FORMAL CREDIT FINANCING AND FINANCIAL PERFORMANCE OF SMALL AND MEDIUM ENTERPRISES IN NANYUKI TOWN, KENYA

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ABSTRACT

The current study sought to investigate the effects of formal financing on financial performance of small and medium enterprises in Nanyuki Town, Kenya. The study was conducted in Nanyuki Town which has a fine mix of thriving SMEs that are the drivers of economic life in the town. The target population was made up of the SMEs and their owners in the town. The study targeted 765 SMEs in Nanyuki town. The sample was selected using stratified and simple random sampling technique. A sample of eighty-eight respondents was selected. Information was collected using questionnaires deployed utilizing drop-and-pick-later technique. Data was analyzed utilizing both inferential and descriptive statistics aided by SPSS software version 21. Correlation analysis as well as multiple linear regression were employed to determine effectively the effect and nature of associations between the variables. The study established poor liquidity condition for the SMEs with both the current ratio and quick ratios standing 1.47:1 and 0.55: 1 respectively which are below the globally accepted standards of 2:1 for current ratio and 1:1 for quick ratio. The profitability of the SMEs was also relatively low with the return on assets standing at an average of 6.67%. The Pearson correlation analysis results indicated a positive association between formal financing option and financial profitability of SMEs. The study recommended that stakeholders and especially the government devise measures to assist SMEs boost their ability to access alternative funds from formal institutions and other alternatives such as government affirmative funds. The government should consider incentives to formal financial players who establish special facilities targeting SMEs and enhance efficiency of affirmative funds targeting SMEs.

Key Words: *financial performance, formal financing, small and medium enterprises*

INTRODUCTION

The importance of small and medium enterprises (SMEs) in the global economy has increased. SMEs are actually starting to be more and more important in terms of innovation development, employment and wealth creation (Nieman, & Nieuwenhuizen, Hough, 2003). Therefore, many governments, multilateral and bilateral agencies and nongovernmental organizations worldwide have policies set up to help the growth of entrepreneurship (Robertson, Slater, Medeira, & Collins, 2003). They are not just deemed to be the principal driving force of economic growth, though they are additionally viewed as essential for sustained development in nearly all economies (Garikai, 2011). Additionally, SMEs are actually a significant source of employment, produce considerable domestic and export earnings, add to the common wellness as well as welfare of economies, and therefore are a vital instrument of poverty reduction (Mephokee, 2004). This amazing contribution of SMEs to the economy of nations is actually a worldwide phenomenon with substantial contribution in all indicators of economic development.

For example, SMEs comprise 99 percent and 99.7 percent of all employers in the European Union (EU) and United States (US) respectively. In Kenya, the SMEs industry engages 74 percent of the labour force and also contributes more than 18 percent of the country's gross domestic product (GDP) (Motilewa, Aka & Ogbari, 2015). In general, SMEs are actually identified by way of sales turnover, value of assets as well as turnover the number of workers employed (Garikai, 2011). The benefits of SME have been captured by statistics that actually call for enhanced funding to the sector. Statistics indicate that there is no far better way to offer an extensive foundation for rapid economic development than to significantly increase the number of active entrepreneurs in a society (Pretorius, Nieman & Van Vuuren, 2005).

The financing of SME has been proportionately addressed and resolved in the developed world but still pose a considerable threat to the existence of SMEs in Africa and the developing world. The following are the options of financing SMEs in the developing world according to Fatoki (2014) who suggested that SMEs must begin businesses with inside equity before shifting to various other sources of finance. Equity could be broadly divided into external equity and internal equity. Ou and Haynes (2006) note that inside equity which may be discussed mainly as retained earnings, contributions from friends and family and owners' contributions is employed a lot more extensively by SMEs.

There has been some significant literature on the use of personal resources to fund SMEs. The proprietors of a new SME contribute what is known as 'sweat equity’ to the firm. (Kendall, Mylenko, & Ponce, 2010). Some scholars who are diabolical opposed to use of credit or borrowing for SMEs aver that SMEs should be funded internally. For instance, Ebiringa (2011) contend that the usage of inside equity by SMEs has particular benefits. Inside equity provides flexibility to management. Conversely, there has been advocacy for the use of debts to finance SMEs by scholars and practitioners. For instance, Wu, Hedges, and Zhang (2007) describe debt as any financing mechanism which is actually a contractual claim on the firm, causes a tax deductible interest payment, has a fixed life and has priority claims on money flows in both the operating and bankruptcy periods.

Commercial banks provide new SMEs a broad range of services in their own right or through partially or wholly owned subsidiaries. These services cover every element of the economic sector like, term loans, trade bill financing, government loan guarantee schemes, factoring, leasing, import and export finance, as well as overdraft facilities (Cosh, Cumming, & Hughes, 2009). This study sought to assess the role of the above-mentioned financing options on the financial performance of SMEs in Nanyuki town.

Financial performance is actually a subjective measure of exactly how effectively a firm is able to utilize its assets in its main economic operations to produce revenues. Rahim, Taufiq, Annuar, and Zariyawati (2009) argue that if firms do not care about earnings, they cannot endure for an extended period. In addition, in case firms do not care about liquidity, they might experience the issue of bankruptcy or insolvency (Eljelly, 2004). Generically, the determinants as well as signals of SMEs fiscal performance or maybe the firm's economic performance on the whole may be grouped into 5 large categories: liquidity, solvency, profitability, financial efficiency and repayment capacity (Crane, 2010). Three widely used monetary ratios to evaluate solvency are actually the debt-to-equity ratio (sometimes referred to as the leverage ratio), the equity-to-asset ratio (sometimes referred to as % ownership) as well as the debt-to-asset ratio. These three solvency ratios offer equivalent information; therefore, the right ration to apply is absolutely a matter of individual choice (Cornett and Saunders, 2014).

In the Kenyan context, SMEs are categorised under the popular Jua Kali informal sector. The SME sector provides direct or indirect employment to over 80% of the population (Ayyagari, Beck, & Demirguc-Kunt, 2007). The government pays close attention to the vibrant sector as it is perceived as the answer to the staggering levels of unemployment particularly among the youthful citizens. It is important to note that over 65% of the population in Kenya is young and jobless. Among the strategies that the Government has implemented to address the need to develop the SME sector are affirmative funds such as the County Enterprise Schemes by County Governments, Women Enterprise Fund, Youth Enterprise Development Fund, Micro and Small Enterprise Authority and Uwezo Fund (Sharu & Guyo, 2015).

As observed by Calice, Chando, & Sekioua (2012), as a matter of fact, both private and public institutions pay close reference to the importance of the Kenya SME sector to economic growth. The banking sector for instance has significantly increased the financing levels to SMEs over the past few years. According to statistics from the Kenya Bankers Association (2014), banks' SME lending portfolio as at December 2013 was estimated to be KSh 332 billion, accounting to 23.4 per cent of the banks' total loan portfolio. This is in contrast to 2009 and 2011, when the total SME portfolio was projected to be KSh 133 and KSh 225 billion, accounting for, 19.5 and 20.9 per cent of total lending. These trends indicate a general growth in SME financing by the financial institutions.

According to Ayyagari et al. (2007), Kenya's SMEs sector comprises 98 percent of all enterprises in the country and engages up to 50 per cent of new employment seekers annually. The SME sector contributes on average 45 percent to the Gross Domestic Product (GDP). The sector thus plays an influential role towards the realization of Kenya's Vision 2030. Kenya has in its official development policies recognized the SMEs segment like a vital player to national growth and has put forth a framework to foster the growth of the sector (Ronge, Ndirangu, & Nyangito, 2002). Stakeholders, championed by the national government recognize the importance of having a conducive environment for SMEs by making access to managerial and technical education, job websites, involvement of Jua Kalis in technological innovation as well as construction of an optimistic enabling environment.

Nanyuki is situated in Laikipia County of Kenya. It is the capital of Laikipia County and it is among the fastest growing towns in Kenya. The city connects the surrounding region with Mount Kenya in the South East and the Great Rift Valley in Western side, known as' Kenya's high country'. Nanyuki lies on the Equator, in the centre of the nation. The city is elevated at 1,947 m above sea level placing it as the 14th highest town in Africa. Nanyuki has a blossoming and industrious economy and it is inhabited by seven hundred and sixty-five (765) SMEs according to the information collected from Kenya National Chamber of Industry and Commerce, Laikipia County (2016).

STATEMENT OF THE PROBLEM

The financial performance of SMEs in Nanyuki town is a tale of mixed fortunes with a few thriving and sustainable business in the midst of many with high failure rate and stagnation. The SMEs in Nanyuki face the tasks of failure to break even before facing a premature closure (Wangari, 2014). This failure to operate for more than one year has been attributed to quick decimation of capital (Garikai, 2011). Another study on SME blamed the oft lack of success of SMEs to constraints in boosting capital away from the owners resources (Aruwa & Suleiman, 2004). This fluid state was well captured and synonymous with the case in European Union in the last decade where the SMEs operating environment was described as disreputably unstable and experiencing a high level of business decline and closure (Eriksson & Kuhn, 2006). Just like it is the case in Nanyuki town and elsewhere in the world, most of the SMEs flop to survive beyond start and youth, failing to become key achievement stories, neither generating wealth for their initiators and employment opportunities for the communities they operate in to severe limitation in financing of their businesses (Thornhill, Amit, & others, 2003). This grim situation of the financial situation of SMEs has necessitated a scientific enquiry into the role of financing. Existing empirical literature has no shortage of causes of business failure and prescriptions. While the factors determining growth and success in large businesses is adequately researched, similar studies regarding SMEs are limited and mostly conducted in the developed nations and hardly in the developing nations (Van Praag, Versloot, et al, 2007; Perks & Struwig, 2005). This condition presents a contextual gap that needs to be addressed. Survival, success and growth of small business has been researched from different perspectives including owner’s skills. Other have cited a plethora and all-inclusive list of the aspects that play a part in the success (or failure) of new enterprises including crowding out in a single market and lack of diversification in the value proposition offered (Baron, 2004). The predominant theme being that the changing aspects of business development remains poorly understood (Dockel & Ligthelm, 2005). Some scholars contend that success of a business is influenced by a mixture of both internal and external factors. There is a dearth of studies assessing the effect of capitalization and individual SME firm level both in Kenya and in Nanyuki which presents a contextual gap on the need for empirical investigation on the subjects in order to inform policy legislation towards boosting growth in the sector. Empirical gaps are also exposed in that most past studies dealt with sources of financing and never attempted to establish the link with financial performance. Other empirical gaps emerge as most very limited studies have endeavored to address a variety of financing options and have therefore been limited to either informal or formal sources. As observed in the ongoing discussion, rarely also have past studies focused on different objective dimensions of financial performance of SMEs which represents a critical methodological gap which was filled by assessing both the profitability and liquidity statuses of SMEs. Thus, the purpose of the current study was to fill the contextual, methodological and empirical gaps that existed in understanding the effect of formal financing on financial performance of SMEs in Nanyuki Town, Kenya.

GENERAL OBJECTIVE

The main objective of the study was to examine the influence of formal credit financing on the performance of SMEs in Nanyuki Town, Kenya.

RESEARCH HYPOTHESIS

The study tested the following research hypothesis;

H_0: Formal financing has no significant effect on the financial performance of SMEs in Nanyuki Town, Kenya.

THEORETICAL REVIEW

The research was based and was directed by financial intermediation theory, pecking order theory, credit rationing theory and information asymmetry theory.

Financial Intermediation Theory

Based on Scholtens and Van Wensveen (2003), the job of the fiscal intermediary is basically seen as that of producing special monetary commodities. These are produced anytime an intermediary discovers that it is able to promote them for rates that are anticipated to go over all costs of their creation, both immediate costs as well as opportunity costs. Monetary intermediaries can be found because of industry flaws.

As a result, in an ideal market situation, without transaction or perhaps information expenses, financial intermediaries would not exist. Many marketplaces are recognized by informational differences among sellers and customers. In financial markets, information asymmetries are especially pronounced. Borrowers generally understand their collateral, industriousness, and moral integrity much better than do lenders. On the flip side, entrepreneurs possess inside information about their own tasks for which they need financing (Winton and Gorton, 2003). Moral hazard hampers the transfer of information among market participants, that is a crucial element for good quality projects to be financed.

In the current study, the objective was to evaluate the influence of the formal financing on the financial performance of SMEs. This theory was useful particularly in the evaluation of the barriers and constraints the SMEs face in getting credit from diverse source surplus funds like SACCOs and commercial banks. The theory guided the establishment of how asymmetry, bargaining power and transactional costs and other market imperfections affect the ability SMEs to source for funds and how that influences their performance.

Pecking Order Theory

The Pecking Order Model was created by Myers (1984) and later enhanced by Myers (2001). Based on this theory, firms favor internal funding more than outside funding. Just in case companies call for outside funding they would choose debt over equity as equity is utilized as a last measure. Firms do not have optimum or predetermined debt to equity ratio because of information asymmetry. The firms adopt careful strategies with regards to dividends and make use of debt financing to optimize the value of the firm. The concepts of the pecking order theory have been supported by a number of academics like (Frank & Goyal, 2007; Yan and Bulan, 2009) that presented proof of negative selection associated with equity problems. While investigation by Maksimovic and Frank (2005) provided related proof on experimental bases about firm's financing demands.

Among the elements of pecking order principle is that with regards to profitable firms, they would regularly choose inside financing instead of driving up completely new debts or perhaps equity. Although, debt is regarded cheaper compared to equity within particular proportions. Myers (2001) implies that is due to the fact that the wealth of the firm as well as shareholders connected with the firm is disrupted by asymmetry of information. This particular argument is actually supported by Fama and French (2000) who discovered that highly profitable companies had been less levered when compared with non-profitable firms. Frank and Goyal (2007) held that big companies have a tendency to accumulate debts to be able to help as well as continue with the payments of dividends while smaller companies have a tendency to behave in reverse conduct principle. Bessler, Drobetz, and Pensa (2008) concluded that non-US firms support pecking order principle.

Although the theory was conceptualized for corporate bodies with choices of debt equity ratios, the theory was useful in guiding the establishment of the preferred financing option for SMEs in Nanyuki and informing reasons for the choices of financing. The theory was used to establish if the SMEs preferred the conservative sources mostly from personal sources or have ventured into liberal financing schemes and loans for SMEs. The effects of formal financing option on the ultimate financial performance of SMEs was also established.

Credit Rationing Theory

Based on Keiding (2015), the financial institutions are mainly private entities that are guided by the goal of earnings maximization. In contrast to this objective, not all people who apply for financing are given access. Hence the industry for credit is not healthy throughout the cost mechanism. Based on Robson, Akuetteh, Stone, Westhead, and Wright (2013), borrowers might be denied credit even in cases they are prepared to spend arbitrarily high interest rates. Credit marketplace is not like the standard market where need is actually equivalent to supply as the borrowers who are prepared to pay higher interest rates might find it hard with regards to repayments. The scenario arises because of the fact that the borrower will not be able to repay the loan because of the increased interest rates (Tirole, 2010). That is the price of borrowing which would prove to be higher compared to the return on investment. Because of the price of the loan, the lender may desist from lending to a borrower that demands for recognition whenever the interest rates are actually higher. With time, this perspective was abandoned when Stiglitz and Hellmann (2000) developed a much better reasoning, where they related credit rationing to information asymmetry which is present among the actors in the financial markets.

Credit rationing arises once the financial institutions recognize their expected returns are beneath their expectations (Ghosh, & Ray, Mookherjee, 2000). The non-monotonic connection between the anticipated returns as well as interest rates arises because of the following elements or reasons: The negative choice effect; happens once the interest rates are unable to filter the able borrowers from the others. That is the borrowers that are in a position to assess their projects effectively and operate within more secure project parameters (Voordeckers and Steijvers, 2009). The borrowers with more secure projects are actually claimed to drop out of the industry whenever the interest rates increase past the expected returns. The financial institution considers the applicants going for increased interest rates much more unsafe. The negative motivator (moral hazard) impact as provided by Stiglitz and Hellman (2000) posits that a growth in interest rate, shifts the option of the borrowers towards riskier projects which once again places the financial institutions expected returns at risk or maybe greater likelihood of poor debts portfolio.

Financing for SMEs is ideally a difficult proposition in the Kenyan markets. The theory was useful in establishing the requirements by funding institutions to the SMEs and how they affect the financial performance of the SMEs. Additionally, the theory was useful in assessing the state of credit advancement to SMEs and how that influenced their survival and financial performance.

Information Asymmetry Theory

This theory was initially conceptualized by Akerlof (1970). The argument was that in most markets, the seller uses several sector statistics to determine the valuation of the items they are promoting. In this particular situation of the credit industry, the customer sees the typical rates of the loans (credit) in the marketplace he is intending to purchase, as the seller has much more personal information of each particular loan product. This places the seller at an advantageous position thus capable to offer items of lower typical market quality at higher prices. In these kinds of conditions, the limitation of the information available to the customer might result in the seller offering less than typical quality of items of the markets which ultimately leads to decrease in size of the marketplace. Information asymmetry theory assumes that a minimum of one party to a transaction has information that is related whereas the other(s) do not.

Information asymmetry influences various other elements of firm efficiency from the determination of the cause of financing. Firm development is actually determined not just by the standard attributes of age and size but, additionally by some other aspects specific to the firm like indebtedness, inside financing, upcoming development opportunities, process and product development as well as business improvements. It is thus crucial that governments have to pay increased attention to MSEs and attempt to produce a business environment which will be advantageous to MSE growth (Anastasov and Mateev, 2010). In response, governments have introduced an assortment of policies like the provision of guidance, in order to facilitate development of new firms as well as to provide help to MSEs to help their survival and foster enhanced rates of growth (Bennett, & Bratton, Robson, 2001). Based on Grimes and Claus (2003), the presence of imperfect, asymmetrically held information causes frictions of the credit industry. SMEs are especially constrained by gaps of the economic system like higher administrative costs, substantial collateral needs as well as lack of expertise within fiscal intermediaries. This theory was useful in determining the effect of information availability or lack of it amongst the SMEs and how that affected the financing options and decisions made by SMEs in the Nanyuki market.

EMPIRICAL LITERATURE REVIEW

The structured capital resources of business financing comprise savings banks, development banks, development banks, merchant banks, and commercial banks. The study by Beck, Demirgüc-Kunt, and Martinez Peria (2008) indicated that formal sources refers to those financial institutions that are established by law to carry out financial business activities and at the same time are saddled with the responsibilities of assisting in growth, development and survival of SMEs by providing facilities after fulfilling a certain criterion like collateral security which is commonly used. In spite of this, Financial Inclusion Experts Group and SME Finance Sub Group 2010 and SAEEED (2009) discovered that ideal instrument of finance stays dependable sources of energy of SMEs development and also growth and they have contributed significantly to the practical use of SMEs in different countries, Kenya inclusive. A report finished by Otuya, Omoka, Ayako, and Kihimbo (2012) affirmed the significance of having successful funding assets to the small business pursuits. These experiments focused on hindrances to credit access by SMEs and did not associate access to finance to the economic performance of the SMEs.

The establishment of network of appropriate recognition institutions helps in enhancing lending problems in addition to phrases in favor of tiny scale enterprises will provide an important avenue for facilitating the access of theirs to credit. Empirical evidence by Atieno (2001) on commercial banks together with other formalized institutions suggested they fall quite short of catering for the credit needs of smallholders, nevertheless, mainly due to the lending terms of theirs & conditions. It's often the rules as well as laws of the traditional financial institutions which have created the myth that the really poor aren't bankable, as well as since they can't pay for the required collateral, they're believed not advantageous of credit. Kimuyu (2002) took up the question on exactly how finance is actually related to various other areas of small business operations. Specifically, the study concentrated on the determinants of the most crucial economic choice of SMEs, which include how you can raise capital for the company, distinguishing between the original capital and any follow up capital acquired for restructuring or expansion. The study hence did not assess the funding challenges from the various financing sources but focused on establishing the most suitable financing source for SMEs.

Based on empirical exploration offered by Wagema (2006) as quoted in Jagongo and Kimutai (2013) which sought to figure out crucial factors which affect access to bank credit by SMEs. The study identified entrepreneurial orientation which includes a fast determinant of entry to credit by SMEs. Further, awareness-based methods acquired from maturation (age), finalized start up expertise, knowledge and vicariously through entrepreneurial parents had been discovered to be connected with higher levels of entrepreneurial orientation. Generally, these findings help support the literature which underscores the primacy of entrepreneurial elements, over operating components in facilitating small enterprises' access to bank credit. Based on the study conducted by Montoriol Garriga and Garcia Appendini (2013) on firms as liquidity providers, they found out that in US, stronger and bigger firms extended more trade funding with the monetary issue while weaker larger received more trade credit. These tests focused on the components which hinder SMES from accessing credit out of correct financial institutions but did not focus on some other financing strategies.

Ntakobajira (2013) interrogated the factors impacting the overall performance of SME traders at City Park hawkers market in Nairobi. The study revealed that that the sources of capital for SMEs differed ranging from bank loans, donations, own savings and advances from friends and family along with various other sources. On access to finance, the study suggests that the Government of Kenya works out modalities regarding how to finance SMEs. However, this research dealt only with sources of capital for SMEs. The current study went further and sought the effect of financing options on financial performance of SMEs.

Kibet, Achesa, and Omwono (2015) investigated the effects of Microfinance on the overall performance of SMEs in Uasin Gichu County. The study discovered that most SMEs borrow investment capital and they apply it for the goal in which they borrowed for, nearly all of them do not have different sources of financing apart from micro finance institutions and they did not have different types of financing before they began getting financing from microfinance institutions. The study suggests that MFIs should partner with the county governments along with other stakeholders to generate understanding of the procedure as well as the accessibility of accessing micro finance loans. Since MFIs have poverty alleviation as their key focus, they need to think about lending startup capital so that the welfare of the borrower as well as the company could be monitored. This study only assessed the influence of microfinance from banks and SACCOs on SMEs while the current study dealt with all financing sources and its effect on financial performance.

Muguchu (2013) interrogated the association between access to investment finance and economic performance of SMEs in Nairobi. The study established that funding constraints impact the smallest firms most adversely and incremental enhancement of the financial methods that can help relax these restrictions will be very good for SMEs. The study recommended that the national government must come to the aid of SMEs by regulating how economic institutions charge interests to these firms. This study was only concerned with investment financial constraints in SMEs and only focused on formal sources of investment finance but overlooked government, personal and informal sources of finance.

RESEARCH METHODOLOGY

Research Design

The researcher used a descriptive survey design technique to establish the association between financing options and financial performance of the small and medium enterprises. According to Saunders, Lewis, Thornhill, and Wilson (2009), a descriptive survey research design is actually affordable and also enables one to obtain great amount of information, allow for standardized details, for ease of comparison and analysis.

Target Population

The targeted population was made up of seven hundred and sixty-five SMEs operating within Nanyuki town. According to the licensing department of the county there were seven hundred and sixty-five (765) registered SMEs within Nanyuki town (County government of Lakipia licensing department, 2015). The target respondents were the proprietors of the SMEs in Nanyuki Town.

Sampling Strategy and Sample size

The study used stratified sampling to select the SMEs for the study whereby the different classification of business were the strata as shown in table 3.1. Simple random sampling technique was grounded on accessibility and preparedness to contribute to the study. The two sampling techniques ensured comprehensiveness and control of bias in sample selection. A stratified random sampling procedure is a population sampling procedure that requires the population to be divided into smaller groups, called strata (Mugenda & Mugenda, 2003). Stratified sampling certifies that the different clusters are represented, even proportionately, in the sample(s) by picking individuals from each of the strata list. The use of simple random sampling strengthened the sample and enable collection of comprehensive data on all the study variables. The study purposively selected the proprietors of the enterprise as the choice respondents as they were the ones ideally equipped with information sought. The sample size of SMEs to be studied was determined using a formula developed by Trek (2015) to determine a statistically representative sample from a known population. Level of precision was set at 90 percent confidence level. this led to selection of a sample of 88 potential participants selected from the target population of 765.

Data Collection Instrument

Questionnaires and secondary information compilation sheets were used as the key resources for information collection. A questionnaire is a device for information collection in which each individual is required to provide answers to the same set of items in a predetermined manner and order (Sekaran, 2006). The researcher, to a significant degree, utilized structured questionnaires as the main instrument for information collection. Kothari (2004) opines that use of a questionnaire as the instrument for data collection allows a researcher to obtain huge quantity of information in a moderately short span of time and assures confidentiality as they can ensure anonymity while certifying standardization.

Data Collection Procedure

The questionnaire was the appropriate instrument for data collection as suggested by Orodho (2009) who posited that a questionnaire is an instrument used to collect information, allowing a measurement in support of or contradicting a specific viewpoint. Questionnaires are actually not hard to administer, provides the respondent enough time to provide a nicely thought-out response and therefore are totally free from the researcher's bias. The drop-and-pick-later technique was used to administer the questionnaire to the respondents. The study also employed secondary data collection checklist to obtain information about the profitability and liquidity of the SMEs. The questionnaires were administered to the target respondents and collected after five working days to provide respondents enough time to respond to all of the questions therein. In order to guarantee validity of the data collection instruments, content validity and face validity of the research instruments was conducted by validation by the supervisor and an examination of the research instruments by a specialist. Research instrument pre-testing utilizing a selected group of employees in the SMEs further ensured that the data collection instruments would gather what the researcher intended them to gather. A total of ten questionnaires had been distributed to ten randomly selected SMEs for pre-testing purposes. In order to ensure reliability of the data gathering instrument, the study utilized the Cronbach Alpha reliability coefficient created using SPSS application for analysis. A score of above 0.7 indicated that the questionnaire was reliable and adequate for the study.

Data Analysis and Presentation

Quantitative strategy to information analysis will be used in data analysis. Main details from the questionnaire were coded and then entered into the computer system for computation of inferential and descriptive statistics that had been examined with the assistance of Statistical Package for Social Sciences (SPSS) edition twenty. Data was examined utilizing both descriptive analysis (means, standard deviation and percentages) and inferential statistics (Pearson Correlation analysis). The correlation model that was applied was of the form;

$$Y = f(X)$$

Where: X = Formal financing; Y = Financial Performance of SMEs

RESEARCH FINDINGS AND DISCUSSIONS

Response Rate and Characteristics of SMEs

A total of 88 questionnaires were administered to the respondents. Out of these, 65 questionnaires were successfully submitted back. This represented a response rate of 73.86%. Results demonstrate that more than two thirds (69.23%) of the respondents were male. The rest, representing close to a third of total respondents (30.77%) were female. Further, most small business in Nanyuki town (36.90%) had existed for 2 years or less. A further (38.50%) had existed for 3 to 4 years. Only (24.60%) of the business had been in operations for more than 5 years.

Financial Performance

The dimensions of financial performance captured include liquidity and profitability performance. The findings from the analysis indicated that average liquidity position of the SMEs in Nanyuki Town, Kenya stood at 1.47: 1 (Current Ratio) and 0.55: 1 (Quick Ratio). This indicates poor state of liquidity for SMEs since both ratios are below the universally accepted and recommended threshold of 2:1 and 1:1 for current ratio and quick ratio respectively. The results are in agreement with past findings by Nyabwanga, Ojera, Simeyo, and Nyanyuki (2013) who also reported the liquidity of SMEs to be below the globally accepted norms.

The study also assessed the profitability of SMEs in regard to return on assets. The findings indicated that the profitability of the SMEs in Nanyuki town, Kenya as indicated by return on assets stood at an average of 6.67% which is relatively low. There is however wide variation in profitability of SMEs with the highest performer reporting a profit of 23.76% with the lowest indicating a mere 1.03% profit. The profitability of SMEs therefore stood low which supports earlier indications by Orinda and Otieno (2014) in an analysis on financial challenges facing SMEs.

Formal Financing

Study findings regarding the extent to which the SME consumes formal sources of credit financing to meet day to day demands showed that the mean was 2.76. This indicates that the respondents showed that consumption of formal finance sources by SMEs to meet day to day demands was only to a moderate extent. The low standard deviation of (1.17) further affirms the validity of this condition indicating that the responses were closely distributed around the mean. The study findings agree with past indications by Kauffmann (2005) and Kimaiyo (2016) who observed that SMEs were rarely able to meet formal finance conditions. Statistics on the most commonly utilised formal sources of finance by small scale business enterprises indicated that majority, representing close to half of all SMEs got formal finance from Micro Finance Institutions. This was followed by SACCOs (38.46%) with the least utilised source being commercial banks (12.31%). The results support earlier results by Chimucheka and Rungani (2013) and Gichuki, Njeru, and Tirimba (2014) who also indicated difficulties in accessing commercial banks finance by SMEs. Statistics on the most common limiting factors for utilisation of formal sources of finance by the SMEs in Nanyuki town, Kenya indicated that majority, representing close to half (46.15%) of respondents listed collateral requirements as the main drawback for access to formal lending by SMEs. This was followed by lending conditions and previous experience at 21.54% and 18.46% respectively. Access to information was listed as the least hindrance to formal funding as it was cited by only 13.85% of respondents. The findings are in agreement with past indications by Babu (2017) and Nikaido, Pais, and Sarma (2015) who also highlighted collateral and lending conditions as among principal hindrances for formal financing.

Effect of Formal Finance on Financial Performance of SMEs

The study utilized the Pearson Correlation Analysis as key tool towards reliably testing the research hypothesis and making justifiable inferences. This is because inferential statistics allow generalizations on the population. For this purpose, the level of significance was set at $\alpha = 0.05$. The hypothesis to be tested was captured as:

H01: Formal financing has significant effect of formal financing on the financial performance of SMEs in Nanyuki Town, Kenya.

Table 1: Pearson Correlation Analysis

		Financial Performance
Formal Financing	Pearson Correlation	.306**
	Sig. (2-tailed)	.021
	N	65
	N	65

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

The results presented on Table 1 show a moderate, positive, and statistically significant relationship between formal financing and financial performance of SMEs. The association is considered moderate as the Pearson Correlation Coefficient of 0.306 is less than 0.5 beyond which the relationship would have been reflected as strong. The relationship is statistically significant as the P-Value or Sig. (2-tailed) value of 0.012 is less than 0.05 level of significance. The results support earlier empirical foundations by Kihimbo, Ayako, Omoka, and Otuya (2012), Atieno (2001), Kimuyu (2002) and Garcia-Appendini and Montoriol-Garriga (2013) who indicated that formal financing would serve to enhance the financial performance of firms.

CONCLUSIONS AND RECOMMENDATIONS

On financial performance, a conclusion was made that the poor state of financial performance indicated by both profitability and liquidity of SMEs could be attributed to financing options among SMEs. On formal financing, the study concluded that formal financing facilities moderately enhance the financial performance of SMEs.

On financial performance, recommendations are made for SMEs to work towards measures to enhance their liquidity and profitability informed by poor performance reported. SMEs are encouraged to revaluate their financing structures to ensure optimal finance mix to boost liquidity and profitability. The stakeholders and especially the government should devise measures to assist SMEs boost their ability to access alternative funds from formal institutions. The formal finance institutions should be encouraged to set SMEs friendly lending conditions to enhance feasibility of the funds. To this regard, the government should consider incentives to formal financial players who establish special facilities targeting SMEs.

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