

**EFFECT OF ISLAMIC FINANCING ON FINANCIAL PERFORMANCE OF
BUSINESSES IN EASTLEIGH BUSINESS COMMUNITY, NAIROBI COUNTY**

By

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MASTER OF SCIENCE IN COMMERCE

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**A DISSERTATION SUBMITTED IN PARTIAL FULFILLMENT OF THE
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MAY 2016

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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EFFECT OF ISLAMIC FINANCING ON FINANCIAL PERFORMANCE OF BUSINESSES IN EASTLEIGH BUSINESS COMMUNITY, NAIROBI COUNTY

ABSTRACT

This study examines the effect of Islamic finance on the Eastleigh Business Community, Nairobi, Kenya, by analyzing the financial performance of the businesses that accesses the Islamic Financing overall period of 3years (2011-2013). The study particularly examines the effect of short term financing, long term financing and equity financing on the financial performance of Muslim owned businesses. The study employs the use of information on the type of financing accessed and more specifically return on Asset to measure the performance of the sampled firms that had access to Islamic financing. The 155 firms in textile industry was undertaken for this study however, the businesses also needed to have been in operation for at least 3 years as at December 2013. Out of the 155 firms the study was able to find 95 firms out of which only 55 firms had been in existence for over three years as at December 2013. Therefore our target population was these 55 firms. Primary data was collected using questionnaires. Stratified Sampling was used to come up with 43 firms that fully responded to questionnaires and formed the study. Descriptive statistics, regression and correlation analysis was used to analyze the variables. The relationship between short term financing and firm's performance was positive and more specifically, cost plus sales was the most significant of all the types of short term. Long term and Equity financing was insignificant to the study. The findings are important to policy or law makers and Authorities such as capital markets authorities to construct and enact policies that would foster business growth without disregarding the Islamic Religion. The study may also be used for further research on related topic. The study recommended review and development of legal framework to fully incorporate Islamic financing to mainstream finance options in Kenya, need for promotion and awareness of the services and also recommended further research on Manufacturing and Construction industries to understand effect on long term financing.

Keywords: Islamic Banking, Financial Performance, Eastleigh Business Community

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LIST OF ABBREVIATIONS AND ACRONYMS

GFC:	Global Financial Crisis
GCC:	Gulf Cooperation Council
GDP:	Gross Domestic Product
ROCE:	Return on capital employed
WACC:	Weighted average cost of capital
AOFFI:	Auditing Organization for Islamic Financial Institutions
INCEIF:	The International Centre for Education in Islamic Finance
ISRA:	The International Shariah Research Academy for Islamic Finance
IILM:	The International Islamic Liquidity Management
HSBC:	Hongkong and Shanghai Banking Corporation
SMEs:	Small and Micro Enterprises

OPERATIONAL DEFINITION OF TERMS

Mudaraba: This is an Investment partnership. As a financing technique adopted by Islamic banks, it is a contract in which all the capital is provided by the Islamic bank while the business is managed by the other party. The profit is shared in pre-agreed ratios, and loss, if any, is borne by the investor, Zaher and Hassan (2001).

Mudariba: It is a type of contract where a person or party who acts as entrepreneur.

Murabaha: it is a type credit enabling clients to buy without having to take out an interest bearing loan. The bank purchases an item and then sells it on to the customer on a deferred basis, Zaher and Hassan (2001).

Musharaka: An investment partnership where profit sharing terms are agreed in advance, and losses are pegged to the amount invested – basically Private Equity.

Rab-al-maal: In a mudaraba contract the person who invests the capital, Zaher and Hassan (2001).

Riba: One of the three main prohibitions in Islamic finance (the others being Maysir and Gharar). This term literally means an increase or addition. Technically it denotes any increase or advantage obtained by the debt issuer as a term of the debt. Any predetermined cost on a loan or investment is riba. This is prohibited in Islam, Zaher and Hassan (2001).

Shariah: Islamic law as revealed in the Quran and through the example of Prophet Muhammad, Peace Be upon Him. A Shariah compliant product meets the requirements of Islamic law, Zaher and Hassan (2001).

CHAPTER ONE

INTRODUCTION

1.1 Background to the Study

In the current world, money is the life blood of any business as it drives the operations of the firm. It is a basic necessity in the formation and growth of institutions and therefore should be available on time and in appropriate time for the execution of any business transaction (Edesses& Michael, 2013). Financing decision involves the determination of sources of finance, whether internal or external (Asutay, 2011). A business entity should make decisions that are aligned towards the core goal of maximizing profits and wealth of shareholders (Zamir, Abbas, Hossein, & Noured, 2012). This will call for the sourcing of cheap, efficient, flexible and reliable sources of funds. Different forms of institutions offer different forms of financing customized towards the customers' needs (Archer and Abdel, 2002). The most popular institutions that offer financing are banks which offer different types of financial products ranging from savings accounts, current accounts and loan products.

According to the Sharia Law, a body of Islamic law, payment of interest on money as well as investing in enterprises that sell merchandises or services which is not according to the Sharia law (Haraam) is prohibited (Matemilola&Bany-Ariffin,2011). The concept of Islamic financing is therefore the prohibition of "Riba", interest on borrowed money. Sharia-compliant financing deals resemble lease-to-own arrangements, layaway plans, joint purchase and sale agreements, or partnerships. There is clear evidence of the growth in Arabic developing world in the industrial sector due to increased flow of investment towards these countries. This has been due to the development of the banking sector that is Sharia compliant (Čihák&Hesse, 2008).

The Eastleigh Town (a town in Nairobi Kenya) transformation into a business hub can be traced to the early 1990s when the first wave of Somali refugees, fleeing civil war, began arriving in noticeable numbers. The immigrants from Somalia started trading from their

rooms in Garissa Lodge, a boarding house that has become a shopping Centre. Over time, business premises were established and trading transactions increased. It is estimated that Eastleigh accounts for a third of all businesses in Nairobi city. Statistics from the Eastleigh Business Community, which has 20,000 registered members, show registered businesses paid approximately KShs. 780 million in taxes in 2011. This signifies the importance of the town in the Kenyan economy (Vanacker&Manigart, 2010).

Islamic banks, though young in the Kenyan industry have played a vital role in the Eastleigh and general economy by accepting deposits in form savings and investment from individuals and the advancing of financing to the businesses that contribute to all sectors of national economy. Due to its distinct strategic location in East Africa, the size of Muslim population and the interest of the Muslim world in investments in Kenya, the country have potential to grow its investment in the various sectors, especially the industrial sector.

1.1.1 Islamic Banking

Islamic finance dates back to the Islamic Golden Age, between 8th-12th centuries when early market economies and forms of mercantilism popularly referred to as “Islamic Capitalism” were developed (Edesses & Michael, 2013).Due to the expanding levels of circulation of a stable high-value currency (the dinar) and the integration of the previously independent monetary areas, the monetary economy experienced a vigorous impact (Asutay, 2011).

This led to development of innovative financial products such as bill of exchange, cheques, promissory notes, transactional accounts, loaning, ledgers, trusts, startup companies, partnerships (mufawada) such as limited partnerships (mudaraba), forms of capital (al-mal) and capital accumulation methods (nama al-mal)Zamir, et al (2012).

1.1.2 Islamic Banking in Kenya

Islamic finance in Kenya was introduced in 2008 when the first two Islamic Banks, First Community Bank (FCB) and Gulf African Bank (GAB), started their operations. Since the introduction of the Islamic banking service, Islamic finance has grown steadily into

investments, pensions and insurance which are in line with the Islamic law that forbids dealing in interest or usury. The two banks are currently handling millions of dollars net worth clearly indicating the growing strength of the Kenyan Islamic business community. In 2013, the International Finance Corporation invested US \$5Million into Gulf African Bank (GAB) to strengthen its capacity to support small and micro sized businesses (SMEs). It was a demonstration of the faith in the Islamic ideas of economics in Kenya (Abor&Biekpe, 2006).

Due to the growth of the two Islamic banks in deposits from the Islamic community, the commercial banks have also launched Islamic banking segments to offer Sharia compliant products. These banks include Chase Bank, Kenya Commercial Bank, Prudential Bank among others. By March 2014, 10 out of the 42 commercial banks in Kenya had created segments that cater for the Muslim community segment. This was informed by the revelation of the fact that out of the population of 42 million in Kenya, approximately 10 million are Muslims. (KNBS, 2010)

1.1.3 Concept of Business Performance

Due to the need of Islamic Finance, Central Bank of Kenya, the state Banking regulator authorized the establishment of sharia compliant banks. In 2008, two Islamic Banks were established i.e. First community Bank and Gulf African Bank. Later, the regulator allowed for the development of sharia compliant financial products. Since the introduction of Sharia Compliant Banks, the regulator also launched international certificate training in the field of Islamic finance, to produce the human resources needed to support the fast-growing sector. Its training arm, the Kenya School of Monetary Studies, offers training on Islamic Finance in partnership with the International Center for Education in Islamic Finance (INCEIF).

1.2 The Problem Statement

Irrespective of the macroeconomic, microeconomic or company specific background, financing decisions are the drivers of the performance of any business entity. Financing is the

engine of any business irrespective of its nature and therefore should be a top priority to any firm's management (Nagaoka, 2007; Martin & Huang, 2009; Levine, 2004). A lot of debate on the subject of Islamic finance which is highly inclined on the Islamic religion has therefore been a contemporary issue in the field of finance. To date, the research on Islamic finance is fragmented and ad hoc (Aklin, 2009). Since the introduction of Islamic banking, there are very few Islamic SMEs that have accessed and benefited from the financing products in Kenya (Ahmed, 2012). In their research, Hassan and Guyatu (2014) noted that in Kenya, Islamic SMEs mainly operating in Eastleigh estate have grown by approximately 300% for the period between years 2007 to year 2013. However, access to banking services and financing are not proportional to the level of growth.

According to the Sharia Law, a body of Islamic law, payment of interest on money as well as investing in enterprises which sell goods or services that are conflicting with its principles (Haraam) is prohibited (Matemilola & Bany-Arifin, 2011). The concept of Islamic financing is therefore the prohibition of "Riba", interest on borrowed money. Sharia-compliant financing deals resemble lease-to-own arrangements, layaway plans, joint purchase and sale agreements, or partnerships. The financial management decisions on financing, investing, working capital management, fund management services and surplus management of Muslim owned businesses are limited owing to their religious background (Abdulrahim, 2008). The deterred growth in the Islamic financing in Kenya are related to the lack of information on emerging issues in Islamic financing that are in line with the Sharia laws (Ahmed 2012).

According to Ahmed & Abdul (2012) in their study, Factors affecting the growth of Islamic banking, observed that most businesses never accessed banking services and financing from the Islamic banks in Kenya due to illiteracy and lack of information on the contemporary Islamic financing issues.

Nasir (2012) in his study observed that the Islamic SMEs in Kenya had realized considerable growth in the last decade as a result of support of Islamic Financing from the religious leadership. However, most Islamic businesses have very limited options on banking services, investment services, insurance services and other financial services (Kroszner, & Strahan, 1999).

A study by The Islamic Research and Training Institute (IRTI) on Islamic economies in the year 2008 observed that Muslim economists have generally held that commercial banking in an Islamic state should be organized on the basis of some form of profit sharing, represented by Mudarabah and Musharakah. However, Islamic financing as it has developed and is developing is not solely based on Mudarabah and Musharakah. It also uses a number of other contracts permissible by Islam in order to conduct its banking business. The elaboration and explanation of these techniques is the subject of this study.

The above research studies have however not addressed the effect of Islamic financing on the financial performance of businesses in the Nairobi Eastleigh community which is the hub of Islamic businesses in the country. By studying the effect of the businesses that have benefited from Islamic finance in the Eastleigh business community, this study will seek to address the subject and suggest probable solutions that will open up the economy.

1.3 Objectives of the Study

The overall objective of the study was to examine the effect of Islamic finance on the financial performance of businesses in the Eastleigh business community.

1.3.1. Specific Objectives

The specific objectives of the research were:-

- i) To establish the effect of Islamic short term debt financing on financial performance of Muslim owned businesses.
- ii) To establish the effect of Islamic long term debt financing on financial performance of Muslim owned businesses.

- iii) To establish the effect of Islamic equity financing on financial performance of Muslim owned businesses.

1.3.2. Research Questions

The research questions are:

- i) What was the effect of Islamic short term debt financing on financial performance of Muslim owned businesses?
- ii) What was the effect of Islamic long term debt financing on financial performance of Muslim owned businesses?
- iii) What was the effect of Islamic equity financing on financial performance of Muslim owned businesses?

1.4 Importance of the Study

The research study will anchor on Islamic finance and therefore will be significant to owners, managers, investors, financiers, policy makers and management in the Muslim business community as it will elucidate how Islamic financing affect the entrepreneurial orientation and business growth. The results and endorsements will therefore help them realign their business growth strategies to Islamic financing.

It will be important to policy or law makers and Authorities such as County Government to create and enact policies that would enable business growth without ignoring the Islamic Religion. This owes to the fact that should Islamic business friendly policies be enforced, more Muslim-owned businesses would experience exponential growth, Muslim investors would be attracted to Kenya or more citizens invest in the country thus lead to better macro-economic performance.

The study will also be used for future references by researchers and students on related topic. It will equally be an empirical source for researches conducted in the future.

1.5 Scope of the Study

The study included only Muslim-owned businesses in Eastleigh Town of Nairobi city and has been in business for the period of 2011-2013. It will also focus on Limited liability companies registered under the Company's Act and submit their annual returns to Kenya Revenue Authority.

CHAPTER TWO

LITERATURE REVIEW

2.1 Introduction

This chapter reviews literature related to the effects of Islamic finance on the performance of businesses. It reviews various research books, journals, published and unpublished works in order to come with a clear picture of effects of Islamic Financing on Performance of businesses in Eastleigh.

2.2 Theoretical Review

Theoretical review tries to compare how different theories address the issue of Islamic financing on financial performance of Businesses. The study used Pecking Order Theory and Trade-off Theory as explained below.

2.2.1 PeckingOrderTheory

Pecking order theory was proposed by Donaldson in 1961 and revised by Myers and Majluf in 1984. It proposes that the cost of financing increases with asymmetric information. It postulates that organizations prioritize their sources of funding according to the cost of financing, with equity form of financing as the last option. Therefore, internal funds are first utilized, and when that is exhausted, debt is issued, and when it is not sensible to issue any more debt, equity is issued.

It states that enterprises conform to a hierarchy of financing sources and favor internal financing when available, and leverage is chosen over equity if external financing is required. Therefore, the form of debt a firm selected can be as signal of its want for external finance.

The pecking order theory is promoted by Myers and Majluf (1984) when they postulate that equity is a less preferred means to raise capital since when the firm issue new equity, investors tend to think that executives think that the firm is overvalued and managers are taking advantage of this over-valuation. Consequently, potential investors will value the new equity lower. Pecking order theory starts with asymmetric information as managers

know more about their companies' prospects, risks and value than outside investors. Asymmetric information affects the choice between internal and external financing and between the issue of debt or equity. There therefore exists a pecking order for the financing of new projects.

Asymmetric information favors the issue of debt over equity as the issue of debt indicates that an investment is viable and that the current share price is below the expected price (were stock price over-valued, the issue of equity would be favored). The issue of shares would indicate no confidence in the management and that they feel the share price is over-valued (Matemilola&Bany-Ariffin, 2011). An issue of equity would therefore lead to a drop in share price. This does not however apply to high-tech industries where the issue of equity is preferable due to the high cost of debt issue as assets are intangible (Brealey, Myers & Allen 2008).

The theory postulates that there is an indirect relationship between debt and profitability. Firms would therefore prefer internal financing to external financing. They adopt a defined dividend policy while trying to source for financing. Fixed dividend policies and unpredictable variations in returns and investment opportunities, implying that internally generated funds are sometimes more than capital expenditures and lower at other times. If higher, the firm clears its debt or participates in marketable assets (Matemilola, Bany-Ariffin, 2011). If lower, the company first drafts its financial or sells its marketable securities, rather than reduce dividends. If external financing is required, firms issue the safest security first. That is, they start with debt, then possibly hybrid securities such as convertible bonds, then perhaps equity as a last resort. In addition, issue costs are least for internal funds, low for debt and highest for equity. There is also the negative signaling to the stock market associated with issuing equity, positive signaling associated with debt (Brealey, Myers & Allen 2008).

Successful companies do not need to depend so much on external finance. Empirical evidence from previous studies (Al-Sakran, 2001; Kayo and Kimura, 2010) appears to

be consistent with the pecking order theory. Most studies found a negative relationship between financial performance more specifically profitability and debt financing (Myers and Majluf, 1984; Daskalakis and Psillaki, 2008, Vasiliou et al., 2009). The return on equity is used as an index for firm profitability in this study.

2.2.2 Trade-off Theory

The trade-off theory of capital structure refers to the idea that a company chooses how much debt finance and how much equity finance to use by balancing the costs and benefits (Kraus & Litzenger, 1973). An important purpose of the theory is to explain the fact that corporations usually are financed partly with debt and partly with equity. It states that there is an advantage to financing with debt, the tax benefits of debt and there is a cost of financing with debt, the costs of financial distress including bankruptcy costs of debt and non-bankruptcy costs (e.g. staff leaving, suppliers demanding disadvantageous payment terms, bondholder/stockholder infighting, etc.). The marginal benefit of further increases in debt declines as debt increases, while the marginal cost increases, so that a firm that is optimizing its overall value will focus on this trade-off when choosing how much debt and equity to use for financing (Frank and Goyal, 2005).

Taxes are large and they are sure, while bankruptcy is rare and, according to Miller, it has low dead-weight costs. Accordingly he suggested that if the trade-off theory were true, then firms ought to have much higher debt levels than we observe in reality. Fama and French (2002) criticized both the trade-off theory and the pecking order theory in different ways. Welch has argued that firms do not undo the impact of stock price shocks as they should under the basic trade-off theory and so the mechanical change in asset prices that makes up for most of the variation in capital structure.

Despite such criticisms, the trade-off theory remains the dominant theory of corporate capital structure as taught in the main corporate finance textbooks. Dynamic version of the

model generally seem to offer enough flexibility in matching the data so, contrary to Miller's verbal argument, dynamic trade-off models are very hard to reject empirically.

The analysis of wide known trade off theory has been made within modern theory of capital structure and capital cost by Brusov-Filatova-Orekhova. It is shown that suggestion of risky debt financing (and growing credit rate near the bankruptcy) in opposite to waiting result does not lead to growing of weighted average cost of capital, WACC, which still decreases with leverage. This means the absence of minimum in the dependence of WACC on leverage as well as the absence of maximum in the dependence of company capitalization on leverage. Thus, it seems that the optimal capital structure is absent in famous trade off theory (Fama&French, 2002)

2.3 Empirical Review

The concept of Islamic financing is therefore the prohibition of “Riba”, interest on borrowed money. Sharia-compliant financing deals resemble lease-to-own arrangements, layaway plans, joint purchase and sale agreements, or partnerships. The preceding section reviews literature on in regard to the study topic that is the effect of Islamic financing on financial performance of businesses.

Islamic finance starting its impressive expansion in the 1970s has grown into a major participant of the global economic and financial system at the end of the first decade of the new millennium. The initial spark was limited to Middle -East, in particular to the Gulf Cooperation Council (GCC) area in 1970s with the opening of Islamic Development Bank in 1975 as the main multinational organization of this new economic and financial concept; followed by the start of business for Dubai Islamic Bank (1975), Faisal Islamic Banks of Egypt and Sudan (1977), Kuwait Finance House (1977), Jordan Islamic Bank for Finance and Investment (1978). Bahrain and Qatar Islamic Banks followed the cause and established themselves as major institutions in domestic retail banking (Wilson, 1990).

This initial phase of the development of Islamic finance can be characterized as an imitation of basic conventional finance. At this stage the main effort was to provide trade and working capital finance to Muslim investors with religious obligations and sensitivities by replicating Shari'ah compliant versions of basic conventional banking instruments (Asutay, 2011). As a reflection of this very basic mentality and the lack of proper finance theory support, Islamic finance was under-estimated by Western investors, who see Islamic finance as a folly of a system, only focused on 0% interest rate on investment, in modern finance. This initial "birth" stage of the 1970s by establishing commercial Islamic banks in the Middle-East was followed by a rapid emergence of Islamic finance through the last two decades of the last millennium particularly in South-East Asia, and mainly through opening of numerous commercial Islamic banks, Islamic investment companies and Islamic Insurance institutions (Asutay, 2011). During this phase Islamic finance has moved from being the simple imitator of conventional finance and grown into a developer and structurer role itself.

At this time, Islamic finance institutions and Muslim investors have gained access to project finance, leasing and insurance products and capital markets by structuring Sharia'ah compliant products and services, both in banking and insurance. This phase also has witnessed the first non-Muslim investor interest, through the means of ethical investment philosophy and acceptance of being theoretically viable as a part of modern economic system.

Today Islamic finance has been accepted as an integral part of global economic system and financial markets. The number of Islamic finance institutions has risen from one institution in one country to over 5 00 in more than 75 countries in less than 40 years (El Qorchi, 2005 and Asutay, 2011). Total assets under the control of Islamic finance institutions are now estimated to be \$950 billion globally (Asutay, 2011) with annual growth rates ranging from 15 to 55 %. It is estimated that within a decade, Islamic finance will reach to a size that can be able to capture half of the total savings of 1.6 billion Muslim communities.

More importantly, as can be seen in Table 1, this growth has been substantial through the world, even in the geographies where the Muslim population is the minority (Reinhart&Rogoff , 2008).

This strong growth on four bases: First, is the strong demand from a large number of immigrant and minority Muslims for Shari'ah-compliant financial services and transactions. Second, is the growing windfall profit from natural resources demanding suitable investments out of the GCC region; and third, is the improved competitiveness of Islamic banking and finance products (El Qorchi, 2005) and finally, fourth, is the increasing concern over the issues such as, corporate governance, corporate social responsibility and ethicality and morality of investment strategies.

2.3.1 Short Term Financing and Business Performance

Islamic markets offer different instruments to satisfy providers and users of funds in a variety of ways: sales, trade financing, and investment. Basic short term financing instruments include cost-plus financing (murabaha), profit-sharing (mudaraba) and forward sale (bay' Salam). These instruments serve as the basic building blocks for developing a wide array of more complex financial instruments, suggesting that there is great potential for financial innovation and expansion in Islamic financial markets.

Cost-plus sale instrument is the most popular instruments in Islamic financial markets. It is based on the traditional notion of purchase finance. The investor undertakes to supply specific goods or commodities, incorporating a mutually agreed contract for resale to the client and a mutually negotiated margin. Around 75 percent of Islamic financial transactions are cost-plus sales.

The Profit-sharing agreement (mudaraba), another short term Islamic financial instrument is identical to an investment fund in which managers handle a pool of funds. The agent-manager has relatively limited liability while having sufficient incentives to perform. The capital is invested in broadly defined activities, and the terms of profit and risk sharing

are customized for each investment. The maturity structure ranges from short to medium term and is more suitable for trade activities.

Under the sale contracts, Deferred payment sale (bay' mu'ajjal) and deferred-delivery sale (bay' salam) contracts, in addition to spot sales, are used for conducting credit sales. In a deferred payment sale, delivery of the product is taken on the spot but delivery of the payment is delayed for an agreed period. Payment can be made in a lump sum or in installments, provided there is no extra charge for the delay. A deferred-delivery sale is similar to a forward contract where delivery of the product is in the future in exchange for payment on the spot market.

2.3.2 Long Term Financing and Business Performance

The main Islamic long term financing include the Equity participation also known as partnership (musharaka) and leasing (Ijara). Equity participation (musharaka) is analogous to a classical joint venture. Both entrepreneur and investor contribute to the capital (assets, technical and managerial expertise, working capital, etc.) of the operation in varying degrees and agree to share the returns (as well as the risks) in proportions agreed to in advance. Traditionally, this form of transaction has been used for financing fixed assets and working capital of medium- and long-term duration.

Leasing (ijara) is another popular instrument, accounting for about 10 per cent of Islamic financial transactions. Leasing is designed for financing vehicles, machinery, equipment, and air craft. Different forms of leasing are permissible, including leases where a portion of the installment payment goes toward the final purchase (with the transfer of ownership to the lessee).

2.3.3 Equity Financing and Business Performance

According to (Sadique, 2007) Islamic Equity Financing is where funds are provided as capital which is subjected to profit or loss, the liability remains with the provider to the extent of the capital, and no increase or creation of debt. This method of Equity Financing as it is based on

contributing equity includes Islamic modes of financing such as *mushārah* and *mudāraba*. *Mudaraba* is a Trustee partnership is a type of financing through which financing institutions provides capital finance for a specific venture requested by the customer. The Financing institution in this case is referred to as *rabb-al-mal* is the owner of the capital and the customer to the institution or the entrepreneur who requested financing is referred to as *mudarib* who is tasked with management of the business and provides professional and technical expertise for initiating and operating the business. Profit is shared according to a pre-agreed ratio. Losses if any, are entirely absorbed by the financing institution. (Mohammed, 2005).

Mudaraba is divided into restricted and unrestricted. Restricted mudaraba (*mudaraba al-muqayyada*), the financier may specify a particular business in which investments may be undertaken while unrestricted one (*mudaraba al-mutlaqa*) is case the *mudarib* may invest the capital provided in any business he deems fit.

2.4 Islamic Financing and Business Performance

From a relatively niche market at the end of the 20th century, Islamic finance has grown exponentially in the 21st century by a compound annual growth rate (CAGR) of 40.3 per cent between 2004 and 2012 to reach US\$1.3 trillion, or just under 1 per cent of the global financial system. There are more than 600 Islamic financial institutions spread across 75 countries. Only 12 per cent of the 1.6 billion Muslims worldwide (one-fifth of the global population) currently use Islamic finance.

Nevertheless, the global Islamic financial services industry has grown in size and geographic coverage, encompassing new jurisdictions and more institutions. The Islamic capital market, namely, the *Sukūk* or Islamic bond or funds and indices, continued to outpace most other global asset classes, growing by a CAGR of 44.0 per cent between 2004 and 2011. Additionally, Islamic equity indices have outperformed their conventional equivalents in the post-crisis period. *Takāful* (Islamic insurance) remains a nascent industry, but is expected to

expand with growing market demand in Islamic countries, which comprise nearly one quarter of the world's population and US\$5.8 trillion, or 8.4 per cent of world GDP (Aziz, 2009).

Latest estimates from TheCityUK suggest that the global market for Islamic financial services, as measured by Shariah-compliant assets, has increased by one fifth to US\$1.46 trillion in 2012. The City UK also projects that Islamic financial assets could reach US\$2 trillion by 2014. The largest centers remain concentrated in Malaysia and the Middle East, including Iran, Saudi Arabia, the United Arab Emirates and Kuwait.

This continuous growth has had two main influences in the global financial system. First; the development of Islamic finance has added new and novel veins supporting the global financial markets, increasing the potential pool supporting the system, and therefore providing extra liquidity which can be the most important commodity in times of crisis (Kashyap, Rajan& Stein, 2002).

The second influence of Islamic finance on the global financial system comes from the financing side. Investors and entrepreneurs with solid business ideas and innovations, but also with the moral and ethical concerns have gained an opportunity to provide and maintain a financing resource for their businesses. As a result, Islamic finance has created much greater access to financial resources for small and micro enterprises (SMEs), entrepreneurs, firms and households, who were previously sidelined in the financial system because of their religious, moral and ethical concerns(Hasan &Dridi, 2010). Consequently, one can assume that Islamic finance has not only made the financial markets safer, but also supported growth in real economy by providing stable and ethical financing resources.

Studies show that the correlation to the real economy also diminishes once the industry matures as well. In most of the countries, the growth levels of Islamic bank assets far exceed the growth of the real economy immediately before an economic crisis. Almost all sample countries seem to have suffered from a speculative growth, in other words an assets bubble. This suggests the speculative nature of this growth in Islamic banks' asset basis.

However, it should also be noted that, this feature is not limited to the characteristics of Islamic finance only. In a very important study, Reinhart and Rogoff (2008) examine a long series of economic and financial crises through the last three centuries and argue that a speculative growth in financial sector assets which has decoupled from the real economy is one of the most important characteristics of a coming economic crisis(Aziz, 2009).

2.5 The Profit Sharing concept of Islamic Financing

Islamic financing model involves the partnerships of a borrower and lender in a business transaction and sharing profit thereof (Nagaoka, 2007). In Islamic finance, the profits from a business transaction be it a bank service, investment, insurance or any other financial service are shared between the company's owners and the customers who purchase their products Zamiretal (2012).

However, there are challenges faced by these institutions. According to Mr. Bashir, the CEO of Takaful Insurance, absence Sharia-compliant financial assets in the capital markets, such as equity securities and fixed income securities has denied them more returns on their funds. The huge investment resources held by the Islamic banks and insurance cannot be invested in the Nairobi Securities Exchange or in government bonds, all which are interest-based (Chapra, 2008). The firms are also not allowed by the government to invest their funds in other countries where Islamic investment instruments are available and well-developed such as in the Middle-East.

2.6 Conceptual Framework

In the conceptual framework, the study shall specifically analyze the changes in the financial performance of firms in Eastleigh as measured by their Return on Assets (ROA) as a result of debt financing. The independent variables will be; short term debt, long term debt and equity financing. The study shall seek to understand how these independent variables determine the financial performance of Islamic owned businesses in Eastleigh Business Community. Financial performance as measured by the profitability ratio, Return on assets, shall be used.

CHAPTER THREE

RESEARCH METHODOLOGY

3.1 Introduction

This chapter presents research design and methodology used to conduct the study. It covers research design, target population of the study, sampling, and data collection procedure. The model used aims at achieving the research objectives and forms the framework upon which data was collected and analyzed. The chapter also presents analysis procedures and how data presentation was made.

3.2 Research Design

Descriptive research design was employed in the study, analyzing the forms of financing alongside the financial performance of businesses in Eastleigh for the period of 2011-2013. The study was based on primary data that was obtained from the sample firms considered for the period under review. The study was seeking to establish whether Islamic funding has a significant effect on the financial performance of businesses in Eastleigh. Financial Performance was measured in terms of profitability measured as returns on assets.

3.3 Target Population

Data collected from the two main Islamic Banks in Kenya, First Community Bank and Gulf African Bank (2014), indicate that there are a total of 620 small enterprises which currently banking with the two banks, of which 270 are based in Eastleigh. 155 firms are in textile industry while the rest are scattered under different industries (Hussein and Omar (2014).

The 155 firms in textile industry was undertaken for this study however, the businesses also needed to have been in operation for at least 3 years as at December 2013. Out of the 155 firms the study was able to find 95 firms out of which only 55 firms had been in existence for over three years as at December 2013. Therefore our target population was these 55 firms. The study focused on this industry due to the accessibility of the businesses, availability of financial record and the proper organized structure of most businesses. This is

unlike most businesses in the other industries like transport that have no organized information, business strategy and financial records.

3.5 Data Collection

Data collection methods refer to the approach that the researcher takes while collecting data in relation to the study (Kumar, 2009). The study used primary data collection method. The primary data was collected using questionnaires. Since the target population was for the specific textile industry (155) out of the 620 small enterprises banking with the two main Islamic banks, Stratified sampling was used. Financial accountants or the entrepreneurs for the 55 firms were engaged through the data collection process. This was administered through the use of questionnaires that were self-administered.

3.6 Instrumentation

The instrument used in the study was a structured questionnaire. The questionnaire was divided into three sections. The first section was used to collect data on background information; the second section was used to collect data on financing, section three was used to collect information on profitability of the firm.

3.7 Validity and Reliability of Research Instruments

Validity is the degree to which results obtained from the analysis of the data actually represent the phenomenon under study (Mugenda & Mugenda, 2003). It has to do with the accuracy of the data collected in representing the variables of the study so as to make accurate and meaningful inferences. According to Kathuri and Pals (2003), validity refers to how well the measured indicators really measure what they are supposed to measure. The validation procedures concentrated on face, content and construct validities of the instruments. The questionnaire items were made relevant, objective and as clear as possible to improve face validity. The items were proof-read to effectively eliminate systematic/non-random error which is due to poor validity of the instruments (Tindal & Marston, 2010).

According to Paton (2000), validity is the quality attributed to proposition or measures to the degree to which they conform to established knowledge or truth. An attitude scale is considered valid, for example, to the degree to which its results conform to other measures of possession of the attitude. Validity therefore refers to the extent to which an instrument can measure what it ought to measure. It refers to the extent to which an instrument asks the right questions in terms of accuracy.

To establish the validity of the research instrument, the study sought opinions of experts in the field of study. This facilitated the necessary revision and modification of the research instrument thereby enhancing validity. The questionnaires were administered through drop and pick method. To get a favorable response rate, the respondents was given one week to fill-in the questionnaires owing to their busy work schedule so as to obtain objective and unhurried response. In addition, the researcher made phone calls and personal visits where it was necessary to remind the respondents to fill-in and return the questionnaires.

Further the researcher used participatory or collaborative modes of research. This means that the researcher involved most of the participants in all phases of inquiry. The purpose “is to arrive at evaluation conclusions as a result of a consensus among persons from different perspectives in relation to the program” (Lynch, 1996).

3.8 Data Analysis

The data collected was prepared for analysis. Preparation entailed checking the questionnaire for completeness and legibility. The information from the questionnaire was keyed in for into excel spreadsheet for statistical analysis. This was to ensure that the data collected was presented in a logical way that provides adequate basis for the generation of conclusions in regard to the specific issue under investigation (Kuada, 2012). Tables and graphs were used for visual representation of the key findings. The method used in data analysis entailed descriptive statistics, correlation analysis and multivariate panel regression analysis.

3.9 Model Specification

The study hypothesis that financial performance of businesses in the Eastleigh business community is a function of Islamic short term financing, Islamic long term financing and equity financing which can be modeled as a multiple regression model as follows:

$$y_{i,t} = \alpha + \beta_1 X_{1i,t} + \beta_2 X_{2i,t} + \beta_3 X_{3i,t} + \epsilon_{i,t} \dots \dots \dots (i)$$

Y_i = firm return on assets

X_1 = short term Islamic debt financing,

X_2 = long term Islamic debt financing,

X_3 = Islamic equity financing,

$\epsilon_{i,t}$ = error term

Regression and Correlation were used to establish the relationship between various types of financing and firm performance.

3.10 Study Hypothesis

H₁: There is a positive relationship between Islamic financing and financial performance of businesses in Eastleigh business community, Nairobi county

H₀: There is no positive relationship between Islamic financing and financial performance of businesses in Eastleigh business community, Nairobi county

CHAPTER FOUR

DATA ANALYSIS AND FINDINGS

4.1 Introduction

This chapter presents the findings of the analysis of the data collected from the respondents who were beneficiaries of Islamic finance in Eastleigh business district. The aim of the study was to find the effect of Islamic finance on financial performance of businesses operating in the Eastleigh and more specifically to find the effect of Islamic short term, long term and equity financing of Muslim owned businesses operating in Eastleigh business community. The findings indicate that there is a positive relationship between returns on assets and sales contracts, cost plus sales, profit sharing and equity financing and a negative relationship with equity participation financial agreements.

4.1.1 Response Rate

The study sample population was 55 firms out of which 43 firms returned fully completed questionnaires while 12 firms did not return the questionnaires. This constituted a response rate of 78.2%. This response was appropriate since according to Mugenda and Mugenda (2008) if a response rate exceeds 70% then it is deemed to be adequate for the study under consideration.

4.1.2 Background Information of the Respondents

Further the study sought to find the demographic information of the respondents. Specifically the study sought information on gender, age, number of years in business and highest level of education attained. Both frequencies and percentages were utilized in summarizing the data as shown in Table 1. The study found that gender composition of the respondents skewed since 70 % were male and 30% female. Male dominance in work environment can be attributed to conservativeness of Islam as a religion that encourages men as head of the households and bread winners in the family. Regarding the age majority were youthful since 44.2% aged between 31-40 years while 25.6% aged between 18-30 years.

The study shows that young people are realizing importance of doing businesses as 70% of those in business under this study are 40 years and below. Most of the business had been in operation for a period of less than eight years since 39.5% had been in operation for a period between 4-8 years and 30.2% who had been in operation between 1 to 3 years. With introduction of Islamic Banking in 2008, many young people started business as they can easily access financing that fits their needs. This agrees with Hassan and Guyatu (2014) who noted that in Kenya, Islamic SMEs mainly operating in Eastleigh estate have grown by approximately 300% for the period between years 2007 to year 2013. This implies that most of the SMEs are in the startup phase thus there is need for continuous provision of financial services which will ensure that the business can be sustained beyond this phase.

Regarding the level of education attained the study found that only 16% had attained university education followed by 27.9% with secondary qualifications and 30.2% who had only primary education level. This implies that high education level was not much a prerequisite to engage in business among the respondents on the contrary those with low education levels tend to engage more in business. None of the firms under study had more than ten employees as most of the firms 86.1% had between zero and five employees while 13.9% had employees between six and ten. This explains as to why many businesses under study did not accessed long term and equity financing. The businesses under study are small and Micro enterprises that trades in fast moving stocks, thus accessing short term financing that involve small amount of financing.

TABLE 1**Background Information of the Respondents**

Attribute		Frequency	Percentage
Gender	Male	30	70
	Female	13	30
	Total	43	100
Age	18-30	11	25.6
	31-40	18	44.2
	41-50	9	20.9
	Others	4	9.3
	Total	43	100
Education level	primary	13	30.2
	secondary	12	27.9
	diploma	1	2.3
	Degree	7	16.3
	Masters	0	0
	Others	10	23.3
	Total	43	100
Business experience	1-3	13	30.2
	6-8	17	39.5
	9-11	10	23.3
	Above 11	3	7
	Total	43	100
No. of employees	0-5	37	86.1
	6-10	6	13.9
	11-20	0	0
	21-50	0	0
	Above 50	0	0
	Total	43	100

Source: Author (2016)

4.2 Financial Characteristics of the Firms under Study

The descriptive statistics were used to summarize the financial characteristics of the firms under study. The findings are presented in Table 2 below. The mean return on assets for the teams under study was 0.358 with a minimum of 0.3 and a maximum of 2.47, this means that on average, Asset in that business gives 35.8% return. The mean for sales contracts was kshs 12540 with a minimum and maximum value of zero and kshs 365000 respectively. Regarding cost plus sales contracts the mean funding was 6969120 with a standard deviation of 956103 a minimum of 20000 and a maximum of kshs 8655999. The mean for profit sharing deals over the study period was 1186362 with a minimum of 1186362 with a minimum of 79340

and a maximum of 2073533 the mean for leasing agreements was zero as no firm surveyed had lease finance over the period under study. The mean for equity participation was recorded to be 50387 with a minimum of zero and a maximum of 2 million, the mean for equity financing was 126582 with a recorded minimum of 18578 and a maximum of 590768.

TABLE 2

Financial Characteristics of the Firms under Study

Variable		Mean	Std. Dev.	Min	Max	Observations	
firm	overall	22	12.45805	1	43	N =	129
	between		12.55654	1	43	n =	43
	within		0	22	22	T =	3
year	overall	2	.8196798	1	3	N =	129
	between		0	2	2	n =	43
	within		.8196798	1	3	T =	3
roa	overall	.3575969	.3877696	.03	2.47	N =	129
	between		.3477763	.13	2.083333	n =	43
	within		.1769372	-.4257364	1.414264	T =	3
sc	overall	12542.64	42414.07	0	365000	N =	129
	between		23386.9	0	121666.7	n =	43
	within		35504.25	-109124	255876	T =	3
cps	overall	6969120	956103.7	200000	8655999	N =	129
	between		827794.3	3567975	8435494	n =	43
	within		489487.2	3601145	1.12e+07	T =	3
ps	overall	1186362	427508.2	79340.02	2073533	N =	129
	between		308971.5	495441.5	1562134	n =	43
	within		297978.9	333029.1	2087853	T =	3
l	overall	0	0	0	0	N =	129
	between		0	0	0	n =	43
	within		0	0	0	T =	3
ep	overall	50387.6	292116.2	0	2000000	N =	129
	between		164810.6	0	666666.7	n =	43
	within		242061.5	-616279.1	1383721	T =	3
ef	overall	126582.2	106712	18578.88	590768	N =	129
	between		105240	19774.89	590768	n =	43
	within		22023.5	65873.64	235667.9	T =	3

Source: Author (2016)

4.3 Trend Analysis of the Firm's Financial Characteristics

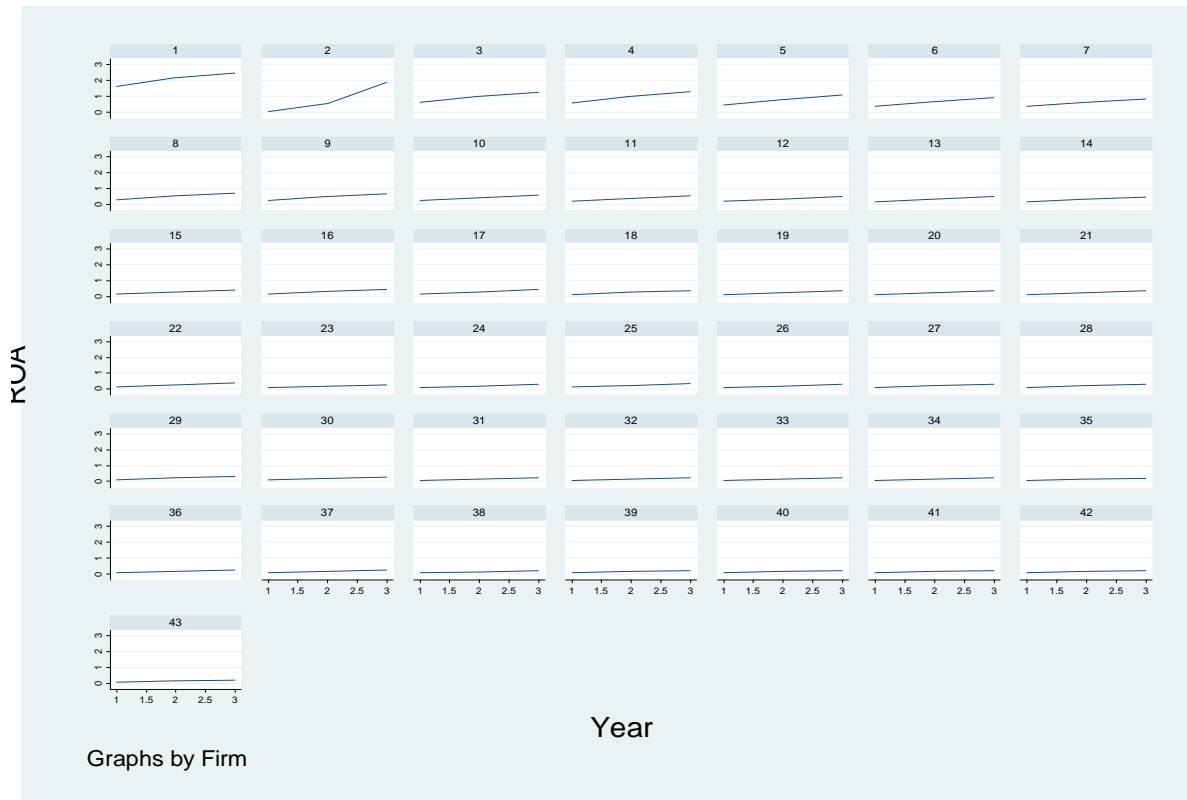
This section provides graphical representation of the changes of the variables used to measure the financial performance of the firms under study over the years 2011 to 2013. It provides us with an overview of the dynamics of financial characteristics of the firm over the period.

4.3.1 Trend Analysis of Returns on Assets

From the figure 2 below, the trend in return on assets which is a measure of financial performance, shows that majority of firms had a steady growth from year to year while a few lacked much growth. Notable under this category is the trend of firm two which showed a considerable growth in return on assets and sustained the same momentum in 2012 and 2013. Other firms like firm one, eight and nine also have shown slow growth. Firm two's growth can be attributed to early access to financing as they accessed financing in 2011 and subsequent years unlike several other firms that only accessed in 2012 and 2013 coupled with 6-10 category of number of employees, 6-8 years' business experience and a post-secondary graduate entrepreneur heading the business. The Study agrees with Fisher et al. (2006) that many professional salespersons at retail stores are associated customer satisfaction and high greater turnover.

FIGURE 2

Trend Analysis of ROA



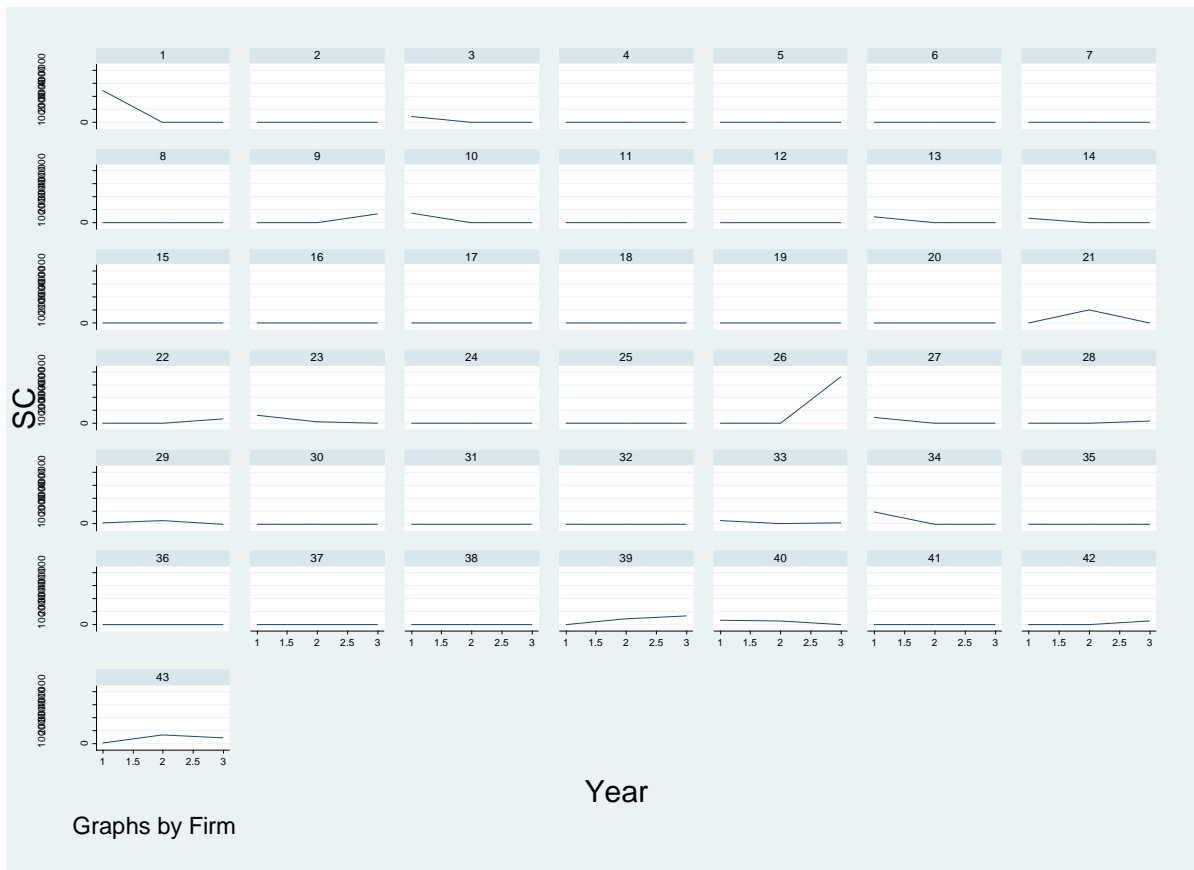
Source: Author (2016)

4.3.2 Trend of Sales Contract Agreements

The movements and trend on sales contract financing agreements has been constant generally with significant changes for a few firms. The trend in firm 1, 10 and 34 shows a decline in this mode of financing. The study observed that the three firms accessed financing in 2011 that gave them good cash flow in that specific year thus showing upward trend initially. However in subsequent years, the trend declined as they pay back the financing they accessed thus affecting their liquidity. Firm 9 and 36 show the highest growths in sales contract financing. Other firms 21, 29 and 43 indicates to both a rise and fall in financial agreements of this type. This being one of the short term financing instruments in Islamic finance shows its growing in prospects over time.

FIGURE 3

Trend of Sales Contract



Source: Author (2016)

4.3.3 Trend of Cost plus Sales

Cost plus Sales financing agreements usually entails a form of purchase finance agreement where the supplier incorporates a mutually agreed margin into the resale contract. The trend in movements of cost plus sales financing agreements from 2011 to 2013 has been constant for majority firms and with a significant upward growth for firm two. This implies that if a business chooses a mixture of different types of financing, it increases financial performance. In his study, Bashir (2003) agrees with the study that firms which diversify financing of their products tend to perform better than those with single type of financing.

FIGURE 4

Trend of Cost plus Sales Agreements



Source: Author (2016)

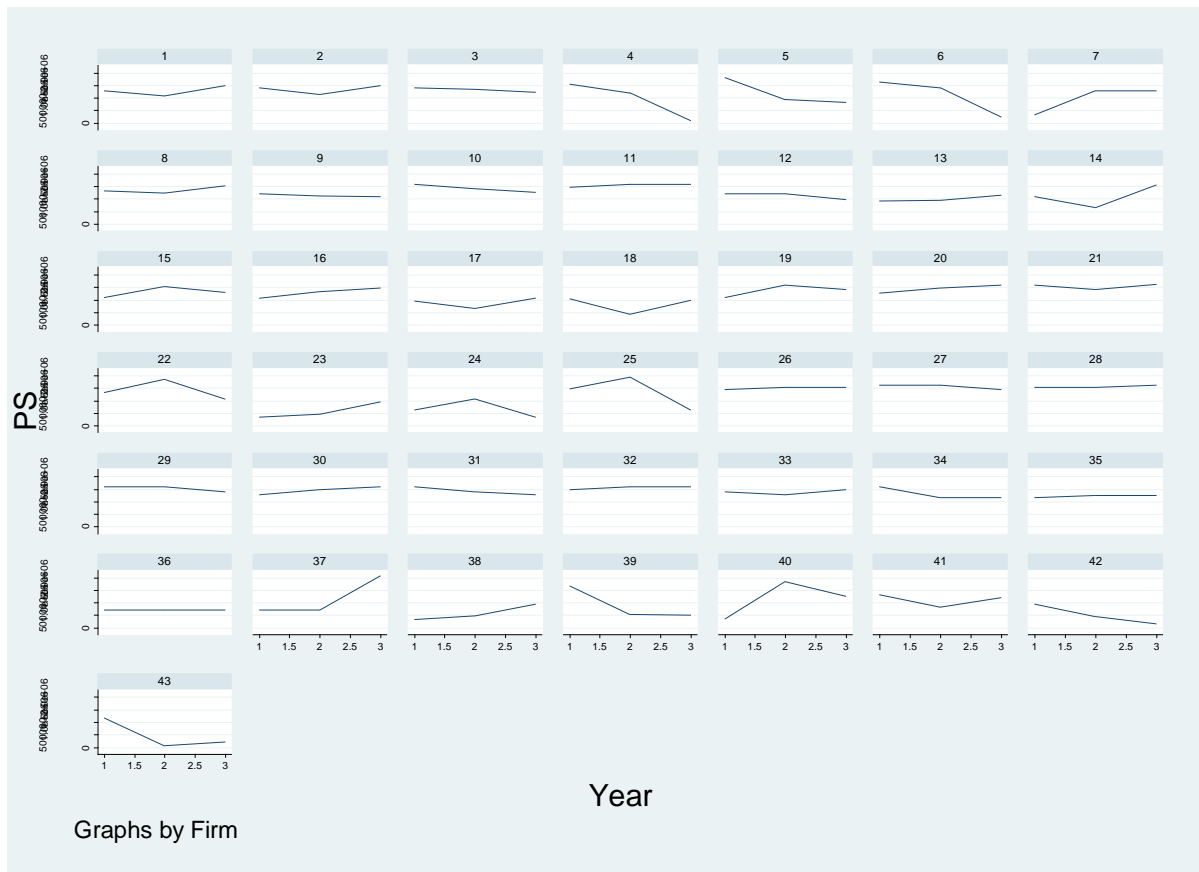
4.3.4 Trend in Profit Sharing Agreements

Profit sharing agreement was the most popular form of short term financing option among the firms under study. This is because profit sharing is the core fundamental of Islamic finance and also the nature of the textile industry under study is more suited to such a financing contract given the high levels of turnover involved. The trends in profit sharing financing agreements, indicates upward movement for most of the firms and downward for others while only a few have maintained a fairly constant trend. This trend again is a clear indication of the growing popularity of this mode of financing for the period 2011-2013. Many businesses tends to appreciate this kind of financing as 42 out of 43 firms under study embraced it. This kind of financing is where an entrepreneur manages business while financing institution finance a section of the stocks and share profit or loss. Financing institution scrutinizes the

business well before financing to minimize on loss. Zubair (2010) in his study Profit sharing ratios in Mudaraba contract agrees with the study that majority of small businesses tries profit sharing mode of Islamic financing.

FIGURE 5

Trend in Profit Sharing Agreements



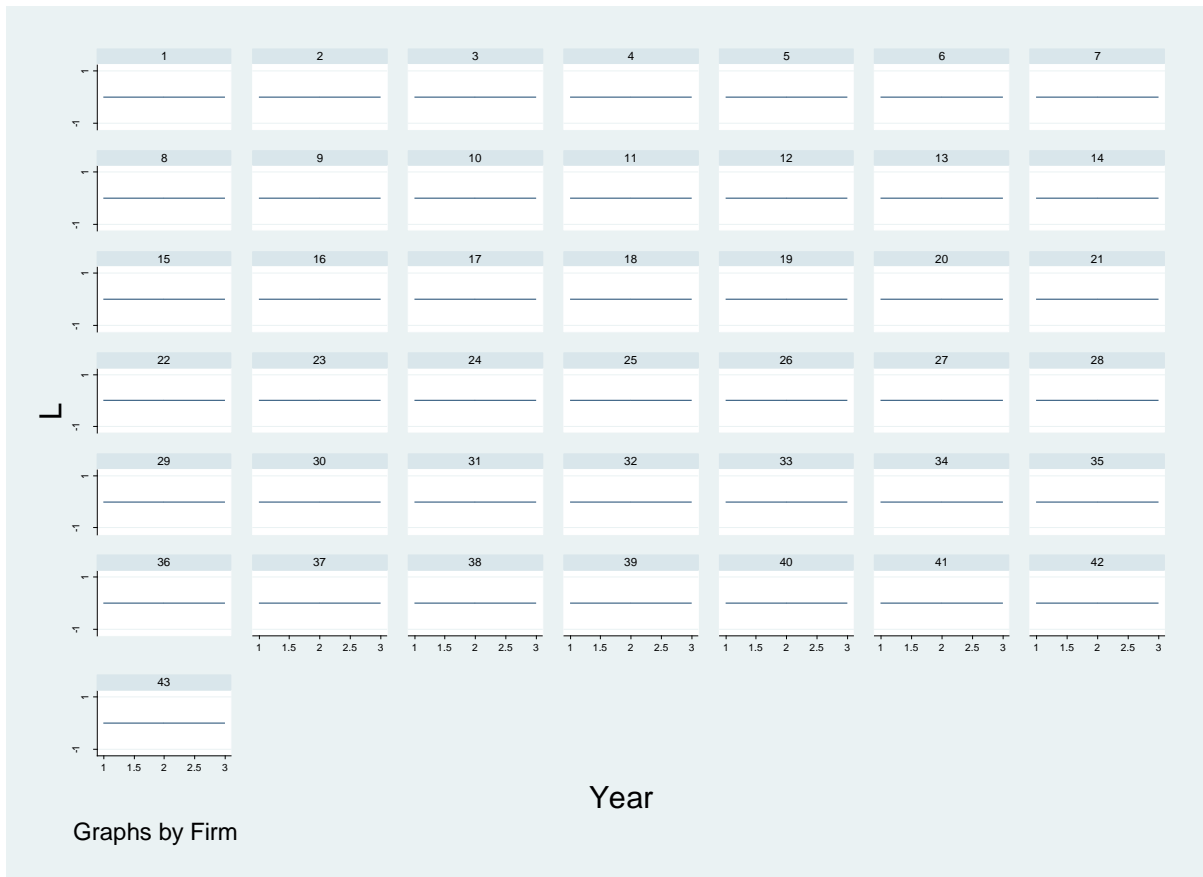
Source: Author (2016)

4.3.5 Trend Analysis of Leasing

All firms studied did not have any lease agreements; hence the trend is a constant. This is because leasing is a long term financing mode not appropriate for the given industry but more popular in construction and other industries in need of heavy machinery and equipment. The study is in agreement with Zubair (2010) who in his study found out that Leasing mode of financing is mostly used by Medium and large enterprises. Textile industry does not use heavy machinery and equipment thus concurs with the study.

FIGURE 6

Trend Analysis of Leasing

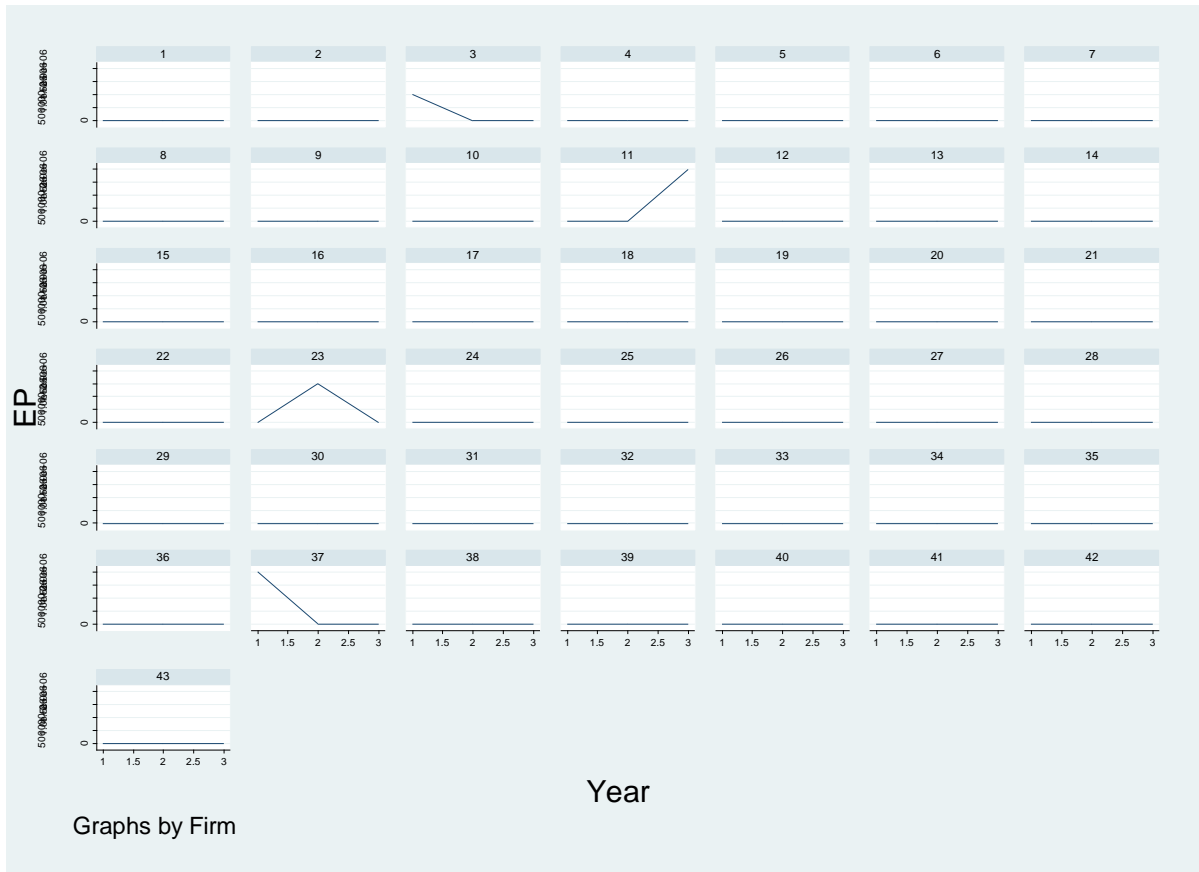


Source: Author (2016)

4.3.6 Trend of Equity Participation Financing Agreements

Out of the firms studied, only firm 3, 11, 23 and 37 did have significant changes in equity participation financing agreements while others have a constant trend. Meaning they did not engage in this mode of financing for the period under study. Of the four firms, firm 11 indicated growth while firms 3 and 37 exhibited decline in the first one and half years and subsequently stabilizing. Firm 23 grew in year 1 (2011) then declining the year 2 and 3.

FIGURE 7 Trend of Equity Participation



Source: Author (2016)

4.3.7 Trend of Equity Financing

From the figure below, equity financing has exhibited mixed trends with majority of firms maintaining a constant trend others have upward and downward movements over the study period. Firms 1, 35 and 41 exhibited growth in 2011 and subsequent decline in 2012 and 2013 while firms 25 and 42 was constant in 2011 and 2012 but realized growth in 2013. The firms that remained constant throughout the study period did not participate in Equity Financing.

FIGURE 8

Trend of Equity Financing



Source: Author (2016)

4.4 Correlation analysis

To understand the relationship between the variables under study, a correlation matrix was obtained and results presented in the table4.3 below. It is evident that there is a positive correlation between returns on assets and sales contracts, cost plus sales, profit sharing and equity financing and a negative relationship with equity participation financial agreements.

TABLE 3

Correlation matrix

	roa	sc	cps	ps	l	ep	ef
roa	1.0000						
sc	0.0736	1.0000					
cps	0.1148	0.0701	1.0000				
ps	0.0347	-0.0034	0.0246	1.0000			
l	1.0000		
ep	-0.0134	-0.0088	-0.0735	-0.0602	.	1.0000	
ef	0.0288	-0.0414	0.2615	0.0355	.	-0.0152	1.0000

Source: Author (2016)

4.5 Panel Data Analysis

Since the study was carried out on the financial performance of the same number of firms over different time period, the data obtained maybe further analysed using panel data techniques. The study sought to establish the effect of the independent variables on the dependent variable based on the model that financial performance of businesses in the Eastleigh business community is a function of Islamic short term financing, Islamic long term financing and equity financing which was modeled as a multivariate panel regression model presented as equation one in chapter three.

4.5.1 Pre Estimation Tests

To determine whether performing regression on the data was appropriate, some tests were conducted. This included test for multicollinearity, and serial correlation. To test for multicollinearity Variance Inflation factor (VIF) was used. This was to ensure that the explanatory variables included in the model were not highly related. Presence of multicollinearity would mean that R^2 will be high but the individual coefficients will have high standard errors, so that the regression looks good as a whole, but the individual variables are not significant. The results from the test indicated that there was no multicollinearity as the VIFs were all below 5.

TABLE 4

Variance Inflation factor (VIF)

Variable	VIF	1/VIF
cps	1.09	0.920194
ef	1.08	0.927167
ep	1.01	0.991144
sc	1.01	0.991227
ps	1.00	0.995034
Mean VIF	1.04	

Source: Author (2016)

The second test conducted was to test of serial correlation to ensure that the error term of the current period is not dependent on the error term of previous periods. Ignoring presence of serial correlation would lead to a possibility that the wrong inferences could be made about whether a variable is or is not an important determinant of variations observed. This test was carried out using the Woodridge test. The results indicated that there was no serial correlation in the data as the p value (0.6578) is greater than 0.005 as indicated in Table 5 below. The hypothesis testing done indicates that there is a positive relationship between Islamic financing and financial performance of businesses in Eastleigh business community.

TABLE 5

Woodridge test

Dependent Variable	F-value	p-value
ROA	1.321	.6578

Source: Author (2016)

4.5.2 Panel Model Specification

On determining that the data meets the necessary assumptions for panel data analysis, it was important to determine the best model to fit between a random effects and a fixed effects model. This was done by the help of the Hausman test whose results are presented in table 6 below. From the results the model that best fits the data is a fixed effects model since the probability of Chi Square (0.0000) is less than 0.05.

TABLE 6

Hausman Test for Model Specification

```
. hausman fixed random
```

	Coefficients		(b-B) Difference	sqrt(diag(V_b-V_B)) S.E.
	(b) fixed	(B) random		
sc	-7.62e-07	-6.51e-07	-1.10e-07	.
cps	2.47e-07	2.10e-07	3.72e-08	6.12e-09
ps	-7.97e-08	-6.12e-08	-1.85e-08	.
ep	-3.32e-08	-2.47e-08	-8.46e-09	.
ef	-9.46e-07	-5.97e-07	-3.49e-07	4.66e-07

b = consistent under Ho and Ha; obtained from xtreg
 B = inconsistent under Ha, efficient under Ho; obtained from xtreg

Test: Ho: difference in coefficients not systematic

chi2(5) = (b-B)'[(V_b-V_B)^(-1)](b-B)
 = 50.76
 Prob>chi2 = 0.0000
 (V_b-V_B is not positive definite)

Source: Author (2016)

4.5.3 Fixed effects model

The fixed effects panel regression model was estimated and the results presented in Table 7 below. The results indicate that the overall model was significant (Prob F < 0.05). These findings reveal that the model has some prognostic power on the dependent variable.

Regarding the significance of the independent variable at 95% confidence interval only cost plus sales financing agreements were found to significantly and positively influence the financial performance of firms under study. The sales contracts and profit sharing financing agreements were statistically significant at 90% confidence interval.

TABLE 7

Fixed effects model Results

```
. xtreg roa sc cps ps ep ef, fe
```

Fixed-effects (within) regression	Number of obs	=	129
Group variable: firm	Number of groups	=	43
R-sq: within = 0.5153	Obs per group: min	=	3
between = 0.0143	avg	=	3.0
overall = 0.0079	max	=	3
corr(u_i, Xb) = -0.4776	F(5,81)	=	17.23
	Prob > F	=	0.0000

roa	Coef.	Std. Err.	t	P> t	[95% Conf. Interval]	
sc	-7.62e-07	3.87e-07	-1.97	0.052	-1.53e-06	8.31e-09
cps	2.47e-07	2.80e-08	8.82	0.000	1.91e-07	3.03e-07
ps	-7.97e-08	4.67e-08	-1.71	0.092	-1.73e-07	1.32e-08
ep	-3.32e-08	5.70e-08	-0.58	0.562	-1.47e-07	8.02e-08
ef	-9.46e-07	6.30e-07	-1.50	0.137	-2.20e-06	3.07e-07
_cons	-1.137691	.2228855	-5.10	0.000	-1.581163	-.6942189
sigma_u	.41995332					
sigma_e	.15484574					
rho	.88031625	(fraction of variance due to u_i)				

F test that all u_i=0:	F(42, 81) =	16.83	Prob > F = 0.0000
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Source: Author (2016)

CHAPTER FIVE

DISCUSSION, CONCLUSION AND RECOMMENDATIONS

5.1 Introduction

This chapter presents the discussion of research findings, conclusions and recommendations. It is organized as follows. First, it presents a discussion of research findings according to research objectives. This is followed by conclusions drawn and finally policy recommendations derived from the conclusions and areas for further research.

5.2 Summary of Findings

The study wanted to understand the effect of Islamic Financing on Financial performance of firms operating in Eastleigh, Nairobi County, with specific objective of establishing the effect of Islamic short term debt financing, long term debt financing and Islamic equity financing on financial performance. Short term Islamic financing was found to be significant to the study while long term Islamic financing and Islamic equity financing was insignificant to the study as discussed below.

5.3 Discussion of the Findings

This study was motivated by the need to understand the role of Islamic financing in determining the financial performance of firms operating in Eastleigh business community. Therefore its objectives were to determine the effect of short term and long term Islamic financing as well as the effect of equity financing on the financial performance of the firms under study.

5.3.1 Short Term Islamic Financing and Firm Performance

The relationship between short term Islamic financing and firm performance was found to be positive. Short term financing options considered were; sales contracts, cost plus sales and profit sharing agreements. The most significant short term financing was found to be cost plus sales financing agreements. Therefore short term Islamic finance positively affects the

financial performance of firms under study. This is concurrent both with finance theory especially the pecking order theory since debt financing was more common in firms under study than equity financing.

This is also supported by other empirical findings, for instance according to Asutay (2011) report that Islamic financing had a positive effect of firm profitability. This study agrees with (Sadique, 2007) who says that the Profit-sharing agreement (mudaraba), another short term Islamic financial instrument is identical to an investment fund in which managers handle a pool of funds. The agent-manager has relatively limited liability while having sufficient incentives to perform. The capital is invested in broadly defined activities, and the terms of profit and risk sharing are customized for each investment. The maturity structure ranges from short to medium term and is more suitable for trade activities.

5.3.2. Long Term Islamic Financing and Firm Performance

The long term Islamic financing options studied included leasing and equity participation. The effect of long term financing was found to be insignificant in this study. This could be attributed to the fact that all the firms used in this study operate in the textile industry which does not require long term financing but rather relies on short term financing as they deal with fast moving stocks. Long term financing is more appropriate for long lived asset investments that require massive financing and investments in machinery that would necessitate leasing agreements. This explains why no firm studied had a leasing financial agreement. The study is in agreement with Zubair (2010) who in his study found out that Leasing mode of financing is mostly used by Medium and large enterprises. Textile industry doesn't use heavy machinery and equipment thus concurs with the study.

5.3.3 Equity Financing and Firm Performance

The relationship between equity financing and firm performance is well studied in literature but yet no consensus has been built. The results of this study show that the effect of equity financing on firm performance is insignificant. This is also consistent with the pecking order

theory that firms will prefer debt over equity and contradicts the trade-off theory that postulates that firms will always find an optimal mix of debt and equity that maximizes financial performance. These findings also contradict existing literature on Islamic finance.

According to El Qorchi (2005) all forms of Islamic finance, both debt and equity have a positive effect on firm performance. Again this disparity could be explained by the characteristics of the industry under study. These findings were in relation to Asutay (2011) who posits that Equity participation (musharaka) is analogous to a classical joint venture. Both entrepreneur and investor contribute to the capital (assets, technical and managerial expertise, working capital, etc.) of the operation in varying degrees and agree to share the returns (as well as the risks) in proportions agreed to in advance. Traditionally, this form of transaction has been used for financing fixed assets and working capital of medium- and long-term duration. According to Hamid and Nordin (2001) in their study of Malaysian banking consumers', realized that there is poor knowledge of specific Islamic banking products and little understanding of the difference between Islamic and conventional banks and suggested that need for better consumer education to assist on understanding Islamic banking products available to them.

5.4 Conclusion

Given that the relationship between short term Islamic finance and financial performance of the firms operating in Eastleigh business district was found to be positive, it may be attributed to the fact that short term financing provides growth opportunities by pulling firms out of their short term financial needs enabling them meet their objectives sufficiently especially given the high velocity of turnover in the textile industry.

Long term financing and equity participation were found to have insignificant effect on financial performance of the firms under study, this may be attributed again to the peculiarities of the textile industry that does not require long term financing such as lease

agreements as well as the reluctance of financial institutions to partake equity in such firms that do not have a solid asset base.

5.4 Recommendations on the Study

In line with the finding of this study the following recommendations are proposed:

There is need to review and develop legal framework to fully incorporate Islamic financing into the mainstream finance options available in Kenya. Equip the regulators with understanding on the functional form of Islamic finance. This would include but not limited to introduction of Islamic finance products into the capital markets, insurance industry and pension schemes.

There is need for Promotion of awareness and capacity building in the area of Islamic finance to improve on the uptake of this innovative financing option especially among the Muslim community. Since Islamic finance meets their financial need under their religious obligations. Other financing options and instruments need be developed to enhance diversity of Islamic finance.

5.5 Recommendations for Further Research

The study recommends further research to be carried out. The population considered under this study is mainly that of textile industry undertaken by small and micro enterprises thus skewed towards short term Islamic financing. The study recommends further research to be done in construction industries manufacturing and other large scale businesses that will likely to embrace leasing, equity participation & other Islamic long term and equity financing. Another area that the study further recommends is the level of awareness of Islamic financing models and it's availability to non-Muslim customers.

5.6 Limitations of the Study and Areas for Further Research

The key limitation of this study is that all firms studied were in the textile industry and therefore the findings may not be generalized for firms operating in other sectors given the industry specific characteristics. Further research is however required to undress the

challenges of accessing Islamic finance and also to understand the dynamics across all sectors of the economy.

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APPENDICES

APPENDIX I

Questionnaire

This questionnaire is divided into **Section 1 and 2**. Please respond as accurately and as honestly as possible to all the questions. Read each question carefully and follow the instructions. Answer all questions by either circling the number in the box, using a tick (✓) in the box or by writing your views on the space provided that best describes your answer. All individual answers will be kept confidential.

SECTION 1: BACKGROUND INFORMATION

Please complete each section as instructed. All the information in this questionnaire will be kept confidential.

DEMOGRAPHIC DATA

Please put a tick (✓) against the answer of your choice.

1. Gender: Male () Female ()
2. Age Category 18-30 [] 31-40 [] 41-50 [] Others: Please specify.....
3. Marital Status Single [] Married [] Divorced [] Widowed []
4. Name of the business (Optional)
5. Please indicate the level of education
 1. Primary Secondary Certificate/Diploma Bachelors
Masters Others: Specify:.....
6. Please indicate the number of years this firm has been operating in years
 - 3-5 []
 - 6-8 []
 - 9-11 []
 - Over 11 [] Please specify.....

7. How many employees do you have at the moment?

0-5 []

6-10 []

11-20 []

21-50 []

Others: [] Please specify.....

SECTION 2: FINANCING

We are working to assess the effect of Islamic financing on the financial performance of Muslim owned businesses. In this regard, we request that you kindly share with us the financing provided to you by the Islamic banks for the period 2011 to 2013 under the categories: Islamic short term finance, Islamic long term finance and Islamic equity finance.

Also share with us the profitability of your firm over the three year period 2011-2013 as a ratio, Return on assets.

PART A: SHORT TERM FINANCING

1. Among the short term financial products indicated below, please tick the one(s) you have accessed in the period of 2011-2013.

Sales contracts

Cost-plus sale

Profit-sharing agreement (mudaraba)

2. Reasons for choosing the above product(s).....
.....
.....

3. Kindly indicate the amount received in each year

Year 2011

Year 2012

Year 2013

PART B: LONG TERM FINANCING

1. Among the long term financial products indicated below, please tick the one(s) you have accessed in the period of 2011-2013.

Leasing (*ijara*) Equity participation (*musharaka*)

2. Reasons for choosing the above product(s).....
.....
.....
.....

3. Kindly indicate the amount received in each year

Year 2011
Year 2012
Year 2013

PART C: EQUITY FINANCING

1. From the list below. Kindly select the nature of your Business.

Sole Proprietorship Partnership Limited

2. If partnership or Limited company, kindly indicate the number of partners/directors.

3. In the period 2011-2013, did the firm accessed capital from its owners? Yes No

If Yes, kindly indicate the amount received in each year.

Year 2011
Year 2012
Year 2013

SECTION 3: PROFITABILITY OF THE FIRM

Kindly share with us the following information in regard to the financial performance of your firm for the period 2011 to 2013. Tick one box from the ranges and input the corresponding value where available.

1. What were the profits of the firm in each of the years below?

Profit Range	Year 2011	Year 2012	Year 2013
0-500,000			
500,001-1,000,000			
1,000,001-2,000,000			
2,000,001-3,000,000			
3,000,001-4,000,000			
4,000,001-5,000,000			
5,000,001-6,000,000			
6,000,001-7,000,000			
7,000,001-8,000,000			
8,000,001-9,000,000			
9,000,001-10,000,000			
10,000,001-15,000,000			
15,000,001-20,000,000			
Over 20,000,000			

2. What was the total asset position of the firm at the end of each of the years below?

Total Asset	Year 2011	Year 2012	Year 2013
0-1,000,000			
1,000,001-3,000,000			
3,000,001-5,000,000			
5,000,001-8,000,000			
8,000,001-10,000,000			
10,000,001-15,000,000			
15,000,001-20,000,000			
20,000,001-25,000,000			
25,000,001-30,000,000			
30,000,001-40,000,000			
40,000,001-50,000,000			
50,000,001-75,000,000			
75,000,001-100,000,000			
Over 100,000,000			

What other aspects that have led to the increase or decrease of the profitability of the firm in this period. (inflation, Addition of expertise, natural disaster, market boom, e.t.c).....

.....

Thank You!!!

Data Analysis.

Firm	Year	ROA	SC	CPS	PS	L	EP	EF
1.00	1.00	1.62	245000.00	8077323.76	1300000.00	0.00	0.00	176233.41
1.00	2.00	2.16	0.00	8117556.82	1100000.00	0.00	0.00	305782.69
1.00	3.00	2.47	0.00	8235569.67	1500000.00	0.00	0.00	149945.28
2.00	1.00	0.03	0.00	200000.00	1400000.00	0.00	0.00	266810.19
2.00	2.00	0.54	0.00	2708677.67	1160000.00	0.00	0.00	240111.48
2.00	3.00	1.87	0.00	7795248.08	1510000.00	0.00	0.00	236324.55
3.00	1.00	0.63	45000.00	6305987.48	1410000.00	0.00	1000000.00	176817.47
3.00	2.00	1.00	0.00	6218782.97	1340000.00	0.00	0.00	172753.46
3.00	3.00	1.25	0.00	6251885.71	1250000.00	0.00	0.00	162624.49
4.00	1.00	0.58	0.00	7299594.34	1540000.00	0.00	0.00	50521.64
4.00	2.00	0.98	0.00	7338438.14	1210000.00	0.00	0.00	44000.72
4.00	3.00	1.27	0.00	7390615.03	120000.00	0.00	0.00	45796.41
5.00	1.00	0.47	0.00	7015960.35	1820000.00	0.00	0.00	123864.38
5.00	2.00	0.80	0.00	7033915.37	960000.00	0.00	0.00	94950.99
5.00	3.00	1.06	0.00	7051145.06	830000.00	0.00	0.00	78582.97
6.00	1.00	0.38	0.00	6600315.44	1650000.00	0.00	0.00	77452.01
6.00	2.00	0.66	0.00	6608081.97	1410000.00	0.00	0.00	96194.37
6.00	3.00	0.89	0.00	6655554.20	250000.00	0.00	0.00	91867.54
7.00	1.00	0.35	0.00	6925222.66	330000.00	0.00	0.00	59051.82
7.00	2.00	0.62	0.00	6980905.74	1300000.00	0.00	0.00	63192.83
7.00	3.00	0.84	0.00	7014596.99	1300000.00	0.00	0.00	64813.60
8.00	1.00	0.29	0.00	6581453.59	1340000.00	0.00	0.00	96730.04
8.00	2.00	0.53	0.00	6619618.97	1250000.00	0.00	0.00	89310.87
8.00	3.00	0.73	0.00	6657831.53	1540000.00	0.00	0.00	76786.48
9.00	1.00	0.26	0.00	6578006.77	1210000.00	0.00	0.00	59051.82
9.00	2.00	0.48	0.00	6636490.54	1120000.00	0.00	0.00	63192.83
9.00	3.00	0.67	65000.00	6660639.12	1101308.93	0.00	0.00	64813.60
10.00	1.00	0.23	75000.00	6276481.57	1592335.78	0.00	0.00	45604.35
10.00	2.00	0.42	0.00	6251821.87	1409927.03	0.00	0.00	38470.58
10.00	3.00	0.57	0.00	6223255.75	1284566.25	0.00	0.00	27504.93
11.00	1.00	0.20	0.00	6126530.37	1487056.40	0.00	0.00	45604.35
11.00	2.00	0.38	0.00	6156834.95	1594952.15	0.00	0.00	38470.58
11.00	3.00	0.52	0.00	6100897.58	1592335.78	0.00	2000000.00	27504.93
12.00	1.00	0.19	0.00	6014996.41	1224176.54	0.00	0.00	72582.93
12.00	2.00	0.35	0.00	6099561.05	1224176.54	0.00	0.00	72582.93
12.00	3.00	0.49	0.00	6183794.69	968413.21	0.00	0.00	72582.93
13.00	1.00	0.18	45000.00	6157733.82	934562.85	0.00	0.00	72582.93
13.00	2.00	0.33	0.00	6246515.09	950248.06	0.00	0.00	72582.93
13.00	3.00	0.48	0.00	6334565.34	1148103.83	0.00	0.00	72582.93
14.00	1.00	0.18	35000.00	6669524.66	1100282.41	0.00	0.00	45604.35
14.00	2.00	0.33	0.00	6629271.64	650000.00	0.00	0.00	38470.58
14.00	3.00	0.47	0.00	6634279.63	1560000.00	0.00	0.00	27504.93
15.00	1.00	0.16	0.00	6543649.56	1110000.00	0.00	0.00	45604.35
15.00	2.00	0.31	0.00	6508197.31	1540000.00	0.00	0.00	38470.58
15.00	3.00	0.43	0.00	6503015.68	1300000.00	0.00	0.00	27504.93
16.00	1.00	0.18	0.00	7619912.71	1073533.01	0.00	0.00	171877.18
16.00	2.00	0.34	0.00	7567749.07	1345070.72	0.00	0.00	150320.86
16.00	3.00	0.47	0.00	7486671.19	1474507.44	0.00	0.00	125884.87
17.00	1.00	0.17	0.00	7763720.71	953845.94	0.00	0.00	171877.18
17.00	2.00	0.32	0.00	7711129.22	656962.82	0.00	0.00	150320.86

17.00	3.00	0.46	0.00	7629283.96	1073533.01	0.00	0.00	125884.87
18.00	1.00	0.14	0.00	6798952.34	1050364.94	0.00	0.00	112271.19
18.00	2.00	0.28	0.00	6997855.77	437342.06	0.00	0.00	89516.85
18.00	3.00	0.40	0.00	7008683.59	989692.96	0.00	0.00	81013.23
19.00	1.00	0.14	0.00	6948255.18	1101308.93	0.00	0.00	112271.19
19.00	2.00	0.27	0.00	7140143.16	1592335.78	0.00	0.00	89516.85
19.00	3.00	0.39	0.00	7156862.10	1409927.03	0.00	0.00	81013.23
20.00	1.00	0.13	0.00	6877487.48	1284566.25	0.00	0.00	112271.19
20.00	2.00	0.26	0.00	7072735.26	1487056.40	0.00	0.00	89516.85
20.00	3.00	0.37	0.00	7086630.96	1594952.15	0.00	0.00	81013.23
21.00	1.00	0.14	0.00	7877624.65	1592335.78	0.00	0.00	113820.79
21.00	2.00	0.27	100000.00	7895815.22	1409927.03	0.00	0.00	113820.79
21.00	3.00	0.39	0.00	7886936.07	1610000.00	0.00	0.00	113820.79
22.00	1.00	0.14	0.00	8268396.06	1342548.57	0.00	0.00	590767.97
22.00	2.00	0.28	0.00	8312298.45	1870000.00	0.00	0.00	590767.97
22.00	3.00	0.40	35000.00	8360558.46	1073533.01	0.00	0.00	590767.97
23.00	1.00	0.10	65000.00	6137021.24	345070.72	0.00	0.00	45604.35
23.00	2.00	0.20	15000.00	6118123.14	474507.44	0.00	1500000.00	38470.58
23.00	3.00	0.28	0.00	6076787.49	953845.94	0.00	0.00	27504.93
24.00	1.00	0.11	0.00	6564446.81	656962.82	0.00	0.00	50516.11
24.00	2.00	0.20	0.00	6619041.47	1073533.01	0.00	0.00	52442.50
24.00	3.00	0.30	0.00	6699494.55	345070.72	0.00	0.00	61290.57
25.00	1.00	0.12	0.00	7682970.77	1474507.44	0.00	0.00	236216.24
25.00	2.00	0.23	0.00	7703669.60	1953845.94	0.00	0.00	236187.67
25.00	3.00	0.33	0.00	7720711.75	656962.82	0.00	0.00	278527.13
26.00	1.00	0.10	0.00	6890398.39	1453686.85	0.00	0.00	37121.94
26.00	2.00	0.20	0.00	6905265.52	1533213.23	0.00	0.00	37121.94
26.00	3.00	0.29	365000.00	6923450.36	1537512.12	0.00	0.00	37121.94
27.00	1.00	0.11	45000.00	7670117.59	1615675.67	0.00	0.00	179091.94
27.00	2.00	0.21	0.00	7720512.60	1615675.67	0.00	0.00	171438.43
27.00	3.00	0.31	0.00	7768660.41	1453686.85	0.00	0.00	164112.01
28.00	1.00	0.11	0.00	7716350.13	1533213.23	0.00	0.00	179091.94
28.00	2.00	0.21	0.00	7766874.29	1537512.12	0.00	0.00	171438.43
28.00	3.00	0.30	20000.00	7814904.69	1615675.67	0.00	0.00	164112.01
29.00	1.00	0.12	8000.00	8655999.47	1615675.67	0.00	0.00	67141.27
29.00	2.00	0.22	25000.00	8419167.64	1592335.78	0.00	0.00	60538.16
29.00	3.00	0.31	0.00	8231313.27	1409927.03	0.00	0.00	60538.16
30.00	1.00	0.10	0.00	7379185.82	1284566.25	0.00	0.00	171877.18
30.00	2.00	0.18	0.00	7327834.46	1487056.40	0.00	0.00	150320.86
30.00	3.00	0.26	0.00	7248207.65	1594952.15	0.00	0.00	125884.87
31.00	1.00	0.08	0.00	6387240.78	1592335.78	0.00	0.00	37121.94
31.00	2.00	0.16	0.00	6403617.46	1409927.03	0.00	0.00	37121.94
31.00	3.00	0.23	0.00	6423049.52	1284566.25	0.00	0.00	37121.94
32.00	1.00	0.08	0.00	6288438.76	1487056.40	0.00	0.00	38903.75
32.00	2.00	0.15	0.00	6276737.86	1594952.15	0.00	0.00	38903.75
32.00	3.00	0.22	0.00	6336935.89	1592335.78	0.00	0.00	46113.27
33.00	1.00	0.08	23000.00	7012780.08	1409927.03	0.00	0.00	112271.19
33.00	2.00	0.16	5000.00	7201569.49	1284566.25	0.00	0.00	89516.85
33.00	3.00	0.24	6000.00	7220895.24	1487056.40	0.00	0.00	81013.23
34.00	1.00	0.08	90000.00	6701231.30	1594952.15	0.00	0.00	18961.39
34.00	2.00	0.15	0.00	6657188.88	1177928.30	0.00	0.00	18578.88
34.00	3.00	0.21	0.00	6614803.69	1177928.30	0.00	0.00	21784.40
35.00	1.00	0.07	0.00	6439464.23	1177928.30	0.00	0.00	189968.99

35.00	2.00	0.14	0.00	6356973.57	1256156.91	0.00	0.00	261791.66
35.00	3.00	0.20	0.00	6200845.58	1256156.91	0.00	0.00	194631.43
36.00	1.00	0.08	0.00	7840728.58	721297.50	0.00	0.00	66675.97
36.00	2.00	0.16	0.00	7762259.14	721297.50	0.00	0.00	60102.96
36.00	3.00	0.23	0.00	7393982.58	721297.50	0.00	0.00	74260.11
37.00	1.00	0.08	0.00	7494174.13	721297.50	0.00	2000000.00	236216.24
37.00	2.00	0.15	0.00	7521580.84	721297.50	0.00	0.00	236187.67
37.00	3.00	0.23	0.00	7552441.64	2073533.01	0.00	0.00	278527.13
38.00	1.00	0.07	0.00	6415790.68	345070.72	0.00	0.00	73573.15
38.00	2.00	0.13	0.00	6417478.72	474507.44	0.00	0.00	72027.90
38.00	3.00	0.19	0.00	6415608.99	953845.94	0.00	0.00	85282.13
39.00	1.00	0.07	0.00	7023925.57	1656962.82	0.00	0.00	111140.86
39.00	2.00	0.14	45000.00	7097186.24	540912.69	0.00	0.00	139382.16
39.00	3.00	0.20	65000.00	7139418.49	522052.81	0.00	0.00	203749.41
40.00	1.00	0.07	34000.00	7111042.15	358269.23	0.00	0.00	127547.51
40.00	2.00	0.14	24000.00	7091406.02	1837844.95	0.00	0.00	134422.35
40.00	3.00	0.21	0.00	7659051.22	1271324.30	0.00	0.00	294613.60
41.00	1.00	0.07	0.00	7721982.47	1322349.88	0.00	0.00	294613.60
41.00	2.00	0.14	0.00	7604443.93	842347.59	0.00	0.00	407067.34
41.00	3.00	0.21	0.00	7631402.33	1220452.91	0.00	0.00	321848.68
42.00	1.00	0.07	0.00	7463812.99	945074.53	0.00	0.00	226242.13
42.00	2.00	0.14	0.00	7591649.46	469153.65	0.00	0.00	217078.74
42.00	3.00	0.20	25000.00	7547640.57	170000.00	0.00	0.00	282804.38
43.00	1.00	0.07	5000.00	7438947.41	1180000.00	0.00	0.00	132377.63
43.00	2.00	0.14	65000.00	7601484.76	79340.02	0.00	0.00	159990.96
43.00	3.00	0.20	43000.00	7508720.11	226984.38	0.00	0.00	98118.49

Source: Author (2016).