# Impact of Microfinance on Small and Medium-Sized Enterprises in Nigeria

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**Abstract** The fundamental objective of this study is to assess the impact of Microfinance on Small and Medium Enterprises (SMEs) in Nigeria. Simple random sampling technique was employed in selecting the 100 SMEs that constituted the sample size of the research. Structured questionnaire was designed to facilitate the acquisition of relevant data which was used for analysis. Descriptive statistics which involves simple percentage graphical charts and illustrations was tactically applied in data presentations and analysis. The findings of the study reveal that significant number of the SMEs benefitted from the MFIs loans even though only few of them were capable enough to secure the required amount needed. Interestingly, majority of the SMEs acknowledge positive contributions of MFIs loans towards promoting their market share, product innovation achieving market excellence and the overall economic company competitive advantage. Other than tax incentives and financial supports, it is recommended that Government should try to provide sufficient infrastructural facilities such as electricity, good road network and training institutions to support SMEs in Nigeria.
**Key words** Small and medium enterprises; Microfinance; Loans; Nigeria

## 1 Introduction

This paper intends to contribute to the array of literature written by different scholars on Microfinance and SMEs development. Like other countries of the world, SMEs in Nigeria have the tendency to serve as sources of livelihood to the poor, create employment opportunities, generate income and contribute to economic growth. Despite its increasing roles, access to credit by SMEs remains one major constraint. The major objective of this work therefore is to find out whether SMEs in Nigeria have access to MFIs loans, and to investigate the contributions of these loans to SMEs performance. Using structured questionnaire to source relevant data, descriptive statistics has been applied in analyzing the respondents' views. The finding exhibits significant relationship between the Microfinance loans and SMEs performance in Nigeria. The paper is arranged as follows: The second section reviews literatures by different authors on alternative financial sources available to SMEs and challenges facing SMEs in reaching them. The third and fourth sections describe the methods applied in collecting and analyzing data, while the last two sections represent data presentation and findings, and conclusion respectively.

## 2 Literature Review

SME remains one of the most reviewed topics in literature, especially as its impact on all kind economies cannot be overlooked. World wide, the SMEs have been accepted as the engine of economic growth and for promoting equitable development. The major advantage of the sector is its employment potentials at low capital cost. The labor intensity of the SME constitutes over 90% of total enterprises in most of the economies and is credited with generating the highest rate of employment growth and account for major share of industrial production and exports (Government of India, 2007), and the rapid expansion of small enterprises in economies of developed countries in the 1980s and 1990s has created a widespread conviction that small, new ventures are the most important source of entrepreneurship and as a dynamic and innovative factor, they contribute directly to economic growth. (Piotr and Rekowski, 2008) However, the SMEs sector is faced with many constraints. Among them is the most pressing one known to be financing.

### 2.1 Small and medium enterprises and access to finance

A major barrier to rapid development of the SME sector is a shortage of both debt and equity financing. 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. Small business especially in Africa can rarely meet the conditions set by financial institutions, which see SMEs as a risk because of poor guarantees and lack of information about their ability to repay loans. Without finance, SMEs cannot acquire or absorb new technologies nor can they expand to compete in global markets or even strike business linkages with larger firms (UNCTAD, 2002). Many factors are believed to be responsible for the refusal of loans and equity fund to SMEs by formal banks. According to Cork and Nisxon (2000), poor management and accounting practices are hampering the ability of smaller enterprises to raise finance. This is coupled with the fact that small businesses are mostly owned by individuals whose personal lifestyle may have far reaching effects on the operations and sustainability of such businesses. As a consequence of the ownership structure, some of these businesses are unstable and may not guarantee returns in the long run. According to Kauffmann (2005), access to formal finance is poor because of the high risk of default among SMEs and due to inadequate financial facilities. However, Cressy and Olofsson (1997) sum up constraints facing SMEs into two; these include demand-based (SMEs) and supply-based (formal banks) financial constraints. The duo define a supply-side finance constraint as a capital market imperfection that leads to a socially incorrect supply of funds to projects, or the incorrect interest rate charged on funds. They further define a demand-side financial constraint as a capital market imperfection in which performance of a firm is adversely affected by a factor internal to the firm. Thus for example, if the firm's owners would like to grow the firm faster, but the only way they can do this is to relinquish equity, and they refuse to do so, it may be said that the firm's demand for funds is demand-constrained. These deficiencies shall lead us to exploring other alternative financial sources for SMEs.

**2.2 Alternative sources of financing SMEs in Nigeria**

Although the banking sector is the largest and most important source of external financing for SME, by and large, it is believed to be under-serving the needs of this sector. SMEs alternatively draw financing from a variety of sources. According to OECD (2006), small firms rely proportionally more on non-bank sources of financing such as internal funds (savings, retained earning, family network) and the informal sector (money lender), as a result of their inability to produce the collateral requested by commercial banks (Satta, 2003). The informal sector is the main channel of credit for SMEs in ASEAN countries. According to RAM Consultancy Service (2005), informal sector channel fund up to 70-80 % of SMEs need in Viet Nam compare to 20-30 % funded by formal channel. Also in Cambodia and Lao PDR, family and friends are said to be the main channel of funding because they provide the cheapest funds compared to either banks or money lenders. The latter which are not licensed entities charge exorbitant rate of up to 20% per cent monthly for unsecured loans. In Nigeria, it is common practice in the country for small business owners to organize themselves into cooperatives commonly called "Esusu". Members of an Esusu would generally contribute a fixed amount daily, weekly or monthly, to be pulled and then collected in turns to fund their business or personal projects (Elumilade *et al,* 2006)

**Table 1 Distribution of Collateral Requirement by Types of Financial Institutions in Nigeria**

| Collateral Requirement | Formal (%) | Informal (%) |
|---|---|---|
| Fixed Asset: | 65 | 5 |
| Land | 79 | 3 |
| a) Building | 100 | 9 |
| b) Vehicle | 29 | 27 |
| c) Other equipment Share Certificate | 85 | 4 |
| Guarantors | 3 | 100 |
| Group | 61 | 100 |

Source: Okpukpara, (2009)

According to Ogujiuba *et al* (2004) the predominant credit facility available to small and medium scale business in Nigeria is bank overdraft, and short-term loans (asset based loans). There is scarcely a firm in the world that does not use overdraft facilities to manage its way through business cycles (CGAP, 2006). Banks prefer overdrafts and short term loans for the simple reasons that (i) they are easily rolled over, (ii) they attract almost market interest rates and (iii) they are fully collateralized. Firms always rely on overdraft to finance long- term investments, and these have to be fully collateralized. Moreover, their average interest rates are 23.5percent, similar to short-term bank loans. The difference in the average interest rate on overdraft between the very large firms and the micro firms is over 5 percent. This suggests that the interest rate differential reflects a risk premium and not just high cost of administering small loans (RPED/World Bank, 2002). According to ECA, (2001), even access to this overdraft and short-term loans are highly limited. In the survey carried out in Nigeria by the USAID (2005), approximately 70 percent of respondents utilizing commercial banks overdraft facilities with lower interest rates were required to pledge collateral in form of Land (48%), Building (31%), fixed asset, such as machinery (35%) and other assets (8%).

**Table 2 Sources of Financing: International Comparison**

| Percentage of short term Financing from: | Nigeria 2008 | Brazil 2003 | China 2003 | India 2005 | Indonesia 2003 | Kenya 2007 | S. Africa 2003 |
|---|---|---|---|---|---|---|---|
| Internal Funds/ Retained Earnings | 70% | 44% | 13% | 47% | 38% | 7% | 66% |
| Borrowed from banks and other financial Institutions | 1% | 30% | 27% | 32% | 16% | 7% | 17% |
| Purchases on credit from suppliers and advances from customers | 25% | 15% | 2% | 9% | 4% | 17% | 12% |
| Borrowed from family, friends and other informal sources | 4% | 5% | 8% | 9% | 20% | 3% | 1% |
| Issued new equity/debt | - | 4% | 12% | 2% | 2% | - | 1% |

Source: ICA Survey (2008) via Isern et al (2009)

Trade credit is another source of external finance for most Nigerian SMEs. This is a short-term credit extended to companies by their suppliers, and by companies to their customers. However, this practice is not as widespread as it could be with trade credit being extended to only the most valued and trusted customers due to lack of confident in the legal system to enforce contracts (RPED, World Bank, 2002) . Conversely, trade financing/credit is more popular in the ASEAN (RAM Consultancy Service, 2005) and Japan (Tsuruta, 2010). 10-14 percent of ASEAN financial institution offer trade financing. Berger and Udell (2004), posit that trade credit are suitable for funding informational opaque SMEs and /or in countries with weak lending infrastructure. For instance, Ge and Qiu (2007) show that in China, a country with a relatively poorly developed formal financial sector, firms support their growth through trade credit financing. Fisman and Love (2003) also show that higher rates of industrial growth in countries with weaker financial institutions are associated with greater dependence on trade credit financing. This also affirms the survey conducted by RPED/World Bank, (2002), where 75-80 percent of their respondents in Nigeria reported giving or/ receiving trade credit. Trade credit is a profitable lending technology, with an annual interest rate of about 12-24%, still, one major fear why supplier and companies don't give trade credit to their clients is the distrust for legal and judiciary system.

Globally, leasing is another widely-used service for SMEs, although the lack of leasing law is constraining development of this sector in Nigeria (Isern, 2009). Leasing is a loan on fixed asset (Desai et al, 2007) and it is also known as "ijarah" under the Islamic bank arrangement (Khan, 2008). According to Ahmad (2009), there are two kinds of ijarah contract used by the financial institutions in Australia. The first is the ijarah or true lease, which represents an exchange transaction in which a known benefit arising from a specified asset is made available in return for a payment, but where the ownership of the asset itself is not transferred. While the second type is ijarah wa iqtima (higher purchase or lease and ownership). This is a lease whereby the lessee derived economic use and ultimate ownership on the nature of a higher purchase. Although leasing has a tremendous potential to address effectively the shortage of medium to long-term finance, in particular SMEs in Nigeria, it is however underdeveloped (RPED/World Bank, 2002). This is also the same in China where leasing companies and other non-financial companies‟ total asset account for around 1 percent of all financial sector assets (IFC, 2008). Although leasing can reduce risk effectively for credit institutions, but their growth are majorly hampered by various factors, including the lack of a coherent legal framework for leasing transactions; widespread problems of contract enforcement; difficulties in repossessing lease equipment from defaulters, and a lack of domestic long-term funds to finance leasing.(Isern, 2009 and RPED/World Bank, 2002).

Venture capital (VC) or risk capital is the name given to equity investment in businesses by outsiders who are not the main owners. Venture capital investments participate in the risk of success and failure of a business and because they face such risk, it is expected that they will look for high returns. Venture capitalist nurture enterprise in their early stages, typically when the marketing of the new product is launched UNIDO (1999) In contraction, OECD (2006) posits that venture capitalist often enter the firm at the middle to later stages of its life cycle. In all, venture capital fosters growth in companies through hands-on involvement in financing, management, and technical support. There are many venture capital schemes in many Asian countries. Japan, Korea, Hong Kong, and Singapore are the centers of venture capital activities in the region. About 35% of SMEs in Singapore meet their funding through venture capital. However, the availability of venture capital in other ASEAN countries such as Viet Nam, Cambodia, Loa PDS, and Myanmar are limited (RAM Consultancy Service, 2005). In Africa, there is little experience of venture capital although there has been a start in some countries like Nigeria. In their study, Dagogo and Ollor (2009) examine the use of venture capital (VC) financing for small and medium-scale enterprise (SME) development in Nigeria by comparing the economic value added (EVA) of venture capital-backed SMEs and those of non-venture capital-backed SMEs. They found that VC financed SMEs clearly outperformed non-VC-financed SMEs, and that the distinctive performance is the effect of management support by venture capitalists in their portfolio SMEs. According to USAID findings, most of the owners of the SMEs that were targeted by project of venture capital in Kenya in 1980s had no desire to reduce their debts in exchange for partial ownership of the company, and moreover many companies either were unwilling or did not have the financial documentation needed by venture capitalist to assess realistically the potential for investment (UNIDO, 1999). Berlin (1998) says, venture capitalists take an active role in the management of the firm they fund and work in close collaboration with the stock market to take the firm they fund public. In this case, they place emphasis on the support they offer start-ups and the controls they might be granted as well as the exit strategy available. This exit strategy can be in form of trade sale or a public issue (IPO) (OECD, 2006). Venture capital funds are usually obtained from institutional investors, especially Pension funds, financial intermediaries and the corporate sector as well as official sector. Most venture capitalist can provide large sum of equity finance and also bring a wealth of expertise to a business, and it is easier to secure further funding from other sources if venture capitalist is successfully attracted. However its importance, one problem faced by venture capital is capital gain tax (OECD, 2006). Some firms' owners, apart from refusing to share their company with the venture capitalist, also see the requirements and processing of securing a deal with venture capitalist as long and complex.

Business Angels (BAs) are wealthy individuals who invest in high growth businesses in return for equity (i.e. share of ownership). They are different from venture capitalist in that they tend to invest more on an "intuitive feeling" rather than based on the precise valuation of the term sheet of the company. BAs often play key important roles in the early stages of the life of the firm. They are individuals with experience, who have capital to invest and seek opportunities of all kinds among newer enterprises. They also play active roles in the development of products and management of the company in its early stage (OECD, 2006). Some BAs operate own their own, whereas others do so as part of a network, syndicate or investment club. Senegal and some African countries host business angels but they appear to be very few and information on their operation is hardly available (zavatta, 2008). This is not the same in Canada where business angels played a financing role in more than 200,000 SMEs which is about 15 percent of the 1.36 million SMEs in 2004. The manufacturing, wholesale/retail and knowledge-based sector were covered. Business angels in Canada are more likely than average to invest in SMEs owned by younger people whose age fall at 40 years and businesses that are majority owned by women. Findings also show that firms financed by business angels were likely to be trying to finance fixed assets (62 percent) than working capital (44 percent). This proves that business angels are more likely to be for expansion purposes rather addressing cash fall. Also, firms financed by business angels received debt financing on relatively better terms than other businesses (Riding, 2006). According to other research, business angels are associated with successful entrepreneurial firms that achieve relatively high rates of return (Riding, 2005). Although BAs have enormous impact on SMEs funding, they don't make investment regularly and may not be actively looking for an opportunity, so they may be difficult to find. They tend to place emphasis on their relationship and how well they can work with an entrepreneur, so tracking down one may take longer than expected.

Across developing countries, micro, small and medium enterprises (SMEs) are turning to Microfinance Institutions (MFIs) for an array of financial services; this is because Microfinance is acknowledged as one of the prime strategies to achieve the Millennium Development Goals (MDGs) which are: poverty and hunger reduction, universal primary education, reduction of child mortality, combating diseases, malaria and environmental sustainability (Mahjabeen, 2008). The reason is because access to sustainable financial services enables owners of micro enterprises to finance income, build assets, and reduce their vulnerability to external shocks (Ehigiamusoe, 2005). The primary objective of microfinance institutions (MFIs) is to provide financial services (credit and savings) to the poor in order to release financial constraints and help alleviate poverty (Godquin, 2004). According to (Kevan and Wydick, 2001), the provision of credit to the poor serves two purposes. First, as borrowed capital is invested in small enterprises, it often results in significant short-term increase in household expenditure and welfare. Secondly, microenterprises credit spurs economic growth in the informal sector through fostering increase capitalization of business, employment creation, and long-term income growth. This study attempts to examine and assess the role of microfinance institutions (MFIs) on SMEs performance in Nigeria. The specific objectives of the study were to:

(1) To find out whether SMEs are able to access capital loans from MFIs

(2) To find out if the capital loans provided by MFIs are effectively utilized by the SMEs

(3) To investigate whether microfinance loans to SMEs actually lead to high competiveness

(4) To investigate if SMEs with the help of the loans obtained form Microfinance achieved significant product level.

## 3 Methodology

The research is descriptive in nature and employs the survey method in assessing the impact of MFIs on SMEs development in Nigeria. In order to effectively conduct a valid analysis in the presentation and analysis of the data collected on the research field, the researcher used descriptive statistics such as tables and charts to depict the relevant data. The study utilizes primary sources of data in which structured questionnaire were extensively used. The purpose is to generate data about the opinion and perceptions of SMEs owners in relation to the effectiveness of MFIs loans to the performance of their companies. Thus, in addition provides means of analyzing the likely impact of Microfinance loans on SMEs. To constitute sample size out of the population of the study, simple random sampling technique was used to select 100 Small and Medium Enterprises operators in Nigeria. All the companies were served with questionnaire even though only 60 were retrieved which represents 60% of all the questionnaires served. The concept of simple random procedure allows unbiased sampling and accords the research work more scientific feature, thereby concretizing the validity of the research findings.

## 4 Data and Findings

### 4.1 Accessibility to MFIs loans

Access to loans is one of the major problems facing SMEs in Nigeria. The idea of creating MFIs is to provide an easy accessibility to SMEs particularly those who cannot access formal banks loans. Figure 4-1 below indicates the respondents' opinion about their accessibility to MFIs loans.

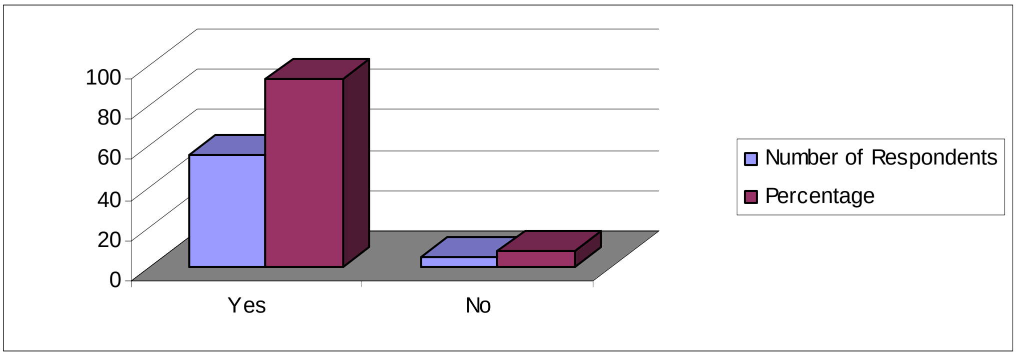


**Figure 1 SMEs Accessibility to MFIs Loans**

In Figure 1, to determine SMEs accessibility to MFIs loans, this question was asked "sourcing capital is one of the major problems facing SMEs in Nigeria, does your company have any access to MFIs loans?" and the result depicts that 55 of the respondents which represents 92% claim they have an access to MFIs, and 5 respondents which represents 8%, a minute and insignificant number of the respondents disclosed that they have no access to MFIs loans. What this implies is that the federal government of Nigeria's efforts through its central banks (CBN) in 2005 to issue a microfinance policy i.e. the Regulatory and supervisory Framework, whereby licenses of operation were issued out to over eight hundred microfinance banks was a right decision. Moreover, most of the community banks which used to operate only within their local environment were required to raise their capital base and operate as microfinance within their states and interstate, thereby given them the opportunity to reach more SMEs. Also, many SMEs were able to approach MFIs for finance because MFIs do not request collateral before they issue out loans to the SMEs.

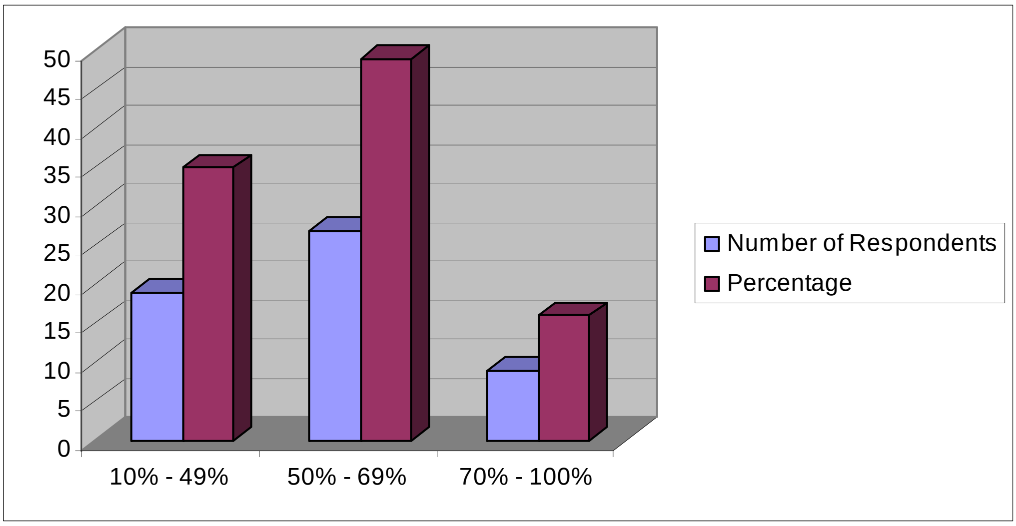


**Figure 2 Percentage Level of SMEs Goals Achievement Using MFIs Loans**

To measure the percentage level of SMEs goals achievement using MFIs loans, this question was asked "What percentage level of goal achievement did your company derived from the loans obtained from MFIs?" Figure 2 presents the articulated assertion of the 55 respondents in which 16% of them claim that they record 70-100 percent goal achievement using loans granted them by MFIs. 49% which represents almost half of the respondents believe they achieve more than half of their goals, which are 50-69 percent using MFIs loans. 35% of the respondents believe they only met 10-49 percent of their targeted goals. This implies that some SMEs could not effectively meet their goals virtually because the loans given to them by MFIs were not sufficient enough to achieve the targeted results.

**4.2 MFIs and competition**

For SMEs to survive in Nigeria there is a need to achieve a substantial market share. Moreover, for them to gain a portion of the market, competitions have to take place between them and other companies. Figures 4-3, 4-4, and 4-5 below indicate respondents' opinion about MFIs loans impact on SMEs ability to compete and secure market share.

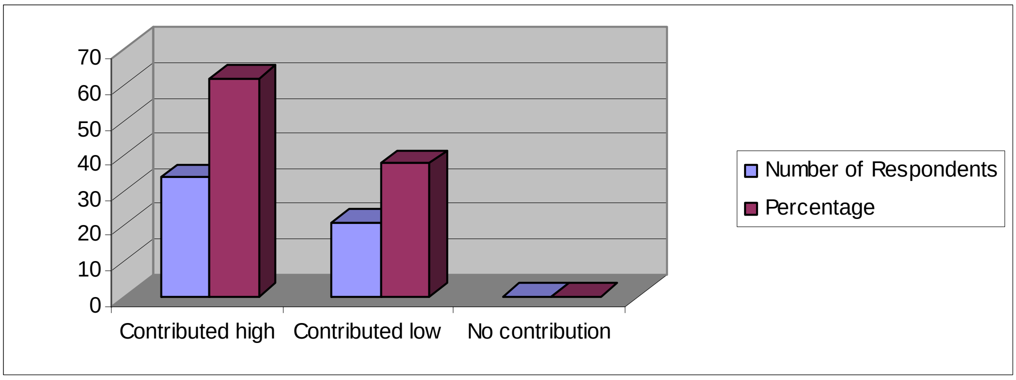


**Figure 3 MFIs Contributions toward SMEs Sales and Marketing Activities**

Figure 3 depicts the opinions of the respondents about the MFIs contribution to SMEs sales and marketing. The question asked was "Has the loan secured from the MFI contributed to the sales and marketing activities of your company?" In their view, 62% of the respondents assert that MFIs loans contribute high to their sales and marketing and 38% posit that these loans contribute low. However, none of the respondents claim that MFIs loans did not contribute at all to their sales and marketing activities. This implies that access to MFIs loans have contributed to SMEs, no matter how little.

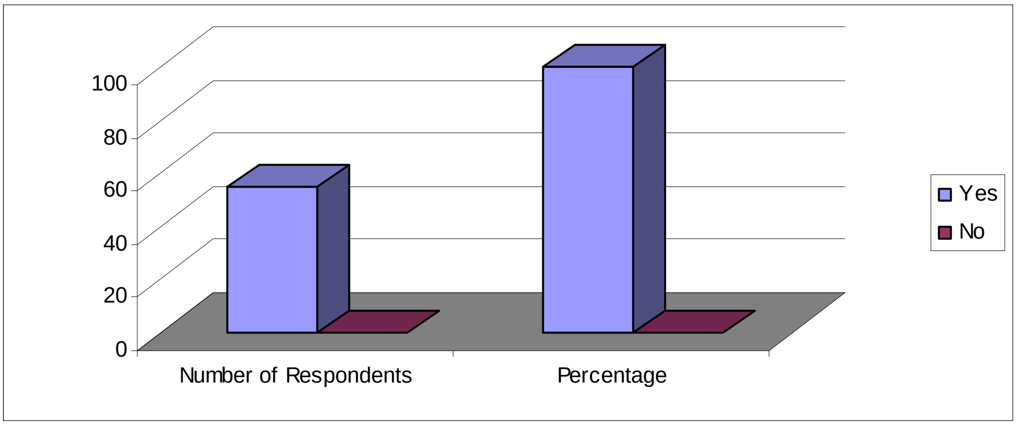


**Figure 4 MFIs Contributions towards SMEs Market Share**

In Figure 4, which indicate MFIs contributions towards SMEs market share, the question that was asked was "Does the loan actually help your company to standardize your product/service to the extent that you achieved substantial market share?" All the respondents agree that MFIs loans contribute to their market share.

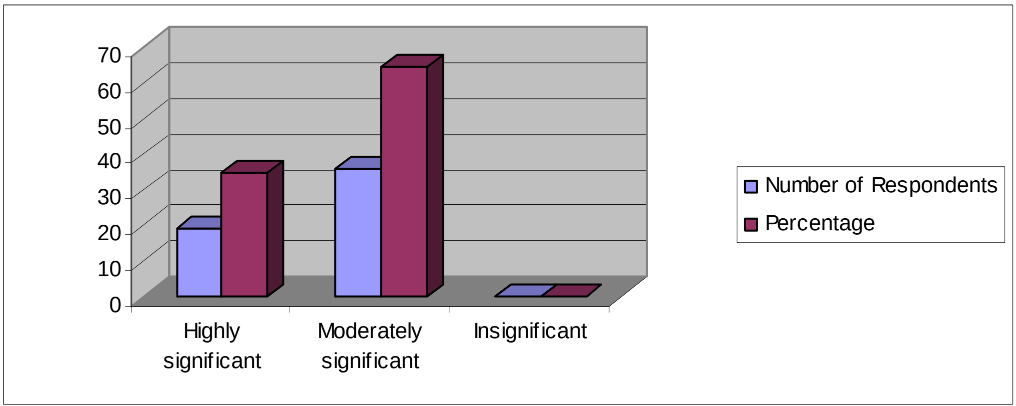


**Figure 5 MFIs Loans to SMEs Competition**

In Figure 5, the question raised was "Competition generally requires the need to exploit financial resources; to what significant level does the MFI contribute to the overall competitiveness of your company?" 35% of the respondents who have access to the loans believe that MFIs loans contribute to their companies' competition at a highly significant level. 65% of the respondents believe that the loans granted to them contribute at a moderate significant level to their competition. None of the respondents claim that MFIs loans do not contribute to their competition. This ascertains respondents' opinions in Figure 4-4 that MFIs loans contribute to their market share.

## 5 Conclusion

This study attempts to empirically ascertain the effect of MFIs on SMEs. Positive and significant relationship has been established between MFIs loans and SMEs performance. The study confirms the positive contributions of MFIs loans towards promoting SMEs market share, production efficiencies and competitiveness. Although MFIs in Nigeria are faced with insufficient funds problems which militate against their efforts to grant sufficient loans to SMEs, yet their tendencies to augment the financial needs of SMEs is considerably acknowledge. Furthermore, it has been unveiled that Government policies and programs designed to develop SMEs in Nigeria are ineffective and thereby need to be re-conceptualized. Apart from provision of tax incentives, and financial supports, it is recommended that Government should try to provide sufficient infrastructural facilities such as electricity, good road network and training institutions. Further study should be conducted on how best SMEs can make use of equity finances such as Venture Capital, Business Angels and other alternative sources of finance available to

SMEs in Nigeria.

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