BORROWED CAPITAL AND PERFORMANCE OF SMALL AND MEDIUM SCALE ENTERPRISES. A CASE OF KISUMU MUNICIPALITY

BY

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MARCH 2010
DECLARATION

This research is my original work and has not been submitted or presented to any University for examination purpose.

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ABSTRACT

Small and Medium Scale Enterprises (SMEs) seem to be the engine of economic growth and development in the developing world. Though this is the case, SMEs in Kenya function with limited access to finance, among other things. This study sought to investigate the extent to which small and medium scale businesses use borrowed capital to enhance their performance in Kisumu. The study investigated the relationship between borrowed capital and performance in the business enterprises. This study would be helpful in explaining the level of performance of SMEs in Kenya.

The study used both primary and secondary data. Business owners and managers were consulted as the source of the primary data. For secondary data, the study used published literature on the rate of performance of businesses in Kenya and written reports about the small and medium scale business organizations. The study used cluster random sampling to obtain the sample population from the target population. The study was conducted through survey and was concerned with the levels of use of credit financing in small and medium scale business enterprises. The survey research design generally entails the use of sample populations to analyze and discover occurrences of events. This study employed, in data analysis, Simple Descriptive Statistics and Correlation Coefficient. The study found the extent to which SMEs access borrowed capital in Kisumu Municipality to be low. Only 36.1% of all SMEs in Kisumu Municipality use borrowed capital. This means that despite the availability of a variety of sources of borrowed capital in Kisumu, many SMEs are still not able to access the borrowed capital. The findings of this study will be useful in establishing the availability and accessibility to borrowed capital by small and medium scale business organizations.
DEFINITION OF TERMS

Borrowed Capital
In this paper, borrowed capital is made up of all resources used in the business but which do not belong to the owner of the business.

Informal Sector
Sectors which cover activities that do not require a lot of formality or record keeping, for example, hawkers, cobblers, open air market traders, hair dressers, among others.

Micro Finance Institutions
These are organizations and financial institutions which offer credit facilities and loaning programs to SMEs.

Performance
This refers to the growth and development of SMEs from one level to another. The level of performance in this study is measured by, profitability, level of cash flow, asset base and rate of stock turnover.

Profile
This refers to a summary of the main characteristics or features of an entity. In this study, it refers to the socio economic characteristics of SMEs.

Small and Medium Scale Enterprises
In this paper, SMEs shall represent the African small owned businesses which need venture capital but have no capacity to attract venture capitalists.
ACKNOWLEDGEMENT

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CHAPTER ONE

1.0 Introduction

This chapter presents the background of the study, the statement of the problem, the study objectives, research questions, and significance of the study and finally the scope of the study.

1.1 Background of the Study

This study was guided by the need of a business organization to maximize its profits through exploiting all the available sources of capital in order to operate optimally. According to Manas’seh (2004), there are three categories of small businesses in Kenya; Small businesses operating under dealership with large corporate suppliers, Asian owned small business which are family owned and hence do not require venture capitalists because they are not ready to share profits and African small owned businesses which need venture capital but have no capacity to attract venture capitalists. This study was concerned with the third category because they more often opt for borrowed capital that comes in various forms.

There are two types of microfinance providers in Kenya: client-based, which rely on both formal and informal structures (traders, shopkeepers, moneylenders, family, and friends) and member-based, which rely on either formal SACCOS or informal Rotating Savings and Credit Associations (ROSCAs) and Accumulating Savings and Credit Associations (ASCRAs). Most are self-regulated and rely heavily on international donor support. Most of their programs have adopted a village banking methodology of lending which involves working with existing groups registered at the Ministry of Cultural and Social Services. In addition to these retail institutions, there are three specialized second tier financial service providers (wholesale MFIs) that are offering financial services to MFIs. Some commercial banks are also offering financial services to MFIs. (GOK 2003)
The Kenya Rural Enterprise (K-REP) Bank, licensed in 1999, was the first commercial bank with the intent of providing banking services to small borrowers and savers. Equity Bank was the second microfinance bank to be licensed as a commercial bank. Stakeholders in microfinance have now formed an Association of Micro Finance Institutions (AMFI), an umbrella organization representing microfinance institutions in Kenya and serving approximately 97,000 clients nationwide. Licensed in March 1999, AMFI’s primary objective is to address issues and challenges affecting the sector. Its activities are currently funded through a grant from USAID. (World Bank 2005) This study therefore sought to establish the extent to which SMEs use borrowed capital to enhance their performance in Kenya.

1.2 Statement of the problem.

SMEs in Kenya function with limited access to finance, among other things Daniels L, & Ngwira A (1993). This study sought to investigate the extent to which small and medium scale businesses use borrowed capital to enhance their performance in Kisumu Municipality. The study investigated the relationship between borrowed capital and performance in the business enterprises.

While the over 40 commercial banks in Kenya have enough liquidity to set in motion significant growth in the small business sector, only a few banking institutions have opened their doors to small borrowers, including SMEs, who are unable to meet the relatively high collateral requirements sought by banks before they can get access to credit, thus limiting their growth. Although entrepreneurs in this sector may have the resilience and work ethic, surveys show that the broad lack of access to credit has frustrated their efforts. (UNDP, 2006).
This study sought to establish the extent to which small and medium scale businesses use borrowed capital to enhance their performance in Kisumu Municipality.

1.3 Objectives of the Study

General Objective

The purpose of this study was to evaluate the accessibility and effects of borrowed capital on performance of SMEs in Kenya, using cross sectional survey design, with a view to maximizing the profitability through optimal use of the borrowed and equity capital at their disposal. Borrowed capital is represented by trade credit, bank overdraft, hire purchase, lease, loans from banks and Micro Finance Institutions (MFIs) and other financial institutions granted towards the business organization.

Specific Objectives

This study was guided by the following specific objectives:

1. To determine the extent to which SMEs access borrowed capital in Kisumu.
2. To determine the relationship between borrowed capital and performance of SMEs in Kisumu.
3. To investigate the contribution of borrowed capital towards performance of SMEs in Kisumu.
4. To identify the barriers to accessibility of borrowed capital by SMEs.

1.4 Research Questions

This study sought to answer the following questions:

1. To what extent are SMEs accessing borrowed capital in Kisumu?
2. What is the relationship between borrowed capital and performance of SMEs in Kisumu?
3. What is the contribution of borrowed capital on performance of SMEs in Kisumu?

4. What are the barriers to accessibility of borrowed capital by SMEs in Kisumu Municipality?

1.5 Significance of the Study.

SMEs are expected to provide the bulk of the 500,000 new jobs needed in Kenya every year. Thus there is need to link SMEs to financial institutions and assist potential entrepreneurs to start and manage their businesses successfully, assist existing entrepreneurs to expand and diversify their business. However, in Kenya, small and medium scale businesses find it difficult to obtain borrowed capital due to high interest rates. (UNDP, 2006). The business organizations ignore the fact that borrowed capital increases profitability and brings about economies of scale.

This study would be useful in encouraging application of acceptable levels of borrowed capital in small and medium scale business organizations. The policy makers such as Parliamentarians, Ministry of Finance and the Central Bank of Kenya would also find the study useful because they need to consider fixing the maximum interest chargeable on borrowed capital in Kenya and provide a legal framework for the existence of MFIs in fact, a Deposit-Taking Microfinance bill has already been drafted by key players in the sector. The bill is now under the review of parliament. A task force, established in 2003, proposed a three-tier framework for the regulation and supervision of MFIs. Tier one would comprise Rotating Savings and Credit Associations (ROSCAs), Club Pools, and Financial Service Associations regulated by an external agency. Tier two would comprise formally constituted microfinance organizations that do not take deposits from the general public but accept collateral tied to loan contracts. It is proposed that an umbrella body such as the Association
of Microfinance Institutions (AMFI) regulate them. Tier three would comprise formally
consstituted MFIs that intend to take intermediate deposits from the general public. The
proposal is meant to empower the Central Bank through the Microfinance Bill to license,
regulate, and supervise these institutions. (AMFI, 2003)

The major challenge hindering outreach and sustainability of microfinance institutions in
Kenya is a “lack of specific legislation and set of regulations to guide the operations of the
microfinance sub-sector.” (GOK 2003). Microfinance institutions are currently established
under fewer than eight different Acts of Parliament: the Non-Governmental Organizations
Co-ordination Act, the Building Societies Act, the Trustee Act, the Societies Act, the Co-
operative Societies Act, the Companies Act, the Banking Act, and the Kenya Post Office
Savings Bank Act. Most of these intuitions do not have the capacity to address issues
regarding ownership, governance, and accountability. (Kibas 2004)

Although many researches exist that profile SMEs in Kenya and underscore their contribution
to national development, little has been done principally on SMEs in relation to the level of
use of borrowed capital, as greater attention is often paid to the need for and accessibility of
capital by SMEs. Against this backdrop this study would seek to provide this data through a
systematic survey of SMEs in Kisumu Municipality.

The results from this study would thus be significant in contributing to research and widening
the knowledge base on impediments to SMEs growth in Kenya. It would provide useful
literature to other researchers who would be interested in pursuing further research in the
same area.
1.6 The scope of the study.

This study on the extent to which SMEs use borrowed capital to enhance their performance in Kenya was concerned with the use of borrowed capital by SMEs and examined the proportion of capital contributed by creditors vis-à-vis the equity capital. The study was confined to the level of use of borrowed capital by all SMEs in Kisumu Municipality. The findings of this research would further be generalized for all other SMEs in Kenya.
CHAPTER TWO

2.0 LITERATURE REVIEW

The chapter expounds on literature review by giving the conceptual framework of the study, the main review, critical review of major issues then lastly summary and gaps to be filled by the study.

2.1 Introduction to Literature Review

Numerous researchers world over have appreciated the role that SMEs play in societal growth and development (Hope, 2001). Many successful experiences around the world have lead to the conclusion that one of the best ways to push a country and its economy towards industrialization is to encourage local economic development through small scale enterprise development (Storey, 1994). The dynamic role of small scale enterprises in developing countries as engines through which growth and development objectives can be achieved has equally been recognized. (Fisseha, 1999)

Although its contribution and generating employment, alleviating poverty, expanding productive base through adoption of appropriate technology and in economic growth has been acknowledged from numerous sources, the growth and development of the SMEs is still not smooth, especially in Kenya (McCormick, 2001). Impact studies on borrowed capital among SMEs have focused on the constraints and capability of credit to improve total production on SMEs and its useful role in resource allocation utilization and productivity. Considerable research has been directed towards analyzing the effects of credit programs on capital formation, productivity and efficiency of SMEs. Opinions from empirical literature vary in respect of the impact of many such programs from time to time, country to country and according to methodology employed by analysts. For example an impact study revealed that...
assisted firms had increased employment by 106 per cent, annual sales by 292 per cent and total assets by 189 per cent; the business survival rate is 94 per cent in the first two years of operation compared to a national average of less than 10 per cent. (AMFI, 2003).

Informal traders in Kenya face a number of significant risks that preclude them from breaking out of a vicious circle of poverty. Their vulnerability to a variety of risks – ranging from health issues through risk of loss of productive assets – is high. This makes finance providers such as MFIs reluctant to grant loans, as the likelihood of default is increased through the traders' inability to be protected from such risks. The Co-operative Insurance Company of Kenya Ltd (CIC Insurance) has set aside 5.9 million Shillings towards this initiative, and intends to scale up micro-insurance to at least 20% of the overall portfolio (up from 14%) by the end of 2006. The project will leverage networks of informal traders to significantly increase the spread of micro-insurance, thus providing the informal sector with protection against risks that keep them within the vicious circle of poverty, and reducing the lending risk for MFIs (UNDP, 2006).

This shows that sources of borrowed capital for SMEs continue to increase and become more accessible and cheaper. This study therefore sought to reveal the extent to which borrowed capital is being used to finance growth and development of SMEs in Kenya.
2.2 Conceptual Framework.

Figure 1: Conceptual Framework

**INDEPENDENT VARIABLE**

- **Borrowed capital**

**DEPENDENT VARIABLE**

- **Enhanced Performance**

**MICRO FINANCE INSTITUTIONS (MFIs)**
- Low interest rates, long payback period, free professional advice, low insurance cost, no collateral, limited in supply, NGO support.

**BANK LOANS**
- Interest rates, payback period, insurance costs, and collateral

**TRADE CREDIT**
- Cost of goods, payback period, stock turnover

**HIRE PURCHASE**
- Monthly instalments
- High deposits

**LOAN FROM GOVERNMENT AGENCIES**
- Low interest rates
- Not readily available
- Restriction on following up

**COOPERATIVE LOANS**
- Low interest rate
- No collateral
- Easy accessibility

**ACQUISITION OF ASSETS**
- New assets lead to efficiency
- Increased rate of production
- Reduced cost of production

**CASH FLOW**
- More cash available for operation
- Payments of debts in time
- Increased sales

**ECONOMIES OF SCALE**
- Benefits of bulk buying
- Lower price of finished goods
- More sales at low costs

**DIVERSIFICATION**
- New business ventures
- More branches opened
- Increased profitability
- Spreading risks

**QUALITY OF GOODS AND SERVICES**
- Increase quality of goods and services
- Better sales
- Popularity of business increased

**RATE OF RETURN ON CAPITAL**
- Increased rate of return on capital
- Faster growth and development
This study consists of two variables namely borrowed capital (independent variable) and Enhanced Performance (dependent variable). Borrowed capital may be available to SMEs in various forms as illustrated in figure 1. Different sources of borrowed capital have varying benefits and constraints as shown. It should be noted that borrowed capital leads to enhanced performance of an enterprise. Once an enterprise has grown and developed to higher levels, it gains confidence and can therefore easily attract more borrowed capital which further spurs performance. This cycle continues from one level to another, thus there is an inter relationship between borrowed capital and performance. This study assumed that Equity capital is available to all SMEs as such it is only the level of use of borrowed capital that needs to be examined. Further the study sought to establish the effective use of the available borrowed capital.

2.3 Main Review

The Independent Variable.

Borrowed capital can be obtained by SMEs in form of Loans from micro finance institutions, banks, cooperative societies, special government agencies such as Kenya industrial Estates (KIE) or loans from Non governmental organizations.

Micro Finance Institutions and SACCOS

Micro Finance Institutions offer loans with low interest rates, long pay back period, free professional advice, low insurance cost, and require no collateral. Most MFIs receive direct support from NGOs. There are two types of microfinance providers in Kenya: client-based, which rely on both formal and informal structures (traders, shopkeepers, moneylenders, family, and friends) and member-based, which rely on either formal SACCOS or informal Rotating Savings and Credit Associations (ROSCAs) and Accumulating Savings and Credit
Associations (ASCRAs). Most are self-regulated and rely heavily on international donor support. Most of their programs have adopted a village banking methodology of lending which involves working with existing groups registered at the Ministry of Cultural and Social Services. In addition to these retail institutions, there are three specialized second tier financial service providers that are offering financial services to MFIs. Some commercial banks are also offering financial services to MFIs. (GOK 2003). The Central Bank of Kenya’s 2004 annual report states that there were 3800 SACCOS and 15 MFIs.

Loan from NGOs and Government Agencies

The Kenya Government has negotiated a $1.2 million (EUR 1 million) loan from the French Development Agency (AFD) for onward lending to MFIs. The fund will be disbursed through three commercial banks. Development partners in Kenya have also outlined new interventions to support the microfinance sector. The Financial Deepening Trust of the UK Department for International Development (DFID) recently launched a new 5-year program, whose major thrust is to support MFIs in the delivery of new products, especially savings products, to their clients. (IFC, 2005). International Finance Corporation (IFC) launched an integrated project to support the growth and development of small and medium scale enterprises.

This shows that there is a lot of interest by the Kenya Government, NGOs, local and international community in the provision of finance to SMEs. This study therefore sought to establish the extent to which SMEs use borrowed capital to enhance their performance.

Bank Loans

The CBK 2005 Monthly Economic Outlook reports that the banking sector is comprised of 49
financial institutions involved with 44 commercial banks, 1 operating non-bank financial institution (NBFI), and 2 mortgage finance companies. (GOK, 2005).

**The Dependent variables**

Optimal performance will be attained if a business organisation has sufficient capital for expansion and sustaining the required daily cash flow. The various sources of capital should be exploited to the maximum. Most SME owners do not use optimally the available sources of borrowed capital. In Kenya, the SME sector contributes up to 18.4 per cent of the gross domestic product and is a major employer, second only to agriculture (UNDP, 2006).

Indicators of performance include acquisition of performance include acquisition of more assets, improved cash flow, economies of scale, diversification, improved quality of goods and services, and increased rate of return on capital. These can adequately be financed by borrowed capital.

**2.4 Critical Review of Major Issue**

There is no uniformly acceptable definition of a Small or Medium Scale Enterprise (SME) and many writers have defined the terms differently (Storey, 1994). Some writers define them using the asset base of the enterprise as the reference point, some use turnover levels, some use the number of employees while others use some combination of the three criteria. Kirimi (1993) distinguishes the enterprises using the criterion of number of employees as follows: Micro enterprises employing 1-5 persons; Small enterprises employing 6-20 persons; Medium enterprises employing 21-50 persons. According to Storey (1994), definitions that
employ measures of size (number of employees, turnover, profitability, net worth, etc.), when applied to one sector could lead to all businesses being classified as small, while the same size definition when applied to a different sector could lead to a different result. This size approach is thus inexhaustible.

Small firms are present virtually in every industry and the characteristics they share as small firms are sometimes not apparent because of the differences arising from the contrasting conditions of the different industries. There is also extreme variation as regards efficiency, methods of operation, the nature of market served and the size of the resources employed. Thus a manufacturing business employing up to 200 people has very little in common with a small shop owned and run by a married couple. (Bolton, 1971). The report by the Bolton committee (1971) proposed that a small firm had three essential characteristics: A small firm is managed by its owner(s) in a personalized way, It has a relatively small share of the market in economic terms and It is independent in the sense that it does not form part of a larger enterprise and its ownership is relatively free from outside control in its principal decisions.

As well as these general qualities, small firms were defined by more specific quantitative measurements. The diversity of the sector was recognized as definitions depended on the industry type. Thus Bolton Committee employed different definitions of small businesses to different sectors. The various sectoral definitions are indicated in table 1.

Although these definitions have formed the basis of subsequent research, they are open to several criticisms including: Low market share is not always a characteristic; small firms can operate in highly specialized niches, or limited geographic markets, where they have a relatively high share; Independence is difficult to measure.
Table 1: Definition of SMEs

<table>
<thead>
<tr>
<th>Small firm type</th>
<th>Definition</th>
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<tbody>
<tr>
<td>Manufacturing</td>
<td>200 employees or less</td>
</tr>
<tr>
<td>Construction</td>
<td>25 employees or less</td>
</tr>
<tr>
<td>Mining &amp; Quarrying</td>
<td>25 employees or less</td>
</tr>
<tr>
<td>Retailing</td>
<td>£50,000 p.a turnover</td>
</tr>
<tr>
<td>Miscellaneous services</td>
<td>£50,000 p.a turnover</td>
</tr>
<tr>
<td>Services</td>
<td>£50,000 p.a turnover</td>
</tr>
<tr>
<td>Motor Traders</td>
<td>£100,000 p.a turnover</td>
</tr>
<tr>
<td>Wholesale Traders</td>
<td>£200,000 p.a turnover</td>
</tr>
<tr>
<td>Road Transport</td>
<td>Five Vehicles or less</td>
</tr>
<tr>
<td>Catering</td>
<td>All excluding multiple or Brewery- managed houses</td>
</tr>
</tbody>
</table>

Source: The Bolton Committee (1971) Turnover threshold are subject to inflation since 1971 about 20 times

Bolton’s definition excluded franchises for example, which do form part of a larger enterprise, but included subcontractors very dependent on one customer; Whilst different size measures are very justifiable (100 employees makes a small manufacturer, but a large consultancy or retailer for instance), they have bedeviled statistical comparisons, especially internationally, as countries employ different definitions.

According to Kibas (2004), the origin of ‘entrepreneur’ concept is traced to the 16th Century German word ‘entreprendre’, which meant ‘to undertake’. The meaning of the term evolved throughout subsequent ages and during the 19th and 20th Centuries, an entrepreneur was seen as one who organizes and operates an enterprise for personal gain –playing the role of owner
and manager. In the 21st Century, an extra role of innovator has been included among other roles of an entrepreneur with the entrepreneur being seen as a reformer and a revolutionary of old ways of operation and introducing something new or untried technology or market. Contemporary writers view entrepreneurs as individuals who are prepared to take enormous, but calculated risks, innovative in areas where most say it can not be done, work long hours over extended periods of time and even suffer personal problems all for the excitement of building an enterprise.

Alternatively, Wynarczyk et al, (1993), identified the characteristics of then small scale enterprise other than size. They argued that there are three ways of differentiating between small and large firms. The small firm has to deal with: Uncertainty associated with being a price taker; Limited customer and product base; Uncertainty associated with greater diversity of objectives as compared with large firms.

The European Commission (EC) coined the term Small and Medium Scale enterprises (SMEs). The SME sector is made up of three components: Firms with 0 to 9 employees – Micro enterprises; Firms with 10-99 employees – Small Enterprises; Firms with 100-499 employees – medium enterprises.

Thus the SME sector is comprised of enterprises (except agriculture, hunting, forestry and fishing), which employ less than 500 workers. In effect the EC definitions are based solely on employment rather than a multiplicity of criteria. The use of 100 employees as a small firm’s upper limit is more appropriate given the increase of productivity (Storey, 1994). Finally the EC definition did not assume the SME group is homogenous, that is, the definition makes a distinction between micro and small and medium size enterprises.
This study will not take such precise quantitative definitions to define its scope of an SME. According to Menas’seh, (2004), there are three categories of small businesses in Kenya; Small businesses operating under dealership with large corporate suppliers; Asian owned small business which are family owned and hence do not require venture capitalists because they are not ready to share profits; African small owned businesses which need venture capital but have no capacity to attract venture capitalists. Thus this study will be concerned with the third category because they more often opt for borrowed capital that comes in various forms.

Much of literature on small holder credit in Kenya focus on impact of credit on productivity and factors behind poor loan repayment. In a number of these studies the researchers have underscored the importance of small scale enterprises in poverty eradication, creation of employment, individual growth, actualization and national economic development (Otunga et al, 2001). A number of government documents also reiterate the significant place of SMEs in National Development (GOK, 2003). There is however scanty data on the profiles and constraints on the extent to which SMEs have used borrowed capital to spur their growth and development.

Despite the wide ranging economic and financial reforms instituted in Kenya, SMEs face a variety of constraints owing to difficulty of absorbing large fixed costs, the absence of economies of scale and scope in key factor production and the higher unit cost of providing services to smaller firms (Hope, 2001) These constraints are discussed under the following headings:
a. Input Constraints

SMEs face a number of constraints in factor markets (Levy, 1993). However, factor availability and cost are the most common constraints. In a study by Parker et al. (1995) SMEs in Ghana and Malawi emphasised the high cost of obtaining local raw materials; this may stem from their poor cash flows. Aryeetey, et al (1994) found that 5% of their sample cited the input constraint as a problem.

b. Finance and Access to Credit

In Kenya the soaring cost of capital due to high interest rates has driven away the small and medium scale investors from the credit sources of financing (UNDP 2006). Aryeetey et al. (1994) reported that 38% of SMEs surveyed mentioned credit as a constraint in the case of Malawi, it accounted for 17.5% of the total sample (Daniels & Ngwira, 1993)

c. Equipment and Technology

SMEs have difficulties in gaining access to appropriate technologies and information on available techniques (Chesworth, 1998). This limits innovation and their competitiveness. In a study by Aryeetey et al (1994), 18% of the sampled SMEs mentioned old equipment as one of the four most significant constraints to expansion.

d. Labour Market

This seems a less important constraint to SMEs considering the widespread unemployment and under employment in the developing countries. SMEs use simple technology which does not require highly skilled workers. Aryeetey et al (1994) found that 7% of their respondents indicated that they had problems finding skilled labour. Studies in Kenya also report few SMEs with labour constraints, due to high levels of skilled unemployment (Pedersen, 2001).

e. Domestic demand

Recent economic policies have led to a decline in the role of the state in productive activity but a renewed private investment has created new opportunities for SMEs. Nonetheless,
limited access to public contracts and sub contracts, arising from cumbersome bidding procedures and/or lack of information, inhibit their participation in these markets. (Schlosser, Michel 2002).

f. International competition

Previously insulated from international competition, many SMEs are now faced with greater external competition and the need to expand market share. SMEs complain that there are too many imported substitutes coming into the country. (GOK, 2004). Aryeetey, et al (1994) reported that tailors in a township in Ghana who used to make several pairs of trousers in a month complained that they went without any orders with the coming into effect of trade liberalization.

g. Regulatory constraints

The Central Bank of Kenya (CBK) 2005 monthly economic outlook reports that the major challenge hindering the outreach and sustainability of SMEs through microfinance institutions is the lack of specific legislation and set regulations to guide the operations of both the SMEs and Microfinance sector.

h. Managerial constraints

Lack of business and entrepreneurial know-how places significant constraints on SMEs development. The scarcity of management talent has magnified impacts on SMEs. The lack of support services or their relatively higher unit costs can hamper SMEs efforts to improve their management because consulting firms often are ineffective for SMEs (Yagge, 1995)
2.5 Summary and Gaps to Be Filled By the Study

The findings from this literature review suggest that SMEs play an important role in economic development. The review has also revealed that although they are significant in national development, SMEs experience a number of barriers to their growth and development. Limited studies have been done to establish the extent to which borrowed capital is being applied in SMEs considering that there has been marked improvement in the availability of borrowed capital. The review has however revealed that most small and medium scale businesses do not qualify for senior debt. Lenders generally require a history of cash flow generation that will be sufficient to pay the interest on debt and eventually repay the principal. When a business prefers to finance growth with debt rather than with equity, the business must be prepared for high interest rates. Those high interest rates pose more operating risk than equity capital, which does not require regular payouts. Even when interest rates are low, taking on debt increases operating risk because interest must be paid in bad and good times alike. For growth and development of any business there is needed to maximize on both equity and debt financing. Small and medium scale business owners must therefore be careful enough to exploit all sources of financing at their disposal.
CHAPTER THREE

3.0 RESEARCH METHODOLOGY

This chapter expounds on the population of study, sampling procedure, data collection procedure, analysis and presentation.

3.1 Research design

This study was conducted through survey. The study was concerned with establishing the level of use of credit financing in small and medium scale businesses. It was specifically intended to investigate the relationship between borrowed capital and performance in business enterprises. Such issues are best investigated through surveying (Mugenda 1999). The design enabled the researcher to provide quantitative and numerical description of small and medium scale size business organizations in terms of value of borrowed capital and the level of performance. Survey research design generally entails the use of sample population to analyze and discover occurrences of events. It is suitable for extensive research and provides the ability to understand populations from a part of it (Krathwohl, 1988). For the purposes of this study, the survey provided quantitative and numeric descriptions of the sample population.

3.2 Population of Study

The target population comprised the 1,218 small and medium scale business enterprises in Kisumu municipality which had paid up the single business permit for the year 2007 by 26th April, 2007 (GOK, 2007). This population was chosen because it provides a variety of small and medium scale business organizations capturing almost all industries including services.

3.3 Sampling Design

The sample consisted of 36 business organizations selected from Kisumu Municipality. The
36 participants was a fair representative of the SMEs in the municipality. Gay (1981) suggests that for co-relational research, 30 cases or more are required to form a representative sample.

The sample size was arrived at by the following clustering schedule.

**Table 2: Sampling Schedule**

<table>
<thead>
<tr>
<th>NATURE OF SMEs</th>
<th>POPULATION</th>
<th>PERCENTAGE</th>
<th>SAMPLE</th>
</tr>
</thead>
<tbody>
<tr>
<td>Retailing</td>
<td>292</td>
<td>24%</td>
<td>9</td>
</tr>
<tr>
<td>Services</td>
<td>365</td>
<td>30%</td>
<td>11</td>
</tr>
<tr>
<td>Wholesale</td>
<td>97</td>
<td>8%</td>
<td>3</td>
</tr>
<tr>
<td>Catering</td>
<td>134</td>
<td>11%</td>
<td>4</td>
</tr>
<tr>
<td>Carpentry</td>
<td>37</td>
<td>3%</td>
<td>1</td>
</tr>
<tr>
<td>Metalwork</td>
<td>37</td>
<td>3%</td>
<td>1</td>
</tr>
<tr>
<td>Tailoring &amp; Dress-making</td>
<td>73</td>
<td>6%</td>
<td>2</td>
</tr>
<tr>
<td>Hardware</td>
<td>73</td>
<td>6%</td>
<td>2</td>
</tr>
<tr>
<td>Pharmacy</td>
<td>73</td>
<td>6%</td>
<td>2</td>
</tr>
<tr>
<td>Quarry</td>
<td>37</td>
<td>3%</td>
<td>1</td>
</tr>
<tr>
<td><strong>TOTAL</strong></td>
<td><strong>1218</strong></td>
<td><strong>100%</strong></td>
<td><strong>36</strong></td>
</tr>
</tbody>
</table>

*Source: Kisumu Municipal Council*

The study employed cluster sampling and convenience random sampling technique to select the SMEs. Cluster sampling is a technique which groups the population into a number of clusters. Convenience sampling is applied where a group of individuals who are (conveniently) available for the study are selected in the population. The cluster forming the population consisted of Retailing, Services, Wholesale, Catering, Carpentry, Metalwork, Tailoring and Dressmaking, Hardware, Pharmacy and Quarry.

The researcher was convinced that the target population could not readily agree to take part in the study bearing in mind that business people may not be ready to reveal their business
secrets. As such, the target and the accessible populations could not be regarded as homogeneous. The findings and conclusions give an accurate view of the entire population because the cluster sampling ensured that each subgroup was fairly represented.

3.4 Data Collection Procedures /Instruments Used.

The researcher used questionnaires, interviews and document analysis as the main tools for collecting data. The selection of these tools was guided by the time available as well as by the objectives of the study. The overall aim of this study was to establish the extent to which borrowed capital is used to enhance performance in small and medium scale business organizations in Kisumu. The researcher was concerned with the data available in form of final accounts and business records. Such information can be best collected through the use of questionnaires and interview techniques. (Sekara, 2003)

A document analysis technique was used to obtain data on the final accounts showing capital, assets and liabilities of the businesses. The data on the use of borrowed capital was collected from 36 respondents from 1,218 business organizations during the research period using questionnaires, interviews and document analysis. The data was collected by the researcher because of the level of accuracy with which the data had to be collected.

3.5 Data Type and Collection

The study used both primary data and secondary data. The primary data was collected using structured questionnaires. The questionnaire was composed of closed-ended and open-ended self-administered items. The questionnaires were administered to 36 out of the 1,218 SMEs'
owners or managers. Secondary data included published literature on the accessibility of borrowed capital and rate of performance of SMEs in Kenya.

3.6 Data Analysis and Presentation

After the information had been gathered from the field, it was coded then tallied and scored for each item. Simple descriptive statistics and correlation coefficient were used to analyse the data. These were presented in the form of frequencies, percentages, tabulation and graphic illustration of the responses.
4.0 DATA ANALYSIS AND PRESENTATION OF RESULTS

4.1 Introduction to Data Analysis

This chapter presents the results of the analysis of the responses made to the interview schedules administered to the sampled respondents and the questionnaires administered to them. The overall objective of the study was to evaluate the effects of borrowed capital on performance of SMEs in Kenya.

4.2 Quantitative Analysis

The extent to which SMEs access Borrowed Capital

The sources of borrowed capital identified among the respondents include Micro-Finance Institutions, Commercial Banks, Government Institutions, Self Help Groups, Cooperative Societies and Trade Credit. However 63.9 percent of the respondents have never used borrowed capital in their businesses. (Table 4) The most commonly used source of borrowed capital is Commercial Banks at 11.1 percent. And the least used are Government institutions and Cooperative Societies at 2.8 percent each.

Table 3: Sources of Borrowed Capital used in Kisumu Municipality

<table>
<thead>
<tr>
<th>Sources of Borrowed Capital</th>
<th>Count</th>
<th>Percent</th>
</tr>
</thead>
<tbody>
<tr>
<td>None</td>
<td>23</td>
<td>63.9%</td>
</tr>
<tr>
<td>Microfinance Institutions</td>
<td>3</td>
<td>8.3%</td>
</tr>
<tr>
<td>Commercial Bank</td>
<td>4</td>
<td>11.1%</td>
</tr>
<tr>
<td>Government Institutions</td>
<td>1</td>
<td>2.8%</td>
</tr>
<tr>
<td>Self Help Groups</td>
<td>2</td>
<td>5.6%</td>
</tr>
<tr>
<td>Cooperative Society</td>
<td>1</td>
<td>2.8%</td>
</tr>
<tr>
<td>Trade Credit</td>
<td>2</td>
<td>5.6%</td>
</tr>
<tr>
<td>Overall</td>
<td>36</td>
<td>100.0%</td>
</tr>
</tbody>
</table>

Source: Researcher
This information was summarized in Figure 2 below.

Figure 2: **Sources of Borrowed Capital in Kisumu**

Source: Researcher

This means that borrowed capital is accessible to SMEs in Kisumu Municipality. This may be in the form of Micro-finance Institutions, Commercial Banks, Government Institutions, Self Help groups, Cooperative Societies and Trade Credit.

**Willingness to Borrow**

To test the willingness of the respondents to borrow they were asked to indicate whether they would go for borrowed capital if they were given an opportunity to borrow. 69.4 percent of the respondents affirmed that they would go for borrowed capital, 27.8 percent however were
not willing to borrow, while 2.8 percent of the respondents were undecided (figure 3) This shows that majority of SMEs are willing to opt for borrowed capital as a means of enhancing performance. This information was summarized in Figure 3 below.

Figure 3: Willingness to Borrow

Source: Researcher

Relationship between Borrowed Capital and Performance of SMEs

Table 4 represents the responses from 13 of the 36 respondents, who had used borrowed capital in their SMES. Performance is a function of increased profitability, level of cash flow, asset base and rate of stock turnover. A respondent who attributed improved performance to one of the performance indicators had a performance level of 1, A respondent who attributed improved performance to two of the performance indicators had a performance level of 2. A respondent who attributed improved performance to three of the performance indicators had a performance level of 3. A respondent who attributed improved performance to four of the performance indicators had a performance level of 4. A respondent who indicated that there was reduced performance or no significant change resulting from the use of borrowed capital had a performance level of 0. The period of time for which the business has been indebted was considered. Table 5 represents the Pearson Product-Moment correlations. This type of correlation was used because both variables that the researcher studied were measured at
interval scales and were continuous. The correlation coefficient between Initial borrowed capital and Performance is 0.729 at a significance level of 0.01 (Table 5). This shows that there is a stronger positive association between borrowed capital and performance, that is, as borrowed capital increases, performance increases with a 99 percent probability of obtaining similar results through chance. This reveals a very strong positive relationship between borrowed capital and performance of SMEs in Kisumu Municipality.

Table 4: Correlated data from respondents who had used borrowed Capital

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Initial Capital</td>
<td>350000</td>
<td>25000</td>
<td>625000</td>
<td>42500</td>
<td>62500</td>
<td>87500</td>
<td>7500</td>
<td>32500</td>
<td>350000</td>
<td>7500</td>
<td>87500</td>
<td>7500</td>
<td>32500</td>
</tr>
<tr>
<td>Current Capital</td>
<td>350000</td>
<td>10000</td>
<td>625000</td>
<td>150000</td>
<td>350000</td>
<td>150000</td>
<td>87500</td>
<td>875000</td>
<td>100000</td>
<td>875000</td>
<td>625000</td>
<td>87500</td>
<td>87500</td>
</tr>
<tr>
<td>Initial Borrowed Capital</td>
<td>67500</td>
<td>15000</td>
<td>150000</td>
<td>67500</td>
<td>150000</td>
<td>87500</td>
<td>7500</td>
<td>675000</td>
<td>87500</td>
<td>32500</td>
<td>150000</td>
<td>17500</td>
<td>27500</td>
</tr>
<tr>
<td>Debt Period (years)</td>
<td>2</td>
<td>1</td>
<td>3</td>
<td>1</td>
<td>3</td>
<td>2</td>
<td>1</td>
<td>4</td>
<td>2</td>
<td>2</td>
<td>5</td>
<td>1</td>
<td>6</td>
</tr>
<tr>
<td>Performance</td>
<td>3</td>
<td>0</td>
<td>4</td>
<td>3</td>
<td>4</td>
<td>2</td>
<td>4</td>
<td>4</td>
<td>4</td>
<td>3</td>
<td>4</td>
<td>2</td>
<td>4</td>
</tr>
</tbody>
</table>

Source: Researcher

Table 5: Pearson Product Moment Correlations

<table>
<thead>
<tr>
<th></th>
<th>Initial Capital</th>
<th>Current Capital</th>
<th>Initial Borrowed Capital</th>
<th>Debt Period (years)</th>
<th>Performance</th>
</tr>
</thead>
<tbody>
<tr>
<td>Initial Capital Pearson Correlation</td>
<td>1</td>
<td>.584(**)</td>
<td>.098</td>
<td>-0.150</td>
<td>-.228</td>
</tr>
<tr>
<td>Sig. (1-tailed)</td>
<td>.</td>
<td>.000</td>
<td>.285</td>
<td>.092</td>
<td>.091</td>
</tr>
<tr>
<td>N</td>
<td>36</td>
<td>36</td>
<td>36</td>
<td>36</td>
<td>36</td>
</tr>
<tr>
<td>Current Capital Pearson Correlation</td>
<td>.584(**)</td>
<td>1</td>
<td>.389(**)</td>
<td>.262</td>
<td>.144</td>
</tr>
<tr>
<td>Sig. (1-tailed)</td>
<td>.000</td>
<td>.</td>
<td>.010</td>
<td>.020</td>
<td>.201</td>
</tr>
<tr>
<td>N</td>
<td>36</td>
<td>36</td>
<td>36</td>
<td>36</td>
<td>36</td>
</tr>
<tr>
<td>Initial Borrowed Capital Pearson Correlation</td>
<td>.098</td>
<td>.389(**)</td>
<td>1</td>
<td>.758</td>
<td>.729(**)</td>
</tr>
<tr>
<td>Sig. (1-tailed)</td>
<td>.285</td>
<td>.010</td>
<td>.</td>
<td>.298</td>
<td>.000</td>
</tr>
<tr>
<td>N</td>
<td>36</td>
<td>36</td>
<td>36</td>
<td>36</td>
<td>36</td>
</tr>
<tr>
<td>Debt Period (years) Pearson Correlation</td>
<td>-0.150</td>
<td>.262</td>
<td>.758</td>
<td>1</td>
<td>.793</td>
</tr>
<tr>
<td>Sig. (1-tailed)</td>
<td>.092</td>
<td>.020</td>
<td>.298</td>
<td>.</td>
<td>.</td>
</tr>
<tr>
<td>N</td>
<td>36</td>
<td>36</td>
<td>36</td>
<td>36</td>
<td>36</td>
</tr>
<tr>
<td>Performance Pearson Correlation</td>
<td>-.228</td>
<td>.144</td>
<td>.729(**)</td>
<td>.793</td>
<td>1</td>
</tr>
<tr>
<td>Sig. (1-tailed)</td>
<td>.091</td>
<td>.201</td>
<td>.000</td>
<td>.090</td>
<td>.</td>
</tr>
<tr>
<td>N</td>
<td>36</td>
<td>36</td>
<td>36</td>
<td>36</td>
<td>36</td>
</tr>
</tbody>
</table>

** Correlation is significant at the 0.01 level (1-tailed). 
Source: Researcher
Table 6: Reason for Expansion

<table>
<thead>
<tr>
<th></th>
<th>Frequency</th>
<th>Percent</th>
<th>Valid Percent</th>
<th>Cumulative Percent</th>
</tr>
</thead>
<tbody>
<tr>
<td>Non expansion</td>
<td>1</td>
<td>2.8</td>
<td>2.8</td>
<td>2.8</td>
</tr>
<tr>
<td>Ploughed back Profits</td>
<td>16</td>
<td>44.4</td>
<td>44.4</td>
<td>47.2</td>
</tr>
<tr>
<td>Personal Savings</td>
<td>9</td>
<td>25.0</td>
<td>25.0</td>
<td>72.2</td>
</tr>
<tr>
<td>Borrowed Capital</td>
<td>10</td>
<td>27.8</td>
<td>27.8</td>
<td>100.0</td>
</tr>
<tr>
<td>Total</td>
<td>36</td>
<td>100.0</td>
<td>100.0</td>
<td></td>
</tr>
</tbody>
</table>

Source: Researcher

Reason for Expansion of SMEs

Asked to give the major reasons why their businesses had expanded, 27.8 percent of all the respondents gave borrowed capital as a reason for their expansion, 25 percent indicated personal savings as the major reason for expansion while 44.4 percent felt that ploughed back profits was the reason for expansion. 2.8 percent of the respondents had not achieved any expansion in their businesses (figure 5). It should however be noted that all respondents who had never borrowed capital who form 63.9 percent (figure 2) are included in this result.
Figure 4: Reason for Expansion

Source: Researcher

Reason for expansion of SMEs

When only those who had used borrowed capital were considered, 50 percent indicated that borrowed capital is the reason for their expansion, 33.3 percent indicated ploughed back profits and 16.7 percent who indicated that their reason for expansion was savings from other sources of income. This means that borrowed capital is a major reason for expansion of SMEs which apply it in Kisumu Municipality. However the majority of SMEs do not use borrowed capital. From the study, it was established that Most SMEs that have ever used borrowed capital would prefer borrowed capital as the best source of capital for growth (Figure 5).
The Contribution of Borrowed Capital towards Performance of SMEs in Kisumu Municipality

The study revealed that borrowed capital is the major source of improved performance in SMEs as shown in Table 7 below.

Table 7: Benefits Gained from Borrowed Capital

<table>
<thead>
<tr>
<th>Source</th>
<th>Frequency</th>
<th>Percent</th>
<th>Valid Percent</th>
<th>Cumulative Percent</th>
</tr>
</thead>
<tbody>
<tr>
<td>Valid</td>
<td>22</td>
<td>61.1</td>
<td>61.1</td>
<td>61.1</td>
</tr>
<tr>
<td>Improved Performance</td>
<td>14</td>
<td>38.9</td>
<td>38.9</td>
<td>100.0</td>
</tr>
<tr>
<td>Total</td>
<td>36</td>
<td>100.0</td>
<td>100.0</td>
<td></td>
</tr>
</tbody>
</table>

Source: Researcher
All respondents who had used borrowed capital agreed that borrowed capital led to improved performance. It should be noted however that 61.1 percent of the respondents could not respond to this question because they had not used any borrowed capital in their business. (Figure 6)
It was observed that most SMEs are sourcing for more credit as a means of sustaining growth and development of their businesses. This represents 75 percent of those who have ever used borrowed capital in their businesses. This information is illustrated in figure 7.

This means that borrowed capital has a lot of potential for enhancing performance of SMEs in Kisumu Municipality. However many SMEs still shy away from exploiting their potential for growth by application of borrowed capital.

The Barriers to Accessibility of Borrowed Capital by SMEs

The barriers to accessibility to borrowed capital were identified as high rate of interest, collateral security required by lenders, commitment fee, restriction imposed by lenders and ignorance on the existence of sources of borrowed capital. It was determined that the major barrier is the high interest rates imposed by lenders which was a concern to 41.7 percent of the respondents. (Figure 8).
Figure 7: Barriers to Accessibility to Borrowed Capital

- High Interest Rates: 41.7%
- Commitment Fee: 22.2%
- Collateral: 5.6%
- Ignorance: 18.4%
- Restriction Imposed by Lender: 11.1%

Barriers to use of Borrowed Capital

Source: Researcher

4.3 Summary of Data Analysis

The Data Analysis shows that borrowed capital is accessible to SMEs in Kisumu Municipality. This may be in the form of Micro-finance Institutions, Commercial Banks, Government Institutions, Self Help groups, Cooperative Societies and Trade Credit. It has also been shown that majority of SMEs are willing to opt for borrowed capital as a means of enhancing performance. However the study has also revealed that the level of use of borrowed capital is quite low despite all these facts. This is due to the fear of the risks associated with the use of borrowed capital evidenced by the barriers to effective use of borrowed capital.
This implies that there is need to look into means and ways of encouraging SMEs to increase their level of application of borrowed capital.

There is a stronger positive association between borrowed capital and performance, that is, as borrowed capital increases, performance increases with a 99 percent probability of obtaining similar results through chance. This reveals a very strong positive relationship between borrowed capital and performance of SMEs in Kisumu Municipality.

The study has revealed that borrowed capital is the major source of improved performance in SMEs in Kisumu Municipality. The barriers to accessibility to borrowed capital were identified as high rate of interest, collateral security required by lenders, commitment fee, restriction imposed by lenders and ignorance on the existence of sources of borrowed capital. It was determined that the major barrier is the high interest rates imposed by lenders which was a concern to 41.7 percent of the respondents. (Figure 8).
CHAPTER FIVE

5.0 SUMMARY OF MAJOR FINDINGS, CONCLUSIONS AND RECOMMENDATIONS

5.1 Introduction

This chapter discusses the findings from data analysis. Conclusions and recommendations are also presented.

5.2 Summary of major Findings

The study found the extent to which SMEs access borrowed capital in Kisumu Municipality to be low. Only 36.1% of all SMEs in Kisumu Municipality use borrowed capital. This means that despite the availability of a variety of sources of borrowed capital in Kisumu, many SMEs are still not able to access the borrowed capital.

On accessibility to borrowed capital by SMEs in Kisumu Municipality, it was found that despite the fact that there are many sources of borrowed capital, many SMEs opt to use equity capital entirely. This means that the SMEs are not operating optimally and thus have limited potential for growth. According to Chesworth, 1998, SMEs have difficulties in gaining access to appropriate technologies and information on available techniques. This limits innovation and their competitiveness. It was however noted that many SMEs are willing to borrow except for the fact that they are unable to meet the requirements on one hand and are not willing to commit themselves on the other hand.

The research findings established that there is a positive relationship between borrowed capital and performance in SMEs in Kisumu Municipality. The correlation coefficient between borrowed capital and benefits gained from borrowed capital is 0.729 at a significance level of 0.01. This shows that there is a stronger positive association between borrowed
capital and performance, that is, as borrowed capital increases, performance increases with a 99 percent probability of obtaining similar results through chance. However, only 36.1 percent of SMEs in Kisumu Municipality are making use of borrowed capital in their businesses.

On the contribution of borrowed capital towards performance, it was revealed that borrowed capital was viewed by SMEs as the most important source of improved performance. In fact this explains why most SMEs are willing to go for more borrowed capital. Over 50 percent of the respondents who had used borrowed capital attributed their improved performance to application of borrowed capital in their SMEs. It also explains why 75 percent of SMEs are sourcing for more borrowed capital as a means of enhancing growth and development in their businesses.

Despite the fact that borrowed capital leads to improved performance of SMEs in Kenya, most SMEs are not able to apply it in their capital structure. In a study by Aryeetey et al (1994), 18% of the sampled SMEs mentioned old equipment as one of the four most significant constraints to expansion. Most SMEs in Kisumu Municipality still use old equipment because of lack of use of borrowed capital which could bring about efficiency. There are still quite a number of barriers to accessibility to borrowed capital. These were identified by the study as high rate of interest, collateral security required by lenders, commitment fee, restriction imposed by lenders and ignorance on the existence of sources of borrowed capital.
5.3 Answers to Research Questions

1. Despite the fact that Credit financing is available in Kisumu Municipality, the level of accessibility to borrowed capital is quite low. Only 36.1 percent of SMEs in Kisumu apply borrowed capital in their businesses. (Table 3)

2. There is a very strong positive relationship between borrowed capital and performance of SMEs in Kisumu Municipality. The correlation coefficient between borrowed capital and benefits gained from borrowed capital is 0.729 at a significance level of 0.01 (Table 5). This shows that there is a stronger positive association between borrowed capital and performance, that is, as borrowed capital increases, performance increases with a 99 percent probability of obtaining similar results through chance.

3. Borrowed capital is the major source of improved performance in SMEs in Kisumu Municipality. 75 percent of those who have ever used borrowed capital in their businesses attributed their improved performance entirely to borrowed capital. (Figure 7)

4. The barriers to accessibility to borrowed capital were identified as high rate of interest, collateral security required by lenders, commitment fee, restriction imposed by lenders and ignorance on the existence of sources of borrowed capital. It was determined that the major barrier is the high interest rates imposed by lenders which was a concern to 41.7 percent of the respondents. (Figure 8).

5.4 Conclusion

Lack of business and entrepreneurial know-how places significant constraints on SMEs development. The scarcity of management talent has magnified impacts on SMEs. The lack of support services or their relatively higher unit costs can hamper SMEs efforts to improve their management because consulting firms often are not equipped with appropriate cost effective
management solutions for SMEs (Yagge, 1995). This has evidently brought a lot of strain in the growth and development of SMEs in Kenya despite the fact that most SMEs are willing to apply borrowed capital. Most SMEs shy away from borrowed capital because of the barriers.

A lot of efforts have been made both by the government and non governmental organizations to avail finance to SMEs. As much as these finances are available this study has revealed that most SMEs are still not able to benefit from them. Thus SMEs in Kisumu are still not able to meet their full potential because they are not able to operate optimally by application of optimal levels of debt financing.

5.5 Recommendations

From this study it is my recommendation that there is need to not only avail credit financing but also to enable the SMEs to access this credit more easily. One of the main barriers to accessibility of finance from commercial banks is the lack of proper accounting records for credit rating. The Kenya Institute of Bankers (KIB) and Metropol East Africa Limited has developed a new credit rating system to enable quick access to loans by SMEs. Banks have shied away from lending to SMEs because of high transaction costs and inadequate data. The mechanism has 82% credit rating efficiency and will help the banks to cut costs on technology. However the Banking Act that prohibits revealing of customers information to other parties might need to be reviewed. Banks can incorporate the model in their systems, or the small enterprises can be rated to enable them access credit from suppliers. With the returns on Government securities shrinking, banks held huge deposits that could be loaned to SMEs through use of appropriate risk evaluation mechanism. SMEs contribute 30% to Kenya’s GDP. (Anjichi, Executive Director KIB, DN Friday, August 10, 2007)
5.6 Suggestion for Further Study

In a number of studies researchers have underscored the importance of SMEs in poverty eradication, creation of employment, individual growth, actualization and national economic development. A number of government documents also reiterate the significant place of SMEs in National Development (GOK, 2003). This study has revealed data on the profiles and constraints on the extent to which SMEs have used borrowed capital to spur their growth and development. Further studies need to be carried out to establish the business entrepreneurial know-how among the owners and managers of SMEs in Kenya. It should also be noted that more research needs to be done to establish an appropriate credit rating system that can enable SMEs to access more credit easily. More studies are also needed to establish the need to sensitize entrepreneurs to be more positive on application of borrowed capital and to overcome the fear of expansion into large scale enterprises.
REFERENCES


IFC (2005), World Development Indicators database, April 2005: Kenya Development data profile


Levy B (1993), Obstacles to Developing Indigenous Small and Medium Enterprises, an Empirical Assessment, the World Bank Economic Review,


McCormick D (2001), Gender in Small Enterprise Development in Kenya, Nairobi


APPENDIX I

THE QUESTIONNAIRE

Do not indicate your name or any other form of identity in this questionnaire.

1. What is the nature of your business? Tick (√) where applicable

   i. Manufacturing  
   ii. Mining and Quarrying
   iii. Retailing
   iv. Services
   v. Wholesale trade
   vi. Catering
   vii. Carpentry
   viii. Metal work
   ix. Dressmaking and Tailoring

2. When did you start this business? State the year in this box

3. What amount of capital did you use to start your business? (Kenya Shillings)

   0-5000  
   5001-10000  
   10001-15000  
   15001-20000  
   20001-25000  
   25001-30000  
   30001-35000  
   35001-50000  
   50001-75000  
   75001-100000  
   100001-200000  
   Over 1m

4. What amount of capital do you have in your business now?

   0-5000  
   5001-10000  
   10001-15000  
   15001-20000  
   20001-25000  
   25001-30000  
   30001-35000  
   35001-50000  
   50001-75000  
   75001-100000  
   100001-200000  
   Over 1m
5. Have you used any borrowed capital in the last five years? Yes □ No □

If yes, what total amount have you borrowed in the last five years?

0-5000 □ 5001-10000 □ 10001-15000 □ 15001-20000 □ 20001-25000 □ 25001-30000 □ 30001-35000 □ 35001-50000 □ 50001-75000 □

Over 1m □

...(If No Move to Question 11)

6. How long have you used borrowed capital in your business. ____________

7. What is your source(s) of borrowed capital? (Tick (✓) as many as are applicable.)

i Microfinance Institution, please specify.........................(ie Faulu Kenya etc) □

ii A Commercial Bank □

iii Government institutions e.g. KIE, ICDC, IDB □

iv Nongovernmental organizations □

v Self help groups □

vi Family and friends □

vii Hire purchase firms □

viii Cooperative society □

ix Trade credit □
8. Who introduced you to the source of borrowed capital? (Tick (✓) where applicable)
   i. Advertisement (specify)
   ii. Friends and relatives
   iii. Personal enquiries
   iv. Public education
   v. Others (Specify)

9. What discourages you from frequent use of borrowed capital? (Tick (✓) where applicable)
   i. High interest rates
   ii. Collateral (security required for borrowed capital)
   iii. Insurance cost of borrowed capital
   iv. Commitment fee requirement
   v. Covenant (A restriction on borrower imposed by lender)
   vi. Others (Specify)

10. In your opinion what has contributed to Performance in your Business?
    i. Ploughed back profits
    ii. Personal savings
    iii. Borrowed capital
11. How has your business performed since you started using borrowed capital in terms of

a) Profitability?
   i. Increased Profitability
   ii. Reduced Profitability
   iii. No significant change

b) Asset base;
   i. Increased Asset base
   ii. Reduced Asset base
   iii. No significant change

c) Rate of stock Turnover;
   i. Increased Rate of stock Turnover
   ii. Reduced Rate of stock Turnover
   iii. No significant change

d) Level of cash flow
   i. Increased Cash Flow
   ii. Reduced Cash Flow
iii. No significant change

12. Given a second chance, would you go for more borrowed capital?
   i. Yes  
   ii. No  
   iii. Indifferent (Undecided)

13. Indicate in what benefits you have gained by use of borrowed capital in your business. ...(Tick (√) as many as are applicable)
   i. Acquisition Of Assets  
   ii. Increased Cash Flow.  
   iii. Economies of scale (Gains from large scale operations)  
   iv. Diversification of Business activities.  
   v. Improved quality of goods and services.  
   vi. Rate of Return on Capital (Increased profitability)  
   vii. None of the above

   (Tick (√) as many as are applicable)
   i. Decrease in Assets  
   ii. Debt Burden  
   iii. Decreased Cash Flows  
   iv. Diseconomies of scale  
   v. Reduced quality of goods and services

Others.(specify)........................................................................................................
15. What has helped you more in expanding your business activities?
   i  Ploughed back profits   1
   ii Personal savings        2
   iii Borrowed capital       3
   iv Others.(specify)        4

16. In your opinion what should creditors (lenders) do to help you make more use of
    borrowed capital?
   i  Reduce the rate of interest.   1
   ii Avail more Credit.             2
   iii Make it easy to access larger Credit. 3
   iv All of the above              4
   v Others( please specify)       5

17. What measures are you putting in place to ensure that your business grows? (Tick (✓) as many as are applicable)
   i  Looking for a business partner. 1
   ii Sourcing for more credit.        2
   iii Selling personal property.      3
   iv Sourcing for a venture capitalist. 4
   v Others( please specify)          5
# APPENDIX II

## WORK PLAN

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<tr>
<th>YEAR</th>
<th>MONTH</th>
<th>ACTIVITY</th>
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<tbody>
<tr>
<td>2006</td>
<td>November – December</td>
<td>Initial Draft Proposal</td>
</tr>
<tr>
<td>2007</td>
<td>January – February</td>
<td>2nd Draft Proposal</td>
</tr>
<tr>
<td>2007</td>
<td>March – April</td>
<td>Final Draft Proposal</td>
</tr>
<tr>
<td>2007</td>
<td>May</td>
<td>Pre-testing instruments</td>
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<tr>
<td></td>
<td></td>
<td>Correction of Instruments</td>
</tr>
<tr>
<td>2007</td>
<td>June</td>
<td>Data Collection</td>
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<tr>
<td>2007</td>
<td>July</td>
<td>Data Analysis</td>
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<tr>
<td>2007</td>
<td>August</td>
<td>Report Writing</td>
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<tr>
<td>2007</td>
<td>September</td>
<td>Submission of final report</td>
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# APPENDIX III

## RESEARCH BUDGET

<table>
<thead>
<tr>
<th>ITEM/ACTIVITY</th>
<th>COST (KES)</th>
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</thead>
<tbody>
<tr>
<td>Transport (Reconnaissance and Actual Fieldwork)</td>
<td>58,000</td>
</tr>
<tr>
<td>Subsistence and Accommodation Allowance</td>
<td>60,000</td>
</tr>
<tr>
<td>Equipment and Stationery</td>
<td>45,000</td>
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<tr>
<td>Printing, Photocopying and Binding</td>
<td>30,000</td>
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<tr>
<td>Miscellaneous</td>
<td>19,300</td>
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<tr>
<td><strong>TOTAL</strong></td>
<td><strong>212,300</strong></td>
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