FACTORS CONSIDERED BY COMMERCIAL BANKS TO ASSESS CREDIT-WORTHINESS OF SMEs: A SURVEY OF COMMERCIAL BANKS IN MOMBASA COUNTY

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DECLARATION

Declaration by the Candidate

This research proposal is my original work and has not been submitted for award of Degree or any publication in any other university.

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DEDICATION
I do hereby dedicate this research proposal to my beloved family especially my husband for providing me with emotional and financial support in undertaking this study.
ACKNOWLEDGEMENT

I am highly indebted to my Supervisor Mr. Samson Kaplelach. With his intellect depth and insight criticism, he read my numerous revisions and helped make some sense of the confusion. My sincere gratitude goes to the MBA Co-coordinator Mr. Peter Ng’ang’a, Mr. I. Wainaina and Mr. Vincent Shiundu for their support and guidance throughout the writing of the proposal. Their scholarly comments and grasp of the title formed the valuable basis for the study.

I wish to thank all my Kenyatta University course facilitators for imparting me with the knowledge which has proved sufficient for conducting this study.

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ABSTRACT

Businesses have in the recent past been awakened by the spirited campaign by the government and the private sector to be more aggressive in order to create employment and spur economic growth towards achieving vision 2030. The small and medium enterprises have not been spared and have therefore sought for financing from lenders such as financial institutions. Financing is a major ingredient to success of any business. This is so because objectives of the business cannot be met if there are no resources in terms of infrastructure and stock besides other overheads such as human resource and marketing. This research was carried out to determine the factors that these financial institutions consider in assessing the credit worthiness of these SMEs. Specific objectives is to find out to what extent banks use profitability, cash flow, liquidity and capital structure to assess credit worthiness of the SMEs. Literature was reviewed and the aforesaid variables were focused upon to see how the lenders use them to determine credit-worthiness of the business. Findings of this study will be of use to the banks for policy making. The findings will also assist the investors in evaluating themselves for creditworthiness. Private sector will also get to know where they could supplement the government in boosting entrepreneurship from the findings. The study took a survey research design and was carried out on all the 30 Commercial banks in Mombasa County. Purposive sampling was used to pick a credit officer from each of the banks. A questionnaire was the instrument of data collection. Out of 30 questionnaires distributed, 29 were returned. Data was analyzed using the Microsoft excel and presented using tables and pie-charts; same was imported to Microsoft Word. Majority of the respondents agreed that profitability, cash flows, liquidity and capital structure composition affect financing of SMEs by financial institutions. The SMEs should thus endeavour to enhance their performance to maintain these factors to ensure their credit-worthiness to lenders.
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CHAPTER ONE: INTRODUCTION

1.1 Background Information

Kenya like many other developing countries, has several small and medium enterprises (SMEs) that are run by upcoming investors who endeavour to empower themselves economically with a view to improve their standard of living. The sources of finance to these enterprises have however been a challenge thus impeding their growth and expansion. This has not only slowed Kenya’s economic growth, but has also retarded increase in opportunities for employment to Kenyans, both graduates and dropouts. Due to exposure, the developed countries have advanced considerably in this sector because structures are already in place and most of the SMEs have a financial cycle whereby the financial needs and options change as the business grows (Aghion et al, 2005). In Kenya, majority of SMEs are in startup stages crippled by lack of finances for their expansion and growth. Lack of expertise to manage the enterprises also comes into play hindering further their development. According to Wynant and Hatch (1991) the young, inexperienced businesses with high indebtedness have problems getting bank loans. Given that Kenya is a developing country that has a dire need for employment for her people to reduce poverty levels, it is imperative that focus on the growth of SMEs should be emphasized in order to achieve vision 2030.

Most SMEs have failed to survive in that most of the investors end up closing the businesses due to lack of finances though at various levels. Some wind up at the start-up stage. This is the stage where the business would not have had enough stock to satisfy demand, enough capital to attract qualified personnel, resources to market the products and finances for infrastructure for the business. This scenario occurs where sources of finance are difficult to come by due to unavailability, accessibility, cost and lack of awareness that different sources of finance exist. Other causes would include among others lack of entrepreneurial expertise and poor management practices. The other stage of SMEs is the maturity stage. This is where enterprises have stabilized and are profitable but not growing. The SMEs in this stage make profits for survival and for the investors. These SMEs are able to employ many people and still remain profitable. This will lead to economic growth for the countries hosting the SMEs and therefore cause better standards of living for humanity. The other stage is where SMEs are mature and
growing very fast. This stage is the best for SMEs because as they grow they create more employment opportunities which in turn improve the standards of living for the people hence reduce poverty levels considerably. This also spurs economic growth for any country through improved tax collection paid by SMEs. These stages that SMEs fall have a direct bearing on the source of finance that they will choose because evaluation by lenders will consider the stage where the SME falls. An SME in the stage where growth is fast will be better placed for financing by lenders due to better credit worthiness than SME in the start-up stage due to poor rating in credit worthiness. In the start-up stage, the SME will be viewed with suspicion that the lender might not settle his repayment and would therefore be reluctant to finance the SME in this stage.

The government of Kenya in its vision 2030 blueprint has come up with strategies to spur economic, political and social status for her people. In this blueprint, the government appreciates that her objectives cannot be realized unless the country gets industrialized and that the backbone of her economy which is agriculture has to be boosted in order to create employment for her people and consequently reduce poverty levels and hence improve standards of living. The government also appreciates that education and improved health are key ingredients to any nation aspiring to grow and therefore the two are of major focus in the vision 2030.

The private sector also plays a crucial role in availing finances to SMEs in Kenya by providing short term and medium term loans to investors in Kenya. The private sector includes among others the micro financial institutions like Faulu Kenya, Kenya Women Finance Trust, Jitegemee credit scheme and Equity Bank. These organizations do not emphasize on the collateral for loan awards but their interests are fairly high, given that they are usually flat rates which are compounded.

According to the Budget speech by the Minister for Finance, 2012, more than 50% of Kenyans are living below poverty level of less than a dollar per day and that Kenya has stagnated white collar opportunities. Kenya also has no option but to put efforts on promotion of SMEs to create more job opportunities and contribute to overall economic growth. This will also boost the health sector which is also critical if vision 2030 is to be realized. The need for boosting education sector can also not be over-emphasized, especially now that there is the free primary education to
the extent of tuition fees. This is besides other government obligations to citizens e.g infrastructure and security.

The history of commercial banks in Kenya dates back in the pre-independence period. Since then they have grown in number and in terms of branch networks. According to the statistics available at the Central Bank of Kenya, their number currently stands at 44 (Appendix II). However, only 34 Commercial banks in Kenya have representatives in Mombasa County, with several branches (Appendix III). Given that the number of these commercial banks is high today, they are operating in a competitive environment and therefore they offer a diversified range of products from personal loans to business loans. In lending individuals and businesses, these banks assess the risks involved before advancing the credit and this study therefore seeks to investigate factors considered by these financial institutions before advancing credit to SMEs.

1.2 Statement of the Problem

There are a number of SMEs in Kenya but many of them are in the start-up stage. The ones that have matured are few while the ones that are fast growing are the fewest. Most of the SMEs are unable to grow due to lack of finances to expand (Sharon, 2012). These investors have sourced funds from the existing lenders both public and private but they have not resulted to the expected business growth. Most of the businesses are not able to meet the demand due to limited finances to stock, consequently unable to honor the loan repayments that are due. These investors sometimes go for short term loans when they should have gone for long term ones. In other cases they go for more expensive loans where there was an option of a cheaper loan. Others are not aware of the finances available in the market and therefore do not go for any external financing. Others do not venture to other sources of finance apart from retained earnings for being risk averse. There are some SMEs that are denied finances due to the fact that they do not meet the set requirements, for example collateral, capital base, years in business, performance of the business in terms of profitability and liquidity, the size of the business, the form of business i.e. whether partnership, sole proprietorship, limited companies. From the foregoing there is need to appreciate and understand the factors that affect the sources of finance to SMEs in Kenya.

Most studies conducted on SMEs in Kenya have focused on challenges faced by SMEs in achieving their objectives other than the factors that financial institutions consider before
advancing credit to SMEs. It is hoped that this study has come up with findings that will assist various interested parties, like SMEs and policy makers in decision making.

1.3 Objectives of the Study

1.3.1 General Objective
The general objective of this study is to establish factors that financial institutions consider in advancing credit to SMEs.

1.3.2 Specific Objectives
The specific objectives of the study are:

a) To establish the extent profitability and cash flow affect assessment of credit-worthiness of SMEs by commercial banks.
b) To examine the extent to which liquidity affects the assessment of credit-worthiness of SMEs by commercial banks.
c) To evaluate the extent to which capital structure composition influence assessment of credit-worthiness of SMEs by commercial banks.

1.4 Research Questions

a) To what extent does profitability and cash flow of SMEs affect their credit-worthiness assessment by commercial banks?
b) To what extent does liquidity of SMEs affect their credit-worthiness assessment by commercial banks?
c) To what extent does capital structure composition of SMEs affect their credit worthiness assessment by commercial banks?

1.5 Justification of the Study
This research study critically evaluates compliance challenges faced by SMEs in securing credit. It is hoped that the findings will assist the entrepreneurs to make the right decisions when settling for a particular finance for the business. It will also give banks insights on the extent to which entrepreneurs are knowledgeable about the requirements of financing. The government would also have an insight of the finances that she should work towards availing to investors to boost their entrepreneurial efforts. The government would also be able to see areas that need
improvement and to be boosted for the investors to access credit at the most reasonable cost for their business growth. The donors will also use the findings to determine the funding objectives to empower the targeted groups. All these would be in effect to create employment and to foster economic growth both locally and globally. The findings will also be useful to the researchers and academicians as a basis for future research in this area of study.

1.6 Scope of the Study
The study focused on all commercial banks located in Mombasa County. The targeted population was the credit officers who the researcher believes represented characteristics of the entire financial institutions in the republic of Kenya. The population included one credit officer from each of the selected banks in Mombasa County. The research endeavored to exhaustively cover all the aforesaid specific objectives to establish the compliance challenges that SMEs face in securing credit. The questionnaires were used to collect data from the sample that the researcher used to determine as representative.

1.7 Limitations of the Study
Bank employees are often very busy during working hours and therefore it was likely to be difficult to get them to fill the questionnaires. However, the problem was alleviated by allowing them to carry the questionnaires home and fill them at their convenient time.
CHAPTER TWO: LITERATURE REVIEW

2.0 Introduction
This chapter contains the theoretical review, the conceptual framework, critical review of literature and research gaps.

2.1 Theoretical Review
The literature review on the various variables which included profitability, cash flow, liquidity, forms and capital structure composition of businesses had been researched on from the business perspective that is to say how they affect the business itself in terms of growth and survival. But there was very little on the factors that lenders consider in awarding loans to business for expansion and meet daily business obligations. The aforesaid variables were the focus to see how they influence lenders in their decision making on the creditworthy businesses, specifically SMEs.

2.1.1 Profitability and Cash Flow
There are various methods of measuring profitability of a business. According to Lucey (2003) different profitability ratios are used to measure profitability of an enterprise. This measure has been used to determine whether SMEs are eligible for financing by various financial institutions. These methods of computing profitability of SMEs include operating profit, profit margin, return on assets and return on equity.

Profitability of an investment can be measured and used for managerial decision making by senior managers. Profitability of any given organization has a direct bearing on its growth and survival (Frankwood and Townsley, 1986) and therefore this would be of importance to investors in the business besides shareholders. Lenders also use profitability as a condition to funding.

This is because if a business is not operating profitably, then its future is not certain and therefore lenders will be reluctant to lend to such a business. But if a business is operating profitably and consistently, these will be gray areas for lenders because there will be less risky on the funds lent as the business continuity is certain and hence repayment is likely without defaulting. SMEs that do not operate profitably are not spared but are victims ending up with no willing lenders to finance their business ventures. This has seen several of them close, stagnate or with little growth
thus unable to realize full potential and compete effectively. This certainly results to slow economic growth and unemployment.

On the other hand, cash flow is about how cash circulates in business enterprises (Frankwood and Townsley, 1986). There are items in the financial statements that do not affect the cash flow such as depreciation. According to Edward (2002) cash is generated from various activities in a business. These include operating activities, investing activities and financing activities. Operating activities include sales and returns outwards. Investing activities include purchase of shares, dividends received while financing activities include sale of shares, issue of debentures and borrowing of loans. Cash flows are usually prepared by business organizations in a financial statement called cash flow statement as stipulated by international financial reporting standards. A high cash flow of a business depicts a well-managed cash flow that will enable the organization meet her obligations (Frigo, 2001). This means that the organization will be able to meet her obligations like loan repayment as and when required. A lending bank will be interested in a persistent high bank balance when considering the credit worthiness of any organization. The lending organization will therefore demand for a five years bank statements and cash flow statements during the evaluation process.

In business as in personal finance, cash flows are essential to solvency (Glen, 2008). They can be presented as a record of something that has happened in the past, such as the sale of a particular product, or forecasted into the future, representing what a business or a person expects to take in and to spend. Cash flow is crucial to an entity’s survival. Having sufficient cash on hand will ensure that creditors and others can be paid on time. If a business or person does not have enough cash to support its operations, it is said to be insolvent, and a likely victim of bankruptcy should the insolvency continue.

The statement of a business’s cash flow is often used by analysts to gauge financial performance. Companies with ample cash on hand are able to invest the cash back into the business in order to generate more cash and profit.

Cash flow is an on-going stream of income you receive from an investment (Robert & Anthony, 2008). You receive this money on a monthly, quarterly or annual basis, depending on the
investment. The strategy behind cash flow is to buy and hold, whereas the strategy behind capital gains is to buy and sell.

You buy a stock that pays you a dividend every year. That dividend is cash flow (Stephen, Randolph and Bradford, 2008). You loan money to a new start-up business and each month the business pays you interest on your loan. That interest is cash flow.

Cash flow is what most buy-and-hold real estate investors are after. For example, you buy a six unit apartment building and you rent out each of the units. Every month you collect the rent, pay the operating expenses and the mortgage, and, if you have managed the property well, you end up with positive cash flow. Since it is possible to have a negative cash flow, it is absolutely important to have a strong financial foundation, so that the investments you make generate cash flow. A positive cash flow depicts a business as being in a better position to service loans of the business than with a negative cash flow.

2.1.2 Liquidity

Liquidity in business refers to availability of cash in times of uncertainty or in times of unwanted cash outlay. It is the capacity of any business to be prepared for any cash disbursements without any burden on where to get some money (Robert, Patricia & Daniel, 2004). This aspect is very important in any kind of business.

In managing business, one should take into consideration the liquidity of the business. One should examine the business whether it has available cash ready for disbursements or whether almost all of the cash is invested in inventories or other non-cash assets. It is very important to know this as to prepare for any uncertain cash outlays (Wyant & Hatch, 1991).

Some business people prefer to invest more on inventory rather than having much cash tied up in their investment. Others prefer to lend cash to other people and apply a much higher interest compared to the bank’s rate. This can be good for the reason that this cash invested in inventories can generate another income rather than putting it only in a bank for savings that can only produce a minimal level of interest (Eugene & Joel, 2004). Others would invest in a long-term investment like real estate and long-term bonds for them to be prepared for the future. The problem with these kinds of investments is that they cannot produce instant cash in emergencies. There are some remedies for these instances. You can borrow money from other financial
sources, you can place your properties up for collateral to acquire some money, or you can sell your structured settlements.

In managing a business, it is very important to have available cash to be used for emergencies or for other unforeseen payments that do not usually occur in a normal business operation (John & Sons, 1987). This is very important because sometimes the eventualities that we never prepared for are the very ones that give us real burdens in the future. To have a good investment mix, one should know and analyze the business and ensure that there is no over-investment occurring in the process.

One should have proper monitoring on the assets and liabilities of the business to know how much liquid cash should be taken into consideration (Robert & Anthony, 1998). In a certain instance, if one does not have enough cash to cover the unprepared expenses, one can use other options to attain available cash. One can borrow from other sources or sell structured elements. There are many ways to choose from, but the important point here is for one to have liquidity in the business. The liquidity of a business is therefore the measurement of the assets it has readily at its disposal to pay out sums of money (Eugene & Houston). There are various calculations that can be used as an assessment of liquidity and they are designed to demonstrate, among other things, how efficiently the operations are at collecting money owed to it.

2.1.3 Capital Structure

The capital structure of an organization is the breakdown of different types of capital to make the total capital base (Ross, Westerfield, Jaffe and Jordan, 2007). For example we can have a simple capital composition of equity capital at 40%, debt capital of 50% and loans of 10%.

Equity capital is the money that is contributed by shareholders and could also be profits from past years that have been retained by the company to plough back to the organization for expansion and growth. Contributed capital is usually the money that was initially contributed by the owners to start up the business. The cost of equity capital is considered to be the most expensive capital because its cost is the return the organization must earn to attract investment (William, Gordon & Jeffery, 2008).

The debt capital as found in the company capital composition refers to the borrowed money whose interest is received at agreed intervals mostly yearly by the lender. It is usually a long
term arrangement whereby it would take several years to repay the loan if the amount was to be redeemed (James, 2007). The debts are sometimes referred to as debentures or bonds and can be redeemable or irredeemable. Where they are redeemable then the whole amount of debentures is paid back to the lender after the agreed maturity date. After this payment no further interest payments are made. In the case of irredeemable debentures or bonds, interest is paid into perpetuity until the end of life of the organization. We also have loan stock capital whereby the loan is repaid as agreed mostly monthly including interest loaded by the lender. Other types of debt capital include short term commercial paper borrowed for periods of even 24 hours for day to day running of the business (Sharon, 2012). The other type of debt finance is the vendor financing whereby an organization can sell goods received from the vendor before paying for the goods at no cost. In this case the company will trade with vendors’ money at no cost but at a profit earned by retailer.

Most people believe that the goal in life is to be debt free, but when deeper understanding of finance is reached we realize that most successful businesses in the world base their capital structure on the cost of capital. They consider how much they will pay as interest and how much are the returns and they go for capital whose returns are higher (Wyant & Hatch, 1991).

Modiglian and Miller referred to as M&M Propositions 1 and 2 state that the best capital structure is the one that minimizes costs. These costs are measured by the weighted average cost of capital (WACC). In the proposition 1, the two scholars state that how equity and debt are structured in an organization does not matter but the real assets which give the firm a value. The same scholars in the proposition 2 argue that the value of the firm depends on the cost of the debt, required rate of return and debt equity ratio of the firm. In their study, they concluded that there is no relationship between WACC and debt equity ratio and therefore the capital structure of the firm does not affect its value as a whole (John & Sons, 1987).

The financial institutions however put a lot of emphasis on the indebtedness of the firm for during credit award evaluation stage. The indebtedness the organization is the higher chances that they do not qualify for the loans. This is because the banks consider them risky with a higher chance of default due to more obligations to be met almost at the same time.
2.2 Empirical Review
Most studies conducted on SMEs in Kenya have focused on challenges faced by SMEs in achieving their objectives. A study conducted by Wanjohi and Mugure (2012) focused on challenges faced by SMEs and the following challenges were found: inadequate educational skills, lack of credit, national policy and regulatory environment, technological change, poor infrastructures and scanty market information. Pietro, C, Victor, M, and Sofiana, S (2012) conducted a study to determine the factors that Barclays Bank considers before advancing credit to SMEs in the East African region. The study was intended to fill the existing gap by focusing on factors that the financial institutions consider in financing SMEs, particularly in Kenya.

2.3 Conceptual Framework
This research focused on the relationship between various factors and their effect on the financial institutions’ decision to finance the small and medium enterprises in Kenya, a survey of all the banks located in Mombasa County. The independent variables are the factors namely liquidity, cash flow, profitability and capital structure. The dependent variable is the financing of SMEs by the financial institutions.

Figure 2.1 Conceptual Framework

Source: Researcher (2012)
2.4 Critic of Existing Literature Relevant to the Study
The existing literature of the variables relevant to this study did not focus on creditworthiness and how they influence credit rating of a business but rather what the variables are. Say for example the cash flow, the literature explained what it is but not how it will impact on a bank in decision to award a loan to a small and medium enterprise. The same happens to the other three variables. The researcher has however endeavored to link them to the problem and to show how these variables can influence the awarding of loans to SMEs by financial institutions. That is to say how the ability of businesses is affected by the variables in honoring the loan payments.

2.5 Summary
The above variables have been discussed by various authors in different extents but they have not put focus on how these variables affect the evaluation of creditworthiness of businesses for loans consideration. The variables however are believed to have a bearing on decisions made by lenders and specifically banks in giving credit to the businesses.

2.6 Conclusion
The literature review indicate how the variables affect the business but did not show to what extent these variables are considered in evaluating a small and medium enterprise for the purpose of loaning the business. This is the gap that this study sought to fill to enable the stakeholders know what is expected during such evaluations and what kind of loan they may qualify for from time to time. These stakeholders include among others the lenders themselves, the businesses, the donors and the government.
CHAPTER THREE: RESEARCH METHODOLOGY

3.0 Introduction
This chapter deals with research design, the population, sampling frame and technique, instruments of data collection as well as validity and reliability of the research instruments.

3.1 Research Design
The type of research design used was a survey. The researcher picked all commercial banks which are located in Mombasa.

3.2 Target Population
A population is an entire group of individuals, events or objects having a common observable characteristic, which a researcher is interested in (Kothari, 2004). This study focused on the thirty four Commercial banks available in Mombasa County according to the Central Bank of Kenya list (Appendix III).

3.3 Sample Size and Sampling Technique
Sampling is the process of selecting a number of individuals or objects from a population such that the selected group contains elements representative of the characteristics found in the entire population. Purposive sampling involves selecting cases that have required information with respect to the research (Mugenda & Mugenda, 2003). The actual participants selection is not random as the subjects are picked purposively to fit into identified quotas (Mugenda & Mugenda, 2003). In this study the researcher used purposive sampling to pick a credit officer from each of the 34 commercial banks in Mombasa County because credit officers are the people who deal with the processing of loans and therefore have firsthand information. This implies that the sample size constituted 34 credit officers drawn from each of the 34 banks in Mombasa.

3.4 Data Collection Technique
The most frequently used method of gathering information is by directly asking respondents to express their views or opinions. The three major tools for data collection are questionnaires, interview schedules and observation guidelines. When constructing and administering research instruments, the same appropriate instrument must be administered to the same respondents without altering the instrument and the conditions of administering the instrument must be as
similar as possible to all the subjects (Orodho, 2003). A structured questionnaire was used in this study. This is due the fact that the researcher obtained factual information regarding the study.

The questionnaire was administered to the respondents by the researcher. In a few instances, the researcher left the questions with the respondents and picked them later. The respondents were requested to give responses on their own. However they were assisted in choosing the right responses from the ones listed in the structured questionnaire whenever they were unable to do it on their own for whatever reasons.

3.5 Data Reliability and Validity
According to Mugenda (2008), reliability is a measure of the degree to which a research instrument yields consistent results or data after repeated trials and validity is the degree to which results obtained from the analysis of the data actually represent the phenomenon under study. The researcher carried out a pilot study, to pre-test and validate the questionnaire. The whole research was conducted by targeting 12 sampled credit officers of the banks in branches randomly selected. The pilot study was to enable the researcher to identify items that require modification. The result helped the researcher to correct inconsistencies arising from the instruments, which ensured that they measure what is intended.

3.6 Data Analysis and Presentation
Data was analyzed by use of quantitative statistics mainly tables and graphs. Inferences were made based on outputs. Regression analysis was used to determine whether the independent variables together predict the given dependent variable. All the analysis was done using MS Excel and outputs exported to MS Word.
CHAPTER FOUR: DATA PRESENTATION, ANALYSIS AND INTERPRETATION

4.0 Introduction
This chapter deals with the analysis of the data collected from the field. The analysis was done using Ms Excel and the findings of the study were analysed to address the objectives of the study and in line with the research questions. Questionnaires were distributed to 30 credit officers out of the 34 banks located in Mombasa Island, as 4 were cooperate banks that do not deal with SMEs. 29 out the 30 questionnaires were returned, representing a response rate of 97%. Sekaran (2004) argues that a response rate of more than 30% is enough to make a valid generalization.

4.1 Personal Information

4.1.1 Gender of Respondents
The respondents indicated their genders as below:

![Respondents' Gender](image)

Figure 4.1.1 Respondents’ Gender
Source: Researcher (2013)

On gender, 83% of the respondents were male while 17% were female. Majority of the respondents therefore were male. This is so probably because the proportion of male Kenyans who pursue higher education is higher than that of female Kenyans.
4.1.2 Length of Service of Respondents

The respondents agreed to indicate their length of service as below:

<table>
<thead>
<tr>
<th>Table 4.1.2 Length of Service</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Length of Service</strong></td>
</tr>
<tr>
<td>------------------------</td>
</tr>
<tr>
<td>Less than 1 year</td>
</tr>
<tr>
<td>Between 1-3 years</td>
</tr>
<tr>
<td>Between 4-6 years</td>
</tr>
<tr>
<td>Over 6 years</td>
</tr>
<tr>
<td>Total</td>
</tr>
</tbody>
</table>

*Source: Researcher (2013)*

On length of service, 14% of the respondents had served for a period of less than one year, 10% between 1-3 years, 48% between 4-6 years and 28% over 6 years. Majority of the respondents had served in their respective banks for a period of between 4-6 years. The implication here is that since majority of the employees have worked for more than four years, then information they provided is most likely reliable. Employees with very short lengths of service may not have thorough product knowledge and they may not be relied on.
4.1.3 Level of Education

The respondents were asked to indicate their level of education.

![Bar Chart: Respondents' Level of Education]

**Figure 4.1.3 Respondents’ Level of Education**

*Source: Researcher (2013)*

On level of education, 17% of the respondents had a master’s degree, 69% bachelor’s degree, 03% diploma while 11% were certificate holders. The findings show that majority of the respondents had bachelor’s degrees. Since all employees were literate, administration of questionnaires was easy as less time was spent clarifying issues, hence increasing reliability of the information.
4.1.4 Age Bracket of Respondents
The respondents agreed to indicate their ages as below:

<table>
<thead>
<tr>
<th>Age Bracket</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Over 51 years</td>
<td>10%</td>
</tr>
<tr>
<td>41-50 years</td>
<td>10%</td>
</tr>
<tr>
<td>31-40 years</td>
<td>35%</td>
</tr>
<tr>
<td>21-30 years</td>
<td>45%</td>
</tr>
</tbody>
</table>

Figure 4.1.4 Age Bracket of Respondents

Source: researcher (2013)

On age bracket, 45% of the respondents were between the ages of 21-30 years, 35% between the ages of 31-40 years, 10% between 41-50 years and another 10% over 51 years. The findings show that majority of the respondents were between the ages of 21-30 years. This implies that majority of the banks hire young people to market their products. Young people are generally considered to be familiar the new trends in the evolving environment, especially the technology know-how.
4.2 Bank Characteristic

4.2.1 Classification of Bank

The respondents were agreed to classify their banks.

Table 4.2.1 Classification of Bank

<table>
<thead>
<tr>
<th>Classification of Bank</th>
<th>No. of Respondents</th>
<th>Percentage (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Government owned domestic bank</td>
<td>02</td>
<td>07</td>
</tr>
<tr>
<td>Privately owned domestic bank</td>
<td>14</td>
<td>48</td>
</tr>
<tr>
<td>Foreign owned private bank</td>
<td>09</td>
<td>32</td>
</tr>
<tr>
<td>Public owned private bank</td>
<td>01</td>
<td>10</td>
</tr>
<tr>
<td>Privately owned with government participation bank</td>
<td>03</td>
<td>03</td>
</tr>
</tbody>
</table>

Total 29 100

On classification of bank, 07% of the respondents indicated that the bank they working for is government owned domestic bank, 48% indicated privately owned domestic bank, 32% indicated foreign owned private bank, 10% indicated public owned private bank while 03% work for privately owned with government participation banks. The study shows that majority of the banks in Mombasa are privately owned domestic banks. This implies these banks can offer loans flexibly, as these banks are familiar with SMEs and the challenges they face, unlike the case of the government banks which are bound by rigid civil service rules.
4.2.2 Period of Operation of the Banks in the Market

On period of operation, 24% of the banks had operated for between 5-15 years, 38% between 16-30 years, 14% for between 31-50 years while 24% of the banks had operated for over 50 years. The study shows that majority of the banks have been in business for between a period of 16-30 years. This implies that the decisions that these banks make are most likely guided by their past experiences with customers.
4.3 Factors Considered in Financing SMEs

4.3.1 Profitability
Respondents were asked to indicate the extent to which profitability criteria is used to assess credit worthiness of SMEs and the responses are figure 4.3.1 below;

![Responses](image)

**Figure 4.3.1 Profitability and Credit Evaluation**
*Source: Researcher (2013)*

From table 4.3.1, the respondents who strongly agreed that profitability is considered during credit evaluation were 66%, while 34% of the respondents agreed that profitability is used during credit evaluation. There were no respondents who indicated neutral, disagree and strongly disagree. The study shows that majority of the respondents strongly agreed that profitability is considered during credit evaluation. This means businesses that make minimal profits or frequently make losses are not likely to qualify for loans, as the uncertain future of non-profit making businesses is viewed with suspicions.

4.3.2 Cash Flow of SMEs and Credit Evaluation
Respondents were asked to indicate whether cash flow of an SME is considered in evaluating credit worthiness of a business and the results obtained are on table 4.3.2 below;
Table 4.3.2 Cash Flow and Credit Evaluation

<table>
<thead>
<tr>
<th>Cash flow consideration in credit worthiness evaluation</th>
<th>No. of Respondents</th>
<th>Percentages (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Strongly agree</td>
<td>24</td>
<td>83</td>
</tr>
<tr>
<td>Agree</td>
<td>05</td>
<td>17</td>
</tr>
<tr>
<td>Neutral</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Disagree</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Strongly disagree</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Total</td>
<td>29</td>
<td>100</td>
</tr>
</tbody>
</table>

From table 4.3.2, it shows that 83% of the respondents strongly agreed that the cash flow of an SME is considered when evaluating her credit worthiness, 17% agreed while no respondents indicated against neutral, disagree and strongly disagree. The study shows majority of the banks consider cash flow of a business before advancing credit, as this is used to gauge financial performance of the business.

4.3.3 Liquidity and Credit Evaluation of an SME

Respondents were asked whether they consider liquidity of a business before advancing credit and responses obtained are shown on figure 4.3.3 below;

![Responses](image)

Figure 4.3.3 Liquidity and Credit Worthiness

Source: Researcher (2013)
From figure 4.3.3, out of 29 respondents, 62% strongly agreed that liquidity of a business is used as a criteria for assessing the credit worthiness of a business, while 38% agree. There is no respondent who indicate against neutral, disagree and strongly disagree. The study shows that majority of the banks strongly consider liquidity of a business in advancing credit. Generally, cash readily available seem to inspire the lenders in advancing loans to firms that indicate the capability of repayment.

4.3.4 Capital Structure and Credit Evaluation

<table>
<thead>
<tr>
<th>Consideration of Capital Structure on Credit Evaluation</th>
<th>No. of Respondents</th>
<th>Percentage (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Strongly Agree</td>
<td>18</td>
<td>62</td>
</tr>
<tr>
<td>Agree</td>
<td>10</td>
<td>35</td>
</tr>
<tr>
<td>Neutral</td>
<td>01</td>
<td>03</td>
</tr>
<tr>
<td>Disagree</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Strongly Disagree</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Total</td>
<td>29</td>
<td>100</td>
</tr>
</tbody>
</table>

On capital structure, 62% of the respondents strongly agreed that capital structure is considered in assessing the credit worthiness of an SME, 35% of the respondents agreed, 3% were neutral while no one either agreed or disagreed. From the study majority of the respondents strongly agreed that capital structure is a critical factor in evaluating credit worthiness of an SME. Some people believe that successful businesses operate on debt free while others consider firms operating on debts yield higher income irrespective of the interests that the debts attracts. Whatever the case, capital structure is thus taken into consideration when advancing credit.
On indebtedness, 42% of the respondents strongly agreed that highly indebted businesses have low chances of securing a loan, another 42% agreed, 10% were neutral, 3% disagreed while another 3% strongly disagreed. The results of the study show that majority of the respondents strongly agreed that highly indebted businesses have low chances of securing a loan. The banks tend to consider highly indebted firms to be risky with many obligations which could possibly not be met at the required time.

**Table 4.3.6 Proportion of Equity to Debt and Credit Evaluation**

<table>
<thead>
<tr>
<th>Greater Equity appeals to Lenders</th>
<th>No. of Respondents</th>
<th>Percentage (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Strongly Agree</td>
<td>10</td>
<td>35</td>
</tr>
<tr>
<td>Agree</td>
<td>18</td>
<td>62</td>
</tr>
<tr>
<td>Neutral</td>
<td>01</td>
<td>03</td>
</tr>
<tr>
<td>Disagree</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Strongly Disagree</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Total</td>
<td>29</td>
<td>100</td>
</tr>
</tbody>
</table>
On equity-debt ratio, 35% of the respondents strongly agreed that a business with greater equity capital appeals to the lenders, 62% agreed while the remaining 3% were neutral. No one either disagreed or strongly disagreed. The study shows that majority of the respondents agreed that a business with greater equity appeals to lenders. Equity capital is the most expensive capital into the business, thus a firm with higher equity is considered more stable, as chances of bankruptcy are minimal and payment of dividend in this case is not a must.

![Pie chart](image)

**Figure 4.3.7 Debt Free Business and Credit Worthiness**

Respondents were asked whether a business without debt has a high chance of securing a loan, 13% of the respondents strongly agreed, 42% agreed, 28% were neutral while the remaining 17% disagreed. No respondents disagreed strongly. The findings of the study that majority of the respondents agreed that that a business without any debt has a high chance of securing a loan, as the chances of defaulting tend to be minimal.
4.4 Other Factors Considered in Assessing Credit Worthiness

Respondents were asked to list any other factors considered in evaluating credit worthiness and the result obtained is shown on table 4.4 below:

**Table 4.4 Other Factors Considered in Assessing Credit Worthiness**

<table>
<thead>
<tr>
<th>Other Factors Considered in Assessing the Credit Worthiness</th>
<th>No. of Respondents</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Integrity/character of the owner</td>
<td>10</td>
</tr>
<tr>
<td>2. Future prospects</td>
<td>3</td>
</tr>
<tr>
<td>3. Annual stock turnover</td>
<td>4</td>
</tr>
<tr>
<td>4. Operation/nature of the business</td>
<td>8</td>
</tr>
<tr>
<td>5. Business experience and projections</td>
<td>6</td>
</tr>
<tr>
<td>6. Credit history</td>
<td>8</td>
</tr>
<tr>
<td>7. Risks and mitigation</td>
<td>2</td>
</tr>
<tr>
<td>8. Security/collateral</td>
<td>13</td>
</tr>
<tr>
<td>9. Sources of repayment</td>
<td>1</td>
</tr>
<tr>
<td>10. Period the customer has maintained an account with the bank</td>
<td>1</td>
</tr>
<tr>
<td>11. Diversification</td>
<td>1</td>
</tr>
<tr>
<td>12. Target market</td>
<td>2</td>
</tr>
<tr>
<td>13. History of operations</td>
<td>2</td>
</tr>
<tr>
<td>14. Credentials of management/owner</td>
<td>2</td>
</tr>
<tr>
<td>15. Repayment period</td>
<td>3</td>
</tr>
<tr>
<td>16. Environment</td>
<td>3</td>
</tr>
<tr>
<td>17. Project viability</td>
<td>1</td>
</tr>
<tr>
<td>18. Loan amount</td>
<td>1</td>
</tr>
<tr>
<td>19. Capability to repay</td>
<td>5</td>
</tr>
<tr>
<td>20. Legality of business</td>
<td>1</td>
</tr>
</tbody>
</table>

Other major factors mentioned by the Bank officers which were not listed in the questionnaire included Owner's integrity, credit history, nature of business, business experience and projections and mainly security. Other factors mentioned are future prospects, annual stock turn-over, risks and mitigation, target market, repayment period as well as the environment. A few mentioned
business legality, diversification, sources of repayment and the period which the customer has maintained with the bank.

When asked if SMEs find it difficult in meeting the bank requirements before given loans, 87% of the respondents agreed while 13% disagreed. The main reasons for agreeing were due to lack of proper records from SMEs, as well as lack of collateral for securing loans. Other factors considered were lack of proper planning, permit and illiteracy. Businesses at startup stage are also discouraged by the lenders.

The respondents were asked if there are circumstances that relax the conditions for giving loans. From the 29 respondents, 72% agreed, considering other factors such as guarantees, high turnovers, prepayment history, relationship with the bank as well as business diversification. However, 28% of the respondents disagreed.
CHAPTER FIVE: SUMMARY, CONCLUSIONS AND RECOMMENDATIONS

5.0 Introduction
This chapter gives a summary of the research, conclusions and the recommendations by the researcher. It actually deals with the level to which the research has attained its objectives and the solution to the problem to the problem is provided by the stakeholders.

5.1 Summary
This research sought to discover the factors that financial institutions consider when evaluating SMEs for financing. This was done through a survey of 30 commercial banks in Mombasa Island. Using purposive sampling and a sample of 30, questionnaires were issued to one credit officer in each of the 30 banks sampled. The decision to use credit officers was based on the fact they are the ones who evaluate the credit worthiness of SMEs.

Majority of the respondents indicated that they strongly agree or agree that profitability affects the financing of SMEs by banks. Secondly majority of the respondents indicated that they strongly agree or agree that cash flow affects the financing of SMEs. Thirdly, on liquidity majority of the respondents indicated that they either strongly agree or agree that liquidity affects the financing of SMEs by financial institutions and lastly on capital structure, majority of the respondents indicated that they either strongly agree or agree that capital structure composition affects financing of SMEs by financial institutions.

The respondents pointed out other factors which could be taken into consideration in assessing credit-worthiness of an SME, mainly, Owner’s integrity, security, credit history, business projection, environment and annual stock turnover.

5.2 Conclusions
When indicating the extent to which profitability affects the financing of SMEs by banks, most of the respondents either strongly agreed or agreed that profitability is a key factor considered for SMEs to receive a loan from a bank. It is therefore accepted that with low profitability which measures a business performance, then a business will most likely not succeed in her quest for financial support from any bank. The findings of this study are supported by Frankhood and Townsley (1986) who argue that when a business is not operating profitably then its future is not certain and therefore lenders will be reluctant to lend such a business.
Most respondents either strongly agreed or agreed that cash flow is a major consideration in credit worthiness evaluation. The findings are supported by Frigo (2001) who argues that a high cash flow of a business depicts a well-managed cash flow. This means that the organization will be able to meet her obligations like loan repayment as and when required. A lending bank will be interested in persistent high bank balance when considering the credit worthiness of any organization. The lending institution will therefore demand for five years bank statements and cash flow statements during the evaluation process. Therefore it is clear that a business with cash flow problems will most likely not receive any loan award from financial institutions.

Most respondents either strongly agreed or agreed that liquidity of a business is considered in evaluating credit worthiness. The higher the liquidity levels the higher the chance for an SME to qualify for a loan from a financial institution. In managing a business, it is important to have available cash to be used for emergencies or for other unforeseen payments that do not usually occur in a normal business operation. This is very important because sometimes the eventualities that we never prepared for are the very ones that give us real burdens in the future (Johnston and Sons, 1987).

Most respondents either strongly agreed or agreed that capital structure is considered during credit evaluation. The financial institutions put a lot of emphasis on the indebtedness of the firm during credit award evaluation stage. The more the indebtedness an organization is the higher the chances that they do not qualify for loans. This is because the banks consider them risk with a higher chance of default due to more obligations to be met almost at the same time (Johnston and Sons, 1987). This therefore means that the capital structure composition has a bearing as to whether an SME will qualify for a loan from financial institutions or not. Highly indebted SMEs risk not receiving any loan from financial institutions and vice versa.

5.3 Recommendations
The recommendations have been given per each research variable as follows:

1. Profitability is considered during credit worthiness evaluation of an SME. Therefore SMEs should endeavour to enhance their performance and efficiency which will
boost their profits and therefore stand a chance to qualify for a loan from the financial institutions. They should also strategize prudently in order to improve performance.

2. Since cash flow is an area of focus during evaluation for loan award for SMEs by financial institutions, then SMEs should ensure that they do not have persistent cash flow problems lest they do not receive any loan from the financial institutions. This will be achieved by proper planning by use of master and cash budgets.

3. Liquidity has been confirmed by respondents to be an issue for loan application consideration for SMEs by financial institutions. Therefore SMEs should ensure that at all times the liquidity ratios are applied to ensure that optimal liquidity level is maintained in order to qualify for financing.

4. Capital structure composition shows how indebted a business is. Most respondents agreed that a highly geared business is not likely to receive finances from financial institution. Therefore SMEs should only borrow when it is necessary to avoid instances of losing out on a loan because she borrowed unnecessarily and when the real need comes the same cannot be financed.

5.4 Areas for Further Research

Since it was not possible to exhaustively cover the entire area of study in business financing, it will be prudent that the following areas be researched further;

i) Challenges financial institutions face in financing the informal sector

ii) The role of information technology in credit management
REFERENCES


[www.equitybank.co.ke](http://www.equitybank.co.ke)

Appendix I: Questionnaire

My name is Amina. I am a masters student at Kenyatta University. As part of the fulfillment of the requirement for the award of a master's degree, am conducting a research on factors that financial institutions consider in assessing credit worthiness of SMEs. Kindly provide your responses to the questions. The information you provide will be treated with utmost confidentiality and will used for academic purposes only.

Part A: Background information

Please tick the appropriate response in each of the questions asked.

1. Name .............................................................................. (Optional)
2. Bank .............................................................................. (Optional)
3. Job Title..........................................................................
4. Department........................................................................

- What is your gender?
  Male ( )
  Female ( )

- For how long have you worked in this bank?
  Less than 1 year ( )
  Between 1-3 years ( )
  Between 4-6 years ( )
  Over 6 years ( )

- What is the level of your education?
  PHD ( )
Masters ( )
Bachelors ( )
Diploma ( )
Certificate ( )

Other (Specify) ............................................................... 

- What is your age bracket?
  Below 20 years ( )
  20-30 years ( )
  30-40 years ( )
  40-50 years ( )
  Over 50 years ( )

Part B: Commercial Bank Characteristics:

- How do you classify your bank?
  Government owned domestic bank ( )
  Privately owned domestic bank ( )
  Foreign Owned Private bank ( )

- For how long has your bank operated in Kenya?
  Less than five years ( )
  5 - 15 years ( )
  16 - 30 years ( )
  31 - 50 years ( )
  Over 50 years ( )
• How many branches does your bank have (in Kenya)? (in Mombasa)

<table>
<thead>
<tr>
<th>Branches</th>
<th>Less than 5 branches</th>
<th>5 - 15 branches</th>
<th>16 - 30 branches</th>
<th>31 - 50 branches</th>
<th>Over 50 branches</th>
</tr>
</thead>
<tbody>
<tr>
<td>Ticks</td>
<td>( )</td>
<td>( )</td>
<td>( )</td>
<td>( )</td>
<td>( )</td>
</tr>
</tbody>
</table>

Part C: Factors that financial institutions consider in financing SMEs in Kenya

The questions below require your opinion on factors that banks consider before advancing credit to SMES. Kindly tick the correct response.

<table>
<thead>
<tr>
<th></th>
<th>Strongly Agree</th>
<th>Agree</th>
<th>Neutral</th>
<th>Disagree</th>
<th>Strongly Disagree</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Profitability and Cash Flow</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>a) Profitability of a business is considered during credit evaluation</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>b) Cash flow is considered in credit worthiness evaluation</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>c) All profitable businesses in the past three years qualify for loans</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>d) Decrease in cash balances in the past two years decreases chances of an SME in securing credit</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>e) Increase in investing activities is an added advantage in applying for credit</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2. Liquidity</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>a) Liquidity of a business is considered in assessing the credit worthiness of a business</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
### 3. Capital Structure

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>a)</td>
<td>Before giving a loan the bank must examine the capital structure of a business</td>
</tr>
<tr>
<td>b)</td>
<td>Highly indebted businesses have low chances of securing a loan</td>
</tr>
<tr>
<td>c)</td>
<td>A business with greater equity capital appeals to the lenders</td>
</tr>
<tr>
<td>d)</td>
<td>A business without any debt has a high of securing a loan</td>
</tr>
</tbody>
</table>

5) Kindly list other factors considered in assessing credit worthiness not listed above

__________________________________________________________________________
__________________________________________________________________________
__________________________________________________________________________
__________________________________________________________________________

6) Do SMEs find it difficult in meeting the bank requirements before being given loans? Please explain

__________________________________________________________________________
__________________________________________________________________________
__________________________________________________________________________
__________________________________________________________________________

7) Are there circumstances that relax on your conditions for giving loans? Please explain

__________________________________________________________________________
__________________________________________________________________________
__________________________________________________________________________
__________________________________________________________________________
1) ABC Bank (Kenya)
2) Bank of Africa
3) Bank of Baroda
4) Bank of India
5) Barclays Bank
6) Brighton Kalekye Bank
7) CFC Bank
8) Chase Bank (Kenya)
9) Citibank
10) City Finance
11) Commercial Bank of Africa
12) Consolidated Bank of Kenya
13) Cooperative Bank of Kenya
14) Credit Bank
15) Development Bank of Kenya
16) Diamond Trust Bank
17) Dubai Bank Kenya
18) Ecobank
19) Equatorial Commercial Bank
20) Equity Bank
21) Family Bank
22) Fidelity Commercial Bank
23) Fina Bank
24) First Community Bank
25) Giro Commercial Bank
26) Guardian Bank
27) Gulf African Bank
28) Habib Bank
29) Habib Bank AG Zurich
30) I&M Bank
31) Imperial Bank Kenya
32) Jamii Bora Bank
33) Kenya Commercial Bank
34) K-Rep Bank
35) Middle East Bank Kenya
36) National Bank of Kenya
37) NIC Bank
38) Oriental Commercial Bank
39) Paramount Universal Bank
40) Prime Bank (Kenya)
41) Standard Chartered Kenya
42) Transnational Bank Kenya
43) United Bank of Africa
44) Victoria Commercial Bank

Source: Central bank of Kenya (2009)
Appendix III: List of Commercial Banks in Mombasa

1) ABC Bank (Kenya)
2) Bank of Africa
3) Bank of Baroda
4) Bank of India
5) Barclays Bank
6) CFC Bank
7) Chase Bank (Kenya)
8) Citibank
9) Commercial Bank of Africa
10) Consolidated Bank of Kenya
11) Cooperative Bank of Kenya
12) Diamond Trust Bank
13) Dubai Bank Kenya
14) Ecobank
15) Equatorial Commercial Bank
16) Equity Bank
17) Family Bank
18) Fidelity Commercial Bank
19) First Community Bank
20) Giro Commercial Bank
21) Guardian Bank
22) Gulf African Bank
23) Habib Bank
24) Habib Bank AG Zurich
25) I&M Bank
26) Imperial Bank Kenya
27) Kenya Commercial Bank
28) K-Rep Bank
29) Middle East Bank Kenya
30) National Bank of Kenya
31) NIC Bank
32) Prime Bank (Kenya)
33) Standard Chartered Kenya
34) Trans national Bank Kenya

Source: Central bank of Kenya (2011)