Effect of Entrepreneurial Finance on the Growth of Small and Medium Enterprises in Kenya

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ABSTRACT

SMEs account for over 95 % of the business population, and are therefore an increasingly dominant form of business organisation in all countries. Access to finance is a key determinant for business start-up, development and growth for Small and Medium-Enterprises. The objective of this paper was to assess the effect of access to entrepreneurial finance on the growth of Small and Medium Enterprises in Kenya. A sample of 142 SMEs was used for the study to represent the entire population. Out of the 142, there were 132 respondents which is 92.96%. Primary data was collected using interview guides, structured and Semi structured questionnaires which were administered to the owners and managers of SMEs. Data was analyzed using Statistical Package for Social Sciences (SPSS) version 20. The study found out that access to entrepreneurial finance has a positive influence on the growth of SMEs. The study recommends that the government should support the legal and regulatory framework that strengthens the financial infrastructure at the same time build capacity of the financial institutions to enhance SMEs access to finances.

Key words: Entrepreneurship, Growth, Profitability, Missing middle, entrepreneurial finance, access to finance, Medium enterprises, Small enterprises

Introduction

Small and medium sized enterprises are considered the backbone of the economy of many countries. Many SMEs are playing a leading role in national industries (Lee, 2007). It is estimated that SMEs make up more than 90% of all business establishments worldwide (Lin, 1998). According to the Economic survey (2006), the sector contributed over 50 percent of new jobs created in 2005. For Organization for Economic Co-operation and Development (OECD) members, the percentage of SMEs out of the total number of firms is greater than 97 per cent. In the U.S., SMEs provide approximately 75 per cent of the net jobs added to the economy and employ around 50 per cent of the private workforce, representing 99.7 per cent of all employers (OECD, 2002). Small and Medium Enterprises (SMEs) make a significant contribution in the global economy, with respect to enterprise development and new job creation. There also is an increasingly important role for SMEs to contribute to economic growth and technological development specifically in those developing countries where liberalization and globalization of the economy is taking place (Christopher & Erik, 2003). Small and Medium Enterprises play a pivotal role in sustaining employment and creating income and prosperity (Lange *et al.*, 2000). According to Kenya Economic Survey (RoK, 2008), out of the total 543.3 new jobs created in Kenya in the year 2009, Micro, Small and Medium Enterprises (MSMEs) created 426.9 of them. This was 89.9% of the total new jobs created in Kenya that year. In the same year, the sector contributed kshs. 806,170 million of GDP which is 59 percent of the total Gross Domestic Product (RoK, 2009). The Kenya economic survey notes that this same sector generated 390.4 thousand new jobs which translated into 87.6 percent of the total jobs generated in 2009. However, there are challenges that they face in the process of growth. It is generally recognized that Small and Medium Enterprises SMEs face unique challenges, which affect their growth and profitability and hence, diminish their ability to contribute effectively to sustainable development. Despite the big role SMEs play in the economy past statistics indicate that three out of five businesses fail within the first few months of operation (Kenya National Bureau of Statistics, 2007). Causes to the failure include limited market access, limited access

to information, finances and technology and unfavorable policy and regulatory environment among others (ROK, 2005). Governments around the world are placing increasing importance upon the success of small business entrepreneurs and providing increased resources to support this emphasis (Burgess, 2001).

Growth is regarded as the second most important goal of a firm, the most important one being firm survival. Aversion to growth has been said to be the principal reason why most SMEs stagnate and decline (Clark *et al.,* 2001). Many other studies have been done (Umar 2008; Okpara and Wynn, 2007; Tushabomwe-Kazooba, 2006; Harris and Gibson, 2006; Eeden *et al.,* 2004; Goedhuys and Sleuwaegen, 2000; Mambula, 2002) regarding factors affecting the growth of SMEs.

1.1 Statement of the Problem

The failure of Small Medium and Micro Enterprises is estimated to be between 70% and 80% (Brink, Cant and Lighthelm, 2003). More than half of new businesses will disappear in the first five years due to poor practices, poor management and shortage of funds (Moya, 2009). Although the small business sector in Kenya has been growing rapidly over the past few decades, it is widely commented on that individual enterprises have not experienced such growth (Esuha & Fletcher, 2002). This underdevelopment has often been attributed to small-scale enterprises' inability to grow and graduate to medium –size enterprises and strong barriers to direct entry into the medium-scale private formal sector (the middle) – referred to as the 'missing middle' commonly the medium enterprises. While statistics show that there are high business birth rates, the death or stagnation of these businesses is equally high ((Rigito, 2010). While the informal sector constitute to over 80% of total employment in Kenya, it only contributes to 18.4% of the GDP (RoK, 2011). The SME sector is widely regarded as the driving force in economic growth and job creation in both developed and developing countries (Sunter, 2000). At the same time, millions of SMEs go bankrupt every year. This has in turn led to the stagnation in growth of the SMEs and therefore most of them not evolving to medium enterprises which is very key towards the industrialization process at the same time highly significant actors in the development of national economies (Arzu and Emine *et. al.*, 2008). While MSEs generate employment and wealth, the majority are unable to grow vertically, thus resulting in the gap between MSEs and the large enterprises, i.e. the missing middle (Moturi, 2006).

The limited access to entrepreneurial finance is a factor inhibiting entrepreneurship and influencing growth negatively, as it impedes the progress that comes from timeous application of resources (Nasser *et al.,* 2003; Preforious and Shaw, 2004; Rwigema & and Venter, 2004; Davila, Foster and Gupta, 2003).

1.2 Objective of the Study

The objective of the study was to assess the effect of access entrepreneurial finance on the growth of Small and Medium Enterprises in Kenya.

2.1 Theoretical review

According to (Saunders, Lewis and Thornhill, 2000) the literature review forms the framework for research, as it helps to develop a good understanding and provide insight into relevant previous research and emerging trends. The theories supporting this study are discussed below.

2.1.1 The Life Cycle Theory

The life cycle theory has been found meaningful by SME owner managers (Massey *et al.,* 2006). Empirical evidence of several authors (McMahon, 2001) approves of the existence of life cycle stages that represent the growth of SMEs. SMEs tend to grow in organic way while large corporations through acquisition (Davidsson, Delmar and Wilund, 2006). The theory applied in this study is stochastic in nature which means that firm growth is affected by many factors and there is no dominant theory to describe growth.

2.1.2 Resource Based Firm Theory

According to the Resource based firm theory definition of (Goshal et, al., 2002), the firm comprises of differentiated technological skills, complementary assets and organizational routines and capacities. Financial resources such as credit are one of the resources that influence the growth of a firm (Hartarska & Gonalez-Vega 2006). According to the theory, availability of resources like access to entrepreneurial finance leads to sustained competitive advantage which in turn leads to growth of Small enterprises.

2.2 Empirical Review

In Kenya various studies have been carried out on growth of SMEs. (Namusonge, 1998) studied Determinants of growth oriented SMEs in Nairobi. The key determinants in the study were managerial experience, education and training and the psychology of the entrepreneur. He concluded that availability and type of finance are key determinants of the growth performance of SMEs. Entrepreneurs' attributes also have influence on growth performance. In the study the specific measures of growth are not highlighted. In his study, the role of quality on

growth of SMEs in Kenya (Wanjau, 2010) established that adoption of quality influences the growth of SMEs. In his study, (Mungah, 2010) Determinants of growth of manufacturing SMEs in Kenya established that interest rate, fuel cost, business skills and political instability were major factors found to influence SMEs growth into large business enterprises.

The subject achieves acknowledged relevance, especially because of the fact that restrictions on credit to small business are a global phenomenon (Baas and Schrooten, 2006). Small firms are more informational opaque and, therefore, have less access to external funding than larger firms; financiers are unable to solve problems of asymmetric information and to adequately fund small business expansion (Hartarska and Gonzalez-Vega, 2006).The availability of appropriate economic resources is important for business development (Tustin, 2003; Goodal, 2000; Zinkota and Ronainen, 2003). This enables SMEs to secure the necessary expertise and raw materials to put entrepreneurial ideas into practice, to be competitive, to survive during unfavourable conditions and to grow (Robertson et al., 2003; Wickham, 2001). The results obtained by (Cooley and Quadrini, 2001), and (Cabral and Mata, 2003), show that the growth of new small companies is hindered by restrictions concerning finance and by the shortage of resources of diverse nature. The strategies of SMEs for finance are fundamental in explaining their growth, and this can be seriously hindered when companies are subject to considerable financial restrictions (Reid, 2003). (Drever, 2006) argued that financial problems (lack of funds) constrained the development and growth of small enterprises, as many of them are unable to access the same kinds of growth funding often available to large enterprises (Watson, 2006).

Empirical evidence reveals the importance of internal finance for SME growth, pointing towards a positive relationship between growth and internal finance, in different economies, namely Germany (Audretsch and Elston, 2002), United States (Carpenter and Petersen, 2002), Portugal (Cabral and Mata, 2003; Oliveira and Fortunato, 2006) and Spain (Moreno and Casillas, 2007). Meyer, (1998) concludes that in cases of insufficient internal finance, access to external finance can be fundamental to encourage company investment and consequently growth. However, insufficiency of internal finance can be a problem, given the greater difficulties faced by SMEs in accessing external finance (Becchetti and Trovato, 2002).

Most financial institutions like banks are very conservative and risk averse and therefore avoid SMEs that are considered risky and with no collateral or dependable track records (Mughan, Lloyd, Reason Zimmerman 2004; Leah and Trucker, 2000; Luiz 2002). Most of those SMEs that are able to secure start up finance find the cost of capital too high Rwigema and Venter, 2004). Financial constraints remain a major challenge facing SMEs in Kenya (Wanjohi and Mugure, 2008) and this is the situation in Thika as well. The study will therefore determine how access to finance influences growth of SMEs in Thika district.

2.3 Conceptual Framework
The conceptual framework summarizes behaviors and provides explanations and predictions for the majority number of empirical observations (Cooper& Schindler, 2008). The various variables in the conceptual framework were access to entrepreneurial finance and as an independent factor influencing growth of SMEs and the SME growth as a dependent variable. This is shown in appendix 1.1.

2.4 Growth
Growth is regarded as the second most important goal of a firm, the most important being firm survival. Aversion to growth has been said to the principal reason why most SMEs stagnate and decline (Clark *et al.,* 2001). Previous research reveals that firm growth is a multidimensional phenomenon, there is substantial heterogeneity in a number of factors associated with firm growth and related research (Delmar *et al.,* 2003).

The commonly used measures of firm growth: (employment growth, sales growth, profit, return on equity [ROE], return on assets [ROA]) and entrepreneurs' perceived growth relative to their competitors in terms of increase in company value (Leona *et al.,* 2010). Comprehensive reviews of the different indicators and formulas used when measuring growth empirically have been conducted, e.g, by (Weinzimmer, Nystrom, and Freeman 1998; Delmar, 1997).

3.1   Research Design
The mixed research design was adopted where both quantitative and qualitative approaches were used with the aim of determining the relationship between the effect of entrepreneurial finance on the growth of SMEs. According to Elliott (2004) mixed research design is preferred to using either quantitative or qualitative method alone since this can result in a tendency to overlook complexities that may only be revealed when a combination of methodologies is employed.

3.2   Target Population
The target population for this study comprised of the licensed SMEs by the the Thika Municipal Council located in Thika District as at 2011 from the local Government ACT (CAP. 265) Municipal Council of (Thika, 2000)

which have been in business for over three years with focus on owners and managers of the SMEs. The total population of SMEs in Thika district as per the registration office as at 2011 was 1,420 across the five sectors. Ten percent of the accessible population is enough Gay (1981), therefore the study surveyed 142 SMEs with between 10-99 employees. This is shown in appendix 1.2.

3.3 Sampling Frame and sampling technique

This constituted of a list of a target population of 1,420 of SMEs obtained from the Thika registrations office as per the local Government ACT (CAP. 265) Thika Municipal council which keeps a list of all registered businesses in the district. The sample was drawn from the target population by use of simple stratified sampling methods. Cooper and Schindler (2008) stratified sampling is a technique used where the population is not homogeneous. The SMEs were first of all stratified according to the nature of businesses then samples selected from each stratum using simple random sampling. The sample distribution is as shown in appendix 1.3.

3.4 Data Collection methods

The study adopted two main methods of collecting data as primary and secondary data. The key instruments that were used in collecting primary data were the self administered questionnaires designed for the owners or managers of the SMEs. Semi structured to open ended questions was used. Cooper and Schindler (2006) advocates for the use questionnaires in descriptive studies because it is less costly and participants can easily be reached. A 5- point Likert scale was used to obtain the ordinal data (Kannan & Aubur, 2004) from questionnaires with structured, fixed set of choices open ended questions were also used. The other instrument used was the interview schedule to supplement information not captured in the questionnaire. Secondary data involved information not collected directly but from published materials and other sources obtained from libraries, internet, public and private organizations and largely desk review of published literature on SME growth.

3.5 Data processing and Analysis

This is the extraction of significant variables, detecting any anomalies and testing assumptions (Kombo & Tromp, 2006). Data analysis was guided by the objectives of the study. Factor analysis for the variables was carried out to ensure the items help in to measure the intended constructs. Reliability test was performed on each variable to determine the degree of consistency in scores due to random error. Cronbach's coefficient Alpha was used to test the validity and reliability of data. Descriptive analysis was also carried out and then presented descriptively using percentages, graphs, pie charts and tables. Pearson product moment correlation analysis was used to test the relationship between the independent variable access to entrepreneurial finance and growth. To test the hypothesis of the of the regression model that there is no significant difference between the critical factors and the growth of SMEs, Analysis of Variance (ANOVA) was used (Cooper & Schindler, 2006). One way ANOVA was employed to test the effect of the independent factor on the growth of (SMEs) and to test the goodness of fit of the regression model which refers to how well the model fits the data (Anderson, Sweeney & Williams, 2002). The study also adopted a regression analysis to further determine the strength of the relationship between the independent and dependent variable. T- test was also used to test the significance of the individual independent variables to the dependent variable.

The regression model used is as follows:

$Y = \beta_0 + \beta_1 X_1$

Where

Y	= Dependent variable (Growth)
β_0	= Growth which is insensitive to the independent variable (access to Entrepreneurial finance
β_1,	= Change in growth Due to unit change in access to entrepreneurial finance
X_1	= Independent variables (Access to entrepreneurial finance)

The model hypothesis:

H_0= The regression coefficient (β_1)   is equal to Zero

H_1= The regression coefficient (β_1)   is not equal to Zero

Test statistics was used to guide inferences at 5% level of significance.

RESEARCH FINDINGS AND DISCUSSION

4.0 Response rate

Out of the 142 questionnaires administered, there was a response of 132 which is 92.96% response. According to punch, (2003) 80 to 85% response is good for face to face survey.

4.1 Reliability test

Reliability is a measure of the degree to which a research instrument yields consistent results or data after repeated trials (Borg, Gall & Gall, 2003). The results showed a Cronbach's value of 0.787 which is above the 0.7 limit hence the results are acceptable.

4.2 Factor analysis

A factor analysis was performed on the effect of access to entrepreneurial finance aspects on the growth of SMEs and the results indicated that the factor loadings were good with the highest on Access to finance from micro finance institutions which had a loading of 0.722, followed by Access to finance with flexible terms with 0.719, Quick access to finances has led to growth of business had 0.673, Access to affordable finances had 0.669, Access to finances from informal sources had 0.640, Access to finance from commercial banks had 0.618, Re-investing back finances had 0.597 and the lowest was Proper management of finances at 0.434 all of which had loadings above the threshold of 0.4 hence results are acceptable.

4.3 Descriptive analysis

A descriptive analysis carried out on access to entrepreneurial finance indicated that access to finances had an influence on the growth of SMEs. The mean and standard deviation showed how the respondents strongly agreed, agreed, or were neutral according to the likert scale of 1-5 which is shown by the means and the dispersion of respondents as shown by the standard deviation. The results show that majority of the responses on the various aspects of access to entrepreneurial finance were above 4.0 and therefore strongly agreed that access to entrepreneurial finance has a strong influence on the growth of SMEs. This is shown in appendix 1.4.

4.4 Correlation analysis for access to entrepreneurial finance

A Pearson product moment correlation was computed to assess the relationship between access to finance and growth of SMEs. There was a positive correlation between the two variables, r= 0.339, n= 132, p= 000. The p value p=0.00 is less than 0.05 level of significance which implies the variable access to finance is very significant and greatly influences the growth of SMEs.

Access to finance allows small and Medium Enterprises (SMEs) to undertake productive investments to expand their businesses and to acquire the latest technologies, thus ensuring competitiveness (Ouma and Munyoki, 2010) which supports this finding. The correlation results are shown in appendix 1.5.

4.5 Regression analysis

The regression results in appendix 1.6 shows that access to finance has a positive influence on the growth of SMEs. The R^2 tells us how well the regression line fits the data. It is also an important indicator of the predictive accuracy of the equation (Cooper & Schindler, 2012). The R = 0.339 and the R^2 value of 0.115 or 11.5% shows that 11.5% of the variation in growth of SMEs is explained by variation in access to entrepreneurial finance. This therefore means 88.5% of variation in the growth of SMEs is explained by other factors not in the model or by chance. Access to entrepreneurial finance therefore is a good predictor of growth in SMEs. This is in line with a study by Becchetti & Trovato, (2002) in which the findings showed that firms with a higher availability of external finance grow faster, especially in firms with less than 50 employees.

The study sought to test the following hypotheses:

H_0 : *Access to entrepreneurial finance has no effect on the growth of SMEs*

H_1 : *Access to entrepreneurial finance has no effect on the growth of SMEs*

Analysis of variance was done to test the significance of entrepreneurial finance to the growth of SMEs. From the results in appendix 1.7 below the p – value (0.000) is less than the level of significance (0.05) implying that the model is significant. Additionally, the F computed 16.862 is greater than the F-critical (3.84) which implies that the model $Y = 14.013 + 0.388\ X_3$ in appendix 1.8 is significant and therefore good for prediction. This therefore implies that access to finance is a significant factor influencing growth of SMEs.

This therefore means we reject the null hypothesis that access to entrepreneurial finance has no influence on the growth of SMEs.

The regression coefficient B indicates the amount of change in response per unit of the predictor variable in the dependent variable Dallal (2012). The B value of 0.388 in appendix 1.8 is significant at p value of (0.000) since it is less than the level of significance (0.05). Additionally, the T computed (4.106) is greater than the T-critical value of (1.96) which implies that the predictor variable is significant. This therefore implies that access to finance is a good predictor and has a significant influence on the growth of SMEs.

Conclusions

5.1 Access to Entrepreneurial finance and growth of SMEs

Findings indicated that access to entrepreneurial finance has a positive influence on the growth of SMEs since it has a positive correlation. This is in line with the findings of other scholars like Cassar, 2004; Moreno & Casllas, 2007; Olawale & Garwe who found out that a firm with access to finance is more likely to grow more than a firm that has a lack of financial resources. This is also supported by Cassar, (2004) who postulated that all businesses require financial resources in order to start and fund growth lack of which can be a constraint on business growth. The findings are also supported by other scholars like Wanjohi & Mugure, (2008), who found out that success of MSMEs, depends on ability to apply finances appropriately in order to spur growth. Access to entrepreneurial finance therefore, has a positive influence on the success and growth of SMEs.

5.2 Recommendations

There is need for the government to develop a policy that will enhance credit guarantee services and improve financial information infrastructure for financial accessibility of SMEs in Kenya.

There is need to put in place a legal framework that strengthens financing policies, policy related funds and institutions that support SME growth.

There is also need to improve financial literacy of the entrepreneurs and individuals to take advantage of the available financial services.

5.3 Areas for further research

The study recommends that further research be done on the effect of government facilitation of financial market activity on growth of SMEs. The study also suggests that a study be carried out on the effect of credit information system on the growth of SMEs in other areas in Kenya other than Thika district. Another study needs to be done on the effect of introduction of the devolved funds and other related government support programmes on the growth of SMEs.

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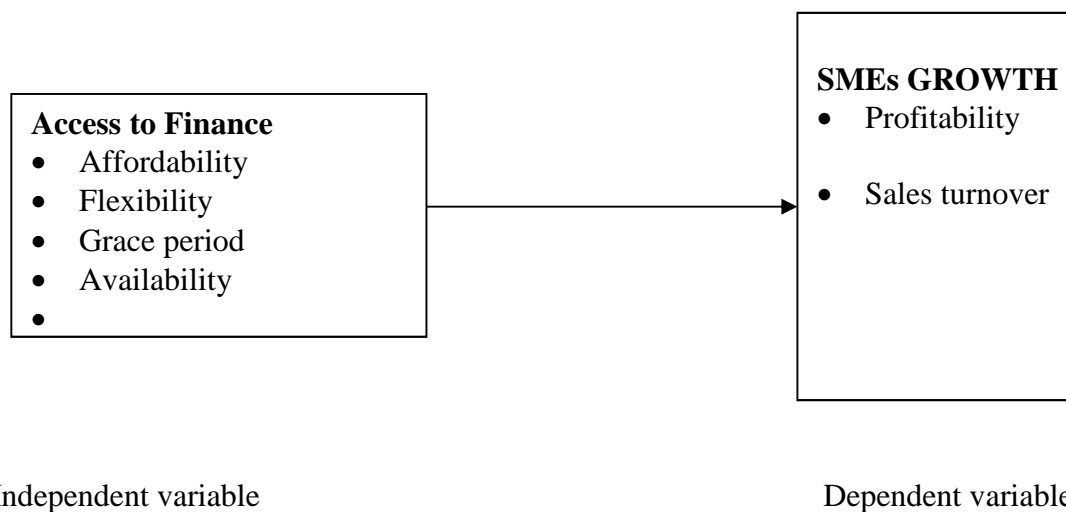
Appendix 1.1: Conceptual framework

Access to Finance
- Affordability
- Flexibility
- Grace period
- Availability
-

SMEs GROWTH
- Profitability
- Sales turnover

Independent variable   Dependent variable

Figure 2. 1: Conceptual framework

Appendix 1.2: **Summary of population and enterprise activities**

Sector	Number	Enterprise Activities
Agricultural activities	199	Manufacture of animal feeds, chemical, pesticides and insecticide and production of agricultural produce among others
Health care	200	Private hospitals and clinics, Chemists and pharmaceutical companies among others
General trade	500	Wholesaling, Distributors, warehousing and retailing of goods among others
Education and Training	171	Private schools and colleges, beauty colleges, driving schools among others
General Services	350	Building and construction, Transport and communication, accommodation, hotels among others,
Total	**1420**	

Source: Municipal Council of Thika, (2011)

Appendix 1.3: Sample distribution

Sector	Target population	Sample
Agricultural activities	199	20
Health care	200	20
General trade	500	50
Education and Training	171	17
General Service	350	35
Total	**1,420**	**142**

Source: Thika local Government ACT (CAP. 265)

Appendix 1.4 : Descriptive statistics for access to entrepreneurial finance

Aspects of access to entrepreneurial finance	Mean	Std. Deviation
Quick access to finances has led to growth of business	4.45	.903
Access to finance with flexible terms	4.23	.837
Access to finance from commercial banks	4.06	1.054
Access to affordable finances	4.27	.837
Access to finance from micro finance institutions	4.05	1.047
Re-investing back finances	4.22	1.014
Proper management of finances	4.41	.847
Access to finances from informal sources	3.91	1.080

Appendix 1.5: Correlation results for access to entrepreneurial finance and growth

Variable	Statistic	Growth	Access to Finance
Growth	Pearson Correlation	1	.339[**]
	Sig. (2-tailed)		.000
	N	132	132
Access to Finance	Pearson Correlation	.339[**]	1
	Sig. (2-tailed)	.000	
	N	132	132

Appendix 1.6: Regression results

R	R Square	Adjusted R Square	Std. Error of the Estimate
.339	.115	.108	4.50630

Appendix 1.7: ANOVA for access to entrepreneurial finance

Sum of Squares	df	Mean Square	F	Sig.
342.419	1	342.419	16.862	.000
2639.871	130	20.307		
2982.290	131			

Appendix 1.8: Correlation coefficient

Model	Unstandardized Coefficients		Standardized Coefficients	T	Sig.
	B	Std. Error	Beta		
(Constant)	14.013	1.741		8.049	.000
Access to Finance	.388	.094	.339	4.106	.000

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