

**EFFECT OF EQUITY FINANCING ON PROFITABILITY OF DEPOSIT
TAKING MICROFINANCE BANKS IN KENYA**

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DECLARATION

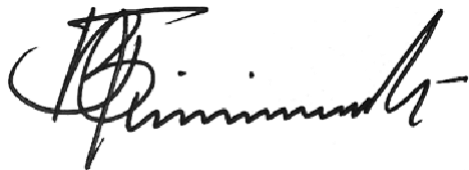
This research project is my work and has not been presented for a degree or in any other institution of higher learning.

Signed *Jck*

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



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DEDICATION

I dedicate this project to my family.

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LIST OF ABBREVIATIONS

CBK	Central Bank of Kenya
CS	Common Stock
DSE	Dar es Salaam Stock Exchange
EPS	Earnings Per Share
KES	Kenya Shillings
MFB	Microfinance Bank
MTBR	market to book ratio
NPLs	Non-Performing Loans
OLS	Ordinary Least Squares
PAT	Profit After Tax
PBT	Profit Before Tax
REN	Retained Earnings
ROCE	Return on Capital Employed
ROE	Return on Equity
SMEs	Small and Medium Enterprises
SPSS	Statistical Package for Social Sciences
TE	Total Equity
TETAs	Total Equity to Total Assets

ABSTRACT

This study sought to establish the effect of equity financing on profitability of deposit taking microfinance banks in Kenya. It was based on correlational research design. This study targeted 14 deposit taking microfinance banks in Kenya between 2018 and 2022. This study adopted the use of secondary data collected from the bank supervision reports downloaded from the CBK website. The data was collected using a data collection sheet. The data from the field was analysed using descriptive and regression statistics. This study diagnosed the analytical model through normality, heteroscedasticity, and Multicollinearity tests. The researcher tested the significance of the model using F-statistics generated through ANOVA. From the descriptive statistics, profitability in terms of return on equity showed a mean of -26.38% between 2018 and 2022. On the other hand, equity financing averaged at 15.10%, Firm size averaged at a log of 20.90; asset quality average NPL ratio was 77.88% while capital adequacy had a mean of 32.97%. The model summary showed a strong relationship existed between predictors (equity financing, size of firm, asset quality and capital adequacy) and profitability. The R square value was 0.551. The study concluded that equity financing has a negative effect on profitability of deposit taking microfinance banks in Kenya. It also concluded that firm size in terms of assets and asset quality in terms of NPL ratio has a positive effect on the profitability of deposit taking microfinance banks in Kenya. On the other hand, a conclusion was made that capital adequacy has a negative effect on the profitability of deposit taking microfinance banks in Kenya. The study recommended that management of deposit taking microfinance banks in Kenya reduce their equity financing in the capital structure. It was also recommended that the management purchase more assets and increase the loan loss provision ratio for increased profitability. The study further recommended a reduction in the core capital for increased income levels, hence, increased profits. Future studies are recommended based on other factors influencing profitability, other measures of variables, different periods, quarterly/semi-annual data, and primary data.

CHAPTER ONE: INTRODUCTION

1.1 Background of the Study

In the finance literature, equity financing is critical in the capital structure of a firm. This is based on its contribution to the profitability of a firm. Equity financing contributes to the profits in a firm by lowering the costs associated with interest from debt financing (Risfandy, 2018). With equity financing, there is no loan to repay. The firm doesn't have to make a monthly loan payment which in turn, gives the company autonomy to channel more fund into business development (Begenau & Salomao, 2019). This leads to increased profits as the expenses reduce as revenues rise.

This study will be based on pecking order theory by Myers and Majluf (1984) and Trade-off theory by Kraus and Litzenberger (1973). The pecking order theory states that firms favor internal funds to fund their investments prior to adopting debt or equity financing. This will guide the researcher into understanding how the equity financing is adopted and its influences to profitability. The tradeoff theory states that a company chooses the amount of debt and equity finance to adopt by getting a balance around costing and profits.

Deposit Microfinance banks in Kenya contributes greatly to the economy of the country. They play an important role in supplementing financing by commercial banks. There is need for an assessment of deposit taking microfinance bank's profitability in respect to equity financing that would ensure that the firms have sufficient internal funding (Waddock & Graves, 2017). The CBK requires the banks to have minimum capital levels to achieve this, which goes hand in hand with guaranteeing financial sector stability. Microfinance banks have had a tough time improving their profitability. Failure by the deposit taking microfinance banks to employ adequate equity balance in their routine operations could be the cause, and if this issue is not resolved, it could lead to financial crisis and business failure (Kaua, 2021).

1.1.1 Equity Financing

Aside from loans, equity financing is an essential element of the company's capital structure (Michalkova, Stehel, Nica & Durana, 2021). Organisations are increasingly recognising and using equity to finance investments due to the comparatively minimal degree of risk associated with equity financing as compared to debt financing. The money that a business generates by selling stockholders portions of its shares is referred to as equity financing. A business which issues new stock is effectively selling stockholders control in the business when they buy the shares. In contrast to the usage of debts in capital structure. Bloom, Sadun, and Van Reenen (2015) understand equity financing as the money generated via an IPO.

Businesses may need to seek money for a long-term initiative that fosters growth, or else they may require it for immediate bill payments (Belo, Lin & Yang, 2019). An organisation can essentially sell its stake in the organisation for cash by transferring shares. A single advantage of equity financing for a company is the reality that the funds obtained are not subject to repayment (Godke Veiga & McCahery, 2019). If the company fails, funds raised aren't returned to shareholders. Equity financing is measured through shareholder's capital, retained earnings, crowd funding, and ploughed back profits (Begenau & Salomao, 2019). This study will measure equity financing in terms of the total shareholder's capital.

1.1.2 Profitability

Profitability relates to the amount of money a company makes from its assets (Reschiwati, Syahdina & Handayani, 2020). On the other hand, Osterwalder, Pigneur, Smith and Etiemble (2020) indicate profitability to be organizational capacity to create returns from the core business. However, Xu, Hu and Das (2019) defined it as a measure of an organization's profit relative to its expenses. For Forero-Quintero et al. (2022) profitability is a term that relates to a company's propensity to make money.

Profit is an essential outcome of running a firm (Cappa et al, 2019). Profits serve as a stopgap for banking institutions to deduct losses on loans as well as a means of funding for capital rebuild in case a banking institution suffer significant losses. Additionally, they enable bankers to draw in outside funding (Barney, 2018). Organizations can hope to thrive in the future if they make good profits (Edmans, 2023). Banks create money when they gain or raise more income than they spend on costs. Profitability is also required for a bank to continue operating and for its investors to get reasonable returns (Yao, Haris & Tariq, 2018). Profitability is usually measured through profitability ratios. According to Jihadi et al. (2021) profitability is measured through Profit Before Tax (PBT), Profit After Tax (PAT) in addition to the return on assets and equity. Skorburg and Shenai (2021) measured profitability through Earnings Per Share (EPS), return on equity (ROE) and market to book ratio (MTBR). Alshebmi et al (2020) measured profitability in terms of return on assets, return on equity, return on invested capital and Net profit margin. This study measured profitability as return on equity ratio.

1.1.3 Equity Financing and Profitability

Equity Financing plays a key role in firm profitability. Dang (2019) claimed that the higher the equity ratio banks have, the fewer risks banks take; hence, the profit would lower. According to business research, equity financing is the most expensive way to raise money. The management team of a company decides to issue equity when there are no other options for raising capital or when the shares are overpriced and the advantages of doing so exceed the drawbacks (Baik, Berfeld & Verdi, 2022).

Bhandari (2020) is among researchers who support positive results when analyzing equity financing' effect on Nepalese commercial banks' profit. Other researchers who found a positive connection around equity financing and profitability (Do & Vu, 2019; & Huynh, 2019). However, Mutie, Muturi and Njeru (2019) found that equity financing had statistically negative influence on profitability in terms of ROCE and ROE. Hasnaoui and Fatnassi (2019) found that

firms with high equity financing levels experience low profitability levels. Barth et al. (2018) concluded that equity financing and profitability did not have a significant relationship.

1.1.4 Deposit Taking Microfinance Banks in Kenya

According to Central Bank of Kenya, there are 14 registered deposit taking microfinance banks. The sector has experienced increased number of firms adopting equity financing in their capital structure. This has been shown by the increased number of microfinance banks selling their shares in the last five years with the recent being Maisha Microfinance Bank Limited (Maisha MFB) which sold 55.8 percent shares to Cactus Cantina Investments Limited in May 2023.

These banks have also shown profitability challenges in the last five years. This has been reflected in the increased number of microfinance banks making losses and consistent losses within the sector. Of the 14 microfinance banks listed by CBK in December 2021, only four of them made declining profits in the year with others making losses. The sector reported a total pre-tax loss of KES 980 million in 2022 compared to KES 877 million in 2021. This shows that the sector experiences an increase in losses.

1.2 Research Problem

Equity financing has proven to be a key factor influencing profitability among firms. This has been accrued to the savings on the financial risks and tax implications that come with debt. Firms that adopt increased equity financing also have a high level of capital available to the business for investment. This in turn leads to increased returns hence enjoy high levels of profitability. The Kenyan deposit taking microfinance sector has experienced increased equity financing in the recent years. For instance, more than 50% of the microfinance banks have sold their stake to both international and local investors in the last five years. The most recent bank to sell its stake was Maisha Microfinance Bank Limited (Maisha MFB) which sold 55.8 percent

shareholding to Cactus Cantina Investments Limited (Cactus Cantina) in May 2023. On the other hand, the sub-sector has shown profitability issues in recent years. According to Central Bank of Kenya Supervision report (2022), microfinance banks (MFBs) reported a total pre-tax loss of KES 980 million. This represents an increase from the loss of KES 877 million recorded in 2021.

Empirically, studies have shown that equity financing influences profitability in different ways. Some have found that equity financing positively influences profitability with others indicate a negative effect. For example, Singh and Bagga (2019) did an empirical study on the effect of capital structure on profitability with equity financing displaying positive effect on profitability of firms. On the other hand, Risfandy (2018) in their study on equity financing and Islamic banks' profitability found that equity financing displayed a negative bearing on profitability. In Kenya, Yator and Gitagia (2023) studied equity financing and financial performances of manufacturing firms listed at NSE; while Kinyua (2022) did a critical literature review on the effect of short-term debt on profitability of microfinance institutions. Nevertheless, Kibunja and Fatoki (2020) studied effect of debt financing on financial performances of listed non-financial firms; Muturi and Njeru (2019) studied equity finance and financial performance of SMEs; while Achieng, Muturi and Wanjare (2018) studied the effect of equity financing options on financial performance of non-financial firms listed at the NSE.

The studies done in Kenya have shown research gaps that call for a study on the effect of equity financing on profitability of deposit taking microfinance banks in Kenya. For example, studies have focused on different concepts other than equity financing and profitability. Kinyua (2022) adopted short-term debt while Kibunja and Fatoki (2020) adopted debt financing as independent while Muturi and Njeru (2019); and Achieng, Muturi and Wanjare (2018) involved financial performances as the dependent. Further, they were done in different contexts other than profitability. For example, Yator and Gitagia (2023) involved manufacturing firms;

Kibunja and Fatoki (2020) involved non-financial firms, while Muturi and Njeru (2019) focused on SMEs in Kenya. The studies adopted different methodologies in their research. The question is what is the effect of equity financing on profitability of deposit taking microfinance banks in Kenya?

1.3 Research Objective

The study sought to establish the effect of equity financing on profitability of deposit taking microfinance banks in Kenya.

1.4 Value of the Study

This study will be of value based on its contribution to theory, practice and policy. This study contributes to theory through the provision of literature which can be used to advance theories or refute their assumptions. The academicians and researchers may benefit from the contribution of this study to theory. Literature on equity financing and profitability would enable the academicians handle with ease. This is because the study would provide answers to their academic assignments. Other researchers may exploit the research gaps existing in the study. This would help them undertake further research on the topic of equity financing and firm profitability.

This study may also create value in its contribution to practice. The understanding on the way equity financing influence firm profitability would provide recommendations and basis for strategy development by the management of deposit taking microfinance banks and other institutions. The management of the deposit taking microfinance banks may adopt the recommendations given in this research in their urge to improve their profitability through equity financing. The understanding how equity financing influence firm profitability would enable the management to come up with relevant strategies that would enhance profitability.

The study would also create value by contributing to policy. The contribution would be through creation of an understanding among policy makers on how the profitability deposit taking microfinance banks in Kenya is influenced by equity financing. This study, hence, would create a basis for policy making in the attempt to enhance their profitability through manipulation of their equity financing.

CHAPTER TWO: LITERATURE REVIEW

2.1 Introduction

This chapter presents the empirical works as well as the theories relating to equity financing and profitability of firms. The chapter also presents the conceptualization of the variables as well as the research gaps that exist in the empirical literature.

2.2 Theoretical Foundation

This section presents the theoretical basis on which this paper is based. The section describes the theories, their assumptions, the criticisms as well as the relevance of the theories relating to equity financing and profitability. This study is based on pecking order as well as tradeoff theory.

2.2.1 Pecking Order Theory

Myers and Majluf's pecking order theory served as the research's foundation (1984). According to the theory, businesses would sooner employ internal money than debt or equity financing for funding investments. The idea states that organizations possess a ranking of funding options, with retained earnings constituting the most favoured sources, subsequent to debt, and equity. According to the hypothesis, businesses will initially go for the least costly means of financing and just switch to costlier ones after the cheapest options run out. According to the hypothesis, companies with a great deal of uncertainty or low profitability are going to select debt financing more than they will equity financing, whereas companies with a high profit margin tend to favour borrowing.

The Pecking Order Theory, which maintains that companies first choose to use internal sources (equity financing) rather than arranging additional debt, was pertinent to this investigation. The Pecking Order Theory states that internal funds are most secure because they are inexpensive

ways to obtain funding and do not face adverse selection issues. Thus, the theory contributes to the understanding of how equity financing affects profitability.

2.2.2 Trade Off Theory

In 1973, Kraus and Litzenberger developed trade-off theory. It is predicated on the idea that the ideal capital structure exists and is established by balancing the costs of debt and tax savings while taking other constant factors into account. Businesses replace debt with equity and equity with debt till they maximize the company's values. In his contribution, Myers (2001) pointed out that a business will borrow money up to a level wherein the rise in the current value of potential bankruptcy expenses offsets the marginal value of tax shielding on extra debt. The conflict between the tax deductions of financing charges and the costs associated with being in debt is explained by trade-off theory.

The theory applied to the investigation because it suggests that the focus on equity financing for deposit taking banking institutions is contingent upon shifts in costs and benefits over the years. Therefore, trade-off theory of capital structure anticipates that businesses will select optimal equity and debt funding mix to equalise the advantages and disadvantages of debt. Whereas financial losses and additional agency issues incentivize corporations to utilize a smaller amount of financing, the tax benefits of debt and difficulty with controlling free cash flows encourage them to utilize it even more. Equity financing may reduce financial risk, as there are no interest payments and debt obligations. Lower financial risk could positively impact profitability by reducing the burden of debt service.

2.3 Determinants of Profitability

This section discussed the determinants of profitability among deposit taking microfinance banks. They included equity financing, size of firm, asset quality and capital adequacy.

2.3.1 Equity Financing

Equity financing plays a key role in the profitability of banking institutions. Firms with a high level of equity financing saves on the cost of debt in terms of interest charged on loans. This in turn enhances the profitability of the firms. Empirically, equity financing positively influences profitability positively or negatively. Singh and Bagga (2019) on their study on the effect of capital structure on profitability found a positive effect. On the other hand, Risfandy (2018) in their study on equity financing and Islamic banks' profitability found that equity financing possessed a negative effect on banks' profitability.

2.3.2 Size of Firm

Within business context, the size of a company is described in light of its market share, amount of assets, and client base. Size of the company is also based on factors including total sales, profits, client network, number of businesses, employees, and earnings per employee. Overall revenue and natural logarithm of total assets are other measurements. Natural logarithm of assets will be used to gauge the success of this research. Firm size and profitability are positively related (Hirdinis, 2019; Zuhroh, 2019). The association between company size and profitability was also found to be unfavourable (D'Amato & Falivena, 2020).

2.3.3 Asset Quality

The overall rating of an investment represents the risk of lending associated with the whole loan and stock portfolios, further investments, extraneous operations, along with additional considerations. Asset quality assesses the relative volatility of each asset in an investment portfolio. Asset quality is a component that affects a financial institution's profits. The sensitivity of a financial institution to specific risks, changes in NPL levels, and overall borrowing all contribute towards its asset quality (Baral, 2005).

It's measured in terms of NPLs in relation to total gross loans and total assets. However, Hamdillah, Purwanto and Ermawati (2021) argues that asset quality positively influences profitability of firms. Zhao and Han (2020) found that negative relationship exists between asset quality and profitability.

2.3.4 Capital Adequacy

Capital adequacy shows how effectively and efficiently banks can measure and mitigate risk (Almazari & Alamri, 2017). According to Musyoka (2017), sufficient capital is the quantity that insulates banking institutions against unexpected economic events by covering loss in the unlikely circumstance that they should arise. Adequate capital adequacy, according to Fatima (2014), ensures that a bank has enough capital to expand its operations and that its total assets are large enough to protect it from bankruptcy amid economic downturns.

Capital adequacy can be measured in a variety of approaches. Different parameters were utilized for measurement. It is measured in terms of core capital in relation to weighted assets (Otwani et al., 2017). As per Fatima (2014), CAR is the quantity of capital within a banking institution related to assets that are weighted to risk. This study will use core capital/ total weighted assets as the measure of capital adequacy. Empirically, Ichsan et. al (2021) found that capital adequacy had a positive effect on profitability. However, Thiongo and Kiama (2018) found a negative connection around capital adequacy and profitability. However, Irawati, Maksum, Sadalia and Muda (2019) established that an insignificant link existed around capital adequacy and profitability.

2.4 Empirical Review

This section reviews studies relating to equity financing and profitability. The studies are reviewed from the international, regional and local perspectives. Habibniya et al. (2022) examined how capital structure affects profitability using survey information from the US

telecom sector. Pooled panels regression modeling was used to analyse imbalanced panels data, which included 421 firm-year values for 72 firms, based on yearly telecom sector information collected in the USA through 2012 to 2020. The results revealed that the ratio of total equity to total assets (TETAs) ratio had a positive impact on ROA but no impact on ROE.

The financial performance of Nigerian listed deposit money institutions and equity financing were examined by Suleiman, Popoola, and Yahaya (2022). The 14 selected deposit money banks' audited annual statements from 2009 to 2018 provided the research's data for a ten-year period. Robust ordinary least square regression was utilised in the investigation to analyse and assess hypotheses. The outcome shows that whilst retained earnings had a positive and considerable impact on return on assets, share capital exhibits a positive but negligible impact.

A research investigation on the impact of debt- and equity-based financing on profitability of Islamic banking institutions in Indonesia was conducted by Wahyudi, Diniyya, Satyarini, and Maulida (2020). The survey populations from 14 Sharia banks were utilised in the present research. Samples were collected between 2008 and 2017. A panel regression technique was used to analyse the data. In addition, estimations were performed for the panel data model. The research's results indicated that ROE was only little impacted by equity-based financing. The return on equity (ROE) of Islamic banking institutions was also impacted by debt-based funding. Debt- and equity-based financing displayed an insignificant impact on Islamic banks' return on assets (ROA).

An investigation on the impact of capital structure on the profitability of processing companies quoted on Tanzania's Dar es Salaam Stock Exchange was conducted by Mujwahuzi and Mbogo in 2020. The investigation used secondary data gathered from reports that appeared on the DSE webpage for 10 years, from 2009 to 2018. The Correlation and the OLS regression models were used to ascertain the association involving capital structure and firm profitability. The capital structure was found to have a negligible and statistically meaningless impact on

indicators of firm profitability. It was discovered that there was little to no correlation across the equity ratio and all of the profitability metrics employed in this investigation.

A research study on the impact of capital structure on profitability of fifty companies quoted at National Stock Exchange of India between 2008 and 2017 was conducted by Singh and Bagga (2019). Panel data regression model, correlation and descriptive were adopted. The link across capital structure and profitability has been examined using four distinct models of regression. Researchers examine the separate effects of total debt and total equity ratios on profitability. The study discovered that equity financing increased businesses' profitability.

However, Risfandy (2018) investigated the profitability of Islamic banks and equity financing. From 2009 to 2014, a sample of nine Indonesian Islamic banks were employed in the study. It's intriguing that the investigation discovered a substantial correlation between poorer Islamic banks' profitability and a larger percentage of equity funding. Large Islamic banks, nevertheless, saw a decrease in this negative association, suggesting that small banks were more affected negatively by equity financing in terms of their profitability than large banks.

The impact of equity financing on the financial performance of industrial companies listed on the NSE was examined by Yator and Gitagia (2023). To investigate its predetermined goals, the study employed a descriptive research approach. Manufacturing companies that were listed on the Nairobi Securities Exchange served as the observation units. Seven (7) manufacturing companies registered on the Nairobi Securities Exchange were the subject of the investigation. Secondary information were gathered for the purpose of the research. Standard deviations were employed for descriptive analysis, panel regression and correlation analysis were employed for inferential analysis. Results indicated a substantial influence of equity financing on financial performance.

A critical evaluation of the literature on the impact of short-term loans on deposit-taking microfinance firms' profitability was conducted by Kinyua (2022). The investigation employed a desk-based review technique, examining pertinent empirical studies to determine major themes and pinpoint areas of knowledge deficiency. According to the research, the profitability of deposit-taking microfinance was positively and significantly correlated with short-term debt.

Over the course of five years, from 2013 to 2017, Kibunja and Fatoki (2020) investigated the impact of debt financing on financial performance of Kenyan listed non-financial enterprises. Data from publicised financial documents of the selected organisations was gathered using a sample of 23 listed non-financial companies, and the panel data regression approach was used for statistical analysis. The study's findings showed that while short-term debt had an inverse association with ROE, long-term debt had a positive but statistically insignificant effect.

The impact of equity financing on financial performances of SMEs in Kenya was examined by Muturi and Njeru in 2019. 291,449 licenced SMEs in the counties chosen by operational wholesale and retail trade was the research's target population. Simple random methods were employed to gather the research's sample. The sample consisted of 384 participants who were chosen from six specific counties: Nairobi County, Mombasa County, Machakos County, Makueni County, Kajiado County, and Kitui County. Mixed data were beneficial. Data was gathered using standardised questionnaire. Statistical Package for Social Sciences (SPSS) was assumed in this research in analyzing quantitative data. Data was analysed utilising correlation and regression analyses. The data was examined. Both descriptive and inferential statistics were used to analyse the data. The results showed that the financial performance of Kenyan SMEs and equity funding had a highly significant connection.

Over 2009 and 2015, Achieng, Muturi and Wanjare (2018) investigated the impact of equity financing alternatives on financial performance of forty non-financial companies listed on NSE. The empirical findings of the investigation demonstrate that whilst REN ratio had

statistically significant and favourable effect on ROA, CS ratio considerably and negatively affects ROA. In general, ROA is positively and considerably impacted by the TE ratio. Conversely, the study's equity variables have no discernible impact on ROE.

2.5 Conceptual Framework

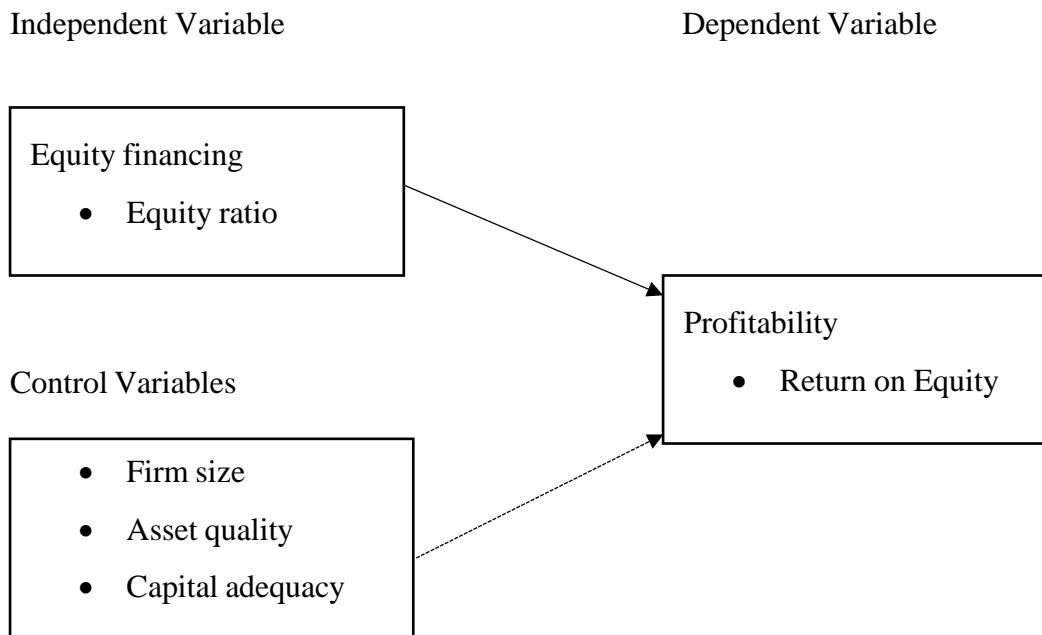


Figure 2.1: Conceptual Framework

2.6 Summary of Literature

The theoretical literature reread in this study showed that equity financing influences the profitability of firms. The empirical literature, however, showed mixed results where some studies showed significant relationship while other studies showed insignificant relationships. The studies done in Kenya had shown research gaps which this study sought to fill. They include conceptual gaps where then studies had looked at other concepts other than equity financing and profitability. Further, some studies had based their analysis on other firms other than deposit taking MFBs, Methodologically, gaps exist where different research methods were adopted.

CHAPTER THREE: RESEARCH METHODOLOGY

3.1 Introduction

This chapter outlined the methods used by researcher in undertaking the study. This included description of research design, population and data collection and analysis techniques.

3.2 Research Design

This investigation adopted correlational research design. Correlational research was adopted in establishing how variables relate with another. Correlational research was preferred in establishing a cause-effect relationship between variables (Seeram, 2019). This design fitted this study in that it guided the research in establishing how equity financing affected profitability of deposit taking microfinance banks due to its capability to establish the cause-effect relationship.

3.3 Population

This study targeted deposit taking microfinance banks in Kenya. The period was between 2018 and 2022. The period was preferred as the sector saw increased losses. The period also provided most recent data to keep the study updated. According to central bank (2022), there are 14 deposit taking microfinance banks in Kenya. The sector was preferred as it has been experiencing an increase in profitability issues with the sector making losses in the recent past.

3.4 Data Collection

Usage of secondary data was assumed. The data was collected from bank supervision reports downloaded from the CBK website. The data was collected through data collection sheet. The sheet contained data relating to equity financing and profitability of deposit taking microfinance banks between 2018 and 2022. The data on equity financing related to total equity

and total assets while the data on profitability related to profits after tax. Other data collected related to NPLs, gross total loans, core capital, and total risk weighted assets.

3.5 Data Analysis

The collected data was edited and cleaned before analysis. After that the data was coded and entered into SPSS for analysis. The analysis was done with the utilization of descriptive and regression statistics. Descriptive statistics involved the use of standard deviation as well as the mean. Regression statistics was used to establish the effect of equity financing on profitability through multiple regression model.

3.5.1 Diagnostic Tests

This study diagnosed the analytical model through normality, heteroscedasticity, and Multicollinearity tests. The normality test checked on whether the residuals follow a normal distribution. This was checked through Shapiro Wilk statistics. The Heteroscedasticity test checked on whether the error term is constant over time. This was done through Breush-Pagan tests. The Multicollinearity testing was undertaken to check if linearity exists amongst predictors involving variance inflation factors checking the extent to which the variance has been inflated.

3.5.2 Analytical Model

This study adopted the following analytical model:

$$Y_{it} = \alpha + \beta_1 X_{1it} + \beta_2 X_{2it} + \beta_3 X_{3it} + \beta_4 X_{4it} + \varepsilon$$

where;

Y_{it} = profitability of firm i at time t

α = constant

β_{1-4} = regression coefficients

X_{1it} = equity financing of firm i at time t

X_{2it} = size of firm i at time t

X_{3it} = asset quality of firm i at time t

X_{4it} = capital adequacy of firm i at time t

3.5.3 Significance Test

The researcher tested the significance of the model to establish whether it's the best model to use. This test was done using F-statistics generated through ANOVA. The model was assumed as significant where the F-statistics are greater than the critical values and possess a p value of below 5%.

Table 3.1: Operationalization of Variables

Variable Type	Variable	Indicator	Measurement
Dependent	Profitability	Return on Equity	$\frac{\text{Profit after tax}}{\text{Total Equity}}$
Independent	Equity financing	Equity ratio	$\frac{\text{Total equity}}{\text{Total Assets}}$
Control	Firm size	Total assets	Natural log of assets
	Asset quality	Non-performing loans ratio	$\frac{\text{NPLs}}{\text{Gross total loans}}$
	Capital adequacy	Capital adequacy ratio	$\frac{\text{core capital}}{\text{total risk weighted assets}}$

CHAPTER FOUR:

DATA ANALYSIS PRESENTATION AND DISCUSSIONS

4.1 Introduction

Profitability was represented by return on equity; equity financing by equity ratio; firm size by natural log of total assets; asset quality; and capital adequacy by core capital to total risk weighted assets ratio.

4.2 Descriptive Statistics

Table 4.2: Descriptive Statistics

	Units	N	Minimum	Maximum	Mean	Std. Deviation
Profitability	%	65	-1487.50	355.56	-26.38	193.86
Equity financing	%	65	-202.22	84.99	15.10	40.47
Size of firm	Log.	65	17.62	24.14	20.90	1.82
Asset quality	%	65	0.00	1500.00	77.88	202.10
capital adequacy	%	65	-257.45	256.25	32.97	69.82

From the descriptive statistics, profitability in terms of return on equity showed a mean of -26.38% between 2018 and 2022. Profitability showed a standard deviation of 193.86% with a minimum of -1487.5% with a maximum of 355.56%. This shows that profitability of deposit taking microfinance banks highly varied across the period between 2018 and 2022. On the other hand, equity financing averaged at 15.10% for the same period. The standard deviation was 40.47% ranging between -202.22% and 84.99%. This shows that equity financing highly varied among the microfinance banks across the years. Firm size averaged at a log of 20.90 indicating that the banks had more than a billion in terms of asset value. The standard deviation

was 1.82 with a log ranging from 17.62 to 24.14 indicating that the banks were almost the same size in terms of assets. For asset quality, the average NPL ratio was 77.88% with a standard deviation of 202.10. The ratio ranged between 0.00% to 1500% indicating that the asset quality differed highly among the microfinance banks between 2018 and 2022. On capital adequacy, the microfinance banks showed a mean of 32.97% with standard deviation of 69.82% between 2018 and 2022. The capital adequacy ranged between -257.45% and 256.25% indicating high volatility of capital adequacy among the banks within the period (2018-2022).

4.3 Diagnostic Statistics

Diagnostic tests were undertaken to check on assumptions of regression model. This involved normality, heteroscedasticity, and Multicollinearity tests.

Table 4.3: Normality Test

	Statistic	df	Sig.
Profitability	.351	65	.000
Equity financing	.701	65	.000
Size of firm	.950	65	.011
Asset quality	.318	65	.000
Capital adequacy	.857	65	.000

The test for normality was done to check on whether the residuals in the data charted a normal distribution. This was done via Shapiro Wilk test. The test's null hypothesis is that residuals are not normally distributed. The hypothesis is rejected where the p value is less than 0.05. The variables showed a pvalue of less than 0.05. This displays normally distributed residuals.

Table 4.4: Heteroskedasticity

Chi-Square	df	Sig.
0.903	1	0.342

The researcher tested whether the error term is constant over time (heteroskedasticity) through Breusch-Pagan statistics which assumes that there is no heteroskedasticity in the data. From the outcomes, the chi-square statistic had a p value of 0.342 which was above 0.05. This shows that the hypothesis was not rejected. Hence there was no heteroskedasticity in the data.

Table 4.5: Multicollinearity

	Tolerance	VIF
Equity financing	.586	1.707
Size of firm	.812	1.232
Asset quality	.882	1.134
Capital adequacy	.895	1.117

The researcher used VIF to check on multicollinearity. The findings showed that the VIF values were below 2. This indicates that the variance in the data were inflated to low levels. Hence, multicollinearity is not a problem in the variable data used in the study.

4.4 Regression Analysis

Table 4.6: Model Summary

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.742 ^a	.551	.521	2.76204

a. Predictors: (Constant), capital adequacy, size of firm, asset quality, equity financing

The model summary showed an R value of 0.742. This shows that a strong relationship existed between predictors (equity financing, size of firm, asset quality and capital adequacy) and profitability. The summary showed an R square value of 0.551. This indicates that equity financing, size of firm, asset quality and capital adequacy contribute 55.1% to change in profitability of deposit taking microfinance banks.

Table 4.7: Analysis of Variance

Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	50750.605	4	12687.651	3.086	.003 ^b
	Residual	246674.608	60	4111.244		
	Total	297425.213	64			

a. Dependent Variable: profitability

b. Predictors: (Constant), capital adequacy, size of firm, asset quality, equity financing

From the ANOVA, the F was 3.086 with a p-value of 0.003. The p-value was below 0.05 indicating that the F statistic was significant. Therefore, the regression model was significant. Therefore, equity financing, firm size, asset quality and capital adequacy displayed significant effect on profitability of deposit taking microfinance banks.

Table 4.8: Regression Coefficients

Model		Unstandardized		Standardized	t	Sig.
		Coefficients		Coefficients		
		B	Std. Error	Beta		
1	(Constant)	-180.105	30.786		-5.836	.000
	Equity financing	-.211	.119	-.142	-2.006	.049
	Size of firm	7.316	1.556	.679	4.702	.000
	Asset quality	.410	.131	.304	3.130	.003
	Capital adequacy	-.172	.064	-.160	-2.693	.009

a. Dependent Variable: Profitability

From the regression analysis, the equation

$$Y_{it} = \alpha + \beta_1 X_{1it} + \beta_2 X_{2it} + \beta_3 X_{3it} + \beta_4 X_{4it} + \varepsilon$$

Was fitted into

$$Y_{it} = -180.105 - 0.211X_{1it} + 7.316X_{2it} + 0.410X_{3it} - 0.172X_{4it}$$

From the fitted equation, a unit rise in equity financing would reduce profitability by 0.211. This shows that equity financing had a negative effect on firm profitability. However, a unit rise in firm size would raise profitability by 7.316. Therefore, firm size in terms of assets positively influenced firm profitability. In addition, unit increase in asset quality would lead to rise in profitability by 0.410. This stipulates that asset quality possessed a positive effect on profitability. Further, unit rise in capital adequacy lowers profitability by 0.172. This shows that capital adequacy displayed a negative effect on profitability.

4.5 Discussion of Findings

From outcomes, rise in equity financing would reduce profitability. This is an indication that firms that increase their equity financing experience reduced profitability. Therefore, equity financing displayed a negative effect on firm profitability. The findings are aligned to Risfandy (2018) who found that equity financing possessed a negative effect on banks' profitability. Nevertheless, they vary from Singh and Bagga (2019) who found that equity financing had a positive effect on profitability of firms. They also differed with those of Habibniya et al. (2022) who found that equity financing had no significant effect on ROE as a measure of profitability. Mujwahuzi and Mbogo (2020) also found an insignificant effect of equity financing on profitability.

Further, increased firm size (assets) would raise profitability. This indicates that banks with increasing firm size experience improved profitability levels. Therefore, firm size in terms of assets positively affected firm profitability. The findings are like those of Hirdinis (2019) who found that firm size affected profitability positively. They are also similar to the findings of Zuhroh (2019) who found a positive relationship around firm size and profitability. However, they differed with those of D'Amato and Falivena (2020) with a negative effect outcome.

Further, rise in asset quality would lead to increased profitability. Therefore, firms with increased asset quality experience an increasing profitability. This stipulates that asset quality possessed positive effect on profitability. The findings are concurring with Hamdillah, Purwanto and Ermawati (2021) who found that asset quality positively influenced profitability. However, they are differing with Zhao and Han (2020) who found that negative link existed around asset quality and profitability.

Further, findings showed that an increase in capital adequacy would lead to a decrease in profitability. Hence, firms with an increasing capital adequacy in terms of core capital to total weighted assets experienced reducing profits. Capital adequacy, therefore, displayed negative effect on profitability. They are similar to outcomes from Thiongo and Kiama (2018).

Nevertheless, they differ with Ichsan et. al's (2021) who established that capital adequacy had a positive effect on profitability. They also differed with outcomes from Irawati, Maksun, Sadalia and Muda (2019) who established that an insignificant link existed around capital adequacy and profitability.

CHAPTER FIVE:

SUMMARY, CONCLUSION AND RECOMMENDATIONS

5.1 Introduction

This chapter presents the summary and conclusions in line with research objective. It also presents the policy recommendations and recommendations for future studies in addition to the limitations of the study. It sought to establish the effect of equity financing on profitability of deposit taking microfinance banks in Kenya.

5.2 Summary of Findings

From the descriptive statistics, profitability in terms of return on equity showed a mean of -26.38% between 2018 and 2022 with a standard deviation of 193.86%. On the other hand, the mean equity financing was 15.10% with a standard deviation was 40.47%. For firm size the average log was 20.90 with a standard deviation of 1.82 indicating that the banks were almost the same size in terms of assets. For asset quality, the average NPL ratio was 77.88% with a standard deviation of 202.10%. On capital adequacy, the microfinance banks displayed mean of 32.97% with a standard deviation of 69.82% between 2018 and 2022.

From the regression analysis, a strong relationship existed between predictors (equity financing, size of firm, asset quality and capital adequacy) and profitability of the firms. Further the R square value of 0.551 showed that equity financing, size of firm, asset quality and capital adequacy were major contributors to the profitability of banks. The ANOVA showed significant F-statistics indicating that predictors had a significant effect on profitability. From the coefficient table, equity financing had a negative effect on firm profitability. On the other hand, firm size in terms of assets positively influenced firm profitability. In addition, asset quality had a positive effect on profitability with capital adequacy having a negative effect on profitability.

5.3 Conclusions

From the findings, equity financing had a negative and significant regression coefficient. This shows that equity financing possessed negative effect on profitability. Therefore, equity financing has a negative effect on profitability of deposit taking microfinance banks in Kenya. The deposit taking microfinance banks with escalated levels of equity financing have low profitability. An increase in equity financing among the banks would lead to decrease in profits among the deposit taking microfinance banks.

From the findings, firm size in terms of assets positively influenced firm profitability. This was shown by a positive regression coefficient. This study, therefore, concludes that firm size in terms of assets has a positive effect on profits of deposit taking microfinance banks in Kenya. The banking institutions with an increased firm size in terms of assets show high levels of profitability compared to those with reducing or not increasing assets.

Further, asset quality displayed positive effect on profitability. This was shown by a significant and positive regression coefficient. Hence, asset quality positively influences profitability of deposit taking microfinance banks in Kenya. The deposit taking microfinance banks that have a high asset quality display high levels of profitability compared to those with low asset quality. Asset quality among the deposit taking microfinance banks is a driving factor to their profitability.

The findings showed that capital adequacy displayed a negative and significant regression coefficient against profitability. Hence, capital adequacy negatively influences profitability of deposit taking microfinance banks in Kenya. Therefore, deposit taking microfinance banks with escalated core capital to total weighted assets ratio displays a reduction in their profitability compared to those with a reducing capital adequacy.

5.4 Policy Recommendations

From the findings, equity financing negatively influences profitability of deposit taking microfinance banks in Kenya. This means that increased equity financing reflects reduction in profitability of deposit taking microfinance banks. There is need to reduce the equity financing within deposit taking microfinance banks in Kenya for an increased profitability among these firms. They also need to replace equity with other forms of financing like debt for increased profitability.

The findings showed that firm size has a positive effect on the profitability of deposit taking microfinance banks in Kenya. This depicts that increased assets among deposit taking microfinance banks in Kenya would lead to an increase in their profitability levels. This calls for an increase in the assets by the management of deposit taking microfinance banks in Kenya for an increased profitability. This calls for purchase of additional assets or increased asset value through revaluation.

The findings also showed that asset quality positively influenced profitability of deposit taking microfinance banks in Kenya. This depicts that an increase in asset quality would lead to increased profitability among deposit taking microfinance banks. Deposit taking microfinance banking institutions ought to increase quality of assets for improved profitability levels. This can be done by maintaining adequate loan loss provisions which will enable the banks to absorb the effects of losses from the NPLs. The management also needs to reduce the expenses accrued to the collection of NPLs. This can be done through adoption of modern technology in loan collection and involving agents in loan recovery which will transfer the costs to the agents.

Further, capital adequacy influences profitability of deposit taking microfinance banks in Kenya negatively. Therefore, deposit taking microfinance banks with an increasing capital adequacy (core capital to total weighted assets ratio) display a reduction in profitability. This calls for a reduction in the capital adequacy ratio among deposit taking microfinance banks in Kenya for an improved profitability within the sector. The management ought to reduce the core capital among their deposit taking microfinance banks which would enable them to lend much more money while generating more income while maintaining the same level of income. They can also increase the total weighted assets for an increased profitability among their banks.

5.5 Limitations of Study

This paper was limited by the variables of study. The study involved equity financing and profitability assuming other factors influencing profitability. The measures of the variables also created a limitation. The study measured equity financing in terms of equity ratio with return on assets used to measure profitability. Other measures of the variables may produce new results. Further, its focus on deposit taking microfinance banks limits the paper. Other firms may produce different results. To overcome these limitations, suggestion for future studies was done.

The period of study also created a limitation. The data was collected for a period between 2018 and 2022. A different period like 10 years may produce different results. The study adopted secondary data which limited it. The historical nature of such data as well as its credibility limited the study. The adoption of most recent data from the CBK overcame the limitation. The adoption of annual data also increased the error in the data. To overcome this, future research is recommended for usage of quarterly or semi-annual data.

5.6 Recommendations for Future Studies

This paper recommends a similar study based on other influencers of profitability. These may include debt financing as well as the capital structure in general. Further, different indicators of equity financing and profitability to compare results. Other industries other than microfinance banking sector ought to be done in future. There is also the need for research focusing on dissimilar spans in order to compare the outcomes. This study also recommends a similar study based on quarterly or semi-annual data. Similar research ought to be done bwith the usage of primary data.

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APPENDICES

Appendix I: Data Collection Sheet

Year	Total Assets	Total Equity	profits after tax	NPLs	Gross total loans	core capital	total risk weighted assets
2018							
2019							
2020							
2021							
2022							

Appendix II: Deposit Taking Microfinance Banks

1. Branch Microfinance Bank
2. Caritas Microfinance Bank
3. Choice Microfinance Bank
4. Daraja Microfinance Bank
5. Faulu Microfinance Bank
6. KWFT Microfinance Bank
7. LOLC Microfinance Bank
8. Maisha Microfinance Bank
9. Muungano Microfinance Bank
10. Rafiki Microfinance Bank
11. Salaam Microfinance Bank
12. SMEP Microfinance Bank
13. Sumac Microfinance Bank
14. U & I Microfinance Bank