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Effect of Profitability on Financing Small and Medium Enterprises (SMEs) by Financial Institutions in Kenya: A Case Study of Equity Bank, Central Kenya

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Abstract:

Businesses have in the recent past been awakened by the ever-growing competition in market share and in extreme exit from the market. The small and medium enterprises (SMES) have not been spared and have therefore sought for financing from lenders such as financial institutions with a view to be able to compete effectively. Financing is a major ingredient to success of any business. This is so because objectives of the business cannot be met if there are no resources in terms of infrastructure and stock besides other overheads such as human resource, marketing etc. This paper seeks to determine the effect of profitability on financial institutions management when considering award of loans to the Smes. The researcher believes that the findings will be of use to the government for policy making, legislation, the findings will also assist the investors in evaluating themselves for creditworthiness. Private sector will also get to know where and when they could supplement the government in boosting entrepreneurship from the findings. Equity Bank: Central Kenya was the case study. The findings were that profitability is a major consideration when evaluating SMEs creditworthiness. Business should exercise utmost discipline and focus towards profit making to enhance eligibility for financing by financial institutions.

Keywords: Profitability, financing SMEs, financial institutions

1. Introduction

Kenya like many other developing countries, has several small and medium enterprises (Smes) that are run by upcoming investors who endeavor to empower themselves economically with a view to improve their standard of living. The sources of finance to these enterprises have however been a challenge thus impeding their expansion and growth. This has not only slowed Kenya's economic growth and retarded increase in opportunities for employment to Kenyans both graduates and dropouts. Due to exposure, the developed countries have advanced considerably in this sector because structures are already in place and most of the Smes are at advanced stages. Smes have a financial cycle whereby the financial needs and options change as the business grows (Aghion, Philippe and Peter 2005). In Kenya, majority of Smes are in startup stages crippled by lack of finances for their expansion and growth. Lack of expertise to manage the enterprises also comes into play hindering further their development. According to Wynant and Hatch 1991 the young, inexperienced businesses with high indebtedness have problems getting bank loans. Given that Kenya is a developing country that has a dire need for employment for her people to reduce poverty levels, it is imperative that focus on the growth of Smes should be emphasized in order to achieve the vision 2030.

Most Smes have failed to survive in that most of the investors end up closing the businesses due to lack of finances though at various levels. Some wind up at the startup stage. This is the stage where the business will not have had enough stock to satisfy demand, enough capital to attract qualified personnel, resources to market the products and finances for infrastructure for the business. This scenario occurs where sources of finance are difficult to come by due to lack of availability, accessibility, cost and lack of awareness that different sources of finance exist. Other causes would include among others lack of entrepreneurial expertise and poor management practices. The other stage of Smes is the maturity stage. This is the stage where enterprises have stabilized and profitable but not growing. The Smes in this stage make profits for survival and for the investors. These Smes are able to employ many people and still remain profitable. This will lead to economic growth to the countries hosting the Smes and therefore cause better standards of living for humanity. The other stage is where Smes are mature and growing very fast. This is the best stage for Smes because as they grow, they create more employment opportunities which in turn improve the standards of living for the people and hence reduces poverty levels considerably. This also spurs economic growth for any country through improved tax collection paid by the Smeseg corporate tax, Vat, excise duty, import duty etc. These stages that Smes fall has a direct bearing on the source of finance that they will choose because evaluation by lenders will consider the stage where the Sme falls. For example, anSme in the stage where growth is fast will be better placed for financing by lenders due to better credit worthiness than Sme in the startup stage due to poor rating in credit worthiness. In the startup stage the Sme will be viewed with suspicion that the lender might not get repayment and would therefore be reluctant to finance the Sme in this stage.

The private sector is also playing a big role in availing finances to Smes in the Kenya by providing short term and medium-term loans to investors in Kenya. The private sector includes among others the micro finance institutions like the Faulu Kenya, Kenya Women Finance Trust, Jitegemee credit scheme, Equity Bank etc. These organizations do not emphasize on the collateral for loan awards but their interests are fairly high given that they are usually flat rates which are compounded.

There is no doubt that more than 50% of Kenyans are living below poverty level of less than a dollar per day and that Kenya has stagnated white collar jobs opportunities. Kenya also has no option but to put efforts on promotion of Smes to create more job opportunities and contribute to overall economic growth. This will help boost the health sector which is also critical for any nation growth. The need for boosting education sector can also not be overemphasized, especially now that there is the free primary education and free secondary education to the extent of tuition fees. This is besides other government obligations to the citizens e.g., infrastructure and security.

2. Literature Review

Equity Bank commenced business on registration in 1984. It has evolved from a building society, a microfinance institution, to now the all-inclusive Nairobi Stock Exchange and Uganda securities Exchange Public listed commercial Bank. With over 6.3 million accounts, accounting for over 57% of all bank accounts in Kenya, Equity bank is the largest bank in the region in terms of customer base and operates in Uganda, South Sudan and Rwanda. Equity bank continues to receive both local and global accolades for its unique and transformational business model. The bank is credited for taking banking services to the people through its accessible, affordable and flexible service provision. In September 2011 for example, Equity Bank was recognized as the only financial service provider in the emerging markets which meets the threshold of sustainability based on the criteria covering innovation, growth and corporate sustainability. Equity Bank is also the holder of the 2007 global vision award in microfinance for initiating a concept of the future that will shape the global economy. (www.equitybank.co.ke)

To alleviate the shortage of sources of finance to Smes, Equity Bank provides various finances e.g., business and development loan for working capital and all other business requirements. She also provides agricultural loans which support customers dealing with all categories of farming to carry out various farming activities including purchase of farm inputs and equipment. BiasharaMara loans are also available from Equity Bank for working capital to small and micro businesses. (www.equitybank.co.ke) However to qualify for financing by Equity bank there are requirements that have to be met by the Smes in order to qualify for the loan awards. These requirements include among others profitability

2.1. Theoretical Review

The literature review on profitability had been researched on from the business perspective that is to say how it affects the business itself in terms of growth and survival. But there was very little on the factors that lenders consider in awarding loans to business for expansion and meet daily business obligations. The aforesaid variable is the focus to see how it affects lenders in their decision making on the creditworthiness of businesses specifically Smes.

2.2. Profitability

There are various methods of measuring profitability of a business. According to Lucey (2003) different profitability ratios are used to measure profitability of an enterprise. This measure has been used to determine whether Smes are eligible for financing by various financial institutions. These methods of computing profitability of Smes include; Operating Profit

Operating profits= Operating income - Operating expenses

This is the profit earned from a firm's core business operations, Zui, Alex & Alan (2009). It does not include profit earned from the firm's investments (such as earnings from firms in which the company has a partial interest) and the effects of interest and taxes. This ration is also known as earnings before interest and taxes (EBIT). (Stephen, Randolph & Bradford,2008).

2.2.1. Profit Margin

This is a ratio of profitability calculated as net income divided by revenues or net profits divided by sales. It measures the dollar amount of the sales that a company actually retains in earnings. Profit margin is very useful in comparing companies in similar industries. A higher profit margin indicates a more profitable company. Profit margin is displayed as a percentage; a 20% profit margin, for example, means that the company has a net income of \$0.20 for each dollar of sales.

Return on Assets (ROA)

= Net income / Total assets

An indicator of how profitable a company is relative to its total assets. ROA provides an idea of how efficient management is at using its assets to generate earnings. It is calculated, as shown here, by dividing a company's annual earnings by its total assets, with ROA displayed as a percentage. . (Frigo, 2001). Sometimes this is referred to as return on investment.

Return on Equity (ROE)

= Net Income/ Shareholders Equity

This is a measure of a corporation's profitability. ROE reveals how much profit a company generates with the money shareholders have invested, (Stephen, Randolph & Bradford ,2008). Return on equity is also known as return on net worth (RONW).

Profitability of an investment can be measured and used for managerial decision making by senior managers. Profitability of any given organization has a direct bearing on its growth and survival, Frankwood and Townsley (1986) and therefore this would be of important to investors in the business besides shareholders. Lenders also use profitability as a condition to funding. This is because if a business is not operating profitably then its future is not certain and therefore lenders will be reluctant to lend such a business. But if a business is operating profitably and consistently these will be gray areas for lenders because there will be less risk on the funds lent as the business continuity is certain and hence repayment is likely without defaulting. Smes that do not operate profitably are not spared but are victims ending up with no willing lenders to finance their business ventures. This has seen several of them closed or stagnate or with little growth thus unable to realize full potential and compete effectively. This certainly results to slowed economic growth and unemployment

3. Research Methodology

This chapter dealt with the research design, the population, sampling frame, sampling technique and instruments used, John & Kuby (2005). It also discussed the data collection procedure, processing and analysis.

3.1. Research Design

This is an applied research with a view to reduce poverty by providing finance to small and medium enterprises. By providing finances to Smes and with prudent management of the finances the businesses will grow and create employment to many thus reducing poverty. This research was conducted at Equity Bank Central Region which has been in the business for several years. The respondents were required to fill questionnaires which would help the researcher to collect data and then they were analyzed and conclusions made.

3.2. Target Population Study

The target population was the employees of Equity Bank, Central Region but excluding the office assistants as indicated in Table 1.

Department	No. of Employees	Percentage
Credit	1000	67%
Others	500	33%
Total	1500	100%

Table 1: Target Population

3.3. Sampling Size

The sampling size was 120 staff from the Equity Bank, central region excluding the office assistants. The 120 were picked from the credit section employees 60% of the employees and 40% from the others category.

3.4. Sampling Technique

The sample was 120 respondents and was picked using the stratified random sampling. This means the respondents were picked on random basis from the strata of the population Bluman(2003). One stratum was credit and the other one was other employees excluding the office assistants. The credit strata took 60% of the sample size while 40% was from others category. This means 72 was from credit and 48 was from others category. This is because it was expected that the credit strata will give more reliable data than the others.

3.5. Data Collection Instrument

The researcher used questionnaire to collect data for the research. The questionnaires were distributed to the randomly selected employees of each stratum. The instrument was simple to fill, not leading and unambiguous in order to get accurate responses.

3.6. Data Collection Procedure

The questionnaires were distributed to the respondents who were given about a week to fill them. These questionnaires were accompanied by an introduction letter by the researcher confirming confidentiality and that the exercise was for academic purpose only to encourage them to fill the questionnaires.

3.7. Data Processing and Analysis

The data was processed using the average and proportions. Tables were also be used. Summary was done and then conclusions.

4. Research Findings and Discussion

The findings are presented in form of tables and are analyzed according to the variables. This was based on the research questions and expresses the views of the respondents as they answered the questions in the questionnaire. The raw data is in the form of tables and the discussion of the same follows them.

4.1. Whether Or Not Profitability Is Considered in Creditworthiness Evaluation

This question sought to find out if profitability is considered in financing SMEs by financial institutions and the results are as shown in Table 2.

Whether Or Not Profitability Is Considered in Creditworthiness Evaluation	Number of Respondents	Percentage
Strongly agree	108	90
Agree	12	10
Total	120	100

Table 2: Consideration of Profitability in Creditworthiness

90% of the respondents indicated that they strongly agree profitability is considered during credit evaluation for any business, while 10% indicated that they agree with the same. Therefore, majority of the respondents agreed that profitability is a key factor in creditworthiness evaluation for the smes.

4.2. Whether Or Not The Higher the Level of Profitability the Higher the Chance Getting Finance

This question sought to find out if the higher the level of profitability the higher the chances of getting loan from financial institutions and the results are as shown in Table 3.

Whether Or Not the Higher the Level of Profitability the Higher the Chance of Getting Finance	Number of Respondents	Percentage
Strongly agree	24	20
Agree	96	80
Total	120	100

Table 3: Level of Profitability Effect on Eligibility for Financing

Majority of respondents indicated they agree that the higher the level of profitability the higher the chances of qualifying for a loan. 80% agreed while 20%strongly agreed.

4.3. Whether Or Not Profitable Business for Last 3 Years Qualifies for Loan

This question sought to find out if a business with a prolonged profitability qualify for loan and the results are shown in Table 3.

Whether Or Not Profitable Business for Last 3 Years Qualifies for Loan	Number of Students	Percentage
Strongly agree	84	70
Agree	24	20
Disagree	12	10
Total	120	100

Table 4: Effect of Duration of Profitability on Eligibility for Financing

70% of respondents indicated that they strongly agree that a longer past duration of business profitability enables the business to qualify for a loan. 20% indicated that they agree with the same. Therefore, majority of respondents strongly agree.

4.4. Whether Or Not a Business Which Has Recorded Losses for Last 2 Years Cannot Qualify for Loan

This question was to find out if a business which has incurred losses in the past 2 years can be financed by financial institutions and results are as shown in Table 5

Whether Or Not a Business Which Has Recorded Losses for Last 2 Cannot Qualify for Loan	Number of Respondents	Percentage
Strongly agree	60	50
Agree	60	50
Total	120	100

Table 5: Effect of Loss Making on Eligibility for Financing

50% of respondents indicated that they strongly agree that businesses that have recorded losses in the previous 2 years cannot qualify for a loan. The other 50% indicated that they agree with the same. Therefore, majority agreed that these businesses cannot qualify for the loan.

4.5. Extent to Which Profitability Affects Financing of SMEs by Banks

This question sought to find out the extent to which profitability affects the financing of smes by financial institutions and the results are as shown in Table 6.

Extent to Which Profitability Affects Financing of SMEs	Number of Respondents	Percentage
Too high	84	70
High	28	23
Low	8	7
Total	120	100%

Table 6: Effect of Extent to Which Profitability Determines Eligibility for Financing

5. Summary, Conclusions and Recommendations

This research sought to discover the effect of Profitability on financial institutions when evaluating smes for financing. This was done by using Equity bank central region as a case study. Using stratified sampling and a sample of 120, questionnaires were randomly issued to the respondents in the two strata i.e., credit section and other sections. These sections represented the areas that employees of Equity bank work.

Majority of the respondents indicated that they strongly agree or agree that profitability affects the financing of smes by financial institutions and that the extent to which profitability affects financing is either too high or high. The conclusions have been made on each research question as follows

Most of the respondents indicated the extent to which profitability affects the financing of smes by financial institutions were too high and either they strongly agree or agree that profitability is key for smes to receive a loan from the bank. It is therefore accepted that with low profitability which measures a business performance then a business will most likely not succeed in her quest for financial support from any bank.

Profitability is considered during creditworthiness evaluation of name. Therefore, smes should endeavor to enhance their performance and efficiency which will boost their profits and therefore stand a chance to qualify for a loan from the financial institutions. They should also strategize prudently in order to improve performance.

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