Effect of Microfinance Lending on the Financial Performance of Businesses: A Case Study of Small and Medium Enterprises in Nakuru East Sub-County, Kenya

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Abstract: ***This Research project was set to provide a critical appraisal of the debate on the effects of microfinance lending on the financial performance of small and medium enterprises. While microfinance has developed some innovative management and business strategies, the effects of microfinance lending on the financial performance of small and medium enterprises remain in doubt. Access to affordable microcredit and business development services such as business training are essential for growth and development of micro and small enterprises. However, entrepreneurs in the SME industry have come to develop great reliance on microfinance lending as a tool for business growth and profitability. Against this background, the number and the spread of MFIs in Kenya continues to grow rapidly. However, their wide presence does not correspond with the extent of reduction in the major challenges that affect the financial performance of SMEs in the country. A study of this nature is very important as it would provide the government with the needed information in designing a policy frame work to enhance the development of the SME industry. It would also enlighten the public on the role MFIs play in the SMEs sector. This research was cross sectional and employed a survey research design. The target population under study was 8,139 SMEs within Nakuru East Sub County. Stratified simple random sampling was used to select a sample size of 99 SMEs from the target population. The research employed the use of questionnaires as instruments of data collection. Data collected from the questionnaire was analyzed, summarized and interpreted accordingly with the aid of descriptive as well as inferential statistical techniques. The study confirms the positive contribution of MFIs loans towards promoting SMEs financial stability, operational efficiency and profitability. It was recommended that MFI interest rates should be standardized. Further study should be conducted on how best SMEs can make use of equity finances such as Venture Capital, Business Angels and other alternative sources of finance available to SMEs in Other Counties.***

Keywords: Financial performance, interest rates, microfinance, MFIs, small and medium enterprises

1. Introduction

Microfinance is a concept that dates back three centuries ago when money lenders were informally performing the role of now formal financial institutions. The informal financial institutions constitute; village banks, cooperative credit unions and social venture capital funds to help the poor. These institutions are the ones that provide savings and credit services for small and medium size enterprises. They mobilize savings and have simple and straight forward procedures that originate from local cultures and are easily understood by the population [5]. These funds are to finance the informal sector SMEs in developing countries.

Microfinance institutions are in operation in East Africa under different models. In this region, provision of microfinance services is a function of Savings and Credit Cooperative Organizations (SACCOS). The SACCOS are formed with respect to a particular economic activity [11]. Access to microfinance loans and other services is limited in Kenya and other East African nations due to lack of collateral and high interest rates [19]. In addition, most of the individuals who qualify for loan facilities from microfinance institutions spend most of their earnings repaying the loan while leaving very little for saving and reinvestment into their enterprises. As such, very few micro-enterprises transition to become SMEs.

The creation of SMEs generates employment but these enterprises are in most cases short-lived consequently causing those who gained job positions to lose them and become poorer than they were before. It is not until recent that microfinance has gained recognition thanks to the Nobel Prize winner Yunus Muhammad of the Grameen Bank. It should be noted that microfinance is not a panacea but it is a main tool that foster development in developing countries [6]. It is known worldwide that the poor cannot borrow from the banks. Banks do not lend to them because they do not have what is required to be granted a loan or to be provided with the bank services.

The lack of financial power is a contributing factor to most of the societal problems. These problems emanate from poverty and it is known that with poverty one is bound to suffer so many consequences ranging from lack of good health care system, education, nutrition e.t.c. Microfinance has proved this bank concept to be wrong. They target the SMEs who are considered risky but the repayment rate turns to be positive.

Microfinance has gained immense popularity within a very short span of time the. In fact it has come to a level of popularity which was not expected at all [16]. The first and the foremost reason of the success of the microfinance are due to the access of poor towards the main stream of economy. Weaker section of the economy can also access the service and can make the necessary financial transaction.

Loans for small scale industries and small manufacturing plants are easily being sanctioned by the microfinance and as a result, lower and middle class people are more attracted towards microfinance [2]. At the same time, microfinance has also made necessary and user friendly repayment options to repay the loan well in time and to take a fresh loan after the closure of the first one. Documentation and the access to microfinance is the other reason why it has become so successful. While availing any loan from the microfinance, the documentation process is least and people can take a loan with the minimum required documentation [17].

Researchers have viewed microfinance in different dimensions. Microfinance gives people new opportunities by helping them to get and secure finances so as to equalize their chances and make them responsible for their own future. It broadens the horizons and thus plays both economic and social roles by improving the living conditions of the people [4]. These improvements are in a nutshell to alleviate poverty, and according to this research project, it was seen from the point of the financial performance of small and medium size enterprises. In contrast to the improvements by microfinance, the UN millennium goal to alleviate poverty by the year 2015 is far from being realized despite the enormous works that microfinance institutions are doing to contribute in this domain [8]. The main challenge facing the SMEs is to gain financial power to enable them boost their income generating activities [20].

2. Statement of the Problem

SME's need both financial and non-financial services to enhance their productivity, profitability and growth. It is asserted that, access to financial and business development services is essential for growth and development of Micro and Small Enterprises. The Microfinance industry has become a major backbone in the sustenance and survival of SMEs in Kenya [16]. Microfinance Institutions (MFIs), as part of their core business, provide credit to SMEs. In addition to these financial services, MFIs also provide non-financial services like business training, financial and business management to help improve the capacity of their clients in managing the loan resources granted them [17].

A survey among the entrepreneurs in the SME industry has revealed that there is great reliance on credit as tool for business growth and profitability [16]. However, most entrepreneurs asserted to the fact that they are faced with a challenge of inadequate capital in their businesses and this inhibits their growth. Some MFI institutions also believe that credit obtained by entrepreneurs is misappropriated [10]. Another constraint of most SMEs is the lack of managerial and business skills. There is the need to build these capacities in addition to financial resources in order to achieve growth [17]. The number of MFI institutions in Kenya continues to grow rapidly. However, their wide presence does not correspond with the extent of reduction in the major challenges that affect the financial performance of SMEs in the country. This research project was designed to establish the effects of microfinance lending on the financial performance of SMEs in Kenya and to propose a more effective approach that MFIs can adopt in order to meet the financial performance oriented needs of SMEs.

3. Objectives

3.1 General Objective

To establish the effect of microfinance lending on the financial performance of business enterprises

3.2 Specific Objective

To assess the effect of interest rates on the financial performance of SMEs in Nakuru East Sub-County

4. Research Question

What is the effect of interest rates on the financial performance of SMEs in Nakuru East Sub-County?

5. Conceptual Framework

Figure 1 outlines the conceptual framework which essentially illustrates the presumed relationship between the independent variable (interest rates) and the dependent variable (financial performance of SMEs).

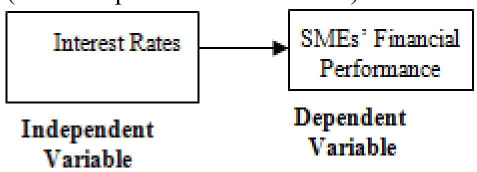

Figure 1: Conceptual Framework

6. Literature Review

This section presents a review of theoretical and empirical literature pertinent to microfinance lending and financial performance of business enterprises.

6.1 Theoretical Review

6.1.1 The Agency Theory

In an agency relationship, one party, called the agent, makes decisions and acts on behalf of another, called the principal. The agency theory attempts to summarize and solve problems arising from the relationship between the SME owners and their agents. Agency relationships are common in financial management, due to the nature of the industry [13]. When one person manages another person's financial affairs, an agency relationship exists by default. A number of specific agency relationships can exist in the world of financial management. Corporate executives and company shareholders serve as a prime example. CFOs and other financial executives make decisions on behalf of the interests of shareholders, the principals in the relationship.

The problem around which the agency theory revolves describes the main challenge of agency relationships: reconciling two distinct sets of personal goals. In an agency relationship, agents are required to work toward meeting SME owner's goals, yet it is the agents' own goals that drive them to succeed on behalf of the SME owner's [10]. In order for an agency relationship to be mutually beneficial, both parties' goals must be addressed within a climate of compromise, but with the understanding that meeting the principal's goals is the primary function of the relationship. To this end, it is vital that information be shared freely and openly between the two parties so agents are always clear on their principals' priorities and principals are always aware of their agents' decisions and actions.

Financial management is all about risk, and each investor comes to the table with a different tolerance for risk. In an agency relationship, chances are high that SME owners and their agents have different risk tolerances, which can lead to misunderstandings and a failure to agree on investing decisions [11]. Even when agents act toward principals' goals, their means of doing so may conflict with principals' risk tolerances. For example, in a shareholder-executive relationship, an executive may wish to acquire struggling companies to achieve the shared goal of increasing market share at a discount, but this plan may be deemed too risky by a majority of shareholders. To address agency conflicts which may threaten the financial performance of SMEs, the financial objectives of SME owners and those of their agents need to be aligned [17].

6.2 Empirical Review

This section reviews studies that have hitherto been conducted on profitability in the light of capital structure.

6.2.1 Interest Rates and the Financial Performance of SMEs

Accessing low interest credit is considered to be an important factor in increasing the performance of SMEs. It is thought that access to credit enables Small and Medium Enterprises to enhance their financial performance [7]. The main objective of microcredit is to improve the performance of SMEs as a result of better access to small loans that are not offered by the formal financial institutions [15]. It is argued that insufficient access to credit by the poor just below or just above the poverty line may have negative consequences for SMEs and overall welfare. Access to low interest credit further increases SME"s risk-bearing abilities; improve risk-coping strategies and enables consumption smoothing over time. With these arguments, microfinance lending is assumed to improve the performance of SMEs [18].It is argued that MFIs that are financially sustainable with high outreach have a greater livelihood and also have a positive impact on SME performance because they guarantee sustainable access to credit by the SMEs.

From empirical studies carried out, low interest lending by MFIs may not even be the most useful financial service for the majority of micro entrepreneurs. The MIT study [1] found no impact on the financial performance of SMEs among the slum dwellers in the city of Hyderabad, India. Similarly, another study which measured the probability of being below the poverty line and the quality of food that people ate, found no discernible effects.

The most-cited source of evidence on the impacts of microfinance lending on the financial performance of SMEs is the early set of studies collected [9]. The findings of these studies are provocative: microenterprises do not benefit from microfinance low interest lending; it is only relatively well established SMEs that can do well with microfinance lending and enjoy sizeable positive impacts. More troubling is the finding that a vast majority of those with starting incomes below the poverty line actually ended up with less incremental income after getting micro-loans, as compared to a control group which did not get such loans.

It is argue [3] that, the indicators of success of microcredit 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 evangelism”. Carrying out research in three countries; Kenya, Malawi and Ghana, it was concluded that, there was little evidence to suggest any significant and sustained impact of microfinance lending on clients in terms of SME development, increased income flows or level of employment. The focus in this argument is that improvement to access to low interest lending by MFIs and market for SMEs was not sufficient unless the change or improvement is accompanied by changes in technology and or technique.

7. Research Methodology

A survey research design was adopted in this study to assess the effect of MFI’s lending on the financial performance of SMEs in Nakuru East Sub County. A survey is an investigation about the characteristics of a given population by means of collecting data from a sample of that population and estimating their characteristics through the systematic use of statistical methodology [12]. The study covered a total population of 8,139 Small and Medium Enterprises in Nakuru East Sub County drawn from various business sectors. An enquiry from the Nakuru County Licensing office showed that 8,139 small and medium businesses had registered with the office as of June 2014. A sample of 99 respondents was extracted from the target population using Yamane’s formula. The sampled respondents were selected through stratified simple random sampling.

A survey questionnaire was used to collect primary data from the entrepreneurs in the SME sector. The use of questionnaires allowed the researcher to collect large amount of data in a relatively short time. Pilot testing was used to ensure reliability and validity of the questionnaires. Validity of the questionnaires was ensured through the assistance of expert opinion of the University supervisors. The questionnaires administered in the pilot study were subjected to reliability test using Cronbach alpha whereby the reliability threshold was alpha equal to or greater than 0.7 [14].

7.1 Data Processing and Analysis

The questionnaires collected from the respondents were ascertained to ensure that only the sufficiently and appropriately filled ones were considered for the study. This was in order to eliminate incomplete data and minimize outliers in the eventual findings. Data collected from the questionnaire was analyzed, summarized, and interpreted accordingly by use of both descriptive and inferential statistical techniques. Statistical Package for Social Sciences (SPSS) computer software version 21.0 was used for analysis. The findings were presented in form of tables

7.2 Research Findings

The researcher prepared and administered 99 questionnaires and 90 were appropriately filled and returned. This represented 90.9% response rate. This rate of response was deemed to be an acceptable margin to report results.

7.2.1 Descriptive Findings for interest rates in context of financial performance of SMEs

The study sought the opinion of the sampled respondents regarding interest rates in context of financial performance of SMEs. Table 1 shows the pertinent findings.

Table 1: Descriptive Statistics for interest rates in context of financial performance of SMEs

	Min	**Max**	**Mean**	**S.D.**
Interest rates charged on microfinance loans are very high	2	5	4.29	1.114
Interest rates charged on microfinance loans are fair and affordable	3	5	3.96	1.262
Interest rates charged on microfinance loans have reduced my financial costs	1	4	1.73	1.197
Interest rates charged on microfinance loans have improved the cash flow position of my business	1	5	1.83	1.173
Interest rates charged on microfinance loans have positively affected the profitability of my business	1	5	1.42	.779

The descriptive findings in Table 1 shows that the mean rating on the rate of microfinance interest rates being high is (4.29) among the SMEs. This means that a majority of the SMEs agree that the interest rates charged by the MFIs are high. Rating on the fairness and affordability of interest rate charged on microfinance loans is moderately high (3.96) meaning that SMEs find the interest charged on the microfinance loans not fair and affordable.

The observed low mean rating of 1.73suggest that majority of SMEs disagree that interest charged on the loans had lowered business financial cost. The same low rating was observed on interest rates improving the cash flow (1.83) and interest rates charged on the loans increasing profitability of the business (1.42). These statistics indicate that interest rates charged on the loans have a negative impact on the business performance.

7.2.2 Effect of Interest Rate on SMEs' Financial Performance

The study employed regression analysis to assess how interest rates affected performance of SMEs in Nakuru East Sub-County. Table 2 illustrates the findings of the aforestated analysis.

Table 2: Regression Model Summary of Effect of Interest Rates on SME'S Financial Performance

Model	*R*	*R Square*	*Adjusted R Square*	*Std. Error of the Estimate*
1	.665[a]	.443	.430	1.93265

Table 2 represents results of regression analysis carried on the rating of the high level of interest rate and the overall SME performance. The findings shows that, the coefficient of determination, $R^2 = 0.443$, meaning that the generated model can account for 44.3% of the observed values.

Table 3: Regression Coefficients

Model		*Unstandardized Coefficients*		*Standardized Coefficients*	*t*	*Sig.*
		B	*Std. Error*	*Beta*		
1	(Constant)	11.48	.83		13.79	.00
	Interest rates charged on microfinance loans are very high	-1.58	.24	-.67	-6.54	.00
	Interest rates charged on microfinance loans are fair and affordable	.07	.21	.04	.34	.74

Table 3 shows that the model uses two independents variable to predict the overall performance of the business which included rating of the high interest rate levels charged on the MFI loans and rating of the interest rate affordability and fairness. The results presented in this table shows that regression coefficient of the rating of the high interest rate levels charged on the MFI loans is -1.58 and that of rating of the interest rate affordability and fairness is .07. The regression coefficient of the rating of the high interest rate levels charged on the MFI loans is significant. This means that a unit increases in the loan interest would lead to a decrease in business performance by 1.58.

8. Summary, Conclusions and Recommendations

In this part, a summary of major study findings is presented and pertinent conclusions drawn. This is followed by suggestions of recommendations in tandem with the study objectives.

8.1 Summary

The study established that there is a positive correlation between level of interest rate charged on the MFI loans and the fairness and affordability of the loans as result of the interest. This means that the high the interest rates the less affordable the loans to SMEs. The study further indicated that the level of interest rates charged on the loans by the MFIs have negative correlation with the parameters of business performance. High interest rates do not reduce the financial cost, improve cash flow as well as increase profitability of the SMEs.

The study showed a regression coefficient of the rating of the high interest rate levels charged on the MFI loans as -1.58 and that of rating of the interest rate affordability and fairness as .07. The regression coefficient of the rating of the high interest rate levels charged on the MFI loans is significant. This means that a unit increases in the loan interest would lead to a decrease in business performance by 1.58.

8.2 Conclusions

The study concluded that, interest rates on MFI loans had an influence on the financial performance of SMEs. The borrowers found the interest rates charged on microfinance loans are very high, not fair and affordable but had, however, reduced the entrepreneur's financial costs, improved cash flow and profitability of their businesses. The study further concluded that Interest rates has an effect on financial performance of SMEs.

8.3 Recommendations

The MFIs should standardize their interest rates and establish mechanisms to counter adverse inflation in order to protect the borrower and reduce loan default level. Capacity building and civic education should also be done to reduce speculation and hearsay about the interest rates being charged by MFIs hence reduces the SMEs fears of the unknown.

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