Effects of Informal Finance on the Performance of Small and Medium Enterprises in Kiambu County

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Abstract- Formal lending institutions including Commercial banks fail to satisfy financial needs of smallholders, mainly due to stringent lending terms and conditions. The general objective of this study was to assess the effect of informal finance on the performance of SMEs in Kiambu County. The specific objectives were; to establish the effect of financial Self-help groups on the performance of SMEs; to examine the effect of family and friends finance on the performance of SMEs; to determine the effect of trade credit on the performance of SMEs and lastly to establish the effect of Shylock financing on the performance of SMEs. The study employed descriptive research design. The population of the study was 7384 SMEs. A sample size of 95 was selected using random sampling. This study used primary data which was collected through use of a questionnaire. SPSS was used to produce frequencies, descriptive and inferential statistics which was used to derive conclusions and generalizations regarding the population. In particular, correlation and multiple regression analysis were conducted. The study found out that self-help group finance, family and friends finance; trade credit finance and shylock finance sources influence the performance of SMEs. Self-help group finance, family and friends finance; trade credit finance has a positive influence on the performance of SMEs while shylock finance sources have a negative influence on the performance of SMEs. The study recommended that SMEs need to put more emphasis on informal form of finance (self-help group finance, family and friends finance and trade credit finance). Shylock finance sources need to be avoided by SMEs if possible since it charges high interests and it terms and conditions are more stringent

Index Terms- Self-Help Group, ROSCA Finance, Shylock finance, Trade Credit

I. Introduction

This chapter introduces background of the study and provides contextual global, national and local perspectives. The latter sub-sections cover statement of the problem, objectives of the study, research questions, significance, and scope of the study.

1.1 Background of the Study

Small and Medium enterprises have been noted to play a significant role in employment and economic growth of many countries .Indeed, in many developing countries as well as developed countries, small and medium enterprises are the focal point of growth and self-employment. In low-income countries, it is estimated that small and medium enterprises account for more than 60 per cent of the GDP and provide over 70 per cent of employment opportunities (Lukacs, 2005).

Access to finance is prerequisite for survival and performance of any enterprise and has become an increasingly important development metric, as one of the factors which can drive widespread economic development (Cracknell, 2012). Financial market in developing countries is composed of formal, semiformal and informal financial institution with formal institutions being unable to meet the needs of firms and individuals in informal settlements (Steel & Andah, 2004).

Formal financial services refers to financial services provided by registered financial institutions that are licensed to offer financial services by the country's bank regulator (in case of Kenya is the Central Bank of Kenya)largely urban based in terms of distribution of branches and the concentration of deposit and lending activities (Ghate,1992). Examples of institutions offering formal financial services are the commercial banks, insurance companies and development banks. On the other hand, the informal financial sector also known as un-organized sector consists of individuals such as money lenders, relatives, friends, neighbours, landlords, traders and group of individuals that operates mainly in the rural setting, (Mehrteab 2005).

1.1.1 Global perspective on Informal Finance

The informal financial sector is an age-long one, an ancient one that dates back at least to the 16th century; the activities predate those of the formal financial system but are not subjected to Government regulation (Iganiga & Asemota, 2008). The definitions of formal and informal financial sectors vary across the globe. Pagura and Kirsten (2006) defined formal and informal financial institutions by dividing them into formal, semi-formal and informal groups.

Informal finance relies on relationships and reputation implying that information asymmetries between informal lenders and their borrowers are less acute, the loan application procedure lighter, and the collateral requirement easier to fulfill. Furthermore, informal financiers are often better positioned to efficiently monitor and enforce repayment when legal enforcement is difficult and time-consuming as in the case of China's fast-moving economy (Allen & Qian, 2010).

The most cited differences are probably that the informal sector has an easier time dealing with problems regarding information and enforcement of contracts, while the formal sector can take advantage of economies of scale and the intermediation of funds over a longer period of time (Jain & Mansuri 2003).In a study of Ghana, Malawi, Nigeria and Tanzania, Steel et al. (1997) stress that informal finance is an important vehicle for mobilizing household savings and financing small businesses, a function that is carried out using specialized techniques that address the problems of information, transaction costs and risks, which prevent banks from serving these market segments.

Small and medium scale firms play important roles in the process of industrialization and economic growth. Apart from increasing per capita income and output, SMEs create employment opportunities, enhance regional economic balance through industrial dispersal and generally promote effective resources utilization considered critical to engineering economic growth (Tagoe, 2005). SMEs make a significant contribution in the global economy. It is estimated that SMEs make up more than 90% of all new business establishment worldwide (World Bank, 2014) Despite such significant contribution made by the SME"s, they continually face funding constraints in the formal finance market. Deakins et al. (2008) carried out an in-depth study of Scottish SMEs and discovered the funding constraints faced by SMEs.

Unfavorable macroeconomic environment has been identified as one of the setbacks encouraging financial institutions to be risk-averse in funding small and medium scale businesses (Ray, 2008).The development of SMEs is believed to be a desirable end as the key drivers of employment and economic growth. However, the growth of SMEs has been hampered due to great difficulties encountered when raising capital because of the pre-occupation of the finance institutions with collateral based lending (Hossain, 2000).

1.1.2 Informal Finance in Kenya

Financial access surveys have revealed increased in use of informal finance in Kenya. Previously assumed to be rural and slums affair, informal finance sources are now strong phenomenon in urban areas where the formal and semi-formal financial services are most easily available (FSD, 2006, 2009). Across all income groups, informal sources of finance have become especially common with the number of people using them increasing from under one million in 2006 to over 1.5 Million in 2009 with estimated that about KShs 60 Billion (US $ 860 M) being intermediated through the informal financial sector annually. This fact underlines the significance of the informal/semiformal financial sectors in Kenya (FSD, 2009).

The importance of small and medium enterprises has been emphasized in all development plans in Kenya since independence in 1963. In Kenya, the SME sector is considered as one of the major contributors to the economy by providing income and employment to a significant proportion of the population (Ngugi & Bwisa (2013). The 2013 baseline survey found that small to medium-sized enterprises employed about 50% of youths and women and they accounted for approximately 79.6% of the total labor force (Republic of Kenya 2013). Ngugi and Bwisa (2013) also noted that SMEs accounted for a significant proportion of economic activities in Kenya's urban and rural areas; generating over 70% of all new jobs annually.

The development of SMEs is believed to be key drivers of employment and economic growth. However, the growth of SMEs has been hampered due to great difficulties encountered when raising capital because of the pre-occupation of the microfinance institutions with collateral based lending (Hossain, 2000).

The small and medium enterprises lack collateral and are unable to comply with the bank long procedures (Macharia, 2012) and hence hindering the SMEs from accessing formal financial services forcing them to opt to informal and semi-formal financing. However, the effect of this decision remains unknown with minimal studies carried out to determine the effect of financial access on the profitability of small and medium enterprises. Economists agree to the fact that financing (formal, informal and semiformal) enhances credit access which in turn enhances SMEs innovation, growth and overall profitability (Cracknell, 2012).

Small and Medium Enterprises have huge potential for employment generation and wealth creation in any economy, yet the sector has stagnated and remains relatively small in terms of its contribution to GDP or to gainful employment (FSD Kenya, 2007). Beck, Demirguc-Kunt, and Maksimovic (2004) determined the financing obstacles faced by firms in over 10,000 sampled firms from 80 countries established that SMEs are faced with higher financing constraints than larger and older firms as part of the reason that limits their growth. In addition, small and medium enterprises have been forced to make extensive reports to financial institutions when applying for finances and at the same time, agree with more restrictive asset usage (Zeller and Sharma, 2000).

1.2 Statement of the Problem

A number of studies have been conducted on the effect of banking institutions on SMEs growth. However, as with many developing countries, there is limited research and scholarly studies about the SME sector in Kenya (Bowen, Morara & Mureithi, 2009). Government policies often aim at replacing modes of informal finance with easier-to- regulate formal finance, even if informal financing continues to be an essential source of credit for the private sector (Jain & Mansuri, 2003).

The amount of formal external finance available to SMEs in particular is far less than expected. Despite SMEs' strong interest in credit, banks' profit orientation may deter them from supplying credit to them because of the high transaction costs and risks involved. The informal credit channel is still the most familiar financing source despite government's efforts to widen access to formal credit SMEs' loan requirements are small, so the costs of processing the loans tend to be relatively high. It is also difficult for financial institutions to obtain the information necessary to assess the risks of new, unproven ventures, especially because the success of small firms often depends heavily on the abilities of the entrepreneur. The complex application procedure for formal credit increases the application cost and discourages SMEs from accessing formal credit, even if they could be satisfied in the formal credit system (Nguyet, 2014)

Credit constraints operate in variety of ways in Kenya where undeveloped capital market forces entrepreneurs to rely on self-financing or borrowing from friends and relatives. Lack of access to long-term credit for small and medium enterprise forces them to rely on high cost short term finance. Informal and semi-formal financial institutions respond relatively well to the financing needs of SMEs in slums and in the rural areas compared to the formal financial institutions (Kashuliza et al., 1998). However, it has also been argued that the interest rates charged by informal and semi-formal sectors are high hence crowding out the benefits associated to informal sector financing (Michael & Cesare, 2006).

In spite of the valuable role in promotion of economic growth, job creation and the mitigation of poverty, research conducted on SMEs in by Mead & Liedholm (1998) confirmed that on average, there are more SME closures than expansions, with approximately only 1% of micro enterprises growing from five or less employees to ten or more. In 2009, 38.7% of the population (7.2 million Kenyans) belonged to at least one informal group that provides financial services. The implication is that informal finance may be complementary to increased formal financial service use rather than competitive to it. (FSD, 2009). The contention of this paper is that indigenous sources of funding used by SMEs should be explored and their effect on performance analyzed.

This study therefore aimed at filling the missing knowledge gap by assessing the effects of informal finance on performance of SMEs in Kiambu County.

1.3 Objectives of the Study

1.3.1 General Objective

The general objective was to assess the effect of informal finance on the performance of SMEs in Kiambu County

1.3.2 Specific Objective

1. To establish the effect of Self help group finance sources on the performance of SMEs
2. To examine the effect of family and friends finance sources on the performance of SMEs
3. To determine the effect of trade credit on the performance of SMEs
4. To assess the effect of Shylock finance sources on the performance of SMEs

1.4 Research Questions

1. What is the effect of self help group finance sources on the performance of SMEs?
2. What is the effect of family and friends finance sources on the performance of SMEs?
3. What is the effect of trade credit on the performance of SMEs?
4. What is the effect of Shylock finance sources on the performance of SMEs?

1.5 Justification of the Study

The findings of this study are expected to be of importance to the various stakeholders who include financial institutions, small and medium enterprises managers and owners, the government and community welfare organization, general public, researchers and academicians. To the financial institutions, they will be able to understand the effect of informal financing on the performance of the SMEs in Kiambu and come up with products that will serve the SMEs better leading to their improved performance.

The study would assist SMEs by enlightening them on the ways of managing the financial challenges they are faced with and also provide alternative sources of finance that would give them better chance of survival, growth and success in the global competitive corporate setting. SMEs managers will be able to learn the effect of financial access on their financial performance and the factors that hinder access to credit. This will make them more informed and hence be able to make more informed financing decisions.

The government could use the this research paper to design and implement policies that are meant to enhance access to credit by SMEs and they contribute significantly to growth and development of the country. The study will come up with policy recommendations that will assist the policy makers when drawing regulatory measures and guidelines aimed at overcoming the barrier of access to finance by SMEs. The study would be of great importance to other researchers and scholars who seek to understand the effect of informal finance on performance of SMEs.

1.6 Scope of the Study

The study focused on SMEs in Kiambu County which is one of the 47 counties in the Republic of Kenya. Kiambu is located in the central region and a total area of 2,543.5 sq Km. According to the 2009 Kenya Population and Housing Census, Kiambu County population for 2012 was projected to be 1,766,058 with 873,200 males and 892,857 females. The county population growth rate is relatively high at 2.81 per cent and has been augmented by influx of people from Nairobi who prefer to live in Kiambu and its environs where there is less congestion and well developed infrastructure. High population density exerts pressure on the available land leading to subdivision of land into uneconomical units. The proximity of the county to the city of Nairobi has seen transformation of large pieces of land into residential houses. Good infrastructure has attracted those working in Nairobi to reside within the county. This has led to the establishment of residential estates with the Tatu city being one of the major housing projects currently under implementation. (County Integrated Plan, 2013)

The county is currently divided into twelve (12) sub-counties namely Limuru, Kikuyu, Lari, Gatundu South, Gatundu North, Githunguri, Kiambu, Ruiru, Thika, Juja, Kiambaa, and Kabete. These are further sub-divided into 29 divisions, 95 locations and 236 sub locations. Kiambu town is the commercial and administrative capital of Kiambu County (Kenya County Guide, 2014) According to the County Integrated Plan (2013), the county has a total of 6,634 registered retail traders and 750 registered wholesale traders. There are also a number of urban centres with the largest beingThika Town which is one of the largest industrial towns in the country. Other urban centers include Kiambu and Karuri in Kiambaa constituency, Kikuyu, Gatundu and Ruiru. Agriculture is the predominant economic activity in the county. The larger population in retail businesses is mainly in new and second clothes, hotels and restaurants, foodstuffs, hardware shops and household goods. The researcher chose the county because it was possible to access both rural and urban areas and also get a good mix of commercial and agricultural activities. There is very little documentation on informal financing SMEs in Kiambu County.

The study targeted SMEs in the Kiambu County. The target respondents were SMES owners and managers. It was also assumed that the target respondents would complete the questionnaires objectively and accurately on the basis of their own perception, knowledge, and experience on the effect of informal finance on performance of SMEs. The study was done in the month of August to September 2015.

II. LITERATURE REVIEW

2.1 Introduction

The chapter presented the theoretical framework .The theoretical framework captured the various theories that informed the study. The chapter also presented the empirical literature review. In the empirical literature review, the findings were critiqued to establish the knowledge gaps. The chapter based its argument on information retrieved from books, journals, research papers, web articles, conference proceedings and session papers. Conceptual framework showed the relationship between independent and dependent variables

2.2 Theoretical Review

This section provided the theoretical foundation for this study which was informed by the Adverse Selection Theory of Financial Markets and Financial Liberalization Theory.

2.2.1 Adverse Selection Theory of Financial Markets

The adverse selection theory of financial institutions originates from the work of Stieglitz and Weiss (1981). In his explanation interest charged by a credit institution are assumed to have a dual role of sorting potential borrowers (leading to adverse selection) and affecting the actions of borrowers (leading to incentive effect). Interest rates thus assumed to affect the nature of the transaction and do not necessarily clear the market. Both effects are seen as a result of the imperfect information inherent in credit markets. Formal lenders insistence on collateral security rations a large number of borrowers out of the credit market, leaving only the few who can afford the required collateral. According to Stiglitz and Weiss (1981), lenders would like to identify borrowers most likely to repay their loans since the banks' expected returns depend on the probability of repayment. Formal institutions fail to cater for the credit needs of small firms who are perceived to be too risky and small enterprises often have greater access to informal credit facilities than to formal sources.

Adverse selection arises because in the absence of perfect information about the borrower, an increase in interest rates encourages borrowers with the most risky projects, and hence least likely to repay, to borrow, while those with the least risky projects cease to borrow. Interest rates will thus play the allocative role of equating demand and supply for loanable funds, and will also affect the average quality of lenders' loan portfolios. Lenders will fix the interest rates at a lower level and ration access to credit. Imperfect information is therefore important in explaining the existence of credit rationing for small and medium enterprises.

Stiglitz and Weiss' theory was designed to apply quite generally, rather than in a specific context of informal credit in developing countries. In the latter context, the theory has often been criticized for its underlying assumption that lenders are not aware of borrower characteristics. The close knit character of many traditional rural and close knit urban societies implies that lenders possess a great deal of information about relevant borrowers' characteristics, such as business ability, size and quality of assets, and risk attitudes. Criticism for this theory stems from the fact that it ignores the fact that borrowers themselves who can seek ways to assure the lender that they are not "lemon" and hence have access to credit.

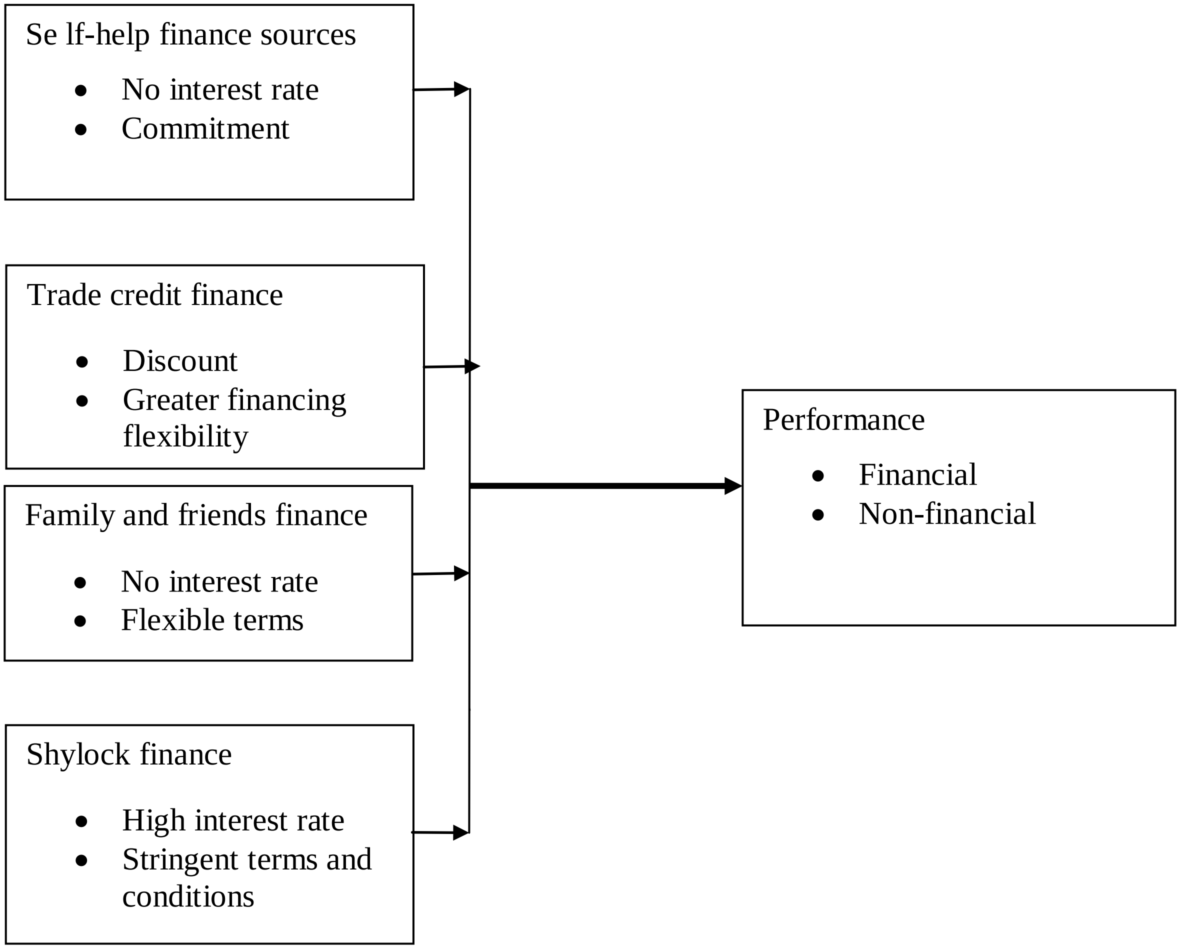
2.2.3 Financial Liberalization Theory

The financial liberalization theory was given prominence by seminal work of McKinnon and Shaw (1973). They popularized the concept of financial repression as a financial system with policies that distort domestic financial markets and credit controls. The observation is that such a system interferes with the economic development of a country as the intermediaries are not well developed for mobilization of savings while allocation of financial resources among competing uses is inefficient. The early hypothesis of McKinnon and Shaw (1973) assumed that liberalization (absence of repression) which would be associated with higher real interest rates as controls are lifted would stimulate savings which would lead to higher levels of investments and therefore to economic growth. McKinnon and Shaw also suggest that liberalization of financial markets allows penetration of financial services among the poor population. These groups of people are always on the lower cadre of the social cycle. Therefore, providing them with accessible tools of finance could be considered a very significant step towards achieving economic growth. This is because peasant communities could be mainly left out due to poor infrastructure, insecurity and abject poverty. Providing these people with access to credit gives them the opportunity to expand their business activities to middle class economy.

Financial repression has generally hindered the development of the institutional capacity of financial institutions in their development of the commercial viability of their operations. Reform of financial markets has taken the form of significant liberalization as countries shifted from the 'repressive' regimes. Governments are no longer required to play major roles in determining credit flows through a system of subsidies, interest rate ceilings, credit allocation and direct intervention. However, liberalization has not been effective in improving credit delivery especially for SMEs. In many African countries, a consequence of the initial growth that resulted from the structural adjustment programmes was a significant increase in the demand for finance by businesses, which formal financial units failed to satisfy. In searching for alternatives to formal sector finance, attention is increasingly being paid to informal and semi-formal finance (including micro-finance) for meeting private sector credit demand, particularly from small enterprises. (Aryeetey, 1998)

2.3 Conceptual Framework

According to Kombo and Tromp (2009), a concept is an abstract or general idea inferred or derived from specific instances. A conceptual framework is a set of broad ideas and principles taken from relevant fields of enquiry and used to structure a subsequent presentation. Mugenda and Mugenda (2003) and Smith (2004), define a conceptual framework a hypothesized model identifying the model under study and the relationship between the dependent and independent variables. Kothari (2004) defines an independent variable also known as the explanatory variable is the presumed cause of the changes of the dependent variable, while a dependent variable refers to the variable which the researcher wishes to explain. The goal of a conceptual framework is to categorize and describe concepts relevant to the study and map relationships among them. Such a framework would help researchers define the concept, map the research terrain or conceptual scope, systematize relations among concepts, and identify gaps in literature (Creswell, 2003). Below is a figurative representation of the variables to be explored by this study



Independent Variables **Dependent**

Figure 2.1: Conceptual Framework

2.3.1 Self-Help Group (SHG) Finance Sources

A typical SHG consists of twelve to thirty members (Rutherford, 2000). The group is not merely a savings and loan association, but provides a platform for a range of issues. Self Help Groups (SHG) brings together community members who have organized themselves into a group with the aim of addressing common problems. Self Help Groups are usually formed with the ultimate goal of enhancing its members' economic empowerment process through recognizing and building its members capabilities. The need to create a grassroots organizational base to enable rural and urban-poor enterprises to come together, to analyze their issues and problems themselves, and to fulfill their needs has been strongly advocated in countries like Indian, Bangladesh and Pakistan(Vetrivel & Mohanasundari, 2011)

There are several types of financial self-help groups in Kenya. These groups include welfare groups, Rotating Savings and Credit Associations (ROSCAs), and investment groups. (FSD, 2009).Members of the Self-Help Groups save a certain amount of money each week or each month and have group meetings weekly or monthly. Out of these collective savings they issue each other loans. Groups decide democratically how much interest they will charge, what the penalties will be for not coming to the meetings or showing up late to the meetings, and what amount they will save each week or month. They decide

what the requirements are for dropping out of the group and the requirements for new members joining. (Flynn, 2013)
ROSCA stands for Rotating Savings and Credit Associations. These financial associations can be found in the informal economy, which is referred to as the third economy among other terms. They make up a significant portion of the informal finance sector (Smets, 2000). ROSCAs are savings and credit groups, which usually comprise of 5 – 20 members, who agree to come together, at regular intervals and usually for a defined period of time, with the intent of engaging in savings and credit activities through contributing to a common fund (Raccanello, 2009).The members agree to contribute a certain amount at each interval, and this amount is usually agreed upon at the start of the scheme. By principle, the contribution is based on balanced reciprocity, meaning each member draws out as much as he puts in (Bouman, 1995). The fund is given in whole or in part to each contributor in turn (Ardener, 2010) (O'reilly, 1996). Once a member has received the fund, he/she will no longer be a candidate for future allocations until the ROSCA cycle ends (Thieme, 2004), although they are obliged to contribute until the cycle ends (Anderson, 2002). Upon completion of a cycle, the members can decide to continue, disband or quit the ROSCA (Eroglu, 2010).

2.3.2 Trade Credit

According to Demurgic-Kunt and Maksimovic (2001) trade credit is important alternative to bank loans as a source of external funding in the SME sector in every developed and developing economy. Trade credit is an agreement in which a supplier allows a business to delay payment for goods and services already delivered. Allowing payment to occur after the receipt of the goods and services helps the business to better manage their short-term cash flows. Trade credit is an alternative source of funding to credit provided by financial institutions, hereafter referred to as bank credit.

Trade credit has been identified as an important source of finance for firms, especially when firms find it difficult to obtain external funding via credit institutions. Over recent years, trade credit in the form of accounts payable and receivable of euro area non-financial firms has moved broadly in line with the business cycle. This confirms the typically procyclical pattern of accounts payable and receivable, as they are closely linked to the exchange of goods and services and, hence, to economic activity (Fernando & Mulier, 2012)

For small and medium sized enterprises, trade credit overwhelmingly dominates finance of operations. Client pre-payment is often more important than suppliers ‘credit for some microenterprises. The use of client pre-payment for goods as a major way of financing small businesses varies considerably among the different industrial sectors and by sub-region. Trade credit is used as a form of business funding for a number of reasons. Suppliers may have an advantage over banks in providing credit because they tend to have more information about their customers and their credit history. Trade credit can be used as an instrument of price discrimination. Given that trade credit is usually extended to buyers on the same basis regardless of the buyer’s underlying credit quality, financially weaker firms typically pay a lower effective price than financially stronger borrowers (Aryeetey, 1998)

According to the study conducted by Garcia-Appendini and Montoriol – Garriga (2011) on firms as liquidity providers they found out that in the U.S stronger larger firms extended more trade credit during the current financial crisis and weaker larger firms received more trade credit.

2.3.3 Family and Friends Finance Sources

In most of the African countries tradition, demands that financial help should be extended to one’s immediate and extended family members. Friends and family who are supportive of the business idea provide money either directly to the entrepreneur or into the business. This can be quicker and cheaper to arrange (certainly compared with a standard bank loan) and the interest and repayment terms may be more flexible than a bank loan. However, borrowing in this way can add to the stress faced by an entrepreneur, particularly if the business gets into difficulties (Chioma & Ngozi, 2014).

Personal savings are the dominant source of credit, especially for initial capital, pointing to the limited ability of the financial markets to meet existing credit demand from certain borrowers and reinforcing the argument that small-scale rural based enterprises do not have access to the financial resources of the formal financial sector. Even within the informal market, the different segments display different degrees of accessibility. Most enterprises used personal savings and credit from relatives (Atieno, 2001)

Financing of the Medium and small business, family and friends played a big role in helping the business owners boost their operations with an average of 40% of the finances coming from them, an average of 24% came from financial institutions while on average 30% of the finances were from business savings (Macharia, 2012).

2.3.4 Shylock Finance Sources

Shylock operations are loaning scheme where individuals grant low amounts of loans to low income individuals for a short time with higher interest rates than the allowed rates in the land. Shylock operations have been legalized in some regions of the world and consequently properly instituted policies have been put in place to regulate its operations (Akoth, 2013)

Shylock loans are common in semi-urban areas and the lender dictates the place and term of the credit. It involves the provision of third party or security as to prevent defaults in repayment. The borrower is usually required to produce a guarantor, pledge his land or both to serve as collateral before the extension of the loan facilities(Ugwuanyi, 2012). Credit from moneylenders is often the most expensive credit available; hence the demand for it usually comes from persons without any other options. Such credit remains nevertheless the only source of informal credit that does not require borrowers to satisfy specific membership obligations (Aryeetey, 1998)

2.3.5 Performance of SMEs

Performance is the function of the ability of an organization to gain and manage the resources in several different ways to develop competitive advantage. Measuring financial performance is very important because it builds on the results, make different decisions in economic units. Financial performance measurement is important to economic units, because it provides useful information about the economic units before decisions or actions (Lahtinen, 2009). Sandberg, Vinbery and Pan (2002) defined the performance of small businesses as their ability to contribute to job and wealth creation through business startup, survival and growth. Financial performance measures are used as the indicators to evaluate the success of economic units in achieving stated strategies, objectives and critical success factors (Lahtinen, 2009).

According to Levasseur (2002) information on financial performance is useful in predicting the capacity of the enterprise hence analyzing how well or poorly an enterprise is doing against its set objectives. Three profitability measures that are universally accepted for their value to management are return on assets, return on equity, and operating profit margin. All three measure the extent to which a business generates net income or profit from the use of its resources. Technically, all three are efficiency measures that measure the relationship between an output, in this case net income from operations, and an input. The inputs for return on assets return on equity, and operating profit margin are total assets, total equity or net worth, and gross farm revenues, respectively. Financial measures that don't include net income as the output in the relationship are labeled "financial efficiency measures" rather than profitability measures. Asset turnover, which measures the intensity with which a firm uses its assets to generate revenues, is a key financial efficiency ratio that also needs to be included in any general manager's list of critical Finance measures (Miller, Boehije & Dobbins, 2013).

2.4 Empirical Review

This section included studies that other scholars have previously undertaken on effect of source of finance on business performance.

2.4.1 Formal versus Informal Finance

Poor people either obtain informal credit or borrow from both financial sectors at the same time. Degryse and Ongena, (2014) conducted a study on Informal or formal financing or combination of the two with evidence on the co-funding of Chinese firms. Using unique survey data, the study found that informal finance is associated with higher sales growth for small firms and lower sales growth for large firms. The study identifies a complementary effect between informal and formal finance for the sales growth of small firms, but not for large firms. Informal finance offers informational and monitoring advantages, while formal finance offers relatively inexpensive funds. Co-funding, i.e. the simultaneous use of formal and informal finance, is the optimal choice for small firms.

Fridell (2007) explored the roles of informal, formal and semiformal Micro credit in Jordan credit. The study found that accessibility and low application costs are the key advantages of informal credit, while these are often perceived to be disadvantages of formal credit. Informal finance was found to be very flexible since the dominant source of informal credit seems to be family, friends, neighbors, it may not be so surprising that most informal loans were interest free and that many do not agree that interest rates are higher for informal lending in general. The informal financial sector was also seen to be disadvantaged by credit ceilings, while the formal sector had reliable funds available. The study concluded that the key method of enhancing credit access to business and individuals and hence reduce the financial exclusion was by encouraging development of informal financial sector. The reduced costs and flexibility was found to enhance credit access which in turn led to increased business performance.

Atieno (2001) found that credit rationing is significantly higher in the formal financial markets as compared to the informal and semiformal financial sectors in Kenya. She found that the concern with the loan repayment among formal lenders determines the amount credit a borrower gets while in the informal financial sector, the main determinant is their limited resource base. She concluded that lending terms imposed by the formal financial sector (emphasizing collateral security) ration a large number of borrowers out of the credit market leaving only a few who can afford the required collateral. On the other hand, some of the borrowers do not get what they want from the informal sector due to the limited resource base creating a credit gap in the rural markets in Kenya.

2.4.2 Informal Finance and Performance

Fadiga& Fadiga-Stewart (2004) conducted a study on collective action and informal financial institutions: An empirical analysis of rotating and savings credit associations (ROSCAS) in Senegal. This study models cooperation among members as well as the financial performance and sustainability of associations using data collected from field research conducted in Dakar, Senegal in 2001. The results show that factors such as homogeneity of individuals within an association, how long the association has existed, how defaults are covered, and rules such residency requirements, individual contributions, and rotation order are to various degree critical to the financial performance and sustainability of ROSCAs and to the fostering of cooperation among members of these associations.

Ostrom (1999) argued that ROSCAs have been able to avoid many of the high transaction costs associated with formal financial institutions. For example, ROSCAs through various monitoring and sanctioning mechanisms can minimize the costs of screening new borrowers by capitalizing on local information about individuals past behavior. In addition, reputations and the self-selection of members help these institutions reduce adverse selection and moral hazard problems. High rates of interaction, proximity and effective mechanisms such as first, second, and third-party enforcement make it easier for mutual monitoring among members to occur and helps ensure that the benefits of cooperating minimize the temptation to default. Social capital such as shared norms, networks of relationships, and trust are important factors that explain how these institutions have been able to remain sustainable. With respect to the impact of group size on collective action, a critical mass of individuals and how associations affect social capital requires further investigation to offer solid conclusions

2.4.3 Access to Finance and Performance

Evidence from the existing empirical literature on the effect of access to finance on informal lending among the poor, and near poor, is mixed. Khandker (2000) found that while enhanced access to formal finance reduces the incidence of borrowing from informal sources. On the other hand, Sinha and Matin (1998) found that microfinance member household does not reduce borrowing from informal credit sources. More recently, Mallick (2012) and Berg et al. (2013) addressed the issue using village level moneylender' interest rates and found that that moneylender interest rates increase with higher formal finance coverage. Berg et al. (2013) also use separate household level survey datasets. Their results suggest that households that borrowed from Microfinance institutions borrow less from informal sources following participation in microfinance.

Kinyua (2014) identified the factors affecting the performance of SMEs in Nakuru Town of Kenya. The research employed a survey research design and employed a stratified random sampling. In his study, he found that performance of SMEs was influenced by finance, management skills, macro environment, and infrastructure. The finding of the study indicates that access to finance had the potential to positively affect performance of SMEs. Similar studies by Nabintu (2013) found that performance of SMEs, was influenced by access to access to finance among other factors such as technological input in the payment system, and availability of management experience. The finding of the study indicates that there is a positive correlation or relationship between financial performance of SMEs and access to finance.

Parker and Torres (2004) found that a shortage of working capital was cited as the primary reason for 25 percent of the Kenyan microenterprises that terminated operations. Informal finance remains the most important source of finance throughout the business cycle. The survey conducted by Daniels, Mead and Musinga (2005) found that almost 95 percent of the interviewed entrepreneurs used family savings as the primary source of working capital..

2.5 Critique of the Existing Literature

The study agrees with Khandker (2000) microfinance creates an increased demand for credit from informal sources as business expands and microfinance alone cannot meet the borrower's credit needs that access to formal financial institutions affects informal finance. However the study is limited to microfinance institutions only critical review of studies on the effect of Informal finance sources on performance of small firms reveals both conceptual and methodological knowledge gaps. For instance, it fails to address other forms of finance and the study was as conducted in the Asian state of Bangladesh which is in different social-economic cluster from Kenya. Ostrom (1999) fails to capture the effect of other non informal source of finance.Degryse & Ongena, (2014) rightfully identify a complementary effect between informal and formal finance for the sales growth of small firms. However their study was limited to Chinese firms. Studies on trade finance and performance include Fridell (2007) whose contextual focus is Jordan, an economy which is significantly different from Kenya, in terms of macroeconomic fundamentals.

Atieno (2001) focused on the Kenyan informal financial sector landscape in separate geographical areas. The studies by Musinga (2005) failed to focus on all the sources of informal finance. Again, the macroeconomic and social environments of the two economies differ from the Kenyan economy. Studies by Cheruiyot, Kimeli, & Ogendo (2012) and Bowen, Morara, & Mureithi, (2009), focus on both formal and informal finance but without specific details about sources of informal finance. The two studies also focus on a different geographical and sectoral segment of the SMEs not agricultural SMEs and neither do they focus on Kiambu County.

2.6 Research Gaps

Various studies that have been carried out globally on the effect of financial accessibility on the financial performance of SMEs show conflicting results. Limited access to finance has been identified as the key constraint globally (Minniti, 2009). Cressy and Ollofson (2006) in their study concluded that the growth and financial performance finance of firms was more constrained by managerial and psychological factors than it was by the availability of external finance. (Cressy, 2006). On the other hand, Schiffer and Weder (2001) in their paper on firm growth and business environment identified constraints on access to finance as the main factor hindering growth of firms.

Kamau(2008) focused on the critical factors affecting accessibility of credit services by small scale tea farmers, Wanjohi and Mugure (2008) Factors affecting growth of MSEs in Rural Areas in Kenya while Wasonga,(2008) did research on challenges in financing SMEs in Kenya. Muniu (2013) carried out a study on the effects of human resource management on financial performance of small and medium enterprises in Kiambu Municipality.

While the scale of informal finance in many developing countries has long been known to be extensive, data at the national level and particularly in Africa has been scarce. This study will help to fill the void in the knowledge gap. This study is therefore conducted so as to identify the effect of informal finance on the financial performance finance of SMEs

2.7 Summary

The above chapter reviewed the various theories that explained the independent and dependent variables. The reviewed theories were then critiqued for relevance to specific variables. The chapter also explored the conceptualization of the independent and the dependent variables by analyzing the relationships between the two set of variables. In addition, an empirical review was conducted where past studies both global and local were reviewed in line with the following criteria, title, scope, methodology resulting into a critique. It is from this critique that the research gaps were identified.

III. RESEARCH METHODOLOGY

3.1 Introduction

The purpose of this study was to assess the effect of informal finance on the performance of SMEs. This chapter presented a review of the research methodology. Specifically, the chapter discussed the research design, the population of the study, the sample size, the data collection procedure and the data analysis.

3.2 Research Design

Research design refers to how data collection and analysis are structured in order to meet the research objectives through empirical evidence economically (Chandran, 2006).According to Cooper and Schindler (2007) research design is the plan and structure of investigation so conceived as to obtain answers to research questions.

This study adopted a descriptive survey research design, one which does not manipulate variables or arrange for events to happen (Orodho, 2003) This study assessed the relationship between informal finance and the financial performance of SMEs. According to Mugenda (2012) descriptive study is a type of study conducted to generate explanatory information or characteristics about a specific phenomenon. It can be used when the purpose is to describe the characteristics of certain events or situations, estimate the proportion of people who behave in certain ways and to make specific predictions (Saunders et al 2009).

3.3 Population of the Study

According to Kombo and Tromp (2006) population is a group of individuals, objects or items from which samples will be taken for measurement or it is an entire group of persons, or elements that have at least one thing in common. The study targeted all the 7384 registered SMEs in Kiambu town.(Kiambu County Integrated Plan 2013-2017). The accessible population for this study was the registered and operating businesses in 2015.

3.4 Sampling Frame

A simple definition of a sampling frame is a set of source materials from which the sample is selected (Mugenda and Mugenda, 2003).The definition also encompasses the purpose of sampling frames, which is to provide a means for choosing the particular members of the target population that are to be interviewed in the survey (Bailey, 2008). The sampling frame of this survey was the list of the registered 7384 SMEs.

3.5 Sample Size and Sampling Technique

A sample is a subset of population (Hyndman, 2008). It is a true representative of the entire population to be studied (Leary, 2001). Similarly sampling is the selection of a subset of individuals from within a population to yield some knowledge about the whole population, especially for the purposes of making predictions based on statistical inference (Scott & Wild, 1986; Black and William, 2004). Its main advantages are cost, speed, accuracy and quality of the data (Ader, Mellenbergh, & Hand, 2008). A good sample should be truly representative of the population, result in a small sampling error, viable, economical, and systematic, whose results can be applied to a universe with a reasonable level of confidence (Kothari, 2004.This study adopted random sampling for the selection of the SMEs. Since the population was less than 10,000, the fisher et al, (2003) formula was employed.

The Fisher formula is as follows:

$$n = \frac{z^2 p(1-p)}{d^2}$$

Where;

n= sample size

z= the standard normal deviate value for the level of confidence, for instance 95% level of confidence =1.96.

d= margin of error or level of precision at 0.1 for CI at 90%

p= proportion to be estimated, Israel (2009) recommends that if you don't know the value of p then you should assume p=0.5

Therefore, sample size is arrived at as follows:

$$n = \frac{(1.96^2)(0.5)(1-0.5)}{(0.1)^2}$$

$$n = 96$$

Since the population is less 10,000, the sample size is further adjusted as follows:

$n_0 = n/ (1+ ((n -1)/ N))$

$n_0 = 96/ (1+ ((96-1)/7384))$

$n_0 = 95$

The sample had 95 respondents who consisted of owners and managers of SMEs. A multistage sampling procedure with simple random sampling was used to select SMEs for the survey. SMEs were randomly selected resulting in a sample size of 95. Data was obtained from sample using questionnaires

3.6 Instruments

Primary data was collected through the administration of the questionnaires. A questionnaire is a pre-formulated written set of questions to which the respondents record the answers usually within rather closely delineated alternatives. A Likert scale of five responses was used. Likert scale is an interval scale that specifically uses five anchors of strongly disagrees, disagree, neutral, agree and strongly agree. The Likert scale measures the level of agreement or disagreement. Likert scales are good in measuring perception, attitude, values and behaviour. The Likert scale has scales that assist in converting the qualitative responses into quantitative values (Mugenda & Mugenda, (2003) and Zikmund, Babin, Carr &Griffin, (2010).Open ended questions was not useful because the data obtained was not normally distributed since the respondents were not restricted to a common way of answering the questions.

3.7 Data Collection Procedure

Data collection refers to the process of gathering raw and unprocessed information that can be processed into meaningful information, following the scientific process of data analysis (Gall, Gall & Borg, 2007).

Primary data is collected or obtained from the original sources. The resulting data is usually referred to as raw data meaning it has not been re-organized and cleaned. Primary data was obtained from questionnaires. The questionnaire consisted of five sections. The first section detailed the demographic information of the respondents. The second section attempted to establish the effect of Self-help groups finance sources on the performance of SMEs. The third section attempted to establish the effect of family and friends finance sources on the performance of SMEs. The forth section attempted to establish the effect of trade credit Finance sources on the performance of SMEs. The fifth section attempted to establish the effect of Shylock finance sources on the performance of SMEs.

3.8 Pilot testing

A pilot study was conducted to test-run the practicability of the study and to detect flaws in the data collection process. This helped to discover errors on the issues raised such as ambiguous instruction or wording, inadequate time limit and measurability of variables defined.

3.8.1 Validity Test

According to Mugenda and Mugenda (2003), validity is the accuracy and meaningfulness of inferences, which are based on the research results. Validity exists if the data measure what they are supposed to measure. Baker, Veit and Powell (2001) states that the size of a sample to be used for piloting testing varies depending on time, costs and practicality, but the same would tend to be 5- 10 per cent of the main survey. According to Cooper and Schindler (2006) the respondents in a pilot test do not have to be statistically selected when testing the validity and reliability of the instruments. For this study, 5% was used thus 5 questionnaires was used and reviewed with a view to improving content validity of the data that will be collected. Content validity is the extent to which a measuring instrument provides adequate coverage of the topic under study (Kothari, 2004). Content validity of the research instrument was evaluated through the actual administration of the pilot group. The study used both face and content validity to ascertain the validity of the questionnaires. Face validity is actually validity at face value. Industry experts and the research supervisor also went through the questionnaire to judge how well the measuring instrument met the standards.

3.8.2 Reliability Test

Reliability is the consistency of a set of measurement items (Cronbach, 1951). Reliability is the consistency of measurement, or the degree to which an instrument measures the same way each time it is used under the same condition with the same subjects. In short, it is the repeatability of measurement. A measure is considered reliable if a person's score on the same test given twice is similar. Five questionnaires were piloted by issuing them to respondents who will not be included in the final study sample. The five questionnaires were coded and responses input into SPSS which was used to generate the reliability coefficient. The researcher used the most common internal consistency measure known as Cronbach's Alpha (α) which was generated by SPSS. It indicated the extent to which a set of test items should be treated as measuring a single latent variable (Cronbach, 1951). The recommended value of 0.7 was used as a cut–off of reliability for this study.

3.9.1 Data Analysis and Presentation

Data analysis is a practice in which raw data is ordered and organized so that useful information can be extracted from it (Gall, Gall & Borg, 2007). Descriptive statistics such as, mean and frequencies were used to perform data analysis. The mean scores was used to rate the factors in order of their importance. After data had been collected through questionnaires, it was prepared in readiness for analysis by editing, handling blank responses, coding, categorizing and keying into statistical package for social sciences (SPSS) computer software for analysis SPSS was used to produce frequencies, descriptive and inferential statistics which was used to derive conclusions and generalizations regarding the population. The particular descriptive statistics was frequencies, mean scores and standard deviation. The particular inferential statistic was regression and correlation analysis.

A multivariate regression model was used to link the independent variables to the dependent variable as follows;

$Y = \beta_0 + \beta_1X_1 + \beta_2X_2 + \beta_3X_3 + \beta_4X_4 + \mu$

Where;

Y =Performance

X_1 =Self Help Group finance sources

X_2 = Family and friends finance sources

X_3 = Trade credit finance sources

X_4 = Shylock finance sources

In the model, β_0 = the constant term while the coefficient β_ii= 1….4 will be used to measure the sensitivity of the dependent variable (Y) to unit change in the predictor variables X_1, X_2, X_3 and X_4. μ is the error term which captures the unexplained variations in the model.

The analysis of variance (ANOVA) was checked to reveal the overall model significance. In particular, the calculated f statistic was compared with the tabulated f statistic. A critical p value of 0.05 was also used to determine whether the overall model was significant or not. The individual regression coefficient was checked to see whether the independent variables significantly affected the business performance. A critical p value of 0.05 was used to determine whether the individual variables are significant or not.

Data was then presented in bar graphs, pie charts and tables.

IV. RESULTS AND DISCUSSION

4.0 Introduction

This chapter comprised of data analysis, findings and interpretation. Results were presented in tables and diagrams. The analyzed data was arranged under themes that reflected the research objectives.

4.1 Response Rate

The number of questionnaires that were administered was 95. A total of 80 questionnaires were properly filled and returned. This represented an overall successful response rate of 84.21% as shown on Table 4.1. According to Mugenda and Mugenda (2003) and also Kothari (2004) a response rate of above 50% is adequate for a descriptive study. Babbie (2004) also asserted that return rates of above 50% are acceptable to analyze and publish, 60% is good, 70% is very good while above 80% is excellent

Based on these assertions from renowned scholars, 84.21% response rate is excellent for the study.

Table 4.1: Response Rate

Response	Frequency	Percent
Returned	80	84.21%
Unreturned	15	15.79%
Total	**95**	**100%**

4.2 Demographic Characteristics

This section consists of information that describes basic characteristics such as gender of the respondent, age of the respondent, level of education and years of operation in the SMEs sector.

4.2.1 Gender of the respondents

The respondents were asked to indicate their gender. Majority of the respondents were male who represented 60% of the sample while 40% were female. This implies that majority of SMEs are male dominated.

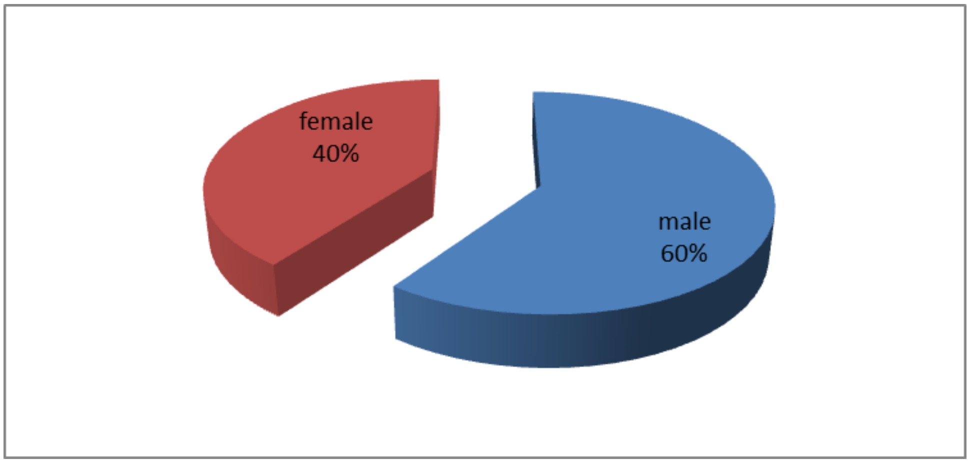


Figure 4.1: Gender of Respondents

4.2.2 Age of the respondents

Respondents were requested to indicate their age brackets. Majority of the respondents, 36% were in age bracket of 31-40 years. 28% were in age bracket of 41-50 years, 21% were above 50 years while 15% who were the least were less than 30 years old. This implies that majority of the employees in the SMEs were relatively old employees and were expected to have a good background of the operations within the organization.

Table 4.2: Age of the respondents

Age	Frequency	Percent	Valid Percent	Cumulative Percent
Less 30 years	12	15	15	15
31-40 years	29	36.3	36.3	51.2
41-50 years	22	27.5	27.5	78.8
Above 50 years	17	21.3	21.3	100
Total	80	100	100	

4.2.3 Highest Level of Education

The respondents were asked to indicate their highest level of education. Results in figure 4.3 show that 57% of the respondents had their highest level of education being college level, 29% had university level while only 14% had secondary qualification. In as far as the title of study is concerned, the results imply that, the respondents were expected to understand the questionnaire and give valid response since they had better understanding as guided by the their level of education which in this case majority having college level as the highest level of education.

Table 4.3: Highest level of Education of Respondents

Education level	Frequency	Percent	Valid Percent	Cumulative Percent
Secondary school	11	13.8	13.8	13.8
College	46	57.5	57.5	71.3
University	23	28.7	28.7	100
Total	80	100	100	

4.2.4 Duration of operation in the SME.

On the question of the duration being in operation, majority of the respondents (54%) have been in the operation for 6-10 years, 22% have been in the operation for over 10 years, 15% have been in the operation for 2-5 years while 9% have been in the operation for a period less than 1 year.

This implies that majority of the respondents have been in the operation for a good period of time thus they were experienced.

Table 4.4: Duration of operation in the SME.

Years worked	Frequency	Percent	Valid Percent	Cumulative Percent
less than 1 year	7	8.8	8.8	8.8
2 to 5 years	12	15	15	23.8
6 to 10 years	43	53.8	53.8	77.5
Over 10 years	18	22.5	22.5	100
Total	80	100	100	

4.2.5 Number of employees

The respondents were asked to indicate the number of employees in their SMEs. A majority of 50% indicated that they had 1 to 5 employees, 25% responded that they had between 6 to 10 employees, 15% indicated that they had 11 to 50 employees while only 8% indicated that they had over 50 employees.

This implies that majority of SMEs within Kiambu county have few employees. The criteria for defining the size of a business differ from country to country, with many countries having programs of business rate reduction and financial subsidy for SMEs. According to European Commission the SME are the enterprises that follow this definition (European Union, 2015).Therefore from this definition, this study can conclude that majority of the SMEs in Thika are micro enterprises as shown in the table.

Table 4.5: European Union definition of SMEs.

Company category	Employees	Turnover	Balance Sheet Total
Medium-sized	< 250	≤ €50 m	≤ €43 m
Small	< 50	≤ €10 m	≤ €10 m
Micro	< 10	≤ €2 m	≤ €2 m

Source: European Union (2015)

Table 4.6: Number of employee

No of Employees	Frequency	Percent	Valid Percent	Cumulative Percent
1 to 5 employees	40	50	50	50
6 to 10 employees	20	25	25	75
11 to 50 employees	12	15	15	90
over 50 employees	8	10	10	100
Total	80	100	100	

4.3 Performance

4.3.1 Financial Performance

The respondents were requested to indicate if the profitability of their business had improved in the last three years. 89% of the respondents who were the majority indicated that profitability of their business had improved while only 11% said that their profitability of their businesses had not improved.

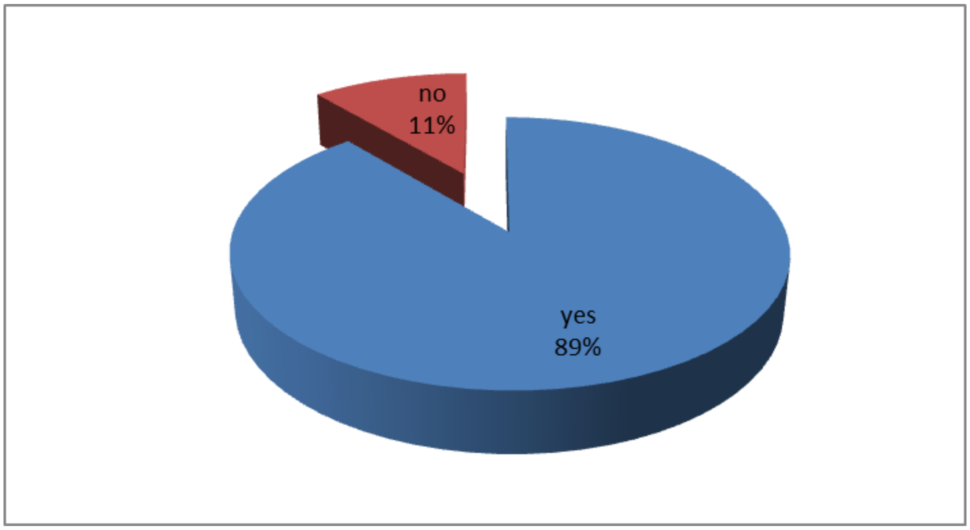


Figure 4.2: Profitability

For those who responded that their profitability of their business had improved, they were further requested to indicate the percentage range of the profitability improvement. In the year 2014, 55% of the respondents who were the majority indicated that they have realized over 5% profitability increment. In the year 2013, 61.10% also indicated that they have realized over 5% increment while in the year 2012, 61.10% who were the majority indicated that they have had between 2 to 5% improvement in profitability.

Profitability is the function of the ability of an organization to gain and manage the resources in several different ways to develop competitive advantage (Lahtinen, 2009). Measuring financial performance is very important because it builds on the results, make different decisions in economic units. Financial performance measurement is important to economic units, because it provides useful information about the economic units before decisions or actions (Lahtinen, 2009).

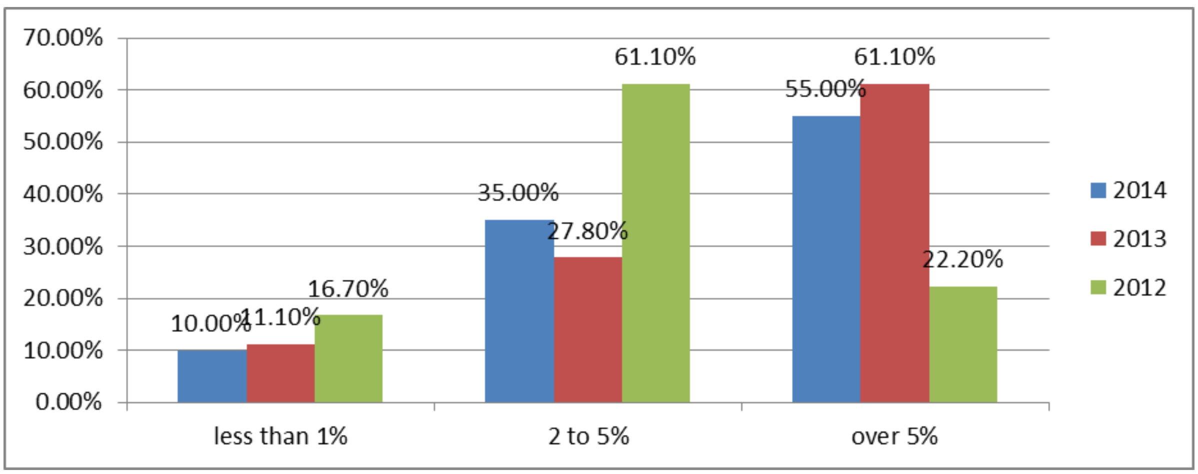


Figure 4.3: Profitability improvement

4.3.2 Non Financial Performance

The respondents were requested to indicate if the customer satisfaction of their business had improved in the last three years. 95% of the respondents who were the majority indicated that customer satisfaction of their business had improved while only 5% said that customer satisfaction of their businesses had not improved.

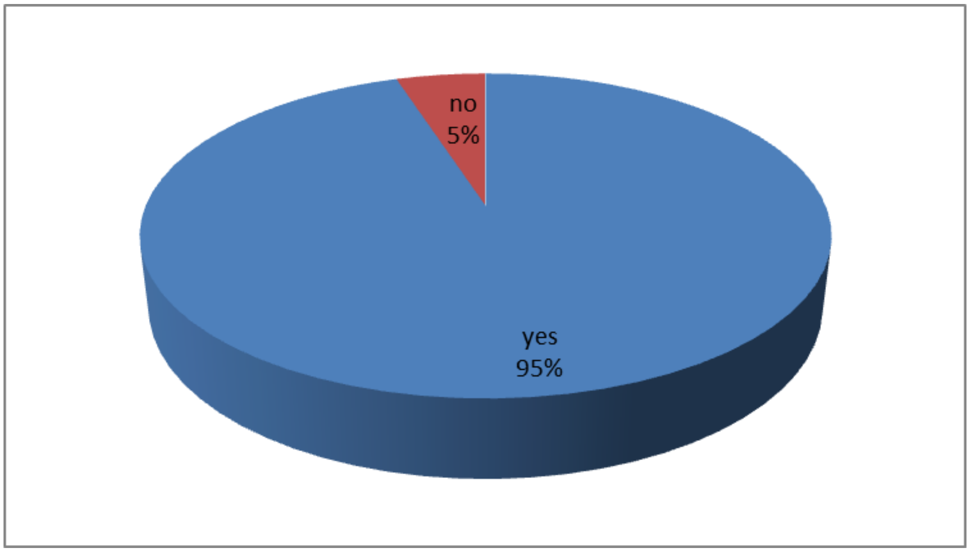


Figure 4.4: Customer Satisfaction

For those who responded that customer satisfaction of their business had improved, they were further requested to indicate the percentage range of the customer satisfaction improvement. In the year 2014, 57.9% of the respondents who were the majority indicated that they have realized over 5% customer satisfaction increment. In the year 2013, 57.9% also indicated that they have realized over 5% increment while in the year 2012, 57.9% who were the majority indicated that they have had between 2 to 5% customer satisfaction improvements.

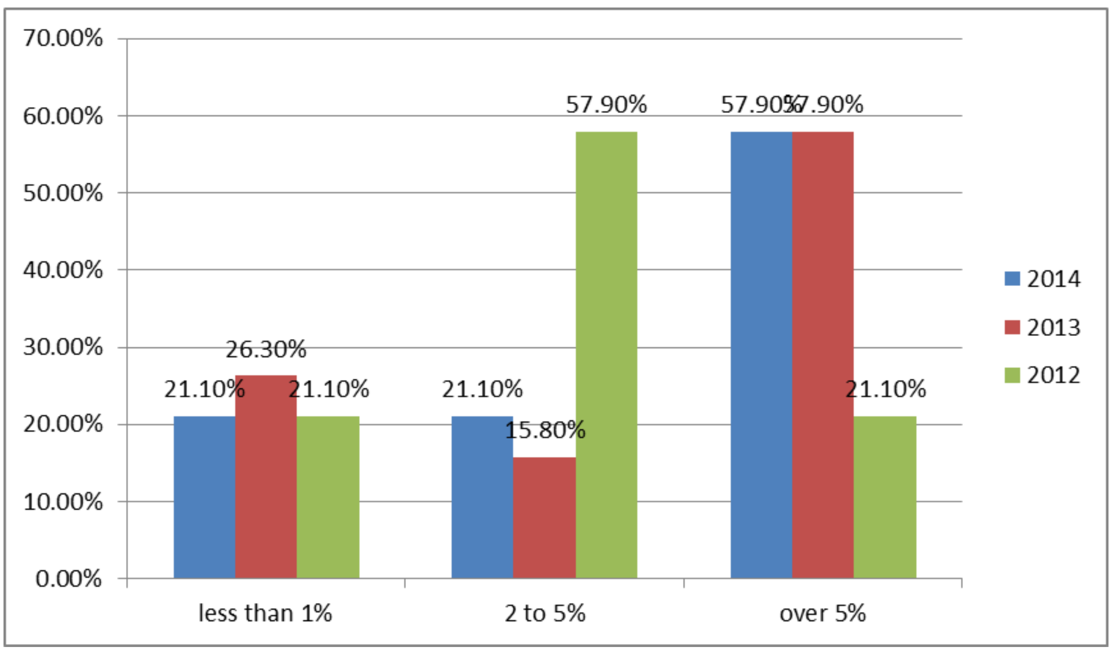


Figure 4.5: Customer Satisfaction improvement

4.4 Effect of Self Help Group (SHG) finance on performance

4.4.1 Descriptive Statistics

The respondents were asked to indicate if they had borrowed money from a rotating saving and credit association/Chama in the last three years. 90% of the respondents indicated that they had e borrowed for the last three years while only 10% indicated that they had not borrowed.

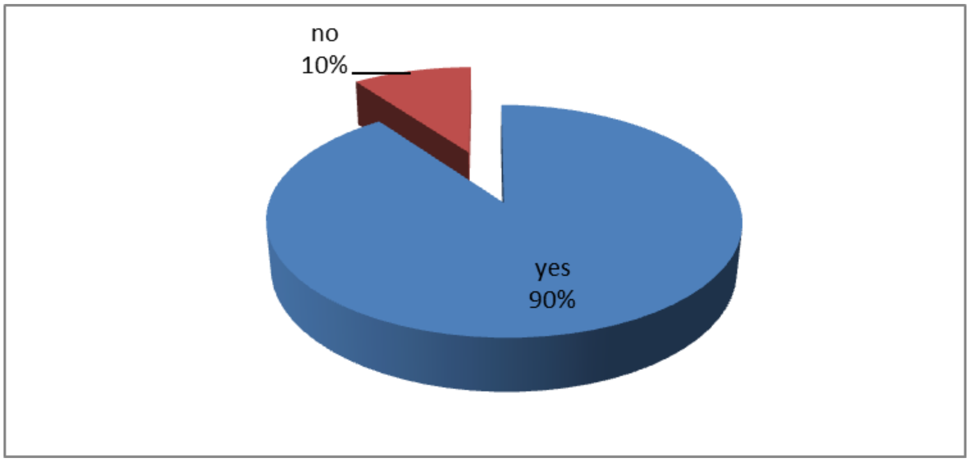


Figure 4.6: Self Help Group (SHG) financing

For those who answered that they had borrowed it, they were further requested to indicate in range the amount they had borrowed from the association in the last three years.50% of the respondents who were the majority indicated that they had borrowed over ksh50, 000 in the year 2014, 58% indicated that they had borrowed between ksh20,000 and 50,000 in the year 2013 while 65.3% indicated that they had borrowed between ksh20,000 and 50,000 in the year 2012.

Ostrom (1999) argued that ROSCAs have been able to avoid many of the high transaction costs associated with formal financial institutions. For example, ROSCAs through various monitoring and sanctioning mechanisms can minimize the costs of screening new borrowers by capitalizing on local information about individuals past behavior. In addition, reputations and the self-selection of members help these institutions reduce adverse selection and moral hazard problems. High rates of interaction, proximity and effective mechanisms such as first, second, and third-party enforcement make it easier for mutual monitoring among members to occur and helps ensure that the benefits of cooperating minimize the temptation to default. Social capital such as shared norms, networks of relationships, and trust are important factors that explain how these institutions have been able to remain sustainable.

Table 4.7: Self Help Group (SHG) finance

Year	less than ksh20,000	ksh20,000-50,000	over ksh50,000
2014	16.70%	33.30%	50.00%
2013	11.60%	58.00%	30.40%
2012	16.70%	65.30%	18.10%

4.4.2 Correlation Analysis

The bivariate correlation was conducted between the Self Help Group (SHG) finance and performance. The results indicated that there was a positive and a significant association between Self Help Group (SHG) finance and performance (r=0.427, p=0.000)

Table 4.8: Correlation matrix

		Performance	Self Help Group (SHG) finance
Performance	Pearson Correlation	1.000	
	Sig. (2-tailed)		
Self Help Group (SHG) finance	Pearson Correlation	0.427**	1.000
	Sig. (2-tailed)	**0.000**	
** Correlation is significant at the 0.01 level (2-tailed).			

The finding is consistent with study by Mbizi and Gwangwava(2013) that revealed that majority of the participants considered the ROSCAs strategy so vital that eighty percent concurred that for the poor ROSCAs is the only viable funding strategy for sustainable Micro Enterprises. Self help group finance sources were deemed to be great assistance in smoothening business financial cycles as well facilitating cash flow management.

4.5 Effect of Family and Friends finance on performance

4.5.1 Descriptive Statistics

The respondents were asked to indicate if they had borrowed money from family and friends in the last three years. 90% of the respondents indicated that they had borrowed for the last three years while only 10% indicated that they had not borrowed.

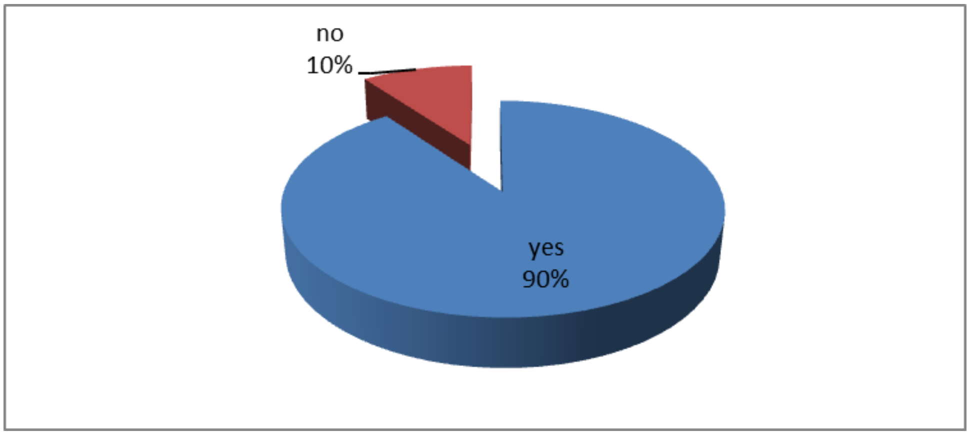


Figure 4.7: Family and Friends finance borrowing

For those who answered that they had borrowed it, they were further requested to indicate in range the amount they had borrowed from the family and friends in the last three years. 57.9% of the respondents who were the majority indicated that they had borrowed over ksh50, 000 in the year 2014, 55% indicated that they had borrowed between Ksh20,000 and 50,000 in the year 2013 while another 55% indicated that they had borrowed between ksh20,000 and 50,000 in the year 2012.

Table 4.8: Family and Friends finance borrowing

Year	less than ksh20,000	ksh20,000-50,000	over ksh50,000
2014	15.80%	26.30%	57.90%
2013	10.00%	55.00%	35.00%
2012	15.00%	55.00%	30.00%

4.5.2 Correlation Analysis

The bivariate correlation was conducted between the Family and Friends finance and performance. The results indicated that there was a positive and a significant association between Family and Friends finance and performance (r=0.200, p=0.007)

Table 4.10: Correlation matrix

		Performance	Family and Friends finance
Performance	Pearson Correlation	1.000	
	Sig. (2-tailed)		
Family and Friends finance	Pearson Correlation	0.200	1.000
	Sig. (2-tailed)	**0.007****	

** Correlation is significant at the 0.01 level (2-tailed).

This finding agree with that of Macharia (2012) who studied the effects of access to finance on Medium and small enterprises investment growth in Ongata-Rongai Township and found out that in financing of the Medium and small business, family and friends played a big role in helping the business owners boost their operations with an average of 40% of the finances coming from them, an average of 24% came from financial institutions while on average 30% of the finances were from business savings. The study also found that the main hindrance of SMEs in getting access to formal financial services due to lack of credit services awareness, lack of collateral, banks vetting procedures, requirements of a guarantor, cost of loans and the employment as a security issue are some of the obstacles hindering utilization of the available credit facilities.

4.6 Effect of trade credit finance on performance

4.6.1 Descriptive Statistics

The respondents were asked to indicate if they had accessed money from trade credit institutions in the last three years. 85% of the respondents indicated that they had accessed for the last three years while only 15% indicated that they had not accessed.

According to Demurgic-Kunt and Maksimovic (2001) trade credit is important alternative to bank loans as a source of external funding in the SME sector in every developed and developing economy. Trade credit is an agreement in which a supplier allows a business to delay payment for goods and services already delivered. Allowing payment to occur after the receipt of the goods and services helps the business to better manage their short-term cash flows. Trade credit is an alternative source of funding to credit provided by financial institutions, hereafter referred to as bank credit.

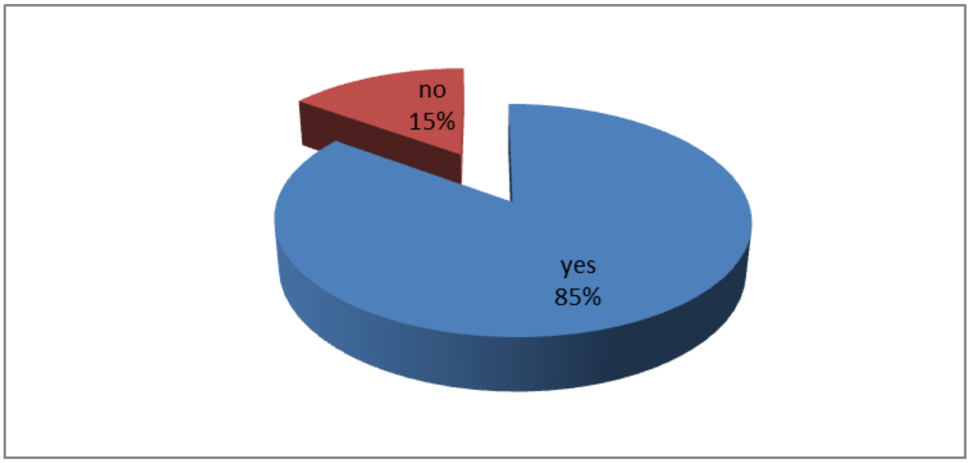


Figure 4.8: trade credit finance access

For those who answered that they had accessed it, they were further requested to indicate in range the amount they had accessed from trade credit in the last three years. 50% of the respondents who were the majority indicated that they had accessed over ksh50, 000 in the year 2014, another 50% indicated that they had accessed over ksh50, 000 in the year 2013 while 55.6% indicated that they had accessed between ksh20, 000 and 50,000 in the year 2012.

Table 4.11: Trade credit finance access

Year	less than ksh20,000	ksh20,000-50,000	over ksh50,000
2014	22.20%	27.80%	50.00%
2013	11.10%	38.90%	50.00%
2012	22.20%	55.60%	22.20%

4.6.2 Correlation Analysis

The bivariate correlation was conducted between the Trade credit finance access and performance. The results indicated that there was a positive and a significant association between Trade credit finance access and performance (r=0.633, p=0.000)

Table 4.11: Correlation matrix

		Performance	Trade credit finance access
Performance	Pearson Correlation	1.000	
	Sig. (2-tailed)		
Trade credit finance access	Pearson Correlation	0.633**	1.000
	Sig. (2-tailed)	**0.000**	
** Correlation is significant at the 0.01 level (2-tailed).			

These findings agree with Kapkiyai and Mugo(2015) that trade credit has positive effect on liquidity of SMEs and that SMEs with more trade credit tend to improve their profitability..

4.7 Influence of shylock borrowing on performance
4.7.1 Descriptive Statistics

The respondents were asked to indicate if they had borrowed money from shylock in the last three years. 55% of the respondents indicated that they had borrowed for the last three years while 45% indicated that they had not borrowed.

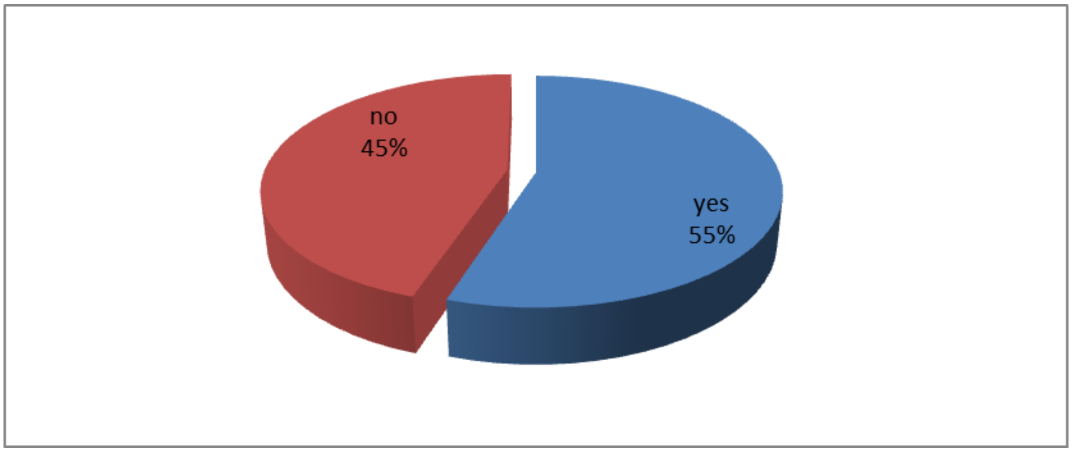


Figure 4.9: Shylock Financing

Those who answered they had borrowed from Shylocks were further requested to indicate in range the amount they had borrowed from shylocks in the last three years. 45.5% of the respondents who were the majority indicated that they had borrowed between ksh20,000 and 50,000 in the year 2014, 45.5% indicated that they had borrowed less than ksh20,000 in the year 2013 while 72.7% indicated that they had borrowed over 50,000 in the year 2012. Atieno (2001) found that credit rationing is significantly higher in the formal financial markets as compared to the informal and semiformal financial sectors in Kenya. She found that the concern with the loan repayment among formal lenders determines the amount credit a borrower gets while in the informal financial sector, the main determinant is their limited resource base. She concluded that lending terms imposed by the formal financial sector (emphasizing collateral security) ration a large number of borrowers out of the credit market leaving only a few who can afford the required collateral. On the other hand, some of the borrowers do not get what they want from the informal sector due to the limited resource base creating a credit gap in the rural markets in Kenya.

Table 4.12: Borrowing from Shylocks

year	less than ksh20,000	ksh20,000-50,000	over ksh50,000
2014	27.30%	45.50%	27.30%
2013	45.50%	36.40%	18.20%
2012	9.10%	18.20%	72.70%

4.7.2 Correlation Analysis

The bi-variate correlation was conducted between the Shylock borrowing finance and performance. The results indicated that there was a negative and a significant association between Shylock borrowing finance and performance (r=-0.413, p=0.007)

Table 4.13: Correlation matrix

		Performance	Shylock borrowing
Performance	Pearson Correlation	1.000	
	Sig. (2-tailed)		
Shylock borrowing	Pearson Correlation	-0.413**	1.000
	Sig. (2-tailed)	**0.007**	

** Correlation is significant at the 0.01 level (2-tailed).

The findings are consistent with those of the study by Mariwa (2012) in the rural areas of Ghana that found that though loans from informal lenders are readily available as and when needed, the

Interest rate charged is extremely high; about threefold of the rates charged by formal financial institutions which impacts negatively on the business.

4.8 Multivariate Regression Model

The results presented in table 4.14 show the fitness of model used of the regression model in explaining the study phenomena. Self help group finance, family and friends finance; trade credit finance and shylock borrowing were found to be satisfactory variables in explaining performance. This is supported by coefficient of determination also known as the R square of 57.3%. This means self help group finance, family and friends finance; trade credit finance and shylock borrowing explain 57.3% of the variations in the dependent variable which is performance. This results further means that the model applied to link the relationship of the variables was satisfactory.

Table 4.14 Model Fitness

Indicator	Coefficient
R	0.757
R Square	0.573
Adjusted R Square	0.528
Std. Error of the Estimate	0.2103599

In statistics significance testing the p-value indicates the level of relation of the independent variable to the dependent variable. If the significance number found is less than the critical value also known as the probability value (p) which is statistically set at 0.05, then the conclusion would be that the model is significant in explaining the relationship; else the model would be regarded as non-significant.

Table 4.15 provides the results on the analysis of the variance (ANOVA). The results indicate that the overall model was statistically significant. Further, the results imply that the independent variables are good predictors of performance. This was supported by an F statistic of 12.762 and the reported p value (0.000) which was less than the conventional probability of 0.05significance level.

This finding is consistent with that of Nabintu (2013) who found that performance of SMEs, was influenced by access to finance among other factors such as technological input in the payment system, and availability of management experience. The finding of the study indicates that there is a positive correlation or relationship between financial performance of SMEs and access to finance.

Table 4.15: Analysis of Variance

	Sum of Squares	df	Mean Square	F	Sig.
Regression	2.259	4	0.565	12.762	**0.000**
Residual	1.682	38	0.044		
Total	3.941	42			

Regression of coefficients results in table 4.12 shows that self help group finance and performance are positively and significantly related (r=0.128, p=0.015). The table further indicates that family and friends finance and performance are positively and significantly related (r=0.16, p=0.013). It was further established that trade credit finance and performance were positively and significantly related (r=0.329, p=0.000), while shylock borrowing and performance were negatively and significantly related (r=-0.372, p=0.000).

Table 4.16: Regression of Coefficients

Variable	B	Std. Error	t	Sig.
(Constant)	2.973	0.371	8.016	0.000
self help group finance	0.128	0.05	2.559	0.015
family and friends finance	0.16	0.104	1.534	0.013
trade credit finance	0.329	0.081	4.04	0.000
shylock borrowing	-0.372	0.096	-3.884	0.000

The specific model was;

Performance=2.973+0.128 self help group finance +0.16 family and friends finance +0.329 trade credit finance -0.372 shylock financing.

This finding agrees with that of Fadiga and Fadiga-Stewart (2004) who conducted a study on collective action and informal financial institutions: An empirical analysis of rotating and savings credit associations (ROSCAS) in Senegal and found that factors such as homogeneity of individuals within an association, how long the association has existed, how defaults are covered, and rules such residency requirements, individual contributions, and rotation order are to various degree critical to the financial performance and sustainability of ROSCAs and to the fostering of cooperation among members of these associations.

This finding also agrees with that of Macharia (2012) who studied the effects of access to finance on micro and small enterprises investment growth in Ongata Rongai Township. The study found that in financing of the micro and small business, family and friends played a big role in helping the business owners boost their operations with an average of 40% of the finances coming from them, an average of 24% came from financial institutions while on average 30% of the finances were from business savings.

In addition, this finding is consistent with that of Kinyua (2014) who found that performance of SMEs was influenced by finance, management skills, macro environment, and infrastructure. The finding of the study indicates that access to finance had the potential to positively affect performance of SMEs. Similar studies by Nabintu (2013) found that performance of SMEs, was influenced by access to finance among other factors such as technological input in the payment system, and availability of management experience. The findings of the study indicate that there is a positive correlation or relationship between financial performance of SMEs and access to finance.

V. SUMMARY, CONCLUSIONS AND RECOMMENDATIONS

5.1 Introduction

This chapter addresses the summary of the findings, the conclusions and the recommendations. This is done in line with the objectives of the study.

5.2 Summary of Findings

This section provides a summary of the findings from the analysis. This is done in line with the objectives of the study.

5.2.1 Self Help Group (SHG) finance source

The first objective of the study was to establish the effect of self help group finance on performance of SMEs. The findings revealed that self help group finance has a positive and significant effect on the performance of SMEs. This is also supported by the majority of statements in the questionnaire which majority of the respondents agreed.

The finding agrees with the Financial Access 2009 Survey that showed strongly expanded of usage of informal financial groups. Groups were found to have multiple functions and a variety of products including savings, loans, investment, and some form of insurance. They also provide the discipline for members to save, which is highly valued by users, as well as other social and financial benefits, including flexibility which could partly account for their continued popularity.

5.2.2 Family and friends finance source

The second objective of the study was to establish the effect of family and friends finance source on performance of SMEs. Results reveal that family and friends finance source on performance of SMEs. This is also supported by majority of the respondents who agreed with most of the statements in the questionnaire.

The findings are consistent with that of study by Kihimbo (2012) on financing of SMEs in Kakamega municipality where it was found that 83.3 percent of the SMEs relied on private sources to keep their businesses operational, 31.7 percent relied on loan from commercial banks and 21.6 percent relied on loan from microfinance institutions. 90 percent of SMEs who sought for formal financing succeeded and majority of these SMEs in Kakamega Municipality got startup capital from family sources.

The findings also align well with study of Cooley (1997) on sources of startup capital. In the survey of SMEs in Kisumu, Eldoret and Meru, it was noted that no firm obtained its startup capital from a formal sector source. More than half of the respondents cited relatives, partners and friends as primary source of capital in all industries studied.

The findings are consistent with those of Atieno (2001) that indicated family sources as the most common source of finance used for both initial and operating capital. For initial capital, this was followed by loans from parents and close relatives and the sale of property. The study showed that for initial and operating capital; own savings at home, friends and relatives provided more than 50% of the loans from the informal market

5.2.3 Trade Credit Finance source

The third objective of the study was to determine the effect of trade credit finance source on performance. The regression model indicated that organization leadership capacity has a positive and significant effect on performance. This is also supported by majority of the respondents who agreed with most of the statements in the questionnaire. Boissay and Gropp (2007), argued that firms that are facing liquidity problems tries to pass on one fourth of the stock to their suppliers through trade credit in order to overcome this distressed situation

5.2.4 Shylock Finance Source

The fourth and last objective was to establish the effect of shylock source of finance on performance of SMEs. The regression results revealed that shylock source of finance has a negative and a significant effect on performance of SMEs. These moneylenders charge high rates and are a risky option for the entrepreneur.

This finding agrees with that of Arora and Ferrand (2007) who argued that “I would not borrow again from shylocks because their interest rates are very high and one has to pay double when they default. We borrow at 25-30% flat rate. I went to a shylock and borrowed against signed transfer of my car. I was not able to repay and he sold my vehicle. With shylocks, they leave you walking as a shadow and it is the last option one can use. Repayment period is short: "Going to shylocks for a loan will be the last option because interest rate is high and repayment period is short as compared to MFIs like Faulu Kenya.

5.3 Conclusions

The study revealed that informal financial sources have a significant effect in performance SMES. Self help group finance, family and friends finance; trade credit finance has a positive influence on the performance of SMEs while shylock finance sources have a negative influence on the performance of SMEs. This implies that informal finance is a vehicle for economic development and its role should be enhanced to reduce the financial exclusion was by encouraging development of informal financial sector. The reduced costs and flexibility was found to enhance the access which in turn led to increased business performance.

5.4 Recommendations

Based on the research findings, the study recommended that SMEs need to put more emphasis on informal form of finance (self help group finance, family and friends finance and trade credit finance)since the informal finance relies on relationships and reputation implying that information asymmetries between informal lenders and their borrowers are less acute, the loan application procedure lighter, and the collateral requirement easier to fulfill. Furthermore, informal financiers are often better positioned to efficiently monitor and enforce repayment when legal enforcement is difficult and time-consuming.

The study also recommended the government should consider coming up with Usury laws that set interest rate ceilings to protect the borrower from exploitation by shylocks. Shylock finance sources need to be avoided by SMEs if possible since they charge unscrupulous interest rates. Credit from moneylenders is often the most expensive credit available; hence the demand for it usually comes from persons without any other options.

5.5 Areas for Further Studies

The study sought to assess the effects of self help group finance, family and friends finance, trade credit finance and shylock finance sources on SMEs. Other studies can also be conducted on the formal and informal institution's lending policies and access to credit by small scale enterprises. There is need to understand much more about why informal finance is still preferred and expanding alongside a rapidly expanding formal sector, and this merits further research. In particular, it would be imperative to find out what are the linkages between informal and formal finance.

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APPENDICES

Appendix I: Letter of introduction

Dear Sir/Madam,
I am a student at the JKUAT undertaking a degree in Masters of Business Administration. I am conducting a research on the effects of informal source of finance on performance of SMEs in Kiambu County.
You have been selected to participate in this study to obtain your perceptions and views regarding various aspects of financing of SMES.
Kindly fill up this information and return. Any information obtained for this purpose will be kept strictly confidential and will only be used for academic purpose.
Your cooperation will be highly appreciated in this regard.
Thank you in advance for your cooperation.

ISSN 2250-3153
Yours truly

Joseph Mungiru

Appendix II: Questionnaire

Section A.SOCIAL DEMOGRAPHIC INFORMATION

1. What is your gender?

Male

Female

2. How old are you? (Years)

Less than 30:

31-40:

41-50:

Above 50:

3. What is your level of education?

Primary

Secondary

College

University

4. How long has the business been in operation?

less than 1 year

2 to 5 years

6 to 10 years

more than 10 years

Please indicate the number of employees

1-5:

6-10:

11-50

Over 50:

Section B: SELF-HELP GROUPS FINANCE

Have you borrowed money from a rotating saving and credit association/Chama in the last three years?

Yes

No

If yes, to the above questions, how much in total have you borrowed from the association in the last three years. Tick appropriately

Year	Less than 20,000	20,000-50,000	Above 50,000
2014			
2013			
2012			
Total			

Section C: FAMILY AND FRIENDS

Have you borrowed money from family and friends in the last three years?

Yes

No

If yes, to the above question, how much in range have you borrowed from family and friends in the last three years?. Tick appropriately

Year	Less than 20,000	20,000-50,000	Above 50,000
2014			
2013			
2012			
Total			

Section D: TRADE CREDIT FINANCE

Have you accessed trade credit in the last three years?

Yes

No

If yes, to the above question, how much trade credit in range did you access in the last three years? Tick appropriately

Year	Less than 20,000	20,000-50,000	Above 50,000
2014			
2013			
2012			
Total			

Section E: SYLOCK FINANCE SOURCES

Have you borrowed money from shylocks in the last three years?

Yes

No

If yes, to the above question, how much in range have you borrowed from shylocks in the last three years? Tick appropriately

Year	Less than 20,000	20,000-50,000	Above 50,000
2014			
2013			
2012			
Total			

Section F: Financial & Non financial Performance

Has the profitability of your business improved in the last three years?

Yes

No

If yes to the above question, by what percentage range did the profitability of your business improve? Tick appropriately

Year	Less than 1%	2-5%	Above 5%
2014			
2013			
2012			
Total			

Has the customer satisfaction improved in the last three years?

Yes

No

If yes to the above question, by what percentage range did the customer satisfaction of your business improve? Tick appropriately.

Year	Less than 1%	2-5%	Above 5%
2014			
2013			
2012			
Total			