EFFECTS OF ACCESS TO CREDIT ON PROFITABILITY OF SMALL AND MEDIUM ENTERPRISES IN ROYSAMBU SUB-LOCATION, NAIROBI COUNTY

BY

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DECLARATION

This Research Project is my original work and has not been presented for an award in any university.

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D61/71185/2014

This Research Project has been submitted for examination with my approval as the university supervisor.

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DEDICATION

This Project is dedicated to my dear parents Mr and Mrs Koskey, my sisters and Brothers who have been a constant source of support and encouragement thought my life.

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LIST OF ABBREVIATIONS AND ACRONYMS

FI	Financial Institution
GoK	Government of Kenya
MFI	Micro Finance Institution
OECD	Organization for Economic Cooperation and Development
SMEs	Small and Medium Enterprises

ABSTRACT

This study was designed to investigate the Effects of Access to Credit on Profitability of Small and Medium Enterprises in Nairobi County. The availability of external finance for small and medium enterprises (SMEs) is a topic of significant research interest to academics and an important issue to policy makers around the globe. Majority of entrepreneurs in the SME sector are still considered not credit worthy by most commercial banks because of their inability to fulfill certain banking terms and conditions. The study aimed to find out how issues like firm size, credit risk, liquidity, deposits and interest rates influence access to credit of small and medium enterprises. It also examined difficulties SMEs face in accessing loans, difficulties financial institutions face in lending to SMEs and the impact of loans on the profitability of SMEs. This study adopted a descriptive survey design as a major method of research where questionnaires will be used to collect data from a sample of small and medium enterprises under the study. The reliability and validity of the instrument of data collection were tested through a test re-test approach. Content validity, construct validity as well as criterion validity were applied to ensure that the instruments represented what they were designed to measure. Secondary data from the annual published reports of SMEs in Kenya for a period of 6 years from 2010-2015 were used to collect data. The target population was 106 selected small and medium enterprises from Roysambu Sub-Location, Nairobi County. A sample of 86 was then selected through systematic random sampling. Data was collected through administering of questionnaires and analyzed by the use of descriptive statistics constituting of correlation and regression. The study findings were then presented and discussed.

CHAPTER ONE: INTRODUCTION

1.1 Background of the Study

Small or medium enterprise (SME) is described as one which is self-regulating, self-governing and not influential in its field of specialization (Ondiege, 1996). It can also be described in terms of trade capacity and by the total number of permanent and casual employees in the business. A small enterprise employs up to a maximum of 50 people. On the other hand, medium enterprises are businesses with more than 50 people but fewer than 100. The business activities carried out by SMEs include trade, provision of service, manufacturing among other activities.

Majority of the population in Kenya are involved small and medium sized firms as a means of generating income with at least 48 percent of all SMEs in Kenya being run by women (ILO, 2008). Getting credit funding is essential for the continued existence of income generating projects all over the world, and inadequate investment is considered a huge impediment to their expansion and performance. Other studies show that this is mostly true for start-ups, and for women investors according to Ouma (2002). Studies of firms in Kenya and other East African countries show that firms and particularly SMEs have for a long time lacked access to both long term and short term financing. Most SMEs lack perfect loan repayment records and management capacity, so they have difficulty securing credit for their business goings on such as purchase of locally available materials and products as well as necessary equipment for manufacturing.

Different theoretical approaches attempt to explain some issues facing credit and mainly based on default risks and associated borrower incentives. The adverse selection theory of credit markets started off with the paper by Stiglitz and Weiss (1981). This theory is based on two hypotheses that financiers cannot differentiate between creditors of varied degrees of risk, and that loan agreements are subject to legal responsibility. If return on investment is less than loan invested, the borrower has no responsibility to repay. This is limited to unintentional loan defaulting. It presupposes that debtors pay back loans when they have the resources to do so. At usurious interest rates, the only candidates are usually debtors who have the potential to generate huge profits but presumably with small risk likelihood.

1.1.1 Access to Credit

According to Mwangi and Bwisa (2013), access to loans entails restrictions placed on households' convenience and suitability criteria of loans. Credit access is mostly a source related issue related to the potential financier's choice of the highest credit ceiling. Small and micro enterprises (SMEs) have become significant participants in the Kenyan fiscal strategies, however they are still facing issues that curb their performance and profitability.

The ability of small and medium sized Firms to live upto their capability in an economy depends on the availability of credit funding (Whincop, 2001). Funding from loans is especially critical for small enterprises, since they are not able to fund themselves through funds ploughed back into the business or through equity funds. Most businesses in Kenya depend on financial products offered by banks and MFIs for options for financing their operations. Most Micro and Small Sized Enterprises in Kenya use business loans, lease finance, hire-purchase and invoice-discounting as means of finance (Manasseh, 2001).

According to Kimuyu and Omiti (2000), access to credit from both formal and informal channels requires a certain amount of security. Most of the time, the collateral necessary is too expensive. This becomes a restriction to small firms most of who do not have ownership documents to assets to present as collateral to secure loans. This study therefore seeks to find out whether there is a relationship between securing loan funds and profitability of small and medium enterprises in Roysambu Sub-location, Nairobi County.

1.1.2 Profitability

Profitability refers to a positive gain from an investment or business operations after subtracting all expenses. Profit returns denotes the amount of monies that a firm has made after the cost of goods sold and all liabilities and expenses have been subtracted (Kauffmann, 2005). This normally indicates whether the firm is making more than it spends or spending more than it makes. To measure the profitability of SMEs different indicators such as total transactions or business expansion, employment creation, total asset worth, market segmentation, returns and productivity are all relevant. There are numerous pointers

of the profitability of an enterprise which include management and functioning pointers, organization efficiency and the monetary pointers.

Muchiti (2009) in his study stated that while the continued existence of the enterprise depends on liquidity, its existence and expansion depends on return on investment. According to Beck and Honohan (2008), total transactions and work creation remain very crucial signs for measuring the expansion and improvement of firms. Entrepreneurial profitability is influenced by internal as well as external issues. Internal issues comprise management style, succession plans.

1.1.3 The Relationship between securing Credit and Profitability

Business enterprises notwithstanding of how large they are requiring financing from the start and throughout their progression and expansion. The initial capital as well as acquisition of required equipment will affect at a great value, the scope of the enterprise which in turn determines the continued existence of a venture and future profitability assuming all factors do not change. The investor has to find a suitable way of financing to initiate the enterprise, drive and run the firm (Hallber, 2002).

The provision of financial services to SMEs controls the scope of a firm in several ways, especially in use of available expertise, access to trade agreements, and access to raw materials which in turn at great lengths impact on the sustainability and profitability of a business. Barriers to credit like collateral requirements, high interest rates and unavailability of varying financing options that provide access to necessary equipment for business use limit small enterprises access to lending and this in turn influences successful survival and growth of these businesses.

Size of a firm is considered one of the essential determining factors of securing lending. Even among the small enterprises category, there a large deviation in size and there are tiny enterprises as well as big enterprises in terms of scope and total figure of casual and permanent employees and revenue and asset base. According to Berger and Udell (1998) minor as well as major enterprises have a higher possibility of having greater cost of

lending and they are supposed to provide security which is most times a challenge because they often have a small asset base to be used as collateral.

Securing lending pushes enterprises to flourish and thrive. Studies conducted by the World Bank show that access to finance improves enterprise productivity. It not only accelerates market entry, expansion of enterprises and decreasing threats according to Beck, Thorsten and Honohan (2008) but also influences originality and starting of new business enterprises. Further to that, enterprises with greater access to funding have higher ability to make use of expansion and investment prospects. As a result, collective economic performance will be improved by improving access to funding (Gok, 2005)

1.1.4 Small and Medium Enterprises in Roysambu Sub-Location

Roysambu Sub-Location is home to the SME sector which consists of a mix of various firms involved in different activities that are focused more in the metropolitan areas. Information at the local authority's offices in Kasarani indicates an increasing number of entrepreneurs who run small businesses. In Kenya categorization of firms is mainly by the total number of staff employed by the enterprises (Njoroge, 2012). Enterprises that employ between 6 to 50 and 51 to 99 employees are categorized as minor firms and medium scale firms respectively (Kinyanjui, 2006).

Most enterprises in Roysambu Sub-Location are mostly comprised of single household groups and sole proprietorship businesses. Most of them are artisans and self-help groups engaged in raw items supply and production from indigenous crops. Majority of income generating activities within this category include manufacture of small household items, clothing and fashion. Others include ceramics, footwear, jua kali artisans, wood, bricks and cement, soft drinks, foodstuffs and cuisine specialists and confectionery (Mokogi, 2003).

1.2 Research Problem

Previous studies have indicated a close relationship between the extent of hardship, hunger, unemployment, economic welfare and living standards for the citizens of countries and vibrancy of the respective country's small enterprises (Onugu, 2005). If Kenya is to solve its main problem of unemployment and able to secure employment for the increasing population and improve the living standards of its people, is pursuing the development of SMEs through the provision of adequate finance a solution to the problem. According to Dalberg (2011) states that loans are essential to create a monetary setting that enables enterprises to improve and flourish.

Small enterprises in developing nations, face significant barriers to securing loans. Funding problems are greater in developing countries in general, but SMEs are particularly limited by policies in the financial system such as high application costs, high collateral requirements and lack of experience in the financial sub-sector (Sekaran, 2003). Increased securing of loans for small firms can improve monetary conditions in developing countries by promoting originality, macro-economic flexibility as well as Gross Domestic Product improvement. SMEs also face internal factors like management style, succession plans and others which can be easily managed within.

However, Daniels and Mead (1998) state that external factors define the macro-environment which may influence business ownership at an early level and during the business growth. Such issues bring up opportunities, threats and information affecting business owners in their immediate environment, regardless of their business previous experience, level of schooling or business idea. Dalberg Institute Geneva (2011) lists other factors to include sociological, demographic, marketplaces both local and international, emerging and established markets, cultural, institutional, legal, fiscal, infrastructural and other physical factors of that particular situation. Technological, Political, environmental as well as legal factors were also cemented by Beck and Honohan (2008) as very critical issues that may affect the expansion of small enterprises.

Access to funding is fundamental in successful implementation of any project. In Kenya, information on the effect of Microfinance on the monetary growth of small enterprises especially those owned by young people is not readily available. Majority of research on the contribution of finance access to growth of small enterprises are too broad with only a few limited to particular fragment of the people including young people, men, women and people living with disabilities in the population.

Mokogi (2003) studied the fiscal consequences of lending by MFIs on Small Scale firms and its influence on their businesses. Among other conclusions, the author stated that usurious interest rates and lack of security were the main barriers to access to loans from Saccos by start-up investors and business people. Mwangi and Bwisa in 2013 studied the challenges facing business start-ups in accessing credit in Makuyu, Kenya. This piece of research was one of a kind as it looked at the young segment of the population engaged in Business. Young people form the majority of rural-urban migration to cities in search of work. Not all the youths can be employed in white collar jobs, which makes them venture into small businesses. The number of people, especially in Roysambu Sub-Location is growing very fast while development and growth of local economies that are essential to support it and enhance the standard of living in towns is slower than the population growth.

This study seeks to answer the question: What are the outcomes of securing loans on profitability of Small and Medium Enterprises in Roysambu Sub-Location, Nairobi County?

1.3 Research Objective

The objective of this study was to determine the effects of access to credit on the profitability of Small and Medium Firms in Roysambu Sub-Location, Nairobi County.

1.4 Value of the Study

This research is significant for scholars as well as researchers, banks, government policy makers and investors in the SME sector. It provides information to the SMEs that will enable it realize its mandate, and promote its participation in community and civic affairs. The government agencies and policy makers could use the research findings of this study to reduce the bureaucratic red tape, particularly bank rates, fixed by central bank. Such practices create credit market imperfections which undermine free market forces of supply as well as demand of loan products in the money market leading to financial gaps.

The most important areas that the research provides material on include work for people, through establishment of small enterprises and policies creating a permitting environment for loan providers that will then offer start-ups the loan products that they require at lower rates. Small enterprises growth, access, training and policies are also other important areas that will be looked into in this research. The material evidence from the research will enable policy makers in the banking sector to understand the significance of good policies that relate to small enterprises and thus come up with strategies to inspire young people to make use of loan products and services. In practice this research will bring in a lot of value to Banks, Saccos, small enterprises and the Nairobi County.

This study also recommends areas of research which could be explored by future studies. Banks will gain material evidence regarding the strong points and limitations thus come up with approaches to take advantage of the opportunities available while making changes on their limitations. SMEs on the part will learn more about loans and loan products and thus make use of such services. SMEs will also appreciate the information provided by the study that there are lots of chances for growth through loans if they have the right information.

CHAPTER TWO: LITERATURE REVIEW

2.1 Introduction

This chapter presents an assessment from different authors on the effect of access to Credit on the Profitability of Small and Medium Firms with stressing on those based in Roysambu Sub-Location, Nairobi County. The chapter therefore presents arguments on the concepts by various authors based on the research objectives. The review is based on published research papers, library books, published journals, articles from the internet and other material.

2.2 Theoretical Literature Review

In this sub-section, the researcher discussed the different theoretical reviews that relate to credit access. Various Scholars have come up with theories related to access to credit that include the financial intermediation theory, adverse selection theory and the Modigliani and Miller Theory.

2.2.1 Financial Intermediation Theory

The theory of financial intermediation relates to access to credit and the cost of doing business. It's the work of Gurley and Shaw in 1960. The presence of financial go-betweens or agents can be illustrated by the existence of different levels of issues including high administrative costs which affects access to credit, lack of clear policies on the same as well as incomplete information availability. The financial or monetary intermediation theory analyzes the functions of financial or monetary intermediation, the way in which having agents in the financial sector influences economic growth also how it affects policies in the banking sector (Andries & Cuza, 2009).

2.2.2 Adverse Selection Theory

The adverse selection theory of credit markets relates to access to credit and the risks associated with lending and borrowing. The theory came from the works of Stiglitz and Weiss (1981). The philosophy is based on two main notions that creditors cannot differentiate between debtors of different levels of risk, and that loan agreements are subject to very little accountability. This means that if the return on investment is less than the total debt owed, the debtor is not accountable to pay from their own monies. The evaluation is limited to unintentional default of loans and assumes that borrowers repay loans when they have the means to do so. Helsen and Chmelar (2014) points out that based on the way lenders choose creditors, the credit market becomes clear when analyzing the undesirable effects of allowing interest rates to rise under the market fluctuations.

2.2.4 The Modigliani and Miller Hypothesis under Corporate Taxes

This theory relates to funds access with regard to the administrative costs of securing loans and how favorable the interest rates are. The theory underlines the critical issues involved in policy decisions in finance for example the fact that securing funding is more expensive than using own funds. There is also a big rise in risk and in the cost of having own funds as debt goes up. The authors say that in a situation where there are no taxes, the cost of capital stays the same and the advantages of using cheaper loans doesn’t change due to the fact that risks increase. The authors add that entrepreneurs should take as many loans as possible for growth and expansion. (Myers, 1984)

2.3 Determinants of Profitability

This sub-section discusses the determinants of profitability in Small and Medium Enterprises that include Loan conditions set by financial institutions, cost of credit including interest rates and risk, firm size as indicated by the value of assets held and culture of the people that manage SMEs.

2.3.1 Loan Conditions

Medium and small enterprises all over the world can rarely satisfy the strict restrictions set by financial sector, which see small enterprises as too risky because of the lack of collateral as well as absence of enough proof about their credit worthiness. In the absence of loan products, small enterprises cannot be innovative enough nor can they diversify to compete in worldwide trading or even do business with larger enterprises (Zavatta, 2008). SMEs do not usually have adequate collateral to provide to mainstream banking institutions to enable them access credit. Additionally, the lack of proper structures and book keeping become a challenge in assessing the operations of SMEs. Consequently, majority of the SMEs get their finances from friends, micro financing institutions as well as shy-locks that unfortunately charge very high interest with a number of clauses not revealed at the time of advancing the financing support. This affects SMEs negatively in the process due to high interest rates charged since it becomes expensive to service thereby causing a liquidity problem.

To add to that, financial sector players may require the person or the signatures of sponsors. Banks and Saccos do not accept any sponsor that a person presents, they scrutinize their financial background for credit worthiness. Most guarantors for fear of the creditor running bankrupt and not repaying the loan will therefore be wary of being a sponsor for any loans. Such issues make it hard for small business start-ups to access loans from financial institutions like banks (Wanjohi, 2009).

2.3.2. Access to Credit

Mwangi and Bwisa (2013) study on issues that small business owners face in Makuyu found out that SMEs are normally perceived to be riskier than larger corporates. Until recently in Kenya, banks had no interest in giving loans to small businesses because of the perception of bad loans and the high administrative costs. Banks are exposed to the risk of giving bad loans due to a complete lack of information from small enterprises. Banks cannot tell the fraction of loans given that will be repaid to full amounts and even when they do assessments, bad loans are not fully done away with. To make up for the potential of huge losses on loans, banks charge a percentage whose size depends on the bank lending policies, percentage of interest rate on total assets, type of customer, size of security and the total amount borrowed. This fuels the interest rates paid by borrowers and reduces the demand for credit.

World Bank (2008) study on the policies and pitfalls in expanding access to Finance argues that the key impediment to the growth of the small enterprises sector which is a scarcity of both credit and equity funding. Being able to get loans has been identified as a main element for small enterprises to prosper in their struggle to grow, be competitive, create employment and to participate in growth of the gross domestic product in developing economies.

2.3.3 Firm Size

Oketch, Abaga and Kulundu (1995) found out that size of a firm positively influences liquidity and that a unit increase in size shall increase liquidity by a considerable percentage. Whereas an increase in company assets leads to higher level of profitability. Ondiege (1996) found out that achieving desired liquidity for a firm requires structures and qualified personnel to manage the systems. Kinyanjui (2006) argues that tiny enterprises face greater funding limitations than bigger firms and that these have a negative influence on their expansion. Medium enterprises face higher monetary controls than large enterprises. Tiny firms often fail to take advantage of economies of scale like huge enterprises do. The researchers argue that due to the fact that small companies have not

accumulated enough return on investment and are therefore unable to rely on bank funding, they have to rely on the original cash investment of their angel investors.

World Bank (2006) on the other hand argues that Firm characteristics affect small enterprises' ability to access lending. How long a firm has been in business and how big it is being identified as important variables in this issue. Size of a firm has been identified as one of the most important indicators in studies related to access to funding. It's the same case for developing as well as developed nations. Due to the fact that this study puts emphasis on small and medium sized enterprises, size is not such a huge contributing factor of access to funding. In tiny firms and enterprises, there is still a huge disparity in the size of the firms due to the fact that there are far huge risks involved. Tiny enterprises have high collapse rate compared to large firms which have been in business for longer periods. Rungani (2009) studied enterprises in various countries and found that there was no correlation between the size of an enterprise and the degree of risk it might pose for a lender. In fact, size of the firm is a major indicator in the analysis of limitations in the financial sector (GoK, 2005). Therefore, both huge and tiny enterprises do not have the same chances when it comes to accessing lending from Saccos and banks.

2.4 Empirical Review

This section presents review of global and local empirical studies on the influence of access to credit on the profitability of SMEs.

2.4.1 International Evidence

Aryeetey et al. (1994), loaning to small enterprises in Ghana is said to be pricier than loaning to larger enterprises in terms of conducting background checks, loan scrutiny and contract execution. Banks say that background checks to gather information about the credit worthiness of a loanee and use of funds, reviewing sustainability studies, carrying out loan analysis and making a decision to fund takes an average of two weeks for large enterprises and that of small enterprises takes three weeks.

Daniels and Mead (1998) write that high administrative costs contribute to the failure of the small enterprises to access funding. They argue that if administrative costs are high, the return on investment that lenders expect from loans fair badly in comparison to other investments like bonds and treasury bills.

Mohieldin and Write (2000) study on the informal and formal loan markets in north africa argues that both the prerequisites of the loanee and that of the loaning institution (supply side) determine whether credit is awarded. They further argued that level of studies, land tenure systems, total assets, and size of enterprise as significant determinants of loan accessibility.

2.4.2 Local Evidence

Access to credit facilities in Kenya operates in different methods where low investment markets encourage business owners to rely on equity funding as well as borrowing from relatives and friends. Funding access impediment to long-standing loans for small firms influences them to rely on short term funding which is costly like shylocking. Small firms go through other issues in financing including the high administrative costs and legal charges (Daniels and Musinga, 1995).

Oketch, Abaga and Kulundu (1995) study on the supply and demand of small and medium firms funding in East Africa found that most small enterprises in Kenya have a very strong emphasis on credit but some are getting into the position where clients are virtually forced to take loans. This may to a certain extent because of the Saccos need to give out loans to achieve long-term growth and partly due to a principle that loans are good for small business owners even if they do not require them.

Kimuyu and Omiti (2000) studied the organizational obstacles to access to credit by Micro and Small Scale enterprises in Kenya. The researchers state that the practical association

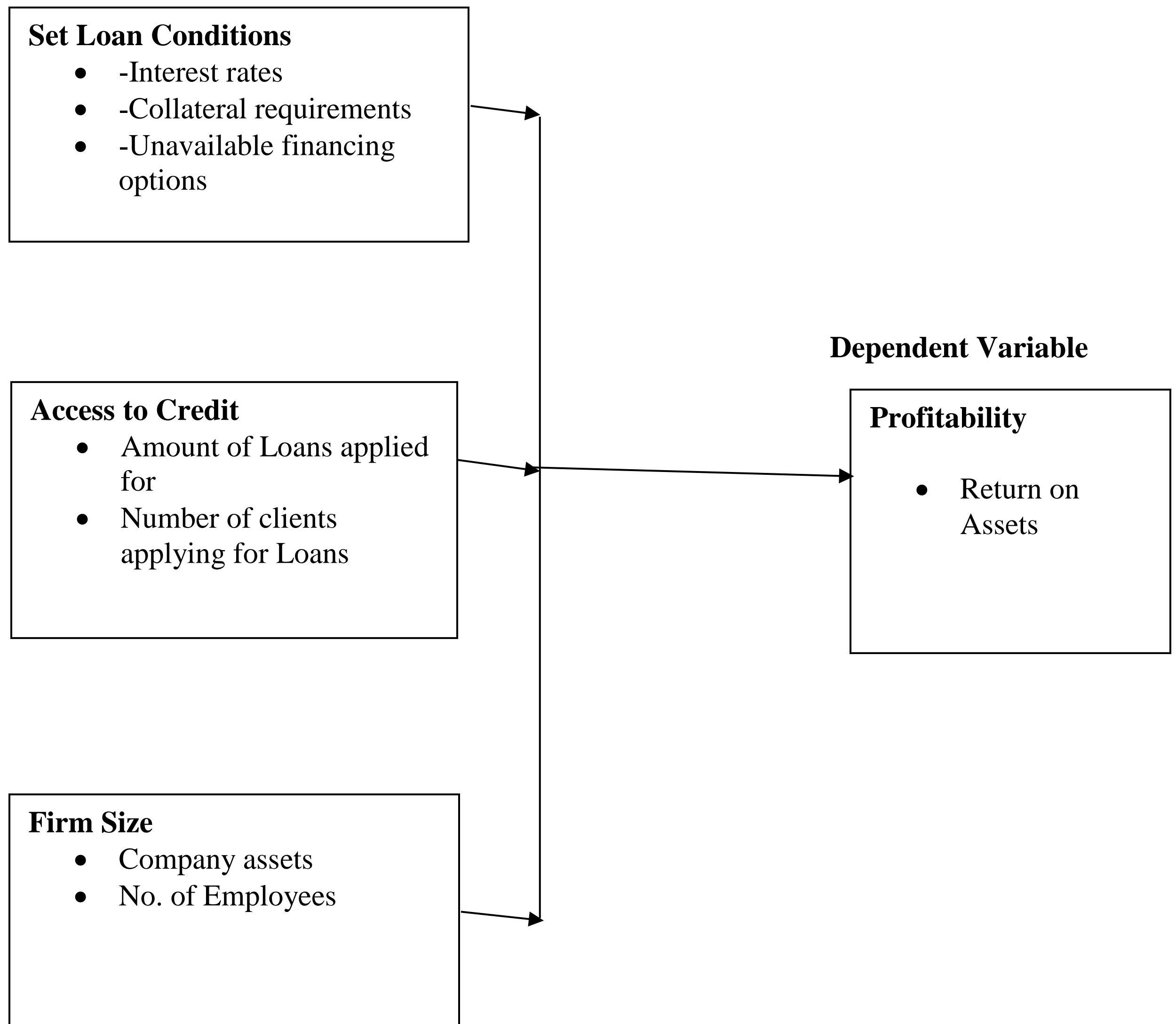
between approach to funding as well as expansion was not well ascertained, despite a range of hypothetical literature theorizing about the potential monetary association.

Mokogi (2003) researched the monetary implications of lending of Saccos and banks on small and micro enterprises. The researcher argues that funding has the potential to encourage small enterprises business growth. However, another issue that comes up is whether funding from loans is the most essential need for growth and profitability. This is due to the fact that there are enterprises which fail to grow and expand despite having funding.

Wanjohi (2009) states that availability of funds affects profitability and performance of small enterprises constructively. How straightforward it is to access funds, the easy it is for small and micro enterprises to prosper, grow and move forward.

Muchiti (2009) writes that a number of medium firms in Kenya have over time flunked in their bid to flourish to large enterprises as visualized in their conceptual plans mainly due to improper structures especially regarding business liquidity and working capital while Mwangi (2015) study on women-run income generating projects in Roysambu Constituency found that interest rates charged by financial institutions are still on the high side. The study findings showed that lower interest rates promoted better occupation and increases income.

2.5 Conceptual Framework



2.6 Summary of Literature Review

In this chapter the researcher gave an overview of credit access worldwide, in African states and in Kenya. The review of literature in this study demonstrates that lack of access to credit facilities adversely affects the performance of SMEs especially those in developing countries which face challenges from commercial banks. This is mainly because of their incapacity to satisfy certain loaning requirements and bank policies. Most loans given to small-scale enterprises are collateral based, without any regard for potential return on investment which limits growth of most businesses. Microcredit loaning has come to be seen as an important tool in reduction of discrimination, development policies, scarcity and susceptibility. Some of the causes why small enterprises have problems getting funding usually are usurious interest rates, long time taken in loan processing and inflexible conditions.

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CHAPTER THREE: RESEARCH METHODOLOGY

3.1 Introduction

This chapter covered research method of the study, and specific procedure followed in undertaking the study. These include research design, population that was targeted, sampling design, research instrument, and collection procedure for data as well as method for analysis of data.

Research methodology is a method by which data is collected for a study. It is the plan for the collection, data analysis and measurement so as to achieve the intended outcomes of a study (Cooper and Schindler, 2003). For a research project to create reliable and unbiased study outcomes, it should follow the principles of scientific investigation which are defined as organized and experimental based methods (Cooper &Schindler, 2006).

3.2 Research Design

This can be defined as the structured plan of investigation that was used to conduct the study in order to answer the questions how much, what, which, who and how to achieve the main objectives of the investigation. It is a strategy for the procedure to be used to gather and scrutinize the data of an investigation. Cooper and Schindler (2006) state that research design explains the reason and rationale behind the investigation method used, format, techniques or the research instruments.

It is a specification used by researcher to guide a research study. This study used descriptive survey design which is a methodical, experimental investigation which cannot be manipulated by the researcher because he does not have direct influence over the independent variable. (Mugenda &Mugenda, 1999). The descriptive survey design optimizes on the strengths of both quantitative and qualitative research methodologies. The survey method allowed collection of data from a large sample population and generate findings that would be a presentation of the whole population at a lower cost (Sekaran, 2003).

3.3 Population of Study

Population can be defined as the overall class of elements or persons of concern that the scholar wishes to base their study on. Mugenda and Mugenda (1999) define target population as an assembly of people to which a scholar wants to derive the study outcomes. The units to analyze are members or elements of the population. The population targeted for this investigation was 106 SMEs which have their base in Roysambu Sub-Location who have received legal business permits as licensed by the Nairobi County Government (NCC, 2015)

3.4 Sample Size

The researcher used Krejcie and Morgan (1970) table (See appendix v) which states that as the total number of elements to be studied increase, the sample size grows at a decreasing rate and remains, ultimately unchanged at a little over three hundred and eighty elements. The sample was consequently 86 respondents.

3.5 Data Collection Method

Mugenda and Mugenda (1999) defines data collection method as a means by which evidence is gathered from the area under discussion in an inquiry. The study adopted the use of a questionnaire as the evidence gathering tool to be used (see appendix iv). The study used secondary sources of data and also the appropriate publications available in the university library. The questionnaires had a set of attitude statements on age, the years of experience in business, and type of business. The suggestion of these questions was described in the study findings. The second part of the questionnaires contained questions related to the study variables which include the cost of credit, sources of finance and profitability of SMEs as a result of credit facilities. The investigator used open as well as closed ended line of questioning. Mugenda and Mugenda (2003) perceive that Open-ended line of questioning allow the respondent to answer them in their own words while on the other hand, closed – ended questions limit respondents with a list of answer choices.

3.6 Validity of Research Instruments

Validity refers to the degree of how sound the research is (Orodho, 2005). It indicates the degree to which a tool measures the constraints being studied (Mugenda and Mugenda, 2003). This study used criterion, content and construct validity. For guarantee of content, the researcher reviewed the questionnaires and confirmed by my supervisor that the data collected represented the content that the test was designed to measure. According to Bordens & Abott (2011), validity is improved through verdict by an expert in constructing the instrument items, simple English language was used to ensure that the respondents will understand. Efforts were made to construct clear and precise items in order to avoid ambiguity. Construct validity was measured by administering a few questionnaires to some respondents and analyzing the results to evaluate whether the questionnaire measures what it is required to measure. Criterion validity was measured by analyzing outcome provided by the data collected using the questionnaires.

3.7 Reliability of the Instruments

Reliability is the extent or level of uniformity with which an instrument assesses a variable (Mugenda & Mugenda, 1999). In order to test the dependability of the tool to be used in the study, the split-half method was used where the investigator randomly divided all items that intend to evaluate the same paradigm into two sets. The researcher administered the entire tool to a chosen number of people and worked out the count for either half. The split-half dependability assessment is basically the relationship between these two counts. The researcher randomly divided the test into two portions using an ordinary-out of the ordinary approach. Each half had the same number of questions as the other. Reliability index was calculated using the Cronbach alpha ($r\alpha$). A dependability of 0.8 and higher is said by many scholars to be okay.

$$r\alpha = \left(\frac{k}{k-1}\right)\left(1 - \frac{\Sigma\alpha j^2}{\alpha^2}\right)$$

where αj = variance of one test item, k represents the total number of test items, Σ is the sum

3.8 Data Analysis and Presentation

Preliminary editing was done where the data will be checked for accuracy and errors committed. Clarity and legibility of all questions will be established and questions with ambiguous responses eliminated. The collected data was examined by use of expressive statistics which consisted of weighted average and percentages. Correlation and regression was used to find out the relationships between the variables. For the unstructured type of questions in the questionnaire, all responses given for each question will be transcribed, compiled and then discussed quantitatively along the main objective areas of the study.

3.8.1 Analytical Model

Linear regression analysis was used as depicted by the below model;

$Y = \alpha + \beta 1X1 + \beta 2X2 + \beta 3X3 + ȩ$

Where Y = SME profitability determined by the return on assets in a certain year.

α= Constant of the regression

$\beta 1$, $\beta 2$, $\beta 3$, $\beta 4$ = Beta Coefficients which analyze how many standard deviations a dependent variable will vary in relation to a standard deviation rise in the independent variables.

X1= Loan Conditions measured by interest rates

X2= Access to Credit measured by the percentage of loans applied and given

X3= Firm Size measured by the Log value of assets

ȩ= Residual or Error term

3.8.2 Test of Significance

The study used R and F-statistic to clearly understand how the different variables in the study connect to each other. To gauge the extent to which the regression model fits the information in this investigation, the researcher employed the use of the goodness of fit statistic. The coefficient of determination calculated was used to examine how close the data is to the fitted regression line. The R test was used to determine the depth and the trend of the connection between variables.

CHAPTER FOUR: DATA ANALYSIS, RESULTS AND DISCUSSION

4.1 Introduction

This chapter depicts the response rate, descriptive statistics and correlation analysis. In addition, the chapter presents regression analysis and a discussion of research findings. The information gathered through questionnaires was scrutinized through STATA software, and data reported using percentages, means, averages, correlation and regression. Qualitative data was analyzed based on content analysis.

4.2 Response Rate

The research assistants targeted eighty-six respondents from Roysambu Sub-Location who are holders of a single business permit for a small and medium enterprise as licensed by the Nairobi County Government.

A total of sixty-seven interviews out of the total sample of eighty-six were successful. Those that were unsuccessful were attributed to various factors including travel to other field sites far away for Business purposes. This makes a 77 % questionnaire return rate. Mugenda and Mugenda (2003) states that a 51% reaction percentage is adequate. Sekaran (2003) suggests 31% as a good percentage reaction for descriptive surveys. Based on these authors, it shows that the reaction percentage rate for this research was adequate for analysis of outcomes.

4.3 Data Validity

The study used content, construct as well as criterion validity. To ensure that the content was valid, the questionnaires were reviewed by research experts to confirm that the data collected represented what the test was supposed to gauge. According to Bordens & Abott (2011), content validity of a tool is enriched by judgment by an expert in constructing the instrument items, simple English language was used to ensure that the respondents understood. Effort was made to construct clear and precise items in order to avoid ambiguity. Construct validity was measured by administering a few questionnaires to some respondents and analyzing the results to evaluate whether the questionnaire measured what

it was required to measure. Criterion validity was measured by analyzing the outcome provided by the data collected using the questionnaires.

4.4 Descriptive Statistics

In order to determine the effect of getting loans on profitability of tiny and medium-sized firms in Roysambu Sub-Location, the study used descriptive statistics to provide a useful summary of set loan conditions, access to credit and firm size of the SMEs using experimental and investigative analysis.

4.4.1: Nature of Business

The respondents were requested to state their nature of business in the questionnaire and the outcomes are as summarized in Table 4.1

Table 4.1: ***Nature of Business***

Nature of Business	Frequency	Percentage	Cumulative Frequency
Retail Shop	9	13.43	13.43
Clothing Store	35	52.24	65.67
Grocery	15	22.39	88.06
Restaurant	8	11.94	100
Total	**67**	**100**	

Source: Research Findings

Majority of the respondents (52%) operated a clothing store as their main source of income, 22% operated a grocery store, 13% of the respondents operated retail shops while 11% of the respondents operated a restaurant.

Further analysis of the mean and standard deviation of the respondents' ages is summed up in table 4.6

Table 4.2: ***Mean type of Business Distribution***

Variable	Observations	Mean	Standard Deviation
Type of Business	67	2.328358	0.8596698

Source: Research Findings

In the questionnaire, those who operated a retail shop were represented by 1, those who operated a grocery were represented by 2, and those who operated a clothing store were represented by 3 while those who operated a restaurant were represented by 4. The mean type of Business was therefore the grocery. The small standard deviation shows the datasets had tightly grouped, precise data.

4.4.2 Type of Business Ownership

The respondents were requested to state their nature of business tenure in the questionnaire and the findings are as summarized in Table 4.1

Table 4.3. ***Nature of Business Ownership***

Business Ownership	Frequency	Percentage	Cumulative Frequency
Sole Proprietorship	41	61.19	61.19
Partnership	26	38.81	100
Total	**67**	**100**	

Source: Research Findings

Majority of the respondents (61%) operated their businesses as sole proprietors while the 39% operated their businesses as partnerships.

4.3 Correlation Analysis

The researcher conducted correlation analysis to find out the association amongst the dependent and each of the independent variables. The assumption is that for every measurement in one variable, there is a corresponding value for the second variable. However, the direction of change will take different forms.

Table 4.4: ***Correlation Analysis***

Variable	Coefficient
Loan Conditions	0.0654
Access to Credit	-0.0512
Firm Size	0.0323

The researcher found a positive correlation (0.0654) or there is a relationship between set loan conditions and profitability of small and medium enterprises. There was a negative correlation or no relationship (-0.051) between access to loans and profitability of SMEs. There is a positive correlation (0.032) between size of the firm and profitability of Small and Medium Firms.

4.6 Regression Analysis and Hypothesis Testing

The researcher used regression analysis to measure the cause and effect association between the dependent and the independent variables. Predictions were also made from the parameter estimates.

Table 4.5: ***Model Summary***

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate	Change Statistics		
					R Square Change	F Change	df 1
1	.865	.057	.631	.0541	.633	1.735	1

Adjusted R squared is coefficient of determination which shows the variation in the dependent variable due to changes in the independent variable, from the findings in the

above table the value of adjusted R squared was 0.631 an indication that there was variation of 63.1% on loan access by SMEs due to changes in banking and Sacco sector policies like loan conditions, need to have collateral, size of the firm. This shows that 63.1 % changes on loans applied for and approved by SMEs could be accounted for by due to changes in interest rate, credit analysis and monitoring of background checks, loan tenure and other factors. R is the correlation coefficient which shows the relationship between the study variables, from the findings shown in the table above there was a strong positive relationship between the study variables as shown by 0.865.

Table 4.6: Coefficients

		Unstandardized Coefficients		Standardized Coefficients	t	Sig
	Model	**B**	**Std. Error**	**Beta**		
1	(Constant)	0.874	0.356		0.459	0.398
	Set Loan Conditions	0.0178	0.126	0.0178	-0.230	0.820
	Access to Credit	-0.0158	0.0156	-0.015	-0.310	0.730
	Firm Size	0.0232	0.0731	0.023	0.280	0.555

For every unit increase in set loan conditions, we expect a 0.017 increase in profitability holding all other variables constant, a standard error of 0.126 and a t-statistic or significant difference from zero of -0.23. The coefficient for loan conditions (0.0178) is not statistically significant at the 0.05 level since its p value (0.820) is greater than 0.05 at 95% level of confidence. For every unit increase of access to credit, we expect a 0.0158 decrease in profitability holding all other variables constant, a standard error of 0.0516 and a t-statistic or significant difference from zero of -0.31. The coefficient for access to credit (-0.015) is not statistically significant at the 0.05 level since its p value (0.730) is greater than 0.05 at 95% level of confidence.

For every unit increase in firm size, we expect a 0.023 increase in profitability holding all other variables constant, a standard error of 0.0731 and a t-statistic or significant difference

from zero of 0.28. The coefficient for firm size (0.023) is not statistically significant at the 0.05 level since its p value (0.555) is greater than 0.05 at 95% level of confidence.

Table 4.7: Anova Results

Model		Sum of Squares	Df	Mean Square	F	Sig.
	Regression	.002	1	.001	.001	.08
	Residual	.000	1300	.000		
	Total	.002	1301			

The significance value (0.08) was more than 0.05 which means that the model is not statistically significant in predicting how access to credit influences the profitability of small and medium enterprises. The F critical at 5% level of significance was 0.001. Since F calculated (.001) is less than the F critical (0.002) this shows that the overall model was not significant.

4.6.1 Linear Regression Analysis

The Linear regression analysis used was depicted by the below model;

$Y= \alpha+\beta 1X1+ \beta 2X2+ \beta 3X3 + ę$

Where Y = SME profitability as measured by the return on assets in a certain year.

α= Constant of the regression

β1, β2, β3, β4 = Beta Coefficients which measure standard deviations change

X1= Loan Conditions measured by interest rates

X2= Access to Credit measured by the percentage of loans applied and given

X3= Firm Size measured by the Log value of assets

ę= Residual or Error term

The regression from the research outcomes is shown below

$Y= 0.874 + 0.0178 (X1) - 0.0158 (X2) + 0.0232 (X3)$

4.7 Discussion of Research Findings

The main objective of the research was to find out the effects of getting loans on profitability of small and medium firms in Roysambu sub location, Nairobi County. Correlation analysis was conducted to find out the association between variables. The assumption was that for every measurement in one variable, there is a corresponding value for the second variable. However, the direction of change will take different form. The researcher found a positive correlation or a relationship (0.0654) between set loan conditions and profitability of small and medium firms. This is mainly because tiny firms seeking smaller loans face greater administrative costs and greater risk payments since they are not solid enough and have far less security to offer. Mazanai and Fatoki (2012) also confirm that tiny enterprises have to come across bigger obstacles to their lending and expansion.

It is also due to the fact that handling of SME lending takes a lot of time and money. The cost of appraising a loan application or conducting background checks on a client in view of a possible loan agreement is largely parallel from the size of the loan amount applied for. In this case, administrative, legal fees as well as costs related to the attainment of material evidence such as the conducting background checks from a credit reference bureau are fixed costs. Where smaller loans and investments are required, it is more challenging to recover these costs including what lenders must incur after payment, especially when conducting field visits, or attending company forums. For every unit increase in set loan conditions, we expect a 0.017 increase in profitability holding all other variables constant. There was a negative correlation or no relationship (-0.051) between access to credit measured by the percentage of loans applied and given with profitability of tiny and medium firms. This is mainly due to SMEs are usually not well prepared in terms of both human and capital resources to withstand monetary difficulties. Indeed, due to susceptibility and huge turnover, SMEs are usually more risky debtors than large enterprises. In countries, which are developed there is also an added problem of a more unstable operating environment including economic instability, which has a negative effect on the chances of fraud happening. For every unit increase of access to credit, we expect a 0.0158 decrease in profitability holding all other variables constant

The researcher found a positive correlation (0.032) or a relationship between size of the firm measured by the total value of all the assets and profitability. Most small firms usually have small numbers of assets in order to avoid extra expenses that come up from having fixed assets such as depreciation, warehousing, insurance and or when assets become obsolete which the investors are not able to cover from the profits that the business realizes. The businesses are able to realize comparatively high return on investment from managing their expenses and therefore will want nothing to do with anything that makes the costs to go up. Every time an enterprise has a lower number of fixed asset, its risks are determined by the return on investment and if is not favorable, this affects its profitability and growth. For every component rise in firm size, we expect a 0.023 increase in profitability holding all other variables constant.

CHAPTER FIVE: SUMMARY OF FINDINGS, CONCLUSION AND RECOMMENDATIONS

5.1 Introduction

Chapter five specifies discussions, conclusions, summary of findings as well as offers suggestions and counsel to the challenges that have been brought forth by this study. In addition, the study suggests areas of further research. The literature reviewed was utilized in making conclusions of this study. The investigation intentions were used to guide the collection of required data from the respondents.

5.2 Summary of Findings

The investigation assessed the influence of credit on profitability of small and medium firms in Roysambu sub-location, Nairobi County. This was done by measuring the effect of set loan conditions on profitability of SMEs, the effect of access to loan funds on the profitability of SMEs and the influence of firm size on profitability of SMEs.

All the respondents of the study were people who are holders of a single business permit as licensed by the Nairobi County Government. Majority of the respondents (52%) operated a clothing store as their main source of income, 22% operated a grocery store, 13% of the respondents operated retail shops while 11% of the respondents operated a restaurant.

The three independent variables represented by Loan Conditions which was measured by interest rates, access to credit which was measured by the percentage of loans applied and given and the Size of the Firm assessed by the total value of assets were each compared to the dependent variable which was profitability of SMEs. The researcher found a relationship between loan conditions and the profitability of an SME. The researcher found out that improving loaning stipulations and provisions in favor of tiny and medium firms would be a good way for encouraging their access to loans and thereby making the businesses profitable.

However, there was no relationship between the percentage of loans applied and given with the profitability of an SME. The study revealed that various factors are considered in SME credit appraisal process before loan approval is granted including level of risk, financial conduct/record, adequacy of collateral, purpose of loan and ability to repay. The researcher found out that banks perceived SMEs as inherently risky with inadequate collateral and lack of information about them as the main challenges while engaging with them.

Lastly, the researcher found a relationship between the size of the firm assessed by the total value of assets in relation to the profitability of an SME. Large companies have the ability to set up adequate policies and to employ qualified staff to ensure success in maintaining optimal liquidity positions. Due to the fact that having both tiny and medium enterprises is important for marketplace rivalry and struggle as well as for monetary growth and in order to ensure marketplace differences, enterprises must be able to access loans and funding. Enterprises that are usually most affected by the economic markets fluctuations are tiny enterprises, as their business knowledge is not out in the public like the one for large enterprises.

5.3 Conclusion

The risks in loaning to the small enterprises segment induces lenders to charge high percentages of interest on the loans granted to this sector. The researcher found out that most problems related to loans, mostly in banks and Saccos, are brought about by the institutions mainly through their loaning principles. This is well shown in the policy where there are maximum and minimum amounts of loans that a client can apply for. SMEs do not usually have adequate collateral to provide to mainstream banking institutions to enable them access credit. The SME operators are in need of credit and do not consider the interest rates. It also shows that borrowers are in need of credit facilities and do not consider the interest charged which explains the high demand of credit. That the number of applicants influences the rate of accessibility.

Formal finance institutions lending to small enterprises still faces huge hindrances as many of SMEs are not able to secure loans. Information gaps between the loanee and the person

receiving the loan still exists as well as usurious interest rates. This investigation shows that creditors only take out small loans from formal financial institutions due to the strict eligibility criteria set by lending institutions as well as the fact that they fear that they might not be able to repay huge loans due to cash flow problems and tough economic times. Small amounts of monies from loans cannot have a huge influence on business growth and expansion.

5.4 Recommendations

The investigation advocates that SMEs should come up with a mechanism of sharing their experiences and information to reduce duplication of products. SMEs should also invest a lot in research to understand the clients and their needs and strive to continuously improve their structures, practices and processes to ensure effectiveness in assistance delivery since the investigation has shown that the sum of loan applicants, management and organizational processes affects the rate of accessibility. Banks should consider reducing the interest rate charged, irrespective of the inherent risk associated with lending to SMEs. The study further recommends proper training of the SME staff and frequent monitoring of the SME Loans. SMEs should also be trained on business management and financial skills.

5.5 Limitations of the Study

This investigation was limited through lack of adequate information as SMEs level of information disclosure differed where some of the SMEs did not disclose all the information on access to credit.

The study area was also vast and required a significant amount of time and funds to traverse and spend during Data Collection some of which the study had no control over. The researcher contracted a research assistant to ensure that the targeted population was reached. Some of the respondents could also not be reached due to other business engagements in other areas.

5.6 Suggestions for Further Research

Due to the fact that this investigation looked at the effect of access to credit on profitability of SMEs in Roysambu sub-location of Nairobi County, similar studies should be conducted in other areas of the country. They can be done in other counties as well as other countries with the same issues in the SME sector. Other areas that should be explored include the state factors that influence accessibility of credit, factors that influence loan default in microfinance institutions. The researcher also proposes studies on the influence of group model on accessibility of loans in microfinance institutions, challenges facing microfinance institutions as well as the contribution of microfinance on gender development.

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APPENDICES

APPENDIX I

Transmittal Letter

UNIVERSITY OF NAIROBI,

DEPARTMENT OF FINANCE AND ACCOUNTING,

P.O BOX

NAIROBI.

Dear Sir/Madam,

RE: Request to fill in the attached Questionnaire

I am Diana Koskey, an MBA Finance student of the University of Nairobi registration number D61/71185/2014**.** I am carrying out a study to investigate the outcomes of access to credit on profitability of Small and Medium Firms in Roysambu Location, Nairobi County.

To facilitate this exercise, you've been randomly selected as a respondent in this research.

You are kindly requested to participate in answering the questionnaire. Please be assured that any information obtained will be handled with utmost privacy and will only be used for the sake of this investigation.

Thank you.

Yours faithfully,

Diana Koskey

Appendix II

Questionnaire

Name of SME ____

Section A: Background Information

1. What is the nature of the business you are involved in?
   a) Retail shop
   b) Grocery
   c) Clothing store
   d) Restaurant

   Other specify

2. What is the nature of your business ownership?
   a) Sole Proprietorship
   b) Co-Owned (partnership)
   c) Clothing store
   d) Restaurant

3. How long have you been in the business?

1-5 year ( ) 6-10year ( ) 11-15years ( ) 16-20years ( ) More than 20years( )

4. What is the approximate total value of assets in your venture?
   a) Lesser amount than ten thousand Kenya shillings
   b) Between ten thousand and fifty thousand Kenya shillings
   c) Between fifty thousand to one hundred thousand Kenya shillings
   d) Between one hundred thousand to five hundred thousand Kenya shillings

5. Approximately what sum total of workers are in your firm?
   a) Fewer than ten
   b) Between ten and twenty
   c) Between twenty and fifty
   d) More than fifty

SECTION B

Access to Credit

1. Have you been advanced credit financing for your firm before? ……………….

   If no, please explain why……………………………………………………….

2. What percentage of your business is financed by a bank loan?
   a) Up to twenty percent
   b) Between twenty-one and forty percent
   c) Between forty-one and sixty percent
   d) Over sixty percent
3. What was the purpose for the loan?
   a) Business expansion
   b) Equipment purchase
   c) Working capital
   d) Other purpose
4. At what interest rate, did you take loan for your business?
   a) Less than ten percent
   b) Between eleven and fifteen percent
   c) Between sixteen and twenty percent
   d) Above twenty one percent
   e) I don't know
5. How did the interest rate on your loan impact your business?

   ………………………………………………………………………………………
   ………………………………………………………………………………………
   ………………
6. If not a loan, what available financing option did you use to purchase equipment your business operation?
   a) Cash
   b) Leasing
   c) Hire-purchase

Sources of Finance

7. Apart from borrowing from Banks and Microfinance Institutions, what other sources of finance do you use to start or expand the enterprise?
   a) Savings
   b) Friends/Family
   c) Asset Finance
8. What percentage of capital were you able to raise through savings, family/friends and asset finance to start your business?
   a) Below 50%
   b) Over 50%
9. How much money do you save for business expansion per year?
   a) Up to twenty thousand Kenya shillings
   b) Between twenty-one and thirty thousand Kenya shillings

c) Between thirty-one and forty thousand Kenya shillings
d) Between forty-one and fifty thousand Kenya shillings
e) Over fifty thousand Kenya shillings

Profitability

10. Since establishing your business, have you reached the break-even point or made profits?
    a) Yes b) No
11. Did the bank loan have an impact on the profitability of your business?
    a) Yes b) No

Thank you for your cooperation

Appendix III

Sample size, given a finite population

N-----n	N-----n	N-----n	N-----n	N-----n
10-----10	100-----80	280-----162	800-----260	2800-----338
15-----14	110-----86	290-----165	850-----265	3000-----341
20-----19	120-----92	300-----169	900-----269	3500-----346
25-----24	130-----97	320-----175	950-----274	4000-----351
30-----28	140-----103	340-----181	1000-----278	4500-----354
35-----32	150-----108	360-----186	1100-----285	5000-----357
40-----36	160-----113	380-----191	1200-----291	6000-----361
45-----40	170-----118	400-----196	1300-----297	7000-----364
50-----44	180-----123	420-----201	1400-----302	8000-----367
55-----48	190-----127	440-----205	1500-----306	9000-----368
60-----52	200-----132	460-----210	1600-----310	10000-----370
65-----56	210-----136	480-----214	1700-----313	15000-----375
70-----59	220-----140	500-----217	1800-----317	20000-----377
75-----63	230-----144	550-----226	1900-----320	30000-----379
80-----66	240-----148	600-----234	2000-----322	40000-----380
85-----70	250-----152	650-----242	2200-----327	50000-----381
90-----73	260-----155	700-----248	2400-----331	75000-----382
95-----76	270-----159	750-----254	2600-----335	100000-----384

Source: Krejcie and Morgan (1970:608)

Where N= Population size, and n= sample size required.