

**SMALL AND MEDIUM- SCALE MANUFACTURING ENTERPRISES IN
KENYA: A PERSPECTIVE ON ALTERNATIVE SOURCES OF
FINANCING**

BY

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Declaration

I declare that this study, “Small and Medium-Scale Manufacturing Enterprises in Kenya: A perspective on alternative sources of financing” is my own work both in conception and execution. All the information that was used has been duly acknowledged in the text and references.

Signed: _____
Stephen O. Migiro

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Dedication

Firstly, this work is dedicated to God, *GREAT THINGS HE HAS DONE*. All I have needed thy hand has provided-‘morning by morning new mercies I see’. Secondly, to my late Mother, Martha Moraa [07.05.05]. Although she did not get formal education herself, she sacrificed a lot and gave all her care, support and wisdom to see me pursue my education, but would not live to share the fruits of her labour. May her soul rest in eternal peace.

Abstract

Small and medium-scale enterprises (SMEs) form the majority of the enterprises in the Kenyan economy. They employ a large share of the labour force. The sector is perceived as an alternative employer. Recent studies show that SMEs are at least as important as large firms in the creation of gross and net new jobs. Notwithstanding their importance, most SMEs are unable to exploit the increased market opportunities due to a number of constraints. This is because of either low productivity, incapacity to face competition from imports or in export markets, constraints to adapt new technologies and or a lack of finance.

Financing of the sectors' activities is always cited as one of the problems facing the sector. The literature review on SME's access to bank finance indicates that most SME operators have limited access to bank finance. SME access to the formal financial sector is constrained by high risks and transaction costs associated with commercial lending. To develop them and maintain their contribution, initiatives are required to enable them grow and flourish.

The aim of this study was to provide a perspective on use of alternative finance by SMEs in Kenya. The study focused on three manufacturing sub-sectors, namely: Textile and Garment, Furniture and Wood products and Metal and Metal products.

To achieve this aim, the study sought to identify factors influencing the financing structure of SMEs such as enterprise demographic factors, investigate alternative methods or models of SME financing; identify factors which limit SMEs access to credit from the formal financial market, main sources of SMEs finance, and suggest and recommend measures to improve SMEs finance in Kenya.

The study employed survey research design methodology in which combinations of research methods were used. These included questionnaire survey, observation; face to-face interviews and literature review. Various enterprise finance theories making up the

meta-theoretical framework used in the study and empirical studies of small enterprises' capital structure are discussed as a prelude to the empirical study.

Empirical data was collected from 380 respondents in order to answer research questions and to test various hypotheses concerning the determinants of capital structure of the enterprises in the study. The aspects of capital structure covered in the analyses were alternative sources of finance [long-term and short-term] and the demographic characteristics of the SME operators and their enterprises.

Quantitative data from the survey was analyzed with the application of microfit software and descriptive statistics. Content analysis was applied to qualitative data from open-ended questions and structured interview schedule on key informants.

The findings indicates that the SME manufacturing activity is male dominated; majority of the manufacturing SME operators fell in the 30-49 age categories; had secondary education; do not to have any formal training in business management; have not changed accounts from one bank to the other; and majority of the enterprises in the survey are sole proprietorships. Further, empirical results indicate that interest rate and collateral requirement are the major factors influencing choice of finance. The overall results show that personal savings is used as the main source of enterprise financing. Specifically, there was general agreement amongst the operators that bank finance is least used and that alternative finance is least used and poorly understood or not understood at all. In addition, there was a very insignificant level of computer literacy among the SME operators in the study.

The study notes that SME financing in Kenya; and in particular the use of alternative finance needs to be addressed. It is recommended that a Small Business policy division be established by the government of Kenya, responsible for promoting small business policy; establishment of a business portal to not only harmonise, but also facilitate provision of online support services to the maximum number of financial and other services; establishment of a central data bank on national business activities including those of small and medium-scale enterprises. The system to maintain comprehensive and

objective data sets relating to the financing of SMEs, particularly on demand for and supply of financing; promote inter-firm linkages and provide information on availability of alternative sources of finance. The study further suggests a hybrid structure of SME financing between the micro-finance institutions (MFIs) and the formal financial institutions. The model suggests an introduction of micro and small business finance windows in commercial banks, developing linkages between micro financial institutions and commercial banks. In addition, the study proposes the establishment of a national SMEs development bank that will act as a revolving fund to boost the development of SMEs. The proposed bank to be linked to municipal/city council SMEs revolving funds. This will ensure that there is an all round concerted effort at stimulating and monitoring SME activities. The strategy will help allocate limited national resources to target industrial activities that will jump-start the industrial process, using both local and foreign resources.

It is further recommended that longitudinal studies be considered to meet data needs in the SME sector. Such studies will help identify real financing gaps among other gaps in the sector for the application of intervention measures.

In conclusion, the study makes a distinct contribution to the theory and practice of financial management, specifically alternative financing in the small and medium-size organizations, not only in Kenya but for other countries in Africa as well. The study also presents a basis for educational, development and training parameters, which enlightened institutions can implement in formal training programmes. Finally, organisations that facilitate the financing of small and medium-size businesses are encouraged to maintain comprehensive and objective data sets relating specifically to the financing of SME's.

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Glossary

Collateral- is an asset pledged by a borrower to a lender until a loan is paid back. If the borrower defaults, then the lender has the right to seize the collateral and sell it to pay off the loan.

Capital structure- refers to the way in which the financing of a firm is arranged between ordinary shares, preference shares and debentures.

Industrial policy- Refers to the government's strategy for boosting economic growth by improving industrial competitiveness. This might mean making fiscal, monetary and foreign currency decisions on the basis of business needs, including keeping interest rates relatively low or increasing government spending on transport and communication infrastructure.

SMEs- Are firms that lie between the micro-enterprise and the large firms. Their securities are not quoted in any established market and the ownership of the firm is in the control of the owner(s) or a small knit group.

Venture capital- is the name given to equity finance provided to support new, expanding and entrepreneurial firms.

Capital- means funds invested in the business, either from shareholders or from lenders.

Financial risk- is the risk caused by the obligations of fixed charges on borrowed funds. Financial risk depends on how the firm is financed.

Credit- rating- is a judgment made by bankers about the financial health of a business and therefore how safe it would be to provide them with funds. The credit – rating will be based upon the strength of the firm's balance sheet and its recent financial history.

Capital gearing- is the proportion of capital employed that is financed by long-term debt.

Manufacturers—refer to those in the manufacturing sector of industry and display many examples of SMEs. This includes printers, bakers, engineering companies, shoe factories, milk factories, etc.

Abbreviations and Acronyms

Bas	Business angels
CBS	Central Bureau of Statistics
EARC	East African regional Commission
FAO	Food and Agricultural Organisation
GDP	Gross Domestic Product
GS	Guarantee scheme
IBRD	Industrial Bank of Reconstruction and development
ICDC	Industrial & Commercial Development Corporation
IDRC	International Development Research Centre
IDB	Industrial Development Bank
ILO	International Labour Office
KIE	Kenya Industrial Estates
K-REP	Kenya Rural Enterprise programme
LGS	Loan Guarantee Schemes
MCN	Municipal Council of Nakuru
MFIs	Micro-finance Institutions
MoT	Ministry of Trade and Industry (Kenya)
MSE	Medium and small enterprises
NGOs	Non governmental organizations
OECD	Organisation for Economic Co-operation and Development
ROSCAs	Rotating savings and credit associations
SSJKE	Small scale and Jua Kali enterprises
SMEs	Small and medium enterprises
SMIs	Small and medium scale industries
UNCTAD	United Nations Conference, Trade and Agreement Development
UK	United Kingdom
UNIDO	United nations Industrial Development organisation
VC	Venture capital

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CHAPTER ONE

INTRODUCTION AND BACKGROUND TO THE STUDY

1.1 Introduction

The focus of this research is on the need for alternative finance for small and medium-scale manufacturing enterprises (SMEs) in Kenya. This chapter provides the background to the study, context, and statement of the problem, research questions, hypotheses, research methods and organization of the study.

1.2 Background to the study

It is known from economic development, in the organisation for economic co-operation and development countries (OECD), and the newly industrialised economies in East Asia that until a certain stage of maturity is reached, growth is driven largely by industrialisation. In most other countries as well, the need for a buoyant manufacturing sector is acknowledged to be an important means to increase overall welfare. But industrial development is not simply a matter of production processes; it is also a matter of a well-functioning financial sector (Isaksson, 2001a:1).

In both developing and developed countries, small and medium scale enterprises play important roles in the process of industrialization and economic growth. Apart from increasing per capita income and output, SMEs create employment opportunities, enhance regional economic balance through industrial dispersal and generally promote effective resource utilization considered critical to engineering economic development and growth (Ogujiuba and Ohuche, 2004:1).

Similarly, a paper by the International Development Research Centre (IDRC) on small enterprise development pointed out that small and medium size enterprise (SMEs), in addition to having high employment creation capacity, possess three other critical attributes which warrant the attention of development specialists and policy makers in developing nations. First, an economy with a large number of these firms will have a fairer income distribution than that which is dominated by a small number of large-scale

enterprises as more people will own businesses. Second, development of small and medium size manufacturing firms entails accumulation of technological capability among a large number of people and firms. The consequence is that the extent of technological accumulation in economies with a large number of small and medium size industrial firms will be widespread. Third, because developing nations, like Kenya, have limited capital, it is more prudent to spread the available resources by promoting the development of efficient and dynamic small and medium size enterprises (IDRC, 1993). The challenges thrown to small and medium size enterprises by the development plans with regard to employment generation, enhancing fair income distribution and deepening technological accumulation makes it necessary that appropriate policy interventions be put in place to enable the enterprises to realise their potential

1.2.1 The Kenyan industrial setting: Past Experience and Future Prospects

Since independence the Kenyan economy has experienced a number of cycles of growth followed by downturns and stagnation. Immediately after independence between 1964 and 1971 the economy registered a GDP growth averaging 6.5%. The oil shocks of the early 1970s, the collapse of East African Community and other external factors caused a marked slowdown in growth in this decade. The "coffee - boom" induced growth in 1976 and 1977. The economy stabilized in the 1980s with GDP growth around 5% being recorded, except in the 1984 drought year. However, in 1989 growth started to decline as a result of poor weather, regional conflict and an influx of refugees, a global recession that lowered demand for Kenya's traditional exports, coupled with short term dislocation caused by structural adjustment and inadequate macroeconomic management and political uncertainty. However, a combination of improved weather, the favourable impact of economic liberalization and the emergence of the global economy from recession led to an improved GDP from 3% in 1994 to 4.9% in 1995 and the predictions that future growth would accelerate to 6-7 %.

Kenya's economy depends largely on Agriculture, which accounts for over one third of the GDP and approximately two thirds of exports. Agriculture is supplemented by manufacturing, commerce and tourism, which collectively account for an additional one-

quarter of GDP. Kenya's industrial sector has grown substantially over the years with its contribution to Gross Domestic Product (GDP) rising from about 8 per cent in 1990 to 14 per cent in 1994. There are more than 700 medium and large-scale enterprises of which 200 are foreign multinationals, mostly from the United Kingdom, the United States of America, Germany and the Far East. The major industrial exports include refined petroleum products and cement. In addition, important industrial raw materials such as soda ash and fluorspar are exported in sizeable quantities. Manufacturing production has been dominated by food, beverages and tobacco, chemical and petroleum products, and metal products. Other products which have increased in importance over the period include textile products, leather and rubber products, cement, clay and glass. Viable investments have been made in the production of food, chemicals, pharmaceuticals, leather, rubber, plastic, sugar, textiles and apparels and motor vehicle assembly.

One of the greatest challenges facing Kenya is the creation of productive employment opportunities for its rapidly increasing work force. The scale of the problem demands that all resources and means are utilized to create jobs, enhance incomes and livelihoods. All non-farm enterprises must be included in the efforts to transform the Kenyan economy. Thus, within the more formal sector, trade, commerce and service industries are already major sources of employment and will play a vital role in economic development and expanding Kenya's exports. Similarly the informal small scale and Jua Kali sector must be fostered to continue to expand and grow for it is expected that more jobs will be created in this sector than any other off the farm sector.

Recent years have demonstrated the dynamism of small scale and Jua Kali enterprises (SSJKE) in creating employment. Furthermore the sector provides an essential training ground for developing the entrepreneurial skills that are essential to Kenya's industrialization.

To this end, an important development in the industrial sector has been the growth of the informal manufacturing sub-sector, commonly known as Jua Kali, in response to the scarcity of formal wage employment. These are small manufacturing ventures that use very little capital in their production process and manufacture a wide range of products.

The most important of these include simple machines, steel windows and doorframes, boxes, charcoal stoves and furniture.

Nonetheless, the sustainable growth of the Kenyan economy is directly related to the rate of enterprise creation and development. This in turn depends on the ease with which small and medium sized enterprises can be started and financed. However, SMEs have always faced difficulty in obtaining formal credit. The absence of robust credit markets is a significant impediment to the sustained growth of businesses. Traditional commercial banks and investors have been reluctant to serve SMEs for a number of reasons (UNCTAD, 2001:1; Murinde, Manos and Green, 2002:22-28), and Nixon and Cook, (2000:3).

1.2.2 Conditions of Credit Markets in Developing Countries

The absence of robust credit markets in developing countries (LDCs) is a significant impediment to sustained economic growth. Productive economic activity is severely limited by the inability of entrepreneurs, small businesses and individuals to obtain loans. In contrast, there is widespread access to credit in most developed countries, and it is relatively easy for entrepreneurs to get a loan to start a business and for small businesses to get a loan to expand their operations (Freedman, 2004:1).

Empirical studies have demonstrated that credit to the private sector plays a crucial role in economic growth. Developed countries enjoy higher growth rates partly because they have more vigorous credit markets (Levine, Loayza and Beck, 2000:56-77). In 2002, the annual domestic credit provided by the banking sector in high-income countries averaged 168% of Gross Domestic Product (GDP) (The World Bank, 2004:272). For the United States of America (USA), it was 159% of the USA GDP, which amounted to over \$16 trillion in bank lending to the private sector. In contrast, the 2002 annual domestic credit provided by the banking sector in middle-income countries averaged just 83% of their GDP and for low income countries the average was 49% of their GDP. The disparity between the level of credit in less developed countries (LDCs) and high-income countries is even greater than these numbers suggest, because banks are the primary source of credit in LDCs, while high-income countries have sizable bond markets and other

significant non-bank sources of credit. Even when credit is available to businesses in LDCs, the loans must be repaid in a very short time frame. Without longer repayment periods, it is difficult to finance investments in new equipment or technology because such investments may not yield sufficient revenues in the short-term to repay a loan (Freedman, 2004:2).

High collateral requirements are another burden for prospective borrowers. Banks make lending decisions largely based on the value of assets pledged by a borrower rather than a borrower's expected revenues and cash-flows. Borrowers often must satisfy collateral requirements well in excess of 150% of the loan amount. This precludes most potential borrowers from debt financing and, in particular, those desiring to start a new business (Beck, Demiurgic and Maksimovic, 2004:2).

The low-volume of lending to the private sector in developing countries is not primarily due to a lack of funds in the banking sector. Banks in LDCs generally lend only a modest portion of their total deposits to private sector borrowers, while a large percentage of their deposits remain in liquid assets such as cash positions, inter-bank loans, central bank debt or short-term government securities. For example, USA banks keep roughly 6% of their total deposits in liquid assets and the bulk of their capital is used for non-sovereign loans. By contrast, many banks in developing countries maintain 50% or more of their total deposits in liquid assets and provide minimal credit to the private sector. The liquidity within the banking system in many developing countries amounts to a significant percentage of GDP. This represents a massive failure of the financial system to allocate capital to its most productive uses (Freedman 2004:1).

There are a number of reasons for the failure of banks in developing countries to lend a higher percentage of deposits to private sector businesses and entrepreneurs. Due to heightened macroeconomic risk and volatility, it is prudent for banks in developing countries to keep a high percentage of deposits in liquid assets. The likelihood of a run on the bank or an economic crisis that triggers a wave of defaults is greater in developing countries, and banks in LDCs sensibly maintain substantial liquid assets so that they can withstand a sizable withdrawal of deposits and maintain solvency during periods of

economic turmoil. Central banks also impose higher reserve requirements due to this heightened macroeconomic risk and volatility. Nevertheless, banks often maintain reserves well in excess of the required amounts (The World Bank, 2001; Levine, Loayza, and Beck, 2000:52-65). There are several reasons why banks in LDCs maintain excess reserves and do not lend more to the private sector.

Firstly, the legal and judicial environment is deficient and property rights are not adequately protected. It is very difficult (and sometimes impossible) to enforce contracts in developing countries. The process is time-consuming, costly and the outcome is not always assured (The World Bank 2004:272). As a result, lenders are not confident that they can get repaid if the borrower defaults. To help ensure that the borrower will repay, lenders impose very high collateral requirements which borrowers often cannot satisfy because they do not have adequate legal title to assets.

Secondly, governments in less developed countries (LDCs) often run large deficits and this drives up interest rates and crowds-out local investment. Banks are able to make a good profit taking in deposits and using them to purchase government bonds, so they are less inclined to search for lending opportunities with entrepreneurs and private firms.

Thirdly, banks have great difficulty ascertaining which borrowers are good credit risks due to a high degree of asymmetric information. Banks do not know nearly as much about a borrower's operations and likelihood of repayment as the borrower knows. Besides, banks lack reliable information and data about borrowers (Berger and Udell, 2004:3). There is lack of accurate financial statements and financial records that can demonstrate that a borrower has been earning enough revenue to repay a loan. Small firms lack proper accounting procedures and owners frequently mix their business and personal finances so financial statements are unreliable (*Ibid.* 2004: 7-10). Besides, there are few, if any, credit bureaus that provide lenders with the credit history of prospective borrowers and whether they have repaid prior debts.

Fourthly, parallel to the reluctance of banks to lend to small enterprises is the reluctance of these enterprises to borrow from banks. The administrative and costly formalities of obtaining bank finance, particularly the time and paper work involved, are a formidable

deterrent to smaller businesses. Some of them lack the formal education to cope with the bureaucracy and others, compounded by problems of location and time pressures, have difficulty in complying with what the institutions require before they grant a credit. In many cases, potential borrowers have to pay for preparation of accounts or special studies on top of the cost involved in the numerous visits to the lending institutions. The transaction costs on the part of a borrower in obtaining a loan from a bank may be proportionally as high as are these costs for the lender.

Fifthly, there is a distinct institutional bias on the part of banks towards lending to the larger corporate sector. In many cases there are links in directorships, joint ownerships and various other common financial dealings between banks and the large enterprises and automatically this induces preference for directing finance to these borrowers.

Sixth, the administrative costs of lending to small enterprises are high, which cuts deep into the profitability of such transactions for lending institutions. This is undoubtedly the case and has been borne out in studies.

1.2.3 Business enterprises and alternative finance

Business enterprises are heterogeneous and have different financing structures (Casasola, Cardone and Margarita, 2002). Financing needs are, therefore, of varying nature. In describing financing needs, a link is made between type of enterprise, financing forms and typical delivery channels. Thus, there are alternative forms of finance to finance business enterprises (van Oyen and Levitsky, 1999:1; Levitsky, 1996:35). Alternative finance refers to sources of finance, other than bank finance.

The other forms of finance for businesses, apart from credits made available through the banking system include initial public offering (IPO), private equity from private investors, private equity from institutional investors, loans from employees, loans from institutional investors, leasing, factoring, venture capital and public loan subsidies in form of credit guarantee schemes. In addition, part of the capital can be financed from supplier credits, and in some situations or sectors, by advances from customers.

1.2.4 Small and medium-scale enterprises and Industries (SMEs or SMIs).

When referring to enterprises in this research, the focus is predominantly on SMEs, both existing and potential, in the manufacturing sector. The terms small and medium enterprises (SME) and small and medium scale industries (SMIs) are, however, often used interchangeably to mean the same thing. Nonetheless, it is important to note that the two terms do not mean the same thing. In economics, an industry means a group of enterprises producing the same type of products. Whereas, an enterprise refers to a business unit, which can be small, medium or large in an industry. This means that enterprises of various sizes are found in an industry. Hence, it is the enterprise that is small sized, and not the industry (Ming-Wen Hu and Chi Schive, 1998)), and this is where the focus lies in this research.

1.2.4.1 History of the small and medium –scale sector in Kenya

The elements of most importance to the history of the Kenyan informal or small scale sector are the East African Royal Commission of 1953-55 and the report of the 1966 Kericho conference, published as *Education, Employment and Rural Development* (Sheffield, 1967). The first one addressed what later became an obstacle to the development of the informal sector. It singled out the restrictions and regulations that were generally the life of the colonial Kenyan African e.g. marketing, provision of credit and licenses to the use and the sale of land itself (King, 1996:4). The commission noted that many of the clusters of settlements just outside the boundaries of major towns formed “important centres of African trade”, (EARC, 1955:208). The 1966 Kericho conference took place after three years of independence as a result of the growing awareness of the primary school leavers’ crisis, which led to dramatically high levels of unemployment among the youth. This is a sector where the unemployed can ‘eke out an existence as casual labourers, stallholders and whose activities include a wide range of petty barter trade and traditional crafts (Harbison, 1967:175:177). The International Labour Organization office (ILO) Kenya Employment mission applied the term informal sector publicly for the first time arguing that, “Their (‘African traders’) activities are on a very small scale and lacking security of tenure, they have no incentive to improve their premises’. Yet to clear these areas of their inhabitants would destroy what in some urban

areas constitutes the only development of African commercial enterprises” (EARC, 1955:208 cited in ILO, 1972).

According to the World Bank (1987), the historical factors have had a strong influence on the size of Kenya's size of micro and small scale manufacturing sector. In Kenya, due to the presence of the settler community, Africans were strongly excluded from engaging in cash crop farming until the 1950s. This impeded the opportunities of Africans to accumulate capital for setting up informal enterprises and limited the purchasing power of the native population in the reserves (Billetoft, 1989). The colonial period can be divided into two distinct periods. In the first period, the policy of the colonial government was geared to develop a strong economically viable settler economy (Carlsen, 1980 cited in Billetoft, 1989). The major aim was to secure a stable and cheap supply of African labour for the settler farms, for the plantations and for building up necessary infrastructure. Africans were restricted to activities that will not hamper the supply of labour to the settler farms and did not result in products that competed for markets with the settler products. The Asian community also played a role in the Kenyan colonial economy and continues doing so up to today. Unlike Africans they did not experience firm restrictions on their activities and they came from a tradition in which capital accumulation; profit seeking, entrepreneurship and acquisitiveness were well-established principles (Freeman and Norcliffe, 1985 cited in Billetoft, 1989). Things changed during the economic crisis of the 1930s. This necessitated the colonial government to change the policy of basing economic development of the country upon settler farmers alone that had become a total failure. The demand for African labour on European farms decreased as export prices of crops like tea and coffee fell. This contributed to more Africans being involved in small-scale farming and cash crop production. This increased pressure on land in the reserves. During and after the Second World War, Asians and Europeans mainly dominated the urban non-agricultural sectors. But an increasing number of Africans took part in local trade in the rural areas, dealing with mainly agricultural products such as vegetables and few industrial products. The rate of growth of the trading centres increased rapidly despite the efforts of the colonial government to stop them due to fear of fierce competition. As a means of further diversifying incomes the Africans were engaged in craft production as substitute to traditional crafts that had

stagnated due to importation of manufactured goods. These crafts mainly included carpentry and tailoring among other informal sector activities.

The second period of the colonial policy was that of the Swynnerton Plan (the involvement of African peasants in the cultivation of cash crops such as tea, pyrethrum and coffee) which was strengthened in the 1940s and 1950s. The production of food crops such as maize was also increased with surpluses available for sale. This increased the cash circulation among the rural people especially those in the reserves, which led to some peasants engaging in the rural informal sector. The establishment of the semi-government marketing boards which were involved in agro-processing of crops like tea and coffee also contributed to the rapid expansion of the rural informal sector because there were many people in the money economy as they were labourers in these factories. Immediately after independence, the Africans were not restricted anymore, for they had access to loans and credit facilities. This contributed to the proliferation and dispersal of tiny rural informal sector activities, as there was too much pressure on land, due to settlers' occupation on huge sections of land and mechanization that replaced human labour. Presently, the informal sector accounts for almost every aspect of the economy.

The name "informal sector" was used for the first time by the British economist Keith Hart in his study of economic activities in Ghana's urban sector (Hart, 1971: 1614). Since then, the term has been variously described by numerous authors including: unorganized, unregistered, third economy, parallel economy, non-institutional, bazaar economy, black market, underground economy, amongst others (ROK, Labour Force Survey, 2003). The terminology was popularized by the International Labour Organization (ILO) 1972 publication of the informal sector in Kenya. Since then, there have been numerous other studies attempting to define its meaning, which have given rise to confusion in the academic literature and clouding the very basis on which these definitions are formulated.

There is very little agreement on a common definition of the informal sector. Since the "discovery" of the informal sector, much effort has gone into definition both from academics (see Mead and Morrison 1996:1614) and policy makers (see Visser 1998).

There are almost as many definitions and names for this area of economic activity as there are writers about it. The degree of informality and the size of employment have been perhaps the two most readily accepted criteria on which classification has rested.

1.2.4.2 The Nature and role of Small to Medium Enterprises (SMEs)

SMEs are defined differently between countries and within sectors. Definitions differ in the break points they employ, and also in the underlying basis used for classification. Hence, SMEs cover a wide range of definitions and measures, varying from country to country and between the sources reporting the SME statistics (Ayyagari, Beck and Demirguc-Kunt, 2003:4). Some of these definitions are based on quantitative measures such as staffing levels, turnover or assets, while others employ a qualitative approach. Meredith (1994:44) suggests that any description or definition must include a quantitative component that takes into account staff levels, turnover, assets together with financial and non-financial measurements, but that the description must also include a qualitative component that reflects how the business is organised and how it operates.

Not only is there a myriad of views concerning the nature of SMEs, but from a governmental standpoint there are a variety of definitions of an SME, depending on the country being considered. For example, in the late 1960's the Australian Federal Government commissioned a report from a committee known as the Wiltshire Committee. This report suggested the following flexible definition of any SME (Meredith, 1994: 31).

“Small business is one in which one or two persons are required to make all of the critical decisions (such as finance, accounting, personnel, inventory, production, servicing, marketing and selling decisions) without the aid of internal (employed) specialists and with owners only having specific knowledge in one or two functional areas of management.”

The Wiltshire Committee concluded that normally this definition could be expected to apply to the majority of enterprises in Australia with fewer than 100 employees. The United States based its definition on the position of the organisation within the overall

market place. According to the United States Small Business Administration (SBA) which is based on section 3 of the Small Business Act of 1953:

“An SME shall be deemed to be one which is independently owned and operated and which is not dominant in its field of operation.”

By comparison, the United Kingdom took a more quantitative approach, defining an SME as,” an enterprise having fewer than 50 employees and is not a subsidiary of any other company.” Following this, many studies (Bradbard, Norris and Kahai, 1990:10-12; Chen, 1993:98) have based their model on this definition.

In Kenya, classification of enterprises is primarily by the number of employees engaged by firms. The Government of Kenya’s Sessional paper No.1 on Economic Management for Renewed Growth (Republic of Kenya, 1986), Sessional paper No.2 on Small Enterprise and Jua Kali Development in Kenya (Republic of Kenya, 1992), and the 1989 - 1993, 1994 - 1996 and 1997 - 2001 Development Plans (Republic of Kenya, 1989: Republic of Kenya, 1994; Republic of Kenya, 1997) provide the bases for classification of enterprises in the country. Those firms which engage less than five employees are referred to as micro enterprises. Those which employ 5-49 workers and 50-99 workers are respectively classified as small- scale enterprises and medium-scale enterprises. The firms with 100 or more workers are categorized as large-scale enterprises.

Like the governmental definitions of SMEs, research initiatives have applied a variety of definitions to the nature of SMEs. A study of Canadian SMEs by Montazemi (1988:243) based its definition on the number of employees, this being in accordance with the Canadian Small Business Guide (1984). While in Kenya, manufacturing firms with one to five employees are regarded by Bigstein and Kimunya (2001) as micro-enterprises, six to twenty (6-20)employees as small enterprises, twenty one to seventy five(21– 75) employees as medium and seventy six and above(76 +) as large enterprises . Thus, enterprises are considered as SMEs if they employ fewer than 76 full-time employees.

Not only do the definitions of SME vary, but there are wide ranging views on the characteristics of SMEs. There have been many studies in the literature that have

attempted to define the characteristics of SMEs. Central to all of these studies is the underlying realization that many of the processes and techniques that have been successfully applied in large businesses do not necessarily provide similar outcomes when applied to SMEs. This is perhaps best summed up by Barnett and Mackness (1983:68-75) and Westhead and Storey (1996:15) who stated that SMEs are not 'small large businesses' but are a separate and distinct group of organizations compared to large businesses.

It is appropriate that we examine some of the characteristics found in the literature. Brigham and Smith (1967:16) found that SMEs tended to be more prone to risk than their larger counterparts. This view is supported in later studies (Walker, 1975; Delone, 1988:55). Cochran (1981:50-59) found that SMEs tended to be subject to higher failure rates, while Rotch (1987) suggested that SMEs had inadequate records of transactions. Welsh and White (1981:48-53), in a comparison of SMEs with their larger counterparts found that SMEs suffered from a lack of trained staff and had a short-range management perspective. They termed these traits 'resource poverty' and suggested that their net effect was to magnify the effect of environmental impact, particularly where information systems were involved.

These early suggestions have been supported by more recent studies that have found most SMEs lack technical expertise (Barry and Milner 2002:319), most lack adequate capital to undertake technical enhancements (Gaskill, Van Auken and Kim, 1993:27; Raymond, 2001:417), most SMEs suffer from inadequate organisational planning (Tetteh and Burn, 2001:178; Miller and Besser, 2000:73) and many SMEs differ from their larger counterparts in the extent of the product/service range available to customer and modes of financing (Reynolds, Savage, and Williams, 1994).

A number of extant studies (Reynolds et al, 1994; Murphy, 1996; Bunker and MacGregor, 2000:76) have examined the differences in management style between large businesses and SMEs. These studies have shown that, among other characteristics, SMEs tend to have a small management team (often one or two individuals), they are strongly influenced by the owner and the owner's personal idiosyncrasies, they have little control

over their environment (this is supported by the studies of Westhead and Storey ,1996:14) and Hill and Stewart (2000:108-111)) and they have a strong desire to remain independent (this is supported by the findings of Dennis ,2000:289) and Drakopoulou-Dodd, Jack and Anderson ,2002:217) .

SMEs play an important role in job creation as evidenced in Kenya's development plans. The development plans for the 1989 - 1993, 1994 - 1996 and 1997 - 2001 periods put special emphasis on the contribution of micro, small and medium size enterprises in the creation of employment in the country (Republic of Kenya, 1989; 1994; 1997). The focus on these enterprises as loci for employment generation reinforced the themes of sessional paper No. I of 1986 on Economic Management for Renewed Growth (Republic of Kenya, 1986), and Sessional paper number 2 of 1992 on Small Enterprise and Jua Kali development in Kenya (Republic of Kenya, 1992). Data from various studies confirm the basis of the thrust of those development plans and Sessional Papers. The results of the 1993 National Baseline Survey of the Micro and Small Enterprises in Kenya (GEMINI PROJECT) estimated that there were 910,455 micro and small size enterprises in Kenya offering employment to 2,050,855 people (Parker and Torres, 1994). Six years later, another survey, the National Micro and Small Enterprise Baseline Survey of 1999 found that there were 1,289,012 micro and small enterprises in the country, employing 2,381,250 people in 1999 in Kenya. In 1997 an estimated 64% of the total work force in Kenya outside small holder agriculture worked within the informal sector (Economic survey, 1998). The share of informal employment in manufacturing was even higher at 79%. Understanding the dynamics of the SME sector is therefore of utmost importance for development policy. These SMEs have been recognized as the engine through which the growth objectives of developing countries can be achieved. It is estimated that SMEs employ 22% of adult population in the less developed countries (Daniels and Ngwira, 1993; Robson and Gallagher, 1993:28). However, the discussion about whether or not the informal sector should be used as a main engine of development is a very controversial one. Some authors have contended that the job creating impact of small enterprises is a statistical flaw (Biggs, Griddle and Snodgrass, 1988). It is argued that increases in employment by small and medium enterprises are not always associated with increases in productivity. Many researchers believe that this sector is for the workers

who are unskilled and poorly paid, owing to the fact that the jobs created in this context are not very productive (Saavedra and Chong, 1996; Cole and Fayissa, 1991; Tokman, 1990). Nevertheless; the important role performed by these enterprises cannot be overlooked. Small enterprises have advantages over their large- scale competitors. They are able to adapt more easily to adverse economic conditions. They are more labour intensive than large enterprises and therefore, have lower capital costs associated with job creation (Liedholm and Mead, 1987).

The Kenyan SMME sector is a mixture of dynamic enterprises involved in an array of activities that are concentrated in urban areas but are also evident in rural Kenya (Green, Kimuyu and Manos, 2002:4). The 1999 Baseline Survey (CBS, and K-REP) indicated that there were 1.3 million Micro and small enterprises employing 2.3 million people and generating as much as 18 percent of the country's GDP (Mullei and Bokea, 1999).

By the end of the year 2001, informal employment was estimated at 4.6 million accounting for 72 per cent of total wage employment and 81 per cent of private sector employment. The contribution of SMEs is more than double that of large manufacturing sector that stands at 7 per cent of the GDP (ROK 2003a). Overall, SMEs create 75 per cent of all new jobs. Estimates based on the 1999 Baseline Survey of SMEs show that in the year 2002 alone, the SME sector employed about 5,086,400 people up from 4,624,400 in 2001. This was an increase of 462,000 persons and consisted of 74.2 percent of total national employment (CBS, K-REP, 1999).

The industrial structure in Kenya is dual, with a large number of very small firms and a small number of large scale firms. There is the missing middle though between small and large firms. Nonetheless, the role of small scale industries in employment creation and generation of income has become a matter of special concern to policy makers (Green, Kimuyu and Manos, 2002:5).

1.3 The Problem in context

1.3.1 Access to finance

The problem in finance for small and medium-scale businesses in the less developed countries context is the lack of access to formal finance. When starting a new business, most small enterprises, often beginning as micro-businesses, are unable to obtain loans, or any form of financing from formal institutions. They start their business by investing their own savings and or using funds obtained from relatives or friends (Oyen and Levistky, 1999:1). This is sometimes supplemented by loans from informal lenders or by credit from suppliers of materials. It is only when the business has been operating for some time, usually as a micro-enterprise or on a small scale that an attempt is made to seek financing from a bank for further development and expansion. Only then is there any likelihood of obtaining access to funds from such financial services, although it will never be easy because of obstacles in access to finance (Webster, 1991).

In summary, obstacles in access to finance by small enterprises typically include (Fisher, 1995:9-24):

- high transaction cost for financial institutions to provide many small size loans as opposed to fewer but larger loans;
- borrowers' risks due to lack of credit history, lack of adequate collateral, uncertainty about entrepreneurial ability and repayment capacity linked to market constraints, deficiency in the legal system in case of loan delinquency etc.;
- cost of lending as compared to the profitability of the business opportunity for which a loan is sought;
- inadequacy of investment projects submitted to banks;
- macro-economic instability and policy bias such as interest rates controls,
- weakness or limited outreach of financial institutions and of instruments focused on raising capital such as stock exchanges, investment funds etc.; preferential treatment of large or state-owned customers;
- difficulties in access due to e.g., cultural barriers (gender, disadvantaged groups), and remoteness.

These are all real problems and it would serve little purpose to ignore them. An additional problem in finance for small businesses in the African context is the interweaving of the finances of the owner, his/her family and that of the business operated. It is often difficult to separate these two elements and to be able to present the financing institution with the clear justification for the sum requested, based on the accounts of the business operation. Also, there is a tendency for owners and their families to extract more funds for the personal use of the family members than the business can actually bear. This impedes the building up of resources and the creation of contingency funds for difficult periods that may arise and makes it virtually impossible to build up reserves for future investment and development of the business (Levitsky, 1996:2; UNIDO, 1999: 1).

1.3.2 Empirical experiences in enterprise financing in context

In a survey of previous work, Biggs *et al's* results (1996), based on one year of Kenyan micro data, discloses that access to formal borrowing increases with business size. Similarly, Bigstein, Collier, Dercon, Fafchamps, Gauthier, Gunning, Soderbom, Oduro, Oostendorp, Patillo, Teal, and Zeufack (2000:37-53) obtain the results that the size of an enterprise and network are important factors for accessing formal credit.

A survey by African manufacturing enterprises between 1992 and 1996 in the manufacturing sectors of food, textile, wood and metal in Kenya, Cameroon, Ghana, Zimbabwe and Burundi found that most businesses find it difficult to raise capital. It was further found that most lending was collateralised and the value of collateral was typically high. Many more businesses obtained overdrafts than bank loans (Bigstein *et al* 2001:4). Lack of collateral is said to explain the mismatch between supply and demand in small scale financial market (Levisky, 1993:9-10). This situation is further aggravated by limited reserve of personal savings and inadequacy of the capital markets (Evans and Carter, 2000:337). In addition, Hellman and Stiglitz (2000:293); Beck, Dermirgue-Kunt and Maksivomic (2002), Bigstein et al (2001) have shown that small businesses are more credit constrained than large businesses.

Other studies in Kenya (Ondiege 1995:7, Daniels *et al*, 1995:3, and Namusonge 1998:14-19) have identified a number of factors that affect the growth of the SME sector. These factors include credit accessibility, technical training, business training and management, marketing, infrastructure and technology. These factors are all viewed to be important to a sector's sustainable development.

Lutabingwa, Gray and Cooley (1996:3) further pointed out the problem of credit inaccessibility in a study on sources of finance for small scale manufacturing in Kenya. Similarly, the ODA and UNICEF report (1995) on sources of credit to micro and small enterprise (MSE) in seven districts in Kenya indicated that SMEs did not have access to credit. The study showed that financial institutions were not favourable sources of credit. 70.2% of the respondents in the study observed that they had no access to credit.

According to Soderbom (2001:7) SMEs in Kenya seemed to receive little information and assistance regarding availability of finance from financial institutions and government departments. The study on manufacturing firms' financing constraints also found that most business owners knew that they would not be granted a loan, as they did not have collateral. Further to the portfolio, 63% of the respondents in Nganga (2003:72), in the study on the mobility and growth of small furniture production enterprises in western Kenya reported that customer deposits was the main source of enterprise re-financing.

1.4 Statement of the problem

SMEs are potentially of great socio-economic significance in employment creation, generation of income and alleviation of poverty as much of the literature indicates. However, their long-term growth and competitiveness is compromised by the constraints on their access to formal-sector finance, among other systematic and institutional problems in developing countries. As a result, SMEs' share of financing resources is disproportionately less than their relative importance in domestic employment and to the value added.

Lack of access to formal finance has been identified by many analytical studies as an inhibiting factor in SMEs growth. This has often led to poor maintenance or replacement of machinery, inability to purchase required materials and services, or to expand (Levitsky and Oyen, 1999:10).

According to Evans and Carter (2000:338) large firms benefit from established capital markets where small firms can not raise funds (Whincop 2001:152). Due to lack of a well-developed capital market, the financial sector is the main source for SMEs external funds (Darson, 1995). SMEs therefore, can not raise funds through bonds and equity issues. Many SMEs are excluded from financial sources such as the stock exchange (Takagi, 2002:74-75).

Limited access of SMEs to credit and financial services has been identified as one of the most important supply constraints confronting the sector in Kenya (Dondo, 1994:1). Similarly, other research in Kenya has shown that financial problems are critical factors that influence growth of SMEs and failure to graduate into large enterprises (Soderbom, 2001:5, Namusonge, 1998, Daniels, Mead and Musinga, 1995 and Lutabingwa, Cooley and Gray, 1996:5).

The cardinal problem of lack of credit to SMEs development is particularly prominent in developing countries, pertaining mostly to credit from formal financial institutions. According to Bigstein *et al* (2000), about 90% of small firms are refused loans due to inability to fulfil conditions such as collateral, when applied for from the formal financial intermediaries.

Due to the problems associated with accessing bank credit facilities, a large proportion of Kenyan SMEs rely more on self-financing in terms of retained earnings. The implication, therefore, is that SMEs do not have adequate credit to meet the needs at different levels of growth. Thus, a finance gap exists for firms starting or wishing to expand. How then can the financing gap be bridged? This is the core question to be answered by the present study.

1.5 Assumptions of the study

- Collateral requirements have hindered SME's access to financing in Kenya.
- Limited financing options have aggravated SMEs financing constraint.
- Bank finance is not the only source of financing manufacturing SMEs in Kenya.

1.6 Aim of the research

Based on the statement of the problem in section 1.4 and assumptions of the study in section 1.5, the general aim of the study was to establish the nature and types of alternative finance and assess the extent to which they were used in financing small and medium-scale firms in Kenya.

1.6.1 Objectives of the research

The boundaries of the research were delineated by the following specific objectives:

- 1.6.1.1 To establish the role of enterprise demographic factors on the use of alternative finance.
- 1.6.1.2. To investigate alternative methods or models of SME financing in order to mitigate the perceived financing gap.
- 1.6.1.3. To identify factors influencing choice of finance.
- 1.6.1.4. To identify SMEs financing constraints.
- 1.6. 1.5. Identify the role of information and communication technologies (ICTs) in SMEs' access to alternative finance.
- 1.6.1.6. Explore government and financial institutional policies on SME financing.
- 1.6.1.7 Suggest policy recommendations to enhance the financing of SMEs.

1.6.2 Research questions

Apart from the research objectives, research questions further delineate the boundaries of the research and give it overall direction. Arising from the statement of the research problem and the purpose of the research, the following are the major research questions:

- 1.6.2.1 Do enterprise demographic factors such as the firm's age and ownership characteristics affect SMEs' use of alternative finance?
- 1.6.1.2 (a) Are SME operators aware of alternative sources of finance?
(b) What are the alternative forms (models) of SMEs finance?
- 1.6.2.3 What are SMEs financing constraints?
- 1.6.2.4. What are the main sources of SMEs financing?
- 1.6.2.5 What is the role of information and communication technology (ICT) in SMEs' use of alternative finance?
- 1.6.2.6 What are the Kenya government policies on SMEs development and growth?

1.6.2.1 Hypotheses

The researcher hypothesizes and tests the relationship between access to credit of several forms and enterprise and entrepreneurial characteristics. Hypotheses formulated in the study include:

- H1. SMEs do not need alternative sources of finance other than bank finance.
- H2. There is no relationship between gender and use of alternative finance.

- H3. The specialization and the separation of the ownership and control functions are positively related to enterprise access to debt finance.
- H4. The educational qualifications of SME operators do not affect attitude towards use of alternative finance.
- H5. Reputation, measured by the enterprise's years of service and the years that it belongs to its current owner will be positively related to enterprise access to external finance.
- H6. There is no significant difference in the perceptions of young SME operators (18-29) and older operators (30-60) towards the use of alternative finance
- H7. SMEs use of alternative finance is dependent on the provision of hard information (Business records, business plan etc).

1.7 Scope and limitations of the research

Spatially, the study was limited to manufacturing SMEs in Nairobi, Nakuru, Kisumu and Eldoret in Kenya. These locations were chosen due to the concentration of manufacturing activities in these towns. The research was primarily concerned with SME use of alternative forms or models of finance. It was largely limited to conventional and non-conventional forms of business finance. These include:-

Conventional credit (Finance)

- Long term loan
- Overdrafts
- Venture capital
- Leasing

Non-conventional bank finance

- Credit guarantee Scheme
- Mutual credit scheme

- Trade credit
- Borrowing from friends and relatives
- Factoring
- Angel finance
- Share capital (equity capital).
- Rotating savings Cooperative Associations(ROSCAs)
- Moneylenders
- Self-help groups
- Savings Clubs
- Friends

Related aspects

- SMEs financing constraints

Further explanation on these sources is presented in chapters three and four.

The study covered the following areas of the manufacturing sector of the Kenyan economy:

- Wood and Furniture works,
- Metal works,
- Textile and Garment.

The survey focused on the stated sub-sectors because of their contribution to value added. For example, in 1981, SMEs produced 68 percent of manufactured products value added (Bigstein and Aquilar, 2001), and in 1998 they accounted for 67 percent (Central Bureau of Statistics, 1999).

The study considered manufacturing SMEs legally organized as unincorporated businesses. This was because of their unique needs, problems and eligibility to access certain options of external sources of finance.

1.8 Justification of the study

Successful industrialization must have an indigenous base, and expansion of the small-scale manufacturing sector would help develop entrepreneurial and managerial skills as a basis for efficient indigenous investment and management of larger industries.

SMEs can serve vital development functions, such as:

- to help generate employment by using more labour in relation to capital invested. This is especially important in developing countries where labour is abundant and capital relatively scarce;
- to act as "seed-beds" for entrepreneurial talent;
- to operate in less populated rural areas with limited markets and poor infrastructure - a feature common in developing countries;
- to be able to start up with very limited resources; "ease of entry";
- to provide "hands on" training facilities for people of varying levels of education in both management and technical skills; and
- to supply both low cost items for the poor and in certain circumstances high cost quality products for the rich and for export.

Small-scale enterprises are fairly distributed across sectors in the Kenyan economy, and their potential in economic activities such as employment and income generation forms an interesting area to be studied. Policies such as financial and technical assistance to help in their growth and development are thus worth studying. Therefore, if SMEs are important to employment generation, income distribution and for all those other identifiable benefits, then how they are financed and the difficulties they may experience in financing are important issues to investigate. Moreover, evaluating the credit-related policies for SMEs would go a long way to helping their development and growth. Finally, a modest contribution would also be made towards the general literature of small-scale manufacturing industry in Kenya.

Besides the preceding argument, existing studies on SME financing have been conducted in more developed economies and have several limitations. Firstly, the firms examined

are some of the largest in the respective countries, so that the results may not be representative of all economies (Thitapha, 2003:9). Secondly, studies conducted in Kenya by various researchers including: Daniels *et al* (1995), Lutabingwa *et al* (1996); Namusonge (1998), Soderbom (2001) and Bigstein *et al* (2000) indicate that SMEs experience a finance gap. For SMEs to meet various financing needs, between 75 and 90 per cent of them in the less developed countries rely on their own savings, internal sources such as retained earnings, and borrowings from relatives and friends (Lutabingwa *et al*, 1996:5). However, as enterprises develop and grow, additional capital will always be needed for expansion. Hence, the need to investigate business use of alternative finance.

1.9 Significance of the study

The expected research outcome and contribution of the study included:

- Identification of the need for the use of alternative models of SMEs financing by manufacturing SMEs in Kenya;
- Development of a financing model that could be used by the Kenya government, financing intermediaries and the small and medium-scale enterprise operators;
- The study will help SME operators benefit from having a better awareness of financing alternatives;
- The results will help policy makers gauge the effectiveness of government policies and programmes;
- The results of the study might provide information to financiers; thus enabling them understand their clients and design products that better meet the market needs;
- It is also hoped that the results of the study might help stakeholders to have a better comprehension of challenges and opportunities surrounding the provision of finance to the Kenyan SMEs and
- The study might form a basis for more informed public debate and further research.

The next section indicates how the study was approached.

1.10 Research methods

The study was carried out using three main research methods, namely,

- Literature review
- Collection and analysis of survey data through statistical analysis
- Presentation and discussion of results

Other methods and details on research design and methodology are presented in chapter five.

1.11 Literature review

The theoretical framework on enterprise financing is presented in Chapter 3. Chapter 4 focuses on the review of existing empirical literature on SME finance. Chapter 5 presents a perspective of alternative sources of SMEs finance and financing schemes. Chapter 6 presents the research design and methodology adopted in the study.

1.12 Sources of data and data analysis

The synthesis and statistical analysis of data was based on survey data drawn from a survey on a sample of three hundred and eighty (380) manufacturing enterprises in Kenya. Econometric models namely probit models and descriptive statistics were used to either test the study hypotheses such as the relationship between access to the various forms of finance and ownership characteristics, firm age and other firm level characteristics, or to tabulate the data. Results of the empirical survey and discussion of findings is presented in chapter seven.

1.13 Sources of study material

Literature was reviewed from research publications, including, journals, conference proceedings, official government publications and books. Considering the fact that enterprise finance is a dynamic field, an effort was made to use the latest publications. More specifically, the following data bases provided needed materials: SABINET and Ebscohost. Additionally, websites of individual organizations such as World Bank, UNCTAD, FAO and ILO were also used.

1.14 Structure of the thesis

The thesis is arranged in seven chapters. Chapters 2, 3 and 4 addresses the research objectives and study questions in sections 1. 6.1 and 1.6.2. Chapter 5 presents Research Design and Methodology, chapter 6 data presentation and discussion of findings and lastly chapter 7- summary, conclusion and recommendations. The details of the chapters are as presented in the table of contents.

1.15 Conclusion

This chapter sets the conceptual and contextual background that underscores the importance of the study. The chapter also sets the aim, objectives and research questions that guided the research. The next presents the theoretical framework for the study.

CHAPTER TWO

THE THEORETICAL FRAMEWORK

2.1 Introduction

A theory is a set of systematically interrelated concepts, definitions, and propositions that are advanced to explain and predict facts (Schindler and Cooper, 1999:47). Theory can be explained or defined by the framework of assumptions and concepts in which it is embedded (Onyancha, 2002:43). Theoretical frameworks are, therefore, defined as orientations or ways of looking at the problem in an investigation. They narrow the range of facts needed in a study, summarise what is known about an object of study and state the uniformities that lie beyond the immediate observation.

Theoretical frameworks provide collections of assumptions, concepts, and forms of explanation. Concepts and constructs are used at the theoretical level while variables are used at the empirical level (Neuman, 2003:62). Thus, theories are generalizations about variables and the relationships among them.

This chapter discusses the combination of theories forming the framework of this study. The aim and objectives of the study suggests a theoretical framework that draws from a combination of theories.

2.2 Theoretical framework for SME finance

2.2.1 Introduction

There are various theoretical models on the financing of firms, starting from the traditional concept of Modigliani and Miller (MM) (1958: 261-97) regarding the financial behaviour of firms. Since then a number of theories have been postulated regarding the financial behaviour of firms. The different theories explain the financial behaviour of enterprises, taking into account their different characteristics and problems. However, most of the existing theoretical frameworks address the needs of large firms. Thus, the

main ground upon which capital structure theory was initially developed concerned the large listed firms (Rajan and Zingales, 1995; Zingales, 2000: 1629).

Concerning the extent to which extant theories of financing appear to explain the financial structure of business concerns, Pettit and Singer (1985) argue:

“Business firms of all sizes select their financial structure in view of the cost, nature, and availability of financial alternatives, p: 54.”

In addition, Pettit and Singer (1985: 58) posit that the ‘level of debt and equity in a smaller firm is more than likely a function of the characteristics of the firm and its managers’. Levin and Travis (1987: 30) provide support for this view, suggesting, in the private corporation, leverage theory does not always apply. The owners’ attitudes towards personal risk and not the capital structure policies public companies use determine what amounts of debt and equity are acceptable. Finally, McMahon *et al.* (1993: 74) reason that:

Given the initial failure of modern finance theory to provide normative and practicable guidance on making financial structure decisions in business enterprises generally, and particularly in small enterprises, the only alternative is to seek for a positive theory. The continued absence of a widely accepted normative theory of financial structure for business enterprises thus underscores the importance of developing and testing the veracity of positive theories of business financing.

There are, therefore, good theoretical reasons to expect the capital structure of small enterprises to be different from that of large enterprises. Hence, there has been increasing recognition that small enterprises are different from large ones and that these differences affect numerous aspects of small firms including their capital structure (Ang, 1991, 1992). As a result various theories have been suggested to explain variations in capital structure among firms (Jensen and Meckling, 1976; Myers, 1984).

Accordingly, there are some specific capital structure considerations that cannot fit into the SMEs context. For example, Pettit and Singer (1985) have pointed out that tax considerations in corporate capital structures are of little importance for SMEs because these firms are less likely to generate high profits, leave alone filing tax returns and therefore are less likely to use debt for tax shields. It then follows that, there is no specific theory addressing the financing structure of small firms. Petit and Singer (1985:49) suggest that predicted differences between small and large firms' financing should be developed from the same body of financial theory. However, this theory must be general enough to address the financial needs of small firms. Hence, the study adopts a meta-theoretical framework of the finance theory that focuses on the special financing needs of SMEs. The framework is based on a combination of theories. These are: the transaction and agency cost theory (the asymmetry of information and credit markets), pecking order theory, and signalling and strategic management theories.

2.2.2 The asymmetry of information and credit markets (transaction and agency costs theory)

The agency theory focuses on transaction costs following the work of (Coase 1937: 274; Fama 1980:292; Jensen and Meckling 1976:315-60; Stiglitz and Weiss 1981:398; and Jensen and Meckling, 1992:319). Transactions cost broadly refer to the cost involved in exchange transactions. These are costs that prevent markets operating efficiently or factors that prevent markets from forming altogether. Transactions cost occur both on the lender's side as well as on the borrower's side. On the lender's side, transactions cost involves cost of information gathering, loan administration, enforcement, etc. Borrower transactions cost mainly involves various charges imposed by lenders such as interest payments, application fees and service fees.

The agency theory is grounded on the existence of asymmetric information (Petersen and Rajan, 1994: 22; Berger Udell, 1998: 198; and Hellman and Stiglitz, 2000:294) among the different agents. It considers a business enterprise from the viewpoint of the various stakeholders it might have, and explores how their financial interests are furthered and

protected in their dealings with each other. The stakeholder relationships that receive most attention in the small and medium-sized enterprise (SME) literature are those between:

- Managers and owners.
- Owner-managers and other owners.
- Insiders (primarily owners and managers) and outsiders (mainly creditors and lenders).

Those who exercise control of an enterprise are seen as being agents for the other stakeholders who are considered to be principals. The most significant problems that may arise from agency relationships in SMEs are:

- Information asymmetry.
- Moral hazard.
- Adverse selection.

The theory of asymmetric information comes from the discipline that is known as “economics of information”. The basic teaching of this discipline is that in many markets such as labour, finance and insurance, information is asymmetrically distributed and is costly to acquire. These markets are not spot markets where buyers and sellers meet and decide on prices. On the contrary, in the credit market for instance there is a time period between forwarding a loan and the repayment. Whether the lender gets his money plus interest back depends on the repayment probability of the borrower. According to Stiglitz (1990:358) financial contracts include elements that lead to the basic problems of adverse selection and moral hazard.

This idea emerged in the 1960s, when economists started to claim that because of high information and enforcement costs, some markets will not exist and other markets will not even be approximately competitive. One of the pioneers in this area, who worked on the problem of adverse selection, was Akerlof (1970:492-6). Akerlof wrote an article on the theory of lemons and quality uncertainty. In his work he argues that in certain markets doing business is difficult because of the adverse selection problem.

His basic model analyses a market in which sellers offer different qualities of products and are aware of these differences. Buyers, however, are unable to distinguish between products and they therefore offer a price that reflects the perceived average quality of the products –treating all products as if the quality is the same. This may force sellers who offer high quality goods to withdraw their goods from the market. Hence the market for these high quality goods can fail to clear, although all agents are acting rationally. Akerlof's work was the first theoretical model on adverse selection.

A second problem, which also arises as a result of informational asymmetries, is moral hazard. Arrow (1963:954) was one of the first contributors to the theory of moral hazard. He focused on the influence contracts between parties have on the behaviour of the relatively more informed party. This gives rise to the principal-agent literature, which analyses a situation where one party, known as the principal, enters into a contract with another party, known as the agent. In this situation, the principal may not be able to observe the agent's behaviour (actions or decisions). The term moral hazard is applied because the actions taken by the agent are based on his own self-interest and not necessarily on the best interest of the principal. Therefore, the principal wants to devise a contract that will induce the agent to undertake actions that are not in conflict with his interest.

The main objective of this section is to discuss the impact of asymmetry of information in credit markets. Credit institutions exchange money today for the promise of money in the future and write a credit contract that includes elements that will make it more likely that this promise is fulfilled. Lending activity entails (a) the exchange of consumption today for consumption in a later period; (b) information acquisition regarding the characteristics of loan applicants (screening problem); (c) measures to ensure that borrowers take those actions that make repayment most likely (incentive problem); and (d) enforcement actions to increase the likelihood of repayment by borrowers who are able to do so. The two main problems lending entails, namely adverse selection and moral hazard are discussed in the following sub-sections.

2.2.2.1 Adverse selection

The adverse selection problem takes place when borrowers have private information about their personal behaviour and/or the project they want to invest in, before the credit relationship begins. While the lender may have a good idea about the average characteristics of the pool of potential borrowers, he may not have full information on the characteristics of each borrower and the riskiness of his project. In order to see how the adverse selection problem arises in financial markets and how the interest rate can be used as a direct screening mechanism to differentiate the risky projects from the safe ones we assume that borrowers and lenders are risk-neutral. There are two groups of borrowers, safe and risky ones, who can choose between safe and risky projects. Both groups of borrowers have the same mean gross return but a different risk variance. Both groups of borrowers know the probability of a successful outcome and the value of output if successful, while the bank is assumed to be ignorant of the probability of success of individual borrower projects. Even though it is assumed that the bank is ignorant about the characteristics of each individual project, it does know the value of the common expected gross return of the two projects.

The model developed by Stiglitz and Weiss (1981:398) indicates that the lender does not use the interest rate as a sorting device because changes in the interest rate may affect the riskiness of the pool of borrowers. The model assumes that riskier borrowers have access to riskier projects with lower probability of success but a higher return if they succeed, while safe borrowers have projects with higher probability of success but a lower return. For any class of projects with the same mean gross return but differing risk, the interest rate can be used to determine the riskiness of a project. At a certain low interest rate even low returns low risk projects will survive. As the interest rate increases, low return projects will start to yield negative expected returns. Thus, the higher the interest rate, the higher the net expected return must be before a borrower finds it worth borrowing for this project. All remaining projects that give the borrower a higher expected net return entail a lower probability of success. Borrowers with low-return, low-risk projects will drop out of the credit market, because they are unable or unwilling to pay higher interest rates.

Hence, the bank cannot use the interest rate as a signalling mechanism. This analysis of credit markets is contrary to the classical teachings of the market mechanism. When there is an excess demand for loans at a given interest rate, classical economic analysis would suggest that the price (interest rate) would rise to choke off excess demand. But in the case of asymmetric information, the lender will choose to keep the interest rate low enough to obtain a favourable risk composition of projects and to ration the available loanable funds through other means. Thus, demand may exceed supply, while the interest rate does not rise as a result.

2.2.2.2 Moral hazard

Another type of information asymmetry problem is moral hazard. Moral hazard occurs in credit markets if raising the interest rate induces borrowers, who have a choice of projects, to invest in a project that yields the bank a lower return than another project in which the borrowers could have invested. Similar to the above case, here it is assumed that both the lender and borrower are risk-neutral. It is assumed that a borrower has to invest in one of two projects (safe or risky) that are available to him, the riskier project has a lower probability of success but a higher payoff if it succeeds, while the safe project has a higher probability of success but with lower return. However, the bank does not know which project has been chosen. Here, the interest rate acts not as selection mechanism, as in the previous case, but as an incentive mechanism, since it affects the actions taken by the borrower once he has obtained the loan. At lower interest rates, it is worthwhile for the borrower to invest in the safer project that brings positive returns. But as the interest rate continues to increase, the borrower is induced to switch from the safer project to the risky one, because with the increased interest rate the safer project starts to yield negative net returns. To be more precise, the higher the interest rate, the higher the net expected return has to be, and only the risky project will fetch higher expected net returns, which induces the borrower to opt for it. This switch affects the expected returns of the lender because of the limited liability characteristics of the loan contract. If the project is successful, the lender will receive at most the loan amount plus the interest accrued, while if the project fails, the lender will receive nothing (or any residual value).

The expected returns to the bank are lower for the riskier project than for the safe project. Accordingly, due to the moral hazard problem banks tend to keep the interest rate low and instead ration credit in order to curb excess demand. The various forms of financial markets try to tackle the asymmetry of information problem differently. The formal financial institutions tend to deal with the selection and incentive problem by imposing stringent collateral requirements or restrictive covenants, or by requiring borrowers to provide carefully documented evidence, showing their intention and ability to repay (Floro and Yotopoulos, 1991). Those who get credit from the formal financial institutions are usually firms and institutions that are active in the formal business sector; they have the necessary collateral, credit history, and/or use a reliable accounting system.

However, the credit needs of the majority of the SMEs remain unsatisfied by the supply of credit of formal financial institutions. Most SMEs are unable to provide collateral, they have no documented credit history, and they lack accounting records.

Informational problems in a firm may vary with the nature of the transactions involved. Smaller number of transactions may create substantial contractual costs (Moschandreas, 2000:332). These problems will hence be more severe for small firms than for large firms. In addition, transaction and agency costs vary with the source of finance (Williamson, 2000:1085). Further more, the transaction costs of debt are firm specific (Moschandreas, 2000:332). Moschandreas further argues that investors lending finance would like to invest in projects where it would be easy for them to monitor to avoid costs arising from post-contractual opportunism (that is moral hazard costs).

The agency theory analyzes the capital structure of the enterprise by taking into account the agency costs, which are the costs of having conflict of interest between the different agents in the firm. The use of debt in the capital structure of the firm leads to agency costs. Agency costs are the costs that arise as a result of a principle-stakeholder relationship, such as between the equity holders or managers of the firm and debt holders (Cassar and Holmes, 2003:125). The Agency theory is, therefore, concerned with costs that arise due to conflicts of interest.

In particular, given the incentive for the firm to benefit equity holders at the expense of debt holders creates a need for debt holders to restrict and monitor the firm's behaviour. Consequently contractual covenants are incorporated into the debt agreements, designed to protect the debt holders from this potential behaviour (Casasola, Cardone and Margarita, 2002:4). All these contracting behaviour increases the cost of capital offered to the firm. Therefore firms with relatively high agency costs due to the inherent conflict between the firm and the debt holders should have lower levels of outside debt financing and leverage (Sorgob-Mira, 2002:3).

The theory further emphasises the prevalence of imperfect information in financial markets. In particular, debt markets are generally characterised by asymmetric information since the borrower is better informed about the value of the project that will be undertaken. Asymmetric information leads to adverse selection and moral hazard in contractual arrangements between firms and external providers of finance (Myers, 1977:157; Scott, 1977:9-14; Harris and Raviv, 1990:329). This means that the lender may restrict the borrower's use of debt because of problems of moral hazard and adverse selection.

The nature of the asymmetric information in this case is that managers know more about their companies' prospects, risks and values than do outside investors. Moreover, if the firm has a financial slack, but the market does not know this, managers will not issue fresh equity, even though it may involve passing up a good investment opportunity, so that the interests of present shareholders are protected. If investors understand this point, then the market will assume that a decision not to issue shares is good news. If management does propose a new share issue, it will be interpreted as bad news, and the share issue will precipitate a fall in the firm's share price (Myers and Majluf, 1984:187-97).

Thus, the Agency theory considers the conflicts of interest brought about on the one hand between shareholders and creditors, and on the other hand between shareholders and managers. SMEs are likely not to suffer from the second problem due to the fact that their property identifies almost exactly with their management. Notwithstanding this,

the agency conflict between owners and lenders may be particularly severe for small firms.

The existence of debt agency costs and the potential problem of adverse selection and moral hazard may induce creditors to require guarantee in the form of collateral assets (Mira, 2002:4). Thus, most SMEs have relatively higher agency costs due to the inherent conflict between the firm and the debt holders. This culminates in SMEs having lower levels of outside debt financing and leverage (Cassar and Holmes, 2003:126).

2.2.2.3 Relevance of agency theory to SME finance

The relevance and application of agency theory to the particular circumstances encountered in SMEs have been considered most notably by Hand *et al.* (1982), Pettit and Singer (1985), Hutchinson (1991), and Ang (1991, 1992). Hand *et al.* (1982: 26) express the opinion that 'although agency relationships exist in all businesses, their effect is likely to be most significant if the businesses are small'. Among the points made by Hand *et al.* (1982: 30) which have a bearing on agency theory as it applies to SMEs are:

- The primary agency contest is not between owners and managers, but between insiders and outside suppliers of funds.
- The many opportunities owner-managers have to divert resources to themselves make monitoring costs high. Thus, outside suppliers of funds tend to be restricted to those who are particularly adept at monitoring the SMEs to which they lend, such as trade creditors and banks.
- Because of the imperfect market for ownership stakes, owner-managers may not bear all agency costs and therefore have limited motivation for reducing them through monitoring or bonding.
- The most important means of averting agency conflicts between insiders and outside interests is an appropriately drawn-up agreement covering such matters as managerial compensation and other employment terms, profit distribution policy, reorganizations, sale of ownership stakes to others, and relations with associated businesses.

Focusing on the risks faced by outside stakeholders in an SME, Pettit and Singer (1985: 52) point out that

Two factors may contribute to a greater level of uncertainty in the estimation of risk for smaller firms. First, the problem of asymmetric information, or differences in the information available to managers and outsiders, is greater for small firms. For example, such firms generally find it expensive to supply audited financial statements, and may find it difficult to overcome this deficiency with other information. Second, the added flexibility that small firms may have makes it easier to substitute one asset for another, potentially leading to a change in the risk of the firm.

Easterwood and Singer (1991) indicate that because of these circumstances, conflicts between owner-managers and outsiders may have more serious consequences in the SME. Hutchinson's (1991: 1) perception of the importance of agency theory to understanding the financial dimensions of SMEs is evident in his assertion that it 'provides a new perspective which helps to explain what might otherwise appear to be anomalous phenomena in the area of small business finance'. Hutchinson (1991: 1) expands on the broader significance of agency theory to the field as follows:

Agency theory helps to explain why small firms exist at all. Given the existence of economies of size, it could be expected that all business activities would be conducted by large organisations. Agency theory provides counter-balancing arguments in favour of smallness. In some cases the benefits of small size are not sufficient to outweigh the benefits of economies of size and in these cases large firms will predominate. In other cases, where economies of size are not great or where agency costs are very great, small size may be the optimum.

Hutchinson (1991:1) then goes on to suggest that agency theory specifically aids understanding of such diverse aspects of SME finance as financial structure, the small firm effect, the valuation of initial public offerings, franchising, management buyouts, differential financial disclosure, and the relationship between venture capitalists and SMEs.

Ang (1991) believes that the unique characteristics of SMEs extend agency theory in a number of significant ways:

- In many SMEs the agency relationship between owners and managers may be absent because the owners are also managers. Nevertheless, the various legal structures which SMEs could adopt create a wider range of agency relationships, with their attendant problems, than might typically be found in large concerns that are almost exclusively companies.
- Because of their predominantly fixed nature, the usual solutions to agency problems such as monitoring and bonding are likely to be more costly in relative terms in SMEs. This will inevitably increase the cost of transactions between the various stakeholders unless alternative solutions are found.
- There is likely to be both the opportunity and the need for finding new solutions to agency problems in SMEs. For example, reputation and good faith emerge as particularly important ways of securing commonality of interests in SMEs.

Ang (1992) reflects on agency problems in SMEs in the following terms:

Costs of bonding and monitoring vary among different types of small businesses. Some lenders have intimate personal knowledge of the small businesses, and others have to depend on more costly on-site auditing. The seriousness of asymmetric information varies quite a bit too. It ranges from the very low, such as among those small businesses whose fortune depends largely on the local economic conditions in which the local bank would have superior knowledge, to very high information asymmetry, such as in the case of a research-oriented high tech start-up where the owners are among the few experts in their narrow field.

2.2.3 The pecking order Theory [POT]

In addition to asymmetric information, debt may be more costly than internal sources due to transaction and bankruptcy costs. Therefore, in contrast to Modigliani and Millers' (1958) famous separability theorem, firms may have a "pecking order" or financing hierarchy when choosing between sources of funds.

Due to high agency costs, most businesses prefer internal finance to external finance. The Pecking Order theory explains this tendency. The Pecking order theory reflects the motivations of the financial manager (or owner manager) to obtain control of the firm, reduce the agency costs of equity, and avoid the seemingly inevitable negative market reaction to an announcement of new equity issue (Baskin, 1989:31-33). According to this theory, firms prefer internal finance to external finance and, if internal funds are insufficient, debt finance is preferred to equity finance as a source of incremental funding for investment projects (Fazzari et al 2000:698 and Myers and Majluf, 1984:581). This preference reflects the relative costs of the various sources of finance.

Implicit in the Pecking order theory are two key assumptions about financial managers, and /or owner managers. The first of these is asymmetric information, or the likelihood that a firm's manager knows more about the enterprise's current earnings and future growth opportunities than do outside investors. There is a strong desire to keep such information proprietary. The use of internal funds precludes managers from having to make public disclosures about the company's investment opportunities and potential profits to be realized from investing in them. The second assumption is that managers will act in the best interests of the company's existing shareholders (Myers and Majluf, 1984:197-112). According to the latter, the preference for internal funds has advantages of no transaction costs and of no adverse signal sent to the market.

The information asymmetry suggests that external finance would be more expensive than internal finance as financiers add a risk premium to cover financing risk. Agency problems also increase the costs of external financing as monitoring and bonding costs are necessarily incurred. Additional equity also signals that the owners are not confident in the firm's future. That is to say that, additional equity signals impending bankruptcy. The implications of this theory are that SMEs will have a preference hierarchy for different types of finance in their financial policy.

2.2.3.1 Relevance of POT for SMEs

Initially, the POT sought mainly to explain the observed financing practices of large publicly traded corporations. However, it was soon recognised that the theory may also

apply to the financing practices of non-publicly traded SMEs that might not have the additional financing alternative of issuing external equity finance. Scherr *et al.* (1990: 10) consider the POT to be an appropriate description of SMEs' financing practices, because the 'Pecking order hypothesis is in keeping with the prior findings that debt is by far the largest source of external finance for small business'. In addition, Holmes and Kent (1991: 145) suggest that in SMEs 'managers tend to be the business owners and they do not normally want to dilute their ownership claim'. Thus, the issue of external equity finance, and the consequential dilution of ownership interest, may be further down the pecking order. The theory's application to SMEs implies that external equity finance issues may be inappropriate. In relation to the owner-manager's control over operations and assets, if the POT holds, then internal equity finance will be preferred, because this form of finance does not surrender control. When external financing is required, obtaining debt rather than equity finance is favoured, because this places fewer restrictions on the owner-manager.

Hall *et al.* (2000: 299) argue that the information asymmetry and agency problems arising between owner-managers and outside investors providing external finance which give rise to the POT are more likely to arise in dealings with small enterprises because of their "close" nature, i.e. being controlled by one person or a few, related people, and their having fewer disclosure requirements'. Scherr *et al.* (1993: 21) suggests that, the costs information asymmetry creates are more important for SMEs than for large enterprises, making differences in costs between internal equity, debt, and external equity consequently greater.

Therefore, the hierarchical approach should have even more appeal to small firms than to large. In addition, the theory's assumption that managers act on behalf of existing shareholders is more relevant to SMEs, because of their closely held nature, and because the managers are usually the existing shareholders. Since the POT is pertinent to both SMEs and large enterprises, the theory may therefore explain the observed differences between SMEs and large enterprises' financial structures. Holmes and Kent (1991:145-146) explain that the application of the POT to SMEs is constrained by the following two factors:

- Small firms usually do not have the option of issuing additional equity to the public.
- Owner-managers are strongly averse to any dilution of their ownership interest and control (which are normally one and the same). This is in contrast to the managers of large firms who usually only have a limited degree of control and often have limited, if any, ownership interest, and are therefore prepared to recognise a broader range of funding options.

Ang (1991:9) provides an alternative to this constrained POT, proposing a modified pecking order of financing preferences for SMEs. This involves new capital contributions from owners ranking behind internal finance, but in front of debt finance.

According to Cosh and Hughes (1994), the POT, with its emphasis on the desirability of the use of funds generated within the business rather than funds raised externally, can readily be applied to SMEs. The POT suggests that use of external funds is very much related to profitability on the basis that SMEs, particularly if they are not stock exchange listed, will make use of internally generated funds as a first resort, i.e. those which make use of external funds will be those with a lower level of profit. Growth is likely to lead SMEs that do not have sufficient internal resources to borrow although if the pecking order is constrained by lack of external funding of any kind, SMEs might restrict their growth to fit the availability of internal funds.

Thus, Cosh and Hughes (1994: 33) argue that within an overall POT, SMEs when compared to large enterprises would:

- rely more on short-term debt including trade credit and overdrafts.
- rely less on new shareholders' equity compared to 'internal' equity and to debt in raising new finance.
- rely to a greater extent on hire purchase and leasing arrangements.

2.2.4 The signalling theory

The signalling theory is due to the works of Ross, (1977:32). According to Ross, enterprises are able to signal their true financial position to outsiders by the capital structure that they choose. Ross's model has three main dimensions. Firstly, the cost of capital is independent of the financing decision of the firm, despite each firm having its own unique level of debt. Secondly, the level of bankruptcy risk rises as the amount of debt issued by the firm increases. Thirdly, the value of the firm is positively related to its debt-equity ratio.

The Signalling theory assumes that firms choose the level of debt, which makes external agents identify their quality (Casasola, Cardone and Margarita, 2002:4). However, it is difficult for SMEs to access external markets to give signals about their quality (Casasola, Cardone and Margarita, 2002:7). This observation notwithstanding, the amount of equity retained by the owner in the enterprise is interpreted by the market as a signal of quality. The market treats higher entrepreneurial ownership through own capital contribution as a signal for a more favourable project.

2.2.5 The strategic theory

The relationship between business strategy and choice of financing has been highlighted by Robson, Gallagher and Daly (1994) and Jordan, Lowe and Taylor (1998:8-12). This theory indicates that business strategy has an influence over the financing decision and by extension over the capital structure. The strategic options that may influence choice of financing include strategies related to the commodity market, and strategies related to the product as well as selection of production factors (Casasola, Cardone and Margarita, 2002).

2.3 Conclusion

The chapter has shown that there is no specific theory for SME financing. The financing structure of SMEs can be addressed by drawing on certain aspects of the existing theories. The theories relevant to SME financing include the information asymmetry and Pecking order theories. Firm characteristics are also reported to play an important role in small and medium-scale financing structures.

Thus, a meta-theoretical framework was found suitable in the current investigation.

The next chapter reviews relevant literature and provides the conceptual framework for the study.

CHAPTER THREE

LITERATURE REVIEW ON THE FINANCIAL STRUCTURE OF ENTERPRISES

3.1 Introduction

The theoretical framework in the previous chapter has indicated that there is no universal finance theory for all firms. The different theories explain the financial behaviour of enterprises, taking into account their different characteristics and problems. In addition, the individual theories address specific aspects of enterprise finance. It follows then that, the perception that a problem exists in enterprise finance is supported by the conclusions of theoretical literature.

This chapter presents a review of relevant literature in the study. The review of literature involves the systematic identification, location and analysis of documents containing information related to the research problem being investigated with a view to identify gaps or contributions to the study , identify independent variables and to develop the research instrument (Mugenda and Mugenda ,1999:29) and Locke et al in Herbst and Coldwell (2004:35).

The purpose of this study was to establish a perspective of alternative sources of financing SMEs in Kenya. The chapter reviews factors influencing the financial structure of a firm, SMEs access to finance, Bank finance; financing constraints, financial and lending infrastructures, innovative lending approaches, IT and SME's use of alternative finance.

3.2 Factors influencing SMEs financing structure

A firm's capital structure or financial structure refers to the mix of its financial liabilities. The determinants of a firm's capital structure comprise of those factors that influence its financing decisions, namely: asset structure; profitability; firm size; growth opportunities; uniqueness; business risk; ownership structure and control; enterprise age ; the firm's

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human capital; retention policy of the owner/manager; debt capacity of the firm ; rate of inflation; availability of loanable funds and cost of debt. These factors are reviewed in sub-sections 4.2.1 to 4.2.16.

3.2.1 Asset structure

Due to the conflict of interest between debt providers and shareholders, lenders face risk of adverse selection and moral hazard (Jensen and Mekling, 1976). Therefore, lenders take actions to protect themselves, here by requiring tangible assets as collateral. The tangibility of an enterprise's assets is measured as a ratio of fixed assets over total assets. As such, collateral may be a major determinant of the level of debt finance available to firms (Scott ,1977:12), Stiglitz and Weiss (1981:398), Williamson (1988:575) and Harris and Raviv (1990:328-35).

While Bradley et al. (1984:864), Titman and Wessels (1988:9) and Rajan and Zingales (1995:1427) find a significant positive relationship between tangibility and gearing, Chittenden et al. find the relationship between tangibility and gearing to depend on the measure of debt applied. While they find a positive correlation between tangibility and long term forms of debt, a negative correlation is observed for short term debt elements. Similarly, Stohs and Mauer (1996:287) find debt maturity to be highly correlated with asset maturity. This suggests that a firm's asset structure influences its use of debt finance. The different forms of debt finance include bank finance, trade credits, leasing and factoring. That is to say, beyond traditional business credit, other sources of financing include, supplier credit, leasing, factoring, angel finance, government lending agencies, loans from associates, friends and relatives, private investors, pension and mutual funds .

The evidence suggests that no study has investigated the relationship between a firm's asset structure and use of alternative sources of finance, other than bank finance as debt finance.

3.2.2 Profitability

Modigliani and Miller (1963) argue that, due to the tax deductibility of interest payments, companies may prefer debt to equity. This would suggest that highly profitable firms would choose to have high levels of debt in order to obtain attractive tax shields. Myers (1984:579) and Myers and Majluf (1984:212-18) predict that, as a result of asymmetric information, companies will prefer internal to external capital sources. Thus a pecking-order is established, whereby companies with high levels of profits tend to finance investments with retained earnings rather than by the raising of debt finance.

That notwithstanding, there are conflicting theoretical predictions on the effects of profitability on leverage. Consistent with this theory, Toy et al. (1974:883), Kester (1986:8-12), Titman and Wessels (1988:6), Barton et al (1989:42-3) Rajan and Zingales (1995:1451) and Michaelas et al. (1999) all find gearing to be negatively related to the level of profitability. Also, while Myers and Majluf (1984) predict a negative relationship according to the pecking order theory, Jensen (1986) predicts a positive relationship if the market for firm control is effective. However, if it is ineffective, Jensen (1986) predicts a negative relationship between profitability and leverage. In this theoretical literature, profitability is measured as the ratio of earnings before interest and taxes (EBIT) to total assets. This then gives rise to the assumption that unprofitable SMEs' only access bank finance. The present study seeks to fill this gap by exploring the current situation on SME's use of alternative sources of financing with a view to mitigate the perceived financing gap among small and medium-scale enterprises in Kenya.

3.2.3 Firm Size

Empirical evidence from research investigating the relationship between firm sizes and their financing supports a positive relationship between firm size and leverage (Michaelas, Chittenden and Poutzioris, 1999:123). Size has been viewed as a proxy for business risk and so has been believed to be influential in respect to financial structure. According to Castanias (1983:16-28) and Titman and Wessels (1988:6), large firms are more diversified, and are able to tolerate higher debt ratios as they have large assets and resources to fall on in case of a variation in earnings that makes payment of interest difficult (Rajan and Zingales, 1995:1434).

On the other hand, Smith and Warner (1979:119) and Michaelas et al. (1999) argue that the agency conflict between shareholders and lenders may be particularly severe for small companies. Lenders can manage the risk of lending to small companies by restricting the length of maturity offered. Small companies can therefore be expected to have less long term debt but possibly more short term debt than larger companies ((Barnea et al. ,1980), Whited (1982), and Stohs and Mauer (1996)). Once again, however, the empirical evidence is inconclusive. Crutchley and Hanson (1989) and Rajan and Zingales (1995) find significant positive correlation between company size and gearing, while Stohs and Mauer (1996) and Michaelas et al. (1999) find debt maturity to be positively correlated with company size. However, Remmers et al. (1974) find no size effect and Kester (1986) uncovers an insignificant negative effect.

Fazzari et al. (1988:153) investigate the link between firm size and access to capital and argue that in times of tight credit, small and medium-sized firms are often denied funds, in favour of better quality borrowers. Gertler and Gilchrist (1994:321-24) show that there is a strong correlation between firm size and the scope for external financing. Smaller firms rely on intermediary finance, while larger firms are not restricted in their access to capital market.

Lizal and Svejnar (2002) focus on enterprises in Czech Republic and in attempting to control for size, split their sample into sub-samples of large firms numbering 100 or more employees and of small firms with fewer than 100 employees. From this exercise they find evidence of credit rationing (i.e. a positive relationship between profit and investment) only for smaller, private firms. In contrast, larger firms in their sample have virtually unlimited access to capital implying a negative relationship between profit and investment for their data. However, contrasting results were obtained as well. For instance, Hu and Schiantarelli (1994) found that *ceteris paribus*, size is positively associated with the probability of the firm being financially constrained. Again, a possible explanation is that banks face a trade-off between higher evaluation and preparation costs for multiple small and medium size loans and higher risk resulting from a focus on smaller number of large projects.

The literature also notes the agency problem of equity peculiar to closely held firms. As already mentioned, information asymmetries make adequate monitoring of smaller firms by lenders difficult, because when a company with limited liability becomes financially distressed, equity takes on 'call option' characteristics (Black and Scholes ,1973:644) and Merton (1974: 458). That might provide an incentive and opportunity for the owners/insiders to misrepresent investment risks and returns and to take more riskier actions than they would be willing to take in the absence of limited liability.

On balance, large firms should have lower agency costs per unit of external finance because of their greater diversification, longer track records, and because of economies of scale in collecting and processing information about their situation. This gives rise to the agency problem in credit markets for smaller firms who experience reduced access to credit relative to other borrowers. Again, based on extant research, the relationship between enterprise size and access to alternative sources of finance ought to be investigated.

3.2.3.1 Criticisms of size and SMEs financial Structure.

The issue of firm-size and financial leverage is controversial, as the number of researchers who have not found there to be a relationship between size and leverage is almost as high as the number of those who have found the opposite. Castanias (1983:1624); and Rajan and Zingales (1995:1436) in their studies concluded that size should not be a determinant of financial leverage. Also, Jensen (1986) argues that agency problems are more likely to prevail in large mature firms than in small firms. Similarly, Scherr, Sugrue and Ward (1993:449), Chittenden, Hall and Hutchinson (1996:64), and Michaelas, Chittenden and Poutziouris (1999) found a negative relationship between short-term liabilities and firm size in their studies.

Thus, research findings on firm size and financial leverage is so far mixed. However, it could still be argued that firm size has a direct relationship with financial leverage based on the available empirical evidence.

3.2.4 Growth Opportunities

Michaelas, Chitenden and Poutziouris (1999) argue that firms may choose a financing option based on their beliefs for future use of financing. In particular, if the firm is more likely to need capital in the future, it has greater incentives to establish credit relationships with outside financiers such as banks. The growth of assets may be considered as a fairly satisfactory indicator of the future development opportunities of the firm and need for more funds. However, there exists quite a large uncertainty as regards the growth factor, both regarding its effect on leverage and how it shall be measured. Firstly, we may expect a positive relationship between growth and leverage since higher growth opportunities implies a higher demand for funds, and, *ceteris paribus*, a greater preference on external financing through the preferred source of debt according to the pecking-order theory. Secondly, Myers (1977:149) argues that due to agency problems, firms investing in assets that may generate high growth opportunities in the future face difficulties in borrowing against such assets. For this reason, we may now instead expect a negative relationship between growth and leverage.

Nevertheless, the evidence on the impact of growth and leverage is mixed. For example, while Michaelas, Chittenden and Poutziouris (1999) find future growth positively related to leverage and long-term debt, Chittenden, Hall and Hutchinson (1996:62) and Jordan, Lowe and Taylor (1998) find mixed evidence. In this connection, Bates (1971) found that growth enterprises had a higher use of internal financing than other enterprises. That is to say that, growth companies may be reluctant to take on debt, if high interest rates or restrictive covenants impose constraints on their future manoeuvrability. Consistent with these predictions, Titman and Wessels (1988:13), Chung (1993:94), Barclay and Clifford (1995:624) and Rajan and Zingales (1995:1429) all find a negative relationship between growth opportunities and the level of gearing.

3.2.5 Uniqueness

Löf (2003) summarizes the idea due to Titman (1984), that the more unique a firm's asset is, the thinner the market for such assets. Accordingly the lower is the expected value recoverable by a lender in the event of bankruptcy. Hence, we may expect

uniqueness to be negatively related to leverage. Following Titman and Wessels (1988), uniqueness is measured as the ratio of expenditures on research and development over sales.

3.2.6 Business risk

Income variability is a measure of business risk. Since higher variability in earnings indicates that the probability of bankruptcy increases, we can expect that firms with higher income variability have lower leverage (Löf, 2003). However, there is limited empirical evidence between risk and leverage for small and medium -scale firms, which suggests a positive rather than negative relationship (Jordan, Lowe and Taylor, 1998; Michaelas, Chittenden and Poutziouris, 1999:121).

The actual financial structure is, therefore, an empirical issue that will depend largely on the mix of theories and firms with different characteristics. The Pecking order theory allows for the dynamics of the firm to dictate an optimal capital structure at any particular point in time (Copeland and Wetson, 1992:78). Furthermore, the capital structure signals the true financial position of the business to outsiders.

3.2.7 Ownership structure and control

The relationship between the SME and the lenders is characterized by the ownership and control structure in the enterprise. It is possible to distinguish two major types of SMEs, i) those in which the manager is the owner of the entire capital, and ii) the medium-sized family enterprises in which there is usually some extent of separation of functions. Also, it is possible to identify two important interest groups: a) the owner-managers; and b) the external owners that do not sit on the management board (Ang, 1991: 9; 1992:193).

If the capital and the control are in the hands of a few agents only, the clash of interests between managers and shareholders is diminished, and it is not necessary to use borrowing as a mechanism of supervision and control over the managerial function. There is also a reduction in the information asymmetries between lenders and borrowers, and possible opportunistic behaviours by owners-managers could be avoided. In

consequence, according to agency theory, a positive relationship is expected between the degree of specialization and separation of the functions of ownership and control, and the total borrowing ratio. Nevertheless, the Pecking order theory points out that SMEs in which there is no separation of functions and in which the owner-manager has invested a major part of his/her personal wealth, so there is no self financing, tend to show a preference for the use of borrowing, in order to avoid involving outsiders and the loss of control in the decision-taking.

The structures of enterprise control should be considered when examining empirically enterprise financing. The financing behaviour may be affected because parameters of the objective function will vary and also because differences in enterprise control structures impact on efficiency of aligning the objectives of insiders with those of providers of finance.

While characteristics both of firms and of institutional frameworks of capital markets differ across economies, different control structures may emerge as a response to those conditions. One example of that relates to the degree of firms' affiliation to wider industrial conglomerates. Hoshi et al. (1991:41-46) examine whether liquidity is a more relevant determinant of investment for the Japanese firms which are affiliated to industrial group with close links to banks, than for those firms which are independent of these alliances.

Their main result shows that the liquidity variable - cash flow, is more important for the independent firms, than for the firms affiliated to an industrial group and/or leading bank. Hall et al. (1998b) study the determinants of investment in scientific firms for the US, France and Japan (1979-89) and find that the links between investment, profit, sales and cash flow are idiosyncratic and country specific.

Galindo and Schiantarelli (2002) provide an overview of recent research on investment financing in Latin America, reporting evidence that firms with foreign ownership are less restricted in their access to finance. The result may not be general, as Colombo (2001:1696) found no significant impact of foreign ownership on access to short-term

debt finance for Hungary. More recently, Harrison and McMillan (2003:83-92) using a sample of firms taken from the Ivory Coast demonstrate that foreign companies are less credit constrained than domestic firms. Foreign ownership may be conducive to easier access to finance not just because of direct funding from foreign partners and greater availability of foreign sources of finance but may be due to less bankruptcy risk, as they adopt faster international standards on product quality and therefore find it easier to gain access to domestic bank debt (Colombo 2001; Harrison and McMillan 2003:94).

3.2.8 Enterprise age

Empirical work on the relationship between the age of a firm and its use of external finance is mixed. Wedig and others (1988:37) reported finding age negatively associated with debt ratios at a high level of significance. They used cumulative depreciation divided by annual depreciation payments as the measure of age in their study. However, Petersen and Rajan (1994:24) found a significant relationship between small firm's age and financial leverage. Similarly, Barton and Mathews (1989:41) concluded that mature firms experience lower earnings volatility and hence are expected to have higher debt ratios. Overall, Scott et al (1989) conclude that age is a measure of risk and reputation. The current study seeks to establish whether enterprise age has any influence on use of alternative sources of finance.

3.2.9 Sector of the enterprise and human capital

Ownership characteristics such as the education and the working experience of the owners of the firm and their personal wealth or family resources may play a role in a firm's propensity to gain access to the financial market (Cavalluzo et al, 1999).

Bates (1991:68) showed that commercial banks are more likely to lend to individuals with more human capital, more equity and with demographic traits that are associated positively with the business viability. Similarly, according to Storey (1995:129-136) experience and education level obtained may provide signals of better human capital. The better the human capital in the enterprise, the greater the firm viability of the start up, growth, expansion and consequently access to debt capital. In this context human capital

is likely to be reflected in the levels of education, their age, whether or not they have previous managerial experience and family's small business background. It may also be argued that the nature of an enterprise or the sector in which it operates would also affect its riskiness. A producer of dairy products or perishable products may face higher risks on its products than a furniture producer. Perhaps more important than the attributes of the business or their owners, the credit history of the firm and its principal owner, sends a strong signal to lenders about the risk of repayments.

3.2.10 The rate of growth of earnings

There is ample evidence that managers have a preference for internal funds over external sources of capital. The main determinant of internal funds is the growth in earnings of the firm. A high earnings growth rate enables management to have more funds from retained earnings, so that less external finance will be required. Thus one might expect a negative relationship between the rate of growth of earnings and the debt-equity (D/S) ratio. The rate of growth in earnings may affect the D/S ratio indirectly in two ways (Koutsoyannis, 1982): Firstly, a high rate of growth, if financed with debt, will increase the earnings per share by more than if it were financed by common stock, due to the tax-deductibility of interest payment (tax shield) (Copeland and Weston, 1992). The effect of the growth of earnings on the debt/equity ratio in this event would be positive. This effect, however, may well be expected to be absorbed by the corporate tax rate which itself is another determinant. Secondly, a high earnings growth rate will almost certainly boost the price of the common stock, making equity financing more attractive than debt financing. This effect of growth in earnings on the D/S ratio should be absorbed by the stock price, which is also a separate determinant of capital structure.

3.2.11 Availability of internal funds: the retention policy of owner managers

The amount of internal funds does not depend only on the growth of total earnings but also on proportion of earnings retained (retention ratio). This in turn depends on the growth potential of the firm and the ability of managers to persuade shareholders that the available investment opportunities are profitable. The retention ratio is expected to be

negatively related to the debt/equity ratio, since a high proportion of retained earnings reduce the need for debt financing.

3.2.12 Credit limit (or debt capacity of the firm)

The attempt of owner managers to adjust their actual debt to equity ratio to their desired level is constrained by the attitudes of creditors. It is generally accepted that lenders in the capital market ultimately define the debt capacity of firms, that is the level of safe (risk free) borrowing, or the amount of debt which firms can undertake without serious danger of financial failure (Koustoyiannis, 1982). Creditors' beliefs about the debt capacity of a firm are thus based on such variables as the size of the firm, its potential growth, and its business risk.

3.2.13 Form of business enterprise

The effect of form of organization on financing is related to the extent that it affects the availability of particular forms of financing. Storey (1994) argues that while some may consider the benefits of limited liability as the critical decision in the choice of legal form of the business, the limited liability gain is not real. On the other hand, choice of legal form involves weighing up credibility, taxation variation against statutory audit costs and public information. Given these, banks may perceive incorporation as good signal as it may portray credibility and formality of operations, or represent an indicator of future growth (Cassar and Holmes, 2003:127).

The existing empirical evidence supports the existence of a positive relationship between form of business organization and financial leverage. For example, Coleman and Cohn (1999) found evidence supporting a positive relationship between leverage and incorporation. Similarly, Freedman and Godwin (1994) suggest that incorporation lead to a greater use of bank financing. Thus, the form of business organization influences its use of different sources of external financing.

3.2.14 Rate of inflation

Inflationary expectations affect both demand and supply of loanable funds. Managers may favour debt financing, *ceteris paribus*, because the repayment of debt will be less cumbersome due to the fall in the real purchasing power of money. However, creditors may be unwilling to supply funds in inflationary conditions for the same reason, unless they are compensated with high interest rates. However, interest rates are normally beyond the control of creditors, being defined by government policy. Thus it is more likely that inflationary expectations will have a stronger effect on creditors rather than on borrowers (firms). One should thereby expect a negative relationship between the debt/equity ratio and the rate of inflation (Koutsoyiannis, 1982)

3.2.15 Availability of loanable funds

The supply of credit is to a large extent influenced by government policy. The imposition of a tight monetary policy makes debt financing scarce and expensive. In such conditions firms are coerced to rely on retained earnings and use more equity financing, despite its higher cost. This factor is closely related to the previous one, since a tight monetary policy is mostly adopted in inflationary periods, and vice versa. Thus the rate of inflation is a fairly good proxy for the availability of loanable funds. Its relation to the debt/equity ratio would be negative.

3.2.16 The cost of debt

Debt has a direct (explicit) cost, consisting of interest payments. Each type of fund has a different cost. The overall cost of capital to the firm is the weighted average of the costs of the various sources of finance (Ross and Westerfield, 1996). The determination of the cost of capital is important for two reasons: It defines the supply of investable funds to the firm and it is widely used as a criterion for investment decisions of the firm. Thus cost may influence use of available sources of finance.

3.2.17 Reputation of the enterprise.

One of the factors that may reduce the agency costs of borrowing and especially those which originate from a situation of over-investment is "reputation of the enterprise"

(Wijst, 1989). Wijst (1989) suggests that the “reputation of the enterprise” may be measured as a function of variables such as age and/or length of service. The reputation is reflected as greater ease in obtaining the required financing.

The capital market’s observation of the SME fulfilling its contractual obligations over a long period is one of the enterprise’s most valuable intangible assets. The credit market accumulates this information. The variable reputation is related to the capacity of the enterprise to tackle its payment commitments originating in borrowing—repayment of the principal and interests (Cardone, *et al.*, 1998). The managers’ willingness to preserve this intangible asset discourages opportunistic decision-taking; high risk investments are rejected in favour of more secure projects, thereby diminishing the agency costs of the borrowing derived from decisions on over-investment. Consequently, according to agency theory and the signals approach, it may be expected that the longer the service, the greater the reputation in the credit market, and, therefore, the greater the facilities to obtain the necessary financing. The “reputation” may also be measured as a function of the number of years that the enterprise has been owned by the entrepreneur. The scarce grade of specialization that generally exists in this type of enterprise with respect to the functions of ownership and control, together with many owner manageresses’ reluctance to delegate responsibilities, creates a great dependency of the SME on the figure of the owner-manager. When this person withdraws from the post—due to decease, illness, retirement, change of activity, etc- problems of succession may arise within the enterprise, causing the credibility and reputation acquired to be lost, and sometimes leading to the disappearance of the enterprise. Consequently, change of ownership is similar to creating and setting up a new enterprise, increasing the information asymmetry and the risk that the lender perceives (Boedo and Calvo, 1997). Therefore, a positive relationship may be expected between the number of years that the enterprise has belonged to its current owner and the level of borrowing.

3.3 SMEs Access to finance

The economic development of a country depends on its enterprises and the ease with which they can start and finance their businesses. Finance has been identified in many surveys as among the most important problems facing SMEs in both developing and

developed countries. Access to finance is a crucial factor that determines the capability of SMEs to expand their businesses, employment and to employ the latest technologies, thus ensuring their competitiveness and the country as a whole (UNCTAD, 2001:1). Despite their dominant numbers and importance in job creation, SMEs have always faced difficulty in obtaining formal credit or equity from financial markets or investors. Limited access to finance is a major obstacle to development of SMEs in Africa as their inherent higher perceived risk makes financial institutions reluctant to lend to them and adequate financial instruments lack (UNCTAD, 2001:1; Murinde, Manos and Green, 2002:1; industry Canada, 2002:22-28, Nixon and Cook, 2000:3).

According to UNIDO (1996:35), SMEs in developing countries need equity or venture capital as well as other alternative finance in the form of loans. Most SMEs in developing countries are undercapitalised and usually rely on loan capital or on retained earnings, which are usually inadequate. In addition, most SMEs in developing countries badly need an injection of equity capital where the investor participates in the risk so that returns are linked to the success of the business.

Notwithstanding the current situation, new enterprises are born every day and / or existing enterprises are expanding by increasing the productive assets. This involves an implicit decision to raise capital in order to finance the growth.

The financial needs and financing modes of business' change and develop over time. Start-ups rely on internal financing, namely, retained earnings, personal savings and contributions from friends, relatives and business associates, in addition to trade credit from financial intermediaries. As a firm starts to establish a track record, it attracts the attention of investors who are willing to inject equity into the company. This facilitates bank loans. By going public, the firm eventually raises funds in the securities markets (IFC, 2000).

Limited access to finance is an important issue for SMEs. While access to capital will not solve all the problems faced by SMEs it remains a crucial factor in ensuring their competitiveness by enabling them to invest in the latest technologies. However,

traditional approaches, in the form of aid programmes, have failed in most cases to facilitate access to resources.

Commercial banks and investors have been reluctant to service SMEs for a number of reasons, including high risks and transaction costs. Emphasis must be placed on enabling financial institutions to receive reliable financial information and lower the costs of servicing SMEs. Furthermore, building the capacity of traditional financial intermediaries to serve SMEs is not enough. The need for new and better financial products and initiatives is paramount.

In order to make use of their potential, enterprises need to be provided with an enabling environment, which encompasses access to capital. However, one of the greatest obstacles to the entry, development and growth of small firms in industrialized and developing economies is access to formal finance (Green, 2003:1).

Depending on their size and environment, enterprises see access to formal finance as more or less challenging. Whereas young and small firms are usually deprived of credit in all surroundings, medium enterprises in industrialized countries are likely to suffer from an insufficient volume of credit or unsatisfactory conditions. Their counterparts in developing and emerging economies may, however, be disadvantaged both in access to credit and in the terms of loans (Berger, Klapper, and Udell, 2001: 2139).

There is a wide taxonomy of financing sources used by small, medium and large enterprises for investment. Whereas all types of firms mostly rely on retained earnings, small and medium enterprises are more dependent on these funds than are large firms. Compared with larger enterprises, small firms are restricted in their access to commercial bank and government funds although the latter play only a marginal role for them. As a consequence of their disadvantaged status, small and, to a lesser degree medium enterprises, seek recourse to informal finance (Fischer, 1995: 13-24; Udell 2002:4).

The larger the firm, the easier access to bank credit and the better are the loan conditions it receives. Loans to large customers are encouraged by banks through employee

incentive schemes, which are often based on the amount of credit granted. Additionally, the vast array of alternatives to domestic bank loans available to large firms, for example recourse to capital or international financial markets, augments their bargaining power at the time of negotiating a loan contract (Freixas and Rochet, 1998).

In contrast to large firms, small enterprises are often unable to cover their financing needs. The fact that small businesses receive less finance or face worse conditions than larger firms puts them at a competitive disadvantage. Without sufficient long-term finance, small firms are unable to expand their businesses and to introduce productivity enhancing technology. This will have adverse consequences for the competitiveness of the sector and the economy as a whole.

In developing countries, the financing problems of small enterprises are exacerbated. Comparing the ratios of credit provided by the financial system and non-bank financial intermediaries to the private sector in industrial and emerging economies can give an indication of the extent of financial repression (Holden, 1996: 113). Whereas domestic credit to the private sector exceeded GDP by far in countries such as Germany (118.2%), the United Kingdom (123.4%) and the United States of America (145.3%), it represented only 26% in India and was as low as 5.9% in Uganda or 2.1% in Sierra Leone (World Bank, 2001). According to Pombo and Herrero (2001) up to 80% of investment demand by SMEs remains unsatisfied in some Latin American and African countries. For micro-enterprises, this figure rises to 95%.

The limited access of small enterprises to formal credit in developing economies is largely due to the relatively underdeveloped nature of the financial system, the lack of liquidity, and inexperience in small-scale lending (Lizano and Mesalles, 1995:38).

Promoting SME access to finance will require combined effort at: improving the business climate, strengthening SME capacity to help them cope with formal banking requirements, promoting financial sector development, including the scaling up of micro finance institutions and diversifying the sources of financing, notably by favouring intra-private sector linkages (Martinez, et al , 2004:527).

3.4 Bank Finance

Bank finance has remained the dominant source of capital and credit for enterprises in both the developed and developing countries. The main source of small business external financing is the conventional bank lending, with almost half of external finance coming from overdrafts and term loans (Bank of England, 2002:15; Srivastava and Biggs, 1996). Similar findings were found in another study on SMEs access to finance by the Observatory of European SMEs (2003:22). The study found that smaller enterprises use relatively more bank financing than larger enterprises. It was further found that *approximately 80% of all European SMEs have at least one credit line*. SMEs in manufacturing, wholesale, transport and communication needed relatively more credit than SMEs in other sectors. Therefore, SMEs active in these sectors had credit lines with three or more banks (Observatory of European SMEs, 2003:22).

Although traditional bank finance remains the most important source of external finance for small firms, it is declining in importance in some of the developed countries as owner- managers diversify their ways of raising money. For example, in the period 1995-1997 bank finance accounted for 47% of external finance in the United Kingdom (UK) against 61% in 1987- 1990 (Bank of England, 2001a:15). Nonetheless, finance gaps exist in SMEs financing because of mismatches between supply and demand. Banks are reluctant to lend without collateral. This results in credit rationing in spite of the rise in demand from SMEs.

Banks in Sub-Saharan Africa as elsewhere minimize information costs by limiting their activities to a few segments of the credit market. For example, in Ghana and Kenya, one study found that banks limit themselves to overdrafts and to medium term bank loans. Besides, both types of credit were found secured with real property. As a result, access to bank credit is largely confined to medium and large firms with secure land titles (Fafchamps et al., 1994:15-28).

The distortions introduced by banks' inability to reach small firms and start-ups in sub-Saharan Africa are only partly compensated by non-bank forms of credit , namely, trade

credit, loans from friends and relatives, and, to a much smaller extent, loans from savings associations. Non-bank credit, however, suffers from the same limitations as the contract enforcement mechanisms on which conventional banks rests most strongly, that is, trust and reputation. In the absence of global reputation mechanisms, access to non-bank credit remains confined to the narrow circle of friends and business relations. As a result, borrowers share the good and bad fortune of their circle of friends and relations. An efficient aggregate allocation of resources cannot be achieved because the size of the pool from which any individual borrower can draw is limited. Non-bank credit is unable to entirely correct distortions in access to credit (Srivastava and Biggs, 1996:8-10).

Although many analytical studies have been carried out on SME financing, there exist very few comparable data or empirical surveys on the nature and extent of SME participation in commercial bank financing across the developing countries, including Kenya. The shortage of up-to-date and comparable data is particularly evident in terms of the sectors and industrial composition of SMEs; the structure and characteristics of SME inputs and turnovers; the contribution of SMEs to income, employment, exports and taxation; and share of SMEs in fiscal and monetary allocations and incentives (APEC, 2002:11-14 and 24-35; Regnier, 2000:35; ILO, 1997:36). Most of the studies and surveys so far undertaken focus on a few, and often individual countries. In addition, many surveys are plagued by a number of methodological problems, making cross-country and cross sectional comparisons unreliable (Thitapha, 2003:9).

Among the major weaknesses of the studies so far done are the small and non-representative sample of firms within the same or different industries, under reported or mis-measured data, limited control on industry specific factors that may impact on the perceptions and responses, and the lack of cross-sectional comparable questionnaires. In particular, enterprises are frequently selected on a non-random basis and this bias over -states the degree of SME participation in bank financing (APEC, 2002:37).

Even with such limitations, it is apparent that for SMEs to meet various financing needs, between 75 and 90 per cent of them in the less developed countries rely on their

own savings, internal sources such as retained earnings, and borrowings from relatives and friends (Lutabingwa et al, 1996:5).

It is very difficult at present to obtain comparable data of the total amount and relative share of institutional or bank finance secured by SMEs in Africa and elsewhere (APEC, 2002:74-75; Vilorio, 2001:142-143).

Besides the constraint of access to bank finance, SMEs have to pay a higher rate of interest and have to comply with more restrictive requirements on institutional credit obtained by them, compared to those imposed on their large-scale counterparts (Aryeetey, 1995:32; Webster, 1991:37-38). Furthermore, SME applicants are required to provide suitable collateral, which is often a difficult requirement on smaller enterprises.

Additionally, loan terms are typically for one year. This fact notwithstanding, many firms within the SME sector are growing beyond the size of the informal sources of finance can support and institutional credit is the only feasible option for financing growth (IFC, 2000:32-33; UNCTAD, 1995:6).

Thus, bank finance does not often cover all the financing needs of SMEs. This justifies the present study. Nevertheless, experience from the economic crisis in East and South East Asia during the period 1997-1998, has shown that over-dependence on bank finance tends to increase financial systematic risks, especially through the cascading effect (Thitapha, 2003:7).

3.5 Bank finance Constraint

Bank finance has remained the dominant source of capital and credit for enterprises in both the advanced and developing countries. However, SMEs' growth and competitiveness is constrained by the lack of access to financing (Ogujiuba and Ohuche, 2004:1; Berger and Udell, 2004; Bigstein et al., 2003; Raihan, 2001:2). Banks are reluctant to lend without collateral. Besides, SMEs have to pay a higher rate of interest and have to comply to more restrictive requirements on institutional credit obtained by

them, compared to those imposed on their large-scale counterparts (Aryeetey, 1995:32; Webster, 1991:37-38).

Banks believe that lending to small firms is more risky than lending to large firms (Brayshaw, Wilkes and Samuels; 1995: 997). A finance gap therefore exists for firms starting up or wishing to grow (Evans and Carter, 2000:338). Notwithstanding this, many firms within the SME sector are growing beyond the size of that informal sources of finance can support and institutional credit is the only feasible option for financing growth (IFC, 2000:32-33; UNCTAD, 1995:6). However, it is very difficult at present to obtain comparable data of the total amount and relative share of institutional or bank finance secured by SMEs in Africa and elsewhere (APEC, 2002:74-75; Vilorio, 2001:142-143). Nevertheless, experience from the economic crisis in East and South East Asia during the period 1997 to 1998 has shown that over-dependence on bank finance tends to increase financial systematic risks, especially through the cascading effect (Thitapha, 2003:7). Therefore, the need for alternative finance is necessary for SME financing to mitigate bank finance constraints.

3.5.1 Collateral Constraint and SME financing

The possession of collateral largely determines whether SMEs as economic agents access the financial market (Rajan and Winton, 1995:1113-1146). Lack or inadequate collateral satisfactory to banks has always been a constraint on SMEs seeking external finance particularly bank finance (ILO, 1995:27). This explains the mismatch between supply and demand in small scale financial market (Levisky, 1993:9-10). This situation is further aggravated by limited reserve of personal savings, inadequacy of the capital markets and lack of other forms of financing (Evans and Carter, 2000:337).

Collateral plays an important role in many models of bank finance. Bester, Besanko and Thakor in Elsas et al (2000 :6), building on ex ante screening model by Stiglitz and Weiss (1981), interpret collateral as a signal which allows a bank to solve the adverse selection problem inherent in debt financing under asymmetric information. In a model with two types of projects, high and low level risk, a separating equilibrium is shown to

exist. Low risk borrowers generally choose contracts with a high level of collateral. High-risk borrowers, in contrast, prefer to have loans with no collateral. The signaling models thus predict a negative correlation between loan risk and collateral.

It can be argued however, that the signaling model is only concerned with the pre-contractual stage of loan contracts. Once the contract has been concluded, the role of collateral in the dynamic setting of information asymmetry remains to be explored.

Bester (1994:14) further develops a second class of models on the ex post monitoring function of banks on micro-enterprises. The model predicts a positive correlation between expected default risk and loan collateralization. In this model, a creditor can not distinguish between strategic defaults and default due to a bad state of the economy.

Therefore, the provision of outside collateral such as mutual credit guarantee will reduce the debtor's incentive for strategic default. However, research is required on the application of this model of finance by small and medium scale enterprises.

3.5.1.1 Role of collateral in a relationship of imperfect information

Collateral helps to solve the problems created by imperfect information. In the case of borrower selection, given the difficulties of the lender in determining the repayment capacity, collateral provides the linkage to that capacity. The larger the value of collateral, the greater the expected payment capacity. In this way collateral discriminates against small borrowers from large borrowers (FAO, 1996:5).

Collateral acts as a mechanism that indirectly influences the borrower's behaviour in taking actions that are favourable to loan repayment. The more valuable the collateral, the more willing the borrower will be able to take actions that are conducive to repayment of his debt. Further more, in loan recovery, the threat of loss of collateral is a mechanism that influences the timely repayment of the loan. Thus, the value of the collateral is positively related to the loan recovery.

Booth and Thakor in Elsas et al. (2000:7) develop a model of relationship lending as a determinant of the collateral decision. In the relationship equilibrium, for borrowers without a positive track record, the bank charges high interest rates and requires the provision of collateral. Empirical studies demonstrate that the larger the collateral a borrower can provide, the lower the interest rate will tend to be (Vermani in FAO, 1996). In addition, collateral has a relationship with loan duration. The need for loan information varies according to the duration of the loan payback period. When the period is longer, there will be a likelihood of something happening that will affect the borrower's repayment capacity. Consequently, lenders will demand more information from borrowers when the payment periods of loans are longer (FAO, 1996:7). However, as already observed it is difficult for the lender to obtain information. Hence, one way of offsetting greater information needs for the long-term loans and of minimizing risks, is to demand more valuable collateral.

As a result, investment loans, which are generally long-term loans, require more valuable collateral than short-term loans. This is a serious limitation for small firms who need to capitalize or replace equipment but have no collateral that is demanded for such long-term credit. This therefore, justifies the study on alternative models of SME finance.

3.5.1.2 Empirical Evidence on the role of Collateral

In a seminal study, Berger and Udell (1990:30-42) empirically analyze the risk-collateral relationship. They use data from the 1988 "United States Survey of Bank Lending Terms" and consistently find a positive relationship between credit risk and collateral. The authors use two different proxies for credit risk. The first proxy is an *ex post* measure of aggregate bank risk. It is defined as the fraction of borrowers with non-performing loans among all borrowers of a given bank. The second risk proxy captures credit risk on the level of the individual borrower. It is defined as the credit spread i.e. the difference between the contractual rate of the loans and a risk-free interest rate. It can be noted though, that the study did not separate lending to large firms, SMEs or lending to individuals.

Berger and Udell in Elsa et al (2000:9) extend this analysis to aspects of relationship lending and the financing of small firms by using data from the 1988 "National Survey of Small Business Finance". They use balance sheet ratios as risk proxies and duration as a proxy for relationship intensity. The authors claim their findings support a positive risk- collateral correlation, though leverage is the only significant explanatory variable out of eight risk measures. Duration, as an explanatory variable for the incidence of collateral, has a significant negative coefficient, thereby implying decreasing collateral requirements for more intensive bank-borrower relationships.

According to Elsa et al (2000: 10), the probability of pledging collateral increases rather than decreases if the bank is the borrower's main bank. However, the study relies only on proxies like firm size and loan type.

In other SME financing studies, the collateral requirement is often cited as a constraint to access of bank finance. For example, in a study on sources of financing by small scale manufacturing in Kenya, Lutabingwa et al. (1996:6) found that most of the entrepreneurs had not accessed external funds because they did not have collateral. However, most of the respondents in the study stated that a source of external funds would improve their businesses significantly. Similarly, Bigstein et al. (1999:494) in their study on Credit constraints in Manufacturing Enterprises in Africa found that the percentage of firms receiving loans is very small and lending is collateralised. The value of collateral was observed to be typically high, on average higher than the value of the loan.

Notwithstanding this, under collateralisation is not exclusively a problem for the borrower (Fleisig, 1994:3). A bank may also conceive as constraining the lack of collateral, especially when a borrower's credit application meets all other criteria except the banks collateral requirement. In this case the bank will be obliged either to take the risk of under collateralised exposure or accept a less preferred form of collateral implying possibly high costs in establishing and enforcing security interests. Sometimes the bank may compensate for these increased risks and costs by charging

correspondingly high interest rates or sometimes it can not do so because of interest rate ceilings, in which case, the bank is doubly constrained by a lack of collateral and interest rate policy.

According to Fleisig, (1994:3) in under collateralised lending, the borrower is constrained by being forced to borrow at higher interest rates to cover monitoring and loan contract enforcement costs or be rationed by not being allowed to borrow at all at these interest rates. Thus, due to collateral requirement, less lending takes place and subsequently reduced volume of investment, than if there were no monitoring problems. In addition, enforcement problems would further reduce credit market transactions. It could be argued that, if lack of collateral results in many loan contracts not being concluded, then the central bank and other authorities responsible in the formulation and implementation of the financial policy should have a reason to be concerned.

3.5.2 Classifying enterprises into financially constrained and unconstrained.

According to Maksimovic, Laeven, Demiguzic and Beck (2004:2) existing literature on enterprise financing constraints (see the surveys by Schiantarelli 1995, Blundell, Bond and Meghir, 1996, Hubbard, 1998:198, and bond and Van Reenen, 1999) is based on the assumption that external finance is more costly than internal finance due to asymmetric information and agency problems, and that the premium on external finance is an inverse of the borrower's net worth.

In a most recent study on the determinants of financing obstacles, Maksimovic et al (2004:3) found that in classifying financially constrained firms, age, size and ownership structure are effective categorizations of firms when studying financing obstacles, and that older and larger firms report lower financing obstacles.

Empirical surveys have grouped firms by dividend payouts or business group affiliation (Hoshi, Kashyap, and Scharfstein, 1991:53), size and age (Devereux and Schiantarelli, 1990) and the degree of shareholder concentrations. For example, Devereux and Schiantarelli (1990) and Oliner and Rudebusch (1992:646), among others, have used

age and size as a criteria to classify firms into groups of financially constrained and unconstrained firms and have found out that small firms are more financially constrained than large firms. Similarly, Schiffer and Weder (2001) have used the World Business Environment survey (WBES) to study the relation between firm size and different obstacles, such as financing, infrastructure and macroeconomic policies and report among others, that perceived financing obstacles are higher for small firms than for large firms.

Kaplan and Zingales (1997:182-86) classify firms into categories of not financially constrained to financially constrained based upon statements contained in annual reports. They classify firms as being financially constrained if these firms are unable to meet their obligations. However, majority of SMEs do not keep accurate financial reports and hence they are assumed to be financially opaque.

Furthermore, Maksimovic et al (2004:6) in their study that involved a survey on the determinants of financing obstacles found that smaller and younger firms are financially more constrained. In addition, Gertler (1994) argues that information asymmetries are likely to be especially large for young and newly established firms, because creditors have not had enough time to monitor such firms and because such firms have not had enough time to build long-term relationships with suppliers of finance.

3.5.3 Access to Information

The access to credit information and the technology in local lending environments determine the extent to which SMEs obtain sufficient external financing to exploit profitable projects. The extent to which the business environment inhibits the optimal provision of credit determines the size of the funding gap that SMEs might face (Berger et al., 2004:7).

Access to information is important both from the SME's perspective and from the perspective of the providers of financial services and products. The SME requires information with which to identify the potential suppliers of the financial products. It requires this information to evaluate the cost of the financial services and products that are being offered. The financial service providers require information with which to

evaluate the risk of the SME which is applying for finance, and to assess the prospects of the SME within the market segment.

Access to information is therefore a basic condition for providing loans to firms. Often the problem of inadequate information is mentioned as one of the main aspects limiting bank finance to SMEs (Observatory of European SMEs, 2003:29; Udell, 2004:5). Most of the information banks obtain from SME operators come from the borrowers themselves: investment plans, working capital requirements and balance sheets. The required information is then scrutinized for internal consistency, and compared to other information the bank has at its disposal. However, interaction with the borrower is the next possible source of information for the bank from the SME borrowers. By handling the borrower's accounts, the bank knows the borrower's volume of transaction and the trend of his/her business. As a result borrowers are most likely to obtain loans and overdraft facilities from a bank that they have been banking with for years (RPED, 1994:103-104). According to the Observatory of European SMEs (2003:23), 60 % of the SMEs in Europe regularly provide this type of information. The report further indicates that there is a positive correlation between the size of the enterprise and the information provided to banks. It further indicates that 70% of the SMEs without credit lines do not share financial information with the bank. The situation is even worse in the lesser developed countries where the level of literacy is dismally low. However, provision of information to the bank may be a necessity for creating a rating culture among SMEs for purposes of accessing external finance.

3.5.3.1 Asymmetric Information

A prerequisite for the efficient allocation of resources by market forces is that all participants share the same relevant information. This is not the case in financial markets.

Borrowers will always know more about the viability of their projects and their ability and willingness to repay than lenders. The lender is thus faced with uncertainty both with respect to the expected rates of return of the project he/she is financing and with respect to the integrity of the borrower. This uncertainty increases with the length of the loan. Borrowers face difficulties in transmitting information about their projects to lenders, as

lenders will suspect them of underestimating the risks of failure. The problem of asymmetric information will be more acute for small businesses than for larger ones because of lower information standards and the greater variability of risk. Small, privately owned firms face no legal reporting requirements and are more vulnerable than large firms (Fischer, 1995:17).

Due to asymmetric information, it is impossible to accurately distinguish between “good” and “bad” borrowers. The two main problems associated with asymmetric information are adverse selection and moral hazard as already explained in chapter 2.

3.6 High Administrative Costs of Small-Scale Lending

Since most of the administrative costs of lending are fixed, independent of the size of the administered loan, economies of scale arise, the larger the loan. Furthermore, administrative costs also include information gathering costs, for example visiting borrowers, analysing their applications and monitoring their loans. For a number of reasons, these costs tend to be higher for small than for large firms (Hatakeyama et al, 1997:68).

Small enterprises are often located away from the main urban centres, their accounting skills and standards are usually lower, and banks lack experience in servicing them. In the case of developing and emerging economies, these difficulties, and therefore the costs involved, are multiplied. Evidence from the Caja Social, a Colombian financial institution granting small loans, suggests that the costs of administering small loans range from 11% to 13% of the Portfolio's value per year (Gudger, 1998). Transaction costs for servicing small firms not yet integrated into the formal financial market rise to a multiple. This implies that the margin over cost of funds must be at least as high.

3.7 High Risk Perception

Commercial banks tend to impute a high risk to small enterprises and are therefore reluctant to extend credit to them. Due to their small size and inherent vulnerability to market fluctuations, the mortality rates of small enterprises are relatively high. These firms are, by their very nature, often relatively young and consequently lack a financial

history and a track-record of profitable projects. In addition, organizational and administrative deficiencies, lower quality management and a lack of appropriate accounting systems may compromise the accessibility and reliability of information from small firms on their repayment capacity. Also, small loans to industry are often classified as personal loans. Banks, therefore, may lack concrete figures of how profitable loans to small enterprises are and what costs they entail. Finally, the relative labour-intensity of small firms implies a high debt-to-asset ratio if loans are made. The associated vulnerability and lack of sufficient and adequate collateral further limits the amount of finance that banks are willing to grant them (UNIDO, 1999:13).

In developing and emerging economies, the disadvantage of small firms with regard to risk-perception is aggravated by a number of factors. Many small enterprises have evolved in the informal economy, making it difficult for them to document their business history and demonstrate their economic potential. Additionally, small entrepreneurs in emerging economies are typically less skilled in book-keeping, marketing and management than their counterparts in industrial countries, adding to the risk perception with regard to their projects. This is exacerbated by inadequate legal frameworks which make the enforcement of contracts difficult for lenders (Starmans, 2000: 67-76).

3.8 Financial institution structure and lending infrastructures

The review of literature on the financial institution structure and lending infrastructures will be quite helpful to advancing the understanding of the markets for providing funds to SMEs. It will also aid understanding of the effects of policies that both facilitate and hinder the access to funding by creditworthy SMEs.

Much of the recent research on SME access to funding focuses on the comparative advantages of different types of financial institutions in using transactions lending approaches versus relationship lending. Transactions lending approaches are primarily based on “hard” quantitative data that may be observed and verified at about the time of the credit origination. This “hard” information may include, financial ratios calculated from certified audited financial statements, credit scores assembled from data on the payment histories of the SME and its owner provided by credit bureaus; or information

about accounts receivable from transparent, low-risk customers that may be pledged as collateral by the SME or sold to the financial institution (Berger and Udell, 2004:4).

Individual transaction approaches are distinguished from one another by the type and source of “hard” information that is main basis for the underwriting decision (Akhavain, Jalal, Frame and White, 2005:4-9).

The relationship lending approach, in contrast, is based significantly on “soft” qualitative information gathered through contact over time with the SME and often with its owner and members of the local community. The soft information may include the character and reliability of the SME’s owner based on direct contact over time by the institution’s loan officer, the payment and receipt history of the SME gathered from the past provision of loans, deposits, or other services to the SME by the institution; or the future prospects of the SME garnered from past communications with SME’s suppliers, customers, or neighbouring businesses. The “soft” information may often be proprietary to the loan officer and may not be easily observed by others, verified by others, or transmitted to others within the financial institution (Berger, Allen and Udell, 1995: 359).

The most common findings in the extant research are that large institutions have comparative advantages in transactions lending to more transparent SMEs based on “hard” information, while small institutions have comparative advantages in relationship lending to less transparent SMEs based on soft information (Berger et al, 2004: 4). A policy implication that might at first instance seem reasonable is that the financial institution structure needs to include a substantial market share for small institutions to meet the demands of less transparent SMEs, since these SMEs may be constrained in the financing they can obtain through the transactions approaches offered by large institutions. Therefore, different lending approaches depending upon the borrower characteristics as well as the financial institution structure and lending infrastructure, may be used to supply funding to SMEs even when relationship lending cannot be effectively employed.

Other research on financial institutions structures and SME access to financing focuses on the comparative advantages of foreign versus domestic financial institutions, and state-owned versus privately owned institutions in lending to SMEs. As well, there is considerable research on the effects of financial institution market concentration on the supply of SME credit (Petersen and Raghuram 1995: 408).

Difficulties in observing which lending approaches are employed complicate policy assessments of which financial institution structure may best address a country's issues of availability of funds to creditworthy SMEs. An additional area of concern regarding SME credit availability is the lending infrastructure of a country, which defines the rights and flexibility of financial institutions to fund SMEs using the lending approaches that best fits the institution and the borrower. This infrastructure includes the commercial and bankruptcy laws that affect creditor rights and their judicial enforcement; the regulation of financial institutions, including restrictions on lending, barriers to entry, and direct state ownership of financial institutions; the information infrastructure, including the accounting standards to which potential borrowers must comply as well as the organizations and rules for sharing information and the taxes that directly affect credit extension that provide the economic environment in which financial institutions may lend in a given country. As shown in recent research by La Porta, et al (1998: 1118) and others, the lending infrastructure as well as the infrastructures, that affect equity markets and other parts of the financial system are quite heterogeneous across both developed and developing countries and may have effects on the capacity of financial institutions and markets to provide finance in these countries.

A country's lending infrastructure directly affects the extent to which each of the individual lending approaches for SMEs are employed. As examples, weak accounting standards may restrict financial statement lending; restrictions on the sharing of credit information may restrict small business credit scoring; weak commercial laws and enforcement of collateral rights may inhibit asset-based lending; and poorly-designed creditor rights and judicial enforcement of these rights may limit most types of lending. In some cases, restrictions that inhibit the use of one lending approach may encourage the use of others. For instance, poor creditor rights with respect to security interests may

promote the use of factoring in which the receivables are sold, rather than pledged as collateral.

Other shortcomings in the lending infrastructure may restrict SME credit availability indirectly by constraining the potential financial institution structure, or the market shares of different types of financial institutions, potentially preventing them from capitalizing on their comparative advantages in the different lending approaches. To illustrate, implicit or explicit government barriers to the entry of foreign financial institutions limit the degree to which foreign institutions may compete to provide credit to SMEs using the approaches in which they have a competitive advantage.

Although global data on the use of different lending models is quite limited, there is some evidence that the use of these models varies significantly across countries. For example, asset-based lending has a significant presence in only four nations, Australia, Canada, the UK and the USA. In addition, the use of factoring varies widely across countries. To illustrate, the ratio of the volume of factoring to GDP in 2002 was 11.9% in Italy, but only 0.9% in Switzerland (Bakker, Klapper, and Udell, 2004: 14). More generally, the significant variance across countries in the models used and the finding that lending models may be virtually unavailable in some countries demonstrate the potential importance of both the financial institution structures and lending infrastructures. It appears that suboptimal financial institution structures and or lending infrastructures in many nations limit the models available for financing SMEs, and thereby significantly reduce credit availability for them.

Thus, the conceptual framework emphasized in this thesis represents an extension of the framework to which most of the extant research adheres. The study focuses on the roles of a country's financial institution structure and lending infrastructure and how they are likely to affect the use or non-use of the different lending approaches in that country, and thereby influence the extent to which SMEs in the country gain access to credit. The financial institution structure may affect the credit availability for both transparent and opaque SMEs because different types of financial institutions have comparative advantages in different lending approaches. The lending infrastructure may directly affect

SME access to credit through restricting the lending approaches that can be legally and profitably employed, and may indirectly affect SME credit supplies through constraining the potential financial institution structure, limiting the abilities of different types of institutions to use their comparative advantages in employing different lending methods.

Research literature provides a considerable amount of evidence on the effects of financial institution structure on SME lending, although the findings rarely go beyond the distinction between transactions lending approaches versus relationship lending to describe parts of the different transactions approaches. The review of literature in the following subsections focuses on the parts of the financial system that are most relevant to SME finance. Here, the researcher briefly reviews the findings with regard to the comparative advantages of large versus small institutions (subsection 3.8.1), foreign-owned versus domestically-owned institutions (subsection 3.8.2), state-owned versus privately-owned institutions (subsection 3.8.3) and market concentration (subsection 3.8.4)

3.8.1 Large versus small financial institutions

There are a number of reasons why large institutions may have comparative advantages in employing transactions lending approaches which are based on hard information and small institutions may have comparative advantages in using the relationship lending approaches which are based on “soft” information. Large institutions may be able to take advantage of economies of scale in the processing of hard information, but be relatively poor at processing soft information because it is difficult to quantify and transmit through the communication channels of large organizations (Stein 2002: 1893-1904). Under relationship lending, there may be agency problems created within the financial institution because the loan officer that has direct contact over time with the SME is the repository of soft information that cannot be easily communicated to the management or owners of the financial institution. This may give comparative advantages in relationship lending to small institutions with lower agency costs within the institutions because they typically have less separation (if any) between ownership and management and fewer overall layers of management (Berger and Udell 2002: 43).

The empirical literature on this topic usually does not observe the lending approaches used by large and small institutions, but rather draws conclusions about these approaches from the characteristics of the SME borrowers and contract terms on credits issued to these SMEs by institutions of different sizes. In most cases, the research is based on data from U.S.A. banks and SMEs. Large institutions are found to lend to larger, older, more financially secure SMEs (Haynes, Ou, and Berney, 1999: 292-310). It is often argued that these findings are consistent with large institutions lending to relatively transparent and relatively safe borrowers that are more likely to receive transactions credits. Large institutions are also found to charge lower interest rates and earn lower yields on SME loan contracts (Berger, Rosen, and Udell 2003:13, Carter, McNulty and Verbrugge 2004:238). It is contended that these results may reflect that large institutions lend to safer borrowers and/or employ lending approaches with lower operating costs, which are more likely to be transaction loans. In addition, large institutions are found to have temporally shorter, less exclusive, more impersonal and longer distance relationships with their SMEs loan customers.

These findings are argued to suggest weaker relationships with borrowers for large institutions, which are indicative of transaction loans. Finally, large institutions appear to base their SME credit decisions more on strong financial ratios rather than on prior relationships (Cole, Goldberg, and White, 2004:238).

It is argued that both the dependence on strong financial ratios and the non-dependence on prior relationships for large institutions are indicative of the use of transactions lending approaches. The researcher argues that these findings are not as clear-cut in the support of the comparative advantages by institution size as they might at first seem. For the most part, prior authors appear to treat transaction lending approaches as a collective whole that may be adequately represented by just one of these approaches, financial statement lending. This is not necessarily the case (Berger and Udell, 2004:12). The researcher agrees that the findings that SME credits by large institutions tend to be associated with weaker lending relationships and less often based on prior relationships and are indeed consistent with the predicted comparative disadvantage of large institutions in relationship lending. However, the researcher does not agree with the

contentions in the prior literature that greater SME transparency, safer SME borrowers, lower rates and yields, and possible lower operating costs and greater reliance on financial ratios for large institutions provide strong support for the hypothesis that these institutions have comparative advantages in transactions lending approaches. Although greater transparency, safer borrowers, lower rates, lower operating costs, and greater reliance on financial ratios are indicative of the use of the financial statement lending approach, they are not necessarily indicative of the types of loans or borrowers associated with the other transaction lending approaches. That is, these other transactions approaches may not necessarily be used to lend to SMEs that are less opaque or safer than relationship borrowers, may not have lower rates or smaller processing costs than relationship loans and may not be based on stronger financial ratios than the relationship lending approach.

To illustrate, note that two of the transaction lending approaches that are often used by large USA banks are not consistent with these characteristics. As indicated above, small business credit scoring appears to be employed by large USA banks to lend to SMEs that are relatively opaque and risky, and these loans have relatively high interest rates. As discussed further in chapter four, this approach is based largely on the personal credit of the SME owner, rather than on strong financial ratios of the firm. Similarly, as discussed in section 3.9.4, the asset-based lending approach employed by many large banks is generally used to lend to relatively opaque and risky borrowers at relatively high interest rates. These loans typically involve relatively high processing costs of monitoring the accounts receivable and inventory pledged as collateral and the primary information is based on the value of the collateral, rather than strong financial ratios of the borrower.

Though large institutions may be disadvantaged in relationship lending and tend to lend to more transparent SME borrowers on average than small institutions, this does not necessarily imply that a sizeable presence of small institutions is necessary for significant credit availability for opaque SMEs. A limited amount of additional research finds that the local market shares of large and small USA banks have relatively little association with SME credit availability in their markets (Jayaratne and Wolken 1999: 437, Berger et al 2003: 398).

The first potential hypothesis that may help explain this finding is that large USA banks are able to accommodate many opaque SME loan customers with transaction technologies other than financial statement lending, such as small business credit scoring and asset-based lending. Namely, large institutions may have more transparent SME borrowers on average than small institutions because they have more financial statement loans to transparent SMEs than small institutions, but these large institutions may also be able to make credit available to significant numbers of opaque SMEs using the other transactions approaches. This hypothesis is difficult to test because the lending approach is usually unobservable.

The second hypothesis may also help explain the finding of little association between the market shares of large and small institutions and SME credit availability. Large institutions may be disadvantaged at serving a significant subset of opaque SMEs, but market forces may be efficient in sorting these opaque SMEs to small institutions in the market that serve these borrowers using the relationship lending approach.

The empirical evidence on the effects of USA bank mergers and acquisitions (M&As) on SME lending provides some support for this second hypothesis, although the lending approaches and the opacity of the borrowers is typically not observed in these studies. The studies find that large institutions reduce their SME lending after M&As, but that other banks in the same local markets appear to respond by increasing their own supplies of SME credit substantially (Berger *et al* 2001:2129; Avery and Samolyk, 2004: 296). As well, new small banks are often created in these markets that provide additional boosts to the local supply of SME credit (Berger *et al*, 2004: 182).

The finding that the availability of credit to SMEs does not appear to depend in an important way on the market presence of large versus small institutions in the USA does not necessarily apply to other nations because of other differences in the financial institution structures of these nations or lending infrastructures in these nations that limit competition for SME credits. In an international comparison, greater market shares for small banks are found to be associated with higher SME employment, as well as more

overall bank lending (Berger, Hasan, and Klapper 2004: 174). These findings hold for both developed and developing nations.

3.8.2 Foreign-owned versus domestically-owned financial institutions

For a number of reasons, foreign-owned institutions may have comparative advantages in transactions lending and domestically-owned institutions may have comparative advantages in relationship lending. Foreign-owned institutions are typically part of large organizations, and so all of the logic discussed above regarding large institutions generally applies to foreign-owned institutions as well. Foreign-owned institutions may also face additional hurdles in relationship lending because they may have particular difficulties in processing and transmitting soft information over greater distances, through more managerial layers, and having to cope with multiple economic, cultural, language, and regulatory environments (Buch 2003: 863). Moreover, in developing nations, foreign-owned institutions headquartered in developed nations may have additional advantages in transactions lending to some SMEs because of access to better information technologies for collecting and assessing hard information. For example, some foreign-owned institutions use a form of small business credit scoring to lend to SMEs in developing nations based on the SME's industry. Other institutions provide home-nation training for loan officers stationed in developing nations (Berger, Hasan, and Klapper, 2004: 177-85).

There is very little empirical evidence on SME lending by foreign-owned institutions in developed nations, although some research finds that these institutions tend to have a wholesale orientation (DeYoung and Nolle, 1996:629), and in some cases tend to specialize in serving multinational corporations headquartered in their home nation, presumably using transaction approaches applied to hard information (Goldberg and Saunders 1981: 25). Some evidence is consistent with the hypothesis that foreign-owned institutions may have difficulty processing local soft information needed to provide cash management services, although this finding is based on data from multinational corporations (Berger, et al, 2003:63).

The empirical findings regarding foreign-owned institutions in developing nations are quite different. Foreign-owned banks usually appear to be more profitable and efficient than domestically-owned banks on average in these nations (Claessens, Stijn, Asli Demirguc-Kunt, and Harry Huizinga, 2001: 894 , Martinez Peria, Maria Soledad, and Ashoka Mody. 2004: 523), although one study finds roughly equal performance after controlling for a number of different types of governance and governance change. The better performance of foreign-owned banks in developing nations relative to developed nations may be due to the better technology access noted above, or some combination of better access to capital markets, superior ability to diversify risks, or greater managerial experience. There is also evidence on the effects of foreign-owned institutions on SME credit availability in developing nations. In most of the studies, foreign-owned banks individually or larger shares for these banks are associated with greater credit availability for SMEs (Dages, Linda, and Kinney. 2000:21; Clarke, George, Robert Cull, and Maria Soledad Martinez Peria. 2002; Beck, Thorsten, Demirguc-Kunt and Maksimovic. 2004:628-33; Berger, Seth, Lawrence, and White. 2004). However, one study has found that foreign-owned banks may have difficulty in supplying SME credit (Berger, Klapper, and Udell 2001:2135). As above for the USA. data, the lending approaches are generally unobserved, and there is even less information available about the characteristics of the SME borrowers or contract terms from which to infer these approaches. Although the foreign-owned institutions almost surely use transactions approaches, it is usually not known which among the approaches is employed or the opacity of the borrowers served.

3.8.3 State-owned versus privately-owned financial institutions

State owned institutions may be expected to have comparative advantages in transaction lending and privately owned institutions may be expected to have comparative advantages in relationship lending simply because state owned institutions are typically larger. There are also a number of additional arguments with regard to the general ability of state owned institutions to affect the supply of funds available to creditworthy SMEs through any lending approach. State-owned institutions generally operate with government subsidies and often have mandates to supply additional credit to SMEs or entrepreneurs in general, or to those in specific industries, sectors, or regions. Although in principle, this might be expected to improve funding of creditworthy SMEs, it could

have the opposite effect in practice because these institutions may be inefficient due to a lack of market discipline. Much of the funding to SMEs may be to firms that are not creditworthy because of this inefficiency. The credit recipients may also not be creditworthy because the lending mandates do not necessarily require that the funding be applied to positive net present value projects, or that the loans be expected to be repaid at market rates. As well some of the funds may be channelled for political purposes, rather than for economically creditworthy ends (Sapienza, 2002:340). State-owned institutions may also provide relatively weak monitoring of borrowers and/or refrain from aggressive collection procedures as part of their mandates to subsidize chosen borrowers or because of the lack of market discipline. In nations with substantial state-owned banking sectors, there may also be significant spill over effects that discourage privately-owned institutions from SME lending due to “crowding out” effects of subsidized loans from state-owned institutions or poor credit cultures that are perpetuated by the state-owned presence.

The empirical findings which are generally either cross -section studies of many nations or focused on one or a few developing nations – are generally consistent with the negative performance effects of state ownership. Studies of general performance typically find that individual state owned banks are relatively inefficient and that large shares of state bank ownership are typically associated with unfavourable macroeconomic consequences (La Porta, Lopez-de-Silanes, and Shleifer. 2002:173 , Barth, Gerard Caprio and Levine. 2004:218 , Berger, Demirguc-Kunt, Levine, and. Haubrich. 2004:433-51). The evidence also generally suggests that less SME credit is available in nations with large market shares for state-owned banks (Beck, Demirguc-Kunt, and Maksimovic 2004:16; Berger, Hasan, and Klapper 2004: 172-6). As well, nonperforming loan rates at state-owned banks tend to be very high, consistent with lending to SMEs with negative net present value loans, weak monitoring of loan customers, and/or lack of aggressive collection procedures (Hanson 2004:140).

Consistent with these findings of generally negative consequences of state ownership, studies of the effects of bank privatization in both developed nations (Verbrugge, Megginson, and Owens 2000:17,) and developing nations (Otchere and Chan, 2003: 953)

typically find improvements in performance following the elimination of state ownership. Similar to the case for foreign-owned institutions, state-owned institutions generally use transactions approaches, but there is little information available on the technologies employed or data from which to infer these technologies. Finally, note that there are exceptions to the measured unfavourable effects of state ownership, cases in which state-owned institutions have eliminated government subsidies and appear to operate relatively efficiently and provide significant SME credit (Townsend and Yaron 2001: 38). In some cases, this may occur as the state-owned institutions employ decentralized management techniques with local responsibility to offset some of the lack of market discipline of state ownership and some of the comparative disadvantages of large size (Robinson, 2001).

3.8.4 Market concentration

Greater market concentration of financial institutions may either reduce or increase the supply of credit available to creditworthy SMEs. Under the structure-conduct-performance (SCP) hypothesis, greater concentration results in reduced credit access through any lending approach. This may occur in several ways as institutions in more concentrated markets may exercise greater market power. These institutions may choose to raise profits through higher interest rates or fees on loans to SMEs; they may choose to reduce risk or supervisory burden by tightening credit standards for SMEs; and or they may choose to be less aggressive in finding or serving creditworthy SMEs, taking advantage of a “quiet life” afforded to managers by the market power. Alternatively, institutions in more concentrated markets may increase SME access to credit using one of the lending approaches, relationship lending. Greater concentration may encourage institutions to invest in lending relationships because the SMEs are less likely to find alternative sources of credit in the future. Market power helps the institution enforce a long-term implicit contract in which the borrower receives a subsidized interest rate in the short term, and then compensate the institution by paying a higher-than-competitive rate in a later period (Sharpe 1990:1074 ; Petersen and Rajan ,1995:413).

Although both theories may apply simultaneously, empirical studies have not come to a consensus as to which of these may dominate empirically and whether the net supply of

SME credit is lower or higher in concentrated markets. Some studies of the SCP hypothesis using U.S. data found that higher concentration is associated with higher SME loan interest rates (Hannan 1991: 138; Berger, Rosen and Udell, 2003:18).

Although this finding may appear to support the SCP hypothesis, it may also be consistent with the alternative hypothesis of an expansion of relationship lending if relationship loans tend to have higher interest rates on average than transactions loans. Relationship loans do not necessarily have higher average rates, as argued above, but we cannot rule out this possibility. As above for the empirical literatures on large versus small, foreign-owned versus domestically-owned, and state-owned versus privately-owned institutions, much of the difficulty in interpreting the effects of market concentration arises because the lending technologies are generally unobserved. A number of recent studies have looked instead to testing these hypotheses by examining the effects of banking market concentration and other indicators of market power such as regulatory restrictions on competition on SMEs and general economic performance. These studies have mixed empirical results. For example, some of the studies find unfavourable effects from bank concentration (Black and Strahan 2002:2807-13 , Berger, Hasan, and Klapper, 2004), while others find favourable effects of bank concentration (Petersen and Rajan 1995: 428 , Cetorelli and Gambera 2001: 625 , Zarutskie 2003: 4-7 , Cetorelli 2004: 546), and still others find the effects may differ with the lending infrastructure or economic environment (DeYoung, Goldberg, and White 1999: 472 , Beck, Demirgüç-Kunt, and Maksimovic, 2004: 634).

3.9 The Lending Infrastructure

In this section, attention is on the lending infrastructures of a country and how it affects the financing of SMEs. The lending infrastructure includes the information environment, the legal, judicial and bankruptcy environment, and the tax and regulatory environments. All of these elements may directly affect SME credit availability by affecting the extent to which the different lending approaches may be legally and profitably employed. The final element, the regulatory environment, may also restrict SME credit availability indirectly by constraining the potential financial institution structure.

3.9.1 The Information Environment

The information infrastructure has a significant effect on the availability of credit to SMEs. One important aspect of the information infrastructure is the accounting environment. The key issues here are existence of strong accounting standards and credible independent accounting firms. These are necessary conditions for informative financial statements. These are also necessary conditions for the feasibility of many components of loan contracting. For example, financial covenants are not feasible if the financial ratios calculated from bank financial statements are not reliable. Indices of global accounting standards, not surprisingly, indicate considerable variation across countries – not only between developed and developing economies but even among developed economies (La Porta et al, 1998:1116).

Another important aspect of the information infrastructure is the availability of information on payment performance. The extent to which lenders share information about performance has been shown to have a significant effect on credit availability (Jappelli and Pagano 2001; Love and Mylenko, 2003:1129). Third-party information exchanges or business credit bureaus provide a formal organizational mechanism for the exchange of commercial payment performance information. Moreover, they have been shown to have power in predicting firm failure beyond financial ratios and other descriptive information about the firm (Kallberg and Udell, 2003:334). Survey data also indicate that without credit bureaus the time to process loans, the cost of making loans, and the level of defaults would all be higher (Miller, 2003:362). These exchanges can be privately owned such as the world's largest, Dun and Bradstreet, or they can be publicly owned such as the national credit registries in Italy and Argentina.

There is considerable variation across countries in terms of the existence of information exchanges, whether they are public or private, and the coverage of the information available through the exchange (Miller, 2003:366). Empirical evidence suggests a statistically important link between the existence of third-party information exchanges and credit availability. Specifically, countries with stronger formal information sharing

exhibit greater bank lending relative to gross domestic product (GNP) and country-level credit risk is negatively correlated with measures of formal information sharing (Jappelli and Pagano ,2001).

3.9.2 The Legal, Judicial, and Bankruptcy Environment

A country's legal and judicial infrastructure significantly influences the context in which loan contracting is conducted. The legal infrastructure that affects business lending consists of the commercial laws that specify the property rights associated with a commercial transaction and enforcement of these laws. The latter determines the confidence of contracting parties in financial contracts. Collectively, these two features constitute the rule of law as it relates to the extension of credit. Countries differ significantly on this dimension: for some, commercial laws are clear and conducive to commercial transactions and enforcement is predictable; for others, commercial law is ambiguous and incomplete, enforcement is problematic, and criminal and racketeering behaviour block the creation of new businesses, undermine existing ones, and deter foreign investment (EBRD, 2003:4-13). Empirical studies have shown that firms in countries with greater financial development and stronger property rights have increased levels of investment funded by external finance while firms in countries with weaker financial development and property rights are more likely to obtain potentially less efficient financing from development banks, the government or from informal sources (Beck et al 2004: 16). Smaller firms may be particularly affected. One study found that the effect of financial, legal and corruption problems consistently constrained the growth of smaller firms more than larger firms in a cross-country analysis (Beck, Demirguc-Kunt, and Maksimovic, 2002: 21).

A country's commercial laws, its bankruptcy laws, and the enforcement respectively of these laws directly affect the ability of banks to deploy specific contracting elements that can be used to mitigate the problem of information opacity. Specifically, they can affect the deployment of contracting elements that have been shown literature to minimize problems of adverse selection and moral hazard such as covenants, maturity, collateral and personal commitments (Berlin and Loeys 1988: 406, Chan and Kanatas 1985: 87 ; Sharpe 1990: 1074).

A country's commercial law on security interests (collateral liens), for example, are crucially important in determining the efficacy of collateral in a loan contract. Key issues included whether a country's commercial law clearly defines how a collateral lien can be perfected, how collateral priority is determined, and how notification of a lien is made. With respect to notification it is important whether a country has an efficient collateral registration system where secured lenders can determine the existence of prior liens and can time-stamp new liens in order to establish temporal priority. A centralized electronic registration system is preferable. At one extreme are countries such as the USA that have a well-developed set of commercial laws (Article 9 of the Uniform Commercial Code) and well-defined registration system. At the other extreme are countries such as many of those in Eastern Europe where commercial laws have been implemented only recently. Although progress is being made on this dimension, many of these Eastern European countries are still deficient in key areas such as, the scope of assets that can be secured, public notification, priority, and in enforcement (EBRD, 2003).

Another problem concerns security interests in movable assets such as accounts receivable and inventory. While provisions exist in many developing economies that allow for security interests in movable assets, they do not allow for group lien filings on these assets (EBRD 2003). This dramatically increases the cost of filing a lien vis-à-vis, for example, the USA where secured lenders can file a single lien on all currently existing and future accounts receivable and inventory rather than having to identify by invoice number and serial number each receivable and inventory item as it is generated.

The efficiency of bankruptcy system is also critical. How long a company stays in bankruptcy either in liquidation or in reorganization is important. Also important is the degree to which the bankruptcy laws and their enforcement adhere to absolute priority. For example, the power of collateral will ultimately depend on whether the priority rights of secured lenders are upheld in bankruptcy. Details of the laws that are often missed in academic analyses can be extremely important here. For example, the rights of secured lenders in the USA may at first seem relatively weak because an automatic stay is immediately invoked upon acceptance of a bankruptcy petition by the bankruptcy

court. The automatic stay prevents all creditors from collecting payments from the bankrupt firm and otherwise enforcing their financial claims. However, under USA bankruptcy law, the judge is required to preserve the collateral claim of secured creditors and to give them “adequate protection” if the collateral or its proceeds are denied to the secured lender. That is, the bankruptcy judge is obligated to preserve the value of a secured lender's claim. Moreover, petitions by secured lenders for a waiver from the automatic stay are often filed at the time of the bankruptcy petition and approved by the bankruptcy judge in the case of specific collateral classes, such as accounts receivable (Udell ,2004).

Strong commercial and bankruptcy laws are not sufficient to create good lending conditions without strong enforcement of these laws. A recent study of the Czech Republic by the World Bank illustrates some of the problems that can occur on this dimension that may inhibit the amount and type of credit that is made available to SMEs. In pursuing commercial claims outside of bankruptcy (that is against a non-bankrupt firm), the World bank found that time absorbed in enforcing loans contracts is considerably longer in the Czech Republic than in five other transition economies that have joined the EU, and somewhat longer than the 15 non-accession EU countries, although it is shorter, interestingly, than in the USA. However, the cost of enforcement was considerably higher than any of these other groups. Pursuing claims in a bankruptcy environment in the Czech Republic appears to be even worse. The World Bank considered this to be the worst alternative. It concluded that unsecured creditors can expect little or nothing for their claims and that secured creditors encountered limited rights, long delays with no compensation, and a poor environment for selling collateral assets with serious consequences on lending decisions (World Bank, 2003: 31).

World Bank reports on Slovak Republic and Lithuania found similar results and suggested that while these problems likely discourage most types of lending ,they may encourage one type; factoring (World Bank, 2002a,2002b). The researcher returns to alternatives to bank finance, such as, factoring in chapter four.

3.9.3 The Tax and Regulatory Environments

The tax and regulatory environments may have direct effects on SME credit availability.

For example, stamp taxes on factored invoices and certain types of value-added taxes can have a negative impact on factoring. In another direct effect, changes in capital regulations and tougher bank supervision in the USA are often cited as contributing to the USA credit crunch in the early 1990s through a reduction in the supply of business credit (Berger and Udell 1994: 589; Peek and Rosengren, 1999:684). The implementation of the new Basel Risk-Based Capital requirements to the extent that they impose a differential implicit tax on SME lending or that they favour one type of lending over another could also have a direct impact in the future (Berger et al, 2004:34).

The indirect effects of the lending infrastructure on SME credit availability may occur through regulations that constrain the potential financial institution structure and prevent institutions from capitalizing on their comparative advantages in the different lending approaches. We include here any government policies that affect entry of different types of financial institutions, their market shares, their abilities to compete and their corporate governance structure.

Government policies that restrict foreign entry may have larger effects on SME credit availability. Research has found that regulatory restrictions on the entry of foreign banks may be more strongly linked to bank performance than the market presence of foreign-owned banks (Levine ,2003), which may suggest these restrictions have particularly strong effects on competition and with potential consequences for SME customers. Finally, government policies with respect to state ownership of financial institutions clearly have important effects on credit availability. Choices to start a state-owned institution and take over a private institution, or privatize an existing state-owned institution may be viewed as regulatory changes to the financial institution structure. State-ownership is generally found to have significant negative effects on SMEs credit availability.

3.10 Development of small and medium enterprises

SMEs promote sustainable economic growth and generate employment. Nevertheless, the development of small-scale enterprises requires external assistance. Market imperfections and institutional failures are among the most important reasons for

increased policy-induced biases that will benefit SMEs and for increased Government intervention.

Governments and international organizations have faced the difficult task of promoting the development of SMEs. A number of SME support programmes in the form of direct and subsidized financial services have been initiated with the aim of facilitating access to finance (Hallberg, 2000:8). Yet, despite success stories in a few countries, the overall results have been poor.

Underlying the search for best practice is a basic question: what form should Government intervention take? There is a need to strengthen local business environments and build local capacity as an effective means of helping SMEs access financial resources

3.10.1 Improving business environment

A vibrant SME sector is an important reserve of innovation, entrepreneurship and productivity growth. However, SMEs do not operate in a vacuum. They operate in business environments determined by Government policies and affected by social and institutional infrastructures. Owing to their size, SMEs are more vulnerable to business environment weaknesses than large enterprises. If policy-induced biases against SMEs are to be reduced, Government intervention that will ensure a healthy business and an enabling environment is vital. The enabling environment encompasses a stable macroeconomic climate, a favourable legal, commercial and regulatory framework, including enforcement of contracts and protection of property rights and physical infrastructure (Berger and Udell 2004:16).

In most developing countries, the major obstacles to private sector development relate to implementation and enforcement of policies. These include administrative inefficiency and bureaucratic obstacles, widespread corruption and inadequate enforcement of laws and regulations. Large enterprises have the resources to overcome these obstacles whereas small firms do not have such resources to the same extent.

Establishing an enabling environment is a long-term goal that requires close cooperation amongst governments, international organizations and other agencies. A strong commitment to this goal by governments, on the one hand, and technical support and assistance from the international community, on the other hand, is crucial.

3.10.2 Technical assistance and capacity-building

The creation of a more favourable business climate is not the only criteria on that would facilitate the growth of SMEs. If SMEs are to develop, they need viable and sustainable financial and technical assistance programmes that would expand their access to critical resources including capital, skills and industry information. By reducing or completely eliminating market imperfections, governmental financial support policies may help SMEs overcome financing constraints. However, such initiatives may themselves create distortions in financial markets by subsidizing non-viable firms or discouraging firms from using non-credit forms of financing (Hallberg, 2000:4).

In many cases, technical support has proven critical to the success of new investments. However, rather than providing such services directly, governments and international organizations must invest in capacity building of local intermediaries, including amongst others, financial service providers, consulting companies and e-business outlets. These types of services enable SMEs to gain access to new investment, technical assistance and other resources. The International Finance Corporation (IFC) states that aid must be provided to SMEs in the form of capacity-building through equity investment. This encourages SMEs to adopt a transparent financial and accounting system while providing technical support to raise management capacity and competitiveness.

In this respect, some SME loans contain technical assistance components that target specific sub sectors. A successful example is the Clothing Industry Training Institute (CITI) in Sri Lanka. In this case, British specialists through UK government support worked with CITI to upgrade technology, quality control and training of garment producers. Today, CITI is at the forefront of training and innovation in the Sri Lankan garment industry.

3.11 SMEs lending Innovative Approaches

The access to credit information and the technology in local lending environments determine the extent to which SMEs obtain sufficient external financing to exploit profitable projects. The extent to which the business environment inhibits the optimal provision of credit determines the size of the funding gap that SMEs might face. This section examines the innovative approaches used in SME financing. The importance of these various types of lending stems from the possibility that SMEs face significant funding gaps, which would occur if firms encountered significant financial constraints due to systematic credit rationing. In a Modigliani and Miller world with complete information transparency, there would be no financial constraints that would inhibit SME growth. Therefore, the severity of the funding gap problem depends on the magnitude of information problems in SME financing and the strength of lending approaches to mitigate these problems.

There is even evidence that informational opacity may lead to excess SME funding (deye Meza 2002). Perhaps the most persuasive evidence that this is not a Modigliani and Miller world is the fact that financial markets are not indifferent about financial contracting. The contracts associated with SME financing are not the same as the contracts associated with funding for larger firms. For example, covenants tend to be more restrictive for smaller enterprises (Ber et al, 1993) and for more informationally opaque firms (Berlin and Mester 1993), loan maturities tend to be shorter for smaller enterprises (Carey and others 1993), and collateral tends to be used more often for riskier borrowers (Berger and Udell 1990, 1992; Carey, Post, and Sharpe 1998; Booth 1992; Klapper 1998).

Recent analyses of SME financing emphasize that lenders use a variety of financing “approaches” (that is, credit products) partly comprised of different combinations of these contract features (Berger and Udell, 2002). More fundamentally, however, these approaches can be differentiated based on how they deploy contract features in underwriting and monitoring borrowers in ways that address problems associated with informational opacity, the type of financing needed, and the lending environment of the borrower. This section assesses five lending approaches used to mitigate the funding gap

problem. All of these approaches address the challenge of financing SMEs whose severe informational opacity makes financial contracting problematic because firm insiders (entrepreneurs) know much more about their firm's quality than do outsiders. This opacity leads to adverse selection when external finance is originated (that is, underwritten) because weak firms mimic strong firms to obtain more favourable financing. It also leads to moral hazard after funding, because entrepreneurs may exploit lenders by shifting from low- to high-risk strategies or may engage in expense preference behaviour.

3.11.1 Financial Statement lending (financial disclosure).

Financial statement lending involves underwriting loans based on the strength of a borrower's financial statements. There are two requirements for this approach. Firstly, the borrower must have informative financial statements that are audited by reputable accounting firms according to generally accepted accounting principles (Berger and Udell, 2004:6). Secondly, the financial ratios calculated from these statements must show a borrower that the business has a strong financial condition.

Financial statement lending addresses the asymmetric information problem by generating information about borrowers through informative financial statements. Interest rates, covenants, collateral, and other contracting elements can be used in conjunction with this information to further ease the risks of adverse selection and moral hazard. To successfully use financial statement lending, a financial system must have well-defined accounting rules, and the borrower must have audited financial statements. For small SMEs this latter condition is problematic even in economies with strong accounting standards because of the cost of such statements.

Under financial statement lending, the lender will base the lending decision on the cash flow of the firm as it constitutes the primary source of repayment. While information asymmetry is common to firms of all sizes, it has far reaching consequences in the case of SMEs. As a result, well-designed technical assistance would improve the flow of information between borrowers and lenders, thereby ensuring a better appreciation by both the relevant risks and returns involved.

The financial statements of large corporations usually have standard formats that conform to generally acceptable accounting practices. SMEs however, do not produce comparable financial information. More often, financial statements are locally audited and disclose limited information. The law of incorporation imposes limited financial disclosure requirements, even in developed countries (Berger and Udell 2004:16).

Banks usually monitor a client's profit and compare it to the company's peer group to determine market conditions. However, reported profits are paper profits that can easily be manipulated. In fact, in many countries, companies have three "official" accounts, one for the bank, one for the tax authorities, and one for the management (ESCWA, 2001:6).

However, liquidity and cash flow are less easy to manipulate. Therefore, they are a better way to verify a Company's ability to repay debts. While verifying liquidity is a paper exercise in large corporations, it can easily be ascertained through a physical examination in the case of SMEs.

Cash flow is the other important way a bank can determine whether or not a borrower will default on a loan. In this case, the bank demands that cash flows exclusively pass through the bank. This provides him with a powerful tool to monitor the company by comparing actual cash flows with the projected cash flows agreed upon with the borrower(Ibid:7). This could then mean that SMEs open and maintain business accounts with a lending bank.

3.11.2 Relationship Lending

Relationship lending addresses the information deficiencies that make financial statement lending problematic for some SMEs. The primary information used by lenders is "soft" information about the relationship between the lender and the borrower (Rajan 1992).

Over time lenders acquire proprietary information about borrowers and their businesses from the provision of loans (Berger and Udell 1995) and other products (Cole 1998; Mester, Nakamura, and Renault 1998; Degryse and van Cayseele 2000). This includes information on the local community and business environment and the entrepreneur and

the SME's interaction with that environment. But this type of labor-intensive lending can be quite costly—costs that are likely passed on to borrowers in the form of higher fees.

Relationship lending is important in many countries, including Germany (Elsas and Krahnen 1998; Harhoff and Körtting 1998), Italy (Conigliani, Ferri, and Generale 1997; Ferri and Messori 2000), Japan (Hoshi, Kashyap, and Sharfstein 1990), Spain (Jimenez and Saurina 2003), and the United States (Petersen and Rajan 1994, 1995; Berger and Udell 1995). The strength of the lender-borrower relationship often affects financial contracting on dimensions such as interest rates, collateral, dependence on trade credit, and credit availability.

Several studies indicate that large banks tend to make loans based on hard information (such as financial statements), while small banks tend to emphasize soft information (that is, relationship lending), suggesting that relationship lending may be best delivered through smaller banks (Berger and others 2002; Berger A. and I. Hassan, 2004; Cole, Goldberg, and White 2004; Scott 2004). These studies are consistent with Stein (2002), which shows that the processing and communication of soft information may be difficult for large banks.

Surveys and other evidence suggest that relationship banking is gradually changing because of a shift from traditional branch banking toward more technology oriented delivery mechanisms, such as telephone, personal computers and internet banking. (Bank of England, 2000:19).

Relationship lending is designed to address information problems that are not cost-effectively solved by other bank lending approaches. According to Rajan (1992:1368),

the primary information used by lenders is based on “soft” information about the relationship between the lender and the borrower. Its emphasis on soft information distinguishes it from all of the other approaches. Under relationship lending, the lender acquires proprietary information about the borrower and the business over time with

respect to the borrowers' banking and the provision of loans (Petersen and Rajan 1994:17, Berger and Udell: 1995:464-65).

3.11.3 Credit Scoring

Small business credit scoring is a transactions lending approach based on hard information about the SME and its owner. The information on the owner is primarily personal data (e.g., personal income, debt, financial assets, home ownership) obtained from consumer and commercial credit bureaus. (e.g., Feldman 1997, Mester 1997). The data are entered into a loan performance prediction model, which yields a score, or summary statistic for the loan. In some cases, financial institutions make underwriting decisions based on "rules," automatically accepting or rejecting based on the score (with some manual overrides). In other cases, the score is used with "discretion" in conjunction with information gathered using other lending approaches.

Small business credit scoring clearly fits the definition of a transactions approach, given that it is based on hard information that is observed and verified at about the time of the credit origination, although the observation and verification is often performed by agents other than the financial institution extending the credit (external provider of the score, credit bureaus). It is equally clear that this technology may be applied to very opaque SMEs, given that much of the information that determines the score is based on the personal history of the owner, rather than the SME. These statistical models are used to quantify default probability or default risk classification and include the linear probability model, logit models, and linear discriminant analysis (Saunders, 2000). Widely used in consumer lending for three decades, credit scoring has only recently been applied to SME and micro-enterprise lending in the USA by large banks, although the rate of adoption by large banks appears to depend on the bank organizational structure (Ackhevain, Frame and White 2005: 79).

Some recent academic studies have found that credit scoring is associated with an increase in overall lending to include more marginal classes of borrowers (Berger and Miller 1992:28). The credit scoring models used in micro business lending tend to be

more complex than those used in consumer lending and tend to place considerable weight on factors associated with the financial history of the entrepreneur (Feldman 1997:24). This follows from the fact that for the smallest SMEs, the creditworthiness of the owner is likely closely intertwined with the creditworthiness of the business (Ang, 1992: 188).

However, like consumer credit scoring, micro-business credit scoring is highly dependent on a strong information infrastructure and, in particular, the existence of informative data from credit bureaus. This is likely not to work for SMEs in environments where there are no commercial or consumer credit bureaus.

3.11.4 Asset-based lending

Lenders may be able to overcome information asymmetry by using asset-based lending, where the borrower's underlying assets are offered as collateral and considered the primary source of repayment. When providing working capital financing, banks look to short-term assets such as accounts receivable and inventory, and to equipment. The pledging of collateral does not, by itself, distinguish asset-based lending from the three previous lending approaches (Berger et al., 2004:9). Collateralization with accounts receivable, inventory, or equipment can be associated with financial statement lending, relationship lending, and credit scoring. The difference is that with the other lending types, collateral (if it is used) is viewed as a secondary source of repayment whereas under asset-based lending, it is viewed as the primary source of repayment.

The amount of credit extended under an asset-based loan is explicitly linked on a formula basis to the liquidation value of the assets used as collateral. This link is continuously monitored to ensure that the value of the assets always exceeds the amount of the loan.

A key benefit of asset-based lending is that an SME's riskiness is not necessarily a barrier to finance if its underlying assets have sufficient liquidation value. Thus, asset-based lending is well suited to high-risk SMEs. Strength of asset-based lending is its ability to generate information about borrower performance through the continuous monitoring of the underlying assets. This helps eliminate the extreme form of risk shifting (moral hazard) that occurs when a firm's insiders know that the company is in distress before

outsiders do (Udell ,2004:8-9). Asset-based lending is an important source of financing in the United States, where asset-based loans account for about one- third of total bank commercial and industrial loans. But it is only significant in two other countries, Canada and the United Kingdom. To be feasible, asset-based lending requires well-defined commercial law that clearly specifies security interests, an efficient lien registration system that clearly defines when liens are filed, and an efficient bankruptcy system that preserves lender priority (particularly security priority) and minimizes time in bankruptcy.

3.11.5 Summary

Overall, the chapter has provided an indication that enterprise financing is largely influenced by a combination of factors. These include; enterprise characteristics, owner's characteristics, the country's institutional and lending infrastructure and the prevailing policy environment.

The next chapter presents a perspective of alternative sources to bank financing.

CHAPTER FOUR

ALTERNATIVE SOURCES OF ENTERPRISE FINANCING: A REVIEW OF LITERATURE

4.1 Background

As indicated in Ogujiuba and Ohuche (2004:1); Berger and Udell (2004); Bigstein et al (2003); and Raihan (2001:2), SMEs' growth and competitiveness is constrained by a lack of access to financing. SMEs need money to finance a range of different needs. In looking at the types of needs and adequacy of funds available, it is important to match the use of the funds with appropriate funding methods. There are different ways for enterprises to obtain financial support throughout their business lifecycle. Before they resort to any of them, it pays for all entrepreneurs to evaluate their options realistically. Thus, the aim of this chapter is to provide the reader with an overview of alternative approaches for enterprise financing. This literature review explores the financing options for SMEs to meet their needs. It has listed descriptions of some of the major sources of financing options and their potential use by SMEs. The financing options include: factoring; leasing; trade credit; angel finance; and venture capital.

4.2 Factoring

Many firms find it difficult to finance their production cycle, since after goods are delivered most buyers demand 30 to 90 days to pay. Sellers issue an invoice recorded for the buyer as an account payable and for the seller as an account receivable which is an illiquid asset for the seller until payment is received. Factoring is a type of supplier financing in which firms sell their credit-worthy accounts receivable at a discount (equal to interest plus service fees) and receive immediate cash. Factoring is not a loan. There is no debt repayment and no additional liabilities on the firm's balance sheet, although it provides working capital financing. In addition, most factoring is done "without recourse", meaning that the firm purchases the receivables, referred to as "the factor", and assumes responsibility for the buyers ability to pay. Factoring is a comprehensive financial service that includes credit protection, accounts receivable, bookkeeping, collection services and financing (Worthy, 2003:4; Berger and Udell, 2004:16).

Factoring is an asset-based finance and an important source of external financing for large and small and medium-size enterprises (SMEs). It is useful for rapidly growing small to medium sized enterprises that have difficulty converting debtors into cash quickly enough to meet their needs. Cash-flow deficiencies, commonly associated with the 'finance gap', are restraining SME performance. It is, therefore, essential that relevant and timely information be made available on all cash-flow funding options. Research on factoring as a Kenyan SME cash management tool, would address a present void in market knowledge. Research that addresses stakeholder understanding and perception as to the role of factoring in Kenya SMEs may advance its overall recognition as a cash management tool and raise the profile of factoring which presently appears to be underutilized (de Vries,2004:1)

An aspect of this study was to elicit the market's perceptions of factoring as an alternative form of finance and identify the level to which factoring is understood by the identified stakeholder groups (SME owner/operators).

There are a number of variations to the theme of financing through factoring and it can be tailored to suit differing client needs (Berryman, 2000:23). This gives credence to its standing as a flexible tool (Carty, 1995:49), but also muddies the water with respect to the market fully understanding factoring. Traditionally there are three prominent categories of factoring:

- *Full-service recourse factoring* where the factoring company provides complete debtor administration in which they purchase the debts and undertake the collection process with their team of experienced specialist credit controllers; though they do not accept liability for any bad debts.
- *Invoice discounting (Non-disclosed factoring)* is a relationship where the debtors are unaware of the factoring arrangement. In essence the SME retains control of their debtor ledger but have the option to draw funds against debtors, and then pay a financial charge for this service.

- *Non-recourse factoring* in which the factoring company offer 100% protection against bad debts, hence, safeguarding businesses against loss of income. Fees tend to be significantly higher (Hattaway, 1999:36).

Like most other forms of financing factoring companies require security. It is common for factor financing to be secured by (1) a debenture that is first ranking over the debtor's assets and (2) personal guarantees of the shareholders (Berryman, 2000:23; Walters, 2000:15). However, the level of security underpinning a borrowing facility is viewed as being well below the expectations of banks.

Robinson (1993:30-32) suggests that factoring should not be considered as an advance of money by a financier in the traditional sense. He argues that factoring is not a lending facility in the true sense where funds are borrowed for a specific capital outlay or other short-to-medium term need and require repayment (with interest) over a prescribed term. Furthermore it cannot be considered as an equity-based approach as it does not require that SME owner/operators relinquish ownership or control of part of the existing company to the external fund provider (e.g. selling shares). Factoring in effect releases a firm's own cash which would otherwise be tied up in accounts receivable. Hence, it can be claimed that it does not directly compete with, but complements, other forms of business finance as the circumstance in which it could be used may be quite different. Never-the-less, commonalities between the various market offerings do exist.

Soufani (2001) contends that factoring is a financing option that supports the working capital of firms; while Summers and Wilson (2000:46) note that a factor's credit management is more efficient than that of smaller firms because they are able to invest in specialised personnel and procedures. Factoring's effectiveness is often a function of the stage of development and growth of the business, where the role of factoring is particularly evident in the early developmental stage of a business life cycle and that the respective roles of other forms of financing (e.g. overdraft, term loans) come into play at later stages of growth (Soufani, 2001:41; Perrin, 1998:23). There are high-profile areas where factoring has become a key tool and that the demography of the businesses that use factoring are broadening and deepening in the UK (Perrin, 1998). With 80% of the UK

corporate business transactions based on credit (Summers and Wilson, 2000:45) this potential market for factoring is not to be underestimated. Worldwide, in fact, factoring volume is estimated at US\$600 billion (McNabb, 2002). The significant variances in factoring costs both historically and between countries (e.g. Soufani, 2001:42; Robinson, 1993:31) may be limiting its overall acceptance and effectiveness. Spragins (1990:95) argues that in some cases the accumulative cost of US factoring fees could be five times as much as interest charges, but does concede that factors provide services banks don't. This argument may be rather extreme, but the cost of factoring is customarily comparable or higher than bank overdraft rates. In addition there are setup costs and the debtor ledger administration fee - a percentage which is based on variables such as average invoice number and size. A further drawback of most full factoring arrangements is that if debts are unpaid after 90 days the factor asks for its money back. Jarvis and Gillie (1998:32) contend that SMEs and their business advisors (predominantly accountants and bankers) perceive the cost of factoring as too high, thus, will traditionally not consider it as an option. Therefore, customarily the popularity of factoring tends to have a direct correlation with availability of overdraft facilities offered by banks. As overdraft finance terms toughen the use of factoring increases and vice versa (Miller, 1995:57).

Factoring companies contend that it is a facility that avails itself to large or small businesses, yet Summers and Wilson (2000) suggest that smaller firms are more likely to use factoring companies. They argue that factors may not specifically find smaller firms more attractive as factoring clients, but these firms are less attractive for other forms of finance such as bank loans. A common denominator is that factoring suits SMEs growing so fast that their banks can not keep pace (Goldman, 1979:209). In essence factoring can be viewed as a financing option that suits young undercapitalised businesses that have high profit margins so that they can absorb the factoring fees (Parks and Gallop, 1999:78). Robinson (1993) claims that the characteristics of businesses which suit factoring as a finance option are those that have: (1) sales on credit and not cash, (2) manufacturers or wholesalers with continuous trading with established customers, (3) no unusual selling terms or conditions, (4) no unusual purchasing terms and (5) businesses that demonstrate sound management and profitable trading. Cooper (1998:15) in contrast, outlines unsuitable businesses as: (1) those that sell on

consignment or with the right of return, (2) high technology companies, (3) certain types of service industries, (4) professional corporations, (5) companies like building contractors and (6) industries in which the gross profit percentage is very narrow and turnover is very slow.

Factoring is generally perceived as having had a history of a bad press, thus often being relegated to the financing option of last resort for SMEs. Many of the detractors (including accountants, business commentators, bankers, and business operators) have argued that factoring is, in fact, the desperate effort of certain firms to get cash injection into their failing businesses when other avenues have been exhausted (Berryman, 2000; Kennedy, 2000; Hattaway, 1999; Cooper, 1998; Jarvis and Gillie, 1998). During the 1980s factoring gained a 'cowboy' image internationally (Cooper, 1998) because many factors lacked professionalism or appropriate financial structures. As a consequence, SME owner/operators felt that employing a factor exposed them to unfavourable reactions from their customers (Jarvis and Gillie, 1998). They perceived that the message factoring sent (as a last ditch financing option) and the manner in which some accounts receivable were handled were detrimental to their customer relationships.

Viewing factoring pragmatically from a cash management perspective, factoring can increase SME liquidity - especially in the early years of business operation (Robinson, 1993). The business can expand as sales grow because of the release of the debtor funds that factoring allows. Factoring is arguably the only form of working capital designed to grow with the business needs (Kennedy, 2000:12). Borrowing is against a SMEs growing turnover rather than against bricks and mortar assets which stay very static in value (Berryman, 2000). McNabb (2002) would suggest that one of biggest benefits is the ability to pay creditors immediately, which can earn considerable discount for early settlement. From a debtor management perspective, there is evidence linking weak credit control with poor collection (de Vries, 2003) and poor businesses performance (e.g. Jarvis and Gillie, 1998). Customarily SME owner/operators do not consider debt collecting to be a part of their core business (Hattaway, 1999) and hence do not give it due attention. With late payment being cited as a major contributor to the high SME failure rates (Howie, 2003; Kennedy, 2002; Mian and Smith, 1992); their inability to

manage debtors is problematic. Benefits therefore exist in contracting this task to factoring companies with professional credit management systems.

In developing countries factoring offers several advantages over other types of lending. First, factoring may be particularly useful in countries with weak secured lending laws, inefficient bankruptcy systems, and imperfect records of upholding seniority claims, because factored receivables are not part of the estate of a bankrupt SME. Second, in a factoring relationship the credit is primarily based on quality of the underlying accounts not the quality of the borrower. Thus factoring may be especially attractive to high-risk SMEs (Berger et al., 2004:2). Factoring can mitigate the problem of borrowers' informational opacity in business environments with weak information infrastructures if factors can develop proprietary databases on account payment performance and if the underlying accounts are the obligations of relatively transparent firms. The latter condition holds when a borrowing SME has receivables from larger enterprises or has foreign receivables from firms in countries with a stronger information infrastructure. In some countries, such as the United States, factoring's importance as a primary source of working capital is concentrated in certain industries. But in other countries, such as Italy, factoring's importance as a primary source of working capital is far more widespread. Both domestic and international factoring are becoming major sources of financing firms in developing economies.

In some developed economies such as the US, the importance of factoring as a primary source of working capital finance tends to be concentrated in selected industries. In other developed economies such as Italy, however, its importance as a primary source of working capital appears to be much more widespread. As shown in Table 4.1, both domestic and international factoring is beginning to emerge as a major source of financing (Bakker, Marie-Renee, Klapper and Udell, 2004:2-3).

About 1 000 companies currently offer factoring services throughout the world, 435 of which were situated in Europe in 2001. Europe counts for 66 % of the world's factoring market. Between 1996 and 2001 the factoring turnover had risen in Europe, reaching € 474 billions purchased debt in 2001 (an increase of 15 % compared to 2000). This kind of

development can be observed in all Member States with the exception of Sweden and France, where a decrease of about 35 % and 76 %, respectively, was achieved between 1996 and 2001. The highest increases of factoring turnover can be seen in Spain (+300 %) and Greece (+547 %) (Factors Chain International, 2002). In Spain, factoring was, at least indirectly, promoted by legal changes. About 11 % of SMEs in Europe use factoring, but considerable differences can be observed between countries. Whereas SMEs in France, for example, are using factoring (32 % of them take advantage of it), it is hardly ever used in Sweden (3 %) (Grant Thornton, European Business Survey, 2001) Factoring is specifically targeted at and suitable for smaller enterprises. On average, 50 % of the total number of European factoring company clients have an annual turnover of less than € 2 million, 81 % of less than € 5 million and 91 % of less than € 15 million (Greater London Enterprise Ltd, 2003). As factoring is a relatively new financing instrument, up to now the penetration rate of 11 % is rather low, the situation is even worse in some developing countries where the business environment is poor.

Table 4.1: Domestic and International factoring

Companies	Domestic	International	Total	5 Yr Growth Rate
Argentina	65	5	70	-95%
Australia	13,716	6	60	169%
Austria	2,598	334	2,932	46%
Baltics	2,012	250	2,262	381%
Belgium	9,500	2,000	11,500	51%
Brazil	12,000	40	12,040	-29%
Canada	2,131	1,030	3,161	62%
Chile	3,300	200	3,500	35%
Costa Rica -	180	5	185%	-18%
Cuba -	30	63	93	50%
Czech Rep	1,600	280 1	,880	141%

Denmark	3,570	2,000	5,570	66%
El Salvador	100	2	102.	.
Finland	8,545	265	8,810	56%
France	68,200	5000	73200	38%
Germany	27,131	7,951	35,082	76%
Greece	3,500	180	3,680	333%
Hong Kong	2,000	1,250	3,250	81%
Hungary	1,080	62	1,142	693%
India	1,500	115	1,615	528%
Indonesia.	1	0	1	97%
Ireland	8,800	50	8,850	44%
Israel.-	20	170	190	13%
Italy	124,510	132	510	51%
Japan	60,000	550	60,550	.
Lebanon	35.	0	35	.
Malaysia	690	28	718	-11%
Mexico	4,435	100	4,535	28%
Morocco	130	30	160	181%
Netherlands	16,000	1,500	17,500	-15%
New Zealand	250	13	263	43%
Norway	6,800	825	7,625	79%
Oman -	10	0	10	52%
Panama	160	0	160	1355%
Poland	2,450	130	2,580	326%

Portugal	11,828	353	12,181	64%
Romania	90	135	225	508%
Russia	470	15	485	.
Saudi Arabia	50	0	50.	.
Singapore	2,060	375	2,435	24%
Slovakia	296	88	384	140%
Slovenia	140	30	170	386%
South Africa,	5350	120	5,470	2%
South Korea	0	38	38	-100%
Spain	36,443	1,043	37,486	199%
Sri Lanka	94	8	102	65%
Sweden	9,650	1,300	10,950	45%
Switzerland	1,298	216	1,514	16%
Taiwan	11,700	4,300	16,000	666%
Thailand	1,400	25	1,425	41%
Tunisia	160	210	210	188%
Turkey	4,200	1,130	5,330	2%
U.S.A.	77,496	3,200	80,696	-8%
UAE	36	1	37.	.
UK	158,270	2,500	160,770	56%

Source: Factor Chain International, <http://www.factors-chain.com>

The global pattern of factoring suggests that it may have an advantage compared to other types of lending, such as loans collateralized by fixed assets, under certain conditions. Factoring appears to be a powerful tool in providing financing to high-risk informationally opaque borrowers. Its key virtue is that underwriting in factoring is based

on the risk of the accounts receivable themselves rather than the risk of the borrower (Worthy, 2003:8).

Factoring may also be particularly important in financial systems with weak commercial laws and enforcement and inefficient bankruptcy systems. Like traditional forms of commercial lending, factoring provides small and medium enterprises (SMEs) with working capital financing. However, unlike traditional forms of working capital financing, factoring involves the outright purchase of the accounts receivable by the factor, rather than the collateralization of a loan. The virtue of factoring in a weak business environment is that the factored receivables are removed from the bankruptcy estate of the borrower and become the property of the factor (Observatory of European SMEs, 2003:32-33).

In addition to the financing component, factors typically provide two other complementary services to their clients: credit services and collection services. The credit services involve assessing the creditworthiness of the borrower's customers whose accounts the factor will purchase. Factors typically base this assessment on a combination of their own proprietary data and publicly available data on account payment performance. The collection services involve the activities associated with collecting delinquent accounts and minimizing the losses associated with these accounts. This includes notifying a buyer that an account is delinquent (i.e., past due) and pursuing collection through the judicial system (UNCTAD 2001; CEC, 2001; Grant Thornton Business Survey final Report, 2003:5)

Essentially, SMEs that utilize a factor are, in effect, outsourcing their credit and collection functions to their factor. This represents another important distinction between factors and traditional commercial lenders. A factor may enjoy a number of important advantages in offering credit and collection services along with its funding services. First, it may enjoy significant economies of scale in both of these activities relative to its clients. Because the factor is handling these services for a large number of different clients it can amortize the fixed costs associated with these activities. Also, most small SMEs likely have very little expertise in either of these two areas. Most entrepreneurs

likely have backgrounds on the product side of their businesses and not the finance side. Finally, factors generate their own proprietary databases on account payment performance. The largest factors essentially become the equivalent of large credit information exchanges essentially offering an alternative source of information to private commercial credit bureaus and public credit registries. They would also enjoy the same economies of scale in information exchange that the credit bureaus and public credit registries do (Observatory of European SMEs, 2003:34).

The difference between bank lending and factoring is that, instead of the firm providing security in the form of a charge over book debts, it assigns those debts to the factor. Thus, unlike banks, factors are not concerned with taking security additional to the book debts (Kallberg and Udell, 2003b). Thus, of the several categories of asset-based loans, the most frequently used in Europe and the United States of America (USA) is factoring.

Despite impressive developments in the factoring market in the USA and in Europe, little academic work has actually been undertaken to establish the role of the factoring industry in small business development and the profile of businesses constituting its client base. This is true for Europe, as it is elsewhere (Grant Thornton Business Survey Final Report, 2003:5). Similarly, national and international industry statistics and data for factoring are also relatively scarce, with only one reasonably comprehensive source, certainly for European countries, being the world factoring year book.

While factoring data is relatively scarce, factoring is a growing source of business finance. For example, factoring and invoice discounting is estimated to contribute around 6% in additional finance to UK SMEs, compared with 6.5% provided through venture capital (British Chamber of Commerce, 1994; Cambridge Small Business Research Centre, 1995; Bank of England 1997, 1998, 1999 in Great London enterprise Ltd, 2003:6).

The availability of funds through factoring in Europe is higher to smaller growing businesses than traditional sources because factors consider the sales invoice as a secure asset, whereas banks typically look for fixed assets as security (Observatory of

European SMEs, 2003:33). In SMEs financing, factoring has five main advantages according to this report:

- Clients know and can plan for the actual value of charges made by factors, whereas bank charges can be variable.
- Factors are able to process and pay against invoices more quickly than the time taken to renegotiate any overdraft extension.
- The use of professional credit management services of the factors often results in an improvement in the adherence of payment terms to the client-i.e. invoices are paid more promptly, thus reducing interest charges.
- The cost of hiring a qualified credit controller is mitigated through using a factor.
- There is a possibility of qualifying for a supplier discount for prompt payment following the factoring of the invoice.

The importance, volume and structure of factoring however differ markedly between countries. For instance in Greece, the first factoring company was established only in 1995, and in Kenya there is no documented evidence on the use of factoring as a source of finance by SMEs. Hence some investigation may be required to establish how it is used as one of the alternative sources of SME financing.

4.3 Trade credit.

Trade credit arises when a supplier allows a customer to delay the payment of goods already delivered. Trade credit encompasses four types of situations: (a) supplier credit [goods received from suppliers on the understanding that payment is to be made later]; (b) customer credit [goods delivered to clients on the understanding that payment is to be made later]; (c) advances to suppliers [pre-payment to suppliers for goods and services to be received later]; and (d) advances from customers [pre-payment received from clients for goods and services to be supplied later] (Srivastava and Biggs, 1996:12).

Trade credit is a form of short term financing that is linked to the purchase of goods. It is an important alternative source of finance for business enterprises (Wolken and Elliehausen, 1993:2). Trade credit is particularly an important source of short-term external finance (Rajan and Petersen, 1996:1; Observatory of European SMEs, 2003:29; Maroto, 2002). It is a spontaneous source of financing as it arises from ordinary business transactions (Brigham and Houston, 2004:578). Hence, it is widely used and represents an important proportion of firms' finance.

Trade credit tends to be higher in small, young and high growth firms that experience higher difficulties in accessing other forms of finance (Berger and Udell, 1998; Nielsen, 1999). The trade credit channel provides access to capital for firms that are unable to raise it through traditional channels. The existence of imperfections on the credit market means that firms have access to different sources of external funding relative to their size (Repullo and Suarez, 2000). Capital market imperfections mean that access is denied to the capital market for firms with a weak financial position. According to Mateut, Bogheas and Mizen (2002:1) wealthier firms borrow on the capital market while intermediately wealthy firms get bank loans and lower wealth firms fail to obtain any funding for their projects.

Meltzer (1960:433) was the first to suggest that a trade credit channel might be a substitute for the bank lending channel, but from a theoretical point of view the implications of trade credit for the broad credit channel view have not yet been explored. Existing theoretical works are mostly concerned with explaining the use of trade credit. For example, Ferris (1981:261) and Schwartz (1974:646) have suggested that trade credit provides transactions services to firms, and Cunat (2001) demonstrates that, in the context of limited enforceability of debts, firms may use both trade credit and bank credit when the supplier and the buyer engage in specific production processes. Other researchers have explained why trade credit is extended at all. Jain (1994:63) argues that non financial firms extend credit to their customers as intermediaries between banks and the ultimate buyers. This supports the conjecture of Bias and Gollier (1997:923) that the seller's provision of trade credit can provide a valuable signal to the banker that the buyer is worthy of credit, thus mitigating credit rationing. However, these researchers do not

explain what the consequences might be for enterprise finance and monetary policy making if firms take up trade credit when other funds are inaccessible and this puts them at odds with the small empirical literature that attempts to address this question (cf Nielsen, 2002).

Nevertheless, in some countries and sectors, trade credit is more common than bank financing. This is the case with the European SMEs (observatory for European SMEs, 2003:30; Kvinge, 1997:14). SMEs use trade credits more often than large enterprises (Kvinge, 1997:14). This is due to the fact that SMEs experience more barriers to finance than large companies (Reitan, 2001:16). However, trade credit can be a costly form of financing for the customer. The supplier charges financing costs and a risk premium.

Trade credit is a distinct lending approach. Researchers have suggested comparative advantages in funding using trade credit over other forms of lending in developing economies (Schwartz, 1974:654; Cook, 1999). Some have suggested trade creditors may have an informational advantage over other lenders in evaluating their customers' ability to pay (Emery 1984:279), solving incentive problems more effectively (Biais and Gollier, 1997), in repossessing and reselling goods in the event of default (Mian and Smith, 1992:187, Petersen and Rajan, 1997:674) or in withholding future supplies (Petersen and Rajan, 1997:677). Finally, it has been argued that if product sellers (i.e., trade vendors) have an informational advantage over other lenders (e.g., banks) and have an automatic collateral priority under local commercial law, then a greater amount of trade credit will be used by less creditworthy companies than higher creditworthy companies (Frank and Maksimovic, 2003:13).

In conclusion, several explanations have been offered for the use of trade credit. The older and more standard view is that trade credit arises from financial market imperfections; this is the financial advantage theory for trade credit. Firms with easier access to capital markets pass trade credit to firms with no access to credit or which would be able to obtain credit only on extremely unfavourable terms (Rajan and Petersen, 1988:663; Nilsen, 1999). The firm granting credit acts as a financial intermediary, intervening in the market.

Other motives for trade credit have been proposed that include transaction costs theory. Imagine a world with perfect capital markets, with costless enforcement of contracts, and in which the only costs to firms are those arising from uncertainty in the matching of the time pattern of payment for goods with the time pattern of receipt of goods. In this world, as shown by Ferris (1981:257), there may be seasonality in consumption patterns for a firm's products. In order to maintain smooth production cycles, the firm may have to build up large inventories. This will have two costs: the cost of warehousing the inventory and the cost of financing it. Thus, by offering trade credit to customers and over time, the firm may be able to manage its inventory position better. The firm can therefore, reduce warehousing costs, especially if customers have a better ability to carry inventory. The transaction theory however, leads to very short trade-credit terms (Ferris, 1981:263). Furthermore, the theory fails to explain why firms do not use overdraft facilities instead.

Trade credit may also arise in response to a sales promotion wherein suppliers are willing to provide credit for a purchase in order to complete the sale. An implication of this argument is that trade credit terms will be related to the turnover in sales. For example, meat and dairy products have rapid turnover rates, so credit terms offered by wholesalers are short, typically a week to ten days. Jewelry, on the other hand has a slow rate of turnover, so credit terms offered to retailers may be as long as six months. A variant of the sales promotion theory for trade credit is that of Long et al. (1993:123) who argue that small firms have difficulty establishing a reputation for the high quality of their goods. There is more publicly available information about product quality for large firms than smaller ones. In order to compensate and establish a high-quality reputation, small firms will therefore offer trade credit. Neither the sales promotion motive nor the transaction motive, however, explains why producers and merchants of goods get involved in credit activities (Srivastava et al, 1994: 80-115).

From existing literature, it is evident that less work has been done on the use of trade credit in less developed countries. Nonetheless, studies in Kenya have found that trade credit constitutes one of the sources of SMEs financing (Soderbom et al., 2001:8-13).

Results from Soderbom's study using a survey methodology indicate that 48.2% of the respondents always or sometimes depend on supplier credit. However, the results also indicate that 58.2% of the respondents never use trade credit. Further research may be required to understand the reasons for the response.

4.4 Lease finance

Leasing is a technique of enterprise financing. It is used to acquire goods with a substantial second-hand value like cars, machines and real estate (Observatory of European SMEs, 2003: 31). It is defined as an agreement whereby the lessor conveys to the lessee, in return for payment, the right to use an asset for an agreed period of time. The lease contract may encompass various types of contracts. Regardless of the type of contract, the lessor has the legal title of ownership of the leased asset during the entire period of the lease. This makes lease exposure relatively low risk as compared with other financing modes and thus readily available as an external source of financing for SMEs (Mutesasira, Osinde and Mule 2001:14).

Within a given capital structure, leases are assumed to substitute for debt (Lewellen, Long and McConnell, 1976:789), and Miller and Upton (1976:773). Lewis and Schallheim (1991:9) drop the assumption of these early models, that leases and debt are substitutes, and frame the lease choice within the optimal capital structure choice. They conclude that leasing and borrowing can be complementary within the firm's optimal capital structure. Consistent with Lewis and Schallheim's predictions, Ang and Peterson (1984:1059) and Finucane (1988:327) find leasing to be positively related to the firm's debt ratio.

Other factors which may be important in the lease decision have been suggested in extant research. Ang and Peterson (1984:1059) find firm size and financial health to be important. Leasing is often viewed as an alternative for firms that undergo high costs of external financing or firms that are rationed (Sharpen and Nguyen, 1995:271-294, UNCTAD 2001:6). In leasing, the lessor is better protected than the banking creditor, thus, justifying the stronger incentive to finance risky firms using it (Krishnan and Moyer, 1994:38). For Krishnan and Moyer, financing by leasing involves bankruptcy

costs for the lessor lower than secured debt for the protected creditor. This is simply so, because in the event of firm default, the lessor can reclaim possession of the asset more easily and more quickly and with minimal legal costs. Furthermore, financing by leasing allows a reduction in the asset substitution risk as the legal ownership of the asset belongs to the lessor, allows conservation of working capital, ease of obtaining credit by firms, convenience, resolution of agency costs and prevents firms from investing in risky projects (Levis and Lasfer, 1998).

In developing countries, equipment leasing has received increasing attention as a possible strategy for allowing SMEs to access advanced equipment so as to be able to upgrade their operations (Carter, et al., 1996; Gallardo, 1997). An important advantage of equipment leasing is that the lessor relies more on the ability of the user to generate sufficient cash flows to make lease payments, rather than relying on other assets (Gallardo, 1997:1). Moreover, if it is the equipment supplier that extends the lease, he may be able to more effectively understand and monitor the lessee. Because a lease is more focused on the cash flow generated by the equipment, the lack of a credit history is less important than in the case of a loan. Also the equipment becomes a significant portion of the collateral.

Leasing allows a small firm to obtain the use of equipment, machinery or vehicles without owning them. The leasing company retains ownership, although in many cases there is a purchase option at the end of the purchase period (Stokes, 2003:425). Instead of borrowing money from suppliers to purchase equipment, small businesses can lease equipment, especially computers, photocopiers, fax machines, lathe machines, tailoring machines and welding machines.

It has been estimated that 80% of all firms in the United States of America lease some or all of their business equipment (Petty, Moore and Longenecker, 2003). Three reasons are commonly given for the increasing popularity of leasing: (i) the firm's cash remains free for other purposes, (ii) lines of credit can be used for other purposes, and (iii) leasing provides a hedge against equipment obsolescence. The authors above caution that while leasing is certainly an option to be considered for financing of needed

equipment, an SME should carefully compare the interest charged on a loan to the cost of a lease, the tax consequences of leasing versus borrowing, and the significance of the obsolescence factor so as to make a good choice. Also, the owner must be careful about contracting for so much equipment that it becomes difficult to meet installment or lease payments.

Leasing is often presented as a cheaper source of funds, especially for companies with low returns but considerable growth opportunities. It is found to be more prevalent in certain industries, in particular firms in transportation, services, wholesale and retail trade (Krishnan and Moyer, 1994:31-42) , in firms without assets that make good collateral, (Finucane, 1988: 329), in firms with high growth opportunities and those that are not regulated (Barclay and Smith, 1995: 899-900), in firms with high insider ownership (Tehran and Taggart, 1996: 9-15), and in small firms (Sharpe and Nguyen, 1995:284). Sharpe and Nguyen argue that small firms are likely to rely more on leasing than large firms.

Levis and Lasfer (1998) argue that the leasing decision is size dependent because of the differences in the financing opportunities available to small and large firms and in their potential agency costs. Given the several similarities between secured debt and finance leases, Stulz and Johnson (1985:510-21) suggest that leasing should be able to mitigate the problem of credit rationing faced by SMEs.

In a study on the determinants of the leasing decision by small and large firms, Levis and Lasfer (1998) find strong evidence suggesting that leasing is a substitute (alternative) for debt financing in small and medium enterprises and that for large firms, leasing is a complement to debt financing. Similarly, Harris and Marston (1988) in their analysis of the changes in leasing and changes in debt financing in a sample of firms, find these two variables to be inversely related, confirming leasing and debt finance are substitutes. However, they find that firms that employ lease financing typically use higher levels of debt compared to firms that do not use leases. In addition, Levis and Lasfer (1998) suggest that profitable firms with sophisticated financial management are likely to lease.

In contrast, small firms are less profitable and hence may find it difficult to use it as an alternative source of finance.

In conclusion, based on past empirical evidence, leasing is a financing mode that enables businesses to mitigate agency costs and it is useful where a firm is facing the problem of information asymmetry. It is a more cost-effective financing option as well as a desperation option for SMEs that are less profitable.

4.5 Venture capital

Venture capital can be defined in a number of different ways depending on the party offering the definition. It can be defined as the investment by professional investors of start-up and medium unquoted firms with a high potential for growth. On the other hand, venture capitalists are intermediaries between investors looking for high returns and entrepreneurs in need of capital (Mattson, 2001:13, <http://www.pecc.org>.accessed 2004.06.26).

Venture capital is external equity capital invested in enterprises with growth potential, often hi-tech and which are not quoted on a stock market. Venture capital generally consists of funds raised on the capital market by specialised venture capital operators. The equity investment is made for the launch, early development and expansion of a business and the main purpose is to raise the market value of the growing company (UNCTAD, 2001).

Wright and Robbie (1998) define venture capitalists by the specialist skills that they possess: 'Venture capitalists can essentially be viewed as seeking a return on their investments and distinctive skills in identifying, investing in and monitoring new and radically changing firms'.

From the different definitions above, the following are a few key characteristics of Venture capital:

- It is neither short-term finance nor long-term capital. Venture capitalists provide funds to finance firms in order to achieve medium-term gains. Therefore, venture

capital is not long-term capital. In essence, venture capitalists buy a stake in an idea, nurtures and grows it for a period of time and then exits at the right time in order to recycle funds.

- It contributes more than finance. Venture capitalists may add value to their investments by giving management technical assistance to support their business portfolio. Value added services might include financial and strategic planning, marketing strategies, recruitment of personnel, access to international markets and technology. However, contrary to popular perception, venture capital plays only a minor role in funding basic innovation (Zeider, 1998).
- Venture capitalists are highly selective. In a survey by Timmon and Bygrave (1986:13), one third of venture capitalists reported they fund 1% or less of the proposals received and 94% said they funded 3% or less due to inherent risks in each investment, illiquidity of the investment or lack of exit in the short-term. These factors combined make the venture capitalists discriminate in their eventual choice of investment.
- Venture capital is expensive. By providing equity capital to unproven business, venture investors are essentially sharing the risk of failure with the entrepreneur. For this reason, the venture capitalists need to finance specialist teams that are capable of giving their portfolio investments specific management and technical advice on how to run a business. Therefore venture capitalists demand a higher rate of return.
- Venture capitalists are often thought of as providing firms with expert advice (Barry et al, 1990: 33). Venture capitalists' expertise and network of contacts with potential suppliers and customers allow entrepreneurs to focus on what they are best at - technical development. Their industry knowledge is precious for developing strategies. They concentrate on start-up firms and use their knowledge of industries and markets to evaluate and mentor entrepreneurs.

4.5.1 SMEs need for venture capital

SMEs can finance growth with retained earnings and external debt, such as bank loans. However, for many rapidly growing enterprises, particularly in the high technology sectors, venture capital is the preferable alternative. Such enterprises lack tangible assets and cash flow. At the same time, they are attractive to investors because of their potential for high growth and profits. Venture capital also provides a solution for entrepreneurs seeking to start a business and for entrepreneurial managers who want to buy companies they already manage (UNCTAD 2001:8-9).

Financing of growth enterprises requires cooperation between the entrepreneur and the investor. This should be taken into account when planning funding strategies for a growing company. For example, in situations where markets are growing fast, rapid growth might be the only opportunity for a company to survive. In this situation entrepreneurs need back up, good connections and business knowledge in order to take the right decisions. This kind of expertise may only be obtained from a management team of a venture capital fund. Venture capitalists seek exit routes, including a public listing on the stock exchange. However, the need for clearly visible exit routes restricts the type of company in which the venture capitalist is interested (Stokes, 2003:134).

Compared to the United States, the lack of venture capital in the early stages of and enterprise life is still considerable in many European countries as is the case in the less developed countries. This lack is felt more in the less developed countries. Too few business ideas are developed to the stage where venture capital is no longer a problem. This equity gap is caused by a number of interrelated factors such as: lack of information among venture capital investors, a weak incentive structure for early stage investments, unwillingness to take risks, unfavourable tax provisions or lack of exit possibilities (UNIDO, 2001:2-5).

Private equity or venture capital is not well established in the small and medium-scale sector of the less developed countries. While such funds are active in Africa, they essentially cover large investments in sectors such as mining, infrastructure, tourism and

telecommunications. Potential returns on investments in small and medium-scale enterprises that require professional management and considerable support are not sufficient to fund this, and therefore virtually no such activity exists (UNIDO, 2001:1).

4.5.2 Venture capital in perspective

The experience with venture capital finance in developing countries is more limited than in industrial countries. Nevertheless, there are more than 250 venture capital funds operating in Eastern Europe and Asia and as many as 400 operating in developing countries worldwide. The relatively short history of most venture capital investments in developing countries and the inherent lack of documentation of private financing arrangements mean that there is little published analysis on the scope of venture capital operations in developing countries (Aylward, 2000:1).

The possibility of setting up a venture capital institution for SMEs in Kenya to enable them obtain more equity capital has not been undertaken to date, even after Sessional paper No.2 (1992), that first addressed the SME sector issues. Different Governments have directly operated venture capital funds, although a few have been successful. The difficulties for governments are manifold. In terms of personnel, government bureaucrats are unlikely to make good venture capitalists. For example, in the Republic of Korea and Japan, the earliest venture capital firms were staffed by government bureaucrats, and by most accounts, they never were even self-supporting (Kenney, et al., 2002, Industry Canada, 2002:35). Thus from this market perspective, venture capital firms have experienced little success, and in many cases, have lost significant sums.

In 1974, the Korean government established the first venture capital firm in the country to be an intermediary financial institution, assisting in the transfer of research results from government-supported research institutes to technically competent SMEs. In 1981, with the assistance of the International Bank for Reconstruction and Development (IBRD) and various Korean private sector entities, The Republic of Korea created another organization, the Korea Technology Development Corporation to support industrial research and development projects. In 1984, still another type of Government venture capital organization was created. These venture capital firms were able to

receive government loans at concessionary rates and then loan to small firms at market interest rates making money on the spread (Kenney, et.al.2001:).

The Mexican government also made an effort to create a venture capital industry in 1992. The venture capitalist firm invested in environmental projects and in the Mexican Internet start-ups (Patino, 2002).

The Government of Israel has played an important role in encouraging the growth of venture capital (Autler, 2000). The Israel venture capital was started in the early 1990s, when the government funded an organization, Yozma, to encourage venture capital in Israel.

The question of the proper role of the government in supporting venture capital financially continues with some arguing the government should not become involved directly (Florida and Smith, 1993). Murray (1994:64) argues that, should governments wish to subsidize a venture capital industry, it will be wise to target seed-stage investments. Using an economic model, Murray (1994) shows that early stage investors experience the highest risks; hence this approach addresses the funding gap, which is most severe at the early stage. Therefore he recommends that government policy target the seed stage, and do this by supplying capital to small private capital funds.

4.6 Business Angels

Business angels are individuals or small groups of professional or business people with an active interest in investing in and assisting new ventures. Business Angels are individuals with the means and desire to invest directly in small companies. They are persons who invest capital in, and bring entrepreneurial know-how and experience to enterprises with growth potential. Business angels are often former company heads or managers, who tend to invest locally and in the business sectors with which they have experience (Expert Group on European Funding, 2000:43)

Angels are individuals investing their own funds, often assuming unsecured, highly illiquid risks. Sometimes they play an active role in the management or finances of the firm, and they generally gain an equity position in the firm in exchange for the investment. Angel investments are generally said to be long-term, often with no predetermined end or "exit." (Farrell, 2000). Most often, they focus on local companies. Business angels often provide guidance and contacts for the entrepreneur with such groups as banks, suppliers, industry associations and others. The credibility that a reputable angel can provide to a small struggling business often allows the SME to possess a competitive edge during the vulnerable start-up stage of development. Business angels will often look for high returns and an exit strategy for their investments. Similar to formal venture capital, they often tie investments with a well-developed business plan, exceptional management, a high growth business idea, and an exit strategy for the business angel's investment (Industry Canada, 2002:33).

Business Angels (BAs) play an important role in financing start-up companies in early stage development. They are a valuable underlying force in the development of businesses in the market economy in many industrial countries. These investors have had an increasingly important impact on the businesses they finance, providing investment capital and managerial support. In the US, the informal investor market has been identified as the most important source of risk capital (The Centre for Venture Economics, 1995).

Business angels base their investment decisions on the expectation of high rates-of-return. While some start-up companies remain with business angels throughout their entire life cycle, others eventually turn to venture capital (VC) financing to meet the rising costs associated with later stages of development. Studies show that in the US, business angels work in cooperation with the VC sector by seeking out and screening new projects, which encourages start-ups and increases deal flow for VC firms. In fact, studies have found that more than half of all VC-funded high technology projects in the US had business angel participation, and that this proportion was even higher among smaller and newer firms (Fenn, Liang and Prowse 1998:54).

The presence of a well-regarded and connected business angel in a previous financing deal may assure VC investors of the quality of the firm and deal. In addition to supplying capital, business angels provide business advice, contacts and access to an extensive, well-developed business network, which can assist the firm to make appropriate strategic decisions as it grows (Equinox Management Consultants, 2001).

All of these types of private (informal) investors are more readily found in the developed countries due to a business culture that rewards entrepreneurial activity and various governments. However, data on the informal market are still scarce and regionally focussed, which makes it difficult to assess the size of the informal venture capital market. It should be noted that business angel network has not yet been established especially in the less developed countries including Kenya and entrepreneurs often find it difficult to locate business angel investors (Industry Canada, 2002:33-34)

A Business Angel network can overcome the problem plaguing banks and venture capitalists in financing SMEs (Stokes, 2003:154). Mason and Harrison (1994) argue that business angels have enormous potential for closing SMEs equity gap. Mason and Harrison have shown that the informal venture capital sector (i.e. business angel finance) is well developed in the USA and claim for it the following advantages:

- Business Angels are willing to invest small sums of less than Ksh6 million that will meet the needs of start-up and existing small firms.
- The time spent in analyzing propositions is much shorter than the formal venture capital sector where the due diligence procedure can take many months.
- Business angels are less likely to seek quick exit routes and will be more patient than formal venture capital sector.
- Business angels will be satisfied with lower returns since there is no need to satisfy shareholders of a venture capital company.

In spite of the advantages of closing the SMEs equity gap, there remain, nevertheless, some disadvantages associated with business angels. These include lack of formal matching procedure established, as business angels are difficult to find. For example,

- There may be limited expertise that the business angel can provide to the SMEs operator. Hence value-added may be problematic and business angels will not be able to tap into extensive networks of contacts that are well established by venture capitalists.
- These matching problems include search costs for both suitable propositions for investments and suitable business angels that can match funding and preferences to the proposition. In addition, Business angels have their own preferences for different types of firms and investment (Deakins, 1999).

2.3.1 Business angel networks.

There are no directories of private investor angels, no public records of their investment transactions. The private investor angel market tends to be regional rather than local or national. Most angel networks originate from college campuses, business incubators, state economic development agencies, and other nonprofit entities. A large number of universities have established angel networks to match entrepreneurs with investors. Firms can join an angel network for a nominal fee. Firm provides its vital statistics: type of business, market potential, and amount of funding required. The angel network distributes this information, but keeps the company name anonymous. The firm's name is revealed if an investor is interested. (online:<http://sbir.gsfc.nasa.gov/SBIR/Financing.htm> accessed 7 August 2005).

Business angel networks are organizations that are set up primarily to facilitate the matching of angels and entrepreneurs. The reasons for the matching services are that the angel investment market is characterized by an information gap on both sides. The entrepreneurs are not finding angels that would be interested in them, and the angels are not able to find enterprises that would fulfil their criteria. Business angel networks that

make the matching process more efficient can alleviate these problems (European Commission, 2000).

Although business angels often invest individually, other forms of investing are possible, including investing as a group. This group can be an informal syndicate or a formalized company. Individual angels can also invest through a company for taxation or other reasons (Industry Canada, 2002:30-35, European Commission, 2000).

2.3.2 Business angel financing

The Business Angels form the informal venture capital market. The market is not at all a new phenomenon of funding for start-up and early stage companies. There is always a finance gap between very early stage financing; where VCs and banks do not invest. In this gap Angel investors fulfill an important role in financing businesses, particularly SMEs. Since angels generally prefer to remain anonymous, however, their investment strategies and impact on SMEs' development are not well documented (Farrell, 2000:43). From a public policy perspective, determining the potential population of informal investors and their potential investment capacity is essential to determining policy recommendations to stimulate informal investment.

In 2002, Industry Canada held a research workshop involving academics from across Canada, the US and the UK to discuss the various measurement challenges involved in sampling informal investors. Researchers agreed that a random household survey would capture an accurate estimate of current and potential angel investments; they also recognized the importance of friends and family as a significant source of informal financing.

4.7 Private Investors

The first type of private investment for an enterprise comes from friends and family and is often referred to as "love money". The decision to invest does not usually consider the technology or business idea itself, but the investor's prior relationship with the entrepreneur. It must be assumed that in order to provide funding, the type I investor

must first have sufficient financial means to do so. Also, the primary reasons for investing usually do not include such considerations as tax incentives. In many cases the investor simply wants the entrepreneur to succeed while the possibility of high returns is a secondary concern (Industry Canada 2002:32).

There are two key differences between type I and type II private investors. First, type II investors do not usually have close personal relationships with the entrepreneur. The entrepreneur is usually introduced to these individuals or through business transactions and networking, or the private investor may have an interest in the SMEs industry. Second, type II investors are more stringent in their investigation of the opportunity and will have much higher expectations of returns. In most cases formal documentation and periodic reporting will be required. Type II private investors are also often confused with angel investors. While there are indeed some similarities - to invest in small businesses; however, they are targeted by entrepreneurs due to their financial capabilities and/or credibility in the industry. In addition, angels have differentiated themselves further from type II investors through their increased usage of information technology. With the use of online screening and matching services found in most angel networks, angels are now functioning more like venture capital firms. They now have a larger pool of opportunities to select from and have formalized much of the selection process by requiring entrepreneurs to submit online applications and business plans.

4.8 Corporate investors

Corporate investors include large existing businesses with proven track records. Corporate investors will often finance a successful partner, customer or supplier if the risk-return ratios match corporate policies. For more risky ventures, such as start-ups, many corporations have developed incubation facilities. New innovations within the company, often called intrapreneurship, are often spun-off into new businesses through such programmes (Industry Canada, 2002).

4.9 Institutional investors

Institutional investors, such as mutual and pension funds, primarily invest in SMEs by providing funds to venture capital firms. Start-ups and seed companies will rarely receive funds directly from the institutional investor; however some have set up large funds with the purpose of investing in small business. In most cases these funds are set up similar to venture capital firms (Industry Canada, 2000).

4.10 The public

The public is the largest potential pool of capital for small business. Due to securities exchange regulations, the public most often can only invest in publicly traded companies registered with the Securities Exchange. The investment is realized during the public offering. However, the public also indirectly invests in SMEs through mutual and pension funds. For example, in the US, there are exemptions to the Securities Act that allow small companies to solicit equity investments from the public without fully registering with the stock exchange. There are restrictions on the amount of the total investment and in some cases the type of investor that is eligible (Industry Canada, 2000).

4.11 Loan Guarantee schemes

It has long been perceived that smaller firms face disproportionately greater difficulty obtaining loans than larger firms. While the theoretical literature does not explicitly identify size of firm as a rationing criterion, numerous empirical studies have identified size of firm as one determinant of access to, and terms of, bank credit. It is argued that loans that support the expansion of small enterprises may convey significant benefits to the borrowing firms and, through job creation and retention, to the rest of society (Hedrick and Nicol, 2002:5).

The reasons for SMEs credit inaccessibility are diverse and are outlined in a report on Guarantees and Mutual Guarantees (2005:8-9) as:

- the risk associated with the high dependence on one single person (or a small team);
- low level of capitalisation from manager-founders own funds;
- lack of clarity of ownership of assets between assets privately owned and those owned by the business;
- insufficient collateral to offer to lenders;
- incomplete or unclear financial statements information;
- insufficient management capacity to clearly communicate the aims and objectives of the business;
- business plans often based on opportunities or owner preferences rather than on the basis of strategic planning.
- reluctance of the manager-founder to share control with an external partner;
- insufficient management capacity to prepare information for and consider proposals from potential investors;
- relatively high and fixed due diligence costs, making relatively small investments uneconomic;
- limited exit options for the investor, especially if there is a difference of opinion between the investor and the manager-founder regarding exit.
- banks may be more comfortable or consider it more lucrative dealing with larger business customers.
- limited chance of recovery of assets for lenders in case of insolvency and little confidence in personal guarantees;
- reluctance among bankers to invest medium to long term in SMEs due to: Lack of a sufficient track record or credit history and/or experience;
- weakness or even the absence of collateral offered by the SME.

While banks have been and indeed continue to be the principal source of external capital for small and medium-sized enterprises, guarantee schemes have a complementary role to play by making available guarantees to compensate for SMEs' insufficient collateral. Consequently, governments and trade associations have often intervened in the credit markets by taking on the role of guarantor of loans that financial institutions advance to SMEs.

The introduction of a guarantor can reduce the above mentioned difficulties. Companies providing guarantees play two roles: one vis-à-vis the SME and one vis-à-vis the financial counterparty ((Industry Canada, 2002).

Firstly, in relation to the SME, guarantee institutions:

- Facilitate access to the external financial resources without diminishing the financial responsibilities of the borrower. This access to finance can prove a catalyst for the launching and expansion of a business;
- Issue guarantees on the basis of a sound and comprehensive analysis of quantitative and qualitative risks(experience, training, competence);
- Enrich the analysis of the risks with the knowledge obtained from their close proximity to the SMEs such as information about local competition, foreseeable developments in technology or marketing. As a consequence, entrepreneurship is stimulated and in this way guarantee schemes contribute to job creation, a suitable financial structure and attractive credit conditions;
- Provide support to the company by giving advice and supervision in terms of financial management.

Secondly, in their relationship with the financial counterparty, guarantee institutions:

- Build an individualised financial file on each company, applying simplified and standardised procedures;
- Externalise the risk of counterparty from the financial responsibility perimeter of the bank, against a generally very moderate premium;
- Frequently supplement the financial and quantitative analysis of the bankers with a more qualitative approach;
- Endeavour, within the limits of the safety provisions, to alleviate the regulatory banking capital to carry the risk of their SME credit portfolios.

Thus, credit guarantee schemes provide an alternative form of collateral and finance for SMEs development (Doran and Levitsky, 1997:9). Advocates advance the following arguments in favour of public sector investment or donor involvement in developing and

operating credit guarantees: guarantees may overcome collateral constraints, offset the risk of lending to SMEs and micro-borrowers, address information constraints, compensate for low profit margins, modify intrinsic characteristics of small business, induce learning, and produce additionality. Each of these arguments is summarized below.

4.11.1 Overcoming Collateral Constraints

Proponents of guarantee funds argue that lenders have difficulty in originating and collecting loans due to a lack of collateral, and that guarantees in effect become a “substitute collateral.” This substitute collateral is viewed as being superior to physical collateral that SMEs and micro borrowers cannot offer or offer in sufficient quantities to secure a loan. The guarantee offered by a third party should be liquid. Should the loan default, the guarantee is easily and quickly called by the lender under the terms of a legal contract that specifies how the lender can recover his money. The third party guarantee is not subject to the problems presented by physical collateral, such as its maintenance in good condition, verification of its value and safekeeping (Doran and Levitsky, 1997:11).

Proponents argue that guarantees compensate for:

- Inadequate registries for collateral and the high costs for registering collateral ;
- Absence of secure land titles ;
- Slow, costly and corrupt legal systems that impede the realization of collateral by a lender;
- Destruction or deterioration of the collateral whether accidental or intentional and borrowers’ disposal or hiding of collateral; and
- Social and political pressure to not vigorously collect loans.

Furthermore, the guarantee fund is a financial entity that publishes its audited financial data, making it easy for a lender to determine the guarantor’s solvency, liquidity, and claims paying capacity. Thus, from most points of view, a third party guarantee by a solvent and liquid guarantor is superior to physical collateral and should enable a lender to make a loan with the confidence that the loan will be recovered in case of default.

4.11.1.1 Off-setting Risks of Lending to SMEs and Micro Borrowers

Lenders are said to have a perception that SMEs and micro-borrowers are inherently higher risk clients. Bankers point to the high failure rates of small businesses, which are almost by definition more vulnerable to market and economic changes. In addition, the small and micro enterprise operators are relatively inexperienced and seldom have the resources to survive a sustained economic downturn. Guarantees can share these risks with banks and thus reduce lender's perception of risk and their exposure to loss in case of default (Stiglitz, and Weiss, 1981:397- 400).

4.11.1.2 Addressing Information Constraints

Credit-rationed groups are unable to obtain loans because of lenders' lack of information and because of the high cost of collecting such information by lenders. Lenders without adequate information have difficulty in assessing the riskiness and profitability of the loans. Guarantees, particularly those issued by grass roots level organizations, can work closely with the target group of prospective borrowers and develop a sufficient amount of information about them, which enable banks to lend (Freedman, 2004:6).

4.11.1.3 Compensating for Low Profit Margins

Lenders are reluctant to deal with credit constrained groups due to reduced profit margins. Most banks are not prepared to cope with a large volume of small loans and generally lack the ability to evaluate applications of many small borrowers whose financial characteristics do not fit easily into the credit evaluation and scoring techniques that they use for larger borrowers. Few lenders are prepared to make the investment in loan technology to gear up for a SME and micro lending programme and fewer still are prepared in loan technology and additional staff required to process many small loan applications. As a result, these additional costs make loans to SMEs and micro borrowers less profitable and less attractive to lenders. Guarantors can address this difficulty by providing data for the loan work up, and presenting these data to banks in the format that they are accustomed to, reducing the bank's administrative costs of loan work ups.

4.11.1.4 Modifying Intrinsic Characteristics of Small Businesses

Credit guarantees can compensate for some of the inherent difficulties faced by small borrowers, proponents argue. Small businesses are often characterized by erratic and seasonal cash flow. They may be subject to sudden and unpredictable price swings of the products they use or produce. Farmers are a classical case of this market price and cash flow risk. Furthermore, as many small businesses are operated by a sole owner or are family businesses, the accounting system is elementary or even absent. Small businesses in many countries have little incentive to develop accounting systems as this would risk being taxed, a risk that is largely avoided in the informal sector. Without a guarantee, banks would be reluctant to lend where accounts are not kept or are dubious; with a guarantee these issues do not influence the credit allocation decisions. As we will see in a later section, some guarantee agencies also perform an advisory role for their clients, helping them manage their businesses to overcome these difficulties that precluded their access to credit.

4.11.1.5 Financial additionality

Guarantee schemes aim to achieve financial and, ultimately, economic additionality. Financial additionality primarily refers to an increase in commercial bank loans to small enterprises that previously did not have access to credit as a result of lacking or inadequate collateral. However, by reducing the risk to banks and assisting firms to establish a repayment reputation, guarantee schemes also achieve financial additionality in terms of an enlargement of the loan size, a longer repayment period, a decrease in the interest rate or in the collateral demanded as well as an increase in the amount of borrowers who graduated to non-guaranteed borrowing. More rapid loan processing is also considered as additionality if it is due to improved lending techniques adopted as a result of banks' experience with guaranteed borrowers (UNIDO, 2003; Freedman, 2004:7).

Beyond the goal of financial additionality, guarantee schemes ultimately aim at achieving economic additionality, i.e. improvements in income and quality of life of the borrowers' households, an increase in the amount of commercial and economic activity in terms of

employment, sales, and new products developed competitiveness, productivity and economic growth.

Another benefit from guarantee schemes which is associated with additionality, but may be more important and valuable in the long run, is the development of institutional capacity in the supply of small business credit. This can be through changes in behaviour of existing banks and non-bank lenders as well as by the encouragement of new entrants into the market (UNCTAD, 2002:23-270).

4.11.1.6 Inducing Learning

The linkage between learning, additionality and the take-up of guarantees may be complex. On the one hand, if additionality is very low, so that few loans are being made that would not have been made in the absence of the guarantee programme, there is unlikely to be much learning occurring. On the other hand, with even a moderate degree of additionality, the learning process can be widespread, and some of the new lending to the target groups which is occurring may not in fact be utilising the guarantee. Indeed it could be argued that the ideal guarantee scheme is one which assists a discovery process of gradually moving the risk frontier of the banks further and further away from a completely risk averse stance towards small business (Balkenhol, 1990).

In order to achieve additionality, guarantee schemes need to effect changes in the banking sector. Firstly, through a learning process, lenders must gradually shift their risk perception of small firms. Guarantees enable lenders to learn about the creditworthiness of borrowers without incurring the initial risk involved. First-time borrowers and those perceived as excessively risky are thus assisted to establish a repayment reputation, which can act as a substitute for collateral. With time, they will be able to “graduate” to non guaranteed loans. Secondly, guarantee schemes are intended to develop institutional capacity in small business lending. By gaining experience with small firm lending, banks are likely to develop ways to lower transaction costs and thus to make credit extension to small firms more profitable. Finally, guarantee schemes may introduce an element of competition into the banking sector if small banks participating in the scheme are able to strengthen their position by developing lending to small enterprises as a new profitable

market segment. Credit guarantee systems are thus intended to shift the banker's risk-reward frontier so that loans to smaller scale borrowers with no or lesser collateral requirements can be included as an additional item in the financing of profitable business (Boocock and Sharif, 1996:25).

The aim of a credit guarantee scheme is to reduce the net losses incurred by banks from defaulting small business borrowers, through the assumption of a share of this loss by the guarantee organisation, normally in return for a guarantee premium. The schemes do not in themselves reduce the total costs of loan appraisal and monitoring, and may indeed increase them, since there is now a third party involved in the transaction. If collateral can be dispensed with entirely, an important element of costs can be reduced, but few schemes work effectively in this manner. The bank may be able to pass on part, if not all, of its share of any increase in transaction costs to the borrower. The bank can also usually pass on at least part of the cost of the guarantee premium to the borrower, though the extent of this varies depending on competitive conditions in the small business lending market. Hence the existence of a credit guarantee scheme should increase the supply of credit to small firms, if the risks and/or costs of lenders decline (Boocock and Sharif, 1996:29).

The demand for credit by small firms should also increase in the presence of a guarantee scheme if the extra costs of credit (transactional and arising from the guarantee premium) are less important than the new availability of credit, for firms with less or no collateral to pledge and or wanting to borrow on longer terms.

A major criticism of credit guarantee schemes is that they increase the danger of 'moral hazard' and contribute to a weakening of credit morality. The will, motivation and commitment of the borrowers to repay the loan can be reduced when they know that a guarantee fund, considered, rightly or wrongly, to come from public sources, will reimburse the lending institution for a substantial part of the loss incurred. There is also a danger of a second level of "moral hazard" being introduced on the part of the lending bank who, it is feared, will not be motivated to supervise the loan properly nor to pursue vigorously the collection of the repayments when most of the loan is covered by a

guarantee. This criticism can be met largely by good design and sound management of schemes. For example, defaulting borrowers need to know that they will be vigorously pursued for available debt recovery even after the bank considers that it has recovered its anticipated share of the loss from the guarantee claim. Banks participating in the scheme need to bear sufficient risk to maintain underwriting and collection standards including obtaining some form of enforceable commitment from borrowers, and the guarantee authority should have an acceptable mechanism for rejecting unwarranted claims (Levitsky and Prasad, 1987).

Expectations of the positive contribution that guarantee schemes can make may easily be exaggerated. It is quite wrong to expect a guarantee scheme by itself to be a panacea for solving the whole problem of harnessing mainstream financial institutions to provide finance to SMEs. This problem is usually a large and complex one, requiring segmented solutions to match segmented market niches and issues. Even where the guarantee programme is targeted at the appropriate SME segment, if the guaranteed loans are used as a substitute for inadequate equity from the owner manager, for example, the high cost of the loans is likely to contribute to increasing, not lowering, the failure rate of small firms. More generally, imposing a guarantee scheme on a faulty financial system, unsound and inefficient financial institutions and a general culture that condones non-repayment of debts, may make matters worse rather than better (Gudger, 1996).

4.11.2 Need for new type of lending by financial institutions

The transformation of credit markets in LDCs will require tackling the aforementioned fundamental obstacles to the flow of credit, and, on a more micro level, it will also require that individual financial institutions within LDCs overcome high risk-perceptions and serve as financial pioneers in new markets. As legal and policy reforms are implemented banks will become more inclined to increase their lending to the private sector. However, banks often perceive new types of lending as inherently risky and are reluctant to devote the time and resources needed for new types of lending even if improvements have been made to the legal framework. Similar to many LDCs today, the United States at the turn of the 20th century had a large informal sector in which most

small businesses lacked access to affordable credit. As collateral laws were improved a new wave of lending to entrepreneurs and small businesses did not spontaneously emerge. Instead, one bank, Bank of America, slowly pioneered lending to the traditionally marginalized small business sector and figured out how to make such lending profitable (Freedman, 2004).

In Africa, guarantee schemes have had a poor record. Where they have been tried, the banks have generally not had confidence that the guarantee organisation, usually the central bank, would settle claims quickly and without dispute. Only in South Africa, and some years ago in Ghana, have there been some relatively successful guarantee schemes but in the latter case, only for a limited period (Leny van Oyen and Levisky, 1999:16). The current study seeks to know whether credit guarantee schemes are used as an alternative form of collateral and finance by SMEs in Kenya.

4.11.3 Mutual guarantee schemes

Mutual guarantee schemes are an alternative to credit guarantee schemes. These involve private groupings of enterprises, often linked to sector-specific interest groups, providing loan insurance to the banks. The principle is that, between the bank and the enterprise, a third party is involved. This third party is a fund or Mutual guarantee Society (MGS), funded by the enterprises' contributions and managed by the enterprises themselves. The fund gives financial (in principle 50 per cent) - as well as moral and technical guarantees to financial backers on behalf of the member enterprise looking for credit.

Based on the assessment of the MGS and the financial guarantee, the financial institution will then grant the credit to the enterprise. Mutual guarantee schemes are especially suitable for very small loans to small enterprises. Further, developing mutual guarantee schemes should help facilitate access to finance in a market-oriented way, especially for small enterprises[online]http://europa.eu.int/comm/enterprise/library/enterprise-europe/issue2/articles/en/enterprise05_en.htm accessed 30 Nov 2004]. Mutual guarantee schemes are successful in Austria, Belgium, France, Germany, Italy and Spain.

4.11.3.1 Group-based lending

Group-based lending, as the term indicates, requires individuals to organize themselves into groups in order to gain access to financial services from a programme. There are many programmes advancing loans through this mode. Sometimes, governments own and run these programs; in other cases international institutions, local and foreign NGOs are involved in reaching borrowers. Normally, group-based lending works as follows. Loans are made to individuals, but all members of the group are held responsible for the loan repayment (joint liability principle). In some programmes loans are given strictly for a certain period of time (usually a year), while in other programmes members are allowed to decide the loan terms themselves. Repayments are made on a weekly or monthly basis; this is done at group meetings or directly to the branches of the microfinance institution. Nowadays, worldwide many programmes use group-based lending to forward loans to small borrowers. Below are some examples.

a. Grameen bank

The Grameen Bank, which was first established in Bangladesh, is the pioneer in group-based lending. In this case, borrowers are grouped voluntarily into groups of five; they receive training on how the credit program works and start saving before they apply for a loan. Between six and eight of these groups come together to form a so-called village centre. A group of village centres in turn forms regional branch office. According to the Grameen Bank model, new groups of borrowers meet and save for a minimum of four weeks before any loans are issued. The group appoints a group leader, and the members determine the rotation of access to credit. Two members of the group get the first loans. If they repay on time, the next two get their loan, and finally the fifth person, who is usually the group leader, gets the loan. All group members are responsible for the evaluation of member applications, monitoring, and enforcement of repayment. The Grameen Bank does not require collateral from its clients. If any group member defaults on a loan, the other four members must cover the loan. If they do not do this, none of the other members will receive a loan until the non-performing loan is repaid. The amount of the first loans is generally small; usually less than \$ 100, repaid at weekly meetings, and has

to be fully repaid within a year. The bank follows stage credit programming and allows group members to be gradually promoted to higher loan amounts, provided they have a good repayment history. The clients are mainly women, and loans are usually used for micro manufacturing, services and retail trade-

<http://www.ub.rug.nl/eldoc/dis/eco/h.t.mehrteab/c2.pdf>

b. Solidarity group lending.

This is a Latin American version of the Grameen Bank. The pioneer of this model of lending is the banco Solidario (Bancosol) of urban Bolivia. Like the Grameen Bank, it lends to groups, but unlike Grameen it forwards loans to all group members at once. The solidarity groups can consist of four to ten members, who select each other. They cross-guarantee each other's loans, based on joint liability contracts. In order not to end up paying for their peers, members monitor each others' economic activities and enforce repayment if the need arises.

The bank issues uncollateralized loans, starting with small amounts of loans and frequent repayment. The repayment schedules are flexible, and borrowers are allowed to choose between weekly, fortnightly and monthly repayments. The duration is also flexible: from a one-month duration up to a year. Loan amounts and terms gradually increase once clients have demonstrated that they are capable of taking on larger loans (stage credit scheme). Access to future larger loans is made dependent on punctual and full repayment of small initial loans. Loans from Bancosol are usually made to provide working capital for small-scale activities, which includes retailing, services, and micro-entrepreneurship.

c. Village banks (VBs).

This model of microfinance originated in Latin America in the 1980s and over the years it has been adopted in African and Asian countries. As the name indicates, it is a village-based and community-managed credit and savings association established to provide access to financial services in rural areas. Most of the time, donors/ NGO's are active in setting up village financial institutions in partnership with local groups. VBs are initially financed through loans provided by a lending institution. Over time, member savings, share capital and accumulated interest rates are expected to increase so that external

funding is no longer necessary. The aim is to make each VB an administratively and financially autonomous institution. Normally, VBs consist of members ranging from 30 to 50 individuals and the members elect a management committee to run the bank. Individual members are required to save prior to requesting a loan and to continue saving during the loan cycle. Individual bank members negotiate their initial loan amount and terms with the committee of the bank. The initial amount is \$ 50 at most and increases gradually, depending on the performance of the member. Loan cycles usually last from 16 to 36 weeks, with equal instalments paid weekly, fortnightly, or monthly. Payments take place at regular meetings, where all members are witness to the transaction. The VB's committee enforces repayment by linking borrowers' access to future loans to their repayment performance. Usually, VBs do not demand collateral; however, all members are jointly responsible for repayment. In order to mitigate the probability of repaying for defaulting members, the committee has to screen potential borrowers thoroughly. They may use the existing village social networks to obtain the necessary information. They use local information and social ties, not only for screening but also for monitoring and enforcing loan repayments. VBs also make use of members' savings to extend loans. This may enhance the perception among members that they have a stake in the institution, which may contribute to peer monitoring, enforcement, and good repayment performance.

d. Credit cooperatives/credit unions.

Credit cooperatives as financial institutions originated in Germany in the nineteenth century. Cooperatives are operated democratically with each member having one vote. The two organs of a cooperative are the general assembly and the management committee. The committee is assigned by the general assembly and has to promote and oversee that banking operations run smoothly. Moreover, it implements internal regulations and policies established by the general assembly. Equity is contributed by members, and leadership is voluntary and unpaid, although professionals can be hired for everyday administration and management tasks. The equity contributions provide the institution with its capital and can be the basis upon which the amount member can borrow is determined. While credit cooperatives are typically initiated with capital contributions from their members, they may also mobilize deposits. Some credit

cooperatives also depend on external funds. Credit cooperatives rely on their management committees to analyze loan requests and to grant and recover loans. Credit committees make use of local knowledge and information in the process of accomplishing these tasks. Cooperatives provide relatively larger amounts and for longer periods of time, when compared to the microfinance approaches discussed above. Some credit cooperatives require collateral, others do not; instead they ask the borrower to bring another member as cosigner. If the borrower fails to repay, the cosigner is fully liable and has to repay on behalf of his colleague. Relying on self-financing enhances the perception³⁰ among members that they have a stake in the institution, which may thus contribute to peer monitoring and enforcement and good repayment performance (Huppi and Feder, 1990:196).

4.11.3.2 Individual-based lending

MFIs have also developed models that can provide financial services to individual borrowers. These institutions successfully combine mechanisms from the formal and informal lending sectors. They use different mechanisms, which help them reduce adverse selection and moral hazard problems, such as frequent and close contact with individual clients, to provide credit products tailor-made to specific needs.. Ledgerwood (1999) summarizes the mechanism used by the individual based lending micro-finance institutions as follows.

- Individual based lending institutions guarantee loans by demanding collateral, co-signing or using endorsement of village committees.
- These institutions screen potential borrowers using credit checks and character references.
- They provide small loans with flexible loan terms and loan sizes based on individual needs.
- They increase loan size progressively through time.
- They have intensive staff-client contact.
- Future access to credit is based on prompt and complete repayment of loans.

The two pioneering banks in individual based lending are the Bank Rakyat Indonesia (BRI) and the Bank Kredit Desa system of Indonesia (BKD).

▪ **Bank Rakyat Indonesia**

BRI forwards loans to clients against some form of collateral or with the help of a co-signer. The bank has a network of branches with a minimum number of employees (average of five employees per branch). Over time employees create personal relationships with the clients and credit officers are often recruited from the community so that they can base analyses on their knowledge of the client's creditworthiness (character-based lending). Detailed financial analysis and projections are often included in the loan application. The bank encourages its staff to maintain high collection rates and maximize profits by linking staff compensation to the volume of repayments collected and/or profitability.

▪ **Bank kredit Desa**

The other institution, BKD, also forwards loans to individuals. Yet, in contrast to BRI, individuals that acquire loans from BKD do not require collateral. Instead, BKD uses its own mechanism, which is to forward loans through village-level management commissions led by village heads. Indonesia has a well-defined administrative hierarchy running from the central government down to the village level, and BKD involves village level administration in the process of screening, monitoring, and the enforcement of loans. The loan applicant usually approaches a locally situated credit branch occupied by a local credit officer and applies for a loan. Depending on how well he knows the applicant the credit officer can provide direct credit to the applicant or he or she can consult the village commission for further approval. Hence, the applicant acquires a loan from the institution only if the officer in charge and/or local administration officials knows that the applicant is creditworthy. Thus, the bank uses local information when screening individual borrowers and enforcing repayments. Staff members have an incentive to do their job well because their compensation is based on loan repayment. The financial approaches discussed show the diversity of methods used in the provision of financial services to the poor and small firms in the developing world.

Group-based lending mitigates problems created by informational asymmetries such as adverse selection, moral hazard and enforcement. Thus, in group-lending programmes the functions of screening, monitoring and enforcing repayments is to a large extent transferred from the bank agent to group members.

This in turn reduces the problem of credit rationing and brings the safe borrowers back to the credit market. The processes of group formation group members are expected to screen each other. Theoretical and empirical studies show that people try to investigate each others behavioural integrity and creditworthiness with the help of existing social networks before they allow others to join their group. Through peer screening they try to prevent irresponsible and credit risky individuals from joining their group. Another advantage of group based lending is the mitigation of the moral hazard problem. This is an incentive rather than a selection problem. After members have received a loan they have to monitor each other to make sure that every member has invested the loan in a safe project, which will guarantee repayment. Members make use of their social ties to acquire the necessary information and create social sanctions and pressure on non-performing members. This is a costly activity for the members, as they have to spend time and energy monitoring each other. However, the creditor can now afford to lower the interest rate, which will offset to some extent the burden of these costs for the borrowers. Also, the microfinance institute is able to lower the interest rate as its monitoring costs have been shifted to members and the probability of repayment of its loans has increased.

The group-based lending contract also provides appropriate incentives to avoid the problem of costly borrower verification. This is sometimes called ex-post moral hazard. It occurs once actions or efforts have been undertaken and returns of the product activity have been realized. Yet, the lender cannot observe the yield from the project. The borrower might find it optimal to divert funds for repayment of the loan to other purposes and default. In group-based lending schemes group members live close to each other and they are well informed of each other's economic activities. Therefore, they face a lower cost of verifying each other's output as compared to a distant lender. Moreover, each member has the incentive to audit his partner.

Peer pressure is a mechanism group members can use in the process of mitigating moral hazard and enforcing punctual repayment. In order to secure future access, members are obliged to monitor each other. Once output is realized and a member proves unwilling to repay, other members can use peer pressure and social sanctions to make him repay. In most of cases, groups are formed from communities with many social connections and a lot of interdependence. Individual community members follow and respect shared social values and norms such as mutual assistance, managing communal properties, etc., and this social system constitutes a powerful device to reinforce repayment among group members. In such communities, if a borrower fails or refuses to repay his share, other community members may turn to social penalties such as warning and hassling, telling the rest of the community that he refuses to repay or complaining to community chieftains (i.e. traditional legal action). This could damage the bad borrower's reputation and it might isolate him socially. Thus, the ability of groups to harness social sanctions and make use of such sanctions in inducing members to repay their share can be an important mechanism to sustain groups and improve repayment performances of programs

The existing literature tries to explain the success of group-based lending. Economists have developed theoretical models that explain this success by showing that group-based lending mitigates the asymmetry of information problems of financial markets, such as adverse selection problems, moral hazard, and enforcement problems (Stiglitz, 1990; Besley and Coate, 1995:13; Ghatak, 1999:32). Firstly, groups are formed on the basis of a self-selection process of members. To this end group members screen the behavioural integrity and creditworthiness of each other before they form a group. Thus, screening by group members may help to mitigate the adverse selection problem of financial institutions. Secondly, once groups have been formed, members agree to monitor each other's economic activities. Through this monitoring process, they may be able to mitigate the moral hazard problem. Finally, once individual members' output has been realized, group members may enforce repayment against defaulting members for which they may use social sanctions and pressure mechanisms. Social ties and connections

among members play a role in facilitating the screening, monitoring and enforcement process.

Related literature has shown the positive contribution of joint-liability programs to reducing screening, monitoring and enforcement costs. Some models focus on group lending and its effects on monitoring and moral hazard behaviour of borrowers. Stiglitz (1990) and Varian (1990) present models in which peer monitoring within groups reduces moral hazard behaviour of individual group members. Group lending programs delegate costly monitoring activities to group members, reducing the costs of lending, which may be translated into lower interest rates the borrowers have to pay (Varian, 1990) and/or larger loan contracts (Stiglitz, 1990).

Banerjee *et al.* (1994) discuss the credit cooperatives that were common in the late nineteenth and early twentieth century in Western Europe. They show that these credit cooperatives created incentive structures similar to the group lending programs, leading to monitoring among borrowers, which helped to reduce moral hazard behavior. Other models elaborate on the Stiglitz-Varian models, dealing with extensions such as the efficient organization of monitoring within groups (Armendariz de Aghion, 1999) and the importance of repeated loan contracts in order to obtain the benefits from peer monitoring and to prevent free rider problems from occurring within groups (Che, 2001). Still other models relax the assumption of costless peer monitoring implicit in the Stiglitz-Varian models (Conning, 2000). Conning (1996) presents a model in which it is shown that group lending will only be used if group members have substantial monitoring and enforcement advantage as compared to outsiders, and if the project returns across borrowers are not highly correlated.

The model also discusses the effects of collusion among borrowers on group lending efficiency and provides a cost benefit analysis of group lending. Some research focus on the role of social ties between group members in reducing moral hazard behavior by individual members. The importance of social ties is explained in terms of the consequences of non-repayment of one member for her or his position within an existing social network, since non-repayment will have a negative impact on the other group

members' current wealth and future access to loans. Strong social ties may help the process of peer monitoring and peer pressure. It is believed that due to these ties members may have better information to monitor and may more easily pressure for repayment (Floro and Yotopoulos, 1991). Others, however, have indicated that social networks may be counterproductive. Since people know each other very well and have close social ties, they may be less eager to pressure for repayment (Wydick, 1999:469). For instance, family or friends may be less eager to use pressure for fear of losing family or friends, which in such cases is valued higher than losing money (Conning, 2000).

Finally, some research work stress the importance of using peer pressure to force repayment within groups and reduce moral hazard (Besley and Coate, 1995). A related argument holds that once sufficiently strong and credible threats of the use of social pressure exist, this may stimulate individuals not to pursue moral hazard behavior (Wydick, 1996). Wydick (2001:413-17) presents a model in which several of the abovementioned issues related to the working of group lending are combined. In this model, groups are created based on self-selection but (in contrast with other models) under imperfect information. Next, monitoring takes place, and members help those who have been confronted with adverse external shocks and exclude those who have misused the money they have received by using social sanctions. In the model of Wydick, borrowing groups are described as dynamic peer review committees.

Whereas the theoretical literature on monitoring and moral hazard within group lending programmes is quite extensive, there are only very few empirical studies of these phenomena. One possible explanation for this is that it is difficult to obtain reliable data on monitoring and moral hazard behaviour of participants in group lending programmes. The only substantial empirical study available is carried out by Wydick (1999), who uses information from group lending programs in Guatemala. Wydick analyses the role of peer monitoring, peer pressure and social ties within these groups in reducing moral hazard behavior of individual group members. His findings show that while peer monitoring and (to a lesser extent) peer pressure help to reduce moral hazard and increase the repayment performance of groups, social ties do not have such effects.

Thus, according to the theoretical literature the three problems related to asymmetry of information of formal financial institutions – i.e. adverse selection, moral hazard and enforcement problems – can be alleviated by group-based lending mechanisms.

4.11.3.3 Empirical research designs and methods on group-based lending

Most of the theoretical literature on group-based lending does not deal directly with repayment performance of programmes. Rather, theoretical models emphasize the role group members play in alleviating adverse selection, moral hazard and enforcement problems (Ghatak and Guinnane, 1999; Morduch, 1999).

Several studies have empirically analyzed the determinants of group repayment performance. Wenner (1995:276) uses data of 25 groups from FINCA, in Costa Rica. He categorizes his data into three types: groups with no loan delinquency, groups with internal loan delinquency only, and groups with external delinquency. Internal delinquency means that one (or more) member(s) did not repay his (their) share, but the group did meet its obligation to the lender. External delinquency means that the group failed to repay to the lender (thus both internal and external delinquency has taken place). Consequently, Wenner has two dependent variables, namely internal delinquency and external delinquency. Binomial probit, multinomial logit and Tobit models are used in the analysis. Independent variables measure group characteristics such as informal and formal screening, group savings and other variables such as the group's organizational strength, infrastructure indexes and visits by program officers to groups.

Wenner finds internal delinquency to be related negatively with formal screening and positively with visits. The first result suggests that groups who have written codes on how members have to behave (formal screening) experience less internal delinquency. The second result, visits by credit officer to groups, indicates that more visits generate more internal delinquency and seems to be an unexpected result. Wenner suggests that a higher number of visits might reflect extra attention given to a perceived 'problem' group. In case of external delinquency he finds formal screening to be negatively related and significant and informal screening and infrastructure indices to be positive and significant.

These results indicate that groups with written code of group rules and regulations show less external delinquency. On the other hand, groups who are located in areas with good infrastructural facilities show higher external delinquency indicating that these groups have other alternative sources of credit. Informal screening is found to have an unexpected sign, i.e., informal screening instead of being a check against delinquency is positively correlated with delinquency. Sharma and Zeller, (1997), use data of 128 groups from four group-based lending programs in Bangladesh. Their dependent variable is the delinquency rate defined as the proportion of the total loan amount in arrears at the date when complete repayment was promised. Their independent variables are related to group, community and lender characteristics. Each of the independent variables is multiplied by loan size. Using a Tobit, the informal screening variable has a value of 1 if the individual belonged to a group that screened according to reputation. The formal screening variable has a value of 1 if the individual belonged to a group and they find the following results. The number of relatives in a group, squared credit rationing and size of loans are found to be positively significant. This result indicates that the more the number of relatives in the same group and the higher the degree of credit rationing, the higher is the percentage of unpaid loans. Similarly, the larger the value of loans forwarded to members the higher seems to be the burden, forcing them to delay payments. The findings in case of relatives in a group and squared rationing suggests that relatives in a group, rather than improving peer pressure through social ties, seem to collude against the lender and lead to delays in their repayments.

Matin (1998) uses data of 246 borrowers from the Grameen bank, Bangladesh. His dependent variable is a dummy variable, which equals one if the loan is not fully repaid at date due. He uses independent variables indicating borrowers' level of education, housing loan, and area of land used, years of membership, alternative credit sources and other personal characteristics. Using a logit model, Matin finds that education and area of operated land were negatively significant, suggesting that groups that consist of members who have some schooling and have land in use below a certain threshold value have a lower probability of showing repayment problems.

In contrast, Matin finds that having a housing loan, the length of membership, other credit sources and total land in use beyond the threshold level to be positively significant. These results imply that a member with housing loan might be burdened by this loan and show delays in his repayments. Similarly, the results indicate that members who have been clients of the lending program for many years might show slackness in their repayment. Likewise, members who have other credit sources and who have land use above the threshold level have a higher probability of showing repayment problems. This might be attributed to the fact that these borrowers have other credit opportunities or that they already have accumulated so much assets that they start to give less value to future access to loans from the programme.

Zeller (1998) uses data of 146 groups from six group-based lending schemes in Madagascar. The dependent variable he uses is the repayment rate. Zeller divides the independent variables into community, lender and group variables. Using a Tobit regression model, he finds the degree of monetarization, density of input retailers, saving service, group size, and coefficient of variation of land holding in upland rice region, social ties, and internal group rules to be positively significant. These results imply that groups located in areas with high levels of monetarization and a higher density of input retailers show higher repayment rates. Similarly, groups belonging to programs with saving service display higher repayment rate, indicating that saving may increase the financial discipline of group members and/or serve as loan collateral. An increase in the size of groups can promote economies of scope, scale and risk management. Yet, as has been discussed elsewhere, increasing the size of a group beyond a manageable level may decrease the internal flow of information and increase the cost of monitoring. In this case, however, group size is found to increase repayment rate. The maximum group size allowed in the sample is only ten members. Therefore, the problems related to larger groups may not occur. Similarly, groups with stronger social ties and groups with internal rules and regulations demonstrate better repayment rates. Moreover, groups with a higher coefficient of variation of ownership of landholdings demonstrate higher repayment rates. This indicates that diversification reduces covariate income risks among group members, which increases the rate of repayment. Yet, the squared coefficient of variation of ownership of upland, is negatively significant, which suggests that too much

diversification of land owned by group members increases the costs of monitoring, which reduces the repayment rate.

Wydick (1999) uses data of 137 groups from FUNDAP, a group-based lending program in Guatemala. The dependent variable is a dummy variable equalling one if a group has a good repayment record (based on lender reports). The independent variables are classified into group social ties, group pressure, and group monitoring and control variables. Out of several independent variables Wydick finds average distance and knowledge of weekly sales of other members to be the only significant variables. Both variables are peer monitoring proxies, which were negatively and positively significant, respectively. The results suggest that the longer the average distance in kilometres between group members' businesses, the weaker the monitoring ability and the lower repayment rate. In case of the community level questionnaire include queries on topics such as infrastructure, the community's exposure to risks, access to agricultural input and output markets, the degree of commercialization of major crops, and the existence of informal and formal financial institutions.

In case of Knowledge of weekly sales of other members, members are asked if they know sales of other group members and he found that the more group members know the weekly sales of each other, the better the enforcement ability and the higher repayment rate of the group. Paxton et al (2000:643), uses data of 140 groups from PPPCR, a group-based lending program in Burkina Faso. They use a two stage econometric model. The dependent variable in stage one is individual member's repayment problems; in stage two it is the repayment of the loan through group solidarity. The separation of the dependent variable into two follows from the structure of the survey they used. The groups were asked whether a member had repayment problems, and if yes, whether or not group solidarity led to repayment of the loan. In stage one group homogeneity and the group domino effect are found to be positively and living in urban areas negatively significant. The results indicate that the higher the degree of homogeneity and the higher the tendency of domino effect of members in a group the higher the group repayment problems. The positive relationship between group homogeneity and repayment problems indicate that social attachments arising as a result of homogeneity of groups is

not leading to higher group repayment performance. In contrast, group homogeneity seems to help groups to collide against the lender. Likewise, as more members within groups and other groups start to default, more repayment problems arise, indicating that even members who were able to repay begin to shirk, based on the idea that the marginal benefit of shirking exceeds the marginal benefit of repaying.

Similarly, groups located in rural areas tend to show higher repayment problems. This might be due to the high degree covariate risk associated with rural agricultural activities in Burkina Faso, forcing members to default during bad harvest seasons. The coefficient of variation of land holding is used to show intra-group risk pooling and diversification of portfolio. Homogeneity is a scale variable describing the similarity of group members in terms of gender, income, ethnicity, occupation, etc. In stage two group leaders' quality, group training, living in urban areas, other credit sources and group pressure are positively significant and the local domino effect and the amount of loan cycles negatively significant. The outcomes point out that those groups with higher leadership quality; better training and practicing peer pressure show higher repayment performance. Similarly, groups that are located in urban areas and that have other credit sources also show better repayment performance. In contrast groups located in areas where many other groups have already defaulted tend to show bad repayment performance. Similarly, with the increase of the amount of loan cycles the repayment performance of groups deteriorates. Karlan, (2003), uses data of 56 groups from GINCA, group-based lending programs in Peru.

The dependent variable is the percentage of unpaid loan amount at the date due. The independent variables are categorized into geographical concentration of members, cultural similarity among members and control variables. Using a tobit analysis the Karlan finds that geographical concentration and cultural similarities were negatively significant, suggesting that the shorter the average distance between group members and the higher the cultural similarity between them the lower the percentage of unpaid loan amounts at the end of the first cycle. In conclusion, empirical studies show that screening, monitoring and enforcement within groups may improve repayment performance.

4.11.3.4 General findings from the overview of alternative finance

The chapter provided an analysis and synthesis of each model with a view to identify gaps or their use in less developed countries. The following were some of the results of the overview:

1. There is limited empirical data on the extent and use of leasing as an alternative source of SME financing. Existing empirical studies have not investigated factors that may not facilitate use of leasing as a mode of financing among enterprises in less developed countries.
2. There is a lack of evidence on the use of factoring as a source of finance by SMEs in Kenya. This means that, there is no factoring institution to manage this asset-based form of financing. Hence, some investigation may be required to establish how far it is used as an alternative source of SME financing.
3. As concerns trade credit, there are no precise figures of the small business credit transactions, though trade credit may provide access to capital for firms that are unable to raise it through traditional channels (Srivastava et al.1988:80-109; Berger and Udell 2004; Klapper, 1998; Carey et al 1998; Levis and Lasfer 1998; Stulz and Johnson, 1985; Krishnan and Moyer, 1994).
4. There is no empirical evidence in developing countries on how institutional investors, such as mutual and pension funds invest in SMEs. Mutual guarantee schemes as alternative enterprise development financing are successful in Austria, Belgium, France, Germany, Italy and Spain. However, little is known about their involvement in less developed countries. Research may be required on their role in SME financing, especially in Kenya.
5. Many corporations in the more developed countries have developed incubation facilities that support franchises. The literature reviewed does not indicate whether this model of SME financing is in use in the less developed countries, including Kenya.

6. There is no empirical evidence on the use of Angel finance as an alternative model of SME finance in the less developed countries. This implies that entrepreneurs are not finding angels that would be interested in them, and the angels are not able to find enterprises that would fulfil their criteria. Therefore, research is required on the use of angel finance and angel networks by SMEs in the developing countries.
7. The possibility of setting up a venture capital institution to act as an alternative model of finance for SMEs in Kenya has not been undertaken to date (sessional paper No.2, 1992). Existing literature on venture capital as an alternative model of enterprise finance only shows the existence of venture agreements between large enterprises and it seems that such arrangements have not been extended to the small and medium-scale enterprises in the less developed countries, including Kenya
8. Bank finance does not often cover all the financing needs of SMEs (Thitapha, 2003:9). Several factors discourage commercial lending to smaller enterprises and confine lending to medium and large companies. Small businesses generally lack formal forms of collateral needed to secure medium-term finance e.g. a reliable credit history and existing capital assets. Banks incur high transaction costs relative to sizes of loans which smaller clients require. Banks face relatively higher degrees of uncertainty about business risks and returns in activities undertaken by smaller enterprises. This suggests the need for a survey to establish the extent alternative forms of finance are employed by SME operators and to suggest intervention measures.
9. The three problems related to asymmetry of information of formal financial institutions – i.e. adverse selection, moral hazard and enforcement problems – can be alleviated by group-based lending mechanisms, credit guarantees and mutual credit schemes.

In conclusion, innovative lending infrastructures may make significant differences in SME credit availability through the use of the various lending models or approaches.

The next chapter presents the research design and methodology used. Since the study was exploratory in nature, a combination of research methods was used in data collection. These methods are thus presented in chapter five.

CHAPTER FIVE

SURVEY DESIGN AND METHODOLOGY

5.1 Introduction

Research is an enquiry within a sound frame of reference and exact problem formulation, (Rochester and Vakari, 1998:167). The task of defining the research problem involves the design of the research project, commonly referred to as research design (Kothari, 2003:39).

A research design is the conceptual framework within which research is conducted. It provides the blue print for the collection, measurement and analysis of data by specifying what to do, and how to answer the research questions. It is a strategic framework that serves as a bridge between research questions and the implementation of the research (Durheim, 1999:29). It involves the structuring of variables in a manner that enables their relations to be determined (Leedy, 1997:104). Various researchers argue that, there are several methodologies that are used to collect data in social sciences depending on the nature, aims and objectives of a given study (May, 1993).

To collect data, the study used multiple methods that included survey questionnaires, interviews and documentary review. Documentary review referred to as desk research was used to collect and review publications documenting SMEs activities, whereas the survey method was used to collect empirical data from the respondents.

Hence, a research design and methodology encompass the philosophy of a research process. Keya, Makau, Mani and Omari (1989:1) describe the philosophy of research design and methodology as a process, which has a continuum of interrelated activities and sub-processes, starting with a needs assessment and ending with the way in which results will be utilized for development. Similarly, Ikoja (2002:184) describes a research design as a theoretical perspective that specifies how a study is executed in such a way that it answers the research questions. In other words a research design is a strategic

framework for action that serves as a bridge between research questions and the implementation of the research.

5.2 Research design and methods

Ikoja (2002) postulates that a research method is a means by which a research project is implemented, while a research design provides the structure that describes what is to be done and how it is to be done. The objective of a research design is to plan, structure and execute the study in a way that maximizes the validity of its findings. The selection of a research method and design is, therefore, crucial since it not only determines the routes by which research outcomes will be reached, but also influences and sets out the expected outcomes.

Researchers on small enterprises have adopted a variety of research designs, data collection techniques and research methods, such as survey method combined with open-ended discussions, interviews and observation (Mead, Sverrisson and Levy in Nganga, 2003:37). Since the study was exploratory research, a combination of research methods was used in data collection. These methods included observation and face to-face interviews, literature review, questionnaire survey and case studies.

The study was conducted in two phases using a survey design. A pilot study was conducted between December 5th 2003 and December 28th to test the research instrument. The pilot study administered a face-to-face questionnaire with a sample of thirty manufacturing SMEs. The pre-study experience was then used to refine the questionnaire, conceptual framework and methodology for the main fieldwork. The pilot study was followed by the main fieldwork (5th Jan -28th Feb., 2004).

5.2.1 Literature review method

Literature review is an account of what has been published on a topic by accredited scholars and researchers (Herbst and Coldwell, 2004:31). It is the selection of available documents on the topic, which contain information, ideas, data and evidence around and related directly to the thesis or research question and the synthesize of the results into a

summary of what is and what is not known, identification of areas of controversy and formulation of questions that need further research.

The reviews involved a detailed study of relevant journal articles, conference papers, technical reports, government and institutional publications relating to the sub-questions in section 1.7.

5.2.2 Survey method

The study involved a survey research. Neuman (2003) observes that surveys are widely used in social science research in cases where researchers seek to explain the causes of a phenomenon by comparing the attributes of each variable within the phenomenon, as well as identifying and examining other characteristics that are systematically linked to the phenomenon. By careful comparison of these characteristics and attributes, inferences are shown. De Vaus (1986) postulates that there are two distinguishing features of surveys. These are (1) the form of data collection and (2) the method of data analysis.

A survey research instrument was used to collect data from a sample of selected respondents. It enabled the researcher to gather the information about the target population without undertaking a complete enumeration. A survey is based on the theory that samples from a population can often furnish the same information at a much less cost with greater efficiency, and sometimes-greater accuracy (Neuman, 2003:35).

The survey method was found appropriate because of various reasons. First, the study sought to find out the perceptions, opinions and attitudes of the respondents towards the use of different methods of financing. Second, the researcher needed to know why enterprises do or do not use certain sources of financing, and what they like or do not like of certain sources of financing. This helped develop some idea of the causal forces at work in the financing dynamics of small and medium-scale manufacturing firms in Kenya. Third, the study had many variables to test and the survey research method was found appropriate in this respect. Neuman (2003:250) says that, survey research allows many variables and multiple hypotheses to be tested. Fourth, the researcher wanted to

know how SME borrowers chose certain sources of financing. Fifth, the researcher wanted to understand the enterprises from a demographic perspective. For example, information on age, education, race, and training etc was necessary for the identification and definition of borrowers.

The questionnaire as a survey research instrument sought information on the following sub-themes based on the study objectives:

- (i) Enterprise demographic profile.
- (ii) Alternative sources/ models of financing.
- (iii) Factors influencing choice of financing sources or models, other than enterprise demographic factors.
- (iv) Relationship lending and SMEs bank finance.
- (v) Development finance (financing schemes for SMEs).
- (vi) Demand and supply side SMEs financing constraints.
- (vii) Government policy.

5.2.3 Descriptive survey

A descriptive survey not only identifies and describes the characteristics of a population, but also estimates the proportions so as to reveal its traits (Powell, 1991). The study was characterized by the use of variables that facilitated classification of data into frequency tables and cross tabulations.

5.2.4 Case study

The case study methodology is an empirical enquiry that investigates a phenomenon within its real -life context to fully understand the experiences of the phenomenon or to depict experiences in the phenomenon by presenting a depth of information rather than breadth (Herbst and Coldwell, 2004:49). The case study allows past and present study, for chronology to be established. It allows interaction with context to be observed (Edwards and Talbot, 1994:29).

The case study method is used to allow a fine-tuned exploration of complex sets of interrelationships. Each case has within it a set of interrelationships, which both bind it together and shape it, but also interacts with the external world. The case may be an individual, a group, an institution or an intervention (Edwards and Talbot, 1994:44). Cases can be used as illustrative examples of groups or interventions. In this research, the case study approach is used to illustrate use of alternative finance by SMEs.

5.2.5 Observation

The observation method is the most commonly used method in studies relating to behavioural sciences (Kothari, 2003:118). Under the observation method, information is sought by the researcher's own observation without asking from the respondent. The observation method was used to collect data pertaining to information and communication technologies (ICTs) amongst manufacturing SME operators. The method was used as a supplementary technique to collect data. Besides, the observation method permitted the researcher to collect data from real enterprise situation (Wegner, 2000:70).

5.2.6 Applied research

Applied research is research that focuses on the use to which research findings will be put. Neuman (2003) observes that applied research is used to either find solutions to specific problems or help practitioners in the accomplishment of tasks. Unlike basic research, applied research emphasizes more on solution seeking than theory formulation. The primary consumers of applied research are people/institutions that will put the results/findings to immediate practical use. As for the current research, these are SME operators, the Kenyan government and other stakeholders.

5.3 Research sites

Research sites comprised of four major urban centres in Kenya. These were: Nairobi, Nakuru, Kisumu and Eldoret..

5.3.1 Nairobi

Nairobi is the capital city of Kenya and one of the largest and fastest growing cities in Africa. It is Kenya's principal economic and cultural centre. Nairobi is East Africa's most

important commercial, manufacturing, financial, and tourist centre. The city has a large industrial complex which manufactures automobiles, food products, beverages, construction materials, cigarettes, chemicals, textiles, clothing, glass, and furniture.

Nairobi has experienced a huge, relatively steady increase in population since Kenya became independent in 1963, as Africans have migrated to the city from Kenya's rural areas and to other towns. While the 1962 census put the number of city residents at 266,794, the census of 1969 counted 509,206. In 1999 the city had an estimated population of 2,143,254 (Thomas Brinkhoff, online.www.citypopulation.de, accessed 20th sept.2005).

5.3.2 Nakuru

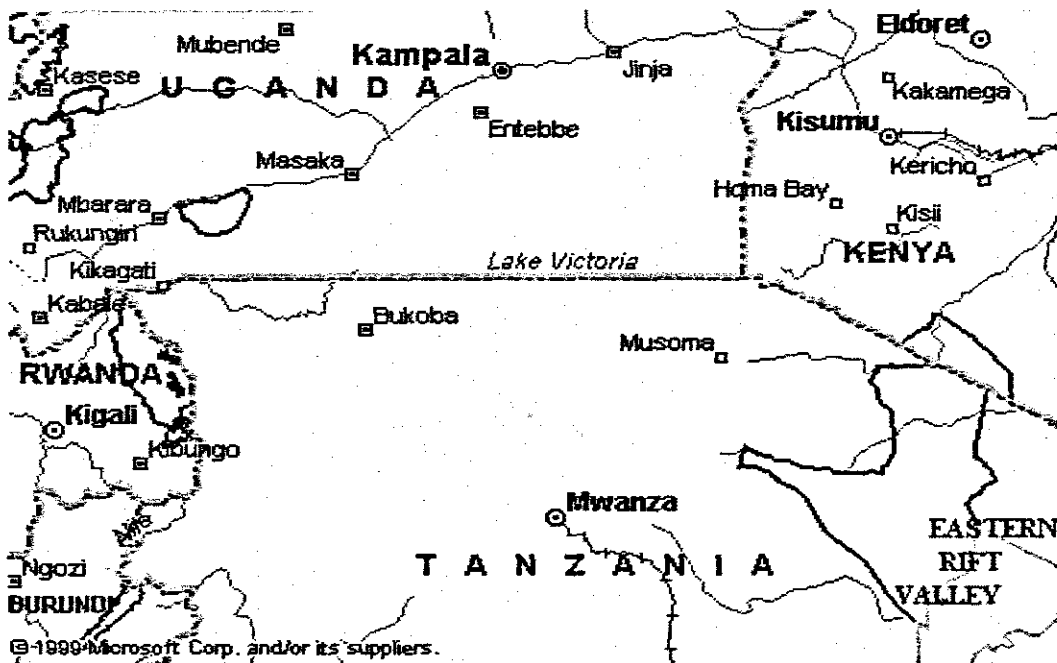
Nakuru is located in the heart of the Great Rift Valley between latitude 0010' and 0020' South and longitude 360 and 36010' East, at a distance of 160 km north-west of Nairobi. The largest part of the town lies at an altitude of about 1700 metres above sea level. In the northern part, on the slopes of the Menengai Crater, the altitude rises to about 1850 metres. Nakuru is located in the midst of a concentration of geographical features together constituting the Lake Nakuru catchment basin. These include the Menengai Crater to the north, the Bahati Highlands to the northeast, the Eburu Hills and Lake Nakuru to the south and the Mau Escarpment to the southwest.

Nakuru is the fourth largest town in Kenya (after Nairobi, Mombasa and Kisumu), with an estimated population of 219,366 in 1999(www.citypopulation.de, Thomas Brinkhoff, 2003-07-13). The major economic sectors of Nakuru are commerce, industry, tourism, agriculture and tertiary services. Commercial activities are concentrated in the Central Business District (CBD) and along various strips and in several smaller nodes. Informal commercial activities have become an increasingly common feature in the town. Small-scale business activities are spread in the town (MCN 1999).

5.3.3 Kisumu

It is the third largest city in Kenya, the principal city of western Kenya and the capital of Nyanza Province.

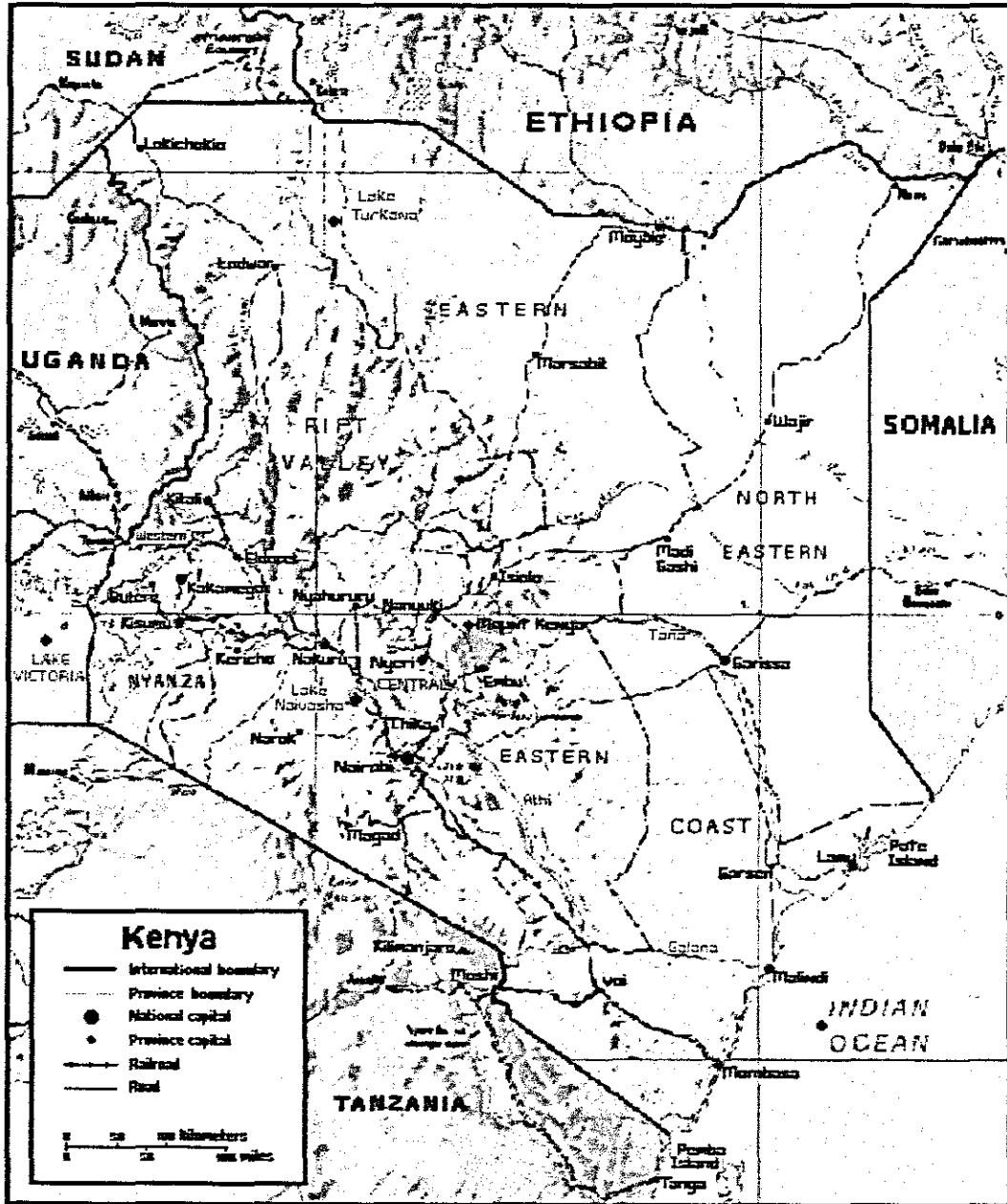
Map 1: Kisumu



5.3.4 Eldoret

This town is home to about 167,016 people in 1999(www.citypopulation.de, Thomas Brinkhoff, 2003-07-13). Eldoret sits in the western highlands of Kenya at an altitude of 2,085m and occupying an area of 270sq.km. Eldoret is both an administrative and industrial centre for north Rift The general economy of Eldoret comprises of tertiary industries like textiles with a number of factories and wood factories. The staple activity though is agrarian with Milk plants, wheat farms and maize (corn) fields accounting for majority of this otherwise rural community. The town has a number of micro and small scale enterprises a cross the sectors.

Map2: Kenya



Map 3: Kenyan Towns



5.4 Target population

Population refers to the universe of individuals, events or objects having common observable characteristics (Mugenda and Mugenda, 1999:9). To define the population, a researcher specifies the unit being sampled, the geographical location and boundaries (Neuman 2003:216). The author further observes that a target population represents a specific pool of cases that a researcher wants to study. In selecting the target population, the fact of appropriateness and practicability was considered. Appropriateness of the target population refers to its suitability in achieving the objectives of the study (Flicks, 1998:41).

The population of the study consisted of owner managers of small and medium sized manufacturing firms in Nairobi, Nakuru, Kisumu and Eldoret, Kenya. To qualify as a manufacturing firm for the study, a firm had to fall into one of the following industrial categories:

- Textiles and Garments;

- Wood and furniture processing;
- Metal and Engineering works which together comprise about 68% of manufacturing employment in Kenya and these represent the bulk of manufacturing output in the country (Soderbom, 2001:12) The study also consulted key informants who comprised policy makers and commercial institutions lending to SMEs.

5.5 Sampling

Kothari (2003:68-69) defines sampling as the process of selecting a number of individuals for a study in such a way that the individuals selected represent the large group from which they are selected. Sampling is used to achieve two main goals. The first is to establish the representativeness of what is being studied and, conversely to reduce bias; the second is to be able to make inferences from findings based on a sample to the larger population from which that sample was drawn. Thus, a sample is a representative of the universe that yields desired results with the required reliability at a minimum cost (Saravanel, 1992:117).

In order to obtain an in- depth study and ensure a high degree of reliability and validity, the researcher used a variety of sampling techniques in selecting the sample for the study. Both probability and non-probability sampling techniques were used. Non- probability sampling was found suitable as the study sought to explore financing ideas that are still undeveloped in a heterogeneous population.

The study employed a multistage sampling procedure. Purposeful sampling was used to select the towns whose SMEs were included in the study, commercial banks and other key informants. Within the selected towns judgmental and random sampling were applied to obtain the actual sample of cases. Judgmental sampling was used to solicit the responses of three hundred and eighty (380) small and medium-scale manufacturing enterprises in Nairobi, Nakuru, Kisumu and Eldoret. The sample sizes for the four towns were 196, 45,103 and 36 respectively. Judgmental sampling requires researchers to use their own judgement in selecting firms to survey. The selection to participate in the study was based on the firm qualifying as a small and medium-scale manufacturing enterprise.

The structure of the firms was considered in the sampling. Hence, for the purpose of this study, where manufacturing enterprises considered SMEs if they employed between five (5) and seventy-five (75) employees. This is consistent with the criteria used by Bigstein and Kimunya (2000) in a survey of manufacturing enterprises in Kenya.

The SME sector is not well documented as censuses in a large range of less developed countries have not been undertaken, and as a result, useful data for SMEs from official sources are largely absent (Nixson and Cook, 2001:7).

The population for SMEs was generated from information provided by the Kenya Management Assistance Programme (KMAP), the Kenya Industrial Estates (KIE) Limited and “Jua Kali” associations. A total of 940 enterprises qualified for inclusion in the study. Because there was no authoritative information regarding which of the firms were small-scale enterprises (SEs) and which ones were medium-scale enterprises (MEs), only one sampling frame was compiled for the 940 enterprises. The enterprises in the frame were organised in alphabetical order. A table of random numbers was used to select 380 (40percent) enterprises which formed the sample for the study.

The researcher then developed sample frames for the respective towns under study. The sample size for the study was distributed proportionately over the towns in the study as shown in table- 1 below. The determination of the sample size was based on a tested formula by Nassiuma (2000). Based on this formula, sample size,

$$S = \frac{N (cv^2)}{Cv^2 + (N-1) e^2}$$

Where S=Sample size

N=Population

CV=Coefficient of variation (Taken as 0.5% @ 95% confidence level)

.e=Tolerance at desired level of confidence (Taken as 0.05 @ 95% confidence level)

Example: S for textile- Nairobi=. 25*180/. 25+ (N-1)*0.0025=65

Table 1.1 below, shows the distribution of the sample sizes in the towns under study.

Table 5.1: Sample size distribution.

Textile					
Towns	Nairobi	Nakuru	Kisumu	Eldoret	Total
N	180	15	45	10	250
S	65	13	31	10	119
Metal					
N	397	18	55	26	496
S	80	15	36	21	152
Furniture					
N	102	20	55	5	182
S	51	17	36	5	109

Source: own construction

5.6 Data collection

Data collection techniques were chosen in accordance with the level of understanding likely to arise from their use. Hence, data was collected through a variety of methods, which included the use of semi-structured interviews on key informants; the researcher administered questionnaires on SME operators. Observation was also made along with documentary review. The instruments were expected to provide precise and adequate data to meet the requirements of the objectives of the study. This is a mixed method strategy. This approach is similar to what Mikelsen (1995) and Denzin (1978) describe as triangulation. In triangulation, the researcher gathers evidence from multiple sources to address the research questions at hand from different points of view.

According to Fetterman in (Baker, 1999:255), the bringing together of different types of evidence in order to test sources of information against each other is a way to determine which explanations are accurate and which ones should be rejected. The purpose of using a triangulation strategy was; first to reduce the possibility of personal bias by not depending on only one method of approach and, second, to support the authenticity of the study by enhancing the credibility of qualitative analyses. It was also used to provide confirmation and completeness of the data collected and its interpretation. In addition, by

triangulating evidence, the researcher wanted to prove or disapprove his hypotheses from comparable pieces of evidence. The method was also used to verify quantitative research with interviews. The other reason for the selection of this strategy was to broaden the study, in which later steps verified earlier ones, addressed possible contradictions in the evidence and helped the researcher to go for convergence and complementarity in the results.

Many other researchers have stretched the potential meaning of triangulation to embrace a wide range of concerns. For example, Denzin in Bryman (2000:131) treats triangulation as an approach in which multiple observers, theoretical perspectives, sources of data, and methodologies are combined. Similarly, Webb, Campbell, Schawrtz and Sechrest in Bryman (2000:131) suggest that social scientists are likely to exhibit greater confidence in their findings when these are derived from more than one method of investigation.

5.6.1 The research instrument

The study used questionnaires as the main data collection instrument. According to Robbin and Bubble in Naidoo (1998:275), the term questionnaire is viewed as a collection of questions related to a particular perception or attitude held by respondents. Most researchers use questionnaires to operationalise study variables in such a manner in which the data for analysis and interpretation may be obtained. Items in the questionnaire had a possible response continuum. These were measured using the Likert scale.

According to Loudon and Bitta (1993:621), the Likert scale involves the compilation of a list of statements relevant to attitudes under investigation with agreement- disagreement response scales. Similarly, Sommer and Sommer in Naidoo(1998) state that the Likert scale simplifies the scoring procedure by using whole numbers (e.g 1,2,3,4 ,5 and vice versa) for each item in the questionnaire rather than numerical averages (e.g 2.5 or 3.2) . The overall attitude of the population under the investigation is then measured by the mean of the sum of the weightings given by the respondents. By summing the numerically coded agree and disagree responses to each item, the scale score is derived. This indicates the extent to which the respondents agree or disagree with the items.

The respondents in the furniture sub-sector were widely dispersed in the four towns under study, whereas in the other two sub-sectors of textile and garment and metal and engineering, the respondents were found in clusters. The population of the respondents from the four towns under study was nine hundred and forty (940). The researcher however, administered structured questionnaires containing essentially closed questions to three hundred and eighty (380) respondents. These were proportionately distributed in the towns under study. This was because samples were taken from a non-homogeneous population and in order to obtain a sufficient number of enterprises, from each sub-group of the population to study.

Two different questionnaires, one for the SME operators and the other for key informants. The key informants of the study comprised of policy makers, loan officers and information technology personnel of a sample of financial institutions. The key informants were drawn from five financial institutions that have dealt with SMEs. They consisted of five loan officers, five IT experts and five policy makers. The questionnaire comprised seven major sections. Section one consisted of items on demographic information of the responding firms that included gender, age, citizenship, education, number of employees, period firm has been in operation, form of business ownership, and training had by the enterprise owners. Some studies have shown that demographic characteristics have influence on enterprise finance. These characteristics were used in this study to investigate whether they had influence on use of alternative sources of financing.

Section two was designed to collect information on the relationship between banking and SMEs access to bank finance. Section three of the instrument aimed at collecting information on the reasons that best explain why manufacturing SMEs had not applied for any bank loan. This was based on the assumption that some manufacturing SMEs had not applied for any bank finance because of certain financing constraints. Section four was designed to assess the respondents' awareness of the different alternative sources of business finance. Section five of the questionnaire examined factors influencing the choice of financing by manufacturing SME operators in Kenya. Section six assessed the

respondents' skills and competencies in ICTs in relation to SMEs financing. And finally, section seven examined government policies on SMEs financing and development.

5.6.2 Instrument reliability

Hammersley (1992:67) and Wegner (2000:89) define reliability as the tendency toward consistency found in repeated measurements of the same phenomenon. Reliability is revealed by the extent to which an experiment, test, or any measuring procedure yields the same results on repeated trials. There are four general categories of reliability estimates in research, each of which estimates reliability in a different way. They are:

- Interpreter or inter-observer reliability: - used to assess the degree to which different raters or observers give consistent estimates of the same phenomenon;
- Test-retest reliability: - used to assess the consistency of a measure from one time to another;
- Parallel-forms reliability: used to assess the consistency of the results of two tests constructed in the same way from the same content domain; and
- Internal consistency reliability: - used to assess the consistency of results across items within a test (online Source: <http://trochim.human.cornell.edu/tutorial>: dated 20.2.2004).

In order to ascertain the reliability of the research instrument, a pilot study was conducted. The term pilot study is used in two different ways in social science research. It can refer to feasibility studies which are "small scale version(s), or trial run(s), done in preparation for the major study" (Polit et al., 2001: 467). However, a pilot study can also be the pre-testing or 'trying out' of a particular research instrument (Baker 1994: 182-3). One of the advantages of conducting a pilot study is that it might give advance warning about where the main research project could fail, where research protocols may not be followed, or whether proposed methods or instruments are inappropriate or rather

complicated. In the words of De Vaus (1993: 54) "Do not take the risk, pilot test first." The pilot study helped the researcher judge the reliability of the instrument by estimating how well the items that reflect the same construct yielded similar results. In the pilot study, the researcher looked at how consistent the results were for different items for the same construct within the measure. The other reasons for conducting the pilot study were:

- 1 Developing and testing adequacy of research instruments;
- 2 Assessing the feasibility of a full-scale study;
- 3 Designing a research protocol;
- 4 Assessing whether the research protocol is realistic and workable;
- 5 Establishing whether the sampling frame and technique were effective;
- 6 Identifying logistical problems which might occur using proposed methods;
- 7 Estimating variability in outcomes to help determine sample size;
- 8 Collecting preliminary data;
- 9 Determining what resources (finance, staff) were needed for the study;
- 10 Assessing the proposed data analysis techniques to uncover potential problems,
- 11 Training research assistants in the elements of the research process.

The pilot study was also used to identify potential practical problems in following the research procedure. For example, problems such as poor recording and response rates were to be identified and precautionary procedures or safety nets were devised. Thus, a small group of respondents who were as similar as possible to the target population was used. The questionnaire was then administered to the pilot respondents, in exactly the same way as it was administered in the main study.

According to Wegner (2000:95), a pilot study identifies shortcomings, which can be resolved before the main study. Mulusa in Kariuki (2003:21) suggests that about ten cases, which represent the target population in all the major aspects of the study, should be used in a pilot study to determine the reliability of the research instrument. The pilot study was conducted on thirty (30) enterprises, ten from each of the sub-sectors under study to test the research instrument before the actual study. The questionnaire was then refined in light of the pre-study experience.

The reliability of the final instrument was calculated using Cronbach Alpha coefficients. The Cronbach Alpha coefficients measure the internal homogeneity or consistency among a set of items i-e the extent to which the same set of respondents replies in a consistent manner to similar items (Diamantopoulous and Schlegelmilch, 1997:36). Due to use of different variables in the study, Cronbach coefficient Alpha was used to determine the reliability of the questionnaire.

According to Huysmen in Naidoo (1998:289), the reliability coefficient is scale free in that its value cannot be less than zero or greater than 1.00. It is generally accepted that standardised tests indicate reliability coefficients in surplus of 0.5. Reliability coefficients less than 0.5 are deemed to be unacceptable, and those above 0.70 are acceptable (Nunally, 1978:226). The calculated Cronbach Alpha for this research was 0.849 and the standardised Cronbach Alpha of .810, indicating a difference of 0.039. This demonstrates that the questionnaire was relatively reliable and consistently measured the dimensions it was designed to measure (see appendix 3).

5.6.3 Validity of the instruments

Validity is another term for truth. It is the extent to which an account accurately represents the social phenomenon to which it refers (Hammersley, 1990:57). Validity of research instruments are important to quantitative researchers as they are to qualitative ones. The researcher had to convince himself that the study findings were genuinely based on a critical investigation of all the respondents and their data, using the right sampling techniques, and that the findings did not depend on a few well-chosen respondents, the problem of anecdotalism (Silverman, 2002:176).

To avoid the anecdotal problem, the researcher used the various methods indicated earlier and data triangulation. In addition the researcher sought to refute some of his initial assumptions about the data collected in the study in order to achieve objectivity. For example, the assumption that bank finance is not adequate to satisfy the financing needs of manufacturing SMEs in Kenya was refuted after confirmation on the true picture in the field. In support of this, Kirk and Miller (1986) argue:

The assumptions underlying the search for objectivity are simple. There is a world of empirical reality out there. The way we perceive and understand that world is largely up to us, but the world does not tolerate all understandings of it equally (1986:11).

This means that the researcher had to overcome the temptation to jump to easy conclusions, just because there was past evidence that had given rise to the assumption. This was a critical method close to what Popper in Silverman (1999:178) calls critical rationalization. The method demands that one must seek to refute the existence of assumed relations between phenomena to be in a position to speak about objective knowledge.

Further, the validity of the research instrument was determined by expert advice from the supervisor who assessed the degree to which the instrument represented and logically connected the underlying theory, and the phenomena under study; and the relevance of the questions in the instrument to the research objectives. A pilot study was also conducted that collected and analyzed data in order to refine the research instrument. The pilot study enabled the researcher to gauge the extent to which the instruments elicited the information or data it was designed to collect. Finally, results from the pilot study and comments from SME experts were used in the formulation and preparation of the refined research instruments that were used to collect data for the investigation of the problem under study.

5.6.4 Research procedure

Permission to conduct research was obtained from the Ministry of Education, Science and Technology, because in Kenya, official approval of research is required. Then, the ministry sent letters to all districts where the study was to be conducted.

Pre-visits were then made to request permission to meet heads of the Districts and local councils, enlist their support in visiting the areas of study.

5.6.5 Ethical considerations in the study

The pre-visits were followed by fieldwork in which the researcher provided research participants with all of the information necessary to allow them to make a decision concerning their participation. This was done through an introductory covering letter attached to the questionnaire. The letter informed the respondents about the objectives and significance of the study, and the confidentiality of the information provided. Respondents were assured of protection from disclosure of information and respect for their privacy. Anonymity and confidentiality was promised and maintained. In addition, the researcher met all other requirements such as proper identification and clarity of purpose.

5.6.6 Methods of Data Analysis and interpretation

A questionnaire was used to gather the required data for the study. For the purpose of analyzing the data, the items in the questionnaire were assigned the Likert- like scale scores (Likert in Schuessler 1971:325). The data was then processed and analyzed using the statistical package for social sciences (SPSS), Microfit, Microsoft Excel and Microsoft word. The softwares were selected because they are user-friendly data management tools.

Quantitative data was analyzed with the application of descriptive statistics, generating frequency distributions. According to Wegner (2000:134) frequency distribution is the most commonly used method to summarize a large number of observations. Thus frequency tables were important in condensing collected data. Besides, cross-tabulations of data between the three sub-sectors in the study were conducted. This was done to determine the sector specific problems relating to enterprise financing and use of alternative sources of financing.

Qualitative data from open-ended questions were analyzed through content analysis. This involved the reading of the data and making interpretations, organizing of the data through categorization or coding, argumentation on the data through causal analysis and making generalizations.

5.7 Problems encountered

While conducting the study, the researcher encountered some difficulties. Firstly, some loan officers of institutions involved in lending to SMEs were reluctant to participate in the key informants' interview. This was experienced at Equity Building Society and Juhudi Kenya. No reasons were provided for their unwillingness to participate, despite the fact that the researcher had indicated the purpose of the study, and promised confidentiality on the information that would be provided. Secondly, some enterprise owners, particularly Asian owners who have not lived in Kenya for long, were not willing to participate in the survey interview. The reason for not participating was that of communication barrier. The majority could not speak Kiswahili or English, other than their mother tongue. Thirdly, some respondents expressed their disappointment in researchers. For example, some asked 'what is the use of giving you information and we do not get feedback on?' "Now how are we benefiting"? "Are you sure this time you will bring us money"? Lastly, travelling was very difficult and some of the research locations were extremely dusty because it was during the dry season.

The next chapter presents empirical data and discusses the findings from the field survey.

CHAPTER SIX

RESULTS OF THE SURVEY AND DISCUSSION OF FINDINGS

6.1 Introduction

The purpose of this study was to provide a perspective on alternative finance among SMEs in Kenya. The study focused on three manufacturing sub-sectors, namely: Textile and Garment, Furniture and Wood products and Metal and Metal products.

This chapter presents and analyzes data and discusses the findings from the survey. The empirical data forming the basis of the discussion was collected from the three manufacturing sub-sectors drawn randomly as: Textile and Garment (119), Furniture and wood products (109) and Metal and metal products (152). The primary sample comprised of 380 enterprises. A survey method was employed to conduct the study. The data collection instruments used were self-completed questionnaires, interview schedule, and observation. The questionnaire was used to collect data from the SME operators while face-to-face interview was used on key informants. Attempt has been made to collate the findings obtained from these instruments and draw some conclusions in line with the objectives of the study. Some of the results have been presented in a cross-tabulation form. This was done to understand the specific sub-sectoral problems. The results presented in the tables often appear as percentages to facilitate their interpretation or in coefficients to interpret effects of the explanatory variables in the hypotheses. Enterprise owners were asked questions specifically geared to finance, financing alternatives and financing constraints. The discussions based on the study objectives and the questionnaire include the demographic profile of the respondents, relationship banking, financing constraints, alternative sources of financing, factors influencing choice of financing, the role of information and communication technologies in accessing external finance (E-finance) and SMEs financing policy and regulatory framework.

SECTION I

6.2 Survey results from SME respondents

6.2.1 Characteristics of the respondents and enterprises

The study examined survey data in order to evaluate the characteristics of small and medium-scale manufacturers that make it more difficult for them to access financing sources and in particular alternative sources of finance such as lease finance, trade credit, hire purchase, angel finance and venture capital. In order to examine these concerns, the characteristics of the manufacturing SMEs with reference to the age of the enterprise, educational background of the operators, gender distribution pattern, form of business ownership and formal training were asked and the respondents were expected to indicate their individual characteristics. Tables 6.1 -6.7 in the following sub-sections present the distribution of the respondents according to their characteristics.

6.2.1.1 Gender

The respondents were asked to indicate their gender. This had a dual purpose, firstly, to find out whether there was gender balance in the sub-sectors in the investigation and secondly, to establish the influence of gender on use of alternative sources of finance. The respective responses were as in chart 1 below. The chart indicates that of the 312 male operators in the study, there were 56(18%) operators in the textile sub-ector, 107(34%) in furniture and 149(48%) in metal and metal works. On the other hand, out of 68 female operators in the study, there were 63(93%) in textile, 2(3%) in furniture and 3(4%) in metal and metal works. Overall, the findings indicate that 312 (82.1%) of the manufacturing SME operators were male while 68 (17.9%) were female. This finding was similar to that by Lutabingwa et al. (1996:3) where the population of the enterprises revealed that twenty percent (20%) of the manufacturing operators were women and eighty percent (80%) male. It was also found that, metal and furniture sub-sectors were male dominated, while textile was female dominated. Thus, the empirical results indicate that there was a significant relationship between gender and the industrial sub-sectors in the study.

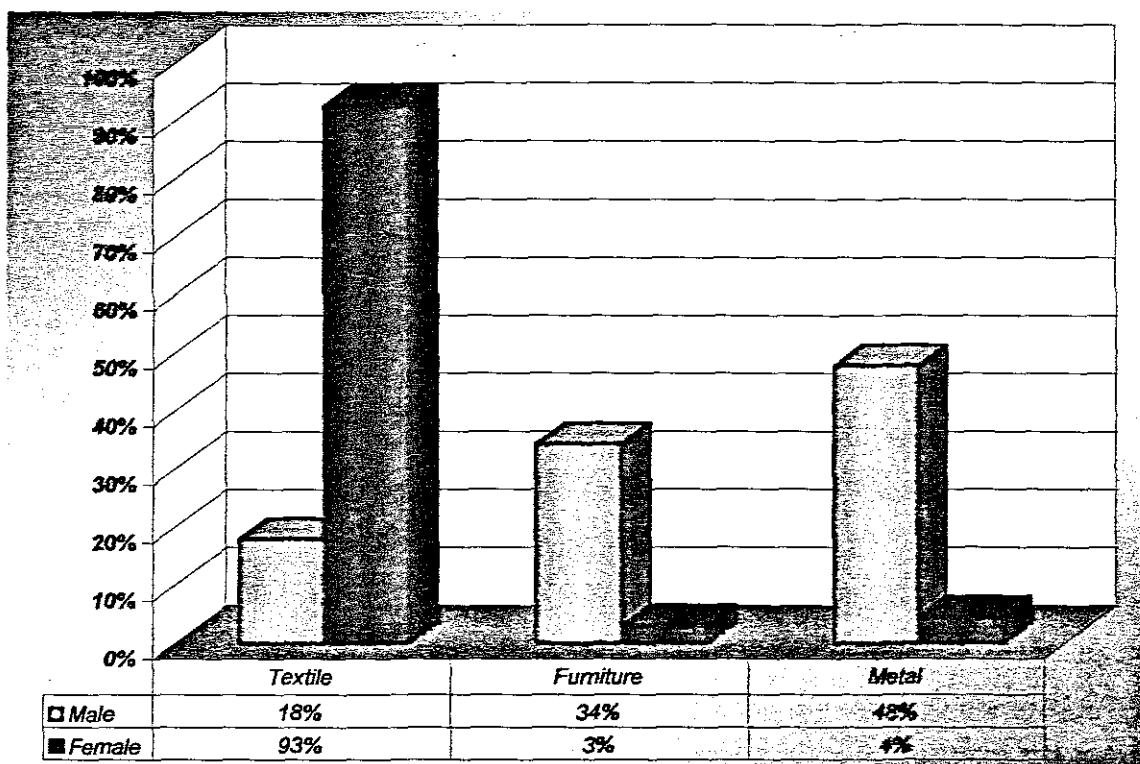


Figure 6. 1: Sector gender distribution pattern

As concerns use of alternative sources of finance, the respondents were asked to rate the applicability of the following sources of finance on a scale of 1 to 4 (1 being always used the source or is applicable to my situation and 4 being don't know source or not applicable to my situation), sometimes was rated as 2 and never 3. The following sources were rated: factoring, leasing, angel finance, venture capital and supplier credit.

An examination of the data in the table below shows that, the most important alternative source used by both genders was supplier credit (a total rating of 37.6 % at 1 and 2 level); leasing (a total rating of 9.5 % at the 1 and 2 level) ; factoring (a total rating of 5.3 % at the 1 and 2 level) ; venture capital (a total rating of 3.3 % at 1 and 2 level); and angel finance (a total rating of 2% at 1 and 2 level) .

The empirical results indicate that alternative sources of finance are not popular among the SMEs in the study. Other interesting findings from the face to face interviews were:

- gender of the major decision maker influences the financing choice

- majority of the respondents do not know alternative sources of finance such as factoring, leasing, angel finance and venture capital.

Table 6.1 Gender and use of alternative sources of finance (N=380)

Alternative sources	1	%	2	%	3	%	4	%
Factoring	6	1.6	14	3.7	189	49.7	171	45
Leasing	16	4.2	20	5.3	317	83.4	27	7.1
Angel finance	4	1.0	6	1.0	164	43.0	209	55
Venture capital	8	2.1	4	1.1	162	42.6	206	54
Supplier credit	49	12.9	94	24.7	221	58.2	16	4.2

Table 6.1 above is based on responses to use of alternative sources of finance. Most of the respondents confirmed the fact that alternative sources are least known to the SME respondents in the study. Interestingly this was reported to be a result of lack of information on the available alternative sources of finance. In addition, the respondents were asked to rate the level of influence of the following factors on their access to bank finance on a scale of 1 to 4 (1 being very much or is applicable to my situation and 4 not applicable to my situation), much was rated as 2 and not much as 3.

An examination of the data in the tables below based on gender shows that, the most important factors influencing access to bank finance or that applied to the situation of the male respondents were collateral (a total rating of 75 % at 1 and 2 level); interest rate (a total rating of 71.8% at 1 and 2 level); service fees (a total rating of 71.5 % at the 1 and 2 level) and relationship with bank (a total rating of 57% at the 1 and 2 level). Similarly, female respondents cited collateral (a total rating of 86.8 % at 1 and 2 level); interest rate (a total rating of 82.9% at level 1 and 2) and service fees (a total rating of 75% at level 1 and 2) respectively.

Table 6.2a Male – factors influencing access to bank finance, N=312

Factors	1	%	2	%	3	%	4	%	Total
Relationship with bank	134	42.9	44	14.1	66	21.2	68	21.8	312
Limited range of bank products	125	40.1	77	24.7	50	16	60	19.2	312
Collateral required	180	57.7	54	17.3	19	6.1	59	18.9	312
Service fees	127	40.7	96	30.8	23	7.4	66	21.2	312
Bank failure to understand borrower's business	146	46.8	49	15.7	60	19.2	57	18.3	312
Interest rate charged	177	56.7	47	15.1	19	6.1	69	22.1	312

Table 6.2b: Female – factors influencing access to bank finance, N=68

Factors	1	%	2	%	3	%	4	%	Total
Relationship with bank	34	42.9	9	13.2	13	19.1	12	17.6	68
Limited range of bank products	30	44.1	20	29.4	10	14.7	8	11.8	68
Collateral required	52	76.5	7	10.3	4	5.9	5	7.4	68
Service fees	37	54.4	14	20.6	11	16.2	6	8.8	68
Bank failure to understand our business	31	45.6	5	7.4	18	26.5	14	20.6	68
Interest rate charged	51	75	4	5.9	4	5.9	9	13.3	68

6.2.2 Age

The interviewee(s) were asked a question that sought to ascertain their personal information with regard to their age(s). The information was necessary to establish whether age had any influence on use of alternative forms of finance. The general age distribution among the respondents was, 18-29 (75 or 19.7%), 30-39 (162 or 42.1%); 40-49 (89 or 23.4%); 50-59 (46 or 12.1%) and 60+ were 8 or 2.1% of the total sample. As concerns use of alternative sources of finance, the empirical results revealed that the following age categories had used alternative sources of finance; 20.3% of the respondents' aged 18 to 29; 2.1% of those aged 30 to 39, 21.8% of those aged 40 to 49,

14.3% of those aged 50 to 59, and 1.5% of those aged above 60 years. This indicates that the SME operators in the 30-39 age brackets had insignificantly used alternative sources of finance. The finding indicates that there was a relationship between age and use of alternative forms of finance. This result may be attributed to level of awareness on alternative sources of finance.

Table.6.3 Age distribution and use of alternative sources of finance (N=380)

AGE	YES	%	NO	%	TOTAL	%
18-29	27	20.3%	48	19.4%	75	20.8%
30-39	56	42.1%	106	42.9%	162	42.6%
40-49	29	21.8%	60	24.3%	89	23.4%
50-59	19	14.3%	27	10.9%	46	23.4%
60+	2	1.5%	6	2.4%	8	2.1%
Total	133	100%	247	100%	380	100%

6.2.3 Educational level

According to Storey (1994:129-136) experience and education level obtained may provide signals of better human capital. The better the human capital, the greater the firm's viability of the start up, growth, expansion and consequently access to debt capital. Hence, to establish the relationship between the SME operators' education and awareness on alternative sources of finance, all the respondents were asked to indicate their educational background. Six categories of highest qualification were used to describe the educational characteristics. These were primary, secondary, village polytechnic, national polytechnic, graduate and postgraduate respectively. It was observed that most of the manufacturing SME owners had secondary education: textile 61 (51.3%), furniture 48 (44%) and metal 73 (48%). There was nonetheless, one postgraduate operator in the metal industry and six graduates each in both the textile and furniture industries. This finding confirmed an earlier study where it had been found that majority of manufacturing SME operators' attained form four level of education, closely followed by

primary education (Irura, 2003:63). This observation may be attributed to the attitude of Kenyan graduates toward the growth prospects of the sector and expected personal growth. Besides, the sector operators are assumed to be those with little education.

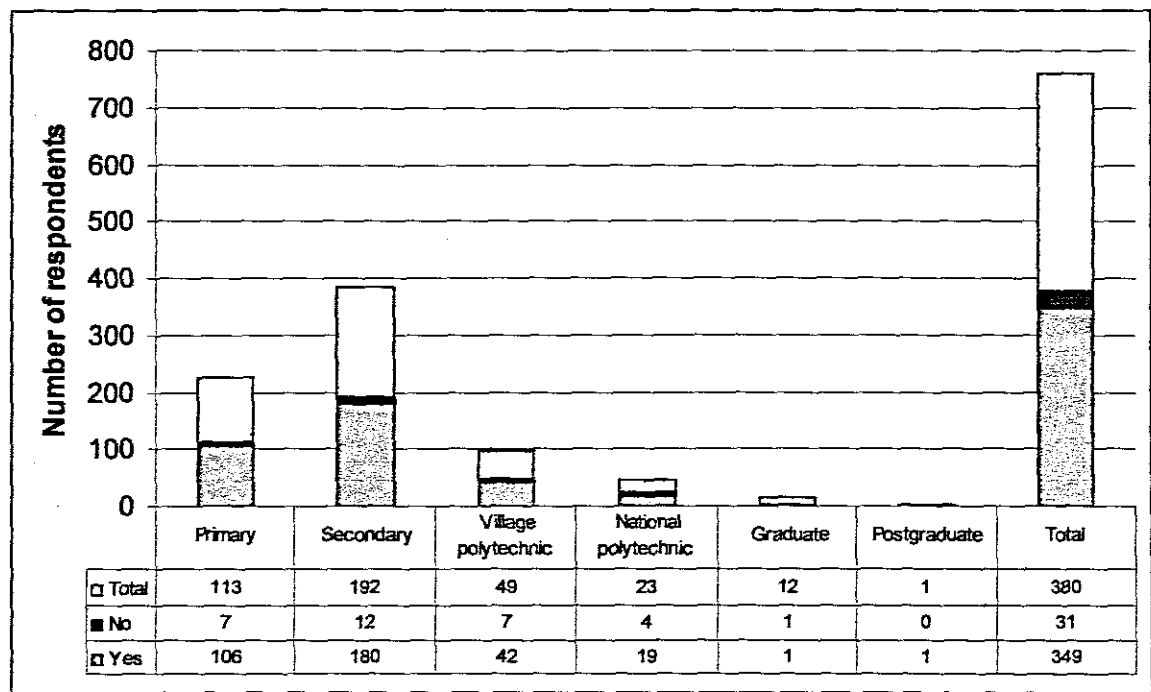


Figure: 6. 2 Applications for Bank Finance

As concerns bank finance, 91.8 %(349) of the respondents had made application for bank finance. However, the acceptance status was as indicated in table 6.9 on page 192.

6.2.4 Formal training

Respondents were asked to indicate whether they had any formal training in business management. The purpose of this item was to establish whether there was any relationship between knowledge on business management, awareness and use of different sources of finance. Majority of the manufacturing SME operators (85.3%) were found to have no formal training in business management. In summary, out of the 380 respondents, the following number of respondents had training in the indicated areas of business management: financial management 40(10.5%); business management 55(14.5%); 40(10.5%); 18(4.7%) and 27(7.1%), while most of the respondents would not see the importance of taking training in business management related issues.

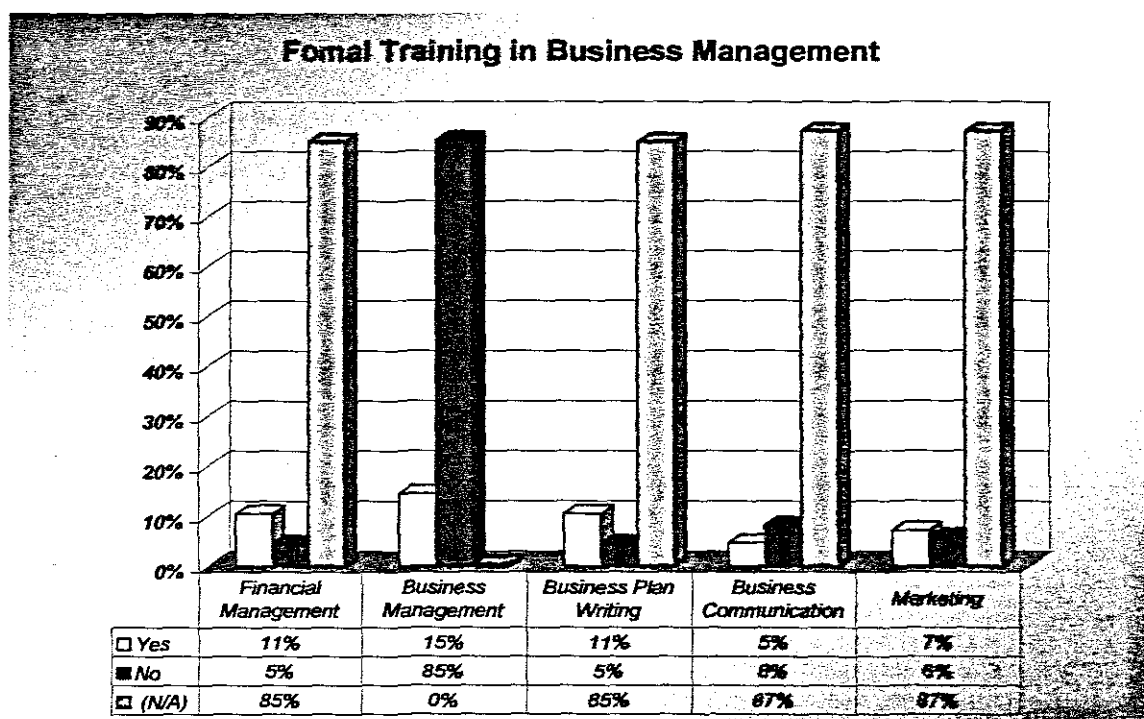


Figure 6.3: Formal Training in Business Management

6.2.5 Age of the Enterprises

The survey sought to find out the duration the respective manufacturing SMEs had been in existence. This was necessary because enterprise age influences use of different sources of financing. Very few enterprises were between one and three years old. The majority of the firms 314 (82.7%) have been in existence for over three years. However, it was observed that 58 (48.7%) of the textile operators had been in existence for between 3-5 years and 27 % (41) of the metal and fabrication industries had been in existence for periods ranging between 1-5 years. Enterprises were found to be slightly older in furniture and metalwork sub-sectors. This finding was similar to that by Aboangye (2000:6) where it was found that the average age of the manufacturing SMEs was less than six years and that metal industries are older than other SME industries.

Table 6.4: Age and Duration of the firm cross tabulation

Age of enterprise operators	Duration of the firm in operation					
	0-1 year	2-3 years	4-5 years	6-10 years	>10 years	Total
18-29	1	17	30	16	11	75
30-39	2	26	57	43	34	162
40-49	2	13	28	15	31	89
50-59	1	3	7	13	22	46
60+	1	0	4	0	3	8
Total	7	59	126	87	101	380

The empirical results indicate that, there is a positive relationship between enterprise age and age of the owner. Further it was found that there is a relationship between enterprise age and access to bank finance. These results are consistent with findings in extant research. For example, Petersen and Rajan (1994:412) found a significant relationship between small firm's age and financial leverage. Petersen and Rajan suggested that older firms have higher debt ratios since they are of higher quality. Similarly, Barton and Gordon (1987:41) concluded that mature firms experience lower earnings volatility and hence are expected to have higher debt ratios.

6.2.6 Ownership form of the Enterprise

The information on form of business ownership was required to establish whether there was a relationship between form of business enterprises and access to external finance. The relationship between the business and the lenders is often characterized by the ownership and control structure in the enterprise. It is possible to distinguish two major types of businesses, i) those in which the manager is the owner of the entire capital, and ii) the medium-sized business in which there is separation of functions.

If the capital and the control are in the hands of agents with a separation of functions, the clash of interests between managers and shareholders is diminished, and it is not necessary to use borrowing as a mechanism of supervision and control over the managerial function. There is also a reduction in the information asymmetries between

lenders and borrowers, and the possible opportunistic behaviours by owner-managers could be avoided. In consequence, according to agency theory, a positive relationship is expected between the degree of specialization and separation of the functions of ownership and control, and the total borrowing ratio. Nevertheless, the pecking order theory (refer chapter 2) points out that businesses in which there is no separation of functions and in which the owner-manager has invested a major part of his/her personal wealth, tend to show a preference for the use of borrowing, in order to avoid involving outsiders and the loss of control in the decision-taking.

The hypothesized effect of legal form of business on financing is related to the extent that it affects the availability of particular forms of financing. Storey (1994) argues that while some may consider the benefits of limited liability as the critical decision in the choice of legal form of the business, the limited liability gain is fictional in actuality. Alternatively, the choice of legal form involves weighing up credibility, taxation variation, versus statutory audit costs and public information. Given the above, banks may perceive incorporation as a good signal as it may portray credibility and formality of operations, or represent an indicator of future growth or growth potential. For example, Coleman and Cohn (1999) found evidence suggesting a positive relationship between leverage and incorporation but not between incorporation and the level of external loans, while evidence from Storey (1994) and Freedman and Godwin (1994) suggests that incorporation leads to a greater use (or supply) of bank financing.

The empirical survey found that majority of the enterprises were sole proprietorships (233 or 61.3%). The results further indicated that there were two private companies in the sample. One was in textile and the other in the metal sector respectively. However, 51.1 % or 48 of the textile enterprises and 34 % or 32 of the metal enterprises were in the form of partnerships.

Table 6.5: Ownership form

Form of business	Frequency	Percent
Sole proprietors	233	61.3
Family	49	12.9
Partnership	94	24.7
Private company	3	.8
Other	1	.3
Total	380	100.0

It was found that apart from private companies in the sub-sectors under the study, the relationship between form of business enterprise and use of finance other than bank finance was negative. It could be argued that this was as a result of majority of the enterprises being sole proprietors, family businesses, or partnerships. Results of ANOVA at 5% significance level yielded an F-ratio of 2.062 at 95% confidence interval. This was less than the critical value 2.37 and the result's significance level was far higher at 0.085 compared to the predetermined significance level of 0.05. This shows that there is no significant relationship between ownership form and use of alternative sources of finance.

It may be argued that, because it is difficult to differentiate the owner from the business resources, and due to lack of financial reports, good track record or collateral, formal financial institutions are reluctant to deal with small borrowers. Furthermore, some respondents in the study appear to have a general attitude that banks are not willing to lend to small borrowers.

6.2.7 Enterprise Size

There are several theoretical reasons why firm size would be related to the capital structure of the firm. Firstly, smaller firms may find it relatively more costly to resolve informational asymmetries with lenders and financiers. Consequently, smaller firms are offered less capital or are offered capital at higher costs than larger firms, which discourage the use of outside financing. Such effects are more prevalent among SMEs because they are more informationally opaque than large firms (Berger et al, 1998:197).

The transaction costs associated with financing may also affect financing choices as transaction costs are most likely a function of scale, with smaller scale financing resulting in relatively higher transaction costs (Titman and Wessels, 1988; Wald, 1999). A related issue is the marginal effects of market access for different sized firms (Scherr, Sugrue and Ward, 1993). This could be a function of high transaction costs effectively making some financing options outside the available set of financing choices of the business. However, market access can also be caused more directly in that some financing options are not in the scale range that financiers would consider issuing finance.

Another explanation for smaller firms having less outside financing or lower debt is if the relative costs of bankruptcy are an inverse function of firm size. These bankruptcy costs can be both direct, affecting liquidation returns, or indirect in the form of stakeholders losing confidence in the businesses survival or through less discretion on operating decisions (Titman and Wessels, 1988). Finally, if operating risk is inversely related to firm size, this should predispose smaller firms to use relatively less debt and outside financing (Cosh and Hughes, 1994). Empirical evidence from research investigating the relationship between size and financing for firms of similar scale to those examined in this study generally supports a positive relationship between firm size and leverage, long-term leverage, outside financing and bank financing. One caveat to this is a negative relationship between short-term liabilities and firm size (Scherr, Sugrue and Ward, 1993; Chittenden, Hall and Hutchinson, 1996; Michaelas, Chittenden and Poutziouris, 1999; Fluck, Holtz-Eakin and Rosen, 2000). For this study, size is measured using number of employees as operationalised in section 1.2.5.

The empirical results indicate that enterprises in the study were not accessing alternative sources of finance nor bank finance. Different reasons were behind this, such as high interest rates, collateral requirement and lack of a awareness of the existence of the alternative sources of finance. This contradicted some of the findings from extant research.

6.2.8 Asset structure

Asset structure should be an important determinant of the capital structure of a business. The degree to which the firms' assets are tangible and generic should result in the firm

having a greater liquidation value (Harris and Rajan, 1991; Titman and Wessels, 1988). This will reduce the magnitude of financial loss incurred by financiers should the company default. By pledging the firms' assets as collateral or arranging so that a fixed charge is directly placed on particular tangible assets of the firm, also reduces adverse selection and moral hazard costs. This will result in firms with assets that have greater liquidation value having easier access to finance, and lower costs of financing. This should pre-dispose these firms to having a higher level of debt or outside financing in their capital structure. Several authors suggest that bank financing will depend upon whether the lending can be secured by tangible assets (Storey, 1994:50; Berger and Udell, 1998:194).

A high proportion of tangible assets can also reduce the costs associated with moral hazard, in that it may reduce the proportion of growth opportunities available to the firm and thus result in less managerial discretion (Wald, 1999). Given the increased information opaqueness in the initial stages of the venture and the lack of other available options for financiers to reduce financial risk, one would expect the relationship to be strongest at start-up rather than once the business is more established. The empirical evidence for a link between asset capital structure and leverage for large firms suggests a positive relationship consistent with theoretical arguments. The limited smaller firm research, while not conclusive, shows signs of a positive relationship between asset structure and leverage, long-term debt, and possibly a negative relationship with short-term debt (Chittenden, Hall and Hutchinson, 1996.; Jordan, Lowe and Taylor, 1998; Michaelas, Chittenden and Poutziouris, 1999:124). As previously mentioned no study examining start-up financing has examined such a relationship directly. Asset structure for this study is non-current assets divided by total assets.

The finding from the study indicates a low fixed asset structure. This correspondingly implies existence of low collateral capacity.

6.2.9 Intention to Grow and Growth Opportunities

Growth opportunities and intention to grow should influence the agency costs associated with financing. Myers (1977:155-58) argues that conflicts between debt and equity holders are especially serious for assets that give the firm the option to undertake growth

opportunities in the future. Additionally, if some start-ups are more likely to experience future growth, due to opportunity or intention this should increase the potential for conflict between the outside financiers and the entrepreneur resulting in lower leverage. However, Michaelas, Chittenden and Poutziouris (1999:116) argue that future growth opportunities will be positively related to leverage, in particular short-term leverage. They argue that the agency problem and consequentially the costs of financing is reduced if the firm issues short-term rather than long-term debt. In addition, the use of outside or bank financing may be related to intended growth as the business may choose financing based on their beliefs for future use of financing. In particular, if the firm is more likely to need capital in the future, it has greater incentives to establish credit relationships with outside financiers such as banks. By establishing these relationships as early as possible the greater potential benefit for the firm both in terms of access and cost of future outside financing. Michaelas, Chittenden and Poutziouris (1999:118) found future growth positively related to leverage and long-term debt while Jordan, Lowe and Taylor (1998:13) found mixed evidence. All these studies used measures of growth ex-post rather than obtaining growth intentions from the major decision-maker. This study dichotomously classifies a firm as having growth intentions if the firm answered "yes" to either of the following: "During the next three years does the business intend to: significantly increase production levels; open new locations; introduce new goods or services". 80% of the respondents indicated that they had intention to grow in the future

6.2.10 Duration one has kept an account with one bank

The respondents were asked to indicate the duration they had maintained an account with one bank. The purpose of this information was to establish whether a long relationship with one bank would enable the bank managers to understand the business of the borrowers and hence advance required credit. Empirical results indicate that 29.2% of the interviewees had maintained an account with one bank for a period of between 4-10 years, followed by 2-4 years or 24.7% of the sample and 18.9% over 10 years.

Table 6.6: Duration one has kept an account with one bank (N=380)

Duration	Frequency	Percent
1-2 years	23	6.1
3-4 years	94	24.7
5-10 years	111	29.2
Over 10 years	72	18.9
No account	80	21.1
Total	380	100

Correlation analysis was run to assess the extent to which duration an enterprise has kept an account with one bank has relationship with bank refusal of enterprise application for a loan. At 95% confidence interval, the coefficient (r) of correlation analysis was found as -0.002. This suggested that there is no significant relationship between duration an enterprise has kept an account with one bank and refusal of enterprise application for loan.

The relationship was measured by the correlation coefficient because it indicates the degree to which one variable can be predicted from the other by reflecting the strength and the direction of association between two variables. The values of Pearson correlation coefficient vary between +1.00 and -1.00. Both extremes represent perfect relationships between variables, and 0.00 represents the absence of a relationship. The direction of the relationship is indicated by the correlation coefficients. Thus, the relationships' coefficient, $r = -.002$ indicates that there is a negative or inverse relationship between the duration an enterprise has kept an account with one bank with bank refusal of enterprise application for loan. This then gave rise to the hypothesis "Duration an enterprise has kept an account with one bank has no relationship with bank refusal of enterprise application for loan".

6.2.11 Bank Mobility and relationship lending

Bank mobility is often used to proxy customer reputation and relationship lending. Both practicing bankers and economic theorists have long argued that bank relationships are valuable. With repeated contracting with borrowers, banks continuously gather information and update their evaluations of firm credit worthiness. Information is gathered through repeat lending or the provision of deposit and other information-intensive financial services. Berger and Udell (1998: 645) note that most small businesses

have maintained a relationship with a bank for 9 years, and that a majority identify a commercial bank as their primary financial intermediary. Theory holds that small businesses that form relationships with a principal bank secure several advantages, including lower interest costs, greater credit availability, lower collateral demands, and protection against credit rationing in periods of firm distress.

This study sought to find out the relationship between bank mobility and access to bank finance. Customer relationship enhances reputation. Diamond (1989:4) suggests that the “reputation of the enterprise” may be measured as a function of variables such as age of the business and the number of times an enterprise has changed bank accounts. Reputation may also be measured as a function of the number of years that the enterprise has been owned by the entrepreneur. A positive relationship may be expected between the numbers of years that the enterprise has belonged to its current owner and the level of borrowing. The reputation is then reflected in greater ease in obtaining the required financing.

The findings indicate that majority of the manufacturing SME operators (64.7%) have not changed accounts from one bank to the other. However, 10% of the operators had changed bank accounts once; 6.3% had changed twice and 2.1% had changed thrice. This means that there is low bank mobility among small and medium-scale manufacturing enterprises in the study.

Table: 6.7a Number of times changed accounts with banks (N=380)

Number of times	Frequency	Percent
More than three times	2	.5
Three times	8	2.1
Two times	24	6.3
Once	38	10.3
Not changed	246	64.6
NA	62	16.3
Total	380	100

Table: 6.7b Duration of firm in operation and times changed accounts (N=380).

Years in operation	More than 3 times	3 times	2 times	Once	Not changed	NA	Total
0-1	1	0	0	1	4	1	7
2-3	0	0	4	6	39	10	59
4-5	0	3	3	9	95	16	126
6-10	0	0	7	10	53	17	87
Over 10	1	5	10	12	55	18	101
Total	2	8	24	38	246	62	380

The results from the respondents indicated that 4 interviewees or 0.01% of the enterprises aged between one and three years had changed accounts twice, while none of those aged between four and ten years had changed accounts more than thrice. The empirical results further indicated that 0.003% of the enterprises aged over ten years had switched accounts between banks more than three times.

It could be observed from the survey that non-mobility of customers did not improve access to finance. The survey results indicate that bank finance was among the least used sources of business finance. This may have been due to lack of adequate reputation banking. More important than the attributes of the business or their owners, the credit history of the business sends a strong signal to lenders about the risk of repayments. It was found that most commercial banks do not have sufficient information on the capacity for loan repayments of the SME borrowers plus their credit histories, personal characters and business commitment.

Table 6.8: Gender: Number of times changed accounts

Gender	Number of times changed accounts with banks					
	>3 times	3 times	2-times	once	Not changed	NA
Male	2	8	18	34	192	58
Percent	100	100	75	89.5	78	93.5
Female	-	-	6	4	54	4
Percent	-	-	25	10.5	22	6.5
Total	2	8	24	38	246	62

The empirical evidence in table 6.8 above suggests that majority of the male operators have not changed their bank accounts. The results indicate that 192 or 78% of the male operators and 54 or 22% of the female operators have not changed accounts between banks.

6.2.12 Access to bank finance

6.2.13.1 Use of Overdraft and Long-term loan

The survey results indicate that majority of the SME operators are in need of bank finance. Of the respondents, 91.8 % (349) had applied for long-term loans and bank overdraft respectively. This presumably, was because institutional credit is the only feasible option for financing enterprise growth (IFC, 2000:32-33; UNCTAD, 1995:6). Besides, banks limit themselves to overdrafts and to medium term bank loans (Fafchamps et al., 1994:15-28).

Table 6.9 Application for Bank finance

Application for Long term loan	Frequency	Percent
Yes	349	91.8%
No	31	8.2%
Application for overdraft		
Yes	349	91.8%
No	31	8.2%
Total Number of respondents & percent	380	100%

Despite the desire to access bank finance, the results from the survey indicate that 61.8% of the loan applications had been rejected, while 38.2% had been accepted. This confirms the findings from previous studies where it had been found that 92% of the operators had elected not to apply for loans and only 9% of the firms received any external funding other than from personal savings, relatives or retained earnings (Lutabingwa 1996:5). In another similar study in Indonesia, Van Dierman (1998) found that less than 20% of the surveyed SMEs in the garment industry had ever applied for and actually obtained a bank loan.

Most business owners assumed that they would not be granted a loan, as they did not have collateral. However, most stated that an alternative source of external funds other than commercial bank loans would improve their businesses significantly. Some owners felt that there was discrimination in the provision of loans, particularly against small businesses.

Nonetheless, the researcher was unable to obtain data on the nature and extent of SME participation in commercial bank financing across the sectors in the study. Previous researchers have also found that it is difficult to obtain comparable data of the total amount and relative share of institutional or bank finance secured by SMEs (APEC, 2002:74-75; Vilorio, 2001:142-143).

Table: 6.10 a Age of SME operators and Enterprise use of Overdraft

Age of SME operators	Did your enterprise apply for any overdraft facility?	Observed		Expected	
		Count	%	Count	%
18-29	No	4	5.4%	6.037	8.2%
	Yes	70	94.6%	67.963	91.8%
30-39	No	11	6.7%	13.297	8.2%
	Yes	152	93.3%	149.703	91.8%
40-49	No	10	11.2%	7.261	8.2%
	Yes	79	88.8%	81.739	91.8%
50-59	No	4	8.7%	3.753	8.2%
	Yes	42	91.3%	42.247	91.8%
60 +	No	2	25.0%	.653	8.2%
	Yes	6	75.0%	7.347	91.8%

Table 6.10b: Age of SME operators and enterprise application for long term loan

Age of SME operators	Did your enterprise apply for long term bank loan?	Observed		Expected	
		Count	%	Count	%
18-29	No	7	9.5%	6.037	8.2%
	Yes	67	90.5%	67.963	91.8%
30-39	No	11	6.7%	13.297	8.2%
	Yes	152	93.3%	149.703	91.8%
40-49	No	7	7.9%	7.261	8.2%
	Yes	82	92.1%	81.739	91.8%
50-59	No	4	8.7%	3.753	8.2%
	Yes	42	91.3%	42.247	91.8%
60 +	No	2	25.0%	.653	8.2%
	Yes	6	75.0%	7.347	91.8%

6.2.13.2 Reasons for not applying for any loan

For the respondents who had not taken any loan, the study sought to know the reasons for not applying. Evidence indicated that there were four main reasons why the respondents would not apply for any bank loan. These were interest rate, collateral, repayment period and the loan screening process, see table 6.11 below

From the key informants, it was further found that banks are primarily concerned with the ability of the borrowers to service debt. In mitigation of repayment default, banks take collateral for their lending, which reflects their conservative approach to risk. This finding is similar to what had been found in another study on SMEs financing in less developed countries by the ILO (1995) where it had been observed that collateral is an essential condition in securing access to bank loans.

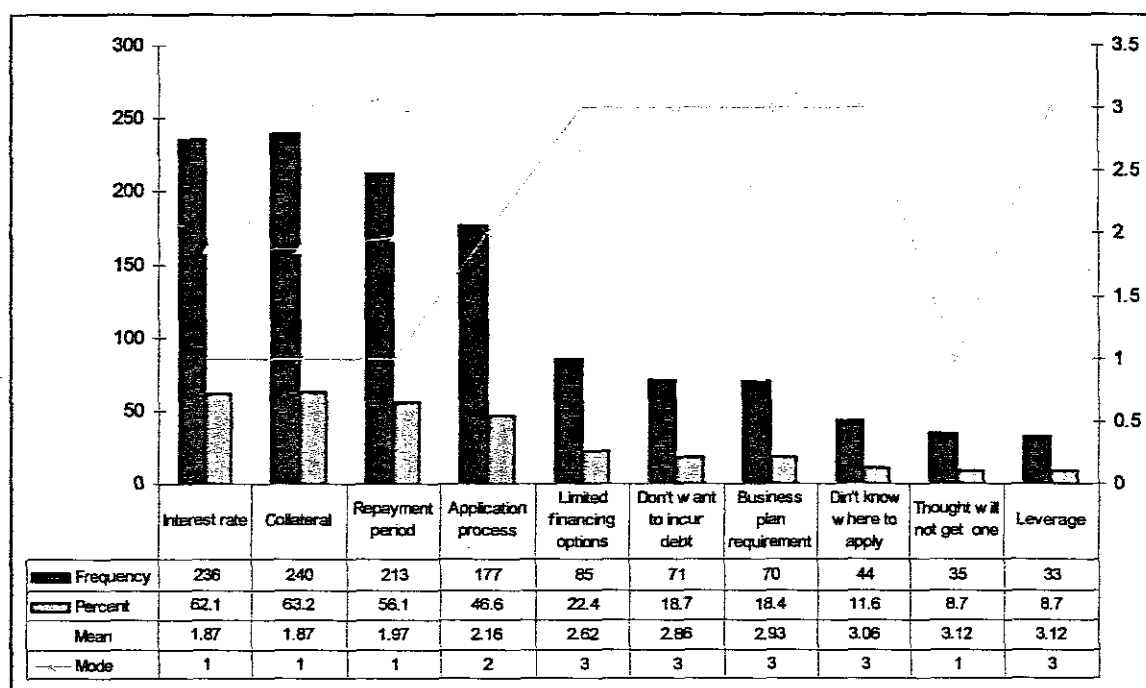


Figure 6. 4: Reasons for not taking loan. N=380 Min. score =1 Max. Score= 5

In addition, it was established that other constraints contributed to the reluctance to apply for any loan. These included the following:

- lack of demand for products as a result of poor state of the economy
- high cost of capital
- attitude by banks on lending to small enterprises and
- lack of information on available bank products.

Notwithstanding this, the banking sector is expected to provide a wide range of services to SMEs including loans, overdrafts, debt factoring, asset-based finance and invoice discounting. However, empirical evidence from the study suggests that there is limited supply of finance and hence SMEs have difficulty accessing debt finance. Thus, the majority of the SMEs had perceived themselves as ineligible to obtain any bank finance because of the inability to meet most of the lending conditions.

6.2.13.3 Collateral and SMEs access to external finance

Studies on the relationship between collateral and access to bank finance have indicated that lack of collateral satisfactory to banks has always been a constraint on SMEs seeking external finance, particularly bank finance. Collateral has always been said to explain the mismatch between supply and demand in the financial market (Levitsky, 1993:9-10; Schneider-Barthold, 1984:51). The results from the study indicate that there is a relationship between collateral and loan application, as 75% (285) of the respondents indicated that there was collateral requirement. This indicates that access to finance is still one of the central problems for SMEs in accessing bank finance. Within this problem area, smaller and, especially, younger businesses felt that they were discriminated against more in terms of collateral requirements than in terms of interest rates. When asked whether they would sometimes use high collateral requirements to deter unwanted clients, the banks' responses were mixed. Most banks rejected this technique. However, about 20 per cent of banks surveyed admitted that they sometimes resort to this method to signal to potential borrowers that the banks are not interested in lending to them. Overall, two banks reported that they are more likely to use this method with smaller clients than with larger clients.

The banks in the survey perceive collateral related problems in lending to SMEs as equally important as problems related to the borrowers themselves. This could suggest that in Kenya, collateral is only to a limited extent a suitable substitute to knowledge of the borrower as a risk-mitigating factor, thus limiting the basic function of collateral in bank lending. Although the most important obstacle overall appears to be the lack of reliable financial information about the borrower. This is closely followed by the lack of suitable collateral.

Within the area of collateral-related problems, lack of suitable collateral and poor marketability of pledged assets are the most important issues, followed by delays in collecting collateral and the pooling of pledged assets into a bankrupt estate.

These results confirmed the results by Biggs and Srivastava (1996:8) in a cross country study including Kenya where all formal loans and overdrafts were against collateral and high collateral-debt ratios were seen as a greater impediment to the expansion of formal bank lending to SMEs.

6.2.13.4 Main Sources of finance

The following table indicates the responses to the question of “which of the following sources of finance do you use to finance your business activities?” SMEs were provided with a list of sources and asked to rate each one on a scale of 1 to 4 depending on how applicable it was to their situation (1 = always; 4=don’t know source). The table below shows the number of responses for each rating and the corresponding percentages. An examination of the data in the table shows that for the respondents in the study, the most important sources of finance that applied to their situation were personal savings (a total rating of 99.5% at 1 and 2 level); retained earnings (a total rating of 90.9 % at the 1 and 2 level) and friends and relatives (57.9 % at the 1 and 2 level) respectively.

This result is similar to the one obtained by Greater London Limited on their survey of SMEs access to finance in the European member states (2000:1) where it was found in some member states (France, Belgium and Portugal) that own capital financing is more prevalent while in some other member states (Germany and Austria), small businesses relied much less on own capital and more on readily available bank loans.

The study found bank finance to be among the least used sources of finance. This finding is similar to the results by ODA/UNICEF (1995) in Kenya, where it had been found that SMEs have no access to bank credit. Biggs (1991) makes similar observations regarding Taiwan.

The study showed that financial institutions are not favoured sources of credit by SMEs. The majority of the respondents then observed that they had no access to bank credit, 361(70.2%). Another study in Kenya by Daniels et al (1995) showed that only about ten percent of the SMEs had ever received any form of formal financial credit. The empirical evidence showed that only about three percent of the SMEs had been reached with credit

from formal institutions. Furthermore, in another study on manufacturing constraints and opportunities in Kenyan manufacturing by Soderbom (2001:53), it was found that the most cited number one problem for the firms was insufficient demand followed by access to credit.

Table 6.12 (see p.199) however, reveals that many SME operators are ignorant of some forms of finance. What is common though is that in most cases SMEs require external finance for working capital or business expansion, be it loans or other types of debt. Unfortunately, the results from the study clearly show no prevalence of overdrafts, bank loans or other alternative forms of finance for the manufacturing SMEs in the study.

Other findings indicate that other forms of debt finance are not popular amongst SMEs and are much lower down the pecking order. This may be due to several factors including a lack of knowledge on their existence and use or lack of business advisors promoting use of other forms of finance other than bank finance. The researcher therefore, suggests that other sources of finance such as leasing would be more ideal in meeting the financing needs of SMEs. Leasing as an alternative form of finance operates with realistic lending criteria. It could assist SME operators in the financing of equipment purchases. Additionally, leasing firms could accommodate all applicants, whether they have been in business for many years or are in the early stages of developing a business. Furthermore, leasing firms focus on the borrower's ability to generate cash flow from business operations to service the lease payment, not on the balance sheet or on past credit history. The empirical evidence suggests that other sources of finance are either not known by the SME operators in the study or have not been developed.

Table 6. 11: Main sources of finance used by SMEs (Sample size=380)

Variables	Always 1		Sometimes 2		Never 3		Don't know Source 4	
	N	%	N	%	N	%	N	%
Personal servings	356	93.7	22	5.8	2	.5	-	-
Friends and relatives	87	22.9	133	35	159	41.8	1	0.3
Bank over draft	17	4.5	36	9.5	286	75.3	41	10.8
Long term loans	15	3.9	37	9.7	290	76.3	38	10
Informal credit	17	4.5	41	10.8	268	70.5	54	14.2
Partner contributions	29	7.6	30	7.9	291	76.6	30	7.9
Supplier credit	49	12.9	94	24.7	221	58.2)	16	4.2
Leasing	16	4.2	(-)	-	317	88.7	27	7.1
Hire purchase	10	2.6	16	4.2	320	84.2	34	8.9
Factoring	6	1.6	14	3.7	189	49.7	171	45
Angel finance	4	1.1	6	1.6	161	42.4	209	55
Venture capital	8	2.1	4	1.1	162	42.6	206	54
Shares	21	5.	20	5.3	291	76.6	48	12.6
Retained earnings	296	77.9	51	13	22	5.8	11	2.9
City/municipal council loan scheme	9	2.4	8	2.1	229	60.3	134	35
SMEs development credit guarantee fund	5	1.3	3	0.8	170	44.7	201	52.9
Sale of fixed assets	6	1.6	13	3.4	228	60	131	34.5
Cash advances from customers	30	7.9	95	25	238	62.6	17	4.5
Government loan guarantee scheme	175	46	58	15	123	32	24	6
SMEs development bank	11	2.9	16	4.2	251	66	102	26.8
SMEs stock exchange	18	4.7	65	17.1	251	66	46	12

6.2.13.4.1 Supplier credit

The empirical result indicates that firm size has no significant effect on the proportion of suppliers who give credit. Majority of the enterprises get credit from a significantly smaller proportion of their suppliers. The study confirms that Kenyan business enterprises buy significantly less on trade credit. The use of supplier credit is less prevalent among manufacturing firms. This confirms the result by Fafchamps, Biggs, Conning and Srivastava (1994:42). This was attributed to the state of the economy and its effect on demand for traded products (refer to table 6.11 above).

The major method for establishing trade credit with suppliers was through repeated interaction, either with individual suppliers or with a community of business people. Surveyed businesses that had received trade credit from their suppliers, first bought goods on cash for a while before qualifying for credit. This process is lengthy and has to be repeated for each individual supplier. Majority of the supplier credit recipients, were able to use personal contacts, credit acquaintances, and business reputation to secure trade credit from the start. It was found that immediate access to trade credit enables firms to leverage their initial capital and instantly achieve a viable size. However, there was no strong relationship between firm size and access to trade credit.

The other interesting finding was that 70% of the respondents stated that they establish their reputation with suppliers by being good paymasters. Most specified that a good reputation has to be established with each supplier individually. More than 60% of the surveyed firms believe their suppliers do not exchange information about their payment record and that delaying payment to one of the suppliers does not affect their reputation with other suppliers. The other 40% perceive themselves as establishing a track record within their business community. Due to lack of information about customers, most of the suppliers of non-Kenyan origin were reluctant to engage in credit transactions with business operators of African origin.

6.2.13.5 Factors influencing choice of finance

Table 6.12 (p.205) indicates the responses to the question of "what factors influence choice of the source of financing?" SMEs were provided with a list of factors and asked

to rate each one on a scale of 1 to 3 depending on how applicable it was to their situation (1 = always through 3=Never). The table shows the number of responses for each rating and the corresponding percentages.

An examination of the data in the table shows that the most important factors influencing choice of finance that applied to the situation of the respondents were interest rate and collateral (a total rating of 77 % at 1 and 2 level); repayment period (a total rating of 72.7 % at the 1 and 2 level) ; loan transaction costs (a total rating of 67.1 % at the 1 and 2 level) ; availability of credit (a total rating of 65.5% at 1 and 2 level); threat of bankruptcy(a total rating of 63.2% at 1 and 2 level) and amount of loan offered (a total rating of 47.1 at 1 and 2 level) .

Table 6.12: Factors influencing choice of finance (N= Sample size=380)

Factors	1	%	2	%	3	%
Interest rate	220	57.8	73	19.2	87	22.8
Collateral requirement	220	57.8	73	19.2	87	22.8
Repayment period	196	51.6	80	21.1	104	27.4
Loan transaction costs	184	48.4	71	18.7	125	32.9
Availability of credit	195	51.3	54	14.2	131	34.5
Threat of bankruptcy	180	47.4	60	15.8	140	36.8
Amount offered	100	26.3	79	20.8	201	52.9
Financing options	112	29.5	38	10	230	60.5
Relationship with the source	116	30.5	28	7.4	236	62.1
Other factors	4	1	-	-	376	98.9

The results confirm Stiglitz and Weiss's (1981) result. According to Stiglitz and Weiss, interest rate plays a dual role of credit rationing and operating as an indirect mechanism for screening and regulating the risk composition of the lender's portfolio. It may also be argued that the incompleteness of financial contracts forces lenders to use various indirect devices to address the information and enforcement problems.

Banks put restrictions in loan contracts, which limit access to funds. They ask for collateral, which many borrowers simply do not have and issue loans repayable over short- term periods only. Collateral, interest rate and restrictions on lending preclude most firms from using financial markets to perfectly meet the needs for funds. Hence, firms may find it difficult to smooth cash-flow fluctuations. For example, some respondents in the study complained that the collateral requirement and interest rate discouraged them from approaching the financial markets for the much-needed funds. These negative conditions need to be mitigated for the SME sector to play its significant role in the economy in employment creation and contribution to the gross domestic product (GDP).

6.2.13.6 Purpose of the loan

The Logit analysis for the application of long term loan (APLTLOAN) and the purpose of the loans is provided in table 6.14 below.

Table: 6.13 Purpose of the loan

Logit Maximum Likelihood Estimation Dependent variable =loan application 380 observations used for estimation from 1 to 380			
Regressor	Coefficient	Standard Error	T-Ratio [Prob]
PINNOV	-1.7296	.77153	-2.2418[.026]
ECAPAC	.34559	.46587	.74182[.459]
WCAP	.38330	.48257	.79428[.428]
RPLM	-.67217	.49346	-1.3622[.174]
ACQNMP	.94203	.50445	1.8674[.063]

Definition of the regressors: P.INNOV = Plant innovation; EXCAP= Expansion of capacity; REPMA= Replacement of machinery and ACQMCA= Acquisition of machinery, WCAP= working capital.

The result indicates that long-term loans are required for the acquisition of new tools, for working capital and for expansion of the business capacity.

6.2.13.7 Satisfaction of financial needs

The study sought to establish whether manufacturing SMEs had unmet financial needs. This was because previous studies such as that by Namusonge (1998) had observed that majority of the small and medium-scale firms depended on informal finance, own savings and retained earnings. The empirical evidence suggests that 90 % (342) of the respondents in the sub-sectors under the study were in need of finance. This was similar to the finding by Biggs and Srivastava (1996:6) where most of the manufacturing firms in Kenya had reported being unable to undertake any profitable investment due to lack of funds. This result is also similar to Maksimovic's finding (2004:10) on a cross-country study on the determinants of financing obstacles, where 63% of the firms rated financing as a major obstacle. Empirical results show that majority of the operators in the manufacturing sectors in the study face financing difficulties that would require alternative solutions.

The study also sought to know whether the manufacturing SME operators were satisfied with the existing range of financial products and services offered by the financial providers. The reason for the question was to establish the need for use of alternative sources of finance. It emerged that only 14 (4.19%) were very satisfied while 98 (29.3%) of the respondents indicated that they were not very satisfied. Different reasons were responsible for this outcome.

All commercial banks have been highly conservative in their lending practices, a tendency reinforced by the legal requirements for ensuring adequate security. Since most SME borrowers lack tangible collateral, and banks are reluctant to lend on the basis of other alternative criteria, they are excluded from the credit circle. Thus most loans go to larger, older enterprises, which are better managed, more profitable, and have a good track record of borrowing and repayment. SMEs' dissatisfaction with borrowing from banks is compounded by the perception that the costs of credit delivery are too high.

The investigation further sought to establish whether manufacturing SMEs in Kenya have unmet finance needs because of unawareness of the financing sources. The relationship was tested using correlation analysis. The correlation coefficient (r) was found as $-.030$. Thus, a weak negative relationship between unmet finance needs and knowledge of the finance sources was found implying that other factors could be behind the gap in the finance needs.

The result of the analysis show that there is a negative relationship between unmet finance needs of enterprises and availability of bank product options. This then suggests that availability of finance options is not the problem in meeting the financing needs of the small and medium-scale manufacturing firms in Kenya. There could be a variety of problems that include factors that limit access to bank products such as knowledge of the products.

6.2.13.8 Financing Constraints

The following table indicates the responses to the question “how often do you experience the following financing problems?” Respondents were provided with a list of constraints and asked to rate each one on a scale of 1 to 3 depending on how applicable it was to their situation (1 = Always; 3 = Never). The table below shows the number of responses for each rating and the corresponding percentages. For example, 327 respondents (or a total of 86.1% of respondents at 1 and 2 level) indicated that repayment period constituted a major constraint while 236 respondents (or a total of 88.4% at 1 and 2 level) indicated interest rate.

The research results on the financing problems are presented in ascending order of magnitude, with the most perceived problem on top of the table and the least at the bottom. The empirical findings indicate that repayment period is always perceived as a major financing constraint by 74.5% of the respondents, followed by interest rate by 71%, and transaction costs and collateral 64.5% of the respondents respectively.

Table 6.14: Financing problems (Sample size=380)

Problem	Always N	%	Sometimes N	%	Never N	%
Repayment period	283	74.5	44	11.6	53	13.9
Interest rate	271	71.3	65	17.1	44	11.6
Transaction costs	246	64.7	59	15.5	74	19.5
Collateral requirement	240	64.5	53	13.9	81	21.3
Threat of bankruptcy	240	63.2	49	12.9	91	23.9
Availability of bank credit	226	59.5	82	21.6	72	18.9
Access to supplier credit	218	57.4	93	24.5	69	18.2
Information on sources	98	52.1	102	26.8	80	21.1
Limited financing options	165	43.4	117	30.8	98	25.8

The other problems identified include amount offered as loan and availability of financing options. The high interest rate could be attributed to the lending relationship between banks and SMEs. In the relationship-lending model by Booth and Thakor in Elsa et al. (2000:7), relationship with the bank determines the collateral decision and the interest rate to be charged. Thus, for borrowers without a positive track record, the bank charges high interest rates and requires the provision of collateral. Collateral has a close relationship with interest rates. Along this line of reasoning, empirical studies demonstrate that the larger the collateral a borrower can provide, the lower the interest rate will tend to be (FAO, 1996:5). This therefore implies that majority of the manufacturing SMEs in the study do not have adequate collateral, have not established relationship with the banks or lack track record, the reason for high interest rates. It could also mean that the regulatory policy on lending to SMEs and interest rate determination would be flawed. The respondents were of the view that alternative methods of financing with minimum cost of capital and collateral requirement could help boost the activities of the sectors in the study.

These findings were similar to the results of a cross-country study by Maksimovic (2004:11) where firms had been asked questions to understand the nature of obstacles in the financial sector. These questions related to:

- collateral requirement of banks
- bank paper work and bureaucracy
- high interest rates
- bank relationship
- access to financing for leasing equipment
- financial information on customers, and
- access to long-term loans.

The results from the study indicated that high interest rate was the major obstacle followed by the lack of access to long -term loans. This finding is similar to the results on enterprise finance in Kenya by Fafchamps, Biggs and Srivastava (1994:9) where it had been found that high transaction costs characterized the financial markets thus discouraging borrowers of loanable funds. This contradicts Modigliani and Miller theorem, which predicted unlimited access to the market for all firms to all financial instruments at the prevailing cost of capital. Hence, SMEs are forced to rely on internal financial resources, that is, own capital, retained earnings and borrowings from relatives and friends.

6.2.13.9 Awareness of alternative sources of financing

Respondents were asked to indicate whether they were aware of the different sources of financing. It was observed from the survey as shown in table 6.15(p207) that majority of the SME operators were not aware of certain sources of finance. For example, 99% (378) of the sample said they were aware of hire purchase as a source of financing, while 82.4% (313) were aware of credit guarantee fund; 82.1% (312) were aware of retained earnings; 79.5% (302) were aware of sale of fixed assets as a source of financ ; 74.5% (283) were aware of friends and relatives and 64.7% (246) were aware of personal savings.

Table 6. 15: Manufacturing SMEs awareness of alternative sources of finance.

Variables	Yes		No	
	N	%	N	%
Personal savings	246	4.7	53	13.9
Friends and relatives	283	4.5	44	11.6
Bank over draft	175	46.1	87	22.9
Long term loans	165	43.3	117	30.8
Informal money lenders	131	4.5	85	22.2
Partner contributions	109	8.7	77	20.3
Supplier credit	29	7.6	21	5.5
Leasing	38	10	342	90
Hire purchase	378	99	2	.5
Factoring	19	5	361	95
Angel finance	81	1.3	299	78
Venture capital	66	17.4	314	82.6
Shares	283	74.5	96	25.3
Retained earnings	312	82.1	68	17.9
City/municipal council loan scheme	35	9.2	345	90.8
SMEs development credit guarantee fund	313	82.4	67	17.6
Sale of fixed assets	302	79.5	78	20.5
Cash advances from customers	285	75	95	25
Government loan guarantee scheme	280	75.7	100	6.3
SMEs development bank	63	6.6	317	83.4

Notwithstanding this, some financing sources were found least known to operators in the study. These included: Leasing 90%(342) , Angel finance 78% (299), Venture capital 82.6%(314) , City or municipal loan scheme 90.8%(345) and SMEs development fund 76.6%(317). Apart from lack of knowledge on what they are, it was acknowledged by some respondents that it was difficult to obtain information on them.

Other findings based on interviews with key informants indicated that SME operator's general knowledge and awareness of finance options available to SMEs in Kenya is poor. This was said to be due to:

- Lack of understanding of what is available to SMEs due to fragmented financial information and a lack of educational opportunities for the less educated to facilitate learning particularly on key aspects of business management.
- Lack of targeting awareness and educational schemes with a view to raise the profile of finance issues amongst the SMEs in Kenya.
- All SMEs should be aware of the business support and finance options available to them. A failure to provide improved financial advice and increase awareness of the finance options may result in inappropriate usage of finance and misconceptions of finance availability. This ultimately will have implications for job creation and the development of the economy. Thus, a heightened awareness of the full range of options of finance available in Kenya would help:
 - SMEs to identify their key finance needs;
 - SMEs to understand the range of finance products available to them and how to access them and
 - Suppliers of finance to meet the identified needs of SMEs

6.2.13.10 Sources of information used to access external finance

The study sought to know how often the manufacturing SME operators used different sources of information to access finance. The respondents were then asked to rate them on the Likert-scale 1 (very often), 2 (quite often), 3 (not very often) and 4 (not at all). They were further asked to state any additional source of information that was not listed. The results indicate that, 74 (32.6%) and 94 (41.4%) of the operators in the textile and metal sub-sectors very often use family and friends to obtain information on external sources of finance. Also, it was found that textile operators very often use local customers to know external sources of financing. The other sources, such as contacts with competitor

firms, leasing firms, venture capital firms, the internet and contacts outside Kenya were found as sources not used at all by the respondents in the cross sectoral analysis.

6.2.13.11 Information needs

Information needs arise when an enterprise runs short of ideas about how to solve a particular business related problem. When the enterprise experiences such a situation, it is said to experience a gap in the knowledge structure in the cause of the problem. The gap may be crucial to the performance of the enterprise and the problem regarding the need for information must be resolved in order to eliminate the deficiency.

In this study there was consensus that enterprises in the study have information needs. The need was identified to do more with sources of finance. The survey results reflect gender parity on financial information needs as 89.4% of the male operators and 88.2% female operators indicated that they needed information on available bank loans; while 84.6% male and 91.2% female operators indicated that they needed information on other sources of business finance. The empirical evidence suggests that almost all manufacturing SME operators need information on available bank loans 339 (89.2%), sources of business finance 326 (85.8%), SMEs loan schemes 316 (83.2%) and information on venture capital 215 (56.6%).

Informants held similar views about the information needs of SMEs, in particular the finance need. They felt that SME operators have difficulties knowing where to access business finance.

There are numerous types of finance available to SMEs in Kenya. However, their details are very fragmented and it is very difficult for both SMEs and business advisors to identify:

- What finance options are currently available?
- Which option(s) is (are) most appropriate, any restrictions for an application and how to apply?

Based on the responses, the majority of the SMEs interviewed would like to know more about other forms of debt finance to enable them make more informed decision as to the most appropriate type of finance. This finding suggests that manufacturing SME operators need information on alternative sources of external finance to bridge the gap in financing.

6.2.13.12 Role of information and communication technologies (ICTs) in SMEs financing.

The study sought to investigate access to financing information, method used to access financing information, types of financial information required, knowledge on computer usage and the functions of computers in relation to access to external finance.

This section reports on findings from the respondents and observations. In reporting these findings, the study accepts the premise of Belkin's ASK model (in Ikoja,2002:369).The model is a sense making approach that users have gaps in their knowledge and seek information to bridge these gaps. By accepting that proposition, information need is tied to information use. Information use is presented as a social action that is distinguishable by a motivation to achieve some goal, McQuail in (Ikoja, 2002:370).Information is usually assessed on the basis of its contribution to the solution of the problem at hand.

The respondents were asked to indicate the functions to which they used computers in their businesses. It was found that a majority of the SME operators in the study have not used information and communication technologies (ICTs). On average 93.2 %(358) of the operators' thought that ICTs were not necessary. Three hundred and fifty eight respondents of the three hundred and eighty in the sample felt that it was not necessary to use computers for word processing, internet browsing, e-mail and for record-keeping. This result could be attributed to the level of education and formal training on the e-business models and role of information and communication technology in enhancing the effectiveness of business functions. The use of information and communication

technologies (ICTs) in enterprises may have a relationship with the literacy of the human capital in those enterprises.

The study further sought to establish the computer literacy level among the small and medium-scale manufacturing firms in the study and its role on information seeking behaviour regarding the availability of external sources of finance.

The empirical evidence from the investigation revealed that there was a very insignificant level of computer literacy among the manufacturing SME operators, only 20 (twenty) respondents from the 380 (three hundred and eighty) respondents were computer literate while 360 (three hundred and sixty) were not. The observation was however not sector specific as it cut across the three sub-sectors in the study. Thus, lack of computer skills may have inhibited the knowledge on available sources of finance and possibly bank products. It is therefore suggested that computer knowledge could mitigate the perceived problem of limited sources of finance and, or bank products. This could be possible through e-commerce, customer to business (C2B) that is, enterprises- to-providers of finance transactions and information seeking on available alternative sources of finance.

SECTION II

6.3 Survey results from key informants of the study

This section presents data obtained from interviews with the key informants of the study. The informants were drawn from government policy makers and loan officers and information technology personnel of a sample of financial institutions that have dealt with SMEs. The sample consisted of five loan officers, five IT experts and five policy makers. The policy makers were those in relevant Government decision making departments and in the financial sector.

The research instrument for data collection was sub-divided into six sections. Section I sought general information. Section II types of finance available to SMEs and information needed. Section III SMEs constraints in accessing bank finance. Section IV alternative methods of finance for SMEs development. Section V E-finance and SMEs' financing and section VI policy measures for SMEs financing.

6.3.1 Types of finance available to SMEs and information needed

The key respondents were asked to state the nature and types of finance available for SME operators in their respective institutions. They were also asked to indicate the information required from the prospective SME borrowers.

6.3.1.1 Criteria for assessing applications for finance.

Banks always use prudence in their loan decisions and while not being risk averse and will not knowingly endanger their depositors' funds by financing business enterprises and projects which do not meet the criteria below.

- a) Feasibility of the business.
- b) Ability to repay the financing.
- c) An assessment of the economic sector in which the businesses will operate.
- d) The promoter's contribution to the capital expenditure required compared to the contribution being requested from the Bank.

- e) The security being made available.
- f) Borrowing business' track record.

6.3.2 SMEs Constraints in Accessing Bank Finance

The respondents were asked to state whether SME borrowers had any specific difficulties in accessing bank finance. Yes, there are specific difficulties since young and small enterprises have a very low capital base and financial requirements are proportionately high and that funds have often been used for other purposes not contemplated under the originally agreed terms. The following were identified as constraints in accessing bank finance.

- a) Lack of contribution by the entrepreneurs.
- b) Lack of experience and know-how resulting in too optimistic forecasts by the SME borrowers.
- c) Difficulties in attaining economies of scale.
- d) Insufficient security, or total lack of it.

Small enterprises are often unable to put up sufficient owners'/shareholders' funds, commensurate with the level of financing facilities being sought. As a consequence, the financing institution may well require a higher level of collateral which may not be available. This applies even more in a start-up situation, where there is no track record to go by, and the venture has yet to prove itself. There is no access to venture capital funds as an alternative, and smaller businesses, whether starting-up or established, are not likely to have access to capital markets.

Difficulties are also encountered due to small businesses' administrative set up often being weak, and their being unable to present properly drawn up business plans and financial projections in support of their applications for finance.

The main difficulty appears to be linked to a perceived high cost of capital, caused by various factors including; banks charging higher interest margins disregarding lower risks and lack of proper financial management.

6.3.3 Alternative Methods of Finance for SMEs' Development

The main source of SME finance is bank finance in the form of medium/long term loans to meet capital expenditure, and overdrafts to finance working capital. This can be obtained from licensed financial institutions. The respondents could recommend leasing, trade credit, venture capital, angel finance and SME co-operative societies as alternative sources of SME finance. Overall, the results indicate that there are limited financing options for SMEs.

6.3.4 E-finance and SME Financing

E-finance encompasses all financial products and services which are available to the consumer through the Internet. A few banks and financial institutions in Kenya have realised the immense power of the Internet and have taken bold initiatives by way of innovative products and services which are being hosted on the Internet platform.

The finding from the key informants' interviews indicates that SME development effort in Kenya is hampered due to lack of quality data and opaque financial information. Third party credit information services are scarce for proper evaluation of credit risk. Private credit risk intelligence services have not emerged in the market place. This has resulted in the unwillingness of banks to increase their SME lending. Legal and regulatory compliance has also been inadequate. Traditional drawbacks like opaque and asymmetric data and, low capital base continue to characterise SME records.

The respondents suggested that this limitation could be sorted out through the help of e-finance models. E-finance models permit flexibility in product parameters as well as facilitate a one-to-one relationship to a larger base of SME customers without the need to open branches. The web based banking model can thus construct a lasting and profitable relationship of the SME and with the facilitating banks. That notwithstanding, the survey

of the key informants revealed that majority of the SMEs lack computer skills to be able to interact with the internet protocol.

6.3.5 Policy Measures for SMEs financing from the Banks perspective.

An examination of policies employed by commercial banks in their dealings with SMEs is provided in this section. The information is drawn from interviews with key informants in Kenya with loan officers of commercial banks. The semi-structured interviews were conducted with individual heads of loans and advances departments. The information taken from the loan officers contributed to corroborating data obtained in the main interviews. While the number of interviews conducted is reasonably limited, it should be noted that they were conducted with major banking institutions in Kenya. The banks have been coded and the information from the various interviews presented and identified with the specific bank. This form of identification provides a means of displaying patterns of domestic/ foreign bank differentiation, while maintaining the confidentiality of the names of the banks involved.

Bank A- A foreign bank that established itself in Kenya to serve corporate clients. The bank had no dealings with the SME sector prior to 2005.

Bank B-A foreign bank that established itself to serve corporate clients, but has had dealings with the SME sector in Kenya.

Bank C-A previously state owned bank that has now been privatized and the state remains a partial owner. The bank has had some dealings with the SME sector, although reluctantly because of the perceived riskiness of the sector.

Bank D-A Co -operative bank that has taken corporate status and has had and continues to have dealings with the SME sector.

Bank E-A Micro-finance NGO converted into a bank. The bank was established for and has dealings with the micro and small enterprises.

As concerns the official policy of the banks, the questions asked focused on understanding how the policies had changed over time with regard to the SME sector. There was, in general, a pattern of changing policies. The reasons for policy changes differed significantly.

Bank A had not previously dealt with SMEs, but recently began a strategy to establish itself as a bank serving SMEs. The decision to target medium-sized domestic firms as a policy objective was a significant change for this multi-national bank. The decisions and eventual formation of policies and strategies signalled a desire and willingness to participate in a market it had previously withheld from and required that the bank establish lending policies and practices different from those it used with the corporate clients.

Bank B had some dealings with firms from the SME sector, both small and medium. The bank is interested in establishing a base of medium-sized clients. The bank however, had not established any clear policy objectives, targets or programmes. . The similarity between banks A and B was their shared identity as multinational corporate banks that were interested in pursuing relations with the medium-sized domestic market.

Bank C dealt with firms from all size categories. The bank considered itself not well established with the SME sector. This was confirmed by interviews conducted with SME operators in the study. It was noted that bank C was interested in establishing a larger customer base with the SME sector. However, interviews with loan and advances managers expressed concern over lack of proper definition of SMEs.

Bank D had always served the SME sector and was not changing its policies. They were engaging in research programmes intended to better their services and competitively attract business from the SME sector.

Bank E was originally started as a microfinance institution. It is now a bank with products tailored to the small enterprises.

Banks A, B and C had records of generally avoiding strategies for the small firm sector. Bank A had no experience with small firms. Bank B had experience with small firms that suggested the category was too risky, because they lacked management and collateral. Bank C had dealings with the SME sector and was considering increasing their customer base in the sector.

The next question in the interviews tried to ascertain why banks were making strategic decisions to target small and medium-sized firms. The result from the key informants indicates that banks in Kenya are making strategic decisions targeting SMEs. This is simply because, SMEs are perceived as a niche area for profit making as the sector has a large customer base. To respond to this market segment, special business units have been set up geared towards attracting and serving the SME sector.

Bank A had a very deliberate set of responses to the question, indicating that specific reasons had driven policy formation for the SME sector. This multi-national bank wanted to have a large domestic client base.

Bank B responded simply to questions regarding the reasons for change in policies towards the medium sector. The interviewee from the bank said it was entirely market driven. The bank perceived the SME sector as presenting business possibilities.

Bank C had a number of reasons for wanting to increase engagement with the medium-sized market. Bank C was eager to increase its capacity for risk diversification. In general Bank C wanted to expand its base of clients beyond state-owned and to include a population of medium-sized firms. Bank C viewed the SME sector as a source of savings that would increase its deposit base. The interviewee discussed the bank's desire to engage with the medium sector as driven by its expectations of being able to do so profitably. Lending to the sector was portrayed as potentially more profitable because of higher interest rates and wider margins. The interviewee also expressed the opinion that small and medium-sized firms were a tremendous source of current and future growth in the Kenyan economy and that the bank was eager to develop strategies to become more

closely allied to the sector. Bank D did not report any changes in their policies and strategies.

Bank E perceived SMEs as a niche area for economic development and profit making. This former microfinance institution has evolved into bank status to enhance its sustainability, and widen the bracket of its beneficiaries from the micro-entrepreneurs to the small and medium enterprises that do not have access to formal finance.

Questioning on how the banks proposed to and actually served the needs of SMEs was intended to ascertain how committed the banks were to their stated policies. It was noted that all banks covered by the survey had set up departments with a set of procedures tailored to dealing with medium-sized firms. Banks have created separate departments to undertake both the solicitation of new clients and to deal with the on-going maintenance of these relations. In spite of all these efforts, the interviewees expressed their fear of information gathering and information asymmetry.

It was further observed that, apart from B and D, the rest of the banks have never run a credit guarantee scheme. Besides, it was noted that the existing schemes are not well focused/ targeting.

6.3.6 Policy responses from government key respondents

According to the government key respondents, Kenya has made a number of policy responses targeting SMEs. The policy responses owe their origin to the structural adjustment programmes, pressure from civil society organisations, and the stakeholders.

In spite of the government having recognised the potential of SMEs from way back in 1972, it emerged from the interviews that there are very few programmes targeting SMEs. The first major step taken by the government was the recent establishment of the Department of Micro and Small Enterprise Development within the Ministry of Labour and Human Resource Development. The Department is charged with the coordination of all issues, programmes and projects relating to the development of SMEs.

It was further reported by some respondents that, the efforts to support SME development have been intensified by the NARC government since it came into power in the 2002 National Elections. The Ministry of Labour and Human Resource Development is the lead Ministry in supporting the development of SMME activities. The Ministry has finalised a Draft Sessional Paper on the development of Micro and Small Enterprises for Employment Creation and Poverty Reduction. The Draft Sessional Paper highlights a number of issues relating to legal and regulatory frameworks, markets and marketing, credit and finance, physical infrastructure, entrepreneurship, business development services, gender, environment, information, management and institutional frameworks for SME sector coordination. The Ministry of Labour and Human Resource Development constituted a Task Force in May 2003 to look into issues affecting SME performance and growth. The Task Force had a number of tasks including review of policies, SME programmes, concerns of SMEs, strengths and weaknesses of SMEs umbrella associations, governance and institutional capacity of SMMEs for job creation and economic growth. A key output of the Task Force has been the observation that associations are important for ensuring the efficient operations of SMEs. The themes of the Draft Sessional Paper and the Task Force Paper are in line with the NARC Government's national policy on economic development, highlighted in the paper on Economic Strategy for Wealth and Employment Creation and the current development Plan (2002 – 2008). The Economic Development Paper emphasises the need to integrate the formal and informal sectors of the economy. For three decades, these sectors were viewed as separate, and with different potential. The increasing poverty and concentration of the population on the informal economy has justified the policy focus on micro and small scale enterprise development.

6.3.7 Suggestions by key informants on how to improve SMEs' access to finance.

The key informants were asked to suggest ways in which SME financing could be improved. Their views were as summarized below.

- The Kenya Government should formulate a comprehensive SME financing policy.

- There is need to harmonise all the SME financing activities.
- A linkage between commercial banks and micro-finance institutions is needed in order to include SMEs in their financing.
- Need for collaboration, partnership and networking with all stakeholders in the financing activity to enhance financing to SMEs.
- Need to set up an information portal. It was suggested by the key informants that an SME information portal could help mitigate the information gap on existing financing sources. Available financing sources are currently fragmented and that the information was not reaching the potential beneficiaries. The SME Portal would also focus on relationship marketing and products for the entire needs of the SME sector.
- Need to establish a national data bank on number of SMEs, loan beneficiaries, defaulters and trend on enterprise performance.
- Need to set bench mark indicators to measure the lending portfolio of the stakeholders in SME financing.
- Government should consider creating the necessary environment, including fiscal benefits, to encourage the setting up of Venture Capital companies.
- The Government could assist in the financial aspect by providing interest subsidies and loan guarantees and /or regulating interest rates.

6.3.8 Summary

This chapter was divided into two sections. The first section presented data from manufacturing SME operators, and the second section data from key informants. The characteristics of manufacturing SME operators in relation to gender, age, training and highest qualification are described.

The findings indicate that, the operators in the study are distributed in the ages of eighteen to over 60 years. It was observed that SME manufacturing was a male-dominated activity. It was further observed that majority of the operators were not professionally trained in business management.

Certain financing sources were found least known or not known at all to the operators in the study. These included: Leasing, Angel finance, Venture capital, City or municipal loan scheme and SMEs development fund.

The findings indicate that the respondents had a critical need for information on alternative sources of finance to enable them finance their business activities. Results indicate that both small and medium scale enterprises in the study were not accessing alternative sources of finance. Findings from the study further indicate a low fixed asset structure. This implies existence of low collateral capacity. An examination of the data shows that, the most important sources of finance that applied to the situation of the respondents were personal savings, retained earnings, and friends and relatives respectively.

The research results on the financing problems indicate that repayment period is always perceived as a major financing constraint, followed by interest rate, transaction costs and collateral respectively. The other problems identified include amounts offered as loan and availability of financing options.

Section two of the chapter has presented the data obtained from the key informants of the study. These included loan officers, policy makers and IT personnel. The findings identified the following as constraints in accessing bank finance;

- a) Lack of contribution by the entrepreneurs.
- b) Lack of experience and know-how resulting in too optimistic forecasts by the SME borrowers.
- c). Difficulties in attaining economies of scale.
- d) Insufficient security, or total lack of it.

The findings from the key informants further indicate that there is no policy on SME financing, and that there are minimal measures to encourage financial institutions to give loans to SMEs, and that financing options are limited. In addition the results indicate

that, the main difficulty facing SME borrowers is high cost of capital. Furthermore, it was found that the financing information to the SME sector is fragmented.

The next section presents results from tests of the study hypotheses.

6.4 Testing of the hypotheses.

According to Melville and Goddard (1996:72), there are five components in conducting hypothesis test and these include:

- Formulation of *the null hypothesis* and the *alternate hypothesis* (H_0 and H_1),
- Choice of an appropriate test statistic,
- Choice of the level (or levels) of significance,
- Determination of degrees of freedom = $(N-1)$ =sample size-1=df
- Determining whether the test is one tailed or two tailed,
- Determination of the critical value(s) =v or point(s) of intersection between alpha and N-1 in the t-table or z -table depending on whether the sample is small or large, or is normally distributed.
- Computation of specific test statistic using empirical data,
- Based on the chosen level(s) of alpha and degrees of freedom, comparing the statistic with the critical value.
- Conclude by either accepting or rejecting the null hypothesis formulated.

The appropriate level of a significance test in social science is 5% (or 95% confidence interval). This level of confidence can be changed to, for example, 1% significance (or 99% confidence interval), 10% significance (or 90% confidence interval). Thus, given both the level of significance and the test statistic, the critical value forming the basis for reject –accept decision of the hypotheses being tested was calculated.

The significance test is therefore, used in the accept-reject decision of null hypotheses. A null hypothesis is rejected if the predicted value of the sample statistic is significantly different from the hypothetical value. In a two- tailed test, the alternate hypothesis is

accepted if the test statistic $u > v$ or $u < -v$. Thus, for the purpose of testing the hypotheses in this study, the t- test statistic and log odd coefficients were used .

The logit model generated t-test values from a fixed random sample of 380 independent observations, resulting in a degree of freedom >120 or critical value of 1.98. The t-values were then compared with the critical value to determine whether there was statistical significance in the tested relationship(s). The following section provides the results of the statistical tests.

6.4.1 Hypothesis 1. *SMEs do not need alternative sources of finance other than bank finance.*

The hypothesis addresses the financing decisions of a business that are often of non-linear form. As such, discrete variable techniques (logit and probit) have been used to model such decisions. The logit technique can be used to model the relationship between the probability of a firm switching from one branch of a financing decision to another, subject to a vector of explanatory variables. For example, Gardiner and Tzcinka (1992:82) test Myers' (1977:157) theory of the relationship between a firm's growth opportunities and its debt levels. They do this by estimating a logit model giving the relationship between a firm's growth rate (and other variables) and its probability of choosing all equity financing versus debt and equity. Jordan, Lowe and Taylor (1998:17) apply similar procedures when modelling the impact of corporate strategy on its firm's capital structure.

The logit model is applicable to problems of a binary choice, that is, when a decision has only two possible outcomes. In more general situations, where there are several possible outcomes, or a multi-step decision tree is to be analyzed, the probit model is more applicable. For example, Chehab (1995) applies a sequential probit model to investigate the preferred choices of the firm between three or more financing alternatives. This is a special case of a general multi-purpose model since it is used to estimate the successive sequential binary choices. Such an approach is used to investigate the choices of financial sources and the popularity of one source over another in relation to the firm's characteristics.

The two models were found relevant to the general aim of the study, to analyze and evaluate alternative finance for SMEs. Logit and probit analysis generally arrive at the same conclusions for the same data. Thus, the logit model was run to test the hypothesis *"SMEs do not need alternative sources of finance other than bank finance"*.

The logit model does not assume linearity of relationship between the independent variables and the dependent, does not require normally distributed variables, and does not assume homoscedasticity (that is, there is same influence along the entire length of the relationship).

Logits are the natural logs of odds ratios. An odd is the ratio of the probability something is true divided by the probability that it is not true. For conversion, odds=probability/1-probability. Also, probability=odds/ (1+odds). The odds ratio is therefore, the ratio of two odds and is a summary measure of the relationship (effect size) between two variables, the dependent and the independent variable. A positive logit means that when the independent variable increases, the odds that the dependent variable equals 1 increase. A negative logit means that when the independent variable decreases, the odds that the dependent variable equals 1 decrease. Logits are used to compare the relative importance of the independent variables, but after transforming them to odds ratios.

The model operates on the premises that X independent variables have a potential effect to the Y dependent variable.

General Logit formulae

$$L_i = \ln\left(\frac{P_i}{1-P_i}\right) = \beta_0 + \beta_1 X_{1i} + \beta_2 X_{2i} + \dots + \beta_n X_{ni} + \mu_i \quad [1]$$

Notation and Definitions

$$L_i = \ln\left(\frac{P_i}{1-P_i}\right) = \text{logit}$$

P_i = represents the proportion of an alternative source of finance being used and $1-P_i$ = Proportion of the specified source of finance not being used, where $0 \leq P_i \leq 1$.

$$\text{Algebraically, } P_i = \text{Prob}[Y_i = 1] = \frac{\exp(\alpha + \beta X_i)}{1 + \exp(\alpha + \beta X_i)} \quad \text{and} \quad [2]$$

$$1 - P_i = \text{Prob}[Y_i = 0] = \frac{1}{1 + \exp(\alpha + \beta X_i)}$$

X_1, X_2, \dots, X_n Are the independent (explanatory) variables and could also be dichotomous or otherwise. They include alternative sources of finance, such as leasing, factoring and trade credit. The model assumes that use of specific alternative sources of finance excludes use of others.

β_1, \dots, β_n Are the coefficients of the independent variables.

β_0 = Y- Intercept. That is the value of the log odds in favour of the dependent variable if the independent variable = 0

μ_i = Disturbance or error term to take into account the influence of other factors (e.g. sources of finance) not included in the model.

A priori, the log odds coefficient of bank finance, venture capital, stock exchange, angel finance , factoring ,SMEs credit guarantee schemes and municipal SMEs development fund are expected to be negative and informal money lenders and supplier credit to be positive or negative.

Presentation of the result

Using microfit software, the results of *Logit Maximum Likelihood Estimation* were generated and presented on the next page.

Table: 6. 16 Logit Maximum Likelihood Estimation

Dependent variable = Enterprise financing

Independent variable= Individual financing sources

380 observations used for estimation from 1 to 380

Regressor	Coefficient	Standard Error	T-[Prob]
Personal savings	.18185	.0761	44614[.656]
Friends and relatives	-.0054184	.16843	-.032170[.974]
Bank over draft	-.015835	.31180	-.050785[.960]
Long term loans	-.018533	.33774	-.054874[.956]
Informal money lenders	-.94956	.25397	-3.7388[.000]
Partner contributions	.24333	.20923	1.1630[.246]
Supplier credit	-.46913	.16922	-2.7723[.006]
Leasing	.50096	.30989	1.6165[.107]
Hire purchase	.32696	.39569	.82631[.409]
Factoring	.034724	.29689	.11696[.907]
Angel finance	.56517	.42394	1.3331[.183]
Venture capital	-.25005	.36786	-.67973[.497]
Retained earnings	.41566	.22517	1.8460[.066]
City/municipal loan scheme	-.21682	.18939	1.1448[.253]
SMEs credit guarantee	-.15712	.27491	-.57154[.568]
Cash advances from customer	-.10544	.18938	-.55676[.578]
SMEs development bank	.14539	.23755	.61203[.541]
SMEs stock exchange	-.36337	.20615	-1.7626[.079]

Interpretation of the results

The significance of each individual regressor in explaining the financing behaviour of the enterprises in the study was tested using the coefficients of the regressors. Logit coefficients, also known as effect coefficients were used to estimate (predict) the odds that the dependent variable equals 1. The log odds coefficients were used to compare the relative importance of the independent variables on the dependent $y = 1$. If the logit for a given independent variable is b_1 , then a unit increase in the independent variable is associated with b_1 unit increase in the log odds of the dependent variable (the natural log of the probability that the dependent = 1 divided by the probability that the dependent = 0). The probability that the dependent variable = 1 is a function of the logit coefficients. For instance, $y = 1$ or $y = 0$ and x_1 , x_2 , and x_3 are independent variables for the logistic model $y = b_0 + b_1x_1 + b_2x_2 + b_3x_3$. Then the probability that the dependent variable $p(y=1) = 1 / [1 + e^{-(b_1x_1 + b_2x_2 + b_3x_3)}]$. The sign of an estimated coefficient gives the direction of the effect of a change in the explanatory variable on the probability of $y=1$. A positive estimated coefficient on enterprise financing suggests that an increase in the use of the source gives a higher probability of enterprise financing using that source.

As expected, the estimated coefficients have the a priori expected signs and most are statistically significant at the 10 percent or better level (that is, less than 10 percent). The hypothesis "SMEs do not need alternative sources of finance other than bank finance" relates to the likelihood that the enterprises in the study obtain and are satisfied with both overdraft and long-term loan from commercial banks. The dependent variable is dichotomous (one if the enterprise has used the source and zero otherwise). From the analysis, the effect of bank overdraft on the predicted odds that $y=1$ is -0.015835 and that of long term loan is equal to -0.018533 with the average probabilities of non- use of the sources being 96%. Similarly, the average probability of enterprise use of alternative finance is 0.381, implying that, there is a probability of a finance gap in use of alternative finance equivalent to $(1-0.381) = 0.619$. This means that "the estimated level of a finance gap in the use of alternative sources of finance is approximately 61.9%. This signals a need for intervention measures in SMEs financing.

A test of the null hypothesis that bank overdraft or long term loan coefficients are positive against the alternative hypothesis that the explanatory coefficients are negative have t-test statistics of -.050785 and -.054874 . For a two-sided test, the approximate 5% critical value is 1.98. The calculated test statistics are less than the critical value and therefore the null hypothesis is rejected in favour of the alternate.

Discussion of the result

There are numerous problems that hinder the growth of small-scale enterprises (SMEs). Among them is lack of access to credit. The cardinal issue of lack of credit to small-scale enterprise development is particularly prominent in developing countries, and pertaining mostly to credit from formal financial institutions as has been found from the findings of this study. According to Bigsten et al. (1999), about 90% of small firms are refused loans when applied for from the formal financial intermediaries, due to inability to fulfil conditions such as collateral or security. The results from the study indicate that 91.8 % (349) respondents had applied for long-term loans and bank overdraft respectively. This, presumably, was because institutional credit is the only feasible option for financing enterprise growth (IFC, 2000:32-33; UNCTAD, 1995:6). However, of the applications, 61.8% were rejected. It is therefore not unusual to see most of the SMEs resorting to “traditional” sources of finance such as business-retained earnings and personal savings. The probability of the effect of retained earnings and personal savings on $y=1$ is 65.6% for personal savings and 66% for retained earnings respectively, implying that the respondents in the study depend on these two sources of financing to finance business activities ($\text{Prob}[Y_i = 1] = P_i = \frac{\exp(\alpha + \beta X_i)}{1 + \exp(\alpha + \beta X_i)}$). This finding provides ample evidence

that owner-managers have a preference for internal funds over external sources of capital. This may either mean that most of the SMEs in the study are experiencing a growth in earnings so that less external funds will be required or other sources are not used because they are not known. However, dependency on retained earnings will also imply that majority of the respondents have developed financial discipline.

In conclusion, the result from the analysis of the hypothesis suggests that SMEs need alternative sources of funding to personal and retained earnings.

6.4.2 Hypothesis 2. *There is no relationship between gender and use of alternative finance.*

The boundaries of the research were delineated by specific objectives. One of this was to establish the role of enterprise demographic factors on use of alternative finance. To this end, the hypothesis, *“There is no relationship between gender and use of alternative finance”* was tested.

The hypothesis tested whether variations in use of alternative finance could be explained by the firm level variable, gender. The alternative sources of finance were as identified in table 6.18 and each of these sources of finance was examined step wise by relating it to the aforementioned firm level variable.

The dependent variable(s) comprised different sources of finance and were dichotomous (one if the source was used and zero otherwise). For example, if bank overdraft was used the dummy value was 1 and zero otherwise.

Thus, the probability that the dependent variable =1 is a function of the sum of the log odds coefficients. The sign of the estimated coefficient(s) gives the direction of the effect of a change in the explanatory variable on the probability of y=1. A positive estimated coefficient of the log odds suggests a level of significance of the respective variable(s) in influencing the dependent variable(s).

Estimated model

$$L_i = \ln \sum_{l=1}^n \beta_l X_{li} \dots \beta_n X_{ni} + \mu_i$$

Where: L_i = logit

β = the y intercept or vector of the coefficient(s).

X= the coefficient or proportion of the source in the set of sources used.

μ_i =Error term (nuisances not included in the independent variables).

X=gender, the explanatory variable

To specify the model, the dependent variable, namely alternative sources of finance are converted to dummy dependent variables($y=1$ and zero otherwise). The reason being that, the researcher was interested in analyzing the binary question on whether or not enterprises have access to certain sources of credit. Linear probability model (Logit) is used to test the hypothesis that the source of credit is a function of the variable gender. Logit analysis is used to determine the statistical significance of the aforementioned independent variable to possible access to various types of finance by SMEs in the study. Since the respondents were 312 male against 68 female; male responses were used in the analysis. Nonetheless, the results are not biased as the female respondents' responses were almost homogeneous indicating non-use of the choices of financing provided in the investigation.

Table 6.17: Logit Maximum Likelihood Estimation

Dependent variable=sources of finance

Independent variable=gender

Sources of finance	Gender	Coefficient	Standard Error	T-[Prob]
Bank overdraft		1.7047	.15691	1.8644[.960]
Long-term loan		-1.8068	.16266	-11.1077[.000]
Informal money lenders		-1.7806	.16114	-11.0496[.000]
Supplier credit		-.37617	.11524	-3.2643[.001]
Leasing		-1.7047	.15691	-10.8644[.000]
Factoring		-2.8538	.24943	-11.4413[.000]
Angel finance		-3.6376	.35818	-10.1559[.000]
Venture capital		-3.6376	.35818	-10.1559[.000]
Retained earnings		2.3168	.19808	11.6963[.000]
Municipal/city SME loan scheme		-4.3438	.50323	-8.6319[.000]
SME development programme		-3.1355	.28331	-11.0672[.000]
Sale of fixed assets		-.75142	.12131	-6.1940[.000]

For a two-sided t-test, the approximate 5% critical value for a sample of 380 respondents is 1.98. The result on the relationship between gender and use of alternative sources of finance is statistically insignificant for all identified sources of finance apart from retained earnings. Therefore, the null Hypothesis, *"There is no relationship between gender and use of alternative finance"* is accepted. Similarly, at the approximate 10% critical value 1.658, the null hypothesis is rejected. This implies that there is no relationship between gender and use of alternative sources of finance. Further, this may mean that use of sources of financing for business finance is not gender dependent

Discussions of the result

Male respondents were 312 against 68 female. This shows that women's entrepreneurship in the sectors in the study is much less significant. This draws attention to the problems and policy issues related to women's entrepreneurship. Efforts should be made to foster a greater awareness of the benefits of entrepreneurship among women. It is underlined that in addition to a weak market environment, women entrepreneurs have to face gender specific barriers. The latter include the collateral due to uneven sharing of privatisation gains, lack of networks and traditional views on the role of women. As a result women entrepreneurs experience greater difficulties than men in obtaining credits, finding business partners, accessing new markets or getting information on business opportunities.

The study found that women SME owners who required financing but did not apply often claimed that the difficulty surrounding the application process, and the likelihood of not being authorized, made them reluctant to request any form of financing, the reason for negative homogeneity of responses on the use of alternative sources of finance.

The major constraint identified by the women in the study is a lack of access to capital on reasonable interest rates terms. Part of the problem they face is related to them being women, in that there is always a percentage of the lending decision that factors in the loan officer's judgment. Given that loan officers in banks in Kenya are typically male, they may be less receptive to the proposals of women, especially if the proposals involve a non-traditional business model or businesses that have been male dominated. In such

cases, the loan officer may not have confidence in the ability of the woman to be successful in the business. In addition, in some cases, women may not be knowledgeable of how to develop their proposals for financing and they may also be unfamiliar with various financing instruments. In addition, there may be internal barriers that predispose women against wanting to take loans and have partners.

The results of the study indicate that efforts should be made to foster a greater awareness of the benefits of entrepreneurship and especially among women. To this end, strong, positive female role models should be exploited to build self-confidence and encourage other women to consider becoming entrepreneurs.

Overall, based upon the results and opinions from the survey, some conclusions can be made about gender and credit:

- Both men and women set up their businesses still with own capital
- Both men and women feel they have the same opportunities to get credit
- Both men and women need more information on credit possibilities
- Women are more careful and take less risks than men
- Both men and women feel that credits for SMEs are in general too expensive
- Both men and women need good advice in preparing business plans
- Both men and women think that expedient loan processing is essential
- Both men and women consider government support to be important

6.4.3 Hypothesis 3 *The specialization and the separation of the ownership and control functions are positively related to enterprise access to debt finance (agency theory, pecking order and signalling approach).*

One of the objectives of the study was to determine the role of enterprise demographic factors such as ownership form on use of alternative finance. To this end, the aforementioned hypothesis was tested.

The hypothesis was tested by use of log –odds coefficients of the explanatory variables.

Where; $L_i = \ln\left(\frac{P_i}{1-P_i}\right) = \sum_{x=1}^n \beta_1 X_{1i} + \dots + \beta_{ni}$

$$\text{And Prob } [Y_i = 1] = P_i = \frac{\exp(\alpha + \beta X_i)}{1 + \exp(\alpha + \beta X_i)} \text{ and}$$

$$1 - \text{Prob } [Y_i = 1] = 1 - P_i = \frac{1}{1 + \exp(\alpha + \beta X_i)}$$

Presentation of the results

It was expected that if the log- odd(s) coefficient(s) of the predictor variable(s) on the dependent variables was positive, then it meant that the form of business was influencing use of the source of finance to that proportion. However, the results indicate that for sole proprietorship, a part from personal savings, hire purchase and informal money lenders, all the other sources had a very insignificant contribution in financing the aforementioned form of business as their log -odds values were all negative. This shows that there is no significant relationship between SMEs ownership form and use of alternative sources of finance. Thus, the hypothesis *“The specialization and the separation of the ownership and control functions are positively related to enterprise access to debt finance was rejected.*

Table 6.18a: Logit Maximum Likelihood Estimation.

Dependent variable is Sole proprietorship

380 observations used for estimation from 1 to 380

Regressor	Coefficient	Standard Error	T-Ratio [Prob]
PS	.66656	.18166	3.6693[.000]
FR	-.39316	.22288	-1.7640[.079]
BO	-.10269	.42585	-.24114[.810]
LTL	-.50842	.43331	-1.1733[.241]
IML	.049080	.33831	.14507[.885]
NPC	-1.3708	.33733	-4.0635[.000]
SC	.61322	.24791	2.4735[.014]
LS	.015528	.37325	.041601[.967]
HP	.85678	.58625	1.4614[.145]

Key: PS=Personal savings; FR=Friends and relatives; BO=Bank Overdraft; LTL=Long-term loan; IML=Informal Money lenders; NPC= national credit programme; SC=Secured credit; LS=leasing; HP=hire purchase

Table 6.18b: Dependent variable = Partnership form of business.**Logit Maximum Likelihood Estimation**

380 observations used for estimation from 1 to 380

Regressor	Coefficient	Standard Error	T-Ratio [Prob]
RE	-1.184	.21330	-5.5520[.000]
GS	-.45420	.62745	-.72389[.470]
SD	-.67354	.67391	-.99945[.318]
SF	.46724	.29684	1.5740[.116]
CL	-.44095	.29204	-1.5099[.132]
SB	.19524	.39108	.49925[.618]

Key: RE= retained earnings; GS= Government credit guarantee Schemes; SD= SME development scheme; SF= Sale of fixed assets; SB= SME bank

Discussion of the results

The relationship between SMEs and the lenders is characterized by the ownership and control structure in the enterprise. It is possible to distinguish two major types of SMEs,

- those in which the manager is the owner of the entire capital, and
- the medium-sized family enterprises in which there is usually some extent of separation of functions. It is also possible to identify two important interest groups: a) the owner-managers; and b) the external owners that do not sit on the management board (Ang, 1992).

If the capital and the control are in the hands of more than one agent, a reduction in the information asymmetries between lenders and borrowers occurs, and possible opportunistic behaviours by owner-managers could be avoided. In consequence, according to agency theory, a positive relationship is expected between the degree of specialization and separation of the functions of ownership and control, and access to external debt.

Nevertheless, the pecking order theory points out that SMEs in which there is no separation of functions and in which the owner-manager has invested a major part of his/her personal wealth, tend to show a preference for the use of borrowing, in order to avoid involving outsiders and the loss of control in the decision-taking. Even with this, it was found that bank finance was least used by both forms of business.

As concerns form of business ownership, the study found that majority of the enterprises in the survey was sole proprietorships 233 (61.3%), followed by partnerships 94(24.7%) and family 49(12.9%). The survey results further indicate that, there were only two private companies in the sample.

The negative skewness found in the relationship could be a result of majority of the enterprises being sole proprietors, family businesses, or partnerships. It may be argued

therefore, that, because it is difficult to differentiate the owner from the business resources, and due to lack of financial reports, good track record or collateral, formal financial institutions are reluctant to deal with small borrowers.

6.4.4 Hypothesis 4. *“The educational level of manufacturing SME operators has no effect on use of alternative finance”.*

One of the objectives of the study was to establish the influence of enterprise demographic factors on use of alternative finance. To meet this goal, the hypothesis, *“The educational level of manufacturing SME operators has no effect on use of alternative finance”* was tested.

Human capital theory posits that individuals with more or higher quality human capital achieve higher performance in executing relevant tasks (Becker, 1975). Human capital provides the small business managers with knowledge that assists them in identifying opportunities and knowledge of ways to more effectively and efficiently pursue growth. Level of education was used in the test to proxy for product differentiation, itself a signal for lower risk and thereby better possibilities of external financing. Also, well educated operators signal better enterprise management and higher survival rate. It was also assumed that lending officers' probability of supporting credit increases with increased level of competence within the business project of the borrowing SME.

In the analysis, the dependent variable comprised of sources of finance, while the independent variable comprised of different levels of education. For interpretation of results, log-odd ratios or (coefficients) in favour of the dependent variable or otherwise as the level of education change were used. The dependent variable(s) were converted to dichotomous dummy values (one if the source was used and zero otherwise). The sign of the coefficients indicates the direction of the impact of the independent variables on the dependent variable(s).

The logit model was used to analyse the tested relationships between the independent and dependent variables respectively.

Presentation of the results

The coefficients log-odds of level of education on use of alternative sources of finance were, other than for retained earnings and cash advances from customers, negative. Similarly, the probability level for use or non-use of the tested alternative sources was zero. Thus, the hypothesis “the educational level of manufacturing SME operators has no effect on use of alternative finance was accepted.

Table 6. 19: Maximum Likelihood Estimation

Dependent variable = Angel finance

380 observations used for estimation from 1 to 380

Regressor	Coefficient	Standard Error	T-Ratio [Prob]
Primary	-4.0257	.71327	-5.6440[.000]
Secondary	-3.3848	.41501	-8.1559[.000]
Village polytechnic	-3.6111	1.0132	-3.5639[.000]
National polytechnic	-3.3673	1.0171	-3.3108[.001]
Dependent variable = Venture capital			
Primary	-4.7275	1.0043	4.7071[.000]
Secondary	-3.3848	.41501	-8.1559[.000]
Village polytechnic	-3.6111	1.0132	-3.5639[.000]
National polytechnic	-	-	-
Dependent variable = Sale of business shares			
Primary	-1.8905	.27649	-6.8374[.000]
Secondary	-2.2801	.25445	-8.9609[.000]
Village polytechn	-2.8912	.72585	-3.9832[.000]
National polytechnic	-2.6391	.73193	-3.6056[.000]
Dependent variable = retained earnings			
Primary	2.2391	.31678	7.0682[.000]

Secondary	2.4171	.26929	8.9755[.000]
Village polytechnic	2.4588	.60027	4.0961[.000]
National polytechnic	3.3673	1.0171	3.3108[.001]
Dependent variable = Government guarantee scheme			
Primary	-2.7282	.38985	-6.9981[.000]
Secondary	-2.9625	.34173	-8.6690[.000]
Village polytechnic	-3.6111	1.0132	-3.5639[.000]
National polytechnic	-3.3673	1.0171	-3.3108[.001]
Dependent variable = Small business development programme			
Primary	-2.7282	.38985	-6.9981[.000]
Secondary	-3.5727	.45337	-7.8802[.000]
Village Polytechnic	-2.8912	.72585	-3.9832[.000]
National polytechnic	-3.3673	1.0171	-3.3108[.001]
Dependent variable = Cash advances from customers			
Primary	.63219	.19419	3.2556[.001]
Village polytechnic	.66351	.29641	2.2385[.026]
National polytechnic	.54654	.37887	1.4426[.150]
Dependent variable = Small business bank			
Primary	-1.8905	.27649	-6.8374[.000]
Secondary	-1.8460	.21495	-8.5881[.000]
Village polytechnic	-1.5052	.41038	-3.6678[.000]

Discussion of finding

According to Storey (1994:129-136) experience and education level obtained may provide signals of better human capital. The better the human capital, the greater the firm viability of the start up, growth, expansion and consequently access to debt capital. The quality of the human capital of the SME owner manager or of the people working in the

SME is a critical factor influencing the likelihood that the business is able to expand successfully (Dess and Picke, 1999:178). However, the quality of human capital can not be easily observed or measured by external parties, such as banks (Petit and Singer, 1985:48 and Keasey and McGuiness 1990:218). One way to assess the quality of human capital is to examine the SMEs success with projects that require similar competence, knowledge and Skills. An SME that has successfully completed a similar project or a project that requires comparable competence, knowledge and skills more likely has the capability to execute the new project. A positive track record impacts a credit decision when similar projects have been successful (Sergeant and Young, 1991:238). For the lending officer, it is therefore advantageous to learn whether a similar project has been completed successfully in the past. This track record is used to evaluate the probability of success for the new project which in turn influences the likelihood of fulfilling a credit agreement. Thus, lending officers' probability of supporting credit increases with increased level of competence within the business project of the borrowing firm.

However, the finding from the study suggests that education level of the respondents did not influence access to external finance. This implies that, besides demographic factors such as education, there could be other factors that influence enterprise access to finance. Further research is therefore required to determine the specific enterprise characteristics that influence enterprise access to external finance.

6.4.5 Hypothesis 5. *Reputation, measured by the enterprise's years of service and the years that it belongs to its current owner will be positively related to enterprise access to external finance.*

The hypothesis tests the influence of the demographic characteristic 'duration of enterprise ownership or enterprise age in business as a link to reputation and subsequent access to external finance. As evidenced in section 6.2.5, there was no relationship between age of the enterprises in the study and use of external finance.

Reputation of an enterprise may increase its chances of accessing external finance. Diamond (1989) suggests that the "reputation of the enterprise" may be measured as a

function of variables such as age and/or length of service. The reputation is reflected as greater ease in obtaining the required financing.

The capital market's observation of the SME fulfilling its contractual obligations over a long period is one of the enterprise's most valuable intangible assets. The credit market accumulates this information. The variable reputation is related to the capacity of the enterprise to tackle its payment commitments originating in borrowing, that is, repayment of the principal and interests (Cardone, et al., 1998: 4). The managers' willingness to preserve this intangible asset discourages opportunistic decision-taking; high-risk investments are rejected in favour of more secure projects, thereby diminishing the agency costs of the borrowing derived from decisions on over-investment. Consequently, according to agency theory and the signals approach, it may be expected that the longer the service, the greater the reputation in the credit market, and, therefore, the greater the facilities to obtain the necessary financing.

The "reputation" may also be measured as a function of the number of years that the enterprise has been owned by the entrepreneur. The scarce grade of specialization that generally exists in this type of enterprise (that is, SMEs) with respect to the functions of ownership and control, together with many owner managers' reluctance to delegate responsibilities, creates a great dependency of the SME on the figure of the owner-manager. When this person withdraws from the post due to decease, illness, retirement, or change of activity, problems of succession may arise within the enterprise, causing the credibility and reputation acquired to be lost, and sometimes leading to the disappearance of the enterprise.

Consequently, change of ownership is similar to creating and setting up a new enterprise, increasing the information asymmetry and the risk that the lender perceives (Boedo and Calvo, 1997). Therefore, a positive relationship may be expected between the numbers of years that the enterprise has belonged to its current owner and the level of borrowing.

Discussion of the results

The experience of the principal business owner may have an impact on the perception of riskiness of her/his promise to repay a debt or on the projections of returns an investor might expect from the firm. In the entrepreneurship literature, a frequently investigated aspect of human capital is previous experience. This experience may lead to expertise in running an independent business (Wright et al., 1997:235) and provide bench marks for judging the relevance of information (Cooper et al, 1995:77). However, in the present study there was no relationship between experience and access to alternative sources of finance. Further research will be required to determine whether the experience factor has a significant impact on firms' access to financing.

6.4.6 Hypothesis 6. *There is no significant difference in young SME operators (18-29) and older operators (30-60) in accessing and using alternative finance. The hypothesis “ There is no significant difference in young SME operators (18-29) and older operators (30-60) in accessing and using alternative finance” was tested using the logit model to estimate the results.*

The analysis indicates negative effects of the log-odds coefficients of the given age brackets on use of alternative finance. This negativity implies that tenure or age of the owner manger does not influence access to external finance in the sub-sectors in the study. Thus, the null hypothesis, “There is no significant difference in young SME operators (18-29) and older operators (30-60) in accessing and using alternative finance was accepted.

Table 6.20: Logit Maximum Likelihood Estimation Results*Dependent variable= alternative sources of finance**Independent variable=age of operators (18-29yrs and 30- 60yrs).*

Independents	Coefficients		Standard Error		T – Ratio	
	18-29yrs	30-60yrs	18 - 29yrs	30-60yrs	18 – 29yrs	30– 60yrs
Regressors						
Bank overdraft	-2.6391	1.6788	.46291	.5707	-5.7010[.0]	-10.6886[.000]
Long term loan	-2.2736		.39694		-5.7278[.0]	
Leasing	-1.8718	-1.7290	.33968	.15984	-5.5104[.0]	-10.8170[.0]
Angel finance	-1.3863	-3.6143	.79056	.35828	-1.7536[.0]	-10.0880[.0]
Venture capital	-3.5973		.71673		-5.0191[.0]	
Supplier credit	-.57536	-.50329	.24056	.11602	-2.3918[.0]	-4.3378[.000]
Factoring	-3.1781	-2.8939	.58925	.25681	-5.3934[.0]	-11.2687[.0]
SMEs bank	-1.7610	-	.32640	-	-5.3953[.0]	-
Guarantee scheme	-3.1781	-3.0343	.58925	.27360	-5.3934[.0]	-11.0903[.0]
SMEs Dev.Programme	-2.6391	-	.46291	-	-5.7010[.0]	-
Cash advance	.69315	-	.24495	-	2.8298[.005]	-

Discussion of the results

Longer tenure as small business manager demonstrates more experience and therefore more human capital. Further, owner managers with longer experience tend to be older and therefore, are assumed to be more risk averse since their investment time horizon is shorter. Empirical evidence supports that owner manager's tenure is associated with lower risk taking (Wiklund, 1999:37-48). Taken together this suggests that longer tenure is associated with higher chances of succeeding in new business projects and a tendency to involvement in projects that have low as opposed to high risk. This should lead lending officers to be more likely to support credit to older SME owners with longer experience. Surprisingly, empirical evidence from the study has indicated that age has not helped SME operators to access external finance. Perhaps, other than the operators age, a combination of factors acting together influence SMEs' access to external finance.

Hypothesis 7 *SMEs use of alternative finance is dependent on the provision of hard information (business plan and /or business records).*

In evaluating the creditworthiness of a customer, bank lending officers have to evaluate the firm's ability to respond to changing conditions and develop and implement effective strategies. For this purpose, the customer's business plan, as part of the strategic planning, can be used in two ways. Firstly, it is an indicator of the ability of management to communicate the strategy of the firm to external parties. The firm's strategy should be clear and consistent in order to persuade external parties, such as banks, to make commitments to the firm's future success. An SME that articulates its intentions in a formal plan will minimize confusion and enable the lending officer to better understand the business. Secondly, a comprehensive strategic plan signals strategic competence. The extent and cohesiveness of information, and an understanding of the factors that affect financial performance and product quality are indirect indicators for the quality of management and therefore, indicators of the ability of the firm to perform well. Taken together, this suggests that SMEs that are better able to produce comprehensive business plans and financial statements containing financial projections are in a better position to receive external finance.

The past financial performance of a business is an important factor to estimate its ability to repay a loan (Gibson, 1993:164-67). Past profitability shows the business' past operational success and, thus, provides tangible representations of the competence of the SME. Indicators for a business' past performance are found in quantitative measures based on accounting information. A business' generated profit or loss is provided through external accounting information. The main purpose of external accounting information is to provide useful data to potential investors, creditors and other users to make rational financial decisions (Kam, 1990: 25). These measures are ratios based on the firm's financial statement. Financial ratios have been reported as reliable predictors of business failure by some researchers (that is, Altman, 1983:75). Therefore, information on past financial performance allows banks and other lenders to assess the creditworthiness of a particular business. While it is possible that new projects are unrelated to previous projects, or that the human capital of the SME has changed, the credit source could still,

with some accuracy, make an estimation of the probability of the success of a new project on the basis of such historical statements.

If the financial performance of the borrowing SME has been poor in the past, this would indicate shortcomings in management or other areas, and the incentive for developing new projects might be dubious. If on the other hand, the firm has been successful in the past, this would indicate that it has the competence to develop new projects. Thus, lending officer's probability of supporting credit increases with higher past financial performance of the borrowing business. This provided the basis for testing the hypothesis, "SMEs use of alternative finance is dependent on the provision of hard information (business plan and financial records)".

Results of the analysis

The probability level of the business plan being required for financing was 50% for long-term bank finance and 40% for small business bank loan, 30% for suppliers of credit of goods and 20% for leasing. Overall, the effect of the log -odds coefficients of the independent variable on financing was significant for long-term loan and not very significant for the other sources. This does not mean that a business plan was no longer needed but because of lack of awareness on how to prepare one and inadequate financial statements to support it, lenders were not taking it as a serious requirement from SMEs in the study.

Table 6.21: Influence of hard information to access of alternative finance*Model: Logit Maximum Likelihood Estimation**Dependent variable= alternative sources of finance**Independent variables=business plan and financial reports*

Independents	Coefficients		Standard Error		T - Ratio	
	Business plan	Financial report	Business plan	Financial report	Business plan	Financial report
Regressors						
Long term Bank loan	0.525	0.512	0.6431	0.6221	1.5700	1.5601[.5]
Supplier credit	.40270	-.39938	.70585	.46068	.57051[.	-.86695[.3
Leasing	-1.7812	-.80831	1.0852	.64820	-1.6414	-1.2470[.2
Angel finance	-	-	-	-	-	-
Venture capital	-	-	-	-	-	-
Factoring	-.89392	-.94547	.84438	.69470	-1.0587.	-1.3610[.1
SMEs bank	-.89392	-.94547	.84438	.69470	-1.0587	-1.3610[.4
Guarantee scheme	-	-	-	-	-	-
SMEs Dev.Programe	-	-	-	-	-	-
Cash advance	-	-	-	-	-	-

Discussion of the finding

Banks and other lenders assume that the past of a business is a relatively good predictor of its future. While this may be a relevant conjecture, it also signals conservatism. It appears more difficult for firms that lack a track record to receive funding and to receive funding for genuinely new projects.

The fact that the business plan was significant for long-term bank loan, leasing and in small bank finance is particularly interesting. The writing of a business plan is widely

endorsed by normative literature, by government and universities (Ammann, 2001; Hindle, 1997). Therefore, if prevalence were an indicator, “common wisdom” would suggest that business plans are of crucial importance to the success of small firms (Barclays bank, 1991). There is, of course, a cost associated with writing a comprehensive business plan. Based on the finding from the key informants, majority of the respondents find little use to write comprehensive business plans that would take away resources from other activities that may be more important when building a growing business.

6.5 Conclusion

The chapter has presented empirical evidence of the perspective on the use of alternative finance by manufacturing SMEs in Kenya. Analysis on the relationship between enterprise and owner characteristics to SME’s use of alternative sources of finance has been undertaken, in addition to the analysis of the hypotheses in the study. The claims of the hypotheses have been tested.

The next chapter presents summaries of the findings (i.e results) from the analysis of empirical data and suggests recommendations to mitigate the SMEs financing problem in Kenya.

CHAPTER SEVEN

SUMMARY, CONCLUSIONS AND RECOMMENDATIONS

7.1 Introduction

The purpose of this study was to investigate a perspective on use of alternative sources of finance among small and medium-scale manufacturing enterprises (SME) in Kenya. This was done by establishing the nature and type of financing used by the manufacturing SMEs and finding out the extent to which they were used in financing the activities of SME operators. The study further sought to establish factors influencing choice of finance and the financing constraints in the sub-sectors in the study. In addition, it aimed to ascertain whether the SME operators were aware of the alternative sources of finance and to establish the reasons for their use or non-use. To accomplish this aim, the study attempted to address the following objectives:

1. To establish the role of enterprise demographic factors on use of alternative finance.
2. To investigate alternative methods or models of SME financing in order to mitigate the perceived financing gap.
3. To identify factors influencing choice of finance.
4. Identify SMEs' financing constraints.
5. Identify the role of information and communication technologies (ICTs) in SMEs' access to alternative finance.
6. Explore government and financial institutional policies on SME financing.
7. Suggest policy recommendations to enhance the financing of SMEs.

A survey method was employed to conduct the study. Data was collected by use of a questionnaire and structured interview guide. A questionnaire was used to solicit information from the small and medium-scale manufacturing enterprises (SMEs) in the three sub-sectors in the study while face to face interview was used to obtain information from key informants from the selected finance institutions participating in loan advances to the sector's borrowers.

The questionnaire was developed having in mind the study objectives and the overall aim of the study. In addition to demographic data, the instrument collected information on relationship banking, financing constraints, alternative sources of financing, factors influencing choice of financing and role of information and communication technologies (ICTs) in SMEs financing and on government policy.

The data collection instruments were pre-tested on thirty operators from Eldoret town, Kenya. The responses from the pilot study participants were later incorporated in the main research instrument.

The completed questionnaires were reviewed to determine their usability. None of the questionnaires was discarded. Hence, a total of three hundred and eighty (380) responses were analyzed.

Analysis of data was done using the statistical package for social sciences (SPSS), Excel and Microfit. . Data was analyzed by frequencies, cross-tabulations, and log-odds coefficients. The log-odd coefficients were employed to accept or reject the claims in the formulated hypotheses. Hypotheses were developed to cross-check the results from the frequencies and cross-tabulations. Relationships between dependent and independent variables were run through the in-built applications of the microfit software. However four hypotheses were not tested as the tabulations provided adequate results of their claimed relationships.

This chapter summarizes the outcomes of the study, gives conclusions, suggests and recommends measures to be taken to improve SMEs access to finance and makes suggestions for further research.

7.2 Summary of Findings by the Research Objectives.

This section summarizes the findings on the research objectives and corresponding questions and research hypotheses that were used to guide the investigation.

7.2.1 Objective one: Identifying enterprise demographic factors influencing access to bank finance.

The corresponding research question was:

Do enterprise demographic factors such as the firm's age and ownership characteristics affect SMEs' use of alternative finance?

7.2.1.1 Gender

SME sector is male dominated. The finding indicates that 82.1% of the manufacturing SME operators are male while 17.9% are female. It was further observed that there was a significant relationship between gender and the operators in the three industrial sub-sectors in the study.

The study sought to establish the influence of gender on the use of alternative sources of finance. The results from the respondents indicate that 65% had not used any of the identified alternative sources of finance. However, it was observed that 39.7% of the female operators had used one or more alternative sources of finance as opposed to 33.7% of the male operators.

7.2.1.2 Age

Majority of the manufacturing SME operators fell in the 30-49 age categories. The results from the study indicate that there was no significant relationship between age and use of alternative sources of finance. This observation was worse for the age categories 60+, 50-59, and 18-29 who were found to have least used any of the alternative sources of

finance. See section (7.2.2). This was attributed to lack of awareness in the existence of alternative sources of finance.

7.2.1.3 Education level

To establish the relationship between the SME operators' education and awareness on alternative sources of finance, the respondents were asked to indicate their highest level of academic achievement from a given range of levels in the research instrument. It was observed that most of the manufacturing SME owners had secondary education: textile 51.3%, furniture 44% and metal 48% (see table 6.6). There was however, one postgraduate operator in the metal and metal work industry and three graduates each in both the textile and furniture sub-sectors respectively. This observation may be attributed to the attitude of graduates toward self-employment and white collar- jobs. It was further observed that there was no significant relationship between age and use of alternative sources of finance. Thus, based on the empirical results from the study, age has minimal influence on use of alternative sources of finance.

7.2.1.4 Formal training

Formal training in different aspects of business management was regarded as a prerequisite to use of alternative sources of finance in this study. The researcher therefore sought to establish whether there was any relationship between knowledge on business management by the SME operators, awareness and use of alternative sources of finance. Majority of the operators were found not to have any formal training in business management (85%). Thus, this may have limited their knowledge and ability to access alternative sources of finance (refer section, 7.2.9).

7.2.1.5 Enterprise age and bank mobility

The study sought to obtain information on enterprise age because it would affect the way enterprises seek and use alternative sources of finance and the financing obstacles encountered. The finding from the study revealed that 48.7% of the textile operators had been in existence for between 3-5 years and 27% of the metal and fabrication industries had been in existence for periods ranging between 3-5 years. Enterprises were found to be slightly older in the furniture and metalwork sub-sectors. In relation to bank mobility, the results indicate that 17% of the enterprises aged between one and three years had

changed accounts twice, while 37.5% of those aged between three and five years had changed their accounts thrice. The results further indicate that 62% of the enterprises aged over ten years had switched accounts between banks more than three times. This therefore suggests that, there is a positive relationship between enterprise age and bank mobility.

7.2.1.6 Age of business account with a single bank in relation to bank Mobility

The findings indicate that 29.2% of the manufacturing SME operators had maintained an account with one bank for a period of between 4-10 years, and over 10 years (18.9%) followed by 2-4 years (24.7%) respectively. This finding suggests that there is minimal change of accounts between banks by SME operators. This variable was intended to establish customer loyalty, bank mobility and access to bank finance. The finding indicate that majority of the manufacturing SMEs (64.7%) have not changed accounts from one bank to the other. However, 10% of the operators had changed bank accounts only once; 6.3% had changed twice and 2.1% had changed thrice. This indicates that, there is low bank mobility among small and medium-scale manufacturing enterprises in Kenya. It was further observed that, there was no relationship between gender and bank mobility among the manufacturing SME enterprises in the study. The empirical evidence indicates that 78% of the male operators and 22% of the female operators have not changed accounts between banks. Notwithstanding the observation, it was found that bank finance is among the least used sources of finance by manufacturing SMEs in the study (see sections 7.2.7 and 7.2.8).

7.2.1.7 Ownership form of the enterprise

As concerns form of business ownership, the study found that majority of the enterprises in the survey was sole proprietorships 233 (61.3%). The empirical results further indicate that, there were two private companies in the sample. One was in textile and the other in the metal sub-sector respectively. On the other hand 48 (51.1 %) of the textile enterprises and 32 (34 %) of the metal enterprises were in the form of partnerships. It was found that there is no significant relationship between ownership form and use of alternative sources of finance, other than share capital (see table 6.15)

7.2.2 Objective two: To investigate alternative methods or models of SME financing in order to mitigate the perceived financing gap.

The corresponding research question was:

Are SME operators aware of alternative sources of finance?

There are a variety of financing sources for business enterprises. Evidence from the study revealed that SME operators are relatively aware of the alternative forms of finance. For example, 99% of the respondents were aware of hire purchase, 82.4% credit guarantee schemes, 82.1% retained earnings, and 79.5% sale of fixed assets. On the other hand it was found that some sources of finance were less known or not known altogether. These include: factoring, leasing, venture capital, angel finance, SMEs development credit guarantee fund, city and or municipal business loan revolving schemes and SMEs capital market (Table:7.19).

7.2.3 Objective three: To identify factors which limit SMEs access to credit from the formal financial market.

The corresponding research questions were:

What factors influence choice of finance?

What are SMEs financing constraints?

There are continuums of factors that influence potential borrowers in their choice of the source of finance. The empirical results indicate that interest rate and collateral requirement are the major factors influencing choice of finance. 77% of the respondents indicated that interest rate and collateral were major factors, followed by repayment period 72.6% and loan transaction costs 67 % (section 6.2.5).

As concerns financing constraints, repayment period is perceived as a major financing constraint by 74.5% of the respondents, followed by interest rate 71%, and loan transaction costs and collateral 64.5% respectively. The other problems identified include amount offered as loan and availability of financing options (see section 6.2.8).

7.2.4 Objective four: To identify main sources of SMEs finance.

The corresponding research question was:

What are the main sources of SMEs financing?

Contrary to popular perception, the study found that bank finance is among the least used source of finance. The overall results show that personal savings is used as the main source of enterprise financing (93.7%), followed by retained earnings (77.9%) and friends and relatives (22.9%). It was found that forms of finance that have played a role in contemporary SME finance in the industrialized countries such as U.S.A are not used at all by the respondents or are used to a very a limited extent. These include, venture capital, leasing, angel finance, factoring and leasing. The empirical evidence on this can be observed from section 6.2.3.4.

7.2.5 Objective five: Identify SMEs' finance information needs and the role of information and communication technologies (ICTs) in SMEs' access to alternative finance.

The corresponding research question was:

What is the role of information and communication technology (ICT) in SMEs' use of alternative finance? Do SME operators have financing information needs?

Evidence from the study indicates that information and communication technologies are minimally used by the SME operators in the study. Eight (8) respondents out of three hundred and eighty (380) in the sample used computers, thirteen (13) respondents used internet for browsing, fourteen (14) for e-mail and eighteen (18) for word processing respectively. This clearly suggests that ICTs are not used by the SME operators to access external sources of funding.

Asked to indicate the functions to which they used computers in their businesses, majority of the SME operators in the study indicated that, they have not used information and communication technologies (ICTs). On average 93.2 %(35 8) of the operators' thought that ICTs were no longer necessary. Three hundred and fifty eight (358)

respondents of the three hundred and eighty (380) in the sample felt that it was not necessary to use computers for word processing, internet browsing, e-mail and for record-keeping (see section 6.2.11).

The empirical evidence from the investigation further revealed that there was a very insignificant level of computer literacy among the manufacturing SME operators. 20 (twenty) respondents out of the 380 (three hundred and eighty) respondents were computer literate while 360 (three hundred and sixty) were not. Thus, lack of computer skills may have inhibited the knowledge on available sources of finance and possibly bank products.

The survey results indicate that, 74 (32.6%) and 94 (41.4%) of the operators in the textile and metal sub-sectors very often use family and friends to obtain information on external sources of finance. Further, empirical evidence suggests that, textile operators very often use local customers to know external sources of financing. Other sources such as contacts with competitor firms, leasing firms, venture capital firms, the internet and contacts outside Kenya are least used by the SME operators in the study (section 6.2.10)

Thus, enterprises in the study have information needs. There is need for sources of finance. The survey results reflect gender parity on financial information needs as 89.4% of the male operators and 88.2% female operators indicated that they needed information on available bank loans; while 84.6% male and 91.2% female operators indicated that they needed information on other sources of business finance. Overall, the empirical evidence suggests that the manufacturing SME operators in the study need information on available bank loans 339 (89.2%), sources of business finance 326 (85.8%), SMEs loan schemes 316 (83.2%) and information on venture capital 215 (56.6%), (section 6.2.10.1).

7.2.6 Objective six: Explore government and financial institutional policies on SME financing.

The corresponding research question was:

What are the Kenya government and financial institutional policies on SMEs financing and growth?

The results from the survey indicate that there is no Government policy on SME financing. However, as for commercial banks, the survey revealed that some banks have set up policies targeting the SME sector. This has been done with the realization that SMEs form a large domestic client base. Furthermore, lending to the sector is portrayed as potentially more profitable because of higher interest rates and wider margins. In addition, small and medium-sized firms are perceived as a tremendous source of current and future growth in the Kenyan economy. Because of this, some banks are now eager to develop strategies to become more closely allied to the sector.

It was further noted that, the absence of a national SME financing policy has led to the establishment of disjointed financial institutional policies towards the SME sector.

7.2.7 Conclusion

The findings from the study suggest that majority of the SME operators are reluctant to apply for bank finance because of both real and perceived constraints. In addition, the empirical evidence indicates that, the alternative forms of finance are not known to the end users in the sub-sectors in the study. Further, it has been found that majority of the operators lack the necessary skills to make use of ICTs and subsequently e-finance. Finally, the demographic traits of the operators have no relationship with the use of alternative sources of finance.

7.3 Recommendations

The recommendations emerging from this study are addressed to the ministries concerned, scholars and other interested stakeholders. These recommendations may be addressed at institutional and national level. They provide practical implications and suggestions for implementation. They include the following:

7.3.1 SMEs financing and intervention measures.

The Kenyan Government recognizes the importance of SMEs and the need to support their development. This is evidenced in the Government of Kenya's Sessional paper No.1 on Economic Management for Renewed Growth (Republic of Kenya, 1986), Sessional paper No.2 on Small Enterprise and Jua Kali Development in Kenya (Republic of Kenya, 1992), and the 1989 - 1993, 1994 - 1996 and 1997 - 2001 Development Plans (Republic of Kenya, 1989; Republic of Kenya, 1994; Republic of Kenya, 1997) and the recent SMEs development draft sessional paper by the Ministry of Labour and Human resource development.

SMEs form the majority of the enterprises in the Kenyan economy. They employ a large share of the labour force as they are more labour intensive. The sector is perceived as an alternative employer (see section 1.2.4.2) SMEs provide a means of dispersing economic development and of raising the standard of living of the population. The development of SMEs is aimed to alleviate poverty and improve distribution of income. To reach this goal, entrepreneurial initiatives are required to enable SMEs grow and flourish. Most SMEs are unable to exploit the increased market opportunities in the new era of structural adjustment and policy reform based on liberalization, deregulation and removal of constraints to develop trade and technology flows. This is because of either low productivity, incapacity to face competition from imports or in export markets, constraints to adapt new technologies and or a lack of finance. Amongst these constraints, finance is perceived to be prominent.

A favourable policy environment may help SMEs in the long-run to compete in the market and consequently ease access to finance. The government should develop and implement SMEs financing and intervention measures. Legislation to meet the financing policy concerns should be enacted. This may include:

[a] Establishment of an independent body to:

- (1) Initiate wide ranging consultation to identify and categorize priority issues in the small and medium-scale manufacturing sub-sectors as away forward to industrialization and employment growth.
- (2) Conduct expert reviews into each category of legislation touching on the financing and development of the SME sector.
- (3) Publish annual recommendations on the financing of the SME sector activities.
- (4) Inform financing policy formulators, inform and influence discussion on financing issues and disseminate information that promotes the growth of SMEs and their access to financial services and financing.

[b] Undertaking policy reforms on bank imposed charges and interest rate, improve collateral legislation, and enable establishment of credit bureaus and SMEs credit registries. Independent analysis of small and medium-scale enterprises through ratings firms is not available in Kenya. Credit registries which collect standardized historical data on borrowers can create a new kind of collateral-reputation collateral. Furthermore, the strategy will help determine the risk and profitability of the potential small business borrowers and loans.

[C] Changes in the laws and regulations that surround financial transactions, in the institutions that support intermediation activities, and to the parties in the transactions is recommended. The expected reforms to target the following areas: improving regulation and supervision of credit unions that are likely to have a large catchment area of SME borrowers, improving the legal framework for secured transactions, improving the legal and regulatory framework for leasing, venture capital, angel finance and factoring. In particular, legislation to protect lessees against high down payment requirements or exorbitant leasing fees should be enacted. As for venture capital, it is suggested that, there

is need to stimulate demand amongst the manufacturing SME operators on the use of venture capital. This may be an important intervention to the manufacturing SME operators' access to finance. In addition, there is a strong case for special tax concessions to encourage venture capital investment. For example, companies in which venture capital firms have invested should benefit from full exemption from corporation tax in the first five years of operation and a 40% reduction for the following two years. This approach may attract venture capitalists in making equity investments in small and medium-scale enterprises. To provide an exit for the venture capitalists, it is proposed that an alternate exchange capital market for SMEs be established. To make the alternative capital market more meaningful, the researcher proposes more government emphasis on the development of high technology firms that will be more attractive to equity investors.

These reforms may help change the face of the financial market as competition will increase among financial institutions serving the whole range of SMEs. Financial institutions may increasingly look for new niches that can be profitably exploited and may thus turn more and more to serving the unmet needs of small and medium-scale enterprises.

7.3.2 Establishment of a Small Business policy division

The government should consider establishing a small business policy division responsible for promoting small business policy. The division's responsibility is to ensure that the business environment is conducive to the growth of small businesses, and target limited government resources more effectively to enhance competitiveness and encourage small firm growth. That way, micro, small and medium enterprises that have little access to external finance, but many low-income owners and employees will experience growth.

7.3.3 Information and regulatory changes.

Information on regulatory changes needs to be more readily available to SMEs and their advisors. Reliable information is a foundation of effective markets. Currently, the information structures are not clear as SME activities are not housed in one ministry. Hence, government and its agencies should make information provision a core part of their strategy for SMEs access to the much needed sources of finance. The researcher suggests that the government should establish a business portal to not only harmonise, but

also facilitate provision of online support services to the maximum number of financial and other services. To ensure that the portal offers the intended benefits, the government should develop a subsidized training package for SME registered operators through tertiary level institutions and other credible advisory service providers such as accounting and computer training organizations. It is believed by the researcher that the business information portal will improve access to external finance both locally and globally. The portal will help facilitate access to global and local markets, enforcing appropriate business regulations, enabling efficient business processes and stimulating domestic demand for information and communication technologies (ICTs).

7.3.4 SMEs Financing Data Bank

There are numerous types of finance available to SMEs in Kenya. However, their details are very fragmented and it is very difficult for both SMEs and business advisors to identify: what finance options are currently available, which option(s) is (are) most appropriate, any restrictions on applications and how to apply.

It is proposed that the government establishes a central data bank on national business activities including those of small and medium-scale enterprises. The system to maintain comprehensive and objective data sets relating to the financing of SMEs, particularly on demand for and supply of financing. To operationalise the system, cluster groups would be established to facilitate provision of cluster specific finance advice and support. Therefore data must be coordinated. It will be vital to market the data base effectively throughout the provinces and to update it on a continuous basis. Data must also be available in the ethnic languages to ensure that all groups in Kenya have maximum exposure to finance options. It will also be important that the data base and general financial information is available in both electronic and non-electronic format, due to variations in computer usage amongst SMEs.

As of now, it is difficult to measure progress in the finance and growth of SMEs in the country. SMEs financing data will be useful to researchers and policy makers in areas such as:

- [i] Guiding beneficial interventions
- [ii] Avoiding market distortions
- [iii] Identification of real finance gaps within the SME sector, and
- [iv] Isolating market bias against specific target groups.

7.3.5 Inter-firm linkages.

Large firms should be encouraged to establish special funds for SMEs who are their sub-contractors. This approach will help enhance the market power of the involved SMEs besides making them qualify access to external finance as they will be associated with the image of the large companies.

7.3.6 Alternative sources of finance.

SME operators should be educated to explore the possibilities of alternative sources of finance such as non-banking credits from suppliers, customer advances, leasing or hire purchase for equipment and premises.

7.3.7 Establishment of a national Business Angel network.

It is proposed that a national Business Angel Network (NBAN) be established under the Investment promotion centre to promote and coordinate angel investment in Kenya. The network could be useful in providing an analysis of regional investors and potential investment opportunities. This can also be used as a first point of call by SMEs to obtain financing information on private investors' money. To motivate participation, a package of incentives may be offered to those willing to partner the government in the development of the SME sector in the pursuit of the national industrialization goal. The information relating to Angel financiers may be classified to encourage free participation and to discourage off-shore investments of domestic resources that could be in circulation within the local economy.

7.3.8 Role of central bank.

The central bank should consider introducing regulations authorizing commercial banks to allocate a certain verifiable percentage of their loan portfolio to SMEs. Currently, there are no regulations requiring financial institutions to allocate part of their loan portfolio to SMEs and to prepare verifiable records. Besides, the central bank could ease reserve

requirements to encourage establishment of many SME financing institutions. This approach will contribute to the development of small and medium-scale enterprises in the economy' and hence employment growth.

7.3.9 Alternative collateral requirement.

Financial institutions should move away from requiring physical collateral and propose alternative practices that may mitigate uncertainties in the loan issuing transactions, such as use of membership guarantees through a cooperative society. Thus, credit should be availed to the manufacturing SMEs in such collective environments and arrangements so as to enable them exploit their full potential. Moreover, SME co-operatives should be formed to regulate their operations, mitigate their problems and improve their lot.

7.3.10 Increasing Access to Financing

Since the core problem in financing SMEs is the risk element that is inherent to the lender-borrower relationship, the strategy for improving SMEs access to financing should focus on mitigating the risks and transaction costs associated with this segment of the market, while strengthening the capacity of specific financial institutions to serve clients, and increasing competitive pressure in financial markets. This strategy should support programs and institutions providing financial services through innovative approaches that increase SMEs access to finance without hampering the performance and sustainability of formal financial intermediaries or distorting market conditions.

7.3.11 Proposals:

- 1) Considering the feasibility of developing seed-capital programs, to be funded through a combination of public and private resources, and structured to provide incentives to equity partnerships.
- 2) The issue of shortage of long term financing can be resolved by mitigating the risk for financial institutions to lend to SMEs. A way to mitigate such risk is to spread it over a large number of players, and to introduce non-financial mitigative instruments. The benefits of such a model include the creation of

lasting linkages between the banking sector and SMEs, the reduction of the banks' risks and the creation of networking among SMEs.

The researcher proposes a financing model in the next sub-section to address the current financing problems of small and medium-scale enterprises in Kenya.

7.4 Suggested financing model for SMEs in Kenya

7.4.1 Introduction

This section aims to propose a model for financing SMEs in Kenya. The suggested model is based on the findings that there is an SMEs financing gap and that existing credit models do not address the needs of SMEs. Currently, there is no system that addresses the financing needs of SMEs, apart from one for the micro-enterprises. Similarly, the model answers part of the research objective that suggests development of a finance model to mitigate the gap in SMEs financing.

The section covers four interrelated issues. As a framework for suggesting a new finance model, it firstly, presents the magnitude of the finance gap in the SME sector in Kenya. Secondly, it conceptualises the concept 'model'. Thirdly, it provides an overview of existing credit models in Kenya and fourthly it describes the abstract model of the proposed finance model.

7.4.2 SMEs Finance gap in Kenya

The aim of the study was to obtain a perspective on alternative finance for SMEs in Kenya. Thus, the premise of the model used to determine the gap was that enterprise financing is a function of alternative sources of finance. Hence, the primary variables in the determination of the finance gap comprised of bank finance and sources other than bank finance. The significance of each individual regressor in explaining the financing behaviour of the enterprises in the study was tested using the logit coefficients of the regressors. The dependent variable was dichotomous (one if the enterprise had used the source and zero otherwise). From the analysis, the effect of bank overdraft on the

predicted odds that $y = 1$ was equivalent to an increase of .015835 and that of long term loan was equal to a decrease of -.018533 with the probability of non- use of the source being 96%. On the contrary, the average probability of enterprise use of sources other than personal savings, friends , bank overdraft and long term loan was 0.317, implying that, there was a probability of a finance gap in use of alternative finance equivalent to $(1-0.317) = 0.683$. This meant that “the estimated level of a finance gap in the use of alternative sources of finance was approximately 68.3%. That signalled that SMEs in the study were experiencing a financing gap that required alternative approaches to mitigate.

7.4.3 The concept ‘Model’

Models are used to solve both simple and complex problems of the practical world. They approximate or abstract reality, which may be constructed in various forms. Models look at how abstractions can bridge the abstraction gap. They look at how patterns can be used to define abstraction and they can be interwoven into intent (mental images of the model). Models deal with relevant variables that have major impact on the decision situation. Thus, many forms of models exist, and the particular form selected depends upon the purpose. In the context of an SME finance product line, it can be mapped from abstract specification to practical model design with relevant sub-systems. Models are used to define or describe a phenomenon, specify relationships and processes; or present a situation in symbolic terms that may be manipulated to derive predictions (Murdick, et al, 1988:386).

A model is a tentative description of what a social process or system might be like (Ikoja, 2002:419). It is a tool of explanation and analysis-very often in diagrammatic form-which attempts to show how the various elements of a situation being studied relate to each other. Models become theory after thorough testing (Watson and Hill, 1996:119). A simple definition of a model is a description of reality (Swanepoel, 2000:178). According to Nonaka in Swanepoel (2000:178), modelling is the last step in the knowledge process.

In this study, the finance model shows the interactive process of the stakeholders, provision of information on finance and subsequently the actual provision of required finance.

7.4.4 Current situation of SMEs credit lending models

While each organisation has its own variation, the lending approaches in Kenya can be classified into four basic models:

Model 1: Individual credit

Model 2: Credit using group guarantee

Model 3: Integrated and sequential training credit for individuals

Model 4: Group- oriented credit

7.4.4.1 Model 1- Individual credit

This model has been adopted by commercial banks and non-bank financial institutions in Kenya. This is a straight forward credit lending model where micro loans are given directly to the borrower. It does not include the formation of groups, or generating peer pressures to ensure repayment. It focuses on the delivery of credit to clients, usually in the small-scale enterprise, who can offer tangible collateral. The weakness of this model is that, it has limited ability to assist majority of the SMEs given their lack of collateral and poor knowledge of business records or plans.

7.4.4.2 Model 2- Group based credit

This model is based on the principle of Grameen Bank. It operates from the premise that credit is the single most important limitation to the success of small and micro-enterprises. And it seeks to establish high volume, high repayment loan schemes that can become self-sustaining within three to five years.

Basically, credit is provided to small groups that guarantee the loans to their individual members and help each other resolve common business problems. This model has been found particularly appropriate for micro-entrepreneurs. Credit is given in small initial amounts, and when successfully repaid, clients may apply for larger ones.

A description of the mechanisms adopted by K-REP provides a useful illustration. Individuals involved in the same trade, link up in groups of five, known as Watanos. Each Watano links up with five others to form a group of 30, which is known as KIWA

and which must register with the ministry of culture and Social services as a self-help group.

After each KIWA member contributes (saves) Kshs 50 a week for 8-weeks, members are eligible for loans. Initially, only 18 members receive loan, three from each watano. After they have repaid satisfactorily for four weeks, the remaining members receive their loans. This model has the advantage of the members' savings acting as a loan guarantee fund. However, it was found that the model has a limitation of exposing members' plans to the public. For business strategic reasons, it was felt, that the model is not very appropriate.

7.4.4.3 Model 3-Integrated and sequenced training, technical assistance, and credit to individuals

Under this approach, programme staff assess loan applications by visiting the enterprise, interviewing the owner, examining the books (if any exist), and evaluating credit-worthiness. At the same time they help the applicant formulate a business plan from which credit needs can be projected and assessed. SEFCO is among the organisations that follow the integrated model. However, this model does not reach many people as the process takes along time. The model is also relatively expensive because of the technical assistance and training.

Model four uses existing groups as a mechanism to provide credit to individuals. It is similar to model 2, in that the groups are required to guarantee all the loans.

Some organisations pursue more than one model in order to benefit different target groups. For example, Kenya Commercial bank used model 1 for its credit scheme to small scale-enterprises, and model 3 for its Jua kali lending scheme.

Organisations often experiment before settling on a model that best suits their resources and their client's needs. Some organisations pursue different assistance models in different parts of the country, often because of multiple donor requirements. For example NCKK pursues model 2 in its K-REP funded programmes.

The current situation consists of micro-credit lending models. Microfinance refers to small scale financial services for both credit and deposits that are provided to people who farm or fish; operate small or micro enterprises where goods are produced, recycled, repaired, or traded; provide services; work for wages or commissions; gain income from renting out small amounts of land, vehicles, and to other individuals and local groups in both urban and rural areas.

A number of microfinance institutions including K-REP, JUHUDI and SEFCO are using micro-credit lending (financing) models. However, the study found that most of the SMEs could not be accommodated with their large size loan requests.

7.4.5 The model

Although many models exist and are functioning, the need for another model is based on their short-comings to meet the required needs of the end users. The issue arising from the existing micro-and small enterprise credit models is scaling up from micro to small and medium enterprise. There is a wide gap between micro, small and medium scale enterprises. They are really different and need different products and services to serve them. So there is need for new strategies scaling from micro to small scale enterprises and avail financial products required at that level.

The disadvantage of microfinance models is that firstly the products are designed for the alleviation of poverty and for the micro entrepreneur just going into business. It is not for the formal business as such. Secondly, the organizational structure, the financial structure is set and that makes it slightly difficult to expand the products and services. Small businesses need a variety of financial products whereas the micro financial institutions are normally offering one or a few limited financial products. For example, small business may need to finance fixed investment which needs longer term maturity, it may need a gestation period before a project can generate cash flow, it may need different forms of services, not only working capital but letters of credit, and it may need equity. These products are quite often produced by the larger financial institutions. But the problem with them is that they feel small business lending is risky.

The study therefore recognizes that lack of access to affordable sources of finance is a major constraint for SMEs that wish to invest and grow; particularly start-up and early stage businesses that need to borrow for periods in excess of one year .

Lack of access to financial services—the absence of convenient credit mechanisms—is a major constraint limiting the development of SMEs. This is because formal financial institutions perceive high risks associated with lending to SMEs and high transaction costs associated with the lack of reliable information on their clients. Adding to banks' limited capacity to lend to SMEs are the difficulty of enforcing contracts (the result of an inadequate legal framework and inefficient court system) and the lack of appropriate instruments for managing risk

The traditional lending practices of banks are based on administratively costly gathering and analysis of information and fixed property for collateral as the principal mechanisms for managing risk. Group lending methodologies that effectively replace these processes in micro financing are not appropriate for small enterprises, which tend to be more individualized and whose loan amounts may exceed what private individuals can guarantee.

SMEs differ from micro enterprises in the amount of finance required, in the difficulty of using character-based methods of finance, their need to be competitive with larger firms and their potential for growth and creation of wage employment. Also, they are more likely to require longer-term investment capital as well as short-term working capital than micro-enterprises. Given that dynamic SMEs can benefit from external finance to realize their potential to grow rapidly and become competitive, strengthening the capacity of the formal financial system to serve them and improving their ability to access banking and other financial services can have significant payoffs.

A fundamental issue that need to be addressed include, development of policy, legal, and regulatory frameworks that are essential to the development of innovative financial institutions and instruments. One possible innovation would be to develop linkages between the formal banking system and non-banking institutions that lend to the micro-enterprises to upscale loans to SMEs.

MODEL A

The study suggests a hybrid structure between the micro-finance institutions (MFIs) and the formal financial institutions. A model that introduces micro and small business finance windows in commercial banks, developing linkages between micro financial institutions and commercial banks .

MODEL B

The study proposes a financing model through the establishment of a national SMEs development bank that will act as a revolving fund to boost the development of SMEs. The proposed bank to be linked to municipal/city council SMEs revolving funds. This will ensure that there is an all round concerted effort at stimulating and monitoring SME activities. The strategy will help allocate limited national resources to target industrial activities that will jump-start the industrial process, using both local and foreign resources.

7.5 Further research

In the perspective on alternative finance for SMEs in Kenya, this study focused on both descriptive and quantitative analysis and hence provides an inventory of the alternative sources of finance. However, the study did not cover the whole country. Thus, it is imperative that further research need to be conducted. The following aspects provide problem areas for further research in the sector.

- [a] Types of financing available in Kenya.
- [b] Types of financing used by SMEs
- [c] Financing requests by amount and source
- [d] Financing success by size and characteristics
- [e] Financing supply by bank size
- [f] Impact of financing decisions by finance providers on SMEs

[g] Spatial pattern of finance disbursements to SMEs

[h] Total number of SMEs and number of SMEs with credit.

It is further recommended that longitudinal studies be considered to meet data needs in the SME sector. Such studies will help identify real financing gaps among other gaps in the sector for the application of intervention measures.

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APPENDIX 1

Letter of Introduction

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Dear respondent,

RE: QUESTIONNAIRE ADMINISTRATION

I am a lecturer in the department of Quantitative skills and Entrepreneurship Studies, Moi University, Eldoret, Kenya and currently a registered PhD student at the University of Zululand, South Africa. I am conducting a study on: **SMALL AND MEDIUM-SCALE MANUFACTURING FIRMS IN KENYA: APERSPECTIVE ON ALTERNATIVE SOURCES OF FINANCE.**

This research is for a Doctoral study. The findings of this study are expected to indicate the level of use of alternative sources of financing. The study endeavours to come up with suggestions for improving SMEs financing in Kenya.

Due to your involvement in the sector, you have been identified to participate in the study. You are therefore kindly requested to spare some few minutes from your busy schedule and respond as best as you can to the items in the questionnaire. Most questions require you to simply tick the answers, while a few require short answers based on your views.

The information provided will be treated with utmost confidentiality and will be used only for purposes of this study.

Thank you very much for your participation.

Yours faithfully,

Stephen O Migiro

**SMALL AND MEDIUM -SCALE MANUFACTURING ENTERPRISES: A
PERSPECTIVE ON ALTERNATIVE SOURCES OF FINANCING.**

QUESTIONNAIRE A: FOR SME OPERATORS

SECTION 1- DEMOGRAPHIC PROFILE

DP1. Please indicate your gender. (Tick one Box)

Male	
Female	

DP2. Please indicate the age bracket to which your age falls.

1	2	3	4	5
18-29	30-39	40-49	50-59	60 or Over

DP 3. Please indicate your highest level of educational achievement? (Tick one box)

Elementary school	High school	Some post secondary	diploma College	University degree	Post-graduate degree

Other, specify.....

DP4 Have you any formal training in business management? Tick one box.

Yes	No

DP 5. If the answer is yes, which of the following training have you taken?

Training	Yes	No
Financial management		
Business plan writing		
Business communication		
Use of ICTs		
Marketing		

DP6. How long has the firm been in operation? (Tick one)

1	2	3	4	5
0-1yr	2-3 yrs	4-5 yrs	6-10 yrs	More than 11 yrs.

DP 7 Please specify the ownership form of your business.

1	2	3	4
Sole Proprietorship	Partnership	Private Company	Other

Other, specify.....

DP 8. Please specify the number of employees currently in the enterprise (Including yourself)

1	2	3	4
1-4	5- 25	26 - 75	76+

DP 9 How much did you invest in fixed assets in 2001, _____ 2002
_____ and 2003 _____?

SECTION 2 : FINANCING REQUESTED

FR 1 What type of financing did the business request from the financing institutions?

1. Bank overdraft
2. Term loan
3. Mortgage loan
4. New line of credit (also called operating loan)
5. Increase in the credit limit of current lines of credit.
6. Other type of debt financing. **Please specify.**

FR 2 Was any credit approved?

YES GO TO FR 5

NO GO TO FR 4

FR 3 How did the business intend to use the financing that was requested from the organization? *[Purpose of the loan]*.

Read list and mark all that apply

- a) Building and land acquisition
- b) To buy vehicle
- c) To buy machinery or equipment
- d) Business acquisition
- e) Product and service development
- f) Debt consolidations
- g) Export financing
- h) Working capital/operating capital: funds used to finance the day-to-day operations of the business such as the purchase of inventory or pay off of account payables etc...
- i) Accounts receivable financing
- j) Process innovation
- k) Replacement of plant or equipment

FR 4 What reasons were given to the business by the credit suppliers for refusing to advance the loan?

Mark all that apply

- a) No reasons given by credit supplier.

- b) Insufficient income or revenue or sales to service financing
- c) Insufficient cash flow
- d) Insufficient collateral/security
- e) Insufficient equity
- f) Insufficient working capital.
- g) Poor credit experience or history
- h) Low personal net worth
- i) The management team was too inexperienced
- j) Business plan not acceptable
- k) Wouldn't personally guarantee the financing
- l) Insufficient information provided by the business
- m) Other reasons. **Please specify.**

FR 5 Indicate whether the credit was authorized based on relationship with loan officer.

YES **GO TO SECTION 5**
NO

SECTION 3 ALTERNATIVE SOURCES OF FINANCING

ASF1 Are you aware of the following sources of finance? (Tick one box for each category).

	1	0
Source of business finance	Yes	No
Personal savings		
Friends and relatives		
Overdraft		
Term Loan (Long-term loan)		
Informal money lenders		
New partner contributions		
Supplier credit		
Leasing		
Hire purchase		
Factoring (Discounting of debts)		
Angel finance (i.e. private investor's money)		
Venture capital		
Sale of Shares		
Retained earnings (profits)		
City council/ Municipal council SMEs Loan Scheme.		

SMEs development credit guarantee fund		
Sale of fixed assets		
Cash advances from clients		
SMEs' Development Bank		
Government commercial Loan Guarantee scheme		
SME stock exchange		

ASF2 Which of the following sources of finance do you use to finance your business activities?

	1	2	3
Source of business finance	Always	Sometimes	Never
Personal savings			
Friends and relatives			
Overdraft			
Term Loan (Long-term loan)			
Informal money lenders			
New partner contributions			
Supplier credit			
Leasing			
Hire purchase			
Factoring (Discounting of debts)			
Angel finance (private investor's money)			
Venture capital			
Sale of Shares			
Retained earnings (profits)			
City council/ Municipal council SMEs Loan Scheme.			
SMEs development parastatal /Agency			
Sale of fixed assets			
Cash advances from clients			
SMEs' Development Bank			
Government SMEs Loan Guarantee scheme			
SME stock exchange			

SECTION 4 FACTORS INFLUENCING CHOICE OF FINANCING

FCF1 What factors influence your choice of the source of financing? (Tick any number of factors)

	1	2	3
Factors influencing choice of finance	Always	Often	Never
Availability of credit from source			
Interest rate			
Collateral requirement			
Loan transaction costs (Charges)			
Information on sources of finance			
Threat of bankruptcy by using source for financing			
Relationship with the source			
Repayment period			
Amount offered			
Financing options provided by the source			
Other factors (SPECIFY)			

SECTION 5 RELATIONSHIP BANKING

RL1 For how long have you maintained a business account with one bank? (Tick one box)

1	2	3	4
1-2 years	3-4 years	5-10 years	Over 10 years

RL2 How many times have you changed banks? (Tick one box)

1	2	3	4	5
More than thrice	Thrice	Twice	Once	Not changed banks

SECTION 7: FACTORS INFLUENCING ACCESS TO BANK FINANCE

BF1 Has your firm ever applied for any overdraft facility/ Long-term bank loan?

Application for_____	1	2
	No	Yes
Overdraft		
Long term bank loan		

BF2 If you have not applied for any loan, which of the following reasons best explains why? (Tick one box for each category.

	1	2	3	4
Category	Strongly agree	Agree	Disagree	Strongly disagree
Inadequate collateral/Lack of collateral				
Don't want to incur debt				
Process too difficult				
Did not need any loan				
Thought I will not get one				
Interest rate too high				
Already heavily indebted				
Did not know where to apply.				
Short repayment period				
Limited financing options				

BF3 Was your business refused the loan because of--- (Tick any number of reasons)?

	Yes	No
Lack of track record		
Business being too risky		
Lack of adequate security		
Absence of a business plan		
Form of ownership		
Inadequate financial information		
Reached borrowing limit		
Owner's lack of management skills		

SECTION 8: GENERAL FINANCING CONSTRAINTS

GFC1 How often do you experience the following financing problems? (Tick one box for each problem).

	1	2	3
Financing problems	Always	Often	Never
Availability of bank credit			
High bank interest rate			
Access to supplier credit			
High bank transaction costs (Charges)			
Information on sources of finance			
Threat of bankruptcy by using Bank Loan			
Collateral requirement (security)			
Repayment period			
Insufficient amount offered			
Limited financing options			
Inadequate business plan			
Presentation of financial reports			
Lack of SMEs' Stock exchange			

GFC 2 How satisfied are you with the range of financial products and services available for Small and medium-scale enterprises in Kenya?

1	2	3	4
Very satisfied	satisfied	Not very satisfied	Very dissatisfied

GFC 3 In your opinion, what do you suggest to improve access to finance?

SECTION 9: ROLE OF INFORMATION AND COMMUNICATION TECHNOLOGIES (ICTs) IN SMEs FINANCING

ICT1 How easy is it to obtain information on the following in Kenya?

	1	2	3	4
Information concerning: -	Easy to obtain	Not easy to obtain	Not able to obtain	Don't know
Sources of finance				
Charges on specific sources of finance				
Financing institutions				
Other financiers (e.g Venture capital, private investors' funds etc)				
New technology				
Laws and regulations				
Export markets				
Other				

ICT2 How often do you use the following sources of information in the financing of your business activities? (Tick one box for each category)

	1	2	3	4
Information from—	Very often	Quite often	Not very often	Not at all
Family and friends				
Local suppliers				
Local customers				
Contacts with competitor firms				
Access to internet				
Bank				
Consultants				
Contacts outside Kenya				
Venture capital firms				
Leasing firms				
Factoring firms				
Hire purchase firms				
Private investors				
Department of industry and trade/ Government				

ICT3 Which methods of communication do you use often in accessing sources of finance?

	1	2	3	4
Methods of communication	Very often	Quite often	Not very often	Not at all
Face to face meetings				
E-mails				
Magazine advertising				
TV/Radio advertising				
Billboard advertising				
Internet				
Consultants				
Other				

If other,
specify.....

ICT4 What type of financial information do you require for your business? Tick whichever is applicable [Tick any number of boxes].

1	Bank products suitable for your business	
2	Sources of business finance	
3	Location of private investors money (Angel finance)	
4	Government SMEs loan schemes	
5	Venture capital finance (Project finance)	

If other,
specify.....

ICT5 When do you require this information? Tick one.

1	Always	
2	Sometimes	
3	Other	

If other, specify.....

ICT6 Do you have any knowledge in computer usage? Yes No

ICT7 If yes, which of the following functions do you use computers for? Tick
 Whichever is applicable?

1	Word processing	
2	Internet browsing	
3	E-mail	
4	Record keeping	
5	Other	

If other, specify.....

ICT8 How important have the following sources of information been to your business?

Information from—	1 Very important	2 Quite important	3 Not very important	4 Not important
Family and friends				
Your own knowledge and experience				
Local suppliers to your business				
Contacts with competitor firms				
Bank manager/Consultants				
Access to the Internet				
Government agency				
Non-Governmental organization				

If other, please specify.....

ICT9 In your opinion, what limitations affect the use of ICTs in your business?

ICT 10 What ICT recommendations do you propose SMEs to use in order to
reduce information asymmetry and access alternative finance?

SECTION 10: GOVERNMENT POLICY

GP1 Please indicate how much you have been affected by change in government
 policy and regulations in the running of your business activities.

	1	2	3	4
	Very much	Much	Not very much	Not aware
Taxation policy				
Finance policy (e.g Bank interest rate)				
Collateral Law/ loan securitization law				
Industrial dev. Incentives/ Policy				
Commercial law and Arbitration policy				

GP2 Please explain how the items in **PG1** affect your access to finance.

GOP1 In your opinion what will be the biggest problems/constraints, which may prevent you from achieving your business goals?

.....

THANK YOU FOR YOUR PARTICIPATION.

APPENDIX 2

A SURVEY OF SME FINANCING BY COMMERCIAL BANKS IN KENYA AND VIEWS OF KEY INFORMANTS.

INSTRUCTIONS:

Please, read the instructions provided for each question. Most of the questions only require you to indicate your response[s] by indicating the rank of the response in the box provided. In cases where you are required to write down your response[s] or comments, please be as brief and to the point as possible.

PART 1: GENERAL INFORMATION

Name of your organization: _____

Your title/position : _____

PART 2: TYPES OF FINANCE AVAILABLE TO SMEs AND INFORMATION NEEDED

- 2.1 Do you provide special financing products to small and medium-scale enterprises? Yes / No
- 2.2 What are the different types of finance available to SMEs from your institution?
- [a] _____
- [b] _____
- [c] _____
- [d] _____
- 2.3 Do you need information about SME borrowers before advancing credit? Yes / No.

2.4 If the answer is yes, which of the following information do you need? Tick the ones required by your institution.

- [a] Statement of assets and liabilities
- [b] Cash flow projections, income statement and balance sheet
- [c] Copy of lease agreement if property is leased or title deed if property is owned
- [d] List of equipment[s] to be financed
- [e] Personal CVs of the applicants
- [f] Feasibility report of the business
- [g] Banking record of the borrowing enterprise
- [h] Risk analysis reports from accredited credit bureaus

2.5 Which of the following criteria do you consider in assessing applications for finance by SMEs?

- a [] Feasibility report of the business
- b [] Ability to repay the financing
- c [] The quality of the management of the borrowing enterprise
- d [] The economic sector in which the enterprise will operate/ or is operating
- e [] The security being made available
- g [] The banking record of the borrowing enterprise
- h [] Predetermined decision frameworks
- I [] Owner's contribution to the capital expenditure required

PART 3: SMEs CONSTRAINTS IN ACCESSING BANK FINANCE

3.1 What are the main difficulties faced by small and medium-scale clients in accessing bank finance [Rank them in order of importance from 10-1].

- a [] Lack of venture capital schemes within our institution
- b [] Lack of track record
- c [] Too optimistic forecasts
- d [] Lack of capital contribution by the entrepreneur to the business.
- e [] SMEs lack of management skills.

- f [] Insufficient security, or total lack of it.
- g [] High indebtedness [high gearing].
- h [] SME's lack of information on existing venture capital schemes/financing options
- I [] Perceived high cost of capital by SMEs
- J [] Form of business ownership
- K [] Repayment period

3.2 SMEs prefer loan contracts with low collateral requirement or no collateral. Do you agree? Yes / No

3.3 Does the collateral requirement help reduce the high risk- borrower's incentive for strategic default? Yes/No

3.4 What is the difference between the interest rate paid by large companies and small companies with no track record? If there is a difference, how much is it and why?

PART 4: ALTERNATIVE METHODS OF FINANCE FOR SMEs' DEVELOPMENT

- 4.1 Which of the following alternative methods of financing could you recommend for use by SMEs in financing their business operations? Rank them in order of preference from 1 to 10.
- a[] Factoring or invoice discounting
 - b[] Leasing
 - c[] Hire purchase
 - d[] Trade credit
 - e[] Venture capital finance
 - f[] Angel finance[private investors' funds
 - g[] SMEs' cooperative societies/mutual schemes
 - h[] Government SME Bank
 - i[] Revolving credit guarantee scheme
 - j[] Local authorities' SMEs credit scheme for SMEs under their jurisdiction.

PART 5: E-FINANCE AND SME FINANCING

- 5.1 Do you allow business banking through the internet? Yes / No
- 5.2 If yes, which of the following services are rendered through the internet mediation?
- a]
 - b]
 - c]
 - d]
 - e]
- 5.3 Do you market your financial products through the internet? Yes / No
- 5.4 From your experience, do SME operators possess the necessary skills to access your products through the internet? Yes/ No

5.5 How are SME borrower's informed about the existence of the institution's financial products?

PART 6: POLICY MEASURES FOR SMEs FINANCING

6.1 Has the lending policy towards SMEs changed over time? Yes / No. Please explain.

6.2 How do you propose and actually serve the needs of SMEs?

6.3 Do you have special departments and / or procedures geared towards attracting and serving the SME sector?

6.4 Why is the bank making strategic decisions to target SMEs?

6.5 Do you have loan guarantee schemes in your institution? Yes/ No. If yes, how are they designed?

6.6 Do SMEs use these guarantee scheme[s] Yes / No. If no, why?

6.7 What are the strengths and weaknesses of the existing loan guarantee schemes?

6.8 Are there measures to encourage financial institutions to give loans to SMEs? Yes / No . If yes, how successful are they?

6.9 What do you suggest as priority measures to help overcome SMEs' financing problems?

6.10 In your opinion, what are the biggest problems / constraints that prevent SMEs from accessing and using bank finance?

THANK YOU FOR YOUR PARTICIPATION

APPENDIX 3

CRONBACH'S COEFFICIENT ALPHA: RELIABILITY STATISTICS

CRONBACH'S ALPHA	.849
CRONBACH'S ALPHA BASED ON STANDARDIZED ITEMS	.810
N OF ITEMS (VARIABLES)	215