

**EFFECT OF MICROFINANCE INSTITUTION FINANCIAL PRACTICES  
ON PERFORMANCE OF SMALL AND MEDIUM ENTERPRISES IN  
KAJIADO COUNTY, KENYA**

**BY**

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**NOVEMBER, 2021**

**DECLARATION**

I declare that this dissertation is my original work and has not been previously published or submitted elsewhere for award of a degree. I also declare that this contains no material written or published by other people except where due reference is made and author duly acknowledged.

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## ABSTRACT

Despite the critical role SMEs play in the economy, their growth and success is always dogged by myriad of challenges due to their limited ability to access expansion finances and bridging the working capital deficits. However, MFIs comes in handy by playing a key role in financial intermediation in so far as growth and Success of the SMEs is concerned considering that to a large extent, they lack collaterals and other borrowing requirements imposed by commercial bank. Alive to that fact, the study thence seeks to establish the nexus between microfinance institutions practices and the performance of small and medium enterprises in Kenya. In doing so, the study adopts a case study of Kajiado County specifically to examine the effect of microfinance lending practices, microfinance savings practices, microfinance insurance practices and microfinance loan recovery practices on financial performance of small and medium enterprises. This study adopted descriptive research due to its ability to explore and offer detailed explanation on the study's unit of analysis, which in this case is the SMEs in Kajiado County. The study target population was 2851 SMEs registered in Kajiado County. However, the study sample was the 372 SMEs registered in Kajiado Township within Kajiado County. Given the small size of the target population, the study employed census. The study utilized secondary data collected using structured questionnaires administered to the SME owners. STATA was used for data analysis in which analyses included computation of measures of central tendency, as well as the measures of dispersion. In addition to the descriptive statistics, correlation analysis of the study variables was used to examine the relationship among the variables. To determine the specific effect of microfinance financial practices on the SME performance, we relied on a linear empirical model using a multivariate Ordinary Least Squares method. In addition, several diagnostic tests namely: heteroscedasticity, multicollinearity, and autocorrelation tests were conducted. The study found that microfinance lending practices to the SMEs has a negative and significant effect on the SME's profitability with one unit increase in micro credit likely to lead to 0.106 units decline in SME profitability holding other factors constant. Further, microfinance savings practices was found to have a negative and significant effect on the SME's profitability with one unit increase in micro saving likely to lead to 0.421 units decline in SME profitability holding other factors constant. In addition, microfinance insurance practices was found to have a negative but insignificant effect on the SME's profitability with one unit increase in micro insurance likely to lead to 0.015 units decline in SME profitability holding other factors constant. Lastly, microfinance loan recovery practices were found to have a negative effect on the SME's profitability with a single unit increase in outstanding loan likely to increases SME profitability by 0.008 holding other factors constant. The diagnostic tests results concluded the absence of heteroscedasticity, multicollinearity and autocorrelation problems.

**Keywords:** SMEs financial performance, MFIs effect and Sustainability

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## TABLE OF CONTENTS

<b>DECLARATION.....</b>	<b>2</b>
<b>ABSTRACT.....</b>	<b>3</b>
<b>ACKNOWLEDGEMENT.....</b>	<b>4</b>
<b>DEDICATION.....</b>	<b>8</b>
<b>LIST OF TABLES .....</b>	<b>9</b>
<b>LIST OF FIGURES .....</b>	<b>10</b>
<b>ACRONYMS AND ABBREVIATIONS.....</b>	<b>11</b>
<b>OPERATIONAL DEFINITION OF TERMS.....</b>	<b>12</b>
<b>CHAPTER ONE: INTRODUCTION.....</b>	<b>13</b>
<b>1.1 Background of the Study.....</b>	<b>13</b>
<b>1.2 Problem Statement.....</b>	<b>21</b>
<b>1.3 General objectives of the Study .....</b>	<b>24</b>
<b>1.4 Research Hypotheses .....</b>	<b>24</b>
<b>1.5 Significance of the Study .....</b>	<b>25</b>
<b>1.5.1 Small and Medium Enterprises.....</b>	<b>25</b>
<b>1.5.2 Policy makers (Micro and Small Enterprises Authority) .....</b>	<b>25</b>
<b>1.5.3 Academicians and Researchers .....</b>	<b>25</b>
<b>1.6 Scope of the Study.....</b>	<b>26</b>
<b>CHAPTER TWO: LITERATURE REVIEW.....</b>	<b>27</b>
<b>2.1 Introduction.....</b>	<b>27</b>
<b>2.2 Theoretical Review.....</b>	<b>27</b>
<b>2.2.1 Credit Access Theory .....</b>	<b>27</b>
<b>2.2.2 Financial Intermediation Theory .....</b>	<b>29</b>
<b>2.2.3 Modern Portfolio Theory .....</b>	<b>31</b>
<b>2.2.4 Agency Theory .....</b>	<b>32</b>
<b>2.3 Empirical Review .....</b>	<b>34</b>
<b>2.3.1 Microfinance Lending Practices and Financial Performance of Small and Medium Enterprises .....</b>	<b>34</b>

2.3.2 Microfinance Savings Practices and Financial Performance of Small and Medium Enterprises .....	37
2.3.3 Microfinance insurance practices and Financial Performance of Small and Medium Enterprises .....	40
2.3.4 Microfinance loan recovery practices and Financial Performance of Small and Medium Enterprises .....	42
2.4 Conceptual Framework.....	45
2.5 Operationalization of Variables.....	46
<b>CHAPTER THREE: RESEARCH METHODOLOGY .....</b>	<b>48</b>
3.1 Introduction.....	48
3.2 Research Design .....	48
3.3 Target Population .....	49
3.4 Sampling and Sampling Procedure.....	49
3.5 Research Instrument and Data Collection .....	50
3.6 Validity and Reliability of the Instrument.....	51
3.7 Data Processing and Analysis .....	51
3.8 Diagnostic Tests.....	52
3.8.1 Heteroscedasticity Test.....	53
3.8.2 Multicollinearity.....	53
<b>CHAPTER FOUR: DATA ANALYSIS, FINDINGS AND DISCUSSION .....</b>	<b>54</b>
4.1 Introduction.....	54
4.2 Descriptive Statistics.....	54
4.3 Validity and Reliability Test .....	56
4.3 Model Fitting .....	57
<b>CHAPTER FIVE: SUMMARY, CONCLUSION AND RECOMMENDATIONS ..</b>	<b>71</b>
5.1 Introduction.....	71
5.2 Summary.....	71
5.3 Conclusions.....	76
5.4 Recommendations.....	77
5.5 Recommendations for Future Research .....	78
<b>REFERENCES.....</b>	<b>79</b>

<b>APPENDICES .....</b>	<b>83</b>
<b>Appendix 1: Questionnaire .....</b>	<b>83</b>

## **DEDICATION**

I dedicate this work to my wife Juliana Wagura and our two sons, Isaac and Daniel for their patience and support during my long absence from home to accomplish this work.

## LIST OF TABLES

Table:2.1: Operationalization of variables .....	18
Table 3.1: Reliability Findings .....	28
Table 4.1: Response on the institutions offering credit services to the SMEs.....	32
Table 4.2: Descriptive statistics for model variables .....	33
Table 4.3: Regression model on effect of microfinance institution financial practices ..	34
Table 4.4: Correlational coefficients .....	36
Table 4.5: Breusch-Pagan / Cook-Weisberg Test Results – Test for Heteroscedasticity.	37
Table 4.6: Multicollinearity test results .....	38
Table 4.7: Durbin Watson bound statistics .....	36

## LIST OF FIGURES

Figure: 2.2: Conceptual Framework .....	17
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## **ACRONYMS AND ABBREVIATIONS**

<b>CBK</b>	Central Bank of Kenya
<b>DFI</b>	Development Finance Institution
<b>GDP</b>	Gross Domestic Product
<b>MFI</b>	Microfinance Institution
<b>MSEA</b>	Micro and Small Enterprise Authority
<b>KNBS</b>	Kenya National Bureau of Statistics
<b>SME</b>	Small and Medium Enterprise
<b>RBV</b>	Resource-Based View

## **OPERATIONAL DEFINITION OF TERMS**

SME	The study follows the MSEA definition of an SME which refers to a business with annual sales or turnover less than or equal to Kes 500,000 (MSEA, 2012).
Microfinance lending services	Refers to the lending services offered by Microfinance institutions to the SMEs in the last 24 months of operation measured by credit received (KNBS Small and Medium Enterprises Survey, 2016).
Microfinance savings services	Refers to saving services offered by Microfinance institution to the SMEs in the last 24 months of operation measured by the amount saved. (KNBS Small and Medium Enterprises Survey, 2016).
SME performance	Refers to the financial performance of the SME in the last 24 months of operation measured by annual net profit and annual growth in sales turnover (KNBS Small and Medium Enterprises Survey, 2016).

## CHAPTER ONE: INTRODUCTION

### 1.1 Background of the Study

The role of microfinance institutions in an economy especially in the developing economies cannot be underestimated given their importance on financial intermediation as far as ensuring allocation of financial resources from net savers to net borrowers. More importantly is the role the microfinances play towards financing Small and Medium Enterprise (SMEs) given that SMEs are always unable to fulfill borrowing requirements mostly set by commercial banks. This leaves the SMEs with microfinances as the only borrowing institutions to their rescue. Vast literature does exist on the various dimensions via which microfinances immensely support SMEs' growth globally. In addition, microfinance institutions offer SMEs key non – financial services such as business skills through training (Consultative Group to Assist the Poor, 2012). Ledgerwood (2008) asserts that besides financial services, most enterprises need skill training to enable them to run their businesses successfully hence microfinance institutions are involved in offering these services too.

According to Mosley (2000), microfinance institutions' key role is to reduce poverty among the developing economies through increased household income levels. In the United Kingdom, Gray, Saunders and Goregaokar (2012) found that SMEs majorly finance their operations through profits reinvesting and family or personal savings. In Kenya, SMEs' role in poverty eradication through job creation cannot be underestimated. Koech (2011) asserts that SMEs in Kenya are the engines for future industrialization hence economic growth. Further, Mwangi (2011) points out that SMEs are crucial incentives of socio-economic and political growth and development globally.

A keen review of SMEs reveal that SMEs play a critical role in the economy forming the bulk of developing economies. The SME sector, also commonly referred to as the informal sector, has created several job opportunities in the developing economies, Kenya not being an exception. For instance, in Kenya, the sector accounted for 78 percent of total employment rate in the years 2005/2006. However, despite the success, SMEs still face a myriad of challenges. Inadequate and limited access to finances have greatly affected their expansion and the rate in which they are bridging the working capital deficits. To this effect, the microfinances have a key role to play in financial intermediation as far as SMEs growth and success is concerned considering that SMEs to large extent lack collaterals and other borrowing requirements imposed by commercial banks. This exposure therefore warrants the need to explore in what are the real effects of microfinance institutions on SMEs in Kenya. Given the diversity in the definition and conceptualization of SMEs, a case study of Kajiado County, which is the focus of the study was deemed ideal given that possibility of having a better definition based on the common economic activities they are engaged in.

### **1.1.1 Why Microfinance Institutions**

Whilst a review of the microfinances institutions in Kenya depicts a large number of unbanked population since the 1980s, SMEs have been perceived as an alternative avenue of attaining a higher financial inclusion given the small population that is financially included through commercial banks (Ogindo, 2006). A large population of individuals and small business remained unbanked and with no access to financial services. The micro-finance institutions therefore emerged with an aim of bridging this gap. In Kenya, some notable MFIs include former equity building society, former family building society, and Faulu microfinance of Kenya and Krep microfinance. The Kenyan, MFIs, are domiciled under Association of Microfinance Institutions

(AMFI) as their umbrella body. By 2017, the AMFI had 34 registered institutions member institutions with approximately 1.1 million savers and 250,000 borrowers. Their loan portfolio is estimated at Kshs. 42.8 billion and the asset base of kshs 67.6 billion with customer deposits of Kshs 38.9 (CBK, 2017). This represents a very robust growth in the microfinance institutions in the country.

Currently, the microfinance institution services has gained popularity among the SMEs due to the fact that they are capable of disbursing short-term loans quickly for financing the working capital with immediate regular weekly or monthly repayments as opposed to banks who require physical collateral such as property of which the SMEs lack (Khan, 2008). It is hence imperative that the study be carried out to ascertain whether MFIs have had an impact and to what extent they have been able to bridge the gap left by commercial banks in supporting SMEs. Such a study is timely given that in year 2012 the Government of Kenya enacted the Micro and Small Enterprise Act 2012 following the implementation of the Kenyan Constitution 2010.

This led to the creation of Micro and Small Enterprise Authority to deal with issues pertaining to SMEs in the country under the ministry of industrialization. However, to realize the evolution, growth, and success of SMEs in Kenya and not barely the enactment of MSEA act 2012, a multifaceted approach is required. Given that limited access to financial services is a challenge faced by many SMEs, examining microfinance impact on bridging the gap left by commercial banks in regards to supporting SMEs would be core in informing amendments and implementation of the MSEA act.

Microfinance financial practices are unique compared to the convention financial practices of other financial services providers such as commercial banks. According to Longenecker, (2006) microfinance institutions offer financial services to persons coming from either low-income poor

or the extremely poor self-employed households. Further, Oketch (2000) asserts that microfinance financial practices go beyond lending to include savings together with credit but also carries other complimentary financial services like payment services and insurance options. Micro credit is often extended without traditional collateral. MFIs core function is perceived to be that of helping low-income households to stabilize their income flows and save for future needs. In good times, microfinance helps small businesses to prosper, and in crisis, it can help them cope and rebuild. True to it, if physical collateral were a must requirement for borrowing, most SMEs seeking financial help from MFIs would be unable to participate because most of them don't have them.

According to Kamau (2010), MFIs presence in Kenya is fast growing. They enjoy a large number of subscribers pooled from low-income households and SMEs in the rural and urban areas. He further mentioned that they gained prominence in Kenya due to the fact that the formal banking sector since independence up to late 2000 regarded the informal sector as risky and not commercially viable. Based on sound operating principles, MFIs uniquely developed and offered new, innovative and pro-poor model of financing SMEs and low-income households and are credited to have greatly contributed to social-economic empowerment to the beneficiaries and their dependents. As a general rule, MFIs work toward a double bottom-line—financial and social—unlike the typical formal financial institution which works solely toward a financial bottom-line.

Westerberg and Wincent (2008) on their part asserted that microfinance is simply the platform that attempts to advance significant access to small cash deposits together with small loans for households with poor backgrounds and who have almost perennially been neglected by traditional banks. Consequently, microfinance is about the delivery of financial services like savings, insurance, payments and loans to poor households or persons living in both urban and rural

contexts and who have challenges accessing the same from traditional banks. Ogindo (2006) observes that a majority of Kenyan MFIs are set-up in two major backgrounds as either NGOs or Savings and Credit Cooperative Societies. Regardless, they have and continue to serve as critical providers of loans to many low-wage earners and small enterprises in metropolitan and countryside regions. Kamau (2010) notes that despite the probability of high risks, MFIs found a way to create and offer novel, ground-breaking, and friendly methods of providing funds to low-income individuals and businesses founded on rigorous operational doctrines.

### **1.1.2 Concept of Firm Performance**

Enterprise performance in finance literature has been viewed as the achievement of the enterprise's goals (Brown, 1996). West and Fair (1996) further defines performance as the ability of an enterprise to optimally utilize the resources at its disposal to achieve its intended objectives and goals with the highest level of efficiency. Therefore, according to these definitions, performance can be a yardstick of evaluating an enterprise overtime. Some of the highlighted measures of performance of an organization in the literature financial performance indicators, market share / power, assets base among others (Whyte, 1991).

Assessing of firm performance has always been of interest to management teams and researchers. In addition, performance in today's economic environment is a critical issue for academic scholars and practicing managers. Researchers have extended efforts to determine measures for the concept of performance. In this regard, there is an incomplete literature and an on-going debate on the issue of firm's performance. Nowadays, firm performance has become a relevant concept in strategic management research and is frequently used as a dependent variable. Although it is a very common notion in the academic literature, there is hardly a consensus about

its definition and measurement (Ivanov & Avasilcăi, 2014). Unlike in the past decades, firm performance in the twenty – first century is principally focused on the capability and ability of an organization to efficiently exploit the available resources to achieve accomplishments consistent with the set objectives of the company, as well as considering their relevance to its users. According to Lebars and Euske (2006) firm performance entails a set of definitions consisting of both the financial and nonfinancial indicators that offer information on the level of accomplishment of objectives and results.

The most common indicators of enterprise performance is the financial performance whose indicators include: sales growth, ROI, ROE, return on sales, and earnings per share. SMEs performance can be measured in monetary terms for instance profits, cost effectiveness, revenue, savings and value of assets held. It can also be measured quantitatively in terms of stock levels, units of sales, number of employees, percentage of market share and quantity of stock held. Time measurement includes man- hours or machine - hours.

### **1.1.3 Small and Medium Enterprises**

Micro and Small Enterprise have several definitions. Micro enterprises are enterprises with employees less than nine, and annual turnover of less than Ksh.500, 000. On the other hand, medium enterprises are enterprises with employee between ten and fifty and an annual turnover of between Ksh.500,000 and Ksh.5 million (Micro and Small Enterprise, 2012). These enterprises are core in an economy. In the Kenya case, they account for 85% of the total national workforce. At the global level, SMEs have been considered critical in terms of employment creation and national growth key determinant hence accounting for a substantial share of GDP (Aremu & Adeyemi, 2011). Global review reveal that the economic stability experienced by Switzerland is credited on the fact the country has invested significantly on efficient small- and medium-sized

companies alongside the large, competitive multinationals. The situation was different from the rest of Europe which had much of its investment in large multinationals that focused on the export market (Guo & Woo, 2016).

Okatch (2011) asserts that in Kenya SMEs are core in employment creation. Similar findings are reported by Kiveu and Ofafa (2013). According to the Republic of Kenya Economic survey report (2013), 660,000 new employment opportunities were created in 2012. Out of these, 90% were in the informal sector and only 10% in the formal sector. In 2013, 742,800 new employment opportunities were created and out of these, 81% were in the informal sector and only 19% in the formal sector (GoK, 2014). However, the access to credit is still a challenge to most SMEs. Wanjohi and Mugure (2008) asserts that insufficient capital tops the list of barriers to socio economic development threatening the success of SME's. Due to the small sizes of most SME businesses and the fact that most of them may not have lived beyond 5 years, a lack of resources in capital means small entrepreneurs need micro-financial services to grow and service their business.

The above challenges have led to most SMEs to resort to informal financial institutions such as savings and loans companies, friends and relatives which may not be sufficient leading to creation of savings and credit groups like chamas (informal savings groups among families, friends or businesspeople sharing similar interests. Some of these groups eventually graduated to Savings and credit corporative organizations which have been very resourceful in financing small businesses. These organizations fall under the Umbrella group referred to as Micro Finance Institutions.

#### **1.1.4 Kajiado County, Kenya**

Being one of the 47 counties in Kenya, Kajiado County is home to eleven major commercial banks, various micro finance institutions and common insurance companies providing financial service in the county. Further, the County Integrated Development Plan, 2013 -2017 points out that the county is well endowed with co-operative societies with over 296 cooperative societies in place. Savings and Credit Cooperative Societies (SACCOs) and housing and livestock marketing societies are the most common in the county. Others include dairy marketing, handicraft and multipurpose co-operative societies. This implies that the non – bank financial institutions play a crucial role in providing financial services to the enterprises in the Kajiado County hence the importance of this study on the effects of microfinance service on the performance of the SMEs in the County.

According to the County Integrated Development Plan (CIDP) 2018 – 2022, Kajiado County continues to enjoys the benefits majorly for being within the Nairobi Metropolis which consists of 4 counties; Nairobi, Kiambu, Machakos and Kajiado. With the changing dynamics in the county, new economic activities are being adopted in the county a move from the predominant livestock keeping activity among the dominant community in the county. In addition, with the rising urbanization rate in the county, demand for other services such as demand for financial services is on the rise as well. With the county having low supply of the financial services owing to the fact of few financial providers / institutions being present in the county, a dare need of focusing on the provision of these services is critical (CIDP 2018 – 2022).

In terms of financial services coverage, the County has a total of 81 banks, Micro Finance Institutions, Mobile money agents. The leading financial services providers are Equity Bank, Kenya Commercial, Standard Chartered, Diamond Trust Bank, Post Bank, Family Bank,

Cooperative Bank, Kenya Women Finance Trust, Barclays, National Bank, I&M and Sidian Bank; 13 micro finance institutions and 9 common insurance companies. Kajiado North has the highest concentration of banks, micro finance institutions and mobile money agents. It is closely followed by Kajiado East and Kajiado Central. However, there is a major gap on the presence of financial services in Kajiado with some areas being served by the neighboring counties. With the county being the 4th largest county in land area, this financial services indicator signifies a very low coverage (CIDP 2018 – 2022).

As per the Small and Medium Establishments Basic Report 2016, Kajiado County has a total of 46,100 licensed and 101,900 unlicensed SMEs. The micro sized establishment constituted more than 90 percent of the licensed establishments placing Kajiado among the top five counties with the greatest number of SMEs. In fact, the county has been considered a conduit for spill overgrowth from Nairobi which shows a marked potential. Whilst significant consideration has recently been put in to the numerous strategies to advance quality of financial services in the county, relatively less consideration has been put to investigate the influence of microfinance institutions services on SMEs performance and in particularly with adoption of microfinance services being derived from factors like micro-insurance factors and expansion of business loans accessibility. This study hopes to fill the gap.

## **1.2 Problem Statement**

Despite the key role played by SMEs in as far as economic growth and development in Kenya is concerned, vast challenges have continued to face these enterprises over time. It is estimated that, in the year 2017, SMEs accounted for 3 percent of the total 6.4 percent of the overall country's economic growth (Economic Survey, 2017). Further, the Central bank of Kenya, (2017) asserts that SMEs account for 30 percent of annual job creations. However, despite this invaluable

importance and significance in the economy, SMEs still face a myriad of challenges that directly affect their operations and growth. As pointed out by Deloitte Kenya Economic outlook, (2016), SMEs challenges range from inadequate financial resources, market inaccessibility, limited entrepreneurial skills, inability to cope with changing technology and unfavorable regulatory environments among others.

The cost of capital is one of the highest factors constraining SMEs growth into large business enterprises. Profits and sales are other factors that influence business growth (Koech, 2011). According to Robai (2006) SMEs face unique issues which affect their financial performance and diminish their ability to contribute effectively to sustainable growth. This challenge has led to most SMEs resort to informal financial institutions such as savings and loans companies, friends and relatives which may not be sufficient leading to creation of savings and credit groups like chamas (informal savings groups among families, friends or businesspeople sharing similar interests. Some of these groups eventually graduated to Savings and credit corporative organizations which have been very resourceful in financing small businesses.

As per the Small and Medium Establishments Basic Report 2016, Kajiado County has a total of 46,100 licensed and 101,900 unlicensed SMEs. The micro sized establishment constituted more than 90 percent of the licensed establishments placing Kajiado among the top five counties with the greatest number of SMEs. SMEs is therefore a major employer absorbing at least 36 percent of the 2018 projected population. Despite this fact, the CIDP 2018 – 2022 indicates that the County has a very low financial coverage despite it being 4th largest county in land area. As of 2018, the County had a total of 81 banks, Micro Finance Institutions, Mobile money agents. This calls for studies of provision of financial services to the SMEs in the County.

Sadly, according to Kenya National Bureau of Statistics-KNBS (2017), an alarming number of SMEs collapse in their first three years of inception due to the challenges aforementioned. As a matter of fact, KNBS assert that in 2017, approximately 400,000 SMEs collapsed in their second year after their establishment hence posing a question on what the missing cog could be in as far as SMEs performance and success is concerned. Omiti and Kimuyu (2000), opined that microfinance institutions were majorly created in Kenya to finance small enterprises with least collateral requirement. This was informed by the fact that due to poor security or collateral base; most SMEs are disqualified from accessing credit markets for a long time. However, according to Makokha (2006), despite the enactment of Microfinance act of 2006 which spells out the operations of MFIs in Kenya, many SMEs still have limited access to credit due to prohibitive terms of lending. Akinyi (2009), affirms this position by mentioning that many SMEs have been left out un-attended due the limited finances.

Various studies carried out on MFIs factor on businesses development in Kenya have yielded inconsistent results. Scanty research evidence exists on the effects of MFIs services on the SMEs performance within Kajiado County with the local studies in this research area having no coverage of Kajiado County. Deviating from other local studies such as Akinyi (2009) whose focus was on factors affecting SME performance whereby financial challenge was found to be among the variables, this study sought to investigate MFIs effects in enhancing the financial performance of SMEs by undertaking detailed analytics on financial practices beyond credit access to savings and insurance practices within Kajiado County.

### **1.3 General objectives of the Study**

The general objective of the study was to examine the effect of microfinance institutions financial practices on performance of small and medium enterprises in Kajiado County in Kenya.

The following were the specific objectives;

- i. To establish the effect of microfinance institutions lending practices on financial performance of small and medium enterprises in Kajiado County.
- ii. To determine the effect of microfinance institutions savings practices on financial performance of small and medium enterprises in Kajiado County.
- iii. To establish the effect of microfinance institutions insurance practices on financial performance of small and medium enterprises in Kajiado County.
- iv. To examine the effect of microfinance institutions loan repayment practices on financial performance of small and medium enterprises in Kajiado County.

### **1.4 Research Hypotheses**

The study was guided by the following research hypotheses:

- i. Microfinance institutions lending practices has no effect on financial performance of small and medium enterprises in Kajiado County.
- ii. Microfinance institutions savings practices has no effect on financial performance of small and medium enterprises in Kajiado County.
- iii. Microfinance institutions insurance practices has no effect on financial performance of small and medium enterprises in Kajiado County.
- iv. Microfinance institutions loan repayment has no effect on financial performance of small and medium enterprises in Kajiado County.

## **1.5 Significance of the Study**

The significance of the study is three – fold namely: the importance to the SMEs, policy makers and researchers.

### **1.5.1 Small and Medium Enterprises**

The study findings are of importance to the SMEs in shedding light on how various services offered by the microfinances to SMEs affect the performance of the SMEs. This is critical in informing SMEs on which services they ought to leverage on for optimal performance.

### **1.5.2 Policy makers (Micro and Small Enterprises Authority)**

To the policy makers, the findings of the study is of importance to institutions such as MSEA. Previous studies in the Kenyan context have revealed that majority of the SMEs fail to live beyond their third year upon their establishment. Some of the core factors attributed to this failure is the inadequate access to credit, inadequate expertise (entrepreneurial skills) among others. The study therefore shed light on how various microfinance financial services such as lending, savings and insurance services affect the performance of SMEs. This is crucial to MSEA more so in policy formulations that is geared towards mobilization of cheap and affordable funds for microfinances. In addition are the policies such as developing incentives such as the tax rebates to microfinances that offer training services to SMEs.

### **1.5.3 Academicians and Researchers**

To the academicians and researchers, the findings of the study is of importance in contributing to the existing empirical literature regarding how the microfinance institutions affect the financial performance of the SMEs through the various services they offer to the SMEs. This way the study offers background information as well as elicit areas for further studies by potential

futures studies in this area of study hence contributing to the existing body of knowledge in the subject area.

### **1.6 Scope of the Study**

The scope of the study was the Small and Medium Enterprises operating the Kajiado County. The study focused on four financial practices offered by the microfinance institutions to the Small and Medium Enterprises. Specifically, the study focused on lending practices, saving practices, insurance practices and lastly the loan recovery practices. The study focused on Small and Medium Enterprises operating licensed and operating in the Kajiado Township selected through purposive sampling criteria. The study sample size of the study was 372 licensed SMEs registered within Kajiado Township which is also the headquarters of the county (Kajiado County Business Registry, 2019).

## **CHAPTER TWO: LITERATURE REVIEW**

### **2.1 Introduction**

This chapter reviews literature to the area covered by the study. The chapter entails theoretical literature upon which the study is anchored on, review of related empirical literature, conceptual framework, and operationalization of study variables. This chapter therefore appreciates the role of literature in the study. As such the chapter supports the fact that every study is not a ground breaker but rather relies on other previous studies and theoretical propositions. The review of theoretical literature is crucial as it points out the theories which the study was anchored on and how such theories are applicable in the actual study. Secondly, the review of the empirical studies gives insights on the possible variables and analysis methods the researcher can adopt in conducting the study.

### **2.2 Theoretical Review**

Theoretical review entails detailed discussions of the theoretical propositions upon which the study was anchored on. The section is critical as it is giving the study a theoretical backing based on previous theories. By so doing, the study can formulate the conceptual framework linking the dependent variable to the independent variables of the study. In addition to detailed discussion of the theories, the actual application of the theories in studies through a justification of how the theories are applicable in the study is offered in this section. This study was underpinned on three theories namely: Credit access theory, Theory of Financial intermediation and Resource based theory.

#### **2.2.1 Credit Access Theory**

The credit access theory was developed by Stiglitz & Weiss (1981). The development of this theory was underpinned on the existing inefficiencies in the financial market that warranted

for the solutions geared toward improving the market efficiencies. According to the theory the inefficiencies experienced in the financial markets are as a result of asymmetric market information distribution. This scenario therefore contributes to inefficiencies in the financial intermediation process. As such the financial institutions result into vetting of the loan applicants to ensure that they lend the finances to credit worth applicants (Kashyap, Stein & Wilcox, 1993).

According to this theory, the financial markets are faced with adverse selection problem arising from the information asymmetry problem since the borrowers tend to withhold much information from the lenders. This therefore results into credit rationing and the lender tend to demand for the loan securities to trade – off the risk of loss of loan defaults. Adverse selection tends to be eminent in the market since the risky borrowers tend to be the majority in the market. Therefore, by the lenders asking for loan securities, the low – risk borrowers who expect a lower interest rate on loans are eliminated in the market leaving the high – risk borrowers who are capable of providing for loan securities.

The proponents of this theory posit that equilibrium rationing in the financial market perhaps is an interesting phenomenon. Therefore, a point comes whereby the lenders charge same interest rate to all borrowers in the market since due to the information asymmetry the lenders are unable to differentiate between low – risk and high – risk borrowers. This theory support objective one that seeks to examine the effect of credit access by the SMEs from the microfinance. The theory is applicable in conceptualizing the effect of microfinance lending services to SMEs on the SMEs' performance. Basically, the theory could offer some explanation to the reasons behind the expensive loans to SMEs that could be arising from information asymmetry given that majority of the SMEs do not keep financial records for their operations in addition to very low entrepreneurial skills that lead to lot of inefficiencies.

### **2.2.2 Financial Intermediation Theory**

Pioneered by Gurley and Shaw (1960), the theory is centered around the economics on information asymmetry in the credit markets. The theory asserts in order to trade – off the cost of information asymmetry and the transaction cost associated with the financial market, then there is the need for financial intermediaries to come into the market to reduce these costs. Two strands to financial intermediaries are fronted. One, is the liquidity provision and second is the transformation of the risk characteristics of financial assets. However, it is notable that in both strands, the focus still remains to be reduction of information asymmetry and the associated transaction costs. Financial intermediaries play an important role in the saving-investment process. An essential role of financial intermediaries is that they satisfy the portfolio preference of both depositors and borrowers at the same time. Bert and Dick (2003) opined that the theory builds on the notion that intermediaries serve to reduce transaction costs and informational asymmetries. They stated that financial intermediaries can absorb risk on the scale required by the market because their scale permits a sufficiently diversified portfolio of investments needed to offer the security required by savers and policyholders. According to them, financial intermediaries are not just agents who screen and monitor on behalf of savers, they are also active counterparts themselves offering a specific product that cannot be offered by individual investors to savers. Their superlative importance in the modern economy cannot be ignored.

According to Pagano (1993), financial intermediation can affect economic growth by acting on the saving rate, on the fraction of saving channeled to investment or on the social marginal productivity of investment. Savers can pool their funds, enabling them to make large investments, which in turn benefits the entity in which they are investing. At the same time, financial intermediaries pool risk by spreading funds across a diverse range of investments and

loans. He further opined that the most productive investments, financial intermediaries increase productivity through risk sharing and risk minimization.

Yusifzada and Mammadova (2015) opined that finance can stimulate the main drivers of growth such as capital and total factor productivity. They further state that financial intermediaries decrease transaction costs of capital accumulation encourage savings and are also essential in increasing total factor productivity by directing investments to the most productive projects and monitoring them in a cost efficient way.

This theory hence supports second objective of the study that seeks to examine the effect of saving services offered by microfinance to the SMEs. The financial intermediation seeks to ensure the efficient allocation of financial resources by pooling financial resources from the supply (net savers) and availing them to the demand side (net borrowers). Therefore, through this theory, the financial service providers such as microfinance institutions offer the saving services to the net savers. This theory is applicable in the study in that it justifies why microfinance institutions are crucial to the growth and the success of the SMEs. It is evident that only a handful of SMEs have access to bank services due to their inability to meet the laid down requirements by banks. In this case, commercial banks have failed in their role of intermediation in so far as providing financial services to SMEs is concerned. This justifies the emergence of the microfinance institutions to provide the financial intermediation services to the SMEs hence the importance of MFIs to SMEs growth and success.

### **2.2.3 Modern Portfolio Theory**

This theory was pioneered by Harry Markowitz (1952). The underlying reasoning of this theory is the investors generally fear risk and are therefore risk averse. Therefore, such risk averse investor have opportunity to diversify their risk by investing their portfolios in such a manner that they earn maximum expected returns at a given market risk. By diversifying their investment portfolios, the risk averse are cable of constructing efficient frontier that earns them optimal returns. According to the theory the investor can estimate the expected return and risk of his / her portfolio. At any time the expected risk falls, the expected return will definitely increase upon combining the different price movements. The theory therefore recommends the need for the evaluation of investor's investment portfolios based on the market price risk.

However, the Modern Portfolio Theory is generally criticized on its assumptions. Its assumptions of zero transactional cost, investors' rationality and risk averse do not hold. Further, the theory assumes zero taxes and similarity in investors' views which are all false given the reality of investor information asymmetry. The relevance of the theory in this study relates Insurance managers invest pooled resources from clients' premiums where the returns are high to meet the possible claims and earn a profit. One way of diversification of the investment is insurance. Insurance will basically entail transferring the risk liability to a third party mainly an insurance company.

This theory supports the third objective that sought to examine the effect of insurance services to the SMEs from the microfinance. Businesses such as SME operate in risky environment full of uncertainties. Therefore, insurance services are key in cushioning the SMEs for possible losses likely to arise in the event of risk incidence occurring. Having an insurance cover, places

the SME at a competitive position compared to peers without the insurance cover since in the event of risky incidence occurring, the entity is assured of indemnity for loss suffered. Therefore, possession of a business insurance cover is a comparative advantage compared to having none. This informs the inclusion of the resource-based value model that asserts that a firm possessing a resources which forms a basis for the superior performance enabling a firm to outperform its competitors based primarily in the application of the various tangible or intangible resources at its disposal.

This theory supports the third objective of the study. Given a wide range of risks facing the SMEs, diversification of such risks through means such as insurance would be core in cushioning the SMEs against possible inherent losses upon the risk occurring. Therefore, SMEs will demand for insurance services to transfer the possible risks in their operations to a third party. Therefore, the modern portfolio theory is applicable in this study in conceptualizing demand for insurance services by the SMEs from the MFIs to cushion them from possible losses likely to occur in the event of a risk occurring.

#### **2.2.4 Agency Theory**

Agency theory was developed by Jensen and Meckling (1976). According to the Agency theory, the principal - agency problem can be reduced by better monitoring such as establishing more appropriate incentives by the manager to the agency. In the field of corporate risk management, agency issues have been shown to influence managerial attitudes towards risk taking and hedging. Also, the Agency theory explains a possible mismatch of interest between shareholder or management and debt holders due to asymmetries in earning distribution which can

result in the firm taking too much risk or not engaging in positive net value projects. Hence, the Agency theory implies that defined hedging policies can have important influence on firm value.

The Agency Theory has been utilized differently to inform loan recovery from borrowers. The financial institutions perform what is called “delegated monitoring”. Municipalities and other borrowers could, in principle, deal directly with individual lenders by borrowing investment funds from large financial institutions like pension funds or insurance companies. They could even borrow from individual savers. However, unless the loan at stake is large, it is inefficient for each saver to try to monitor financial conditions and all the other factors affecting loan repayment.

A financial institution performs this intermediaries and monitoring function by gathering saving information from numerous sources, assembling specialized professionals capable of loan appraisal and loan oversight, allocating capital and then monitoring both its loans and the financial condition of borrowers. This approach is quite relevant to the study in sense that the Bank can monitor the provision of their loans and their disbursement through selected institution like the municipalities which is able to make a close follow up of their returns.

This theory supports the fourth objective of the study. By utilizing the Agency theory, the current study was capable of analyzing the action of the microfinance institution to influence loan recovery by the borrowers (SME) so as to improve performance of the SME. Basing on the assumptions of this theory, loan recovery efficiency microfinance institutions is mutually determined by principal and agent.

## **2.3 Empirical Review**

Vast empirical literature does exist on the effect of microfinance services on the performance of SMEs globally. Several such works are reviewed in this section in line with the study objectives.

### **2.3.1 Microfinance Lending Practices and Financial Performance of Small and Medium Enterprises**

Obli (2011) studied SMEs in the Kumasi metropolis in Ghana. The study focused on the challenges faced by the SMEs in Ghana with regard to access to financial services. The study found that the SMEs had minimal access to financial services from the financial institutions due to the perceptions of their lack entrepreneurial skills and lack of financial records. Madole, (2013) investigated how SMEs in Tanzania were affected by the microfinance credit. The study focused on the NMB Bank in Morogoro. The study found that SMEs benefited through increased sales and profitability. Further, the study found that ability to access credit by the SMEs was informed by SME age, assets base and ability to provide for a loan security. Fauster (2014) examined how SMEs are affected by the credit from the financial institutions in Ghana. The study applied inferential statistical analysis and found that MFIs lending to the SMEs increased the mean sales revenue.

Ahiawodzi (2012) focused on examining the determinants of access to credit by small and medium enterprises in Ghana. The study focused on 78 SMEs and used questionnaires to collect data. Data was analyzed using correlations and regressions analysis. The study findings revealed that when SMEs are able to access financial services, it leads to better financial performance. Nkeobuna (2012) also carried out a study linking micro-credit products and performance of SMEs in Ghana using correlation and regression analysis. The data collected was primary. Results

showed that micro-credit products had a positive and significant correlation with financial performance of SMEs in both financial service and agricultural sector.

In Ghana, 50 SMEs were studied Owusi (2012). The study focused on the SMEs domiciled in Kumasi, Accra and Tamale. The study relied on the regression model to estimate the effect of micro credit on the financial performance of the SMEs in Ghana. In a nutshell the study found that micro credit positively impacts SMEs' profitability levels. The study therefore recommended the need to expand credit facilities extended by the microfinance institutions to the Ghanaian SMEs beyond those domiciled in Kumasi, Accra and Tamale regions.

In the Kenyan context, Kalui and Omwansa (2015) examined 372 SMEs firms in Machakos County. Descriptive research design with stratified random sampling technique was adopted in drawing the study sample. The results showed that, the MFIs' lending positively impact on the SMEs' financial performance. Kibet, Achesa and Omwono (2015) investigated the SMEs in Uasin Gishu County in Kenya. The study found that by focusing on clients as opposed to products, SMEs stood to achieved accelerated growth. The study found that a substantial number of SMEs experienced financial exclusion.

Lagat and Kosgei (2015) examined SMEs performance in Kiambu County. The study focused on the sample of 270 SMEs drawn from a target population of 429 SMEs operating in the Kiambu Township. A multiple regression analysis was adopted for inferential statistics analysis. The study findings were that access micro credit statistically and significantly determines the performance of SMEs.

Mutuma and Omagwa (2019) examined microfinance services and financial performance of small and medium enterprises in Meru town, Kenya. The study sought to examine effect of

credit facilities, savings programs and entrepreneur training programs on financial performance of SMEs. The study sample was 93 respondents. Data was collected using structured questionnaires. The study found strong positive nexus between Microfinance Services and Financial Performance of the SMEs. Specifically, micro credit facilities, micro saving savings programmes and entrepreneur training to SMEs was found to improve SME performance.

Kisaka and Mwewa (2014) did an evaluation on the impacts of micro-credit, micro-savings and training on growth of SMEs in Machakos County in Kenya. Their main focus was to establish the way growth of the SMEs is affected by training, and micro credit and savings. A sample of 100 SMEs was selected from 8 forms of businesses and data was gathered from the selected sample using questionnaires. Multiple regression analysis was used to assess association between variables. It was found that growth of SMEs is positively influenced by micro credit.

Kurgat (2007) conducted a study on KWFT and established that customers preference was credit and saving services in the MFIs with the main reason for them saving being expansion of their business as indicated by 62% of the respondents, 40% used the funds in educating their kids, 26% for emergencies and another 71% considered compulsory savings as a way of encouraging saving. Research findings established that microfinance credit is very crucial in improving financial performance as well as outreach especially in remote regions where accessibility to financial services poses a great challenge.

Waithanji (2011) analyzed effect of microfinance financial services on the financial performance of SMEs in Kiambu county A sample of 60 SMEs were drawn from 2,061 SMEs licensed to operate in the county. The study reported a positive relationship between MFI lending and financial performance of the SMEs. Muthoka (2012) examined the link between microfinance

financial services and financial sustainability among SMEs in Nairobi East District. The study used primary data and ran regression model to establish the relationship. The findings revealed that micro credit and financing products had led to financial sustainability among SMEs. Cooper (2012) analyzed the impact of micro-finance services on the growth of 50 SMEs in Nairobi. The study found that SMEs are entirely dependent on borrowing for growth. MFI lending was also found to impact SMEs sale turnover.

In addition, Mbithe (2013) explored SMEs performance in Machakos County. The findings were that MFI lending services to SMEs increase sales and enhances business expansion. The findings agreed with Koech's (2011) view that capital market, expenses, ability to obtain funding, indemnity, ease to obtain information, financial management, and the cost of registering companies are the major elements that determine the extent of growth. Mbithe (2013) outcomes are also reflected by Cooper (2012), who discovered the strong and positive influence of MFI lending services on the expansion SMEs.

### **2.3.2 Microfinance Savings Practices and Financial Performance of Small and Medium Enterprises**

Kalui and Omwansa (2015) investigated how SMEs operating in Machakos County were affected by the financial products offered by the Microfinance Institutions operating in the County. The study sample size was 372 SMEs drawn through stratified random sampling. Primary data was collected using structure questionnaires administered to the SMEs' owners and managers. The study findings were that micro savings offered by Microfinance Institutions positively effects on the financial performance of SMEs by cushioning the business against possible losses arising from business risks. Lagat and Kosgei (2015) examined SMEs performance in Kiambu County. The

study focused on the sample of 270 SMEs drawn from a target population of 429 SMEs operating in the Kiambu Township. A multiple regression analysis was adopted for inferential statistics analysis. The study findings were that access to savings schemes statistically and significantly determines the performance of SMEs.

Mutuma and Omagwa (2019) investigated SMEs in Meru County in Kenya. A descriptive research design was adopted for a sample of 93 SMEs. Primary data was collected using questionnaires. To necessitate empirical analysis, multiple regression analysis was adopted in the study. The study findings were that MFIs saving products have positive and significant effect on SMEs financial performance. Further, the study found that SMEs were more inclined into the MFI's savings plan.

Kisaka and Mwewa (2014) did an evaluation on the impacts of micro-credit, micro-savings and training on growth of SMEs in Machakos County in Kenya. Their main focus was to establish the way growth of the SMEs is affected by training, and micro credit and savings. A sample of 100 SMEs was selected from 8 forms of businesses and data was gathered from the selected sample using questionnaires. Multiple regression analysis was used to assess association between variables. It was found that growth of SMEs is positively influenced by micro- savings.

Nkeobuna (2012) also carried out a study linking micro-finance products and performance of SMEs in Ghana using correlation and regression analysis. The data collected was primary. Results showed that micro-credit products had a positive and significant correlation with financial performance of SME s in both financial service and agricultural sector.

Sulemana and Adjei (2015) studied the effects microfinance has on agricultural produce in developing countries. The study was carried out in Pru district in Ghana. From the research

findings, it was established that savings was used by users of the MFI to make it is possible for them to gain more loans in the future. Those MFIs also required the farmer to have accounts in order for them to access loans. Therefore, encouraging farmers to save will ease their access to loans so that they can expand farming and attain their desired benefits. There are several measures that have been suggested for the purpose of motivating clients to save.

Kurgat (2007) conducted a study on KWFT and established that customers preference was credit and saving services in the MFIs with the main reason for them saving being expansion of their business as indicated by 62% of the respondents, 40% used the funds in educating their kids, 26% for emergencies and another 71% considered compulsory savings as a way of encouraging saving. Research findings established that savings is very crucial in improving financial performance as well as outreach especially in remote regions where accessibility to financial services poses a great challenge.

Still in Kenyan context, Mutuma and Omagwa (2019) conducted a study on the SMEs in Meru County in Kenya. A descriptive research design was adopted for a sample of 93 SMEs. Primary data was collected using questionnaires. To necessitate empirical analysis, multiple regression analysis was adopted in the study. The study findings were that MFIs saving products have positive and significant effect on SMEs financial performance. Further, the study found that SMEs were more inclined into the MFI's savings plan.

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microfinance financial services and financial sustainability among SMEs in Nairobi East District. The study used primary data and ran regression model to establish the relationship. The findings revealed that micro savings products and financing products had led to financial sustainability among SMEs.

### **2.3.3 Microfinance insurance practices and Financial Performance of Small and Medium Enterprises**

A study was conducted on SMEs in Machakos town in Kenya by Kalui and Omwansa (2015). Primary data was relied on in the study with the descriptive research design being adopted on data collection and analysis. A sample of 372 SMEs drawn using the Stratified random sampling criteria. The responses to the questionnaires were given by the business managers and owners. The findings were that insurance product and services by the MFIs to the SMEs has a positive effect on the SMEs financial performance.

In Ghanaian context, Fauster (2014) examined how MFI insurance products and services have influenced the SMEs performance. The study heavily relied on the inferential statistical analysis. The study examined the effect of an array on insurance products and services offered to Ghanaian SMEs by the MFIs. The study found that the MFIs' insurance products and services increased the SMEs' average sales given the positive correlation average sales had with the insurance products and services offered. Sitati (2014) conducted a study to investigate the effect of banc assurance on performance of financial institutions. The study found out that, Banc assurance model was a good source of revenues, customer acquisition, and retention and as one of the factors that investors consider before taking the risk of investing in commercial industry. The study also revealed that Banc assurance has very minimal influence on determining the success

and speed of compensating business losses, death of insured applicants among others regardless of the existence of the strategic alliances.

Further, Amoah and Mungai (2020) examined the effect of financial literacy training and micro insurance on the financial performance of Small and Medium Enterprises in the Sekondi-Takoradi Metropolis of Ghana. The study aimed at determining the effect of financial literacy training on the financial performance of SMEs; establishing the effect of micro insurance on the financial performance of SMEs; determining the moderating effect of government regulations on the relationship between financial literacy training, micro-insurance and the financial performance of SMEs. The study found that both the financial literacy training and micro-insurance had a positive and significant effect on the financial performance of SMEs.

Mutuma and Omagwa (2019) examined microfinance services and financial performance of small and medium enterprises in Meru town, Kenya. The study sought to examine effect of credit facilities, savings programs and entrepreneur training programs on financial performance of SMEs. The study sample was 93 respondents. Data was collected using structured questionnaires. The study found strong positive nexus between Microfinance Services and Financial Performance of the SMEs. Specifically, micro credit facilities, micro saving savings programmes and entrepreneur training to SMEs was found to improve SME performance.

In addition, Mbithe (2013) explored SMEs performance in Machakos County. The findings were that MFI insurance services to SMEs increase sales and enhances business expansion. The findings agreed with Koech's (2011) view that capital market, expenses, ability to obtain funding, indemnity, ease to obtain information, financial management, and the cost of registering companies are the major elements that determine the extent of growth. Mbithe (2013) outcomes

are also reflected by Cooper (2012), who discovered the strong and positive influence of MFI services on the expansion SMEs. However, despite the vast empirical literature on the effect of microfinances services on the performance of the SMEs globally, regionally and locally for the Kenyan context, scanty empirical research evidence exists on the effects of MFIs services on the SMEs performance within Kajiado County. Taking the above into consideration, the study seeks to investigate the effects of microfinance institutions services on SMEs financial performance within Kajiado County in Kenya.

However, Naomi, (2013) conducted a research on impacts of MFIs services on growth of SMEs in Machakos County. She used quantitative descriptive design to investigate the type of business categories. The target population was 5311 SMEs operating in different business categories. The study mainly used primary data collected using structured questionnaires issued to 100 businesses. The study was on dependent and independent the regression analysis conducted established that two of the independent variables (savings and access to loans) have a positive correlation with the dependent variable. Sales growth is negatively affected by micro insurance.

#### **2.3.4 Microfinance loan recovery practices and Financial Performance of Small and Medium Enterprises**

Ngondo (2018) argues that the use of penalties on delayed debt payments has been used by financial institutions as part of their debt recovery strategies over the last few decades. Chava (2014), argues that penalties are considered to be a pro-active strategy since the borrower is made aware of the risks of paying penalties in the case of default or late repayment. Furthermore, he notes that the waiver of penalties and interests is used in encouraging payment. According to Kamar and Ayuma (2016), the technique an institution will use significantly depends on the relationship it has with the borrower. Recovery of debt is especially expensive for the lender since

they have to incur extra costs. Mraba (2011) assessed how non-repayment of loans in commercial Banks the case of NMB Bank and 50 respondents affected the borrowers. Findings indicated that lender employed various methods to provide services to borrowers such as provision of education to borrowers in order to access the loans and the department was established for effective coordination on the same. Findings indicated that borrowers who timely paid their loans were those who were doing better in businesses because they were able to get profit used to pay loans either annually, quarterly or monthly. Also, the findings indicated that pre-loan training increased the number of borrowers and the rate of loan repayments.

Migwi (2013) carried out a study to investigate credit monitoring and recovery strategies adopted by commercial banks and found that all commercial banks monitor loans to ensure proper payment. This indicates that commercial banks take keen interest of loan repayment to ensure that they undergo minimal losses. However, depending on the action taken by bank, the study found that application of punitive measures to recover the loan affects the borrower's performance adversely. Further, the study found that optimal group liability in microfinance lending finds that introducing penalties for loan default can increase the willingness and promptness of repaying loans. However, the study is focused on the microfinance sector where joint liability can be used as an effective tool for encouraging loan repayment. The idea of creating a greater sense of liability from defaulting is found as a deterrent to loan default in microfinance.

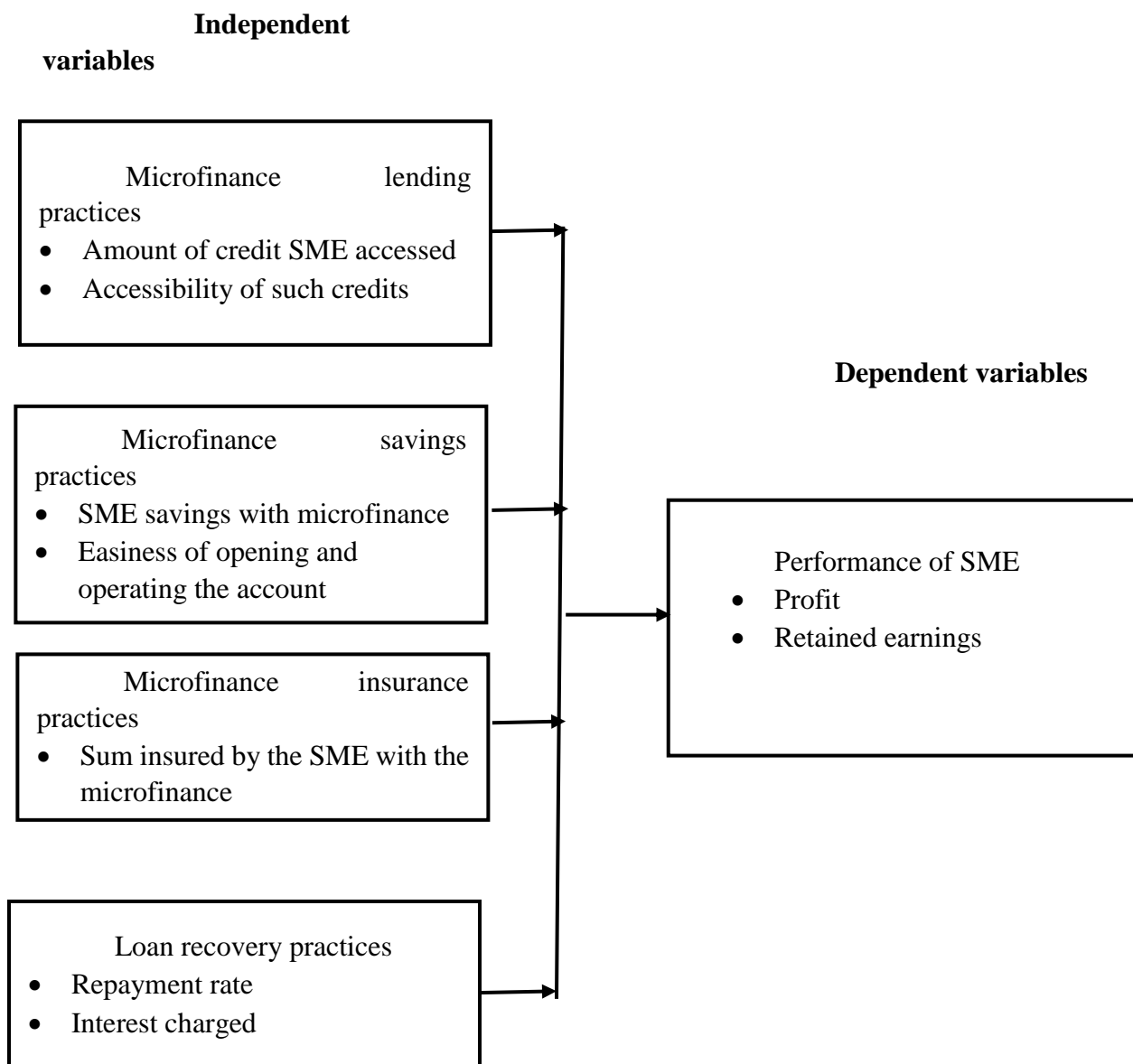
In Kenya, Mutuma and Omagwa (2019) conducted a study on the SMEs in Meru County in Kenya. A descriptive research design was adopted for a sample of 93 SMEs. Primary data was collected using questionnaires. To necessitate empirical analysis, multiple regression analysis was adopted in the study. The study findings were that MFIs loan recovery practices have positive and significant effect on SMEs financial performance. Again, Sakilu (2016) conducted a study to

assess default in a group Lending Model used by Micro-Finance Institutions (MFIs) in Tanzania. The study investigated if the default in MFIs and the recovery techniques adopted by the MFIs has any impact on client population. Findings from the study revealed that the recovery techniques adopted by the MFIs has varied impact on the borrowers. Further, transaction cost was found not have an impact to loan repayment. Likewise, the study concluded that both MFIs and their clients had a vital role to play in order to improve loan repayment. It is recommended that in order to assure good repayments, MFIs have train their clients, provide them a grace period to their clients.

Further, Khieu and Mullineaux (2019) discovered that loan characteristics, such as the presence of certain types of collateral were significant determinants of recovery rates. On the contrary, Dermine, Neto and de Carvalho (2016) found that the size of loan has a negative correlation to the actual rate of repayment cumulatively for 12 to 48 months after the loan default. But, it seems that loan characteristics has been one of the positive determinant of loan recovery because, the credit control policies among the Banks concentrate on the history of the borrowers. This in turn affect the firm performance accordingly.

## 2.4 Conceptual Framework

Robson (2011) defines a conceptual framework as a representation that is diagrammatic of relationships of the variables under study. The predictors for this study were: Microfinance lending practices, Microfinance savings practices, Microfinance insurance practices and Loan recovery practices. The dependent variable used in the study was performance of Small and Medium Enterprises in Kenya, specifically Kajiado County.



*Figure: 2.1: Conceptual Framework*

## 2.5 Operationalization of Variables

**Table 2.1: Definition and measurement of variables**

<b>Independent Variables</b>		
<b>Variable</b>	<b>Definition</b>	<b>Measurement</b>
Lending practices	Refer to the access to provision of lending services by microfinance to the SME	Amount of credit received by SME from microfinance institution in the last 24 months
Saving practices	Refer to the access to provision of saving services by microfinance to the SME	Amount of savings that the SME has saved microfinance institution in the last 24 months
Insurance practices	Refer to the access to provision of insurance services by microfinance to the SME	Amount of business sum insured that the SME has saved with the microfinance institution in the last 24 months
Loan recovery practices	Refers to mechanism put in place by the microfinance to recover the loan due in case of default in repayment	Amount of loan outstanding that the SME owes the microfinance institution
<b>Dependent Variable</b>		
<b>Variable</b>	<b>Definition</b>	<b>Measurement</b>
Profitability	Refers to the financial performance of the SME. It is mainly the total revenues net of operating expenses for a given period of time.	The profit of the SME in the last 24 months.

## **2.6 Summary of Literature Review**

Microfinance plays a very pivotal role in the growth of any country according to scholars of microfinance economics. They offer critical and essential services to the SMEs given that many of their products are tailored to meeting the need of the small businesses. This role of the microfinances is reiterated and evidenced in the empirical studies reviewed in this study. Madole, (2013) found that microfinance credit increased SME's sales and profitability. Further, Mutuma and Omagwa (2019) found that SMEs were more inclined into the MFI's savings plan in Kenya. Kibet, Achesa and Omwono (2015) found that by focusing on clients as opposed to products, SMEs stood to achieved accelerated growth. Fauster (2014) found that the MFIs' insurance products and services increased the SMEs' average sales given the positive correlation average sales had with the insurance products and services offered.

However, despite the findings by the sampled empirical studies, there has been limited coverage of the Kajiado County in the Kenyan context in so far as microfinance financial practices and financial performance of the SMEs is concerned. This limited coverage is despite of the fact that Kajiado County is a host of significant companies in the area that has created a robust business hub in the region. This study sought to fill in this gap.

## **CHAPTER THREE: RESEARCH METHODOLOGY**

### **3.1 Introduction**

This chapter covers the research methodology to be adopted by the study. More specifically, the chapter looks at the research design, the target population, sample and sampling procedures, research instruments, data collection instruments validity and reliability, data collection procedures and lastly the data processing and analysis.

### **3.2 Research Design**

Research design is a framework for specifying relationships between the variables in the study and gives an outline of each procedure from the hypotheses to the analysis of data (Cooper & Schindler, 2014). The study adopted quantitative research design. The adoption of the descriptive research design is informed by the nature of the data the study dealt with and research questions to be answered as well as the hypotheses being tested. In this case, the study dealt with quantitative data such as profits of SMEs, amount borrowed from the microfinance, amount of savings and business sum insured.

In addition, the study sought to use a quantitative method mainly a regression model in examining the relationship between dependent and independent variables empirically. These reasons therefore warranted the adoption of quantitative research design for this study. By applying the quantitative research design, the study sought to establish the relationship between microfinance lending services, saving services, loan repayment services and insurance services on one hand and the financial performance of SMEs on the other hand.

### **3.3 Target Population**

According to Mugenda and Mugenda, (2003) target population is defined as the total number or the entire group of individuals, events or objects that the researcher wishes to study. Neuman (2000) defines a study target population as all the units that the research covers or to which its findings can be generalized. From these two broad definitions, the study target were the registered SMEs covered in Kajiado County. Therefore, the study target population was 2,851 SMEs registered in Kajiado County (Kajiado County Business Registry, 2019).

### **3.4 Sampling and Sampling Procedure**

Given the large geographical coverage of Kajiado County coupled with sparse distribution of the SMEs by their location of operation, the study applied purposive sampling to select the study sample. Therefore, the study sample size was 372 licensed SMEs registered within Kajiado Township which is also the headquarters of the county (Kajiado County Business Registry, 2019). Adoption of purposive sampling is informed by the fact that within the Township SMEs are densely populated therefore easy to administer questionnaires. Secondly, Kajiado township being the County headquarters microfinance institutions are more likely to have set up their county head offices there as opposed to the outskirts' regions of the county. The study targeted the owners / COEs of these SMEs. The target population is distributed around Kajiado Township. This implies that the SMEs registered outside Kajiado Township were not considered in this study. Given the small size of the target population, the study employed census in its undertaking. This is because the target population was too small to warrant any meaningful sampling.

### **3.5 Research Instrument and Data Collection**

The study relied on secondary data. The study envisaged to use research instrument deemed appropriate for tabulating these data to enable analysis. More specifically, structured questionnaires with close-ended self-administered. The questionnaires were dropped and picked up upon the respondent filling in. The questionnaires were administered by the researcher to the managers / owners of the businesses. The questionnaires were administered to the sampled respondents face – to – face to allow probing for unclear responses as well as seeking for more information from the respondents. The hard copy questionnaires were printed and distributed to the respondents with the help of the research assistants. The questionnaire also captured the personal information of the respondent in the introduction for follow up if need be during the data entry and analysis stage.

The study questionnaire was divided into seven major sections. Section one covered general information about the SME on aspects such as SME location, number of employees and the sector of operation. Section two covered the aspects of micro – credit / lending practices and how they influence SME profitability. Section three covered the aspects of micro – saving / saving practices and how they influence SME profitability. The fourth section entailed aspects of micro – insurance practices and how they influence SME profitability. The fifth section covered the aspects of microfinance loan recovery practices and how they influence SME profitability. Section six was on aspects of SME profitability seeking to get the SME's profit levels in the last 24 months, the average total sales and average total expenses for the last 24 months of operation.

### **3.6 Validity and Reliability of the Instrument**

Validity is the extent to which data collection instrument measures what it is intended to measure (Mbwesa, 2006). This Study adopted content validity. To improve validity, the researcher translated the interview schedule from English into Kiswahili and/or the local language where necessary to ensure that the respondent fully understands the questions at hand. In addition, to ensure research instrument validity, data collection tool was pilot - tested to determine whether the questions are clearly understood by the sampled respondents. Any areas needing correction and clarification about questionnaires were corrected after the pilot study but prior to the actual field work.

Reliability is the degree to which a research instrument yields consistent results upon repeated trials (Mugenda and Mugenda, 2003). To ensure reliability in data collection the questionnaire included some questions linked to each other to gauge on the Cronbach's alpha for the tool was computed from the pre – test responses. If the Cronbach's alpha is found to be above 0.7 then the tool is concluded to be reliable for the data collection, otherwise a revision of the tool is called for followed by another pilot testing.

### **3.7 Data Processing and Analysis**

The study utilized secondary data in its empirical analysis. Specifically, the study utilized data collected from the Small and Medium Enterprises in Kajiado County. The data collected will entail amount of credit borrowed from microfinance institution, amount of saving the business has with the microfinance institution, amount of sum insured that the SMEs has insured with the microfinance institution, amount the SMEs repays to service the loan with the microfinance institution, the total assets of the SME, The age of the SME and SME profitability. STATA was



### **3.8.1 Heteroscedasticity Test**

Heteroscedasticity is an econometric problem where the error terms have no constant variance (variance is not the same). This is a post estimation diagnostic test. Non-existence will mean that confidence levels and test statistics are biased (Greene, 2003). It is a serious problem in econometrics that tends to have consequences on the Ordinary Least Square (OLS) estimators. In this study, we note that there was no need for testing for heteroskedasticity problem. This is because the study relied on the Generalized Linear models for estimation. Ideally, from the econometric point of view, the Generalized Linear Models effectively accommodates the problem of skewness in data and heteroscedasticity through variance-weighting. Upon estimating the empirical model, Breusch-Pagan-Godfrey test was used to examine heteroscedasticity. The accepted threshold test for the heteroskedasticity was p – value of 0.05 or 5 percent. Any p – value of the respective chi – square of the heteroskedasticity test that is greater than 0.05 is rejected implying the presence of heteroskedasticity.

### **3.8.2 Multicollinearity**

Multicollinearity problem mainly arises when two independent variables are linearly dependent the study applied the Variance Inflation Factor (VIF) to check for the presence / absence of multicollinearity problem in the estimated empirical model. This is a post estimation diagnostic test. A rule of thumb of VIF 10, was applied in testing for multicollinearity problem whereby a VIF of less than 10 will imply absence of multicollinearity among the independent variables. The accepted threshold test for multicollinearity is a VIF that is less than or equal to 10. Any VIF greater than 10 is rejected implying the presence of multicollinearity.

## **CHAPTER FOUR: DATA ANALYSIS, FINDINGS AND DISCUSSION**

### **4.1 Introduction**

This chapter focuses on the analysis and interpretation of the data that was collected. Specifically, the chapter covers descriptive statistics of the study variables, analysis of the study variables and regression model results. Further, the chapter covers the findings of the study as well as the discussion of the results emanating from the study findings.

### **4.2 Descriptive Statistics**

Data was collected using questionnaires from the sampled 372 Small and Medium Enterprises in Kajiado County registered and operating within Kajiado Township. The responses were received from all the 372 Small and Medium Enterprises. However, a descriptive analysis regarding the sources for financial service by the SMEs reveal that out of the 372 SMEs sampled, only 218 of the SMEs have sought for credit, savings and insurance services from a microfinance institution for the last 24 months. This account for 58.60 percent of the SMEs. Only 8.33 percent of SMEs sought for credit, savings and insurance services from commercial banks, 12.90 percent from Saccos with 20.16 percent of SMEs having not sought for any financial services from any provider in the last 24 months. Descriptive results are presented in Table 4.1.

**Table 4.1: Response on the Institutions Offering Credit Services to the SMEs**

<b>Financial Institution</b>	<b>Frequency</b>	<b>Percent</b>	<b>Cumulative</b>
Bank	31	8.33	8.33
Microfinance institution	218	58.60	66.94
None	75	20.16	87.10
SACCO	48	12.90	100.00
<b>Total</b>	<b>372</b>	<b>100.00</b>	

Based on the analyses, those that sought for financial services from the microfinance, descriptive statistics of the empirical model variables were computed. Results in Table 4.2 reveal that out total of 281 SMEs sought for credit services, the SME with the lowest amount borrowed was Ksh 6,000 with the largest loan amount borrowed by the SME being Ksh. 258,000. The mean loan amount borrowed by the SMEs was Ksh, 92,779.82 with a standard deviation of 5,125.22. Regarding the savings practices, the descriptive analysis results indicate that the lowest amount saved by the SME is Ksh. 10,000 with the highest saving being Ksh. 70,000. The mean saving was Ksh, 43,864.68 with a standard deviation of 12,428.37.

The results on the insurance practices indicate that the lowest sum insured by the SME is Ksh 10,000 with the largest sum insured being Ksh.150, 000. The mean sum by the SMEs was Ksh. 71880.73 with a standard deviation of 29,076.33. Lastly, regarding the outstanding loan amount, descriptive statistics indicate that the lowest outstanding loan by the SME is Ksh 1,000 with the largest outstanding loan being Ksh.31, 000. The mean outstanding loan by the SMEs was Ksh. 15,495.41with a standard deviation of 7,719.893. Further, the SME profitability results

indicate that lowest profit was is Ksh 8,000 with the highest profit being Ksh. 98,500. The profit was Ksh. 40,927.07 with a standard deviation of 21,616.13.

**Table 4.2: Descriptive Statistics for Model Variables**

Variable	Obs	Mean	Std.Dev	Min	Max
Amount borrowed	218	92779.82	58125.22	6000	258000
Amount saved	218	43864.68	12428.37	10000	70000
Sum insured	218	71880.73	29076.33	10000	150000
Loan outstanding	218	15495.41	7719.893	1000	31000
Profit	218	40927.07	21616.13	8090	98700

#### **4.3 Validity and Reliability Test**

To ensure validity and reliability of the data collection tool, a pilot study was conducted. For this purpose, the study used samples equivalent to 10 percent of the study sample size for pilot study purposes. The 10 percent of the sample was selected randomly leading to 37 SMEs. Upon selection, the data collection questionnaire was administered to the selected respondents. The data from the pilot study was analyzed to test whether the tool is valid and reliable through computation of the Cronbach alpha. The validity and reliability test results are presented in Table 3.1. The findings indicate an overall Cronbach Alpha coefficient of 0.96473 for all the questions for the 37 questionnaires items as per the results presented in Table 4.3. This implies that the data collection tool was reliable and valid to collect the required data.

**Table 4.3: Reliability Findings**

	Obs	Sign	Item-test correlation	Item-rest correlation	Alpha
Microfinance lending practices	37	+	0.8014	0.7713	0.9647
Microfinance saving practices	37	+	0.7505	0.7142	0.9657
Microfinance insurance practices	37	+	0.933	0.922	0.9623
Microfinance loan recovery practices	37	-	0.7239	0.6842	0.9662
<b>Test scale</b>					<b>0.96473</b>

### **4.3 Model Fitting**

This section covers the empirical model results for the regression of model estimated in line with the specific objectives of the study. In addition, the section discusses the findings the study based on the empirical models fitted using the data collected. Lastly, the section covers the diagnostic test carried out during the analysis.

#### **4.3.1 Regression Model**

To estimate the effect of microfinance institution financial practices on performance of Small and Medium Enterprises in Kajiado County in Kenya, the regression models were estimated. Linear Ordinary Least Squares regression model was adopted by the study in undertaking the empirical model estimation. In estimating the regression model, robust standard errors were used. The usage of the robust standard errors was deemed useful since they are unbiased and free from errors in variances across the observations. It notable that, it only data for the 218 SMEs that sought

for financial practices from the microfinance institutions was used and not that data for all the 372 SMEs. The regression model results are presented in Table 4.4.

**Table 4.4: Microfinance Institution Financial Practices and SME's Profitability**

Profit	Coef.	St.Err.	t-value	p-value	[95% Conf Interval]	Sig
Amount borrowed	-0.106	0.024	-4.48	0.000	-0.152 -0.059	***
Amount saved	-0.421	0.112	-3.77	0.000	-0.641 -0.201	***
Sum insured	-0.015	0.047	-0.32	0.753	-0.108 -0.078	
Outstanding loan	0.008	0.176	0.04	0.965	-0.339 0.355	
Constant	70141.9	6579.15	10.66	0.000	57173.4 83110.6	***
Mean dependent var	40927.073	SD dependent var		21616.129		
R-squared	0.560	Number of obs		218.000		
F-test	10.145	Prob > F		0.000		
Akaike crit. (AIC)	4941.440	Bayesian crit. (BIC)		4958.363		

\*\*\*  $p < 0.01$ , \*\*  $p < 0.05$ , \*  $p < 0.1$

i. **Microfinance Institutions Lending practices and Financial Performance of Small and Medium Enterprises**

The regression model results present the coefficient of the various microfinance financial practices when regressed on the SMEs' profitability. Further the respective standard error and the t – statistic for the coefficient is computed from STATA analytical software. In addition, the respective p – value of the coefficient is also computed. From the results in Table 4.4, it is evident that microfinance lending practices to the SMEs has a positive effect on the SME's profitability. The regression model coefficient of the microfinance lending practices indicates that when the amount of microfinance lending increases by one unit, SME profitability reduces by 0.106 units holding other factors constant. In addition, the magnitude of the effect, the study goes further to examine on whether the effect of microfinance lending practices on SMEs profitability is statistically significant or not. This is determined by the p – value of the respective t – statistics. The estimated model results indicates that the respective t – statistics is 4.48 with a p - value of 0.000. Using the percent significance level to test for the significance of the t – statistics, the results indicates that the p – value (p – value = 0.000) is less than 5 percent. Therefore, we reject the null hypothesis that microfinance lending practices has no significant effect on SMEs profitability. The conclusion therefore is that microfinance lending practices significantly effects SMEs profitability in Kajiado County Township. The results indicates that the effect of microfinance lending practices on SMEs profitability is significant at 1 percent significance level.

This finding on the microfinance institutions lending practices disagree with the Madole, (2013) who investigated how SMEs in Tanzania were affected by the microfinance credit and found that SMEs benefited through increased sales and profitability. Similar findings were reported by Ahiawodzi (2012) who examined the determinants of access to credit by small and

medium enterprises in Ghana and found that when SMEs are able to access financial services, it leads to better financial performance. Similarly, Nkeobuna (2012) in linking micro-credit products and performance of SMEs in Ghana found that micro-credit products had a positive and significant correlation with financial performance of SMEs in both financial service and agricultural sector.

In addition, Fauster (2014) who examined how MFI financial products and services have influenced the Ghanaian SMEs' performance. Upon using regression analysis model, the study found that loans from the microfinance institutions positively and significantly impacted on the SMEs' profitability. In Ghana, 50 SMEs were studied Owusi (2012). The study focused on the SMEs domiciled in Kumasi, Accra and Tamale. The study relied on the regression model to estimate the effect of micro credit on the financial performance of the SMEs in Ghana. In a nutshell the study found that micro credit positively impacts SMEs' profitability levels. The study therefore recommended the need to expand credit facilities extended by the microfinance institutions to the Ghanaian SMEs beyond those domiciled in Kumasi, Accra and Tamale regions.

In the Kenyan context, Kalui and Omwansa (2015) examined 372 SMEs firms in Machakos County. Descriptive research design with stratified random sampling technique was adopted in drawing the study sample. The results showed that, the MFIs' lending positively impact on the SMEs' financial performance. Kibet, Achesa and Omwono (2015) investigated the SMEs in Uasin Gishu County in Kenya. The study found that by focusing on clients as opposed to products, SMEs stood to achieved accelerated growth. The study found that a substantial number of SMEs experienced financial exclusion.

Lagat and Kosgei (2015) examined SMEs performance in Kiambu County. The study focused on the sample of 270 SMEs drawn from a target population of 429 SMEs operating in the

Kiambu Township. A multiple regression analysis was adopted for inferential statistics analysis. The study findings were that access micro credit statistically and significantly determines the performance of SMEs.

Mutuma and Omagwa (2019) examined microfinance services and financial performance of small and medium enterprises in Meru town, Kenya. The study sought to examine effect of credit facilities, savings programs and entrepreneur training programs on financial performance of SMEs. The study sample was 93 respondents. Data was collected using structured questionnaires. The study found strong positive nexus between Microfinance Services and Financial Performance of the SMEs. Specifically, micro credit facilities, micro saving savings programmes and entrepreneur training to SMEs was found to improve SME performance.

Kisaka and Mwewa (2014) did an evaluation on the impacts of micro-credit, micro-savings and training on growth of SMEs in Machakos County in Kenya. Their main focus was to establish the way growth of the SMEs is affected by training, and micro credit and savings. A sample of 100 SMEs was selected from 8 forms of businesses and data was gathered from the selected sample using questionnaires. Multiple regression analysis was used to assess association between variables. It was found that growth of SMEs is positively influenced by micro credit.

Kurgat (2007) conducted a study on KWFT and established that customers preference was credit and saving services in the MFIs with the main reason for them saving being expansion of their business as indicated by 62% of the respondents, 40% used the funds in educating their kids, 26% for emergencies and another 71% considered compulsory savings as a way of encouraging saving. Research findings established that microfinance credit is very crucial in improving

financial performance as well as outreach especially in remote regions where accessibility to financial services poses a great challenge.

ii. **Microfinance Institutions Saving practices and Financial Performance of Small and Medium Enterprises**

The second specific objective of the study was to examine the effect of microfinance saving practices on SMEs' profitability. The regression results indicate that microfinance savings practices to the SMEs have a positive effect on the SME's profitability. Specifically, the fitted regression model results indicate that when the amount of saving with the microfinance institution increases by one unit, SME profitability reduces by 0.421 units holding other factors constant. Looking at the respective p – value of the coefficient, the results indicate that the p – value of the respective t – statistics is 0.000. Using the 5 percent significance level, we conclude that microfinance saving practices positively and significantly influences SMEs' profitability holding other factors constant. From the p – values, the results indicates that the effect of microfinance lending practices on SMEs profitability is significant at 5 percent significance level.

The study findings disagree with the Kalui and Omwansa (2015) who investigated how SMEs operating in Machakos County were affected by the financial products offered by the Microfinance Institutions operating in the County. The study findings were that micro savings offered by Microfinance Institutions positively effects on the financial performance of SMEs by cushioning the business against possible losses arising from business risks. Further, Mutuma and Omagwa (2019) investigated SMEs in Meru County in Kenya and found that the MFIs saving products have positive and significant effect on SMEs financial performance. Further, the study found that SMEs were more inclined into the MFI's savings plan. In addition, the study findings disagree with Kisaka and Mwewa (2014) who did an evaluation on the impacts of micro-credit,

micro-savings and training on growth of SMEs in Machakos County in Kenya and found that growth of SMEs is positively influenced by micro- savings.

Kisaka and Mwewa (2014) did an evaluation on the impacts of micro-credit, micro-savings and training on growth of SMEs in Machakos County in Kenya. Their main focus was to establish the way growth of the SMEs is affected by training, and micro credit and savings. A sample of 100 SMEs was selected from 8 forms of businesses and data was gathered from the selected sample using questionnaires. Multiple regression analysis was used to assess association between variables. It was found that growth of SMEs is positively influenced by micro- savings.

Nkeobuna (2012) also carried out a study linking micro-finance products and performance of SMEs in Ghana using correlation and regression analysis. The data collected was primary. Results showed that micro-credit products had a positive and significant correlation with financial performance of SME s in both financial service and agricultural sector. Sulemana and Adjei (2015) studied the effects microfinance has on agricultural produce in developing countries. The study was carried out in Pru district in Ghana. From the research findings, it was established that savings was used by users of the MFI to make it is possible for them to gain more loans in the future. Those MFIs also required the farmer to have accounts in order for them to access loans. Therefore, encouraging farmers to save will ease their access to loans so that they can expand farming and attain their desired benefits. There are several measures that have been suggested for the purpose of motivating clients to save.

iii. **Microfinance Institutions Insurance practices and Financial Performance of Small and Medium Enterprises**

The third specific objective of the study was to examine the effect of microfinance insurance practices on SMEs' profitability. The regression results indicate that microfinance insurance practices to the SMEs has a negative effect on the SME's profitability. Specifically, the fitted regression model results indicate that when the SME's business sum insured with a microfinance institution increases by one unit, SME profitability reduces by 0.015 units holding other factors constant. This implies the microfinance insurance practices increases SME profitability. Further, the respective p – value of the coefficient, the results indicate that the p – value of the respective t – statistics is 0.013 which is less than the p – value in absolute terms. Using the 5 percent significance level, we conclude that microfinance saving practices insignificantly influences SMEs' profitability.

The study findings agree with Naomi, (2013) who found that micro insurance had a negative effect on the sales growth among SMEs in Machakos County. However, the study findings disagree with Fauster (2014) who examined how MFI insurance products and services have influenced the Ghanaian SMEs' performance. The study found that the MFIs' insurance products and services increased the SMEs' average sales given the positive correlation average sales had with the insurance products and services offered. Further, similar study findings are reported by Amoah and Mungai (2020) who examined the effect of financial literacy training and micro insurance on the financial performance of Small and Medium Enterprises in the Sekondi-Takoradi Metropolis of Ghana and found that both the financial literacy training and micro-insurance had a positive and significant effect on the financial performance of SMEs.

Further, Amoah and Mungai (2020) examined the effect of financial literacy training and micro insurance on the financial performance of Small and Medium Enterprises in the Sekondi-Takoradi Metropolis of Ghana. The study aimed at determining the effect of financial literacy training on the financial performance of SMEs; establishing the effect of micro insurance on the financial performance of SMEs; determining the moderating effect of government regulations on the relationship between financial literacy training, micro-insurance and the financial performance of SMEs. The study found that both the financial literacy training and micro-insurance had a positive and significant effect on the financial performance of SMEs.

Mutuma and Omagwa (2019) examined microfinance services and financial performance of small and medium enterprises in Meru town, Kenya. The study sought to examine effect of credit facilities, savings programs and entrepreneur training programs on financial performance of SMEs. The study sample was 93 respondents. Data was collected using structured questionnaires. The study found strong positive nexus between Microfinance Services and Financial Performance of the SMEs. Specifically, micro credit facilities, micro saving savings programmes and entrepreneur training to SMEs was found to improve SME performance.

iv. **Microfinance Institutions Loan Recovery practices and Financial Performance of Small and Medium Enterprises**

Lastly, the study sought to examine the effect of microfinance loan / credit recovery practices on SMEs' profitability. The regression results indicate that microfinance loan recovery practices has a positive effect on the SME's profitability. Specifically, the fitted regression model results indicate that when the loan outstanding among increases by one unit, SME profitability increases by 0.008 holding other factors constant. However, the effect was found to be insignificant given that the p – value of the respective t – statistic is 0.965 which is greater than 5 percent

significance level. The positive effect of the loan outstanding on the SMEs profitability could imply that due to the stringent measures put in place by the microfinance in recovery of the outstanding loan balance, the SMEs tend to be financially disciplined to avoid any recourse by the microfinance in case of any default. This financial discipline emanating from the fear of recovery recourse by the SME could inform the positive effect the loan recovery practices have on SME profitability.

The study findings disagree with Sakilu (2016) who investigated default in a group lending model used by Micro-Finance Institutions (MFIs) in Tanzania. The study investigated if the default in MFIs and the recovery techniques adopted by the MFIs has any impact on client population. Findings from the study revealed that the recovery techniques adopted by the MFIs has varied impact on the borrowers with the adverse effect on the client being more evident. In addition, Mraba (2011) assessed how non-repayment of loans in commercial Banks the case of NMB Bank and 50 respondents affected the borrowers. Findings indicated that lender employed various methods to provide services to borrowers such as provision of education to borrowers in order to access the loans and the department was established for effective coordination on the same. Further, the study found that high outstanding loan are more likely to slow down the growth in borrowers.

Migwi (2013) carried out a study to investigate credit monitoring and recovery strategies adopted by commercial banks and found that all commercial banks monitor loans to ensure proper payment. This indicates that commercial banks take keen interest of loan repayment to ensure that they undergo minimal losses. However, depending on the action taken by bank, the study found that application of punitive measures to recover the loan affects the borrower's performance adversely. Further, the study found that optimal group liability in microfinance lending finds that

introducing penalties for loan default can increase the willingness and promptness of repaying loans. However, the study is focused on the microfinance sector where joint liability can be used as an effective tool for encouraging loan repayment. The idea of creating a greater sense of liability from defaulting is found as a deterrent to loan default in microfinance.

#### **4.4.2 Diagnostic Test**

In addition to fitting the empirical models, various post estimation diagnostic tests were carried out as defined in the study methodology. The results of various diagnostic tests are discussed as follows:

##### **i. Correlation Test**

Correlation analysis is mainly conducted to determine the nature and degree of associations among the model variables. It is a crucial test in informing presence or absence of multicollinearity in the regression model analysis. In this study, the Pearson correlation coefficient was applied to test for the level of correlation among the model variables. Table 4.4 presents Pearson correlation coefficient test results.

**Table 4.5: Correlational Coefficients**

	Profitability	Amount borrowed	Amount saved	Sum insured	Outstanding loan
Profitability	1.0000				
Amount borrowed	0.2101 (0.000)	1.0000			
Amount Saved	0.2905 (0.000)	0.1007 (0.1124)	1.0000		
Sum Insured	0.0782 (0.1323)	-0.0655 (0.2073)	0.1589 (0.0119)	1.0000	
Outstanding loan	0.0368 (0.4795)	0.0221 (0.6703)	-0.0697 (0.2722)	-0.0944 (0.0689)	1.0000

*Note: significance levels are in brackets*

The correlational coefficient results indicate that microfinance lending, saving, insurance and loan recovery practices all are positively correlated with SMEs' profitability. However, the correlational coefficients results indicate weak correlations since all the correlation coefficients being below the 50 percent correlation level. Its however notable that though the correlations coefficient depict weak level of associations among the variables, lending practices – profitability correlation and saving practices – profitability correlation are significant at 5 percent significance level since their respective p – value are less than 5 percent. However, insurance practices - profitability correlation and loan recovery practices – profitability correlation are insignificant at 5 percent significance level since their respective p – value are greater than 5 percent. Varied

correlation among lending, saving, insurance and loan recovery practices are depicted with variations in the significance of the correlations being evident too as indicated in Table 4.3.

**ii. Heteroscedasticity Test**

Heteroscedasticity is an econometric problem of not constant but rather keeps on changing. The presence of heteroscedasticity problem implies that the estimated model coefficients are not Best, Linear and Unbiased Estimators (BLUE). This further implies that any hypothesis testing carried out using such coefficients and their respective standard errors would be inconsistent. To test for the heteroscedasticity problem, Breusch-Pagan-Godfrey test was used. The result in Table 4.5 show that the Probability values for the respective chi square statistics for the Breusch-Godfrey LM for all the models are greater than 5 percent (Prob > chi2 = 0.6038) indicating absence of heteroscedasticity in the fitted empirical model.

**Table 4.6 Breusch-Pagan / Cook-Weisberg Test Results – Test for Heteroscedasticity**

Breusch-Pagan / Cook-Weisberg test for heteroscedasticity	
Ho: Constant variance	
Chi2(1) = 8.36	Prob > chi2 = 0.6038

**iii. Multicollinearity Test**

Multicollinearity is a regression problem that arises from interrelation between the independent variables in a model. To test for multicollinearity, the Variance Inflation Factors (VIF) was applied. From the results in Table 4.6, the mean variance inflation factor is 2.695. Using a rule of thumb of 10, we conclude that there is no multicollinearity among the variables since the mean VIF for the model are less than 10.

**Table 4.7: Multicollinearity Ttest Results**

<b>Variable</b>	<b>VIF</b>	<b>1/VIF</b>
Microfinance lending practices	3.27	0.305934
Microfinance saving practices	3.14	0.318897
Microfinance insurance practices	3.12	0.320494
Microfinance loan recovery practices	1.64	0.333686
<b>Mean</b>	<b>2.7925</b>	<b>1.279011</b>

## **CHAPTER FIVE: SUMMARY, CONCLUSION AND RECOMMENDATIONS**

### **5.1 Introduction**

The chapter presents the summary, conclusion and recommendations of the study. Specifically, the chapter presents summary of the findings after data analysis in line with the study variables, the coverage of the study and conclusions arising from the summary of the findings as well as the policy recommendations drawn from the study findings.

### **5.2 Summary**

From the study findings its evident that microfinance financial practices have a significant effect on the profitability of the SMEs in Kajiado county. In presenting the study summary of the findings, the presentation is in line with the specific objectives of the study.

#### **5.2.1 Effect of Microfinance Institutions Lending Practices on Financial Performance of Small and Medium Enterprises**

Regarding the microfinance institutions lending practices, the study found that microfinance lending practices to the SMEs has a negative effect on the SME's profitability. The regression model coefficient of the microfinance lending practices indicates that when the amount of microfinance lending increases by one unit, SME profitability reduces by 0.106 units holding other factors constant. Further the effect was found to be significant at 5 percent significance level.

The findings are largely contrary to the findings by majority of the empirical studies in this area of study. However, given the challenges that the SMEs face one of the key being financial illiteracy, the study findings would allude to the aspect of SMEs' mismanagement of the borrowed funds hence the negative effect microfinance lending on the SME's profitability. Further, the negative effect of saving on SME profitability could be explained by the fact that SME being

financially constrained any savings held with the microfinance could translates into withdrawal of funds from the business operations. This hurts the SMEs operations through financial starving hence the possibility of it adversely affecting SME's profitability.

This finding on the microfinance institutions lending practices disagree with the Madole, (2013) who investigated how SMEs in Tanzania were affected by the microfinance credit and found that SMEs benefited through increased sales and profitability. Similar findings were reported by Ahiawodzi (2012) who examined the determinants of access to credit by small and medium enterprises in Ghana and found that when SMEs are able to access financial services, it leads to better financial performance. Similarly, Nkeobuna (2012) in linking micro-credit products and performance of SMEs in Ghana found that micro-credit products had a positive and significant correlation with financial performance of SME s in both financial service and agricultural sector.

### **5.2.2 Effect of Microfinance Institutions Savings Practices on Financial Performance of Small and Medium Enterprises**

The second specific objective of the study was to examine the effect of microfinance saving practices on SMEs' profitability. The regression results indicate that microfinance savings practices to the SMEs has a negative effect on the SME's profitability. Specifically, the fitted regression model results indicate that when the amount of saving with the microfinance institution increases by one unit, SME profitability reduces by 0.421 units holding other factors constant. Further, from the p – values of the t – statistics, the results indicates that the effect of microfinance lending practices on SMEs profitability is significant at 5 percent significance level.

The negative effect of saving on SME profitability could be explained by the fact that SME being financially constrained any savings held with the microfinance could translates into

withdrawal of funds from the business operations. This hurts the SMEs operations through financial starving hence the possibility of it adversely affecting SME's profitability. Therefore, though the savings services by the microfinance institutions is crucial in enhancing saving culture among the SMEs, this comes with the repo effect on the financial performance of the SMEs. Therefore, to reverse this effect, there is need for the microfinance institutions to develop financial products linked to the micro savings such that the SMEs are capable to access credit facilities against their amounts of saving.

The study findings disagree with the Kalui and Omwansa (2015) who investigated how SMEs operating in Machakos County were affected by the financial products offered by the Microfinance Institutions operating in the County. The study findings were that micro savings offered by Microfinance Institutions positively effects on the financial performance of SMEs by cushioning the business against possible losses arising from business risks. Further, Mutuma and Omagwa (2019) investigated SMEs in Meru County in Kenya and found that the MFIs saving products have positive and significant effect on SMEs financial performance. Further, the study found that SMEs were more inclined into the MFI's savings plan. In addition, the study findings disagree with Kisaka and Mwewa (2014) who did an evaluation on the impacts of micro-credit, micro-savings and training on growth of SMEs in Machakos County in Kenya and found that growth of SMEs is positively influenced by micro- savings.

### **5.2.3 Effect of Microfinance Institutions Insurance Practices on Financial Performance of Small and Medium Enterprises**

The third specific objective of the study was to examine the effect of microfinance insurance practices on SMEs' profitability. The regression results indicate that microfinance

insurance practices to the SMEs has a negative effect on the SME's profitability. Specifically, the fitted regression model results indicate that when the SME's business sum insured with a microfinance institution increases by one unit, SME profitability reduces by 0.015 units holding other factors constant. The respective p – value of the coefficient, the results indicate that the p – value of the respective t – statistics is 0.013 which is less than the p - value. Using the 5 percent significance level, the study concluded that microfinance saving practices insignificantly influences SMEs' profitability holding other factors constant at 5 percent significance level.

The study findings the study findings agree with Naomi, (2013) who found that micro insurance had a negative effect on the sales growth among SMEs in Machakos County. However, the study findings disagrees with Fauster (2014) who examined how MFI insurance products and services have influenced the Ghanaian SMEs' performance. The study found that the MFIs' insurance products and services increased the SMEs' average sales given the positive correlation average sales had with the insurance products and services offered. Further, similar study findings are reported by Amoah and Mungai (2020) who examined the effect of financial literacy training and micro insurance on the financial performance of Small and Medium Enterprises in the Sekondi-Takoradi Metropolis of Ghana and found that both the financial literacy training and micro-insurance had a positive and significant effect on the financial performance of SMEs.

#### **5.2.4 Effect of Microfinance Institutions Loan Repayment Practices on Financial Performance of Small and Medium Enterprises**

Lastly, the study sought to examine the effect of microfinance loan / credit recovery practices on SMEs' profitability. The regression results indicate that microfinance loan recovery practices has a positive effect on the SME's profitability. Specifically, the fitted regression model results indicate that when the loan outstanding among increases by one unit, SME profitability reduces by 0.008 holding other factors constant. the positive effect of the loan outstanding on the SMEs profitability could imply that due to the stringent measures put in place by the microfinance in recovery of the outstanding loan balance, the SMEs tend to be financially discipline to avoid any recourse by the microfinance in case of any default. This financial discipline emanating from the fear of recovery recourse by the SME could inform the positive effect the loan recovery practices have on SME profitability. However, the effect was found to be insignificant given that the p – value of the respective t – statistic is 0.965 which is greater than 5 percent significance level.

The study findings disagree with Sakilu (2016) who investigated default in a group Lending Model used by Micro-Finance Institutions (MFIs) in Tanzania. The study investigated if the default in MFIs and the recovery techniques adopted by the MFIs has any impact on client population. Findings from the study revealed that the recovery techniques adopted by the MFIs has varied impact on the borrowers with the adverse effect on the client being more evident. In addition, Mraba (2011) assessed how non-repayment of loans in commercial Banks the case of NMB Bank and 50 respondents affected the borrowers. Findings indicated that lender employed various methods to provide services to borrowers such as provision of education to borrowers in order to access the loans and the department was established for effective coordination on the

same. Further, the study found that high outstanding loan are more likely to slow down the growth in borrowers.

### **5.3 Conclusions**

Based on the study findings it can be concluded that microfinance financial practices significantly affect the profitability among the SMEs in Kajiado County. More evidently the microfinance credit products, insurance and savings products which were found to have negative effects on SMEs profitability. This is contrary to the expectations of the logic. However, given the challenges that the SMEs face one of the key being financial illiteracy, the study findings would allude to the aspect of SMEs' mismanagement of the borrowed funds hence the negative effect microfinance lending on the SME's profitability.

Further, the negative effect of saving on SME profitability could be explained by the fact that SME being financially constrained any savings held with the microfinance could translates into withdrawal of funds from the business operations. This hurts the SMEs operations through financial starving hence the possibility of it adversely affecting SME's profitability. Similar explanation could be offered with regard to micro insurance services.

Lastly, the positive effect of the loan outstanding on the SMEs profitability could imply that due to the stringent measures put in place by the microfinance in recovery of the outstanding loan balance, the SMEs tend to be financially discipline to avoid any recourse by the microfinance in case of any default. This financial discipline emanating from the fear of recovery recourse by the SME could inform the positive effect the loan recovery practices have on SME profitability.

## **5.4 Recommendations**

Based on study findings, the study postulates several recommendations. First is the need for the microfinance institutions and the microfinance institutions association to devise measure aimed at expanding the provision of microfinance institutions practices to majority of the SMEs who have been largely financially excluded. These include sensitization campaigns targeting SMEs, development of SMEs' specific financial products and services that incentivize SMEs' uptake. Such products could comprise of micro credit products with lesser requirements for qualification, micro saving products and micro – insurance products. Training the SMEs on how to effectively manage the borrowed funds is key in reversing the negative effect microcredit was found to have on the SME profitability.

Secondly regarding the micro saving practices, there is the need for sensitization on how the SMEs can efficiently utilize savings held with the microfinance institutions to boost their profitability. Further, creation of financial products such as lending that can be secured against the SME's savings with microfinance could go a long way in unlocking the potential of micro savings on part of the SMEs. In this case, the microfinance institutions could develop financial facilities that a SME can take against the amount of savings as the collateral. This would be key in offering cheap financing to SMEs that have savings with the microfinance institutions.

Thirdly, with regard to the effect of micro insurance practices, there is the need for the microfinance institutions to develop financial products which the SMEs could use to unlock the potential of sum insured with the microfinance institutions. For instance, developing insurance policy scheme that allow the SME to redeem the sum insured during the times of financial distress could go a long way in promoting access for financial resources by the SMEs. Further, developing

micro insurance products that allow the SMEs to access the sum insured after a certain period of time could go a long way in promoting access for financial resources by the SMEs. However, it's notable that given the short life of majority of the SMEs, such products should have long time lines within which the SME can access the sum insured.

Lastly, the positive effect on loan recovery practices call for the need to develop borrower friendly measures of loan recovery. Such measures could entail offering of friendly repayment terms that are cognizant of changes in the business environment such as economic hardships, extending repayment grace periods to SMEs facing business challenges, consideration for debt restructuring to either extend the repayment tenure among other measures that could be borrower friendly.

### **5.5 Recommendations for Future Research**

The study recommends future studies to conduct similar analysis across different counties in Kenya. This study focused on Kajiado County only. Therefore, it would be a worth adventure for the future studies to undertake similar research undertaking across all counties especially the counties with very low distribution and coverage of microfinance institutions. Such studies would offer good comparison grounds of performance among SMEs operating in counties with high coverage of microfinance institutions compare to counties with low microfinance institutions coverage. This would inform policy pronouncement of the need for microfinance institutions coverage expansion among the counties with low coverage.

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## APPENDICES

### Appendix 1: Questionnaire

My name is David Mathai, a student at KCA university graduate school. This questionnaire is aimed at enabling me to collect data for undertaking my research project entitled "Effect of microfinance practices on performance of small and medium enterprises in Kajiado County, Kenya".

I therefore kindly wish to take a few minutes of your time to go through the following questions.

#### Section one: Details of the respondent

Name of respondent (optional)	.....
Gender	Male [ ]                      Female [ ]
Current location of the business	.....
Number of employees in the business entity	.....
Which sector is your business registered and operating under (Tick one that applies)	Trade                      [ ] Transport                      [ ] Manufacturing                      [ ] Financial services                      [ ] Agriculture                      [ ]

**Section two: Microfinance lending services to SMEs**

What has been your sources of financing for your business in the last 24 months?	a) Microfinance [ ] b) Banks [ ] c) Savings [ ] d) Profit plough back [ ]
If you have borrowed from a microfinance institution, how much amount of credit did you seek for?	Ksh.....
How long (in days) did it take for the credit to be advanced to you?	..... days
What was the repayment period for the credit advanced to you by the microfinance institution?	.....
What is the interest rate (in percentage) were you charged for the credit by the microfinance institution?	.....
What was the <b>main</b> reason for your borrowing (tick <b>one</b> that applies)	Business expansion [ ] Financing working capital [ ] Other, specify .....

**Section three: Microfinance savings services to SMEs**

In the last 24 months, which has been your main institutions for savings	a) Microfinance [ ] b) Banks [ ] c) Saccos [ ]
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If you are saving with a microfinance institution, on average how much amount do you save in a year?	Ksh.....
How long (in days) did it take to open savings account with the microfinance	..... days
What was the repayment period for the credit advanced to you by the microfinance institution?	.....
What is the return (interest rate) you earn from the savings you have with the microfinance institution?	.....

**Section four: Microfinance insurance services to SMEs**

In the last 24 months, which has been your main institutions for offering insurance services	a) Microfinance [ ]
	b) Banks [ ]
	c) Insurance companies [ ]
How much amount of in terms of insurance premiums did you seek for?	Ksh.....
What is the sum insured for the business insurance cover you have with the microfinance institution?	Ksh.....
How long (in days) did it take for the insurance services to be advanced to you?	..... days

**Section five: Microfinance loan recovery practices to SMEs**

<p>What has been your sources of financing for your business in the last 24 months?</p>	<p>a) Microfinance [ ]</p> <p>b) Banks [ ]</p> <p>c) Savings [ ]</p> <p>d) Profit plough back [ ]</p>
<p>If your financing is from microfinance institution, what is your monthly loan repayment</p>	<p>Ksh.....</p>
<p>If the financing is from microfinance institution what is your outstanding loan amount?</p>	<p>Ksh.....</p>
<p>According to the credit terms by the Microfinance in case the loan fall due or you default, what is the penalty for the default? (penalty in interest rate)</p>	<p>..... (%)</p>
<p>According to the credit terms by the Microfinance in case the loan fall due or you default, what is the grace period granted to you for payments due to be done? (grace period in days)</p>	<p>..... days</p>

**Section six: SME profitability**

What was the average profit for your business in the last 24 months?	Ksh .....
What was the average total sales (sales turnover) for your business in the last 24 months?	Ksh .....
What was the average total expenses (operating) for your business in the last 24 months?	Ksh .....

**END**