# THE EFFECT OF MICROFINANCE SERVICES ON THE FINANCIAL PERFORMANCE OF SMALL AND MEDIUM ENTERPRISES IN EMBU COUNTY, KENYA

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**A RESEARCH PROJECT SUBMITTED IN PARTIAL FULFILMENT OF THE REQUIREMENTS FOR THE AWARD OF THE DEGREE OF MASTER OF SCIENCE IN FINANCE, SCHOOL OF BUSINESS UNIVERSITY OF NAIROBI**

# DECLARATION

I declare that this research project is my original work and has not been submitted for examination in any other university or institution of higher learning

Signed……………………… Date ………………………………………

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D63/68147/2013

**BY SUPERVISOR'S DECLARATION**

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

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# DEDICATION

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| | |
|---|---|
| **CGAP** | Consultative Group to Assist the Poor |
| **NGOs** | Non-Governmental Organizations |
| **MFI** | Micro-Financial Institutions |
| **SME** | Small and Medium Enterprises |

# ABSTRACT

Microfinance is “the provision of financial services to low-income poor and very poor self-employed people”. The research was aimed at investigating the effects of micro-finance credit on the financial performance of Small and Medium Enterprises (SMEs) in Embu County, Kenya. SMEs form the majority in the county. It helps in creation of employment in the county and in the country in general. The formal banking sector in Kenya over the years has regarded the informal sector risky and not commercially viable. This research problem was studied through the use of survey design. Out of the 1,579 SMEs licensed in Embu County, this study randomly sampled 60 SMEs. The study found that there is a direct relationship of microfinance services and especially micro- credit and financial performance of the companies. The study also concludes that the enterprises benefit from loans from microfinance institutions, the SMEs seek financial assistance from the MFIs due to amount offered, interest rate, and easy loan repayment. There is need to provide an enabling environment for SMEs to grow and thrive, and thus there needs to be developed strategies to enhance increased access to microfinance credit by SMEs from commercial banks and microfinance institutions. It is important for the government to set up policies that will ease microfinance credit to SMEs.

# CHAPTER ONE: INTRODUCTION

## 1.1 Background of the study

Microfinance is "the provision of financial services to low-income poor and very poor self-employed people". Low-income poor and very poor self-employed people are those that need financial help but may be unable to obtain them due to lack of their inability to meet the specific standard requirement. Thus, microfinance is their gateway to financial freedom. It can do so by providing services such as savings, loans and insurance to such people. Therefore, microfinance encompasses micro-insurance and micro-credit.

Ledgerwood (1999) argues that micro-finanial services to include savings, credit, insurance and payment services. Galor and Zeira (2012) define microfinance as "the attempt to improve access to small deposits and small loans for poor households neglected by banks. Both agree that microfinance is an important part of a growing economy especially one whose majority of its people are poor.

There are different providers of microfinance services and some of them are; nongovernmental organizations (NGOs), savings and loan cooperatives, credit unions, governmental banks, commercial banks and non-bank financial institutions. Their target groups are self-employed low income entrepreneurs (Ledgerwood, 1999). MFIs have the following characteristics:- Loans are usually relatively short, less than 12 months in most instances, and are generally for working capital with immediate, regularly, weekly or monthly repayments. They are also disbursed quickly after approval, particularly for those seeking properly repeat loan. The traditional lenders requirements for physical collateral such as property are usually replaced by a system of collective guarantee where members are mutually responsible for ensuring that their individual loans are repaid. Loans application and disbursement procedures are designed to be helpful to low income borrowers. They are simple to understand, locally provided and quickly accessible (Khan, 2008).

Baseline survey of 1999 defines SMEs as those non Primary enterprises (excluding agricultural production, animal husbandry, fishing, hunting, gathering and forestry), whether in the formal or informal sector which employ 1 -50 people. Micro enterprises are those that employ 10 workers or fewer and small enterprises as those employing more than 10-15 workers. Small enterprises include a variety of firms, village handicraft makers, small machine shops, restaurants and computer software shops, firms that possess a wide range of sophistication and skills and operate in very difficult markets and social environments. The owner may or may not be poor, some are dynamic, innovative and growth oriented while others are traditional lifestyle enterprises that are satisfied to remain small (Hallberg, 2000).

### 1.1.1 Micro-Finance services

The concept of micro-financing arose out of the need to provide to the low-income earners who were left out by formal financial institutions. The practice of micro-credit dates back to as early as 1700 and can be traced to Irish Loan Fund System which provided small loans to rural poor with no collateral. Over the years, the concept of micro-finance spread to Latin America, then to Asia and later to Africa.

The today use of the expression micro-financing has its roots in the 1970s when organizations, such as Grameen Bank of Bangladesh with the micro-finance pioneer Mohammad Yunus, were starting and shaping the modern industry of micro-financing. (Mwangi, 2011).

In Kenya, micro-finance movement gained momentum in the late 1980s as a result of exclusion of large proportion of the population from the formal financial institution mainly banks. Micro-finance emerged with the aim of filling the gap left by banks in providing credit to individuals, micro, small and medium enterprises which were on the rise during this period. (Ogindo, 2006). In the early 1990s with the opening up of political space and ensuing economic disturbances, the need for credit by individuals, micro, small and medium enterprises increased and this led to the recognition of micro-finance institutions in Kenya. Among the pioneer MFIs in Kenya are Equity Building Society (currently 4 Equity Bank), Family Building Society (currently Family Bank), Faulu Kenya and KRep. MFIs in Kenya have been established using either an NGO or a Savings and Credit Cooperative Society Framework.

MFIs have been important sources of credit for a large number of low income households and MSEs in the rural and urban areas of Kenya. (Wambugu, 2007). MFIs gained prominence in Kenya due to the fact that the formal banking sector since independence up to late 2000 regarded the informal sector as risky and not commercially viable. (Ogindo, 2006). The MFIs developed and offered new, innovative and pro-poor modes of financing low-income households and MSEs based on sound operating principles. Since their inception, MFIs have greatly contributed to socialeconomic empowerment to the beneficiaries and their dependants. (Kamau, 2010).

(Robinson,1998) defines microfinance as a development too that grants or provides financial services and products such as very small loans, savings, micro leasing, micro insurance and money transfer to assist the very or exceptionally poor in expanding or establishing their businesses. It is mostly used in developing economies where SMEs do not have access to other sources of financial assistance. The term microfinance can also be defined as provision of financial services to low income clients including the self-employed. Financial services generally include savings and credit; however some finance organizations also provide insurance and payment services. In addition to financial intermediation, many MFIs provide social intermediation services such as group formation, development of self-confidence and training in financial literacy and management capabilities among members of a group. (Ledgerwood,1999).

Microfinance activities include: small loans generally for working capital, informal approval of borrowers and investments, collateral substitutes such as a group guarantee or compulsory savings, access to repeat and large loans based on repayment performance, streamlined loan disbursements and monitoring and secure saving products. The services provided to Microfinance clients can be categorized into four different categories. These are financial intermediation, enterprise development, social intermediation and social services.

Financial intermediation is the provision of financial products and services such as savings, credit, insurance, credit cards and payment system which should not require ongoing subsidies. Social intermediation is the process of building human and social capital needed by sustainable financial intermediation for the poor. Enterprise development services or non-financial services assist micro entrepreneurs include skills development, business training, marketing and technology. Social services focus on advancing the welfare of micro entrepreneurs including education, health, nutrition, and literacy training. These services require ongoing subsidies and are always provided by NGOs or the state. (Ngehnevu and Nembo, 2010).

MFIs have the following characteristics: short term loans usually disbursed quickly aftr approval – less than 12 months in most instances and are generally for working capital with immediate regular weekly or monthly repayments. The traditional lenders requirements for physical collateral such as property are usually replaced by a system of collective guarantee where members are mutually responsible for ensuring that their loans are repaid. (Khan, 2008).

### 1.1.2 Financial performance of small and medium enterprises

Financial performance is a subjective measure of how well a firm can use assets from its primary mode of business to generate revenues. The term is also used as a general measure of a firms overall financial health over a given period of time, and can be used to compare similar firms across the same industry or compare industries or sectors in aggregation. The most common measure of financial performance is ratios.

A ratio is simply a mathematical expression of an amount or amounts in terms of another or others. A ratio can be expressed as a percentage, as a fraction, or a stated comparison between two amounts. The computation of ratio does not add any information not already existing in the amount or amounts (Wahid, 1994).The recommended measures for financial analysis that determine a firms financial performance are grouped into five broad categories: liquidity, solvency, profitability, repayment capacity and financial efficiency (Maria, Florica and Catalina, 2002).

Liquidity refers to an enterprise ability to meet its short term obligations as and when they fall due. They are used to assess the adequacy of a firms working capital. The three basic measures are net working capital, current assets that are financed from long term capital resources that do not require repayment in the short term, implying that the portion is still available for repayment of short term debt. Current ratio measures the debt paying ability of an enterprise. A high current ratio is assumed to indicate a strong liquidity position while a low current ratio is assumed to indicate weak liquidity position. Quick ratio on the other hand tests the debt paying ability of an enterprise without having to rely on inventory and repayments (Ormiston, 2007).

Profitability ratios evaluate the firms earnings with respect to a given level of sales, a certain level of assets, the owners investment are share value. Evaluating the future profitability potential of the firm is crucial since in the long run, the firm has to operate profitably in order to survive. The ratios are importance to creditors, shareholders, suppliers, employees and other stakeholders. The ratios include gross profit margin, net profit margin, return on assets and return on equity.

It is important to remember that past and present financial information are not the only factors affecting a firms financial performance rather measuring a group performance is more important than focusing on only one or two measures at the exclusion of others (Carton, 2004). The common financial indicators of financial performance include: sales growth, return on investment (ROI), and return on sales, return on equity (ROE), and earnings per share. The popular ratios that measure organizational performance can be summarized as profitability and growth: return on asset (ROA), return on investment (ROI), return on equity (ROE), return on sale (ROS), revenue growth, market shares, stock price, sales growth, liquidity and operational efficiency. (Carton, 2004)

### 1.1.3microfinance services and financial performances

Microfinance is the proper tool to reduce income inequality, allowing citizens from lower socio-economical classes to participate in the economy. Moreover, its involvement has shown to lead to a downward trend in income. However, on its own it cannot eradicate poverty.

The two main mechanisms for the delivery of financial services to such clients are relationship-based banking for individual entrepreneurs and small businesses and group-based models, where several entrepreneurs come together to apply for loans and other services as a group (Diagne and Zeller, 2001). Microfinance credit can play a pivotal role in economic growth. Banks and lending institutions provide the services that allow people to save and invest available assets and resources, which further supports and strengthen economic activity. Within underdeveloped communities, the role of microfinance institutions provides the credit access and financial services needed to develop income earning businesses.

Most microfinance programs make use of some form of group-lending schemes, such as peer selection and monitoring, regular public repayments and joint liability. With group lending schemes, explicitly uses joint liability, though it applies to any mechanism that implies some peer screening, monitoring or enforcement (Barnes, 2001). Under joint liability, individual borrowers have to form groups to apply and all group members are held collectively responsible for the repayment of each other‟s debt. Several authors have proposed various explanations for the new opportunities that this mechanism might offer (Coleman, 2006).

### 1.1.4 SMEs in Kenya and in Embu County in Particular

Small and Medium Enterprises (SMEs) is an important sub sector for the Kenyan economy like many other developing countries since it employs about 85% of the Kenyan workforce (about 7.5million Kenyans of the current total employment). The current constitutional framework and the new Micro and Small Enterprise Act 2012 (MSE Act 2012) provide a new window of opportunity through which the evolution of SMEs can be realized through the devolution framework. However, the impact of devolution on SMEs development depends on the architecture of the regulatory and institutional framework inclined to support SMEs in an economy.

Embu County is one of the fastest growing counties in Kenya. It is divided into five sub-Counties; namely, Embu West, Embu North, Embu East, Mbeere North and Mbeere South. Agriculture is the backbone and livelihood of the people of Embu County. However, being a largely metropolitan county, SMEs are coming up in other sectors like: trade and commercial services, financial services and construction.

## 1.2 Research problem

The poor need financial products and services to build assets stabilise consumption and shield themselves against risk. Microfinance is the idea that low-income individuals are capable of lifting themselves out of poverty if given access to financial services. In Kenya, the government really supports the SME sector as a way of providing jobs to the youth. Thus the subject of business growth is an interesting area for a study in the Kenyan context.

Small and medium enterprises cut across all sectors of the economy, providing a prolific source of employment, income, and government revenue and poverty reduction. The sector comprises a huge percentage of all businesses in the country, give approximately 4million people jobs. The sector provides goods and services, promotes competition, innovation and an enterprise culture and provides opportunities for the development of appropriate technological and managerial competencies. Most SMEs in Kenya face difficulties in accessing credit facilities from financial institutions due to their limited assets. This hinders growth and expansion of these SMEs leading to poor performance of SME. SME being a major source of employment to the people of Embu county, access to credit is one of the key issues towards their development. As such it should be thoroughly addressed.

(Mutuku 2010) studied on the impact of microfinance institutions on SMEs in Kenya and found out that they had a great impact on employment creation and poverty alleviation. (Mbugua, 2010) studying on the impact of micro finance services on financial performance of SMEs in Kenya found that micro finance services enhance financial performances of SMEs. (Ngugi,2009); (Kioko, 2009); (Makena, 2011) studied on the financial challenges faced by SMEs and found that inadequacies in access to finance are key obstacles to SMEs growth. (Kemei, 2011) studied on the relationship between microfinance services and financial performance of SMEs. The findings were that positive and significant relationships have been established between MFIs loans and SMEs performance. (Copper, 2012) studied on the impact of microfinance services on the growth of SMEs in Nairobi and found a strong positive impact.

No study had focused on the effects of microfinance services on the growth of SMEs in Kenya in Embu County particularly. The researcher felt that there was need for a study on this area and thus this study intended to bridge this gap and focus on the effects of microfinance services on the growth of SMEs in the county. To achieve the research objective, the study was guided by the following research question: how do microfinance services influence the financial performance of SMEs?

## 1.3 Objective of study

### 1.3.1 Main Objective

To determine the effect of microfinance services on the financial performance of Small and medium enterprises in Embu County.

### 1.3.2 Specific Objective

i. To establish the effect of microfinance services on the growth of SMEs in Embu County
ii. To determine the effect of microfinance credit on setting up of a new enterprise
iii. To determine the effect of microfinance institutions in providing financial education to SMEs in Embu County

## 1.4 Value of study

This study will increase to the body of knowledge on the effect of microfinance credit on the financial performance of SME in Embu County and in Kenya as a whole. It would be of great importance to other researchers and academicians who can find it useful in providing information on the small and medium enterprises of microcredit financing on financial performance of SMEs in Embu County. It can also be of significant to researchers as it provides basis upon which further studies can be carried out on broad subjects' microcredit financing of SMEs. It is supposed to shed some more light on the relationship between microfinance credit and growth and survival of small and medium enterprises. This can help the relevant parties come up with better and alternative policies to address possible problems and challenges faced by the small and medium enterprises. It will also offer empirical evidence on the impact of the micro-credit on the financial performance of SMEs for use in short term and long term interventions especially in the fight against poverty.

This study is also very important since it is going to enlighten the government and the public on the role of Microfinance Institutions in the SMEs sector. It will provide information to the Microfinance Institutions on the extent to which their credit to the SMEs affect the business with main regard to improving the social welfare. It will be equally important the small and medium entrepreneur by providing more knowledge on equity sourcing through MFIs and develop saving skills for business.

A study like this is helpful to the government in policy making on financing of small and medium enterprises through microfinance and other financial institutions. This includes the best ways to be used to finance the SMEs sector by microfinance institutions.

# CHAPTER TWO: LITERATURE REVIEW

## 2.1 Introduction

This chapter reviews the literature surrounding the area of Micro financing and SMEs. Section 2.2 reviews micro financing and the theories of micro finance. It also looks at SMEs and the situation in Kenya and reviews micro finance services and entrepreneurship. Section 2.3 shows the main determinants of financial performance among the SMEs. Section 2.4 discusses MFI services. Section 2.5 review empirical studies previously done. Section 2.6 summarizes the chapter.

## 2.2 Theoretical Review

This study looks into three main theories that try to explain the impact of microfinance services on SMEs. These include microfinance credit theory, games theory, poverty reduction technique theory.

### 2.2.1 Microfinance Credit Theory

Microfinance in Kenya is a now fully fledged sector. Dondo (1999) traced the history of MFIs in Kenya to the mid 1950s when the joint Loan Board Scheme was established to provide credit to indigenous Kenyans with small trading business loans. The Microfinance sector in Kenya has grown since it inceptions in the 1970s and is one of the most established in Africa (Kashangaki et al, 1999). The birth of specialized microfinance in Kenya was in the 1980s when Kenya Rural Enterprises Fund (K-REP) and the Kenya Women Finance Trust (KWFT) were established. In the 1990s more MFIs emerged like Faulu Kenya, Small and Medium Enterprise Program commonly known as SMEP and Jamii Bora.

The concept of group lending is commonly heralded as the main innovation of microfinance and claims to provide an answer to the shortcomings of imperfect credit markets, in particular to the challenge of overcoming information asymmetries. Information asymmetries may lead to the distinct phenomena of adverse selection and moral hazard. In the case of adverse selection, the lender lacks information on the riskiness of its borrowers. Riskier borrowers are more likely to default than safer borrowers, and thus should be charged higher interest rates to compensate for the increased risk of default (Rahman, 2010). The standard model of lending commonly contains two mechanisms which address the issue of information asymmetries: assortative matching or screening to deal with adverse selection, and peer monitoring to overcome moral hazard.

Early models were developed by Stiglitz (1990) and Swain, (2008).These models examined how group liability schemes resolve moral hazard and monitoring problems. Other models developed by (Rafiq et al, 2009). Gangopadhyay et al. (2005) were inspired by Stiglitz and Weiss (1981) and focused on adverse selection and screening mechanisms. Moreover, social ties among group members, i.e. social connections in the language of Anand and Kanbur (1993), also referred to as social capital; appear to play an important role in the context of group liability schemes in terms of enhancing repayment behavior, as theorized by PisaniYoskowitz (2010).

### 2.2.2 Games Theory.

This theory is based on Grameen lending model of microfinance which is based on group peer pressure whereby loans are made to individual groups of four to seven .The microfinance games theory also supports the idea of group lending among micro finance institutions. Many of the new mechanisms rely on groups of borrowers to jointly monitor and enforce contracts themselves. Group members collectively guarantee loan repayments and access to subsequent loans is dependent on successful repayment by all group members. Payment is usually made weekly.

The groups have proved effective in deterring defaults as evidenced by loan repayment rates attained by organizations such as Grameen Bank (Bangladesh) that use this type of microfinance model. The model has also contributed to broader social benefits because of their mutual trust arrangement at the heart of group guarantee system and the group itself often becomes the building block to a broader social network. Ledgewood (1999). However, group based mechanisms tend to be vulnerable to free riding and collusion. Inefficiencies are well known to emerge in similar contexts .Gruber (2005).

In Kenya, most MFIs put very competitive rates for people is*chamas*to be able to obtain loans from them. However, these rates for those who borrow collectively as a group and invest in it.It also encourages them to save with the MFIs.

### 2.2.3 Poverty Reduction Technique Theory

The pressing need for growing economy is to create jobs for the large unemployed and under employed labour force. This is mainly brought about by discrepancies between the large number of educated professionals and a smaller number of jobs to accommodate them. Studies have been conducted to look into such issues. They have ended up arguing that jobs creation can be done either by generating wage employment or by promoting self-employment.

Microfinance could be used as a major way to promoting self-employment. This is mainly through provision of financial services to the small startups that end up providing jobs to many other people. Several authors have looked at its suitability to accomplish this, and most have agreed that microfinance alone cannot be used as such a tool. For it to be effective, it has to be coupled up with other factors to ensure positive results.

This study looks at microfinance as a tool to reduce poverty levels to the people of Embu County. Thus it tries to answer whether microfinance has helped these people in mostly providing jobs through the SMEs sector.

## 2.3. Determinants of Financial Performances of SMEs

Financial performance of SMEs is determined by several factors:

### 2.3.1 Age of the Firm

Age is a key determinant of financial performance of the firm. The period of operation that a firm has been in operation highly determines the financial performance of the firm. Firms that have a vast experience in the market are able to gain economies of scale from the suppliers and other stakeholders of the firm as a result of good relationships and trust. Such a firm is more likely to perform better than a firm that is new in an environment.

The firm might spend a lot of money before it gets adapts to the environment (Santalo and Becerra, 2008).

### 2.3.2 Debt

Debt is funds borrowed from a financial institution at a certain percent of interest rates which should be paid within a specified period of time. It is appropriate for the firm to maintain a proper balance between debt and equity. Debt is a determinant of financial performance of SMEs.The firms leverage decisions centers on the allocation between debt and equity on financing a firm (Raheman et al., 2007).

The emphasis on long-term finance and on the potentially adverse consequences when it is in short supply is somewhat at odds with recent theoretical contributions that emphasize the fact that the use of short-term debt may be associated with higher quality firms and may have better incentive properties.

### 2.3.3 Growth of the firm

Growth of the firms is an essential determinant of the firm, growth of the firm is attributable to increase in net assets.

Firms are a collection of a certain number of resources that provide the means to successfully take advantage of those opportunities and grow (Pinaki, 1998).

### 2.3.4 Size of the Firm

Smaller firms exhibit larger degrees of information asymmetry between insiders and outsiders. In addition, these firms also face higher costs in issuing new equity (Sebastian 2010). Large firms are more likely to manage their working capitals more efficiently than small firms. Most large firms enjoy economies of scale and thus are able to minimize their costs and improve on their financial performance (Kumar, 1995).

There are a number of ways that can be used in measuring the size of a firm. Sales turnover is one of the measures that can be used. Sales turnover (Sales revenue) is the money that you get from the sale of products and thus the costs of sales have not been deducted from this. Number of employees, is one of the simplest measures to know about the size of the firm, capital employed by a business may and can vary depending in the size of the business.

A small business will need less capital to finance its investment, whereas, a large business enterprise will need a lot of capital to plan and finance the investments. (Pandey, 2005).

## 2.4 Microfinance Institutions and Their Services to SMEs

Microfinance has been seen as a tool for financial self-sustainability and ensuring the welfare of SMEs. A majority of microfinance programs target SMEs with the explicit goal of empowering them. Microfinance allows poor people to protect, diversify, and increase their sources of income, the essential path out of poverty and hunger. The ability to borrow a small amount of money to take advantage of a business opportunity, to pay for school fees, or to bridge a cash-flow gap can be a first step in breaking the cycle of poverty. Microfinance also helps safeguard poor households against the extreme vulnerability that characterizes their everyday existence. Loans, savings, and insurance help smooth out income fluctuations and maintain consumption levels even during lean periods (Brockhaus, 2001).

Various writers have indicated microfinance as means of SMEs financial self sustainability. Bengston states that micro financing for individuals aims to make their micro enterprises more financially rewarding this should contribute to a measure of economic empowerment within the family and in social and political spheres. The rationale for supporting microfinance and the targeting micro finance programs is that microfinance is an effective means or entry point for empowering individuals (Cheston and Kuhn 2002).

### 2.4.1 A Savings opportunity

The task of smoothing consumption is made more complicated if there is nowhere to store money safely. In an emergency, richer people might choose between dipping into their savings and borrowing. The choice for the great mass of the unbanked in the developing world is limited to whom to borrow from, often at great cost (Cheston and Kuhn, 2001). That they can borrow at all is partly due to the rapid growth of microfinance, which specializes in lending small amounts to poor people. Several big microfinance institutions (MFIs) also offer savings accounts: Grameen Bank in Bangladesh is a prominent example.

But the industry remains dominated by credit, and the ability to save through an MFI is often linked to customers' willingness to borrow from it. Of 166 MFIs surveyed in 2009 by the Microfinance Information Exchange, a think-tank, all offered credit but only 27% offered savings products. Advocates of a greater variety of financial services for the poor argue for more balance (Guichandut, 2006).This may be on the horizon. More MFIs are becoming interested in the potential of savings, thanks partly to the global financial crisis. A majority of more than 400 MFI managers surveyed last March by the Consultative Group to Assist the Poor (CGAP), a microfinance group based at the World Bank, said that they had faced liquidity problems during the crisis (see chart). This, together with rising financing costs and exchange-rate fluctuations for those MFIs that rely on external finance, has prompted many credit only MFIs to warm to the idea of funding at least part of their lending activity using local savings (Guichandut, 2006).

### 2.4.2 Financial Credit

Accessing credit is considered to be an important factor in increasing the development of SMEs. It is thought that credit augment income levels, increases employment and thereby alleviate poverty. It is believed that access to credit enables poor people to overcome their liquidity constraints and undertake some investments such as the improvement of farm technology inputs thereby leading to an increase in agricultural production (Hiedhues, 1995). The main objective of microcredit according to Navajas et al, (2000) is to improve the welfare of the poor as a result of better access to small loans that are not offered by the formal financial institutions.

(Buckley, 1997) argue that, the indicators of success of microcredit programs namely high repayment rate, outreach and financial sustainability does not take into consideration what impact it has on micro enterprise operations and only focusing on microfinance. On the other hand, (Burger,1989) indicates that microfinance tends to stabilise rather than increase income and tends to preserve rather than to create jobs. Facts by Coleman (1999) suggest that the village bank credit did not have any significant and physical asset accumulation. The entrepreneurs ended up in a vicious cycle of debt as they use the money from the village banks for consumption purposes and were forced to borrow from money lenders at high interest rate to repay the village bank loans so as to qualify for more loans. The main observation from this study was that credit was not an effective tool to help the poor out of poverty or enhance their economic condition. It also concluded that the poor are too poor because of some other hindering factors such as lack of access to markets, price stocks, unequal land distribution but not lack of access to credit.

### 2.4.3 Entrepreneurial Development

Selecting a target market depend on the micro service provider and the perceived demand for financial services. In any country, there are underserved enterprises and households, ranging from the ultra-poor who may not be economically active, to small growing enterprises that provide employment in their communities. This range or continuum constitutes the demand size for micro finance services. Often, the supply side does not offer a corresponding continuum services. Microfinance institutions need to supply services that fill the gaps and integrate the underserved group into the market.

The goal of microfinance institutions as development organization is to service the financial needs have served and underserved market as a means of meeting development objectives. The importance of microfinance to entrepreneurial development made the Central Bank of Kenya adopted it as the main source of financing entrepreneurship in Kenya. Despite this, however, finance is still considered as one of the major hindrances to entrepreneurial development in Kenya. While government and Non-Government Organizations (NGOs) have been engaging a number of programmes and policies to encourage entrepreneurship in the country, Kenya is still on the list of the poorest countries in the world with unemployment level rising alarmingly.

It is therefore necessary at this junction to undertake an assessment of the extent to which microfinance can impact entrepreneurial development (Cheston and Kuhn 2002).

## 2.5 Review of Empirical Studies

Nilsson (2010) conducted a study to investigate the impact of micro finance institutions (MFIs) on the development of small and medium size businesses (SMEs) in Cameroon. The study adopted a case study approach that involved the Cameroon Cooperative Credit Union League. The study concluded that microfinance is an important asset to developing countries since it is able to cater for financing needs of the very poor in the society.

Owusu (2002) investigated on the various financing options for SMEs in Ghana, a random sample of 10 formal and informal finance sources and 50 SME‟s in 6 selected small and medium industries in Kumasi, Accra and Tamale. A regression model was used for data analysis, the results of the regression analysis found that micro finance credit was the major source of income for SMEs. A positive correlation was shown between access to credit and financial performance of SMEs.

Idowu (2004) conducted a study on the impact of Microfinance on Small and Medium Enterprises (SMEs) in Ghana. The findings of the study reveal that significant number of the SMEs benefitted from the MFIs loans even though only few of them were capable enough to secure the required amount needed. Interestingly, majority of the SMEs acknowledge positive contributions of MFIs loans towards promoting their market share, product innovation achieving market excellence and the overall economic company competitive advantage.

Bran and Woller (2010) carried out a study to establish the effects of microfinance in India. The study concluded that microfinance has brought better psychological and social empowerment than economic empowerment. The study further recommended that the impact of microfinance is commendable in courage, self confident, self-worthiness, skill development, awareness about environment, peace in the family, reduction of poverty improving rural savings, managerial ability decision making process and group management. In other variables the impact is moderate. As a result of participation in microfinance, there is observed a significant improvement of managerial skills, psychological well being and social empowerment. It is recommended that the SHGs may be granted legal status to enhance the performance.

Wachira (2011) investigated the factors that influence the use of microcredit amongst the SMEs based at Mutindwa market of Buru Buru estate. Descriptive survey approach adopted in this research for primary data collection involved administration of a questionnaire to the SMEs. The study found out that there is a strong relationship between MFI loan use and the loan terms and conditions. MFls loans were noted to be popular because of their group lending model where security was by group guarantee demonstrating the fact that a majority of the loan consumers who are commonly women lacked tangible collateral. The study concludes that improving the lending terms and conditions especially through exploring a wide range of security options, pursuing a gender parity client-base and offering diversified business knowledge in favor of small-scale enterprises would provide an important avenue for facilitating their access to credit and accelerate the use of MF loans and the subsequent enterprises.

Cooper (2012) conducted a study on the impact of micro-finance services on the growth of SMEs in Kenya. The study targeted 50 SMEs in Nairobi. The researcher used self developed questionnaire as an instrument of data collection and analyzed the data using quantitative analysis. The study established that SMEs largely depend on micro financing for growth. A significant percentage of SMEs was found to have access and do seek micro credit for their businesses. The study also established that microfinance services have assisted enterprises to change their status through growth in sales level from micro to small and from small to medium. Though SMEs have easy access to micro finance services, the study indicated that they have no exemption from strict requirements when applying for loans. The study also established that most SMEs in Nairobi do not demand for micro-insurance services and that Microfinance Institutions offer minimal training to SMEs. The study concluded that microfinance services have a strong positive impact on the growth of SMEs in Kenya. SMES in Nairobi depend on micro financing for growth. The study recommends that there is need to relax the requirements for loan application and that the government of Kenya should provide a favorable environment that can allow MFIs to thrive not only in Nairobi but also in other parts of the country

## 2.6 Summary of the Literature Review

From the literature review, it is evident that access to microcredit finance has asignificant influence on financial performance of SMEs. Micro financing credit is a credible and effective instrument for poverty alleviation and as such its contribution toeconomic growth and performance of SMEs .Financing of small and medium scale enterprises is essential for creating employment and economic growth. The literature review discussed above has shown that microfinance credit is important for growth and development of SMEs. It is important to note that restrictive credit requirements and guidelines in regulatory systems inhibit access to microfinance credit by borrowers. This is a constraint to financial performance of SMEs. This study is geared to determine the effects of microcredit finance on financial performance of SMEs.

# CHAPTER THREE: RESEARCH METHODOLOGY

## 3.1 Introduction

This chapter presents a systematic discussion on research strategy to be adopted in establishing the effect of microfinance institutions on growth and development of SMEs.The chapter presents the research methodology under the following subsections; the research design, target population, sampling procedure and sample size, research instruments, validity and reliability, data analysis procedures and ethical considerations.

## 3.2 Research Design

Hakim (2000) describes research design as a general plan in data collection necessary for the fulfillment of research objectives. In this study, the cross sectional analysis was used. A cross sectional analysis is a type of descriptive study in which data is analysed at a specific point of time. A descriptive study is concerned with determining the frequency with which something occurs or the relationship between variables (Cooper and Schindler, 2003).

This approach was appropriate for this study, since the researcher intended to collect detailed information through descriptions and is useful for identifying variables and hypothetical constructs. It also enabledher to present data in an easy and meaningful way.

## 3.3 Population

Population refers to an entire group of individuals, events or objects having a common observable characteristic. In Embu County, there are 1,579 licensed SMEs in various sectors that include: trade and commercial services, financial services and construction.

This study focused on the owners and staff of these SMEs. There are 11 MFIs whose staffs who were also considered.

### 3.4 Sample

This study applied the stratified random sampling technique.A sample refers to a small group obtained from the accessible population (Mugenda and Mugenda, 2003). A target of 60 SMEs was studied.

### 3.5 Data Collection

Data collection is the process of gathering and measuring information on variables of interest with the aim of answering the research question, test hypothesis and evaluate outcomes. In this study, both primary and secondary sources of data were used.

Primary data was done through administration of semi-structured questionnaires. According to Best and Kahn (2004) a questionnaire is easy to administer. Questionnaires also reduce bias since the researchers' own opinions would not influence the respondents to answer questions in a certain manner unlike if it were a telephone or face to face surveys. To ensure uniformity in response and to encourage participation, the questionnaire will be kept short and structured with mostly multiple-choice selections in a Likert scale.

Secondary data was obtained from newspapers, journals and magazines as well as other sources such as the MFIs annual reports.

### 3.6 Data Validity and Reliability

Prior to visiting MFIs for data collection researcher obtained a letter from authorities to permit him proceed in obtaining that data and ensure trust worthiness of respondents. The content validity and reliability was assured by ensuring that each question in the questionnaire was valid and correctly structured for easy understanding. To ensure reliability the researcher conducted a pilot study for pre-testing the questionnaire using two microfinance institutions.  According to Masibo (2005), pre-testing provides a check on the feasibility of the proposed procedure for coding data and shows up flows and ambiguities in the instrument of data collection

A t-statistic test was used to determine the significance of the independent variables in influencing performance of SMEs. The t-test was used to test the questionnaire to ensure confidentiality of the respondents as it is a part of the ethical procedure to ensure that respondents are protected.

### 3.7 Data Analysis

The completed questionnaires was reviewed and edited for accuracy, consistency and completeness. The responses coded and entries made into Statistical Package for Social Science (SPSS version 20).Regression and correlation analysis was applied to show the relationship between variables. The dependent variable being the financial performance of SMEs in Embu County,will be measured using return on assets (ROA). The independent variable is access to credit measured by checking the loan book records from SMEs. This is because the value for most SMEs is measured in terms of financial records after access to credit. The data will be analyzed and presented in charts and tables. The inferential statistic was used to show the nature and magnitude of relationships established between the independent, intervening and dependent variable using regression analysis.

### 3.7.1 Analytical Model

Multiple linear regression models using ordinary least square stepwise method will be used to investigate the effect of microfinance services on financial performances of SMEs in Embu County.

It will be:

$$\mathbf{Y = \alpha + \beta 1X1 + \beta 2X2 + \beta 3X3 + \beta 4X4 + \varepsilon}$$

Where:

Y = SMEs performance of SMEs in Embu County measured by return on Assets

**α**= Regression Constant Term

X1 = total assets

X2 = Borrowing rates as given by MFIs in their records

X3 = Loan Size

X4=sales turnover of the SMEs

ε= error term

# CHAPTER FOUR: DATA ANALYSIS, FINDINGS AND DISCUSSIONS

## 4.1 Introduction

This chapter presents the analysis and findings with regards to the objectives of the study. The objectives of this study were to establish the effect of microfinance services on the growth of SMEs in Embu County, to determine the effect of microfinance credit on setting up of a new enterprise, and to determine the effect of microfinance institutions in providing financial education to SMEs in Embu County

## 4.2 Questionnaires response rate

There are many licensed SMEs in Embu County. However a sample of 60 SMEs was chosen from the various strata for data analysis. Each of them received a questionnaire which was to be filled and returned. After a much follow up, only 52 managed to return their dully filled questionnaires. This was a 87% response rate which was sufficient. This was achieved through great cooperation between respondents and the researcher.

### 4.3 General information of the respondents

This study sought to know the background information of the respondents in regards to their categories of business, gender and age of the entrepreneur, education level of the manager and how long the business has been in operation. This was fundamental to understand the basic state of the businesses and help the researcher in making a valid conclusion.

### 4.3.1 Business Category

There are various business categories that the SMEs perform under in Embu County. Being a metropolitan county with vast land and good climate for agribusiness, it was not a surprise to find that the agribusiness category took a majority followed by the general category which included supplies, retail and wholesale trade services.

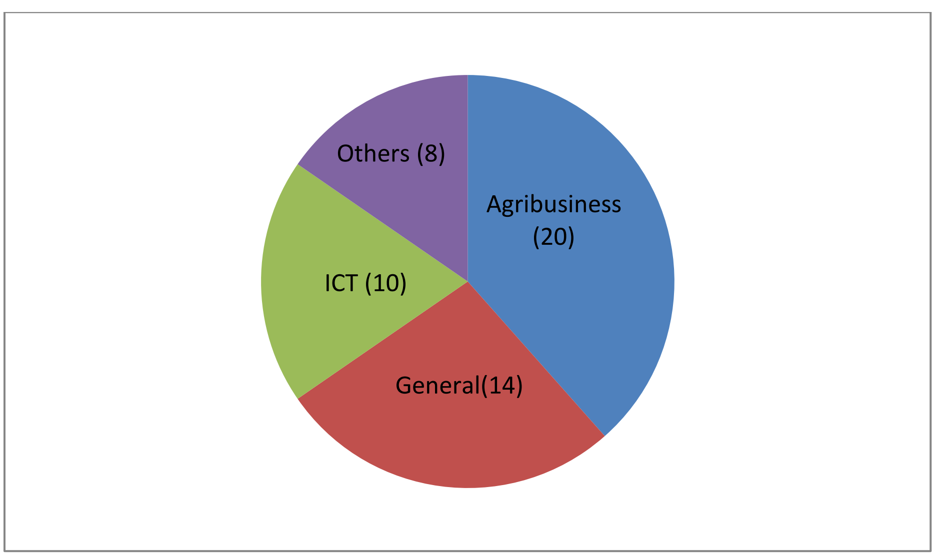
The table below shows the distribution as found.

**Table 4.1: distribution of responded by their business categories**

| | | |
|---|---|---|
| Agribusiness | 20 | 38.46 |
| General | 14 | 26.92 |
| ICT | 10 | 19.23 |
| Others | 8 | 15.38 |
| Total | 52 | |

Source: research findings

**Figure 4.1:distribution of responded by their business categories**



Source: research findings

It can be observed that the agribusiness industry led by 38% of the total group while the general category followed closely by 27%. The ICT sector was also dominant taking a 19% of the total. The others category took a 15% and it included the construction and professional services.

### 4.3.2 Gender of the entrepreneur

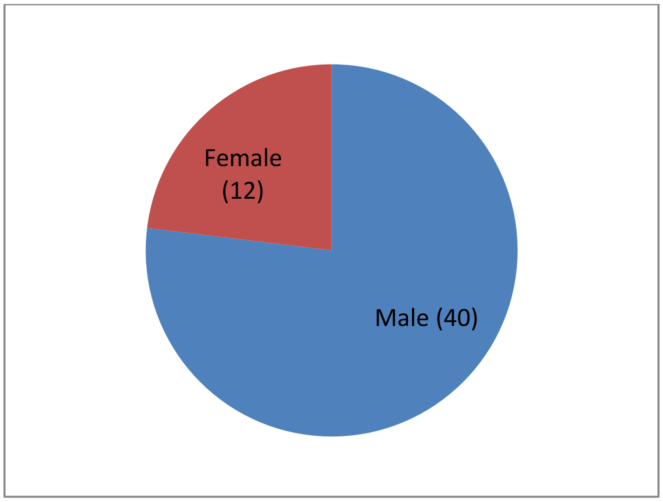
The researcher sort to find the gender of the respondents. As shown below, the majority were male entrepreneurs who lead with a 77% while the women were at 23%.

**Table 4.2: distribution of responded by their gender**

| | | |
|---|---|---|
| Male | 40 | 76.92 |
| Female | 12 | 23.08 |
| Total | 52 | |

Source: research findings

**Figure 4.2:distribution of responded by their gender**




Source: research findings

### 4.3.3 Distribution by age of entrepreneur

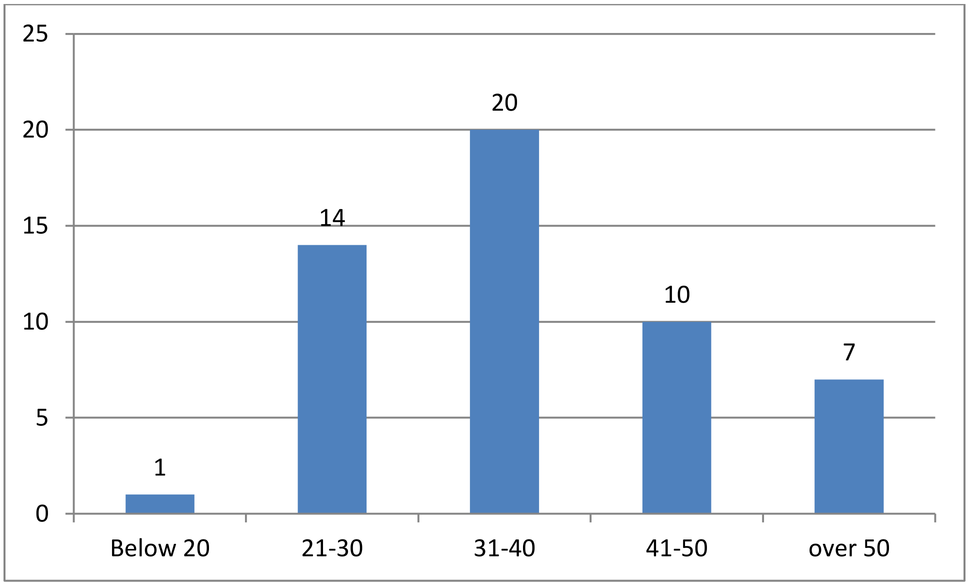
The table below shows the distribution of the respondents in respect to the age.

**Table 4.3: distribution of responded by their Age**

| | | |
|---|---|---|
| Below 20 | 1 | 1.92 |
| 21-30 | 14 | 26.92 |
| 31-40 | 20 | 38.46 |
| 41-50 | 10 | 19.23 |
| over 50 | 7 | 13.46 |
| Total | 52 | |

Source: research findings

**Figure 4.3:distribution of responded by their Age**




Source: research findings

According to the table above, 2% of them were aged below 20years, 27% were aged between 21-30 years, and 39% between 31-40years, 19% between 41-50years and 13% were above 50years. Majority of the respondents were aged between 31-40years. From the figure, the distribution was normally distributed with fewer lying in the extreme ends and majority around the median. This was sufficient evident that the study was a fair representation the whole population.

### 4.3.4 Distribution by level of education

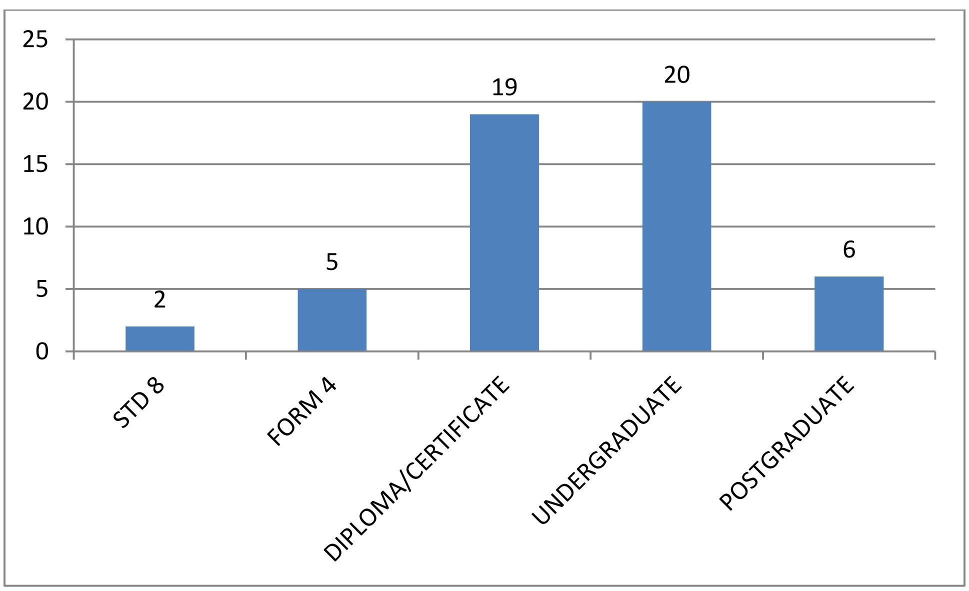
The researcher took to know the highest level of education attained by the manager of the SMEs. This is shown in figure 4.4 and table 4.4 below.

**Table 4.4: distribution of responded by their education level**

| | | |
|---|---|---|
| STD 8 | 2 | 3.85 |
| FORM 4 | 5 | 9.62 |
| DIPLOMA/CERTIFICATE | 19 | 36.54 |
| UNDERGRADUATE | 20 | 38.46 |
| POSTGRADUATE | 6 | 11.54 |
| Total | 52 | |

Source: research findings

**Figure 4.4:distribution of responded by their education level**




Source: research findings

As noted above, the majority which was 38% had attained undergraduate degree while 37% had diploma or certificate. Few of them had the primary, secondary and postgraduate levels as their highest. This distribution was fair and it showed that the study took into account all levels attained.

## 4.4 Microfinance Services and Their Effects on Financial Performance of Smes.

In line with the main objective of the study, the researcher took to find out which valuable services the SMEs received from the various microfinance institutions available.

### 4.4.1 Valuable Services offered by MFIs

The SMEs were asked to choose from the various categories provided that included credit, saving, insurance and training. They were also provided room to add on any other services they received which they felt were valuable to them.

**Table 4.5: Valuable service offered by MFIs**

| | | |
|---|---|---|
| Credit | 52 | 100.00 |
| Savings | 52 | 100.00 |
| Micro insurance | 20 | 38.46 |
| Trainings | 30 | 57.69 |
| others | 10 | 19.23 |

Source: research findings

From the above,it is noted that all respondents get loans and credit from MFIs. It was also seen that 19% got other valuable services from MFIs that included payment services.

### 4.4.2 Source of Start Up

The respondents were asked to state their major source of startup capital. The results are as tabled below.

**Table 4.6: Major source of start-up capital**

| | | |
|---|---|---|
| Savings | 10 | 19.23 |
| Friends and relatives | 9 | 17.31 |
| Loans from financial Institutions | 29 | 55.77 |
| others | 4 | 7.69 |
| Total | 52 | |

Source: research findings

From the findings majority of the entrepreneur got loans from the MFIs and other financial institutions which represented a 56% of the whole sample. This is an indication that most of them found the financial institutions to be convenient and readily available. 19% and 17% got their initial source of capital from their own savings and from friends and relatives respectively. The others 7% got its sources from other sources.

### 4.4.3 Why Seek Financial Help FromMFIs

Since it was noted that most SMEs got financial help from MFIs to run their business, the researcher seek to find out what were the major reasons behind this. Thus an open ended question was posed to them to answer the same. This is tabulated below.

**Table 4.7: Why seek financial help**

| | | |
|---|---|---|
| Fair Interest rate | 19 | 36.54 |
| Flexible repayment periods | 15 | 28.85 |
| Amount offered | 13 | 25.00 |
| others | 5 | 9.62 |
| Total | 52 | |

Source: research findings

The study showed that 37% resorted to seeking financial help from MFIs due to their fair interest rate, 29% got the help due to their flexible repayment periods, 25% had the amount offered as their reason for getting financial help and 10%stated other reasons. These reasons were provided to be the need for business expansion and emergency money for daily running of the business.

After realizing that most SMEs sought financial help from MFIs, they were then asked to rate the quality of services they received from MFIs.

**Table 4.8: Rating of MFIs services**

| | | |
|---|---|---|
| Fair | 5 | 9.62 |
| Average | 30 | 57.69 |
| Excellent | 17 | 32.69 |
| Total | 52 | |

Source: research findings

From the table above, majority of them were quite satisfied with the quality of services received from MFIs, 32.69% rated the services to be excellent while 9.62% said the services were fair.

They were also asked to mention if any, the problems they encountered while dealing with the MFIs in regards to asking for loans.

**Table 4.9: Problems faced by MFIs while dealing with MFIs**

| | | |
|---|---|---|
| Yes | 40 | 78.43 |
| No | 12 | 23.53 |
| Total | 52 | |

Source: research findings

## 4.5 Financial performance of SMEs

The study required the respondents to give estimates of their assets, incomes and expenditures. Respondents were also required to attach copies of financial statements namely income statements and balance sheets where applicable.

### 4.5.1 Distribution of assets among SMEs

The respondents were asked to give an estimation of their assets both the fixed and the current assets. The fixed assets included but not limited to machineries and cars. The current assets comprised of inventories, cash at bank and account receivables. They attached their balance sheets. The liabilities side included long term and short term liabilities.

**Table 4.10: Distribution of Assets**

| | YEARS | 2010 | 2011 | 2012 | 2013 | 2014 |
|---|---|---|---|---|---|---|
| FIXED ASSETS | MINIMUM | 2,562,680 | 2,904,655 | 3,401,651 | 3,804,160 | 4,011,650 |
| | MAXIMUM | 6,000,255 | 6,208,955 | 6,521,950 | 7,205,300 | 7,352,190 |
| | AVERAGE (A) | 4,281,468 | 4,556,805 | 4,961,801 | 5,504,730 | 5,681,920 |
| CURRENT ASSETS | MINIMUM | 952,642 | 1,002,695 | 1,501,252 | 1,556,542 | 1,609,884 |
| | MAXIMUM | 1,925,640 | 2,012,582 | 2,102,652 | 2,205,645 | 2,387,220 |
| | AVERAGE (B) | 1439141 | 1507638.5 | 1801952 | 1881093.5 | 1998552 |
| TOTAL | (A)+ (B) | 5,720,609 | 6,064,444 | 6,763,753 | 7,385,824 | 7,680,472 |

Source: research findings

From the table above, there was a steady growth in both the fixed and current assets and hence the total assets in the periods studied. This showed that there was growth in the financial performance of the SMEs. This may be due to sound financial decisions taken by the SMEs.

From their balance sheets, the table below on owner's equity was established.

**Table 4.11: Distribution of Owners' Equity**

| **Years** | 2010 | 2011 | 2012 | 2013 | 2014 |
|---|---|---|---|---|---|
| **Minimum** | 3,325,425 | 3,325,425 | 3,325,425 | 3,325,425 | 3,325,425 |
| **Maximum** | 12,684,675 | 12,684,675 | 12,684,675 | 12,684,675 | 12,684,675 |
| **Average** | 8,005,050 | 8,005,050 | 8,005,050 | 8,005,050 | 8,005,050 |

Source: research findings

It is shown that there was a stable owner's equity with an average of 8,005,050 Kshs.

**Table 4.12: Distribution of Retained Earnings**

| Years | 2010 | 2011 | 2012 | 2013 | 2014 |
|---|---|---|---|---|---|
| Minimum | 2,465,000 | 2,687,000 | 2,881,560 | 2,998,540 | 3,000,000 |
| Maximum | 4,005,890 | 4,105,680 | 4,256,895 | 4,556,250 | 4,991,000 |
| Average | 3,235,445 | 3,396,340 | 3,569,227.5 | 3,777,395 | 3,995,500 |

Source: research findings

As shown above, the respondents were able to plough back some of their profits over the years of study.

**Table 4.13: Distribution of Sales**

| Years | 2010 | 2011 | 2012 | 2013 | 2014 |
|---|---|---|---|---|---|
| Minimum | 945,865 | 1,225,846 | 1,268,712 | 1,315,845 | 1,358,754 |
| Maximum | 1,924,623 | 1,955,641 | 2,079,120 | 2,056,485 | 2,286,538 |
| Average | 1,435,244 | 1,590,743.5 | 1,673,916 | 1,686,165 | 1,822,646 |

Source: research findings

Based on the above schedule there was steady increase in volume of sales over the duration of study.

**Table 4.14: Distribution of Net Income**

| **Years** | **2010** | **2011** | **2012** | **2013** | **2014** |
|---|---|---|---|---|---|
| **Minimum** | 455,160 | 554,230 | 600,180 | 610,160 | 700,450 |
| **Maximum** | 700,289 | 750,790 | 790,165 | 850,510 | 900,240 |
| **Average** | 577,724.5 | 652,510 | 695,172.5 | 730,335 | 800,345 |

Source: research findings

Based on the above schedule there was steady increase in net income over the duration of study.

The researcher then sought to find the net profit margin of the respondents. He used the equation:

Net Profit Margins =Net Income/Net Sales

The table below shows his findings on net profit margin

**Table 4.15: Distribution of Net Profit Margin**

| Years | 2010 | 2011 | 2012 | 2013 | 2014 |
|---|---|---|---|---|---|
| Net Income | 577,725.00 | 652,510 | 695,173.00 | 730,335 | 800,345.00 |
| Sales | 1,435,244.00 | 1,590,743 | 1,673,916 | 1,686,165 | 1,822,646 |
| Net Profit Margin | 0.403 | 0.410 | 0.415 | 0.433 | 0.439 |

Source: research findings

The table shows a steady increase in the net profit margin of the SMEs over the duration of study.

**Table 4.16: Distribution of Return on Assets**

| Years | 2010 | 2011 | 2012 | 2013 | 2014 |
|---|---|---|---|---|---|
| Net Income | 577,725.00 | 652,510 | 695,173.00 | 730,335 | 800,345.00 |
| Total Assets | 5,720,609 | 6,064,444 | 6,763,753 | 7,385,824 | 7,680,472 |
| Return on Assets | 0.101 | 0.110 | 0.114 | 0.119 | 0.122 |

Source: research findings

The table showed that the return in assets increased over the duration too.

## 4.6 Inferential Analysis

The researcher conducted inferential analysis involving the coefficient of determination to establish the relationship between the independent and dependent variables of the study. Inferential analysis was used to determine the relationship, if any, between the two variables and how strong is that relationship. It helped reach better and more conclusive conclusions beyond that of the data available. The main focus was the effect of microfinance services on the financial performance of SMEs in Embu County.

## 4.7 Multiple Regression Analysis

In order to establish the relationship between independent and dependent variables, a multiple regression was conducted. Multiple regression is a statistical technique that allows us to predict a score of one variable on the basis of their scores on several other variables. The main purpose of multiple regression is to learn more about the relationship between several independent or predictor variables and a dependent or criterion variable.

The coefficient of determination is a measure of how well a statistical model is likely to predict future outcomes. The coefficient of determination, r2 is the square of the sample correlation coefficient between outcomes and predicted values. As such it explains the extent to which changes in the dependent variable can be explained by the change in the independent variables or the percentage of variation in the dependent variable.

**Table 4.17: Model Summary**

| Model Summary | | | | |
|---|---|---|---|---|
| Model | R | R Square | Adjusted R Square | Std. Error of the Estimate |
| 1 | .824a | .778 | .701 | 0.315 |
| a. Predictors: (Constant), Microfinance credit (Million Kenya shillings) | | | | |

Source: research findings

In order to explain the percentage of variation in the dependent variable (ROA), the researcher used coefficient of determination obtained from the model summary in table 4.17 above. From the analysis, the independent variable, microfinance services which included micro credit and micro services 82.4% of the variation in financial performance of SMEs in Embu County of SMEs as explained by adjusted R2 of 70.1%. The study conducted an Analysis of Variance, in order to test the significance of the model. The findings were as shown below.

### 4.7.1 ANOVA

Analysis of variance shows the relationship between the two variables. This section shows you the p-value ("sig" for "significance") of the predictors effect on the criterion variable. P-values less than .05 are generally considered statistically significant. In this case the researcher will observe the relationship between microfinance and financial performance of SMEs.

**Table 4.18: ANOVA**

| Model | Sum of Squares | Df | Mean Square | F | Sig |
|---|---|---|---|---|---|
| Regression | 2.009 | 4 | 0.4985 | 0.5015 | .000(a) |
| Residual | 3.013 | 28 | 0.1010 | | |
| Total | 5.016 | 33 | | | |

From the ANOVA results, the probability value of 0.000 was obtained implying that the regression model was statically significant in predicting the relationship between microfinance credit and financial performance of SMEs in Embu County and the predictor variables as it was less than α=0.05. By the help of the F-Test table (5%, 4) tabulated value was 3.472 which was less than F= 5.201. This indicated that the model was significant.

**Table 4.18: Test of Coefficients**

| Model | Unstandardized Coefficients | | Standardized Coefficient | t | sig |
|---|---|---|---|---|---|
| | B | Std Error | Std Error | | |
| (Constant) | 1.192 | 1.052 | 0.002 | 3.147 | 0 |
| Total Assets | .254 | .105 | .131 | 1.115 | .005 |
| Borrowing Rates | .185 | .345 | -.105 | .734 | .002 |
| Sales Turnover | .309 | .659 | .124 | .346 | .004 |
| Size of the Loan | .256 | .775 | .001 | .798 | .002 |
| a. Dependent Variable: ROA | | | | | |

The researcher conducted a simple regression analysis so as to determine the relationship between financial performance of SMEs in Embu County (dependent variable) and microfinance services of SMEs in Embu County. The following regression equation was obtained:

ROA = 1.192+.254X1+.185X2+.309X3+.256X4

From the regression model obtained above, holding all the other factors constant, financial performance of SMEs in Embu County.The obtained regression equation further implied that there was a direct relationship between microfinance credit and financial performance of SMEs in Embu County of SMEs. The analysis was undertaken at 5% significance level. The criteria for comparing whether the predictor variables were significant in the model was through comparing the corresponding probability value obtained and α=0.05. If the probability value is less than α, then the predictor variable is significant. Therefore, from the above analysis microfinance credit was significant in the model as its corresponding predictor variables were less than 5%.

### 4.8 Summary of Findings

From the findings obtained, most SMEs borrowed from financial institutions for their start-up capital. These were represented by a majority of 55.78%. However, this included both formal and informal financial sector. On further probing, it was discovered that majority of them borrowed from MFIs. The findings revealed that MFIs were sought after due to their cheap loans and flexible repayment periods. These showed that MFIs were the most trusted and they cater most for their financial needs. In order to fund their day-to-day financing, most SMEs ploughed back their profits. However, a good percentage sought additional financing from MFIs.

The study sought to find the various services offered to SMEs by the MFIs. The findings showed that all SMEs got micro- credit and micro-savings services from MFIS. A smaller percentage mentioned that they received micro-insurance and training services from MFIs. The respondent the n went ahead to find out the relationship between the various services received and financial performance of the MFIs.

There was astrong positive relationship between the micro-credit and the financial performance of the SMEs. According to Diagne and Zeller (2001), insufficient access to credit is the major problem faced by most SMEs. Access to credit therefore increases

SMEs risk-bearing abilities; improve risk-copying strategies and enables consumption smoothing overtime. With these arguments, microfinance is believed to improve the welfare of the poor.This was emphasized with Navajas et al, (2000), the main objective of microcredit to improve the welfare of the poor as a result of better access to small loans that are not offered by the formal financial institutions.

There was a strong positive relationship between the micro-savings and the financial performance of the SMEs. Cheston and Kuhn (2001) found that in an emergency, richer people might choose between dipping into their savings and borrowing from the financial institutions. However, this may not be case with the poor and in this case the SMEs. Thus most MFIs have over time encouraged the art of saving in order to get credit. With savings, SMEs have been able to cater for their needs better and hence improve themselves.

From the findings obtained, regression equation further implied that there was a direct relationship between microfinance services and financial performance of SMEs in Embu County. The analysis was undertaken at 5% significance level. Therefore, from the above analysis microfinance credit was significant in the model as its corresponding predictor variables were less than 5%.This shows that the model is a good predictor which is well explained by the coefficient of determination R2=70.1%.

# CHAPTER FIVE: SUMMARY, CONCLUSIONS AND RECOMMENDATIONS

## 5.1 Introduction

This chapter presents the summary of findings, conclusion, recommendations and suggestions for further research derived from the findings. It also presents the limitations that were encountered while doing the study.

## 5.2 Summary of the findings.

Kenya is among the fastest growing economies in the world. It owes this success to creation of employment mostly to the youth and providing better services to its people. As such, the president has over the years encouraged the youth to start their own SMEs and hence improve their own lives. SMEs have ended up contributing majorly to the country's total employment. Despite this very important contribution, only a few survive past their first year. Lack of finances is seen to be the disturbing factor. Due to their small sizes and lack of security, SMEs are not able to access credit from banks. Their survival rate is then put in jeopardy.

The purpose of this study was to establish the effects of microfinance services on financial performance of SMEs in Embu County. The main purpose of SMEs is to generate employment but these enterprises are usualy short lived and consequently are bound to die after a short while causing those gained job positions to lose them and even go poorer than how they were. This study thus sought the impact of microfinance services on financial services of the SMEs.

The study employed a cross-sectional survey research design. The sample was picked from all business categories in Embu County. Random sampling was used to select a sample of sixty (60) small and medium enterprises. Questionnaire was the principle tool for collecting primary data whereas the respondents provided financial statements in the case of secondary data. Data was analyzed using descriptive statistics and multiple regression approach. From the analysis the study revealed that all SMEs borrow to increase their financial performance. They borrow mainly from MFIs due to their fair interest rates, Flexible repayment periods and amounts of loans they offered.

### 5.3 Conclusions

MFIs provide financial services to those who are said to be poor and hence can't access formal financial services. It is concerned with provision of financial services to poor people using means which are just, fair and sustainable for example they accept social collateral rather than financial collateral, access to larger amounts of loan if repayment is performance is positive, easy way to access finance in not much paper work, and easy and short procedures.

Embu county residents rely on SMEs for their daily livelihood. However, study shows access to credit from formal financial institutions has continued to be on the low side. This means that it is difficult for the SMEs to grow and hence improve the economic standards of the residents. Small scale loans can reduce the capital constraints experienced by the SMEs. Savings services, on the other hand, create better opportunities to create wealth and manage risk through diversification of assets.

With the growth of SME sector, more SMEs require more funds to finance their growth in both the fixed assets and working capital. They require credit in ever increasing amounts. They need these funds to carry out their daily activities. The study showed that all SMEs borrow credit and access savings from the MFIs. Majority of them do not have other sources of financing other than MFIs. The study concluded that ROA increased with each loan showing that microfinance services have a positive effect on the financial performance of SMEs in Embu County. Regression results implied that micro-credit contributed more to the financial performance of SMEs and hence higher ROA.

## 5.4 Policy recommendations

It is important for the government to set up policies that will ease microfinance credit to SMEs. It needs to provide a conducive environment for SMEs to grow and thrive. The policies should consider both the SMEs and MFIs so as to prevent future conflicts between the two. This will create a window for growth and development of the economy as a result of more job opportunities and increased flow of money circulation in the economy.

Financial institutions should provide better training services to SMEs on the sound financial management practices. This will help SMEs account for loans borrowed, make better financial judgments and hence grow in the long run. They should also lower lending rates to SMEs and train on risk management too. MFIs should partner with county governments and other major stakeholders to create awareness of availability of microfinance services to SMEs.

## 5.5 Limitations of Study

This study used secondary data in the public domain. Unlike primary data which is usually first hand from respondents, secondary data is usually already obtained. The secondary data was tested for reliability and validity. It remained relevant since it showed current financial status and macro-economic conditions in Kenya.

The study adopted a multiple regression model with four variables: one dependent variable which was financial performance of SMEs and three independent variables that included micro-credit, assets turnover and sales turnover of the SMEs. Results and findings may be drawn by future researchers if they adopted a similar model but investigate other variables that may have an effect on financial performance of SMEs.

This study was carried out within a limited time frame and resources which constrained the scope and depth of the study. This necessitated the adoption of a sample design hence these findings cannot be used to make generalizations on the effect of microfinance credit and financial performance of SMEs in Embu County.

### 5.6 Suggestions for Further Research

This study focused on SMEs in Embu County and therefore the findings of this study cannot be generalized to all the SMEs in the 47 counties in Kenya. The study recommends that further research could be conducted on SMEs countrywide to investigate on the effects of microfinance credit on financial performance of SMEs to find out whether there are commonalities or unique factors.

This study concentrated on SMEs only, further research may be done among large enterprises in order out the effect of micro-credit on financial performance of these firms. For the small and micro enterprises sector to grow small businesses need to link with the rest of the economy. Most of these businesses are so small that creating a link seems almost impossible. Further research should be done in this area to establish the best way of linking small and micro businesses with large companies in the economy.

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## APPENDIX I: LETTER OF INTRODUCTION

FIONA WANJA NJAGI,

UNIVERSITY OF NAIROBI,

SCHOOL OF BUSINESS,

P. O. BOX 30197-00100,

NAIROBI.

**RE: THE EFFECT OF MICROFINANCE CREDIT ON THE FINANCIAL PERFORMANCE OF SMALL AND MEDIUM ENTERPRISES IN KIAMBU COUNTY, KENYA**

I am a Master degree student in the School of Business, University of Nairobi. In partial fulfilment of the Master of Science in Finance degree, I am conducting the above underlined study.

You have been selected to form part of this study. To this end, I kindly request your assistance in completing the attached questionnaires. The information and data you will provide is for academic purpose only and will be treated in strict confidence.

Thank you in advance.

Yours sincerely,

FIONA WANJA NJAGI.

# APPENDIX 2:QUESTIONNAIRE

This questionnaire is meant to collect data on the effects of Microfinance services on the growth of SMEs in Embu County. Any information given by the respondents during this exercise will be treated with strict confidentiality. Kindly answer the following questions by writing a brief answer statement or ticking in the spaces provided as will be applicable.

**BACKGROUND – PERSONAL INFORMATION**

1. Name of the business______________________________________________
2. Nature of the business/Category________________________________________
3. Tick the form of ownership

a) Sole proprietor ( )    Partnership ( )

b) Company ( )    Other (specify)_

4. When was the business established ______________________________________________

5. Gender of entrepreneur

Male ( ) Female ( )

6. What is the education level of the Manager?

Std 8 ( ) Form 4 ( ) Diploma ( ) Undergraduate ( ) Postgraduate ( )

7. What is the main business activity?

8. How long have your business been operational?

| Duration Option |
| --- |
| Less than 1 year [1] |
| 1-5 years [2] |
| 6-10 years [3] |
| 11-15 years [4] |
| Over 15 years [5] |

**PART II PROVISION OF MICROFINANCE SERVICES**

9. What other valuable services do you get from MFIs

…………………………………………………………………………………………

…………………………………………………………………………………………

…………………………………………………………………………………………

10. What was the major source of your start-up capital?

……………………………………………………………………………………………..

…………………………………………………………………………………………

……………………………………………………………………………………………

……………………………………………………………………………………………

……..

11. Do you benefit from loans from microfinance institutions?

Yes [ ] No [ ] If Yes, how

……………………………………………………………………………………………

…..

12. what made you seek financial help from microfinance instituitions

Flexible repayment period ( )

Fair interest rates ( )

Amount offered ( )

Other……………………………………

13. In a scale of 1-5, rate the below in respect to training if any by MFIs. Note 1 =Less favourable; 2=moderately satisfactory;3= satisfactory;4=Very satisfactory and 5=Most satisfactory

| **Skills** | **Most satisfactory** | **Very satisfactory** | **Satisfactory** | **Moderately satisfactory** | **Less satisfactory** |
|---|---|---|---|---|---|
| Basic business | | | | | |
| Skills | | | | | |
| Capital Investment decisions | | | | | |

| | | | | | |
|---|---|---|---|---|---|
| Risk Management | | | | | |

14. What is the value of your business in total assets_________________________________

15. How much savings have you made from the last one yearKshs______________________

16. What is the average monthly sale? Kshs__________________________________

17. How many full time employees do you have _________________

18 Has your business/company experienced growth in terms of sales, assets, employees, new branches, size in the last four years?

Yes ( ) No ( )

19. What do you attribute this growth to mainly?

20. Have you disposed any assets in the last four years and in what proportions?

**Income from the business enterprise**

| **Item** | **2010** | **2011** | **2012** | **2013** | **2014** |
|---|---|---|---|---|---|
| How much sales did | | | | | |

| | | | | | |
|---|---|---|---|---|---|
| you make? | | | | | |
| How much did you spent on inputs? | | | | | |
| What was your cost of doing business? | | | | | |
| Estimated profit | | | | | |