FINANCIAL CONSTRAINTS OF SMALL AND MEDIUM ENTERPRISES: A CASE STUDY OF KISUMU COUNTY, KENYA

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Abstract

The objective of this paper is to analyse and present the financial constraints faced by the small and medium enterprises in Kisumu County. According to national baseline survey (1999), 36.2 % of the Small and Medium sized Enterprises (SMEs) in Kenya, reported that their business closed down due to shortage of working capital. Despite the fact that the SMEs had operated for some years, about 94.2% of the respondents still found it difficult to obtain bank funds to finance business development. The survey also showed that only 5.8 % of the Small and Medium sized Enterprises interviewed in 1999 applied for loans. The survey therefore suggested the existence of a gap between the demand for bank credit by SMEs and the supply of funds by banks. This gap poses a question mark and triggers the need to conduct a study on the financial constraints of small and medium enterprises in Kisumu County. The factors identified to affect the supply side were creditworthiness of the borrower, collateral requirement by the banks, Risk default and business plan. Amongst Kenyan banks, the lack of acceptance collateral or security as a guarantee towards repayment of loans was the biggest SME-specific hindrance and obstacle to SME lending, cited by 100 percent of the banks. It was followed by risk default, creditworthiness of the borrowers, a suitable business plan and finally quality of management.

Keywords- Small and Medium sized Enterprises**,** finance, financial constraints.

JEL Codes: G21; G28; G29; O12; O16; L25

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1. Introduction

In Kenya access to credit by the SMEs is still one of the major constraints, despite the emphasis which is made to increase the availability of the credits to the SMEs. A survey which was conducted in 1995 on small firms, found that up to 32.7% of the entrepreneurs mentioned that they lack capital, which is the main problem, while only 10% of the entrepreneurs had ever received loans. The main credit source in Kenya is the informal credit market, which provides easier access to credit for SMEs, rather than in the formal credit market which have the lending terms and conditions, such as collateral, application procedures as well as the repayments periods. Therefore due to these factors, most of the SMEs obtain their initial capital for starting their business as well as their operating capital from the informal sources. As a result, most of the SMEs accumulate their personal savings and use them both as initial and operating capital. For the initial capital, this was obtained through the loans form the parents, close relatives and the sale of properties, while for the operating income; the funds were obtained through the sale of properties and the supplier's credits. (Atieno, 2001). The objective of this study is to determine the financial constraints of small and medium enterprises in Kisumu County.

1.0 Theoretical Framework

1.1 Financing Constraints of SMEs

Financial constraints are imperfections that prevent SMEs from funding all desired investments. These imperfections can be a result of both exogenous and endogenous factors to the firm. A financially constrained firm can be thought of as a firm whose investment spending is limited to its ability to generate internal financing.

Credit constraints have been defined by the OECD (2006) as occurring when SMEs cannot obtain financing from banks, capital markets or other suppliers of finance even when they have the capability to use those funds productively.

Storey, (1994) Suggest that bank financing will depend upon whether the lending can be secured by collateral.

Berger and Udell (1995) found that small and young firms – with generally shorter banking relationships – pay higher interest rates and are more likely to be required to pledge collateral.

Cressy and Olofsson (1997) sum up constraints facing SMEs into two; these include demand-based (SMEs) and supply-based (formal banks) financial constraints. The duo define a supply-side finance constraint as a capital market imperfection that leads to a socially incorrect supply of funds to projects, or the incorrect interest rate charged on funds. They further define a demand-side financial constraint as a capital market imperfection in which performance of a firm is adversely affected by a factor internal to the firm.

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UNCTAD (2002), posit that Small business especially in Africa can rarely meet the conditions set by financial institutions, which see SMEs as a risk because of poor guarantees and lack of information about their ability to repay loans.

Atanasova and Wilson (2004) suggest that firm's total assets, taken as a proxy of available collateral, is an important determinant of bank loan availability.

Y.W. Chin Penang (2004) suggests that many micro firms lack collateral and insufficient documents to support their loan application. Banks require collateral as a safe guard for their loan

Falkena et al., (2004). Suggests that the costs involved in the credit assessment and monitoring of a loan or investment make it disproportionately more expensive to provide funds to an SME. He found that a new entrant into the lending market for SMEs may face substantial problems in accessing information about the credit standing and risk characteristics of the SME borrower.

Kauffmann (2005), posit that access to formal finance is poor because of the high risk of default among SMEs and due to inadequate financial facilities.

Kumar and Francisco (2005), stated that collateral has been proxied by land, machinery or personal assets. Hence a positive association between collaterilizable assets and having access to credit.

Bougheas et al. (2006), using UK manufacturing firms from 1989 to 1999, found that several firm-specific characteristics such as size, collateral, riskiness, age and profitability were important determinants of access to credit.

OECD (2006), posit that the greater difficulty of smaller firms in accessing credit relative to larger firms revolves around differences in risk profile and information asymmetries between the firm and lending institution. It is difficult for SMEs to convince banks of the quality of their business plans and, for newer firms in particular, it can take a considerable amount of effort to build a reputation that signals that they are low risk. From the bank's point of view, the costs involved in assessing and monitoring SMEs act as a disincentive to funding this market.

OECD (2006), posit that banks may, in some circumstances, prefer to ration credit rather than use interest rate changes to compensate for risk if there are concerns that this might result in adverse selection and hence a riskier loan portfolio .

Chimucheka and Rungani (2011) found that South African SME applications for finance from banks were unsuccessful because they lacked of collateral (37%), the lack of a financial deposit (17%), poor business plans (7%) and non-viable business ideas. They also found that 28% of South African SMEs surveyed had never applied for financing from a bank. The main reasons given were not knowing the procedures for applying for a loan (53%), not knowing about the sources of finance available from the banks (23%), the high interest rates (7%). Seventeen percent indicated that they had enough capital to start and run their own businesses.

1.2 Research questions

The study tends to answer the following questions:

1. Which are the sources of funds for the SMES?
2. What are the financing constraints of assessing bank credit?

1.3 Objectives of the study

The general objective of study is to provide the financial constraints of small and medium enterprises in Kisumu County.

The specific objectives of the study were;

1. To determine the sources of funds for the SMES
2. To determine the financing constraints of assessing bank credit.

2. Methodology

The population of the study constitutes all small and medium enterprises in different sectors and commercial banks.

2.1 Sampling Frame

Simple random sampling technique was used to select 455 Small and Medium Enterprises operators from 1515 licensed in Kisumu Kenya and 8 commercial banks in Kisumu Kenya. The concept of simple random procedure allows unbiased sampling and accords the research work more scientific feature, thereby concretizing the validity of the research findings.

2.2 Data Collection

2.2.1 Sources of data

The study utilized primary sources of data in which structured questionnaire were extensively used to make it easy for the respondents to indicate their views. The purpose is to generate data about the opinion and perceptions of SMEs owners in relation to the effectiveness of bank credit to the performance of their firms. Thus, in addition provides means of analyzing the likely impact of bank credit on SMEs.

2.2.2 Data Collection Procedure

The study collected primary data by use of l questionnaire administered on key informants from the 455 Small and Medium Enterprises operators from 1515 licensed in Kisumu Kenya and 8 commercial banks in Kisumu Kenya.

2.5.3 Instrument for data collection

The research made use of the questionnaires to collect the necessary information from the small and medium enterprises in Kisumu county Kenya. The items in the questionnaires addressed the specific objectives and research questions.

2.6 Data Analysis

In order to effectively conduct a valid analysis, the researcher used descriptive statistics which involved simple percentage, mean and standard deviation. The data on the financing constraints of assessing bank credit constraints of small and medium enterprises was tallied to establish frequencies which were converted to percentages and used to calculate the mean and standard deviation to illustrate relative levels of opinion. The use of five-point Likert scale questions enabled respondents to indicate their opinion on various financial constraints faced by small and medium-sized enterprises.

3.0 Results and Discussion

3.1 Sources of financing for SMEs

The main source of finance in Kenya is the informal credit market, which provides easier access to credit for SMEs. Most of the SMEs obtain their initial capital for starting their business as well as their operating capital from the informal sources such as accumulating their personal savings. On financing business expansion, 87% of the respondents used retained earnings, 36% used personal savings into the business. 83% used trade credit while, only 57% of the respondents financed their business by bank loan. This is because of the high perceived rejection rates, too complicated application procedures, less ability to access loans not knowing about the sources of finance available from the banks and the high interest rates.

Table 1: Sources of financing for SMEs

source	Frequency (455)	Percentage %
Retained earnings	396	87
Bank	259	57
Personal savings	164	36
Trade credit	378	83
From friends	182	40
Other financial institutions	18	4

Source: survey data (2008)

Notes:

1. Figure in parenthesis is the total number of responding SMEs.
2. The SMEs may rely on more than one source of funds.

3.2 SMEs' financing constraints – Demand side factors

SMEs encounter great difficulties while raising fixed and working capital because of the reluctance of banks to SME'S. The perception of the respondent about the financing constraints was measured on a 5-point likert scale ranging from one to five. The response were recorded on a five-point likert scale ranging from 1=totally unimportant to 5=very important. For N< 455, means that some respondents did not offer any opinion regarding the importance of a give financing constraint. These are constraints that come from the own limitations of the firms, such as the project proposal, collateral requirements, bank charges, and savings

3.2.1 Project proposal

For the SMEs to qualify for a business loan, financial institutions require detailed information about the business including revenue, profit and expenses. Most of the SMEs that they lack the ability to formulate a proper project proposal. The study showed that requirement of project proposal is not considered by many respondents as a major obstacle to their loan demand (Mean=2.945 and S.D=1.103) as shown in table 2 below

3.2.2 Collateral requirements

Securing borrowers' property rights to assets they can pledge as collateral particularly help small and medium firms to access finance and obtain cheaper and longer-term loans. The use of appropriate collateral is the most common mechanism which is used by the financial institutions so as to reduce the informational problems in financing the SMEs. Lending to SMEs is backed by collateral so as to reduce moral hazard and adverse selection. Collateral requirements for SME loans are higher than for consumer loans, because SMEs' credit risk is usually more difficult to evaluate. The study showed that requirement of collateral is generally more stringent and therefore discourages them from borrowing (mean=3.800 and S.D=1.101) as shown in table 2 below. This is confirms the work by Beck et al. (2004) who found that better protection of property rights increases external financing of small firms significantly more than it does for large firms, particularly due to the differential impact it has on bank and supplier finance.

3.2.3 Bank charges

When banks lend to SMEs, they tend to charge them a commission for assuming risk and apply tougher screening measures which drive up cost on all sides. The study revealed that financial institutions charge higher interest rates to SMEs than to larger companies in order to compensate for the higher costs of information collection, the smaller volume of external financing and the greater risk of failure. Younger firms are more likely to pay higher interest rates to reflect their comparatively higher risk profile. The study also revealed that the high bank charges and fees discouraged the SMEs from borrowing. (Mean=2.806 and S.D=1.153). Table 2 below how the SMEs ranked the constraint**.**

3.2.4 Savings

Saving is important for households to weather difficult times, like drought, damage and fire and to plan for the future. The commercial banks are gradually moving away from the highly risky mass markets to individual account holders, whose balance could act as collateral in the event the borrower loses his or her job. Amount of savings usually determines how much is advanced as bank loan. The higher the saving, the higher the ability of the customer to repay loan for a bigger bank loan. Most of the respondent reported that they did not secure bank credit because their savings were low and therefore did not have the ability to repay loans (Mean=4.189 and S.D=1.168). See table 2 below.

Table 2: **financing constraints to SMEs: Demand side factors.**

FACTOR	RANGE	MIN	MAX	MEAN	S.D
Project proposal	4.00	1.00	5.00	2.945	1.103
Collateral requirement	4.00	1.00	5.00	3.800	1.101
Bank charges	4.00	1.00	5.00	2.800	1.153
Savings	4.00	1.00	5.00	4.189	1.168

Source: survey data (2008)

3.3 SMEs' financing constraints – Supply side factors

Commercial banks consider a number of factors before advancing bank loan to SMEs. The perceptions of the banks about the importance of the factors were measured on a five-point likert scale ranging. The responses were recorded on a five-point likert scale ranging from1-totally unimportant to 5-very important. For N< 8, it means that some respondents did not offer any opinion regarding the importance of a given financing constraints.

3.3.1 Creditworthiness of the borrower

All the commercial banks interviewed reported that they cannot obtain enough information about the investment opportunities and the behavior of the SMEs, making them reluctant to extend financing. This happens when there is no credit history of the potential borrower, when the cash flow calculations cannot be trusted due to weak accounting standards or when the lender simply does not have the sophistication to assess the quality of investment. All the commercial banks reported that before advancing loans to SMEs they requested them to provide more information about their credit status. Mean= 4.625 and S.D= 0.484). Table 3 below

3.3.2 Collateral requirement

Due to high risk of default among small and medium enterprises the commercial banks interviewed reported that they require the borrower to raise acceptable collateral or security as a guarantee towards repayment of loans. Secured loans are granted by commercial banks to businesses which are able to put collateral in form of property, personal investment or other tangible holding to back the loan. All the commercial banks interviewed reported that they required the borrower to raise acceptance collateral or security as a guarantee towards repayment of loans. A hundred percent of the banks in the sample demand collateral from their SME borrowers. Collateral requirements for SME loans are higher than for consumer loans, because

SMEs' credit risk is usually more difficult to evaluate according to 63 percent of the banks. (Mean= 4.750 and S.D= 1.323) Table 3 below.

3.3.3 Risk default

It refers to the failure of the borrowers to repay the loans advanced to them by commercial banks. Commercial banks regard the SMEs as high risk borrowers due to perception of a high risk of business failure, their insufficient assets and low capitalizations and vulnerability to market fluctuations. Majority of commercial banks denied SMEs credits because of a higher defaulting rate. The banks therefore consider risk default as a major determinant. (Mean= 4.750 and S.D= 1.323) Table 3 below.

3.3.4 Business plan

Banks interviewed reported that they are much more likely to approve a loan when they can see a clear and defined plan for how a business intends to make profit. If an entrepreneur develops a comprehensive business plan at an early stage in the project, the risk perception is reduced and their likelihood of obtaining capital is increased. Plan which is not well thought out will likely be rejected. At least 85% of the bank interviewed considered the factor as major determinant. (Mean= 4.125 and S.D= 0.927) Table 3 below.

3.3.5 Quality of management

Quality of management determines the success or failure of any business. Better management enables businesses to command respect and trust from commercial banks because of their better chances of success and higher profitability for the banks. Studies by Shane and Stuart (2002) and Rudez and Mihalic (2007) positively associate managerial competencies with new venture performance. The higher the level of managerial competency exhibited by the owners of a new firm, the greater the viability and survival of the new SME, the more successful they are in accessing credit. Commercial banks interviewed reported that they considered the quality of management of the SMEs before advancing bank loan. This is because SMEs without quality management do not command their respect and trust as they are perceived to have limited chances of success. (Mean= 2.875 and S.D= 1.691) Table 3 below.

Table 3: **financing constraints to SMEs: Supply side factors**.

FACTOR	RANGE	MIN	MAX	MEAN	S.D

Creditworthiness	1.00	4.00	5.00	4.625	0.484
Collateral requirement	1.00	4.00	5.00	4.750	1.323
Risk default	1.00	4.00	5.00	4.750	1.323
Business plan	3.00	2.00	5.00	4.125	0.927
Quality of management	4.00	1.00	5.00	2.875	1.691

Source: survey data (2008)

4. Conclusions

The first objective of the study was to determine the sources of finance available to the SMEs. The main source of finance in Kenya is the informal credit market, which provides easier access to credit for SMEs. Most of the SMEs obtain their initial capital for starting their business as well as their operating capital from the informal sources. Some of the SMEs accumulate their personal savings and use them both as initial and operating capital. On financing business expansion, 87% of the respondents used retained earnings, 36% used personal savings into the business. 83% of the SMEs surveyed financed their operations through trade credit while, 57% of the respondents financed their business by bank loan.

The second objective of the study was to determine financing constraints of accessing bank credit by SMEs in Kisumu Kenya. The factors identified to affect the demand side were Project proposal, Collateral requirement, Bank charges and Savings. According to the statistics on financing constraints to SMEs in table 9, it is observed that SMEs face various problems in obtaining finances they required. The main hindrance and obstacle to SME lending, cited by 455 SMEs being poor savings (mean = 4.189 and SD = 1.168) and lack of acceptable collateral (mean = 3.800 and SD = 1.101) followed by bank charges (mean = 2.806 and SD = 1.153) and project preparation and evaluation (mean = 2.945 and SD = 1.103). The results are in agreement with the earlier findings of Kauffmann (2005), Hatega (2007) and World Bank and ADB (2004)

The factors identified to affect the supply side were Creditworthiness of the borrower, Collateral requirement by the banks, Risk default and Business plan. Amongst Kenyan banks, the lack of acceptance collateral or security as a guarantee towards repayment of loans was the biggest SME-specific hindrance and obstacle to SME lending, cited by 100 percent of the banks. It was followed by risk default, creditworthiness of the borrowers, a suitable business plan and finally quality of management

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