THE ROLE OF FINANCIAL INTERMEDIATION IN THE GROWTH OF SMALL AND MEDIUM MANUFACTURING ENTERPRISES IN KENYA: A SURVEY OF SMALL AND MEDIUM ENTERPRISES IN NAIROBI

C. J. Mairura*

Prof. G.S. Namusonge**

Dr. Kabare Karanja***

Abstract: *The purpose of this study was to establish the role of financial intermediation in promoting the growth of small and medium manufacturing enterprises in Kenya. It has been observed that financial intermediaries play an important role in supporting entrepreneurs who start innovative activities such as new businesses.*

The study sought to examine the nature of support SMEs receive from financial intermediation, to identify the evaluation procedures undertaken by financial intermediation before they offer support, to examine the regulatory framework in place for the support on SMEs, to establish how managerial competence influence support to SME's and its effects on SMEs' growth.

Differences in regulations governing banking and non-bank financial intermediaries, lack of autonomy and weak supervisory capacities to carry out the Central Bank's surveillance role and enforce banking regulations, inappropriate government policies which contributed to an accumulation of nonperforming loans, and non-compliance by financial institutions to regulatory requirements of the 1989 Banking Act among others posed a challenge to the Kenya banking system. Many banks that collapsed in the late 1990's were as a result of the poor management of credit risks which was portrayed in the high levels of nonperforming loans ROK (2005).

The primary data was collected through structured questionnaires containing both closed and open ended questions. The data was analysed using descriptive statistics such as frequency, percentages, means and standard deviation as well as inferential statistics such as ANOVA, Multiple linear regression and correlation analysis.

The findings show that most of the respondents agreed with the fact that, they received a lot of support from the financial intermediaries, Support received enhanced business growth,

Growth of business is attributed to the nature of support received as accounted by 49.2 percent, who agreed that they received a lot of support, 73.5 percent said that support received enhanced business growth and 55.6 percent strongly agree and agree cumulative responses.

The findings of the study showed the role played by financial intermediaries in promoting SMEs' growth in Kenya. The results of the study form the basis for recommendations to relevant stakeholders to ascertain the appropriate leading strategy for improving SME sector in Kenya.

***Keywords**: growth, manufacturing, financial intermediation, SME, Kenya.*

INTRODUCTION

Studies by Winborg and Landstrom (2001) demonstrated the positive impact and dynamic role that SMEs play in most developing countries. Globally the small and medium enterprise sectors of individual nations are growing in size and significance. Consequently, the successful provision of business assistance has come to be viewed as imperative in terms of advancing the fortunes of the small business sector and in contributing to economic growth. Mostly, the assistance in this sector is finance, market information, etc. Access to credit has been considered as one of the main problems that SMEs have to deal with in order to survive and keep growing (Peel & Wilson, 1996). An appropriate combination of access to credit, credit conditions, and adequate financial and operational policies, is the only way to deal with the complex problem of SMEs survival and growth. It is widely recognized that financial institutions play an important role in supporting entrepreneurs who start innovative activities such as new businesses.

About 475,000 (four hundred and seventy five thousands) new jobs were created between 2006 and 2007 with the informal sector accounting for 427,000 (four hundred twenty seven thousand) of the additional jobs (89.9%). ROK. (2008). The growth was attributed to the favourable business environment, availability of credit from financial institutions, and increase in investment opportunities in Kenya. However, the sector has potential to employ more, if proper mechanisms are put in place with full support of the implementers.

PROBLEM STATEMENT

Access to credit has been considered as one of the main problems that SMEs have to deal with in order to survive and keep growing. An appropriate combination of access to credit, credit conditions, and adequate financial and operational policies, is the only way to deal with the complex problem of SMEs survival and growth. This study assessed the role of Financial Intermediation in promoting the growth of Small and Medium Enterprises (SMEs) with a special focus on manufacturing businesses in Nairobi.

Small-scale enterprises have become important contributors to the Kenyan economy. The sector contributes to the national objective of creating employment opportunities, training entrepreneurs, generating income and providing a source of livelihood for the majority of low-income households in the country (ROK, 2005) accounting for 18 per cent of GDP. With about 70 per cent of such enterprises located in rural areas, the sector has a high potential for contributing to rural development. Yet the majority of entrepreneurs in this sector are considered un-creditworthy by most formal credit institutions. Whereas a small number of NGOs finance an increasing number of micro-enterprise activities, most formal institutions still deny these enterprises access to their services.

As the financial sector grows, institutional diversity is expected. However, this has not been the case, as reflected in the limited growth of other competing institutions like Post Bank, insurance and the Nairobi securities and exchange. The Kenyan banking sector is dominated by a few large firms, which focus mainly on short-term lending.

Lack of access to credit is the major constraint inhibiting the growth of MSEs, and more so for women entrepreneurs. The issue and problems limiting SME acquisition of financial services include lack of tangible security coupled with inappropriate legal and regulatory framework, and limited access to formal financing due to poor and insufficient capacity to deliver financial services to SMEs (ROK, 2005). The growth and relative sophistication in the Kenyan financial system have not been matched by efficiency gains in the quality of services offered to the customers and the economy in general (Atieno, 2001).

GENERAL OBJECTIVE:

The broad objective of this study was to assess the role of Financial Intermediation in promoting the growth of Small and Medium Enterprises (SMEs) with a special focus on manufacturing businesses in Nairobi.

SPECIFIC OBJECTIVES:

i. To examine the type of support received from financial intermediaries, and its influence on manufacturing SME's growth

ii. To assess the effect of the financial intermediaries' credit evaluation procedures on the growth of SMEs in Kenya

iii. To examine the existing regulatory framework governing financial intermediaries' and its effect on SMEs' growth.

iv. To examine how SME's managerial competence influence support from financial intermediaries and its effect on growth.

LIMITATIONS

The study faced the following challenges: first, the manufacturing SME owner/manager of the business thought that they were to benefit financially from the research; therefore, this may have influenced their responses. Secondly the respondent's level of education determined the response time, because some respondents took more time to respond. Thirdly, some enterprises lacked proper records to facilitate their response. However, this was minimized through explanation of the subject matter in the questionnaire and the assurance that the information was to be treated confidentially.

The assumption for the study was that credit delivery influences, determines and directs the growth of manufacturing businesses.

Manufacturing Sector

Kenya's manufacturing sector is mainly agro-based, hence its strong linkage with the agricultural sector cannot be over-emphasized. The sector contributes about 10 percent of the Gross domestic product (GDP) annually. Growth in business and investment evidently leads to increased output in manufacturing, and ultimately contributes to the overall economic growth.

To increase competitiveness of manufactured goods, the government is reducing the cost of doing business, especially in the areas of legislation, in addition to creating an enabling environment for investment (ROK, 2008). This enabled a number of manufacturing entities to expand their production capacity and access regional as well as overseas markets.

Approved industrial credit towards manufacturing sector went up in 2007. The number of new jobs created in the manufacturing sector in 2007 increased by 2.3 percent. This brings the total number of direct formal employment to 261.3 thousand persons from 254.9 thousand persons recorded in 2006 (ROK, 2008).

The sector contributes about a tenth of the Gross Domestic Product (GDP) and is also one of the key employers within the formal sector. The sector's real value added grew by 6.2 percent in 2007 compared to 6.3 percent recorded in 2006. Since 2003, the sector has shown improved growth resulting from enhanced power supply, increased market opportunities with East Africa Community (EAC) and Common Market for Eastern and Southern Africa (COMESA), favorable tax reforms and other incentives. Employment in the SME sector grew by 6.1 percent in 2007 compared to 6.3 percent recorded in 2006. Employment in the sector reached 7,475.6 thousand in 2007 from 7,048.7 thousand in 2006. This indicates that a total of 426.9 jobs were created in the sector in 2007 compared to

420.2 thousands in 2006. The distribution of employment indicates that the manufacturing was number two with 21.7 percent

Growth of Small and Medium Enterprises

Small scale enterprises have become an important contributor to the Kenyan economy. The sector contributes to the natural objectives of creating employment opportunities, training entrepreneurs, generating income and providing a source of livelihood for the majority of low-income earners in the country (ROK, 2005), accounting for 18.4% of Gross Domestic Product (GDP). Yet the majority of entrepreneurs in this sector are considered un-creditworthy by most formal credit institutions. Whereas a small number of NGOs finance an increasing number of the micro enterprises, most formal institutions still deny these enterprises access to their services.

Lack of access to credit is a major constraint inhibiting the growth of the SME sector, especially the small scale entrepreneur (Roil, 2005). The area of concern regarding SMEs credit availability is the lending infrastructure of a nation which defines the rights and flexibility of financial institutions to fund SMEs, using the tending technology (Berger, 2004). There are no structured institutional mechanisms in Kenya to facilitate the flow of financial resources from the formal financial sector through micro-finance institutions. This increases the cost of credit to both the entrepreneur and financial institutions.

METHODOLOGY

This study adopted a survey research design. Sekeran (2000) states that surveys are useful and powerful in finding answers to research questions, but they can do more harm than good if not correctly targeted. Survey research design helped to collect both primary data since the population was scattered in different geographical locations. This study used a mixed method approach. (Crewell & Clark, 2006). The mixed methods approach is a procedure for collecting, analysing and mixing both quantitative and qualitative data in a single study or a series of studies. Qualitative research seeks to describe and analyse the behavior and culture of humans and their groups from the point of view of those being studied (Orodho & Kombo 2002: Kombo & Tromp, 2006).

Target Population

The target population for this study included all the Small and Medium manufacturing enterprises operating in Nairobi, and which are licenced by City council. The manufacturing sub-sector was chosen due to its growth potentiality as compared to other sub-sectors (Abuodo, 1996; Odiege, 1995). Also the sector contributes significantly to the economic growth and employment. A sampling list of all these enterprises was constructed from lists of licenced businesses obtained from city hall.

The City Council of Nairobi has classified SMEs into categories as shown in the appendix table 15.

The researcher employed stratified random sampling in selecting respondents. The populations were segregated into sub-populations or strata, herein referred to as business categories. In this instance, stratification made a pronounced improvement in statistical efficiency and secondly it provided adequate data for analysing the various subpopulations or strata.

DATA ANALYSIS AND RESULTS

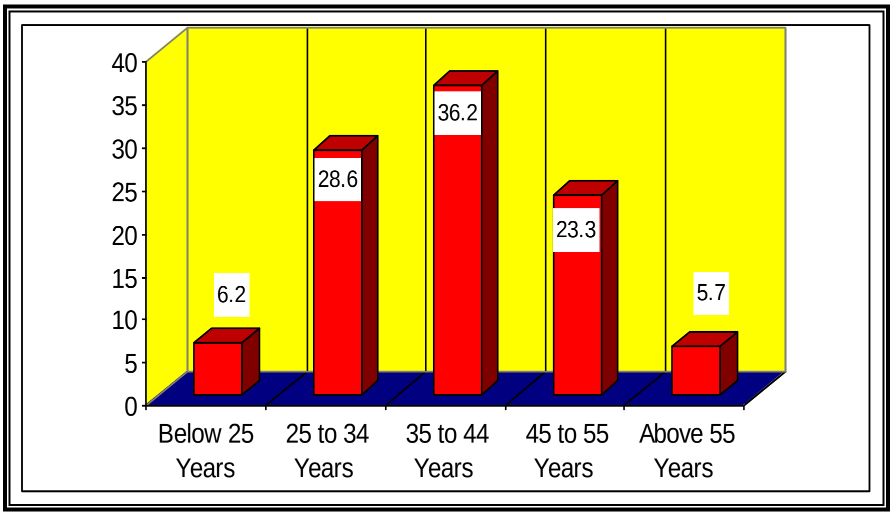

Figure 1: Age of the respondents

Table 1: Support Received by respondents from Financial Intermediaries

Support from Financial Intermediaries	Frequency (n)	Percentages
Offering banking services	153	78.1
Offer credit to the business	122	62.2
Advisory services	77	39.3
Training	68	34.7
Financed the start of business	35	17.9
No support	11	5.6

Table 2: Effect of Support by Financial Intermediaries on the Business Growth

	Strongly Agree %	Agree %	Neutral %	Disagree %	Strongly Disagree %
I receive a lot of support from the financial intermediaries	12.4%	36.8%	21.4%	26.9%	2.5%
Support received enhanced business growth	20.4%	53.1%	20.4%	6.1%	0.0%
Business can progress well without the support of financial intermediaries	12.8%	2.0%	24.0%	12.8%	48.5%
Growth of business is attributed to the nature of support received	13.8%	41.8%	25.5%	16.3%	2.6%

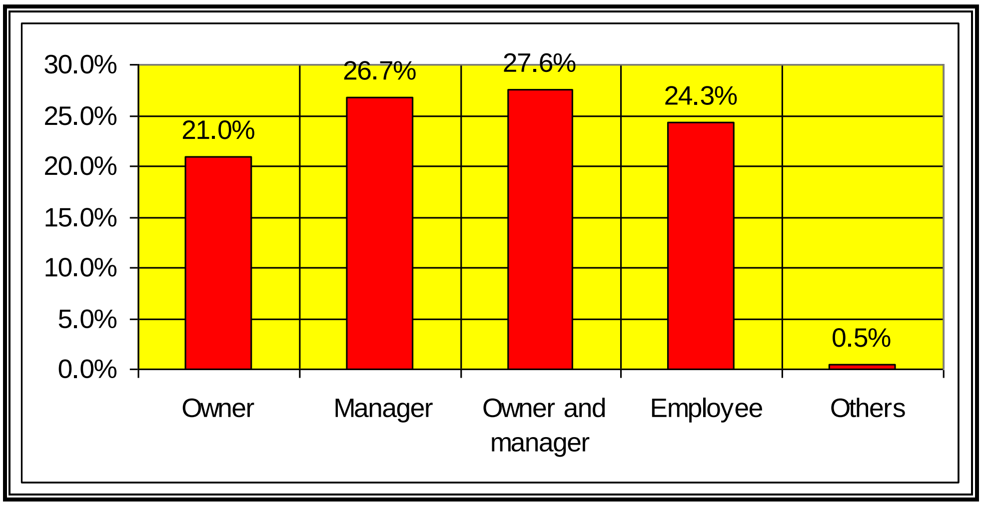

Figure 2: Status in the Business

Table 3: Pearson Correlations between Support Received and Growth of SMEs

		Growth of SMEs	Support Received	Deductions
Support Received	Pearson Correlation Coefficient	.305(*)	1	Positive correlation
	Sig. (P-value)	.000	.	Significant
	N	153	153	
Growth of SMEs	Pearson Correlation	1	.305(*)	Positive correlation
	Sig. (P-value)	.	.000	Significant
	N	153	153	

* Correlation is significant at the 0.05 level.

Table 4: Multiple Linear Regression Analysis

Model		Coefficients Beta	T-statistic	Sig. level (P-Value)
1	(Constant)		1.522	0.131
	Support Received	.156	3.756	0.008(*)
	Evaluation Procedures	-.082	-0.931	0.354
	Regulatory Framework	.225	2.461	0.015(*)
	Managerial Competencies	.338	3.962	0.000(*)

(*) means the variable is significant at the 0.05 level.

a) Dependent Variable: Growth of manufacturing SMEs

The findings presented in table 4.14 show that the support received, regulatory framework, and managerial competencies were statistically significant since their P-values were less than the 0.05 (P<0.05) level of significance while the Evaluation Procedures was found not statistically significant since its p-value was greater than the 0.05 (P>0.05) level of significance as shown in Table 4.14. This leads to rejection of null hypothesis one, three, and four as stated above and accepting hypothesis two above. The non-significant variable was therefore removed from the model since it was found to have no significant effect on the dependent variable. Thus, the new regression model appears as shown in model two.

Equation 4.2: A Multiple Linear Regression Model Two

$\mathbf{Y}= \alpha_0 +\beta_1 X_1+ \beta_3 X_3+ \beta_4 X_4+ \varepsilon$

Equation 4.2 shows that support received, regulatory framework and managerial competencies were the most significant financial intermediation related factors that determined the growth of manufacturing SMEs. From this equation, it can be concluded that growth of manufacturing SMEs is manly contributed by the support received, regulatory framework, and managerial competencies. Accordingly, the financial intermediaries need to put more effort in improving their SMEs Evaluation procedures so as to ease credit access procedures. This will therefore contribute to the growth of manufacturing SMEs in the region in the long run.

SUMMARY AND CONCLUSIONS

Summary

The study targeted SMEs manly from the manufacturing sub-sector most of which were owned by males (70%) and aged between 35-44 years (66%). The study showed that most of the respondents (35.7%) had tertiary education and had worked in their respective businesses for between 5 to 10 years (42.9%). This shows that they had acquired technical training, experience and were well conversant with the running of their businesses.

Through Multiple response analysis, the study established that the main supports given to businesses by financial intermediaries were banking services (78.1%) and credit to the business (62.2%). Other forms of support offered by financial intermediaries included; advisory services (39.3%), training (34.7%) and financing the start of businesses (17.9%). This shows that the financial intermediaries supported the SMEs manly by offering banking services and extending credit facilities to the businesses.

Through the use of a five-point Likert scale, the means and the standard deviations of the key aspects were computed and assessed on the scale as shown in chapter four. The findings revealed that evaluation procedures make it difficult for businesses to access support from financial institutions.

From the overall perspective, the existing regulatory framework governing the operations of financial intermediaries was found to be supportive to the plight of small business. However, to some extent, the findings show that existing regulatory framework governing financial intermediaries limits the effective support the SMEs' receive from financial intermediaries.

The findings also showed that most of the SMEs had the needed technical training (73.2%) and adequate managerial training needed to run the business (70.4%). The findings showed that the managers/owners' technical training, managerial skills and experience in the business influence the support the businesses got from the financial institution which in turn enhanced business growth.

CONCLUSIONS

The study showed that the financial intermediaries played a significant role by offering banking services and extending credit facilities to SME businesses. Other support offered by financial intermediaries included; advisory services, training and financing the start of businesses. The study revealed that the existing evaluation procedures adopted by financial intermediaries were a big hindrance to credit access because they were stringent and bureaucratic. Evaluation procedures made it difficult for businesses to access support from financial institutions. The existing evaluation procedures wasted a lot of business time and made financial intermediaries services inaccessible to most businesses.

Based on the statistical analysis performed, it can be concluded that the most significant aspects of financial intermediaries that affected the growth of SMEs included; support received, regulatory framework, and managerial competencies. These were found to have contributed significantly to the growth of manufacturing SMEs. SMEs evaluation procedures were found not to have contributed to the current growth of SMEs hence the need to revise the existing financial intermediaries' evaluation procedures. This will therefore contribute to the growth of manufacturing SMEs in the region in the long run.

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