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# Evaluation of Micro-Credit Finance on Financial Performance of Small and Medium Enterprises in Nakuru County, Kenya

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***Abstract:*** *Small and Medium enterprises play an increasing role in the contemporary knowledge invention function as a conduit of economic development. SME's are the backbone of many economies and notably a source of employment as well as a major source of tax generation, provide solutions to societal and growth problems such as food security, besides entrepreneurship is a social safety net for women and youth. Providing monetary services to SMEs plays a crucial task in determining how they carry out their businesses as they require an array of enabling and supporting financial services in order to enable them in actual fact utilize profuse resources in their field of specialty and to recognize their full potential. The banking sector in Kenya over the years has regarded the sector as risky and not viable commercially. The research study objective was an evaluation of micro-credit finance and financial performance of Small and Medium Enterprises (SMEs) Nakuru County, Kenya. The research adopted a descriptive research design; the study used a sample of 106 respondents out of whom 65 responded. Data analysis was done using SPSS version 22.0. The study established that increase in interest rates affected the financial performance of SME's to a great extent, The study also established that strict credit policies affected access to credit thus affecting the financial performance of SME's. The study also established income level of entrepreneurs affected the financial performance due to inability to finance the accessed credit. The study concludes that micro credit banks in Nakuru County are emphasizing on interest rate and income capability to increase financial performance. Based on the study it clearly stipulates that sales per annum, initial capital investment, total value of assets and net profit measures the financial performance capability for any SME's businesses. The study recommends that the management of micro finance banks should take into consideration on interest rate and particularly on how to lower the interest rates. This enabled the management to create a comprehensive understanding that can be leveraged to influence more SME's to take up loans and thereby increase financial performance. The study also recommends that government should come up with rules and regulations to prevent the customers from being exploited through high interest rates and other incidental fees. This enabled more customers to take up loans thereby expanding their SME's businesses. The study recommends that the Management of banks and other key players in monetary sectors should formulate better policies that are favorable to small and medium enterprises to enable them access credit facilities easily.*

***Key Words:*** *Interest rates, Income level & Financial performance.*

### 1.3 General Objective

The general objective of the study was an evaluation of micro- credit finance on financial performance of (SME's) in Nakuru County.

### 1.3.1 Specific objectives

i) To establish the effect of micro-credit finance interest rates on the financial performance of Small and Medium Enterprises in Nakuru County, Kenya.
ii) To find out the effect of access to micro-credit finance on the financial performance of Small and Medium Enterprises in Nakuru County, Kenya.
iii) To determine the relationship between income level and financial performance of Small and Medium Enterprises in Nakuru county, Kenya.

### 2.2 Theoretical Literature

Theories usually predict and explain a phenomena and, in many cases to challenge the extent of existing knowledge within n the limits of the critical bounding assumptions. The theoretical framework introduces and describes the theory which explains why the research problem under study exists.

### 2.2.1 Entrepreneurship Innovation Theory

The theory was developed by Joseph Schumpeter in (1949) who is scholar in research. The theory describes an entrepreneur as a person who helps the process of economic development, in this case an entrepreneur is viewed as creative, innovative and has a foresight. According to Schumpeter innovation is viewed in different range of dimensions. An entrepreneur is termed innovative when he introduces a new product, new production method, opens up a new market, finds out a new source of raw materials and finally able to introduce a new organization in any industry.

### 2.2.2 The Financial Intermediation Theory

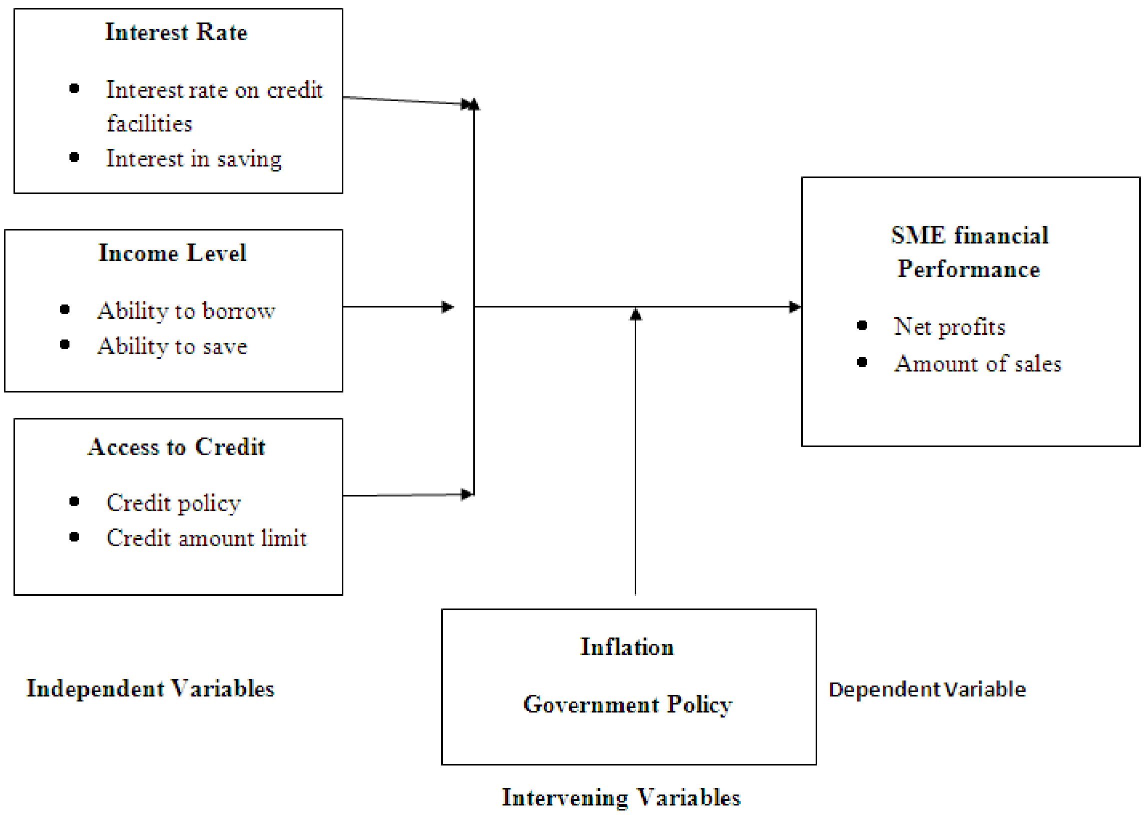
The theory of Financial Intermediation emerged in 1970s with contributions from Akerlof (1970), Spence (1973) and Rothschild and Stiglitz (1976). The theory is based on the assumption that financial intermediaries are basically built on the economics of imperfect information. The existence of financial intermediaries is based on the intuition that they can reduce transaction costs and information that arise as a result of information asymmetry between borrowers and lenders. Financial intermediaries play a major role by enhancing efficient functioning of markets, in addition, factors that usually determine the amount of credit channeled through financial intermediaries can have significant macroeconomic effects (Spence, 1973).

### 2.2.3 Pecking order theory

Pecking order theory was suggested first by Donaldson in 1961 and was later modified by Stewart C Myers and Nicolas Majluf in 1984. Pecking order theory states that the companies will priotize their sources of financing in regard to the cost of financing. In this case there are three sources of finance internal (savings), external (debt) and equity .Internal sources of finance should be used first when depleted then debt is issued and when debt finance cannot be used anymore equity is preferred. The theory is based on asymmetric information in this case managers are knowledgeable about companies' prospects, risks and value than outside investors.

### 2.5 Conceptual Framework

A conceptual framework is the researcher's own idea and conceptualization. It may be adaptation of a model used in a previous study with modifications to suit the inquiry or my own model. It shows the relationship between independent variable (access to credit, income level and interest rate) and dependent variable the SME'S financial performance. Refer to the figure 2.1



## RESEARCH METHODOLOGY

### 3.1 Introduction

This chapter introduces the research design and methodology of the study; it discusses all the methods and techniques that will guide the research undertaking such as research design, target population, sampling technique and sample size, data collection instruments, data collection procedure, reliability and validity, data analysis and presentation and ethical consideration with the expected results as a representation of the study.

### 3.2 Research Design

The study used a descriptive research design, the descriptive study is concerned with finding out who, where and how much of a phenomenon, which is the concern of the study. A survey could be descriptive, exploratory or involving advanced statistical analysis. There are several studies that have employed survey design for instance; Waithanji, (2014) used survey to study SMEs operating in Nairobi that have been financed by MFIs.

### 3.3 Target Population

The target population of the study comprised of SME‟s operating in Nakuru County that were in various strata which is as follows; financial services, trade and commercial services of these SME‟s as shown n the table below. In Nakuru County there are 3,090 SMEs licensed, according to (NCR 2015) Refer to table 3.1

**Table 3.1: Target population**

| SME's category | Number of SME's (Population) |
|---|---|
| Small | 1410 |
| Medium | 1680 |
| **Total** | **3090** |

*Source: (NCR 2015)*

### 3.4 Sampling Technique and Sample size

The SME's in Nakuru County operate under various categories. The study adapted a stratified random sampling to obtain 53 SME's in Nakuru County, Kenya. The strata were based on the various categories as follows financial services, Trade and Commercial services. The sample size of the number of respondents was obtained using the formula by Nassiuma (2000) as indicated below;

$$n = \frac{Nc^2}{C^2 + (N-1)\, e^2}$$

Where n= sample size, N=population size, c=coefficient of variation =21%, and e=error margin (2%. In this study c will be taken as 21% and *e* to be 2%. Applying the formula

$$n = \frac{3090(.21)^2}{(.21)^2 + (3090-1)(0.02)^2}$$

Sample size = 106

The sample size of the study was 106 respondents.

**Small enterprises**

$$\frac{1410}{3090} \times 53$$

= 48

**Medium Enterprises**

$$\frac{1680}{3090} \times 106$$

=58

### 3.5 Data Collection instruments

The researcher used questionnaires to collect data from SME's respondents. A questionnaire with high reliability would receive similar answers if it done repeatedly. In order to ensure uniformity in response and to encourage participation, the questionnaire will be short and structured with mostly multiple-choice selections in a likert scale. The questionnaires were preferred in this study because respondents of the study were literate and quite able to answer questions asked adequately. Likert scale was used because it was easy to understand and responses were easily quantifiable and subjective to computation of mathematical analysis Kinyua, (2014). Refer to the instruments see Appendix I.

### 3.6 Data collection Procedure

Data collection process commenced after getting a letter from Kenyatta University authorizing the student to collect data. The researcher will use both primary and secondary. Structured questionnaires were used to collect primary data from respondents in SME's in Nakuru County. The Questionnaire was self-administered to two respondents per SME then the questionnaires were collected after five days. Secondary data was obtained from related materials in the periodicals, journals and books relevant to the study.

### 3.7 Reliability and validity

Reliability is achieved when research instrument has internal consistency. Reliability is determined by administering an assessment at two different points in time to the same individuals and determining the correlation or strength of association of the two sets of scores (Kothari, 2011).

Validity is the degree to which an instrument measures that what it was to measure Kothari, 2013).The validity of research instruments is achieved when they measure what they are intended for and do so clearly without accidentally including other factors. The validity of this research instrument was measured through the opinion of experts especially the research supervisor, who is knowledgeable in the field. Any ambiguity or non-clarity in the questionnaire items was cleared before the questionnaire was taken to the field for data collection.

### 3.8 Data Analysis and Presentation

Kothari (2009) argues that data collected has to be processed, analyzed and presented in accordance with the outlined measures. The study data analysis involves the transformation of data into meaningful information for decision making, editing, error correction, rectification of omission and finally putting together or consolidating information. Kothari, (2013) argues that regression is the working out of a statistical relationship between one or more variables. The research data collected was analyzed qualitatively and quantitatively. The researcher model for the study was multiple regression models and analysis of variance (ANOVA) to show the effect and influence of the independent variables on the dependent variables. The model is specified as follows;

$$Y=\beta_0+\beta_1X_1+\beta_2X_2+ \beta_3X_3 + \varepsilon$$

Where: Beta (β) is the constants

($B_0$, $\beta_1$, $\beta_2$, $\beta_3$) are coefficients.

Y = SME's Financial Performance

$X_1$ = Interest Rate

$X_2$ = Income level

$X_3$ = Access to credit

ε = error term

## RESEARCH FINDINDS AND DISCUSSIONS

### 4.1 Introduction

This chapter shows results and discusses findings as per the objectives of the study. After receipt of questionnaires from the field, raw data was analyzed, summarized and presented in form of tables and graphs to reflect statistics that accompany explanation for better understanding. The study was set to determine how micro-credit interest rates affect the financial performance of SME's.

### 4.4.1 Micro-credit Interest Rate and financial performance of SME's

Most of the respondents strongly agreed that high interest rates on loans to SME's affect the economy of the business with a mean of 4.65 and standard deviation of 64.3% indicating that interest rates on loans has an influence on financial performance (Aldrich,2005). Most of the respondents strongly agreed with opinion that low interest rate on individual savings discourage individual saving with a mean score of 4.54 and a standard deviation of 79%. This is an indication of high response rate therefore managers need to articulate on the issue to ensure better financial performance. Low interest rates have a positive effect on the financial performance of SME's, (Nkeobuna 2012).

**Table 4.3: Interest Rate**

**Descriptive Statistics**

| | N | Mean | Std. Deviation |
|---|---|---|---|
| Low interest rate increases loan uptake by SME's | 65 | 3.72 | .839 |
| High interest rate decrease loan uptake by SME's | 65 | 3.95 | .891 |
| High interest rate on individual SME's saving increases SME's saving ability | 65 | 4.28 | .839 |
| Low interest rate on individual savings discourage individual saving | 65 | 4.54 | .788 |
| High interest rate on loans to SME's may affect the economy of the business | 65 | 4.65 | .643 |
| Valid N (listwise) | 65 | | |

**4.4.2 Income Level and financial performance of SME's**

Most of the respondents strongly agreed with opinion that high level of income determines ability to pay workers by SME's with a mean score of 4.60 and a standard deviation of 61% clearly indicating that a bigger number of response rate. Most of the respondents strongly agreed that high level of income determines ability to save more by SME's with a mean of 4.58 and a standard deviation of 81% clearly signifying that higher income level will give more room for saving by the SME's. Most of the respondents agreed that commercial banks in Kenya lends out loans to SME's based on security in terms of income level with a mean of 4.42 and a standard deviation of 66%, Clearly showing high response rate. This clearly shows that banks would lend out loans on terms of security basis. Apparently, Income level of the entrepreneurs determines the ability to pay loans on time as well as collateral for loans, Idowu, (2012).

**Table 4.4: Income Level**

**Descriptive Statistics**

| | N | Mean | Std. Deviation |
|---|---|---|---|
| High level of income determines ability to pay workers by SME's | 65 | 4.60 | .607 |
| High level of income determines ability to save more by SME,s | 65 | 4.58 | .808 |
| High level of income determines ability to borrow by SME's | 65 | 4.48 | .687 |
| High income level increases the security for SME's owners to borrow more loans | 65 | 4.45 | .685 |
| Most commercial banks in Kenya lends out loans to SME's based on security in terms of income level. | 65 | 4.42 | .659 |
| Valid N (listwise) | 65 | | |

**4.4.3 Access to Credit and financial performance of SME's**

Most of the respondents agreed that limited access to credit products discourages borrowing by SME's with a mean of 4.45 and a standard deviation of 64%. Most of the respondents strongly agreed that strict credit policies hinder access to credit SME's having a mean of 4.48 and a standard deviation of 62% a clear indication of a good response rate. Therefore banks should make favorable policies that would accommodate borrowing of credit facilities by the SME's. Most of the respondents agreed that credit of amount available determines the extent of business operations by SME's having a mean of 4.40 and a standard deviation of 88%. Basically access to credit exerts a considerable positive effect on financial performance of SME's, Ahiawodzi, (2012).

**Table 4.5: Access to Credit**

**Descriptive Statistics**

| | N | Mean | Std. Deviation |
|---|---|---|---|
| Credit of amount available determines the extent of business operations by SME's | 65 | 4.40 | .880 |
| Strict credit policies hinder access to credit to SME's | 65 | 4.48 | .615 |
| Limited to credit products discourage borrowing by SME's | 65 | 4.45 | .638 |
| Access to credit information enhances the SME's chance and ability to borrow more loans | 65 | 4.43 | .749 |
| Access to credit has been made easy and affordable by most commercial banks in Kenya. | 65 | 4.49 | .664 |
| Valid N (listwise) | 65 | | |

### 4.4.4 Financial Performance

From the findings above most of the respondents agreed that low operations expenses increases financial performance with a clear mean indication of 4.40 and a standard deviation of 75% showing a significant response rate. Most of the respondents strongly agreed that high interest rate for SME borrowers may affect financial performance having a mean of 4.45 and a standard deviation of 69%. Apparently, cost of finance determines the extent of borrowing, Nkeobuna, (2012). Most of the respondents strongly agreed that access to credit facilities increases the financial performance of the SME's with a mean of 4.54 and a standard deviation of 76%. Access to credit has a positive relationship on financial performance of SME's, Ahiawodzi, (2012). Financial performance for the SME's is based on the following variables; net profit, total value for assets, sales per annum, initial capital investments and how much accessed as credit.

**Table 4.6: Financial Performance**

**Descriptive Statistics**

| | N | Mean | Std. Deviation |
|---|---|---|---|
| Low operations expenses increases financial performance | 65 | 4.40 | .746 |
| High interest rate for SME's borrowers may affect financing performance | 65 | 4.45 | .685 |
| Decrease in income generation affects financial performance | 65 | 4.48 | .773 |
| Access to credit facilities increases the financial performance of the SME's | 65 | 4.54 | .761 |
| High income levels for SME's loan borrower's increases financial performance for banks. | 65 | 4.55 | .751 |
| Valid N (listwise) | 65 | | |

### 4.5 Correlation Analysis

Karl Pearson's correlation coefficient was used to compute the correlation between the dependent variable and the independent variables. According to Kothari, (2008), this relationship is assumed to be linear and the correlation coefficient ranges from -1.0 (perfect negative correlation) to +1.0 (perfect positive relationship). The correlation coefficient was calculated to determine the strength of the relationship between dependent and independent variables (Kothari, 2013). From table 4.8, the analysis indicates the coefficient of correlation, r equal to 0.038, 0.121 and 0.120 for interest rate, income level, and access to credit respectively. This indicates positive relationship between the independent variables namely interest rate, income level and access to credit and the dependent variable financial performance. The results are presented by table 4.7.

**Table 4.7: Correlation Analysis**

**Correlations**

| | Financial Performance | Interest Rate | Income Level | Access to Credit |
|---|---|---|---|---|
| Financial Performance | 1 | | | |
| Interest Rate | .038 | 1 | | |
| Income Level | .121 | .185 | 1 | |
| Access to Credit | .120 | .679 | .262* | 1 |

***. Correlation is significant at the 0.05 level (2-tailed).**
Source: Research data (2016)

**4.6 Regression Analysis**

Is a statistical model for estimating the relationships among variables (David, 2005).It includes many techniques for models and analyzing several variables, when the focus is on the relationship between a dependent variable and one or more independent variables (Cressie,2011).

**4.6.1 Analysis of Variance (ANOVA)**

The study used ANOVA to establish the significance of the regression model. In testing the significance level, the statistical significance was considered significant if the p-value was less or equal to 0.05. Table 4.10 below clearly shows that regression model is significant to evaluation of micro-credit finance and financial performance of small & medium enterprises in Nakuru County. The results indicate high reliability based on the significant level with Frequency of 23% and P value of 0.000. The results are presented by table 4.8.

**Table 4.8: ANOVA**

**ANOVA[a]**

| Model | | Sum of Squares | Df | Mean Square | F | Sig. |
|---|---|---|---|---|---|---|
| | Regression | 34.136 | 3 | 11.379 | 2.376 | 0.000[b] |
| | Residual | 292.079 | 61 | 4.788 | | |
| | Total | 326.215 | 64 | | | |

a. Dependent Variable: Financial Performance

b. Predictors: (Constant), Access to Credit, Interest Rate, Income Level

*Source: Research data (2016)*

**4.7 Inferential statistics**

The study used multiple regressions to determine the relationship between independent variables and dependent variable. As depicted in table 4.11 below, there was a positive relationship between financial performance and the three variables.

**Table 4.9: Multiple Regression Analysis**

**Coefficients[a]**

| | | Unstandardized Coefficients | | Standardized Coefficients | | |
|---|---|---|---|---|---|---|
| Model | | B | Std. Error | Beta | T | Sig. |
| | (Constant) | 14.959 | 4.345 | | 3.442 | .001 |
| | Interest Rate | .145 | .110 | .161 | 1.313 | .194 |
| | Income Level | .110 | .119 | -.114 | -.926 | .358 |
| | Access to Credit | .314 | .129 | .303 | 2.436 | .018 |

a. Dependent Variable: Financial Performance

*Source: Research data (2016)*

The regression equation was:

$$Y = 14.959 + 0.145X_1 + 0.110X_2 + 0.314X_3$$

Where;

Y = the dependent variable (Financial Performance of SME's)

$X_1$ = Interest Rate

$X_2$ = Income Level

$X_3$ = Access to Credit

The regression equation above has established that taking all factors into account (Financial Performance as a result of interest rate, income level and access to credit constant at zero, financial performance 14.959). A unit increase in interest rate would lead to a 0.145 decrease in financial performance. A unit increase in income level would lead to a 0.110 increase in financial performance. A unit increase in access to credit would lead to a 0.314 increase in financial performance (Kothari, 2008).These coefficients indicate the extent to which each of the variables affects the financial performance of small and medium enterprises in Nakuru County.

**SUMMARY, CONCLUSIONS AND RECOMMENDATIONS**

**5.1 Introduction**
The chapter provides the summary of the findings from chapter four, and it also gives the conclusions and recommendations of the study based on the objectives of the study. The chapter finally presents the limitations of the study and suggestions for further studies and research.

**5.2 Summary of the Study**
The study was set out to evaluate the impact of micro-credit finance and financial performance of SME's in Nakuru County. Descriptive survey design was used as the suitable research design and data collected using questionnaires and the participants were 65 respondents from SME's. The dependent variable of study was the financial performance of SME'S and the independent variables were interest rate, access to credit and income level. Data was presented using tables and graphs. The study objective one was to establish the effect of micro-credit interest rate on financial performance of SME's in Nakuru County. Findings from the research , based on data analysis was that Most of the respondents strongly agreed with opinion that low interest rate on individual savings discourage individual saving with a mean score of 4.54 and a standard deviation of 79%. Besides, high interest rates on loans to SME's affect the economy of the business with a mean of 4.65 and standard deviation of 64.3% indicating that interest rates on loans had an influence on financial performance. Cost of finance is the greatest obstacle to accessing finance, Beck, (2007).

The study objective two was to determine the relationship between income level and financial performance of SME's in Nakuru County. Findings from the research , based on data analysis was that, Most of the respondents strongly agreed with opinion that high level of income determines ability to pay workers by SME's with a mean score of 4.60 and a standard deviation of 61% clearly indicating that a bigger number of response rate, as well as high level of income determines ability to save more by SME's with a mean of 4.58 and a standard deviation of 81% clearly signifying that higher income level will give more room for saving by the SME's, thus directly affecting the financial performance of the business. Apparently the level of income determines the entrepreneur's ability to pay loans as well as collateral to access credit, Idowu, (2004).

The study objective three was to find out the effect of access to micro-credit finance on financial performance of SME's. It was discovered that, limited to credit products discourages borrowing by SME's with a mean of 4.45 and a standard deviation of 64%. Besides, strict credit policies hinder access to credit SME's having a mean of 4.48 and a standard deviation of 62%. Therefore banks should make favorable policies that would accommodate borrowing of credit facilities by the SME's. Credit amount available determines the extent of business operations by SME's having a mean of 4.40 and a standard deviation of 88% and directly influences the financial performance of SME's. Access to credit exerts a considerable positive effect on financial performance of SME's, Ahiawodzi, (2012).

Finally, the study found out that most of the respondents agreed that low operations expenses increases financial performance with a clear mean indication of 4.40 and a standard deviation of 75% showing a significant response rate. Most of the respondents strongly agreed that high interest rate for SME borrowers may affect financial performance having a mean of 4.45 and a standard deviation of 69%. Financial performance is achieved through incorporation of the following indicators; net profit, total value assets, sales made per annum, initial capital investment and how much accessed as credit facilities.

**5.3 Conclusion**
Based on the findings of this study the following conclusions were drawn:

The results reveal that interest rate, income level and access to credit had a strong positive and significant correlation on financial performance of small & medium enterprises in Nakuru County. The study also concludes that micro credit banks in Nakuru County are emphasizing on interest rate and income capability to increase financial performance. Based on the study it clearly stipulates that sales per annum, initial capital investment, total value of assets and net profit measures the financial performance capability for any SME's businesses.

**5.4 Recommendations**
Based on the following findings of this study the following recommendations were made:

The study recommends that the management of micro finance banks should take into consideration on interest rate and particularly on how to lower the interest rates. This will enable the management to create a comprehensive understanding that can be leveraged to influence more SME's to take up loans and thereby increase financial performance.

The government should come up with rules and regulations to prevent the customers from being exploited through high interest rates and other incidental fees. This will enable more customers to take up loans thereby expanding their SME's businesses.

Management banks and other key players in monetary sectors should formulate better of policies that are favorable to small and medium enterprises to enable them access credit facilities easily.

**5.5 Limitation of the Study**

The study faced challenges of time constraint which limited the researcher from collecting data for the study particularly where the respondent delayed in filling the questionnaire and travelling for collecting the filled questionnaires. The researcher had to adjust to the limited timeframe so that the study could be completed within the stipulated period. The respondents were also found to be uncooperative because of the sensitivity of the information that was required for the study. The researcher explained to the respondents that the information they provided was to be held confidential and was only for academic purpose only. There was also limitation of finances hence limiting vigorous data analysis. Errors when analyzing the data and also arise when respondents hold information which they consider confidential and sensitive. The researcher had to source for additional funds so that the research could be completed as planned.

**5.6 Suggestions for Further Research**

The general objective of this study was evaluation of micro-credit finance on financial performance of small and medium enterprises in Nakuru County. Specifically, this study evaluated the impact of interest rate, income level and access to credit on financial performance of small & medium enterprises in Nakuru County. These factors are not exhaustive hence further research can be carried out to unearth other areas like securitization, mortgages and on how they affect financial performance on SME's.

The study limited itself to small and medium enterprises only whereas the banking sector is very wide and constitutes microfinance institutions and Sacco's that also issue loans to finance mortgages. It would be an interesting idea for future researchers to do a comparative study on the same variables with either microfinance institutions or Sacco's to find out whether the findings and conclusion drawn from this study will hold then compare the findings to make reliable conclusions.

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