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# Credit Financing and Performance of SMEs in Lira Municipality, Uganda

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**Abstract**
This study sought to examine the role of Credit financing on performance of SMEs in Lira Municipality**.** A sample of 120 respondents was considered with response rate of 100%. The findings indicated that extending credit to SMEs enables them to access essential resources, increase business diversification and increase productivity levels. The study recommends that Credit institutions should continue providing credit at affordable rates while endeavoring to train their clients on how to keep financial information, which is essential in assessing the borrower's credit worthiness. SMEs should practice documenting their transactions, including information on personal characteristics, which are essential in assessing the credit worthiness of potential borrowers.
**Keywords:** Credit Financing, Interest rates, Creditor information, Collateral security, Firm Performance

## Introduction

The term Small and Medium Enterprises (SMEs) covers a wide range of definitions and measures, varying from country to country and between the sources reporting SME statistics. Although there is no universally agreed definition of SMEs, some commonly used criteria are the number of employees, value of assets, value of sales and size of capital (Bataa, 2008). In Uganda, SMEs are officially defined based on both the number of people employed and annual turnover of the enterprise (Turyahebwa, Sunday, & Ssekajugo, 2013). They are small enterprises employing a minimum of 5 people and a maximum of 50 people, with an annual sales/revenue turnover of more than UGX 360 million and total assets of more than UGX 360 million. The contribution of SMEs to Uganda's economy is well over ninety percent (90%) of the total non-farm private sector employment, approximately 2% of the national Gross Domestic Product (GDP), and over 20% of incomes of the labor force (Nyanzi, 2015). However, ninety percent of small and micro enterprise collapse in their first year of startup, due to lack of access to credit (Arinaitwe & Mwesigwa, 2015).

The persistent lack of assets and weak financial foundations often make it difficult for SMEs globally to perform and expand in their operations, consequently the inadequate equity capital invested in SMEs makes these businesses more reliant on other sources such as bank lending and other types of financial credit (Harash, Suhail, & Jabbar, 2014). Most SMEs rely on either internal financing from suppliers or specialized financial products (Emad, Suhail, & Jabbar, 2014). Internal borrowings sometimes involve fresh capital injections from shareholders, owner's personal savings, and retained or undistributed profits from the business obtained in the previous years (Yeboah, Kwadwo, & Adigbo, 2014). External informal sources include suppliers, financial assistance from family and friends, trade credit, venture capital and angel financiers (Abdulaziz M & Worthington, 2013) while formal external sources represent financial intermediaries such as banks, financial institutions and securities. While there are many sources of credit available to SMEs, (Nderitu & Githinji, 2015) argues that SMEs should focus only on trade credit in order to optimize their financial performance.

Access to credit remains a constraint to SMEs as regards to working capital. SMEs have limited access to capital markets, locally and internationally, in part because of the perception of higher risk, informational barriers, and the higher costs of intermediation (Kofi, Tanyeh, & Gaeten, 2013), which constrains growth and competitiveness (Agbazo & Omane, 2012). Studies on SMEs have pointed out that access to credit is an impediment to SMEs' contribution as engine to national economic development (Onyimba & Muturi, 2016); (Kofi *et al*, 2013); (Rodica, 2012); (Organization for Economic Co-operation and Development, 2013). Credit to SMEs has caused trauma and self pity an unfulfillment perpetuating a vicious cycle of financial problems to majority borrowers. A survey on how repayment of credit/loans affect performance of rural enterprise, records in Kenya revealed that outstanding loan balances advanced to SMEs kept on growing in the subsequent years depicting a problem with performance of these enterprises (Gichana & Barasa, 2013). They noted that availing credit to SMEs does not necessarily lead to additional assets, expand market share nor increase the ability to purchase additional stock. Access to credit determines SMEs' competitive readiness and ability to fully exploit and participate in the global economy and business opportunities stemming from economic integration (Emad *et al*, 2014).

## Statement of the Problem

Government of Uganda has established numerous centers like Uganda Micro Support Center, Uganda

Investment Authority (UIA), Commercial banks and others; to support SMEs though their growth and development is still low. Inadequate capital for the young entrepreneurs has proved a great challenge, thus SMEs have no option than to go for credit from financial institutions. Credit institutions extend credit based on business information and owners profile and measuring SMEs on accounts statements remains. Measuring SMEs performance in Lira Municipality remains a challenge due to lack of information about their operations.

**Objective of Study**

To examine the role of Credit financing on performance of SMEs in Lira Municipality

**Literature Review**

**Credit Financing**

Accessing to finance is a major factor affecting the growth and success of SMEs. The adequate access to financing is critical to enable SMEs to contribute to the economic development of the nation (Hasnah, Saniza, Jayaraman, & Ishaka, 2013). Credit financing involves the procurement of interest bearing instruments, secured by asset-based collateral and have term structures (Nderitu & Githinji, 2015). The structure could be long-term, short-term or trade credit. To finance working capital, most SMEs rely on internal financing, and or short-term credit from suppliers, and or specialized financial products like factoring. In case of capital expenditures, which normally represent larger amounts than working capital needs, SMEs rely on internal financing, often involving fresh capital injections from shareholders (World Bank, 2014). Long-term funds are not suitable for short-term projects as they burden the firm with costs of servicing unnecessary debt. Similarly, short-term debts are not appropriate for financing long-term projects since the loan may have to be repaid before the end of the project (Ackah & Vuyor, 2011). Although there are many bank and non-bank financial institutions that would be willing to provide funds to SMEs in Lira Municipality, SMEs are not able to meet the requirements of these financial institutions. Chief among these requirements are the high interest rates, creditor information and collateral security.

**Interest Rates**

Banks in developing countries tend to be less exposed to SMEs. Firstly, banks provide lower share of investment loans, and charge higher fees and interest rate (Yeboah *et al*, 2014). Interest can be defined as the premium received by the lender after a stated period. From the borrower's point of view, interest is the cost of capital at the time of obtaining a loan. According to (Agbazo & Omane, 2012), interest rate in the context of demand for credit by the SMEs is the measure of the price paid by a borrower to a lender for use of financial resources for a time interval. Banks believe that lending to SMEs entails higher risks and larger transactions costs (Rafaelita, 2012), thereby justifying their high interest rates (Waithaka & Njeru, 2015). According to (Osoro & Muturi, 2013), many inefficient firms that had been favored by government and getting credit at low rates simply collapsed when the financial sector was liberalized. The high interest rates charged by the formal and semi-formal sectors are high, which crowd the benefits associated to informal sector financing.

**Creditor Information**

The very demanding requirements and bureaucratic lending procedures by the formal financial institutions remain a challenge to credit access by SMEs (Otieno, Muganda, Musiega, & Wekesa, 2015). These bureaucratic lending procedures require that a number of SMEs provide accurate information on their financial status (Otieno *et al*, 2015), which they do not have in most cases. The environment in which SMEs operate is too rudimentary to facilitate documentation. SMEs customers do not ask for receipts whenever they buy goods, suppliers do not ask for invoices, private contracts are rarely documented and requirements for audited accounts are not enforced (Turyahebwa, Sunday, & Ssekajugo, 2013) thus making it difficult to keep and produce information to creditors whenever required. For small businesses, owner characteristics may be the most important determinant of a bank's credit decision, yet most of these characteristics cannot be documented by any database (Kofi, Tanyeh, & Gaeten, 2013). The failure of SMEs to secure credit due to their information opacity manifests in the start-up phase. However, (Abdulaziz M & Worthington, 2013) noted that in the subsequent stages of growth as SMEs mature, they start to establish a track record in addition to the ability to provide collateral. The financing constraint of SMEs is the problem of information asymmetry, since financial institutions perceive SMEs as being more risky compared with large enterprises (Amornkitvikai & Harvie, 2016). Lenders are thus worried about their adverse selection costs and increased risk of moral hazard behavior with SMEs.

**Collateral Security**

Collateral security seems to be the greatest hindrance to financial credit by SMEs. Collateral refers to security or guarantee for the loan borrowed (Hasnah, Saniza, Jayaraman, & Ishaka, 2013). In Uganda for example, the Bank of Uganda stipulates that all loans above a certain minimum must be adequately secured, with first-class guarantees or a bond over property as preferred by the security type (Calice, Chando, & Sekiou, 2012) , which most SMEs do not have. Where the required security does not fit the needs of the target group, potential borrowers will not apply for credit even when it exists and when they do, they will be denied access. Failure of SMEs to meet bank requirements for credit acquisition leaves them open to alternative sources of credit. Abdulaziz & Worthington (2013) pointed out that offering more trade credit to SMEs can assist these firms in their post-entry survival, thereby strengthening their opportunity to thrive. They however, emphasized that bank financing helps SMEs accomplish better performance levels as the borrowed funds are employed more efficiently when they are monitored by, and answerable by the bank. This implies that SMEs are likely to use their own or family funds to start and operate their businesses (Amornkitvikai & Harvie, 2016) and (Waithaka & Njeru, 2015).

**Firm Performance**

Finance and accounting literature evaluate SMEs performance by applying financial ratios such as profitability ratios, liquidity ratios, market ratios, and debt ratios, yet these are just the last performance indicators, as they are in fact, influenced by how firms perform in terms of their efficiency and productivity, and how inputs and product prices change (Amornkitvikai & Harvie, 2016). However, SMEs performance may be measured using objective, subjective and operational measures (Harash, Suhail, & Jabbar, 2014). Financial measures (derived from the accounts of a company) are referred to as objective measures because they can be individually measured and verified. Traditional statement of finance performance, statement of assets and liabilities and management account, are not enough to effectively measure performance of businesses, which are seeking to survive and add shareholder/owner value. Measuring performance in SMEs requires identifying what the business does in terms of levels of processing and attaching key performance indicators to those processes (Madole, 2013). He observed that credit obtained from banks improves business performance in terms of increased business profit, increased employees, increased sales turnover, increased diversification, increased business capital and assets as well as reduction of poverty among customers. In addition, (Chong, 2008) noted that financial measures include profit before tax. According to (Harash, Suhail, & Jabbar, 2014) the non-financial measures of performance of SMEs include employee growth, customer satisfaction, satisfaction with performance of competitors and overall satisfaction. Based on the source of financing, performance of SMEs can be measured in terms of solvability ratio, and coverage of interest (Popa & Ciobanu, 2014).

Availability of finance determines the capacity of an enterprise in terms of choice of technology, access to markets, and access to essential resources, which in turn greatly influences the viability, and success of a business (Mugunchu, 2013). A new business start-up with high growth potential may use grant funding to develop a product before moving onto funding from business angels, venture capitalists or banks once the product is developed (BIS Department for Business Innovation and Skills, 2012). Higher finance development increases new firm entry in sectors, which are heavily dependent upon external finance. Better access to finance leads to higher productivity within an economy. SMEs that do not have access to external funds due to stringent terms that the financiers tend to tie to their credit and investment have impaired capacity building (Madole, 2013). However, short-term loans are not conducive to greater productivity while long-term loans may lead to improvements in productivity (Nderitu & Githinji, 2015).

Profitability is the greatest indicator of performance of SMEs who struggle for survival, on top of proving their credit worthiness and solvability to their financiers. In this study, income and expenses are used to measure profitability. Profitability is the excess of revenue over expenses, which is seen by the ratios like gross profit margin and pre-tax margin (Odongo, 2014). Though profitability ratios are essential in measuring performance, their measurements are rather in most SMEs. This is because most SMEs in developing countries lack proper documentation (Turyahebwa *et al*, 2013). SMEs which survive on loaned capital struggle to cover their debt costs. The more firms cover debt costs using operating capital, the more they experience decreasing levels of profitability (Popa & Ciobanu, 2014). The same study observed that high debt costs reduce the profits earned by shareholders. Profitability measures help in assessing the success of a business undertaking. An undertaking that is not generating profits/revenue can not survive (Bitila, 2014). A profitable undertaking has the capacity to pay back the owners in form of return on investment made.

Solvability ratio measures the credit worthiness of the firm and determines the constraints on cash management and hence decrease profits (Popa & Ciobanu, 2014). Solvency gauges the company's ability to pay all financial obligations if all assets are sold or continue viable operations after financial adversity.

**Methodology**

The study was conducted based on cross section survey design. This design was chosen to ensure that the study accurately described the true nature of existing conditions at that time. The target populations for this study were small and medium enterprises (SMEs) operating in Lira municipality, covering the divisions of Adyel, Ojwina, Central and Railways respectively. These areas were chosen since there had been a lot of growth in credit financing businesses in Lira Municipality. The respondents were drawn from categories of SMEs, which included Metal fabricators, Leisure and hospitality, timber dealers, groceries and general merchandise dealers. Stratified random sampling was conducted to select 120 respondents. The research strategy employed both descriptive and correlations analysis. Self-administered questionnaires were used to enable the respondents have adequate time to respond to the same set of questions in a predetermined order. A 5- point Likert scale ranging from 1-5 where 1 (strongly disagree), 2 (disagree), 3 (not sure), 4 (agree), 5 (Strongly agree) was used to gather data.

## Results and Discussions

### Background Characteristics

Responses by gender indicate that (54.9%) were male while (45.1%) were female. The age composition indicated that majority participants were aged between (30 - 39) years of age, and comprised (58.8%) of the total number of participants. In terms of marital status, most participants (62.7%) claimed to be single, while only (34.3%) revealed to be married, though the type of marriage could not be established. Findings on the nature of business of the participants indicated that (90.2%) operated trade and service related businesses. Most of the businesses (53.9%) were solely owned much as a significant number (31.4%) were in partnership. About (86.3%) of the participants had been in business for not more than eight years.

Table 1. Correlations tests

| | | Credit Financing | Performance |
|---|---|---|---|
| Credit Financing | Pearson Correlation | 1 | .543(**) |
| | Sig. (2-tailed) | | .000 |
| | N | 102 | 102 |
| Performance | Pearson Correlation | .543(**) | 1 |
| | Sig. (2-tailed) | .000 | |
| | N | 102 | 102 |

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

The study indicated a correlation coefficient (r = .543). This implies that an average positive relationship exists between credit financing and performance of SMEs. A (p-vale <.05) shows that the correlation is statistically significant. A variation in the level of credit financing is associated to a moderate variation in the level of performance of SMEs. However, a coefficient of determination of (R Square = .295) seems to suggest that credit financing contributes about (29.5%) of all the possible factors that are likely to account for performance of SMEs in Lira municipality.

Table 2. ANOVA Tests

| Model | | Sum of Squares | df | Mean Square | F | Sig. |
|---|---|---|---|---|---|---|
| 1 | Regression | 10.312 | 1 | 10.312 | 41.708 | .000(a) |
| | Residual | 24.724 | 100 | .247 | | |
| | Total | 35.036 | 101 | | | |

a Predictors: (Constant), Credit Financing
b Dependent Variable: Performance

ANOVA results indicate that sum of regression squares (10.312) is less than sum of residual squares (24.732). A smaller regression sum of squares suggests that the regression model is not adequate to account for variation in performance of SMEs associated to variations in credit financing. However, a (p-value <. 05) indicates that the model is statistically significant. This percentage could account for the rigid procedures held by credit institutions before extending credit to SMEs, which do not favor their accelerated performance.

To determine how credit financing was affecting SMEs in Lira Municipality, a set of indicators were used. Factor analysis was used to identify which credit financing indicators affected SMEs the most. Partial correlations between factor components and indicators were established.

Table 3. Component Matrix

| | Components | | |
|---|---|---|---|
| | 1 | 2 | 3 |
| Affordable interest rates | .689 | | |
| Convenient loan repayment | .643 | | |
| Favorable interest rate | .624 | | |
| Information on financial performance | | .569 | |
| Timely access to loans | | .499 | |
| Access to bigger loans | | .358 | |
| Loan used for intended purpose | | | .402 |
| Credit history | | | .391 |
| Security limits access to loans | | | .353 |

Extraction Method: Principal Component Analysis.
a 6 components extracted.

By considering the indicators with the largest partial correlation load, affordable interest rates (.689), information on financial performance (.569) and using loans for the intended purpose (.402) were as essential conditions for accessing credit. This seems to suggest that credit institutions that provided affordable interest rates and labored to sensitize their clients on the relevancy of financial information and using the acquired loans for the intended purpose registered success in improving performance of SMEs.

The study used a number of factors to assess performance of SMEs in Lira Municipality. Factor analysis was used to identify which indicators featured most among the key outputs of credit financing. Partial correlations between factor components and indicators were established.

Table 4. Rotated Component Matrix (a)

| | Components | | |
|---|---|---|---|
| | 1 | 2 | 3 |
| Essential resources | .781 | | |
| Growth potentials | .741 | | |
| Access to markets | .704 | | |
| Business diversification | | .778 | |
| Access to business | | .721 | |
| Profits | | .591 | |
| Productivity levels | | | .803 |
| Capital base | | | .630 |
| New technology | | | .434 |

Extraction Method: Principal Component Analysis.
Rotation Method: Varimax with Kaiser Normalization.
a Rotation converged in 6 iterations.

By considering those indicators with the largest load, participants pointed out access to essential resources (0.781), increased business diversification (0.778) and increased productivity levels (.803) as key outcomes of credit financing. This seems to suggest that SMEs that had ever borrowed funds were able to access essential resources, which they would use to diversify their businesses with evidence of increased productivity levels.

**Discussion**

The study indicated an average positive relationship between credit financing and performance of SMEs in Lira Municipality. The results support (Madole, 2013) who observed that credit obtained from banks improves business performance in terms of increased business profit, increased sales turnover, increased diversification, increased business capital and assets as well as reduction of poverty among customers. SMEs that do not have access to external funds due to stringent terms that financiers tend to tie to their credit and investment have impaired capacity building. The study indicated that a variation in the level of financing is associated with moderate variation in the level of performance. These findings support (Nderitu & Githinj, 2015) who noted that short-term loans are not conducive to greater productivity while long-term loans may lead to improvements in productivity. Popa & Ciobanu, (2014) observed that high debt costs reduce the profits earned by shareholders. The more firms cover debt costs using operating capital, the more they experience decreasing levels of profitability. Credit institutions that provide affordable interest rates and labor to sensitize their clients on the relevancy of keeping financial information registered success in improving performance of SMES. The statstics are in line with (Turyahebwa *et al*, 2013) who advanced that measuring performance of SMEs in developing countries using profitability ratios is limited by lack of proper documentation.

**Conclusion**

Credit financing is one of the factors responsible for performance of SMEs in Lira Municipality. Extending credit to SMEs enables them to access essential resources, increase business diversification and subsequently increase productivity levels. Credit institutions that have facilitated growth and performance of SMEs provide affordable interest rates; train their clients on the relevancy of keeping financial information and, how to use the acquired loan for the intended purpose.

**Recommendation**

Credit institutions should continue providing credit at affordable rates while endeavoring to train their clients on how to keep financial information, which is essential in assessing the borrower's credit worthiness. This will help SME in growing their business to successful and performing businesses. On the other hand, SMEs should practice documenting their transactions, including information on personal characteristics, as they are essential in assessing the credit worthiness of potential borrowers.

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