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# Effects of Microfinance Lending on Business Performance: A Survey of Micro and Small Enterprises in Kitale Municipality, Kenya

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**Abstract**

The provision of financial services, especially credit and saving facilities plays an important role in the development of the economy. Despite the efforts of microfinance institutions to take microfinance services within the reach of poor people and MSEs that have not benefited from the conventional formal financial system, growth and expansion of MSEs sector had not shown any sign of growth and expansion. The main objective of this study was to investigate the effects of microfinance institutions lending on micro and small enterprises performance within Kitale Municipality. This study adopted a descriptive survey research design and the target population was 1,200 MSEs which were registered within Kitale Municipality and had operated for at least three years. The target population was stratified into homogeneous categories as wholesalers, retailers, restaurants and service delivery. A sample of 120 MSEs was drawn proportionately and randomly from the strata. A semi- structured questionnaire was used to collect data. Completed questionnaires were verified and coded by the researcher in a computerized package then analyzed and summarized in frequency tables, pie charts and figures. The association between microfinance lending and MSE performance variables was established through Chi square and correlation tests at 95% significance level. A multivariate logistic regression was used for significant bivariate variables at 95% significance level. The amount of loans is significantly and positively related with performance of MSEs in Kitale Municipality. Microfinance institutions should reduce the period required for MSEs to participate in training and group formation to facilitate speedy access to MFI loans. The amount of loan given by MFIs to MSEs should be increased to enable the MSEs grow to medium scale enterprises.

**Keywords:** Microfinance institutions, Microfinance lending, Micro and Small Enterprises, Micro and Small Enterprise performance.

## 1.0 Introduction

Micro and small enterprises (MSEs) have become the focus of attention for the economic development, economic growth and job creation in the world. The importance of Micro and Small Enterprises in the economies has been recognized by many players such as World Bank, UN agency UNCDF, governments, non-governmental organizations and private entities (Kenya Economic Survey, 2009)

Liedholm and Mead (2005) in the review of national surveys conducted in several African countries estimate that between 17% - 27% of the working population was employed in MSEs, being nearly twice the employment of large scale enterprises and public sector. The United States Agency for International Development (USAID) considers that MSEs employ a third or more of the labour force in low income countries (USAID, 2010). In Kenya, Nasirembe (2007) indicated that the MSE sector employs around 2.3 million people and generates around 14% of the country's Gross Domestic Product (GDP).

Microfinance traces its origins to 1976, when Dr. Mohammed Yunus started a small microfinance scheme as an experiment in the rural areas of Bangladesh. The experiment evolved from its initial success into the Grameen Bank, the world's first microfinance institution, which popularized group lending, in which loans were issued to individual members of small, homogeneous groups, who collectively guarantee loans issued to their members. All members were barred from further access to credit in the case of default by one group member, providing strong incentives for the group to ensure repayment by each individual borrower. This microfinance model eventually spread around the world, especially in third world countries (Roy, 2009).

Habibulla (2010) and John (2011) in their studies found that MFIs loans increased the income of MSEs operators and poor people the in Bangladesh and Zimbabwe respectively. Their studies focused on business performance in terms of increased sales, acquisition of asset and technology while household studies focused on increased income from firms as profit or wages and salaries to establish a link between the availability of microfinance lending and overall well being of the poor. Thus, both research and practice have seen an increasing concern about the microfinance Institutions' lending and MSEs performance.

Besides, the empirical evidence emerging from various studies such as Mkazi (2007) about the MFIs lending on MSEs performance has so far yielded mixed results that are inconclusive especially for developing countries like Kenya. In spite of this emphasis previous studies did not provide sufficient justification for the link between microfinance institutions' lending and MSEs performance in the developing countries like Kenya, therefore the question of whether microfinance institutions lending improves or worsens MSEs performance is stills worthy of further research such as the one being undertaken in this study. In addition, the effects of microfinance institutions lending on the MSEs have not received adequate attention in Kitale

Municipality, Kenya. This means there was a major gap in the relevant knowledge on developing countries including Kenya, which has to be covered by research within Kitale municipality.

### 1.2 Statement of the Problem

Despite the efforts of microfinance institutions such as K-Rep, Family Finance, Kenya Women Finance Trust, Equity Bank among others to take microfinance within the reach of poor people and MSEs, who have still not benefited from the conventional formal financial system, the MSEs sector had not shown any sign of growth and expansion ( Kenya Economic Survey, 2009) . It was in this context that the study investigated the effects of microfinance institutions lending in enhancing the performance of MSEs.
The situation in Kenya was even more difficult, while there were a number of agencies that provide micro-finance to MSEs' there was an almost total lack of interest in evaluating whether this was necessary, and whether the particular measures that were being undertaken were effective and/or efficient. Many MSEs' were left un-attended to due to the limited finances available (Akinyi, 2009). Although the Microfinance Act of 2006 stipulated the operations of MFIs in Kenya many MSEs had not accessed lending and those that have acquired loans from MFIs find it expensive to pay (Makokha, 2006). The studies on MFIs factor on businesses development in Kenya have yielded mixed results. Besides, no study had investigated the effects of MFIs loans on MSE performance within Kitale municipality. Taking the above into consideration, the study investigated the effects of microfinance institutions lending on business performance within Kitale Municipality, Kenya.

## 2.0 Literature Review

### Levels of microfinance institutions loans to MSEs

The review of literature on the growth MSEs indicated that many micro and small enterprises (MSEs) fail to expand due to limited financial resources ,poor managements ,use of outdated technologies ,stiff competitions from bigger firms, poor management of account receivables ,unfavorable government policies among .According to Yaron (1997) the study found that poor access to loans and limited finance as the main causes limiting the growth of micro and small enterprises .

A study by Grameen Bank (1983) found that many MSEs had limited capital, lacked relevant skills and used outdated technologies that constrained their growth. However, there are a number of factors that influence the decisions of MSEs' operators and mangers before deciding the source and amount of finance to finance business investments to invest in business activities. Prasad, Green and Murinde (2005) found that financing policy, capital structure and firm ownership are all strongly linked. Their argument was that financing policy by firms requires managers to identify ways of funding new investment. The managers may exercise main choices: use retained earnings, borrow or issue new shares.

Carpenter and Petersen (2002) argue that firms whose financial needs exceed their internal resources may be constrained to pursue potential opportunities for growth. The insufficient internally generated liquidity is therefore one of the factors which are frequently cited as the causes of micro and small business failure in developing economies. It is from this perspective, the micro credits are considered to be an appropriate solution because the amount of money needed to start a micro or small business is generally quite minimal (Sonfield & Barbato, 1999).
Access to credit enables the MSEs owner to cover some or all of the cost of capital equipment, expansion, or renovation of buildings. Similarly, UWFT (2005) found that majority of MSEs that accessed adequate funds from microfinance institutions increased their volume of sales and the profit. The study also found MSEs acquired assets using MFIs loans. According to a study by UNDP (2002) found that MSEs in Kenya were able to acquire fixed assets and technologies using MFIs. The study established a positive significant relationship between amount of loan and MSEs achievement of goals. Makokha (2006) revealed that inadequacy of capital hindered the expansion of businesses. The study further found that larger loans enabled MSEs to graduate to medium enterprises. This argument is supported by Otto, Muli and Ong'ayo (2010) in their study that indicated that those MSEs that received large loans frequently had larger labour force than those MSEs that received smaller loans. Appropriate loan sizes for clients matching their needs, realistic interest rates, savings as a prerequisite, regular, short and immediate repayment periods and achieving scale can contribute to the sustainability of micro and small enterprises.
The review of literature shows mixed results .Some studies argue that loan size borrowed significantly and positively do contribute to the development and growth of businesses especially Micro and small Enterprises, while other studies indicated that MFIs that accessed MFIs loans did not show any sign of growth. Due to mixed results it was worthy to investigate the relationship between loan sizes and performance.

## 3.0 Research Methodology

This study adopted a descriptive survey research design .The target population were all established micro and small enterprises operating in Kitale Municipality. The owners or managers were considered decision makers as regards financing and management of the businesses. A total of 2,060 MSEs were registered with Kitale Municipality .However, for the purpose of this study only MSEs that had operated for three years and above were considered to form the target population since it was assumed this length of time could provide meaningful measures of performance. This reduced the number of MSEs to 1,200. The target population was stratified into homogeneous categories as wholesalers, retailers, restaurants and service delivery. A sample of 120 MSEs was drawn proportionately from the strata. For homogeneous groups, 10% of the sample is considered as representative ( Mugenda & Mugenda, 2004). Elements from each stratum were selected using random sampling technique to give each element an equal chance to constitute a sample of 120 as indicated in table 3.1

**Table 3.1 Target population and Sample size**

| Type of business | Target Population | Sample |
|---|---|---|
| **Wholesalers** | 220 | 22 |
| **Retailers** | 380 | 38 |
| **Restaurants** | 120 | 12 |
| **Service delivery** | 480 | 48 |
| **Total** | **1200** | **120** |

Source: Field Research 2013.

A semi- structured questionnaire was used to collect data. The researcher administered and collected completed questionnaires from the respondents. This minimized the chances of respondents not responding to the questionnaires. Completed questionnaires were verified and coded by the researcher in a computerized package then analyzed and summarized in frequency tables, Pie charts and figures. The association between microfinance lending and MSE performance variables was established through Chi square and correlation tests at 95% significance level.

## 4.0 Research Findings and Discussion

### 4.1 Respondents demographics

Gender equity was observed among the MSE operators in the study area. Half of the respondents 60(50%) had attained post secondary level of education while about one third 40(33.3%) of the MSE owners had attained secondary education. A small proportion, 20(16.7%) had primary education as shown in table 4.1

**Table 4.1: Gender and education of the respondents**

| characteristic | Frequency (%) |
|---|---|
| **Gender** | |
| **Male** | 60(50%) |
| **Female** | 60(50%) |

| | |
|---|---|
| **Education background** | |
| **Primary** | 20(16.7%) |
| **Secondary** | 40(33.3%) |
| **Post secondary** | 60(50%) |

**4.2 MSE Characteristics.**

Of the 120 MSEs under study, 48(40%) were in the service delivery while 38(31.7%) accounted for retail businesses. Wholesale businesses accounted for 22(18.3%) while restaurant businesses accounted for only 12(10%).Slightly above half 66(55%) of the MSEs had been in existence for over five years. About one third 38(31.7%) of the MSEs had operated for a period between 3-5 years with a small proportion16 (13.3%) having operated for less than three years.

**4.2 MFI loan accessibility and effect on MSE performance.**

41.7% of the respondents admitted having ever taken MFI loans. In response to the preference of microfinance loans by MSEs majority of the response 88% preferred microfinance. Loans because the procedure of accessing them were simpler than conventional banks loans which required collateral. Also the study found that majority of respondents preferred MFI loans because they attracted affordable interest rate and had no hidden costs unlike bank loans. However 12% of respondents disagreed that procedure for accessing MFI loans and interest charged were simpler and affordable respectively. The study established that MFIs loans are preferred by MSEs because collateral are not required for accessing them.
Those who did not access cited fear for rejection (53.2%) and little loan (57%). Conditions for loan access were group savings (60%),property pledged(26.7%) and guarantor(13.3%).Half(50%) of those who accessed MFI lending received between Kshs. 50,000- 100,000 , 17% received below Kshs 50,000 and only 6.7% received above kshs. 500,000. Slightly more than half,65 (54.1%) of the respondents reported increase in income and sales volume from MSE and 44(88%) of those who accessed microfinance loans reported that they could repay loan plus interest from their business activities. A study by Muhammad (2004) observed that many MSEs closed their stores due to inability to repay loans and interests. Majority 49(70%) of MSEs that did not access MFI loans reported no increase in sales and income. This finding is consistent with that of Hussein (1995) who disclosed that 93% of MSEs that access adequate capital increased their stock and sales.
The study findings revealed that there was a significant positive relationship between amount of loan taken and increase in income ($p = 0.005$). There was observed significant difference between those who agreed and those who disagrees that amount of loan increased income of MSE business activities. Larger loans are likely to increase income of MSEs as supported by Makokha(2006) who found that larger loans enable MSEs to graduate to medium enterprises.

**Table 4.2 Relationship between amount of loan taken and increase in income**

| characteristic | Increase in income | | $\chi 2$-value | P-value |
|---|---|---|---|---|
| | Agree | Disagree | | |
| **Amount of loan** | | | | |
| **<=200000** | 37(94.9%) | 2(5.1%) | 7.927 | 0.005 |
| **>200000** | 7(63.6%) | 4(36.4%) | | |

## 5.0 Summary, Conclusions And Recommendations

### 5.1 Summary

This research study was concerned with establishing the effects of microfinance institution lending on MSE performance .The study also sought to establish the effect of amount of loan accessed to SMEs performance. The research study finding indicated that majority of MSEs preferred MFI loans in cluster of Ksh50,000 – 100,000. The research study has established that respondents preferred MFI loans because collateral is not required unlike bank loans. The study found that majority of those who access loans reported that they could repay loans plus interest from business activities. The study indicated a strong positive significant relationship between the amount of loan and performance of MSE increase in income/sales.

### 5.3 Conclusion

Based on the findings of the study, the level of access to MFI lending by MSEs is low (41.7%) and fear of request rejection and little amount of loans explains this finding. Majority of MSEs 44(88%) that accessed the loans reported increase in sales and income and could repay loan and interest. 49(70%) of those MSEs that didn't access loans did not realize increase in income. The amount of loan significantly positively related with performance of MSEs in Kitale Municipality.

### 5.4 Recommendations

Based on the conclusions, the study recommends the following:
The amount of loan given by MFIs to MSEs should be increased to enable the MSEs grow to medium scale enterprises. The amount of loans given to MSEs should be increased to propel MSEs transition to medium and large scale businesses.
The MSEs should be allowed a grace period before the start of repaying of the loans. The MFIs demand for the payment immediately of the loans advanced to borrowers. The longer the grace period will enable borrowers to pay interest and principal using income generated from the borrowed money. This will accommodate more startup MSEs to participate in MFI lending.

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