Factors Affecting Financial Performance of Small and Medium Enterprises (SMEs): A Case of Manufacturing SMEs in Kenya

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ABSTRACT

Small and Medium Enterprises (SMEs) do play a vital role in various economies across the world. SMEs in Kenya not only have a share in Kenya's Gross Domestic Product (GDP) but also constitute a larger portion of Kenya's employment openings. For longevity of SMEs in Kenya, the financial aspect cannot be ignored. Technology and human capital cannot be ignored either since it is out of well-trained work force that Research and Development (R&D) can be conducted in support of innovation related activities and outcomes which largely support the technological aspect of a firm. The study applies Descriptive research whereby data collected was analyzed using regression analysis that confirmed econometric least square model of the study. The study has confirmed a direct relationship between SMEs financial performance and the independent variables; bank credit, technological costs, GDP, growth in number of SMEs and employee costs. The study is highly recommended for use by stakeholders in SMEs and Government of Kenya in efforts to ensure external financing is available to SMEs.

Keywords: *Financial, Performance, SMEs, Kenya*

INTRODUCTION

Small and Medium Enterprises (SMEs) have stake in most economies across the world. SMEs play a major central role in regard to entrepreneur skills, innovation and employment (Kinyua A., 2014). World Bank Group (2015) report indicates that formal SMEs contribute to 45 and 33 percent to total employment and Gross Domestic Product (GDP) respectively in emerging economies. According to World Bank Group (2015), there is approximately 365-445 million Micro, Small and Medium Enterprises (MSMEs) with 285-345 million belonging to informal enterprises.

There has been a tremendous increase in MSMEs share in Kenya's GDP from 13 in 1993, to 18 percent in 2003 and 20-25 percent in 2011-2016 and constitutes over 85% employment opportunities. Kenya's is most industrialized country in East African region and its manufacturing sector constitutes 14 percent of GDP (World Bank, 2016). Even though SMEs provide solution to various economic problems, they also face challenges that deter their growth. One major challenge is access to finance; Ryan

et al (2014) noted constrained access to external finances by SMEs with banks limiting funding to small enterprises as compared to large enterprises. Eniola & Entebang (2015) found out that unfavourable government policies influenced negatively on SMEs performance with decreasing issuance of total credit by both commercial and merchant banks to SMEs.

Beck & Demirgüç - Kunt (2006) found our weak institutions and limited access to credit hinders start-up and growth of SMEs with consideration of legal systems and information flow, which do not favour SMEs. Kinyua A. (2014) established limited sources of funds to SMEs in Kenya due to strict regulations by lending institutions but failed to capture credit from banks.

Ngui T. (2014), Magutu P. et al (2015) highlighted innovation and technology inabilities in Least Developed Countries (LDCs). Ngui T. (2014) noted stagnant rate of new firms formation and collapse of already established SMEs before 5 years. A report by UNDP with focus on Kenyan SMEs noted difficulties for SMEs to access funds despite large number of

lending institutions in Kwale and Kitui counties in Kenya. Nyaboga et al (2015) looked into lease competence and structure effect on SMEs performance in efforts to determine favourable lease terms with positive connection to SMEs cash flows. The study concluded low competences among lessee managers hence constrained payment of rental fees that in return affect SMEs cash flows. Protegerou et al (2017) looked into human capital for new firms; Blasco & Pertold_Gebicka (2013) considered employment policies that are not adhered to for better employees' working conditions. The above studies failed to bring out the internal decisions by SMEs on funding, costs incurred by SMEs in ensuring day to day running of activities as well as embracing technology to enhance operational efficiency.

Therefore, it's evident that SMEs still face challenges despite being a major contributor in Kenya's economy. Before looking into longevity of SMEs in Kenya, there is, need to establish SMEs characteristics rendering them weak in relation to accessing finances and internal weaknesses that affect SMEs operations putting into consideration; research and development (R&D), economic environment, human resource and technological aspect and their cost implications with focus on informal manufacturing sector in Kenya.

Main objective of this study is to determine factors affecting performance of SMEs in, Kenya. Specific objectives of the study will be; first, examine extent to which bank credit contributes to financial performance of SMEs. Second, establish internal costs associated with daily operations of SMEs; employment and technological costs. Third, determine the extent to which economic environment affects performance of SMEs. Last but not least, the study aims at establishing the expansion levels through growth in number of SMEs. The study aims at benefiting SMEs, Government of Kenya and academicians and other stakeholders in the SMEs sector in efforts to realize importance of SMEs in Kenya's economy and in efforts to realize Millennium Development Goals (MDGs) as highlighted in Vision 2030.

LITERATURE REVIEW

Theoretical Framework

Growth of SMEs is compromised due to one major challenge; limited access to SMEs financing (Afande, 2015; Eniola and Entebang,

2015; Albuquerque et al, 2017; Kinyua A., 2014). It's out of this context theories on sources of finance are considered in this study. First is Pecking Order Theory (POT) that dictates hierarchical orders of financing decisions of firms (Matias & Serrasqueiro, 2016). Agliardi et al (2016), Mwarari & Ngugi (2013) noted order of preference in POT first, second and third sources of financing as internal, debt and equity financing respectively. According to Proença et al (2014), small companies do opt for internal financing; however, this will depend on firm's internal funding capacity to meet its needs at each stage, Agrebi (2009). Matias & Serrasqueiro (2016) established that SMEs financing decisions follow POT predictions, in case of debt financing decision if firms don't generate enough funds internally then, Proença et al (2014), short-term debt is preferred than long-term debt.

Management characteristics also prefer POT preference whereby informed managers (Chen et al, 2013) opt for internal financing where else optimistic managers focus on maximizing profitability levels of a firm to enable internal financing and ensure optimal cash inflows associated with debt financing. Despite finance costs associated with debt financing, Proença et al (2014) noted that risk averse managers would still opt for external financing. In most cases, there is no space for equity financing (Chen et al, 2013) since there is a direct link between debt financing and fund deficit.

Second, Trade-Off Theory (TOT) is an approach used to strike a balance between merits and demerits associated with use of debt financing. Initially, Modigliani & Miller (1963) noted that optimal capital structure could be acquired through a balance between financial distress costs and the tax benefit. Father research has classified TOT into two categories; static TOT or dynamic TOT. In the Static TOT hypothesis, a firm's optimum debt ratio is determined by a trade-off between costs and benefits of borrowing, Lin et al (2008) with firm's assets and investment plans held constant.

Lopez-Gracia and Sogorb-Mira (2008) emphasized an offset merits (between tax benefit and reduced cash flow) and demerits (increased cost of financial distress and increased agency costs between owners and creditors). Mwarari & Ngugi (2013) indicated

firms' preference of Debt than Equity until a point of financial distress significance is attained. Therefore, Tangible assets have low financial distress than intangible assets, Mwarari & Ngugi (2013) and Jong et al (2011).

Third, Relationship Lending Theory (RLT) which dictates lending technologies in different countries with different institutional setting on; legal, judicial, social and tax systems, Namara et al (2017). Berger et al (2006) noted that SMEs benefit from small institutions that rely on soft information to enable relationship lending. Retap et al (2016) highlighted factors contributing towards a successful quality lending index among them; trust, commitment, amount of information sharing, closeness, satisfaction level and quality of the relationship. Berger et al (2006) emphasized on good relationship between lending officer of a financial institution and SMEs' management.

Therefore, there is a lot of work by management team of SMEs before arriving of final decision regarding external financing. Various risks are involved in each form of financing but also there is benefits associated by each. Risk averse investor opt for internal financing, which provides minimal chances of raising enough funds for expansion of business. Relationships in various bureaucracies handling issuance of credit is very important towards better resource allocation to productive sector on an economy.

Conceptual Framework
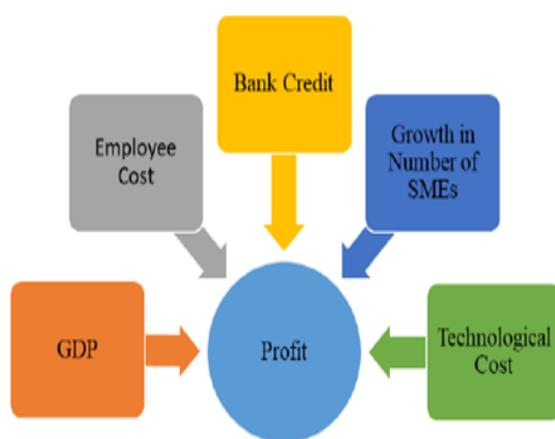
Figure1. *Conceptual Framework*

Factors determining financial performance of SMEs in Kenya have been classified into two categories; independent and dependent variables as shown in figure 1. Profit is a proxy to measure financial performance of SMEs, which is the dependent variable. Independent

variables; employee costs; proxy for human resource, bank credit; proxy for source of financing, technological costs; proxy for operational efficiency, GDP; proxy for macro-economic environment, Change in number of SMEs; proxy for sector expansion.

Reviews on Financial Performance of SMEs

Afande (2015), Deloitte (2016) described SMEs as major income sources for many economies especially in LDCs. SMEs creates employment opportunities, advocates for innovation and acts as a source of revenue for Governments through taxation. Various empirical studies have been conducted concerning factors influencing growth of SMEs. Ngui T. (2014) focused on role of SMEs on employment and economic development, various countries across the world were factored among them; Japan, Britain, USA, China, Pakistan, China, Kenya, Ireland, Nigeria and Zimbabwe. Ngui T. (2014) established a direct relationship between SMEs and economic development since it contributed to countries' GDPs and provided employment opportunities of over 50% of total employment in various economies.

However, Ngui T. (2014) pointed out that SMEs create employment as well contributing to unemployment due to uncertainties surrounding their operations especially in developing countries due limited research capacity and ability to undertake huge risks that needs proper funding. Studies conducted by (Protegerou et al, 2017; Blasco & Pertold_Gebicka, 2013 emphasized need for firms to ensure the workforce is well equipped with necessary knowledge and skills to enhance firm performance and growth.

With emerging technologies, stock of qualified workforce is necessary. Protegerou et al (2017) advocated for university education, professional expertise and working experience since there is need for firms to keep pace from emerging technologies and science advancements, which is facing out manual ways of doing things. Blasco & Pertold_Gebicka (2013) emphasized need for firms to embrace training for existing employees and orientation programs for new employees hence a well-equipped workforce in terms on knowledge and skills. For SMEs to remain competitive in the end, fund commitments towards such trainings are necessary.

Mwarari & Ngugi (2013) conducted a survey on factors affecting SMEs listing in security

markets for raising capital. Their study acknowledged integral part of SMEs in socio-economic development. Limited access to funds and higher costs associated to firm set-up and operationalization is behind exploration of alternative sources of funding which is long term. Mwarari & Ngugi (2013) cited low asset structure for most SMEs as a challenge towards accessing long-term debt.

Size of SMEs at entry serves a forecaster for future growth and survival. Biggs & Shah (2006) conducted a survey for Sub-Saharan Africa countries to determine how social capital influences SMEs performance. The study established that size of the firm at start up directly linked to type of networks of partners at start-up. A good network of partners provides a better connection that opens doors for access to credit, other firm inputs, technology and markets.

Bank ownership has impact on access to credit by borrowers. Beck & Demirgüç-Kunt (2011) took into consideration 91 banks in 35 developing countries and 7 developed countries. The survey categorized bank ownership into; government owned, domestic owned and foreign owned. It was established that government banks uses hard information and collaterals to lend while private banks uses soft information to issue credit through relationship lending technology. Therefore, SMEs are locked out of debt financing by government owned banks despite reduced interest rates that leads to overall reduction in cost of financing. Quartey et al (2017) found out that credit financing in Africa is riskier than other continents. The study focused on 15 member countries of Economic Community of West African States (ECOWAS) and narrowed to sub-region of 6 countries; Mali, Ghana, Gambia, Guinea, Ivory Coast and Senegal. The study revealed that large firms proves creditworthiness through adequate collateral hence, leading to better access to credit funds than small firms.

Berger and Black (2011) empirical study on larger and small banks differ in lending to SMEs. The study concluded that soft information benefits SMEs that requires needs funds from small banks that embrace relationship-lending technology. However, the survey found that even larger banks that prefers hard information in lending to borrowers but depending on level of asset tangibility to meet standard for those that can be considered as collaterals.

Innovation being a driver in any economy, Maduku et al (2016) took into consideration 205 SMEs in South Africa to determine extent of adoption of mobile marketing technology by SMEs. The study established that weak financial foundations, high cost involved in raising capital and lack of technological expertise contribute to limited use of mobile technology by SMEs. Therefore, for technology to take root, SMEs management needs to advocate for innovation in their operations despite cost implication during set-up. Magutu P. et al (2015) focused on Supply Chain Technology (SCT) and its effect on manufacturing companies in Kenya. The study that comprised of 138-sample size with 12 strata representing various sectors of Manufacturing SMEs concluded that SCT dictates supply chain strategy and firms' overall performance despite costs involved.

In conclusion, SMEs contribution to socio-economic wellbeing of various economies has not been realized fully due to challenges they face. With easy access to funds and improved economic environment, SMEs could have the capacity to solve other challenges for instance; lack of innovation, high costs in relation to technological implementations, lack of expertise and inefficiency in operations that deters growth of SMEs in realizing their full potential in maximization of profits and preserve a better position in the economy. Growth is number of SMEs is a good signal for expansion of the SMEs sector which can only be made possible through good macro-economic environment and easy accessibility of funds.

METHODOLOGY

This section outlines research design adopted in conducting the study in efforts to arrive at the research objective that is finding out factors that influence financial performance of SMEs in Kenya. The study adopted descriptive research design where a survey was conducted on a sample of manufacturing SMEs in Kenya. Secondary data was collected from Kenya National Bureau of Statistics (KNBS) website.

Target population includes manufacturing SMEs in Kenya, there are 682 SMEs (KAM, 2016) with an average of 48 SMEs representing 14 categories. 15 SMEs representing a third of SMEs in the manufacturing sector makes sample size for this study. 150 Questionnaires were administered to relevant respondents in

efforts to capture relevant data about objective of this study. Secondary data was acquired from Kenya National Bureau of Statistics database. Eviews 7, a statistical analysis tool was used to analyze the data.

The study used regression analysis to establish relationship between the independent variables and the dependent variable. This follows the regression equation below;

$$Y = \beta_0 + \beta_1 X_1 + \beta_2 X_2 + \beta_3 X_3 + \beta_4 X_4 + \beta_5 X_5 + \varepsilon \qquad (1)$$

Where;

Y is the dependent variable, profits, X_1-X_4 are independent variables, X_5 is macro-economic variable, $\beta_1 - \beta_5$ are unknown beta co-efficient for the independent variables.

From equation 1, introduction of natural logarithm to for easy computation of variables as shown in in equation 2.

$$Log Y = \beta_0 + \beta_1 Log X_1 + \beta_2 Log X_2 + \beta_3 Log X_3 + \beta_4 Log X_4 + \beta_5 Log X_5 + \varepsilon \qquad (2)$$

Further, the model is equation 2 unknown variables are replaced by known independent and dependent variables in equation 3 as follows:

$$Log P = \beta_0 + \beta_1 Log CB_1 + \beta_2 Log CN_2 + \beta_3 Log E_3 + \beta_4 Log T_4 + \beta_5 Log GDP_5 + \varepsilon \qquad (3)$$

Statistical Summary

Where:

Log = Natural Logarithm

P = Profits

CB = Credit from Banks

CN = Growth in Number of SMEs

E = Employee Costs

T = Technological Costs

GDP = Gross Domestic Variable

ε = Stochastic error term

Independent variable; P is a profitability measure for financial performance for SMEs. CB, CN, E, T and GDP are the independent variables, which have possible effect on SMEs financial performance. The econometric model in equation 3 will be approximated through the Ordinary Least Squares (OLS) technique

FINDINGS AND DISCUSSION

Response Rate Analysis

The study targeted 150 questionnaires with each target firm receiving at least three, 130 respondents managed to fill and return the questionnaires. Table 1 presents summary of respondent details.

Table1. *Response Rate Analysis*

Response Rate	Frequency	Percentage (%)
Response	131	86.7%
No Response	19	13.3%

Table2. *Summary of Analysis*

	LOGP	LOGCB	LOGCN	LOGGDP	LOGE	LOGT
Mean	3.55	1.94	1.45	1.07	1.77	1.94
Median	3.30	1.69	1.38	1.43	2.01	1.69
Max	4.38	2.77	2.39	2.12	3.02	2.77
Min	2.70	1.09	0.00	-1.46	-0.22	1.09
Std. Dev.	0.57	0.57	0.53	0.98	0.95	0.57
Skewness	0.15	0.15	-0.65	-1.27	-0.69	0.15
Kurtosis	1.49	1.49	3.40	3.42	2.40	1.49
Sum Sq. Dev.	8.63	8.63	7.47	25.01	23.52	8.63

Table 2 provides a summary about the samples and observations made during data analysis. Mean, Median Maximum, minimum and standard deviation are some of the measures considered to describe data set for both dependent and independent variables in the study.

Unit Root Test

For estimation purposes, the initial model for financial performance of SMEs is determined using OLS model based on Equation 1. Results in table 3 in regard to the estimated equation

shows that all variables profits (P), bank credit (CB), growth in number of SMEs (CN), employment costs (E), GDP and technological costs (T) are stationery at their levels. The Augmented Dickey-Fuller (ADF) test conducted provides a summary of statistical values as shown in Table 3 and confirms that all independent variables are stationary at their levels either at 1% or 5% level.

Equation Estimation

The result of model specification indicates that

CB, CN and T have a positive effect on SMEs financial performance. For instance, For instance, 10% change in bank credit will lead to an increase profits by 5.7%, 10% change in technological costs will increase profits by 4.3% and 10% increase in number of SMEs will lead to increase in profits by 3.2%. Macro-economic variable; GDP also tend to have effect on SMEs performance whereby growth in GDP contributes to SMEs profitability levels by 4.6%. However, the results indicate an inverse relationship between SMEs performance and employee costs whereby 10% change in employment costs will cause a reduction in SMEs profits by 1.9%.

Table3. *Test Results for Stationery through the ADF Test*

Variables	ADF Value	ADF Critical Value	Proba	Inference
LogP	-3.71	-2.98	0.46	Stationary at level
LogCB	-7.23	-3.71*	0.27	Stationary at level
LogCN	-4.04	-2.25*	0.005	Stationary at level
LogE	-4.63	-3.72*	0.001	Stationary at level
LogGDP	-3.87	-3.61*	0.007	Stationary at level
LogT	3.22	2.65**	0.10	Stationary at level

*1% level of significance, **5% level of significance

R-square is the square of the simple correlation coefficient between various results and produced values. The independent variables contribute 69.5% of overall SMEs financial performance while the reminder 30.5% is for other variables not determined in this study. The results are indicated in table 4.

Table4. *Estimated Equation*

Variable	Coeff	Std. Error	t-Stat	Prob.
C	1.609	3.201	5.032	0.072
LOGCB	0.571	1.931	4.443	0.280
LOGCN	0.321	1.941	1.711	0.102
LOGE	-0.191	1.471	-4.202	0.001
LOGGDP	0.467	1.061	-0.442	0.662
LOGT	0.437	3.871	2.596	0.430
R-squared	0.695	S.E. of regression		4.170
Adjusted R-squared	0.670	Prob(F-statistic)		0.000045
F-statistic	9.926	Mean dependent var		3.557
S.D. dependent var	0.576	Durbin-Watson stat		1.146
		Sum squared resid	3.662	

Table5. *Diagnostic Test Results*

Test Type	Null Hypothesis	Stat	Proba	Inference
Heteroskedasticity Test: ARCH	ARCH effect does not depict errors	F-Stat = 0.5379	Prob. Chi-Square = 0.1468	Fail to reject H_0
Heteroskedasticity Test: Breusch-Pagan-Godfrey	No Heteroskedasticity	F-Stat = 1.4494	Prob. Chi-Square = 0.2886	Fail to reject H_0
Ramsey RESET Test	Correct model specification	F-Stat =2.3492	Prob. Chi-Square 0.4163	Fail to reject H_0
Breusch-Godfrey Serial Correlation LM Test	No serial correlation in the residual	F-Stat = 1.3445	Prob. Chi-Square = 0.1641	Fail to reject H_0
Jarque-Bera Statistic	Residuals are normally distributed	Jarque-Bera Stat = 1.3762	Prob = 0.5025	Fail to reject H_0

Diagnostics Test Results

In order to ascertain the model specification robustness, residual and stability diagnostics tests were carried out and the results are as shown below in table 5. The results indicate that the regression model is appropriate. The model does not suffer from heteroskedasticity, non-normal distribution of residuals, serial correlation or mode misspecification.

Normality Test

Histogram in Figure 2 provides evidence that the residuals are normally distributed through

Jarque-Bera statistics value of 1.3762 tests at a probability of 50.25%, which is greater than 10% to confirm normality.
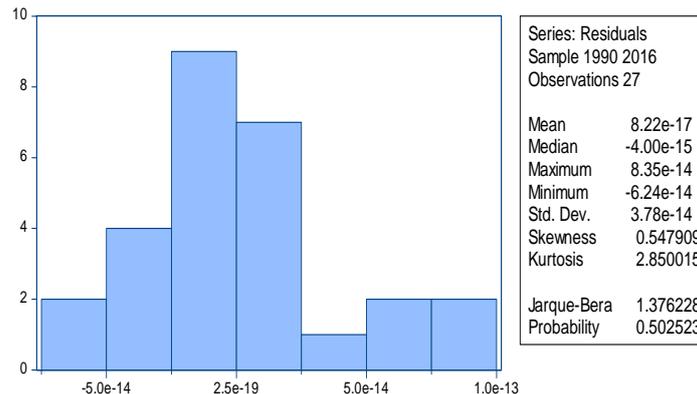
Figure2. *Normality Test Histogram*
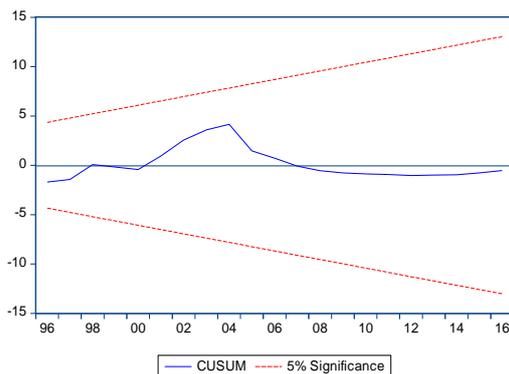
Figure3. *CUSUM Test*

Stability Test

Figure 3 shows that residuals are normally distributed at 5% level of significance through the CUSUM test. The plots lie between 5% critical bandwidth, which confirm stability of coefficients, and model specification.

CONCLUSION

The study focus was on examining factors that influence overall financial performance of manufacturing SMEs in Kenya. Nairobi; Capital City for Kenya is the main economic hub for Kenya and SMEs do have a position in country's economy. Back credit, GDP and technology are top three factors that enhance financial performance of SMEs.

Bank credit issuance to SMEs remains a major puzzle for many SMEs with no capacity to qualify bank credit funding. It is evident from the research that bank credit have impact on overall firm performance since own funding and retained earnings are not enough to move SMEs from one state to another in terms of growth. For technological aspect, SMEs cannot be left behind concerning changing technologies and

growth in science. Therefore, it is evident from the study results that manufacturing SMEs have embraced technology in its operations. For successful implementation of technologies, more funds are channeled to innovation ideas, research and development and equipment. Additional costs are channeled to employment of information and technology (IT) experts beside costs incurred to ensure existing employees are well equipped with IT skills and knowledge in different aspects; communication, accounting, production. From the study, it is evident that the technological aspect has been on the increase in SMEs sector this not only reduces overall costs but also leads to efficiency in SMEs' operations.

Employment costs is also another factor that can never ignored, despite advancement in technologies, SMEs need to consider human labour. Kenya being among Least Developing Countries (LDCs), employees working in various capacities need to be motivated. Salary increment is one of such motivating factor among others; training and development, reward and punishments which also come with employee costs. However, the study reveals a negative relationship between SMEs financial performance and employment costs.

The study is of significance for SMEs in Kenya regardless of sectors they belong to since they have a major impact on Kenya's overall economy. Funding seems to be the main factor through which SMEs can grow since they enable SMEs to have capacity to outdo their competitors, hence long-term survival in competitive environment. The study is useful to the Government of Kenya n implementation of

rules and regulations that govern issuance of credit to SMEs and it will assist in formulation of policies to ensure the environment is favorable to all stakeholders participating in the SME sector.

The study also proves that a better economy enables increases chances for SMEs to perform better financial. When economy is growing, SMEs tend to grow in terms of profitability, therefore, SMEs performance depend on state of macro-economic environment and same time, economic growth also depends on SMEs performance.

The study recommends further research that could lead to full exploitation of factors that affect financial performance of SMEs as a major step of unlocking the economic puzzle about SMEs contribution to overall economy. Due to unavailability of secondary data regarding SMEs' financial statements, the research embraced primary data to collect same data. Therefore, the study recommends necessary stakeholders in the SMEs sector to put necessary steps towards development and management of websites for individual SMEs, which can serve as an information and advertising centre.

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