FINANCING SME GROWTH IN KENYA

JUNE 2016

GrowthCap
Building SME-focused capacity

FSD Kenya
Financial Sector Deepening

Growth Cap
Building SME-focused capacity

Financing SME Growth in Kenya

FSD Kenya
Financial Sector Deepening

The Kenya Financial Sector Deepening (FSD) programme was established in early 2005 to support the development of financial markets in Kenya as a means to stimulate wealth creation and reduce poverty. Working in partnership with the financial services industry, the programme's goal is to expand access to financial services among lower income households and smaller enterprises. It operates as an independent trust under the supervision of professional trustees, KPMG Kenya, with policy guidance from a Programme Investment Committee (PIC). Current funders include the UK's Department for International Development (DFID), the Swedish International Development Agency (SIDA), and the Bill and Melinda Gates Foundation.

Government of Kenya

UKaid from the British people

EMBASSY OF SWEDEN
Nairobi

BILL & MELINDA GATES foundation

Table of contents

Abbreviations

FI	Financial Institution
FSD Kenya	Financial Sector Deepening Trust Kenya
Hallmarks	A publication by David Hall and Dinah Bennett developed from qualitative research conducted in the UK investigating how successful firms grow; on which this research project is based.
SME	Small & medium enterprise or sometimes small business. Both of these terms are used interchangeably throughout this report.

Acknowledgments

The research was undertaken by a team of researchers guided by Dinah Bennett, an international consultant to FSD Kenya, together with Edoardo Totolo, a research economist at FSD Kenya.

First and foremost, thanks to all of the business owners who gave their time freely to participate in this study. Thanks also to the excellent local consultants who conducted the majority of the interviews along with the FSD Kenya associates. The local consultants were:

Isha Kasule, Moeish Consult Ltd

Dr Wanjiru Kibe, Finesse Consulting

Chris Odongo, Wylde International

The FSD Kenya associates were: Grace Mungai, Duncan Oyaro, Michael Njeru, Esther Nyauncho and Sandra Chege.

This summary report was written by Dinah Bennett and Grace Mungai with editing support given by Dr Pat Richardson, an international adviser to GrowthCap.

EXECUTIVE SUMMARY

One of the key reasons why banks are challenged in serving SMEs appropriately, is that they lack an understanding of the evolving needs of fast growing SMEs. In part this is due to the fact that SME growth stories are extremely diverse. In addition, SME success is not always directly measurable in a single company's financial statements.

To help contribute to a better understanding of the relationships between finance, entrepreneurship and growth in the SME segment in Kenya, FSD Kenya undertook an in-depth qualitative case-study based piece of research, with a sample of 18 growing SMEs based in Nairobi.

The research illustrates the heterogeneous nature of entrepreneurship, the varying growth journeys experienced by these 18 entrepreneurs and the complexity of the financial decisions they had during their growth journeys.

In a number of the cases, banks had played an important role in enabling the entrepreneur to achieve business success. Nevertheless, many of those interviewed experienced moments in their development journey where the banks were unable to provide them with the necessary finance, requiring them to look elsewhere for funds and support. The entrepreneurs felt that the banks needed to make changes to improve financing for SMEs. These suggestions are summarised below, together with additional recommendations that the researchers felt came out of the study.

Recommendations for banks

Key recommendations are that the banks need to:

- Appreciate the life-world and preoccupations of the entrepreneur, the needs of the small, growing business as well as the complexities of the growth process and financial dynamics of the SME;
- Understand the small business growth process is 'non-linear', that business success often comes after failures, and that the fast growing nature of the Kenyan economy constantly exposes entrepreneurs to new/evolving challenges;
- Build competencies in understanding the financial dynamics of small businesses;
- Go beyond paying lip service to small business sector and transform transactional banking practices into real relationship banking models;
- Consider adopting new ways to assess the asset base of a small business;
- Undertake more effective segmentation of their small business customer base in order to help develop more effective approaches for dealing with types of SME customers;
- Better understand the practice of multi-banking and address this as it may be contributing to undermining the relationship between an entrepreneur and his/her bank.

Recommendations for SMEs

The research identified a number of areas where entrepreneurs could improve their communication with FIs . In particular, many entrepreneurs need to:

- Know how to approach banks more effectively so that they are able to explain the nature of their businesses, describe their plans and communicate their funding needs more clearly;
- Build the skills and knowledge that will help them better understand the financial dynamics of their businesses. This should help enable them to carry out better financial planning and better appreciate the financial consequences of their actions;
- Consider the negative aspects of practicing multi-banking. This might be seen as a useful way of managing risk and cash flow but can compromise the business' credit history and access to the finance it needs.

Recommendations for further research

Clearly the relationship between small businesses and FIs is complex and evolving. Further research is needed around several issues that emerged from the research:

- The research revealed some interesting aspects around the motivation to set up and grow a business and involvement of the extended family and close friends in this process;
- With regard to the portfolio entrepreneur, there is much to learn about the sub-types and about how the different businesses are used in a synergistic manner to achieve business goals and support the extended family. It would be useful also to understand how it affects the relationship with the formal financial sector.
- The research found a relatively low level use of formal equity capital. It would be interesting to better understand the role of equity investors and the reasons why the stock exchange does not appear to be well used by the SME sector in Kenya;
- The idea of exiting the business by selling it off for a profit does not appear to be practiced in Kenya. It would be helpful to understand the reasons behind this;
- There were insufficient women in the sample to draw conclusions about the extent to which and ways in which gender impacts on business growth. In this respect, it would be useful to extend the study to a larger group of women entrepreneurs;
- The role of intangible assets was another area of interest, especially as it relates to the relational capital of the entrepreneur, i.e. the networks of contacts and the reputation of the entrepreneur in the marketplace.

Section 1

INTRODUCTION

The Kenyan banking sector acknowledges, just as most banking sectors do globally, that there is an information asymmetry when it comes to understanding SMEs. Research[1] has shown that banks have a tendency to treat small and medium enterprises (SMEs) as mini-corporate customers, as a result they don't best serve the needs of these businesses and in doing so lose opportunities to develop new customer relationships. When SMEs find themselves poorly serviced by the financial institutions (FIs), their growth can be restricted; and this in turn may have a negative impact on the national economy.

One of the key reasons why banks are challenged in serving SMEs appropriately, is that they lack an understanding of the evolving needs of fast growing SMEs. In part this is due to the fact that SME growth stories are extremely diverse: for some, success means expanding the portfolio of businesses, for others it means growing the core activity of the business. In addition, SME success is not always directly measurable in a single company's financial statements and in such cases FIs need to look at the owner manager's complete portfolio of businesses and their accounts.

1 For example: FinAccess Business – Supply: Bank Financing of SMEs in Kenya by: Berg, G. et al. FSD Kenya 2015 and SME Banking in Kenya by Oyaro, D. et al FSD Kenya 2016

Furthermore, it is important to note that the Kenyan economy has been evolving at a rapid pace and is set to continue doing so for some time which makes presents a challenging environment to work within.

These factors make it extremely challenging for banks and other FIs to continuously adapt to and accommodate the evolving nature of the demand for financial services from SMEs.

To help contribute to a better understanding of the relationships between finance, entrepreneurship and growth in the SME segment in Kenya, FSD Kenya undertook an in depth qualitative case-study based piece of research with a sample of growing SMEs based in Nairobi.

The research set out to examine: the characteristics and risk propensity of Kenyan entrepreneurs; the drivers of growth among these SME owners, with a particular focus on the financing practices used at different stages of developing their businesses (both debt and equity financing as well as formal and informal practices); and the critical incidents that influenced their trajectories of growth.

An african handicrafts shop in Nairobi: One of the key reasons why banks are challenged in serving SMEs appropriately, is that they lack an understanding of the evolving needs of fast growing SMEs.

Section 2

THE RESEARCH

THE PRINCIPLES

Underpinning the research study is a basic understanding of SME business growth, or the business life cycle (Berger and Udel, 1998). According to this approach every business passes through different critical moments during its life cycle: these moments can be growth opportunities, periods of crisis, or major changes in the structure and\or core activities of the business. Finance is likely to play a key role at these critical times, either as a response to opportunities or as a 'cushion' against difficult moments.

From the start-up phase to maturity, businesses use different combinations of financial instruments, which can include equity finance, debt finance (short-term/long term) as well as 'social' (informal or network-based) finance (friends, family, savings groups, parent or affiliated companies, etc.). However, there is no conceptual framework that definitively identifies links or correlations between a financial instrument and the stage of life cycle. It is still unclear why and when businesses use network-based financial instruments and when they favour formal debt or equity finance. While this decision may depend on the type of investment planned (capital investment, working capital, emergencies, covering losses, etc.) other theories – such as the 'life-cycle theory'– suggest that financing decisions are closely dependent on the age of the businesses, their size and information availability. The life-cycle theory also suggests that financing decisions may change throughout the life-cycle and growth process of the business: insider finance is prevalent in the initial stages of the business; as the business grows, other instruments are used, such as trade-credit, angel investing and venture capital. Public equity tends to become relevant only when the business is relatively mature and has gone through several phases of its life-cycle (Berger and Udel 1998).

Within this context, how to structure the capital of the business is one of the key financial decisions that a business owner must make. Michaelas et al (1998) identify a number of factors that may influence the capital structure. This decision is not only influenced by the characteristics of the business itself. The characteristics of the owner as well as other external characteristics are also important influencers.

More recent research concludes that the reasons behind the decisions to use network-based financial instruments and when to resort to formal debt or equity finance is highly context specific, though some generalisations may be drawn (Mullineux and Murinde, 2014).

In addition, researchers have highlighted differences in the financing patterns of male-owned and female-owned businesses (Coleman, 2000; Brush et al, 2001; and Brush et al, 2004). Women-owned businesses tend to start up with lower levels of overall capitalisation – on average one third of that used by male-owned firms (Carter and Rosa, 1998); lower ratios of debt finance (Haines et al, 1999) and are much less likely to use private equity or venture capital (Greene et al, 1999; Brush et al, 2001). Reasons cited in the research include structural dissimilarities between male-owned and female-owned firms, (inadvertent) gender discrimination on the supply-side, and higher levels of debt aversion among women.

Daivin Motors, an auto and body repair workshop.

THE APPROACH

The research design for the study, adopted followed the seminal 'Hallmarks research' into SME growth undertaken in the UK (Hall, D. and Bennett, D. 2000), which was based on a qualitative approach to investigating how successful firms grow.

The FSD Kenya study looked at the evolution of the business from creation through to its current operations. A critical incident approach was used to identify moments in the businesses' development where particular events gave rise to the need for funds and to establish how this need for funds was solved. This approach provided rich data that highlighted the diversity of small business development and the varied needs for funds. At the same time, the approach made it possible to identify patterns and commonalities among the different cases studied.

The research was undertaken by a team of researchers engaging with 27 businesses, in the first instance, and then working closely with 18 businesses who met the sampling criteria over a 10-month period from late in 2014 through 2015. The criteria were that the businesses had been trading between 3 and 15 years at the time of the research; employed between 10 and 50 people; and were all based in Nairobi.

The 18 businesses selected were drawn from different sectors; they offered a wide range of products and services; and were at different levels of company evolution/sophistication. In this way they provided a small yet varied group that shed light on the banking practices of smaller businesses.

Chapter 3

KEY FINDINGS

As the research was both qualitative and exploratory, the objective was to search for underlying patterns to business growth, rather than generate findings that could be generalised to the entire entrepreneur population. This, together with the Nairobi based sample group studied means that the research cannot be taken as representative of Kenyan entrepreneurs as a whole. Nonetheless, by analysing the stories of these businesses the research has been able to gain insights and raise issues worth further research.

The findings are discussed below under 5 headers:

- Entrepreneurial characteristics and drivers;
- Business practices;
- Growth and critical incidents;
- Sources of finance;
- Entrepreneurs' views of banking.

ENTREPRENEURIAL CHARACTERISTICS AND DRIVERS

One key objective of the research was to understand the characters and drivers of entrepreneurship that lay behind the SME growth stories.

Characteristics

- Among the 18 entrepreneurs there were a range of different personality types, from the almost stereotypical outgoing, larger than life entrepreneur to the more reserved, almost introvert individual. That said, extrovert personalities and strong communicators tended to predominate in the sample. Evidence from the research suggested that the way business is done in a firm tends to reflect the personality of the entrepreneur, and the image of the entrepreneur is an integral part of the business brand.
- While drivers and personalities might differ, the research identified a set of core characteristics among all of the business owners interviewed.
    - **Resilience and innovation.** The business owners demonstrated resilience in the face of adversity, responding to multiple challenges, whether internal or external to their businesses. For example, one owner was defrauded of a substantial sum by his partner with whom he had founded the business. Yet he was able to keep the business growing and subsequently managed to set up two other related businesses
    - **Valuing honesty.** The majority of those interviewed felt that honesty in business is a key factor for success. One entrepreneur was convinced that one of the reasons for his success in business is that he is a man of his word and is known as such. Honesty applies equally when dealing with customers and suppliers alike; with one entrepreneur noting *"If we make a mistake we will always tell the customer (where relevant). Honesty is what people buy."* When discussing the issue of honesty, a number of respondents raised the issue of bribes and other corrupt practices. Several noted that the business which always plays by the rules may find itself losing out to the more unscrupulous competition; be unable to take advantage of certain opportunities; or simply find it more difficult to get certain things done. As one interviewee noted: *" We would be dollar millionaires by now if we weren't honest".* Dishonesty might bring short term gains but for many this was not seen as a respectable nor a sustainable business strategy.
    - **Great capacity to network and build relationships.** All of the business owners interviewed, appeared to be excellent relationship builders and networkers, clearly grounded in their local communities as well as their business communities. These networks not only help the entrepreneurs to get referrals, increase their client base, and link to mentors or potential partners; but they also allow the business owners to build their own reputation. As one entrepreneur noted *"I am a man of many friends."*, with another stating *"networks are net worth."*
    - **Actively engaged in measured risk taking.** In discussing their risk taking propensity, the entrepreneurs in general, appeared to be relatively risk and debt averse as far as financial practices were concerned. Investment in the business was usually incremental, although entrepreneurs supplemented their own funds (or those that they could obtain from soft sources) with bank loans when necessary.

Drivers

- The motivation to start up the first business varied across the 18 entrepreneurs consulted. Many had started their business at a very difficult period in their personal life (loss of a loved one, loss of family breadwinner, deterioration of economic circumstances); others experienced frustration in their current profession or employment; some identified specific opportunities in the market and were driven enough to pursue these; while others were entrepreneurs 'by vocation', in the sense that they had always been determined to set up their own business.
- The 18 businesses studied encompassed three categories[2] of entrepreneurs, based on their background and behaviour with the majority having pursued several businesses, either sequentially or simultaneously.
    - **Single business entrepreneurs** as the term implies, operated a single business and were not involved in any other enterprise. Two (11%) of the entrepreneurs interviewed were running a single business at the time of the research. It is important to note that

2 Based on research carried out by Parker (2014), Plehn-Dujowich (2010) and Westhead et al (2005)

these owners had evolved their businesses over time, adding new product or service lines, targeting new customer segments and in one case transforming their core business. These evolutions reflected changes in the marketplace, better understanding of the market by the entrepreneur as well as greater experience and growing confidence.

- **Serial entrepreneurs** were those continuously entering and exiting new entrepreneurial ventures, but concentrating on a single venture at a given time. Over a third (39%) Some of the entrepreneurs, stated that their current business was not their first business; moreover, many of their original businesses were in different sectors to their current ventures.. Nevertheless, in many instances synergies among the different businesses could be observed. In several cases the entrepreneur had been able to leverage the experience or his/her contacts from the initial business (or from previous employment) in order to develop the second and subsequent ventures.
- **Portfolio/Multiple entrepreneurs** were those pursuing multiple entrepreneurial activities at the same time and this group comprised the half of the 18 entrepreneurs interviewed. It was clear that this category of entrepreneur is highly heterogeneous. Most had two or three businesses although one respondent had a portfolio of seven businesses, including retail, farming and service activities. Many were directly involved in the management of several businesses; others delegated the day-to-day running of the businesses to a manager.

  For some the decision to have several businesses was grounded in the need to manage risks better and for others it was a logical step up or downstream in their supply chain. Some appeared to set up in real estate as part of an asset building strategy, although in part, this seemed to be a response to the banks' requirements for collateral especially when the main business was not based on physical, tangible assets. For others in this group the multiple businesses simply reflected the entrepreneurs' well developed abilities to spot opportunities in the market and take advantage of them.

BUSINESS PRACTICES

Four themes emerged during the discussions about how the entrepreneurs managed their businesses.

- **The role of family involvement in the business.** Although the businesses studied were not described as family businesses as such, nonetheless family members were found to be important to the

Staff taking orders at Naked Pizza, a local fast food outlet in Nairobi.

entrepreneurs. The extended family played an important role in many aspects of the businesses: as shareholders; providers of finance; 'trusted caretakers'; and as a source of labour.

- **People first.** All of the entrepreneurs showed a strong commitment to taking care of those working in their businesses. This commitment took different forms, depending on the business. Some offered training and development opportunities to staff; others put in place structures to reward performance and contribution; for others it was more about showing staff that they were valued. As one entrepreneur noted *"When I am in the office I make a point of shaking the hand of every single member of staff. They are key to our business and must be treated as such."*

  Many of those interviewed adopted an almost paternal attitude and role with their employees with one interviewee stating *"I give staff hope. I speak to them; show that I care. Those who are willing to work hard to make my business a success I support. Two have their own homes which I have built for them."*

  It was interesting to note that several companies said despite taking care of their staff it was not always easy to retain them. One entrepreneur indicated that many of his best employees had used their time at his business as a form of 'training ground', only to leave once they had enough experience to set up their own business

- **Prioritised excellent customer service.** Successful entrepreneurs know their customers, understand customer needs and respond with a strong customer focus in their businesses. This insight into the needs of their customers and the potential for their own businesses in the market place, had enabled a number of the entrepreneurs to diversify their offering for a particular customer target group and/or develop new businesses.

- **Not afraid of competition.** Most, if not all of the businesses, demonstrated a sound understanding of their market and their customer base and alongside this they did not appear to be afraid of competition. If anything, they were positive about competition, seeing it as a driver to innovate. One entrepreneur said that competitors had set up identical companies to his core business and that his website had been copied four times. This had forced him and his team to continually review and update what they were doing in order to stay ahead.

GROWTH AND CRITICAL INCIDENTS

It is important to recognise that the **concept of 'growth'** means very different things to individual entrepreneurs. Some of the owners interviewed expressed the concept of growth firmly in terms of the growth of their business or businesses, i.e. taking a focused enterprise perspective. For others, the concept of growth was interpreted on a more personal level, expressed as generating employment opportunities for family and friends. This latter point was especially clear, when talking with those categorised as 'serial' or 'portfolio' entrepreneurs.

Critical incidents examined situations when the business owners applied his/her enterprise to resolving key situations, using their initiative and often taking a risk. The critical incident approach to the interviews was helpful in isolating those events that had financial implications and those that did not.

Critical incidents requiring recourse to funds included:

- Growth spurts that required additional general working capital to keep pace with a sudden and often unexpected increase in demand;
- The need to invest in the business, in order to finance a planned expansion or a diversification strategy;
- Very short term needs for funds to bridge the gap between spending cash and receiving funds – troughs in the business' cash flow. These needs might refer to gaps of no more than a few hours or days to somewhat longer periods;
- Sudden shocks to the business, generally caused by factors external to the entrepreneur. These included: changes in environmental circumstances, or occasioned by the behaviour of a partner, client or supplier. In one example, an entrepreneur was unfortunate enough to buy pieces of land that were subsequently found not to be owned by the 'seller' in the first instance. In another example, an entrepreneur almost lost his business when his business partner stole a substantial amount of money.
- The need for quick investment in order to react to moves made by competitors. For example, one firm experienced five separate occasions where copycats set up nearly identical businesses, taking everything from his website, with only the business name and contact information changed.

Responding to crisis. Responding to these types of shocks was stressful for the entrepreneurs but they also saw them as learning opportunities. One owner interviewed, almost lost his business, but believes he was able to survive this incident because he had no credit with his international suppliers and little outstanding debt. He derived a great deal of learning from the whole experience, realising that he required to have a more 'hands on approach to the financial aspects' and also to put in place proper management information systems. He felt this also made him more resilient to other business 'shocks' when they inevitably came along.

All of the entrepreneurs interviewed used their support networks extensively, as well as their own initiative, to bounce back and/or to move ahead from these shocks. They also leveraged their assets, compensating for the lack of financial assets with other intangible assets, i.e. their 'social capital' such as their networks, and their reputation. These are also the networks that are called upon in crises. As one owner noted *"I am a dare devil ... I took the risk, had inadequate capital but had very well established networks to support me."*

SOURCES OF FINANCE

The research showed that all of the entrepreneurs interviewed used a wide variety of instruments and sources to cover their need for funds.

Non bank finance

- There was a significant use of informal sources of funding for establishing the initial businesses, ranging from using credit terms from suppliers through to moneylenders and *chamas*[3], from friends and family to the entrepreneurs' own funds.
- In many cases the researchers discerned a form of bootstrapping, where the entrepreneurs remained in employment in order to have a steady source of income while they built the business, often relying on others for the day-to-day management of the business. For example, one business owner set up three unrelated businesses starting in 2001 and only resigned from his full-time employment in 2013.
- From the interviews it seemed that moneylenders were used by businesses at all stages of growth as a 'lender of last resort' and were generally seen as necessary evil. They were predominantly used as bridging loans for short-term needs. As one entrepreneur noted; *"if you need money now or in an hour's time, it's the shylock*[4] *that I would go to. 10% a month is expensive but it's instant – the money is there."*
- Some serial entrepreneurs practiced cross financing through their multiple businesses, using earlier businesses to generate funds to put into a more ambitious business; as well as the practice of reinvesting profits generated in the business. Several said they had set up other cash based businesses to ease cash flow issues on their 'main' business concern. Some had deliberately set up businesses involving real estate so that they would have both income and collateral.

Bank finance

- Most of the entrepreneurs had a very good understanding of the banking system and were capable of managing multiple relationships with banks, choosing among them and selecting the best provider depending on their requirements.
- The practice of multi-banking is prevalent among all of the business owners interviewed, with some working with up to eight banks. That said, often one or two banks were used as core institutions with the others playing a more peripheral role.
- Not all companies were in favour of using more than one bank. Those who did not engage in multi-banking felt that a bank cannot get a full picture of a business if the business uses multiple banks and this weakens the relationship. Furthermore, they considered that the practice of multi banking can create a significant administrative burden on the business because of having to report to more than one financier.
- For many, an important criterion of choice was the speed of response to their requests. Interestingly, response rates were often directly related to the relationship the business owners had with specific individual(s) at their banks. This highlighted once again the importance of networks. When the contact at a bank changed, so often the level of service also changed, leading the business owners to switch banks.
- Many cash based businesses spoke of the benefit of being with a bank that had a wide branch network and cited Equity Bank and Family Bank as examples who 'measure up' on this criterion. The advantage of having access to local branches was both for security as well as cutting down the travelling time incurred with frequent bank visits.

Shareholding /Equity Investment

- The research showed that generally speaking, formal equity financing had played a minor role in the 18 businesses interviewed.
- None of the business owners interviewed were sole shareholders in their businesses. This is explained largely by the fact that having two directors is a mandatory legal requirement for a business to be incorporated in Kenya. It is also a mandatory requirement by some multinational companies for entrepreneurs to become one of their franchisees.
- Shareholders often involve family members, although in many cases the family members are shareholders in name only and do not have an active role in the business. Some of the businesses were jointly owned with friends and former colleagues.
- Only 2 out of the 18 business owners interviewed had formal equity finance in their business and one of these said that they had regretted doing this, stating *"I wish I knew then what I know now about equity finance. I feel as though I have sold my soul."*
- Several entrepreneurs had been approached by private equity investors and had declined their offers for a number of reasons. These included: the entrepreneurs' lack of understanding of what equity finance involved; a feeling that they would lose control of the business; and a feeling that they would not be able to realise the true value of the business if they accepted equity funds at the time. Two of those interviewed were

3 *Chama* is an informal cooperative society that is normally used to pool and invest savings by people in East Africa, and is particularly prevalent in Kenya. *Chamas* were popular among some of the cohort interviewed during this study. Some of the interviewees indicated they were networks based on family or friends. A similar type of informal group is the 'investment club', where entrepreneurs pool money in order to seek investment opportunities.

4 In Kenya, the term "shylock" is used to refer to loan sharks. A loan shark is a person or body that offers loans at extremely high interest rates. The term sometimes refers to illegal activity, but may also refer to predatory lending with extremely high interest rates such as payday or title loans. Loan sharks sometimes enforce repayment by blackmail or threats of violence.

actively considering equity investment at the time of the research.

- The group of SME owners interviewed appeared to have a poor understanding of capital markets and are unaware of the ways in which they can be used to raise funds. Therefore, it was not surprising that many of those interviewed did not know about, or had ever thought about listing on an exchange to raise capital.
- The research found no examples of an entrepreneur who was explicitly building their business in order to 'exit' at a given point in time (cashing out by selling the business). Perhaps this practice is simply not yet seen as a priority amongst entrepreneurs in Kenya or perhaps it may be considered a less attractive option?

ENTREPRENEURS' VIEWS OF THE BANKING SYSTEM

The research provided insight into the owner manager relationship with their bankers, as well as their perceptions of banks and FIs in general. Some of the owner managers in the sample had less than positive experiences with their banks over the years, while others fared much better. The nature of the research meant that it was not possible to generalise, nevertheless, the 18 entrepreneurs provided insights into the issues they faced with their banks and ideally what they would like their banks to provide.

- **Need for more effective ongoing relationship management** Although a number of banks do focus on small businesses and relationship management approaches, in practice, the entrepreneurs felt they were not well understood by or appropriately catered to by the banks. The 'relationship' that the entrepreneurs had with their banks was so often exclusively with front office staff; even where more established relationships with managers existed, these were rarely taken into consideration by other departments, when funds were sought. When funding requests were successful, they were often heavily dependent on a personal relationship, yet this link broke down when the banking professional concerned moved on. This left the entrepreneur with the task of building a new relationship within the bank.
- **Need to understand the small business reality** A number of the entrepreneurs felt that many banking professionals do not understand the reality or 'life-world' of the entrepreneur, often making unwarranted assumptions about the entrepreneur and his/her business (usually negative assumptions). As one entrepreneur stated *"When has a banker ever had to stand in a kiosk and sell eggs?"*
- **Need for better segmentation.** Some of those interviewed felt that it was difficult to get their bank manager to understand the nature of their business. As a result, it was a challenge to get the peculiarities of the business' need for funds across, and as a result they were offered financial products and services that were not entirely suitable for their needs. As one entrepreneur noted: *"One size approach or facility does not fit all – banks often have no understanding of the nuances of different industry sectors and the needs of businesses within each segment ..."*
- **Need to understand how small businesses grow.** Many quotes taken from the interviews centred on the failure of bankers to understand the non-linear growth trajectory of small businesses. The businesses, profiled in this research, did not grow in a consistent and linear manner generally. On the contrary, many experienced periods of stagnation or crisis, even downturns as well as growth spurts. This stop-start nature of growth is a feature of many small businesses in their early years and yet many bankers did not seem to appreciate this. Several entrepreneurs had strong views on this as illustrated by the quotes below.
  - *"Owner managers dream big but banks don't understand them, furthermore they do not understand the core business."*
  - *Banks don't seem to want to grow with the business."*
  - *"Support appears to halt when a business reaches a certain size."*
- **Need to go beyond safe lending practices.** The entrepreneurs were generally frustrated that they were seen as no more than a balance sheet and profit and loss account by the banks. The entrepreneurs interviewed all felt that banks were only interested in physical assets as collateral. They felt banks, in general, don't take into account intangible assets of the business such as reputation and relationship history, tending to opt directly for the personal collateral of the entrepreneur if the business itself does not own tangible assets. This frustration is clearly articulated by one respondent who commented *"They completely disregard my reputational collateral. I had always delivered on projects that the bank had financed. I had a personal account with the bank and each of my businesses held an account with them – yet they would totally disregard all of this when arriving at credit decisions"*

  Entrepreneurs feel that the concept of collateral needs to be extended beyond personal, land or property based assets. This appeared particularly important in the case of the service and technology-based businesses interviewed. As one interviewee noted *"My order book was full but I had no assets as such and the banks wouldn't touch me."* As the digital age has taken hold, the typical configuration of a business's assets has changed, and banks have not been able to respond to this.
- **Need faster reaction times and swift and appropriate feedback.** From the research it is evident that one of the strengths of the entrepreneurs has been their ability to react to changes in the environment, to latch on to opportunities as soon as they spot them, and to respond to them swiftly. If banking decisions and transactions cannot be completed quickly, then opportunities are lost. The entrepreneurs said that they often are not able to rely on their bank to respond quickly to their need for finance and this can cause significant problems.

Section 4

RECOMMENDATIONS

Workers prepare a consigment of drugs and other medical equipment for distribution at Ansell Pharmaceutials, a local SME.

The research set out to examine: the characteristics and risk propensity of Kenyan entrepreneurs; the drivers of growth among these SME owners; and the financing practices used at different stages of developing their businesses.

The findings illustrate the heterogeneous nature of entrepreneurship and the varying growth journeys experienced by these 18 growing smaller businesses in Kenya. The findings also show the complexity of the financial decisions taken by the business owners during their growth journeys and provide insights into how the early experiences of an entrepreneur can influence the decisions he/she makes as their business develops and grows. In a number of the cases, banks had played an important role in enabling the entrepreneur to achieve business success. Nevertheless, many of those interviewed experienced moments in their development journey where the banks were unable to provide them with the necessary finance, requiring them to look elsewhere for funds and support.

The findings, in the way they have been discussed throughout this report have already, *de facto* presented a number of areas where entrepreneurs feel that changes need to take place.

These are reiterated below in summary form alongside a number of other recommendations that the researchers felt came out of the study.

RECOMMENDATIONS FOR BANKS

Key recommendations are that the banks need to:

- Appreciate the life-world and preoccupations of the entrepreneur, the needs of the small, growing business as well as the complexities of the growth process and financial dynamics of the SME;
- Understand the small business growth process and associated complexities. In particular, understand that growth is 'non-linear', that business success often comes after big and small failures, and that the fast growing nature of the Kenyan economy constantly exposes entrepreneurs to new/evolving challenges;
- Build competencies in understanding the financial dynamics of the small business;
- Go beyond paying lip service to the small business sector and transform transactional banking practices into real relationship banking models;
- Consider adopting new ways to assess the asset base of a small business;
- Develop a more appropriate service portfolio which is more in line with the needs of their SME customers;

- Undertake more effective segmentation of their small business customer base. This would be a useful precursor to developing strategies for dealing more effectively with different SME segments;
- Better understand the practice of multi-banking and address this as it may be contributing to undermining the relationship between an entrepreneur and his/her bank.

RECOMMENDATIONS FOR SMES

It is important to bear in mind that one objective of the research was to provide insights that would help improve the mutual understanding between entrepreneurs and banking professionals. Hence the onus is on both parties to improve the effectiveness of the communication between them. Reflecting on this the research identified a number of areas in which entrepreneurs need to improve. In particular, many entrepreneurs need to:

- Know how to approach banks more effectively so that they are able to explain the nature of their businesses, describe their plans and communicate their funding needs more clearly;
- Build the skills and knowledge that will help them better understand the financial dynamics of their businesses. This should help enable them to: carry out better financial planning; better appreciate the financial consequences of their actions; and more clearly communicate their development needs to external stakeholders including the banks;
- Consider the negative aspects of practicing multi-banking. This might be seen as a useful way of managing risk and cash flow but can compromise the business's credit history and access to the finance it needs.

RECOMMENDATIONS FOR FURTHER RESEARCH

Clearly the relationship between small businesses and FIs is complex and evolving as revealed by this research. It is acknowledged that this research was limited in its scope and scale. Never less it has shown the importance of hearing the voice of entrepreneurs, to the task of transforming SME centric financial services in Kenya.

Clearly further research is needed around some of the issues that have arisen in the course of this study. In particular, the following areas are noted for further attention.

- The research revealed some interesting aspects around the motivation to set up and grow a business and involvement of the extended family and close friends in this process.
- With regard to the portfolio entrepreneur, there is much to learn about the sub-types and about how the different businesses are used in a synergistic manner to achieve business goals and support the extended family. Further research into the extent to which this is general practice in Kenya would be useful. It would be useful also, to understand how it affects the relationship with the formal financial sector. For example, does it complement, or even substitute their funding role? Do banks take this portfolio issue into account when they evaluate loan applications? Do the banks see this a riskier business and a way of diversifying funds?
- The relatively low level of use formal equity capital among the businesses interviewed was noted. It would be interesting to study in greater depth the role of equity investors and the reasons why the stock exchange does not appear to be used.
- The idea of exiting the business by selling it off for a profit does not appear to be practiced in Kenya. It would be helpful to understand the reasons behind this.
- There were insufficient women in our sample to draw conclusions about the extent to which and ways in which gender impacts on business growth. In this respect, it would be useful to extend the study to a larger group of women entrepreneurs.
- The role of intangible assets was another area of interest, especially as it relates to the relational capital of the entrepreneur, i.e. the networks of contacts and the reputation of the entrepreneur in the marketplace. This represents another area worth further research.

REFERENCES

Berg, G., Fuchs, M., Ramrattan, R. and Totolo, E. and Central Bank of Kenya. (2015) *FinAccess Business – Supply: Bank Financing of SMEs in Kenya*, Financial Sector Deepening Trust Kenya, Nairobi, Kenya.

Berger, A. N. and Udell, G.F. (1998) *The Economics of Small Business Finance: The Roles of Private Equity and Debt Markets in the Financial Growth Cycle,* Journal of Banking & Finance, 22, 613–73.

Brush, C.G., Carter, N.M., Gatewood, E.J., Greene, P.G., & Hart, M.M. (2001) *The Diana Project: Women business owners and equity capital: The myths dispelled,* Report prepared for the Kauffman Foundation, Kansas City, MO.

Brush, C.G., Carter, N.M., Gatewood, E.J., Greene, P.G., & Hart, M.M. (2004). *Clearing the Hurdles: Women Building High Growth Businesses*. Englewood Cliffs, NJ: Prentice Hall-Financial Times.

Carter, S. and Rosa, P. (1998) *The Financing of Male- and Female-Owned Businesses,* Journal of Entrepreneurship and Regional Development, 10: 225-241.

Coleman, S. (2000) *Access to Capital and Terms of Credit: A Comparison of Men- and Women- Owned Small Businesses,* Journal of Small Business Management, 38 (3):37-52.

Greene, P.G., Brush, C.G., Hart, M.M., and Saparito, P. (1999) *Exploration of the venture capital industry: is gender an issue?,* in P D Reynolds, W D Bygrave, S Manigart, C M Mason, G D Meyer, H J Sapienza and K G Shaver (eds) Frontiers of Entrepreneurship Research, Babson College, Babson Park, MA, pp. 168-181.

Haines, G.H. Orser, B.J. and Riding, A.L. (1999). *Myths and Realities: An Empirical Study of Banks and the Gender of Small Business Clients,* Canadian Journal of Administrative Sciences, 16(4): 291-307.

Hall, D. and Bennett, D. (2000). *The Hallmarks for Successful Business Development*. 2nd ed. UK: Management Books.

Michaelas, N., Chittenden, F. and Poutziouris, P. (1998) *A Model of Capital Structure Decision Making in Small Firms,* Journal of Small Business and Enterprise Development, 5, 246–60

Mullineux, A.W., Murinde, V., (2014) *Financial Sector Policies for Enterprise Development,* Journal Africa Review of Development Finance http://dx.doi.org/10.1016/j.rdf.2014.05.001

Oyaro, D., Richardson, P.A., and Kashangaki, J. (2016) *SME Banking in Kenya* Financial Sector Deepening Trust, Nairobi, Kenya.

Parker, S.C. (2014) *Who become serial and portfolio entrepreneurs?* Journal Small Business Economics, 43 (4), 887-898.

Plehn-Dujowich, J. (2010) *A Theory of Serial Entrepreneurship,* in Journal of Small Business Economics, 35, 377–98

Westhead, P., Deniz, U., Wright, M. and Binks, M. (2005) *Novice, Serial and Portfolio Entrepreneur Behaviour and Contributions,* Journal of Small Business Economics, 25 (109–32.

info@FSD Kenyaenya.org • www.FSD Kenyaenya.org
FSD Kenya is an independent trust established to support the development of inclusive financial markets in Kenya
5th floor, KMA Centre • Junction of Chyulu Road and Mara Road, Upper Hill • PO Box 11353, 00100 Nairobi, Kenya
T +254 (20) 2923000 • **C** +254 (724) 319706, (735) 319706