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A Review of the Effect of Microfinance Services on the Profitability of SMES in Kenya

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Abstract:
Small and medium-scale enterprises (SMEs) are entities of utmost importance in the economic development of a country, as they not only generate job opportunities but also provide goods and services to meet basic human needs. Microfinance institutions (MFIs) are purveyors of financial services such as microcredit, micro savings, and microinsurance, which empower low-income individuals and SMEs to achieve their financial goals. The present study delves into the effects of these microfinance services on the profitability of SMEs in Kenya. The existing empirical literature has shown a significant positive correlation between the utilization of microfinance services and the profitability of SMEs. However, it is imperative to note that gaps exist, including the dearth of localized studies focusing on SMEs in Kenya and the need for more robust methodologies to establish causal relationships. To conclude, SMEs in Kenya can undoubtedly benefit from microfinance services to enhance their profitability. Although existing literature provides valuable insights into this relationship, further research is warranted to address methodological limitations and contextual factors specific to the Kenyan SME landscape.

Keywords: Microfinance, Micro-credit, Micro savings, Micro-insurance, Profitability, SMEs

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1. Background of Study

Small and medium-scale enterprises, abbreviated as SMEs, have attracted global attention as they play a vital role in economic development, which goes a long way in creating job vacancies globally in their process of providing goods and services that satisfy human needs. The significance of small and medium-scale enterprises and the role they play in global economies has attracted significant attention from major financial players such as the World Bank, the United Nations agency, various governments, not to mention both non-governmental organizations, parastatals, and privately established entities (Wanambisi & Bwisa, 2013).

Based on the existing work of the "Consultative Group to Assist the Poor", abbreviated as CGAP, a microfinance institution is generally defined as an

organization that offers financial services to less affluent individuals and organizations in the form of microcredit, micro savings, and microinsurance (Rotich, Lagat, & Kogei, 2015). There exist various definitions of microfinance, and an alternative definition is the provision of micro finance services to individuals who earn low incomes. These financial services offered by the MFIs also offer the less affluent an opportunity to better their livelihoods in a bid to eradicate poverty. People living below the poverty line need a wide range of financial services and help in order to smoothly run and operate sustainable businesses, build both their fixed and current assets, and be able to manage the risks associated with running their businesses (Rotich, Lagat, & Kogei, 2015).

The idea relating to microfinance has attracted global attention, with many small and medium-scale enterprises worldwide utilizing the services offered by these financial institutions as a means to grow their respective businesses in order to alleviate poverty and guarantee their profitability while promoting economic development at the same time. Regarding SMEs in Kenya, they play a significant role in the provision of the different services aimed at satisfying the daily needs of the local population as well as taking advantage of the existing gap in the market (Rotich, Lagat, & Kogei, 2015). Nonetheless, these small and medium-scale enterprises are often victims of the many formalities required for them to be able to access financial services from the existing commercial banks for several reasons ranging from limited collateral to the issue of creditworthiness, among many other limiting factors.

Micro-finance institutions, together with their services, have come a long way in bridging the gap between the SMEs in Kenya and access to financial services by offering alternative sources of financing for these enterprises by offering small credit services, allowing cash deposits in respective savings accounts, among many other financial services customized towards the satisfaction of these organizations financial needs to ensure their profitability, and giving them a competitive edge over other SMEs in other areas in Kenya. Therefore, conceptualizing the effects of microfinance services on the profitability of SMEs in Kenya, is by all means significant in ensuring the economic growth of Tudor and improving the livelihoods and living standards of the local community, which is generally made up of families and students who endeavor to be entrepreneurs.

There exists an important positive relationship between accessing microfinance services and the profitability of these respective SMEs in Kenya. Essentially, SMEs that enjoy the financial services offered by microfinance institutions are expected to show higher profit margins than those that do not utilize microfinance services. Despite the financial services offered by the microfinance institutions being available and accessible, the definitive extent to which they promote or affect the profitability of SMEs in Kenya is unknown (Wanambisi & Bwisa, 2013). While anecdotal evidence suggests that access to the various services offered by microfinance institutions in an actual sense does positively influence the financial performance of businesses, empirical research by various organizations and individuals specific to the local context is deficient, if not non-existent.

2. Micro-finance Services

This section aims to provide a comprehensive understanding of the effects of microfinance services on the profitability of SMEs in Kenya. This section introduces the importance of microfinance as a tool for economic development and poverty alleviation. It emphasizes the significance of studying the specific impacts of microfinance services on SMEs, considering their role in the local economy and their potential for growth and sustainability.

2.1 Micro-credit

Microcredit, as a service offered by MFIs, plays a vital role as a tool that aims to improve the socio-economic status of the poor, including women. We offer a range of benefits to help beneficiaries, such as small and medium-sized business (SME) owners, expand their businesses. Microcredit facilities serve a significant purpose in ensuring the socio-economic empowerment of entrepreneurs by promoting their creditworthiness and enabling them to gain a competitive edge at all levels within the business life cycle. It was found that microcredit, as a service offered by MFIs, is one of the most significant factors that influences the general growth as well as the expansion of small and medium-scale enterprises, especially those with medium to relatively low net worth (Alhassan, Hoedoafia, & Braimah,

2016). Access and utilization of microcredit services helps to improve individual and business income levels, gives businesses a favorable chance to expand, gives them a competitive edge, and enables firms to increase their sales volume, which in turn leads to an increase in the net profit margin. It is also thought that exclusive access to microcredit services enables various SMEs to overcome their cash liquidity constraints, thereby offering a chance for them to take part in huge investment opportunities.

In the Republic of Ghana, a study by Alhassan et al., (2016) revealed that microcredit has been recognized as an essential driver that stimulates the overall growth of SMEs. Regardless of the significant role microcredit services play in the growth of SMEs as well as the general expansion of SMEs, it was also noted that a large number of formal commercial banks perceive it as an undesirable venture to enter into contracts with these SMEs because commercial banks tend to have a blanket opinion that they are high-risk clients. Small-scale entrepreneurs in particular are victims of such circumstances mainly because most of their businesses are based locally at home, most of which are unregistered by the relevant authorities. This fact locks them out of accessing financial services such as credits from various institutions. WOEs are mainly based in their homesteads and are not incorporated following the statutory regulations provided for in the company act. Thus, microcredit services allow the less affluent enterprises whose access to financial services is severely limited due to various forces acting within their environment to increase both their fixed and current business and individual assets and improve their living standards. It has also been noted that the provision of exclusive financial services to less privileged individuals and enterprises should be made possible and practical since MFIs can cover their entire costs via the provision of microcredits to those who need them. The concept of digital credit pertains to the provision of financial advances that are readily accessible through a digital platform that is available online or can be accessed by means of mobile devices. In the past, it has been observed that numerous households have encountered difficulties in obtaining credit, particularly in developing nations (Kamau, 2022). However, the rise of digital credit has significantly improved the accessibility of microcredit services.

Regardless of microcredit being a service that can positively stimulate growth, it does not necessarily guarantee a permanent solution that will eradicate poverty and lead to profitability. Just as credit cards and mortgages have been introduced, they have made lives better and made people poorer in already developed countries. In a similar manner, microcredit has also made its recipients poorer and left them in worse condition than they initially were. In as much as microcredit offers some degree of non-economic benefits, it also does not significantly eradicate poverty. By supporting small businesses, microfinance can help improve household well-being and act as a vehicle for self-determination. Microcredit recipients performed better than non-recipients because these credits improved their livelihoods and helped ensure the viability of their businesses. The availability of microcredit has had a positive impact on the growth of many SMEs, giving them a competitive advantage over large firms and thereby improving their overall socio-economic status.

2.2 Micro-savings

Savings is a means of saving a portion of your current income for later consumption or investment. The money saved can be kept at home, placed in a savings account, or invested in different types of capital. Savings is an essential service for entrepreneurs looking for a safe and convenient deposit service that allows for small transactions and easy access to funds. Customers preferred the credit and savings services of microfinance institutions for reasons such as saving for business growth, children's education, and emergencies. In addition, a higher percentage of customers see compulsory savings as a savings opportunity. The study by Omondi and Jagongo (2018) concludes that savings mobilization is important for improving financial performance and advocacy, especially in rural areas where access to financial services is difficult. However, we believe that leveraging savings is costly and risky compared to other sources of finance and that entrepreneurs would be better served to build wealth through savings rather than borrowing money. You can also claim Identifying the role of savings in small business wealth creation is critical to finding possible solutions to any shortcomings. His MFI savings products for small businesses are facing intense market competition due to the entry of new commercial banks and the shrinking of old banks. Competition may benefit SMEs through higher savings rates, but lower interest rates may affect the income available for MFI loans.

The emergence of microfinance institutions, abbreviated as MFIs, has made little progress, as full-fledged financial intermediaries and MFIs only provide credit, and savings mobilization remains a forgotten part of microfinance.

Microfinance institutions can reach out to SMEs by offering suitable savings products. MFIs should conduct research to ensure that the pricing of savings products is financially sustainable. However, the success of saving in microfinance institutions depends not only on the design of the savings product but also on pricing and marketing. MFIs must also have sound controls and appropriate management information systems to protect their customers' deposits. While this argument may be important for microfinance institutions, SME growth must also be considered to ensure the interests of SME customers. The steady growth of SMEs will increase the availability of microfinance funds and reduce costs. A company's growth opportunities are correlated with its level of liquidity. Companies with more investment opportunities maintain higher levels of liquidity to avoid limiting or canceling profitable investment projects. Some would argue that this type of business needs a reliable savings bank to maximize its growth opportunities. MFI needs to create effective savings programs by shifting its capacity to support small business savings services. However, it should be noted that too much liquidity is harmful to small businesses as they may not be using it wisely, and effective cash flow management training is also important.

2.3 Micro-insurance

Microinsurance is a product offered by microfinance institutions to protect low-income people from certain disasters through periodic premium payments commensurate with the likelihood and cost of associated risks. MFI clients' risks are mitigated by integrating microinsurance into their lending and savings activities. Essentially, microinsurance offers low-income people a way to protect themselves from accidents that can affect their lives and businesses. This product helps entrepreneurs protect themselves from risks and avoid debt by protecting life, property, health, and other valuables. Microinsurance for the financial performance of SMEs is critically important to microinsurance, which protects the activities of microfinance customers (Amoah & Mungai, 2020). Microinsurance is a low-cost product that requires diverse planning and delivery systems, including premiums based on community risk rates. Microfinance institutions include customer savings and loans in insurance policies to ensure credit risk mitigation. Microinsurance covers, among other things, health, life, wellness, property, and produce from entrepreneurs. The poor are the most likely victims of disasters. Low-income people can protect their property and businesses from any tragedy with microinsurance. Similarly, microinsurance helps entrepreneurs reduce their risk levels and avoid debt by protecting their resources.

2.4 Profitability

Profitability, a term that denotes the financial viability of an organization, serves as a snapshot of its economic health and the performance of its management. Investors, on the other hand, can extract valuable insights into the prospective future of an organization by scrutinizing its financial performance. This financial performance analysis, in turn, provides a comprehensive understanding of whether the operations and profits of the organization are on track to increase and offers an optimistic outlook for the organization's stock (Ateino, 2022). The concept of microfinance began with the need to financially serve low-income individuals who were unable to access the services offered by commercial banks and other formal financial sectors. In the recent past, the concept of microfinance and profitability has spread to Latin America, later to Asia, and then all the way to Africa. In Kenya, the microfinance and profitability movement gained popularity in the late 1980s since a large number of people had limited access to commercial banks. Microfinance emerged to fill the gaps in bank lending to individuals and small and medium enterprises, which flourished thereafter. Back then, in the 1990s, at a time when there was economic instability, this led to an increase in the borrowing needs of individuals, SMEs, and microfinance institutions in Kenya. In Kenya, the pioneer MFIs include Equity Building Society, presently called Equity Bank; Family Building Society, which is currently referred to as Family Bank; Faulu Kenya; and K-Rep. Microfinance institutions, mainly abbreviated as MFIs in Kenya, have been incorporated within the framework of non-governmental organizations, also abbreviated as NGOs, or savings and credit cooperatives, abbreviated as SACCOS. MFIs are an important source of credit and have contributed to the

income of many less financially privileged households and SMEs situated in the rural as well as urban parts of Kenya. In Kenya, from independence until the late 2000s, the formal banking sector saw the informal sector as risky and not economically viable, which increased the importance of MFIs. Based on sound operating principles, MFI has developed and delivered new, innovative, and suitable financing formats for low-income households and SMEs. Since its establishment, MFI has made a significant contribution to the socio-economic empowerment of its beneficiaries and their dependents (Kisaka & Mwewa, 2014). The enhancement of the profitability of firms in relation to the return on equity can be achieved through a series of measures. One such measure, as suggested by this study, is for microcredit providers to focus their attention on ensuring that the appropriate balance between equity and debt financing is established. It should be noted that the involvement of current owners in the process of acquiring additional capital financing is of paramount importance. This involvement may facilitate the attainment of the desired ratio of equity and debt financing, thereby contributing to the overall profitability of the firm (Ochoki et al., 2023).

Establishing criteria that would mitigate risks and enhance profitability has proved challenging for many businesses. Due to a lack of data or the expensive expense of consulting with experienced financial experts, some have turned to sensitivity analysis approaches, and small and medium enterprises (SMEs) have, to some extent, resorted to a trial-and-error approach (Chasha et al., 2022). The provision of microfinance services has the potential to augment the level of liquidity within the economic system, thereby leading to a heightened degree of economic stability. Furthermore, this enhanced liquidity can facilitate the financing of long-term profitable endeavors such as research and development initiatives and expansion proposals (Ngari, 2023). Ideally, MFIs should subsidize financial services like microcredit, micro savings, microloans, and microinsurance to help the very poor, especially the poor, expand and start small businesses. As defined by many students, the development of this scheme is mainly used in states where SMEs do not have access to other alternative sources of finance. Microfinance activities that lead to profitability include general short-term loans that can be used to increase working capital, informal approval of borrowers and investments, the substitution of collateral such as group guarantees and mandatory savings, and access to regular and large loans based on repayment performance. Access, optimized loan disbursement, monitoring, and secure savings the services provided to microfinance customers can be classified into four different categories. This is financial intermediation, or the provision of financial products and services such as savings, credit, insurance, credit cards, and payment systems that require ongoing subsidies. MFI has the following features: Loans tend to be relatively short-term (most often less than 12 months), are usually intended to provide working capital, and have immediate, regular weekly or monthly repayments. Also, especially for those who apply for recurring loans, they are paid immediately after approval. The traditional requirement of a lender for physical collateral, such as real estate, is usually replaced by a collective guarantee system in which union members are mutually responsible for making sure the loan is repaid.

3. Microfinance services and Profitability

Drawing upon the rigorous theoretical underpinnings, the conceptual framework which forms the basis of this study comprises an array of constituent elements. The primary variables and their intricate interrelationships within the context of the investigation have been elucidated in Figure 1.

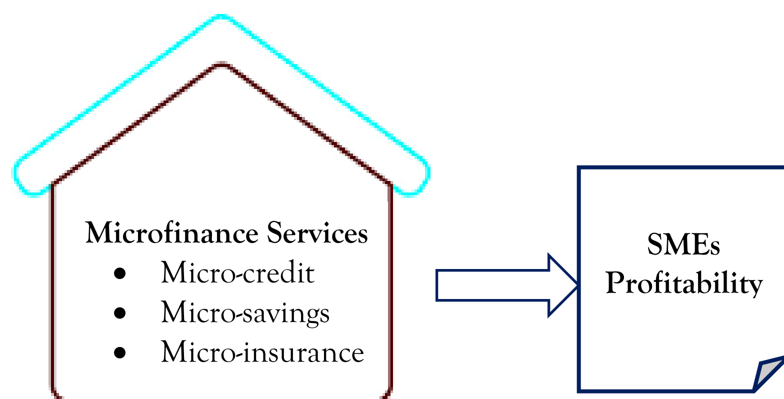

Figure 1: Conceptual framework

Microcredit refers to the provision of small loans to individuals or small businesses that may not have access to traditional collateral or a credit history. These loans are typically used for income-generating activities such as starting or expanding a small business, purchasing inventory, or investing in productive assets. Microcredit often involves flexible repayment terms and may be accompanied by financial literacy training or business development support. A micro-savings service allows you to save small amounts of money on a regular basis. Microfinance institutions offer savings accounts designed to meet the needs and limitations of low-income people. These accounts may have low minimum deposit requirements, low fees, and convenient access points for depositing and withdrawing funds. Small savings help people build financial resiliency, build up capital, and cover unexpected expenses. Microinsurance provides risk mitigation and protection against various hazards and vulnerabilities faced by low-income individuals and small businesses. Microfinance institutions offer insurance products tailored to the needs of their clients, such as health insurance, life insurance, property insurance, or crop insurance. These microinsurance services provide a safety net for clients, helping them manage risks and avoid falling deeper into poverty due to unforeseen circumstances.

5. Empirical Review

The existing literature relevant to the study has several strengths but also some limitations. Strengths include the empirical evidence linking microfinance services to improved profitability and the inclusion of diverse geographical contexts. However, some limitations include the lack of localized studies specifically focusing on SMEs in Kenya and the need for more rigorous methodologies to establish causal relationships. Additionally, there is a scarcity of studies that explicitly consider the unique contextual factors influencing the effects of microfinance services on profitability. One limitation of the existing literature is the lack of localization studies focusing specifically on brick-and-mortar stores in Kenya. Empirical reviews include studies conducted in a variety of contexts, but the lack of studies specifically targeting the area studied limits the applicability of the results to local conditions. This gap highlights the need for more localized research, taking into account the unique characteristics and challenges faced by SMEs in Kenya.

Another drawback of the empirical review is the need for a more rigorous methodology to establish a causal relationship between microfinance services and profitability. Some of the studies reviewed may have been based on correlational analyses that do not establish a causal relationship. Additionally, the lack of control or longitudinal models in some studies limits our ability to draw definitive conclusions about the causal effects of microfinance services. Future studies should aim to use more robust study designs to overcome these methodological limitations. While the empirical review provides insights into the overall relationship between microfinance services and profitability, it may not adequately address the unique contextual factors that influence these effects. Factors such as local market conditions, the regulatory environment, cultural dynamics, and the specific challenges faced by SMEs in Kenya may significantly impact the relationship between microfinance services and profitability. Future studies should consider these contextual factors to provide a more nuanced understanding of the effects of microfinance services.

The empirical review of the existing literature on the effects of microfinance services on the profitability of SMEs has both strengths and limitations. The consistent finding of a positive correlation between microfinance and profitability is a significant strength, suggesting the potential benefits of microfinance services. The inclusion of studies from diverse geographical contexts enhances the generalizability of the findings. However, limitations such as the lack of localized studies, methodological constraints, and limited consideration of contextual factors should be addressed in future research. By acknowledging these limitations, the current study aims to contribute to the field by filling these gaps and providing a more comprehensive understanding of the effects of microfinance services on the profitability of SMEs in Kenya.

6. Summary and Conclusions

In summary, the literature review has provided an overview of the existing theories, conceptual frameworks, and empirical studies related to the effects of microfinance services on the profitability of SMEs in Kenya. The financial inclusion theory highlights the role of access to financial

services, while the agency theory emphasizes the importance of effective relationships and monitoring between microfinance institutions and SMEs. The empirical evidence suggests a positive impact of microfinance services on profitability. However, there are limitations in the existing literature, including the lack of localized studies and the need for further research to establish causal relationships. The conceptual framework outlines the key variables and their relationships in the study. It includes the independent variable of microfinance service utilization, the dependent variable of general shop profitability, and mediating and moderating variables such as loan size, interest rates, business size, business age, socio-economic factors, market conditions, and the regulatory environment. This conceptual framework serves as a guide for the subsequent empirical investigation.

The empirical review of the literature analyzes previous studies conducted in both local and other geographical contexts. The findings consistently indicate a positive correlation between microfinance service utilization and the profitability of small businesses, providing empirical evidence of the potential benefits of microfinance services. However, limitations, such as the lack of localized studies specifically focusing on SMEs in Kenya and the need for more rigorous methodologies to establish causal relationships, are identified. The critique of the existing literature highlights the strengths and weaknesses of the empirical review. The positive correlation between microfinance and profitability, the inclusion of diverse geographical contexts, and the identification of research gaps contribute to the understanding of the topic. However, in future studies, limitations such as a lack of local studies, methodological limitations, and limited consideration of contextual factors need to be supplemented. In conclusion, microfinance services offered by MFIs play a significant role in enhancing the profitability of SMEs in Kenya. Despite limitations in the existing literature, there is empirical evidence of the positive impact of microfinance services on the financial performance of these enterprises. Further research is needed to delve into localized studies and consider the unique contextual factors influencing this relationship.

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