

## **Relationship between sources of business financing and financial performance of small and medium enterprises in lurambi sub-county**

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**ABSTRACT:** *The purpose of this study is to determine the effect of sources of business financing on the financial performance of Small and Medium enterprises in Lurambi Sub-County. Specifically, the study sought to determine the effect of commercial loan-financing on the financial performance of Small and medium enterprises. Descriptive survey was used. The population of interest comprised of 450 small and medium enterprises in Lurambi Sub-County. Stratified random sampling was used to select 88 small and medium enterprises. The survey instrument used was questionnaires which were administered to owners and managers. Analysis of data was done using descriptive and inferential statistics. The study findings will be utilized by policy makers at national and county government levels, non-governmental organizations, aid agencies and lenders in formulating relevant policies that would help small and medium enterprises to realize better financial performance. The study established that, sources of business financing affected financial performance of small and medium enterprises significantly; commercial loan financing affected financial performance significantly. The study recommends that small and medium enterprises should make use of commercial loan financing for them to realize higher levels of financial performance. The Central Bank of Kenya should ensure that financial institutions revise their lending rates in tandem with its revisions. The Government of Kenya should encourage lenders to share the financing risks with the government in order to reduce the cost of commercial loan financing.*

**KEYWORDS:** *Business financing, commercial loan financing, financial performance.*

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### **I. INTRODUCTION**

#### **1.1 Background**

Abouzeedan (2013) while outlining financing sources for SMEs mentioned owners savings, business retained earnings, bank loans, trade credit among others as principal funding sources in Sweden. Onakoya, Fasanya and Abdulrahman (2013); Vo, Tran, Bui & Trinh (2011); Abouzeedan (2003); Njeru, Namusonge and Kihoro (2012); Wangu (2013); Joeveer, Pissarides and Svejnar (2006) claims that despite measures put in place by the Swedish and other governments to ensure accessibility to funding by SMEs, they still experienced financing problems and the firms were still characterized by a notable financing gap that is yet to be filled. Xiao (2014); Klapper (2006); IFC (2013); Timoshenko (2012) observes that most SMEs experienced financial frictions that needed to be resolved. Timoshenko (2012); Wang (2013); Berger and Udell (2004) claims that financing gap and limited sources of funds was a major setback to entrepreneurial development of SMEs in China and emerging markets such as those in Asia and Africa including Kenya.

Financial performance of SMEs in Kenya and other emerging economies has continued to decline over the years: many of them have collapsed, others auctioned or put under receivership due to poor financial performance (Munyuny 2013; Siekei et al., 2013; Chepkemoui, 2013; Pandey, 2010; Berger and Udell, 2004). SMEs participation (Njeru et al., 2012; Joeveer et al., 2006; Onakoya et al., 2013; Nkonoki 2010; Kyokutamba 2011) in the Kenyan economy and other emerging economies is significant as they are involved in the creation of more employment opportunities to many people. However, their financial performance remains an issue of significant concern as many of them continually fail to pick up; three out five firms fail within a few month/years after inception (Agbozo and Yeboah, 2012; Osoro & Muturi, 2013; Chepkemoui, 2013). Abouzeedan (2003); IFC (2013); Xiao (2014); Memba, Gakure & Karanja,(2012) observes that SMEs' financial

performance stands out as an issue to be explored as these firms remained small and some collapsed even though they had been adequately supported. Kihimbo et al., (2012) identifies inaccessibility to funds, high costs as reasons for poor financial performance for firms in Kakamega municipality, hence the future of industrial growth in Lurambi Sub-County is dependent on the SMEs’ sound financial performance.

**1.2 Statement of the problem**

Small and medium enterprises (SMEs) in many countries have received a lot of attention and support from governments and other stakeholders (Timoshenko, 2012; Wang, 2013; Joeveer et al., 2006; Klapper, 2006; IFC, 2013; Agbozo & Yeboah, 2012; Wangu, 2011; Momba et al., 2012; Onakoya et al., 2013), however their financial performance is still wanting: (Xiao, 2014) many have stagnated at the same level, they have remained small and others are on the verge of collapsing. They have shown a lot of volatility in returns, growth and have failed to break even in their trading activities. They still experience a large financing gap and they have problems in financing and refinancing their business operations. In Kenya, there is still a large financing gap among the SMEs. Their financial performance can be described as stagnant, failing and three out of five SMEs hardly make it past a few months after their creation (Osoro & Muturi, 2013; Siekei, Wagoki & Kalio, 2013; Njeru et al., 2012; Hassan & Mugambi, 2013; Wawire & Nafukho, 2010; Muteru, 2013; Chipkemoi, 2013). Hence this study sought to test the effect of sources of business financing on financial performance of SMEs in Lurambi Sub-County.

**1.3 Objectives of the study**

**1.3.1 General Objective**

The purpose of the study is to determine the relationship between sources of business financing and financial performance of Small and Medium Enterprises (SMEs) in Lurambi Sub-County.

**1.3.2 Specific Objective**

The study was conducted on the basis of the following specific objective:

- i. To determine the effect of commercial loan financing on the financial performance of small and medium enterprises in Lurambi Sub-County

**1.4 Research Question**

The study was guided by the following question:

- i. Does commercial loan financing affect the financial performance of small and medium enterprises in Lurambi Sub-County?

**II. CONCEPTUAL FRAMEWORK**

The conceptual model has sources of business financing as an independent variable while financial performance as a dependent variable. Each one had scales to measure them as seen in figure 1.

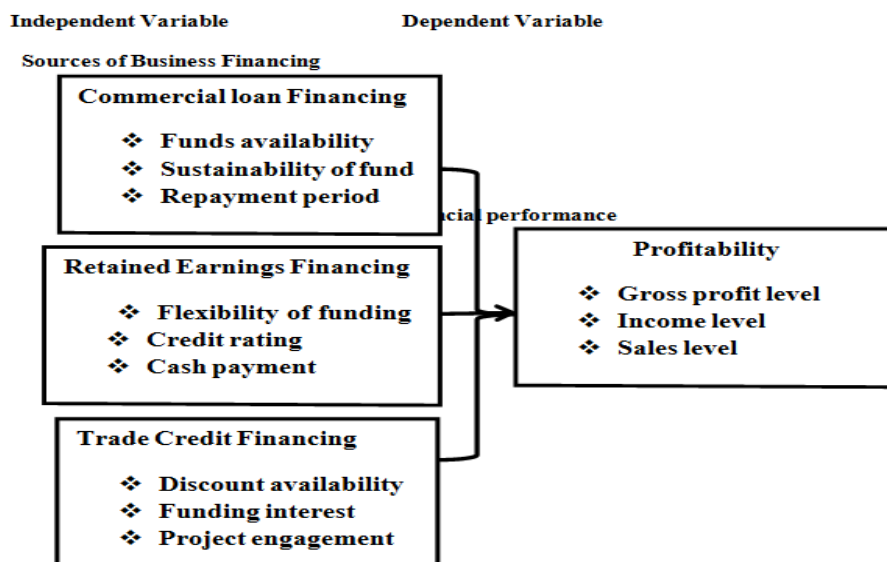


Figure 1: Conceptual Framework

## **2.1 Sources of Business Financing**

Timoshenko (2012) outlines the fact that SMEs account for an enormous proportion of the overall share of firms in Latvia and yet their share of credit is still below par. Commercial loans from banks remains a major source of funding constituting about 50% to 70% of total external finance used with much of the remaining being trade credit. This underscores the crucial role played by these two forms of funding in the quest of SMEs' desire to bridge finance gap. The capability to source capital (Ledgerhood & White, 2006; Akinbola & Otokiti, 2012) is a basic component for SMEs to realize higher financial performance. Vo et al., (2011) observes that in Vietnam SMEs were quick to utilize commercial loans and trade credit to fund their business operations in their early years of commencing business. They reduced their reliance on internally generated finances shifting focus to external funding. Abouzeedan (2003) claims that restrictive lending in Sweden meant that borrowers had fewer financial options to turn to hence retained earnings, owners' savings, depreciation and trade credit proved to be useful to SMEs at such critical moments.

## **2.2 Commercial Loan Financing**

Timoshenko (2012) argues that commercial loans constitute a major source of external funding for the Latvian SMEs. In 2009, it rose from 33% to 35% in 2012, signifying its importance as a financing option favoured by entrepreneurs in the SMEs business. This prompted the Latvian Government to come up with programmes that would see the operators in the sector access more funding from commercial banks. In such cases the Government takes the position of a guarantor to institutions advancing loans to SMEs by covering all costs in cases where the SMEs become bankrupt. The Parliamentary Act has seen many firms access more funds to start and operate their business. Vo et al., (2011) observes that firms at start-up stage had reservations in sending loan requests to banks in Vietnam. They either assumed that they did not urgently require commercial loans or it was hard to attain approval for formal loans due to their stage in the business cycle. However, their counterparts: those that were in operation for some times (about 86%) found it very appealing to use commercial loans to launch expansion programmes and keep their business activities in operation than other forms of financing. Mishra and Soota (2014) recognized commercial loans as a vital source of financing that can be utilized by firms to expand their projects, modernize and renovate their existing equipment and carrying out technological updates.

Abouzeedan (2003) states that the Small Business Administration (SBA) an American Government agency participates in SMEs funding by encouraging and motivating banks and other financial institutions to lend to SMEs and start-up ventures by guaranteeing up to 90% of the loan amount to qualified borrowers. The study believes that commercial loans remains a principal source of financing for SMEs in Sweden into the unforeseeable future even though SMEs continue facing competition from large businesses for the same funds. Agbozo and Yeboah (2012) observes that 53% of respondents intimate to be using commercial loans as a key source of financing with 35% indicating that access to loan had risen over the period and loans were mostly preferred as they basically depended on the good relationship between the borrowers and the lenders. Xiao (2014) claims that SMEs that utilized commercial loans reduced financial distress allowing them to finance more projects hence, generating more cash flows. Quianoo (2011) outlines reasons that may push SMEs to seek commercial loan funding to finance activities such as opening new branches, commencing new investment projects among other factors. Commercial loans were mostly suited for SMEs financial needs as they were more realistic and reliable in European countries as they lacked options such as those available to large enterprises such as issuing shares and debentures in the capital markets.

Egbuna and Agali (2013) observe that 20% of respondents in the study indicated that they obtained their commercial loans from banks and 22.9% sourced from friends and relatives at a fair interest in Nigeria. Osoro and Muturi (2013) still observes that 50% of respondents in the SMEs obtained their initial capital as commercial loans from Micro-Finance Institutions (MFIs) and 20% acquired their loans from friends in Kisii-Kenya. Kihimbo et al., (2012) claim that among the SMES in Kakamega Municipality in Kenya, commercial loans were some of the sources of beginning capital. These loans were acquired from friends, Commercial banks and MFIs. All these prior studies alludes to the fact that commercial loans have been utilized by SMEs to finance business operations ranging from start-up capital and capital to finance continuing activities at various levels of business cycles. Thus it is vital that the current study carries out tests to establish the nature of relationship between this variable (commercial loan financing) and financial performance of SMEs.

## **2.3 Financial Performance of Enterprises**

Osoro and Muturi (2013); Chepkemoi (2013) stated that financial performance highlights the status of an organization's financial output, emanating from management decisions which are executed by the personnel in various departments. The firm's level of goal achievement in terms of shareholders wealth maximization is well articulated by the information presented in the financial statements. The financial statement (Pandey, 2010; Munyuny 2013; Chepkemoi 2013) is an accurate presentation of the firm's financial performance; showing

financial variables such as assets, profit and sales, standing out very clearly as indicators of an enterprise’s well-being. Wangu (2011); Osoro and Muturi (2013) concludes that an enterprise’s performance can be prudently measured by variables such as profitability, sales level, production level and employment level among other factors; hence profitability was applied in measuring financial performance of SMEs in Lurambi Sub-County.

### III. MATERIALS AND METHODS

#### 3.1 Research Design

The research design used was a descriptive survey. Descriptive survey tries to collect information from a representative group upon which inferences are drawn about the behaviours of the entire target population. Its main aim is to find reasons why a particular activity is happening (Zikmund, Babin, Carr & Griffin, 2010). The merits of descriptive surveys are that they enhance rapid collection of data, are economical, efficient, accurate means of assessing information about a population and are less rigid in their application (Zikmund et al., 2010; Hart, 2005). This design was employed because the study was a fact finding enquiry hence required a description of the state of affairs of the current situation after which the results would be generalizable to the whole target population (Kihimbo et al., 2012; Siekei et al., 2013). Thus descriptive survey was the most suitable design for this study.

#### 3.2 Target population and Sampling Frame

This was made up of a list of 450 small and medium enterprises (SMEs) in Lurambi Sub-County that were currently active. The list was obtained from Kakamega County offices (Town management and Kakamega County Revenue Departments). The SMEs were classified as under three main sectors comprising of trade, service and industrial and related services. The distribution of the 450 SMEs was trade (169), services (189) and industrial and related services (92). Samples were picked from each of the above mentioned sectors.

#### 3.3 Sample and Sampling Techniques

**Table I: Sample Size**

Criteria/sector	Population	Sample size	%age
Trade	169	33	37.5%
Service	189	37	42.0%
Industrial and related services	92	18	20.5%
<b>Total</b>	<b>450</b>	<b>88</b>	<b>100%</b>

After stratifying the target population using stratified sampling, simple random sampling was used to pick the SMEs for the study from the three sectors: trade, service and industrial and related services. Random sampling was used to ensure that all members of the target population have equal chances of participating in the study. Random numbers were assigned to SMEs in the list in each stratum. Numbers were then read from the random table and elements in the frame with those numbers were included in the sample. Nassiuma cited in Osoro and Muturi (2013); Munyony (2013); Khaemba et al., (2013) asserts that the most common method of deriving a sample size in most surveys is the use of a coefficient of variation. In this method, a coefficient of variation ranging between 21% to 30% and a standard error of between 2% to 5% are normally acceptable. Hence the study used a coefficient of variation of 21% and a standard error of 2% to minimize variability in the sample and error. Therefore, using the coefficient of variation a sample size was arrived at as follows:

$$n = \frac{N(C^2)}{C^2 + (N-1)e^2}$$

Where n = the sample size  
 N = the population size  
 C = the Coefficient of Variation  
 e = standard error

$$\text{Hence: } = \frac{450(0.21^2)}{0.21^2 + (450-1)0.02^2} = 88 \text{ respondents}$$

Having calculated the sample size, stratified proportionate sampling method was used to arrive at the population sizes for every strata of each of the three sectors: trade, service and industrial and related services using the proportionate method from Chepkemoi (2013) which grouped the target population as follows:

$$nh = \frac{(Nh)n}{N}$$

Where n = the total sample size

N = the total population  
 Nh = the population size for stratum h  
 nh= the sample size for stratum h

**3.4 Research Instruments**

Primary data was collected from the field. Questionnaires were used to collect primary/quantitative data from the field. Quantitative data is in numeric and results are more readily analyzed and interpreted. Questionnaires enhance rapid collection of data and are very economical (Siekei et al., 2013). Structured questionnaires had closed ended questions. The questionnaire had a declaration, instructions to respondent and the actual questionnaire items. The actual questionnaire items section was sub-divided into organizational characteristics section, the respondent characteristics, commercial loan financing and financial performance (profitability) section.

**3.4.1 Validity of the instruments**

To establish content validity of the questionnaires content validity index (CVI) was (Kyokutamba, 2011) used;

$$CVI = \frac{n}{N}$$

Where n = number of items rated as relevant  
 N = total number of items in the questionnaire

CVI = content validity index

With a computed content validity index of 0.8, the research instrument was valid. An instrument (Kyokutamba, 2011) with a content validity index of at least 0.5 is considered sufficient. Content validity was also achieved by discussing the construct items with the supervisors and lecturers in the department of Commerce and Economics studies. Construct validity scored fairly well as the measurement scales reflected the key components of commercial loan financing and financial performance as described in the reviewed literature. It therefore follows that they are validated measures previously employed by other studies and as such they are deemed to be valid in this study.

**3.4.2 Reliability of the instruments**

**Table II: Summary of Cronbach’s Alpha test results**

Variable	Measure	Cronbach’s Alpha	No. of items
Commercial loan financing	Funds availability; Sustainability of funds; Repayment period.	0.808	10
Financial performance (Profitability)	Gross profit level; Income level; Sales level.	0.785	8

Cronbach’s coefficient, Alpha (α) method of internal consistency/homogeneity was used; which measures the consistency within the questions/instrument showing how well they measured characteristics and behaviours within the test (Kyokutamba, 2011; Sabana, 2014):

$$\alpha = \frac{K}{K-1} [1 - \frac{\sum \delta^2 k}{\delta^2}]$$

Where δ<sup>2</sup>k= Sum of variances of the k questions in the instrument  
 K= Number of questions in the research instrument  
 α = Alpha Coefficient  
 δ<sup>2</sup>= Variance of the total test

The measurement scales ‘computed Cronbach’s Alpha (α) results from a pilot study done on 15 SMEs in Malava town in table II, indicate that the measurement scales were reliable as the α are well above 0.6 threshold which (Kyokutamba 2011; Sabana, 2014) is the recommended coefficient for a given research instrument. Hence the internal consistency reliability of the measures used was considered sufficiently high enough to have adequately measured the study variables. This allowed for more testing and further analysis of the linear regression model.

**3.5 Data Collection Procedure**

Methods of administration of the instruments were self-administration and drop and collect method technique where the researcher and the research assistant left the questionnaire with an informant and went back to pick it. This method was preferred because data was collected from a large representative sample of SMEs' respondents and there was reduced bias. The owners of SMES or their personnel (managers) filled the questionnaires under proper guidance and in most instances (face to face); the filled questionnaires were picked by the team. It took approximately one week to collect data from the field

**3.6 Data Processing and Analysis**

Quantitative analysis was done to present the outcome of the research. Statistical packages for social sciences (SPSS) were used to carry out the analysis. Data was analyzed using descriptive statistic such as frequencies, percentages, means and standard deviations. Inferential statistics (multiple regression and correlation) analysis was carried out to test and establish relationships between sources of business financing and financial performance of SMEs

**IV. RESULTS AND DISCUSSION**

This is a presentation of the research findings and a discussion in line with the research objectives and 88 administered questionnaires were returned for analysis using the SPSS (Version 19) packages. The response rate was 100% because respondents were reminded to complete and fill the questionnaires on time. The 88 completed questionnaires formed the basis of this analysis hence the presentation and the discussion.

**4.1 Descriptive Statistics**

Descriptive analysis was basically anchored on commercial loan financing and financial performance of SMEs. Descriptive measures used were the mean, standard error, standard deviation, Skeweness and kurtosis.

**4.1.1 Commercial loan financing of SMEs**

**Table III: Commercial Loan financing**

Commercial Loan	Std.				
	mean	Error	Std. Dev.	Skeweness	Kurtosis
i. Easy access to funds depending on SME's ability	3.43	.082	.770	-.462	.332
ii. Flexible repayment period allowing SME enough time to repay	3.57	.064	.657	-.257	-.062
iii. The funds are less risky to use	3.61	.083	.780	-.240	-.245
iv. The funds have less restrictions in their usage and application	3.42	.085	.798	-.358	.152
v. Acquired assets pays off funding cost leaving the SME with the asset value	3.50	.079	.742	-.206	-.216
vi. The funds are self-sustaining in the long-run	3.56	.081	.757	-.118	-.271
vii. The SME retains its decision making powers after using fund	3.59	.072	.672	.009	-.177
viii. The SME is able to engage in risky ventures with high returns	3.53	.076	.660	-.128	-.143
ix. usage of the funds increases investment prospects of SME	3.58	.070	.656	-.051	-.150
x. The funds adapts more easily to SME's financial needs	3.60	.078	.736	-.097	-.210
<b>Average score</b>	<b>3.54</b>	<b>0.077</b>	<b>0.723</b>	<b>-0.191</b>	<b>-0.099</b>

Descriptive statistics in table III reveals the outcomes of responses to ten statements formulated in line with commercial loan financing using a Likert scale of values ranging from 1 to 5. The value 1=strongly disagreed, 2=disagreed, 3=neither agreed nor disagreed, 4=agreed and 5=strongly agreed. For commercial loan financing, the average mean value was 3.54 with a standard error of 0.077, which implies that most respondents agreed with the fact that the application of commercial loan financing had benefits highlighted by the ten statements to SMEs. With a standard deviation of 0.723; discrepancies from the mean were fairly small. The data set was normally distributed as it had a Skeweness of -0.191 (Asymmetrical) and a Kurtosis of -0.099.

These results are consistent with the static tradeoff theory (Munyuny, 2013) which asserts that capital structure is based on the tradeoff between the benefits and costs of commercial loan financing.

#### 4.1.2 Financial performance of SMEs

**Table IV: Financial performance of SMEs**

Financial performance	mean	Std. Error	Std. dev.	Skeweness	Kurtosis
i. The SME realized higher output increasing gross profits	4.35	.061	.568	-.547	1.711
ii. The SME's costs reduced increasing business income	4.26	.059	.557	-.390	1.951
iii. The SME's net profits increased due to improved expenditure planning	4.28	.058	.546	-.369	2.129
iv. Reduction in taxation led to higher margins for the SME	4.25	.054	.509	-.201	3.056
v. Higher investment levels led to more revenue for SME	4.24	.064	.547	-.346	2.196
vi. Improvement in product quality led to higher sales	4.14	.067	.628	-1.245	6.245
vii. The SME acquired more assets improving their returns	4.16	.060	.623	-1.287	6.673
viii. Acquisition of current technology led to higher revenues	4.18	.066	.617	-1.333	7.166
<b>Average score</b>	<b>4.23</b>	<b>0.061</b>	<b>0.574</b>	<b>-0.715</b>	<b>3.891</b>

Respondents were asked to evaluate the financial performance of their enterprises with respect to profitability based on the statements and results in table IV indicated that the average mean from responses on profitability was 4.23 with standard error of 0.061 which revealed that most respondents agreed with eight statements that alluded that most SMEs were performing well financially. With an average standard deviation of 0.574, the distribution was similar. The Skeweness of the data set was -0.715 (asymmetrical) and kurtosis of 3.891 which was larger than the mean hence a peaked distribution. This is consistent with Osoro and Muturi (2013) and Vo et al., (2011) when they claim that application of various funding channels resulted in improved financial performance of SMEs. Financial performance was felt in variables such as sales growth, profit, assets and better financial management among SMEs.

#### 4.2 Inferential statistics

Inferential analysis was done for independent variables and dependent variables (commercial loan financing and financial performance respectively).

##### 4.2.1 Correlations between Variables

The purpose of the study was to establish a relationship between sources of business financing and financial performance of SMEs. Correlation test was carried out to determine whether there was a relationship between the independent and dependent variables.

**Table V: Correlation Matrix**

		CLF	Profitability
<b>Profitability</b>	Pearson Correlation	.327**	1
	Sig. (2-tailed)	.002	
	N	88	88

\*\* . Correlation is significant at the 0.01 level (2-tailed).

##### 4.2.1 (a) Relationship between commercial loan financing and financial performance of SMEs

Table V reveals a moderate, positive and statistically significant linear relationship between Commercial loan financing and financial performance of SMEs with a Pearson Correlation ratio (R) of 0.327 and a p-value of 0.002 ( $p < 0.05$ ) at 95% confidence level. This shows that there is a linear relationship between commercial loan financing and financial performance. Application of commercial loan financing by SMEs affected their financial performance. Consistent to these findings, are results from (Munyuny, 2013) Eldoret municipality which indicates that there was a positive and significant correlation between long-term loan and profit margin ratio. Hence commercial loan financing was an important determinant of financial performance of SMEs in Lurambi Sub-County.

**4.2.2 Multiple Linear Regression Analysis**

Regression tests were carried out to achieve the objectives under study from the data obtained regarding the extent to which respondents had agreed with the various statements concerning the independent and dependent variables.

**Table VI: Business financing and financial performance of SMEs**

<b>Goodness of fit</b>						
	<b>R</b>	<b>R Square</b>	<b>Adjusted R Square</b>	<b>Std. Error of the Estimate</b>		
	.530 <sup>a</sup>	.281	.256	.38792		
<b>Overall significance: ANOVA (F-test)</b>						
<b>Model</b>		<b>Sum of Squares</b>	<b>Df</b>	<b>Mean Square</b>	<b>F</b>	<b>Sig.</b>
1	Regression	4.945	3	1.648	10.954	.000 <sup>a</sup>
	Residual	12.640	84	.150		
	Total	17.585	87			
a. Predictors: (Constant), Trade Credit Financing, Commercial Loan Financing, Retained Earnings Financing						
b. Dependent Variable: PROFITABILITY						
<b>Individual significance</b>						
<b>Model</b>	<b>Unstandardized Coefficients</b>			<b>Standardized Coefficients</b>		<b>Sig.</b>
	<b>B</b>	<b>Std. Error</b>		<b>Beta</b>	<b>T</b>	
(Constant)	2.497	.313			7.984	.000
CLF	.125	.047		.251	2.658	.009
REF	.204	.075		.273	2.716	.008
TCF	.155	.063		.243	2.455	.016
a. Dependent Variable: PROFITABILITY						

**4.2.2 (a) Sources of business financing and financial performance of SMEs**

Regression analysis was carried out to find out how sources of business financing explained or accounted for changes in financial performance of SMEs in Lurambi Sub-County. Table VI shows that the independent variable (sources of business financing) is statistically significant in predicting financial performance of SMEs. With a coefficient of determination ( $R^2$ ) of 0.281, the predictor variables influenced the dependent variable by 28.1%. Hence sources of business financing affected financial performance significantly at  $F(3, 84) = 10.954$  and  $p < 0.05$  at 95% confidence level as shown by table VI. Consistent with these findings is (Akinbola & Otokiti, 2012) which found that lease option affected the profitability of SMEs significantly in Lagos state in Nigeria. Also (Chepkemoi, 2013) capital structure significantly affected financial performance of SMEs in Nakuru Kenya; venture capital (Memba et al., 2012) was found to be an important component for SMEs' growth in Kenya. Hence the importance of sources of business financing to financial performance has been equally underscored by extant studies.

Therefore the linear regression model becomes:

$$\text{FinP} = 2.497 + 0.125(\text{CLF}) + 0.204(\text{REF}) + 0.155(\text{TCF})$$

Where: **FinP**= financial performance

**CLF** = commercial loan financing

**TCF** = trade credit financing

**REF** = retained earnings financing

**4.2.2 (b) Effect of commercial loan financing on the financial performance of SMEs**

Results reported in table VI indicate that the partial regression coefficient (beta) for commercial loan financing is 0.125, which shows that if all other explanatory variables in the model are held constant, a one percent change in commercial loan financing would result in 0.125 unit change in financial performance of SMEs which is statistically significant as  $p < 0.05$  at 95% confidence level. This still shows that SMEs that utilize commercial loan financing improves their level of financial performance significantly. Commercial loan



financing (Kihimbo et al., 2012) is an important source of financing as it is widely used by SMEs in Kenya. The Pecking order theory of financing consistently (Frank & Goyal, 2005) predicts that financing deficit will drive commercial loan financing among SMEs higher as it has a significant effect on their profitability. Thus the pecking order theory's predictions support this study solidly. Consistent to this are results from Joeveer et al., (2006) which found that on average the combined effect of EBRD and non-EBRD loans on SMEs' revenue were statistically significant in Georgia, Russia and Ukraine. The competitive environment in which SMEs operated (Joeveer et al., 2006) saw commercial loans expand business operations, but did not automatically translate into higher profitability as the effect on profit was a net residual effect from high revenues and reduced costs hence this led to a moderately significant positive effect on financial performance. Osoro and Muturti (2013) found that accessibility to credit affected financial performance of SMEs positively in Kisii Kenya; the effect was seen in increased turnover and expansion in the number of workers. Klapper (2006) reported that factoring was a significant source of funding among Mexican SMEs and improved their financial performance as its cost was not big enough to water down the positive gains.

Firms that procured loans (Wangu, 2013) from micro-financing experienced a significant increase in their revenues and net profits in Uganda. Wang (2013) observed that SMEs in Taizhou China that obtained their finances from micro-finances were likely to realize a significant increase in revenues and profit margins. Timoshenko (2012) observes that commercial loans affected SMEs development towards export oriented market positively, as the participating Latvian firms realized higher exports. There are factors that usually (Quianoo, 2011; Abouzeedan 2003; Vo et al., 2011; Wangu 2011; Onakoya et al., 2013; Kihimbo et al., 2012; Osoro & Muturi, 2013; Egbuna & Agali, 2013; Agbozo & Yeboah, 2012; Xiao, 2014; Sabana, 2014; Joeveer et al., 2006) erode the significant benefits of commercial loan finances to SMEs and they include high interest rates charged by lenders, repayment schedules that put a lot of pressure on borrowers and high transaction costs such as commissions, other fees among other items. The lending cost components such (Kyokutamba, 2011) as insurance fee, membership fee, legal fees, bank fees, government levies, contingency reserve and the high rate of borrowing as advocated by the trade-off theory (Miglo 2013; Atiyet, 2012; Bolton et al., 2013) increases the operating and production cost which in turn waters down financial performance of SMEs. The presence of finances (Memba et al; 2011) may not in itself guarantee very good financial performance of SMEs but other factors such as strategic marketing, proper pricing principles, research and development (R&D) and appropriate management capabilities will play a vital role in ensuring that commercial loan affect financial performance of SMEs in the most significant way.

#### **4.3 Summary**

The specific objective was to determine the effect of commercial loan financing on the financial performance of small and medium enterprises in Lurambi Sub-County. A Pearson correlation ratio of 0.327 and a p-value of 0.002 show a relationship that is significant between commercial loan financing and financial performance at 95% confidence level. With a partial regression coefficient (beta) of 0.125 and a p-value of  $0.009 < 0.05$  means that commercial loan financing is a significant predictor of financial performance of SMEs.

#### **4.4 Conclusions**

Commercial loan financing has a positive effect on financial performance and this effect is statistically significant in predicting financial performance of SMEs. SMEs that use commercial loan financing will expand their business operations and experience significant increase in their profitability. The effect is moderate as these gains are dependent on the tradeoff (Joeveer et al., 2006) between high returns and costs including financing costs.

#### **4.5 Recommendations**

On the basis of the foregoing conclusions, the study presents the following recommendations to the SMEs business community, policy makers, lenders and scholars for review and consideration. Investors and managers of SMEs should consider commercial loan financing as an important determinant of financial performance. SMEs should come together to form larger groups in order to access bigger commercial loans from banks, microfinance institutions and other lenders which are cheaper to source as they carry lower transaction costs and such costs are shared by SMEs in the group reducing its impact on individual SME's financial performance. Government agencies engaged in availing funds to SMEs should avail such funds at the lowest possible rate or otherwise provide them at zero interest rate for the SMEs to realize sustained and robust financial performance. The Kenyan Government funding programmes for SMEs such as the Women Enterprise Fund, Youth Development Funds, Uwezo Fund and Kakamega County's Mikopo Mashinani Fund should be tailored to meet individual SME borrower's needs besides the current group affiliation focus in order to improve the reachability and accessibility of the funds to many needy business operators. The Kenyan and County Governments should step in to act as guarantors of commercial loans obtained by SMEs from lenders as this will ensure that the SMEs experience sound and sustainable financial performance.

The Kenyan Government through the Central Bank of Kenya (CBK) should make it mandatory for banks and lenders to revise their lending rates annually in tandem with CBK revisions and set a ceiling within which these rates should lie to make commercial loans cheaper to SMEs borrowers. For instance the Central Bank could demand that no lender should add a risk premium of more than 2.5% on top of the prevailing Kenya Bankers' Reference Rate (KBRR) and violators of this rule are highly penalized. The Government of Kenya (GOK) should encourage financial institutions to share the financing risks between themselves and the Government in order to make commercial loan financing have a greater significant contribution to financial performance of SMEs.

#### 4.6 Areas for further research

The following areas can be explored in future: other factors that were not captured by this study that could affect financial performance in Lurambi Sub-County. Also other studies can use secondary data that are audited to ascertain relationship between sources of business financing and financial performance of SMEs.

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