# THE EFFECT OF MICROFINANCE SERVICES ON MICRO ENTERPRISES GROWTH AND DEVELOPMENT
## (A CASE STUDY OF COMMERCIAL MICROFINANCE)

**BY**
**KIIKU JAMES NDAMBUKI**
**REG.NO. BBA/2959/31/DF**

**A DISSERTATION SUBMITTED TO THE FACULTY OF BUSINESS AND MANAGEMENT IN THE PARTIAL FULFILLMENT FOR THE AWARD OF BACHELOR DEGREE IN BUSINESS ADMINISTRATION OF KAMPALA INTERNATIONAL UNIVERSITY**

**JULY 2006**

# DECLARATION

The researcher will like to declare that this dissertation is his own original work. The paper has been presented for the award of a Bachelors of Business Administration.

Names ........KIIKU JAMES NDAMBUKI........

Regno........BBA/2959/31/DF........

Signature........

Date ........07/08/2006........

The research has been submitted for examination with my knowledge as the university's advisor

Names...Dr. Sunday Nicholas........

Signature ........

Date...16/8/06........

## ACKNOWLEDGEMENT

The researcher would like to acknowledge the help of Dr Nicholas Sunday, who dedicated his time, effort and advice towards the research. Also the researcher will like to acknowledge the help of the respondents, Mr. John Muhwezi and Mrs. Agnes Asese. Lastly the researcher would like to acknowledge the help of Mrs. Agnes Mwambi Kiiku for all the financial needs incurred during the time of research.

# TABLE OF CONTENT

# ABBREVIATIONS

| | |
|---|---|
| B.O.U | Bank of Uganda |
| C.M.F | Commercial Microfinance limited |
| M.F.I. | Micro finance institution |
| M.D.I | Micro deposit taking Institution |
| N.G.O | Non Governmental Organization |
| S.M.E | small and micro enterprises |
| UGX | Ugandan shillings |
| USD | American dollars |
| A.M.I.F.U | Association of Microfinance Institutions Uganda |

# 1.0 CHAPTER ONE

## *1.1 INTRODUCTION*

Microfinance according to Ledger Wood (1999) is the provision of small sized loans to low income earners and small businesses.

The sector is a relatively new field in the financial world with the first models being established in the Asian countries of Bangladesh, Indonesia and Pakistan in the late 1980s.

Micro financing has been sought out by the various stake holders in its system that is: government, non government organizations, donors, and the micro credit firms as a financial and social intermediation tool.

The microfinance system usually involves small loans which have high interest rates. This is because the average cost of operation is usually high. For example currently in Uganda the cost of operation is about forty percent of the total capital structure of most microfinance organizations. When compared to the bigger M.F.I s which have about fifteen percent operation cost this is very high. .

Also the microfinance business that is supplied with loans must have a cash flow which is greater than the principal and interest payments in order for them to have sustainable operations.

This paper has looked at the micro enterprises growths which have benefited from the microfinance loans. It has gauged if business vulnerability has increased or decreased with finance from the microfinance sector.

The paper has looked at provision of microfinance services in Uganda and has critically examined the impact of provision of the new loan scheme currently offered by microfinance companies which is salary loans.

## *1.2 PROJECT BACKGROUND*

### 1.2.1 DEFINITION

According to Ledger Wood (1999) micro financing has been defined as the provision of financial services to low income clients including the self employed

Micro enterprises refer to small scale enterprises both in the urban and rural areas. The various micro entrepreneurs include: boda boda operators, black smiths, carpenters, small scale farmers and taxi operators among other small scale businesses.

According to the microfinance Bill 2002 a microfinance institution is referred to as a licensed, supervised and regulated by the Bank of Uganda (B.O.U) under the M.D.I Act. Under the M.D.I Act this institution is allowed to conduct the following microfinance business:

- Accept deposits from the public.
- Use such deposits to make loans or extend credit including to micro enterprises and low income households usually characterized by the use of collateral substitutes or compulsory savings.
- Transact such other services as may be prescribed by BO.U

### 1.2.2 HISTORY

Micro financing is not about financial intermediation only but it is also a developmental tool for social intermediation. This makes the micro finance model a developmental tool rather than a profit oriented business, and for it to be successful it needs to meet both objectives.

The microfinance model began in earnest in the late 1980s. It came about due to the inefficiencies of the subsidized credit models that government and NGO, s were using at the time. These needed constant refinancing and proved unsustainable. (S. Marguerite 1999). A market based solution was been sought for and this resulted into the first pilot scheme led by Dr Yunus Mohammed of Bangladesh who led a group of landless people majority of them being women in a microfinance scheme which started using collateral substitutes and now is the grammeen model.

The initial models were very active in teaching apart from offering credit which required subsidies. But currently most microfinance schemes especially in Asia have adopted a minimalistic policy where training has taken a back seat. They are also developing into more formal financial institutions. In Uganda we have: Commercial Microfinance, Rural Centenary Bank, Pride M.D.I Ltd, FINCA, Faulu Uganda, ACCORD, ACCION, Uganda Microfinance limited and many others.

### 1.2.3 SIZE OF MICROFINANCE

The microfinance sector although a recent financial development has grown rapidly and has been used world wide. According to the World Bank estimate current microfinance accounts four only 4% the total demand for microfinance services.

The microfinancier May 2006 estimates that there are about 500 registered M.F.Is in Uganda these are graded into the following categories

| Category | Number | Status/capital | Number of clients |
|---|---|---|---|
| A | 6 | Formal co. | Above 20,0000 |
| B | 8 | Formal NGO/ Saccos | 5000-20000 |
| C | 40 | NGO and Saccos | 35-49 |

Source the Microfinancier May 2006

The leading microfinance institutions are:

Rural centenary bank a fully fledged commercial bank, Uganda microfinance limited, Pride M.D.I and Commercial Microfinance, Faulu Uganda and FINCA Uganda L..T.D

### 1.2.4 SUCCESS AND FAILURE

The microfinance model has enabled development to take place. Success stories include: Rural Bangladesh where the sector survived even the currency crisis of 1997-1998(S.Maugurite 2000) and urban Mali and k –rep Kenya.

The microfinance model theoretically should reduce vulnerability (poverty levels). Vulnerability in this paper includes both the financial and social aspects of a client.

According to (Khandlker1998) he shows that microfinance services reduce the vulnerability of the poor. This belief is shared by many microfinance practioners and the success stories prove of this. But contrasting this belief (Murdoch 1998) shows that the microfinance services will only increase the vulnerability of the poor and therefore negatively impact the growth of S.M.Es.

For the microfinance model to be sustainable, the lenders should be able to recover loans on schedule when the repayment capacity of the borrower equals or exceeds debt service which consists of principal and interest payment. If the sum of the cash inflow is less than the M.F.I loan it will only increase the vulnerability of the business (Von piske 1991, 277)

The impact of microfinance service according to (Asimwe 2002) can be done in four levels; the enterprise level, family/household, the individual /community level and the S.M.Es level. This paper has looked at growth at the enterprise level.

### 1.2.5 BACKGROUND OF THE STUDY AREA

Commercial microfinance is a microfinance institution. It has been in operation from 2000.

Legally the institution is registered under tier two of the Bank of Uganda as a credit institution. Its headquarters are at Nakivubo road Plotno.19 P.O.Box 24594 Kampala Uganda. Commercial microfinance offers loans in all traditional microfinance loans that is; group loans , individual loans and the current innovation of salary loans .It also has other products such as savings accounts, C.M.F fixed deposit, C.M.F junior savings .C.M.F easy saver and safe keeping facilities.

The research has examined the activities of commercial microfinance including its performance and the performance of its loans beneficiaries.

## 1.3 OBJECTIVE

To establish the effect of microfinance services on micro enterprises growth in Uganda and more specifically in commercial microfinance.

## 1.4 SPECIFIC OBJECTIVES

The research paper has examined C.M.F'sperformance from 2000-june 2005. It has looked at business performance over the loan term which is 18 months.

1. To measure business performance financed by micro credit.
2. To examine commercial microfinance performance.
3. To examine the relationship between the loan structure and business growth.
4. Compare cost of financing with other sources of credit.
5. Come up with recommendations basing on my findings.

## 1.5 RESEARCH HYPOTHESIS

- Business financed by microfinance has been struggling.
- Commercial Microfinance Uganda L.t.d has been performing relatively well in terms of loan collection and profitability.
- There exists a direct relationship between business performance and a favorable loan structure.
- Micro credit is more costly than conventional credit sources (normal bank loans).

## 1.6 RESEARCH QUESTIONS

The research has answered the following questions for Commercial Microfinance from 2000 to 2005 and the small businesses over the loan term.

- What is the level of business performance financed by micro credit?
- What has been the performance of Commercial Microfinance Uganda L.t.d?
- Have small and micro businessmen been satisfied with the current loan structure?

- What is the difference of cost of finance (interest rates) between micro credit and conventional loans?

## *1.7 SIGNIFICANCE*

- This paper will be useful to potential applicants of microfinance loans, to determine the best source of finance.
- Government and other regulatory bodies can use this paper as a gauge to the effectiveness of the current microfinance schemes as a tool for economic development.
- The paper will be used by academics to study the significance of microfinance services.
- It will help microfinance practioners to come up with suitable loan products.
- This paper is examinable to the award of a degree in Bachelors of Business Administration.

## *1.8 SCOPE OF THE STUDY*

The research has been conducted at Commercial Microfinance Parliamentary Branch. It has measured the productivity of loans issued and specifically salary loans.

## 1.9 STATEMENT OF THE PROBLEM

Since the inception of micro financing its purpose has been reducing the vulnerability of the poor in society. This has been mainly through the expansion of micro enterprises.

Currently the Ugandan microfinance industry has more than 500 registered M.F.Is but only a handful of these have successful operations.

Of the current M.F.Is only Rural Centenary, Pride Uganda, and Uganda microfinance have carried impact assessment of their activities.

According to (khlandlker1998) he found out that M.F.Is reduces poverty levels. Contrasting micro credit has been found to increase client's vulnerability. (morduch1998).

The typical microfinance loans; are small in amount, have high interest payments and low gestation periods, an element which is not suitable for any business development especially in developing countries. (Shariff and wood 1997)

At the same time it would seem that M.F.I has led to expansion of business. Based on the microfinance institute growth (Otero and Rhyne1993)[1] in their theory of institutional impact assessment

The rapid expansion of the microfinance sector would seem to indicate that the microfinance has had a positive impact in Uganda. Given the number of M.F.Is opening up and the expansion of the existing institutions

In contrast it is also emerging that microfinance organization may be expanding at the expense of the poor people. To quote one disappointed client (Microfinancier 2004) "They came here to increase poverty. They insist on full recovery of their loans and interest, whether it has benefited you or not. We have sold all our property in order to service them. They have now gone for our salaries because we have nothing more to sell."

According to Morduch business vulnerability will increase if the repayment is greater than the business revenue in the loan period[2]. This is manifested by:

---

[1] Otero and Rhyne advanced a theory to measure microfinance performance base solely on the performance of the M.F.I they conclude that growth in institution inherently meant that S.M.Es were performing well.

- Low profitability levels especially the net profits as cost of finance is expected to take up most business revenue.
- Financing of the loan from external sources other than business sources for example selling land or borrowing informally from relatives.
- Small number of repetitive loan applicants.
- In cases of existing businesses the capital base will be expected to shrink due to the higher financing cost incurred. This might be expected to be financed from equity.
- Negative cash flows in the loan term.

The paper has sought to examined the effect of micro credit on the micro enterprise sector has examined the new innovation of salary loans currently being offered.

## *1.10 THEORETICAL FRAME WORK*

This paper is based on the micro finance model as first developed by Dr Yunus Mohammed (S.Maugurite) 1999. In his theory he propagated that the poor could pay for loans at market rates. This was conditioned if the loan sizes were suitably packaged to meet the needs of the poor.

In the microfinance model first developed collateral substitute such as group guarantees, moral suasion, were developed. These were the key elements which helped the micro loan programme offset the traditional requirement of physical collateral used by commercial banks. Group targeting has been extensively used in Bangladesh and forms the grammeen model which draws its strength from the use of the group

Another important element was the use of indirect targeting which was meant to induce the low level income earner and avoid credit drift[3]. It used group meetings and other techniques which putt off the rich not to use microfinance sources of credit.

---

[2] The period which the loan beneficiary will complete paying the loan inclusive of both interest and principal payments.

[3] Credit drift refers to the process which well to do clients who can afford conventional credit go for micro credit which is easier to acquire.

The Grammeen bank model uses a field manager who is sent ahead to familiarize himself with the village. The manager is in charge of fifteen to twenty two villages.

Loans are given out to groups consisting of five members. At first only two members can qualify for a loan product. The loan is payable over a fifty week period. The Grammeen model uses collective responsibility to secure the loan as an alternative to collateral. When the loan is fully repaid the other members of the group can apply for loans. Thus there is group pressure upon payment since all members would wish to benefit.

The paper is supported by the following synthesis of theories. Rostein Rodan[4] theory of a big push. He shows the need for a big push in economic development. He attributes this due to the indivisibility of the labour function. Richard. R. Nelson[5] put forward the low level equilibrium theory. These theories conclude that:

- Population growth is a function of investment. There is a tendency of per capita income to revert to minimum tendencies if, population growth increases without an increase in investment or availability of new land to absorb the growing population.

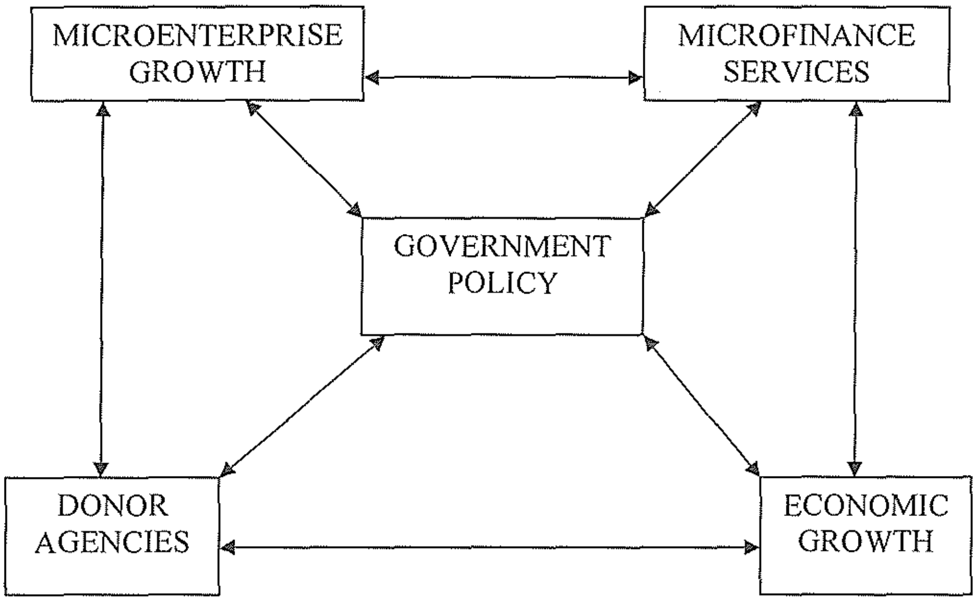
- That only a concentration of a large number of entrepreneurs will confirm profit expectations of the individual enterprises. If only a few entrepreneurs are willing to engage in such investments the rate of growth of society as a whole is likely to be such that profits will be disappointed and those few entrepreneurs will result into zero sum activities.
- The configuration of income rising in developing countries may be such that only a discontinuous jump to considerably higher levels of capital accumulation will bring the economy into a zone of steady growth.

The papers theoretical frame work will consist on the following elements. The independent variable is provision of micro finance by the micro deposit taking institutions (M.D.Is) namely Commercial Microfinance. The dependent variable will be the micro enterprise growth. The moderating variable will be government policy. Other

[4] P.N Rostein Rodan, notes on the theory of the big push M.I.T .C.I.S March 1957
[5] R.R. Nelson "a theory of the low level of equilibrium trap" American Economic Review, December 1956 pp894-908

variables will include door agencies and the level of economic growth. These other variables have a direct impact on the growth of the micro sector but will be auxiliary in the study and will complement effect of microfinance which is the subject of investigation.

HYPOTHETICAL FRAME WORK




In developing a proper theoretical frame work it will be also essential to give a discussion of what comprises a micro loan apart from the already discussed characteristics of small size and low gestation periods, interest which is the cost of finance has been determined by different institutions differently below is basically what comprise the micro loan interest model as put forward by (Mulindwa 1999)

$$I = O.P + F.C + G$$

Where:

O.P = operating cost

F.C = Financial cost

G = required growth rate of the institution

I = required interest rate

The interest level is a summation of the operating cost, cost of finance and the growth rate of the institution. The cost which stand out to be most dominate are the operating cost which as previously noted account for over 40% of the institutions total cost. Financial costs are the cost of finance sourced by the institutions that include donor sources, government grants, and deposits from the public. These factors directly influence the growth of small scale business. The required rate of growth by the institution will be affected by the economic growth rate which is influenced by government policy

According to Murdoch (I997) S.M.E growth rate has been negatively impacted by the low gestation period and high interest rates.

Tying these three theories together we can come up with the following deductions:

- The poor can pay loans at high rates and there by increase their income
- High interest rates will lead to low business success and narrow spread of micro credit availability. On the other hand it will maintain institutional viability and growth.
- If business is to succeed there must be many entrepreneurs for business to succeed and the economy to grow.

The paper has used the above guidelines to examine the impact of micro finance on small and micro enterprises.

# 2.0 CHAPTER TWO

## *2.1 LITERATURE REVIEW*

**Introduction**

The researcher has examined related literature on the research title. The literature reviewed has given guidance on the research problem. The researcher has tried as much as possible to use recent data in referencing in order to come up with a realistic picture on the subject matter.

## *2.2 DEFINITION*

According to Ledger Wood (1999) micro financing has been defined as the provision of financial services to low income clients including the self employed.

Micro enterprises refer to small scale enterprises both in the urban and rural areas. The various micro entrepreneurs include: boda boda operators, black smiths, carpenters, small scale farmers and taxi operators among other small scale businesses.

According to the microfinance bill 2002 a microfinance institution is referred to as a licensed, supervised and regulated by the Bank of Uganda (B.O.U) under the M.D.I Act under the M.D.I act this institution is allowed to conduct the following micro finance business:

- Accept deposits from the public.
- Use such deposits to make loans or extend credit including to micro enterprises and low income house holds usually characterized by the use of collateral substitutes or compulsory savings.
- Transact such other services as may be prescribed by BO.U

## *2.3 SMALL AND MICRO ENTERPRISES*

Micro enterprises refer to small businesses which are run by a few workers usually not than ten and use domestically available raw materials and low technology.

According to Levisitky (2002) he defines small enterprises as a business with less than ten workers and a capital of less than USD IO, 000.

Harper and Finnegan on the other hand define micro enterprises as a developmental business which hires less than 100 employees and that they are engaged in trade, industry or services. They may be owned and managed by individuals or group of individuals.

Micro enterprises differ from different parts of the world. For example a S.M.E in Indonesia could be having a capital of USD 10,000 while that in Uganda could be having of a capital of USD 150.

The paper has defined term micro enterprise as a small developmental business with capital of not more than USD5, 000. As a developmental business the microfinance must be utilizing local technology and using local available skills and manpower. The various micro enterprises in Uganda include: urban, boda boda riders, small shops and kiosks, saloons, small hotels and taxis. Rural based industries' include small scale farmers and grocery vendors.

## *2.4 EVALUATION*

Evaluation of the microfinance institution remains a major set back in the sector compared to other well developed fields such as medicine. This has been due to the limited amounts of funds spent on research in the sector.

Evaluation of microfinance institutions remains a forgotten tool among microfinance practioners "a great tragedy". Haggablade(1992). There has been a limited number of impact analysis due to lack of management's commitment and whenever it has been done it has not been continuous.

This will bring us to another question how and when should impact on microfinance be measured? It is common when reading microfinance news and bulletin to note various M.F.I s quoting how much they have as their outstanding loans what is their repayment rate.

Harper and Finnegan (1998) show that impact should be measured on what has been achieved and not what has been spent. It is likely that an M.D.I will gauge its success from the level of outstanding loans and the repayment rate to gauge its performance or profitability. But this method only considers the M.D.I and not the loan beneficiary.

Friedman (1979) asserts that evaluation should be a collaborative effort rather than a judicious one. If impact is to be truly done it would be a de-service to leave out the performance of S.M.Es. Thus this paper has looked at both business and institutional performance.

## 2.5 FACTORS FOR A SUCCESSFUL MICROFINANCE SYSTEM

It has never been shown that the net effect of subsidizing small firms is to create more wealth in a country (Harper and Finnegan 1997)

The microfinance model (ledger wood 1999) as advanced by Dr Yunus Mohammed proved that the poor could pay for credit at competitive market prices provide it was suitably packaged.
S.Maugurite (2000) gave factors which were necessary for an efficient microfinance system to operate. The following perquisites were to be met:

- Efficient and committed labour intensive organization

- An efficient and accountable labour intensive organization.

- Simple and transparent accounting reporting system.

- Appropriate staff training and performance based incentives
- Decentralized authority for loan decisions
- Simple M.I.S and user friendly products and services priced for industrial viability.

As the microfinance is not static model applications have to be developed when one moves across different countries. But for an institution to achieve these goals it should essentially reach a large number of clients for them to have the necessary economies of scale that will enable the M.F.Is system to be sustainable and profitable in the long run.

As previously noted most microfinance institutions in Uganda have high operating costs of over 40% their revenues which is high compared with large M.F.Is in Asia with lower cost of about 15% of their operating revenues. (Mulindwa, 2006).

## 2.6 REPAYMENT PATTERNS IN THE MICROFINANCE SECTOR

In the microfinance sector the repayment of a loan has been traditionally high with institutions having at least above 80%.

A high repayment rate is a perquisite of institutional sustainability. This is due to the high cost per loan associated with micro-credit.

## 2.7 THE ROLE OF WOMEN IN MICROFINANCE

Women play a central role in developing a microfinance system Levistky (2002). In Kenya K-rep bank report 1987 showed that the repayment rate of women was 92% compared with 70% of men.

The grammeen model advanced by Dr Yunus Mohammed had similar results women paid about 94% compared with 80% of their male counterparts. Dr Mohammed shows the importance of women in the microfinance system and asserts that they are the most viable tool for development in society. As they use the family as the basic economic unit. Although women have been the driving force of microfinance they have received a small share of total loans in the Grammeen model total amounts of loans granted to women account for only four percent of the total loan portfolio.

## 2.8 FINANCING THE SMALL AND MICRO ENTERPRISES

Small and micro enterprises are developmental enterprises. They have been run and managed by low income individuals. Leviskys definition's that they are developmental because they reduce poverty through:

- Setting up entrepreneurship culture.
- Promoting local private sector
- Supply goods and services and substitute imports
- Create employment and increase income.

Financing of S.M.Es has been through the provision of micro credit. Formally this has been done by microfinance institutions. Informally it has been done by loan sharks, contributions from friends, personal savings and informal associations such as women groups.

For a micro enterprise to benefit from a financing source the return on amount invested should be equal or greater than the principal and interest payment of the loan. (Von Piske 1991, pp 277).

According to (Otero and Rhyne 1993) there is evidence that a microfinance system can be sustainable and profitable as long its borrowers continue to pay, although such payments may leave the borrower poorer.

## *2.9 REGULATION OF THE MICROFINANCE SECTOR*

According to (Namara)[6] the microfinance sector remained unregulated before the enactment of the microfinance bill 2002. The regulation sought for has been prudential regulation where all stake holders have come up and agreed upon the regulatory frame work and operate under it.

The bill has provided the much needed legal frame work under which M.F.I s were operating under. The enactment of the bill was mostly pushed by large microfinance institutions which wanted to transform quickly into formal financial institutions.

The regulatory body for the microfinance sector is the Bank of Uganda which now grants operating licenses under tier three of its regulations. This has enabled the M.F.Is to now legally collect deposits which has been done illegally in the past.

The regulation of microfinance has brought together different stake holders that include: A.M.I.F.U; Bank of Uganda; the Ministry of Finance, Economic development and Planning; the Ministry of Microfinance, Donor agencies, Microfinance Practioners and Microfinance Clients.

It is aimed at securing depositors money and ensure smooth operations of the M.D.Is by setting up industry standards such as capital adequacy requirements

Regulation remains a dynamic future of micro financing because the industry is still young and every day presents different challenges.

[6] Suleiman Namara's article on regulation of microfinance on the microfinancier December 2002. The author wrote on his capacity as director of A.M.I.F.U.

### 2.9.1 REACHING THE POOR AND SUSTAINABILITY

There has been an ongoing debate about the objectives of the microfinance, this has been whether to reach a large number of poor clients or ensure institutional sustainability. Those in favour of reaching the poor have been named as the poor camp while those for sustainability are the sustainability camp.

The poor camps argue that the goal of microfinance is poverty alleviation hence the system should be designed to reach large number of clients. For this to be possible credit should be subsidized.

On the other hand the sustainability camp argues for commercial micro credit in order to provide for long term institutional viability. They argue that for a large number of clients to be reached we need institutional viability where the interest rates are high. They further argue that the high rates do not discourage or affect the borrowing patterns of the poor (Rhyne 1995 study).This camp argue that institutional viability should be a means to an end of reaching the maximum number of people.

Rhyne concludes that some commercial institutions may operate for profits only and although this is negative it can be regulated by government and other bodies. However she concludes that this remains the only source of sustaining credit in the long run (Rhyne 1998)

# CHAPTER THREE

## *3.0 RESEARCH METHODOLOGY*

### *3.1 STUDY POPULATION*

The research which has been carried out has been qualitative. It has examined the benefit of microfinance service to a number of micro enterprises which include: taxi and boda boda business. These businesses have been supplied with finance from Commercial Microfinance.

### *3.2 THE UNIT OF ANALYSIS*

The paper has examined the sustainability of the S.M.Es financed by the micro loans from C.M.F. It has done this by examining the monthly cash payments and the monthly cash inflows of the businesses.

### *3.3 SAMPLE DESIGN*

The research being qualitative has looked at a small sample design. The sample has been drawn from willing loan beneficiaries and was targeted to salary loan beneficiaries since it is intended to look at the impact from educated beneficiaries.

### *3.4 DATA COLLECTION TOOLS*

The researcher has used the following data collection tools:

#### 3.4.1 OBSERVATION

The researcher examined physical assets to ascertain the businesses exits sand verified any information supplied by commercial microfinance and the loan beneficiaries

### 3.4.2. INTERVIEWS

The researcher conducted interviews with loan officers from Commercial Microfinance, and the loans beneficiaries. The interviews were a flexible source of information particularly from high level management. They covered all the information not included in the questionnaires.

### 3.4.3 QUESTIONNAIRES

These have been used to gather statistical information about general business performance, two questionnaires were given out. The first one was for the loan beneficiary which examined the actual business performance. The second was targeted to the loan issuer to verify the information especially about loan terms.

### 3.4.4 TRIANGULATION

The researcher has used this method to cross check data with other beneficiaries from other microfinance organizations. This helped to give the researcher a different perspective and help corroborate data given by beneficiaries from Commercial Microfinance.

## *3.5 DATA ANALYSIS*

The data analysis has been done according to the objectives of the research. It has answered the research questions. The researcher has tabulated the all the information gathered and accurately analyzed the data. Any divergence between the monthly cash payments and inflows has been clearly shown.

# CHAPTER FOUR

## *4.0 PRESENTATION AND FINDINGS*

### *4.1 INTRODUCTION*

The chapter analyzed data collected from the questionnaires and the methodology previously stated in chapter three. It's aim to achieve the stated objectives and answer the research questions.

### *4.2 BUSINESS PERFORMANCE*

The chapter has analyzed the two businesses a taxi business and a boda boda business. Both businesses have been solely financed by credit from Commercial Microfinance. The businesses are sole proprietorships. The owners have opened them up in order to provide themselves with additional income as they are both salaried workers

#### 4.2.1 THE TAXI BUSINESS

The respondent acquired a loan from Commercial Microfinance worth 10 million Ugandan shillings at a rate of 2.9% per month. She used the loan to acquire a Toyota Hiace worth about 8 million the rest of the money was used to pay for insurance, fit seats, pay for road license and some U.T.O.D.A charges this didn't account for the whole extra two million. The researcher suspects most of the extra money which is estimated to about UGX500, 000 was spent on domestic consumption.

#### 4.2.2 THE BODA BODA BUSINESS

The respondent obtained a loan worth UGX2, 400,000 at rate of 2.9% he used the loan to purchase a TVS motor cycle worth about 2.3 million at the time. He put the motor cycle in business by employing an operator. The additional income was spent on insurance and other expenses. The researcher also estimates that about UGX 100,000 was spent for personal use.

### 4.2.3 A SUMMARY OF THE MONTHLY BUSINESS PERFOMANCE

TYPE OF BUSINESS

**TAXI BUSINESS**

| | | |
|---|---|---|
| TOTAL MONTHLY REVENUE | | 2500000 |
| DAILY REVENUE | 70000-83000 | |
| TOTAL MONTHLY EXPENSES | | |
| 1470000 | 198000 | |
| SALARY | | |
| DRIVERS | 450000 | |
| CONDUCTOR | 250000 | |
| SERVICE | 600000 | |
| UTODA | 690000 | |
| BASIC NET INCOME | PER MONTH | 520000 |

**BODA BODA**

| | | |
|---|---|---|
| TOTAL MONTHLY REVENUE | | 750000 |
| DAILY REVENUE | 15000-25000 | |
| SALARY | 300000 | 300000 |
| SERVICE PER MONTH | 100000 | 150000 |

| | | |
|---|---|---|
| BODA BODA CHARRGES | | 50000 |
| BASIC MONTHLY INCOME | | 250000 |

## 4.2.4 BUSINESS PERFORMANCE COMPARED WITH MONTHLY CHARGES

**TAXI BUSINESS**

| | |
|---|---|
| MONTHLY CHARGES | 784015 |
| MONTHLY INCOME | 520000 |
| | - |
| NET REVENUE | 264015 |

**BODA BODA**

| | |
|---|---|
| MONTHLY CHARGES | 188274 |
| MONTHLY INCOME | 200000 |
| NET REVENUE | 61,726 |

## *4.3 THE EFFECTIVE INTEREST RATE*

Waterfield 1995 defined the actual cost of credit to be a summation of the total monthly payments and additional charges a loan recipient is charged. This is given by:

Effective cost= amount paid in interest and fees/average principal amount outstanding

Where:

Average principal outstanding= principal amount outstanding/number of payments

The effective rate will automatically raise the nominal rate for the taxi business

| | |
|---|---|
| Amount paid in interest= | 4,112,284 |
| Fees which include: | |
| Application fees= | 20,000 |
| Processing fees 2.0% of loan amount | 200,000 |
| Insurance 1.2% of amount | 120,000 |
| Total interest payments | 4,452,284 |
| | |
| Average principal outstanding | 7,877,956 |

Effective cost= 0.56

56% per annum

4.6% per month

4.3.1BODA BODA EFFECTIVE RATES

Amount paid in interest and fees /average principal amount

1,085,742/1,890,713

= 0.57 per annum

=57% per annum
=4.7% per month

4.3.2CHANGE IN PAYMENTS

TAXI

When the payments are analyzed using the effective rates the average increase in expenditure is expected to rise by 1.7 % and 1.8% per month, for the taxi and boda boda businesses respectively.

This is expected to reduce the net revenue of the businesses by the same margin. The paper has analyzed the effect o the boda boda business which has a slight positive figure.

An increase of 1.8 % on average will increase the monthly payments to 314,656 from 188,274 this will yield a negative revenue of (-64,656) from 61,176.

The paper has not analyzed the effect on the taxi business while taking into account the effective rate since it s already negative the figure is expected to further decline by the same margin as above.

## *4.4 COMMERCIAL MICROFINANCE PERFORMANCE AS AT JUNE 2005*

### 4.4.1 Commercial Microfinance Income Statement

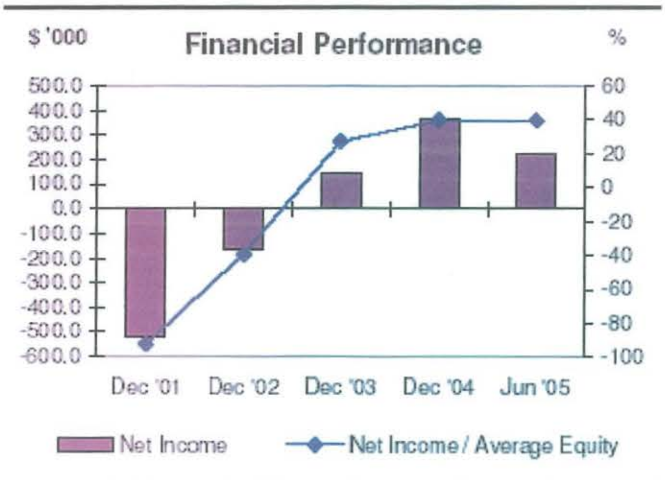
| Income Statement for the year ended: | 31-Dec-01 | 31-Dec-02 | 31-Dec-03 | 31-Dec-04 | 30-Jun-05 * |
|---|---|---|---|---|---|
| Interest and Fee Income | 770.2 | 1,091.8 | 1,156.4 | 1,686.5 | 1,394.6 |
| Interest and Fee Expense | (50.0) | (51.0) | (58.4) | (122.9) | (191.4) |
| **Net Interest Income** | **720.2** | **1,040.8** | **1,098.1** | **1,563.6** | **1,203.3** |
| Provision for Loan Loss | (6.5) | (55.8) | (71.3) | (33.4) | (64.9) |
| **Net Interest Income After Provisions** | **713.7** | **985.0** | **1,026.8** | **1,530.1** | **1,138.3** |
| Operating Expense | (1,393.7) | (1,205.0) | (965.9) | (1,359.6) | (956.8) |
| **Net Operating Income** | **(680.1)** | **(220.1)** | **60.9** | **170.5** | **181.6** |
| Other Income | 157.6 | 58.2 | 78.7 | 195.9 | 38.5 |
| Other Expenses | - | - | - | - | - |
| Extraordinary Items | - | - | - | - | - |
| **Net Income Before Taxes** | **(522.5)** | **(161.9)** | **139.6** | **366.4** | **220.1** |
| Taxes | - | - | - | - | - |
| **Net Income** | **(522.5)** | **(161.9)** | **139.6** | **366.4** | **220.1** |

Source www.microrate .com

### 4.4.2 COMMERCIAL MICROFINANCE EFFICIENCY AND PRODUCTIVITY

| | | | | | |
|---|---|---|---|---|---|
| **Efficiency and Productivity** | | | | | |
| Operating Expenses / Average Gross Loan Portfolio (%) | 107.6 | 78.8 | 55.1 | 46.6 | 52.2 |
| Cost per borrower | n.a. | 166.4 | 85.7 | 178.1 | 278.4 |
| Average outstanding loan size | n.a. | 107.8 | 241.0 | 541.3 | 745.4 |
| Number of Borrowers per Staff (no.) | n.a. | 128.1 | 84.1 | 67.9 | 47.5 |
| Number of Borrowers / Credit Officer (no.) | n.a. | 536.3 | 269.1 | 239.9 | 177.0 |
| Operating Expenses / Net Interest and Other Income (%) | 158.8 | 109.7 | 82.1 | 77.3 | 77.0 |
| **Profitability** | | | | | |
| Net Income / Average Equity (%) (ROE) | (92.6) | (39.5) | 27.2 | 39.4 | 39.6 |
| Net Income / Average Assets (%) (ROA) | (18.0) | (5.4) | 4.2 | 7.0 | 7.7 |
| Portfolio Yield (%) | 59.5 | 71.4 | 66.0 | 57.8 | 76.0 |
| Net Interest Income / Average Gross Loan Portfolio (%) | 55.6 | 68.1 | 62.6 | 53.5 | 65.6 |
| Non Interest Income / Total Operating Income (%) | 17.0 | 5.1 | 6.4 | 10.4 | 2.7 |

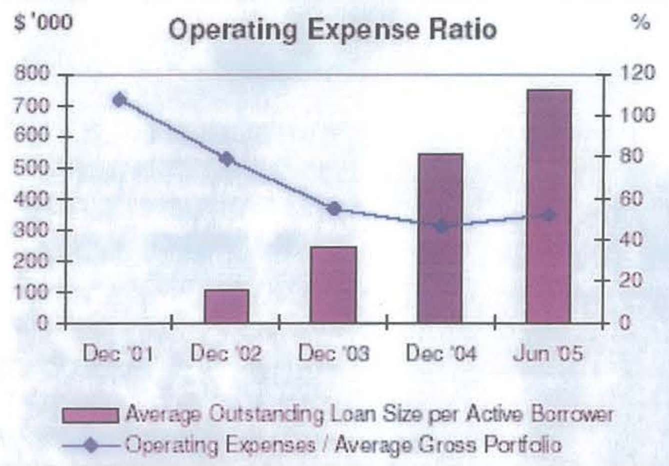
source www.microrate .com




Source www.microrate .com

The profitability of commercial microfinance has been impressive from it has risen from: a loss of 525,000 to 250,000 million USD in profit. The financial performance has moved from a negative amount in just a span of five years.

The operating performance has also improved it has reduced from USD1393000 In 2000 to 956000 USD in 2005




Source www.microrate .com

## 4.5 OTHER SOURCES OF CREDIT

This refers to finance from commercial banks the loans include both secured and unsecured credit. For the purposes of comparison the paper has examined the unsecure loans which closely compare with the microfinance loans expect the loan terms. The aver age loan in Uganda is about 26%. This translates to about 2.1% per month the credit is much cheaper than microfinance credit and with C.M.F credit by about 0.8% per month or 9.6%.per annum.

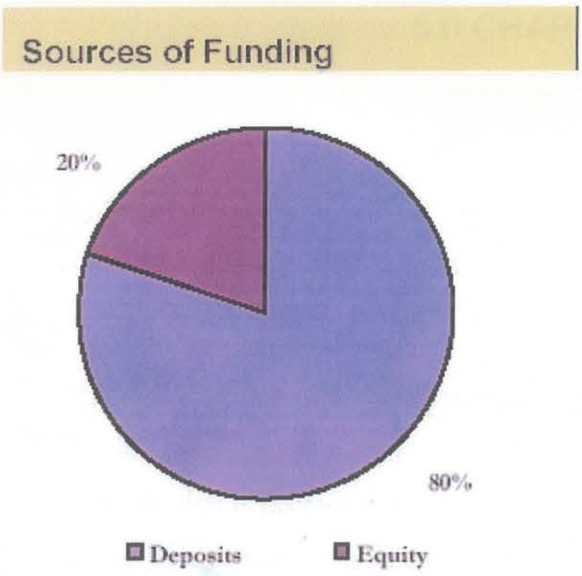
Finance from friends remains comparatively cheap with most of the time being interest free. Interest charged sometimes may be up to 10%. with the terms of payment and especially the duration being flexible.

On the other hand finance from loan sharks remains most expensive with interest being most of the time being around six times the cost of a normal microfinance loan (S.Maugurite 2000)

**Commercial microfinance capital structure**

| | | 2004 | 2003 |
|---|---|---|---|
| **Shareholders' equity** | | | |
| Share capital | 17 | **2,726,000** | 2,726,000 |
| Share capital pending allotment | | **557** | 557 |
| Revaluation reserves | | **27,000** | 33,750 |
| Retained profits | | **(749,863)** | (1,393,692) |
| **Total shareholders' equity** | | **2,003,694** | 1,366,615 |
| **Total shareholders' equity and liabilities** | | **11,631,661** | 7,171,611 |

Source: www. The mix market .com




Source: www.microrate .com

Commercial Microfinance follows a deposit based source of financing with customers deposits accounting for about 80% of the total equity as at June 2005

## *4.6 THE RELATIONSHIP BETWEEN THE LOAN STRUCTURE AND BUSINESS GROWTH*

The loan structure doesn't support business growth, Modurch (1997) shows that if the revenues from microfinance are less than the repayment installments then business growth will suffer. If the loan structure was more favorable the two businesses could use the extra money to either expand heir business or make their products more competitive by for example taking better care of their physical assets or may be to provide for depreciation some thing which small businesses cannot afford to do due to low working capital.

### 5.4 The Relationship between Institution viability and Small and Microfinance growth

We can deduce that the high interest rates have enabled institutional profitability. The high interest rates charged by commercially oriented microfinance institutions argue for higher rate since the poor people have an inelastic demand for credit [7](S.Maugurite 1999).

The microfinance institutions can charge high rates in order to facilitate rapid growth, profitability and eventual sustainability. Commercial Microfinance charges high rates compared with other lending sources such as commercial banks, housing finance schemes and SACCOS.

The nominal rates of 35% per annum and effective rates of almost 60% mean that although the institutes will achieve sustainability in a short period of time. Businesses on the other hand will find it difficult to operate due to the unfavorable credit terms. The sustainable institution may find nobody to lend to in the long run. This might be due to the economic hardship caused and the lack of public trust.

### 5.5 Subsidized interest rates vs. Commercial rates

The paper doesn't answer the on going debate on whether to use subsidized interest rates or not. But at the same time it gives us a clear insight on how going commercial from the onset can lead to increased vulnerability. The low level equilibrium trap shows that development has to be spear headed by a large number of entrepreneurs for them to have assured profits (Higgins 1999 pp345).

The commercial microfinance fundamentalists argue that for the system to be sustainable we must establish institutional viability. This will reach a large number of clients over a longer period of time (S.Maugurite 2000). If we hold the low level equilibrium trap to be true then we can only deduce that the profits motives of the small number of entrepreneurs will be suppressed and they will only end up being more vulnerable.

---

[7] Poor people have limited sources of credit hence they will borrow from expensive sources even if the interest rates are high.

## 5.6 Benefits of microfinance

Microfinance companies are here to stay whether they increase vulnerability or not. The benefits from micro finance are not only in the allocation of funds, they also perform other vital roles.

These organizations provide jobs to the population, they provide revenue to the government in form of taxes, they help in development of our infrastructure, and also they help to monetize our economy, and help educate our rural population by providing basic training.

## 5.7 SUMMARY

The microfinance sector has grown rapidly showing that the system is becoming viable (Otero and Rhyne) 1998. But this institutional viability has not automatically translated into micro enterprise growth for the two businesses analyzed. The results have yielded a negative growth pattern especially in the taxi business. This indicates that institutional viability has come at the expense of small business growth (Mudorch 1998).
The researcher also notes that its much wiser for clients to seek out the true amount of credit they are purchasing using the effective rate since it include all fees and charges M.D.I include in their loan package.

## 5.8 RECOMMENDATIONS

The research paper has come up with the following recommendations to the various stake holders of microfinance.

- The borrowers of microfinance should shop wisely for credit and should avoid credit drift by avoiding cheap credit which is easier to acquire but expensive in the long run. For example the research calculated the effective cost of a micro loan to be 56% per annum compared with 28% offered by commercial banks.

- Businesses using commercial micro credit should care fully analyze their debt capacity. They should determine if the cash inflows will cover the debt obligations in the loan term, and where a discrepancy emerges they should seek alternative financing prior to taking up the loan. This will help the business to start up well with no huge financial burden and when the loan term is over the business can return to profitability.

- Government and other regulatory bodies should come forward and control the lending rates to the poor. This is because the poor have inelastic demand for credit (Otero and Rhyne 1999) and they could be exploited by profit maximizing firms.

- The government should make the rates cheaper and credit available to more clients so that we can jump start our economy. It can accomplish this by providing more funding to the microfinance sector (subsidize) or provide cheaper credit by means of control.

- The microfinance institutions should also work toward's more efficiency. Commercial microfinance operating costs amount to about 46% which is still very poor compared to microfinancing in Asia. Lower operating cost will mean low rates for clients and higher profits for the institution. This will promote both institutional and business sustainability.

# REFRENCES

Ian M.D little *,Economic Development ,theory, policy and International relations* a twentieth century fund book 1992, N.Y U.S.A

Steve Hanke *Prospect for privatization, academy of political science* A.P.S 1987

Jonson Holmberg *Policies for A small planet* from the international institute for environment and development by EARTH SCAN PUBLICATIONS ltd London 1992 Edition reprinted 1992 ,120 Pentoville road London N

Maugurite S. Robinson *The microfinance revolution* by the I.B.R.D WORLD BANK, Washington D.C Open society institute N.Y 2002

Maugurite S. Robinson The microfinance revolution by the World Bank open society institute 2001.

Benjamin Higgins *Economic Development Problems, principals and policies* by Universal bookstore New Delhi India 1999

R.M Ocaya *A Research of the Economic Performance of Highly Indebted African Countries by* Bruno. for ECOMIC POLICY AND RESEARCH.CENTER ,1996

Sustainable banking with the microfinance handbook an institutional perspective by Joanna Ledger Wood published by the World Bank I.D.R.B Washington D.C, 20433
www.grameen bank.org
www.cmf. Com
www.micro rate .com
www.The mix market.com
www.bank of Uganda.com

# APPENDICES

## *APPENDIX 1. QUESTIONNARES*

My names are Kiiku James Ndambuki a student at Kampala International University. Iam conducting a research titled: The Effect of micro finance to micro enterprises. The objective of the research is to determine the extended to which the microfinance sector has aided (helped growth of the micro industry).

The following questionnaires are designed to collect information about the use and adequacy of microfinance supplied by our various practioners. The information will be use for only academic purposes. The researcher kindly request that the questionnaires be answered truthfully all information will be treated confidential and all ethical considerations shall be observed to prevent malice.

Thank you for your cooperation.

INDIVIDUAL QUESTIONNNARE

1. NAMES OF RESPONDENT..........................
2. SEX ...................M..............F
3. AGE.......................................
4. OCCUPATION...........................
5. BUSINESS VENTURE UNDER TAKEN.......................
6. LOAN SIZE (amount).....................
7. INTREST CHAREGED (per month)................%

8. OTHER CHARGES

Type amount

i. ..................... ................

ii. ................ ................

iii. ................ .............

iv. ................ .............

Total monthly charges

8. Monthly business income................................

9. Organization advancing the loan..........................

10. Criteria for choosing the organization.....................

11. Satisfaction with loan terms

LEVEL REASON

(VERY

SATISFIED)...........................................................................

.........................................................................................

.........................................................................................

(SATISFACTORY)..................................................................

.........................................................................................

.......................................................................................

(NOTSATISFIED)....................................................................

.........................................................................................

.........................................................................................

## *APPENDIX 2. ORGANIZATIONAL QUESTIONNARE*

1) Name of the organization.........................................................................

2) Legal status of the organization, registered and operates in which class or which tier of the bank of Uganda.......................................................................................

..........................................................................................................................

3) When did the organization begin its operation?

.........................................................................................

4) What are the rates of lending commercial salary loans?

.........................................................................................

5) What is the average repayment rate of the salary loans?

.........................................................................................

6) Has they been any impact analysis carried out concerning the repayment rate of the loans? If yes when was it carried out

.........................................................................................................................

7) Briefly what is the criterion of choosing a successful applicant for a salary loan?

.......................................................................................................................

8) What are the various sources of financing the organization s using?

(tick where appropriate)

DEPOSITS ☐

DONOR FUNDING ☐

COMMERCIAL CREDIT ☐

EQUITY ☐

## *APPENDIX 3. RESEARCH BUDGET*

| ITEM | UGX |
|---|---|
| TRANSPORT | 25,000 |
| LIBRARY CHARGES | 20,000 |
| INTERNET CHARGES | 20,000 |
| PRINTING AND BINDING | 40,000 |