

# Ascertaining Factors Influencing Debt Financing Access by Small and Medium-Size Enterprises (SMEs): Empirical Studies from Rubaga Division, Kampala in Uganda

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**Abstract:** *Unquestionably, access to finance from financial institutions is essential for the profitability and sustainable growth of the small and medium enterprises sector (SMEs). The purpose of the study was to ascertain the factors influencing access to debt finance by SMEs in Rubaga, Kampala, Uganda with a view to establishing a coherent model directed at improving SME access to debt finance. The study adopted the cross-sectional/correlational design and intrinsically it was hypothesized that age and trading/borrowing experience of the business, collateral and interest rates positively influence access to debt finance by SMEs with the financial life cycle theory used in conceptualizing this relationship. The study used a respondent sample of 130 SMEs operating in Rubaga, Kampala whose owners were the unit of enquiry. The Pearson Rank correlation coefficient and regression analysis were used for data analysis. The findings revealed strong positive correlation between interest rates, collateral requirements for debt acquisition, age/trading experience and the access to debt finance by retail SMEs in Kampala. The correlation coefficients were 0.601, 0.600 and 0.644 respectively. The results also indicated that age/trading experience of the SMEs influences debt finance highly since a unit increase in age and trading/borrowing experience of the business improves debt financing access of SMEs by 0.274 units, which is averagely 0.1 units higher than collateral (0.191) and interest rates (0.177). Correspondingly, in view of the latter observation and the realization that financial needs for small businesses change as they grow and gain experience, the study recommends that financiers need to organize regular and comprehensive financial literacy programmes that target the growth-specific operations of SMEs. Financial literacy programmes about the benefits of asset financing, hire purchase, the importance of financial cards, regular book-keeping and financial statement analysis, among others, would be beneficial in that regard. These programmes should in principle enhance their ability to access debt finance and apply it suitably.*

**Keywords:** Factors; Debt Financing ; Small and Medium-Size Enterprises (SMEs);Rubaga Division ;Kampala ;Uganda ;Access

## 1.1 Introduction

According to Bataa (2008), the role of Small and Medium-size Enterprises (SMEs) in the development process remains at the forefront of policy deliberations in developing countries as in developed countries. Bataa seems to believe that the advantages claimed for SMEs are various, including the encouragement of entrepreneurship; the greater likelihood that SMEs will utilize labour-intensive technologies and thus have an immediate impact on employment generation; they can usually be established rapidly and put into operation to produce quick returns; and that, they may well become a countervailing force against the economic power of larger enterprises. Indeed, Deakins (2008) submitted that the development of SMEs accelerates the achievement of wider socio-economic objectives, including poverty assuagement. Then again, CEEDR (2007) argued that the ability of SMEs to grow depends highly on their potential to invest in restructuring, innovation and qualification; all of which need capital and therefore access to equity or debt finance. Against this background, the unswervingly recurring criticism of SMEs about their problems regarding access to debt finance is a highly relevant constriction that endangers the economic growth of Uganda and other developing countries on the whole.

This study therefore sought to ascertain the factors influencing debt financing as an approach for accelerating the growth and improvement of the profitability of Small and Medium Enterprises in Kampala, with reference to selected retail businesses in Rubaga. Because various factors influencing SMEs' access to debt financing have been advanced by a number of researchers, for this study the researcher considered prime lending rates, collateral requirements and age/trading experience of the business as the factors influencing debt financing while access to debt financing by SMEs was the dependent variable.

## 1.2 Background of the study

### 1.2.1 Historical Background

According to Kira (2013), debt financing by financial institutions is essential for the profitability and sustainable growth of the small and medium enterprises sector (SMEs), nationally and internationally. Indeed, Abdulsaleh (2013) determined that access to debt finance was particularly more important for establishing smaller businesses such as retail businesses, and for the expansion of small businesses into medium-sized enterprises. Abdulsaleh postulated that the growth and development of existing businesses would consequently boost the national economic growth of any country. Certainly, the African Development Bank (2012) established that in the right business atmosphere, SMEs can grow into large firms, changing the game locally, carving their forte globally. ADB suggested that the process starts with supportive administrations that create the right policy environment, and then grows from there. In fact, in India, Andhra Pradesh state authorities first began providing the information technology SME sector with incentives in 1998. Consequently, Andhra Pradesh presently anchors a flourishing futuristic industry whose many SMEs and other players have changed the face of India's fifth-largest state (Abdulsaleh, 2013).

According to data from the World Bank, many of the countries in Sub-Saharan Africa report a high number of SMEs in the economy (World Bank, 2011). The World Bank unfortunately also references that the cost of operating these businesses remains high in general and as such Sub-Saharan Africa is still ranked as the region in the world where it is most difficult to do business. However, the business environment in several African countries has improved substantially over the last decade (World Bank, 2011). Moreover, in many African countries, the retailing activity is distributed widely among a large number of more or less formal SMEs, while, for example, in China, economic activity is to a large extent organized in larger entities, both within manufacturing, agriculture and services (Fjose, 2010). Fjose, however, acknowledges that growth opportunities in Sub-Saharan Africa are severely disadvantaged by access to finance. He therefore counsels that the obvious long-term solution for improved access to finance is policy improvement on areas such as property rights, regulations on bankruptcy and financial market reforms.

In Uganda, in spite of the largely visible SME presence, the potential of the SMEs has not been envisaged fully and this is a distress for all stakeholders in the economy (Kamweru, 2011). Consequently, debt financing, short and long term has become increasingly important in Uganda and beyond as a major strategy in the development agenda for poverty reduction and in the promotion of Small and Medium Enterprises. This process is seen as paramount in amplifying private sector-led growth through supporting the SME sector (Odongo, 2014). African Development Bank (2012) advises that authorities in Uganda need to place more attention on addressing the key financial limitations of SMEs if the sector is to become competitive in the long run.

### 1.2.2 Theoretical background

A number of empirical studies have used the lifecycle theoretical model by Modigliani as cited in Deaton (2005) as their favoured approach to understanding the fiscal behaviour of SMEs (Phelps, 2007; Nofsinger, 2011 and Holzl, 2009). In line with these studies, Fatoki and Asah (2011) observed that SMEs that have been in business for more than five years have a far better chance of being successful in their credit applications compared with SMEs established for less than five years. From the banks' perspective, experienced entrepreneurs are believed to be better performers than less experienced entrepreneurs. It is therefore cogent to factor experience into the process of appraising the solvency of SMEs (Gompers, 2010).

In the same regard, Nofsinger and Wang (2011) advanced that the trading experience of a business is another major factor that explains the difference in debt financing levels available to SMEs; yet Fatoki and Asah (2011) believe that as a business grows its ability to enhance its information and financial management practices simplifies its access to debt finance from financial institutions. Equally, La Rocca (2011) established that access to debt finance mainly in European and American markets is influenced by the positive association between the debt ratio and the asset structure, an association that is greatly enhanced as the firm celebrates more birthdays. Likewise, Fatoki and Asah (2011) proposed that because relatively young SMEs are characterized by a lower portion of tangible assets in their total assets, they are therefore more likely to encounter difficulties in applying for outside finance due to their incapacity to provide the collateral required.

Despite the efforts that have been made to theorize SME financial behaviour in an attempt to conceptualize the diverse financing patterns followed by SMEs at different profitability and growth stages, it appears that different theories suggest different approaches. However, there is general agreement on the effect of SME characteristics and those of entrepreneurs on the financing methods chosen and employed by SMEs at different stages of growth and profitability (Abdulsaleh, 2013).

### 1.2.3 Conceptual background

Debt finance has been recognized in many business surveys as the most important factor determining the survival and growth of small and medium-sized enterprises in both developing and developed countries. According to De la Torre (2009), debt financing is a system of funding in which a company takes delivery of credit [which includes long-term debt (repayable in more than a year) and short-term loans (repayable within a year)] and gives its promise to repay the credit while access to finance is the ease with which SMEs can get credit to undertake fruitful investments to swell their business fortunes and to acquire the latest technologies, thus guaranteeing their competitiveness and that of the nation as a whole. It has also been defined as the non-existence of price and non-price barriers in the use of financial services (Frasch, 2013). On the other hand, Srinivas (2015) defines Small and Medium-size Enterprises (SMEs) as registered businesses with less than 250 employees that contribute heavily to employment and GDP, often have great difficulty accessing financial services in many emerging markets and grow in ways linked to the formalization of an economy. In a study by Atupele (2013), using company level statistics from the World Bank Enterprise Survey, results indicated that firm size and asset structure, access to information and interest rates considerably determined the use of debt financing; while firm age and trading history were moderately decisive in determining the use of debt financing. The results also indicated that there were noteworthy differences in the use of debt financing between small and medium firms, with small and younger firms using less debt compared to medium firms. Correspondingly, Rocha et al (2011) in a study about the status of bank Financing for SMEs in the Middle East and North Africa that was based on a survey of 139 banks in 16 countries established that in spite of a positive perception of the allure of the sector, the SME sector in the region remained mostly underserved. Direct government intermediations through public banks, credit guarantee schemes and other forms of subsidized financing were suggested to play a major role in SME lending, partly recompensing for the low level of private sector involvement, which in turn reflects the MENA's weak financial infrastructure.

In Uganda the SME sector contributes 20% to Gross Domestic Product and it provides employment to over 1.5 million people which accounts for 90% of total non-farming private sector workers (ADB, 2012). The benefits of the small and medium enterprises in the Ugandan economy cannot be overstated. Small and medium enterprises play a substantial role in employment and income generation, producing import substituting options that significantly drive the Ugandan economy. Predictably though, Odongo (2014) exposed impediments like unsatisfactory liquidity, ineffectual financial efficiency of resource utilization, high risk of solvency leading to financial distress and high lending terms of financial institutions as being linearly related to the financial performance of SMEs, with the lending terms contributing to 26.6% loss in revenue of SMEs that borrowed in Uganda, which in turn handicapped their growth efforts. Therefore, this impact study on SME growth and profitability in consequence of debt financing was geared towards establishing whether the access to debt financing bridges the SMEs' growth and profitability gap in Uganda.

#### 1.2.4 Contextual background

SMEs have been recognized as being great contributors to national economies offering both employment and platform for innovative ideas. They form a larger percentage of the businesses that operate in especially developing countries. They are however faced by many constraints that hinder their profitability and, consequently, their growth. One of the main constraints that have been highlighted over the years is the financial constraint. The need for finance is of paramount importance for the success of any firm, be it big or small (IMF, 2007 and 2008). In attempting to gain access to financial services, SMEs continue to face constraints caused by many factors. For instance in Norway, about 60 per cent of small companies (1-20 employees) die within 5 years, although during this period a significant number of the companies grow out of this category, employing between 20 and 100 persons. A very small share, 0.2 per cent, display remarkable profitability and employ more than 100 after 5 years (Fjose, 2010).

In Africa, however, ADB (2012) pointed out that the major challenge facing many developing countries, especially in -Saharan Africa, is coming up with suitable development strategies that will capture the financial services' requirements of Small and Medium Enterprises (SMEs) which constitute about 70 per cent of the business sector in the region. Several studies have established that the commonest influencing factors of debt finance access in Africa are the firms' profiles such as ownership structure; size of the firm; business type; and age of the business (Musamali and Kipkirong, 2013). Others have proposed that interest rates, collateral requirements, sales and the declared strategies for operations, profits, growth and exports also influence SMEs' access to finance (Xiang, Worthington and Higgs, 2011).

In Uganda, although there is a high rate of business start-ups, the country is also among those with the highest number of SMEs that perform poorly and close business before the end of the first year (UIA, 2013; Namatovu et al., 2010). Expectedly, SMEs in Uganda are presently being faced with many serious difficulties such as shortage of capital for expanding and renovating equipment, low productivity and competitiveness, lack of experience in terms of marketing, production management, and financial management (Turyahebwa, 2013). The difficulty of meeting the specified collateral requirements by banks has been cited as a

major cause of these financing problems, coupled with misuse of funds meant to assist SMEs grow into sustainable ventures (Mwangi, 2011). This study was aimed at providing an insight into the debt financing access problem for Ugandan SMEs and how debt financing can be gainfully utilized in facilitating the profitability and growth of SMEs.

## 2.0 Literature Review

### 2.1 Conceptual Review

#### 2.1.1 Small and Medium-size Enterprises

To date there is no commonly acknowledged definition of small and medium enterprises (IFAC, 2011). The definition varies across countries and industries. According to the World Bank, Small and Medium Enterprises are officially defined on the basis of both the number of people employed and the annual turnover of the enterprise (World Bank, 2011). The Ministry of Finance, Planning and Economic Development defines a small enterprise as an enterprise employing a minimum of 5 people and a maximum of 50 people; and/or has an annual sales/revenue turnover of a maximum of Ugandan Shillings 360 million and total assets of a maximum of Ugandan Shillings 360 million, while a medium enterprise is defined as an enterprise employing between 50 and 100 people; and/or has an annual sales/revenue turnover of more than Ugandan Shillings 360 million and total assets of more than Ugandan Shillings 360 million (MoFPED, 2008)

In Uganda, the common terminology for SMEs is small business (Uganda Investment Authority, 2013). The contribution of SMEs to the Ugandan economy cannot be over-emphasized since SMEs contribute over 90% of total non-farm private sector employment; constitute approximately 20% of the national GDP; contribute over 20% of incomes of the labour force; and have great potential for reducing poverty levels (ADB, 2012). Namatovu (2010) observed that the majority of the enterprises are found in restaurants and

food processing, garages for motorcars and motorcycles, retail and wholesale trade, metal fabrication, furniture assembling, schools and transport services.

#### 2.1.2 Role and benefits of SMEs

There is a general consensus that the performance of SMEs is important for both the economic and social development of developing countries (Kira, 2013). From the economic perspective, SMEs provide a number of benefits. SMEs have been noted to be one of the major areas of concern to many policy makers in an attempt to accelerate the rate of growth in low-income countries. These enterprises have been recognized as the engines through which the growth objectives of developing countries can be achieved (Mwangi, 2011). They are potential sources of employment and income in many developing countries and they seem to have advantages over their large-scale competitors in that they are able to adapt more easily to market conditions, given their broadly skilled technologies. Additionally, they are able to withstand adverse economic conditions because of their flexible nature (Maziku, 2012). Moreover, SMEs are more labour-intensive than larger firms and therefore have lower capital costs associated with job creation (Makoni, 2014). Likewise, they perform useful roles in ensuring income stability, growth and employment and since SMEs are labour-intensive, they are more likely to succeed in smaller urban centres and rural areas, where they can contribute to a more even distribution of economic activity in a region and can help to slow the flow of migration to large cities. Also due to their regional dispersion and their labour intensity, it is argued, small-scale production units can promote a more equitable distribution of income than large firms and they improve the efficiency of domestic markets; yet they also make productive use of scarce resources, thus facilitating long-term economic growth (Turyahebwa, 2013).

Still, SMEs contribute to a country's national product by either manufacturing goods of value, or through the provision of services to both consumers and/or other enterprises. This encompasses the provision of products and, to a lesser extent, services to foreign clients, thereby contributing to overall export performance. SMEs also account for about 90% of the formal business entities in Uganda, contributing

80% of GDP and providing about 61% of employment (World Bank, 2011). From an economic perspective, however, enterprises are not just suppliers, but also consumers; this plays an important role if they are able to position themselves in a market with purchasing power: their demand for industrial or consumer goods will stimulate the activity of their suppliers, just as their own activity is stimulated by the demands of their clients. Demand in the form of investment plays a dual role, both from a demand-side (with regard to the suppliers of industrial goods) and on the supply side (through the potential for new production arising from upgraded equipment). In addition, demand is important to the income-generation potential of SMEs and their ability to stimulate the demand for both consumer and capital goods (Odongo, 2014).

#### 2.1.3 Debt Financing of SMEs in Uganda

**Debt financing** is the practice of borrowing funds from outside an organization from such institutions as commercial banks,

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money lenders, micro-finance institutions and SACCOs. It includes long-term debt (loans repayable in more than a year) and short-term loans (loans repayable within a year) (Frasch, 2013). This study was guided by the perceptions of SME owners on banking and micro-finance debt financing accessibility.

#### **2.1.4 Factors that influence debt financing of SMEs**

Financing of SMEs' viable projects have an important implication on sustainability and growth of the SMEs but the factors influencing the access to debt financing to firms are many and complex. For the purpose of this study, the researcher adopted the following factors and is conceptualized as below.

##### **2.1.4.1 Interest rates/ prime lending rates**

Interest Rate also known as the Cost of Finances (COF) is the cost and interest and other charges involved in the borrowing of money to build or purchase assets. Whited (2010) in his contemporary study on rural finance argues that the cost of money is intended to compensate a contractor for the capital cost of employing certain facilities in the performance of contract. The cost of money charged by lending institutions includes operating costs, administrative costs, and an acceptable rate of return. Correspondingly, Odongo (2014) established that cost of money may be fixed for the term of the loan, or adjusted to reflect changing market conditions. Odongo also proposed that the cost of money is looked at on the SMEs' borrowing side as the charges paid for borrowing from financial institutions and mention four main components of cost of money which are reflected as: cost of funds, loan loss expenses, operating expenses, and profits. Financial institutions set their interest rates on the basis of the Central Bank Rate (CBR), which is the rate at which they transact with the central bank. The CBR is in principle determined on the basis of the prevailing macroeconomic conditions and in Uganda; this is done by Bank of Uganda which is the Central Bank of Uganda (Namatovu, 2010).

##### **2.1.4.2 Collateral requirements for debt acquisition**

Bougheas et al. (2005) argue that collateral is an important factor for SMEs in order to access debt finance. Collateral reduces the riskiness of a loan by giving the financial institution a claim on a tangible asset without diminishing its claim on the outstanding debt. Coco (2000) points out that collateral requirements are the lender's second line of defense. Barbosa and Moraes (2004) argue that SME owners-managers that invest heavily in tangible assets tend to have higher financial leverage since they can borrow at lower interest rates if their debt is secured with such assets.

##### **2.1.4.3 Age and the trading/borrowing experience of the business**

According to Villalonga (2004) the age of the firm has implications on financial access and as such the link between age of the firm and growth or profitability has been given attention in the industrial organization literature. For example, Cooley and Quadrini (2001) are of the view that firm growth decreases with firm age while Chandler (2009) believes that age of the firm can affect performance by inducing organizational inertia and by impairing firms' ability to perceive valuable signals. This proposition is limited by the tendency of firms to codify their success with organizational measures, rules of conduct, and processes (Adizes, 2004). The organizational inertia restricts them from recognizing, accepting, and implementing change. Another perspective is given by Chandler (2009) that the longer a firm exists; the more it signals that it can weather tough economic conditions. Furthermore, by staying in business, a firm can signal that it does not adopt opportunistic behaviour. It also signifies that the firm and in particular the owners or managers are mature enough to deal with business challenges. Older firms provide a resume which lenders can use to gauge their credit worthiness. Ngoc et al. (2009) found that it is often difficult and expensive for young SMEs to access debt financing, due in large part to information asymmetry between the banks and firms. Therefore, Bougheas et al. (2005) argue that young firms are more prone to failure than older ones.

##### **2.1.5 Profitability and Growth of Small and Medium Enterprises**

The aim or goal of any firm is to make profits and later grow or expand its operation (Mashene, 2014). The firm size is the result of firm growth over a period of time and it should be noted that firm growth is a process while firm size is a state. The growth of a firm can be determined by supply of capital, labour and appropriate management and opportunities for investments that are profitable (Fjose, 2010). Accessing finance has been identified as a key element for SMEs to succeed in their drive to build productive capacity, to compete, to create jobs and to contribute to poverty alleviation in developing countries. Without finance, SMEs cannot acquire or absorb new technologies nor can they expand to compete in global markets or even strike business linkages with larger firms. The effects of debt financing on the profitability of SMEs need to be understood in terms of business capital and stock growth (ADB, 2012).

#### **2.2 Contextual Review: Factors influencing Debt financing of SMEs**

Researches on the SME sector have attracted attention from researchers, policy makers, and practitioners due to their contributions to economic growth. In spite of the potential it has on economic development and growth the sector is facing a serious challenge arising from lack of financing services. Mashenene (2014) & Kwaning (2015) argue that, traditionally, the focus is on obstacles created by financial institutions or equity funds, or on imperfections in the broader institutional environment. However, Mwangi (2011) claims that SMEs also make decisions about financing and display attitudes that have an important bearing on financing decisions. He adds that constraints may therefore also appear on the demand side of the financing marketplace. The economics literature on enterprise financing has identified some obstacles that may prevent SMEs from obtaining adequate financing. Several studies underscore various obstacles to debt financing, but for the purpose of this study, the factors below are pertinent to our objectives.

### **2.2.1 Cost of debt finance/interest rates and access to debt financing by SMEs**

Zecchini and Ventura (2009) argue that currently, there's widespread agreement that for various financial institutions to operate profitably and sustainably, there's need for them to keep their costs as low as possible by levying proportionate interest rates and fees high enough to cover those costs. However, inability to access finance may be one of the reasons why we do not see a robust correlation between SME prevalence and economic growth, and financial constraints are particularly preventing small firms from reaching their growth potential in terms of financial performance (Wanjohi, 2009). These researchers further avow that although SMEs ought to pursue financial sustainability by whatever means available, financial institutions constrain their efforts by levying high interest rates to cover the costs of their lending and other services.

Rosenberg (2009) together with Zecchini and Ventura (2009), maintain that the interest rates charged to SMEs represent money taken out of clients' pockets, and it is unreasonable if it not only covers the costs of lending. Even the lending/ interest rate that only covers costs and includes no profit can still be unreasonable if the costs are excessively high because of avoidable inefficiencies which in turn results to poor financial performance of SMEs. There is therefore an inverse relationship between lending rates and access to debt finance for business renaissance. In effect, the low lending rate can lead to improved access to debt finance by SMEs, hence improved profitability and growth; while high lending rates constrain SMEs' access to debt finance which makes stagnated performance of SMEs inevitable (Wanjohi, 2009). In Uganda, financial institutions' average lending rates have remained high, averaging between 18% - 26% this has mainly been due to lack of competition in the banking sector. Mashenene (2014) suggests that this is due to a few banks controlling a large market share, high operational inefficiency, high operational costs and the high risk of borrowers (Mashenene, 2014).

### **2.2.2 Collateral requirements and access to debt financing by SMEs**

As the provision of collateral plays an indispensable role in easing SME access to debt finance, SMEs that have more fixed assets tend to utilize higher financial leverage (Nofsinger, 2011). The reason for this is that these firms can borrow at lower cost of debt finance/interest rates as their loans are secured with these assets serving as collateral. This explains why La Rocca (2011) describes collateral as the lender's second line of defense. In his investigation of the role of collateral and personal guarantees using a unique data set from Japan's SME loan market, Fatoki (2011) found that a positive relationship between the use of collateral and the strength of the borrower-lender lending relationship results in easier SME access to debt finance.

A similar conclusion was reached by Odit and Gobardhun (2011) when examining the factors determining the use of financial leverage by SMEs in Mauritius. They concluded that access to debt finance is affected by the positive association between the debt ratio and the asset structure. Furthermore, they revealed that SMEs with a lower portion of tangible assets in their total assets are more likely to encounter difficulties in applying for outside finance because of the inability to provide the collateral required. In fact, when granting loans financial institutions protect themselves with collateral/assets (mostly fixed assets) which are twice or more times the value of the loan. The conventional requirements usually exclude the SMEs because they often lack assets. Many banks, particularly the transnational ones, do not accept collateral that is far from the main urban centres and this presents an undesirable problem for debt finance access by SMEs in developing countries (World Bank, 2011).

### **2.2.3 Age (trading experience) and access to debt finance by SMEs**

With regard to age and experience, as measured by the number of years in an industry, Abdulsaleh (2013) established that experience also enhances the availability of credit. In fact, Nofsinger and Wang (2011) hypothesized that the experience of the entrepreneur is one factor that explains the difference in debt financing levels available to SMEs. The findings of the study proved this hypothesis. They further explained that prior experience in the industry positively correlates with the share of debt financing in the firm and added that the cumulative experience of the owner-manager plays a crucial role in overcoming some of the problems that hinder SME access to debt finance, including information asymmetry and moral hazard. From the lender's perspective, as experienced entrepreneurs are believed to be better performers than less experienced entrepreneurs, it is then rational to factor experience into the process of evaluating the creditworthiness of SMEs (Gompers, 2010).

Kamweru (2011) argues that firms that are younger have no reputation and no established credit history that providers of

external finance can use to evaluate their creditworthiness; as such they are more constrained in the use of external financing. On the other hand, he contends that older firms have a well-established credit history and have built a good reputation with providers of external finance; as such are less constrained in the use of external finance. The reputation and the credit history which older firms establish over the years in doing business reduce the problem of information asymmetry and help the firms to easily access external financing (Frazer, 2005; Petersen and Rajan, 1994; Abor and Biekpe, 2009; Diamond, 1989; Beck et al, 2008; Maurizio et al, 2009).

Owing to lack of business experience of many small owner-managers in the early years of the business, business risk may be more significant than for large firms. Small firms generally have smaller financial reserves to draw on in times of crisis and are also relatively highly geared compared to larger firms due to the difficulty and expense of attracting new equity finance. Thus, such firms are characterized not only by higher business risk but also higher financial distress risk. Banks tend to respond to this risk by adopting a capital-gearing rather than an income-gearing approach to lending. Thus, rather than focusing their attention on evaluating the income streams flowing from an investment project, they may focus more on the value of collateral available in the event of financial distress. This creates a problem for small firms in that they often do not have significant fixed assets to secure on their early years of establishment (World Bank, 2011).

### **3.0 Methodology**

#### **3.1 Research Design**

Sekeran (2009) defines research design as the scheme, outline or plan that is used to generate answers to a research problem. Sekeran also defines it as the master plan specifying the methods and procedures for collecting and analyzing the needed information.

A cross-sectional survey design was used to examine the experiences of the sampled SMEs' proprietors about the factors influencing their access to debt financing and how it affects the profitability of their businesses in the long run. The design was chosen because it enabled the researcher to capture a lot of information in a short period of time. It also allowed for lessened bias within the sampling process, on the same wavelength as Sekeran (2009), who advanced that a cross-sectional survey design may be carried out to obtain information about preferences, attitudes, practice and concerns or interests of a group of people on a given issue and the results extrapolated to the entire population. The cross-sectional survey design was also chosen because it could be used to gather data from a population at a particular time (Sekeran, 2009). For this particular study, the cross-sectional design was used to gather data from selected proprietors and employees of SMEs in Rubaga Sub County.

#### **3.2 Study population**

Sekeran (2009) basically defined population as the universe of units from which the sample is to be selected. The term 'units' is employed because it is not necessarily people alone who are sampled. It can also be defined as the entire group of people, events, or things of interest that the researcher wishes to investigate. According to the Census of Business Establishments in Uganda of 2011, a sampling frame of

454,104 enterprises was identified from the whole country

The study therefore used data that was collected from retail businesses located in Rubaga Sub County in Kampala. The population of retail businesses in Rubaga Sub County is just 10.6% (194 establishments) of those in Kampala (1830) (National Small Business Survey Report, 2015). These SMEs were selected because they are growth-oriented in order to understand the constraints to their access to debt finance.

#### **3.3 Sample Size**

Sekeran (2009) further defines a sample as a subset of the population and adds that it comprises some members selected from the population, i.e. some of the elements of the population form the sample. It is also defined by Amin (2005) as a segment of the population selected for investigation. Rubaga Sub County in Kampala has an estimated population of 194 retail SMEs as established earlier. The study considered any SME proprietor/ employee regardless of age and gender. This was done in order to minimize bias.

Within the population, a sample of 130 enterprises was selected as a representative of the whole population. In addition, 15 loans officers from Foundation for International Community Assistance (FINCA) were scheduled for interviews (selected by convenience sampling) for methodical discernment of the subject matter of the study.

#### **3.4 Sampling Techniques**

*Simple random sampling* is the basic sampling technique where we select a group of subjects (a sample) for study from a population). Each individual was chosen entirely by chance and each member of the population had an equal chance of being included in the sample. Every possible sample of a given size had the same chance of selection as advanced by Biddix (2010). The researcher employed this sampling technique in order to minimize one-sidedness in selecting sampling units for the sample.

*Convenience sampling* involves identifying and selecting individuals or groups of individuals that have been selected from the target population on the basis of their accessibility or convenience to the researcher. This sampling technique was used because of the improbability of availability of the staff from financial institutions. The researcher sought to make use of this technique to interview respondents of convenient accessibility and proximity to the researcher (Smeeton, 2003). This technique was used together with the *Purposive method of sampling* chiefly dictated by the nature of the target group which was aimed at getting specific information from these respondents. A total of 130 respondents from SMEs were requested to fill the questionnaires, while 15 interviews were held with loans officers who were the key informants.

### **3.5 Data Collection Methods**

#### **3.5.1 Key Informants interviews**

An interview guide is a set of questions that the researcher asks during the interview (Vogt, 2007). The researcher designed an interview guide that was used during the interview of the key informants. Questions that were asked in this section were technical and specifically intended to get methodical responses about the research questions which would otherwise not have been properly comprehended by the other respondents. Fifteen interviews were held with loans officers who were the key informants

#### **3.5.2 Questionnaire method**

A questionnaire is a data collection instrument used to gather data over a large sample or number of respondents (Amin, 2005). This structured questionnaire was developed with the aid of suggested guidelines by Sekeran (2009). The first section of the instrument probed for background and demographic data, while the subsequent section delved into the respondents' insights about the study objectives. In each section, the respondents were given clear instructions on how to complete the item. The questionnaire was refined during the piloting of the instrument. A total of 130 questionnaires were sent out and properly monitored to allow for a satisfactory response rate.

### **3.6 Data collection instruments**

Primary data was obtained by the researcher from respondents through interviews, administration of questionnaires. Secondary data was obtained from documented statements. Interviews were conducted among FINCA-selected staff, while the questionnaires were addressed to the enterprises. As regards secondary data, annual reports and other published material were used. These included loan manuals, financial reports, among others, that were relevant to the study.

### **3.7 Pre-testing (Validity and Reliability)**

#### **3.7.1 Validity of instruments**

Validity of an instrument refers to the appropriateness of the instrument to measure what it intends to measure (Amin, 2005). To ensure validity, 5 key informants were requested to do a pretest of the instruments. To ensure greater chances of data validity, the questionnaire was reviewed with the research supervisor for expert input. Approval from the supervisor was obtained who then assented to conducting a field test with the 5 key informants. Several changes were made as appropriate, based on both the field test and expert opinion.

#### **3.7.2 Reliability**

Reliability is defined by Vogt (2007) as the consistency of either measurement or design to give the same conclusions if used at different times. The first step in ensuring reliability was by providing clear operational definitions of the variables under study. Thereafter, internal consistency was measured through internal consistency reliability (Sekeran, 2009) as well as split-half reliability using Cronbach's alpha.

### 3.8 Data Analysis

The researcher performed both quantitative and qualitative data analysis. It involved drawing inductive inferences from data and distinguishing the phenomenon of interest from the statistical fluctuations present in the data as proposed by Amin (2005).

#### 3.8.1 Data processing

Data from the field was sorted, coded and organized in tables. Frequencies and percentages were also presented at this stage.

#### 3.8.2 Qualitative Analysis

Data from key informants was analysed thematically and this involved condensing individual responses into similar themes and integrating them into interview schedule for easy analysis. Stand out respondents' statements, comments or remarks were reported 'as is'. The use of the qualitative design was aimed at giving deeper insights of the issues that were uncovered by the study. Data collected was categorized according to emerging variables from each question in the interview guide and discussions (Smeeton,

2003).

#### 3.8.3 Quantitative Analysis

The quantitative data analysis focused on the examination of numerical values aggregated from the study about which descriptions such as the mean and standard deviations were made. Data collected was checked to ensure accuracy; this was useful in ensuring that the objectives of the study were being addressed (Sekeran, 2009). Analysis was done according to the objectives of the study. Descriptive statistical analysis was found to be an ideal analysis technique and subsequently used in ascertaining the difficulties that SMEs faced in accessing credit/ debt finance. This is because this kind of analysis allows measurement and description of the relationship between two variables (Amin, 2005). Aided by the tabulation of data extracted from a close-ended questions surveyed, it was easier to understand the issues identified by the respondents. Likewise to help answer the question whether or not SMEs have challenges in accessing credit in Kampala as contained in the objectives in chapter one, regression analysis was done and the Pearson's correlation coefficient was computed using the SPSS programme to measure the direction, strength and significance of the relationship between the factors influencing access to debt financing by SMEs.

### 3.9 Ethical Considerations

The objective of ethics in research is to ensure that no one suffers adverse consequences from the research activities (UCLA Centre for Policy research, 2015). The researcher's aim is to ensure that the rights of the respondents are not violated. This was done with the following in mind;

- ✚ No provision for respondents' actual names on questionnaires; ✚
- ✚ Respondents' consent to being included in the study;
- ✚ Communicating of the rationale for the study to the respondents prior to data collection.

## 4.0 Presentation, Analysis and Interpretation of Findings

### 4.1 Response Rates of respondents

A Response rate is the percentage of people who respond to the survey. A low response rate can give rise to sampling bias if the non-response is unequal among the participants regarding exposure and /or outcome. Therefore a response rate of above 50% is considered acceptable (Survey monkey, 2015). In this study, the sample size was 130 retail SMES' proprietors and 15 key informants but the study managed to interview only 88 proprietors and 12 loans officers as shown in the table below.

**Table 1: Response rates to the study**

Category	Sample Size	Actual Response	Percentage
Retail SME owners	130	88	67.7
Loans officers	15	12	80
<b>Total</b>	<b>145</b>	<b>100</b>	<b>69%</b>

Consistent with the above table, out of the 130 questionnaires administered, 88 were returned fully completed, giving rise to a

response rate of 67.7%. Out of 15 respondents targeted for key informants' interviews, only 12 respondents were interviewed, giving rise to a response rate of 80%. The overall response rate of the respondents was thus 69%, which was considerably higher than the 50% rate suggested by Survey monkey (2015).

#### 4.2 Empirical results: Influencing factors of access to debt financing by retail SMEs

Primary data sources were used in this study. Therefore primary data was entirely used in testing the assumed relationships. Primary data was used owing to the fact that they best represented the perceptions of Loans' officers, SME owners and employees. Invariably, perceptions representing challenges to debt finance access identified from the perspectives of retail business owners did not exist in form of secondary data but a generalization for the entire SME sector. Respondents for this study were therefore required to assign a discrete value to a preferred level of agreement (see Table 3). The structured questionnaire was designed to measure four main variables and also to record the perspectives of the key informants. Because of the less formalized nature of their businesses, the research assistant was only required to make appointments with the owners by word of mouth prior to the data collection. A number of them were also available by way of phone contacts, which was their preferred form of interview. Similarly, all employees and key informants were initially informed about the study by an initial visit and through phone contact. Prior to data analysis, completed questionnaires were coded and entered into MS Excel and then SPSS. Data entered were checked for anomalous items such as outliers. Outliers were replaced with the median value.

In this section, descriptive statistics were presented before computing inferential statistics. The descriptive statistics presented were measures of central tendency (median), frequencies and percentages. The median rather than the mean or standard deviation was used to estimate the extent to which a variable was perceived as restrictive to credit access and therefore ensuing profitability. This is because as a general rule, mean and standard deviation are invalid parameters for descriptive statistics whenever data are on ordinal scales, as are any parametric analyses based on the normal distribution. "Nonparametric procedures, based on the rank, median or range, are appropriate for analyzing these data, as are distribution free methods such as tabulations, frequencies, contingency tables and chi-squared statistics" (Elaine and Seaman, 2007).

Table: Unmerged responses about the influencing factors of access to debt financing by retail SMEs

	Variable	strongly agree	agree	neutral	strongly disagree	disagree
	<b>INTEREST RATES</b>	<b>5</b>	<b>4</b>	<b>3</b>	<b>2</b>	<b>1</b>
q1	Interest rates in Uganda are very high	33	49	5	1	0
q2	The loan repayment period impacts access to credit and increases interest	14	53	18	3	0
q3	Fluctuation in interest rates affects access to credit	11	48	17	11	1
q4	Amount of interest paid on loan sways credit access	10	42	12	21	3
q5	Banks set their interest rates on the basis of the Central Bank Rate	9	54	7	12	6
q6	Interest rates should be uniform across banks	15	61	5	6	1
q7	Islamic banking will become more popular than commercial banking	23	50	9	4	2
q8	Islamic banking is better than Commercial banking	27	53	3	3	2
	<b>COLLATERAL/ SECURITY</b>					
c1	Collateral requirements are very stringent	29	56	0	1	2
c2	I have ever been denied credit because of collateral complications	20	44	16	7	1
c3	Collateral should be fronted as one of the main requirements	14	58	7	7	2
c4	Maximum credit accessible is dependent on collateral	14	44	10	18	2
c5	Collateral requirements discouraged my interest in accessing credit	12	57	8	3	8
	<b>AGE OF SME</b>					
a1	My business' age has ever been a contentious issue for credit access	16	48	7	14	3
a2	Poor/ no credit history of the SMEs is a credit access challenge	32	31	14	10	1
a3	Credit history determines credit worthiness	43	31	6	7	1
a4	A firm's financial management experience can determine its credit access	30	25	2	22	9
	<b>PROFITABILITY</b>					
p1	Credit raises asset levels and productivity	29	46	7	6	0

p2	Credit greatly increases sales revenue and profits	34	35	11	6	2
p3	Credit improves market expansion rates	31	34	8	10	5
p4	Credit improves diversification ability and facilitates product development	36	28	12	5	7

Source: Primary data

### Debt financing and its impact on SME growth and Profitability

Table : Summary of responses to assertions of Profitability

Variable	In agreement		neutral		In disagreement		
	Median	Freq	%age	Freq	%age	Freq	%age
<b>PROFITABILITY</b>							
Credit raises asset levels and productivity	5	75	85.2	7	8.0	6	6.8
Credit greatly increases sales revenue and profits	5	69	78.4	11	12.5	8	9.1
Credit improves market expansion rates	4	65	73.9	8	9.1	15	17.0
Credit improves diversification ability and facilitates product development	4	64	72.7	12	13.6	12	13.6

Source: Primary data

The findings stress that as per the majority of the respondents, credit from financial institutions enhances the profitability of their establishments. It is envisaged from the table that on average, over 70% of the traders seemed to believe that credit raises asset levels and sales revenue, ability to expand and facilitates diversification. In particular, an overwhelming majority (85.2%, 75 and 5) were in agreement with the suggestion that credit raises asset levels and productivity while it was 78.4% (69, 5) in support of increased sales revenue as a result of credit financing. Correspondingly, 73.9% (65, 4) and 72.7% (64, 4) were in agreement with the view advanced that credit improves both expansion and diversification ability respectively. These results suggest that accessing credit is considered to be an important factor in augmenting the growth and profitability of Small and Medium Enterprises by retail SME owners. It is thought that credit augments income levels, enhances the ability to expand and diversify production lines and thereby further supplement growth and profitability. Key informants' interviews gave the impression that access to credit enables small business owners to overcome their liquidity constraints and undertake some investments, thereby leading to an increase in production and profitability levels.

### 4.3 Inferential Analysis

In this section, correlation analysis was effected by the computation of the Pearson Rank correlation coefficient while regression analysis was done using ordinary least squares regression method which were collectively robust methods for analyzing the relationship between the two constructs (influencing factors for accessing debt financing by retail SMEs). In this analysis, access to debt financing was the independent variable while factors for debt finance access were the dependent variable

#### 4.3.1 Correlation Analysis: Relationships within the variables

Pearson rank correlation coefficients were computed for the various relationships in order to estimate the strength of the relationships between the constructs. Below are the hypotheses tested and the ensuing results;

##### 4.3.1.1 The Research hypotheses

**H1:** Low cost of debt finance/interest rates significantly boosts access to debt finance by SMEs in Kampala.

**H2:** Inflexible collateral requirements significantly affect access to debt finance by SMEs in Uganda.

**H3:** Age and the trading/ borrowing experience of the business significantly affect access to debt finance by SMEs in Kampala.

Table : Correlations between the independent and dependent variables

Correlations	<i>interestrate</i>	<i>collateral</i>	<i>age</i>	<i>debt finance access</i>
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<i>interestrate</i>	Pearson Correlation	1	.669"	.696"	.601" Sig.
	(2-tailed)		0.000*	0.000*	0.000* N 88
<i>collateral</i>	Pearson Correlation	.669"	1	.645"	.600" Sig.
	(2-tailed)	0.000*		0.000*	0.000* N 88
<i>age</i>	Pearson Correlation	.696"	.645"	1	.644" Sig.
	(2-tailed)	0.000*	0.000*		0.000* N 88
<i>debt finance access</i>	Pearson Correlation	.601"	.600"	.644"	1
	Sig. (2-tailed)	0.000*	0.000*	0.000*	
	N	88	88	88	88

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

Source: SPSS output

Results from the correlation analysis revealed strong positive correlation between low cost of debt finance, inflexible collateral requirements for debt acquisition, age (trading inexperience) and the access to debt finance by retail SMEs. The correlation coefficients between interest rates, collateral requirements, age and debt finance access by retail SMEs were; 0.601, 0.600 and 0.644 respectively. These results indicate good positive correlation between the dependent and independent variables as they were significantly different from 0 since the p values < 0.01. However, all of them contribute differently with age (trading experience) contributing more to debt finance access for profitability improvement. It can therefore be deduced on the basis of these results that although measures taken to improve access to debt finance by SMEs that focus on countering the interest rate effect and amassing credible security are significantly important, it will be the focus on building up air-tight creditworthiness cases, supported by proper trading documentation as the business grows that will ease credit availability for SMEs’ profitability and expansion drives. This also reveals that if access to debt finance is less complicated and adequate in small and medium enterprises there can be an increase in the profitability and growth of SMEs.

**4.3.2 Regression Analysis**

Regression analysis was used to compute the variation shared by the constructs. In effect regression analysis was used to identify how much of the variation the debt financing determinants accounted for in the variation of profitability levels of the SMEs. The researcher did not depend on the predicted unstandardized coefficients owing to uncertainty about the randomness of the data and whether sufficient assumptions had been met to perform prediction. Below are the results;

**Table : Summary of the fitted model**

**Model Summary**

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.699 <sup>a</sup>	.489	.471	.34797

a. Predictors: (Constant), age, collateral, Interest rates

Source: SPSS output

The above results show the model summary of the prediction of access to debt financing by age, collateral and interest rates. Firstly, R represents a strong positive correlation between the two constructs. In this table, the age, collateral and interest rates account for 69.9% of the variation in SMEs’ access to debt financing, reflecting a high effect of age, collateral and interest rates (challenges perceived by SMEs) on access to debt financing. The error term (i.e. other challenges not captured in this study and possibly challenges not common to SMEs and financial institutions) thus account for 30.1% of the total variation.

**Table : ANOVA table**

ANOVA						
Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	9.733	3	3.244	26.795	.000 <sup>a</sup>
	Residual	10.171	84	.121		
	Total	19.904	87			

a. Predictors: (Constant), age, collateral, interest rates

b. Dependent Variable: debt finance access

Source: SPSS output

The above table is an associated ANOVA test. This test is used to verify if the regression analysis is a better way of verifying the linear relationship between the factors and debt financing access by SMEs. This test is done at 5% significance level. From the table, the test is significant,  $F=26.795$ ,  $p < .05$ . This result makes way for interpreting the coefficients table below.

**Table : Coefficients table**

Coefficients						
Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.
		B	Std. Error	Beta		
1	(Constant)	1.264	.290		4.356	.000
	Interest rates	.177	.110	.191	1.613	.041
	collateral	.191	.088	.243	2.176	.032
	age	.274	.089	.355	3.075	.003

a. Dependent Variable: debt finance access

Source: SPSS output

The table above shows the coefficients of the prediction of debt finance access by retail SMEs from business trading experience and age, collateral, interest rates. It can be seen that the interest rates, collateral requirements and age (trading experience) of the business significantly predict debt finance access by SMEs at the 5% significance level [ $t = 1.613$ ,  $p < .05$ ,  $\beta = 0.191$ ], ( $t = 2.176$ ,  $p < .05$ ,  $\beta = 0.243$ ), ( $t = 3.075$ ,  $p < .05$ ,  $\beta = 0.355$ ) respectively]. Moreover, a unit change in interest rates, collateral and age alters the conditional average debt finance access by 0.177, 0.191 and 0.274 respectively.

The regression analysis, therefore, indicates that challenges perceived by SMEs and financial institutions are highly related. In the equation above, the coefficients of business trading experience and age, collateral, interest rates are positive, indicating that improved debt finance access as perceived by SME owners change along with their ability to gainfully recapitalize. If, for instance, SME respondents are not able to provide collateral security in accessing credit facilities, this situation would be perceived by both SMEs and banks as a challenge. Invariably, as this challenge increasingly manifests itself among SMEs, the higher the difficulty to recapitalize for improved profitability.

## 5.0 Discussion, Conclusions and Recommendations

## **5.1 Discussion of Findings**

### **5.1.1 Interest rates and access to debt finance by SMEs**

The study determined that there is a significant positive relationship between interest rates and access to debt finance by SMEs. The interest rates levied by financial institutions to SMEs are high and unfavorable as they significantly increase the cost of borrowing. The respondents were overwhelmingly concerned with access to credit from financial institutions and willingness to pay the interest on the borrowed funds because it was the only alternative source of finance. This view is supported by Rosenberg (2008) who puts forward that SMEs are more concerned about access to financial services from financial institutions than the cost of money because they want to have business growth in making more profits and accumulate assets in the short term. The author established that the global average interest rate was about 35 per cent in 2008, yet the average in Mexico was above 60 per cent and in Sri Lanka it was below 20 per cent. According to Mashene (2015), in a study about SME financing in Tanzania, the author established that, similar to this study, high interest rates encountered by SMEs were regarded as major constraints to accessing credit. These findings imply that high interest rates discourage SMEs from accessing loans from financial institutions as borrowers are oblivious of sustainable repayment measures. However, Brigit et al, (2004) alongside Rosenberg (2008), advanced that borrowing should be an individual obligation for the purpose of meeting all the lender's costs charged on the borrowed funds regardless of the loan size.

### **5.1.2 Collateral requirements and access to debt finance by SMEs**

The researcher established that collateral requirements significantly affect access to credit from financial institutions. A significant positive relationship between collateral and access to debt finance by SMEs was revealed by this study. These findings suggest that a lack of collateral significantly dents any hope of getting a loan from formal lenders. This is a major challenge for small business owners since they largely operate with inadequate asset levels, comprising largely current assets rather than superior fixed assets that would be acceptable to lenders as security for their funds. It is also believed that even when small business owners are able to access credit, personal assets are attached as security. The attachment of private assets is not sustainable because, for instance, the large part of Africa has been experiencing an economic recession. This, coupled with overall macroeconomic instability, limits the ability of small business owners to utilize the borrowed funds profitably. This view was shared by Calice's (2012) findings presented at the Second European Academic Research Conference on Global Business, Economics, Finance and Banking. Calice advanced that in Uganda 50 per cent of the banks cited the lack of adequate guarantees as an obstacle to SME lending. In effect, 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 the preferred security type (Kasekende and Opondo, 2003). However, this makes it difficult for Ugandan banks to lend to SMEs in view of the various challenges that this sector faces in terms of coming up with acceptable security. Calice (2012) further revealed that ninety- four per cent of the banks in that were sampled demanded collateral from their SME borrowers. It was envisaged that collateral requirements for SME loans were higher than for consumer loans, because SMEs' credit risk is usually more difficult to evaluate according to 63 per cent of the banks that Calice surveyed. SMEs were also considered riskier than other segments for a half of the banks surveyed. Moreover, in a separate study, it was advanced that SMEs had to post more collateral because of this risk relative to individual clients. This was according to one third of the banks interviewed by Turyahebwa (2013). The informality of retail SMEs is perhaps the main reason why banks in Uganda require SMEs to lodge security relative to corporate clients. This is attributed to the fact that retail SMEs tend to be more vulnerable to economic and political shocks relative to corporate clients, and this would justify an extra layer of security from an SME borrower.

### **5.1.3 Age/ trading experience of the business and access to debt finance by SMEs**

It was established that age and trading/borrowing experience of the business have a positive significant relationship with access to debt finance, indicating that age and trading/borrowing experience of the business is important in determining access to debt finance and its use for improving profitability and growing the business. For this study, age was used to include the trading experience of the firm. The positive relationship was expected since small firms are likely to seek debt financing in order to sustain or finance their growth and profitability. The study also reveals that availability of trading and credit financial information for the business over its life cycle is important in determining access to debt finance as a tool for improving profitability and growing the business. This reduces the problem of information asymmetry in making financial information available to providers of debt finance and, as such, small firms are able to prove the quality of their projects. At the same time providers of debt finance have access to information at lower costs. This reduces loan administration and operation costs and allows SMEs to gain from the use of debt financing.

However, according to Mwangi (2011), the documentation required in most instances is, to a large extent, akin to that required for large corporations and therefore is considered excessive for retail SMEs. In his study about 'External financing in Eastern

and Southern Africa', Mwangi advances that most of the countries in the region do not have a separate simplified business company registration process for SMEs, which is not any different from the process for larger corporations. This implies that the documentation requirements will prove to be excessively burdensome for SMEs. Overall, 50 per cent of the banks stated that the ability for SMEs to document their credit history and financial performance over their lifetime were a significant obstacle to SME lending. It is, however, envisaged that the researcher's findings along with Mwangi's findings and the financial growth life cycle model (Berger and Udell, 1998) support the inference that small businesses have a financial growth cycle in which financial needs and options change as the business grows, gains further experience, and becomes less opaque with regard to information access. This is modelled in a stylized fashion in which firms lie on a size/ age/ information continuum. In effect, as firms advance along the continuum, they gain access to increased sources of external debt and equity capital.

## **5.2 Conclusions**

### **5.2.1 Interest rates and access to debt finance by SMEs**

The study established that several retail SME owners perceive prime lending rates in Uganda as high with informants suggesting that the very high interest rates/costs of debt finance were justifiable because of the recent economic downturn. However, retail business owners argued that it is because of the economic downturn that they could not afford to borrow at high rates. Additionally, retail SME owners also believed that the amount of time in which a loan has to be repaid affects one's access to credit and availability of capital in the business. Moreover, from the results, Islamic Banking was a preferred form of banking to commercial banking because it does not involve interest rates. It is therefore apparent from this study that accessing credit is considered to be an important factor in swelling the profitability and augmenting the growth of Small and Medium Enterprises, yet the ease with which this is achieved is significantly affected by the high interest/ prime lending rates. Therefore, it is apparent that when lending terms reduce, the financial performance of SMEs should tremendously improve and facilitate expansion and diversification.

### **5.2.2 Collateral requirements for credit acquisition and access to debt finance by SMEs**

This study presupposes that although credit augments income levels and profitability of small businesses, it is only businesses that can easily meet the required collateral that profit from the credit. Collateral requirements have been cited as a major cause of financing problems by several retail SME owners interviewed. A significant positive relationship between collateral needs for debt finance and SME profitability was observed by this study. These findings suggest that a lack of collateral significantly dents any hope of getting a loan from lenders. This is a major challenge for small business owners since they largely operate with inadequate asset levels, comprising largely current assets rather than fixed assets that would be acceptable to lenders as security for their funds. The unavailability of debt finance as an alternative recapitalization tool slows down business profitability and growth.

### **5.2.3 Age/ trading experience of the business and access to debt finance by SMEs**

According to this study, increase in age, trading history and credit experience along with improved information availability ease the business' access to credit. This in effect improves the business' risk-bearing abilities, risk-copying strategies and consumption smoothing over time. The realization that age of the firm has a positive significant relationship with access to debt finance indicates that firm age is a major determinant of making alternative credit capital available to small businesses. This is supported by the realization that age/trading experience of the SMEs influences debt finance access (recapitalization for improving profitability) highly because a unit increase in age/trading experience improves debt finance available for SMEs by 0.274 units which is averagely 0.1 units higher than the collateral and interest rates' effect. The positive relationship also stems from the recognition that small firms seek debt financing in order to sustain or finance their growth and profitability drives. On the basis of these findings, it is imperative for small businesses to document their financial performance as they grow since this information is a basis for accessing credit from financial institutions.

## **5.3 Recommendations**

SMEs, retail or wholesale, are vital to all economies and are a key source of economic growth in advanced industrialized countries as well as in emerging and low-resource economies. They should therefore be able to operate reliably in order to achieve profitability and sustainability in the long run. This study provides the following recommendations to the challenges faced by SMEs in accessing finances from financial institutions:

### **5.3.1 Interest rates and access to debt finance by SMEs**

A necessary condition for the sustainable growth of the SME lending market in Uganda is the presence of a stable macroeconomic environment. The Bank rate which is dependent on the state of the economy is a major determinant of the prime lending rates adopted by financiers at a particular point in time. Bank of Uganda should as a priority strive to counter recession effects regularly. For instance, the government of Uganda needs not create unnecessary militarized standoffs with the public, especially in the capital city as they destabilize the economy of the country. Likewise, there is a need for commercial banks to promote transparency by regularly publishing bank charges and interest rates in the print media, as is done elsewhere in order to improve credit information sharing in Uganda. The banks should not be more interested in maintaining their dominance of certain

market niches rather than sharing information. This is likely to increase competition and thus ultimately reduce interest rates. Lastly, it is ideal for low-income earning SME owners to avoid trade credit since it can lead to high cash outflow of financial resources to the suppliers. However, strong macroeconomic performance and a stable fiscal and monetary framework that is consistent have to be sustained throughout the year.

### 5.3.2 Collateral requirements for debt acquisition and access to debt finance by SMEs

A better understanding of the SME segment and the implementation of measures aimed at addressing some of their intrinsic weaknesses should be a further policy priority. Efficiency of the courts and issues surrounding the definition of collateral, have been listed as important constraints to the development of the SME lending market. Therefore, the Government of Uganda should put in place a comprehensive national land policy to guide land usage and also to streamline land ownership. The current constitutional provisions have not adequately solved the historical conflict between mailo landlords and tenants, which has made tenants unable to use their land as collateral in banks because they have no land titles, the titles are with the mailo landlords who are the owners of the land. Targeted interventions on the relevant legislation might contribute to speeding up enforcement procedures and improve the efficiency of the judiciary. For SMEs, what constitutes acceptable collateral is an important issue. Reforming the legal framework for secured lending and reviewing the regulatory treatment of collateral would facilitate SMEs to pledge a wider share of their assets as a guarantee for their borrowings rather than just fixed assets.

### 5.3.3 Age/ trading experience of the business and access to debt finance by SMEs

The realization that financial needs and options for small businesses change as they grow, gain further experience, and become less opaque in access to information, the study recommends that SMEs should endeavour to prepare and keep proper books of accounts to avoid deficit accounting. Commercial banks and microfinance institutions need to organize regular and comprehensive financial literacy programmes that target the operations of SMEs. Financial literacy programmes about the benefits of asset financing, hire purchase, the importance of financial cards, regular book-keeping and financial statement analysis, among other credit products appropriate for the SME market, would be beneficial in that regard. These programmes should in principle enhance their ability to access debt finance and apply it suitably. Equally, the Government of Uganda should support and strengthen the existing Credit Reference Bureaus which will enable lenders to make informed decisions about borrowers, thereby reducing lending risks, and thus improving access to finance. Finally, the government should explore the possibility of introducing a simplified company registration process, which takes into consideration the peculiarities of especially newly-formed SMEs compared to larger established companies.

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