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Access to Finance and Performance of Small and Medium Enterprises in Rwanda

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Abstract: ***Small and Medium Enterprises play an important role in development of many countries. They have lifted hundreds of millions of people out of poverty in developed countries. Using internal finance, it is not easy to acquire enough resources in business, and financial institutions provide loan as external sources to increase the capital. This helps to use the fixed cost at maximum level to increase profit. Unfortunately, the great number of SMEs are facing the problem of lack of finance due to several challenges and lead to poor performance which finally, influence negatively job creation and some of them failure. To overcome these challenges, the research was conducted to assess the effect of access to finance on the performance of SMEs in Rwanda. Deeply, the researcher analyzed the determinants of access to finance and the factors of SMEs performance, then the relationship between them was drawn to assess their significance level. To achieve the research objective, the researcher used the explanatory research design and the sample size of 152 respondents was selected from 246 registered SMEs in Muhanga District as target population, by using Yamane's formula. The researcher also used multistage sampling method for selecting sample size. This study was conducted using quantitative methods. The data were collected using a self-administered questionnaire, analyzed using Statistical Package for Social Sciences and presented in form of tables. Multiple regression used to determine the p-value and the level of significance for this test was 5%. The statistical Pearson correlation coefficient of 0.891 confirmed that access to finance impact positively the relationship between two variables under study.***

Keywords: Access to finance, financial performance of SMEs

1. Introduction

As per the 2014 Business Establishment Census report by the National Institute of Statistics of Rwanda (NISR), smaller scale, and medium business network possess 98% while extensive organizations remain at just 2%. In any case, SMEs contribute just 41% as far as making occupations in private division, because of a few difficulties that back off the rate at which SMEs can effect on advancement in Rwanda. Given the fact that SMEs play a major role in the economic development of any nation, the Government of Rwanda has established a number of programs to significantly increase the number of SMEs in the country as a tool to reduce the abundant unemployment existing in rural areas of Rwanda. Small and Medium Enterprises are quite important for any economy especially developing and least developed economies in terms of job creation, increasing tax base, increasing export range leading to reduction of imbalance of trade balance in Rwanda.

A research on micro and small business sponsored by the Danish government and released in Kenya, on April 2010, found out that players in this sector are dissatisfied with access to finance especially from major financial institutions in Kenya. About 65% of micro, small and medium investors in Kenya, according to the survey, say that they did not receive any financial assistance from financial institutions during difficult economic times. Only 12% said they received financial help with good terms of repayment (Gabriel, 2011). Bankers, on the other hand, hold that borrowers with good credit ratings stand to benefit from reduced interest rates on loans, besides a waiver on other lending conditions such as collateral requirements. The survey shows that lenders tend to shy from the SME market on fears of defaults despite the presence of financially sound firms (Onyango, 2010). This suggests that there exists a 'financing gap' when it comes to SMEs' funding. However, lack of access to finance in term of lack of collateral, lack of real assets, non-existing credit history to the financial institutions, and lack of experience for accessing to debt finance lead to poor performance of SMEs. Ward has showed that 90% of SMEs make loss in five first years and 85% of them are sold or closed. He found that the problem of lack of finances is the biggest in business (Ward, 2005). There is considerable evidence to support the contention that SMEs, in particular, face a number of obstacles and problems in accessing finance, mainly because of their limited resources and perceived risk and achievement of organizational objectives.

In Rwanda, though the Government of Rwanda had put in place several programs to help SMEs to perform, access to finance of SMEs is still a big challenge which also affect the growth and threatening their survival due to lack bank's reluctance to fund the SMEs or get business aids to finance their strategic and operation plans. Due to these challenges SMEs lead to finance their activities by borrowing at high interested rate and take high risk of borrowing from informal lenders yet SMEs are the drivers of country's development through job creation, GDP growth, increasing saving capacity of household, increase investment capacity of citizens, increase their financial profitability and pay taxes and increase productivity of self-reliance and increase production capacity.

This research aimed at assessing the effect of access to finance of SMEs on financial performance of selected SMEs in Rwanda. The specific objectives are presented as follows:

1) To determine the effect of bank interest rate on SMEs financial performance

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2) To evaluate the extent to which borrowings affect SMEs financial performance
3) To determine the significance level of working relationships and experience of SMEs on their financial performance

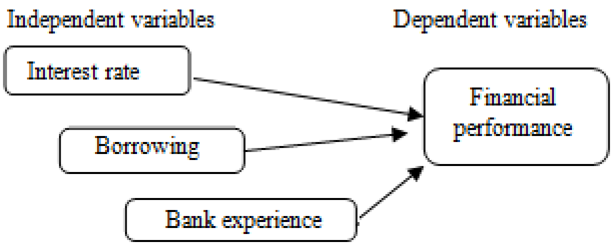
This research is guided by the following research hypotheses:
Ho1: Bank interest has a positive effect on the financial performance of SMEs in Rwanda
Ho2: Borrowings have positive effect on the financial performance of SMEs in Rwanda
Ho3: There a positive significant effect of working relationships and experience between financial institutions and financial performance of SMEs in Rwanda.

2. Literature Review

According to the research conducted in Muhoza sector of Musanze district; Jean Bosco found that the major reasons why firms sought external finance were to improve the profitability (91%), to improve firm efficiency (87%), to prevent liquidity problems (72%), to improve firm insolvency (69%), and increase of asset quality (64%). Other reason why SMEs sought external finance is to meet expenditures which counted for 39% of the responses (Jean Bosco. H; 2015). All of these reasons are in the same framework of other different researchers where the common goal is profit maximization.

Performance improvement is the primary goal of entrepreneurial firms, as it demonstrates the level of success of its business operations (Murphy, Trailer & Hill, 2006). Organizational performance can be explained in different kind of perspectives and there are several aspects that are mutually considered to define organizational performance comprehensively, rather than financial measure of profits that are heavily criticized and profitability reflects the overall performance of profit organizations (Draft, 2008)

Like any other business entity, SMEs are suffering from a number of challenges that even makes some to go extinct. These challenges include issues of incentives, laws and regulations, globalization, resources to improve standards, poor accounting/accountability (Ward, 2005), cost of compliance to high tax regime in most states (Ekpenyong & Nyang, 2002; Ward, 2005). One of the biggest problems facing SMEs among the listed ones is that of finance. This is because, most SMEs lack collateral to access bank loans. Despite the numbers of Micro-community Banks across the country, access to loans because of lack collateral pose a serious constrain to the productivity levels of SMEs.
According to Magembe (2007), the use of landed property as collateral for loans is also a huge challenge to SMEs operators in Nigeria. Most of them have no landed property and their asset based is very poor. Consequently, they operate with limited financial resources, which adversely affect their productivity. Most SMEs workers/staff are poorly remunerated and lack motivation for high level performance because of the poor financial base of these organizations. The poor financial based of most SMEs is also responsible for high labor turnover in these organizations. The cumulative effect is that both management and loyal staff are frustrated and at-times the enterprise goes extinct. The following conceptual framework highlight the relationship of the variables.



3. Empirical Review

Pretorius & Shaw (2004) observe that accessibility to external finance is essential to solve shortage of SMEs cash flows. Financing is required for SMEs to set up and enlarge their business operations, new product development, research and development, human resource development and acquirement of up to date production equipment's and technology. Most of SMEs rely on internal finance but still internal finance is inadequate for SMEs development and profitability. Most of SMEs failures to access debt financing result into an inadequate capital structure.

Thomas Kigabo (2013) conducted a study to determine how financial institutions influence trade in Rwanda especially for rural traders. The findings revealed that finance to small traders is limited with only a small number of people who have collateral as a security. Also, small traders more often face difficulty in obtaining bank loans than big corporation because bank do not have much management information about those small traders. The commercial banks help in financing both internal and external trade. Banks provide loans to retailers and wholesalers to stock goods in which they deal.

Fatoki & Asah (2011) find out that SMEs located in urban are successful in access to debt financing compared those located in rural areas. Physical closeness between lenders and borrowers produce an improved form of environmental scrutinize that aid SMEs to access credit from lenders. Consequently, there is a positive relationship between firm's location and access to debt financing by SMEs.

The research conducted by Cardone C., M and Margarita S.(2005) in Spain entitled, "Do banking relationships improve credit conditions for Spanish Small Scale Enterprises" The main objectives of this study was to provide the banking relationship that are developed in this market and their impact on credit rationing. The results of this study showed that accessibility of banking services and the high level of security are highly significant and valuable to these enterprises.

In the study conducted in Ruhengeri high education institute, (Jean Bosco.; 2015) has assessed the role of Access to finance for the Performance of Small and Medium Enterprises in Muhoza Sector. The results show that the factor influencing access to external finance was the application procedures for loan with 84%. Also, the results confirmed the role of access finance such as improve profitability (91%), improve firm efficiency (87%), prevent liquidity problems (72%), improve firm solvency (69%) and increase of assets quality (64%) and to meet expenditures which accounted for 39 percent of the responses. The results revealed that 95.7 level of significance present the change in liquidity, profitability, efficiency, increase in assets value, increase in employee salaries, and that is positively and significantly related to the change in costs of accessing finance, interest rates and application procedures for loan, collateral requirements, and guarantees from government and other factors not studied in the study. Though access to finance plays a major role in the performance of SMEs, it continues to be a major problem that SMEs face in their operations. The study concludes that SMEs should be sensitized about funding programs and financial schemes provided by the government and private sector and that public and private sectors put in place funding programs and financial schemes to assist SMEs.

Kitondi et al (*2007*) point out that lenders use firm's business information to access current and future performance of the firm. Lenders are interested to know the status of their loan interest and principal by evaluating the firm's capital structure. Furthermore, lenders use the business information to decide borrower's credibility whether to issue or extend a loan.

Critical Review and Research Gaps Identification

Several researchers have conducted studies on financial access and the performance of SMEs. These include, among others, Pretorius & Shaw (2004) who observed that accessibility to external finance is essential to solve shortage of SMEs cash flows. But he ignored the conditions related to financial access. Fatoki & Asah(2011) found that SMEs located in urban are successful in access to debt financing compared those located in rural areas. But they didn't compare size, age, transparency accounting, manager's skills, credit rating, and taxes and regulations of SMEs for making performance. Kitondi et al (2007) point out that lenders use firm's business information to assess current and future performance of the firm. They didn't where the information come from for assessing current and future performance, the information come in the profitability assessment for banks, business plan, and types of loan (short or long term). It is important to note that all these studies were not conducted in the Rwandan context. Thomas Kigabo (*2013*) conducted a study to determine how financial institutions influence trade in Rwanda especially for rural traders. But he did not analyze the relationship relating to their performance. And Jean Bosco Harerimana (*2015*) has assessed the role of Access to finance for the Performance of Small and Medium Enterprises. He discusses on accounting documents but he didn't discuss on the strategic orientations, entrepreneurs' orientations, the market orientations, and technological orientations which are the determinants of performance of SMEs as well. Hence, this study to fill the gaps is needed.

4. Theoretical Framework

Adverse selection theory

This theory is also known as anti-selection. It is developed by D. Marinescu, D. Marin; 2011. This is a term used to describe a market process in which buyers or sellers of a product or service are able to use their private knowledge of the risk factors involved in the process and the transaction to maximize their results at the cost of the other parties to the transaction. Antiselection is most likely to occur in transactions where there is information asymmetry: one party has more or better information than the other party. Although asymmetric information tends to favor the buyer in markets, the seller usually has the information related to the best quality than the buyer. These phenomena are related to this topic when we compare the level of information gotten by SMEs managers, government and the commercial banks.

Frequently, people who choose to take loan know that they have risk factors that are higher than the others because they must realize profit for bank and for themselves at the given period of time. The bank also uses the risk factors to set the interest rate because they should lose money when the number of people failure to pay back.

The bankers could try to deal with the challenges of adverse selection by ensuring only certain clients, such as those with historical banking, big companies or young people. If banks have the option of denying coverage to individuals considered "high risk", such as those with pre-existing problems, they will try to deal with only those who are considered the least likely to failure. This practice, known as "cherry picking" or "skimming", may lead financial institutions to cooperate with the big companies. To combat this practice, the government can provide additional incentives to motivate both parties regardless of their individual risk factors.

Signaling arguments

This theory is developed by Rebecca Bliege Bird and Eric Alden Smith, 2004. Signaling is the idea that a party called the agent, credibly transmits information about itself to another party ,the principal . The signaling took root in the idea of asymmetric information , which indicates that in some economic transactions, inequalities in access to information upset the normal market of exchange of information, goods and services. This theory is adequate to the topic since the SMEs managers are more based in production than information seekers In the job market, potential employees are looking to sell their services to employers for a salary or a price . Generally, employers are willing to pay higher wages to employ better workers. While the individual may know his or her own level of ability, the hiring company is not able to observe such an intangible trait; so there is an asymmetry of information between the two parties.

Academic degrees can be used as a signal to the company, indicating a certain level of ability that the individual may possess; which reduces the information gap. This is beneficial for both parties as long as the signal indicates a desirable attribute a signal such as a criminal record may not be desirable.

Theory of change

It has developed by Frederic Perls,1970. This theory suggests that the first step in assessing any service is to determine its expected results, the activities it intends to implement to achieve those results, and the contextual factors that may affect the implementation of the activities and their potential to produce the desired results. For example, the goal of many entrepreneurs is to improve the wellbeing of neighborhood children and families. In this case, one of the main activities of an initiative might be to replace the categorical and centralized services with integrated family resource centers in the neighborhoods. An important contextual factor could be the political environment, including the presence or absence of legislation that allows pooled funding of state resources for innovative community initiatives.

With a theory of change in hand, the measurement and data collection elements of the evaluation process will be facilitated. For example, a theory of change asks participants to be as clear as possible about not only the ultimate outcomes and impacts they hope to achieve, but also the means by which they hope to achieve them (Weiss, 1995). Therefore, a theory of change assessment determines what needs to be measured final and interim results and implementation of activities to achieve those outcomes and helps guide choices about when and how to measure these elements. With this good theory of change, the stakeholders should confirm before you commit to an assessment and, should review throughout the implementation and evaluation. Hence, the performance of SMEs is appropriate to this theory.

5. Methodology

The study employed an explanatory research design. This method made people understand the causes and effect of performance of SMEs. And help to determine the causal effect of the relationship between SMEs access to finance and their financial performance. Explanatory research is appropriate to understand why managers can make decision to close the business while they were other alternative solutions. This research targeted 246 active SMEs and registered in Muhanga District. During this research a multistage sampling technique was used to determine the sample size.

The selected sample was 152 registered companies for this study as it is selected using the formula below. The level of error margin in this research was 5%, meaning that the confidence level of the result on this research is 95 %. A sample of a certain number of respondents was taken using the method of Yamane's formula (1972). The formula used to determine the sample is written as follow

Sample calculation

$$n = \frac{N}{1 + N(e)^2}$$

Where n: required sample size
N: population (N= 246)
e = Standard error (e = 0.05)

$$n = \frac{246}{1 + 246\,(0.05)^2} = \frac{246}{1 + 0.615} = \frac{246}{1.615} = 152$$

A self-administered questionnaire was used to gather data. The questionnaire contains closed ended questions. For closed-ended questions, alternative responses presented to the respondents were filled in by the space provided on the form according to the respondent's choice. Questionnaire and document review were used as data collection tools in this study. The questionnaire was administered face to face, where the respondent is not directly available, the research left the questionnaire to the respondent to be filled by himself/herself and the document review fulfilled immediately after gathering information in the questionnaire. This helped extract more information on questions, save time and resources. One data collector was hired, and was inducted to support this study. The modalities of administrating the questionnaire will adequately discuss with data collector before starting the data collection.

According to Ochieng (2009), for a study to be of real meaning, it ought to apply valid and reliable instrument. Before starting, the researcher was checked and pre-tested the questionnaire for validity and reliability to the managers of SMEs, this pretest was done in Muhanga District.

Before starting, the researcher checked and pre-tested the questionnaire for validity and reliability to the managers of SMEs, this pretest was done on 12 SMEs in Muhanga district, Reliability refers to the consistency with which repeated measures produce the same results across time and across observers. Statements in the questionnaire were developed in line with the research objectives and questions. To ensure reliability and validity of the instrument, researcher reviewed the questionnaire to confirm the consistency, conciseness, intelligibility and clarity of the statement

6. Research Findings

Table 1: Correlation coefficient of variables

	Bor	Bex	In	ROE	Sav	Inv	Pro	Int
Bor	1	.832**	.543	.380	.209	,210	.793**	.512
Bex	.453	1	.378	.450	.757**	.456	.486	.642
In	.765	.345	1	.635	.463	.369	.348	.476
Ret	.732	.290	.642	1	.763	.459	.584	.395
Sav	.720	.634	.465	.730**	1	309	.538	.512
Inv	.436	.569	.320	.388	.320	1	.341	.583
Pro	.784	.439	.490	.320	.670	.548	1	.238
Int	.324	.309	.686	.450	.492	.387	.420	1

**. Correlation is significant at the 0.01 level (2-tailed).
Int: Bank Interest rate
Bor: Bank borrowings
Bex: Bank Experience

Un: unemployment
RoE: Return on Equity
Sav: Savings
Inv: Investment
Pro: Production

The table indicates that bank borrowings, interest rate and working relationship and experience of SMEs in Rwanda have a relationship with their financial performance. Thought the relationship is not strong, but the relationship exists and measured by the Pearson correlation coefficient

Table 2: Regression Coefficients analysis between predictors and performance

Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.
		B	Std. Error	Beta		
	(Constant)	1.505	.395		3.815	.000
	Int	-.062	.087	-.079	-.712	.000
	Bor	-.033	.102	-.036	-.327	.000
	Bex	.019	.061	.034	.307	.000

a. Dependent Variable: Performance

The findings indicated that when SMEs have the borrowing capacity and borrow at affordable interest rate, with high level of working relationship and experience of SMEs, they have a good significance effect on job creation and create jobs to many people and businesses are expanded, savings increased and investment are promoted. Production increased for all SMEs that were targeted. P-value <0.005.

7. Conclusion

Finance plays a central role in enterprise development but this is only possible if it is accessible and reasonably priced. While SMEs are increasingly seen as playing a strategic role in economic growth and development, they suffer from liquidity problems. Furthermore, they usually experience difficulties in accessing loans from the banking sector and other financial intermediaries to finance working capital and to provide credit for a smooth transition through liquidity cycles.

Some of the reasons why SMEs find difficulties in accessing finance are internal to SMEs and they include Long Procedures, limited management and technical skills, lack of collateral, poor technology, and lack of credible financial accounts. Reasons that are external to SMEs include poor physical infrastructure, limited market, and the distance from SMES to financial institutions in rural areas. Where SMEs succeed in accessing financial resources, the cost of funds (interest rates) is high, sometimes leading to nonperforming loans.

Therefore, while finance, would play a crucial role to enhance enterprise development, both the countries within which SMEs are located and SMEs themselves need to overcome constraints that would improve their access to financial resources. Countries such as Rwanda, therefore, should create the necessary policy, legal, and regulatory environment. This should be supported by the establishment of effective information dissemination systems such as credit reference bureau to provide information on the credit history of borrowers. SMEs on the other hand should overcome internal constraints such as lack of skills, lack of financial records and accounting systems, and poor loan repayment culture.

8. Recommendations

1) SMEs recommended minimizing the credit conditions such collateral requirement, level of interest rate and application procedures so as to enable more SMEs to acquire loans.
2) SMEs on the other hand should overcome internal constraints such as lack of skills, lack of financial records and accounting systems, and poor loan repayment culture.
3) SMEs need to improve their financial records and accounting systems. Proper records need to be kept and maintained and the books of accounts have to be clear and should reflect a realistic picture of their operations and financial conditions.
4) A good system and books of accounts are not only helpful to the banks; they are also crucial in managing and monitoring business as well as guiding tax authorities.
5) SMEs have to improve their operating efficiencies and capabilities as this impact on production costs and profits. Material wastage is a major source of high costs in small businesses.
6) To increase their capacities and minimize wastage, SMEs need to invest in skills development and infrastructure to be able to benefit from e-finance.

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