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Effects of Demand Side Factors on Access to External Finance by Small and Medium Manufacturing Enterprises in Nairobi, Kenya

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Abstract

Purpose - This paper investigates how demand-side factors affect access to external finance by small and medium manufacturing enterprises (SMMEs) in Nairobi, Kenya. The demand-side factors considered in the study are firm characteristics, financial management practices and entrepreneur characteristics.

Methodology - The study employs an exploratory survey design utilizing quantitative methods in data collection and analysis. Data is analyzed using descriptive and inferential statistics. Logistic regression is used to test the relationship between demand-side factors and access to external finance because of the dichotomous nature of the dependent variable.

Findings – The study establishes that some of the demand-side factors significantly influence access to external finance. These factors include variations in entrepreneur's networks, firm growth and earnings volatility which explain variations in odds of access to external finance by 39.9 percent for networks and 45.8 percent for earnings volatility and firm growth.

Implications – To minimize SMMEs financial constraints, social networking amongst entrepreneurs, firm growth and stabilized earning should be prioritized by management and policy makers. Though ethnic orientation influences the odds of access to external finance, policy efforts should be put in place to ensure efficiency in external financing markets so that entrepreneurs are not disenfranchised on this basis.

Value - The study recommends establishment and support of sustainable social networks that guarantee enterprise growth given that firm growth also influence odds of access to external finance. Further studies should probe the significance of good financial management practices on odds of access to external finance in diverse settings and industries.

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Key Words: *Demand side factors, Small and medium manufacturing enterprises*

Introduction

The significance of Small and Medium-size Enterprises (SMEs) in economic development has been recognized worldwide. Abor (2008) and Floyd and McManus (2005) observe that most developing countries, have an absence of many large firms thus implying that the SME sector is the main engine of growth. In Kenya, Kithae, Gakure and Munyao (2012) explain that SMEs play a pivotal role towards the achievement of the broad goals outlined in vision 2030 and are critical drivers towards making Kenya an industrialized country with high quality of life for its citizen.

SMEs are widely recognized as being the key sources of dynamism, innovation and flexibility in the industrialized, emerging and developing economies, and are major net job creators in these economies (OECD, 2006a; 2006b). The belief that better private sector performance in Africa can reduce poverty remains central in policy discussions. Bigsten and Soderbom (2006) observe that though the performance of Africa's manufacturing sector has generally been quite poor, many people still believe that manufacturing can act as an engine of growth in the continent, by creating skilled jobs and positive spillover effects and, more generally, by modernizing the economy.

In Kenya, under the economic pillar of vision 2030, manufacturing is a key sector expected to deliver an envisaged 10 per cent economic growth rate per annum, by increasing and sustaining its contribution to Gross Domestic Product (GDP) by at least 10 percent per annum. The sector is expected to support the country's social development agenda through creation of jobs, generation of foreign exchange and attracting investment. Inspite of the expected benefits and economic contributions, SMMEs face enormous challenges. Bowen, Morara and Mureithi (2009) identify inadequate financing alongside other challenges for SMMEs in Kenya which confirms Wattanapruttipaisan (2003) observation that SMMEs long term growth and competitiveness is compromised by chronic and often acute constraints on access to the formal finance sector.

Lack of access to adequate financial services as a challenge facing SMEs is documented by various scholars including Atieno (2009), Bowen, *et al.* (2009), Nkurunziza (2005) and Bigstein, *et al.* (2003). Atieno (2009) attributes this to a number of factors. Foremost, the nature of credit markets, which are segmented and incomplete. Secondly, on the supply side, most formal financial institutions consider SMEs uncreditworthy due to their lack of growth potential and small size of activities.

Demigurc – Kunt, Beck and Honohan (2008) refer to access to finance as the possibility that individuals or enterprises would make use of financial services that include; credit, deposit, payment, insurance and other risk management services. Access to finance is distinguished from the actual use of financial services, because non-use of finance can be voluntary or involuntary. Voluntary non-users of financial services have access to finance but do not use financial services either because they have no need for those services or because they decided not to make use of such services due to cultural, religious or other reasons.

Invoking theories of impefect information in financial markets, Harvie (2010) explain that financing gap occurs when specific categories of firms that should receive financing are systematically unable to acquire it, despite a willingness to pay higher interest rates, showing market failure especially if such lending opportunities are profitable. Sarapaivanich (2006) and Becchetti and Trovato (2002) opine that financing gap can be as a result of demand-side factors, supply-side factors and market failure. Market failure involves the general economy. Supply side factors and demand side factors are specific to providers and solicitors of external finance respectively.

Informed by the propositions of imperfect information theories in financial markets, this study explores the effect of various demand side factors on access to external finance by small and medium sized manufacturing enterprises in Kenya. Specifically, the study answers questions as: How do firm characteristics influence access to external finance by SMMEs in Nairobi, Kenya? How do financial management practices affect access to

external finance by SMMEs in Nairobi, Kenya? What is the effect of entrepreneur characteristics on access to external finance by SMMEs in Nairobi, Kenya?

Methodology

The study is an exploratory survey using quantitative methodology in data collection and analysis. A list of 37 licensed SMMEs based in Babadogo, Nairobi County, Kenya was obtained from the Nairobi County offices. Babadogo is a formal manufacturing hub created as an alternative manufacturing zone to decongest the already established industrial area. The study is based on primary data obtained from self administered semi structured questionnaires to 31 entrepreneurs of the manufacturing enterprises thereby attaining a response rate of 83.78%. Secondary data on performance and liquidity management in the firms was collected from five year (2011 to 2015) audited financial statements.

The semi structured questionnaire sought information on: Access to external finance, entrepreneur characteristics, firm characteristics and financial management practices. The study conceptualizes that access to external finance (ACC) is a function of demand side characteristics whose components are entrepreneur characteristics (EC), firm characteristics (FC) and financial management practices (FMP). Hence:

$$ACC = f(EC, FC, FMP) \quad \text{(i)}$$

The study uses Logistic regression models in analyzing the data for inferential statistics. Field (2009) explains that Logistic regression is a multiple regression with categorical outcome variable and continuous or categorical predictor variables. Weltevreden and Boschma (2008) indicate that Logistic regression is used when the dependent variable is dichotomous. Logistic regression is therefore considered suitable for this study because of the binary/dichotomous nature of the dependent variable (access to external finance), which can have either of two outcomes; 1 (access) or 0 (no access). The models for testing the proposed hypotheses are as:

$$ACC_i = \frac{e^{\beta_0 + \beta_1 X_1 + \beta_2 X_2 + \beta_3 X_3 + \beta_4 X_4 + \beta_5 X_5 + \beta_6 X_6 + \beta_7 X_7 + \varepsilon}}{} \quad \text{(ii)}$$

$$1+ e^{\beta_0+ \beta_1X_1+ \beta_2X_2+ \beta_3X_3+ \beta_4X_4+ \beta_5X_5+ \beta_6X_6+ \varepsilon}$$

$$ACC_i = \frac{e^{\beta_0+ \beta_8X_8+ \beta_9X_9+ \beta_{10}X_{10}+ \beta_{11}X_{11}+ \beta_{12}X_{12}+ \beta_{13}X_{13}+ \beta_{14}X_{14}+ \varepsilon}}{1+ e^{\beta_0+ \beta_8X_8+ \beta_9X_9+ \beta_{10}X_{10}+ \beta_{11}X_{11}+ \beta_{12}X_{12}+ \beta_{13}X_{13}+ \beta_{14}X_{14}+ \varepsilon}} \quad \text{.....(iii)}$$

$$ACC_i = \frac{e^{\beta_0+ \beta_{15}X_{15}+ \beta_{16}X_{16}+ \beta_{17}X_{17}+ \beta_{18}X_{18}+ \varepsilon}}{1+ e^{\beta_0+ \beta_{15}X_{15}+ \beta_{16}X_{16}+ \beta_{17}X_{17}+ \beta_{18}X_{18}+ \varepsilon}} \quad \text{...(iv)}$$

Table One: Operationalization of Study Variables

Variable	Measurement
Dependent (Access to External Finance)	
Access to External Finance (ACC)	Binary Responses – 0 for no access to finance and 1 for Access to finance
Independent (Entrepreneur Characteristics)	
Education Background (X_1)	Highest level of entrepreneurs education
Entrepreneurs Experience (X_2)	Cumulative number of years of business experience
Networking (X_3)	Entrepreneurs personal relationships with external actors
Entrepreneurs Age (X_4)	Age of entrepreneur
Entrepreneurs Generation (X_5)	Generation currently managing enterprise
Entrepreneurs Ethnicity (X_6)	Ethnic orientation of entrepreneur
Gender (X_7)	Gender of the entrepreneur
Independent (Firm Characteristics)	
Firm Age (X_8)	Number of years in business
Firm Size (X_9)	Number of employees
Firm Profitability (X_{10})	Average return on assets (ROA) over past five years
Firm Growth (X_{11})	Average sales growth over past five years
Asset Tangibility (X_{12})	Average Fixed asset structure ratio = Tangible net fixed assets/ Total assets
Volatility of Earnings (X_{13})	Average standard deviation of net income after tax and donations
Legal Form of Business (X_{14})	Legal ownership status of the firm
Independent (Financial Management Practices)	
Liquidity (X_{15})	Average current ratio of the enterprise = Current Assets/ Current Liabilities
Financial statement information (X_{16})	Preparation of Financial statements by enterprise
Capital Budgeting(X_{17})	Application of capital budgeting techniques for investment decisions
Business Planning(X_{18})	Preparation of Business Plan by enterprise

Results and Discussions

Table two, three and four below presents the logistic regression results for predicting accessibility of external finance for entrepreneurs of the SMMEs using entrepreneur characteristics as the predictors.

Table Two: Logistic Regression on Entrepreneur Characteristics and Access to External Finance

Classification Table[a,b]

			Predicted		
			Acess to external Finance		Percentage
	Observed		Yes	No	Correct
Step 0	Acess to external Finance	Yes	21	0	100.0
		No	10	0	.0
	Overall Percentage				67.7

a. Constant is included in the model.

b. The cut value is .500

As indicated in table two above, when only the constant is included in the model, the overall percentage of firms that are correctly predicted in the model as having access to external finance is 67.7 percent. From the table, it is inferred that 21 of the firms are observed to have access to external finance and are correctly predicted to have access to external finance. 10 of the firms are observed not to have access to external finance but are not correctly predicted to have access to external finance.

Table Three: Logistic Regression on Entrepreneur Characteristics and Access to External Finance

Classification Table[a]

			Predicted		
			Acess to external Finance		Percentage
	Observed		Yes	No	Correct
Step 1	Acess to external	Yes	19	2	90.5

	Finance	No	6	4	40.0
	Overall Percentage				74.2
Step 2	Acess to external Finance	Yes	18	3	85.7
		No	0	10	100.0
	Overall Percentage				90.3

a. The cut value is .500

As indicated in table three above, introduction of networking of the entrepreneur into the model improves the overall correct predictive ability of the model on access to finance from 67.7 percent to 74.2 percent. 19 firms are observed to have access to finance and are correctly predicted to have access to finance. 4 firms are observed not to have access to finance and are correctly predicted not to have access to finance. 6 firms are observed not to have access to finance but are incorrectly predicted to have access to finance. 2 firms are observed to have access to external finance but are incorrectly predicted not to have access to external finance.

Table three shows that introduction of ethnic orientation improves the correct prediction ability of the model from 74.2 percent to 90.3 percent.18 of the firms are observed to have access to external finance and are correctly predicted to have access to external finance. 10 of the firms are observed not to have access to external finance and are correctly predicted not to have access. 3 of the firms are observed to have access to external finance but are incorrectly predicted not to have access.

A test of the full model including networking of the entrepreneur, against a constant only model was statistically significant χ^2 (df = 1, N = 31) = 8.275, $p<0.05$. The model was able to correctly classify 90.5 percent of entrepreneurs who got access to external finance and 40 percent of entrepreneurs who did not get access to external finance, for an overall success rate of 74.2 percent.

A test of the full model including networking and ethnic orientation of the entrepreneur, against a constant only model was statistically significant χ^2 (df = 2, N = 31) = 15.762,

p<0.05. The model was able to correctly classify 85.7 percent of entrepreneurs who got access to external finance and 100 percent of entrepreneurs who did not get access to external finance, for an overall success rate of 90.3 percent.

Table four below presents the logistic regression coefficient, Wald test and Odds ratio/ Exp (B) for the two predictors (networking and ethnic orientation) while employing 0.05 criterion of statistical significance.

Table Four: Logistic Regression Coefficients on Entrepreneur Characteristics and Access to External Finance

Variable	Coefficients			
	Model One		Model Two	
	β	Sig (Odds ratio)	β	Sig (Odds ratio)
Networking	-1.490	.016 (.225)	1.994	.011 (.136)
Ethnic Orientation	-	-	-21.927	.999 (.000)
Constant	3.858	.043 (47.361)	27.919	.999 (.000)
-2 Log likelihood	30.710		23.224	
Nagelkerke R Square	0.327		0.557	

Since Nagelkerke R Square is 0.327 in Model one, in table four above, it is inferred that 32.7 percent variations in access to external finance are explained by variations in entrepreneur networks. The coefficients from model one (β= -1.490, EXP (β) = 0.225, P<0.05) show that a unit decrease in firm networking would lead to a decrease in access to external finance by up to 1.49 units and the relationship is statistically significant. The odds ratio of 0.225 indicate that an entrepreneur with networks was 0.225 times more likely to access external finance than entrepreneurs without networks having allowed for the other entrepreneur's characteristics.

Model two in the table four above indicates that 55.7 percent variations in access to external finance are explained by variations in entrepreneur networks and ethnic orientations. The coefficients from model two (β= 1.994, EXP (β) = 0.136, P<0.05) show that a unit increase in firm networking would lead to an increase in access to external finance by up to 1.994 units and the relationship is statistically significant. The odds ratio of 0.136 indicate that an entrepreneur with networks was 0.136 times more likely to

access external finance than entrepreneurs without networks having allowed for the other entrepreneur's characteristics especially ethnic orientations.

From model two in table four above, the coefficients (β= -21.927, EXP (β) = 0.000, P>0.05) infer that ethnic orientation is not statistically significant in predicting access to finance of a firm. The study therefore confirms the proposition that networking as an entrepreneurial characteristic significantly influence the odds of access to external finance by SMMEs in Nairobi, Kenya.

Table five below summarizes the logistic regression results for predicting accessibility of external finance for entrepreneurs of the SMMEs using firm characteristics as the predictors.

Table Five: Logistic Regression on Firm Characteristics and Access to External Finance

Classification Table[a,b]

Observed		Predicted		
		Acess to external Finance		Percentage Correct
		Yes	No	
Acess to external Finance	Yes	21	0	100.0
	No	10	0	.0
Overall Percentage				67.7

a. Constant is included in the model.

b. The cut value is .500

As indicated in table five above, when only the constant is included in the model, the overall percentage of firms that are correctly predicted in the model as having access to external finance is 67.7 percent. From the table, it is inferred that 21 of the firms are observed to have access to external finance and are correctly predicted to have access to external finance. 10 of the firms are observed not to have access to external finance but are not correctly predicted to have access to external finance.

As presented table six below, introduction of firm growth into the model improves the correct prediction ability of the model on access to finance from 67.7 percent to 74.2 percent. 19 of the firms were observed to have access to external finance and were correctly predicted to have access. 4 of the firms were observed not to have access to external finance and were correctly predicted as not having access to external finance. 2 of the firms were observed to have access to external finance but were incorrectly predicted as not having access to external finance and 3 of the firms were observed not to have access to external finance but were incorrectly predicted to have access to external finance.

Further, introduction of earnings volatility improves the prediction ability of the model from 74.2 percent to 77.4 percent as presented in table six above. 17 of the firms were observed to have access to external finance and were correctly predicted to have access to finance, 7 of the firms were observed not to have access to external finance and were correctly predicted not to have access to external finance. 2 of the firms were observed to have access to external finance but were incorrectly predicted to have access to external finance. 6 of the firms were observed not to have access to external finance but were incorrectly predicted to have access to external finance.

Table Six: Logistic Regression on Firm Characteristics and Access to External Finance

Classification Table[a]

		Predicted		
		Access to Finance		Percentage
Observed		Yes	No	Correct
Access to Finance	Yes	19	2	90.5
	No	6	4	40.0
Overall Percentage				74.2
Access to Finance	Yes	17	4	81.0
	No	3	7	70.0
Overall Percentage				77.4

Classification Table[a]				
		Predicted		
		Access to Finance		Percentage
Observed		Yes	No	Correct
Access to Finance	Yes	19	2	90.5
	No	6	4	40.0
Overall Percentage				74.2
Access to Finance	Yes	17	4	81.0
	No	3	7	70.0
Overall Percentage				77.4

a. The cut value is .500

A test of the full model including earnings volatility, against a constant only model was statistically significant χ^2 (df = 1, N = 31) = 8.275, p<0.05. The model was able to correctly classify 90.5 percent of enterprises who got access to external finance and 40 percent of enterprises who did not get access to external finance, for an overall success rate of 74.2 percent.

A further test of the full model including firm growth and earnings volatility, against a constant only model was statistically significant χ^2 (df = 2, N = 31) = 12.326, p<0.05. The model was able to correctly classify 81 percent of enterprises who got access to external finance and 70 percent of enterprises who did not get access to external finance, for an overall success rate of 77.4 percent.

Table seven below presents the logistic regression coefficient, Wald test and Odds ratio/ Exp (B) for the two predictors (earnings volatility and firm growth) while employing 0.05 criterion of statistical significance.

Table Seven: Logistic Regression Coefficients on Firm Characteristics and Access to External Finance

Variable	Coefficients			
	Model One		Model Two	
	β	Sig (Odds ratio)	β	Sig (Odds ratio)

Earnings Volatility	-1.430	.016 (.225)	-1.715	.010 (0.180)
Firm Growth	-	-	0.637	.040 (0.529)
Constant	3.858	.043 (47.361)	6.742	.010 (847.614)
-2 Log likelihood	30.710		26.660	
Nagelkerke R Square	0.327		0.458	

Model one in table seven above indicates that 32.7 percent variations in access to external finance are explained by variations in earnings volatility. The coefficients from model one (β = -1.430, EXP (β) = 0.225, P<0.05) show that a unit decrease in firm earnings volatility would lead to a decrease in access to external finance by up to 1.43 units and the relationship is statistically significant. The odds ratio of 0.225 indicate that an entrepreneur with volatile earnings was 0.225 times more likely to access external finance than entrepreneurs with non volatile earnings having allowed for the other firm characteristics.

Model two in table seven above indicates that 45.8 percent variations in access to external finance are explained by variations in earnings volatility and firm growth. The coefficients from model two (β = -1.715, EXP (β) = 0.180, P<0.05) show that a unit decrease in firm networking would lead to a decrease in access to external finance by up to 1.715 units and the relationship is statistically significant. The odds ratio of 0.180 indicate that an entrepreneur with volatile earnings was 0.180 times more likely to access external finance than entrepreneurs without networks having allowed for the other entrepreneur's characteristics especially ethnic orientations. From model two in table seven above, the coefficients (β = 0.637, EXP (β) = 0.529, P<0.05) infer that firm growth is statistically significant in predicting access to finance of a firm. A unit increase in firm growth leads to an increase of 0.637 units in access to external finance. The odds ratio of 0.529 indicate that a growing firm was 0.529 times more likely to access external finance than a non growing firm.

Since two attributes of firm characteristics (firm growth and earnings volatility) are statistically significant in explaining access to finance, the study confirms the proposition

that some firm characteristics (firm growth and earnings volatility) significantly influence the odds of access to external finance by SMMEs in Nairobi, Kenya.

Table Eight: Logistic Regression Coefficients on Financial Management Practices and Access to External Finance

Classification Table[a,b]

			Predicted		
			Access to external finance		Percentage Correct
	Observed		Yes	No	
Step 0	Access to external finance	Yes	21	0	100.0
		No	10	0	.0
	Overall Percentage				67.7

a. Constant is included in the model.

b. The cut value is .500

As presented in table eight above, the overall percentage of firms that are correctly predicted in the model as having access to external finance is 67.7 percent. From the table, it is inferred that 21 of the firms are observed to have access to external finance and are correctly predicted to have access to external finance. 10 of the firms are observed not to have access to external finance but are not correctly predicted to have access to external finance. From the logistic regression analysis, the study establishes that none of the financial management practices namely; working capital management, financial statements information, capital budgeting and business planning is suitable in distinguishing the enterprises amongst those that have access to external finance and those that do not have access to external finance. In light of this finding, the study proposes that application of financial management practices do not significantly influence the odds of access to external finance by SMMEs in Nairobi, Kenya.

Conclusions

The influence of demand side factors on access to external finance by SMMEs motivates this study. The identified demand side factors from literature are classified as entrepreneur characteristics, firm characteristics and financial management practices.

On the first category of demand side factors (entrepreneur characteristics), the study finds that networking is significant in explaining variations in access to external finance by the SMMEs. The finding that variations in entrepreneur network may explain up to 32.7 percent variations in the odds of access to external finance confirms postulations by Curran *et al.* (1993) that effective networks assist in providing information, advice as well as capital to small enterprises. It also confirms Levitt and March (1988) proposition that networking provides a platform by which entrepreneurs share knowledge and means for learning from the experienced firms in the industry.

Introduction of ethnic background as entrepreneur characteristic in the study confirms that up to 55.7 percent variations in access to external finance by the SMMEs are explained by variations in both networking and ethnic background. Though the relationship is not significant, the explanatory power of the model reinforces the propositions by Ram *et al*. (2002) and Irwin and Scott (2010) that some ethnic groups find it difficult to access external finance. Ram, Smallbone and Deakins (2002) also explain that some distinctive characteristics of ethnic minority enterprises have higher potential and implied ability to access external finance.

On the second category of demand side factors (firm characteristics), the study establishes that firm growth and volatility of earnings are significant in explaining access to external finance by the SMMEs. The finding that 32.7 percent variations in odds of access to external finance are explained by variations in earnings volatility confirms the literature by Drobetz and Fix (2003). The negative relationship confirms that volatility of earnings is inversely related to the capacity of the firm to obtain debt.

From the findings, it is inferred that 45.8 percent variations in access to external finance are explained by variations in earnings volatility and firm growth. This finding confirms the arguments by Cosh and Hughes (1994), Michaelas, et al. (1999), Jordan, et al. (1998) and Cassar and Holmes (2003) that firm growth creates demand for investment funds and internal funds and equity are not sufficient to sustain the growth process. These study findings therefore confirm the proposition that earnings volatility and firm growth as firm characteristics significantly influence the odds of access to finance by the SMMEs.

Recommendations

Given that entrepreneur characteristics, notably networking influences access to external finance, the suppliers of funds and the entrepreneurs themselves should endeavor to develop and support sustainable social networks for the growth of the enterprises. Though ethnic background may seem to have a play in access to external finance, policy efforts should be put in place to ensure there is efficiency in the market for external financing and ethnically minor entrepreneurs are not disenfranchised on this basis. As firm growth also influences the access to finance, managers of the SMMEs should ensure they attain steady earnings growth with minimal deviations to avoid financial constraints for firm operations. Government policy should support SMMEs earnings growth, earnings stability and development of stable social networks. The study fails to confirm the proposition that the financial management practices adopted significantly influence the odds of access to finance by the SMMEs. The study however identifies a necessity for further investigations on the role of the cited financial management practices on access to external finance in different industries and other regional settings.

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