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**THE RELATIONSHIP BETWEEN FINANCIAL STRUCTURE  
AND PERFORMANCE OF MICRO AND SMALL ENTERPRISES  
IN NAIROBI, KENYA. //**

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**BY**

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A RESEARCH PAPER SUBMITTED IN PARTIAL FULFILLMENT OF THE  
REQUIREMENTS FOR THE DEGREE OF MASTER OF BUSINESS ADMINISTRATION  
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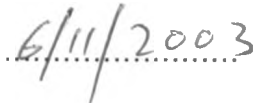
**SEPTEMBER 2003**

## DECLARATION

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

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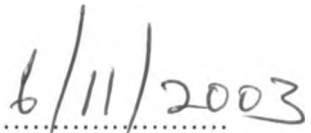
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This research project has been submitted for examination with my approval as university supervisor.

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Date  .....

## EPILOGUE

*“When a piece of scholarly work can be read without effort,  
a lot of effort has gone into its writing”.*

## DEDICATION

To God ... He is my Strength, and to my wife Ruth, my best fit.

## **ACKNOWLEDGEMENTS**

I wish to acknowledge the hand of the almighty God in all what I did during the period of the MBA course.

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## LIST OF ACCRONYMS

CBS	-	Central Bureau of Statistics
CEO	-	Chief Executive Officer
KES	-	Kenyan Shilling
MFI	-	Micro Finance Institution
MSE	-	Micro and Small Enterprise
NGO	-	Non-Governmental Organization
SPSS	-	Statistical Package for Social Sciences
UK	-	United Kingdom
US	-	United States of America



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## ABSTRACT

Interest in the role of small and medium-sized enterprises (MSEs) in the development process continues to be in the forefront of policy debates in developing countries and considerable attention has been paid in the last decade to the problem of poverty-reduction in these countries (World Bank, 1997).

The study used a sample drawn from the 1999 baseline survey of micro and small scale enterprises in Kenya to analyze the relationship between the financing behavior of these enterprises and their performance within the framework of sources of funds for MSEs and performance indicators. The study provides a descriptive detail of financial structure of what can be said to possibly be the “typical” financial structure of micro and small firms in Kenya. A range of variables, which influence the performance of MSEs have been explored. Some of the variables considered include, the type of trade, age of the business, profit (as viewed by the business owners), sales growth, asset structure and size (measured by the number of employees).

The study found that MSEs financed by internal funds perform better than those with debt in their financial structure. Secondly, whenever the firms have utilized debt, short-term debt has been preferred to long-term debt.

All in all, the study finds that a relationship exists between financial structure of MSEs and their performance.

# CHAPTER ONE

## 1.0 INTRODUCTION

### 1.1 Background

Considerable attention has been paid in the last decade to the problem of poverty-reduction in developing countries (World Bank, 1997). It is generally agreed that the development of Micro and Small scale enterprises (MSEs) can be a key ingredient in poverty reduction (King, 1996). However, MSEs generally suffer from a range of problems in their establishment and development. Among these problems, finance is perhaps the most central. A recent World Bank study found that about 90 per cent of small enterprises surveyed stated that credit was a major constraint to new investment (Parker and Torres, 1994). *A priori*, it might seem surprising that finance should be so important. Requirements such as identifying a product and a market, acquiring any necessary property rights or licenses, and keeping proper records are all in some sense more fundamental to running a small enterprise than is finance. However, potential providers of finance, whether formal or informal, are unlikely to commit funds to a business which they view as not being on a sound footing, irrespective of the exact nature of the unsoundness. Lack of funds may therefore be the immediate reason for a business failing to start or to progress, even when the more fundamental reason lies elsewhere. In this sense therefore, one would argue that finance is the "glue" that holds together all the diverse aspects involved in a small business start-up and development.

Cook and Nixson (2000) recently surveyed the literature on finance for MSEs. They observe that most extant research on MSEs is concerned with the industrial countries. There is much less literature on developing countries, in part because basic data availability is much sparser. They identify several key research questions, which require investigation. Among these they particularly note that little is known

about the relationships between the financing of MSEs and their ownership characteristics, size, and performance.

This study investigates how the source of finance is related to other aspects of small business. Specifically, the study seeks to determine the relationship between sources of finance and performance of MSEs. The key issues addressed by the study are, the sources of finance for Kenyan MSEs (whether from formal or informal sources, as either borrowed funds against using equity among others) and the linkages between the sources of finance and performance of MSEs.

## **1.2 Statement of the Problem**

An extensive body of research has identified stylized facts on the determinants of capital structure, that is, the relative proportions of debt and equity financing for big firms. Several firm characteristics - size, growth opportunities, profitability, non-debt tax shields, or the proportion of fixed assets, for example have been shown to affect financial structure (King, 1996; Cook and Nixson, 2000; Cosh and Hughes, 1996). Intra-industry similarities in capital structure have also been repeatedly found (Gibson, 2001; King, 1996). However, the empirical evidence on financial structure of MSEs is very small.

For a long time, finance literature has ignored the interaction between the financial structure and performance of MSEs. Since the pioneering work of Brander and Lewis (1986) a lot has been learned about the mechanisms linking these two decisions. However most of the work remains on a theoretical level with a few empirical studies focusing on America and Europe (Cook and Nixson, 2000). There appears to be limited empirical studies on the financial structure of MSEs in Kenya.

The Kenyan economy presents a typical example of an emerging economy and one whose market structure is drastically changing. The competitive environment in this country leaves entities with very little option but to strategically position themselves in the market. For success in a depressed economy as the one witnessed in Kenya, mundane tools must be utilized by business entities to create a competitive hedge

over and above their competitors. One possible tool that can be used is none other than the strategic-use of the firm's financial structure.

Empirical evidence in this area as stated above is mixed and the main gist of this study was to establish whether there exists any link between MSE financial structure and its performance.

### **1.3 Objectives of the study**

The study had the following specific objectives;

- i) To determine the financial structure of MSEs in Nairobi.
- ii) To establish the relationship between financial structure and performance of MSEs in Nairobi.

### **1.4 Justification of the study**

Most of the theoretical work on small firm finance and the behaviour of institutions that lend to small scale enterprises has been undertaken on the industrialized countries, particularly the US and the UK (Cook and Nixon, 2000). A large proportion of this work has tended to concentrate on firms that, in terms of size, lie towards the upper end of the spectrum, where the range of ownership and financing options becomes wider. This has left a gap as far as micro and small enterprises are concerned.

In general, two areas of research have become prominent. First, there are studies that have attempted to examine the implications of different financial structures found in different sized firms. In part, these are based on survey work, which has attempted to catalogue the range of finance sources available to smaller firms and to examine their implications for growth and investment. In firms where forms of equity have been employed, this work has been extended to incorporate an investigation into a number of distributional issues concerning income flows to owners and managers and inside and outside shareholders (Myers, 1998). Much of this analysis has been set within the framework of a principal-agent approach. The conditions under which each respective interest operates are examined with reference to the

internal incentive systems that emerge in firms and to the external factors, such as the macroeconomic policy environment and the development of legal systems that offer potential protection to outside investors in firms (La Porter et. Al, 1998).

Second, there has been a concentration of theoretically based studies examining the behaviour of various lending institutions, as suppliers of finance to small and medium-sized enterprises. Typically, for small enterprises, the studies have involved models of lending behaviour based on an agency framework. Central to the hypotheses that have emerged from this body of research is the notion that information asymmetries lead to sub-optimal flows of finance available to smaller firms compared to larger firms. Imperfect information can lead to restricted flows of finance whether the problem lies within the firm, through poor record management or in banks, through the relatively high costs associated with gathering information on smaller firms (Binks, Ennew and Reed, 1992). There is considerable debate over whether or not banks in low income countries have a comparative advantage in lending to smaller firms precisely because they may possess an accumulated knowledge concerning the riskiness of investing that places them in a position to make optimal rather than sub-optimal decisions over lending to smaller enterprises. Building relationships with banks increases the information flow between lender and borrower (Berger and Udell, 1995).

The emphasis on the relative inadequacy of theoretical work ought not to imply that the stock of knowledge gained about finance and smaller enterprises through empirical work is not valuable. Considerable insights have been gleaned from a wide range of empirical investigations (Cosh and Hughes, 1996). Most of this kind of analysis continues to be undertaken in the context of the industrialized countries which raises a number of issues concerning its relevance and applicability to the low income country case. Nevertheless, it is useful to review some of the theoretical perspectives that have been developed, principally in an industrialized context, to explain aspects of financial behaviour among small firms and to examine their implications for low-income countries.

## 1.5 Importance of the Study

- i) The study will be useful to policy makers in enhancing suitable policies concerning the MSE sector.
- ii) The study will improve managerial performance by identifying “best” practices associated with applying the most appropriate financial structure and thereby, enhance performance. By doing so, even small and unquoted firms will be able to operate in a new strategic dimension and thereby improve the general economic situation in Kenya.
- iii) The study will add to the academia gap of knowledge in this area.

### 2.0 LITERATURE REVIEW

This section sets to review relevant literature in the area of MSE financing and performance.

#### 2.1 Definition of Terms

##### Micro and Small Enterprises (MSEs)

The National Micro and Small Enterprises Baseline Survey of 1999, divided the definition of MSE into three criteria;

- ◆ The first criterion defines micro enterprises as those employing up to 10 workers (including the working owner) and small enterprises as those employing more than 10 up to 50 workers. If the size range 1-10 is considered micro in nature, then nationally more than 99% of the MSEs in Kenya are of the micro group, in fact 97% of these enterprises are in the size range of 1-5 workers. (CBS, et al. 1999). The study will therefore use the size range of 1-5 for micro enterprises and 6-49 as definition for small enterprises.
- ◆ The second criterion is based on enterprises that are essentially non-primary businesses i.e. non-farm business activities excluding agricultural production, animal husbandry, fishing, hunting, gathering, forestry. Since the focus of this study was Nairobi, this second criterion is of no relevance.
- ◆ The third criterion is non-farm-based business activities that involve some form of processing before marketing.

For the purpose of this study, the first criterion has been used. The terms Business Enterprise and Firm is used interchangeably to refer to an economic entity either producing goods or providing services of any nature.



## **Financial Structure**

Financial structure is defined in the context of MSEs to mean sources of funds in other words the right-hand side of a firm's balance sheet, detailing how its assets are financed, including debt and equity issues. This includes both long and short-term sources of finance available to MSEs (Mullei and Bokea, 1999).

## **Performance**

Performance refers to the yard-stick(s), which indicate if an entity serves its purported reason for being (Kimuyu 2001). This study will focus on the economic performance of business enterprises on the premise that the prime reason why businesses are formed is to serve some economic purpose.

## **2.2 MSEs in Kenya**

Interest in the role of small and medium-sized enterprises (MSEs) in the development process continues to be in the forefront of policy debates in developing countries. The advantages claimed for MSEs are various, including: the encouragement of entrepreneurship; the greater likelihood that MSEs will utilize labour intensive technologies and thus have an immediate impact on employment generation; they can usually be established rapidly and put into operation to produce quick returns; MSE development can encourage the process of both inter- and intra-regional decentralization; and, they may well become a countervailing force against the economic power of larger enterprises. More generally, the development of MSEs is seen as accelerating the achievement of wider economic and socio-economic objectives, including poverty alleviation.

Early research treated small enterprises as peripheral survival mechanisms whose developmental impact was marginal (Ongile and McCormick, 1996). This view was irrevocably changed by the 1972 International Labour Organisation report that demonstrated the significant employment and wealth creation potential of the burgeoning, and often informal, small enterprise sector (ILO, 1972). Since the ILO report, the general outlook towards MSEs has shifted dramatically. Benign neglect

has been replaced by a recognition that the sector could be the lynchpin for improving economic prospects in the developing world (King, 1996). But the shift after the 1970s also benefitted from a heightened realisation that a high and rising share of industrial employment was still in the small enterprise sector. Previous slanting of government policies towards promotion of large, capital intensive industry meant that the potential for inducing more efficient use of capital and improving income distribution lay in more neutral policies. MSEs also link closely with agriculture so that their promotion would be part of an agriculture-led development strategy. As compared with large enterprises, MSEs are invariably more labour-intensive and often more efficient. Indeed, labour-intensive production tends to be more efficient where labour is plentiful and capital scarce, which is frequently the case in developing countries (Snodgrass and Biggs, 1995). MSEs promote more equitable distribution of income because they are more labour-intensive than larger enterprises, and because owners of small businesses are more likely to be poorer than the owners of large businesses. Small enterprises also nurture entrepreneurs who may eventually expand their firms and move to high value adding activities.

The Kenyan MSE sector is a mixture of self-employment outlets and dynamic enterprises involved in an array of activities that are concentrated in urban areas but are also evident in rural Kenya. There are about 1.3 million establishments employing 2.3 million individuals and generating as much as 14% of the country's GDP (Mullei & Bokea, 1999). A majority of these small enterprises are sole proprietorships; a third of the enterprises operate from homes; and one half are female-owned. According to recent research, female-owned small enterprises are more likely to be informal, usually start smaller, use less start-up capital, grow slower if at all, have more limited access to credit and more often operate from less permanent premises and homes (Parker and Torres, 1994; Kimuyu and Omiti, 2000).

Through the small enterprise sector, unskilled rural migrants acquire skills needed for survival in the more challenging urban environment. The sector also attracts skilled persons retrenched from formal sector jobs, and is often regarded as a second-best option for those unable to find or to keep jobs in the modern sector. The size of an MSE's total labour force varies widely across business establishments and activities. However, the two key components of the labour force are entrepreneurs and apprentices. Informal garages absorb appreciably more apprentices and workers than the formal service sector that is dominated by proprietors. In the recent past, employment growth in Kenya's small enterprise sector has far outpaced growth in the larger modern sector (Aboagye, 1986). However, many MSEs still require workers with skills that school leavers often lack, and therefore the small enterprise sector is not likely to solve Kenya's daunting unemployment problem on its own (Ongile and McCormick, 1996).

Although most small enterprises are younger than the large ones, their ages vary across locations and activities. For the informal small businesses, the first two years are critical for survival since mortality rates are highest around this age. In many sectors, lack of entry barriers creates severe competition that leads to the demise of the less efficient and poorly managed enterprises. However, there are higher capital and skill requirements in construction and vehicle garages, and these act as effective entry barriers so that there is less competition in these sub-sectors.

### **2.3 Expectations on financial structure**

Financial structure is an important decision in firms and is related to firms production and operating activities (Peel and Wilson, 1996). To fund production and operations, financial resources are required. These resources are either in the form of debt, the cost of which is the interest paid, or in the form of equity which has a cost represented by the providers required rate of return. As both types of financial resources carry a cost, a reasonable expectation exists that there is an optimal mix

of debt and equity that minimizes the total cost. The traditional approach (Modigliani and Miller, 1958, 1963) to guiding the optimal financial structure concludes that “firms should use as much debt as possible” on the principle that generally debt has a lower cost than equity. This view alludes that, under conditions of perfect markets and cost-less and free-flowing information access, modifying a firm's capital structure does not change the firm's value or owner's wealth. However, there is considerable evidence that the outcome reflected in such a proposition is not evident in practice and that small firms especially seem to develop structures that have a minimum, rather than a maximum, amount of debt (Chittenden et al., 1996)

Concerns on the possibility that there may be something different about the financial structure of small firms was expressed in the early identification of a “finance gap” in the area of financing of MSEs by Berger and Udell (1998). The core concern was on the type of financing needed at the various stages of small firms growth, the nature of private equity and debt contracts associated with this financing, and the connections and sustainability among these alternative sources of finance. In deed the nature of their private equity and debt contracts may provide a mechanism to enhance understanding of business attitudes and managerial behaviour of small firms. Apparently, the irrational economic behaviour of maximizing attributes other than financial wealth that is so often associated with the owners of small firms may better be understood alongside an enhanced understanding of their finance structure choices (Gibson, 1993).

## **2.4 Sources of finance for MSEs**

The role of finance has been viewed as a critical element for the development of micro- and small-sized enterprises. Previous studies have highlighted the limited access to financial resources available to smaller enterprises compared to larger organizations and the consequences for their growth and development (Saito and Villanueva, 1981). Typically, smaller enterprises face higher transactions costs than larger enterprises in obtaining credit (Saito and Villanueva, 1981). Insufficient

funding has been made available to finance working capital (Peel and Wilson, 1996). Poor management and accounting practices have hampered the ability of smaller enterprises to raise finance. Information asymmetries associated with lending to small-scale borrowers have restricted the flow of finance to smaller enterprises. In spite of these claims however, some studies show a large number of small enterprises fail because of non-financial reasons (Liedholm, MacPherson and Chuta, 1994).

A study carried out by Kariuki (1995) on bank credit access in Kenya illustrates the issue of limited access to financial resources by MSEs. A survey of 89 small and medium-scale firms in manufacturing and service industries in Kenya, combined with secondary information from commercial banks, found that from 1985 to 1990 the average real volume of credit for the sample firms fell, except for the year 1986 which showed a marginal increase of 1.5 per cent. Several deterrents to utilizing formal credit were identified. Small-scale borrowers were found to be faced with higher nominal interest rates at higher inflation rates in the latter half of the 1980s. Moreover, the explicit transaction costs of borrowing were found to be high in relation to interest costs. The cases of Bangladesh, Nepal and the Philippines appear to support these claims (Helmsing and Kolstee, 1993). Despite specific programmes aimed at small scale enterprises, only between 12 per cent and 33 per cent of those surveyed were found to have access to formal credit and, of those, the majority were from the larger end of the sector. Again, factors such as the relatively high cost of processing small loans, the need for high collateral and bureaucratic procedures were seen to restrict lending to small scale enterprises. The taxation policies, which were also examined, were found to have little impact on small-scale enterprises, particularly as many of those surveyed were found not to be paying taxes.

Similar evidence regarding the lack of importance given by small scale enterprises to tax policies is also found in Southern Africa, including Niger, Botswana, Swaziland, Lesotho, Malawi, and Zimbabwe (Mead, 1994). Studies for these locations found little concern for government regulations, except from those enterprises concentrated in targeted locations and specific sectors such as food processing. Instead the greatest concern for the majority of those surveyed was the lack of access to working capital, credit and finance.

In his study of MSEs in Kenya, Ondiege (1996) reviewed data from 1498 MSEs in Nairobi, Mombasa and Kisumu during 1988 – 1989 and found that most of the enterprises' initial capital was from the entrepreneur's own savings. Eighty-two, Eighty-five and Eighty-two percent of the respondents respectively in Nairobi, Mombasa and Kisumu indicated so. About 6 to 10 percent of his sample obtained their initial capital from friends and relatives, while 4 to 7 percent financed their businesses by borrowing from friends. If these findings are any thing to go by, it is clear that majority of the businesses surveyed were financed informally. Only less than 2 per cent of the surveyed enterprises indicated that they had access to credit from formal private and government lending agencies or NGOs to start their businesses.

In a more recent study by Mwindi (2002), MSEs were found to finance the initial capital of their businesses from their personal savings while MFIs provide a substantial proportion (as compared to other sources) of the loans to pay for the working capital of the businesses. Precisely, after formation, 50 percent of MSE financing came from business, 40 per cent from MFIs and 10 percent from friends and relatives. This concurs with Prasad, Green and Murinde (2001) finding that while the start-up capital is obtained from a majority of informal sources (own savings, friends and relatives), additional capital to finance working capital and to purchase assets was obtained from external sources with MFIs taking a leading role.

## **2.5 MSE Financial Structure**

There are several sources of funds that MSEs utilize. These include, own funds on one hand and borrowed funds from family and friends, NGOs, moneylenders etc. on the other hand. Notable is the fact that there are some MSEs who source their initial and/or additional capital from donor supported initiatives as well as subsidized loans from NGOs.

Gibson (2001) in his research of European MSEs found that compared with large firms, MSEs are more dependent on internal sources of funds (Owner's own capital and retained profits) than on external sources of finance (financial markets and indebtedness). He also acknowledged that MSEs suffer from an inadequacy of both own funds as well as loanable funds. He further observed that MSEs in Europe and USA are more capitalized than in the developing countries. This under-capitalization

of MSEs may be highly linked to difficulties faced by a majority of MSEs in emerging economies.

A firm that relies too much on debt can suffer from an excess of financial charges that would jeopardize its future development. In contrast, the firm that relies too much on own funds may miss opportunities to increase its assets because such an increase would have implied debt.

On the whole, (Dubocage, 2001) points out to the following components of financial structure; own funds, leverage, reserves and short-term financial debt. He concludes that MSEs tend to rely more on short-term (as opposed to long-term) financial debt than larger firms. This tendency may correlate with their high working capital requirement and higher flexibility. The author further observes that MSEs that have more owner funds are more successful than those, which utilize a "greater" percentage of debt. Debt in this case was distinguished from various sources with bank loans being singled out as a hand-cap to MSE performance.

## **2.6 Explanations for MSE Financial Structure**

The genesis of an enhanced understanding of small firms financial behaviour has emerged in the various attempts made to explain the apparent anomalies of small firm capital structure. The major attempts, discussed below can be classified as the life cycle approach; the pecking order framework; a trade-off choice framework; and agency theory.

The life cycle approach suggests that access to finance is dependent on the stage of development of the firm. New firms rely on owners' initial resources because they are, arguably, not informationally opaque (Berger and Udell, 1998). Survival and moderate growth opens access to short term debt that remains a continued source of funds because of limited access to long term debt and/or equity. Rapid growth firms are also forced to accept the poor liquidity circumstance short term debt reliance until they find themselves in a position to enter the equity markets (Chittenden et al., 1996). This explains an apparent preponderance of short-term debt finance in many small firms and also suggests changing target (or optimal) debt-equity ratio in a firm. Allied to the life cycle approach is recent work suggesting a relationship between managerial strategy and capital structure (Jordan, et al., 1998).

The pecking order framework was initially proposed by Myers (1984) and suggest “firms finance their needs in a hierarchical fashion, first using internally available funds, followed by debt, and finally external equity” (Chittenden et al., 1996). The prevalence is a reflection of the relative costs of the available sources of funds, possibly as a consequence of information opacity, and an aversion to the use of external equity. It emphasizes friction based on potential informational asymmetries. Of central concern appears to be a concentration by small firms on “sources of finance that minimize intrusion into business” (La Porta et al., 1998) Consequently firms do not have an optimal debt-equity ratio but rather the “ debt-equity ratio varies overtime, depending on the firms’ need for external finance”.

Trade-off choice explanations explore frictions between costs of financial distress and the tax deductibility of the cost of debt. It suggests that firms trade-off several aspects, including the exposure of the firm to bankruptcy and agency costs against the tax benefits associated with debt use (Mead, 1994). Firms anticipate higher finance cost because of potential liquidation etc. and consequently avoid debt. Offsetting these considerations is that tax benefits encourage debt use by firms (tax deductibility of interest) and final capital structure adopted by a firm will be a tradeoff between these tax benefits and costs associated with bankruptcy and agency. This implies that there is a target debt-equity ratio for a firm which only changes as benefits and costs alter overtime.

Agency cost extends consideration to information asymmetry, costly state verification, moral hazard and adverse selection problems in relationships between small firms and finance providers (Berger and Udell, 1998). Fixed cost elements of transactions and the closely held nature of small firms are in most circumstances, likely to make the cost of solving such problems higher for small firms. While debt contracts might appear optimal after inside finances are exhausted, there are moral hazard conditions that lead some firms to directly move to third party external equity (Berger and Udell, 1998). There are also suggestions that a contributing factor to these problems is the poor quality of financial information produced by small firms that increase monitoring costs in agency circumstances (La Porta et al., 1998). The debt-equity mix for a firm is therefore a function of real and perceived agency cost relationships.



The primary implications of these diverse explanations of small firms capital structure is reasonably clear although not excessively enlightening. Small firms will adopt a target debt-equity ratio that is influenced by their current circumstances. As suggested by Berger and Udell (1998), firms with different profiles are likely to be financed with different combinations of debt and equity. There is no universal optimum in respect to capital structure, although the expectation from the preceding discussion seem to point out the tendency of small firms to rely on short-term debt with little or no third party external equity.

## **2.7 Influences on Financial Structure**

Variables often identified as indicative of the circumstances that might influence differences in the financial structure include, the type of trade, age, profit, asset structure, size and growth (Berger and Udell, 1998). Less frequently identified but still possibly explanatory variables include risk, tax rates, time, access to capital markets, family control, CEO age, business objectives and business planning (Jordan et al., 1998).

## **2.8 Performance of MSEs**

The measurement of the performance of MSEs is quite a task to researchers due to sparsity of data and poor record keeping by these enterprises. Hutchinson (1989) finds a predictable relationship between the stage of development of firms and their financial profiles (financial profile being an evaluation of the overall performance picture of the enterprises); that the financial profile of small firms changes as they grow to maturity and that the financial profile of growth small firms has features in common with bankrupt firms. He found that, growth small firms had a statistically significant higher level of profitability than bankrupt firms but similar levels of indicative gearing and liquidity levels.

Kinyanjui (1996) documents that the founder's age, level of education, previous occupation, and entrepreneurial disposition as the key attributes that impacted on the performance of small enterprises. These attributes though qualitative give a lead to a

number of decisions that entrepreneurs make. These include location of MSEs, employment performance, scope in sourcing of finance, etc. Kimuyu (2001) finds that gender of the proprietor, proprietor's educational attainment, membership to business support groups, formality status (whether the business is formal or informal), business activity, business location, seasonality of the business and ownership structure as also factors contributing to the performance of MSEs.

Ondiege (1996) finds the value of equipment, current value of business assets, amount of savings (average monthly gross savings before deduction of the entrepreneur's private consumption made by the enterprise), sales volumes, number of full-time employees as some of the quantitative indicators of performance of MSEs. Prasad et al., (2001) include success rate in loan applications and MSE growth (measured by growth in sales, growth in profits, growth in assets, growth in the number of employees) as blanket indicators of whether the firm is performing well or not. The former, however needs to be controlled for the impact of the presence or absence of collateralizable assets which is key to credit facilities sourced from the formal sector.

## **2.9 Financial Structure and Performance of MSEs**

While the qualitative performance indicators have been noted, the quantitative measurements shall be used in establishing whether there exists any link between the various sources of funds and performance. Sources of funds for MSEs can be seen to come from three main sources; namely; own savings, friends and relatives (free of interest or borrowed funds) and borrowing from external sources. On the other hand, the following quantitative indicators present clearly as usable in the measurement of MSE performance; the value of equipment, current value of business assets, amount of savings (average monthly gross savings before deduction of the entrepreneur's private consumption made by the enterprise), sales volumes and their growth, and number of full-time employees (Ondiege, 1996)

## 2.10 Past Empirical Research

As observed elsewhere, a vast volume of work has empirically investigated the capital structures of firms in the industrial economies. In recent years there have also been some empirical studies of firms in developing economies. Most of these latter studies aim at documenting basic facts about corporate financial structures in developing economies, and are based on the analysis of financial ratios. They may therefore be classified as univariate empirical studies. On its own, a set of financial ratios does not necessarily provide much information; accordingly, emphasis has been put on *inter-country* comparisons among industrialized countries and between industrial and developing countries. This section classifies a number of interesting empirical results in a set of "observations", each one representing a broadly acceptable stylized fact.

**Observation 1:** *Regardless of whether de-facto market-based capital structure behaviour is observed, retentions are the dominant source of finance for firms in the main industrial countries.*

This observation is drawn from synthesis of the findings by Corbett and Jenkinson (1994). They examined corporate capital structures at the aggregate level in Japan, Germany, the UK and US, for the period 1970-1989. Internal funds were the main source of finance in all countries, with the UK financing the highest proportion (97.3%) of its investment by retentions, and Japan financing the lowest (69.3%). Similar results are reported by Mayer (1988) for France, Japan, Germany, the UK and US for 1970-1985. The UK was again the highest user of retentions (107% of investment) while Germany was the lowest with 67%.

**Observation 2:** *Firms located in developing economies rely less heavily on internal finance than those found in developed economies.*

Observation 3 was first suggested by Hamid and Singh (1992) who analyzed the corporate finance characteristics of the top 50 manufacturing firms in: India, Thailand, Jordan, Malaysia, Taiwan, Mexico, Pakistan, Zimbabwe and South Korea over the period 1980-1987. They find that firms in developing countries used less internal finance than their developed economy counterparts. They attribute this to different growth rates, and to lower retention ratios, rather than, for example, to the distorting influences of inflation which has had a major influence in at least some

developing economies. As with firms found within the developed economies, the use of internal sources of finance does vary across developing countries. Atkin and Glen (1992) survey macro-economic data on the corporate sector in several developing economies (Zimbabwe, Pakistan, Malaysia, India and South Korea), and find that Zimbabwean and Pakistani firms rely most heavily on internal finance: 58.5% and 58.3% respectively of all sources, whilst South Korean firms were least dependent with 12.8%. They argued that, as South Korea has a more advanced financial system, it provides a greater number of external financing options for investment projects; and, indeed, South Korean firms do use a greater amount of external finance, both equity and long-term debt, than do Pakistani firms.

**Observation 3:** *Equity and debt are equally important as the major source of firm finance in developing countries, although one is more important in some countries and the other is more important elsewhere.*

Hamid and Singh (1992) found that firms found within developing economies rely more heavily on equity than on debt to finance growth relative to their counterparts in the developed economies. A reverse pecking order was observed. Corbett and Jenkinson (1994) noted that these conclusions are puzzling, given the developing countries' lax accounting and auditing protocols, which increase information imperfections, their less well-defined property rights, and small and inefficient capital markets. Taken together, these factors suggest that firms will use bank-based finance in addition to other borrowings rather than the capital markets.

**Observation 4:** *Firms in developing economies may use more or less debt than those in developed countries.*

Hamid and Singh (1992) noted that companies found within Jordan, Malaysia, Taiwan, Mexico, Pakistan and Zimbabwe have gearing levels that are similar to those of firms in developed economies, whereas firms in Thailand and South Korea have higher levels. The studies also note that Indian firms have gearing levels that are similar to those of companies found within developed countries

Although the study has set out four more or less consensual observations, it will be clear that, overall, it is difficult to generalize about corporate capital structures: either within the industrial countries, or within the developing countries, or in comparisons between the two. Depending on the country, the time period, and the data

definitions, different studies come to different conclusions. This suggests that the root of the differences in corporate capital structures may lie in the different underlying circumstances faced by individual firms. If firms in the same country all faced exactly the same circumstances and constraints, one would expect to see greater uniformity of results within individual countries.

In conclusion, it would appear particularly important therefore to survey the various tests of theories of corporate capital structure, as these theories seek the source of cross-sectional differences among firms in more fundamental differences of circumstance among individual firms: their industry and stakeholders. For MSEs, the motivation behind their study cannot be over emphasized owing to their peculiarity on one hand and the sparsity of studies in this area on the other hand.

## CHAPTER THREE

### 3.0 RESEARCH METHODOLOGY

This section discusses the research design, sampling method, data collection and data analysis.

#### 3.1 Research Design

The survey method has been employed in this study.

#### 3.2 Population

The population of study consisted of all MSEs operating in Nairobi. The 1999 MSEs baseline survey estimated that there are approximately 127,400 (equivalent to 9.8% of all MSEs in Kenya) MSEs in Nairobi (CBS, et. Al., 1999).

#### 3.3 Sampling plan

Due to the large number of MSEs, sampling by sectors was used in selection of the MSEs which were surveyed. The study used the 1999 National Baseline Survey of micro and small scale enterprises in Kenya as a sampling frame. This survey estimated some 1.3 million MSE in Kenya of which 9.8% of MSEs are in Nairobi (CBS, et. Al., 1999). A bigger majority of the MSEs in Nairobi are concentrated in retail trading (65,746), Motor-vehicle repair and service (14,532) and Hotels and restaurants (10,765). [MSE Baseline Survey, 1999]. A proportionate sample of 60 MSEs was drawn from the three sectors. A sample size of 60 has been considered appropriate in a number of other studies (Wanyungu, 2000; Mwindi, 2002), for the reason of making it easy and less costly to administer questionnaires. The data was collected from a wide range of localities within the city of Nairobi. These included, the East-lands, Nairobi West and the Southlands.

#### 3.4 Data collection

Primary data was collected by using directly administered semi-structured questionnaires to the entrepreneurs.

Secondary data was obtained from records available in libraries of MFIs, government offices and MSEs themselves.

### 3.5 Data presentation and analysis

The data collected is presented using tables and descriptive statistics.

Data analysis was done using SPSS statistical package. The data was analysed using descriptive statistics (frequencies and percentages) and inferential statistics (correlation analysis). Descriptive statistics enabled the researcher to describe the various variables in the study such as sources of funds, value of equipment, current value of business assets, amount of savings (average monthly gross savings before deduction of the entrepreneur's private consumption made by the enterprise), sales volumes and number of full-time employees in the MSEs.

Correlation analysis was used to relate the sources of funds and the performance indicators. This enabled the researcher to identify whether there is a relationship between the various sources of funds and the performance of MSEs. Correlation measures the degree of association between two variables, which are not necessarily independent. This technique is preferable since it does not imply causation but rather shows how variables move together.

The following are the hypothesis of the study;

**Null Hypothesis ( $H_0$ ):** There is no relationship between MSEs financial structure and MSE performance.

**Alternate Hypothesis ( $H_A$ ):** There is a relationship between MSEs financial structure and MSEs performance.

## CHAPTER FOUR

### 4.0 DATA ANALYSIS AND FINDINGS

This chapter presents the data findings on the relationship between financial structure and performance of MSEs in Nairobi, Kenya.

As priory stated, the study had two objectives namely; to determine the financial structure of MSEs in Nairobi and to establish the relationship between financial structure and performance of MSEs in Nairobi.

#### 4.1 Data Collection

Data was obtained from 60 MSEs through a questionnaire using direct interview method. Of the 60 MSEs, 43 were from the retail trade sector, 9 from motor vehicle repair and service sector while 8 were Hotels and restaurants. The sample distribution per locations is as shown in the table I below;

**Table I: MSEs Population and Sample**

Sectors	No. of MSEs*	No.of MSEs selected**	Distribution per Location **		
			Eastlands <sup>1</sup>	Nairobi west <sup>2</sup>	Southlands <sup>3</sup>
Retail trading	65,746	43	21	11	11
Motor-vehicle repair and service	14,532	9	3	3	3
Hotels and restaurants	10,765	8	4	2	2
<b>Total for Highest 3</b>	<b>91,043</b>	<b>60</b>	<b>28</b>	<b>16</b>	<b>16</b>

\*Source: CBS, ICEG, K-Rep, National MSE Baseline Survey, 1999.

\*\* Research methodology<sup>1</sup>

<sup>1</sup>**Eastlands** :- Embakasi, pipeline, industrial area, Dohnholm, Umoja, Komarock, Kayole, Kariobagi, BuruBuru

<sup>2</sup>**Nairobi West**: - South B, South C, Nairobi West and Kibera

<sup>3</sup>**Southlands**: - Langata, Karen



The findings and conclusions are therefore based on observations from the 60 firms drawn from the three sectors across three locations in Nairobi and its environs.

#### 4.2 Background of the Studied MSEs

The average size (in terms of number of employees) of the MSEs surveyed was 3 employees. The size 1 to 5 employees accounted for 95% of the firms surveyed and therefore are categorised as micro enterprises. Of the remaining 5 percent, only 2 enterprises had more than 10 employees. This structure is in line with the findings of 1999 MSEs baseline survey (CBS, et al., 1999) which established that in 97% of MSEs in Kenya are in the size range of 1-5 workers. MSEs size is tabulated in table II below.

**Table II: MSEs Size - Number of Employees**

No. of employees	Frequency	Percent	Cumulative Percent
1	31	51.7	51.7
2	9	15.0	66.7
3	7	11.7	78.3
4	7	11.7	90.0
5	3	5.0	95.0
6	1	1.7	96.7
10	1	1.7	98.3
25	1	1.7	100.0
<b>Total</b>	<b>60</b>	<b>100.0</b>	

Source: Research Data

In terms of ownership, 86.7% of the surveyed enterprises were sole proprietorships, 13.7% were partnerships while none was incorporated as a company. Table III shows form of ownership of the MSEs surveyed.

**Table III: Ownership of MSEs**

<b>Form of ownership</b>	<b>Frequency</b>	<b>Percent</b>	<b>Cumulative Percent</b>
Sole proprietorship	52	86.7	86.7
Partnership	8	13.3	100.0
<b>Total</b>	<b>60</b>	<b>100.0</b>	

**Source: Research Data**

The average age of the MSEs surveyed was 7 years. Hence MSEs in Nairobi can be looked at as very young.

#### **4.3 Sources of Finance for MSEs**

The survey gives separate categorical information about the main source of the initial capital for the businesses and any additional capital. There are some ambiguities in the coding of these and other responses. For example, there may be missing observations either because MSEs did not require any start-up or additional capital or because of a non-response to the question. An important conclusion from table IV is that relatively few MSEs have financed their capital with debt, and fewer still have used lenders outside the family for this purpose: just 16.7% of all the firms raised part of their initial capital in the form of debt from outside the family; and 18.3% raised additional capital this way.

**Table IV: Internal Capital (INTERCAP)**

Percentage of capital	Frequency	Percent	Cumulative Percent
.00	1	1.7	1.7
5.00	1	1.7	3.3
10.00	1	1.7	5.0
35.00	1	1.7	6.7
40.00	2	3.3	10.0
50.00	1	1.7	11.7
75.00	2	3.3	15.0
84.00	1	1.7	16.7
100.00	50	83.3	100.0
<b>Total</b>	<b>60</b>	<b>100.0</b>	

**Source: Research Data**

Previous studies have highlighted the same limited access to external financial resources available to smaller enterprises compared to larger organizations and the consequences for their growth and development (Saito and Villanueva, 1981). Mwindi (2002) and Ondiege (1996) share similar findings that most of the enterprises' initial capital was from the entrepreneur's own savings.

#### **4.4 MSEs Financial Structure**

The survey found that MSEs are more dependent on internal sources of funds (Owner's own capital and retained profits) than on external sources of finance (financial markets and indebtedness). The average owners equity was 94.3%, average short-term debt was 4.2% and the average long-term debt was 1.5%. These findings are similar with Gibson (2001) findings in his research of European MSEs. On a similar footing, Hamid and Singh (1992) found that firms found within developing economies rely more heavily on equity than on debt to finance growth relative to their counterparts in the developed economies. In the case of MSEs, the equity is mostly internal equity as most of them prefer to go into business on their own and with very little willingness to venture into partnerships.

**Table V: Financial Structure of MSEs**

Source of Finance	N	Minimum	Maximum	Mean	Std. Deviation
Owners Equity	60	0	100	94.30	17.77
Short Term debt	60	0	67	4.20	12.33
Long Term debt	60	0	21	1.50	2.71

**Source: Research Data**

Based on the above table, one can conclude that the average financial structure for MSEs surveyed was 94.3% to 5.7%; Owners Equity to Debt respectively. Of the total indebtedness of the MSEs, short-term debt accounted for 74% and thus a tendency to rely more on short-term (as opposed to long-term) debt. The same observation was made by Dubocage (2001) a tendency, which he pointed out that it may correlate with their high working capital requirement and higher flexibility required.

#### **4.5 Performance of MSEs**

As mentioned elsewhere, performance of MSEs was measured by the value of equipment, current value of business assets, amount of savings, sales volumes, number of full-time employees, growth in sales, growth in profits, and growth in assets as was the case of Ondiege (1996) and Prasad et al., (2001). The following are the notable results on each of the measures: -

##### **4.5.1 Value of Equipment**

The value of equipment was measured as a percentage of the total assets. Thirty-five percent (35%) of the MSEs did not own any equipment, about 70% had less than 50% of their assets in form of equipment while 30 % of the MSEs had over 50% of their assets as equipments. Table VI is a summary of the value of equipment. Further analysis shows that the bulk of the MSEs with less than 50% of their assets as equipment were in the retail-trading sector. This observation may be attributed to the nature of business of retail-trade enterprises. However, it is important to note that

MSEs by their nature have a serious impediment owing to a lurk capacity to acquire assets. Tools and equipments are of particular importance in enhancing the productivity and therefore the profitability of these enterprises.

**Table VI: Value of equipment to total assets**

	Percentage	Frequency	Percent	Cumulative Percent
<b>Valid</b>	0	21	35.0	35.0
	5	1	1.7	36.7
	6	2	3.3	40.0
	10	3	5.0	45.0
	11	1	1.7	46.7
	12	2	3.3	50.0
	13	3	5.0	55.0
	15	1	1.7	56.7
	20	3	5.0	61.7
	27	1	1.7	63.3
	30	1	1.7	65.0
	33	2	3.3	68.3
	35	1	1.7	70.0
	50	1	1.7	71.7
	56	1	1.7	73.3
	58	1	1.7	75.0
	60	1	1.7	76.7
	70	1	1.7	78.3
	75	1	1.7	80.0
	80	1	1.7	81.7
	92	1	1.7	83.3
	95	1	1.7	85.0
	96	2	3.3	88.3
98	3	5.0	93.3	
100	4	6.7	100.0	
	Total	60	100.0	

**Source: Research Data**

#### 4.5.2 Value of Business Assets

The average value of business assets was Kes 174,000, with a minimum value of Kes 3,000 and a maximum value of Kes 2.5million as shown in table VII below.

Approximately 70 % of the MSEs had a value of assets of less than Kes 100,000 while only 5% of the MSEs had assets of over Kes 1,000,000. As with the case of equipments, MSEs' operations may be greatly curtailed by inadequate assets.

**Table VII: Value of Assets**

	<b>N</b>	<b>Minimum</b>	<b>Maximum</b>	<b>Mean</b>	<b>Std. Deviation</b>
Value of assets	60	3000	2500000	174019.33	421751.53
<b>Valid N (listwise)</b>	60				

**Source: Research Data**

For ease of analysis and in order to draw meaningful conclusions, the value of assets has been standardized by annual turnover.

#### 4.5.3 Sale and Growth in Sales

Growth in sales was evident in 70% of the MSEs surveyed while 30 % did not record any growth in sales during the last 3 years. Sales and growth in sales had a positive bearing on profitability of the enterprises. Growth in sales is as summarized in table VIII below.

**Table VIII: Growth in Sales Volume**

<b>Growth</b>		<b>Frequency</b>	<b>Percent</b>	<b>Cumulative Percent</b>
<b>Valid</b>	Yes	42	70.0	70.0
	No	18	30.0	100.0
	<b>Total</b>	<b>60</b>	<b>100.0</b>	

**Source: Research Data**

#### 4.5.4 Number of Full time Employees

Comparing the total number of employees with the number of full-time employees, the study found out that MSEs invariably engage just the right size of staff. In almost

all the cases, all the employees were on full-time basis except for enterprises in the motor-vehicle repair and service where 60% of the workers were full-time. A Caveat here is necessary since it the study observed that majority of motor-vehicle garages engage apprentices and staff with specialized skills on part-time basis.

#### 4.5.5 Growth in Profits

Growth in profit was observed in 53.3% of the MSEs while 46.7% of the MSEs surveyed did not post any growth in profits during the last 3 years. Growth in profit is summarized in table IX below. Growth (or decline) in profits was found to be a fair measure of performance since all the enterprises surveyed were suppressed to the same economic conditions. This observation is strengthened by the fact that growth in profits was equitably spread over all the three sectors as well as in all locations.

**Table IX: Growth in Profit**

Profit Growth		Frequency	Percent	Cumulative Percent
Valid	Yes	32	53.3	53.3
	No	28	46.7	100.0
	Total	60	100.0	

**Source: Research Data**

#### 4. 6 Financial Structure and Performance of MSEs

Correlation analysis was used to relate the sources of funds and the performance indicators and therefore identified the degree of association between the two variables.

Financial structure was separated into owners' equity and debt, variables of which were subjected to correlation analysis on each of the indicators of performance. The results showed that owners equity manifested a positive correlation with the value of equipment, sales and sales growth, and number of full-time employees while it had a

negative correlation with growth in profits. However, all the correlations were weak and in a number of cases very weak.

On the other hand, debt had a negative correlation with the value of assets, sales, growth in profit and number of full-time employees but has a positive correlation with sales growth. As with the case of correlations with assets, the debt correlations are notably weak.

The positive correlation with owners equity affirms the assertion elsewhere that MSEs financed by owners funds rather than by debt tend to post a better performance. On the other hand, the negative impact of debt to MSEs performance is evidenced by the negative correlations.

The above observation is affirmed by Dubocage (2001) who pointed out that MSEs that have more owner funds are more successful than those, which utilize a "greater" percentage of debt. He singled out bank loans as a hand-cap to MSE performance.

Table X overleaf summarizes the correlations.



**Table X: Correlations**

		<b>Owners Equity</b>	<b>Total Debt</b>	<b>Value of equipment to assets</b>	<b>Value of Assets</b>	<b>Annual Sales</b>	<b>Growth in Sales</b>	<b>Growth in Profit</b>	<b>Number of full time employee</b>
<b>Owners Equity</b>	<b>Pearson Correlation</b>	1.000	-.688(**)	.223	.084	.074	.174	-.094	.105
	<b>Sig. (2-tailed)</b>		.000	.087	.523	.573	.183	.477	.426
	<b>N</b>	60	60	60	60	60	60	60	60
<b>Total Debt</b>	<b>Pearson Correlation</b>	-.688(**)	1.000	-.198	-.045	-.047	.040	-.013	-.089
	<b>Sig. (2-tailed)</b>	.000	.	.130	.731	.720	.764	.922	.499
	<b>N</b>	60	60	60	60	60	60	60	60

\*\* Correlation is significant at the 0.01 level (2-tailed).

**Source: Research Data**

#### 4.6.1 Testing of the Hypothesis using t Test and correlation analysis

The hypothesis for testing was;

$H_0$ : There is no relationship between MSEs financial structure and MSE performance.

$H_A$ : There is a relationship between MSEs financial structure and MSEs performance.

**Test Statistics:** t Test at 5 per cent level of significance and correlation at 1 per cent.

Since the computed t (ref. Table XI (B)) is greater than the tabulated t (2.001), the decision here is to fail to accept the null hypothesis and conclude that there is a relationship between MSEs financial structure and MSEs performance.

**Table XI: T-Test**

**(A) One-Sample Statistics**

	N	Mean	Std. Deviation	Std. Error Mean
Value of equipment to assets	60	31.27	37.59	4.85
Value of Assets	60	54.7431	93.6050	12.0844
Annual Sales	60	1412650.00	2653834.03	342608.50
Growth in Sales	60	1.30	.46	5.97E-02
Growth in Profit	60	1.47	.50	6.49E-02
Number of full time employee	60	2.45	3.29	.42

**(B) One-Sample Test**

	Test Value = 0					
	t	df	Sig. (2-tailed)	Mean Difference	95% Confidence Interval of the Difference	
					Lower	Upper
Value of equipment to assets	6.443	59	.000	31.27	21.56	40.98
Value of Assets	4.530	59	.000	54.7431	30.5624	78.9239
Annual Sales	4.123	59	.000	1412650.00	727091.97	2098208.03
Growth in Sales	21.790	59	.000	1.30	1.18	1.42
Growth in Profit	22.582	59	.000	1.47	1.34	1.60
Number of full time employee	5.767	59	.000	2.45	1.60	3.30

#### **4.6.2 Interpretation of the Hypothesis**

From the research findings, it is evident that the presence of debt lowers the performance of the MSEs. This is evident from the responses, which show that firms financed by internal funds post a superior performance than those with borrowed funds in their financial structure.

The correlation analysis indicated a positive relationship between owners' equity with all the tested aspects of performance except for growth in profits. On the same footing debt and performance have a negative correlation for all aspects except for growth in sale volume which has a weak positive relationship with the presence of debt.

The positive correlation with owners equity as mentioned elsewhere affirms the assertion that MSEs financed by owners funds rather than by debt tend to post a better performance. On the other hand, the negative impact of debt to MSEs performance is evidenced by the negative correlations. The hypothesis testing further affirms the above observations.

## CHAPTER FIVE

### 5.0 SUMMARY OF RESEARCH FINDINGS, CONCLUSIONS, LIMITATIONS OF THE STUDY, RECOMMENDATIONS TO POLICY MAKERS AND SUGGESTIONS FOR FURTHER RESEARCH.

#### 5.1 Summary of Research Findings and Conclusions

It will be recalled that the aim of the study was to investigate the relationship between financial structure and performance of MSEs in Nairobi, Kenya. In addition, the study was carried out with two principle objectives, firstly to determine the financial structure of MSEs in Nairobi and secondly to establish the relationship between financial structure and performance of MSEs in Nairobi. The findings of these objectives are summarized in the following section.

##### 5.1.1 Summary of Research Findings

MSEs in Nairobi were found to be of small size with a majority of them employing between 1 and 5 employees. The small sizes of MSEs in Nairobi and in general can be explained by the entrepreneurs' need for control of the enterprise among other factors. Further, the study found MSEs in Nairobi to be very young with an average age of 7 years.

The study established that MSEs use more internal funds than external funds. Further, the external sourcing is concentrated within the family circle and friends and relatives rather than from financial institutions and other formal lenders. This overdependence on internal sources of funds may be seen as an impediment to expansion of MSEs. The study found an average financial structure for MSEs of 94.3% to 5.7%; Owners Equity to Debt respectively.

MSEs generally hold very few assets. Most of the MSEs with more assets tended to have debt in their financial structure and posted better performance. This phenomenon can be explained by the fact that the presence of assets enhances the process of collateralization. Even though MSEs were found to borrow mostly from "close" sources (i.e. within the family circle, friends and relatives), those with collateralizable assets enjoyed a wider scope for sourcing debt funds.

Growth in sales and increased profitability were observed in a bigger percentage of the MSEs although the growth was dismal in some cases. The study observed that MSEs with high profits tended to use more internal funds. High profits give more internal retained earnings and thereby leading to less borrowing by the enterprise.

However, MSEs were generally found to be under performing and in most cases, superior performance was portrayed by MSEs financed internally. Of particular note is the fact that MSEs, which ploughed back a better part of their profit, posted a superior performance.

### **5.1.2 Conclusions**

Although the results of this study may be regarded as preliminary, they emphasize four findings;

First, MSEs in Nairobi are to a greater extent financed using internal funds. Debt is drawn from a wide variety of sources especially from the family circle, friends and relatives, but including co-operatives, banks, NGOs, and other financial institutions. The excessive use of internal funds is explained by the ease of their accessibility and by the fact that external funds generally inaccessible by for smaller entities.

Secondly, Internally financed MSEs post better performance than those with debt capital in their financial structure. There exists a relationship between the volume of sales, profitability and performance such that MSEs with high sales volume posted high profitability and used more internal funds.

Thirdly, a greater percentage of debt used is short-term debt and that long-term debt comprises a very small percentage of the financial structure. Many lenders are not willing to lend to MSEs for longer periods due to the perceived riskness of these enterprises.

Fourthly, MSEs in Nairobi tend to be small and hence have a very small number of employees in addition to being very young.

## **5.2 Limitations of the Study**

The study findings have been interpreted with a few caveats due to shortcomings that faced the study. These limitations include;

Firstly, important data may have been left out owing to the perceived “private and confidential” nature of the same. Even though the researcher made all best effort to obtain all the needed information, corroborative secondary information would have added more value. The big issue here is the fact that SMEs rarely keep any financial information.

Secondly, majority of the entrepreneurs interviewed were semi-illiterate. This made the administration of the questionnaires quite a task and might have lead to some questions being misinterpreted. Extra effort was put and in some cases a repeat interview for clarifications was done.

## **5.3 Recommendations to policy makers**

The study makes the following recommendations;

- i) The study recommends that MSEs consider expanding their capacity by embracing loan funds from MFIs and other cost-effective external sources such as NGO initiatives. This is on the premise that a firm that relies too much on own funds may miss opportunities to increase its assets because such an increase would have implied debt.
- ii) MSEs should avoid financing from banks and other financial institutions, as such sources of funds are not cost effective for the MSEs. This recommendation is based on the premise that MSEs financed heavily by bank loans often suffer from an excess of financial charges that would jeopardize their future development.

#### 5.4 Suggestions for Further Research

The following areas are suggested for further research;

- i) Since the study concentrated on Nairobi, a similar study can be carried out focussing on the MSEs in rural areas in Kenya.
- ii) MSEs performance has been measured using only the quantitative indicators. Since there exists a horde of qualitative measurements of MSEs performance, a study can be carried using the qualitative measurements.

## EPITAPH

*“ If education is to be a road map, be sure it describes the right highway. There is no worse situation than years burried in books, the two (you and the books) are finally required to see what remedy there is on “a” particular dispute, only to discover that there was no resemblance of mission, goals and objectives between education and the way it's designed on one hand and you and the purpose of seeking education on the other”.*



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## **APPENDIX I: QUESTIONNAIRE**

### **SECTION I: BACKGROUND INFORMATION**

1) Name of the Business \_\_\_\_\_

2) Nature of the Business (Please tick as appropriate)

Retail trading  Hotels and restaurants

Motor-vehicle repair and service  Other (Specify) \_\_\_\_\_

3) Number of Employees in the Business \_\_\_\_\_

4) Form of ownership (Please tick one)

Sole Proprietorship  Partnership

Company  Other (Specify)

5) Location of the Business \_\_\_\_\_

6) When was your business established? \_\_\_\_\_

7) What is the main objective (s) of your business? \_\_\_\_\_

\_\_\_\_\_

## SECTION II: FINANCIAL STRUCTURE

8) What proportion of total financing have you contributed in your business?  
\_\_\_\_\_ %

9) Indicate the proportion of funds for your business obtained from the following sources of finance.

Micro Finance Institution	___ %	Friends and relatives	___ %
Other Business' Income	___ %	Own savings	___ %
Bank Loan	___ %	Other (Specify)	___ %

10) Which of the following formed your financial needs at the time you received financial funding?

Initial Capital/Equipment	[ ]
Additional Capital	[ ]
Working Capital	[ ]
Others (Please Specify)	[ ]

11) Indicate the sources of finance you used to start your business, in percentage terms.

Micro Finance Institution	___ %	Friends and relatives	___ %
Other Business' Income	___ %	Own savings	___ %
Bank Loan	___ %	Other (Specify)	___ %

12) What proportion of additional finance used for your business did you obtain from the following sources?

Micro Finance Institution	___ %	Friends and relatives	___ %
Business Income	___ %	Own savings	___ %
Bank Loan	___ %	Other (Specify)	___ %

13) What percentage of the capital in you business is;

Own Funds	_____ %
Borrowed Funds (payable within the next 12months)	_____ %
Borrowed Funds (Repayment beyond the next 12months)	_____ %

### SECTION III: PERFORMANCE

14) What is the value of the equipment of your business as a proportion of your total assets? \_\_\_\_\_ %

15) What is the value of your business assets? Ksh. \_\_\_\_\_

16) How much savings have you made from the business during the last 1 year? Ksh. \_\_\_\_\_

17) How much are your monthly sales? \_\_\_\_\_

18) How many full-time employees do you have? \_\_\_\_\_

19) Have you experienced any growth in your firm?

Yes [ ]

No [ ]

20) If yes, please complete the table below: (Place a tick where appropriate)

Area of Growth	This year	One year ago	Two years ago	Other years (specify)
1. Sales volume				
2. Stocks				
3. Employment				
4. New Businesses				
5. Others (Specify)				

21) Indicate the extent to which each of the following have contributed to this growth.

	Very Low	Low	Moderate	High	Very High
Loans/Credit	1	2	3	4	5
New Markets	1	2	3	4	5
New products	1	2	3	4	5
Re-investment of profit	1	2	3	4	5
Other (Specify)	1	2	3	4	5

22) Income from the business enterprise

Item per month	Currently	1 year ago	2 years ago
a) How much sales do you make per month?			
b) How much did you spend on inputs?			
c) How much did you pay on salaries/wages?			
d) How much did you pay for monthly rent?			
e) How much did you spend on electricity and water (if any)?			
f) How much did you pay for transport?			
g) How much did you spend on other operating costs (specify)			
h) Total monthly costs			
i) Estimated profit for the year.			

23) Indicate the proportion of the profit from your business used in each of the following uses for the last two years?

Purchased assets            \_\_\_ %            Expanded the business            \_\_\_ %

Saved                            \_\_\_ %            Used for daily expenditure            \_\_\_ %

Purchased land                \_\_\_ %            Started another business            \_\_\_ %

For non-business responsibilities, e.g. paying school fees            \_\_\_ %

Others (please specify) \_\_\_\_\_ \_\_\_ %



Please give your assessment of the overall performance of your business using the response scale given below.

**Scale: 1. Very Low   2. Low   3. Moderate   4. High   5. Very High**

24) Sales growth for the last 2 years \_\_\_\_\_

25) Average profitability in the last 2 years \_\_\_\_\_

26) Ability to attract & maintain employees \_\_\_\_\_

*(E.g. Longest serving employee vs newest employee)*

27) Please indicate, in order of priority, four major problems faced by your business.

i. \_\_\_\_\_

ii. \_\_\_\_\_

iii. \_\_\_\_\_

iv. \_\_\_\_\_

28) Please provide any other information considered useful concerning your business.

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**THANK YOU**