

The effect of financial constraints on small and medium enterprises finance essay...



**ASSIGN
BUSTER**

CHAPTER 1

Introduction

The relation between financial constraints and the survival and growth of the SME has been document across Africa and world. The researcher will look at the economy of Kenya and make evident of the financial constraints that are facing the small and medium enterprise hence affecting the survival and growth of small and medium size enterprises. There is a need to research in this field since the SME are the backbone of the Kenyan economy. In fact with the growing inflation, not to mention the difficulties the SME have in accessing the financial aids they are barely making it to the second birthday.

Overview of the Context

Kenyan is a developing country in Africa. The increasing role of the SME sector is confirmed by the recently completed Kenya 2003 Economic Survey, According to the survey, total employment recorded in the informal sector increased from 3. 7 employees in 1999 to 5. 1 million in 2002, while the formal sector increased only from 1. 74 million to 1. 76 million employees during the same period. However, the growth of the informal sector in number of employees does not necessarily reflect growth and high productivity of the enterprise itself, as the number of informal sector companies grew largely because of the depressed formal economy and under employment in the formal firms.

Having said that, the SME in Kenya faces a lot of challenges and one of them is the financial constrains which really inhibits its growth and survival. Hence the call for this research paper. The researcher will use the research

methodologies to extract evidence that really financial constraints is a major factor that affect the growth and survival of the SME' in Kenya.

Statement of the problem.

In Kenya, SME have little access to finance, which thus hampers their emergence and eventual growth and survival. Financial constraint remains a major challenge facing SME in Kenya Wanjohi and Mugure (2008) and this will be evidence in this research paper. Their main sources of capital are their retained earnings and informal savings and loan associations, which are unpredictable and not very secure.

SME can rarely meet the conditions set by financial institutions, which see them as a risk because of poor guarantees and lack of information about their ability to repay loans. The financial system in most of Africa is under-developed however and so provides few financial instruments.

The researcher has come up with some of the reasons why SME find it hard to access finance in Kenya:

High interest rates by the financial institutions

Delay in the loan processing due to lack of securities and other requirements by the financial institutions.

Some of the SME do not have a good track records hence most of the local banks fear to give them the unsecured loans.

Banks are particularly nervous of smaller businesses due to a perception that they represent a greater credit risk. Kariuki's (1995) study of bank credit

access in Kenya illustrates this point further. A survey of 89 small and medium-scale firms in manufacturing and service industries, combined with secondary information from commercial banks, found that from 1985 to 1990 the average real volume of credit for the sample firms fell, except for the year 1986 which showed a marginal increase of 1.5 per cent. Small scale borrowers were found to be faced with higher nominal interest rates at higher inflation rates in the latter half of the 1980s. Moreover, the explicit transactions costs of borrowing were found to be high in relation to interest costs.

Because the information is not available in other ways, SME will have to provide it when they seek finance. They will need to give a business plan, list of the company assets, details of the experience of directors and managers and demonstrate how they can give providers of finance some security for amounts provided.

The researcher recognized that in the current context of the most severe financial and economic crisis in decades, various factors such as increased risk aversion, decreased liquidity, bleak prospects for economic growth, etc. are having or are expected to have a highly negative effect on SME and entrepreneurs' access to short and long term financing.

Small firms are particularly vulnerable because:

It is more difficult for them to downsize since they are already small.

They are individually less diversified in their activities.

They have weaker financial structures or lower capitalization.

<https://assignbuster.com/the-effect-of-financial-constraints-on-small-and-medium-enterprises-finance-essay/>

They have lower or no credit ratings.

They are heavily dependent on credit.

They have fewer options for finance, especially in financial markets. With this in view, the measures that most governments are taking or planning to take to counteract the effects of the crisis and stimulate their economies should include easing SME and entrepreneurship access to finance. Numerous money lenders in the name of Pyramid schemes comes up, promising hope among the SME that they can make it to the financial freedom through soft borrowing. The rationale behind turning to these schemes among a good number of entrepreneurs is mainly to seek alternatives and soft credit with low interest rates while making profits.

Objectives

The general objective of the research is to establish the effects that the financial constraints have on the survival and growth of the small and medium enterprises in Kenya.

Some of the specific objective that the researcher will bare in the study will evolve around the small and medium sized enterprises in Kenya.

To establish effect of economic activities on the survival and growth of the SME in Kenya.

To assess the impact of high interest rates by local commercial banks on the survival and growth of the small and medium sized enterprises in Kenya.

To establish the effect of commercial banks lending policies and access to credit on the growth and financial performance of SME in Kenya.

To establish the effect of the firm capital structure on the growth and survival of the small and medium enterprises in Kenya.

To establish the impact of government policies in Kenya on the economic growth on the survival and growth of the small and medium business.

1. 5 Research Questions

How do high interest rates affect the survival and growth of the firm in Kenya?

What effect do the banks lending policies and access to credit have on the growth and survival of the SME in Kenya?

How do the government policies in Kenya on the economic growth affect the survival and growth of the small and medium sized business?

What effect do the external borrowings have on the survival and growth of the small business enterprises in Kenya?

How the economic activities affect the growth and survival of the firm in Kenya?

1. 6 The significance of the study.

Small and medium sized enterprises are the backbone of virtually all economies in the world. However, the process has long been constrained by the limited availability and accessibility of financial resources to meet a

variety of operational and investment needs within the SME sectors. SME and entrepreneurs play a significant role in all economies and are key agents of employment, innovation and growth. A significant number of entrepreneurs and SME could use funds productively if they were available, but are often denied access to financing, thus impeding their creation, survival and growth. Although SME form a broad spectrum as far as their relative size, sector of activity, seniority, location and performance are concerned; there is a vital need for innovative solutions for their financing in particular for innovative and high- growth SME in a globalised knowledge-based economy.

The researcher however will be interested to know how does this financial constraints really affect the growth and survival of SME and she will undertake the study to establish the necessary facts that make the growth of SME restrained in Kenya.

1. 7 The scope of the study.

The Kenya government is committed to foster the growth of SME emerged as one of the key strategies in the 1986 report Economic Management for Renewed Growth. It was reinforced as a priority in the 1989 report, The Strategy for Small Enterprise Development in Kenya a document that set out the mechanisms for removing constraints to growth of the SME sector. In 1992, the government published the SME policy report, Sessional Paper No. 2, Small Enterprises and Jua Kali Development in Kenya. This report was reviewed in 2002, leading to a new policy framework that provides a balanced focus to SME development in line with the national goals of fostering growth, employment creation, income generation, poverty reduction and industrialization

<https://assignbuster.com/the-effect-of-financial-constraints-on-small-and-medium-enterprises-finance-essay/>

SME in Kenya have not seen much development since Kenyan independence due to financial constraints and other factors that are not going to be discussed on this research paper. Small enterprises have a potentiality of boosting a Kenya economy. Although they are faced by many challenges, they still have opportunities to grow. These include linkage with multinational companies, networks with other businesses, diversification of market and products, enabling environment and franchising opportunities which is greatly being encouraged by the coalition government that is currently running the government of Kenya although the impact has yet to be felt on the small and medium enterprises due to its size and limited resources.

CHAPTER 2

LITERATURE REVIEW

2.1 Introduction.

Kenya being a developing country, the researcher will borrow some of empirical research done by experts in other developed and developing countries.

A large number of empirical studies have addressed the issue of financial constraints, mainly in order to study the relation between the firm's investments and the availability of internal and external funds. Under perfect capital markets, internal and external sources of financial funds are perfectly substitutable Modigliani and Miller (1958), so that the availability of internal funds should not affect investment decisions. Small firms cannot exploit economies of scale in the same way as large firms can they face more financial constraints. Since young companies have not accumulated

sufficient cash flow and are unable to rely on bank financing, they have to depend on the equity investments. The analysis of the effects of financial constraints on the firm survival and growth therefore is important.

2. 2 Theoretical account of financial constraints

The financing constraint literature has been the first to recognize that partitioning firms helps to provide important insights into their behaviors. The pioneers in this field have undoubtedly been Fazzari, Hubbard and Petersen (1988) who point out the fact that firms are definitely not homogeneous. They classify firms according to their dividend payout ratio. Their main aim in doing this is to show that firms that have different dividend payout ratios and therefore belong to different categories, have differential access to finance. Some firms are financially constrained while others are not. Following Fazzari, Hubbard and Petersen (1988), a number of studies have tried to distinguish between various categories of firms. For instance, Whited (1992) uses measures of indebtedness, interest coverage, and whether or not a firm has a bond rating to discriminate among firms. Kaplan and Zingales (1997) use both quantitative and qualitative data to distinguish among firms. Bond et al (1999) classify firms according to whether a firm operates in a bank-based or market-based system. Cleary (1999) uses a financial constraint index to differentiate between firms, which takes into account a number of factors such as firm liquidity, leverage, profitability, and growth. Carpenter and Guariglia (2003) use the number of employees to distinguish between large and small firms. However, the factor common to all these studies is that they have tried to discriminate only within firms that have access to capital markets.

A high percentage of Small and Medium Scale Enterprises remains in the informal sector with limited opportunities for growth. Africa has one of the largest informal sectors in the world, World Bank, (2006). In Kenya the availability of finance tends to be extremely limited and difficulty to get external financing as researcher came to find out on this quest on the Kenya town and from the SME managers. The SME financial resources are usually restricted to equity capital and bank debt to those who are able to access it. As the business establishes itself, however, it gains access to resources from its own productive activity and sources of external finance. According to Aghion (2007), access to external finance improves market selection by allowing small firms to be more competitive. Additionally, financial accessibility significantly facilitates the growth of firms. Unlike large firms, SME are restricted in their funding options. Therefore, a new hierarchy of sources of finance for SME can be defined. In this new hierarchy of sources of finance for SME there are three sources of finance, internal finance, debt finance and new capital contributions. Large firms that have access to capital markets are able to issue equity; however, SME do not normally have access to this form of finance of new capital contributions Cost of new debt financing Cost of internal finance

2. 3 The Financial constraint variables

According to many studies, small firms do not even recognize their own growth potential Scott & Rosa (1996). This is more evident in the research since most of the managers of the small and medium size enterprises are more concerned about the survival of the firm rather than the growth of the

firm in most Kenya region. This research however will look at some of the variables that help to clarify this phrase in the Kenyan market.

2. 3. 1 The effect of government policies.

Similar evidence regarding the lack of importance given by small scale enterprises to tax policies is also found in Southern Africa, including Niger, Botswana, Swaziland, Lesotho, Malawi, and Zimbabwe Mead (1994). Studies for these locations found little concern for government regulations, except from those enterprises concentrated in targeted locations and specific sectors such as food processing. Instead the greatest concern for the majority of those surveyed was the lack of access to working capital, credit and finance.

2. 3. 2 The effect of commercial bank lending rates and access to credit.

According to Holmes and Kent (1991), SME are characterized by 2 factors: they cannot issue equity and are concerned about ownership and control. Small firms usually do not have the option of issuing additional equity to the public. Even if they were able to issue private equity, managers of SME would restrain from doing so as issuing equity would lead to a dilution in ownership and control. Therefore, managers of SME will usually prefer to go for debt financing, mainly comprising of bank financing. On the other hand, managers of larger firms usually consider a broader range of funding options.

As Steel (1994) highlights, high transactions costs and risks associated with small loans, a lack of collateral and an historical orientation towards larger

enterprises, continue to restrict small scale enterprise access to formal credit. This no different from Kenya where access to credit is really issue and Kariuki's (1995) study of bank credit access in Kenya illustrates this point further.

2. 3. 3 The impact of government policies

Data on the SME sector in Kenya is scarce, although the National SME Baseline Survey provides comprehensive and reliable information; it has not been updated since 1999 and does not contain information for medium-sized firms. The survey indicates that the contribution of the SME sector to GDP increased from 13. 8 percent in 1993 to 18. 4 percent in 1999. Thia shows that the government policies put in place in Kenya also do affect the growth and survival of the small and medium size enterprises.

2. 3. 4 The effect of internal capital structure.

It should be noted that growth is not the objective of all firms. For example, when firms are faced with serious difficulties during periods of economic downturns, they may shift their objective from growth to survival waiting for better economic conditions to expand. This has been observed in crisis economies where firms downsize and try to keep their costs as low as possible until the economic situation improves. Some firms may choose to remain small if their entrepreneurial capabilities are inconsistent with large size because financial constraints force the poor to start small business, the lack of firm growth could result in social immobility where the small firms remain poor. On the other hand, if small firms have the potential of becoming large, poor firm owners could become rich as their firms expand.

Moreover, firm growth in Africa, where technology is usually labour intensive, <https://assignbuster.com/the-effect-of-financial-constraints-on-small-and-medium-enterprises-finance-essay/>

is usually associated with job creation, which in turn is the key to poverty reduction. Therefore, whether firms have potential to grow or remain small has important policy implications. Slow growth of firms in Africa has been explained as being the result of the lack of access to financial resources McCormick et al. (1997) and Biggs and Srivastava, (1996). This is particular to developing economies where financial markets are under-developed.

2. 4 Conceptual Framework.

The financial constrained as outlined above is a diverse business phenomena that need to be researched since it's the back bone of any business growth and survival may it be a small business in the slums or a major manufacturing business. The researcher is mainly focused on the small and unquoted firms in Kenya. The local commercial banks have a role to play in all this and so is the government. The firm own capital structure also do contribute a lot to the survival and growth of the firm. In Kenya the economic activities that are carried out also influence a lot the GDP of the country hence the economic growth.

CHAPTER 3

METHODOLOGY

3. 1 Introduction

The researcher will mainly use secondary research methodology although the tertiary methodology or the search tool will also be used for the purpose of this research. This will include books, magazines, newspapers to collect data and information regarding the topic. The researcher will also make use of the internet to obtain information about SME and other related

information. Secondary data are data that have been collected for some other purpose. Secondary data can provide a useful source from which to answer the research question(s). Punch (1998) mentions several advantages of using existing data. Expenditure on obtaining data can be significantly reduced and data analysis can begin immediately, so saving time. Also, the quality of some data may be superior to anything the researcher could have created alone Thomas (2004). On the other hand, the chosen research method also has several disadvantages such as data that have been gathered by others for their own purposes can be difficult to interpret when they are taken out of their original context. It is also much more difficult to appreciate the weak points in data that have been obtained by others.

3. 2 Research Area

The propose research area is the SME in Kenya. The length of time within which to finish this project will be estimated one month since time and resources might be a major constraint. The researcher proposes to choose at least 15 major towns in Kenya since Small business are all over the country and do research in a at least 10 firms in each town, so as to capture the operation of financial reporting in the country so as to ascertain whether financial constraints are really a major constraint in the survival and growth of small and medium size business in Kenya.

As a mean of testing the hypothesis of the study, the researcher will apply the methods below of data collection.

3. 3 Observation

To judge the effect of financial constraints on survival and growth of a small business in Kenya. The researcher will have to visit the local banks and financial institutions and find out how one's access to finance limits the growth of the business. I propose to use time-series method to judge the observation. The observation will assist me to ascertain that the formal financial sector has provided very little or no service to small business men hence they are unable to finance their small business.

3. 4 Interview

This will be conducted individually. Structured and unstructured questions will be used to collect information on the subject under investigation. This is to help the researcher obtain responses to questions like; in your view is business growing? How best can it be financed? , and others. I propose to conduct the interview in such a manner that each sector will have equal probability of being selected. Interviews will enable me to do most of the qualitative part of my research, and the information gained here is usually more realistic.

3. 5 Questionnaire

I will prepare systematic and well organized questions that will enable me; have responses to the questions raised in the introduction and moreover test the hypothesis of the research. This is demonstrated in Chapter 1 where several questions to this effect have been formulated.

3. 6 Data Analysis

I will not only rely solely on the information from the various responses from the varied sectors but, also the statistical publications from international organization in Kenya who have done a similar research on SME. I propose to make a thorough analysis of the official and unofficial data received. I will propose the use of quantitative and the qualitative analysis.

REFERENCES

Punch, K F. (1998), Introduction to social research: Quantitative and qualitative approaches.

Kariuki N (1995) ' The Effects of Liberalization on Access to Bank Credit in Kenya', Small Enterprise Development, 6 (1), 15-23

Central Bureau of Statistics, International Center for Economic Growth, and K-Rep Holdings, National Micro and Small Enterprise Baseline Survey, 1999.

Central Bureau of Statistics, Ministry of Planning and National Development, Economic Survey, 2003

Wanjohi, A. M. and Mugure, A.(2008). Factors affecting the growth of MSEs in rural areas of Kenya: A case of ICT firms in Kiserian Township, Kajiado District of Kenya.

Republic of Kenya (1992). " Sessional Paper No. 2 on Small Enterprises and Jua Kali

Development in Kenya." Government Printer, Nairobi

Biggs, T. and Srivastava, P. (1996) “ Structural Aspects of Manufacturing in Sub-Saharan Africa: Findings from a Seven Country Enterprise survey,” World Bank Discussion paper No. 346.

Modigliani, F. and Miller, M. (1958), the cost of capital, corporation finance and the

theory of investment.

Aghion, P., Fally, T. and Scarpetta, S. (2007): “ Credit constraints as a barrier to the entry

and post-entry growth of firms”, Economic Policy, vol. 22 (52): 731-790.

Savignac, F. (2008): “ The impact of financial constraints on innovation: what can be learned from a direct measure? Economics of Innovation and New Technology, Volume 17 (6): 553-569.

Petersen, M. and Rajan, R. (1994): “ The benefits of firm-creditor relationships: Evidence from small business data”, Journal of Finance, 49, 3-38.

Aghion, P., Fally, T. and Scarpetta, S. (2007): “ Credit constraints as a barrier to the entry and post-entry growth of firms”, Economic Policy, vol. 22 (52): 731-790.

World Bank. (2006) “ Doing Business in 2005”. The World Bank. Washington D. C., USA.

Scott, M. & Rosa, P. (1996). Opinion: Has Firm Level Analysis Reached its Limits? Time for a rethink. *International Small Business Journal* 14, 4, 81-89.

Mead D (1994) ' The legal, regulatory and tax framework and small enterprises', *Small*

Enterprise Development, 5 (2), 10-17

Steel W (1994) ' Changing the institutional and policy environment for small enterprise development in Africa', *Small Enterprise Development*, 5 (2), 4-9

Kaplan, S. and L. Zingales (1997), " Do investment-cash-flow sensitivities provide useful measures of financing constraints?" *Quarterly Journal of Economics*,

112, pp169-216.

Whited, T. (1992), " Debt, Liquidity Constraints and Corporate Investment: Evidence from Panel Data," *Journal of Finance*, 4 , pp1425-1460.

Kaplan, S. and L. Zingales (1997), " Do investment-cash-flow sensitivities provide useful measures of financing constraints?" *Quarterly Journal of Economics*, 112, pp169-216.

Carpenter R. E and A. Guariglia (2003), " Cash Flow, Investment and Investment Opportunities: New Tests using UK panel Data," Unpublished.

Fazzari, S., G. Hubbard, and B. Petersen (1988), " Financing Constraints and Corporate Investment," *Brookings Papers on Economic Activity*, 1, pp141-95.

Holmes, S. and Kent, P., (1991), “ An Empirical Analysis of the Financial Structure of Small and Large Australian Manufacturing Enterprises”, Journal of Small Business Finance, 1 (2), pp141-154.

QUESTIONNAIRES.

Why did you choose to start a business in this area?

Does your business follow the government policies in regard to paying taxes

Yes €1

No €1

What is the number of the employees in your business?

How is the business in this area affected by the economy trends preferring at the moment?

Who is the highest ranking member of your business?

What is the annual turnover of your business?

Where does your business get the initial capital to start it up?

What is your source of financing?

What form of financial instruments do you have in place?

<https://assignbuster.com/the-effect-of-financial-constraints-on-small-and-medium-enterprises-finance-essay/>

Which banking or financial sectors do you operate in your business?

How do the interest rates affect your business?

What are some of the difficulties do you experience when getting bank access?

What can you say is the reason for your business failure to grow?

How is the government policies put in place in Kenya helping you achieve your financial goals?

What are the major issues does your enterprise face when accessing credit facilities in the banking sectors in the Kenya?

What would you say is the challenge facing the small business in Kenya in terms of finances?
