaires with data from secondary sources. Reliability was tested through piloting the research instruments on 10 owner/managers of SMEs where understandability of questions, ambiguity and clarity was checked and corrected.

CHAPTER FOUR: DATA ANALYSIS AND PRESENTATION OF FINDINGS

4.1 Introduction

This chapter presents the findings from the data gathered on the relationship between microfinance services and the financial performance of SMEs in Nandi County. For the purpose of showing the relationship amongst various variables, the data is presented in the form of tables, charts, frequencies and percentages where applicable. The targeted respondents were 53 owner managers of the sampled 53 SMEs.

The data and information regarding the relationship between microfinance services and the financial performance of SMEs in Nandi County was obtained using a semi–structured questionnaire. The successful respondents were 41 representing a 77% response rate. The chapter is guided by the study's conceptual framework and the research questions. The data was collected, organized, coded, classified and analyzed using both qualitative and quantitative methods using the SPSS version 18 software package and narrative summary analysis.

4.2 General Information

4.2.1 Gender of Respondents

The study sought to establish the gender of the respondent owner/manager. Findings are presented in figure 4.1.

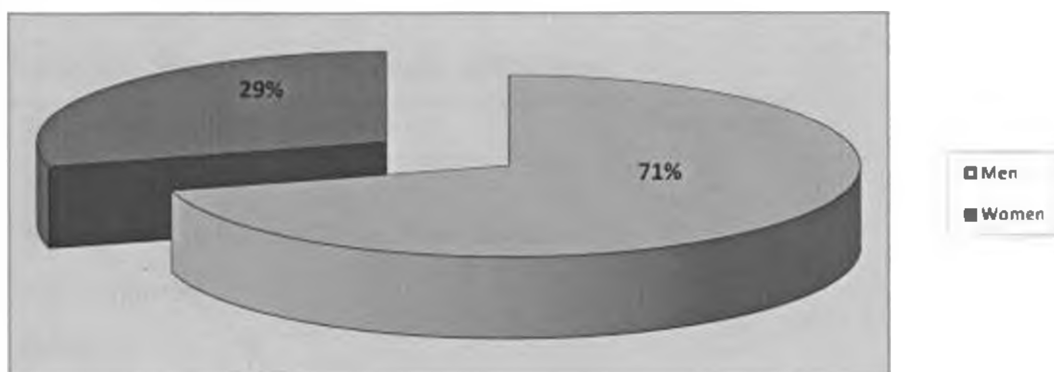

Figure 4.1: Gender of respondents

Findings presented in figure 4.1 indicate that gender split was skewed towards male with 71% with a 29% female proportion of respondents. These indicate that males still dominate the small business environment in the rural areas.

4.2.2 Age of Respondents

The study also sought to establish the age ranges of the respondents. This was to establish the diversity of the owner/managers in relation to age distribution. Findings are presented in table 4.1.

Table 4.1: Age of Respondents

Age	Frequency	Percentage
18 – 35 yrs.	8	20
36-45 yrs.	14	34
46 – 60 yrs.	16	39
Above 60 yrs.	3	7
Total	**41**	**100**

Results as indicated on table 4.1 indicate that 20% of respondents were aged between 18 and 35 years while 34% were aged between 36 and 45 years. Those who were aged between 46 and 60 years were 39% while 7% were aged above 60 years.

4.2.3 Business Description

The study also sought to establish the stage of development of the small and medium enterprises targeted by this study. This was to determine the need for finance for these businesses since the stage of the business dictates the finances required for startup, growth or development. Results are presented in table 4.2.

Table 4.2: Stage of Development of Business

Stage of Business	Frequency	Percentage
Newly started	2	4
Young, but with established production and customers	6	15
Growing	8	20
Well established, with steady production and customers	13	32
Mature, but in need of renewal	12	29
Total	**41**	**100**

Findings presented in table 4.2 indicate that 4% of surveyed business were newly started while 15% were young but with established sales and customer base. Those that were growing were 20% while 32% were well established with steady revenue and customers. Those who were mature but needed renewal were 29%. This indicates that the 32% who were well established with steady customers, all the ones required financial support in one way or the other.

4.2.4 Type of Business

The study sought to establish the type of business or activity these small businesses that were surveyed were involved in. Findings are presented in figure 4.2.

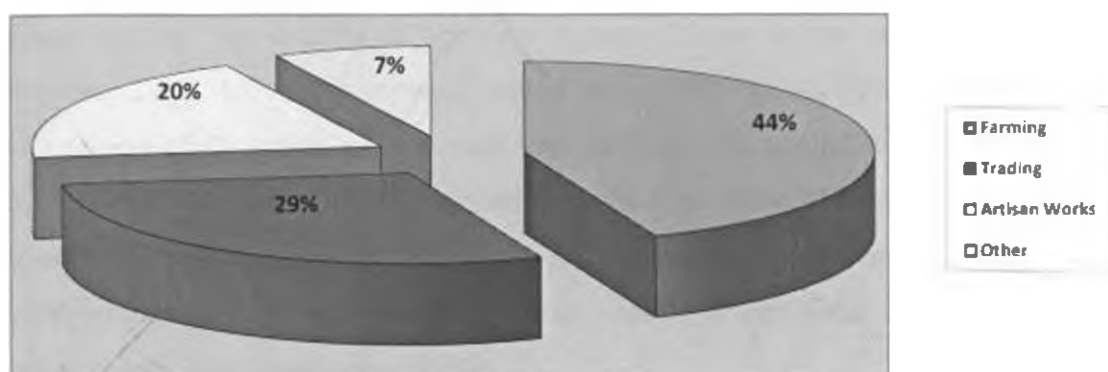

Figure 4.2: Type of Business

Findings presented in figure 4.2 indicate that 44% of the businesses were involved in farming activities and 29% in trading activities. Those who were engaged in artisan activities were 20% while 7% indicated other activities which included financing, security and small scale manufacturing.

4.2.5 Composition of Startup Capital

The study sought to establish what percentage of borrowed capital and own capital was composed in the small businesses in Nandi County. Findings are presented in table 4.3.

Table 4.3: Percent of Total capital comprised of Borrowed Capital

Composition (%)	Frequency	Percent
0 – 20%	16	39
21 – 40%	10	24
41 – 60%	8	20
61 – 80%	5	12
Above 80%	2	5
Average	**41**	**100**

Results presented in table 4.3 indicate that total 39% of businesses had total capital comprising of below 20% of borrowed capital. Those whose total capital comprised of between 21 – 40% of borrowed capital were 24% while 20% had their total capital comprising of 41 – 60% of borrowed capital. Borrowed capital was between 61 – 80% of total capital in 12% if the businesses while those businesses whose total capital comprised of over 80% debt were 5%. There was a relationship between age of businesses and composition of borrowed capital in total capital where older businesses had a lower percentage of debt than younger firms.

Source of borrowings mentioned included friends, family members. microfinance institutions, banks and savings and credit cooperative societies. Loans from Sacco's and MFIs topped the list while those from banks were very limited.

4.2.6 Whether Businesses Utilized Microfinance services

The study sought to establish whether the surveyed businesses utilized services provided by microfinance institutions and if so the frequency of usage of these services. Findings are presented in figure 4.3.

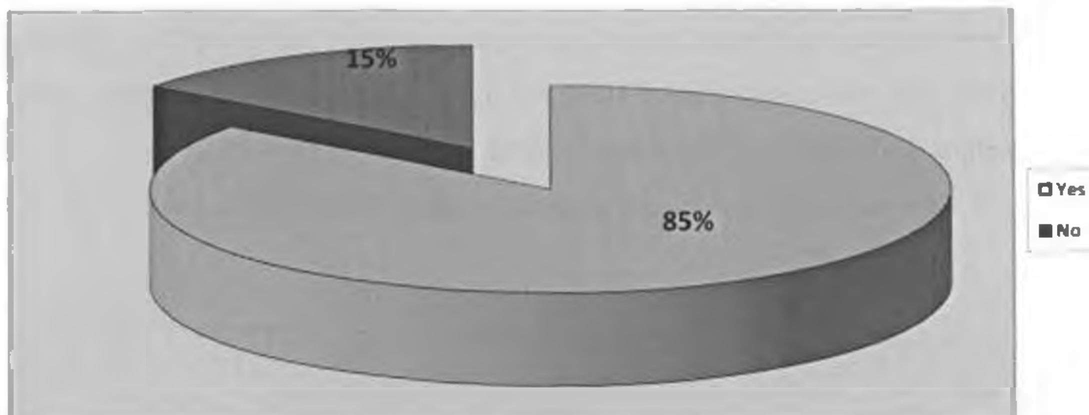

Figure 4.3: Whether Businesses utilized microfinance services

Findings presented in figure 4.3 indicate that 85% of the businesses had utilized microfinance services while 15% indicated not to have utilized microfinance services. The study further enquired on the frequency of usage of the microfinance services with results as presented in figure 4.4.

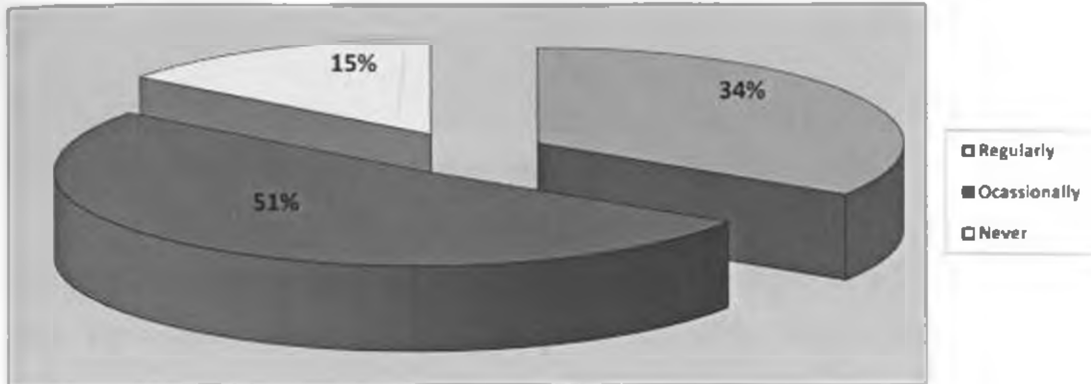

Figure 4.4: Frequency of use of microfinance services

Results as indicated in figure 4.4 indicate that 34% of the businesses utilized microfinance services regularly while 51% utilized these services occasionally. Those who never used these services were 15%.

4.3 Accessibility of Financial Services

This section presents data on accessibility of financial services to small and medium businesses. This section is dedicated to find out whether financial services are readily accessible to small and micro businesses as indicated from the survey.

4.3.1 Loan Application

The researcher inquired from the SMEs whether they had ever applied for a loan to nay financial institution for business purposes. Results from this question were analyzed and results presented in figure 4.4 were derived. Results point out that most of the SMEs surveyed were involved in external finance seeking. Those who had applied a loan at one time comprised of 95% while those who had never applied for a loan were 5%.

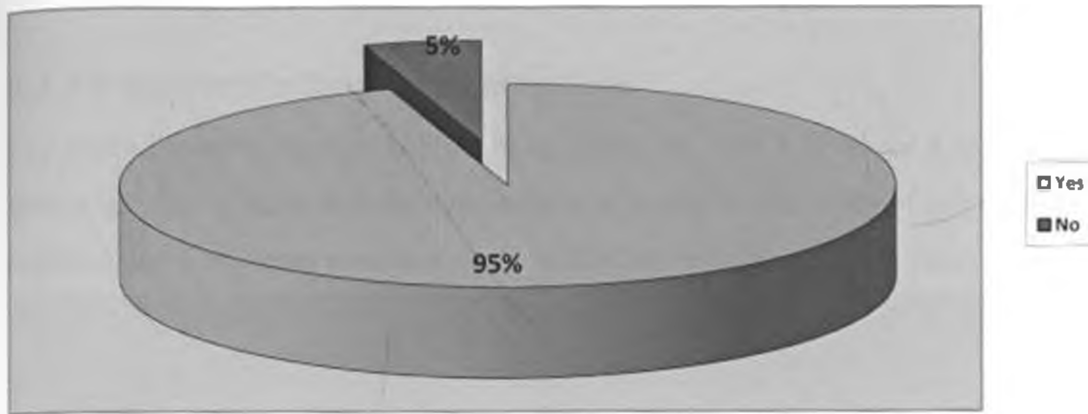

Figure 4.5: Whether SME had ever applied for a loan

The researcher further inquired where those who had sought for a loan had applied for the loan. Those institutions indicated included banks, MFIs, Sacco's and rotating savings and credit organizations or Chama's. Chama's, MFIs and Sacco's were the most popular sources of finance for these SMEs.

4.3.2 Times businesses had applied for loans

Loans are the major source of finance services provided by MFIs. The study further sought to establish how many times the SMEs had applied for loans. Results are presented in table 4.4.

Table 4.4: Number of Times businesses had applied for loans

Number of times	Frequency	Percent
0	2	5
1	14	34
2	9	22
3	6	15
4	1	2
5	3	7
Above 5	2	5
Average	**41**	**100**

Results presented in table 4.4 indicate that total 34% of businesses had applied for a loan once while 5% had never applied for a loan. Those who had applied for a loan twice were 22% while those who had applied three times were 15%. Those who had a plied for a loan 4 times were 2% while those who had applied for a loan five times were 7%. Those who had applied for a loan for more than five times were 5%.

4.3.3 Whether it's Easy to access a loan

The study further sought to find out from those who had a plied for a loan whether it was easy to get one. Results as indicated in figure 4.6 indicate that 69% of those who had applied reported that it was easy to access a loan while 31% reported that it was not easy.

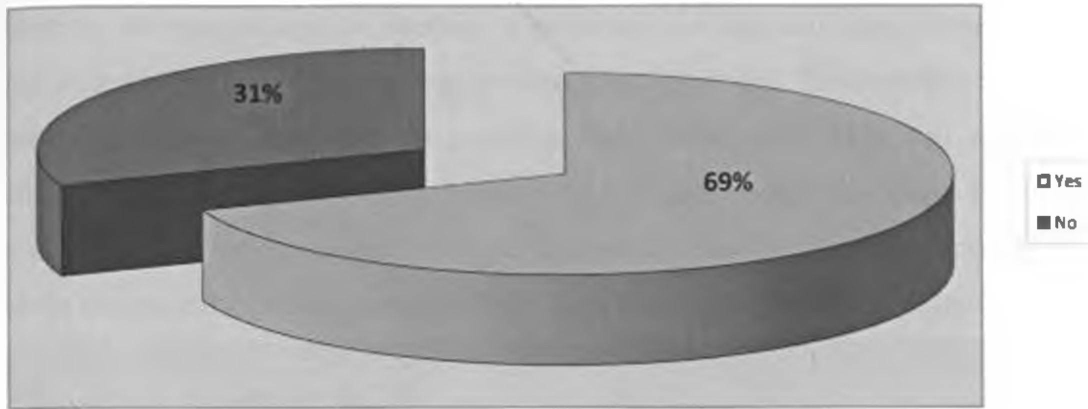

Figure 4.6: Whether it's easy to access a loan

4.3.4 Whether Requirements by MFIs are easy to meet

The study sought to find out whether the criteria, procedures and requirements to access a loan were easy to comply with as perceived by the SMEs. This was to find out how accessible loans were to small business in the area. Results from the data collected are presented in figure 4.7. Those who perceived the requirements as easy to meet were 51% with the rest viewing the requirements as not easy to meet.

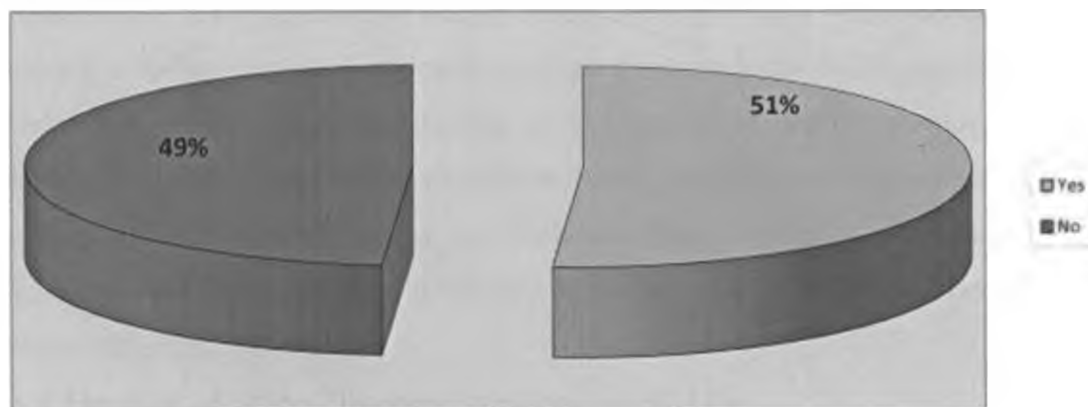

Figure 4.7: Whether Requirements are easy to meet

Criteria used by microfinance services providers included loan repayment history, capitalization of business, type of business, ownership of the business, profitability of the business and years of operation of the business. Other major considerations included plan for

the business, education and experience of the owner/manager and history with the specific organization offering the loan. However, the study established that criteria and requirements differed from organization to organization.

4.3.5 Whether loanees had challenges in repaying

Respondents were required to state whether they had any challenges in repaying loans. Further, the study sought to establish what those who had challenges in repaying their loans did to settle the loans. Results are presented in figure 4.8. These results indicate that 67% have encountered challenges in repaying their loans while 33% had never encountered challenges in settling their loans. Those who had encountered challenges indicated that they had negotiated for repayment terms, sold assets to settle the loans, borrowed other loans to settle the current or repaid the loans from other sources of finance other than the business.

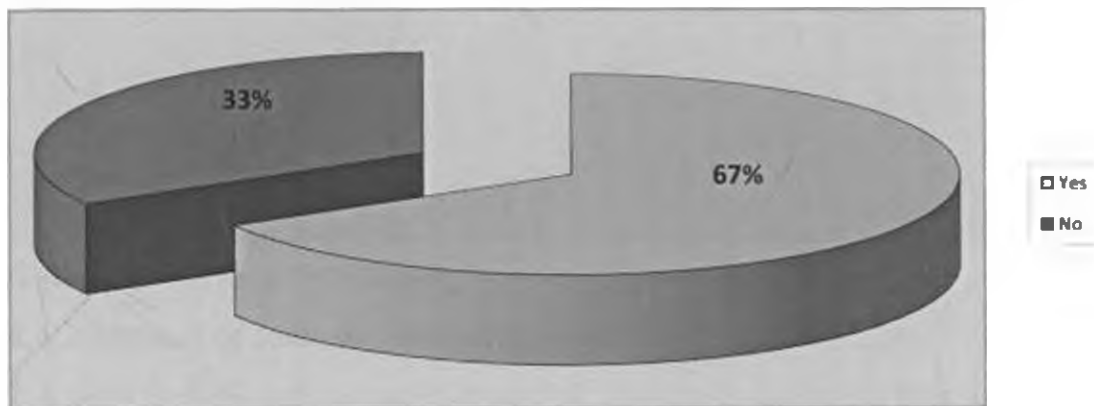

Figure 4.7: Whether SMEs have had challenges in loan repayment

Respondents also indicate that despite loans, MFIs provided other services which included money transfer services, voluntary savings facilitation by MFIs legally restricted from mobilizing funds themselves emerges as the next most popular service. MFIs were also reported to offer a varied range of other services, including micro leasing, direct deposit and cell phone card sales. Other services mentioned included insurance and personal development. Other services mentioned to be offered by MFIs included health services, networking and banking.

4.4 Impact of Microfinance Services on SMEs

The main objective of this study was to establish the effect of microfinance services to the performance of SMEs. This section provides the descriptive statistical analysis of responses from all questions that were aimed at establishing the impact of MFI services to SME performance.

4.4.1 Access to MFI loans

Sourcing capital is one of the major problems facing SMEs in Kenya. The study sought to find out whether the surveyed SMEs had any access to MFIs loans as the major products offered by MFIs. Results were analyzed and are presented in figure 4.8. These results indicate that 59% of the SMEs had access to MFI loans while 41% did not have access to these loans. This indicates that more than half of SMEs in Nandi County had accessed a loan at one time from the MFIs. This is a good indicator given that only a small proportion of SMEs get loans nationally.

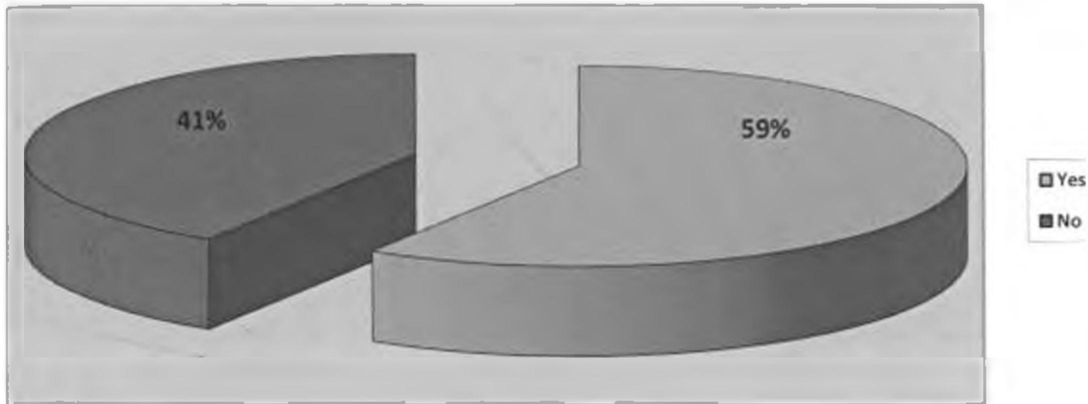

Figure 4.8: Access to MFI loans

4.4.2 Impact of loan on Competitiveness

The study further sought to establish from the SMEs who had at one time received loans what the impact was. This was to test based on the perception of the SMEs how MFI loans are valuable. The respondents were required to state their opinion about MFIs loans impact on their SMEs ability to compete and secure market share. Results are presented in figure 4.9. Findings indicate that 50% of the loanees indicated that the loans had contributed highly to their competitiveness while 27% viewed the contribution of the loan to competitiveness as low. Those who viewed the loans as having no contribution to competitiveness were 23%.

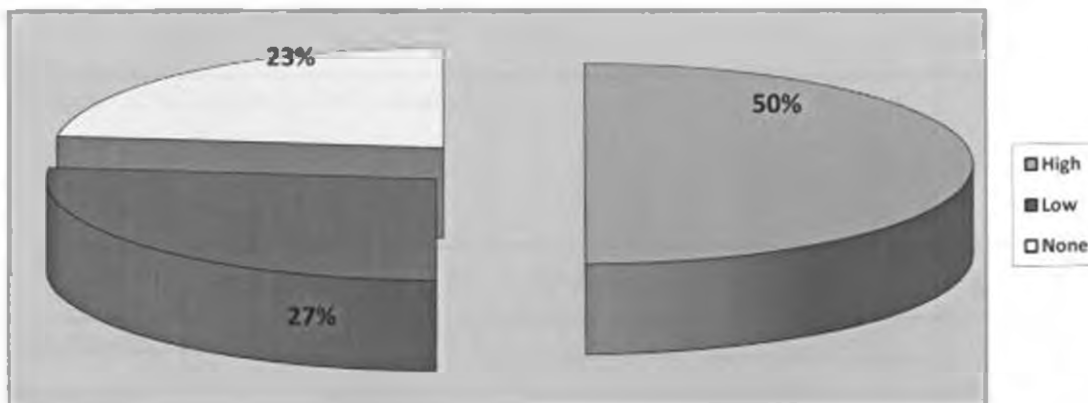

Figure 4.9: Contribution of loan on Competitiveness

Further, respondents were asked to state their views on whether the loans actually helped their businesses to standardize their products/services to the extent that they achieved substantial market share. Results indicate that 65% of the businesses who had loans from MFIs were helped by the loans to increase their market share while 35% of the businesses saw no difference in market share as a result of the loans provided by MFIs.

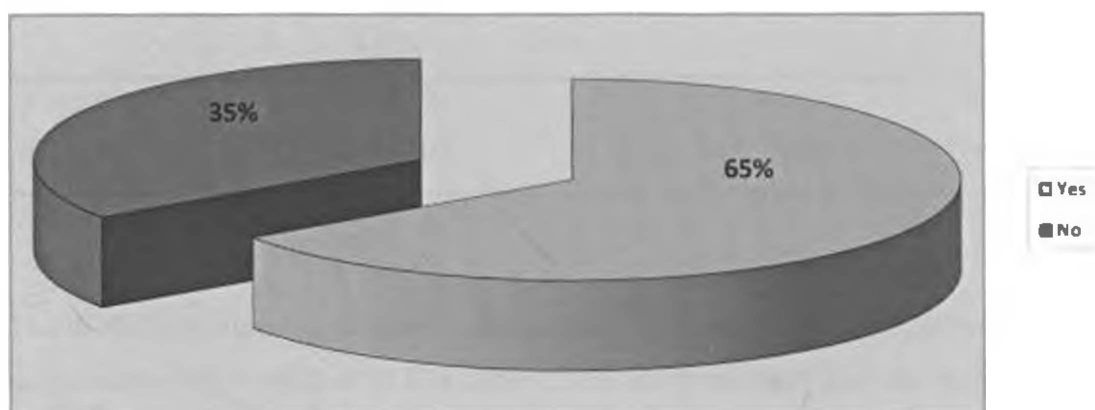

Figure 4.9: Contribution of loan to Market Share

4.5 Regression of Amount of Loans on Performance

The study sought to find the relation between microfinance services use and performance of MFIs. Usage of microfinance services from microfinance institutions was the independent variable while performance of the SMEs was the dependent variable. Use of microfinance services was indicated by the amount of loans the SME had received from an MFI while performance of the MFI was measured by profitability as a percentage of assets (ROA). Results of the regression analysis are presented in table 4.5 – 4.7.

Table 4.5: Regression Model Summary

R	R Squared	Std. Error of the Estimate
.784	.615	1.13547

Predictors: (Constant), Performance

Table 4.6: ANOVA

	Sum of Squares	df	Mean Square	F	Sig.
Regression	12.937	1	12.937	10.034	.003
Residual	50.282	39	1.289		
Total	63.220	40			

Predictors: (Constant), Performance

Dependent Variable: Usage

Table 4.7: Coefficients of the Model

	Unstandardized Coefficients		Standardized Coefficients	t	Sig.
	B	Std. Error	Beta		
(Constant)	1.048	.539		1.945	.059
Performance	.127	.040	.452	3.168	.003

Dependent Variable: USAGE

The model has some explanatory value and it is significant at 1% significance level. This is indicated by the F ratio of 10.034. The R^2 of 0.615 indicates that the model can be sued to explain 61.5% of the variation in performance of SMEs. This indicates that the model has some explanatory power though not very much. The t-ratio of performance in the model is 3.168 which is significant at 1% significance level. This indicates that usage of microfinance services by SMEs is a good predictor of performance of SMEs. Thus has an SME utilizes MFI services, its performance improves.

The resulting model is;

$Y = 1.048 + 0.127X + \varepsilon$

Where Y represents performance in terms of return on assets while x represents usage of microfinance services measured by the times the business had accessed a loan from an MFI.

ε is an error term which is random

4.6 Summary and interpretation of findings

The aim of the study was to establish the effect of microfinance services and performance of MFIs. The study established that 85% of the businesses had utilized microfinance services while 15% indicated not to have utilized microfinance services. This study also established that the mainstream financial institutions had blacked them out from financial services. Other non-traditional financial institutions such as Chama's, MFIs and Sacco's had come to bail these small businesses. These findings concur with those from a study by Amanda et al. (2007) which studied access to financial services by women owned businesses in Kenya. This study had established that access to financial services ranked as the biggest hindrance to small and medium enterprises. However, the study indicated that microfinance institutions had come up to solve that challenge with little success. The study by Amanda et al. further indicated that microfinance sector is highly segmented and disconnected. MFIs target different market niches and operate under different methodologies and organizational missions. However, in this study, the contribution by these organizations offering microfinance services is evident.

The researcher inquired from the SMEs whether they had ever applied for a loan to any financial institution for business purposes. Results from this question indicated that most of the SMEs surveyed were involved in external finance seeking. Those who had applied a loan at one time comprised of 95% while those who had never applied for a loan were 5%. The researcher further inquired where those who had sought for a loan had applied for the loan. Those institutions indicated included banks, MFIs, Sacco's and rotating savings and credit organizations or Chama's. Chama's, MFIs and Sacco's were the most popular sources of finance for these SMEs. These findings agreed with findings from earlier studies such as Amanda et al. (2007), Hospes, Musinga and Ongoayo (2002) and a study carried out by United Nations Capital Development Fund (2003). These studies found out services offered by MFIs were limited. They had found that commercial banks provide the widest range of services but are not interested in servicing Small and Medium Enterprises (SMEs) because of the perception of the higher credit risk and the high transaction costs. Servicing of SMEs was left to informal financial systems and microfinance institutions. These studies further established that despite some positive trends by the banks and microfinance institutions in reaching out to the SMEs, small and medium entrepreneurs reported that they continued to encounter 'challenge of smallness' when they approached a traditional financial institution.

Discriminatory treatment by bank officials who prefer dealing with larger entrepreneurs and business people and often do not take SMEs seriously was frequently cited in that study. This study had the same findings where very small businesses were denied loans on unclear circumstances.

The study further sought to find out from those who had applied for a loan whether it was easy to get one. Results indicate that 69% of those who had applied reported that it was easy to access a loan while 31% reported that it was not easy. This concurs with results from a study by Hospes, Musinga and Ongoayo (2002) on Kenya women Finance trust clients. This study had established that KWFT clients were empowered by microfinance services to undertake a variety of enterprises ranging from small trade through hawking and different shops of service provision including running of private clinics, schools, hair salons and sale of bathroom and toilet services in slum areas. The clients were finding loan application and accessing other products easy since the MFI had clear rules and procedures which were tailor made for the small businesses. Some clients according to this study were involved in agro-based production and marketing while a few undertook manufacturing of clothing items and food processing. While a few of the businesses were operated in formal commercial places with business buildings and facilities, a majority of them took place in informal sites including the homestead or just under a tree, while many were mobile with no fixed abode. This MFI had made access to finance possible to SMEs. This finding was also echoed by many SMEs surveyed in this study. The study further found that 67% of those who had received loans from MFIs had encountered challenges in repaying their loans while 33% had never encountered challenges in settling their loans. Those who had encountered challenges indicated that they had negotiated for repayment terms, sold assets to settle the loans, borrowed other loans to settle the current or repaid the loans from other sources of finance other than the business. Default is common in MFIs that engage in lending the poor with micro enterprises as indicated by a study by Muganga (2010). However as in this study, Muganga established that MFIs had designed measures to assist those who were in loan repayment difficulties. These measures included assisting them in lengthening the loan repayment period, offering them advice and business training and assisting them with capacity building to empower them to manage finances properly.

The study findings indicate that 50% of the loanees indicated that the loans had contributed highly to their competitiveness while 27% viewed the contribution of the loan to

competitiveness as low. Further, 65% of the businesses who had loans from MFIs were helped by the loans to increase their market share. Regression analysis results supported this finding where the regression model was significant at 1% significance level. The R^2 of 0.615 indicates that the model can be used to explain 61.5% of the variation in performance of SMEs. This indicates that the model has some explanatory power. The t-ratio of performance in the model is 3.168 which is significant at 1% significance level. This indicates that usage of microfinance services by SMEs is a good predictor of performance of SMEs. Thus bas an SME utilizes MFI services, its performance improves. These findings that report a positive effect of microfinance services to performance agrees with other previous works. One was by Muganga (2010) who studied the impacts of microfinance programs on business performance and individual wellbeing in Kenya and South Africa. This study was a comparative study of the situation in the two countries. The study established that as the overall amount and number of loans to the poor increase, there was a direct positive relationship with the recipient's income over time. Thus, if utilized effectively, microfinance is a tool that the poor can use to pull themselves out of poverty. Muganga's study also aimed at testing if that is what is truly taking place in the developing economies. This was to see if microfinance was indeed achieving its goals. Since the small loans provided are designed to increase entrepreneurship within the poor, we would expect to see an increase in the overall number of small businesses and entrepreneurship activity in the regions studied. This study also had the same results which indicated a positive relationship between use of microfinance services and business performance among the SMEs.

These findings also agree with another study by United Nations Capital Development Fund (2003). This study was a case study of Nigeria, Kenya, Malawi and Haiti. This study was aimed at establishing the impact that MFI services had on individuals, communities and enterprises. In terms of enterprise assets, some impact was found in Nigeria. For Malawi and Haiti no impact on enterprise assets could be observed. For Kenya, where the findings relied on qualitative research, there was not enough data to make a determination, though results pointed to a positive impact. Further, the study concluded that the programmes in Nigeria and Kenya, which operated in diversified economies, demonstrated positive impact in levels of enterprise income. This study had the same observations and conclusions as positive effect of microfinance service utilization and SME business performance was found.

CHAPTER FIVE: SUMMARY CONCLUSIONS AND RECOMMENDATIONS

5.1 Summary

The purpose of this study was to determine the impact of microfinance services on the performance of SMEs in Nandi County. Despite the apparent success and popularity of microfinance, no clear evidence yet exists that microfinance development have positive impacts. While there are tales and other inspiring stories purported to show that microfinance can make a real difference in the lives of those served, rigorous quantitative evidence on the nature, magnitude and balance of microfinance impact is still scarce and inconclusive (de Aghion and Morduch, 2010).

The causal research design was used to carry out this study. The target population of this study was all the medium and small enterprises in Nandi County. These are the enterprises that deal with agricultural and other related activities that are registered and have a physical office in Nandi County. The simple random sampling method was applied to select a sample of 53 SMEs. The study used both primary and secondary data. Primary data was collected using semi-structured questionnaire to the owner/managers of the selected SMEs. Secondary data was taken from articles and from small and medium size enterprises, as well as website of major MFIs in the region: Faulu Kenya and Kenya Women finance Trust. The study utilized the SPSS software Version 18 to do the analysis as this involved quantitative analysis. A regression analysis was also performed on the variables to determine whether microfinance services have an effect on performance of SMEs in Nandi County.

On the impact of microfinance services on SME business performance, 50% of SMEs indicated that the loans had contributed highly to their competitiveness while 27% viewed the contribution of the loan to competitiveness as low. Further, 65% of the businesses who had loans from MFIs were helped by the loans to increase their market share while 35% of the businesses saw no difference in market share as a result of the loans provided by MFIs. The study sought to find the relation between microfinance services use and performance of MFIs. Usage of microfinance services from microfinance institutions was the independent variable while performance of the SMEs was the dependent variable. Use of microfinance services was indicated by the amount of loans the SME had received from an MFI while performance of the MFI was measured by profitability as a percentage of assets (ROA). The

resultant model indicated that usage of microfinance services affect the performance of SMEs in Nandi County. This indicates that usage of microfinance services by SMEs is a good predictor of performance of SMEs. Thus bas an SME utilizes MFI services, its performance improves

5.2 Conclusions

The aim of the study was to establish the effect of microfinance services and performance of MFIs. The following conclusions are arrived at after considering the results. First, access to financial services is still a hindrance to small and medium enterprises. However, the study indicated that microfinance institutions had come up to solve that challenge with huge success. A large proportion of SMEs had accessed loans from banks. MFIs. Sacco's and rotating savings and credit organizations or Chama's. Chama's, MFIs and Sacco's were the most popular sources of finance for these SMEs. This indicates that these organizations have emerged to bridge the gap between access of financial services and SMEs. However, the study still concludes that services offered by MFIs are still limited. The study also concludes that as MFIs become bigger, they result to discriminate against the small businesses. Despite some positive trends by the microfinance institutions in reaching out to the SMEs, small and medium entrepreneurs reported that they continued to encounter challenge of smallness. Very small businesses were denied loans on unclear circumstances. The study concludes that access to formal financial services is still a major challenge to SMEs. The SMEs have developed a wide variety of informal, community-based financial arrangements to meet their financial needs. In addition, an increasing number of formal sector organizations (non-government, government, and private) have been created for the purpose of meeting those same needs. The rise of the microfinance industry represents a remarkable accomplishment taken and many SMEs can access financial services which they could not have accessed before. MFIs provide similar products and services to their customers as formal sector financial institutions like banks where banks were found to have microfinance arms which catered from small and micro businesses. The scale and method of delivery differ, but the fundamental services of savings, loans, and insurance are the same. However, most efforts by MFIs have focused on enterprise lending (loans for enterprise formation and development) which remain by far today the dominant product offered by MFIs. MFIs offer very few added services and lending is their chief product. However, this is slowly changing as the business,

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political and economic environment change. Increasingly today MFIs in Nandi district have begun to offer additional products, such as savings, consumption or emergency loans, insurance, and business education or capacity building.

This study attempted to empirically ascertain the effect of MFIs services on SMEs. Positive and significant relationship has been established between MFIs loans and SMEs performance. The study confirms the positive contributions of MFIs loans towards promoting SMEs market share, production efficiencies and competitiveness. Although MFIs in Nandi County are faced with insufficient funds problems which affect their capacity to design more and better products, their tendencies to augment the financial needs of SMEs is considerably acknowledged. This study has established that SMEs in Nandi County have been empowered by microfinance services to start and grow a variety of enterprises. MFIs have made access to finance possible to SMEs. This study concludes that as the overall amount and number of loans to the SME increase, there is a direct positive relationship with the recipient's performance as indicated by market share, profit and asset base.

5.3 Policy Recommendations

From the study conclusions, three recommendations are made. First, it has been unveiled that government policies and programs designed to develop SMEs in Nandi County are ineffective and thereby need to be re-conceptualized. Apart from provision of loans through women enterprise and youth enterprise funds, it is recommended that the government should try to provide sufficient infrastructural facilities such as electricity, good road network and training institutions. This is because SME development has been touted as an important drive towards vision 2030 and the millennium development goals.

Secondly, micro-finance provides the needed opportunity for entrepreneurs to start or improve business in order to make profit and improve their lives. The ability of entrepreneurs to make use of the opportunity provided by micro-finance factors to ensure enterprise performance depends on their attitude to risk: that is their ability to access information and willingness to act on the information. Thus, credit, savings, training and social capital could have positive impact on opportunity for entrepreneurial activity of entrepreneurs which could lead to business performance: depending on the entrepreneur's attitude to risk. This study therefore recommends to entrepreneurs to engage actively in

looking for opportunities and ways of exploiting those opportunities. Many entrepreneurs shy away from taking loans due to their risk averse attitude which kills the spirit of entrepreneurship. SME owners/managers should be prepared to take risks.

Lastly, the study recommends to institutions offering microfinance services not do discriminate small businesses just because of their smallness. A clear criterion for loan access and repayment should be set which should be flexible to cater for the needs of the diverse sizes, nature and preferences of different small and medium enterprises. Further MFIs should do research and find creative ways of providing services to SMEs such that the MFIs can benefit and at the same time developing the SMEs and entrepreneurship. MFIs should also continually review their product service offering to ascertain that what they are providing is what the clients want.

5.4 Limitations of the study

This study had several limitations. First, accessibility of the owner/managers of the SMEs in Nandi County was a challenge. This is because most of these owner/managers were barely present at their work places and the researcher had to make several trips to the locations to access the subjects. In some instances, the owner managers were not accessible totally where the researcher interviewed the second in command in such cases.

Another limitation was reliability of the collected data. The researcher depended mostly on the subjective responses of the respondents in some cases since some small businesses in Nandi County did not produce documentary evidence of measures of profitability, amount of loans and assets worth. However, the researcher informed the respondents of the need to give as accurate information as possible in the survey to enable valid conclusions which would guide policy and practice.

Another limitation was time and interruptions of the interview. The researcher found that it took much time to get responses from the SMEs which stretched the researcher's schedule much. However, the continued insistence and follow up of the researcher ensured a good return rate.

5.5 Recommendations for Further Research

Further study should be conducted on how best SMEs can make use of equity finances such as venture capital, business angels and other alternative sources of finance available to augment the traditional sources of finance that SMEs are using today. Another study should also be carried out in the different counties of the country to find out how and whether microfinance is providing the desired effect to SMEs.

Secondly, a study should be carried out in MFIs to find out their governance structures, products and their performance standards. This would be aimed at establishing whether these microfinance institutions are properly positioned to develop the SME sector in the country. Development of MFIs has been related to development of SMEs and reduction of poverty. A study on MFIs is therefore called for.

Another study would be carried out in the government backed finance services such as the youth enterprise fund and the women enterprise fund to determine the contributions these funds are making to enhance development of the SME sector. SME sector is indicated as the main driver to Kenya achieving the status of an industrialized country and also in the way to attain the millennium development goals and Vision 20230. The efforts of government to develop the SME sector should be a subject of a future study.

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Appendix I:Questionnaire to Nandi County members who own small businesses

Instructions

Answer the questions by ticking the best choice that applies to your situation in the spaces provided or by answering in the provided spaces.

SECTION A: GENERAL INFORMATION

1) What is your gender?

Male [ ]

Female [ ]

2) Your age is between?

18-35 [ ]

36-45 [ ]

46-60 [ ]

Above 60 [ ]

3) Which of the following best describes the current development of your business?

Newly started [ ]

Young, but with established production and customers [ ]

Growing [ ]

Well established, with steady production and customers [ ]

Mature, but in need of renewal [ ]

4) What type of business?

Farming [ ]

Trading [ ]

Artisan works [ ]

Others [ ] Please specify............................

5) What percentage can you estimate to be the startup capital for your business?

Own savings...........

Borrowed capital...............

If borrowed please give the source(s)....................................

....

....

6) How long have you been in business?

0-1year [ ]

1-5 years [ ]

5-10years [ ]

Above 10 [ ]

Can't remember [ ]

7) a) Do you use services provided by MFIs

Yes [ ]

No [ ]

b)How often do you used microfinance institution services?

Regularly [ ]

Occasionally [ ]

Never [ ]

SECTION B: ACCESSIBILITY OF FINANCIAL SERVICES

1. a) Have you ever applied for a loan ("borrowed capital") to finance your business?

Yes [ ]

No [ ]

b) If yes above, where?

MFI [ ]

Bank [ ]

Others [ ] Please Specify ....

c) If yes above, how many times? ....

If you have applied for a loan for your business from an MFI, please answer the following questions, 2-6

2) Was it easy to be given a loan?

Yes [ ]

No [ ]

3) Is the criteria and procedure used by the MFIs easy to comply with?

Yes [ ]

No [ ]

4) What criteria does the MFI normally use

....

....

....

5) a) Have you ever had challenges in repaying your loan?

Yes [ ]

No [ ]

b) If yes how did you finally pay it?

....

....

....

c) Do you or can you conclude that MFI services have helped you in developing your business?

Yes [ ]

No [ ]

Explain ....

6) a) Apart from financial services offered by the MFIs. have the MFIs provided other services that have helped develop your business?

Yes [ ]

No [ ]

b) Please explain those other services if your answer is yes above

....

....

....

SECTION C: IMPACT OF MICROFINANCE SERVICES ON SMES

1. Sourcing capital is one of the major problems facing SMEs in Kenya. does your company have any access to MFIs loans?

Yes [ ]

No [ ]

2. What percentage level of goal achievement did your company derived from the loans obtained from MFIs? ....%

3. What is your opinion about MFIs loans impact on your SMEs ability to compete and secure market share?

   Contributed high [ ]

   Contributed low [ ]

   No contribution [ ]

4. Does the loan actually help your company to standardize your product/service to the extent that you achieved substantial market share?

   Yes [ ]

   No [ ]

5. Competition generally requires the need to exploit financial resources: to what significant level does the MFI contribute to the overall competitiveness of your company?

   Highly Significant [ ]

   Moderately Significant [ ]

   Insignificant [ ]

6. What profit did your SME make the last financial year? Kshs ....

7. What do you estimate as the total value of your assets? Kshs ....