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Challenges Facing Uptake Of Equity Financing By Small And Micro Enterprises In Kenya: A Case Study Of Small Financial Services Enterprises In Nairobi County

Hosea Mengich

Jomo Kenyatta University Of Agriculture And Technology (JKUAT), Kenya

Dennis Walobwa Ndalira

Defence Forces Technical College, Embakasi, Nairobi, Kenya

Florence Nyabola Juma

Catholic University Of Eastern Africa (CUEA), Nairobi, Kenya

Abstract:

The world over, economies are rediscovering entrepreneurship and its tool, innovation as a major source of strategic competitiveness (OECD, 2002). This is marked through the increasing involvement and the importance of Small and Micro Enterprises (SMEs) as vital players in their economies in the source of new employment and productive investment as well as a basis for growth and poverty reduction. Despite the economic potential of SMEs, they face several constraints all of which limit their potential to invest, innovate and improve productivity. There has been a low uptake of equity financing by SMEs according to Strategic Business Advisors (2008) financial deepening report. This research identified challenges facing uptake of equity financing by small and micro enterprises in Kenya with a focus on Nairobi County. The analyzed factors influencing uptake of equity financing were access to markets, transaction costs, legal and regulatory framework and access to information. Respondents were be picked by simple random. Data was collected using questionnaires. The data collected was evaluated, and analysed using statistical tools and content analysis so as to select the most accurate and quality information. The study found out that there was a positive significant relationship between the access to markets and uptake of equity finance of SMEs in Nairobi. The relationship between the transaction cost and uptake of equity finance was also found to be significant and positive. In addition, the results of the study showed that there was a significant relationship between regulatory framework and uptake of equity finance. The result further indicated that there is a significant relationship between information access and uptake of equity finance.

Key words: Equity financing, financial enterprises, challenges, uptake

1.Introduction

There is an increasing recognition of the role Small and Micro Enterprises (SMEs) play in socio-economic development in Kenya. Research in Kenya has shown that the informal sector provides more employment than the formal sector (Mitulla, 2003). The government has recognized that SME is the panacea to reduce of poverty levels, hence initiated projects such as the Youth Enterprise Development Fund (YEDF) and SME Fund to provide loans for investment in the micro, small and medium enterprises. The contribution of SME is more than double that of medium and large manufacturing sector that stands at 7% of GDP [ROK, 2003a]. Overall the SME create 75% of all new jobs. Estimates based on 1999 Baseline Survey show that in the year 2002, the SME sector employed 5,086,000 people up from 4,624,400 in 2001. This was an increase of 462,000 persons and constituted of 74.2% of total national employment. (CBS, ACEG & K-REP, 1999). According to Economic Survey (2011), in the year 2010, 503,000 jobs were created of which 80.6% or 440,400 were in the SME sector.

There has been a major concern on the high failure rates and lack of growth of the SMEs into medium enterprises or even large formal organizations; three out of five firms collapse within few months of operations (Strategic Business Advisor, 2008).

1.1.SMEs Access To Capital Markets In Kenya

There are initiatives being undertaken within the region and beyond to enable SMEs to access financing from various sources including through the capital markets. These initiatives include private equity (PE) and venture capital (VC), fund of funds and establishment of alternative investment market segments in the capital markets for SMEs (Felice, Friedman & Grose, 2006). In Kenya, Equity Capital was established in 1986 to invest in the equity of unquoted companies. It was funded in part by soft loans from USAID and grants to support management costs. However, challenges in finding promising equity investments in either SMEs many of which were unwilling to accept outside shareholders, or larger firms which could easily obtain bank financing, led the managers to abandon VC in favour of providing fundraising services on a fee-earning basis. (Christopher, Kimuyu, Manos & Murinde, 2007).

The Small and Medium Enterprises Exchange (SMEX), a listing for SMEs on the Nairobi Stock Exchange commenced operations in 2013 with less stringent listing requirements than those at the Nairobi Stock Exchange (NSE). In June 2012, the establishment of SMEX received a major boost following the gazettelement of the Capital Markets Regulations to pave way for the Growth Enterprise Market Segment (GEMS) at the Nairobi exchange. The GEMS is a collaborative initiative between the Capital Markets Authority (CMA), the Central Depository and Settlement Corporation (CDSC) and the Nairobi Stock Exchange which facilitates the listing of Small- and Medium-Sized Enterprises. To provide the legal framework for GEMS, two draft laws of the Nominated Advisors (NOMADS) Rules 2011 and the SME Public Offers Listings and Disclosure (POLD) Requirement Regulations 2002 were revised (Wagacha, 2011). The NSE is also working with the CMA to publish the rules for NOMADS which are aimed at assisting SMEs to list on the GEMS and to comply with good corporate governance practices. In addition, a corporate governance course for directors of the SMEs will be provided by the NSE to transfer knowledge on corporate governance competencies and to assure potential investors that the SMEs are being managed professionally (Wagacha, 2010).

2.Statement Of The Problem

SMEs play a significant role in the socioeconomic development process of Kenya by contributing significantly to the overall growth in terms of Gross Domestic Product (GDP), creating employment and exports. The 1999 Baseline Survey [CBS, ACEG & K-REP] indicated that there were 1.3 million SMEs which contributed to 18% of Kenya's GDP. By the end of 2001 informal employment was estimated at 4.2 million contributing 72% of total wage employment and 81% of private sector employment.

Most SMEs heavily depends upon bank loans and generally experience a 'financing gap,' even in developed countries. This financing gap, often defined as the difference between the demand for funds by SMEs and the supply of funds, occurs because of various reasons. Research suggests that the fundamental reasons behind the SMEs' lack of access to funds can be found in their peculiar characteristics, in addition to the fact that SMEs suffer from financing gaps because of market imperfections on the supply side. In reality, SMEs face financing gaps probably because of a combination of reasons originating from both the supply and demand sides. This financing gap for SMEs is most prominent in capital market financing and most countries, including developed ones, have problems in SME financing through equity finance developed by capital market.

One of the perennial problems of SMEs is the access to capital; banks have had difficulties in financing SMEs. Some of the reasons why banks are reluctant to lend SMEs include lack of collateral required by banks; inadequately compiled financial records and accounts and low level of technical and management skills (Wanjohi & Mugure, 2008). According to statistics from World Bank Investment Climate Surveys (2002-2003), Equity Financing constituted to 0.58% as a source of financing to SMEs in Kenya. Therefore the purpose of the study was to identify the challenges facing uptake of equity financing by SMEs.

3.Research Objective

The general objective of this study was to investigate the challenges facing uptake of equity financing by Small and Micro Enterprises in Kenya with reference to Nairobi County.

4.Literature Review

4.1.Theoretical Framework

The capital structure is defined as a specific mix of debt and equity a firm uses to finance its operations. (Green, Murinde & Suppakitjarak, 2002). The topic of capital structure remains an active area of financial research. While much has been learned about what factors are correlated with leverage and financing decisions, there still is no model of capital structure that is generally agreed upon. The following theories were used in this study to explain capital structure decisions.

4.1.1.Pecking Order Theory

This concept of optimal capital structure is expressed by Myers and Majluf (1984). Pecking Order theory tries to capture the costs of asymmetric information. It states that companies prioritize their sources of financing (from internal financing to equity) according to the law of least effort, or of least resistance, preferring to raise equity as a financing means "of last resort." Hence: internal financing is used first; when that is depleted then debt is issued; and when it is no longer sensible to issue any more debt, equity is issued. This theory maintains that businesses adhere to a hierarchy of financing sources and prefer internal financing when available, and debt is preferred over equity if external financing is required (equity would mean issuing shares which means 'bringing external ownership' into the company).

This theory suggests that firms avoid external financing while they have internal financing available and avoid new equity financing while they can engage in new debt financing at a reasonably low interest rate (Myers & Majluf, 1984).

4.1.2. Trade Off Theory

Trade – off theory allows the bankruptcy cost to exist. It states that there is an advantage to financing with debt (namely, the tax benefits of debt) and that there is a cost of financing with debt (the bankruptcy costs and the financial distress costs of debt) so that a firm that is optimizing its overall value will focus on this trade-off when choosing how much debt and equity to use for financing.

Firms are assumed to trade off the tax benefits of debt with the bankruptcy costs of debt when making their financing decisions. Green, Murinde and Suppakitjarak (2002) observed that tax policy has an important effect on the capital structure decisions of firms. Corporate taxes allow firms to deduct interest on debt in computing taxable profits. This suggests that tax advantages derived from would lead firms to be completely financed through debt. This benefit is created, as the interest payments associated with debt are tax deductible, while payments associated with equity, such as dividends, are not tax deductible. Therefore, this tax effect encourages debt use by the firm, as more debt increases the after tax proceeds to the owner increase (Modigliani & Miller, 1963).

4.2. Conceptual Framework

A conceptual framework is a group of concepts that are broadly defined and systematically organized to provide a focus, rationale and a tool for integration and interpretation for information (Achtenberg & Vrines, 2002).

The aim of the study was to investigate the challenges facing the uptake of equity financing in Kenya. The variables of study included; access to markets, transaction costs and regulatory framework and access to equity financing information. These four variables are the independent variables for which any change or manipulation of the variables result in change of the dependent variable thus increasing or decreasing the uptake of equity financing by SMEs. This relationship is shown below:

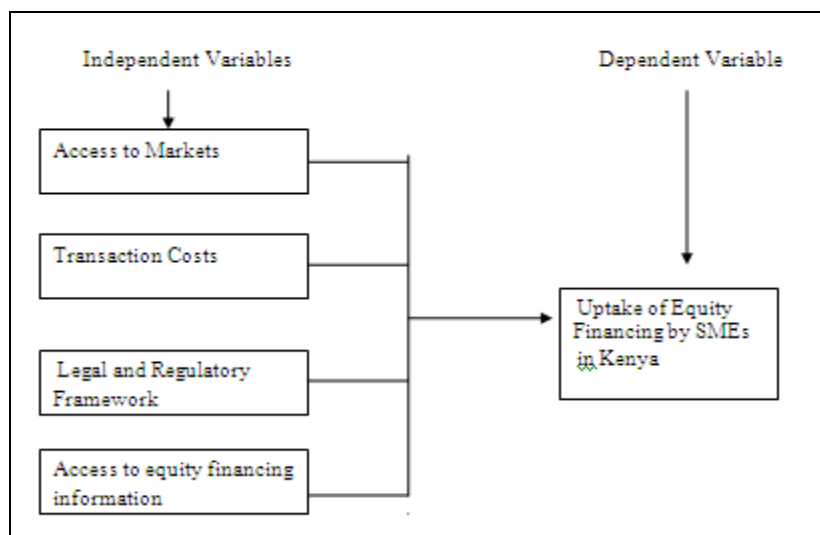


Figure 1: Conceptual Framework

4.2.1. Access To Markets

The Capital Market is a critical pillar to economic growth. In Kenya the Capital Market Authority (CMA) is the institution established by an Act of Parliament to promote, regulate and facilitate the development of an orderly and efficient Capital Market in Kenya. The SME market has had limited knowledge of how alternative, non commercial bank financial products, specifically risk capital, works and who the target market is. To promote access to market, CMA reckons that unlocking the potential of SMEs which constitute about 40% of gross domestic product in Kenya and about 80% of the labour force, is key to propelling the country to double digit growth as envisaged in Vision 2030 Economic Blueprint. The market for private equity and or long-term risk investment in Kenya is in an early development stage with few players taking part in the market.

Kenya's capital market is still in its infancy and thus, instruments currently listed and traded comprise shares (equity) and bonds (debt). Venture capital which can partly address the scarcity of equity for SMEs through investment in unlisted companies, as is the case with the Private Equity and Venture Capital program in Brazil, is not widely available in Kenya. The main source for Kenya's SMEs is internal financing followed by banks. Kenyan SMEs do not use credit cards or leasing as a source of finance (CMA, 2012).

Equity financing has been the oldest financial instrument in the Kenyan market. It is a sign of ownership in a company and carries limited liability. Potential investors can invest in the product through an Initial Public Offer (IPO), a Rights Issue, Private Placement or through the Nairobi Securities Exchange. Presently, Kenya has equity valued at over Kshs 1 Trillion (USD 13.15 Billion) from over 55 companies available trading at the Nairobi Stock Exchange (CMA, 2012).

The field of equity financing is fairly new to SMEs and fast evolving as an alternative and cheaper source of finance. Based on its effectiveness in boosting of large enterprises which have benefited from it immensely, there is no doubt it ought to be replicated to this critical sector. Availability of this financing to SMEs is curtailed in Kenya, due to the fact of the undeveloped capital market and lack of adequate policy and regulatory framework to guide its availability to pool of entrepreneurs who are informed on matters of financial literacy based on access to market information (Wanjohi & Mugure, 2008).

Kenya's risk capital market is still in the early stages of development (SBA, 2008), both on the demand and supply side. On the demand side, SMEs largely rely on internal and bank financing to finance operations. On the supply side, very few funds operate in Kenya to date, although the number is increasing. Total venture capital (VC) currently available amounts to about USD 200m. Of this, about USD 40m target early-stage SMEs, compared to over USD 25 billion in the USA. The pension fund and insurance industry contribute less than 10% of total funding for venture capital in the country, compared to above 30% in some developed countries (SBA, 2008).

4.2.2.Transaction Costs

A transaction cost is fee charged by a financial intermediary such as a bank, broker, or underwriter (Mead, 1988). The relatively smaller loan size and the high information costs increase the per unit transaction costs associated with credit to SMEs. For any financial institution the following costs are considered to be fixed: administrative costs; legal fees; and costs related to the acquisition of information about the loan applicant. In the case of SMEs, these costs (per unit of finance requested) are relatively higher compared to the larger enterprises and thus act as an impediment to lending to SMEs.

Transaction costs are a critical factor in deciding whether to make a product or buy it. Raising finance is often a complex process. Business management needs to assess several alternatives and then negotiate terms which are acceptable to the finance provider. The main negotiation points are often as follows; during the finance raising process, an accountant is often called to review financial aspects of the plan. Their report may be formal or informal, an overview or an extensive review of the company's management information system, forecasting methods and their accuracy, review of latest management accounts including working capital, pension funding and employee contracts. This due diligence process is used to highlight any fundamental problems that may exist.

Equity financing may require complicated legal filings and a great deal of paperwork to comply with various regulations. For many small businesses, therefore, equity financing may necessitate enlisting the help of attorneys and accountants, thus additional cost (Cole, 2002). When firms go public, they incur direct and indirect costs associated with the initial public offering (IPO). Direct costs are fairly predictable – They include registration, underwriting and attorney and auditing fees. The indirect cost, commonly known as IPO under pricing, is one of the most perplexing puzzles in finance. It is observed in almost every financial market in the world and across all procedures of share allocation. IPOs are, on average, underpriced. In countries where regulations and restrictions are imposed in the IPO market, under pricing is high.

4.2.3.Legal And Regulatory Framework

Kenya's financial system is by far the largest and most developed in East Africa and its stability has improved significantly over the past years, many challenges remain. The legal and regulatory framework to encourage the establishment of locally funded investment vehicles has, however not developed holistically. The fragmented nature of the current regulatory framework has left potential fund managers and investors unclear as to the implications of attempts to mobilise the growing pool of long-term funds in, among others, retirement benefit schemes and life insurance funds (Strategic Business Advisors, 2008).

Stringent listing requirements have locked out small business from tapping into the capital markets. SMEs have been unable to meet minimum listing requirement such as having a minimum asset base of between Kshs 20 million and Kshs 100 million and a shareholder roll of over 100 Shareholders. Creating a counter for SMEs is expected to enable them to tap into a new pool of funds, which are largely meant for corporate bodies and the government. NSE reckons that a special market division for the SMEs will help them gain access to manageable and affordable capital for growth and expansion and provide an exit strategy for family owned business enterprises through separation of ownership and management. Listing on the NSE will require firms to have a higher accounting standards and full disclosures of their operations. Firms are also expected to be profitable for three years in a row before listing. Sweetening the obligations and requirements, tax and policy incentives is expected so as to attract the SMEs to the bourse. With a raft of the proposed amendments with the rules governing the trading at the stock market, interested companies will have relaxed rules which will provide an avenue for access to capital (Wanjohi & Mugure, 2008).

4.2.4.Accessibility To Equity Financing Information

For equity and debt markets to be developed for SMEs, relevant and complete information about these enterprises has to be accessible. This information could range from management to financials of the company. Currently, information about SMEs in most developing countries is scattered between the companies themselves and banks which finance their operations. The credibility of the information especially on SME financial activities is also questionable based on the interviews with the banks. This would therefore call for a concerted effort between the government, the Capital Markets Authority, financial institutions and SMEs to come up with an information gathering and sharing system. Access to credible and comprehensive information will contribute to reducing information asymmetry inherent in SMEs. Banks may not fully disclose to the investors the risks associated with SMEs.

The benefit of accessibility of information has been positively associated with successful business growth by several authors including Kirimi (1988). Growing enterprises utilize external advice as opposed to business advice being a major determinant of growth. In a

survey of over 2500 enterprises, Biggs, T., and Sha, M. (2006) found that 95% of enterprises made use of external advice. Wagacha (2010) also suggest that external advice is sought to supplement existing staff and managerial expertise and enhance organizations efficiency and effectiveness, thus advice is utilized as it offers positive benefits to enterprise performance.

Felice, Friedman & Grose (2006) noted that accountants were the most widely used form of external advice followed by banks. King and McGrath (2002) also identified a wider range of potential sources for external advice including accountants, lawyers, through social networks with friends and relatives, customers and suppliers. Necessary information on equity financing provides efficient and effective use of available capital and opportunities.

5. Research Gaps

There is very little information on literacy levels of SMEs to Equity Financing. Greater literacy may speed up adoption of equity financing as it provides a variety of alternatives which when utilized would promote their growth. It is imperative to move beyond the traditional and limited approaches and instead explore innovative and value oriented applications as this financing mode through the development of entrepreneurial programmes to educate SMEs. Special efforts are required in order to raise public awareness on equity financing as it is not well known or fully appreciated. Public awareness is essential because of lack of a strong credit culture and stringent financial and legal conditions on debt financing. Unfortunately there is limited research done in Kenya on equity financing therefore this research intends to fill this research gap.

6. Methodology

The study used a descriptive research design since it is a process of collecting data in order to answer questions concerning the current status of the subject under study. This design was suitable because it describes the factors that influence uptake of equity financing by SMEs. The population of study involved SMEs registered with the Nairobi City Council (NCC) as at 2009. The target population was 65 SMEs that have been in business for at least four years. The study used simple random sampling to select respondents from the target population. This research used questionnaires and personal interviews to collect data and complimented by library and desk research. The primary data for this research was collected using questionnaires and personal interviews. Descriptive statistics was then applied to help establish patterns, trends and relationships and to make it easier to understand and interpret the implications of the study.

7. Data Analysis And Findings

Data was obtained from 60 questionnaires which were administered and returned. This represented 92.3% response rate, which is considered excellent to make conclusions for the study.

Most enterprises in the country are mainly dependant on debt financing (Wanjohi & Mugure, 2008). This is due to the fact, that the equity financing mechanism in the country is underdeveloped and mainly favors the large enterprises (SBA, 2008). Based on the observation the researcher sought to establish if SME owners at Nairobi had made effort to acquire equity fund. Majority (76.7%) had not attempted to acquire the funds while only 23.3% had attempted to acquire equity funds. Research suggests that the fundamental reasons behind SMEs' lack of access to funds can be found in their peculiar characteristics, in addition to the fact that SMEs suffer from financing gaps because of market imperfections on the supply side (OECD, 2001). The reasons for not seeking equity funds were sought and responses to open ended questions provided. 33.3% of respondents indicated that equity funds are not available on the market as 28.6 % said that they have not heard of equity funds as a source of business funds. The research further found that 21.4% of equity fund providers target large enterprises as the rest of respondents (6.7%) indicated high cost as a reason for not seeking the funds.

The study investigated SME equity fund eligibility and found out that 56% of respondents who attempted to access equity fund were not eligible for the loan while only 44% were legible. The finding were in contrast with the international microfinance consensus that asserts that putting in place a regulatory framework that allows for unlimited entry of private sector capital and creating a level playing field for all investors and practitioners will allow all firms to grow and acquire capital for expansion. The SMEs could not qualify for funds due to regulatory framework governing acquisition of equity funds in Kenya. The finding were in line with Wanjohi and Mugure (2008) observation that availability of equity financing to SMEs is curtailed in Kenya, due to the fact of the undeveloped capital market and lack of adequate policy and regulatory framework to guide its availability to pool of entrepreneurs who are informed on matters of financial literacy based on access to market information.

In line with Mead (2008) study, the costs (per unit of finance requested) are relatively higher compared to the larger enterprises and thus act as an impediment to lending to SMEs. The study established that 86% of respondents agree that cost factor is an impediment to equity financing. This was due to relatively smaller size of funding required by SMEs as well as higher information and monitoring costs and implementation costs per deal when processing the finance in capital market.

For many small businesses, equity financing may necessitate enlisting the help of attorneys and accountants, thus additional cost (Cole, 2002). When firms go public, they incur direct and indirect costs associated with the initial public offering (IPO). Direct costs are fairly predictable – They include registration, underwriting and attorney and auditing fees. Based on these findings the researcher asked the respondents to rate the cost of equity financing. 56% indicated that the cost of equity financing was high and 35% indicated that the cost was average. 3.3% observed that cost was low as 5% indicated that the cost was very high.

The research sought information on whether stringent regulatory framework affected the uptake of equity finance by slowing and complicating the process. Majority (55%) of respondents agreed that current regulatory framework negated the speed and ease of

equity finance uptake by SMEs. The item was not answered by 12% of study participants while 33% indicated that stringent regulatory framework did not affect the uptake of equity funds by SMEs.

According to Capital Market Authority Discussion Paper (2010) a major challenge facing SMEs emanate from the fact that Kenya does not have SME policy specifically addressing financial challenges facing SMEs. The research sought information on the need and role of a policy on SME financing. 40% of respondents said that implementation framework of a policy helps in improving uptake of equity funds as 31.7% indicated that policy creates awareness to the intended beneficiaries. The study also established that 13.3% believed that a policy will provide guidelines on equity financing. However, 15% did not respond to the item and indication of lack of knowledge on roles of policies on development of SMEs in Kenya.

The study sought information regarding the awareness level of equity funds among SMEs in Nairobi. The benefit of accessibility of information has been positively associated with successful business growth by several authors including Zavatta and Zernike (2008). Growing enterprises utilize external advice as opposed to business advice being a major determinant of growth. The study established that majority (66.7%) of respondents were not aware of equity financing opportunities available to SMEs in Nairobi. Only 30% of respondents were aware of equity financing options available in the market.

7.1. Correlation Analysis Results

	Access to market	Transaction Cost	Regulatory Framework	Access to Information	Uptake of Equity Finance
Access to market	1				
Transaction Cost	.434	1			
Regulatory Framework	.293	.427	1		
Access to Information	.273	.412	.323	1	
Uptake of Equity Finance	.316	.484	.493	.270	1

Table 1: Correlation Is Significant At The 0.05 Level (2-Tailed)

Source: Research, 2013

The study used the Pearson's product moment method to determine the strength of the relationship. This type of correlation is used when both variables under study are measured at ratio or interval scales and are continuous (Mugenda & Mugenda, 2003). Table 1 details the correlation matrix which indicates that uptake of equity finance is positively correlated with all variables under study. Uptake of equity finance is correlated with access to market at 5 percent significance level (0.316). Transaction cost is positively correlated to regulatory framework and access to information at 5 percent significance level (0.427) and (0.412) respectively. The table also indicates that there is correlation between access to information and regulatory framework at 5 percent significance level of (0.323).

8. Conclusion

The result of correlation analysis showed that there was a positive significant relationship between the access to market and uptake of equity finance of SMEs in Nairobi ($p=0.316$, $p>0.05$). This shows that a positive change in access to market would help improve the uptake of equity finance by SMEs.

The relationship between the transaction cost and uptake of equity finance was found to be significant and positive ($p=0.484$, $p>0.05$). This implies that the correlation between the two variables is significant such that a reduction in transaction cost will lead to more uptake of equity finance.

In addition, the results of the study showed that there was a significant relationship between regulatory framework and uptake of equity finance. The correlation coefficient between these two variables was found to be 0.493 with associated p-value of 0.05. This implies that an improvement in regulatory framework for SMEs can lead to more uptake of equity finance.

The result further showed that the correlation coefficient with equity finance information access is 0.270 with an associated p-value of 0.05 which implies that there is a significant relationship between informational access and uptake of equity finance. An improvement in informational access to SMEs would lead to more SMEs adopting equity finance.

9. Recommendations

Based on the above conclusions the study recommends that accessibility can be improved by creation of a well publicized Over-The-Counter market and appropriate capital market segments will facilitate investment through private placement. The government should offer tax exemptions to newly registered companies offering equity funds to SMEs for a period of five years to promote development of equity financing.

There is need for some of exemption from registration that permits capital raising without going through the entire registration formalities. The CMA must consider whether and to what extent the registration rules can be altered for SMEs. They need to adopt provisions consistent with current circumstances.

There is need for Capital Market Authority to undertake a best-practice review of existing regulations as well as a broader examination of the incentive structure for establishing fund in Kenya. Licensing fees might also be modified and priority consideration for bidding government contracts might be given to publicly traded SMEs.

Many owners and managers of SMEs do not understand they can maintain control of their company even under materially changed circumstance, nor are they aware of the significant economic benefit (in addition to capital raising) that can result from public market in a company's securities. An educational process is required. The educational program can be developed by CMA and its stakeholders and implemented through Financial Education partnership programme steered by Financial Sector Deepening- Kenya Project.

In order to ensure that adequate attention, guidance and support are provided to SMEs, a small Business Development Agency should be established. The agency could provide any and all of the following services: regulatory coordination, education and training, financial assistance and equity fund development.

10. Areas For Further Studies

The study established that regulatory framework is most influential determinant to uptake of equity finance. The factors that contribute to such occurrence were not explored. These factors can be investigated through further research.

Lastly, the research only explored the factors influencing the uptake of equity finance by financial institutions in Nairobi whose findings might not be similar to other sectors of the economy in different areas. Other research need to be conducted in other sectors and areas to compare and corroborate the results of this study.

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