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Influence of Credit Lending Terms of Microfinance Institutions on Financial Performance of Small and Medium Enterprises in Eldoret Town, Kenya (Chapter 1 -3)

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Abstract
This research proposal sets out to establish the influence of MFI credit terms and performance of SMEs in Eldoret Town. The study will be guided by the following objectives; To determine the effect of collateral on capital size of small enterprises, to examine the relationship between loan period and return on capital employed Liquidity level, net profit margin and turnover, to examine the effect of interest rates on the return on capital employed, net profit margin, liquidity level and turnover, to determine the effect of loan size on the return on capital employed, Liquidity level and the turnover. Cross-sectional correlation design will be used and a sample of 356 respondents will be adopted. The respondents will be chosen from the SME owners operating in Eldoret Town. The data collected will be entered using Microsoft Excel and then exported to a statistical package for social scientists (SPSS) for analysis. This will generate frequency tables for demographic and descriptive data. The relationship between the study variables will be established using chi square and correlation tests at 95% significant level. Regression analysis will be used to determine the prediction potential of the model. The Model will be; $Y=a+\beta 1X1+\beta 2X2+\beta 3X3+\beta 4X4+\varepsilon$

Keywords: *Credit Lending Terms, Microfinance Institutions, Financial Performance, Small and Medium Enterprises*

1.0 INTRODUCTION

Microfinance encompasses the provision of financial services and the management of small amounts of money through a range of products and a system of intermediary functions that are targeted at low income clients (Asiama, 2007).The low income clients are normally the Small and Medium Enterprises. The importance of financial services to SME around the world cannot be over emphasized. Most SME around the world depend on MFI credit in order to spur the growth of their business. The history of Microfinance institution can be traced back to the era of Muhammad Yunus in 1976 of Grameen Bank. In Bangladesh, Muhammad Yunus addressed the banking problem faced by the poor through a programme of action-research. With his graduate students in Chittagong University in 1976, he designed an experimental credit programme to serve them. It spread rapidly to hundreds of villages. Through a special relationship with rural banks, he disbursed and recovered thousands of loans, but the bankers refused to take over the project at the end of the pilot phase. They feared it was too expensive and risky in spite of his success. Eventually, through the support of donors, the Grameen Bank was founded in 1983 and now serves more than 4 million borrowers. The initial success of Grameen Bank stimulated the establishment of several other giant microfinance institutions like BRAC, ASA, and Proshika.

According to Microfinance Information Exchange (MIX) report of 2008 it showed that there are a total of 2420 MFIs all over the world, representing 99 million borrowers in 117 countries. Most MFIs are concentrated in South Asia and Sub-Saharan Africa, while most borrowers are concentrated in South Asia, and East Asia/Pacific region. In Sub-Saharan Africa alone there are 533 MFIs (MIX report, 2008). In Kenya there exists deposit taking Microfinance Institutions and non-deposit taking Microfinance institutions. The deposit taking MFIs are regulated by the Central Bank of Kenya (CBK). Regulations for Non Deposit Taking Microfinance Institutions are yet to be put in place. The Ministry of Finance is in the process of discussing the best way forward for regulating the non-deposit taking microfinance businesses. There are nine MFI operating in Eldoret which include, Kenya Women Finance Trust (KWFT), SMEP, Faulu, Remu, Rafiki, UWEZO, Century, ZUMA C and U&I deposit taking MFIs (CBK, 2013). In Eldoret there exist five deposit taking Microfinance institutions out of the nine which are operational. Credit lending terms refer to standards or negotiated terms offered by a seller to a buyer that control the monthly and total credit, maximum time allowed for repayment, discount for cash or early payment, and the amount or rate of late payment penalty (Kakuru, 2007).

MFI loans are unsustainable because of the tough credit lending terms to SME's such as high interest rates, necessity of high valued collaterals, short payback period (Katto, 2008). The terms do not only affect SMEs while managing their day-to-day financial operations, but also frustrate their abilities to maximize their working capital potentials and therefore poor performance. There is no single or universally accepted definition of SMEs. SMEs varies from country to country depending on factors such as the country's state of economic development, the strength of the industrial and business sectors, the size of SMEs and the particular problems experienced by SMEs. Hence, there is no definition of SMEs which is suitable for all countries of the world. However in Kenya, according to Session

Paper No. 2 of 2005 SME is an enterprise with between 1 to 50 employees, the World Bank defines an SME as one that fits to either of the following criteria that is to say: (1) A formally registered business (2) with an annual turnover of between Kenya Shillings 8 to 100 million (3) an asset base of at least Kenya Shillings 4 million and (5) employing between 5 to 150 employees. The MSME Bill 2011 has used 2 criteria to define SMEs in general that is: (a) the number of people/employees and (b) the company's annual turnover. For enterprises in the manufacturing sector, the definition takes into account the investment in plant and machinery as well as the registered capital.

Micro and small enterprises (MSEs) have become the focus of attention for the economic development, economic growth and job creation in the world. The importance of Micro and Small Enterprises in the economies has been recognized by many players such as World Bank, UN agency UNCDF, governments, non-governmental organizations and private entities (Kenya Economic Survey, 2009). Small and medium enterprises (SMEs) greatly contribute in promoting economic growth and poverty alleviation in both developed and less developed countries. SMEs contribute immensely to Gross Domestic Product (GDP) and it has a sizeable influence in growth of economy. However SMEs are constrained in their access to formal credit, Commercial banks and other financial institutions, fail to provide credit for the needs of firms due to information asymmetry and SMEs do not meet the required collateral (Wageningen, 2013). Small and medium scale enterprises (SMEs) are lifeblood of most economies. On the average SMEs represent over 90% of the enterprises and account for 50% to 60% of employment in most African countries, According to Abor & Quartey, (2010).The number of SMEs operating in Eldoret is about 8175 (Municipal annual reports, 2012).

According to (Kenya National Bureau of Statistics, 2007) indicates that three out of five business fail within the first few months of operation and this is mostly attributed to improper financing that SMEs get which are characterized by strict credit lending terms. (Oketch, 2000) argue that lack of credit has been identified as one of the most serious constraints facing SMEs and hindering their development and performance. Performance is commonly measured by either or all of; Return on capital employed, Net profit margin and, Revenue, Working Capital Size.

2.0 LITERATURE REVIEW

2.1 Review of Theories

The chapter will review some theories associated with credit terms and performance of small enterprises, these theories include; MM theory, Pecking order theory and the Static trade-off Theory. The choice of the above theories is because it tries to show the relationship between the credit terms and credit offered to small firms by Microfinance institutions on their performance. It further describes if it is necessary for an SME to borrow from a MFI or they can seek other sources of financing for their enterprises.

2.1.2 Trade-off Theory

Trade-off theory claims that a firm's optimal debt ratio is determined by a trade-off between the bankruptcy cost and tax advantage of borrowing (Scott, 1977). Higher profitability decreases the expected costs of distress and let firms increase their tax benefits by raising leverage. Firms would prefer debt over equity until the point where the probability of financial distress starts to be important. The type of assets that a firm has determines the cost of financial distress. For instance, if a firm invests largely in land, equipment and other tangible assets, it will have smaller costs of financial distress than a firm relies on intangible assets. So for debt financing, both small and large firms must provide some kind of guarantees materialized in collateral. But small firms are seen as risky because they have higher probability of insolvency than large firms (Berryman, 1982).

2.1.3 Pecking Order Theory

Pecking Order Theory, states that capital structure is driven by firm's desire to finance new investments, first internally, then with low-risk debt, and finally if all fails, with equity. Therefore, the firms prefer internal financing to external financing (Myers and Majluf (1984). This theory is applicable for large firms as well as small firms. Since small firms are opaque and have important adverse selection problems that are explained by credit rationing; they bear high information costs (Psillaki, 1995). Since the quality of small firms financial statements vary, small firms usually have higher levels of asymmetric information. Even though investors may prefer audited financial statements, small firms may want to avoid these costs (Pettit and Singer (1985). Therefore, when issuing new capital, those costs are very high, but for internal funds, costs can be considered as none. For debt, the costs are in an intermediate position between equity and internal funds. As a result, firms prefer first internal financing (retained earnings), and then debt and they choose equity as a last resort (Pettit and Singer, 1985).

2.1.4 MM Theory

Regarded as the starting of modern theory of capital structure, Modigliani and Miller (1958) illustrates that under certain key assumptions, firm's value is unaffected by its capital structure. Capital market is assumed to be perfect in MM world, where insiders and outsiders have symmetric information; no transactions cost, bankruptcy cost or distortionary taxation exist; equity and debt choice becomes irrelevant and internal and external funds can be perfectly substituted(Robichek & Myers, 1966; Marsh, 1982). If these key assumptions are relaxed, capital structure may become relevant to the firm's value.

2.1.5 The Modified pecking Order" financing theory

In the MPO, the preference order of financing sources is the same as in the PPO, except that safe debt is preferred to risky debt. The MPO theory differs from the PPO theory on two major issues. First, the MPO suggests that information asymmetry, rather than the management's unwillingness to accept market scrutiny, determines managers' preference for internal financing (Donaldson 1961 & 1969). Information asymmetry refers to the market's lack of understanding of the true value of a firm's investment opportunities when the firm issues new securities to finance investment projects (Myers and Majluf, 1984). The consequence is the undervaluation of the security and therefore the undervaluation of the firm. The likelihood of undervaluation is related to the riskiness of the security to be issued. The riskier the security, the more likely it is that the market will undervalue the firm. While using internally generated funds can enable a firm to avoid such undervaluation, issuing less risky securities can reduce the undervaluation. As common stock is the most risky security for outside investors, new stock issuance is most likely to cause undervaluation. Therefore, in the MPO, internally generated funds are the most preferred, followed by safe debt, risky debt, and finally new equity.

2.1.6 Static Trade-off Theory

In a static trade-off framework, the firm is viewed as setting a target debt-equity ratio and gradually moving towards it. Debt financing has one important advantage over equity: the interests that firm pays are tax-deductible while equity income is subject to corporate tax. But debt also increases financial risk that makes debt financing choice not cheaper than equity. So, in a static trade-off consideration, managers regard the firm's debt-equity decision as a trade-off between interest tax shields of debt and the costs of financial distress. In particular, capital structure moves towards targets that reflect tax rates, assets type, business risk, and profitability and bankruptcy costs. Actually, the firm is balancing the costs and benefits of borrowings, holding its assets and investment plans constant (Myers, 1984). The general results of various work in this aspect of leverage choice is that if there are significant "leverage-related" costs, such as bankruptcy costs, agency costs of debt, and loss of non-debt tax shields, and if the income from equity is untaxed, then the marginal bondholder's tax rate will be less than the corporate rate and there will be a positive net tax advantage to corporate debt financing. The firm's optimal capital structure will involve the trade-off between the tax advantage of debt and various leverage-related costs.

Due to the distinctions in firm-specific characteristics, target leverage ratios will vary from firm to firm. Institutional differences, such as different financial systems, tax rate and bankruptcy law etc., will also lead the target ratio to differ across countries. The trade-off theory predicts that safe firms, firms with more tangible assets and more taxable income to shield should have high debt ratios. While risky firms, firms with more intangible assets that the value will disappear in case of liquidation, ought to rely more on equity financing. In terms of profitability, trade-off theory predicts that more profitable firms should mean more debt-serving capacity and more taxable income to shield; therefore a higher debt ratio will be anticipated. Under trade-off theory, the firms with high growth opportunities should borrow less because it is more likely to lose value in financial distress.

Theoretical Review Literature for SMEs growth and Performance: Various theoretical models have been developed which describe the growth of SMEs. One class of theoretical models focuses on the learning process, either active or passive, and the other models refer to the stochastic and deterministic approaches.

2.1.7 Passive Learning Model:

In the Passive Learning Model (PLM) (Jovanic, 1982 cited in Agaje, 2004), a firm enters a market without knowing its own potential growth. Only after entry does the firm start to learn about the distribution of its own profitability based on information from realized profits. By continually updating such learning, the firm decides to expand, contract, or to exit. This learning model states that firms and managers of firms learn about their efficiency once they are established in the activities when levels of efficiency. As firm ages, the owner's estimation of efficiency becomes more accurate, decreasing the probability that the output will widely differ from one year to another. The implication of this theoretical model is that smaller and younger firms should have higher and more viable growth rates (Stranova, 2001, Cunningham and Maloney 2001 and Goedhuys, 2002).

2.1.8 Theoretical links between Microfinance and SME Development

Accessing credit from Financial Institutions is considered to be an important factor in increasing the growth and development of SMEs. It is thought that credit augments income levels, increases employment and thereby alleviates poverty. According to (Hiedhues, 1995), it is believed that access to credit enables poor people to overcome their liquidity constraints and undertake some investments such as the improvement of farm technology inputs thereby leading to an increase in agricultural production. Navajas, (2000) argues that the main objective of microcredit is to improve the welfare of the poor as a result of better access to small loans that are not offered by the formal financial institutions. Diagne and Zeller (2001) argue that insufficient access to credit by the poor just below or just above the poverty line may have negative consequences for SMEs and overall welfare. Access to credit further increases SME's risk-bearing abilities; improve risk-copying strategies and enables consumption smoothing overtime. With these arguments, microfinance is assumed to improve the welfare of the poor.

According to the studies done by (Rhyme and Otero, 1992) they argued that MFIs that are financially sustainable with high outreach have a greater livelihood and also have a positive impact on SME development because they guarantee sustainable access to credit by the poor. Buckley,(1997) arguments indicates that, the indicators of success of microcredit programs namely; high repayment rate, outreach and financial sustainability does not take into consideration what impact it has on micro enterprise operations and only focusing on “microfinance evangelism”. Carrying out research in three countries; Kenya, Malawi and Ghana, Buckley (1997) came to the conclusion that there was little evidence to suggest that any significant and sustained impact of microfinance services on clients in terms of SME development, increased income flows or level of employment. The focus in this augment is that improvement to access to microfinance and market for the poor people was not sufficient unless the change or improvement is accompanied by changes in technology and or technique.

There exist also interesting findings from the research studies done by Zeller and Sharma (1998), they argue that microfinance can aid in the improvement or establishment of family enterprise, potentially making the difference between alleviating poverty and economically secure life. On the other hand, Burger (1989) indicates that microfinance tends to stabilize rather than increase income and tends to preserve rather than to create jobs. According to Coleman (1999) suggestions; the village bank credit did not have any significant and physical asset accumulation. The women ended up in a vicious cycle of debt as they use the money from the village banks for consumption purposes and were forced to borrow from money lenders at high interest rate to repay the village bank loans so as to qualify for more loans, which shows that the credit from village bank did not contribute directly to the growth of their businesses. The main observation from this study was that credit was not an effective tool to help the poor out of poverty or enhance their economic condition. It also concluded that the poor are too poor because of some other hindering factors such as lack of access to markets, price stocks, unequal land distribution but not lack of access to credit. This view was also shared by Adams and Von Pischke (1992). A study of thirteen MFIs in seven countries carried out by Mosley and Hulme (1998) concludes that household income tends to increase at a decreasing rate as the income and asset position of the debtors is improved. Diagne and Zeller (2001) in their study in Malawi suggest that microfinance do not have any significant effect in household income

2.2 Criticism of the Theories

2.2.1Modified Pecking order theory

The results of Learya and Michael R. Roberts (2004) research show that firms violate the pecking order's financing hierarchy more often than not. Of the observations where firms use external finance, less than 40% are consistent with the pecking order's prediction. That is, firms appear to have sufficient internal reserves to fund both current and anticipated investment yet still turn to external capital markets for funds. Of the observations where firms use equity financing, less than 20% are consistent with the theory's prediction. That is, despite the ability to fund investment with internal funds or debt, firms turn to equity markets for financing.

Interestingly, large firms are more likely to violate the financing hierarchy than are small firms, consistent with Fama and French (2003) but opposite the findings of Frank and Goyal (2003) and Lemmon and Zender (2003). The cause of these seemingly conflicting results is due simply to different empirical approaches. While it is true that firms with greater investment and fewer internal resources are more likely to turn to external finance, the majority of external financings occur despite firms having sufficient funds to cover their current and anticipated investment needs. Similarly, firms are more likelyto use equity financing as investment increases and/or cash flow decreases (as found by Lemmon and Zender and Frank and Goyal) but the majority of equity financings occur when firms still have sufficient debt capacity to their investment needs as suggested by(Fama and French,2003).

2.2.2 Static Trade -off theory

The empirical relevance of the trade-off theory has often been questioned. Miller for example compared this balancing as akin to the balance between horse and rabbit content in a stew of one horse and one rabbit. Taxes are large and they are sure, while bankruptcy is rare and, according to Miller, it has low dead-weight costs. Accordingly he suggested that if the trade-off theory were true, then firms ought to have much higher debt levels than we observe in reality. Myers was a particularly fierce critic in his Presidential address to the American Finance Association meetings in which he proposed what he called "the pecking order theory". Fama and French (2003) criticized both the trade-off theory and the pecking order theory in different ways. Welch has argued that firms do not undo the impact of stock price shocks as they should under the basic trade-off theory and so the mechanical change in asset prices that makes up for most of the variation in capital structure.

Despite such criticisms, the trade-off theory remains the dominant theory of corporate capital structure as taught in the main corporate finance textbooks. Dynamic version of the model generally seem to offer enough flexibility in matching the data so, contrary to Miller's verbal argument, dynamic trade-off models are very hard to reject empirically. The analysis of wide known trade off theory has been made within modern theory of capital structure and capital cost by Brusov-Filatova-Orekhova. It is shown that suggestion of risky debt financing (and growing credit rate near the bankruptcy) in opposite to waiting result does not lead to growing of weighted average cost of capital, WACC, which still decreases with leverage. This means the absence of minimum in the dependence of WACC on leverage as well as the absence of maximum in the dependence of company capitalization on leverage. Thus, it seems that the optimal capital structure is absent in famous trade off theory.

2.3 Empirical review

2.3.1 Credit terms

The American Bankers' Association defines credit as borrowed money. The types of credit include credit cards, personal loans, overdrafts and home loans. The credit terms also refer to the debt repayment of your agreement with a creditor, such as60 months, 48 months in form of duration. Organization for Economic Co-operation and Development, (2006) indicates that MFIs are the main source of external finance for SMEs. This is an indicator that the banking system needs to be prepared to extend credit to the SMEs. However, there are number of hurdles which include macroeconomic, institutional and regulatory nature that may bias the entire banking system against lending to SMEs. The impact of Macroeconomic policies may result to excess demand for available domestic savings, while government policy may favor industrialization and/or import substitution, which effectively gives large domestic firms privileged access to finance. On the contrary, these terms frustrate the SME sector firm accessing credit because all the efforts and policies favor large borrowers at the expense of the small operators that are the SMEs.

Chowdhury (2002) argued that that local market competition among MFIs in Bangladesh is driven by credit terms especially in terms of loan amounts, interest rates and repayment time and that some borrowers and MFIs opt for a package of low interest rates tied with low amount of loan disbursed and some other borrowers goes for a package of high interest rates tied with high amount of loan disbursed. This shows that credit terms of MFIs really affect the performance of SMEs. However, when assessing comparatively small and straightforward business credit applications, MFIs may largely rely on standardized credit scoring techniques (quantifyingsuch things as the characteristics, assets, and cash flows of businesses/owners). This coupled with the terms and conditions that are perceived to protect their loans at times appear as burdens to the borrowers and because they (SMEs) do not have adequate or no collateral as indicated by Katto (2008) their performance ends up being affected.

A research in Rwanda was done using a descriptive survey research design and Correlation design. A random sample of 196 active agricultural cooperatives was obtained from various districts in the southern province of Rwanda. Correlation and regression models were used to test whether the performance of agricultural cooperatives is affected by credit terms and credit accessibility and also if there is any relationship between the two. The findings revealed a positive and significant relationship between credit terms, credit accessibility and the performance of agricultural cooperatives; the two independent variables explain about 17.6% of the performance of agricultural cooperatives. The study reveals that credit accessibility is the most significant determinant of the performance of agricultural cooperatives. To attain a higher performance level of agricultural cooperatives, better mechanism for accessing credit must be put in place and credit terms must be simplified (Ismael, 2013).

2.3.2 SME performance

Brem (2008) studied about Performance Measurement Systems (PMS) in SMEs shows that the main contributions focus on the development of only theoretical models and not much on guidelines for practical implementation. Furthermore, Brem established an important neglected aspect as the general fitness or readiness of an SME to implement a PMS. In this aspect, a case study in a German Small Medium Enterprises was conducted and the findings indicate that the existence of specific contingency factors such as Corporate Strategy, software based Enterprise Resource Planning (ERP) and Activity Based Costing (ABC) – strongly supports the successful implementation of a PMS and its later use. Of course to ensure a reliable performance measure among SMEs, there is need to use the Key Performance Indicators because a new paradigm of performance measure has been adopted by many SME's. This is based on identifying what the business does in terms of levels of processes and attaching Key Performance Indicators to those processes. There cording and analysis of the Key Performance Indicators should significantly contribute to the achievement of business goals (Richard, 2010). The main reason for using KPIs include; To show businesses how well they provide services, how long they take to respond to customers' requests , their product delivery performance and how much time they take to correct their mistakes and eliminate their weakness.

The KPIs are those critical measures which ultimately determine profitability and shareholder value. The traditional Statement of Financial Performance, Statement of Assets and Liabilities and Management Accounts are not enough to effectively manage businesses which are seeking to survive and add shareholder/owner value. Management needs additional timely information, much of which is not traditional Financial Data, if they are going to effectively manage their businesses. A Performance Indicator (PI) measure is a measure of the behavior of a business process. In business, understanding the state of the financial health of a business is a very important issue relating to business survival. There is a strong similarity between physical fitness and the health of a business. The Cash Flow of a business can be likened to the blood circulating through a person. If there is blood loss in the flow, the consequences are swift and predictable (Richard, 2010).

Sudhir & Subrahmanya (2009), argue that growth over a period of time can be used for performance measurements of SMEs since this, rather than short term performance, will reflect the long-term strategy of the firm. The researchers (Sudhir &Subrahmanya) also probed how far Indian SMEs carried out technological innovations as a result of technology and other related inputs acquired through subcontracting relationships and achieve growth using the case study approach covering two SMEs in Bangalore in India. From the study it was established that customer requirements were the major causal factors while internal factors such as self-efforts and in-house technical capability along with external factors in the form of technical inputs, suggestions and initiative from Large Enterprises (LE) customers were the sources of innovations for these SMEs. Because of these innovations, SMEs achieved growth in terms of investment in plant and machinery, output and customer base, which are ideal indicators of SME performance

2.3.3 MFI-SME relationship

According to the study done by Zeller and Sharma (1998) they argue that microfinance can aid in the improvement or establishment of family enterprise, potentially making the difference between alleviating poverty and economically secure life. On the other hand, Burger (1989) indicates that microfinance tends to stabilize rather than increase income and tends to preserve rather than to create jobs. Microfinance Institutions provide a wide range of financial andnon-financial services to small and medium entrepreneurs, loans, savings mobilization, micro-insurance, money transfer and financial education among others and that in Kenya; the microfinance industry has been recognized for its major contribution towards the fight against poverty and improvement of household welfare. Several semi-urban and rural people have been able to participate in the livelihood activities through access to microfinance services. This however requires a great deal of cooperation between the clients and the lenders so as to ensure that there is a good working relationship (Omeke, 2010).

However, today the vibrant microfinance industry is encountering stiff competition at the marketplace. The entry of new commercial banks and downscaling of the old banks 'operations into the SME sector has instigated tough and unprecedented competition against MFIs. The traditional commercial banks had neglected the SME markets as high-risk sectors. Likewise, there has been improvement on the quality standards of service delivery. Hence, the ultimate, beneficiary from all these reforms and innovations is the customer who has received a good and strong intimacy with the SME/MFI relationship especially with the demand tailored services.

In order for MFIs to remain afloat, they need to realign and reposition themselves at the marketplace. MFIs must adopt and come up with varied innovative market survival strategies to avoid being edged out by the well-established financial institutions. Therefore, MFIs should capitalize on the already existing competitive advantage and long relationship they have had with the SMEs to have a cutting- edge over the other financial institutions. All they need to do is streamline and improve on the speed and quality of service delivery by providing demand-driven and market responsive services and/or products. In their arguments, Ozkan and Ozkan (2004) maintain that building relationships with financial institutions improves firms' ability to access external financing. This suggests that firms with a higher proportion of bank debt will be able to access external financing more easily. Establishing MFI relationships with SMEs reduces information asymmetry and agency problems, since valuable information about SME quality can be disclosed. Thus, establishing stable links with financial institutions can improve both the availability and the conditions of financing. Various works have empirically demonstrated that keeping banking relationships can be beneficial to firms, insofar as contact between the MFI and SME can improve the availability of funds and lower their costs.

In a study by Fidrmuc, (2009) about banks and SMES in emerging market, it was established that there is a lot of uncertainty about the risks involved in lending. The study used a unique unbalanced panel of 700 short-term loans made to SMEs in Slovakia between January 2000 and June, 2005. It was found out that of the loans granted, on average 6.0 percent of the firms defaulted. This affected the relationship between the banks and SMEs hence deflecting the possibilities of accessing finances in future because the terms would change and become more stringent against the borrowers for fear of more defaults Kumar and Jeyanth (2007) agree with Fidrmuc that a good relationship between SMEs and MFIs helps them to easily access finances and information. They add on that capacity building of staff for preparedness is perhaps the most important task. MFIs are unique in their way of operation as the staff has rapport with even the most remote clients. Their argument was that in the event of emergency, MFI personnel are often the first to reach affected communities. Hence they should be trained on disaster risk reduction before disaster strikes as to their responsibilities and the extent of their decision making authority. Client preparedness is another area where any MFI can play a constructive role in strengthening their relationship with SMEs because they serve the marginalized groups, their clients often live in highly vulnerable physical locations. Encouraging clients through education on disaster risk reduction and designing loan products to develop disaster-proofing shelters.

The MFIs can develop relationships with specialized institutions on disaster management. Except in areas frequently hit by cyclical disasters, MFIs are rarely aware of disaster warning systems. Rather than suggest that each MFI create these partnerships, however, donor organizations or microfinance network organizations may be more cost efficient channels to track and disseminate disaster warning information. This channel of communication may also serve to link MFIs with relief organization that can also prepare by developing lines of credit– either with commercial banks or donors for emergency drawn down. All of these partnerships offer important opportunities for MFIs to become better prepared to serve their clients as well as survive the crisis themselves without losing their financial services perspective.

2.3.4 Credit terms, Liquidity and performance

Wageningen (2013) Small and micro enterprises (SMEs) greatly contribute in promoting economic growth and poverty alleviation in both developed and less developed countries. SMEs contribute immensely to Gross Domestic Product (GDP) and it has a sizeable influence in growth of economy. However SMEs are constrained in their access to formal credit, Commercial banks and other financial institutions, fail to provide credit for the needs of firms due to information asymmetry and SMEs do not meet the required collateral. Pedro and Martinez (2001) did an analysis of the explanatory factors of the cash holdings of a sample of 860 small and medium-sized firms from Spain and they found that those firms pursued a target cash level to which they attempted to converge, and this level was higher for firms with larger cash flows, for those that are more highly leveraged and for those that had more short-term debt. In contrast, the cash level falls with the use of bank debt and in the presence of substitutes for cash. Despite these contributions of SMEs, their major barriers to growth and development appear to be shortage of both equity financing and debt. Thus, according to Lader (1996), one other important problem that SMEs often face is access to capital. Lack of adequate financial resources also places significant constraints on SMEs growth and development.

According to the findings of Ferreira and Vilela (2004) they found that the existence of growth opportunities in firms is an important factor that positively affects cash levels. Firms with more growth opportunities may incur greater costs of financial distress because their value depends on their growth opportunities rather than on tangible assets or specific cash flows. Thus, this type of firm will keep higher cash levels to avoid costs of financial distress. It is therefore important that firms with good growth opportunities tend to keep higher cash holdings. This means that firms with more investment opportunities keep higher liquidity levels in order not to limit or cancel their profitable investment projects. The value of these firms depends on carrying out these projects, so that the cost of not having sufficient cash to make the investments is higher. However Klapper and Udell, (2001) argue that firm Size is significant in determining its liquidity levels. The traditional models to determine the optimal liquidity demonstrate that there are economies of scale associated with the cash levels required to confront the normal transactions of the firm, so that larger firms can keep lower cash holdings. It's therefore important to consider that firm size is related to another set of factors that may influence liquidity levels such as the level of fixed costs and these costs are proportionately greater for SMEs.

Cohen (2000) argues that participation in microfinance programs contributes to reduced vulnerability to liquidity risks among SMEs. Microfinance services help the SMEs to diversify their income sources, building up physical, human and social assets, and focus on good money management, rebuild the household's base of income and assets after economic shocks have occurred and to smooth consumption. Hence for this, the impact assessment studies carried out in Kenya confirm positive effects of microfinance services on poverty eduction.

Chowdhury (2002) emphasizes that favorable credit terms such as adequate loan amounts, affordable interest rates and flexible repayment schedules help SMEs keep enough finances to run their working capital activities, it helps them improve their performance because they will always have an opportunity cost of reinvesting their proceeds in order to generate more revenues something that increases on their return on capital employed. In return, their (SME) net profit margin will raise something that lifts the capital size (APEC, 2003).
According to Ndegwa (2011) in a study done in Nairobi Kenya he found that that as SMEs grow they require funds to finance growth in fixed asset and increase working capital. SMEs therefore require long-term credit in ever increasing amounts so that they can purchase raw materials, supplies and carry out activities that they need to facilitate the production process. From the study findings it was concluded that, access of credit by SMEs from MFIs greatly influences their performance. The descriptive statistics on net profit indicate that the net profit after access of credit from MFIs was more than the net profit before access of credit. This is attributed to the increased working capital of the SMEs and expansion of business operations. These findings have implications for management of MFIs to ensure that policies are instituted to facilitate easy access of loans by SMEs from MFIs. Management of MFIs should therefore, among other things come up with policies which can help those with no collaterals but good ideas to access credit from MFIs, encourage personal service delivery, provide financial advisory services to individual proprietors when advancing credit to them, lower lending rates while improving service delivery and train people on risk management and financial management.

2.3.5 Credit terms, MFI-SME relationship and performance

According to Organization for Economic Co-operation and Development (OECD) report of (2006) it noted that the SME sector does not have access to external funds due to stringent terms that the financiers tend to tie to their credit and investment, this leads to the possibility that capacity building are seriously impaired. It was also noted in the report that the difficulties that SMEs experience can stem from several sources of their financial needs. For instance, the domestic financial market may contain an incomplete range of financial products and services, the lack of appropriate financing mechanisms .In this case, suppliers of finance (MFIs) may rationally choose to offer an array of financial services that leaves significant numbers of potential borrowers without access to credit. Such credit rationing is said to occur if among loan applicants who appear to be identical some receive credit while others do not; or there are identifiable groups in the population that are unable to obtain credit. According to Asia-Pacific Economic Cooperation (APEC) (2003), it is recognized that the roles of micro finance institutions are very important for development of SMEs. At least two main goals of giving access for SMEs through development of micro finance institutions, namely: increasing business activity of micro enterprises through working capital or investment fund, and promoting and developing spirit of entrepreneurship. This without close relationship between MFIs and SMEs may not be achieved.

In a study about MFI-SME financing in Afghanistan by Mennonite Economic Development Associates (2009) it was established that financing interventions that focus exclusively on SMEs may in the end prove to be a high credit risk. While there is value in focus and specialization in financial service delivery, it can also become a weakness if the needs of SMEs are set at to limit its affordability and access

2.3.6 General Constraints to SME Performance

Despite the great potential role of SMEs to spur growth and employment opportunities in developing countries, a number of constraints affect their ability to realize their full potential. SME development is hampered by a number of factors, majorly finance, lack of managerial skills, equipment and technology, regulatory issues, and access to international markets (Anheier and Seibel, 1987; Steel and Webster, 1991; Aryeetey, 1994; Gockel and Akoena, 2002). A lot of research shows that Regulatory constraints also pose a great challenge to SME development and although wide ranging structural reforms have led to some improvements, prospects for enterprise development remain to be addressed at the firm-level. The high start-up costs for firms, including licensing and registration requirements, can impose excessive and unnecessary burdens on SME, which affect negatively on their performance especially at an early stage of the business life cycle. The high cost of settling legal claims, and excessive delays in court proceedings adversely affect SME operations

One important and great problem that SMEs often face is access to capital (Lader, 1996). Lack of adequate financial resources places significant constraints on SME performance and development. Cook and Nixson (2000) observe that, notwithstanding the recognition of the role of SMEs in the development process in many developing countries, SMEs development is always constrained by the limited availability of financial resources to meet a variety of operational and investment needs, and access to the limited finances involves strict requirements of collateral for SMEs to be financed. A World Bank study found that about 90% of small enterprises surveyed stated that credit was a major constraint to new investment (Parker, 1995). Levy (1993) also found that there is limited access to financial resources available to smaller enterprises compared to larger organizations and the consequences for their growth and development. The role of finance has been viewed as a critical element for the development of SMEs (Cook & Nixson, 2000).

A large portion of the SME sector does not have access to adequate and appropriate forms of credit and equity, or indeed to financial services more generally (Parker, 1995). In competing for the corporate market, formal financial institutions have structured their products to serve the needs of large corporates. Even if SME's possess good ideas for business they are still locked out from accessing credit because of stringent and unfavorable credit terms. A cursory analysis of survey and research results of SMEs in South Africa, for instance, reveals common reactions from SME owners interviewed. When asked what they perceive as constraints in their businesses and especially in establishing or expanding their businesses, they answered that access to funds is a major constraint, and in case they access it using collateral they still make small margin of profits since they pay high interest on the loan up to 33% therefore affecting their performance negatively. This is reflected in perception questions answered by SME owners in many surveys (Graham and Quattara, 1996; Rwingema and Karungu, 1999). In Ghana, access to finance has been identified as a dominant constraint facing the Ghanaian Small and Medium Enterprises (SME) sector (Abor & Bikpe, 2006).It might seem surprising that finance should be so important. Requirements such as identifying a product and a market, acquiring any necessary property rights or licenses, and keeping proper records are all in some sense more fundamental to running a small enterprise than is finance (Green, 2002).

2.3.7 Small and medium enterprises and access to finance

A major stumbling block to rapid development of the SME sector is a shortage of proper and affordable financing. Accessing finance has been identified as a key element for SMEs to succeed in their drive to build productive capacity in their business, to compete, to create jobs and to contribute to poverty alleviation in developing countries. It is evident that Small business especially in Africa can rarely meet the conditions set by financial institutions, which see SMEs as a risk because of poor guarantees and lack of information about their ability to repay loans. Without finance, SMEs cannot acquire or absorb new technologies nor can theyexpand to compete in global markets or even strike business linkages with larger firms (UNCTAD, 2002). Many factors are believed to be responsible for the refusal of loans and equity fund to SMEs by formal banks and MFIs. According to Cork and Nisxon (2000), poor management and accounting practices are hampering the ability of smaller enterprises to raise finance. This is coupled with the fact that small businesses are mostly owned by individuals whose personal lifestyle may have far reaching effects on the operations and sustainability of such businesses.

As a consequence of the ownership structure, some of these businesses are unstable and may not guarantee returns in the long run, therefore being categorized as risky by MFIs. According to the study by Kauffmann (2005), access to formal finance is poor because of the high risk of default among SMEs and due to inadequate financial facilities. However, Cressy and Olofsson (1997) sum up constraints facing SMEs into two; these include demand-based (SMEs) and supply-based (formal banks) financial constraints. The two define a supply-side finance constraint as a capital market imperfection that leads to a socially incorrect supply of funds to projects, or the incorrect interest rate charged on funds. They further define a demand-side financial constraint as a capital market imperfection in which performance of a firm is adversely affected by a factor internal to the firm. Thus for example, if the firm's owners would like to grow the firm faster, but the only way they can do this is to relinquish equity, and they refuse to do so, it may be said that the firm's demand for funds is demand-constrained.

2.3.8 Knowledge gap

There have been attempts in the past to study the Influence of MFI credit terms on SME but much focus has been on the impact of MFIs in poverty alleviation among the SME, especially in Kenya little research has been done to find out the influence of MFI credit lending terms on the Financial performance of SMEs in Eldoret town, Uasin Gishu County, therefore this research proposal will addresses that gap.

3.0 RESEARCH METHODOLOGY

3.1 Research design

The study will adopt a descriptive survey design and correlation design. A descriptive survey design is one in which information is collected without changing the environment (nothing is manipulated).Descriptive studies can involve a one-time interaction with groups of people (cross-sectional study) or a study might follow individuals over time (longitudinal study).Correlation design will provide a clear understanding of the relationship between MFI credit lending terms and SMEs Performance in Eldoret.

3.2 Target population

The study will cover 3560 registered and licensed SMEs in Eldoret. For the purpose of this study only SMEs that had operated for three years and above will be considered to form the target population since it will be assumed that this length of time will provide meaningful measures of performance.

3.3 Description of research Instruments

3.3.1Interview guide

In Quantitative research (survey research); interviews are more structured than in qualitative research. In a structured interview, the researcher asks a standard set of questions and nothing more (Leedy and Ormrod, 2001).Face -to -face interviews have a distinct advantage of enabling the researcher to establish rapport with potential participants and therefor gain their cooperation. These interviews yield highest response rates in survey research. They also allow the researcher to clarify ambiguous answers and when appropriate, seek follow-up information. Disadvantages include impractical when large samples are involved time consuming and expensive (Leedy and Ormrod, 2001).

3.3.2 Questionnaires

Questionnaires will be given to the respondents by the researcher. People are more truthful while responding to the questionnaires regarding controversial issues in particular due to the fact that their responses are anonymous. But they also have drawbacks. Majority of the people who receive questionnaires don't return them and those who do might not be representative of the originally selected sample (Leedy and Ormrod, 2001).The researcher will give out structured questionnaire to the respondents.

3.4 Description of the Sample and sampling procedures

The target population will be stratified into homogeneous categories as wholesalers, retailers, restaurants and service firms. A sample of 356 SMEs will be drawn proportionately by use of simple random sampling from the strata. For homogeneous groups, 10% of the sample is considered as representative. One respondent will be selected from each SME since most of the SMEs are found to be managed solely by the owners.

3.4 Data sources

The study will use both primary and secondary data. Primary data will be collected from the owners of SMEs while secondary data is gotten through the review of relevant literature from publications such as the municipal council financial reports, journal articles, textbooks and other related publications.

3.5 Description of Data collection Procedures

Data will be collected by the use of questionnaires and interview schedules .The researcher will administered and collect completed questionnaires from the respondents. This will minimize the chances of respondents not responding to the questionnaires. In an attempt to produce a quality and reliable study, the researcher will first sought a research permit and an introductory letter from the university for permission to undertake research .The researcher also intends to collect the data himself to avoid any collection of information through unethical means such as research assistants who fill questionnaires themselves instead of taking interviews from the respondents.

3.6 Description of Data Analysis Procedures

The data collected will be entered using a statistical package for social scientists (SPSS) for analysis. This will generate frequency tables for demographic and descriptive data. The relationship between the study variables will be established using correlation tests at 95% significant level. Regression analysis will be used to determine the prediction potential of the model. The Model will be;

$Y=a+\beta_1X_1+\beta_2X_2+\beta_3X_3+\beta_4X_4+\varepsilon$

Where Y is the dependent variable that is the performance of SMEs a is the constant

X_1, X_2.X_3, X_4 are independent variables.

X1 – Analyzing the effect of collateral on capital size of small enterprises

X2 – Analyzing the effect of loan period on the return on capital employed Liquidity level, net profit margin and turnover

X3- Analyzing the effect of interest rates on the return on capital employed, net profit margin, liquidity level and turnover.

X4 -Analyzing the effect of loan size on the return on capital employed, Liquidity level and the turnover

While β is beta, measures deviation in the variables

And ε is the error term

3.7 Reliability and Validity Testing

The study instrument will be first tested for reliability using the content validity index and crombach alpha co-efficient respectively. This will help to yield consistent measurements, and drew satisfactory conclusions. For validity test the researcher will be able to measure the extent to which the results of the study can be generalized (Campbell and Stanley, 1966). Face validity: Face validity refers to whether the questions seem appropriate or not in the context of the study. Criterion validity: This is where validity is determined by relating performance measure to another measure that may be used as a standard against which results are measured. Content validity: This is related to face validity. Content validity is where the accuracy of the instrument in measuring the factors of concern to the study is scrutinized.

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