FACTORS AFFECTING THE EFFECTIVENESS OF BANK CREDIT IN ENHANCING THE PERFORMANCE OF SMALL AND MEDIUM ENTERPRISES IN KENYA: A CASE OF KISUMU CITY.

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DECLARATION

This Research project is my original work and has not been presented for a degree in any other University.

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This research project has been submitted for examination with my approval as the University Supervisor.

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DR   WILLY MUTURI.

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DEDICATION

I give praises to Almighty God, the most gracious, for giving me the strength and determination to complete this study.

To my mum Mary, children Marylyn and Derrick Elvis for their love, prayers, support, patience and perseverance during my study period.

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LIST OF ACRONYMS AND ABBREVIATIONS

AfDB   African Development Bank

CBR   Central Bank Rate

FSD   Financial Sector Deepening Kenya

GOK   Government of Kenya

IFC   International Finance Corporation

ILO   International Labor Organization

KCB   Kenya Commercial Bank

KER   Kenya Economic Report

KIPPRA   Kenya Institute of Public Policy Research and Analysis

NCR   National Credit Regulator

OECD   Organization for Economic Cooperation and Development

RBV   Resource Based View Theory

SMEs   Small and medium-sized enterprises

SBTDC   Small Business and Technology Development center

UNIDO   United Nations Industrial Development Organization

DEFINITION OF TERMS

Credit terms Are defined as standards applied by commercial banks in determining the ability to repay loans. These terms help in assessing credit worthiness of borrowers and hedge against the risk of loss in case of non-repayment. They include collateral, interest rate and repayment period (Nyangoma, 2012; Agarwal, 2006).

Managerial Competency Competency is defined as specific behavior and characteristics of a person that result in effective or superior performance (Sanda *et al.*, 2011).

Loan Utilization Is the usage of a loan to finance various business activities

(Kamwanza,2014)

Performance Performance is the ability of the firm to meet both its long term and short term goals efficiently and effectively. It is measured using proxies such as profitability, return on asset, liquidity, solvency, and sales growth (Akinyi, 2014).

Effectiveness Effectiveness means "*doing the right thing*." Effectiveness means measuring the extent to which targets are being met, and detecting the factors that hinder or facilitate their realization which also involves establishing cause-effect relationships about the extent to which a particular policy produces the desired outcome. Effectiveness also refers to summative evaluation and unlike efficiency, effectiveness is determined without reference to costs (Chaffey, 2016)

Small and Medium Enterprises. (SMEs). Are businesses in both formal and informal sectors classified into farm and non-farm categories employing 1-50 workers. (GOK, 2005).

Small Enterprise   A firm, trade, service, industry or a business activity whose annual turnover ranges between five hundred and five million shillings, which employs between ten and fifty people; and whose total assets and financial investment shall be between ten million and fifty million shillings in the manufacturing sector; and for service and farming enterprises, where the equipment investment as well as registered capital of the enterprise is between five million and twenty million shillings(Micro and Small Enterprise Act,2012)

ABSTRACT

Whereas bank credit is given in an attempt to raise the performance of SMEs, the performance of the beneficiary SMEs in Kenya still remains low. Existing reports indicate that although bank lending to the SME sector has grown significantly, the exponential growth in SME lending has not translated to improved performance of the beneficiary SMEs. A high failure rate in the SME sector is still reported despite the increased access to bank credit. Consequently there was need to investigate why access to bank credit has not enhanced the performance of the recipient SMEs in Kenya. If this situation is not arrested many more firms will continue to close down despite the increased lending to the sector. Therefore, this study sought to examine factors that hinder the effectiveness of bank credit in enhancing the performance of SMEs in Kenya. Specifically, it investigated whether credit terms, loan utilization and managerial competence affect the effectiveness of bank credit in enhancing the performance of SMEs in Kenya. Specific objectives of the study were; to establish the influence of credit terms on the effectiveness of bank credit in enhancing SME performance. To find out how bank loan utilization influenced the effectiveness of bank credit in enhancing SME performance in Kisumu city and to examine the influence of managerial competence on the effectiveness of bank credit in enhancing SME performance in Kisumu city. The study targeted a population of 1527 SMEs within Kisumu city with at least 3 employees who borrowed loans ranging from 1 million and maximum of 50 million. The study adopted a descriptive cross sectional survey design. Proportionate sampling technique was used to select respondents where a sample of 316 SMEs was selected based on Yamane's formula at 95% confidence level. A structured questionnaire was used to collect primary data while document analysis was used to collect secondary data. Data was analyzed using percentages, frequencies and means using SPSS version 17.0. The analysed data was presented in form of tables, graphs and charts from which statistical inference was made. Factor analysis and multiple regression was used to determine the relationship between bank loans and the performance of SMEs. Findings revealed that credit terms on aspects of interest rate, cost of credit, and lack of collateral and small loans were the most significant challenge for a majority of SMES which made bank loans less effective in enhancing SME performance. Loan diversion challenges were also rated as significant while managerial competency challenges were considered insignificant since majority had requisite skills. Recommendations made include; enforcement of the banking amendment act 2015, banks to design more of the products tied to specific assets and building the capacity of SMEs on the need to increase investment in capital assets to be used as collateral.

CHAPTER ONE

INTRODUCTION

1.1.   Background of the Study

Small and medium-sized enterprises(SMEs) are recognized as the drivers of socio-economic growth, both in developed and developing economies due to their significant role in creation of new jobs, rise in GDP, entrepreneurship and innovation (Karadag,2015).The Organization for Economic Cooperation and Development (OECD, 2005) posits that Micro, Small and Medium-scale enterprises (MSMEs) make important contributions to economic and social development, constitute the vast majority of business establishments, are usually responsible for the majority of jobs created and account for one third to two thirds of the turnover of the private sector. The Small Business and Technology Development center (SBTDC,2013) reports that in the United States, SMEs provide employment for half of the private sector workforce and contribute over 50 percent of the non-farm private GDP. United Nations Industrial Development Organization (UNIDO,1999) estimates that SMEs represent over 90 percent of private business and contributes to more than 50 percent of employment and of gross domestic product (GDP) in most African countries. Therefore the performance of the SME sector is crucial if Kenya is to realize the 10% growth rate as envisioned in the Kenya vision 2030 strategy.

The importance of SMEs in Kenya was first recognized in the International Labor Organization report on "Employment, Income and Equity in Kenya" (ILO, 1972; Ronge, Ndirangu & Nyangito, 2002). The report underscored SMEs as an engine for employment and income growth. The Kenya Institute of Public Policy Research and Analysis (KIPPRA, 2012) asserts that because of their low capital requirements in business startup, there is potential of reducing poverty through the SME sector. In

developing countries such as Kenya, SMEs are therefore the main self-help instrument for poverty eradication, industrial growth and equitable development.

Extant studies indicate that access to bank credit has a positive impact on the performance of SMEs. The FSD (2015) citing Beck and Demigurc-Kunt (2006) opines that when SMEs are credit constrained it severely affects their possibilities to grow and innovate. Madole (2015) in a study to examine the impact of microfinance credit on the performance of SMEs in Tanzania found that bank credit obtained by SMEs in Morogoro enabled them to improve businesses in terms of: increased business profit, employees, sales turnover, business diversification and increased business capital and assets. Madole further argues that without finance, SMEs cannot acquire new technologies, compete in the global market or establish linkages with larger firms. Mbugua,Njeru and Tirimba (2014) also opine that as a result of scarcity of finance, small enterprises are unable to expand, modernize or meet urgent orders from customers. Iloh, Chioke and Nnanyelugo (2015) contend that Commercial bank credits play a crucial role in the development of an economy as it influences positively the level of economic activities in any country in terms of what is to be produced, who produces it, and how much is to be produced. Capital is therefore necessary for the long-term survival and growth of small enterprises. Berry, Blottnitz, Cassim, Kesper, Rajaratnam, and Seventer (2002) assert that unlike large, particularly publicly-listed firms, SMEs do not have the option of issuing shares or debentures in the capital market mainly due to the high transaction costs associated with publicly issued debt and equity which makes it too expensive for them. Owing to this inability to access the public debt and equity markets, SMEs tend to rely heavily on commercial banks as a source of debt financing while others rely on lending technologies such as money lenders that are expensive and often unsuited to their needs (IFC, 2015). These limitations to financial services may seriously limit their expansion potential, innovation, research and development activities.

The African development bank (AfDB, 2012) opines that the involvement of Kenyan banks in the SME segment has grown remarkably over the last few years and the trend will continue in the foreseeable future. The Financial Sector Deepening report (FSD, 2015) on; "bank financing of SMEs in Kenya" established that the total SME lending portfolio by 2013 was estimated to be KSh332 billion, representing 23.4 per cent of the commercial banks' total loan portfolio which represents an exponential growth of SME loan portfolio estimated at 19.5 and 20.9 per cent of total lending in 2009 and 2011 respectively. However, although these reports indicate an exponential growth in SME lending (AfDB, 2012; FSD, 2015), this has not translated to improved performance of the beneficiary SMEs (Mensah, 2004; Quainoo, 2011; Iloh *et al*, 2015). Empirical studies done in both developed and developing economies reveal that most SMEs never celebrate their fifth birth day (Fatoki, 2014; Njoroge 2013; Oluoch, 2014; Iloh *et al*, 2015). Extant studies also reveal that despite the increase in credit supply to SMEs, the performance of the sector particularly in Kenya has been dwindling (KIPPRA, 2012). Given the pivotal role of SMEs in fuelling innovation and employment-creation and the importance of bank credit as the main source of capital for SMEs, understanding the opportunities, gaps and challenges in the SME finance market is crucial to maintaining the desired growth momentum (FSD, 2015). Therefore, this study sought to examine factors that hinder the ability of bank credit in enhancing the performance of SMEs in Kenya. Specifically, it investigated whether credit terms, loan utilization and managerial competence limit bank credit ability to enhance the performance of SMEs in Kenya.

Nyangoma (2012) citing Agarwal (2006) defines Credit terms as standards applied by commercial banks in determining the ability to repay loans. These terms help in assessing credit worthiness of borrowers and hedge against the risk of loss in case of non-repayment. They include collateral, interest rate and repayment period. Access to credit on the other hand refers to the availability of a supply of reasonable quality financial services at a reasonable cost. Improved access to credit helps businesses grow and advance their financial performance (Nyangoma, 2012; Claessens, 2006). On the

contrary, acquisition of such credit has proved to be difficult due to credit terms that are perceived unfavorable. A high cost of credit and unavailability of long and medium term financing is a major constraint inhibiting the growth of SMEs sector in Kenya. St -Onge & Stevenson (2005) suggest that the issues and problems limiting SMEs acquisition of financial services include lack of tangible security coupled with inappropriate legal and regulatory framework that does not recognize innovative strategies for lending to SMEs. Moreover, most formal financial institutions perceive SMEs as high risk and commercially unviable due to high administrative costs compared to the loan amount given. Consequently, only a few SMEs access credit from formal financial institutions in Kenya and the loans are mostly limited to a maximum of 5 million (FSD, 2015).

The G20 Seoul Summit (2010) reports that a study by the IFC and McKinsey found that between 45 to 55 percent of the formal SMEs in the emerging markets do not have access to formal institutional loans or overdrafts despite a need for one while of the micro and informal enterprises 65-72 percent in emerging markets lack access to credit. Empirical studies also reveal that compared to other countries that have attained middle income status such as Argentina, Chile, China, Korea, Malaysia Singapore and Thailand, the lending rate in Kenya is still relatively high at 19-24 % compared to most of these countries where the lending rate is below 10 per cent (FSD,2015 ;KIPPRA,2012). Even though high interest rates contribute significantly to the commercial banks bottom line, this high cost of credit impedes investment growth (KIPPRA, 2012). The Kenya Economic report (KIPPRA,2012) further attributes the high interest rates in Kenya to factors such as; scale diseconomies since only 19% of the bankable population utilize formal financial services, high intermediation costs and a weak judicial system especially in the enforcement of contracts. The FSD(2015) also established that although credit Reference Bureaus were established to facilitate sharing information between lenders and borrowers to improve the credit rating of borrowers, very few banks in Kenya entirely rely on credit scoring as a lending technology. Banks rely on a variety of lending technologies such as relationship lending, close monitoring and the CAMPARI

model. Due to inadequate information at the borrower level majority are rationed out. Nyangoma (2012) reports that in Uganda ,collateral is up to 150% of the loan, the repayment period is as short as 24 months, and interest rates range from 23% to 30% per month. Odongo (2014) corroborates this view that the cost of money on micro credits is very high in Uganda due to the large administrative costs in relations to the location of SME operations and inadequacy of records and information relating to their operations. He asserts further that most SMEs in Uganda that have had access to financial resources from financial institutions end up in a poor financial state leading to business collapse due to lack of entrepreneurial skills and inadequate technical and management support services.   Consequently, Some SMEs have difficulties in raising short-term funds for working capital as well as long-term funds for business investment which makes it difficult for them to achieve their performance in terms of liquidity, long term solvency and profitability resulting to lost business opportunities, and failure to grow (Nyangoma,2012; Badagawa, 2008). This study posits that unfavorable credit terms increases cost of capital which limits investment in productive assets.

The main purposes of finance in a business are investing in capital assets and meeting working capital requirements. Marcouse *et al*., (2003)   argues that both working capital needed for day to day running of the business and money for capital assets expenditure have to be found before business starts to generate any income. Empirical studies reveal that loans advanced to a majority of SMEs for capital expenditure and working capital have been diverted to purposes outside the loan covenant resulting to poor performance of these SMEs. Proper loan utilization plays a key role in determining whether bank credit advanced to SMEs results to positive outcomes in terms of business performance. Amara, Owusu and Adjabeng (2015) argue that inability of bank credit to yield desired outcomes in terms of improved business performance can be blamed on loan diversion. Kamanza (2014) found a positive significant relationship between loan diversion and loan default among women entrepreneurs in Msambweni constituency Kenya. His findings on diversion of loan funds by borrower's further revealed that out of the 76

respondents 52(68.4%) had used the loan for other purpose not agreed upon such as school fees, domestic expenses and medical expenses while only 24(31.6%) had used the loan for the intended purpose. Of those who diverted the loan 65% either never paid or had difficulty in repaying the loans.

Sanda,Sackey and Yiva (2011) define Competency as specific behavior and characteristics of a person that result in effective or superior performance. Boyatzis (1982) as cited by Sanda *et al.*, (2011) defines competency as an underlying characteristic of an individual that relates causally to effective or superior performance. Competence also refers to areas of work in which a person is competent. It can be argued that managerial competence is more crucial in the performance of large firms as opposed to small firms. As firm size expands and becomes more complex, the need for advanced management practices becomes crucial. Jennings and Beaver (1997) opine that owner-managers of small, entrepreneurial firms rely more on their traditional skills and intuitiveness, rather than the managerial approaches to deal with the daily operational problems. Lack of managerial competence has been widely reported as a major factor contributing to SME failure. Karadag (2015) opines that most entrepreneurs lack entrepreneurship skills particularly on preparation of business plans which makes it difficult for them to access startup capital. He also established that although most SMEs lack finance and accounting knowledge, majority of the SME owner/managers refrain from hiring professional finance managers for fear of delegating their "managerial power", which causes their financial problems to grow and even threaten the survival of their enterprises. Sanda *et al.*, (2011) established that executives who exhibited competence in financial planning, ability to mobilize financial resources for their firms and prepare and implement budgets had better business performance than their counterparts without these competencies. Hormiga, Batista and Sanchez (2011) found that managerial competencies as measured by education, managerial experience, start-up experience and knowledge of the industry positively impact on the performance of SMEs. They argued that education seems to provide the knowledge base and analytical

and problem-solving skills to more effectively deal with the demands of entrepreneurship. Intellectual capital is critical to management process and can create sustained competitive advantage. Being knowledgeable can help an entrepreneur to be innovative (Fatoki, 2014). Lack of managerial experience, skills, and personal qualities as well as other factors such as adverse economic conditions, poorly thought out business plans and resource starvation have been found as the main reasons why new firms fail. Hormiga *et al*., (2011) further argues that the distinguishing feature of high growth and low growth small firms is the education, training and experience of senior managers. Therefore, the greater the level of managerial competency, the greater the performance and the more likely the survival of SMEs (Fatoki, 2014).

Whereas the supply side of SME loans shows positive prospects of increased lending to the SME sector, the demand side paints a gloomy picture of SME failure despite the increased access to bank credit. There is therefore need to investigate factors that hinder the effectiveness of bank credit in enhancing performance of SMEs. This study examined how credit terms, loan utilization and managerial competence affect the effectiveness of bank credit in enhancing the performance of SMEs in Kisumu city.

1.2   Statement of the Problem

Whereas bank credit is given to increase the performance of SMEs, the beneficiary SMEs in Kenya still exhibit low performance. Existing reports indicate that although bank lending to the SME sector has grown significantly from a low of 19.5% in 2009 to a high of 23.4 % by 2013 (FSD, 2015;AfDB,2012) the exponential growth in SME lending has not translated to improved SME performance (KIPPRA, 2013; Githaiga & Kabiru, 2015). A high failure rate in the SME sector is still reported despite their increased access to bank credit. For instance, there are negative signals such as; commercial banks posting high non-performing loans in the SME sector, SME manufacturing firms exhibiting a slow rate of capital formation and minimal investment activity (KIPPRA, 2013; Chelagat,2012) and a high failure rate of SMEs (Njoroge 2013; Oluoch,2014;Iloh *et al*,2015) which indicate poor performance of the SME sector in Kenya hence the need to investigate factors that limit the effectiveness of commercial bank loans in enhancing the performance and survival of SMEs in Kenya. If this situation is not arrested many more firms will continue to close down despite the increased lending to the sector.

Existing literature on bank credit and the performance of SMEs is also available albeit with research gaps. Odongo (2014) in a study on lending terms and the financial performance of SMEs in Soroti Uganda using a regression model found that lending terms conceptualized in terms of cost of money, loan size and lending period explained about 26.6% of the variation in financial performance of SMEs. He concluded that lending terms alone had a low influence on the financial performance of SMEs and thus proposed a further investigation incorporating managerial competence. Nyang'oma (2012) in a study to establish the extent to which credit terms and access to credit have affected financial performance of SMEs in Kampala found that credit terms explained 33.1% of the variance in financial performance of SMES in Kampala Uganda. These studies focused on credit terms which explained less than 35% of the variance in financial performance of SMEs. The current study will include loan utilization and managerial competence in attempt to explain the remaining 60% of the variance in

financial performance that was attributed to other factors. Moreover, given the geographical diversity and difference in economic development, there is need for a similar study in Kenya.

Most Studies done in Kenya have focused on the impact of microfinance on the performance of SMEs e.g Gathongo, 2014; Rotich, Lagat & Kosgei, 2014; Mwewa ,2012) However, MFIs have flexible loan products and small loan size of up to 500,000/= mainly targeting the financially excluded informal sector micro enterprises. On the contrary, Commercial bank SME lending ranges from 1 to 50 million which warrants an independent research on how these loans have influenced the performance of SMEs. Moreover research on effect of managerial competencies on the utilization of bank credit by SMEs has not been given much attention in Kenya. Existing literature has been done in other countries such as South Africa (Fatoki, 2014), Malaysia (Lee, Huam, Osman, & Rasli (2010) and Ghana (Sanda *et al*., 2011). This necessitates similar studies to be done in Kenya to establish how the competency of SME managers could affect their ability to utilize loans borrowed from commercial banks. It's against this backdrop that this study sought to examine factors influencing the effectiveness of bank credit in enhancing the performance of SMEs in Kenya. Specifically, it investigated whether credit terms, loan utilization and managerial competence affected the effectiveness of bank credit in enhancing the performance of SMEs in Kenya using a case of SMEs in Kisumu City.

1.3   Objectives of the Study

1.3.1   General Objective
This study sought to establish factors that influence the effectiveness of bank credit in enhancing the performance of SMEs in Kenya.

1.3.2   Specific Objectives

The study focused on the following specific objectives;

1. To establish how credit terms influence the effectiveness of bank credit in enhancing the performance of SMEs in Kisumu city.

2. To find out how loan utilization influences the effectiveness of bank credit in enhancing the performance of SMEs in Kisumu city.

3. To examine the influence of managerial competence on the effectiveness of bank credit in enhancing the performance of SMEs in Kisumu city.

1.4. Research Questions.

The following research questions were answered;

1. How does credit terms influence the effectiveness of bank credit in enhancing the performance of SMEs in Kisumu city?
2. What is the influence of loan utilization on the effectiveness of bank credit in enhancing the performance of SMEs in Kisumu city?
3. To what extent does managerial competence influence the effectiveness of bank credit in enhancing the performance of SMEs in Kisumu city?

1.5. Significance of the Study.

The study will provide commercial banks management including; KCB ,Cooperative, Equity bank and NIC among others with data that may help to better understand the bank's involvement with SMEs and ascertain how best the banks can repackage their SME loan products to increase the performance and growth prospects of their SME clients. The study will also bring to light the knowledge and skills gaps among the banks

SME clientele that could inform future training programs. Future researchers and academicians will also find this study useful as it will contribute immensely to existing body of knowledge on SME financing and serve as a catalyst for further research on innovative ways of financing SME and financing challenges faced by SMEs. Policy makers particularly government agencies such as the Ministry of Finance and Ministry of Industrialization will find results of the study useful as it will provide insight and a more reliable guide for monitoring the financing challenges of SMEs and also highlight areas of policy gaps that require policy intervention.

1.6.   Scope of the Study.

The study covered 1527 Small and Medium Scale enterprises with at least 3 employees operating within Kisumu city who borrow 1-50 million loan from commercial banks. It mainly investigated factors that influence the ability of bank credit in enhancing the performance of Small and medium Scale enterprises in Kenya. Major factors investigated were; credit terms, loan utilization and managerial competency.

1.7.   Limitations of the Study

The study was limited to factors influencing the effectiveness of bank credit in enhancing the performance of SMEs in Kisumu city, Kenya. There is need to replicate the study in other Counties in Kenya for external validity and generalization of the results. The study also encountered a number of limitations due to the inherent 'fear of the unknown'. Some SME managers were hesitant to allow the researcher access to their business records particularly financial records. The limitation was mitigated by explaining to the respondents the importance of the research and assuring them anonymity and secrecy of their views hence respondents gave socially acceptable responses.

CHAPTER TWO

LITERATURE REVIEW.

2.0. Introduction.

This chapter discusses pertinent literature reviewed in terms of entrepreneurship theories and conceptual framework. It also discusses an empirical review on SME performance, credit terms, loan utilization, managerial competence, critique, and summary and identifies research gaps in the existing literature.

2.1. Theoretical Review

2.1.1 Social Capital or Social Network Theory

Proponents of this theory assert that entrepreneurs are embedded in a larger social network structure that constitutes a significant proportion of their opportunity structure (Clausen, 2006). Shane and Eckhardt (2003) say "an individual may have the ability to recognize that a given entrepreneurial opportunity exist, but might lack the social connections to transform the opportunity into a business startup. It is thought that access to a larger social network might help overcome this problem". Kudshin (2004) as cited by Jaafar, Abdul-Aziz and Sahara (2009) assert that a network flow between actors which contains advice, information, friendship, emotional support, motivation and cooperation can lead to important ties useful to entrepreneurial ventures. This implies that entrepreneurs must build reputation enhancing relationships with outside resource providers who are willing to share valuable information, technology and finance (Jaafar et al., 2009). Leyden, Link and Siegel (2013) argue that an entrepreneur is in constant search for knowledge and key to the acquisition of the knowledge are the social networks which increases the probability of success of their entrepreneurial innovations.

The literature on this theory shows that stronger social ties to resource providers facilitate the acquisition of resources in terms of access to capital, recruiting skilled

labour and accessing tacit knowledge which enhances the probability of opportunity exploitation (Shane & Stuart, 2002; Hsu, 2004). For instance, Hsu (2004) found that venture capitalists preferred investing in firms that they learnt through referrals by close contacts including entrepreneurs they had financed previously. Other researchers have suggested that it is important for nascent founders to have access to entrepreneurs in their social network, as the competence these people have represents a kind of cultural capital that nascent ventures can draw upon in order to detect opportunities (Rezulli,Aldrich & Moody,2000:Burton & Raider,2002).Therefore the social network theory emphasizes the need for entrepreneurs to maintain rich network of social capital that will enhance access to information on opportunities and mobilize resources for opportunity exploitation.

2.1.2   The Economic Theory of Entrepreneurship.

Mark Casson's Economic Theory (Casson, 1982) holds that entrepreneurship is a result of conducive economic conditions he therefore asserts that economic development and entrepreneurship are interdependent hence with favorable economic conditions entrepreneurship develops faster.   Casson (1982) further affirms that economic incentives are the main motivators for entrepreneurship activities. These incentives include; taxation policy, industrial policy, sources of finance and raw materials, infrastructure availability, investment and marketing opportunities and access to information about market conditions. This theory implies that growth of SME businesses has a direct link to economic growth which can only occur within a conducive macro environment of the national economy concerned.

The implication of this theory is that enterprises are delicate adventures and without the support of the government new enterprises cannot take off. Markets are unstable and unpredictable and the government should be perceived to be business supportive rather than one that stifle business (Bula, 2012). The Kenyan government should provide an enabling environment to entrepreneurs with a view to inculcating entrepreneurial culture

in Kenya. This can be achieved by establishing pro-business policies and through its supervisory role ensure that credit terms are friendly to SME borrowers to spur economic growth.

2.1.4. Resource Based View Theory

The Resource Based View Theory (RBV) argues that resources are a critical part of an organization's operation (Pfeffer & Salancik, 1978). Tokuda (2005) in his article on; "Critical Assessment of the Resource-Based View of Strategic Management" traces the Resource Based view theory to the work of Penrose (1959). According to her work, firm development is an evolutionary and cumulative process of resource learning, in which increased knowledge of the firm resources both helps create options for further expansion and increase absorptive capacity. According to Penrose, it is never 'resources' per se that are important but rather what matters most are the services that are produced by resources. She argues that: "The services yielded by resources are a function of the way in which they are used. Exactly the same resources when used for different purposes or in different ways and in combination with different types of or amounts of other resources provide a different service or set of services. (Penrose, 1959 : 25). The RBV suggests that the resources possessed by a firm are the primary determinants of its performance, and these may contribute to a sustainable competitive advantage of the firm (Hoffer & Schendel, 1978; Wenerfelt, 1984; Grant, 1991). For resources to contribute to competitive advantage, they must be heterogeneous (unique, difficult to accumulate and imitate). Consequently, If all firms in a market have the same stock of resources, no strategy is available to one firm that would not also be available to all other firms in the market hence no firm will have a competitive advantage (Tokuda,2005).

Mills,Platts & Bourne(2005) citing Barney (1991) state that resources includes all assets, capabilities, organizational processes, firm attributes, information, knowledge of employees, etc. controlled by a firm that enable the firm to conceive of and implement

strategies that improve its efficiency and effectiveness. Grant (1991) distinguishes resources and capability as follows: Resources are inputs into the production process which include items of capital equipment, skills of individual employees, patents, brand names, finance etc which are not productive on their own. Productive activity requires the cooperation and coordination of teams of resources. A capability on the other hand is the capacity for a team of resources to perform some task or activity. Grant therefore concludes that while resources are the source of a firm's capabilities, capabilities are the main source of its competitive advantage. This study conceptualizes that human capital resource as measured by their managerial competencies play an important role in the utilization of financial resources of a firm resulting to superior performance.

2. Conceptual Framework.

The schematic diagram below shows the relationship between independent and dependent variables.

Factors (Independent Variable)

Effectiveness of bank credit in enhancing SME performance

(Dependent Variable)

Credit Terms

- Collateral Requirements
- Repayment Period
- Loan pricing(admin cost, interest rates)

Loan Utilization

- Acquisition of assets
- Settlement of other debts
- Increase working capital
- Source for raw materials

Managerial Competence

- ❖ Financial Management skills
- ❖ Entrepreneurship skills

- Profitability
- Accumulated assets
- Volume of Sales
- Product/service innovations

Fig 2.1 Conceptual Framework. ▲

2.3. Empirical Review

2.3.1 Credit terms

Credit terms are defined as standards applied by commercial banks in determining the ability to repay loans. These terms help in assessing credit worthiness of borrowers and hedge against the risk of loss in case of non-repayment. They include collateral, interest rate and repayment period (Nyangoma, 2012; Agarwal, 2006). On the other hand Kakuru (2007) defines Credit terms as standards or negotiated terms offered by a seller to a buyer that control the monthly and total credit amount, maximum time allowed for repayment, discount for cash or early payment, and the amount or rate of late payment penalty. Agarwal (2006) defines access to credit as the availability of a supply of reasonable quality financial services at a reasonable cost. Access to finance is measured by amount borrowed and frequency of access which is the number of times one can access credit which depends on the ability of the business to meet credit terms set by commercial banks (Nakiyingi, 2010).

Despite the increased supply of loans to the SME sector, the limited access to commercial bank loans by a majority of SMEs could be attributed to stringent credit terms. The National Credit Regulator (2011) found that although there is sufficient credit being made available to SMEs in South Africa the terms and conditions under which it can be accessed are not appropriate for the SME sector it is intended to serve. In other words, there is sufficient "quantities" of funding available, but the "quality" of funding (i.e. the product design/services being offered) does not match the needs of the sector which limits consumption. Financing is necessary to help SMEs to set up and expand their operations and develop new products while limited access to credit results in reduced financial performance in terms of sales, profits and liquidity (Olutunla & Obamuyi, 2008). Nyangoma (2012) found that there is a significant positive association of credit terms and access to credit on financial performance of SMEs. Favorable credit terms facilitate ease of access to credit thereby improving financial performance of SMEs in terms of sales liquidity and profitability.

Coco (2000) as cited by NCR (2011) points out that collateral is important as it helps to reduce informational asymmetries and moral hazard problems that arise between banks and entrepreneurs. Collateral can be repossessed by the creditor in case of default thus enhancing creditor protection. This view is supported by Berger and Udell (1998) who opine that Collateral and guarantees are powerful tools that allow financial institutions to offer credit on favorable terms to small businesses whose informational opacity might otherwise result in either credit rationing or the extension of credit only on relatively unfavorable terms. Collateral and guarantees may also reduce the cost of intermediation because a financial institution may be able to assess the value of pledged or guaranteed assets at lower cost than it can assess the value of the business as a going concern. Berger and Udell (1998) further opine that use of owner's personal assets as collateral to secure a business enhances the creditor's claims of new assets. Owners using personal assets to secure the loans are unlikely to pursue unnecessary risky projects as there is more at stake; therefore, small businesses using owner collateral are less likely to default. Whereas real-estate collateral provides an incentive and a justification to lend and repay, as well as a means to offset losses in case of default collateral requirements pose another major challenge for SMEs access to finance. Most banks practice credit rationing of SMEs due to their inability to raise the required collateral (Kauffman, 2005; G20Seoulsummit, 2010; Nyangoma, 2012). Nyangoma (2012) found that collateral demanded in Uganda was as high as 150% of the loan making it unfavorable to most SMEs. According to OECD (2006) the suitable financing source remains an obstacle especially for the growth of innovative SMEs, a problem known as the "SME financing gap". Consequently, small firms rely proportionally more on non-bank sources of financing such as internal funds (savings, retained earnings, family network) and informal sector (money lender), as a result of their inability to produce the collateral requested by commercial banks.

A survey carried out in Nigeria by the USAID (2005) established that approximately 70 percent of respondents utilizing commercial banks overdraft facilities were required to pledge collateral in form of land, buildings and machinery. The National Credit Regulator (NCR, 2011) observed that majority of South African SME applications for finance from banks were unsuccessful for lack of collateral (37%), the lack of a financial deposit (17%), poor business plans (7%). The findings are comparable to the World Bank Enterprise Survey of 2008 in which 31% of micro and 39% of small firms cited unacceptable collateral as a reason for loan application rejections. Kauffman (2005) opines that a number of strategies can be used to remove obstacles of SME access to finance which include; Making loans to intermediaries (NGOs and federations of SMEs) who then lend funds to members which helps cut administration costs. Secondly, loaning to clusters of SMEs, as is the case in Asia would enable member firms to seek finance together, provide collective guarantees or even set up their own financial body. The threat of expulsion from the cluster ensures that promises are kept, which allows the network to overcome shortcomings in the legal system.

According to Todaro (1992), interest rates is the amount the borrower must pay the lender over and above the total borrowed expressed as the percentage of the total amount of the funds borrowed while ACCA (2003) defines interest rates as a measure of the cost of borrowing. Bank interest rates are rewards expected by the lenders (bank) for the period the borrower spends using the borrowed funds. It is the time value of money for the funds granted to borrowers in a specific period of time. According to the Kenya Bankers Association (Mwega, 2014), low bank interest rates have a positive impact on the quality of the bank loan books therefore bank's best interests are served when interest rates remain low and stable which has a direct relationship with the quality of the banks' loan books, with expectations that non-performing loans will increase in a regime of high interest rates. On the contrary, Mwega (2014) observes that Kenyan banks have repeatedly been portrayed as using their market power to extract high interest rates from businesses, especially SMEs. The larger banks tend to use their

reputational advantage to charge higher rates on loans and advances, while not having to pay high interest rates to attract deposits. Chelagat (2010) found a link between interest rate and non-performing loans. She argues that in the case of floating rate loans, increased interest rate affects the difficulty in servicing debt which leads to a higher number of non-performing loans. She further asserts that loan losses can be minimized through careful appraisal of loan requests, continuous monitoring of customer conditions and proper follow up on how the loan has been utilized as there is a possibility that the loan may not be utilized for the intended purpose leading to project failures.

Edakasi (2011) in a study on the effect of interest rates on loan repayment in Uganda (Equity bank) found that 23 % of the respondents disagreed that micro credit loans had helped their businesses to grow. Majority (77%) of respondents also complaint that high interest rates had eroded their profits making loan repayment difficult. Consequently, many micro-credit customers had pulled out using loans any more while others were planning to stop seeking for loans once their current running loans are fully repaid if the bank does not revise its interest charged on loans. The study also established that lack of entrepreneurship skills accounted for 26.7% of loan defaults. Bawuah, Yakubu and Alhassan (2014) opine that high interest rates compel small businesses to reduce inventories, incur high production cost and experience sharp falls in sales which ultimately affect their profit margins and growth and increases chances of loan default. However, with favorable credit terms, access to finance is enhanced hence a firm has more cash at hand to invest in profitable projects and increase its sales volume resulting to increased revenues and profitability. The enactment of the banking amendment Act 2015 is expected to be a relief to SME borrowers in the Kenyan market. Section 31 of the act compels a bank or financial institution to disclose all costs and terms relating to a loan so that borrowers can make informed decisions. Most banks do not disclose to borrowers the full cost of the loan particularly the administrative costs applied on the loan facility. It is also a requirement that commercial banks shall charge not more than 4% the base rate set and published by the Central bank.

Extant studies on the impact of lending period shows mixed results. Most banks maintain short term lending periods for SMEs for a start. Beginning the credit relationship based on short-term finance enables banks to build credit histories with borrowers, even in markets with poor land title regimes, poor collateral registries, and weak credit bureaus. It also allows banks to gain experience, reach an increasing number of new cohorts of smaller firms over time, and graduates these enterprises to access medium and long-term loans as well as unsecured financing (G20 Seoul Summit, 2010). While the FSD (2015) recommends these short term loan products such as overdrafts in financing working capital requirements, it cautions that short term loans are ill suited to finance long term investment needs of SMEs as they are expensive and expose SMEs to interest rate risks. Yusuf, Amao and Olawale (2014) recommend that to overcome loan repayment challenges faced by a majority of SMEs, banks should give a long loan repayment period to ensure that the end-users have better use of the loan, and increased ease of repayment because payment will be spread over a wide period of time. Odongo (2014) also concurs that short-term loans make SMEs not to perform well in their operations because of big installment payments remitted back to the MFIs in the short time. On the contrary, Chelagat (2010) found that SMEs that are given long grace periods and long repayment periods have a higher chance of default. Chelagat reports that 43.4% of the respondents opined that loans with a repayment period of more than 5 years have a higher chance of default, 33.3% of the respondents indicated 3 to 5 years, whereas 23.3% of the respondent indicated 1 to 3 years which is an indication that most loans with higher repayment period were susceptible to default. It is evident therefore that credit terms as measured by collateral requirements, interest rates and repayment period greatly influence the performance of SMEs and hence dictate whether a given loan product is effective or not. Favorable credit terms increase access to large amounts of capital that result to improved financial performance while unfavorable terms constraint SME access to capital resulting to poor performance.

2.3.2 Loan Utilization.

Banks provide loans mainly for purchase of fixed assets such as machinery and working capital. Whereas bank loans are a major source of external capital for a majority of SMEs, effective utilization of these loans has been a major challenge and cause of failure for a large number of SMEs (Amara *et al.,* 2015). Karadag (2015) asserts that inefficient use of financial resources and insufficient working capital management in terms of cash inventory and receivables management are reported as key financial challenges for SMEs in Turkey. Karadag (2015) also reports that a research done by Çetin, Akyüz and Genç (2008) on SMEs in Usak city of Turkey found that 80% of the SMEs did not have a finance department, and majority of them faced difficulties at collecting their receivables and utilizing bank loans. Githaiga and Kabiru (2015) opine that SMEs in Kenya still experience various difficulties in improving their financial performance since short term loan, trade credit and long term loans are not well managed. Setargie (2013) in a study on Credit Default Risk and its Determinants in Microfinance Industry in Ethiopia found that diversion of loans to non-productive activities outside the business meant that less money was available for investment consequently resulting to loan default and poor business performance. Kamwanza (2014) found that of the 76 women entrepreneurs who had received micro credit loans in Msambweni constituency 52(68.4%) respondents had used the loan for other purpose not agreed upon while only 24(31.6%) had used the loan for the intended purpose. Results also reveal that among those who had diverted the loans, over 65% either never repaid the loan or repaid with difficulty with only 23.7% paying without difficulty.

Although studies reveal that a large number of SMEs even when given access to appropriate capital often fail to apply it to productive firm investments (Banerjee *et al*. 2010; Karlan and Zinman 2010). Overcoming the challenge of ensuring micro entrepreneurs utilize capital for productive business investments has proved elusive so far. Amara *et al*., (2015) suggests reasons for this failure which they groups into three categories: **individual, organizational, and environmental**. They opine that some

factors that hinder investment in business assets reside at the *individual level*, such as present bias, fear of debt, and lack of self-control, financial illiteracy, or insufficient risk-taking when making investment decisions. Other factors arise at the *organizational level*. These include certain business characteristics, such as operating in a sector that requires greater liquidity or one with high degrees of seasonal variation, which may force the entrepreneur to under invest in long-term business projects in order to maintain higher levels of working capital in the short-term. *Environmental level* factors are also likely to play a role in reducing the amount of money a micro entrepreneur invests in her business e.g. the income shocks and high uncertainty faced by female micro entrepreneurs in developing countries might lead them to divert capital for needs outside their business, e.g. household items, education fees, or health expenditures (Banerjee & Duflo 2007, 2011; Collins *et al*., 2009).

Amara *et al*.,(2015) in a study on "Enhancing Productive Firm Assets: A Field Experiment on an Innovative Savings-Loan Product for Female Entrepreneurs in Ghana" using an experimental design sought to establish whether marketing an *unlocked savings-loan product* (no restrictions on how capital from savings deposits and loan proceeds is invested) or a *locked savings-loan product* (capital investment is dedicated ex ante to a productive firm asset) leads to better productivity and growth outcomes for female-led micro enterprises. Findings revealed that locked savings –loan products led to more consistent savings behavior, greater investment in productive assets for micro and small firms resulting to better productivity and growth outcomes of micro and small firms. They further argue that although financial institutions typically give the micro entrepreneur an unlocked savings account or loan i.e. one that is not contractually committed to the purchase of a specific productive asset, thereby allowing reallocation of the capital to non-business purposes. Such a loan is premised on the assumptions of Standard economic theory which suggests that an unlocked savings or loan product should be superior because it allows the micro entrepreneur to determine the optimal use of the money. This view, however, assumes that micro entrepreneurs are fully rational

actors who can make utility maximizing choices. In reality, given the individual, organizational and environmental factors noted above, many micro entrepreneurs are unable to commit to using a loan for optimal business investments. Instead they divert the capital to other purposes which constraints their investment choices resulting to poor business performance. Loan utilization is therefore a key determinant of whether the set objectives are achieved or not. Proper loan utilization means that SME managers spent the bank credit on activities agreed upon in the loan contract which results to growth of the business in terms of assets, profits, product innovation etc. This study hypothesizes that inappropriate utilization of bank credit by SMEs reduces the cash available for investment in productive business assets resulting to poor business performance of SMEs in Kenya hence diminishing the effectiveness of the bank credit in enhancing the performance of SMEs.

2.3.3   Managerial Competence.

The term, "competent", is used to identify someone who is efficient and effective in performing to a standard (Kagire and Munene, 2007). Nakiyingi (2010) defines managerial competencies as a set of skills, related knowledge, traits and attitudes that allow an individual to perform a task or an activity within a specific function or job. Armstrong and Baron (1995) and Sanda *et al*., (2011) concur that competency is the applied knowledge and skills, performance delivery, and the behaviors required to get things done very well. Bird (1995) asserts that entrepreneurial competencies are the underlying characteristics such as generic and specific knowledge, motives, traits, self-images, social roles, and skills which results in venture birth, survival, and/ or growth. Baum, Locke and Smith (2001) on the other hand define competencies as individual characteristics like knowledge, skills, and abilities required to perform a specific job, and categorize them into general competencies consisting of organizational skill and opportunity skill; and specific competencies consisting of industry skill and technical skill. Competency therefore refers to a specific behavior and characteristics of a person that result in effective or superior performance.

A number of studies propose that intellectual capital is critical to management process and can create sustained competitive advantage (Penrose, 1959; Tokuda, 2005; Sanda *et al*., 2011; Fatoki, 2014). Fatoki (2014) further opines that being knowledgeable can help an entrepreneur to be innovative. Hormiga *et al*. (2011) found that managerial competencies as measured by education, managerial experience, start-up experience and knowledge of the industry positively impact on the performance of SMEs. They opine that education provides the knowledge base and analytical and problem-solving skills to more effectively deal with the demands of entrepreneurship. Gerli, Gubitta and Tognazz (2011) reported that the entrepreneurial competency portfolio has an impact on the organizational performance. In particular, competencies like efficiency orientation, planning, persuasiveness, self-confidence, organizational awareness, directing others, teamwork, leadership and benchmarking are related to a higher firm performance. Ahmad *et al.,* (2010) reported that entrepreneurial competencies are strong predictors of business success in SMEs, and the association between entrepreneurial competencies and business success was more strongly evident in hostile and dynamic environments than in more benign and stable environments. Hee and Kee (2013) citing Kang (2009) found that competencies are positively related to entrepreneurial success, and specifically, high entrepreneurial competencies and high managerial competencies are linked to satisfaction on financial performance whereas high managerial competencies and high technical competencies are linked to satisfaction on non-financial performance. Laguna *et al*., (2012) also found that general managerial competencies (organizational skill, opportunity recognition skill) have significant indirect effects on business growth, while specific managerial competencies (industry and technical skill) have significant direct effects on business growth. They therefore call on SME managers to improve their managerial skills through training in order to guarantee business success.

Citing Nguyen and Ramachandran (2006) Fatoki (2014) points out that managerial competency is one of the key criteria for banks to grant loans. However he laments that

lack of managerial experience, skills and personal qualities as well as other factors such as adverse economic conditions, poorly thought out business plans and resource starvation have been found as the main reasons why new firms fail (Fatoki,2014). Griffin (2012) and Ropega (2011), asserted that most of the business failures are due to SME owner-managers' incompetence, inadequacy and inexperience in managing their business and taking quick remedial action in crisis situations. Odongo (2012) found that most SMEs in Uganda that have had access to financial resources from financial institutions end up in the poor financial state leading to business collapse before its first anniversary due to lack of entrepreneurial skills, inadequate technical and management support services. Hani and Khaled (2012) opine that the performance capability of managers has very crucial consequence on the functionality of the business. Thus lack of education and professional training are the reasons of a lot of managerial problems in SMEs. They observe that, entrepreneurs perform badly in many areas of management such as, bookkeeping, marketing, costing, warehousing, stock control, production scheduling, and quality control. The owner/managers in some cases either do not understand financial statements or do not use them for planning purposes. Some owner/managers still do not distinguish the personal expenditure and business expenses, and have no precise awareness of their production costs. They recommend that for SMEs to survive owners/managers must be familiarized with management aspects such as; finance, personnel, sales, production management etc. Karadag (2015) opines that managerial mistakes in terms of failure to develop a strategic plan and poor financial control are among the most important reasons of business failures in small businesses.

Extant literature also reveals divergent views on financial management practice that are key to the performance of SMEs. Karadag (2015) presents these views to support the assertion that important financial management constructs are context specific. For example, Peel and Wilson (1996) regarded capital budgeting and financing activities as the major elements of financial management practices for small businesses in UK, while Nguyen (2001), conducting a research study on Vietnamese SMEs, argued that the

practices which are key to the profitability and performance of SMEs in Vietnam are those related to the 'accounting information systems, financial planning, working capital management, fixed-asset management and financial reporting and analysis. Kennedy and Tennent (2006) used financial record keeping as the general indicator of financial management conduct in small businesses in Australia while Butt, Hunjra and Rehman (2010) addressed "capital structure decision, dividend policy, investment appraisal techniques, working capital and financial assessment" as the most common financial management practices in Pakistan.

Mazzarol, Reboud and Clark (2015) opine that the most important areas of financial management in SMEs are cash flow cycle and working capital management. Without cash or the liquid assets (working capital) that are necessary to operate on a daily basis, the company risks becoming insolvent and failing. Research has shown a positive relationship between the efficient management of cash flow (the cash conversion cycle) and working capital, and the firm's profitability (Yazdanfar & Ohman, 2014; Mazzarol *et al*., 2015). The more efficiently a firm manages its working capital the more it can boost its profitability which requires speeding up the recovery of accounts receivable while carefully managing inventory turnover. Therefore, owner-manager needs to ensure that they monitor their accounts payable and accounts receivable closely. However, the main reasons many owner-managers get into difficulty are the poor financial control systems and management practices in their firms due to owner-managers having insufficient skills and knowledge of financial accounting controls to know what to do (Uwonda *et al*., 2013). This typically results in these SMEs experiencing cash flow and liquidity problems with high levels of bad and doubtful debts (Abanis *et al*., 2013). The resource-based theory and existing empirical literature show clearly that it is the resources or competencies of a firm which make it different from others that are important for its market success (Tokuda, 2005). Human capital competencies are a key factor in explaining why some firms outperform others and has the potential to bring about a competitive edge. In the Kenyan context, the study opines that possession of

financial management skills in terms of budgeting, record keeping and financial planning skills by SME managers would improve their ability to utilize bank credit for superior business performance. Consequently, this study considers managerial competencies in terms of financial management skills and entrepreneurial skills as an important predictor of whether or not SME managers are able to effectively use bank loans to bring about superior business performance.

2.4. Effectiveness of Bank Credit

Empirical literature indicates that the effectiveness of an intervention can be measured in terms of the expected outcomes or the extent to which set objectives are achieved and targeted problems solved. Various studies have been undertaken to measure the effectiveness of micro credit programs worldwide. For instance; Terano, Mohamed and Jusri(2015) in a study to measure the effectiveness of microcredit programs among small businesses in Malaysia using factor analysis, concluded that the program was effective as it had positive outcomes in terms of assisting members to increase income, improve their loan management skills and allowed members to save and repay the loan. Similar studies done by Twyearfur and Hafiz (2012) and Wengcong (2013) to assess the effectiveness of micro credit also used proxies such as increased income, growth in assets, business profitability, standard of living and poverty reduction. Taha (2012) in a study on the effectiveness of micro credit programme in alleviating poverty and empowering women in Egypt using a Quasi experiment design measured program effectiveness in terms of its ability to enable loan holders to sustain their businesses by making profits, expand business, hire new workers and ability to re-invest in the business. These findings are also corroborated by other researchers such as Ismaila and Imoughele(2014) and Nwanyanwu (2012) among others.

Chaffey (2016) contends that unlike efficiency, effectiveness is determined without reference to costs and, whereas efficiency means "*doing the thing right*," effectiveness means "*doing the right thing*." He further asserts that effectiveness means measuring the

extent to which targets are being met, and detecting the factors that hinder or facilitate their realization which also involves establishing cause-effect relationships about the extent to which a particular policy produces the desired outcome. In the words of these author, effectiveness also refers to summative evaluation. Chaffey also developed a tool to measure effectiveness based on the Balanced score card previously developed by Kaplan and Norton (1993). Indicators of effectiveness proposed are as shown in Table 2.1.

Table 2.1: Indicators of Effectiveness

Balanced scorecard sector	Effectiveness
Financial results (Business value)	• Profit contributed • Innovations
Customer value	• Sales and sales per customer • New customers • market share • Customer satisfaction ratings • Customer loyalty index
Operational processes	• Fulfillment times • Support response times

Source: Chaffey (2016)

Hasan and Tibbits (2000) as cited by Chaffey (2016) note that the internal process measures are majorly concerned with efficiency while the customer and business value perspectives are indicative of the level of effectiveness. This therefore implies that growth in profits; customer base and volume of sales are good indicators of organizational effectiveness. Chaffey (2016) argues that financial metrics such as turnover and profitability tend to be retrospective rather than looking at future potential,

as indicated by innovation, customer satisfaction and employee development aspects of the balanced score card. He therefore proposes use of measures of effective performance such as customer satisfaction index, sales volume, range of innovations in the business, range of products and profits particularly in measuring the performance in the financial domain and customer focus domain of the balanced score card.

Extant studies also indicate that SMEs mainly seek external finance for working capital or cash flow improvement, purchase of equipment or motor vehicle, land and buildings or marketing activities (BIS,2012). Accordingly the FSD (2015) reveals that main bank products for the SME market segment in Kenya are; working capital finance, term loans, overdrafts, local purchase order (LPO) financing and asset finance loans. Effective utilization of these loans would therefore mean that they must be used for the right purpose (i.e doing the right thing). Consequently well utilized asset finance loans would result in increased volume of productive assets in the business while properly utilized working capital loans and LPO finance would result to an increase in cash flows in the business enabling them to service their customer orders on time ultimately increasing the volume of sales, growth in customer base and increase in innovations in terms of new products (Mbugua, Njeru & Tirimba, 2014).

These studies indicate that the effectiveness of bank credit can be measured by growth in assets of a business as a direct effect or from outcomes such as improved profitability, customers' base, and business expansion among others. In this study therefore effectiveness of bank credit was measured in terms of how well the loan was utilized by the SME managers to achieve the set objectives as agreed upon in the loan contract. Proper utilization of working capital loan is expected to translate to increased sales, customer base/market share, new products or services in the market. While asset finance loans should result to higher volume of assets and increased profits from the improved productive capacity. These indicators were thus used to measure the effectiveness of bank credit in enhancing SME performance.

2.5. Critique of the Literature Reviewed

A number of theories have been advanced to explain the growth of entrepreneurial ventures. Proponents of the Social network theory affirm the importance of entrepreneurial networks as a source of social capital. Networks have been found to be valuable sources of information on entrepreneurial opportunities (Clausen,2006; Jaafar et al.,2009; Leyden *et al*.,2013) and also facilitate access to resources such as capital and skilled labour which are key to opportunity exploitation(Shane & Stuart,2002; Hsu,2004). The Economic theory by Mark Casson (1982) on the other hand alludes that entrepreneurship firms can only thrive in a favorable economic environment with economic incentives such as favorable taxation policy, industrial policy, affordable finance, infrastructure and favorable market conditions. The Resource Based View theory on the other hand argues that possession of resources by a firm that are unique, which cannot be accumulated or imitated can give a firm a competitive advantage and are primary determinants of its performance (Hoffer & Schendel, 1978; Wenerfelt, 1984; Grant,1991). Barney (1991) singles out key resources to include all assets, capabilities, organizational processes, firm attributes, information, knowledge of employees, etc. controlled by a firm that enable the firm to conceive of and implement strategies that improve its efficiency and effectiveness. The theory further suggests that possession of Knowledge capital has the potential for a sustained competitive advantage (Fatoki, 2014).

Empirical studies that have examined the relationship between bank lending and SME performance found a positive correlation between affordable bank loans and business performance (Nyangoma, 2012; Yusuf *et al*., 2014 and G20 Seoul Summit, 2010). Ease of access to finance enables firms to develop new products, expand their markets to increase sales which results to improved financial performance (Olutunla&Obamuyi, 2008; Nyangoma, 2012; Odongo, 2014). However, most SMEs in developing economies have difficulties in credit acquisition due to unfavorable credit terms (Nakiyingi, 2010; NCR, 2011; Odongo, 2014). Although collateral is important as it helps to reduce information asymmetries, moral hazard problems and a motivation to lenders since

borrowers with collateral are unlikely to venture into risky projects (Berger & Udell, 1998; Otero & Lopez, 2001; NCR, 2011; Amara et al, 2015). On the contrary, studies have found lack of adequate collateral to be the main reason for credit rationing of SMEs by commercial banks.(Kaufman,2005;G20 Seoul summit,2010; Nyangoma,2012) Low interest rates have also been attributed to affordable loan repayments minimizing loan defaults and volume of non- performing loans in commercial banks (Mwega, 2014). However, the Kenya financial market is dotted with a large number of loans at high interest rates making the capital expensive for a large number of SMEs and has been linked to the high volume of non-performing loans (KIPPRA, 2012; Chelagat, 2010) is reason for small business stagnation and failure (Edakasi, 2011) and compels SMEs to reduce inventories, incur high production costs and reduce their volume of sales which negatively affects financial performance of SMEs. Whereas Yusuf *et al*., (2014) and Odongo (2014) recommend a long loan repayment period for SMEs to enable them spread out loan installments for ease of repayment, Chelagat (2010) contradict this view and opines that long grace periods and repayment periods increase the chances of loan default due to moral hazard problems.

Whereas bank credit provided to SMEs is supposed to be used in the purchase of productive business assets, research findings reveal that effective utilization of loans is a major challenge for a majority of SMEs (Amara et al., 2015; Kadarag, 2015; Githaiga & Kibiru, 2015). Evidence shows that most SMEs fail to use loan capital for productive firm investments which means that less capital is available for investment activities (Setargie, 2013; Kamwanza, 2014). Amara *et al*., (2015) attributes this failure to individual challenges, organizational challenges and other environmental factors which makes them to divert loans to other uses limiting investment capital. Studies also affirm that managerial competence has a positive impact on organizational performance (Tokuda, 2005; Hormiga *et al*., 2011; Fatoki, 2014). Fatoki further opines that being knowledgeable can help an entrepreneur to be innovative. Therefore business failures and poor financial performance can also be attributed to managerial incompetence

(Odongo, 2014; Hani & Khaled, 2012, Ropega, 2011). This study investigated whether credit terms, loan utilization and managerial competence are among the major factors influencing the effectiveness of bank credit in enhancing the performance of SMEs in Kenya.

2.6. Summary

The Social network theory underscores the importance of social networks which are key to opportunity identification and acquisition of resources for opportunity exploitation. The economic theory on the other hand suggests that firms can only thrive in a favorable macro environment with economic incentives. While proponents of the RBV theory suggests that the resources possessed by a firm are the primary determinants of its performance and these may contribute to a sustainable competitive advantage of the firm (Hoffer & Schendel, 1978; Wenerfelt, 1984; Grant, 1991). For these resources to result to competitive advantage they must be unique, difficult to imitate and accumulate. The study considers bank credit and managerial competence as key resources that can be harnessed to bring about competitive advantage under favorable lending terms.

Whereas access to finance is necessary to help SMEs to set up and expand their operations and develop new products, limited access to credit results in reduced financial performance in terms of sales, profits and liquidity (Olutunla & Obamuyi, 2008). Research has found that there is a significant positive association of credit terms and access to credit on financial performance of SMEs. Favorable credit terms facilitate ease of access to credit thereby improving financial performance of SMEs in terms of sales, liquidity and profitability. (Nyangoma, 2012).However, poor performance of SMEs can be blamed on unfavorable credit terms (Kauffman, 2005; G20 Seoul summit, 2010; Nyangoma, 2012). Which include lack of collateral(Nyangoma,2012; NCR,2011), high interest rates(Chelagat,2010 ;Edakasi,2011; Mwega,2014) and short lending period(Yusuf *et al*,2014; Odongo,2014).

Even though bank loans are a major source of capital for a majority of SMEs, effective utilization of these loans has been a major challenge and cause of failure for a large number of SMEs.((Amara *et al*.,2015;Karadag,2015; Githaiga and Kabiru ,2015).Extant research shows that SMEs often divert loans to non-productive activities outside the business meaning less money is available for investment resulting to loan default and poor business performance(Setargie ,2013; Kamwanza,2014). This failure to utilize loans effectively can be attributed to individual, organizational and environmental factors as well as the unlocked business loans that SMEs receive form financial institutions (Amara *et al*., 2015). Managerial competence has also been found to have a positive relationship with business performance (Fatoki, 2014; Hee & Kee, 2013; Ahmad *et al.,* 2010). It is conceptualized that credit terms, loan utilization and managerial competence influence the effectiveness of bank credit in enhancing the performance of SMEs in Kenya.

2.7. Research Gaps.

Extant literature reviewed indicate that although bank lending to the SME sector has improved significantly over the years, the performance of the recipient SMEs is still wanting (Amara *et al.*,2015;Karadag,2015; Githaiga and Kabiru ,2015). The SME manufacturing firms in Kenya exhibit a slow rate of capital formation and minimal investment activity (KIPPRA, 2013; Chelagat,2012) and a high failure rate of micro enterprises (Njoroge 2013; Oluoch,2014;Iloh *et al*,2015). All these signals point to an unfavorable financial performance of the beneficiary SMEs which necessitates the need to investigate the extent to which commercial bank lending has contributed to the performance and survival of SMEs in Kenya. If this situation is not arrested many more firms will continue to close down despite the increased lending to the sector.

Although there exists empirical research on this topic, it does not offer conclusive evidence on which factors play a more significant role in influencing the effectiveness of bank credit in enhancing the financial performance of SMEs. The literature only provides some general guidance on this topic, but has yet to address the proposed

research questions. Odongo (2014) in a study on lending terms and the financial performance of SMEs in Uganda Soroti district using a regression model found that lending terms conceptualized in terms of cost of money, loan size and lending period explained about 26.6% of the variation in financial performance of SMEs. He concluded that lending terms alone had a low influence on the financial performance of SMEs, he thus proposed a further investigation incorporating managerial competence. Nyang'oma (2012) in a study to establish the extent to which credit terms and access to credit have affected financial performance of SMEs in Kampala found that credit terms explained 33.1% of the variance in financial performance of SMES in Kampala Uganda. The two studies focused on credit terms which explained less than 35% of the variance in financial performance of SMEs. The current study included loan utilization and managerial competence in attempt to explain the variance in financial performance of SMEs. Moreover, given the geographical diversity and difference in economic development, there is need for a similar study in Kenya. In Kenya most studies have focused on the impact of microfinance on the performance of SMEs (e.g Gathongo, 2014; Rotich, Lagat & Kosgei, 2014). However, MFIs have flexible loan products and small loan size of up to 500,000/= mainly targeting the financially excluded informal sector micro enterprises. On the contrary, SME lending ranges from 1 to 50 million which warrants an independent research.

Research on the effect of managerial competencies on the performance of SMEs in Kenya is scanty. Existing research has been done in other countries such as South Africa (Fatoki, 2014), Malaysia (Lee *et al.,*2010) and Ghana (Sanda *et al.*,2011) .This necessitates similar studies to be done in Kenya to establish how the competency of SME managers could affect their ability to utilize loans. Moreover, no study has directly investigated how the utilization of loans in small businesses could affect the performance of beneficiary SMEs. Therefore, this study examined factors that hinder bank credit in enhancing the performance of SMEs in Kenya.

CHAPTER THREE

RESEARCH METHODOLOGY

3.1 Introduction.

This chapter provides a description of how the research was carried out to meet the objectives of the study. Therefore, it presents the research design, target population, sampling procedure and sample size, research instruments, data collection procedure, reliability and validity of the instruments and data analysis.

3.2 Research Design

The study adopted a descriptive cross sectional survey design. Babbie& Mouton (2010) recommend this design where the researcher wants to collect original data for describing a population that is too large to observe directly. Samples are also mainly based on probability sampling which leads to generalizability of data collected (Kumar, 2011).

3.3 Target Population

The target population were SMEs operating in Kisumu city with at least 3 employees financed by KCB bank, Cooperative bank, Equity and NIC bank. The SMEs must be in the category of those borrowing 1-50 million. These banks were selected because they have common criteria of categorizing SMEs. Financial Sector Deepening report (FSD, 2015) established that banks mainly use loan size to define SMEs. While the banks are aware that loan size is not the best proxy for the size of their business clients, it is used because loan-size information is easy to collect and serves as a second-order proxy for the overall size of the business. SME records obtained from the four Commercial banks indicate that SMEs in this category were 1,527 in total as shown in Table 3.1.

Table 3 2: Target Population

S/No	Bank	Number of SMEs
1.	Kenya Commercial Bank(4 branches)	700
2.	Cooperative Bank (2 branches)	236
3.	Equity bank (2 branches)	379
4.	NIC bank (1 branch)	212
Total		**1527**

3.4   Sample and Sampling Technique

Four commercial banks were purposively sampled based on their uniform criteria of SME loan. Proportionate sampling was used to determine the number of SMEs to be interviewed. Simple random sampling was used to select respondents within the stratum which gave all SMEs in the stratum equal chance of being included in the sample (Kothari, 2004; Kasomo,2006). The sample size was calculated using Yamane's formula (1967) on the basis of which a sample of 316 SMEs managers was selected.

$$n= \frac{N}{1+ N (e)^2} = \frac{1527}{1+ 1527(0.05)^2} = 316.469382 \sim 316$$

Where, n = sample size, N = population size, e = level of precision.
The level of precision is the range in which the true value of the population is estimated to be; it is expressed in percentage points (±5%).
This sample size was thus calculated at 95% significance level.

Sample proportion= 316/1527= 0.20694172~0.2069

Table 3.3: Sample Size.

S/No	Bank	Number of SMEs	Proportion	Sample size
1.	Kenya Commercial Bank	700	0.2069	145
2.	Cooperative Bank	236	0.2069	49
3.	Equity bank	379	0.2069	78
4.	NIC bank	212	0.2069	44
Total		**1527**		**316**

3.5   Data Collection Instruments.

Primary data was collected using a structured questionnaire with both closed and open ended questions. Secondary data on the performance of SMEs and bank lending to the sector was collected through desk research by analyzing industry reports, government publications and reports and journal articles. Cohen (2007) recommends use of closed, structured questions where the sample size is large. Use of closed ended questions also allowed the researcher to collect standardized information from the respondents while open questions enabled the researcher to gain insights on the aspects of bank lending that could be impacting on SME performance.

3.6   Data collection Procedure

In collecting data, the researcher first obtained an introductory letter from the Graduate school of Jomo Kenyatta University of Agriculture and Technology. The researcher

then sought permission from the regional managers of the selected banks to allow the collection of data from the bank branches within Kisumu City after which she obtained a list of SMEs from the SME loan departments of the respective banks. Using proportionate sampling respondents were selected and the questionnaires administered on a drop and pick basis by the researcher in order to increase the response rate in line with recommendations by Guthrie (2012).

3.7. Pilot Testing.

To ensure that the instruments are reliable and valid, a pilot study involving thirty (30) randomly selected respondents with similar characteristics as the target population obtained from SMEs financed by KCB bank Kisumu West branch was carried out. This was based on the recommendations of Mugenda and Mugenda (2003) that a sample of 10% is adequate for piloting. The pilot study assisted the researcher in making the necessary corrections on the instruments to ensure the questions were accurate and consistent and correctly capture the objectives of the study before carrying out the actual research. These respondents were not included in the final sample for the study.

3.8. Reliability of Research Instruments

Reliability of a research instrument enhances its ability to measure consistently what is intended. Reliability was increased through piloting whereby the questionnaire was administered to the 30 respondents of the pilot study. Results of the pilot study were used to correct the research instrument to ensure the questions remained focused on the research objectives. The Cronbach Alpha was also calculated to determine scale reliability of the instrument.

3.9. Validity of Research Instruments

Validity is defined as the degree to which the researcher has measured what he has set out to measure (Kumar, 2011; Kothari, 2004; Smith 1991: 106).According to Kerlinger

(1973: 457) as cited by Kumar (2011) the commonest definition of validity is epitomized by the question: "Are we measuring what we think we are measuring?" The face and content validity of the research instruments was established by seeking opinions of experts in the field of study especially my research supervisors and other lecturers at Jomo Kenyatta University of Agriculture and Technology as well as the manager KCB Kisumu West branch. Their advice and suggestions enabled the researcher to make the necessary changes to the questionnaires. In addition, content validity of the instrument was determined through piloting, where the responses to the questions were checked against the research objectives. Any questions found ambiguous and/or irrelevant was removed or modified.

3.10. Data Analysis and Presentation

After the questionnaires were collected from the respondents, they were first scrutinized for completeness and consistency. They were then coded and captured into SPSS version 17.0 program. Quantitative data was analyzed and summarized using means, frequencies and percentages. The analyzed data was then summarized and presented in tables, graphs and charts for ease of comparison. Factor analysis was also done to reduce data into a small number of variables/factors that explain most of the variance observed. The reduced factors were then used as variables for multiple regression analysis. Kothari (2004) and Yong & Pearce (2013) recommend factor analysis for reducing data measured on ordinal or interval scales for further analysis such as multiple regression, correlations and multicollinearity tests. For data to be sufficient for factor analysis, Comrey & Lee (1992) as cited by Yong and Pearce (2013) recommend a sample size of 300 participants where each of the variable subjected to factor analysis must have at least 5-10 observations. Therefore the data in the current study met this requirement. A multiple regression model was then extracted from the reduced factors which was used to determine the influence of credit terms, managerial competence and loan utilization

on the average performance of SMEs in Kisumu city. The tests were done at 95% confidence level.

CHAPTER FOUR

RESEARCH FINDINGS AND DISCUSSION

4.1   Introduction

This chapter presents analysis and findings of the study as set out in the research methodology. The results are presented on the factors affecting the effectiveness of bank credit in enhancing the performance of small and medium enterprises in Kenya: A case of Kisumu city.

4.2   Response Rate

Three hundred and sixteen (316) questionnaires were distributed on a drop and pick basis. 300 questionnaires were returned from which 4 questionnaires were discarded for being incomplete. The researcher ended up with 296 usable questionnaires which represented a response rate of 93.67%. Mugenda and Mugenda (2003) recommend a response rate of 50-70%. Therefore the response rate of 93.7 % was deemed adequate for analysis and reporting.

4.3.   Reliability of the Instrument.

Reliability of the instrument was determined through piloting and Cronbach alpha. The Cronbach Alpha was calculated to determine scale reliability of the instrument which gave an overall alpha value of α = **0.777.** Reliability of individual scales on the questionnaire were also tested by calculating the Cronbach's alpha which gave the values as shown in Table 3.4.

Table 4.4: Questionnaire Reliability

	Variable	Cronbach Alpha Value	No of Items
1	Credit Terms	0.678	8
2	Loan Utilization	0.597	5
3	Managerial Competency	0.860	7

Field (2005) recommends a minimum overall alpha value of 0.7 although he also opines that in psychological constructs, values below 0.7 can realistically be expected. In this study the alpha value of 0.777 shows that the instrument had a good level of internal consistency.

4.4   Demographic Characteristics

Respondents were asked to provide information regarding their demographic profile which included gender, age, level of education, type of business, duration in business and form of ownership. Where essential, data was analyzed based on disaggregated sub groups as per the demographic characteristics. Any important trends noted were highlighted to draw out lessons for policy intervention.

4.4.1. Gender of the Respondents

The analysis established that majority of the respondents in the study were male (57.7%) while female represented 42.23 % of the respondents as shown in Figure 4.2 Therefore majority of the respondents were male although females were also fairly well represented.

.3
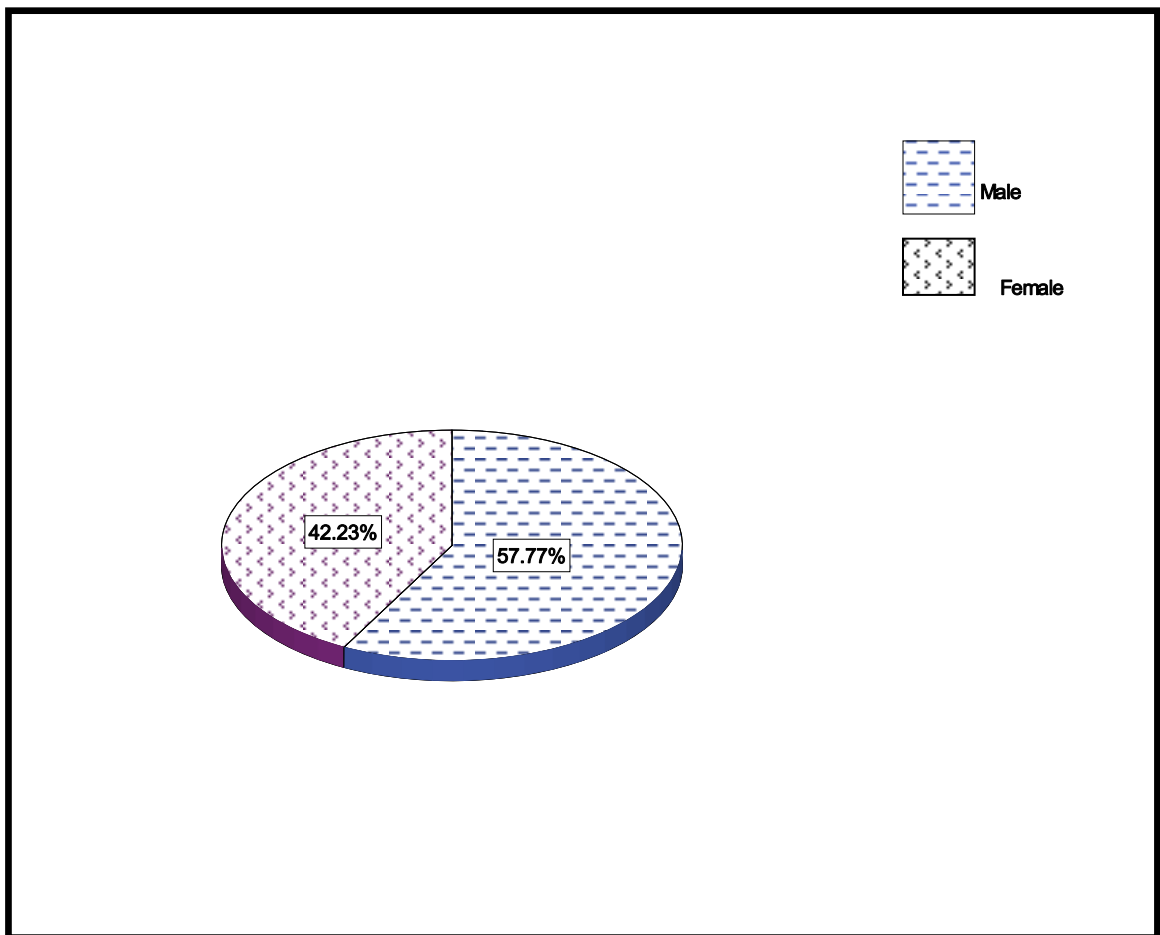
Figure 4.2   Gender of Respondents

4.4.2   Age of the Respondents

Majority (59.12%) of the respondents indicated that they were between 18 to 35 years of age, 29.05 % were between 36 to 60 years and 11.82 %   above 60 years. This implies

that majority of SME managers are in the youth bracket of 18-35 as shown in Figure 4.3.
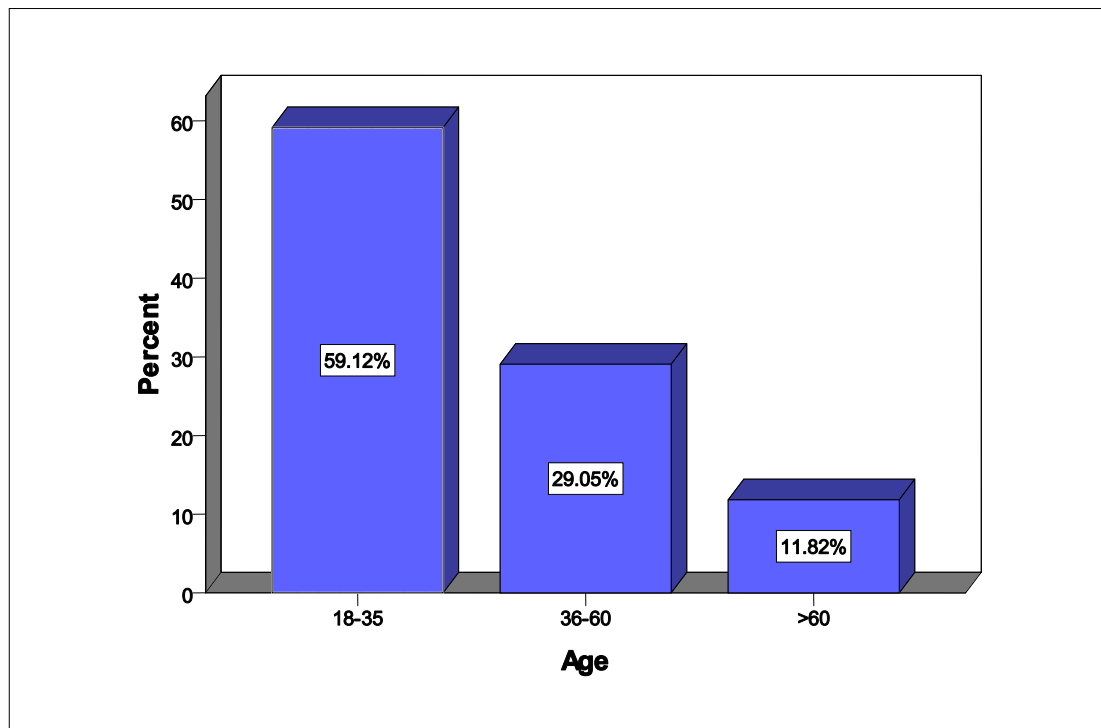
Figure 4.3 Age of Respondents

4.4.3. Educational Attainment

From the results as depicted in Figure 4.4 majority (49.32 %) of the respondents were University graduates, 25.34% had College level of education, and 20.27% had Secondary education while only 5.07% had primary education there was no respondent without education. This implies that most of the SME managers in the study area are well educated with more than half having at least College Education which has a positive impact on the level of financial literacy.
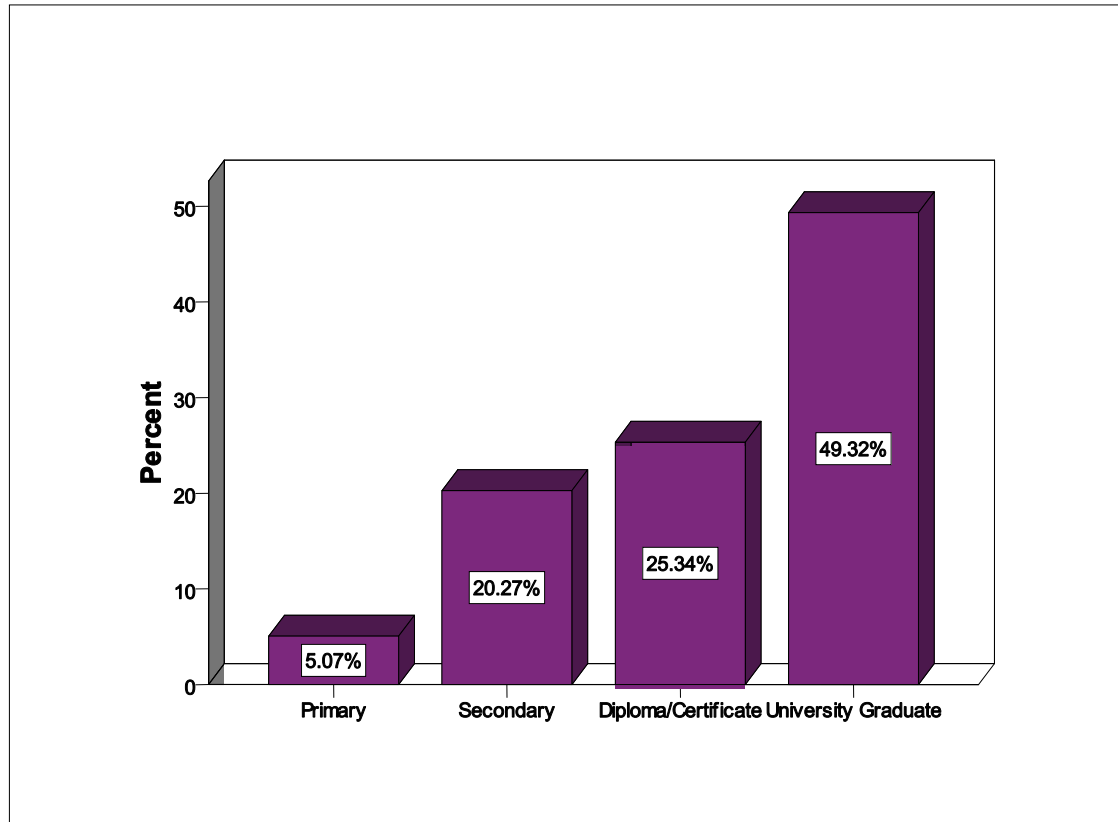
Figure 4.4. Education Attainment

4.4.4. Type of Business.

It was established that majority of the respondents (49.99%) are in Retail /Wholesale business, 41.22% in Service business,8.78% in Agribusiness and only 1.01% in Manufacturing as shown in Figure 4.5. This is consistent with the findings of KIPPRA (2012) that majority of the SMEs in Kenya operate wholesale and retail trade due to low capital requirements for the sector while the manufacturing sector accounted for only 9% of the total SME establishments as at 2011.
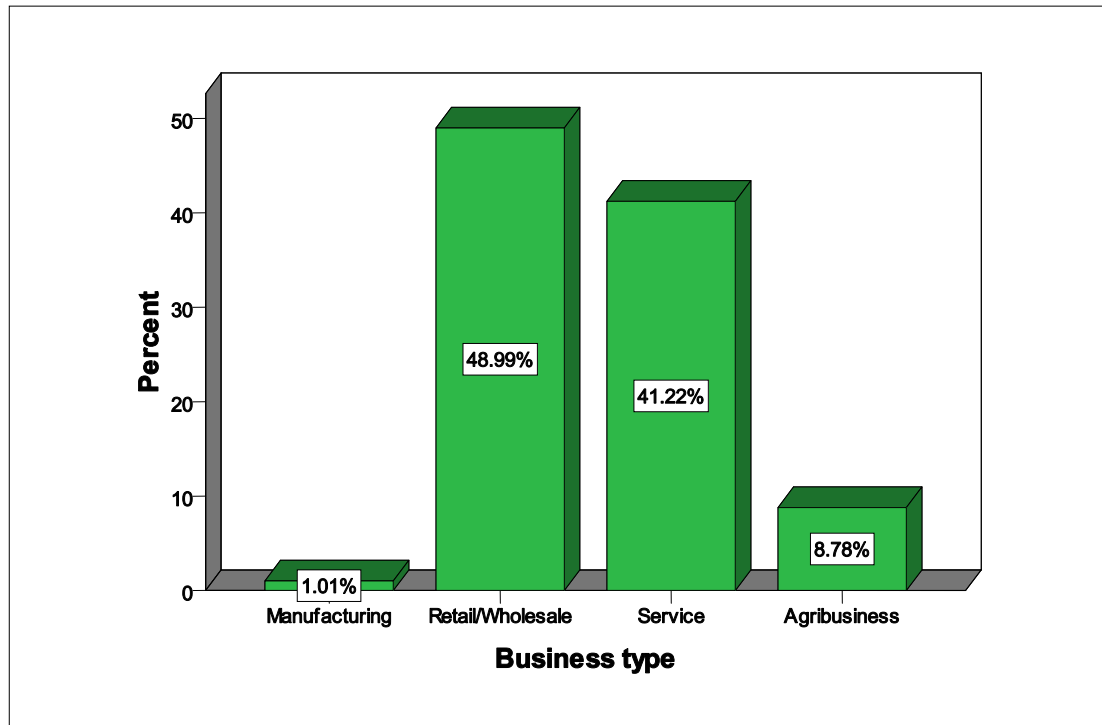
Figure 4.5 Business Type

4.4.5. Duration in Business

The analysis revealed that majority (44.26%) of the businesses have been in existence for 0-5 years, 43.58% for 6-10 years,8.45% for 11-20 years and only 3.72 % above 20 years. This implies that the bulk of SMEs have been in existence for less than 10 years as shown in Figure 4.6.
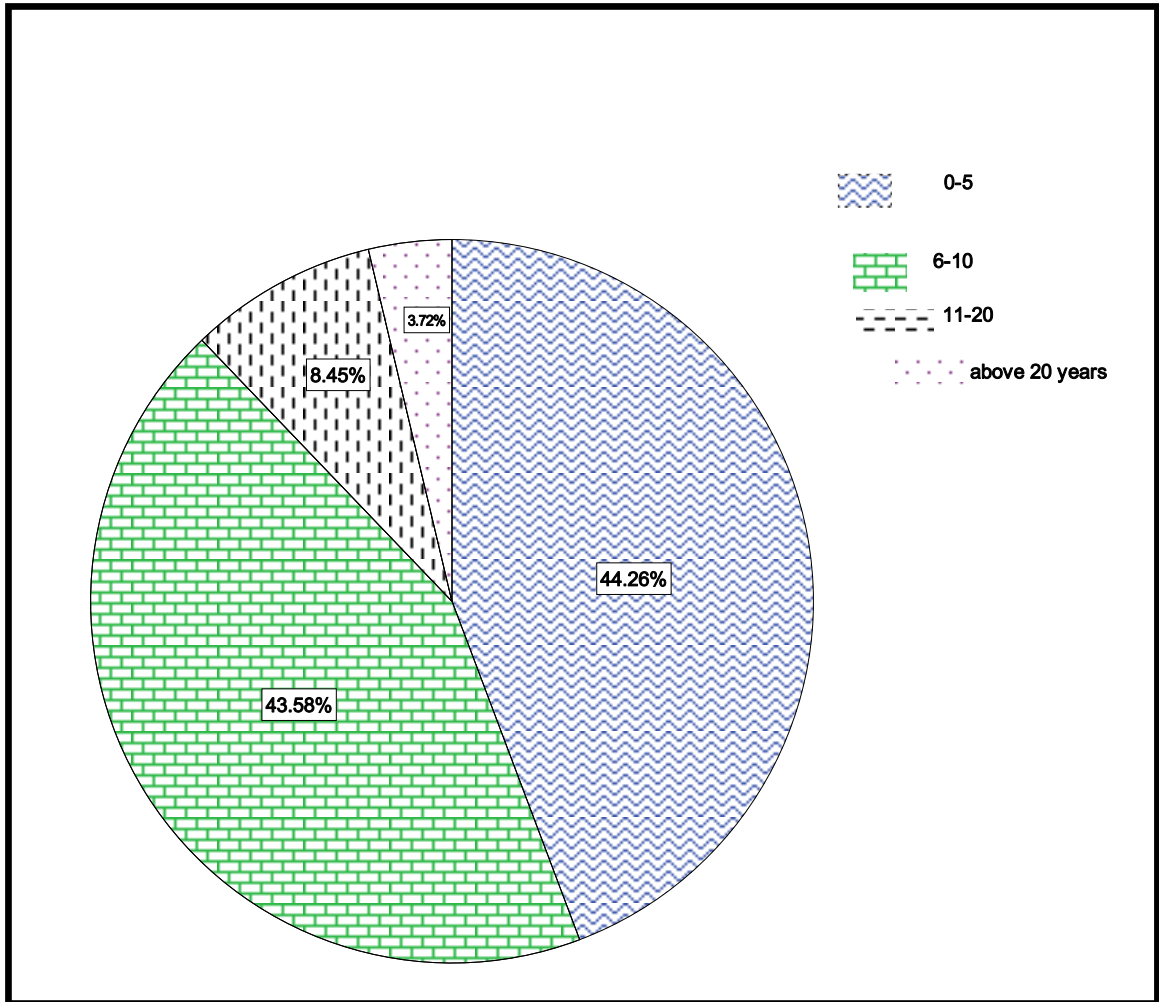
Figure 4.6 Duration in Business

4.4.6. Number of Loans

The study further established that majority of the respondents (73.65%) had borrowed loans less than five times, 20.69% had been given loans 6-10 times with only 5.74% borrowing more than 10 times. A cross tabulation of duration in business and number of loans as shown in Table 4.5 reveals that all businesses who have borrowed more than 10

times have been in existence for at least 10 years .This implies that a longer duration in business has a favorable rating of the SME which increases the chances to access credit.
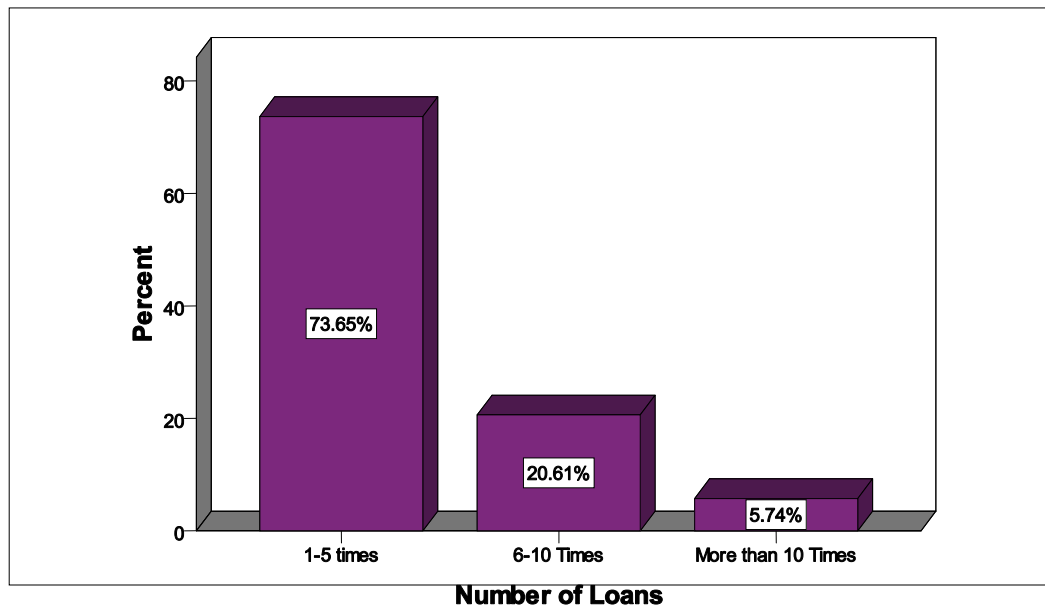
Figure 4.7 Number of loans

Table 4.5: **Cross tabulation of Duration in business by Number of Loans**

<div align="center">Number of Loans</div>

		1-5 times	6-10 Times	More than 10 Times	Total
Duration in business	0-5	117	14	0	131
	6-10	91	38	0	129
	11-20	10	9	6	25
	above 20 years	0	0	11	11
Total		**218**	**61**	**17**	**296**

4.4.7. Single Highest amount borrowed
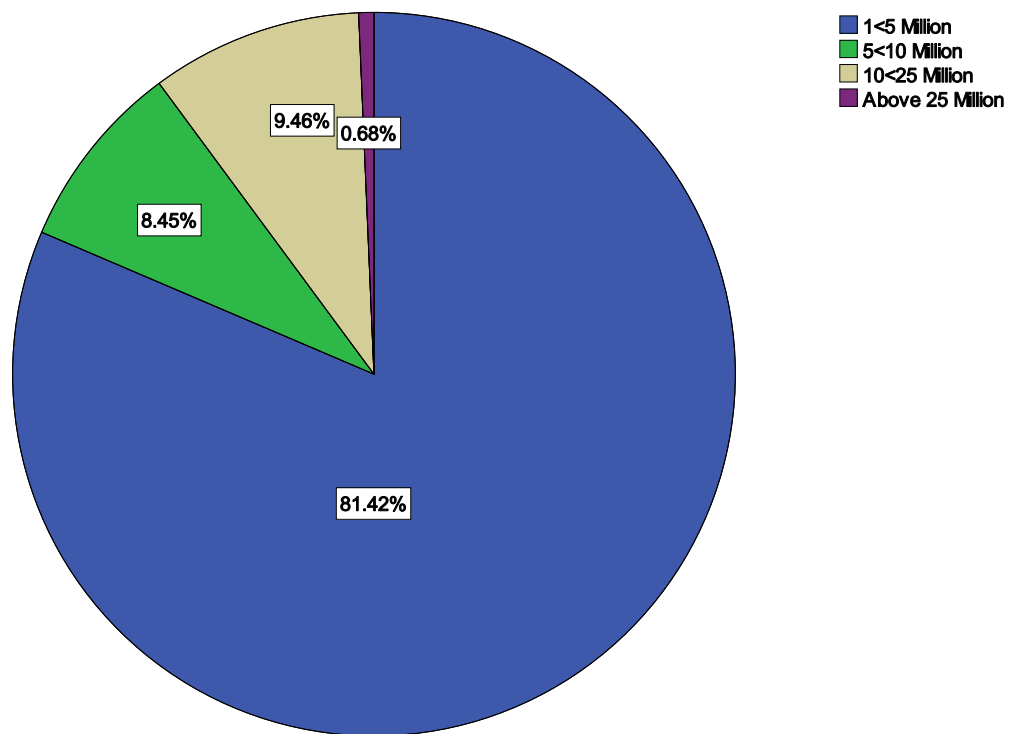
Figure 4.8   Single Highest amount borrowed

Findings in figure 4.8 indicate that the highest amount borrowed by a majority of the SMEs was less than 5 million. This confirms findings reported by FSD Kenya (2015) that the maximum loan size is KSh1.9 million for small firms, KSh5.4 million for medium enterprises, and about Ksh41 million for large firms. This implies that majority of SMEs are not able to access large loans which may have more favorable lending terms to provide adequate capital for investments.

4.5. Credit Terms

Objective one sought to establish whether credit terms had any influence on the performance of SMEs in Kisumu city. Respondents were presented with 7 questions on a likert scale to state their level of agreement with the statement where SD= Strongly Disagree, D=Disagree, U= Unsure, A=Agree, SA= Strongly Agree.

Table 4.6: Credit Terms

Credit Term Aspect	SD	D	U	A	SA	TOTAL
This firm can afford the cost of credit in terms of interest rates and administrative costs charged by commercial banks on loans borrowed.	**30.4**	28.0	4.1	22.6	14.9	100.0
This firm feels interest rates charged are reasonable.	**41.2**	24.7	6.1	17.2	10.8	100.0
This firm has sufficient collateral to get credit from commercial banks.	29.4	15.9	8.1	**35.5**	11.1	100.0
The Security required to get loans limits the firm's ability to borrow from commercial banks.	9.5	17.6	14.2	**34.8**	24.0	100.0
The loan repayment period given to this firm is convenient.	24	**29.1**	13.9	27.4	5.7	100.0
Most loans obtained by the firm are short term loans.	4.7	23.6	8.4	**43.2**	19.9	100.0
This firm feels a loan given to management to determine the use is more productive than one where the bank dictates the purpose.	7.1	18.6	8.8	31.8	**33.8**	100.0

Findings as shown in Table 4.6 reveal that majority of the SMEs were uncomfortable with the credit terms offered by commercial banks. Specifically; Majority of the respondents (30.4 %) strongly disagreed that their firms can afford the cost of credit charged on loans borrowed. Cumulatively 62.5% strongly disagreed, disagreed or were unsure which implies that most SMEs were not comfortable with the cost of credit. Most borrowers are never fully aware of the full cost of credit at the time of borrowing since the information is never disclosed by the banks. It's against this backdrop that the new banking amendment Act 2015 was enacted into law. Section 31A compels a bank or financial institution that offers a loan to a borrower to disclose all charges and terms related to that loan so that they are able to make informed decisions. Findings on interest rates revealed that most of the respondents (72%) either strongly disagreed, disagreed or were unsure on whether the interest rates charged were reasonable. This means that interest rates charged were regarded as unreasonably high by most SME managers. This confirms finding that compared to other middle income countries, interest rates in Kenya are generally higher ranging between 19-24% compared to the Asian tigers where the rate is below 10% (FSD,2015 ;KIPPRA,2012; Mwega,2014). Moreover, high interest rates have been found to erode profits making loan repayment difficult (Edakasi, 2011). Section 33 of the banking amendment act 2015 pegs the maximum interest rate chargeable to a loan facility to not more than 4% above the Central Bank Rate (CBR). It is expected that the enforcement of this law will make loans more affordable to borrowers.

 Although collateral enhances credit protection by reducing informational asymmetries and moral hazard problems that arise between banks and entrepreneurs since it can be repossessed by the creditor in case of default (NCR, 2011). Majority of the respondents lacked adequate collateral to access bank loans. On whether collateral required is favorable only 37.5% agreed or strongly agreed against 62.5 who disagreed (SD, D, U). Further 58.8 % either agreed or strongly agreed that security required limits their ability to borrow loans from commercial banks which implies that collateral requirements are not favorable to allow adequate access to loans by SMEs .This corroborates the assertion

that most banks practice credit rationing of SMEs due to their inability to raise the required collateral (Kauffman, 2005; G20Seoulsummit, 2010; Nyangoma, 2012).

On whether the loan repayment period was convenient, only 33.1% either agreed or strongly agreed against 66.9% who strongly disagreed, disagreed or were unsure. On whether most loans obtained by the firm are short term loans, findings indicate that 63.1% of the respondents either agreed or strongly agreed that most of the loans they were accessing were short term. Short term loans attract a short repayment period consequently resulting to high interest rates. While the FSD (2015) recommends these short term loan products such as overdrafts in financing working capital requirements, it cautions that short term loans are ill suited to finance long term investment needs of SMEs as they are expensive and expose SMEs to interest rate risks. Yusuf *et al.*, (2014) recommend that to overcome loan repayment challenges faced by a majority of SMEs, banks should give a long loan repayment period to ensure that the end-users have better use of the loan, and increased ease of repayment as it will be spread over a wide period of time.

The last question on the credit terms scale sought to establish whether SME managers feel locked loans (bank dictates use e.g. asset financing loans) are more productive or unlocked loans where the manager determines the use. Results indicate that 65.6% of the SME managers felt a loan given to management to determine its use is more productive than one where the bank dictates its use. This preference could be attributed to their high level of financial literacy given that majority were university graduates. However, Amara *et al.*, (2015) cautions that an unlocked loan is only productive if the SME manager is able to overcome individual, environmental and organizational challenges that often result to loan diversions which hinders investment in productive assets.

 A cross tabulation of gender and credit terms aspects did not reveal any significant trends for reporting. This is attributed to the fact that most commercial banks in Kenya use lending technologies such as credit scoring, relationship lending, and close

monitoring which do not use gender as a proxy for lending but mainly use CAMPARI model with proxy such as **C**haracter of the borrower, **A**bility to pay, **M**argin, **P**urpose of the loan, **A**mount required and **I**nsurance costs (FSD, 2015). This study therefore concludes that no significant relationship exist between gender and credit terms offered.

4.6. Loan Utilization

The second objective sought to establish how the borrowed loans were utilized in the business and whether it affected performance of the SMEs business. Respondents were presented with 5 questions on a likert scale whereby;

1. Never   2. Rarely.   3. Sometimes. 4. Often 5. Always as shown in Table 4.6.

Table 4.7: Loan Utilization Aspects

S/no	Loan utilization Aspects	1	2	3	4	5
				%		
1.	We borrow specific loans to purchase fixed assets	8.8	20.3	45.9	16.9	8.1
2.	This firm uses loans to finance working capital	4.1	21.3	32.8	30.4	11.5
3.	We use loans to pay other debts	31.8	20.6	32.4	11.5	3.7
4.	This firm experiences loan repayment difficulties when loan is diverted	6.8	17.2	36.1	32.1	7.8
5.	Funds received are adequate for the financing needs of the business	8.4	34.7	19.9	35.1	2.4

Results as shown in Table 4.7 indicate that majority of the respondents understand the need to borrow specific loans to purchase business assets. In particular; on whether the firms borrowed specific loans to purchase fixed assets, 70.9% either sometimes, often or always borrowed specific loans. Investment in assets increases the collateral available which enables the firm to be rated more favorably by the financiers. Collateral can be repossessed by the creditor in case of default thus enhancing creditor protection (NCR, 2011; Berger & Udell, 1998). Further, Amara *et al*., (2015) assert that locked loan product where capital investment is dedicated *ex ante* to a productive firm asset leads to better productivity and growth outcomes than loans where the manager is free to determine the use .The second statement sought to establish whether the firm uses loans to finance working capital, findings reveal that majority (74.7%) sometimes, often or always used loans against 25.4% who never or rarely used. The FSD (2015) attributes this scenario to two reasons; Firstly SMEs tend to apply for working-capital loans more often than for investment loans because of the structure of the SME segment that is predominantly retail/wholesale. Secondly this finding might also reflect the risk assessment made by banks on short-term versus long-term loans as well as the perceived difficulty of recovering loans and seizing collateral in Kenya.

Findings on whether the firm uses loans to pay other debts show that whereas 52.4% never or rarely used loans to pay other debts, a significant number at 47.6% agreed that they sometimes, often or always use loans to pay other debts. Moreover, majority of respondents (76%) agreed that they sometimes, often or always experience loan repayment difficulties when loans are diverted. Even though loans that are not contractually committed to the purchase of a specific productive asset are aimed at allowing the SME manager to determine the optimal use of the money such loans are often relocated to non-business purposes which means less money is available for productive investment resulting to poor business performance (Amara *et al*., 2015; Kamwanza 2014 ; Banerjee *et al*. 2010). The last statement sought to establish whether funds received were adequate for the financing needs of the business. Findings revealed

that whereas 35.1% agreed that the loan amount received was often adequate for the financing needs of the business a significant 34.1% indicated that the amount received is rarely adequate. This can be attributed to the fact that most SMEs are only given short term loans with small loan limit which may not be adequate for the needs of the business (FSD, 2015).

A Cross tabulation between gender and loan utilization aspects was also done to establish whether gender had any influence on how the loan borrowed was used in the firm. Table 4.8 gives a summary of the results.

Table 4.8: Cross Tabulation of Gender by Loan Utilization

Loan Utilization Aspects	Male N=171		Female N=125	
	SD+D+U (%)	A+SA (%)	SD+D+U (%)	A+SA (%)
We borrow specific loans to purchase fixed assets	25.73	**74.27**	33.6	**66.4**
This firm uses loans to finance working capital	32.75	**67.25**	15.2	**84.8**
We use loans to pay other debts	58.48	**41.52**	44.0	**56.0**
This firm experiences loan repayment difficulties when loan is diverted	20.47	**79.53**	28.8	**71.2**
Funds received are adequate for the financing needs of the business	35.67	**64.33**	52.0	**48.0**

Strongly Disagree (SD)   Disagree (D)   Unsure (U)   Agree (A) and

Strongly Agree (SA)

These results indicate that gender of the SME manager influences how loans are utilized in the business. Specifically; a larger proportion of men (74.27%) than women at 66.4 % borrowed loans to purchase specific fixed assets. On the contrary, of the 125 women surveyed 84.8% borrowed loans to finance working capital compared to only 67.25% of the 171 male respondents who borrowed loans to finance working capital. On whether loans are used to pay other debts, findings revealed that more women (56.0%) tended to divert loans to other purposes than men (41.52%). This corroborates the findings by Kamwanza (2014) and Amara *et al*., (2015) who established that women entrepreneurs were likely to divert loans to uses outside the business caused by income challenges and the bigger social responsibility of taking care of families. On whether the firm experienced repayment challenges when loans were diverted, results indicate that more men (79.53%) were likely to experience difficulties than women (71.2%).This is partly due to the fact that men mainly invested in fixed assets that may not easily be converted to cash in the event of liquidity problems while women invested in working capital that is easier to convert to cash. This may also mean that women invest in working capital as a precautionary measure. The last statement sought to establish whether funds received were adequate for business needs. Findings revealed that a larger proportion of men (64.33%) felt that funds were adequate compared to only 48% of the women who were satisfied. This could be attributed to the fact that more women diverted loans than men. Setargie (2013) found that diversion of loans to non-productive activities outside the business meant that less money was available for investment consequently resulting to loan default and poor business performance.

4.7. Managerial Competence

Objective three sought to establish whether a relationship exists between managerial competence and the performance of SMEs. Respondents were presented with a likert scale of 7 items whereby; **Strongly Disagree (SD)   Disagree (D)   Unsure (U)**

Agree (A)   Strongly Agree (SA).

Results are summarized in Table 4.9

Table 4.9: Managerial Competency Aspects

S/no	Managerial Competency Aspects	SD	D	U	A	SA
1.	I have adequate skills and knowledge on drafting business plans.	1.0	12.5	8.4	56.8	21.3
2.	I have adequate knowledge on establishing business networks and linkage with large companies	0	15.9	6.8	61.8	15.5
3.	I have adequate knowledge and skills on marketing management.	1.4	15.9	2.0	64.2	16.6
4.	Am able to use capital budgeting techniques to Appraise investments.	2.4	20.6	7.1	49.7	20.3
5.	I have adequate knowledge and skills on budgeting, book keeping and financial planning.	4.4	25.3	7.8	44.9	17.6
6.	I have adequate knowledge and skills to interpret the financial statements generated by my business.	2.4	19.6	8.1	52.4	17.6
7.	The firm has adequate financial controls to monitor utilization of loans.	0	18.6	7.4	55.7	18.2

Findings in Table 4.9 revealed that over 60 % of the respondents agreed or strongly agreed that they had the requisite skills on various aspects of managerial competency. This could be attributed to their education level since most of them were university graduates. Managerial competency means that borrowed loans are well utilized resulting to positive outcomes in the business making the loan effective. Hormiga *et al.,* (2011) found that managerial competencies as measured by education, managerial experience, start-up experience and knowledge of the industry positively impact on the performance of SMEs. They opine that education provides the knowledge base and analytical and problem-solving skills to more effectively deal with the demands of entrepreneurship. Ahmad *et al.,* (2010) reported that entrepreneurial competencies are strong predictors of business success in SMEs.

A cross tabulation was also done between gender and managerial competency to establish whether there exists any significant relationship between gender and level of competency. Results are summarized in Table 4.10

Table 4.10: Cross Tabulation of Gender by Managerial Competency Aspects

	Male N=171		Female N=125	
Managerial Competency Aspects	**SD+D+U (%)**	**A+SA (%)**	**SD+D+U (%)**	**A+SA (%)**
I have adequate skills and knowledge on drafting business plans.	12.87	**87.13**	34.4	**65.6**
I have adequate knowledge on establishing business networks and linkage with large companies	19.29	**80.70**	27.2	**72.8**
I have adequate knowledge and skills on marketing management.	19.88	**80.11**	18.4	**81.6**
Am able to use capital budgeting techniques to appraise investments.	22.22	**77.78**	40.8	**59.2**

	35.09	**64.91**	40.8	**59.2**
I have adequate knowledge and skills on budgeting, book keeping and financial planning.				
I have adequate knowledge and skills to inte 24.16 the financial statements generated by my busi		**75.84**	27.2	**72.8**
The firm has adequate financial controls to Monitor utilization of loans.	23.98	**76.02**	28.8	**71.2**

Findings as shown in Table 4.10 reveal that with the exception of competency on marketing management where both gender had equal proportions of those who agreed or strongly agreed that they had requisite skills and knowledge, on all the other aspects of managerial competency, male gender had a higher proportion of respondents that had the requisite skills which implies that men were more competent on financial management aspects than women. This is supported by findings by Lusardi and Mitchell (2009) which established that men are generally more financially literate than women.

4.8. Influence of Bank Credit on Performance of SMEs

The study further sought to establish how commercial bank loans had contributed to the performance of SME businesses in Kisumu city which implied the effectiveness of the loan. Respondents were presented with a likert scale of 5 items to indicate whether the performance of their businesses was; **Below Target (1), remained constant (2) or Above Target (3) in the last 5 years.** Findings are shown in Table 4.11.

Table 4.11: Performance of SMEs

S/no	Performance Aspects	1	2	3
1.	Investment in capital assets for the last 5 years	22.6	**42.2**	35.1
2.	Growth in customers base for the last 5 years	21.3	**39.9**	38.9
3.	The volume of sales the business has made for the last 5 years	28.0	**40.5**	31.4
4.	The level of profits the business has raised for the last 5 years.	25.7	**45.3**	29.1
5.	Introduction of products or services that was new or improved to the market in the last 5 years.	16.9	**58.8**	24.3

Results as shown in Table 4.11 reveal that for most of the respondents, there was minimal growth in capital assets, customer base, volume of sales profits and introduction of new or improved products or services since their performance has remained constant for the last five years. This implies that bank loans borrowed were not effective in bringing about SME growth. This can be attributed to stringent credit terms and loan utilization challenges experienced by majority of the SMEs in the study area. Whereas the main goal of establishing Credit Reference Bureaus was to facilitate sharing of information about borrowers to eliminate information asymmetry between lenders and borrowers and facilitate access to cheap loans by SMEs, FSD (2015) established that a relatively high number of banks, especially domestic banks in Kenya, do not use credit scoring at all and seem to rely entirely on relationship-based technologies as a basis for lending. This assertion is further supported by the enactment of banking amendment act 2015 which caps the maximum interest rate chargeable on a

loan facility to not more than 4% above the Central Bank Rate (GOK, 2015) to cushion borrowers from the expensive loans in the Kenyan financial market.

4.8.1. Rotated Component Factor analysis.

Factor analysis was used to reduce data into a small number of variables/factors that explain most of the variance observed. Factor analysis identifies underlying variables/factors that explain the pattern of correlations within a set of observed variables. The reduced factors can then be used as variables for further analysis such as collinearity tests or regression analysis (Kothari,2004; Yong & Pearce,2013).A multiple regression model was then extracted from the reduced factors which was used to determine the influence of credit terms, managerial competence and loan utilization on the average performance of SMEs in Kisumu city.

Data was subjected to factor analysis using principal component factoring and varimax rotation. The Kaiser-Meyer-Olkin (KMO) measure of sampling adequacy was 0.644 indicating that the data was sufficient for factor analysis. Using an eigen value cut off of 1.0 there were three factors that explained cumulative variance of 52.6%. A scree plot was also used to confirm the finding of retaining three factors as shown in Table 4.12

Table 4.12: Factor Reduction Matrix

Total Variance Explained

Component	Initial Eigenvalues			Extraction Sums of Squared Loadings			Rotation Sums of Squared Loadings		
	Total	% of Variance	Cumulative %	Total	% of Variance	Cumulative %	Total	% of Variance	Cumulative %
1	4.401	22.005	22.005	4.401	22.005	22.005	4.352	21.762	21.762
2	4.233	21.164	43.169	4.233	21.164	43.169	3.997	19.986	41.749
3	1.877	9.383	52.552	1.877	9.383	52.552	2.161	10.803	**52.552**
4	.994	7.576	60.128						
5	.988	6.288	66.415						
6	.986	4.928	71.343						
7	.874	4.372	75.715						
8	.826	4.128	79.843						
9	.673	3.364	83.208						
10	.543	2.717	85.925						
11	.484	2.419	88.344						
12	.452	2.262	90.606						
13	.369	1.846	92.452						
14	.342	1.710	94.162						
15	.321	1.605	95.767						
16	.283	1.413	97.181						
17	.203	1.013	98.194						
18	.166	.831	99.024						
19	.120	.601	99.625						
20	.075	.375	100.000						

Extraction Method: Principal Component Analysis.

Table 4.13: Rotated Component Matrix[a]

	Component		
	1	**2**	**3**
Collateral Required is Favourable	.870		
Interest Rates charged are Reasonable	.837		
Firm can Afford Cost of Credit	.802		
Convenient Loan Repayment Period	.729		
Firm has Sufficient collateral to get Credit	.712		
Collateral required Limits the firms ability to borrow	.663		
Most Loans given to the Firm are Short Term	.479		
Loan Use determined by Mgt is more productive than where the bank dictates the use			.734
Firm Experiences repayment Difficulties when Loan is diverted			.475
The firm uses loans to finance Working Capital			.522
Use loans to pay debts			.524
Funds Received are adequate for Business Needs			.422
Specific Loans are borrowed to Purchase fixed Assets			
Ability to Draft Business Plans		.833	
Ability to Establish Business Networks and Linkages with other Companies		.796	
Adequate Knowledge and Skills on Budgeting, Book Keeping and Financial Planning		.709	
Ability to Interpret Financial Statements		.703	

Ability to use capital Budgeting to Appraise investments	.701
Firm has Adequate financial Controls	.656
Skills on Marketing Management	.632

Extraction Method: Principal Component Analysis.
 Rotation Method: Varimax with Kaiser Normalization.
a. Rotation converged in 4 iterations.

The Rotated component matrix in Table 4.13 shows factor loadings after rotation using principal component analysis with Varimax rotation and a significant factor criterion of 0.4 as recommended by Kothari (2004) and Yong and Pearce (2013). This implies that factor scores less than 0.4 were suppressed in the output. The three factors were therefore interpreted as; Factor 1 credit Terms, Factor 2 Managerial Competence and Factor 3 Loan utilization. The three factors were then saved as variables for regression analysis using SPSS.

4.8.2. Regression of credit Terms, Managerial Competence and Loan Utilization on Performance of SMEs.

A multiple regression analysis was used to determine the overall influence of credit terms, managerial competence and loan utilization on the average performance of SMEs in Kisumu city. Scores to be regressed were computed by factor analysis and saved as regression variables on SPSS. The dependent variable average performance was calculated as the average score on indicators of performance which were; growth in assets, volume of sales, customer base, profits and introduction of new products in the market and saved as a new variable average performance. The regression was done at 95% confidence interval and 5% margin of error.

The overall regression model was as follows;

$$Y = \beta_0 + \beta_1 X_1 + \beta_2 X_2 + \beta_3 X_3 + \epsilon$$

Where;

Y= Average SME performance

$\boldsymbol{\beta_0}$ = Constant

$\boldsymbol{\beta_1}$. $\boldsymbol{\beta_3}$ = Coefficients of the regression model

$\boldsymbol{X_1}$ = Credit Terms

$\boldsymbol{X_2}$ = Managerial Competence

$\boldsymbol{X_3}$ = Loan Utilization

$\boldsymbol{\epsilon}$ = Error Term.

The resulting regression output is shown in Table 4.14 and Table 4.15.

Table 4.14: Regression Model Summary

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.490[a]	.240	.233	.663

a. Predictors: (Constant), REGR factor score   3 for analysis 2, REGR factor score   2 for analysis 2, REGR factor score   1 for analysis 2

b. Dependent Variable: Average performance.

Table 4.15: Regression Coefficients

Model	Unstandardized Coefficients		Standardized Coefficients	t	Sig.
	B	Std. Error	Beta		
1 (Constant)	**2.176**	.039		56.478	.000
REGR factor score 1(credit terms)	.235	.039	**.311**	6.094	.000
REGR factor score 2 (managerial competence)	.187	.039	**.247**	4.845	.000
REGR factor score 3(Loan utilization)	.218	.039	**.288**	5.640	.000

a. Dependent Variable: Average performance

Findings in Table 4.14 indicate that the correlation coefficient (R value) for the model was 0.490. R value is used to show the strength and direction of the relationship between the variables. In this case the R value of .490 indicates a moderately positive relationship between variables (Israel, 2010). The Coefficient of determination (R^2) was found to be 0.240(24%). This implies that the three variables studied which were; credit terms, managerial competence and loan utilization account for 24% of the variability in SME performance in Kisumu city.

Table 4.15 shows the regression coefficients of the model. From the regression findings substitution of the model; $Y=\beta_0+ \beta_1X_1+ \beta_2X_2+ \beta_3X_3+\epsilon$ becomes;

$Y=2.176+ 0.311X_1+ .247X_2+ .288X_3+\epsilon$

The model shows that holding the three factors constant at zero (credit terms, managerial competence and loan utilization) average performance of SMEs in Kisumu city will be at 2.176. However a unit positive change in credit terms would result to 31.1% (β_1 = .311, sig=0.000) increase in average performance of the firm, a unit positive change in managerial competence would result to 24.7% (β_2 = 0.247, sig=0.000) increase in average firm performance while a unit positive change in loan utilization would bring

about a 28.8% (β_3= .288) increase in average performance of SME firms. These findings further reveal that credit terms were the most significant predictor of SME performance accounting for 31.1% of the variance followed by loan utilization accounting for 28.8 % of variance in SME performance. This corroborates the findings by Nyangoma (2012) who found that there is a significant positive association of credit terms on financial performance of SMEs. Favorable credit terms facilitate ease of access to credit thereby improving financial performance of SMEs in terms of sales, liquidity and profitability. The study also confirms findings that stringent credit terms such as high interest rates, administrative expenses, short repayment period and collateral requirements make bank credit less effective in enhancing SME performance (NCR, 2011, G20 Seoul Summit, 2010; Olutunla & Obamuyi, 2008).

Loan utilization was found to account for 28.8% of the variance in SME performance. Findings revealed that use of specific loans to finance working capital and investment in fixed assets had a positive influence on performance aspects while use of loans to pay other debts affected performance negatively. This supports findings reported that loan diversion limits the amount of money available for investments resulting to poor business performance (Chelagat, 2010; Setargie, 2013; Amara *et al*., 2015). Mbugua *et al*., (2014) asserts that well utilized asset finance loans would result in increased volume of productive assets in the business while properly utilized working capital loans and LPO finance would result to an increase in cash flows in the business enabling them to service their customer orders on time ultimately increasing the volume of sales, growth in customer base and increase in innovations in terms of new products. Managerial competence accounted for the lowest effect on average SME performance at 24.4% which could be attributed to the fact that most SME managers had the requisite competencies with a majority citing lack of managerial skills as an insignificant challenge. Ahmed *et al.,* (2010) opines that possession of entrepreneurial competencies are strong predictors of business success.

CHAPTER FIVE

SUMMARY OF THE FINDINGS, CONCLUSIONS AND RECOMMENDATIONS

5.1.   Introduction

This chapter presents summary and key findings of the study and draws conclusions from the findings of the study. It also offers recommendations to various stakeholders for effective policies to ensure that loans advanced to SMEs by commercial banks translate to the desired growth. The section then ends with recommendations for further research.

5.2.   Summary of the Findings

This research set out to investigate whether credit terms, loan utilization and managerial competency hinder the effectiveness of bank credit in enhancing the performance of SMEs in Kenya. Effectiveness was measured based on how well the bank loans accessed by SMEs in the study area enabled them to achieve the desired objectives in terms of growth in capital assets, volume of sales, customer base, profits and new or improved products in the market.

5.2.1. Effect of Credit Terms on the Effectiveness of Bank credit in Enhancing

Performance of SMEs

Objective one sought to establish whether credit terms had any influence on the effectiveness of bank credit in enhancing the performance of SMEs in Kisumu city. Findings revealed that majority of the SMEs were uncomfortable with the credit terms offered by commercial banks in terms of; cost of credit, interest rates, repayment period and collateral requirements since they make the loan expensive for the business hence

less effective in bringing about the desired growth. Aspects of credit terms such as high interest rates and administrative costs, short repayment period and small loans were rated as **very significant** challenges hindering the effectiveness of commercial banks loans in enhancing the performance of SMEs in Kisumu city. It was also established that no significant relationship exist between gender and credit terms offered. This is attributed to the fact that most commercial banks in Kenya use lending technologies which do not consider gender as a proxy for lending.

The results also revealed that credit terms was the most significant predictor of SME performance since they accounted for 31.1% of the variance in average performance of SMEs. This implies that the limited growth in SMEs in Kisumu city could be attributed to unfavorable credit terms because for a majority growth was either below target or remained constant.

5.2.2. Effect of loan Utilization on the Effectiveness of Bank credit in Enhancing Performance of SMEs

The second objective sought to establish how the borrowed loans were utilized and whether it affected the effectiveness of bank credit in enhancing the performance of the SMEs. Results indicated that majority of the respondents understood the need to borrow specific loans to purchase business assets since over 70% of the respondents agreed that they borrowed specific loans to finance working capital and purchase fixed assets. Investment in assets increases the collateral available which enables the firm to be rated more favorably by the financiers since it enhances creditor protection while low investments in capital assets limits the available collateral for bigger more long term loans since it increases the risks in lending making SMEs to be rationed out by financiers.

Findings also revealed that use of specific loans to finance working capital and investment in fixed assets had a positive influence on performance aspects while use of

loans to pay other debts affected performance negatively making the loan less effective. The study also found that a significant number at 47.6% of the respondents used loans to pay other debts. Moreover, majority of respondents (76%) agreed that they experience loan repayment difficulties when loans are diverted. Even though most respondents preferred loans that are not contractually committed to the purchase of a specific productive asset, such loans are often relocated to non-business purposes which means less money is available for productive investment resulting to poor business performance. Challenges of loan diversion were rated as **significant** by a majority of the respondents.

The results further indicated that gender of the SME manager influenced how loans were utilized in the business. Specifically; A larger proportion of men (74.27%) than women at 66.4 % borrowed loans to purchase specific fixed assets. On the contrary, most women at 84.8% of the 125 respondents borrowed loans to finance working capital compared to only 67.25% of the 171 male respondents who borrowed loans to finance working capital. Findings also reveal that more women (56.0%) tended to divert loans to other purposes than men (41.52%) and where funds were diverted results indicated that more men (79.53%) were likely to experience difficulties than women (71.2%) in loan repayment. This is partly due to the fact that men mainly invested in fixed assets that may not easily be converted to cash in the event of liquidity problems while women invested in working capital that is easier to convert to cash. This may also mean that women invest in working capital as a precautionary measure. Loan utilization was found to account for 28.8% variance in SME performance. Which implies that proper utilization of SME loans has the potential to significantly improve SME performance.

5.2.3. Effect of Managerial Competency on the Effectiveness of Bank credit in Enhancing Performance of SMEs

Objective three sought to establish whether a relationship exists between managerial competence and the effectiveness of bank credit in enhancing SME performance since possession of entrepreneurial competencies has been found to be a strong predictor of business success. Findings revealed that over 60 % of the respondents agreed or strongly agreed that they had the requisite skills on various aspects of managerial competency which could be attributed to their high level of education. Majority of the respondents also considered inadequate entrepreneurship and inadequate financial management skills as **insignificant** challenges. Consequently, managerial competency was not a challenge among most SME managers in the study area.

With the exception of competency on marketing management where both gender had equal proportions of those who agreed or strongly agreed that they had requisite skills and knowledge, on all the other aspects of managerial competency, male gender had a higher proportion of respondents that had the requisite skills which implies that men were more competent on financial management aspects than women.

Performance for majority of the SME managers who were found to have the requisite managerial competencies (agree, strongly agree) either remained constant or was above target. On the contrary, most of the managers who rated themselves as incompetent (strongly disagree, disagree or unsure) reported a performance below target in terms of investment in capital assets. Overall managerial competence was found to account for 24.4% variance in SME performance.

5.3. Conclusion and Recommendations

5.3.1 Conclusions

In light of the key findings as discussed above. This study concludes that; credit terms, loan utilization strategies and managerial competency are key determinants of the effectiveness of bank credit in enhancing the performance of SMEs. Specifically;

Credit terms were the most **significant** challenge in the utilization of commercial banks loans since majority of the SMEs found credit terms offered unfavorable. Therefore a negative relationship exists between unfavorable credit terms and the effectiveness of bank credit in enhancing performance of SMEs. Unfavorable credit terms make the loan expensive for SME borrowers resulting to poor performance in terms of investments in capital assets, growth in sales volume, customer base, profits and introduction of new products in the market. This makes the loan less effective in enhancing SME performance. The study also concludes that gender has no significant influence on the credit terms offered to SMEs.

The effectiveness of bank credit in enhancing SME performance is directly influenced by how the loan is utilized in the business by the SME manager. Loans utilized to finance working capital and investment in fixed assets has a positive influence on business performance in terms of growth in assets. However; use of loans to pay other debts affects business performance negatively. The gender of the SME manager has a significant influence on how loans are utilized in the business where women were more likely to divert loans to other purposes than men. Positive utilization of bank loans has the potential to improve the performance of SMEs.

Majority of the SME managers in the study area had the requisite managerial competencies. Consequently inadequate entrepreneurship skills and inadequate financial management skills were considered as insignificant challenges which implies that managerial competency was not a challenge among most SME managers in the study area. Managerial competencies had a positive influence on effectiveness of bank credit

in enhancing performance in terms of investment in capital assets. Competent managers are more likely to make sound investment decisions than those who are incompetent.

Male gender was also found to be more competent on most of the financial management aspects tested than women.

5.3.2. Recommendations

The following recommendations are made in line with the conclusions of this study;

1. The Central bank should ensure credit terms charged on SME loans are affordable by; ensuring that banks disclose the full cost of the loan in terms of interest rate and administrative costs charged to make SME managers make financing decisions from an informed position and ensuring that the recommended interest rates based on the CBR rate are not exceeded by commercial banks.

2. Banks to give SMEs more long term loans to facilitate investment in productive fixed assets that can be used as collateral for bigger loans.

3. Commercial banks should design more financial product that are tied to investments in specific productive assets (Asset finance Loans) as opposed to working capital loans that are prone to diversion. This approach would result to increased investment in firm assets which will in turn limit loan diversion and improve business performance in terms of productive capacity.

4. Commercial banks to organize capacity building seminars for their SME clients particularly women on key areas such as credit management, financial management and the risks of loan diversion.

5. 4.   Suggestions for Further Research.

1. This study focused on SMEs in Kisumu city thus findings of this study cannot be generalized to all SMEs in the 47 counties in Kenya. Therefore in order to improve on external validity in terms of generalization of the study findings, there is need for the study to be replicated on SMEs drawn from other Counties across the country to find out whether there are commonalities.

2. Factors included in this study accounted for 24% of the variance in SME performance. There is need to investigate the effect of other external factors such as how access to information on entrepreneurial opportunities affect choice of investments which ultimately affects bank credit effectiveness.

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APPENDIX I: *QUESTIONNAIRE*

Dear Respondent

This questionnaire is being administered to collect data on the topic "**Factors Affecting the effectiveness of Bank Credit in Enhancing the Performance of Small and Medium Enterprises. A Case of Kisumu City Kenya.**". You are requested to participate in this research. Your honest responses are important and the information will be strictly confidential and will be used for academic purposes only. Please complete this questionnaire in accordance with instructions given.

PART A: DEMOGRAPHIC DATA (Tick an option of your choice)

1. What is your gender? a) Male ☐   b) Female ☐

2. What is your age bracket?

a)   18- 35 year   b)   36-60   c) Above 60 years.

3. Educational Attainment

a) None   b)Primary graduate c)Secondary d) Diploma/certificate
e)University graduate

4. What type of business are you in?

a) Manufacturing   b) Retail/Wholesale   c) Service   d) Agribusiness

5. For how long have you been in business?

a) 0-5 years b) 6-10 years   c) 11-20 years d) Above 20 years.

6.   Form of ownership: a) Sole Proprietorship b) Partnerships c) Limited liability Companies

7. How many times has your firm borrowed money from commercial banks?

a) 1 – 5 times   b) 6 – 10 times   c) 10 or more times

8. The single largest amount ever borrowed was

 a) 1 < 5Million   b) 5< 10 Million   c) 10 < 25 Million   d) Above 25 Million

PART B: CREDIT TERMS.

Please mark the given statements according to your level of agreement; **5. Strongly agree. 4. Agree 3.Unsure 2. Disagree 1. Strongly Disagree (tick one)**

S/no	Credit Terms Aspects	1	2	3	4	5
1.	This firm can afford the cost of credit in terms of interest rates and administrative costs charged by commercial banks on loans borrowed.					
2.	This firm feels interest rates charged are reasonable.					
3.	The firm feels collateral required by commercial banks is favorable					
4.	This firm has sufficient collateral to get credit from commercial banks.					
5.	The Security required to get loans limits the firm's ability to borrow from commercial banks.					
6.	The loan repayment period given to this firm is convenient.					

		1	2	3	4	5
7.	Most loans obtained by the firm are short term loans.					
8.	This firm feels a loan given to management to determine the use is more productive than one where the bank dictates the purpose.					

PART C: LOAN UTILIZATION.

Please mark the given statements according to your level of agreement; **5. Always 4.**

Often 3.Sometimes.   2. Rarely.   1. Never (tick one)

S/no	Loan utilization Aspects	1	2	3	4	5
6.	We borrow specific loans to purchase fixed assets					
7.	This firm uses loans to finance working capital					
8.	We use loans to pay other debts					
9.	This firm experiences loan repayment difficulties when loan is diverted					
10.	Funds received are adequate for the fina needs of the business					

PART D: MANAGERIAL COMPETENCE

State whether you; **5. Strongly agree. 4. Agree 3.Unsure   2. Disagree   1. Strongly Disagree (tick one)**

S/no	Managerial Competency Aspects	1	2	3	4	5
1.	I have adequate skills and knowledge on drafting business plans.					
2.	I have adequate knowledge on establishing business networks and linkage with large companies					
3.	I have adequate knowledge and skills on marketing management.					
4.	Am able to use capital budgeting techniques to appraise investments					
5.	I have adequate knowledge and skills on budgeting, book keeping and financial planning					
6.	I have adequate knowledge and skills to interpret the fina statements generated by my business.					
7.	The firm has adequate financial controls to monitor utilization of loans.					

E: PERFORMANCE OF SMES.

Using a scale of 1-3 given below rate your level of satisfaction with how commercial bank loans have contributed to the financial performance of your business;

Below Target (1)   **Remained constant (2)**   **Above Target (3).**

S/no	Performance Aspects	1	2	3
6.	Investment in capital assets for the last 5 years			
7.	Growth in customers base for the last 5 years			
8.	The volume of sales the business has made for the last 5 years			
9.	The level of profits the business has raised for the last 5 years.			
10.	Introduction of products or services that were new or improved to the market in the last 5 years.			

11. Do you face any challenges in using commercial bank loans? a)Yes b) No

12. If yes, what are the challenges? **Not significant (1)** **Significant (2) Very significant (3).**

S/no	Challenge	1	2	3
5.	High Interest rates and administrative costs			
6.	Short repayment period			
7.	Inadequate Financial management skills			
8.	Inadequate Entrepreneurship skills			
9.	Small Loans			
10.	Social Problems (Loan diversion)			
11.	Limits expansion			
12.	Undue pressure for repayment			

Thank you very much for your cooperation.

Appendix 2: Letter of Introduction.

JOMO KENYATTA UNIVERSITY
OF
AGRICULTURE AND TECHNOLOGY

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E-mail: kisumucbd@jkuat.ac.ke

DATE: 21st JULY, 2016.

TO WHOM IT MAY CONCERN

REF: INTRODUCTION OF Ms LEAH ATIENO AUMA REG. NO HD313-C012-4089/2013

This is to introduce Ms. Leah Atieno Auma of Reg. No. HD313-C012-4089/2013, who is a Master of Science in Entrepreneurship student at Jomo Kenyatta University of Agriculture and Technology – Kisumu CBD Campus.

She has completed her course work and is currently doing research. The research activity involves extensive data collection among others.

We would appreciate any assistance that can motivate her to advance in this noble discipline.

Yours faithfully,

Dr. JARED O.H. NDEDA
DIRECTOR, JKUAT KISUMU CBD CAMPUS.

J. K. U. A. T.
KISUMU CBD CAMPUS

2 1 JUL 2016

DIRECTOR

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