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FINANCIAL CHALLENGES FACING SMALL AND MEDIUM ENTERPRISES IN KISUMU CITY, KENYA

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Abstract

Many developing economies like African countries heavily depend on Small and Medium Enterprises (SMEs) to support economic growth and accelerate employment opportunities. Kenya has been continuously growing in the recent decade. The growth has been contributed towards alleviation of poverty and increased per capita income amongst SMEs. Recent regional and global economic meltdown requires new growth to strengthen Small and Medium Enterprises to boost gross national products. SMEs play a critical role in both developed and developing countries. They are considered to be a source of job and wealth creation. However, SMEs faces a lot of challenges in their operation. These challenges are lack of finance and limited access to credit, high interest rates, laws and regulations and credit rationing. The study seeks to establish financial challenges facing SMEs in their operations. The study was conducted through cross sectional survey. Systematic sampling was done in order to come up with a representative sample to eliminate bias. Data was collected through close ended questionnaire developed in likert scale and analyzed through descriptive statistic in accordance with objective of the study. The response was received from Nyamasaria, Town Center, Manyatta, Mamboleo, Jua – kali and Nyalenda area of Kisumu City. It was found that, lack of adequate finance and limited access to credit, high interest rates and laws and regulation are some of financial challenges facing SMEs in Kisumu City. The Government should incorporate SMEs to participate in decision affecting their operation directly. There is need to simplify regulatory framework in order to expand access to finance through securitization by SMEs.

Key words: enterprise, financial challenges, SMEs.
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I. INTRODUCTION

There are common understanding amongst policy makers, academicians, economist and businessmen that Small and Medium Enterprises contribute towards economic growth, employment creation and alleviation of poverty. In South Africa, 91% of businesses are SMEs and contribute between 52% and 57% to gross domestic product, and 61% of employees are absorbed in SMEs sector [2]. In Kenya, Small and Medium Enterprises contribute 18% to gross domestic product and absorb 75% of labor force [16]. This analysis shows significant contribution of SMEs towards job creation and economic growth. Small and Medium Enterprises faces different barriers to survival, growth and innovation [17]. Majority of failures of SMEs performance were due to multiple factors such as undercapitalization, insufficient working capital, short term liquidity, insufficient startup capital and poor management [17]. In this regard, more attention should be directed towards resolving these challenges in order to improve financial performance of SMEs.

II. LITERATURE REVIEW

It is widely accepted that, vibrant, robust and growing SMEs sectors is very important components of progressive, healthy economy [13]. Access to finance is not sufficient for small firms to innovate, Upgrade and become more productive to participate in global market. It is one of the key to unlock their potential [5]. Credit to SMEs expanded by more than 2% in 2014 in Greece. In Chile, Colombia and Turkey, the annual growth in SMEs lending surpassed 10%, yet condition remain much tighter for SMEs than larger enterprises with rising or persistent high interest rates in most countries [5]. Banks aggregate SMEs lending portfolio in December 2013 was estimated to be Ksh 332 billion representing 23.4% of their total loan portfolio. This shows that as much as loans portfolio increase in 2013 to accelerate financial inclusivity amongst SMEs sector in Kenya, access to finance is considered to be the major constrain in smaller business in Kenya [5].

Despite recent improvement in financing SMEs, situation remains fragile in the medium term [5]. Downside risks in macro – economic outlook may reverse gains made and banks deleveraging will continue to impact SMEs lending especially where banking system is burdened by high level of non – performing loans. SMEs face several obstacles compared to larger business counterpart when engaging in remote business operation [4]. SMEs have less access to information and communication channel faces difficulties complying with labor, environmental, social and international standard [4]. Debt financing for SMEs remains a challenge in most countries with higher interest rates, shorter loan tenure and collateral requirement [5]. Equity finance remains limited and volatile with business regulation always at disadvantage of SMEs [5]. As in [5] Finance is the primary obstacle constraining SMEs growth and operation in developing countries. The report noted that, most important issue constraining bank lending to SMEs are deficiency in enabling environment for financial services, lack of collateral and insolvency, weak regulatory framework and loan default rate.

In US, SMEs complains about banks excessive oversight failures to meet their specific borrowing needs and lack of flexibility regarding the use of alternative financing source [15]. Challenges facing SMEs in Kenya are categorized as Financial, Market, Information Communication and Technology and Government regulation [6]. The challenges facing SMEs are grouped as limited access to finance, lack of data base, low research and development expenditure. Underdeveloped sales channel and low level of financial inclusion as some of the reasons behind slow growth of SMEs in Tokyo, Japan [12].

Access to credit is crucial for the growth and survival of small and medium sized enterprises (SMEs) [10]. Policy makers attempt to pursue financial sector policies to propel financial intermediaries to extend more credit to SMEs [10]. Access to credit still remains a challenge to SMEs, especially those in developing economies and continues to dominate discussion both within business cycle and at the corridor of various governments [10]. Financial intermediaries that uses the asset based lending techniques looks at the underlying asset of the firm (which are taken as collateral) as a primary source of repayment [2]. For working capital financing, banks use short term asset such as account receivable and inventory. For long term financing, they use equipment. The pledging of collateral by itself does not distinguish asset based lending from any of the other lending technologies. Collateralization with accounts receivable, inventory and or equipment is often associated for example with financial statement lending, relationship lending and credit scoring, where collateral is used as a secondary source of payment [2].

Financial characteristic such as business registration, accurate documentation of transaction and financial activities as well as good business planning have positive relation with credit accessibility [10]. Ownership constitute a great deal of requirement towards accessing credit from financial institutions as all entrepreneurs who were able to access loans indicated that they own assets such as houses, land, business products and business vehicles which are easily used as collateral depending on the amount of credit being sought [10]. However, access to credit was not tied completely to asset ownership [10]. Access to finance is a key determinant for business startup, development and growth for small and medium size enterprises. SMEs have very different needs and faces different challenges with regard to financing compared to large businesses [1]. Lack of equity capital invested in small firms makes these businesses more irrelevant than other sources such as bank lending and other types of financial products. The current economic environment has brought SMEs needs into particular fouls given the significantly lightened credit supply condition arising from the reduced ability and willingness of banks to provide the finance on which this sector is particularly reluctant [1].

Lack of adequate finance and limited access to credit, rapid technological changes, new laws and regulations and high rate of interest has been identified as the major challenges facing SMEs in their financing endeavors [14]. Despite potential role of SMEs to accelerate growth and job creation in developing countries, there are a number of bottlenecks affecting their ability to realize their full potential [3]. SMEs development is hampered by a number of factors, including finance, lack of managerial skills, equipment and technology, regulatory issue and access to international market [3]. The fundamental reasons behind SMEs lack of access to fund can be found in their peculiar characteristics while others argued that SMEs suffer from financing gap because of market imperfection on supply side [14]. SMEs faces a lot of financing gaps probably because of combination of reasons originating from both supply and demand sides. The supply side refers to providers of finance (Financial institutions and investors) while the demand side is composed of SMEs who require financing from financial institutions and other providers of finance [14]. The financing gap is most prominent in capital market financing. Most countries including the developed one have problems in SMEs financing through capital market [14].

The effect of banking condition, monetary policy and economic growth on small business may change as economic condition changes [7]. If so their (and likely future) effects are likely depend on the prevailing interest rate and economic growth rate and this differs from their past average effects [7]. To allow for the possibility that the magnitudes of these effects vary with the economic condition, they separately estimated effects for the period when monetary policy was tighter and when national economic growth was slower [7]. Indeed the estimate effects did vary considerably with interest rate and economic growth. The concept of credit rationing is important for SMEs, because the most common source of external financing for small firm is bank debt [11]. Small firms however find it more difficult to obtain bank loans than do large firms because when they do obtain loans, it is usually at high interest rate and on more stringent terms than larger firms [11].

Access to capital market is still under developed both to SMEs and for retail lending entities that could lend them [8], while direct market access poses transaction cost and liquidity problems, securitizations has significant potential for increasing access to capital and lowering the cost of capital [8]. There are several regulatory issues that presently hinder implementation of this solution [8].

III. MATERIALS AND METHODS

The objective of the study was to establish financial challenges facing SMEs in Kisumu City, Kenya. The study was based on cross sectional survey design. Simple random sampling was done in order to eliminate biasness. Structured close ended questionnaires developed in likert scale were used and analyzed through descriptive statistics in line with objective of the study.

IV. RESULTS

Analyses of data received from the despondence are indicated below. The data shows the results of financial challenges facing Small and Medium Enterprises.

The results showed that the financial challenges facing SMEs are, lack of adequate finance and limited access to credit (1), high interest rates (2), laws and regulations (3).

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Table 1, Lack of adequate finance and limited access to credit

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	Strongly Agree	66	77.6	77.6	77.6
	Agree	18	21.2	21.2	98.8
	Neither agree nor disagree	1	1.2	1.2	100.0
	Total	85	100.0	100.0	

Majority of the respondents strongly agree that lack of adequate finance and limited access to credit are the major financial challenges facing small and medium enterprises in Kisumu City with 77.6%. 21.2% agree that it is a challenge while 1.2% neither agree nor disagree.

Table 2, high interest rates.

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	Strongly Agree	40	47.1	47.6	47.6
	Agree	30	35.3	35.7	83.3
	Neither agree nor disagree	2	2.4	2.4	85.7
	Disagree	11	12.9	13.1	98.8
	Strongly Disagree	1	1.2	1.2	100.0
	Total	84	98.8	100.0	
Missing	System	1	1.2		
Total		85	100.0		

47.6% strongly agree that high interest rates are of the financial challenges affecting small and medium enterprises in Kisumu City, 35.7 agree, 2.4% neither agree nor disagree, 13.1% disagree and 1.2% strongly disagree.

Table 3, laws and regulation.

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	Strongly Agree	37	43.5	46.8	46.8
	Agree	24	28.2	30.4	77.2
	Neither agree nor disagree	3	3.5	3.8	81.0
	Disagree	10	11.8	12.7	93.7
	Strongly Disagree	5	5.9	6.3	100.0
	Total	79	92.9	100.0	
Missing	System	6	7.1		
Total		85	100.0		

Majority of the respondents 46.8% strongly agree that new laws and regulation is one of the financial challenge facing small and medium enterprises in Kisumu City, 30.4% agree, 3.8% neither agree nor disagree, 12.7% disagree and 6.3% strongly disagree.

V. DISCUSSION

The respondent identified lack of adequate finance and limited access to credit as one of the financial challenges facing SMEs in Kisumu City with 77.6% strongly agree , 21.2% agree, 1.2% neither agree nor disagree. This finding is in agreement as in [12][10][14][1][9]. It is therefore critical for policy maker to direct policy orientation toward embracing financial inclusivity to enhance availability of finance to SMEs. 47.6% of the respondents strongly agree that high interest rate has an impact on operation of SME, with 35.7% agree, 2.4% neither agree nor disagree, 13.1% disagree and 1.2% strongly disagree. The finding correspond as in [4][11][5]. This finding has a strong bearing concerning interest rate cap passed by Kenyan Parliament and implemented by Central Bank of Kenya. It is therefore believed that the policy direction towards interest rate cap will address the gap of financial inclusivity among SMEs sector.

Laws and regulation is another issue that featured prominently in the respondents response as a factor hindering success in their operation, with 46.8% of the respondents strongly agree, 30.4% agree,3.8% neither agree nor disagree, 12.7% disagree and 6.3% strongly disagree. These results correspond as in [8][3][14][4][9]. It is therefore important for the government to simplify regulation to ensure success of SMEs performance in the economy.

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VI. LIMITATION OF THE STUDY

There were a lot of challenges while carrying out the study. Out of 100 questionnaires issued to respondents, 85 were received from the respondents, while 15 questionnaires were not filled by the respondent because of busy schedules. Out of 85 received, some respondents did not attempt some of the questions. Some were very cautious while receiving and responding, and this may have compromised the quality of the answer received.

Concentration of similar business in same geographic area was also a challenge. Most garage and auto spares are concentrated in jua kali, while Nyalenda, Manyatta, and Kendele have a lot of provisional stores. Concentration of similar businesses in same region has some influence in the result obtained.

VII. CONCLUSIONS AND RECOMMENDATIONS

Small and medium Enterprises face a number of challenges in their operation. The financial challenges facing SMEs are,

I. Lack of adequate finance and limited access to credit,
II. High interest rate and
III. Laws and regulation.

The study reveals that inadequate finance and limited access to credit is the major financial challenge facing SMEs followed by high interest rate and laws and regulations. The government needs to foster close working environment with SMEs and incorporate them in policy direction that has bearing in their operation. The government need to simplify regulatory framework and work out modalities geared towards expanding access of funds through securitization of their stock in organized market. New laws should be subjected to stakeholders' participation to improve effectiveness and mitigate adverse effect that may arise during implementation.

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