# FACTORS INFLUENCING THE CHOICE OF SOURCE OF CAPITAL IN MICRO, SMALL AND MEDIUM-SIZE ENTERPRISES

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## DECLARATION

This project is my original work and has not been presented for a degree in any other University.

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**SUPERVISOR'S DECLARATION**

I confirm that this project has been submitted for examination with my approval as the University Supervisor

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# ABSTRACT

In Kenya, there are about 2.2 million micro-, small- and medium-sized enterprises (Strategic Business Advisors [Africa] Ltd, 2007), of which 88% are non-registered. Of this non-registered group, only 23% have bank accounts, and only 10% have ever received credit from any formal source. MSME's face many constraints, the lack of appropriate financial products and services in variably appears in surveys and analysis as one of the leading hurdles to realizing growth. Therefore this study seeks to establish factors influencing the choice of source of capital in MSME'S. The general objective of the study was to establish the factors influencing the choice of source of capital in MSME'S. The study adopted a mixed quantitative and qualitative design to describe the factors influencing choice of source of capital in MSM'S. Forty (40) of the total population of MSME's who had consistently operated for more than five years were randomly sampled and subjected to this study. Quantitative data collected was analyzed by the use of inferential statistics and presented through percentages and frequencies. This study finds that whether SMEs can provide collateral or guarantee is a decisive factor, factors such as share ring of information between the MSME'S and the various creditors , trans action cost, cost of credit play an important role. Most of SMEs are in growth phrase, with small or medium size, relating to choice of source of entrepreneurial finance are the same for all SMEs regardless of their ability to obtain market information with regard to sources of capital. This study is faced with the problem of generalizing the research findings to all the MSME's in Kenya, therefore other researchers may focus on the supply side factors influencing choice of source capital of by MSME's that MSME's have poor credit risk mitigation measures.

## ACKNOWLEDGMENTS

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## DEDICATION

This project is dedicated to my family members, parents and friends who have been with me all through my academic years. With their love and care they have shaped me in the way I am today, not forgetting my lectures and community for their great love and support.

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# CHAPTER ONE

## 1.0 INTRODUCTION

This chapter contains background of the study, statement of research problem, general objectives, significance of the study and the conceptual frame.

## 1.1 Background to the Study

In Kenya, there are about 2.2 million micro-, small- and medium-sized enterprises (Strategic Business Advisors [Africa] Ltd, 2007), of which 88% are non-registered. Of this non-registered group, only 23% have bank accounts, and only 10% have ever received credit from any formal source. SMEs (small, micro and medium size businesses) are accountable for above 50 percent of manufacturing gross domestic product. It is estimated that in Kenya, small scale enterprises generate 18% of the national income (G.O.K, 2004). Atieno (1998) has observed in a survey done in Kenya that about 70% of the respondents got their initial capital from family, friends and relatives while 81% got their operating capital from the same financial institution. Choice of source of capital is thus an on-going problem in the case of entrepreneurial firms (Bates and Nucci, 1989).

SMEs have a very limited capital base, their startup capital is normally sourced from their meager saving and borrowings from friends and family this in turn affects the cash flow of the enterprise limiting the firms' financial activities. in the set up phase of the firms life cycle, small enterprises' in developing economies often receive funding from informal sources and tend to persevere against problems such as managing cash flow through short-term debts and personal sources such as own savings. (CGAP, 2013; SiaandNails, 2008).

Kenya MSME's (micro, small and medium size businesses) tend to face three kinds of problems which are primarily financial aid, trade opportunities for growth purposes, enterprise diversification and appropriate business practices. Mwarari (2013), she emphasizes financial aid on a higher level and goes on to insist that the sector will at no time realize the full potential of growth if the financial challenges are not addressed. To Mwarari size and age of the firm do play an important role in determining the capital structure of the business. Availability of finances is determined by the kind of capital mix the entrepreneur feels will take the enterprise to the intended goals. She decries the discrimination meted out on the newer and smaller firms when seeking for financial aid from financial institutions. On the same note she insists the need of Kenyan financial institutions to look beyond the collaterals when evaluating the financial applications from the entrepreneurs. Mwarari(2013),

According to Tracy and Tracy (2007) capital is vital for starting business and its growth. Some of the sources of capital identified by Tracy and Tracy (2007) for micro business enterprises are: Family, friends, and close business associates have been some of the key sources of finance. They have played a vital role in ensuring entrepreneurs are able to launch their business and even sustain them. This is the primary source of capital in Kenya and most developing countries (Mwarari, 2013). The range of capital raising options from family and friends stretches from the founders of a business tapping their own credit worthiness or resources (savings, home equity, or credit cards).depending with one's occupation the amount of saving may differ as well as their credit worthiness when it comes to sourcing from financial institutions to relatives or trusted business associate aiding with the needed seed money to launch the enterprise. Generally, this type of financing tends to be for lower financial value since it is usually taken in form of equity or part ownership rather than a debt due to uncertainty of success of the business.

Secondly, the sources of capital that a small entrepreneur may prefer in the business world are the large number of private financial sources spread cross the economy. These include venture-capitals (VCs), angels or white knights e.g. Shark Tank, investment banker, and other types of private investors available. Private financing opportunities come in arrange of forms, shapes and sizes, yet tend to drift towards a common set of objectives: which is that the dollar size of the financial commitment is generally much larger, these groups tend to be more risk-based capital sources seeking higher returns from equity driven investments. (Tracy and Tracy, 2007)

Thirdly debt capital sources are the most sort after e.g., leasing companies, banks, governmental programs (microfinance in Kenyan context), factoring companies and asset-based lenders. For every debt-based need, some form of financing is available in the lending market. These entrepreneurs, similar to private investors, tend to have a common set of objectives when extending financing capital in the form of debt. The main characteristic is security of some sort: personal guarantee or an asset for example must be present. Debt providers usually look for somewhat stable business environments where a firm has been in business for quite an extended period of time and has a debt worthy track record. (Tracy and Tracy, 2007)

## 1.2 Statement of the Research Problem

The different factors influencing sources of capital between MSME'S, Study shows this difference is due to information acquired, perceived risk, demographic factors such as, income level, age, gender, marital status, occupation, religion and transaction costs. Banks, like all enterprises, incur costs to do business. They incur costs to assess credit, process and monitor loans, implement and maintain technology, put up branches, as well as costs for capital provided. MSME's loans are high-cost lending transactions because they are significantly small, compared to loans to corporations. Adding to the problem, MSME's loans are often more time consuming to assess, monitor and manage. Beck, Demiguc-Kunt and Peria (2008). During economic difficulty, MSME’s tend to experience bankruptcies more than corporations because they have fewer resources to cushion them. MSME's also tend to have weaker management skills to anticipate and respond to adversity. The greater probability of defaults by MSME’s is another reason for bank reluctance to loan to this sector. World Bank Study by Beck (2007). Many bankers perceive that small businesses require much more advisory support and hand holding than mid-market or large corporate clients. Beck, Demiguc-Kunt and Peria (2008).

Karanja, Mwangi and Nyakarimi (2014) did a study to determine factors influencing access to credit services by women entrepreneurs in Kenya. Since they focused mainly on the supply side factors; thus their study failed to cover the demand side factors that influence the choice of source of capital. Machira, Njati, Thiane and Huka (2014) on the other hand did a study on the accessibility of Women Enterprise Fund among small and micro women enterprises owners in Kenya. This study focused on the demographical characteristics and technical skills factors influencing access to the fund by women entrepreneurs. Wangai and Omboi (2011) also did a study on factors influencing demand for credit among small scale investors. Their study limited itself to the individual characteristics of the borrower and their influence towards access to credit facilities. Thus these studies tend to fail to capture the influence of the holistic environment in which the borrower operates in and its effect in the choice of source of funding.

Therefore this study is relevant in Kenya since MSME's are a key component of the economy throughout the world. In Kenya, MSME"s have the potential to contribute significantly to economic growth and poverty reduction through increased production and employment Mwarari (2013). This role has long been recognized by the Government of Kenya.Vision2030, Kenya's long-term development plan, places a strong emphasis in the sector. One of the pillars in vision 2030 that was defined to spur growth of SME's is financial pillar that led the government to set up a youth fund for youthful entrepreneurs between the ages of 18-35. However according to Youth entrepreneurship Report of 2009 by Mars Group the total government allocation stood at Ksh 2.4billion but the up take by the youthful entrepreneurs stood at Ksh 1.5billion.

According to HongboDuan, Xiaojie&Hongbo (2009) MSME's face many constraints, the lack of appropriate financial products and services in variably appears in surveys and analysis as one of the leading hurdles to realizing growth. Therefore this study seeks to establish factors influencing the choice of source of capital in MSME'S.

### 1.3 General objective of the study

The general objective of the study was to establish the factors influencing the choice of source of capital in MSME'S.

### 1.4 The specific objectives of the study

The study is based on following objectives

1. To establish whether information acquired will influence choice of source of capital

2. To determine whether perceived risk influence choice of source of capital.

3. To establish if transaction cost influence choice of source of capital.

4. To determine whether demographic factors influence choice of source of capital

### 1.5 Research Questions

The research questions are used as a guideline to the research work

1. Does information acquired by MSME'S influence the choice of source of capital?

2. Does risk influence choice of source of capital?

3. Does transactional cost influence choice of source of capital?

4. Does demographic factors influence the choice of source of capital?

### 1.6 Significance of the study

The finding of this study will benefit entrepreneurs who want to venture in business by starting their own enterprises, financial institutions that offer loans to MSME'S, financial researchers and academicians.

#### 1.6.1 Entrepreneurs

Current and prospective investors in business will be able to understand better all the different components and factors that influence the choice in the source of capital for MSME'S, how this factors impact the enterprise's value, profits and the consequences of different financial choices.

#### 1.6.2 Financial institutions

Lenders will have a chance to understand the consequences of different financial choices enforced by the firms, how the raise and lower transaction cost, how the financial information is shared among the institutions and the borrower and finally how the can improve on lender borrower relations

#### 1.6.2 Financial researcher and Academicians

Access to finance by MSME'S is a wide topic where quite a number of studies have been done yet, there is no empirical evidence that has been exhaustively covered and that all options that relate to it have been researched and reviewed. The research focused on the demand side of finance thus other researchers may focus on the supply side factors influencing access to finance by MSME's. This would shed light on the extent of information acquisition experienced, risk mitigation strategies employed when lending to MSME's. This would also explain why transactional cost is the most significant variable among the factors influencing access to finance by MSME's.

### 1.7 Scope of the Study

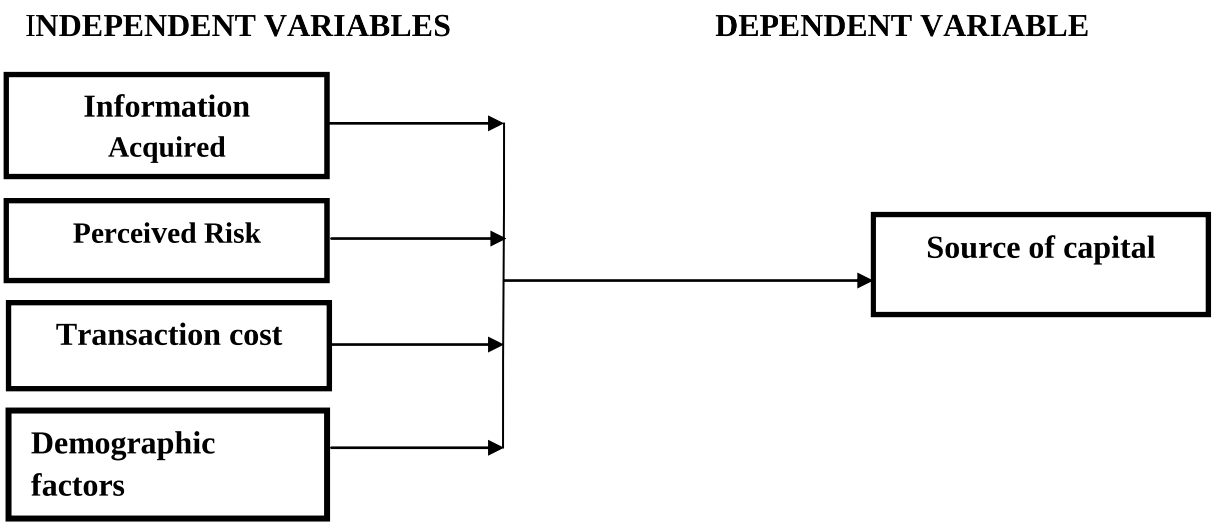
The study focused on MSEs in Roysambu in Nairobi County, Kenya. The primary focus been factors influencing the choice of source of capital during the period of 2016

### 1.8 Conceptual Framework

The conceptual frame work model below shows the various factors that impede access to finance, both the dependent and the independent variables. These factors need to be addressed exhaustively for MSME's to access finance.

The independent variables are information acquired, perceived risk, demographic factors and transaction cost. This is a major obstacle to MSME's access to capital since they create and denote the business environment that the SME's have to thrive in. lack of adequate information on to various sources of finance and their consequence to the firm, risk factor whereby we see some MSME's at times servicing more than one loan, demographic factors such discrimination of women and youth, discrimination by the lenders in terms of age, income levels religion i.e. Islamic banking and the transaction cost of doing business inevitably depict the source of capital the enterprise will desire (dependent variable).

**Figure 1Conceptual Framework**




**Source: researcher (2016)**

# CHAPTER TWO

## 2 LITERATURE REVIEW

### 2.1 INRODUCTION

This chapter presents a review of theoretical and empirical literature from various scholars on various factors influencing the choice of source of capital in micro, small and medium-size enterprises. In the literature review, researchers provide their views and research outcomes on the four factors that I am studying. This section situates its arguments on credit rationing theory, market failure theory and information acquired theory.

### 2.2.0 Credit Rationing Theory

According to Keiding (2013) the financial institutions are mostly private entities which are guided by profit maximization objective. Contrary to this objective not all individuals who apply for financing are granted access. Thus the market for credits is not balanced through the price mechanism. Individuals may be denied credits even if they are willing to pay arbitrarily high interest rates. De Meza and Webb (1987) states that the credit market is not like the normal market where demand is equivalent to supply as the borrowers who are willing to pay higher interest rates may find it difficult when it comes to repayments.

Credit rationing is defined as a situation in which there is an excess demand for commercial loans at the prevailing commercial loan rate (Stiglitz and Weiss 1981, and Modigliani, 1969). They further identify two types of credit rationing: 1. *Pure credit rationing:* Occurs when some individual's gets loan while at the same time identical individuals with the same characteristics do not get. The identical individuals are vying at the same credit and non-credit terms; 2. *Redlining: A* situation that occurs when an identifiable group of individuals cannot access a given supply of credit at whichever rate of interest unless the credit supply is increased.

The scenario arises due to the fact according to Hodgman (1960), the borrower would be unable to repay the loan due to the increased interest rates. That is the cost of borrowing would turn out to be higher than the return on investment. Due to the cost of the loan the lender may desist from lending to a borrower who demands credit when the interest rates are higher. With time this view was abandoned when Weiss and Stiglitz developed a better explanation where they related credit rationing to the information acquired that exists within the actors in the financial markets.

According to Stiglitz and Weiss (1981) theory credit rationing arises when the financial institutions realize their expected returns are below their expectations. The non -monotonic relationship between the expected returns and interest rates arises due to the following factors or reasons:

The adverse selection effect; occurs when the interest rates is not able to screen the capable borrowers from the rest. That is the borrowers who are able to evaluate their projects and stay within safer projects parameters Hodgman (1960). The borrowers with safer projects are supposed to drop out of the market when the interest rates rise beyond the expected returns. The financial institution considers the applicants going for higher interest rates more risky. The adverse incentive (moral hazard) effect Stiglitz and Weiss (1981) argue that an increase in interest rate shifts the choice of the borrowers towards riskier projects which again puts the financial institutions expected returns at risk or higher probability of bad debts portfolio.

Credit rationing is sometimes done deliberately to cushion the financial institutions on foreseeable risks. In instances that the institutions cannot be able to mitigate risks that may arise due to the free market principles being followed the institutions may decide to ration credit however much the borrowers who demand funds are willing to pay higher interest rates. It is an example of market imperfection, or market failure, as the price mechanism fails to bring about equilibrium in the market De Meza and Webb (1987). The imperfection refers to the absence of equilibrium in spite of willing borrowers. In other words, at the prevailing market interest rate, demand exceeds supply, but lenders are not willing to either loan more funds, or raise the interest rate charged, as they are already maximizing profits. Thus creating a link to the information asymmetry, that tends to exist between the lender and the borrower. This theory tends to explain the financing gap that may exist within the finance market Stiglitz and Weiss (1981).

### 2.2.1 Market failure theory

The proper role of banks and microfinance institutions as a starting point for the analysis of MSME's financing should be approached in light of establishing their limiting factors. The following theory justifies the reason behind the inefficient supply of finances to MSME's in the market. According to private market efficiency theory as discussed by Mendes (2004) points that under certain circumstances private markets will allocate goods and services among individuals efficiently in the sense that no waste occurs and that individual tastes are matching with the economy's productive abilities. The hue and cry of MSME's seems to point to failure of MSME's in meeting all the requirements as the policy of lending in financial institutions stipulates. Banks and Sacco's most of them being private entity's do try and are able to provide efficient outcomes and if the MSME's were providing the right atmosphere, then there would be little or no scope of lack of finances. In many cases, however, conditions for private market efficiency are violated from the demand side through factors like information acquired and transmitted, lack of clear risk management policy among others Galaz V (2004).Competitive markets allocate resources efficiently. For financier (debt and equity providers) to play a legitimate role the ideal conditions must be present and efficiency must be the most important criterion for directing resource allocation. 'Market failure' occurs therefore when financial service providers in the markets do not allocate goods or services efficiently. The existence of market failure provides an efficiency-based rationale for concluding that MSME's are being limited in access to finance mirowski, P. (2007).

### 2.2.2 Information Acquired Theory

This theory was first introduced by Akerlof's in 1970. His argument was that in many markets the seller uses some market statistics to measure the value of the goods he is selling. In this scenario of the credit market the buyer sees the average prices of the loans (credit) in the market he is intending to buy while the seller has more intimate knowledge of each specific loan product. According to Akerlof (1970) this puts the seller at a more advantage thus able to sell goods of less than average market quality. In such circumstances the limitation of the information available to the buyer may lead to the seller offering less than average quality of goods in the markets which eventually leads to reduction in size of the market.

Information acquired theory assumes that at least one party to a transaction has relevant information whereas the other(s) do not. Some acquired information models can also be used in situations where at least one party can enforce, or effectively retaliate for breaches of, certain parts of an agreement whereas the other(s) cannot. Spence & Stiglitz (2001) demonstrated that market may break down completely in the presence of circulating information and the three distinct consequences emerging, adverse selection, moral hazard, & monitoring cost.

Information acquired has been found to increase the transaction costs. In a research conducted by Jensen and Thursbay (2001) they found that a licensee of a technology or invention sometimes incurs more cost in a bid to transfer technology from the inventor. This arises due to the fact that the inventor may retain valuable information pertinent to the invention but not contained in the patent or contract document. In the entrepreneurship perspective where there are instances of information acquired both the financial institution and the entrepreneur may turn to several methods to bridge this gap. The entrepreneur according to Leland and Pyle (1977) may decide to invest or to put her personal finance in the business. This is referred to as signaling or a show of commitment on the part of the entrepreneur that the business he or she wants to be funded by the financial institution is a going concern and she is in it for long term. In other instances the financial institution may go for co-financing. On the other hand the finance institutions have been resorting to offering financial guarantees, information brochures, branding their credit facilities all this is geared towards reducing the information acquired.

To further reduce the information gap between the seller and the buyer both of the parties can resort to evaluating product qualities on their own dimensions. According to Stigler (1961) products have search, experience and credence qualities which customers can use in determining whether to purchase the products. Also the sellers can build some indicators surrounding these qualities to guide the customers in their search. Stigler offers an exposition on the three qualities stating that search qualities are those characteristics that can be used to evaluate a product before purchase, experience are those characteristics that can be used only after purchase and credence is hard to evaluate even after experiencing the product. This third quality needs more than constant promotion and organizational image to maintain within the customers mind. Through this discourse we can infer that Stigler implies that repeat customers are easier to serve and are more preferred than first time buyers. This may be the reason why financial institutions prefer repeat customers.

Financial institutions are called upon to identify credence indicators that are identifiable by their customers to facilitate the evaluation mechanism by interested entrepreneurs searching for finance. Richheld & Sasser (1990) show that the reason why financial institutions prefer repeat customers is due to less cost involved in transacting business with them. The information gap between the institution and the customer has drastically reduced due to the attribute of experience. He continues to impute that firms should develop capabilities and resources within the firm that are contingent on the service qualities they are providing.

The three results of the acquired information syndrome on the financial or more precisely the credit market are best reflected in the sourcing of external funds by the SME's. The transaction between the borrowers offers the best example's to study their practical implications. Most MSME's have to inevitably take recourse to the external source of financing for them to meet their objectives. The borrowed funds come with some conditions, which have to be met by parties to these transactions. Both the parties to this financial transaction have to exchange the relevant information between each other. Do, both the parties pass on the information acquired is a hard question. It is proved by several examples in the domestic and the global finance that circulation information is theoretical and whereas acquired information is a reality.

The reviews of literature of demographic factor variables that have been found to have stable relationship with factors affecting choice of source of capital are age, gender and education and income levels, this factor affected firms growth by affecting employee turnover and retention Schroder (2008). Depending with once age gap the study found that different sources of capital were available for example the Kenyan government has established a youth fund for Kenyans aged 25-35. Banks and other financial institutions prefer age group above 35 since they are assumed to be more stable economically and career oriented.

Crawly (2005) , Gender also limited the source of capital that one was entitled to the study found out that women had more sources of capital compared to men, Torrington et al., 2005), women had Sacco's and institutions that were tailored to their financial needs while men had no such institutions. education and income levels mostly coincided to the knowledge of the different sources off capital while at times income levels mattered most on the amount one acquired from sources such as banks, the higher the income level the better the credit worthiness of entrepreneurs

## 2.2 Empirical Review

Access to external sources of finance may increase growth possibilities since it facilitates the development and improvement of firm's products and services or hire new employees. In transition economies, the development that financial markets experience may create barriers linked to the access to finance. Hence, academic research considers financial constraints as an important obstacle for entrepreneurship and firm growth. Empirical evidence supporting factors influencing choice of source of capital for business growth can be found in Brown, Earlem & Lup,(2005), who examines firm growth determinants. Conversely, Johnson, McMillan and Woodruff (2000) evaluate institutional reforms in five Eastern European countries (including Romania), and they conclude that access to bank finance does not prevent business growth.

Matavire et al., (2013), in their study on challenges facing MSMEs in accessing finance from financial institutions: The case of Belaway, Zimbabwe found out that MSMEs fail to secure loans because of restrictive requirements of the financial institutions, top among them being collateral security. Among their recommendations is that the government should play its role of enabling SMEs to obtain finance from financial institutions. Makena, et al., (2014), in their study on challenges facing women entrepreneurs in accessing business finance in Kenya: Case of Ruiru Township, Kiambu County, lack of collateral was one of the objectives. However, the study found out that lack of collateral was a greater hindrance to credit accessibility by women entrepreneurs. This is due to lack of tangible assets like land, which are used as assets to secure credits. Among their recommendations is that the government should play its role of enabling SMEs to obtain finance from financial institutions.

Gitari, (2012) in her study on factors affecting women entrepreneurs' financial performance in Kenya: a case of Ngara Market found out that lack of information on who is offering what and the cost of obtaining such services limit them and that high inventory costing are some of the major drawbacks for success in women entrepreneurship. The high cost of running the entrepreneurs is a big threat to the women development due to lack of adequate capital and on the other hand lack of information on how to access funds to boost the business also is a major threat. Ntakobajira, (2013), did a study on factors affecting the performance of MSE's traders at City Park hawkers market in Nairobi County, Kenya. The study concluded that access to finance affected performance of MSEs to a great extent because it limited the entrepreneurs' ability to take advantage of opportunity as and when they arose.

Another study was done which sought to identify critical factors that influence access to bank credit by MSEs. The study indicated that entrepreneurial orientation is a direct determinant of access to credit by MSEs. Further, knowledge-based resources gained from maturation (age), training, previous startup experience and vicariously through entrepreneurial parents were found to be associated with greater levels of entrepreneurial orientation. Overall, these findings support the literature that underscores the primacy of entrepreneurial factors, over operating environment in facilitating small enterprises' access to bank credit (Wagema, 2006). Nalyanya, (2012) in his study on investigation into factors affecting the performance of small scale enterprises in ASAL areas Hola Town – Tana River District, recommended that the government could consider giving cheap loans to small scale enterprises without collaterals.

Although most studies indicated that there were problems relating to cost of credit, availability of information on finance, collateral requirements and business risks, there have been few studies that have dealt with all in combination. For instance, Gitari, (2012) found in her study on factors affecting women entrepreneurs' financial performance in Kenya: a case of Ngara Market that lack of information on who is offering what and the cost of obtaining such services limit them and that high inventory costing are some of the major drawbacks for success in women entrepreneurship. She however did not study the effect of cost of credit and collateral provision on accessibility of credit facilities.

Mira and Ogollah, (2013) in their study on challenges facing accessibility of credit facilities among women owned enterprises in Nairobi Central Business in Kenya concluded that lack of information accessibility, insufficient skill and knowledge level, lack of collaterals required and socio-cultural roles had a strong and negative influence towards the accessibility of finance. However, they did not look at the effect of cost of credit on accessibility of credit facilities. This study therefore sought to find out how trans action cost, availability of information on finance and the perceived risks affect the choice of source of capital by MSE's.

### 2.3 Research Gaps

A lot of research has been carried out locally and internationally reviewing challenges facing micro and small enterprises in accessing credit facilities. Most of these researches concentrated on their study areas based on their own objectives. The literature available does not concern itself on factors affecting the choice of source of capital, cost of credit, and availability of information on finance, demographic factors and business or perceived risks in one combination. Therefore, the study sought to address the factors influencing the choice of source of capital for MSME'S in Roysambu Nairobi County, Kenya.

### 2.4 Summary

The independent variables are information acquired perceived risk cost of transaction, and the demographic factors. The dependent variable was factors influencing access to capital by micro and small entrepreneurs in Roysambu Nairobi County, Kenya. The theories credit rationing theory, market failure theory and information acquired theory

# CHAPTER THREE

## 3.0 RESEARCH METHODOLOGY

### 3.1 Introduction

This chapter presents the methodology, which will be used to carry out the study. It contains the study design, the target population, sampling design, data collection procedures or instruments that were used to discuss the qualitative data and finally it discusses the expected output

### 3.2 Study design

The study adopted a descriptive survey design to describe the factors influencing choice of source of capital in MSM'S. Quantitative design involves of numerical data collected and on the other hand descriptive research and design uses techniques of mean, median, maximum, minimum, standard deviation, skewness and kurtosis (C.R Kothari, 2007). Each independent variable was manipulated at a time and related to the dependent variable.

### 3.3 Target population

A Population refers to a group of individuals or items that share one or more characteristics from which data can be gathered and analyzed (C.R Kathari 2007). The target population was 2000 in Roysambu. Out of this target population those that had consistently operated for more than five years and had sourced for capital either as a startup or in the same period were found to be 400.

### 3.4 Sampling design

According to Mugenda & Mugenda (1999), Gay (2002) and Creswell (2003), do suggest that 10% of the population is enough to be used as a sample when the population is big. Thus forty of the total population of MSME's who had consistently operated for more than five years were randomly sampled and subjected to this study.

### 3.5 Data collection procedures or instruments used

During the initial preparations of the study the reliability and validity of the research instrument were tested. The initial group consisted of 40 individuals with the same characteristics as the sample. In this study the secondary data in which each answer to each questions were aggregated to form an overall score were used. While validity was tested through the use of content analysis. A self-completion questionnaire with closed ended questions was developed and administered to the respondents through email and others through handing out of questionnaires.

### 3.6 Data presentation and analysis

Quantitative data collected was analyzed by the use of inferential statistics and presented through percentages and frequencies. The information was displayed by use of bar charts and in prose-form. The study targeted a sample size of 40 respondents from which 32 filled in and returned the questionnaires, either through email or through physical basis making a response rate of 80%, this response rate was satisfactory to make conclusions for the study as Cooper and Schindler (2003), states that a response rate of between 30 to 80% of the total sample size can be used to represent the opinion of the entire population, so as to establish the factors influencing the choice of source of capital by MSME's.

### 3.7 Model specification

The variables in the study were classified into dependent and independent variables the dependent variable is the source of capital while factors are information acquired, perceived risk, transaction cost as the independent variables.

## CHAPTER FOUR

## 4.0 DATA ANALYSIS, FINDINGS & DISCUSSION

### 4.1 Introduction

This chapter presents the results of the analysis of the data collected during the study. This chapter has been presented in three sections, that is, section one covered respondent's background information, section two dealt with key factors influencing the choice of source of capital for MSME'S and qualitative analysis.

### 4.2 Characteristics of Respondents

The characteristics of respondents are important in that they will help the researcher obtain basic information regarding the SMEs in Roysambu County; it will also give information on type of business, whether itssole proprietor, partnership of Limited company as well as the size of the organization based on the number of employees both full time and part time. These are SMEs who carries different types of trade and offer services in the locality.

### 4.3 Response Rate

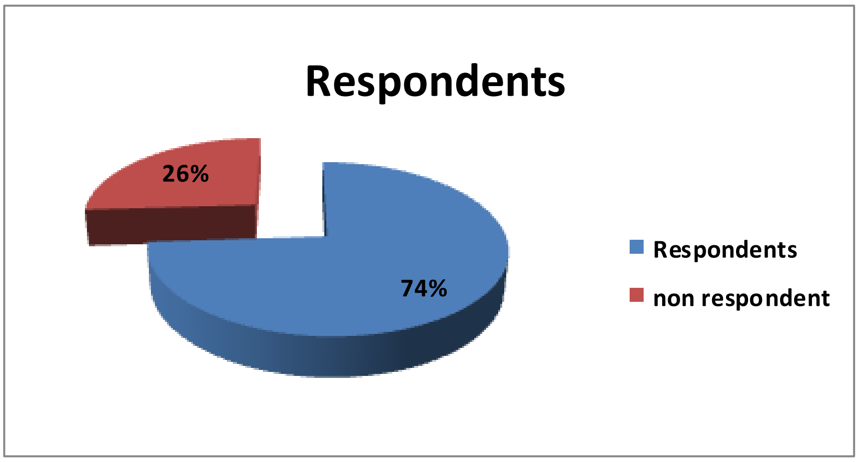
The response rate is important in that it shows the number of owners or managers who responded on the questionnaire that was given. It helps the researcher to determine if the number of respondents was enough to form an opinion. The higher the number of respondents the reliable the information obtained and the researcher received 32questionnaires out of 40 which were administered and represents 80% response rate as shown in the figure below. From the data obtained it shows that 80% of the sample responded which is deemed as a true representation of the total population and would enable the researcher to draw conclusion. This high response was a result of the fact that the researcher gave questionnaire to the respondents which were picked later therefore giving enough time and also giving explanation to those who faced difficulties in answering the questions.

**Table 1; Response rate**

| Response rate | Frequency | percentage |
|---|---|---|
| Response | 32 | 74 |
| None response | 8 | 26 |
| Total | 40 | 100 |

**Source author (2016)**

**Figure 2; Response rate**




**Source author (2016)**

### 4.3 Type of business organization

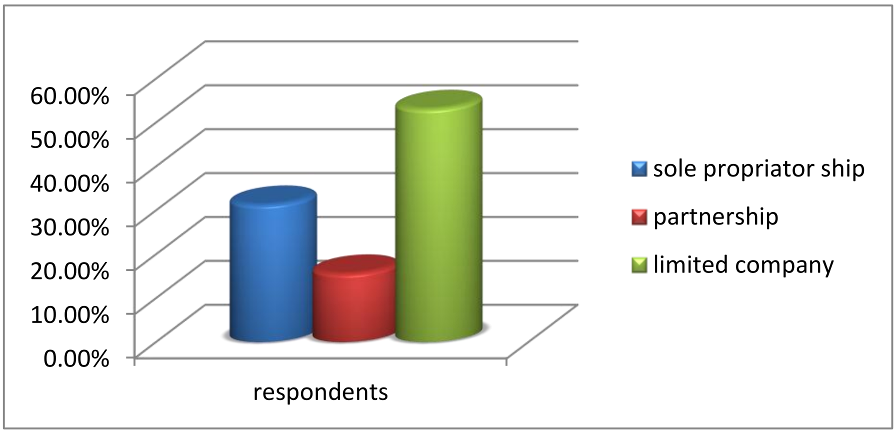
The type of business is clearly defined based on its legal registration status in that there is sole proprietor where the owner operates and has registered the business as sole owner, partnership where they own business jointly maybe with a friend or spouse and limited company that have several owners each having a certain percentage of ownership. It's a well-known fact that most of SMEs in this locality have been passed through generations, other than for few business owners who have relocated from other parts to set up business in the area especially after the improvement of infrastructure and drastic change in population growth. Data obtained on type of business is shown below on table below

**Table 2Distribution by Type of business**

| | Frequency | Percent | Cumulative Percent |
|---|---|---|---|
| **Sole proprietor** | **10** | **31.3** | **31.3** |
| **Partnership** | **5** | **15.6** | **46.9** |
| **Limited company** | **17** | **53.1** | **100.0** |
| **Total** | **32** | **100.0** | |

**Source author (2016)**

**Figure 3; Distribution by Type of business**



Out of the 32respondents, I came to the conclusion that the firms under the study were registered as sole proprietor (10), partnership (5) or limited company (17). More specific 53.1% of the respondents companies were limited companies, 31.3% operated as sole proprietors and the rest 15.6% were partnerships. The results shows that the business are registered as limited company, this is mainly because limited companies have perpetual life, and makes it easy to raise additional capital from the directors/owners, the legal status of limited companies also enable get special consideration like tenders, credit facilities since there separation of ownership between the company and business. Succession also plays part in that most businesses owner incorporates their children to ensure continuity.

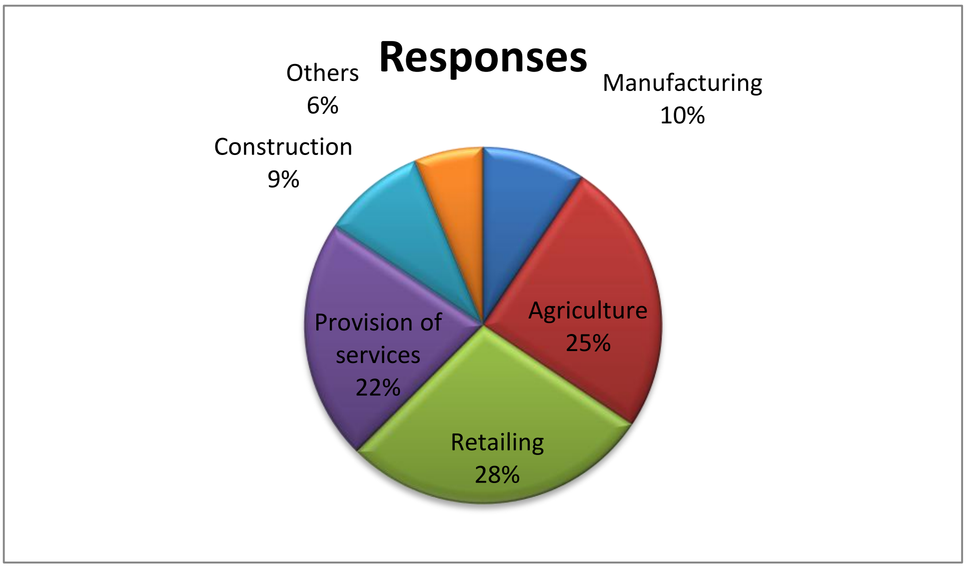
Industrial distribution, table 3 shows that SMEs cover a wide range of business, respectively distributed in industry of construction, manufacturing, industrial, agriculture, service and others, accounting for 68.7%, 9.9%, 20.2%, 1.12% of the sample, among which construction, manufacturing, industrial sector dominates other sectors.

**Table 3; Industrial distribution**

| Business type | Responses | Percentage |
|---|---|---|
| **Manufacturing** | **3** | **9%** |
| **Agriculture** | **8** | **25%** |
| **Retailing** | **9** | **28%** |
| **Provision of services** | **7** | **22%** |
| **Construction** | **3** | **9%** |
| **Others** | **2** | **6%** |

**Source author (2016)**

**Figure 4; Industrial distribution**

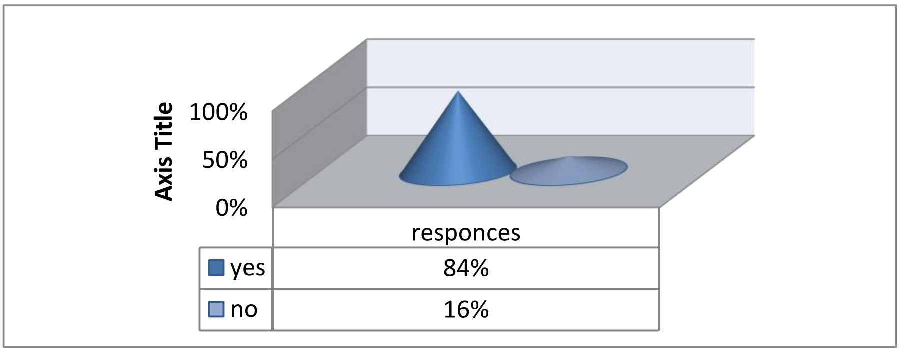



**Source author (2016)**

**4.4; Sources of funds to finance business**

The respondents were asked to state whether they have ever borrowed funds to finance their business from any financial institution. The question was intended to establish how most of the SMEs finance their operation and expansion as they outgrow the owner's capital and whether they know about any other sources of finance. Though it's well known that most of the SMEs have bank accounts the researcher wanted to establish if the SMEs borrow from the Banks since it gives indication on whether they obtained the loan applied for, or not and their opinion on the process. The results are as shown in figure3 below

**Figure 5; Have you borrowed funds to finance your business from any financial institution?**




**Source author (2016)**

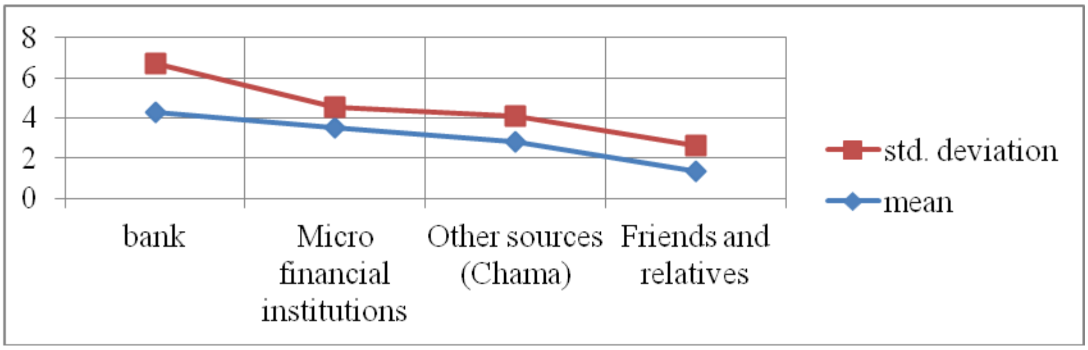
As shown in figure 3, most of the respondents (84%) indicated that they had borrowed funds from financial institutions to finance their business while as little as (15%) had not borrowed funds from any financial institutions. This shows that majority of SMEs relied on funds from financial institutions to finance their operations and hence has borrowed at one time to finance their operations. Most of these SMEs had earlier indicated that they prefer borrowing from financial institutions despite the challenges they face.

**Table 4; preferred sources of finance**

| Preferred source of finance | Mean | Std. Deviation |
|---|---|---|
| **Bank** | **4.1562** | **1.19432** |
| **Micro financial institutions** | **3.5200** | **1.01982** |
| **Other sources (Chama)** | **2.8112** | **1.25147** |
| **Friends and relatives** | **1.3750** | **1.26364** |

**Source (Author 2016)**

**Figure 6; preferred sources of finance**




**Source author (2016)**

The study found that respondents to a large extent; prefer to source for funds from banks (mean of 4.1562) and micro finance institutions (mean of 3.5200). On a moderate rate, the SMEs source finance from Chama's and only on rear occasions do they get funds from friends and relatives to finance their business operations. The results from the questionnaire shows that most of the SMEs prefer to source finance from Bank's despite the conditions imposed, this is because they have confidence with the Bank's since they can be able to get finance in the  future once they establish strong relationship. The other reason is because the SMEs trust banks more than other sources of finance due to their reliability.

## 4.5. Effect of Information Availability on Choice of Source of Entrepreneurial Finance.

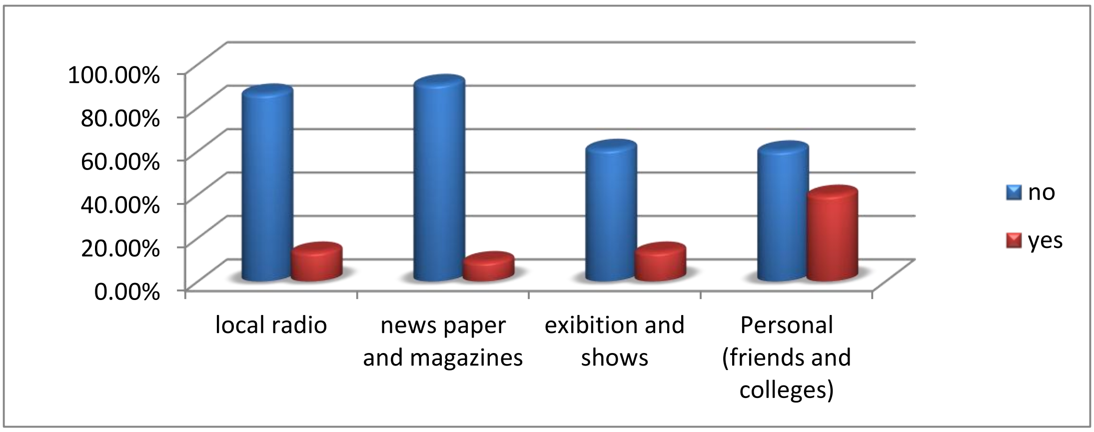
The majority of the respondents did not view local radio stations as a source of information on potential sources of entrepreneurial finance. An equally large percentage of respondents unanimously opinioned that newspapers and magazines were not a source of information. Most of the respondents (60.90%) did not view local exhibitions and shows as sources of information. A significant smaller number (39.10%) did not share this opinion. A majority (60.20%) did not consult friends and colleagues for information on potential sources of entrepreneurial finance. A significant number however, did consult from those around them.

Table 5; selected sources as information sources

| Sources of Information Availability | No | Yes |
|---|---|---|
| Personal enquiries | 60.20% | 39.80% |
| exhibitions & shows | 60.90% | 39.10% |
| Radio stations | 86.40% | 13.60% |
| Newspapers/ magazines & journals | 90.80% | 9.20% |

Source author (2016)

Figure 7; selected sources as information sources



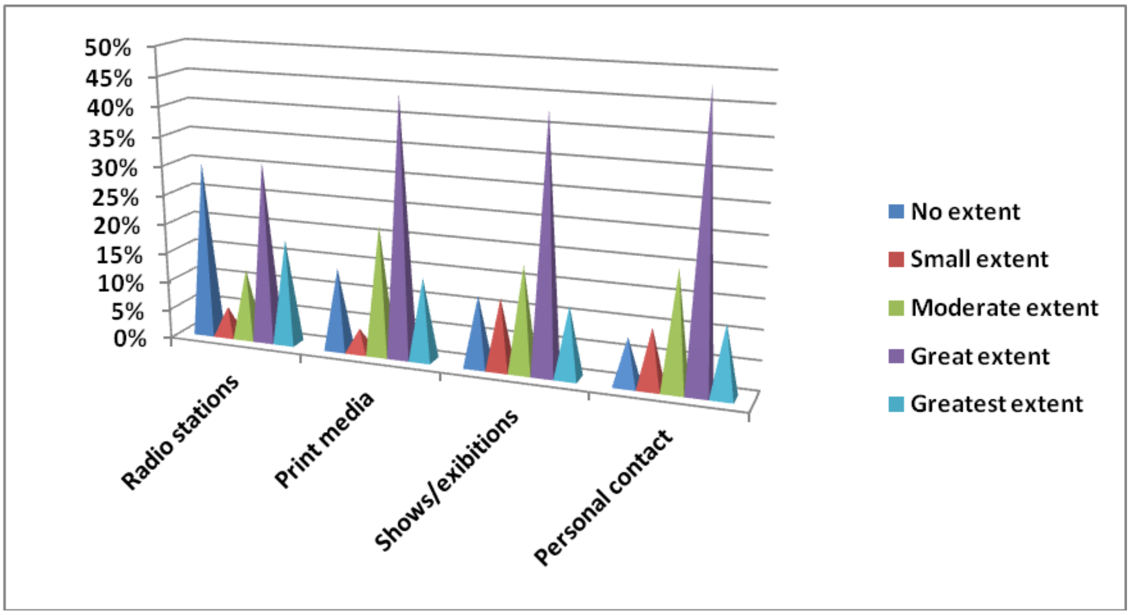

Source author (2016)

**Table 6; Influence of Information on Sources on Choice of Source of Finances**

| | No extent | Small extent | Moderate extent | Great extent | Greatest extent |
|---|---|---|---|---|---|
| **Radio stations** | **30%** | **5%** | **12%** | **31%** | **18%** |
| **Print media** | **14 %** | **4%** | **22%** | **44%** | **14%** |
| **Shows/exhibitions** | **12%** | **12%** | **18%** | **43%** | **12%** |
| **Personal contact** | **8%** | **10%** | **20%** | **48%** | **12%** |

**Source author (2016)**

**Figure 8**Influence of Information on Sources on Choice of Source of Finances




**Source author (2016)**

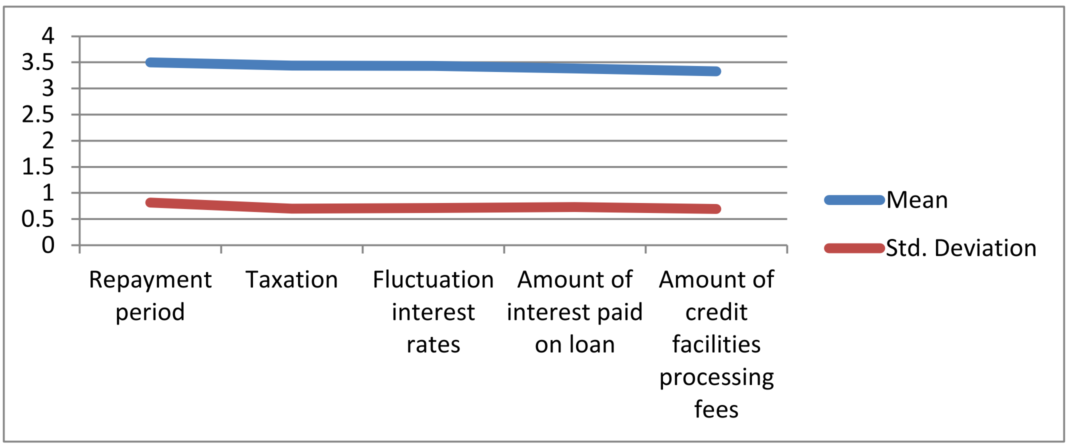
Among those who responded, the situation was tied between those who rated radio as not influencing choice of source of finance at all, and those who rated radio as influencing finance to a great extent. Majority of the respondents rated the print media as influencing choice of source of finance to a great extent followed by those who rated these media to a moderate extent. Exhibitions and shows largely influenced choice of source of entrepreneurial finance to a great extent. Personal contacts mostly influenced choice of source of entrepreneurial finance to a great extent with a significant number also influencing issues to a moderate extent.

**Table 7; Cost of transaction**

| Factors under consideration | Mean | Std. Deviation |
|---|---|---|
| **Repayment period** | **3.5** | **0.817** |
| **Taxation** | **3.44** | **0.697** |
| **Fluctuation interest rates** | **3.43** | **0.713** |
| **Amount of interest paid on loan** | **3.38** | **0.731** |
| **Amount of credit facilities processing fees** | **3.33** | **0.692** |

**Source author (2016)**

**Figure 9; Cost of transaction**




**Source author (2016)**

On the extent to which cost of credit influenced access to credit, the study found out that repayment period influenced access to credit to a great extent (*M*= 3.50, *SD*= 0.817) followed by taxation at a moderate extent (*M*= 3.44, *SD*= 0.697) and then fluctuation of interest rates also at a moderate extent (*M*= 3.43, *SD*= 0.713). Amount of interest paid on loan had an influence to a moderate extent (*M*= 3.38, *SD*= 0.731) while the amount of credit facilities processing fees also influenced access to credit facility to a moderate extent (*M*= 3.35, *SD*= 0.692). The results are as shown in Table 5.

### 4.6 Perceived Risks

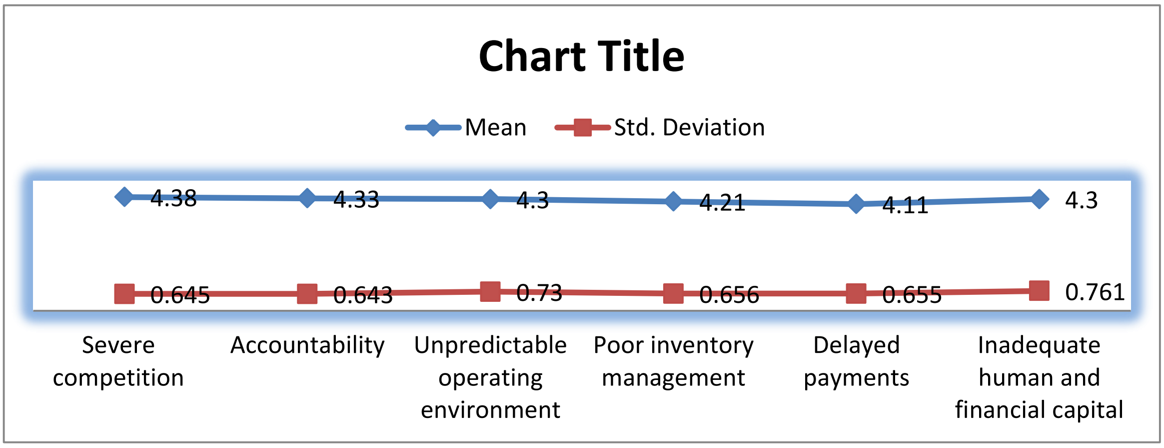
In regard to the extent to which perceived risks influenced access to credit facilities by the micro and small enterprises, the study established that perceived risk had an influence to a great extent (*M*= 4.20, *SD*= 0.689). The risk of severe competition influenced access to credit to a great extent (*M*= 4.38, *SD*= 0.645) while the risk of accountability had an influence to a great extent (*M*= 4.33, *SD*= 0.730). The factor with the least influence was the risk of inadequate human and financial capital which influenced access to credit also to a great extent. The results of the study are as shown in Table 6. These findings are supported by Green (2003), who argued that commercial banks tend to impute a high risk to small enterprises and are therefore reluctant to extend credit to them especially due to their small size and inherent vulnerability to market fluctuations and the mortality rates of small enterprises.

**Table 8; Perceived Risks**

| Factors Under Consideration | Mean | Std. Deviation |
|---|---|---|
| Severe competition | 4.38 | 0.645 |
| Accountability | 4.33 | 0.643 |
| Unpredictable operating environment | 4.30 | 0.730 |
| Poor inventory management | 4.21 | 0.656 |
| Delayed payments | 4.11 | 0.655 |
| Inadequate human and financial capital | 4.30 | 0.761 |

**Source author (2016)**

**Figure 10; Perceived Risks**



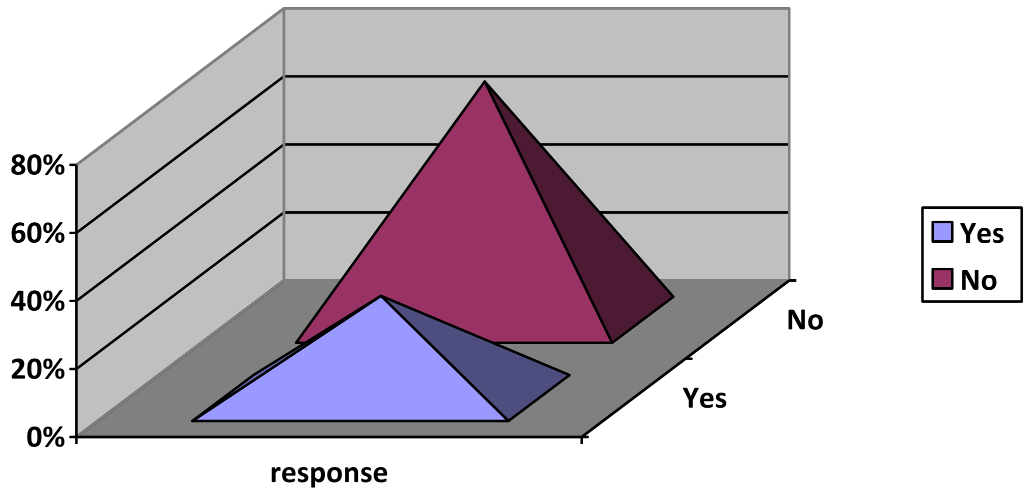

**Source author (2016)**

**Table 9; is three a relationship between demographic factors such as gender age an educational level attributed to the source of capital for MSME'S**

| | response |
|---|---|
| **Yes** | 30% |
| **No** | 70% |

**Source author (2016)**

**Figure 11; is three a relationship between demographic factors such as gender age an educational level attributed to the source of capital for MSME'S**




**Source author (2016)**

As shown in figure 11, most of the respondents (70%) indicated that they demographic factors played Avery insignificant role in most of their institutions to finance their business while as little as (30%) had found out that demographic factors played a key role when sourcing for funds from any financial institutions. This shows that majority of SMEs were owned by entrepreneur's who had little thus and most had started sourcing for capital at different age limits and lived at time where gender discrimination was minimal

## CHAPTER5

## 5.0 Summary, Conclusions and interpretations

### 5.1 Introduction

This chapter presents conclusions drawn from the research findings and the recommendations for practice, improvement and for further studies. The chapter also contains limitation of the study and areas for further research.

### 5.2 Summary

The general objective of the study was to establish the factors influencing the choice of source of capital in MSME'S. A field survey was conducted in which primary data were collected using a structured questionnaire. A total of 32 entrepreneurs from the various firms in Roysambu locality that had sourced for capital in a period not less than 5years were interviewed. The study used mainly descriptive statistics in the analysis. The results showed that most enterprises had not used credit before. Out of those who had, the majority had used informal sources. The major reasons for not seeking credit were lack of information about credit and high transaction cost. The use of specific credit sources, either formal or informal, was justified as the only source available. This may indicate the existence of only a limited range of options to choose from.

In both formal and informal markets, personal savings was the dominant source of finance, especially for initial capital, which may point to the inability of the financial markets to meet the existing credit demand and reinforces the argument that small-scale rural based enterprises do not have access to the financial resources of the formal financial sector. The research found that differences exist on the nature of information requested and availed to the financial institutions and information expected to and provided by the MSME's. This information acquired may be a contributing factor towards the amount of loan advanced by the financial institutions.

The researcher then concludes that information acquired though not a significant factor influences the choice of source of finance by MSME's.. Among the sources of information selected, the print media chosen showed that it was a good source of information, meaning that newspapers and magazines influenced the choice of source of financing. Perceived risk management is an important factor that influences loan accessibility by the MSME's. This research establishes that majority of the MSME's have high credit risk exposure due to them operating more than two loans. This raises their credit risk profile which the lenders may not be aware of. The research is consistent with the literature review that established that MSME's have poor credit risk mitigation measures.

Transactional cost has been established to be a significant predictor. This discrepancy or scenario may be constructed to the need of the financial institutions in cautioning themselves from lack of access of tangible information or records on business performance of MSME's. Also to shield themselves from the poor risk management policies and procedures by the MSME's they may have increased the transactional cost according to the amount of money borrowed. All of the three research questions were supported, which were information acquired, business risks and transactional costs. The transactional cost emerged to be the most critical factor or the most significant predictor. This shows the importance of demand side factors in determining the amount the financial institutions take into consideration when lending MSME's. It was found that there is a positive weak relationship between Educational level, gender and age as a significant variable when it comes to the choice of source of capital. This was because most of the respondents were either married and had ventured in business together, their level of education was not an issue either to the financial institutions or to other MMSE'S that they had come into contact with. Most of the respondents did not view age as anything else but a number.

## 5.3 Conclusion

There are many reasons that lead to SME's difficulty in borrowing from bank. Most theories imply that collateral, firm size, internal funds, willingness to accept bank's clauses, close relationship with bank have positive effect on SMEs' ability to get bank loan. As far as SMEs in Kenya are concerned, our this study finds that whether SMEs can provide collateral or guarantee is a decisive factor, factors such as information acquired between the MSME's and the various creditors is crucial for MSME'S to access capital, transaction cost affected the cost of credit by making the cost of debt costly and intern affected the perceived risk making it difficult for MSME's to access capital. Most of MSMEs are in growth phrase, with small or medium size, relating to choice of source of entrepreneurial finance are the same for all MSMEs regardless of their ability to obtain market information with regard to sources of capital. According to the findings, it is concluded that there is a relationship between demographic factors af a factor affecting the choice of sorce of capital for MSMEs. It is evidential that among the relationships, all relationships were positive though weak. Further it is needed to note that respondent sample was quite skewed in terms of gender since male respondents are higher in the sample.

## 5.4 Recommendations

In view of the above conclusions, the MSME's sampled in this study possess different requirements for them to access finance from financial institutions. The implication is that any attempt to improve access to finance by MSME's has to focus on these three variables. Overall it seems that information acquired affected the amount accessed by the borrowers. The following recommendation is made to address this factor.

The MSME's do need to change the mode of operations and how they manage information relevant for one to qualify for financing. This requires change on the way information is shared but also how it is utilized by the entrepreneurs. The information storage and exchange between the financial institutions and MSME's would create a high level of trust. The financial institutions should create a common platform for sharing information on the borrowers. This would minimize risks due to serial defaulters. Thus this study recommends that managers should take strong personal stands on the need for change on information collection storage and dissemination.

There is recognition of the need to train the MSME's on good business risk management practices. Thus the researcher does recommend for the MSME's to uphold the culture of record keeping coupled with simple bookkeeping to mitigate on the numerous business risks identified. This would in turn reduce the amount of time spent in processing the loan application and the number of contacts a borrower makes to the financial institution. This would in turn reduce the transaction cost of the loan. The financial institutions should be in the forefront in ensuring that the MSME's do adhere to the minimal requirements for a business to access a credit facility.

### 5.6 Area of further research

The research focused on the demand side of finance thus other researchers may focus on the supply side factors influencing access to finance by MSME's. This would inform us on the extent of information acquired, risk mitigation strategies employed when lending to MSME's. This would also shed light on why transactional cost is the most significant variable among the factors influencing access to finance by MSME's.

### 5.7 Recommendations

In order to improve SMEs' ability to borrow from bank, building mechanism to reduce information must be considered, the mechanism concerns factors outside of SMEs including multi-level bank system, guarantee and venture capital industry, etc. There is considerable amount of literature dealing with relationship between SMEs' financing and development of multi-level banks system, guarantee agency, venture capital. The literatures argue that multi-level bank system, developed guarantee and venture capital industry benefit SMEs to get loan bank. This study recommends that managers should take strong personal stands on the need for change on information collection storage and dissemination.

In fact, large enterprise-oriented bank systems (seeTable5), undeveloped guarantee and venture capital industry in Roysambu constitute important external factors that owe a lot to SMEs' inability to get bank loan. How the external factors affect SMEs' ability to get bank loan is our future research object.

The researcher does recommend for the MSME's to uphold the culture of record keeping coupled with simple bookkeeping to mitigate on the numerous business risks identified. This would in turn reduce the amount of time spent in processing the loan application and the number of contacts a borrower makes to the financial institution. This would in turn reduce the transaction cost of the loan. The financial institutions should be in the forefront in ensuring that the MSME's do adhere to the minimal requirements for a business to access a credit facility.

### 5.8 Limitations

This study is faced with the problem of generalizing the research findings to all the MSME's in Kenya. This is attributed to the diversity of environmental characteristics in the various regions in Kenya. Most of the data was collected from secondary sources and any error from and any error from the original source could not be avoided however all the data was from reliable sources only.

### 5.9 Further research

The research focused on the demand side of finance thus other researchers may focus on the supply side factors influencing access to finance by MSME's. This would inform us on the extent of information acquired experienced, risk mitigation strategies employed when lending to MSME's and other demographic factors. This would also shed light on why transactional cost is the most significant variable among the factors influencing access to finance by MSME's

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**Appendix1**

**QUESTIONNAIRE**

**FACTORS IFLUENSING THE CHOICE OF SORCE OF CAPITAL FOR MSME'S**

**Instructions*:***

*Kindly complete the following questionnaire using the instructions provided for each set of questions***.**

**Statement of Confidentiality:**

*The responses you provide will be strictly confidential. No reference will be made to any individual(s) or organization in the report of the study. The questionnaire is entirely for academic purposes.*

1. Select type of business:

- o Sole proprietorship
- o Partnership
- o Limited Liability Company

2. Kindly select the nature of business and specify the business carried out:

- o Manufacturing
- o agriculture
- o Retailing
- o Provision of services e.g. restaurant, security
- o Construction
- o Others

3. Have you borrowed funds to finance your business from any financial institution?

- o Yes

- No

4. Preferred sources of finance?

- Banks
- Microfinance
- Others (Chama’s)
- Friends and relatives

5. What was the significance of information available on choice of source of capital?

- Radio stations
- Newspapers and  magazine
- exhibitions and shows
- persona (friends and colleagues)

4. What is the influence of information on choice of source of capital?

- No extent
- Small extent
- Moderately
- Great extent

5. Which transaction cost influences most the choice of source of capital?

- Repayment period
- Taxation
- Fluctuating interest rate
- Amount of interest paid on  loan
- Amount of credit facilities processing fee

6. To what extent does perceived risk influences the choice of source of capital.

- Severe competition  poor inventory
- Accountability
- Poor inventory management
- Inadequate human and financial capital

7. Is three a relationship between demographic factors and choice of source of capital? (Age, gender, educational level)

- Yes
- No

**APPENDIX 1I: LETTER OF INTRODUCTION**

**………………………**

**………………………**

**……………………….**

Dear sir/madam

**REF: REQUEST TO COLLECT RESEARCH DATA**

I am a researcher carrying out research on the factors influence the choice of source of Capital in MSME,S in Roysambu. The purpose of the questionnaire is to gather information from the managers of various MSME’S. You have been selected as one of the respondents who will assist to get the necessary data for the study. You are hereby assured that the information you will give will be treated with confidentiality it deserves and used strictly and only for academic purposes.

I look forward for your help.

Thank you.

Yours faithfully,

**DANIEL.K.NJOROGE Researcher**

## APPENDIX III: RESEARCH PROJECT BUDGET

**Table: Research project budget**

| NO | ACTIVITY | BUDGET( KSHS) |
|---|---|---|
| **1** | Purchase of stationery | 1000 |
| **2** | Transport cost | 2500 |
| **3** | Analysis of the report | 3000 |
| **4** | Printing of 3 copies of the report | 1600 |
| **5** | Binding of two copies | 700 |
| **6** | Miscellaneous /contingency | 1200 |
| **TOTALS** | | 11000 |