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ABSTRACT

Most firms globally are Small and Medium Enterprises (SMEs), which play a significant role in employment creation and global economic development. Despite the role of SMEs in building economic growth in Kenya, they face several challenges. Existing literature indicates that many SMEs fail to expand due to limited financial resources, poor management, outdated technologies, stiff competition from more prominent firms, poor management of account receivables, and unfavourable government policies, among others. Poor access to loans and limited finance are stated as the leading causes limiting the growth of Small and Medium Enterprises. Therefore, this study determined the effect of bank loan financing on the financial performance of SMEs in Mombasa County. The study adopted resource dependency theory. The research design used in the study was descriptive. 109 SMEs in Mombasa County, Kenya, were chosen as the sample size using the stratified sampling technique. The study adopted primary data. To examine the validity and reliability of the questionnaires, pilot research involving 15 SMEs was conducted. The validity of the questionnaire was evaluated using factor analysis, while the reliability was assessed using Cronbach's alpha. With the help of the statistical package for social science (SPSS version 25), descriptive and inferential statistics were used to analyze the data. The hypothesis analysis was tested within the range of 95% level confidence interval and 5% levels of significance.The findings showed that bank loan financing significantly affects SME financial performance indicating that hypothesis H_0 was rejected at the 5% significance. According to the study data, bank loan financing is positively correlated with the financial performance of SMEs in Mombasa County, Kenya. SMEs' financial performance was significantly influenced by bank loan financing. The study recommended that SMEs consider using bank loan financing to improve their performance. The government should implement measures to make it easier for SMEs to access bank loans.

Key Words: *Loan Financing, SMEs, Loan to Value Ratio, Credit Score, Long Term Loan, Short Term Loan*

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INTRODUCTION

The term financial performance can be used as generally proportion of company's financial prosperity through a given period of time (Barasa, 2022). Financial performance implies a company's financial condition over a certain period that comprises the collection and use of funds (Fatihudin, Jusni, & Mochklas, 2018). It is the company's ability to manage and control its resources. It indicates a firm's ability to manage its finances. Firms strategize the improvement of capital structure, growth in revenue, boost of cash flow, and reduction in expenses (Vaidya, 2022). Financial performance is measured using ratios like liquidity, leverage and profitability. Liquidity ratios are those ratios which are computed to evaluate the capability of the entity to meet its short term liabilities (Okelo, 2021). Profitability ratios measure the various aspects of the profitability of a company, such as what is the rate of profit on sales, whether the profits are increasing or decreasing and if decreasing the cause of their decrease. Some important profitability ratios are: gross profit ratio, operating ratio, operating profit ratio, net profit ratio, return on investment, return on equity and return on assets.

SMEs are the backbone of the global economy. They represent 90% of all companies and are responsible for close to 70% of jobs and GDP internationally. Despite their remarkable mutual influence, they are often faced by economic shocks and instabilities in a situation that is not satisfactory for their survival and expansion (Rajah & Woeffray, 2022). The global Covid-19 pandemic, combined with the measures taken in response to it, significantly affected SMEs in the European Union. Two of the most affected sectors were accommodation and food services, in which SME value added dropped by 37.8% and SME employment by 11.1%, whereas transportation and storage experienced decreases of 16.1% and 0.7% respectively (Dir, 2021).

Nigeria's SMEs account for 96% of the total number of businesses in the country as well as contribute about 50% to the national GDP (PwC's, 2020). According to a report by the IFC (2019), the financial performance of SMEs in Nigeria has been declining due to limited access to finance, poor infrastructure, and a challenging regulatory environment. A survey conducted by the NASME (2019) found that 76% of SMEs in Nigeria were experiencing declining sales, while 63% reported declining profits.

SMEs play an important role in Kenya's economy. The significance of small and medium enterprises in driving economic growth in cannot be overstated. Kenya as a country has over 7.6 million recognized SMEs creating part of the largest sector in the business enterprises, amounting to almost 96% of all businesses in the country. It contributes almost 18.4% of Kenya's GDP with an employment rate of 83% of Kenya's workforce (Gatuyu & Kinyua, 2020). They are also a source of innovation, competitiveness, goods and services, and business skills. SMEs cover an extensive range of activities across all sectors of the economy. This comprises manufacturing, service, tourism, building and construction, transport, agriculture, wholesale, and retail, among other sectors (CBK, 2021)

Statement of the Problem

Despite the critical role played by the SME sector in the Kenyan economy in terms of growth and development through creation of employment, contribution to GDP as well as alleviation of poverty, the financial performance of SMEs has continued to decline over the years (Barasa, 2022). In Kenya, about 20% of SMEs fail within their first year, 30% of the SMEs fail before the end of the second year, 50% of the SMEs fail before the end of the fifth year and 70% of the SMEs fail before the end of the tenth year (Job, 2022).According to KNBS (2018) Mombasa County had a total of 113,735 SMEs, which accounted for 4.4% of the total SMEs in Kenya. However, the report also noted that Mombasa County had one of the lowest

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percentages of SMEs that had access to formal credit, with only 14.5% of SMEs in the county reporting having a bank loan.

In addition, a report by KEPSA (2019) found that SMEs in Mombasa County faced numerous challenges, including high taxation, limited access to finance, and competition from imported goods. The survey also found that many SMEs in the county lacked the necessary skills and capacity to compete effectively in local and international markets. Furthermore, a report by the Mombasa County Government (2020) noted that many SMEs in the county had been adversely affected by the COVID-19 pandemic. The report stated that many SMEs had experienced a decline in sales and profitability due to reduced demand, supply chain disruptions, and increased operating costs. The report also noted that SMEs in the county had limited access to finance, which had additionally compounded the challenges they faced.

Despite extensive research on the relationship between debt financing and financial performance, empirical studies have so far yielded conflicting findings (Poursoleyman, Mansourfar, & Abidin, 2023). According to a 2018 study by Deng, there is a link between debt financing and financial performance that is negative but statistically insignificant. According to a study by Okelo (2021), debt financing has a significant impact on the financial performance of SMEs. According to a recent study (Ombongi & Long, 2018), there is a clear link between SMEs' financial performance and the independent variables of labor expenses, bank credit, technology costs, GDP, and growth in the number of SMEs. The research by Mugisha, Omagwa, and Kilika (2020) showed that short-term debt has a negative and significant impact on SMEs' financial performance. (Wambua, 2019), study concluded that debt financing negatively and significantly affect financial performance of SMEs. From the review of the previous studies, the locals have yet to focus on debt financing and the financial performance of SMEs in Mombasa County, Kenya. Hence, this study is required to investigate the effect of debt financing on the financial performance of SMEs in Mombasa County, Kenya.

Objective of the Study

The objective of the study was to assess the effect of bank loan financing on financial performance of SMEs in Mombasa County, Kenya.

The study tested the following hypothesis;

- **H_0:** Bank loan financing has no significant effect on financial performance of SMEs in Mombasa County, Kenya.

LITERATURE REVIEW

Theoretical Review

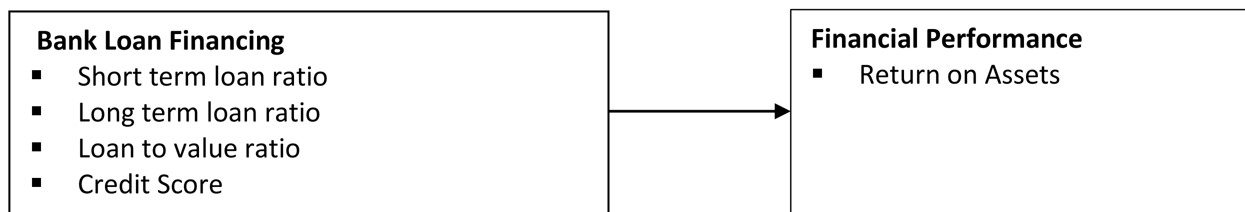
The study was guided by the resource dependency theory.

Resource Dependency Theory

Resource Dependency Theory (RDT) was proposed by (Pfeffer & Salancik, 1978). The theory states that organizations depend on external resources to function and survive. It suggests that organizations have limited resources and cannot internally produce the needed help. Therefore, they must rely on external sources to acquire these resources. The theory assumes that organizations are not self-sufficient; and need resources to operate and survive. Some critics argue that RDT has limited explanatory power. It focuses solely on acquiring resources and does not consider the internal dynamics of organizations or the impact of other factors, such as organizational culture, leadership, or innovation.

This theory is of value to this study as it suggests that SMEs rely on banks for resources such as loans, and the relationship between banks and SMEs is interdependent. Banks require SMEs to provide information about their financial status, which the banks use to evaluate their creditworthiness. The banks also provide SMEs with information about the financial market, which is essential for their survival and growth. The theory supports bank loan financing variables.

Conceptual Framework



Independent Variable **Dependent Variable**

Figure 1: Conceptual Framework

Bank Loan Financing and Financial Performance of SMEs

Bank loan financing is the funds borrowed from private individuals, banks, cooperatives, microfinance institutions, and other lenders to support SMEs' business operations (Dominic, 2019). The funds are borrowed under the terms and conditions of the lending party, and the borrowing SME is usually required to pay back the principal amount plus interest. Bank loan financing is measured by funds usage, sustainability of funds, and the repayment period. Where needed, a lender will safeguard himself by requesting the borrower to provide collateral. The bank's motive for requiring collateral is to gauge whether you think your company is worth the risk you are asking them to take.

Previous studies have revealed that lack of financing is the main hindrance to the growth of SMEs in many countries. SMEs may get additional financial assistance from banks attracting different financial costs that the firm should bear (Okelo, 2021). According to Esubalew and Raghurama (2021), the effect of bank loan finance on the performance of SMEs is similar based on the size that owners should not cease requesting the service. Since SMEs size does not play a moderating role, policymakers, banks, and owner-managers should refrain from formulating a size-specific policy and strategy if enterprises fall under the SME category. Ophelia et al. (2021) Sought to establish the impact of debt financing on the performance of Small and Medium Enterprises in Ghana. The results of the study show that debt-financed loans, both long and short-term, have a negative impact on financial performance. If SMEs are assessed fundamentally to advance their financial performance. This necessitates capacity building in company management and sounds financial record keeping. This should be reflected in reduced loan processing time and borrowing costs.

In many developing countries, obtaining financial services at reasonable rates and fair terms has been a significant challenge for SMEs. Nonetheless, this problem has yet to be paid much attention in Vietnam. Giang, Trung, Yoshida, Xuan, and Que (2019) Study investigate the causal effects of access to finance on the productivity of SMEs operating in the manufacturing sector in Vietnam. The empirical results indicated that firms having access to a bank loan could significantly improve. The pursuit of making financial services accessible to businesses at affordable costs is crucial to the performance of enterprises (Esubalew & Raghurama, 2020). The loan is one of the channels sanctioned by banks with various interest rates depending on the type of loan. Different researchers observed that the amount of loans given to enterprises have a significant effect on enhancing the performance of SMEs.

Measurement of Financial Performance

Measuring enterprises' performance is essential to assessing a firm's continuance and growth capability. Measurement of financial performance also identifies its strengths and weakness (Onyiengo, 2019). It is crucial to comprehend vital

and technical analysis; it is necessary to learn finance to understand the company's financial performance through economics, financial management, and accounting (Fatihudin, Jusni, & Mochklas, 2018). Desired performance measures vary between researchers depending on the objectives and hypothesis of the research. Financial performance is measured using ratios like liquidity, leverage, and profitability. This study used profitability. This is because it is a standard measure of business performance irrespective of enterprise size. In Kenya, Barasa (2022) used non-financial measures to assess the financial performance of SMEs. This study used Return on Asset (ROA) to measure financial performance. ROA is a financial ratio that measures the profitability of an enterprise concerning its total assets. It is calculated by dividing the enterprise's net income by its total assets. The formula for calculating ROA is as follows:

$$\mathbf{ROA} = \frac{\mathbf{Net\ Income}}{\mathbf{Total\ Assets}}$$

Empirical Literature Review

The empirical review presents essential empirical research findings from relevant literature on debt financing and the financial performance of SMEs in Mombasa County, Kenya.

(Aziz & Abbas, 2019), investigated the effect of debt financing on firm performance: a study on the non-financial sector of Pakistan. This study attempted to examine the association of different debt financing on firms' performance in 14 sectors of Pakistan. The time frame of 9 years from 2006 to 2014. The methodology used was panel least square and adopted the Hausman test to select the fixed effect or the random effect modelThe study results indicated that debt financing negatively and significantly impacts firm performance in Pakistan.

(Ophelia et al., 2021), studied the impact of debt financing on the performance of SMEs in Ghana. The study's objectives were to define the effect of short-term loans on SMEs' performance and deter long-term loans on SMEs' performance. The SMEs sample was drawn from the Ghana Stock Exchange (GSE) database of 42 listed companies. 8 SMEs were selected based on their stated capital of at least GHC 300,000. The study focused on information generated about the research problem in 5 years, from 2015-2019. The study hypothesis was tested using multiple regression analysis. The study revealed that debt-financed through both short and long-term has a detrimental impact on SMEs' financial performance.

(Okelo, 2021), the study sought to establish the effect of debt financing on the financial performance of SMEs in Homa Bay Town, Kenya. The targeted population was 825 retail SMEs in Homa Bay Town, with a sample size of 296 SMEs. Primary data was collected using structured and semi-structured questionnaires. The study established a significant effect of debt financing on the financial performance of SMEs in Homa Bay Town.

METHODOLOGY

The study adopted a descriptive research design. Descriptive design are designed to collect primary or secondary data from a sample to analyze them statistically and generalize the results to a population. The merits of descriptive design are that they are accurate means of assessing information about a population, enhance rapid data collection, are efficient, economical, and are less rigid in their application. The study targeted 150 SMEs located in Mombasa County, Kenya. The sampling frame of this study was 150 SMEs across the selected sectors in Mombasa County, Kenya. The study adopted a stratified random sampling technique. The strata were based on the general trade, financial, and commercial services categories. Stratified random sampling allows the researcher to consider the different subgroups of people in the population and helps guarantee that the sample correctly represents the population on precise characteristics. This was achieved by dividing the population into strata. The formulae by Yamane (1973) was used to obtain a representative sample size of 109.

The study adopted primary data. Structured questionnaires were used as the main research instrument for data collection. Data were collected by administering questionnaires with the help of the research assistants. The questionnaires were distributed to the owners of SMEs operating in Mombasa County, Kenya. A total of 15 SMEs from Mtwapa town in Kilifi County were used to provide the pilot data, which were randomly selected.

The data collected was compiled, sorted, edited, classified, and coded. Data were analyzed using the Statistical Package for Social Sciences (SPSS version 25) tool. Descriptive statistics tested were mean, standard deviation, skewness, and kurtosis. Inferential statistics tested included correlation, multiple regression analysis, ANOVA, and hypothesis testing. The coefficient correlation was used to analyze the strength of the relationship between variables. Analysis of Variance (ANOVA) was used to test the significance of the model. R2 was used to measure the extent of the goodness of fit of a regression model. The hypothesis was tested by performing multiple regression analyses to establish the relationship between bank loan financing, trade credit financing, informal financing, and lease financing as the independent variables and financial performance as the dependent variable. The null hypothesis was tested at the 0.05 (5%) significant level. Analyzed data was presented using frequency tables, charts, and graphs to determine each category's response percentage in the variable that included response rate to questions.

Regression analysis helps model the relationship between dependent and independent variables from which a regression equation was drawn.

FINDINGS AND DISCUSSIONS

Bank loan financing forms one of the debt financing tools firms, and SMEs finance their short- and long-term business operations. The study established that a bank loan an SME receives significantly influences their financial performance. These findings were consistent with findings by Giang, Trung, Yoshida, Xuan & Que (2019) in Vietnam. However, the results were variant from studies found by Ophelia et al. (2021) in Ghana, who found a negative impact on financial performance. The SMEs seek good sources of bank loans in terms of interest and repayment period, hoping that the business is profitable to service the loans. It is a risk the lender and lending institution face. The banks ask for collateral to mitigate the effect of chance. The bank's motive for requiring collateral is to gauge whether the SME is worth the risk it asks the bank to take. So debt financing in the form of bank loans provides the SMEs with the financial resources they need to do business and grow.

SUMMARY, CONCLUSIONS AND RECOMENDATIONS

Summary

The study's objective sought to assess the effect of bank loan financing on the financial performance of SMEs in Mombasa County, Kenya. Most indicators for bank loan financing considered were short-term loans, long-term loans, loan-to-value ratios, and credit scores, while a measure of financial performance was profitability. A descriptive statistical method was used to reach the results where most respondents agreed with an average mean score of 3.72 (rounded off to 4) that bank loan financing had a significant positive effect on the financial performance of SMEs in Mombasa County, Kenya. One of the critical implications of these findings is that SMEs that can access bank loans as means of debt financing are associated with superior financial performance than those with contrary access.

Conclusions

The study's objective sought to assess the effect of bank loan financing on the financial performance of SMEs in Mombasa County, Kenya. The evidence supported the hypothesis that bank loan financing has a significant effect on the financial performance of SMEs. This implied that bank loan financing was statistically significant in explaining the effect on the financial performance of SMEs. The ANOVA results indicated a positive correlation between

bank loan financing and the financial performance of SMEs in Mombasa County, Kenya.

Recommendations

On managerial recommendations, the study recommended that SMEs in Mombasa County, Kenya should consider using bank loan financing to improve their financial performance. On policy recommendations in Kenya's Mombasa County, the government should put measures in place to make it easier for SMEs to obtain bank loans.

Recommendations on Further Research

Future research should extend on these findings and investigate possible moderators and mediators of debt financing and financial performance link in SMEs. Future research should consider using both primary as the current one and also use secondary data using the debt ratios of SMEs. The current study covered all SMEs in the county of Mombasa. Building on the current study, future research should narrow the analysis of debt financing to either financial based or commercial based SMEs. A study of this kind is likely to provide a deeper understanding of the sector specific debt financing and financial performance linkage.

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