THE INTERNATIONAL JOURNAL OF BUSINESS & MANAGEMENT

Credit Accessibility and Performance of Small and Medium Enterprises in Meru County, Kenya

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Abstract:
This study sought to investigate the credit accessibility and performance of SMEs in Meru County, Kenya. Specifically, the study sought to determine the influence of lending procedures on the performance of SMEs in Meru County. The study adopted a descriptive research design. The targeted population comprised 599 SMEs registered by the Meru County Government, which were operating in the previous three years, and then within the nine sub-counties of Meru County. The researcher used Krejcie and Morgan's table to determine sample size from a given population to determine a sample of 234 SMEs and proportionate random stratified design to identify the SMEs to comprise the sample. Questionnaires were used to collect data from respondents, with each SME being represented by the owner or a senior employee. Data were analyzed and presented using descriptive statistics like frequency tables and graphs. Chi-square tests were conducted to test for any relationship between independent variables and the performance of SMEs in the county. The study revealed that the majority of the respondents (83%) agreed that the loan application process was complicated. It was revealed that the lending procedure had a statistically significant relationship with the performance of SMEs in Meru County. The study recommends that financial institutions should simplify the loan application process as much as possible.

Keywords: Small-micro-enterprises, collateral, lending procedures, credit accessibility, credit awareness, collateral requirements

1. Introduction

1.1. Background to the Study

Small and Medium Enterprises (SMEs) are credited with the transformation of the economies of many nations globally in varying degrees (World Bank, 2015). According to the Edinburg Group (2013), SMEs are a dominant feature on the global business stage, comprising 95% of all enterprises. Moreover, these entrepreneurial ventures account for about 60% of employment opportunities in the private sector.

The World Bank (2015) further asserts that governments, development banks, and central banks invest immensely in this sector since they have realized the transformative role of SMEs. The European Commission (2016) considers SMEs as the backbone of the economy of Europe, comprising 99% of entrepreneurial transactions on the continent. Since 2011, SMEs have created about 85% of all new employment. The focus on SMEs as drivers of European economy is evident in the formation and thriving of the Small and Medium Entrepreneurs of Europe (SME Europe), an organization that proposes to influence EU policy in a manner that favours SMEs (SME Europe, 2016).

According to the UK Department of Innovation and Skills (2015), Small businesses comprised about 99.3% of private sector enterprises by January 2015, with 99.9% of these businesses being SMEs. In addition, 15.6 million people were employed by SMEs, which represents 60% of the entire private sector labour in Britain. In Azerbaijan, Moldova, Armenia, Georgia, Ukraine, and Belarus, 95% percent of businesses are SMEs (EBRD, 2016). The Edinburg Group (2013) asserts that in OECD countries, 95% of enterprises are SMEs, and they contribute about 55% to national GDPs.

Africa's economic growth is also, to a large extent, driven by SMEs. In Sub-Saharan Africa, 90% of all businesses are SMEs (IFC, 2016). In South Africa and Ghana, for example, SMEs comprise 91% and 92% of all businesses, respectively, and contribute over half of national GDPs. In Morocco, these types of enterprises comprise 93% of all industrial companies (The Edinburg Group, 2013). *Sousa dos Santos (2015), citing the case of Angola, opines that SMEs are pivotal to economic growth in African countries. A study in Nigeria revealed* that the lending procedures were not customer friendly to SMEs, and there was a weak credit system in screening credit-worthy borrowers, hence leaving potential borrowers unable to access credit (Obinne & Igwebuike, 2013).

In Kenya, the SME sector is considered a major contributor to the economy because it provides income and employment to a significant proportion of the population. The Government has recognized the potential of the SME sector in employment creation and poverty reduction in numerous policy documents. The Kenya Economic Survey of 2014 revealed that employment within the SME sector increased from 4.2 million persons in 2000 to 5.5 million persons in 2003, accounting for 75.3 percent of the total persons engaged in 2003. The sector contributed 45 percent of the country's

Gross Domestic Production and employed 85% of Kenya's labour force (SMEFEST, 2016). The SME sector should, therefore, not only be seen as a provider of goods and services but also as a driver of competition and innovation and enhancing the enterprise culture, which is necessary for private sector development and industrialization (KNBS, 2015).

1.2. Statement of the Problem

The SME sector is acknowledged globally as a pivotal pillar of economic growth. The European Commission (2016) recognizes SMEs as the backbone of the economy of Europe considering over 85% of the jobs created by the private sector are in the SME industry. In developing nations like those in Sub-Saharan Africa, the significance of this sector cannot be overemphasized, particularly because of its ability to assuage the unemployment crisis, its positive contribution to respective national GDPs and poverty alleviation (Gichuki, Njeru & Tirimba, 2014).

As early as 1965, Kenya had developed a strategy called "African Socialism and its Application to Planning in Kenya," which, among other things, sought to accelerate private sector investment and growth (Obwocha, 2006). Unfortunately, while numerous legislations have been enacted to boost the growth of SMEs, these entrepreneurial ventures still operate way below their capacities, chiefly because of credit and funding challenges.

KNBS (2015) estimated that three out of eight SMEs failed within the first months of operation. Unless various stakeholders understand the issues surrounding the relationship between credit accessibility and the performance of SMEs and take mitigating and corrective measures, this sector will not live up to the expectations of entrepreneurs, society, and governments.

A number of related studies have been done elsewhere. The majority of them concentrate on factors limiting SMEs from accessing credit. They include Avevor (2016), Gichuki *et al.* (2014), Hvingelby, Jensen (2013), Ackah and Vuvor (2004), and Falkena *et al.* (2001). Omboi and Wangai (2011) carried out a study on factors that influence credit accessibility in the Imenti Central Sub-County. However, Nyumba *et al.* (2015) delved into the role of interest rates in the performance of SMEs, while Kinyua (2014) studied factors that influenced the performance of Jua Kali SMEs.

The study was unique in that it investigated credit accessibility and the performance of SMEs in Meru County. No study had delved into this topic, and none had been done in Meru County.

1.3. Specific Objective

To determine the influence of lending procedures on the performance of SME business in Meru County.

1.4. Research Hypothesis

- Ho_1: There is no significant relationship between lending procedures and the performance of SME businesses in Meru County.

2. Literature Review

2.1. Theoretical Review

2.1.1. Demand Theory

According to Grant and Vidler (2002), the demand theory essentially is an analysis of the link between the price of goods and services and pertinent prices. This theory examines how buyers make decisions on what to purchase and how price, in turn, influences how much of a product customers demand. This theory was developed by a French Economist called Leon Walras, who lived between 1834 and 1910. Economists later created the law of demand out of this theory. According to this law, the higher the price of a product, the lower the demand for that product, and vice-versa. All factors held constant (McEachern, 2013).

In the context of access to credit, demand depends on the price, the latter being the cost of accessing and using the funds. When borrowers seek money from a lender, they are subject to terms and conditions like demand for collateral and varying interest rates during repayment. Consequently, when the terms of credit are favorable to the borrower, more of the credit facility will be demanded. When loans are used appropriately, they can lift families and individuals out of poverty, thus offering improved living standards. Credit also improves the buying power of individuals and helps them to budget, unlike when they have no economic power (Arnold, 2010). In the context of this study, improving credit accessibility will result in greater borrowing, which will, in turn, improve the performance of SMEs.

2.1.2. Credit Rationing Theory

There are many analytical attempts to expound on the way credit markets work. Novel theoretical developments are utilized in this regard. For example, the competitive development equilibrium has been challenged through the analysis of imperfect information and incomplete markets within the context of developing nations' credit markets. This offers novel theoretical bases for the development and implementation of relevant policies. According to Basu (2012), the proponents of credit rationing theory, Stiglitz and Weiss, opines that there are two roles of interest rates emanating from the credit institution. These are choosing borrowers (often devastating) and influencing how borrowers behave (thus creating the need for incentives).

While interest rates influence transactions within the market, they do now essentially make the market better. It is because credit markets have imperfect information that this scenario arises. Banks are keen to select the kind of borrower who is likely to repay a loan, as this boosts the bank's profitability. This leads to adverse selection. Financial institutions often use interest rates to identify worthy borrowers – those willing to pay the stated rates. Despite this, there

is a possibility of borrowers defaulting despite being willing to pay high-interest rates. This implies that the interest rates are directly proportional to default risk, which in turn has adverse effects on the return on investment for banks. The need for incentives arises because the terms and conditions of the loan (including interest rates) keep changing thus occasioning similar behaviour in the borrower, who has to consider how their project will be impacted by the changes (Peterson, 2012).

To understand the function of credit demand within the context of SMEs, one has to understand how the borrower decides to participate or the choice of whether or not to borrow and where to borrow from. There are several factors that determine this decision, in particular, the economic power and opportunities of the borrower. According to Matthews and Thompson (2005), credit rationing is, therefore, assumed to exist within the framework of the credit demand schedule. Where there is a low supply of credit, there also appears to be a similar level of expressed demand. Moreover, when the credit market experiences failure, it becomes costlier to get credit as compared to the inherent utility. This makes entrepreneurs engage in different activities to finance working capital. For this reason, formal credit institutions have to contend with alternative sources of credit.

2.1.3. Asymmetry Theory

Bebczuk (2003) asserts that information asymmetry is a situation in the credit market whereby the borrower is adequately informed of the inherent risks and benefits of investing in the business for which they are borrowing money. Conversely, the lender does not have sufficient information on the borrower (Bloem & Gorter, 2001). Due to this asymmetry in information, the lender faces problems of adverse selection and moral hazard. This explains the predicament of MFIs whereby they have to expend surplus resources in assessing and monitoring borrowers, yet the borrowers only qualify for small amounts.

Despite this, it is possible to turn qualitative data into quantitative data by using a scale and assigning weights based on a predetermined threshold. The cost of processing the documents is downscaled while subjective judgements and potential prejudices are eliminated when this is done (Greuning & Bratanovic, 2009). The systems used for rating can be enriched by ensuring it establishes the level of risk involved in advancing the loan. Using a numerical scale is essential because it helps to determine the factors that are significant while expounding on the risk of default as well as the extent to which individual factors are important. Moreover, such a scale aids in improving how the potential risk is priced, eliminating applicants who have bad loans and estimating how much is needed to fill the gaps that may result from losses of loans in the future. Information asymmetry is one of the key challenges facing both lenders and SMEs. Lack of or incomplete information influences funding or borrowing decisions for financial institutions and SMEs, respectively (Turyahikayo, 2015).

2.2. Empirical Review

Financial institutions have developed stringent lending conditions, which have reduced the uptake of financial credit among small and micro enterprises. In Mozambique, a study on factors influencing access to finance by SMEs in Maputo Central Business District by Osano and Languitone (2016) revealed that most SMEs are denied credit and discriminated against by lenders in the provision of financing because of high risk and for not having adequate resources to provide as collateral. This study established that the structure at that time of that financial sector did not augur well for small-scale borrowers. The researchers recommended improvement of the regulatory framework of the industry as this would encourage SMEs to borrow more from banks. This study, however, had two key respondents – the banking sector and SMEs. On lending procedures, the findings were based on the responses of bankers as opposed to SMEs. In as much as the researchers wanted to generate the information they could correlate, ignoring the opinions of borrowers in terms of lending conditions is a fundamental weakness of this study.

Anyieni (2014) corroborates the findings of Osano and Languitone (2016). The former studied access to funding by SMEs in Kisii County, Kenya. This study established that many small and medium entrepreneurs could not access credit due to the many barriers erected by borrowers in the form of stringent conditions and strict requirements. The key strength of this study was its concentration on SMEs as opposed to lenders. One of the weaknesses of this study, though, is that it does not state the researcher methodology that was used. This would have been crucial in establishing whether the findings were viable. Moreover, the conceptual model is not adhered to while discussing findings.

Favourable lending conditions can, to a great extent, lead to increased uptake of financial credit. A study by Gichuki *et al.* (2014) on the challenges facing Micro and Small Enterprises in accessing credit facilities in Kangemi Harambee Market in Nairobi City County established that access to credit facilities was highly limited by strict collateral requirements such as group guarantees, individual guarantors, having a bank account, having equity capital and assets as title deeds and log books. The researchers recommended that lenders should come up with conditions that were attractive, flexible, and affordable to encourage more entrepreneurs to borrow. This study used a stratified random sampling technique, which ensured that entrepreneurs from all available types of SME businesses were included.

Masoud and Mwirigi (2013) argue that the difficulty faced by SMEs in accessing credit is due to the inability of most SMEs to meet the conditions set by financial institutions. Granting credit is still a major problem, as many small and micro enterprises cannot fulfill lending conditions. While these requirements may differ from one lending institution to the other, the differences are negligible, and SMEs owner face what can be called institutional challenges. In addition, a study by Muguchu (2013) on the relationship between access to credit and the financial performance of SMEs in Nairobi, Kenya, revealed that most SMEs borrowed only a small amount of money from financial institutions since they were only eligible to access such amounts given the criteria set by the institutions, and also because they were reluctant to borrow large amounts that they would likely not be able to repay.

A study by Kung'u (2011) on factors influencing SMEs' access to finance in Westland Division, Kenya, revealed that lending institutions require collateral or asset tangibility, especially while dealing with the small and micro enterprises sector whose information availability is scarce, hence higher information asymmetry. The study also revealed that lack of borrowing was associated with a lack of assets for these firms because those assets were viewed by the financial institutions as owners' or managers' personal assets rather than business assets. In cases where one had more than one asset, credit takers feared the burden associated with a bank loan and, therefore, opted to continue in their current financial constraints rather than risk the few assets they had. This reduced uptake of financial credit in both the short- and the long- term.

One of the emerging lending approaches is through groups of entrepreneurs. According to Yunus (2007), group lending is a decision by a financial institution and not the industry in general. This mode of lending has succeeded in the case of Grameen Bank, but not every lending institution has been as successful. In Kenya, for example, lending through groups has not gained popularity. Institutions that are licensed to offer credit often impose inflexible conditions for group-based borrowers.
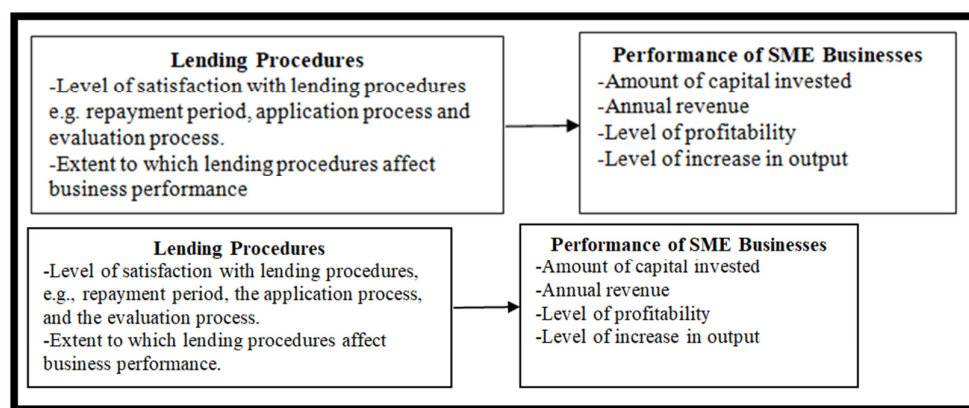
2.3. Conceptual Framework

Figure 1: Conceptual Framework

3. Research Methodology

3.1. Research Design

The study adopted a descriptive survey study design. A research design is best understood as a glue holding together different but related elements of a study (Trochim, Donnelly, & Arora, 2015). In this study, the researcher purposed to collect and analyse data from a cross-section of SME business owners and/or managers at a specific time. The purpose of this study was to investigate credit accessibility and performance of SME businesses in Meru County to identify gaps and recommend viable solutions for productivity for these enterprises.

3.2. Target Population, Sampling Design, and Sample Size

The study was based in Meru County. There were 599 registered SMEs by the Meru County government, which had been in operation for 3 years (Meru County Government, 2016). The study used only the owners of the SMEs, and where the owner was not available at the time the researcher visited the business, the study relied on the SME's manager for information.

The sampling design describes how the researcher will derive the sample from the population (Kothari, 2010). This study involved 599 SME businesses that were registered by the Meru County government and had been in operation for a minimum of 3 years then. The study was conducted in nine sub-counties of Meru County (Meru County Government, 2016).

Krejcie and Morgan's (1970) table for determining sample size for a given population was used to derive the sample from the population. This is because there was a definite number of SMEs to comprise the population, according to data obtained from the County Government on registered SMEs. Based on this table, for a population of 599, the sample size should be 234 entities. The researcher used a proportionate random stratified sampling design to derive the sample.

The researcher further used purposive random sampling to ensure a proportionate representation of the various types of SMEs represented in each stratum/sub-county. This was important because some types of businesses tend to be dominant in certain areas, and simple random sampling may not result in a holistic sample.

3.3. Research Instruments

Data was collected using questionnaires. The questionnaire had both open-ended and closed-ended questions. The questions contained straightforward directions so that the respondents would not feel any difficulty in answering the questions. The method was the best since it was free from bias; there was the adequacy of time to give well-thought

answers, convenience in reaching respondents, and the results were more dependable and reliable, as supported by Kombo & Tromp (2006).

3.4. Data Collection Procedure

The drop-and-pick method was used to collect data after booking an appointment with the respondents. This method was useful in administering the questionnaires to the sampled population since it ensured that respondents were reached without any external influences (Denscombe, 2007). The questionnaires were picked after 3 days, and this ensured respondents had filled out the questionnaires at their convenient time within given timelines.

3.5. Data Processing and Analysis

Frequencies and descriptive analysis were used to analyse data. The findings were presented in the form of charts and tables. Further inferential statistics were carried out to test whether there were any relationships between the four independent variables and the performance of small and medium enterprises. In this study, a Chi-square test at 0.005 was performed to test the relationship between independent variables and dependent variables. According to Mugenda and Mugenda (2003), this method is used to measure the association between the independent variable and the dependent variable. Data analysis was done with the help of Statistical Package for Social Sciences (SPSS) version 22.

The study carried out three diagnostic tests on the data. Multicollinearity was used to check interconnection among the variables. Multicollinearity occurs when these factors are highly correlated with the value of r being less than 0.9 (Tabanchick & Fidell, 2007). This test was carried out using Variance Inflation Factor (VIF). Heteroscedasticity was used to determine whether, as the predictor variable increased in size, the variance of the outcome variable increased. Normality Test was used to investigate whether the variables followed the normal distribution.

4. Research Findings and Discussions

The study sought to find out the extent to which lending procedures affected the respondents' businesses. The respondents were required to state whether their businesses were affected either positively, negatively or with no effects at all.
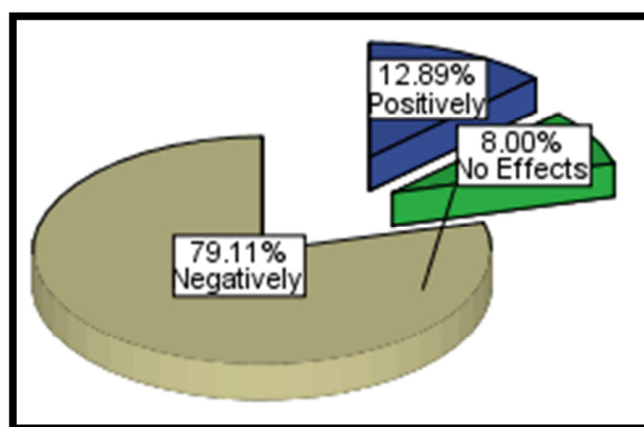

Figure 2: Lending Procedure and Business Performance

According to Figure 2, most of the respondents (79%) indicated that the lending procedures adopted by financial institutions negatively affected their businesses. Only 13% of the respondents indicated that the procedures used by financial institutions while advancing credits to small and medium enterprises affected them positively. Eight percent of the respondents indicated they felt the procedures adopted by financial institutions did not affect them at all. With most of the respondents acknowledging that lending procedure affected their businesses negatively, financial institutions should at least change the ways in which they lend their customers credit as they try to minimize cases of bad debts. This will ensure that the performance of small and medium enterprises is positive, which will mean more business to the financial institutions in terms of deposits and loans for expansion purposes.

Respondents were probed further to explain how the lending procedure affected the performance of the business. Most of the respondents (51%) indicated that their businesses experienced slow growth. Twenty-nine percent indicated that their business stagnated, with 7% indicating that they looked for finances elsewhere. These sources could be from friends, family members, or even from government institutions through devolved funds such as Youth Enterprise Development Fund, Women Enterprise Fund, or *Uwezo* Funds. Only 13% of the respondents indicated that the loans helped boost their business. This proportion is equal to the number of respondents who indicated that the lending procedures positively affected businesses.

4.1. Test of Hypothesis

In this section, a Chi-square test was conducted to establish whether there was any significant relationship between the lending procedure and the performance of small and medium enterprises. In this model, the lending

procedure was the independent variable, whereas the performance of small and medium enterprises was the dependent variable. The results of the test of the null hypothesis were stated as follows:

Ho$_1$: There is no significant relationship between lending procedures and the performance of SME businesses in Meru County.

The results in table 1 indicate a p-value = 0.002, which is less than the level of significance (5%). Therefore, at 5% level of significance, the null hypothesis that there was no significant relationship between lending procedures and the performance of small and medium enterprises in Meru County can be rejected. This indicates that there was some evidence that there was a significant relationship between the lending procedure and the performance of small and medium enterprises.

	Value	Df	Asymp. Sig. (2-sided)
Pearson Chi-Square	30.758	12	.002
Likelihood Ratio	34.549	12	.001
Linear-by-Linear Association	.048	1	.826
N of Valid Cases	225		

Table 1: Chi-square Test for Lending Procedure and Performance of SMEs

According to this study, more than half of the respondents agreed that the lending procedure employed by most of the financial institutions in Meru County is very complicated. The respondents also cited the presence of many regulations and requirements which had to be met before they got the credit. These regulations and requirements mostly made small and medium businesses in the county experience slow growth or stagnate in general. The study also revealed that most of the respondents (77%) agreed that the loan repayment period was favouring them. Only 5% indicated that the loan repayment period was favouring them. A Chi-square test revealed some evidence to suggest that there existed a relationship between the lending procedure and the performance of SMEs in the county.

5. Conclusion

The study revealed the extent to which lending procedures affect the performance of small and medium enterprises in Meru County. The loan application process, if not properly improved, will lead to more and more small and medium enterprises performing dismally. This will have a multiplier effect on the economy of the county, considering the fact that these enterprises employ thousands of people in different job groups. Financial institutions should at least develop a customer-friendly repayment plan. This can be in the form of giving customers a grace period, for example, of about six to nine months before they start paying back the loan. If the repayment period is not favourable to credit takers, then they may be forced to dig deeper into their pockets which, in the short-run, may affect the liquidity position of small and medium enterprises negatively.

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