*IOSR Journal of Business and Management (IOSR-JBM)*
*e-ISSN: 2278-487X, p-ISSN: 2319-7668. Volume 21, Issue 10. Series. IV (October. 2019), PP 01-13*
*www.iosrjournals.org*

# Effects of Debt Financing on the Growth of Small and Medium Enterprises in Kapsabet Town, Nandi County

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***Abstract:*** *Small and medium enterprises (SMEs) are considered important in both developed and developing countries. They produce goods and services which help to increase economic growth and contribute significantly to employment creation. Although SMEs play a crucial role in economic development their operations are often crippled by lack of adequate financing. The purpose of this study was to investigate the effect of debt financing on the growth of SMEs in Kapsabet town, Nandi County. The study was based on a descriptive survey design. The study targeted 2000 registered SMEs in Kapsabet Town. The target population comprised of 420 SMEs. Yamane's formula was used to obtain a sample size of 80 respondents. The respondents were selected through purposive and stratified random sampling techniques. Questionnaires were used to collect data. The data was coded, quantified and analyzed quantitatively and qualitatively. Quantitative data was analyzed by the use of descriptive statistics such as mean, standard deviations, frequencies and percentages and inferential statistics which included regression analysis. Data analysis was done with the aid of statistical package for social sciences (SPSS) version 25.0. Based on the study findings, the study concludes that debt financing impacted on the growth of SMEs in Kapsabet town. SME relied on trade credit to promote growth their SMEs. There was a positive relationship between trade credit and growth of SMEs in Kapsabet town. The study also concluded there was a positive relationship between microcredit and the SMEs' growth. The study recommends that SMEs should establish good credit history with the lending institutions sothat they can continue accessing funding.*

***Key words:*** *Debt Financing, Microcredit, SME Growth, SMEs, Trade Credit*

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Date of Submission: 07-10-2019 Date of Acceptance: 22-10-2019

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## I. Introduction

Debt financing is the acquisition of capital from a particular lender to run a business and repay it back within a specified period of time with interest (Horne, 2013). According to Torre (2016) debt financing is a system of funding in which a company takes delivery of credit which includes long term debt and short term loans and gives its promise to repay the credit thus guaranteeing11 their competitiveness and that of the nation as a whole(Frasch, 2013). Debt financing option is aimed at improving the business earnings to recover its cost, benefit the proprietors, and retain the surplus (Damodaran, 2013). Debt financing option is utilized by both startups, and existing enterprises to expand and get out of tough economic conditions (Hussain, 2016). Debt financing option takes the form of trade credit also known as spontaneous credit from suppliers, SME loans, loans from individuals, financial institutions and the governments.

Debt financing is the most important factor determining the growth of SMEsin both developing and developed countries. The definition of SMEs differs from one country to another depending on staff establishment, value of noncurrent assets and rate of turnover. Mensah (2016)defines SMEs as enterprises with six to twenty nine employees or having non-current assets amounting to or less than $100,000.Srinivas (2015) defines SMEs as registered businesses with less than 250 employees that contribute heavily to employment and GDP, often have great difficulty accessing financial services and grow in ways linked to the formalization of an economy. The essence of MSEs is to create employment opportunities to minimize poverty (Onoja&Ovayioza, 2015).

### 1.1.1Global Perspective of Debt Financing and Growth of SMEs

The significance of MSEs of providing employment opportunities that ultimately minimizes poverty has motivated various governments all over the world to offer them funds at subsidized interest rates (Onoja&Ovayioza, 2015). Those SMEs which do not receive funds from the governments resort for trade credit, short-term loans and long-term loans from suppliers, relatives, friends and Microfinance institutions (Matarirano, 2007).Generally, SMEs have the capacity to achieve rapid economic growth and employment

creation (Reddy, 2015). Studies by Hatega (2007) and Kauffmann (2016) underscore the importance of SMEs in both economic growth and employment creation. The importance of the sector is particularly apparent in its ability to provide reasonably priced goods, services, income and employment to a number of people (Kauffmann, 2016). It is for this reason that there has been a growing interest and concern by governments and development agencies all over the world for the improved performance and growth of SMEs.

Globally, empirical studies show that SMEs contribute over 55% of Gross Domestic Product (GDP) and over 65% of total employment in high-income countries such as Britain, USA, Canada and China (Asta&Zaneta, 2010). In middle-income countries, formal SMEs contribute about 20% more to employment and GDP than the informal enterprises. Thus, in these countries, eliminating factors that discourage informal enterprises from entering the formal SME sector would also bring about gains in economic terms. In addition, SMEs are an important source of export revenues in some developing economies. For example, SMEs contribute a larger share of manufactured exports in more industrialized East Asian economies (56% in Chinese Taipei, more than 40% in China) and in India (31.5%) compared to 1% in Tanzania and Malawi.

**1.1.2 Regional Perspective of Debt Financing and Growth of SMEs**

Due to the important role played by SMEs, African governments have put in place programmes to encourage growth of the sector through such interventions as creation of an enabling legal framework, access to markets, finance, training, infrastructure, capacity building, taxation and financial incentives among others (Eden, 2016). For example, in Nigeria, the overall regulatory framework for the SMEs is driven by specific SMEs acts which specify the key institutional linkages for effective coordination.

In Malawi and Ghana, the contribution of SMEs to employment and GDP is less than that of the formal sector, where the great majority of the poor make a subsistence living (Aremu&Adeyemi, 2011). Therefore, an important policy priority in such countries is to reform the policies that divide the informal and formal sectors, so as to enable SMEs obtain adequate debt financing to spur business growth (Meyer-Stammer, 2016).

**1.1.3 Kenyan Perspective ofDebt Financing and Growth of SMEs**

The Kenya situation is no different from the rest of the world in as far as the recognition and support of the small business is concerned. The new SME Act provides a window of opportunity through which the growth of SMEs can be realized. However, the impact of debt financing on growth of SMEs depends on its ability to support the growth of SMEs (Langat, 2013). However, the number of SMEs has been increasing rapidly for the last two decades with the majority based in the rural areas. According to the National Small Enterprise Baseline Survey (GoK, 2007), about 1.3 SMEs have been started in Kenya. In Kenya SMEs are those enterprises with between 11 and 50 workers and annual turnover of less than or equal to KES 500,000 as well as capital formation not exceeding KES 5 million. Unlike large enterprises, MSEs survive by resisting harsh economic conditions because of their sizes and flexibility (Rosemond, Daniel & Rudolf, 2012).

Therefore, the usage of debt capital in Kenya has been on the rise among the SMEs and well managed firms have maintained suitable growth as well as profitability in the various industries across the market. The SMES segment has grown at almost twice the rate of GDP and is expected to grow at 10-12% per year. SMEs in Kenya have played an affirmative role in debt capital financing strictly to SMEs. The level of employment within SMEs in 2017 accounted for over 74.2% of the total number of persons engaged in the country. However, SME Baseline Survey also indicates that there is high rate of failure and stagnation among many start-up businesses. According to Langat (2013) 57% of small businesses are in stagnation with only 33% showing some level of growth. Yet, development plans for Kenya have consistently been putting special emphasis on the contribution of small and medium size enterprises in the creation of employment in the country (RoK, 2012). In Kapsabet town there are about 5000 registered SMEs. Lately, there have been manycases of failure and stagnation of SMEs in the area.

**1.2 Statement of the problem**

Debt capital is important in the success of any business (Derbile, 2003). An ideal level of debt capital should maximize the value of the firm and minimize capital cost. Despite the perceived benefits, debt capital usage in SMEs in Kenya has been low. There are many SMEs in Kenya which have been unable to access debt financing from existing institutions in the finance sector. The study puts the access of loans at 2.8% which is relatively low compared to the universal global levels of debt capital access of SMEs. Davidson (2012) observes that large amount of business financing creates a variety of problems to SMEs. On the other hand if the SMEs have too much debt, its access to financing may be constricted before the SMEs had a chance to complete its growth strategy. In this regard there has not been an extensive study on how the debt capital has affected the growth of SMEs. In view of this, there is need to examine the extent to which SMEs should embrace use of debt capital in order to improve the SMEs short-term and long term growth objectives. Past studies have focused on factors inhibiting the growth of SMEs in Kenya. However, recent studies have not focused on effect of debt

financing on the growth of SMEs in Kenya. It is against this background that the study sought to investigate the effect of debt financing on the growth of SMEs in Kapsabet town.

**1.3 Objectives of the Study**

i. To determine the effect of trade credit on the growth of SMEs in Kapsabet town.
ii. To establish the effects of microcrediton the growth of SMEs in Kapsabet town.

**1.3 Hypotheses of the Study**

**Ho1:** There is no statistically significant effect of trade credit on the growth of SMEs in Kapsabet town
**Ho2:** There is no statistically significant effect of microcredit **on the** growth of SMEs in Kapsabet town

## II. Literature Review

**2.1 TheoreticalReview**

Theories of debt financing try to explain what happens to the overall cost of capital and the value of the firm when the proportions of the funds that make up the debt financing are varied. This section discusses the theories that guided the researcher in understanding the relationship between the variables and to what degree the theories have been investigated. This assisted in developing new hypothesis to be tested. These theories included theKeynesian Theory of Public Debt and the agency Theory.

**2.1.1 Keynesian Theory of Public Debt**

The economics of public debt in modern public finance was powerfully influenced by the Keynesian Revolution which produced theoretical results entirely different from the body of economic thought existing at the time of its development. The scientific basis forthemodern theory of public debt was provided by the General Theory of Employment, Interest, and Money in 1936. The new theory in its purest form finds expression in Functional Finance which holds that the absolute size of the national debt does not matter at all, and that, however, large the interest payments that have to be made, these do not constitute any burden upon society as a whole.The proponents of the no burden doctrine treat the economy as a unitand accordingly holdthat private debt differs from national debt in being external. It is owed by one person to others. Because it is interpersonal, the proper analogy is not to national debt but international debt. This theory was relevant in the current study given that it helped to explain the intricacies surrounding sources of government financial services such as Uwezo fund and youth fund.

**2.1.2 Agency Theory**

Agency theory addresses the agency issue in which one party (the principal) delegates work to another (the agent), who performs that work (Jensen &Meckling, 1976). There is an agency relationship when the actions of one individual affect both his welfare and that of another person in an explicit or implicit contractual relationship. The individual who undertakes the actions is the agent and the person whose welfare (utility), measured in monetary terms, is affected by the agent's actions is called the principal (Myles, 2010). The typical case of agency relationship is the one that exists between the lender (the principal) and the borrower (the agent). In an agency relationship, the principal wants the agent to act in the principal's interest. However, the agent is expected to have his own interest and consequently, may not act in the principal's best interests. If both parties to the relationships are utility maximizers, there is a good reason to believe that the agent will not always act in the best interests of the principal. Hence, the principal's problem is to design an incentive contract that induces the agent to undertake actions that will maximize the principal's welfare(Jensen &Meckling, 1976). However, both the principal and agent are confronted with uncertainty. This uncertainty may appear in various ways. The principal may be uncertain about actions undertaken by or information held by the agent. This is called asymmetric information.

The state of asymmetric information occurs when the agent holds information that the principal does not have. The uncertainty also bears on the outcomes of the agent's own actions (Mary, 2007). The principal becomes uncertain about the causality between agent's actions and the outcomes. This state of uncertainty and the resulting state of asymmetric information that exists between the principal and his agent impose certain constraints which complicate the contract between them (Artley, 2001; Myles, 2010). In the context of this study debt financing may fail to promote the growth of SMEs if asymmetric information occurs between the agents (SMEs operators) and the principal (lenders). For instance, the theory could explain how selfish actions of lenders (principals) affect the growth of SMEs and thus affect the welfare of SMEs operators. Their actions could include high interest rates which lead to poor growth of SMEs (Muga, 2014). Hence, the agency theory was useful in explaining why some SMEs collapse.

**2.2 Conceptual Framework**

The conceptual framework explains the relationship between the independent variables and the dependent variables (Kothari, 2004).The conceptual framework is presented in figure 1 which indicates that the independent variables for the study weretrade credit and microcredit, while the dependent variable for the study wasthe growth of SMEs.

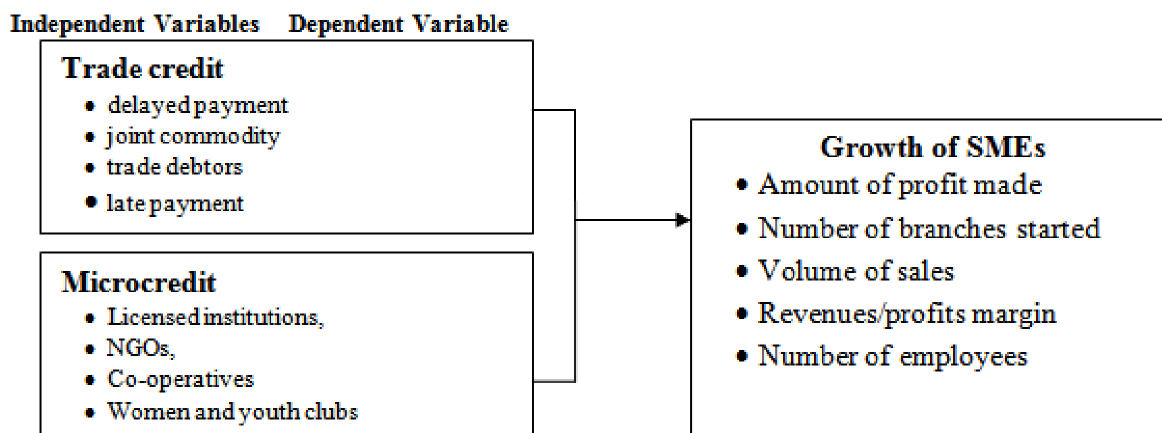


**Figure 1:** Conceptual Framework

**2.3Empirical Review**

This section presents a review of related literature on the effect of debt financing on the growth of SMEs. The review is based on observable phenomena derived from empirical studies.

**2.3.1 Debt Financing**

Firms need capital in their operations. They can finance their operations using internal funds, debt and equity. Debt finance is raised by borrowing from financial institutions. A lot of research has been carried out on the impact of debt financing on performance of firms. The results from these studies are inconsistent. Cecchetti (2011) studied the effects of debt on firms and concluded that moderate debt level improves welfare and enhances growth but high levels can lead to a decline in growth of the firm. Rainhart and Rogoff (2016) argued that debt impacted positively to the growth of a firm when it is within certain levels. When the ratio goes beyond certain levels financial crisis is very likely. However, over borrowing can lead to bankruptcy and financial ruin (Ceccetti, 2011). High levels of debt will constrain the firm from undertaking project that are likely to be profitable because of the inability to attract more debt from financial institutions. The nature of debt is an important determinant of productivity of a firm. Jaramillo and Schiantarelli (1996) stated that the availability of long-term finance allows firms to improve their productivity.

A firm with a high debt ratio will channel most of its income to debt repayments thereby forgoing investment using internal funds. As more debt is employed in the debt financing of a firm, the business risks also increase.Ahmad, Abdullar and Roslan (2012) carried a study in Malaysia which sought to investigate the impact of debt financing on firm performance by analyzing the relationship between return on assets (ROA), return on equity (ROE) and short-term debt and total debt. The study established that short-term debt and long-term debt had significant relationship with ROA. A study by Ebaid (2016) sought to establish the relationship between debt level and business growth of companies listed on the Egyptian stock exchange. Using the return on assets, return on equity and gross profit margin as dependent variables and short-term debt, long-term debt and total debt as independent variables, the findings showed that there was a negative impact of short-term debt and total debt on return on assets (ROA).

Fosu (2013) carried out a research in South Africa to investigate the relationship between debt financing and corporate performance paying particular attention to the degree of competition. The paper examined the extent to which the relationship between debt financing and corporate performance depended on the level of product market competition. The findings from the research showed that there was positive relationship between debt financing and corporate performance. The study also found out that product market competition enhanced the performance effect of leverage.Ogebe, Patric and Alewi (2013) investigated the impact of debt financing on corporate performance in Nigeria. The study paid particular attention to macroeconomic variables (GDP and inflation) on firm performance. The study concluded that there was a strong relationship between leverage and corporate performance.

**2.3.2 Effect of Trade Credit**

Trade credit is an arrangement between a buyer and seller by which the seller allows delayed payment for its products instead of cash payment(Mian& Smith, 2015).Trade credit plays an important role in firm financingpolicy. For the buyer, it is a source of financing through accounts payable, while for theseller, trade credit is an investment in accounts receivable.

Previous studies have focused on explaining the determinants of trade credit, with most of this literature focused on large firms(Niskanen&Niskanen, 2016). However, tradecredit is particularly important in the case of small and medium-sized companies, sincetrade debtors are the main asset on most of their firms' balance sheets. Given the significant investment in accounts receivable, the choice of creditmanagement policies could have important implications for firm'sgrowth. Studies such as Demigurc-Kunt andMaksimovic (2017) argue that firms operating in countries with more developed SMEs systems grant more trade credit to their customers. In countries with weak legal systemsthe provision of trade credit by suppliers may also be an important channel by whichfirms can access capital indirectly, through their suppliers,because of the difficulty in accessing financial markets (Rajan&Zingales, 2018).

Trade credit might be used tosmooth demand, thus enhancing firm growth. There is evidence that tradecredit as an instrument in mitigating information asymmetry regarding product qualityincreases a firm's profitability. On the contrary, larger companies get more return oninvestment in trade credit than smaller firms with no reputation in product markets.There are many reasons that lead suppliers to extend credit. Chiefly,granting trade credit enhances firm's sales, and consequently may result in higherprofitability. Meltzer (2012) states that a primary function of trade credit is to mitigatecustomers' financial frictions, thus facilitating increased sales and market share growth(Nadiri, 2015). In addition to resolving financing frictions, trade credit can boost sales byalleviating informational asymmetry between suppliers and buyers in terms of productquality (Smith, 2011). In this sense, the seller's investment in tradecredit facilitates exchange by reducing uncertainty about product quality. Besides increased sales, trade credit mayincrease revenues through interest income or reduction in transactioncosts (Emery, 2011). However, the provision of trade credit entails negativeeffects such as default risk or late payment, which may damage firm profitability.Moreover, extending supplier financing involves administrative costs associated with thegranting and monitoring process, as well as transaction costs for converting receivablesinto cash (Emery,2011). Further, carrying receivables on the balance sheet implies directfinancing and opportunity costs, so reducing funds available for expansion projects.

**2.3.3 Effect of Microcredit**

Micro-finance institutions (MFIs) have proved to be a reliable delivery vehicle for financial services to SMEs. They consist of licensed institutions, SMEs, co-operatives as well as a large collection of associations ranging from women and youth clubs to loosely organized bodies. They offer savings, payments and insurance services to their clients (Mwangi, 2011). The strength of MFIs is that they serve the rural areas at low costs. Their service delivery is flexible, which makes it easy for SMEs to access financial services from them. Their weaknesses, though, lie in their weak operational and management information systems, poor internal controls, limited access to technical assistance, and dependence on donor funding. SMEs need capital injection to facilitate their operations and growth, but the existence of the financing gap requires microcredit to fill the gap (Derbile, 2003). This implies that success of microcredit has been achieved in alleviating poverty in developing countries. SMEs gain self-employment, create job opportunities and women gain economic empowerment to meet their family needs.Mayoux (2017) asserts that microcredit programmes have been promoted as among key strategies for poverty alleviation and women empowerment. Economic independence is gained by enabling SMEs meet their basic needs.

Microcredit programmes provides SMEs with access to networks and equipping markets to necessitate wider experience by individuals. Microcredit programmes results in social benefits. According to Kiraka (2013) many studies have been done in the past and reveal that micro credit improves capacity to cope with economic difficulties because there is a positive influence on the well-being of borrowers. Despite the positive impacts of micro credit, there are arguments against microcredit. Micro credit does not create assets for the poor and the very poor borrowers, but increases income to meet daily expenditure. To some it reduces assets due to the demand of repayment of loan as it is severe that borrowers are compelled to sell assets to repay loan.

**2.3.3Debt Financing and Growth of SMEs**

The aim of any firm is to make profits and later grow or expand its operation (Mashenene, 2014). The firm size is the result of firm growth over a period of time and it should be noted that firm growth is a process while firm size is a state. The growth of a firm can be determined by supply of capital, labor and appropriate management and opportunities for investments that are profitable (Fjose, 2010). Accessing finance has been identified as a key element for SMEs to succeed in their drive to build productive capacity to compete, to create jobs and to contribute to poverty alleviation in developing countries. Without finance, SMEs cannot acquire or

absorb new technologies nor can they expand to compete in global markets. The effects of debt financing on the profitability of SMEs need to be understood in terms of business capital and stock growth. According Caruabna (2017) market share growth is one which a portion of customer base keeps on increasing in the same proportion of resource input. Market share can be thus defined as a portion held by a particular business entity relative to a competitor.

This study focused on increase in volume of sales, employment levels, andprofitability and total assets as a measure of growth of SMEs. Due to the important role played by SMEs, measures have been put in place to encourage growth of the sector through such interventions as creation of an enabling legal framework, access to markets, finance, training, infrastructure, capacity building, taxation and financial incentives among others and devolving SMEs policies and frameworks to the county governments (Eeden, 2005).

Several scholars have studied the effect of diverse factors on the growth of SMEs in Kenya. According to Langat (2013) the challenges facing SME include lack of access to credit among others. In Kapsabet town, a number of SMEs growth indicators have been observed including the number of business enterprises, number of business activities, increase in market for the production, increase in employment absorption rate, overall economic growth and increased rate of investment in real estate by SMEs entrepreneurs. Preliminary studies show that the mandate given to SME debt financing is important and can help promote the growth of SMEs.

According to a report by the Republic of Kenya (2012)government funding initiativescan enhance the growth of business opportunities at the county level. These include county consultative meetings, explicit and open policy development processes and transparent county government activities. These supportive county government institutions evidenced by an operational public-private dialogue framework would provide avenues through which the SMEs associations can present their interest .through the county assemblies. According to Iorpev (2012) these initiatives are tasked with ensuring that SMEs produce quality products that meet both local and international standards, while enhancing consistency and cooperation with other sectors. Recent studies show that some county governments have started upgrading the SME products, building capacity to manufacture upgraded products, promoting innovation and technology transfer, instilling a culture of quality and standardization and promoting the use of intellectual property as a tool of trade and business. A study by Kiraka(2013) found out that these initiatives have recorded encouraging results in some counties including training over 1,000 SMEs on mass production of quality products while diversifying on their debt financing.

**2.4 Critique of Literature Review**

This section presents a critique of empirical literature. It presents a critique of review of previous studies on the effect of debt financing and growth of SMEs. Studies will be compared and contrasted in terms of methodology, objectives, variables, conclusions and research gaps. Rennie (2016) investigated debt financing in SMEs in USA. The mainstay of this study was to find out how lending policies were shaped by both internal and external factors. This study differs from the present study in the sense that the present study investigates the effect of debt financing on growth of SMEs whereas Rennie (2016) attempted to explain the factors that affected lending options for SMEs. In addition, its geographical area is also different with the one in which the present study is. Heshmati (2013) in his study on dynamics of debt financing of Micro and small firms in Sweden found that listed companies have easier access to the equity market compared to smaller companies because of low fixed cost thus indicating a negative relationship between firm size and debt levels. Shubita and Alsawalhah (2012) in a study of the relationship between debt financing and profitability of industrial Jordan companies suggested that firms with high profits depend heavily on equity as their main financing option.

In African countries most empirical studies have highlighted the significance of debt financing to the extent of identifying factors influencing the structure of debt financing (Oyatoye&Arileserre, 2012). Based on a survey design, Ubom (2014) studied the link between debt financing of firms and socioeconomic development and investment in Ghana. Kihinde (2012) studied relationship between debt financing mix of SMEs and overall performance of firms in Nigeria. The study revealed that most of the SMEs have all equity finance structure and have less debt finance compared to equity finance. It also revealed that the earnings survival and performance of the SMEs is strongly influenced by debt financing mix.

In Kenya Mutugi (2012) sought to establish factors that influenced growth of SMEs in Makueni County. He however chose to dwell on the qualitative factors such as innovation, organizational culture and ownership structure. The study concluded that capital structure, innovation and ownership structure were determinants of growth of SMEs. Birundu (2015) examined the effect of debt financing on the business growth of small and medium enterprises in Thika Sub-County, Kenya. In his findings there was no significant effect of debt financing on the business growth of SMEs in Thika sub-County, Kenya. Karanja(2014) carried out a study on effect of debt financing on business growth of Kenyan SMEs. The study concluded that debt financing has significant impact on the growth of SMEs.

**2.5 Summary of Literature Review**

The literature reviewed has presented analysis of studies in different areas with regard to the role of debt financing on the growth of SMEs. It is evident that many SMEs have failed due to ineffective debt financing that keep them out of business (Nyaga, 2012). Some have suffered due to unfavourable business environment and lack of sound policy decisions for sustainable SMEs growth (Seibel &Parhusip, 2016). Closer analysis of literature review confirms existence of multiple institutions handling SMEs issues in Kenya. In addition, the extentsto which debt financing may affect SMEs growth have been examined (Asta&Zaneta, 2010; Langat, 2013). Moreover, debt financing is expected to increase the incentives for growth of SMEs.

**2.6 Research Gap**

From the review of relevant literature it is evident that research in the area of debt financing has been done both internationally and locally. Rennie (2016) investigated debt financing in SMEs in USA focusing on how lending policies were shaped by both internal and external factors. Shiu (2014) analyzed the determinants of SMEs performance in the UK. Heshmati (2013) studied the dynamics of debt financing of Micro and small firms in Sweden. Shubita and Alsawalhah (2012) carried out a study on the relationship between debt financing and profitability of industrial Jordan companies. Ubom (2014) studied the linkage between debt financing of firms and profitability in Ghana. Kihinde (2012) studied the relationship between debt financing mix of SMEs and overall performance of SMEs in Nigeria. Mutugi (2012) studied the factors that influenced growth of SMEs in Makueni County. Kamau (2010) and Birundu (2015) studied the relationship between debt financing and business growth in Nakuru County and Thika Sub-County. From these review, it is evident that a few studies have been carried out in regard to debt financing. However, there is no specific study on debt financing and growth of small and medium enterprises in Kapsabet town, Kenya. Therefore, this study was conducted in order to fill the gaps in literature.

## III. Methodology

The study was based on descriptive survey design. Descriptive survey design was used to obtain information concerning investment debt financing and explain the effect of debt financing on the growth of SMEs in Kenya. The approach was quantitative in nature and relied on primary data and secondary data. The descriptive survey design enabled researcher to explicitly predict the impact of debt capital usage in the operation of SMEs in Kapsabet Town without observing all SMEs in totality. Secondary data was obtained from financial reports and policies on SMEs in Kapsabet Town.

The target population for this study was SMEs legally registered in Kapsabet Town. An estimated 2,000 registered SMEs operate in Kapsabet town. Since it was not easy to target all SMEs in Kapsabet town, a summary of the accessible population is shown in Table 1

**Table1:** Distribution of Accessible population

| Type of Business | Target Population |
|---|---|
| Hotel Industry | 50 |
| Electronic Shops | 70 |
| Retail Shops | 120 |
| Agrovet and Human Dispensing Chemists | 30 |
| Cosmetic Shops | 42 |
| Spares and Automobile Shops | 69 |
| Boutiques | 39 |
| **Total** | **420** |

In order to give a fair and equal opportunity to each SME, the researcher used stratified random sampling. The sample size was selected from the list of registered SMEs operating in Kapsabet Town. In order to carry out a scientific study, the target population was categorized into type of business and from each type equal number of respondents was selected to constitute the sample size. To obtain a representative sample size the following formulae by Yamane (1973) was used:

$n = N/(1+Ne^2)$ Where

**n:** is the sample size

**N:** target population

**$e^2$ :**is the standard error with 0.1 level of significance

The sample size obtained from this formula is 80 respondents. This presented in table 2.

**Table 2:** Sampling Frame

| Type of Business | Target Population | Sample Size | Percentage (%) |
|---|---|---|---|
| Hotel Industry | 50 | 10 | 12.5 |
| Electronic Shops | 70 | 13 | 16.25 |
| Retail Shops | 120 | 23 | 28.75 |

| | | | |
|---|---|---|---|
| Agrovet and Chemists | 30 | 6 | 7.5 |
| Cosmetic Shops | 42 | 8 | 12.5 |
| Spares and Automobile Shops | 69 | 13 | 16.25 |
| Boutiques | 39 | 7 | 8.75 |
| **Total** | **420** | **80** | **100** |

The researcher employed the questionnaire in data collection. The questionnaire was self-administered and will involve direct and face to face meeting between the researcher and the respondents. The questionnaire consisted of a list of both close ended and open ended questions. The close ended questions were structured in Likert rating scales. The questionnaires had five sections seeking data on the demographic details of the respondents, effect of trade credit, effect of microcredit, effect of bank loans and effect of borrowing from the government financial institutions on the growth of SMEs.A pilot study was conducted before carrying out the main study. The instrument was taken for piloting with ten SMEs in Eldoret Town. The pilot study helped to see whether the results of the pilot study correspond with the objectives of the study.The researcher scrutinized the instrument comparing it with the set objectives to ensure that it contained all the information that helped to answer the research questions and address the study objectives.The internal consistency method of testing reliability was used. This provided a unique estimate of reliability for the given test administration. The reliability was ensured by testing the instruments during pilot study.Cronbach's alpha for estimating internal consistency reliability was used. Cronbach's alpha of 0.70 and abovewas considered acceptable.

Data was categorized through coding and tabulations. Before the actual data analysis, data obtained through questionnaire was validated and edited. The returned questionnaires were scrutinized to determine correctness and accuracy of responses. The results were coded based on the study variables. Cross tabulations were also generated to explain the various attributes of the variables studied and to represent the quantitative data. In this study descriptive and inferential statistics were used in data analysis, with the aid of the latest version of Statistical Package for Social Sciences (SPSS) version 25. Tables were used to represent data collected for ease of analysis. Descriptive statistics included mean, standard deviations, frequencies and percentages.Regression analysis was used to determine the nature of the relationship between the study variables at a generally accepted conventional significant level (P=0.05). This helped to ascertain the extent to which each of the independent variables significantly affected thegrowth of SMEs as the dependent variable.The regression model is: $\mathbf{Y = \beta_0 + \beta_1 x_1 + \beta_2 x_2 + e}$Where:

**Y** = Growth of SMEs
$\mathbf{B_0}$ = Constant Term
$\boldsymbol{\beta_1}$ to $\boldsymbol{\beta_4}$ = Regression Coefficients
$\mathbf{x^1}$ = Trade credit
$\mathbf{x^2}$ = Microcredit
**e** = error

## IV. Results and Discussion

### 4.1 Descriptive Statistics

Analysis of descriptive statistics was done to establish the respondents' views on various study variables. Thus, respondents' views were sought in regard to trade creditand microcredit, and growth of SMEs.The researcher computed the means and standard deviation values of the responses to explore the respondents' perception in regard to trade credit. The findings are as presented in table 3.

**Table 3:** Perception of Respondents on Trade credit

| | SA | A | N | D | SD |
|---|---|---|---|---|---|
| **Statements** | % | % | % | % | % |
| Through trade credit, suppliers reduce the transaction costs associated with liquidation of lending exchange | 28 | 37 | 17 | 10 | 8 |
| My SME relies on trade credit to promote growth | 39 | 35 | 10 | 5 | 11 |
| I finance my SME through trade credit when other types of finances are not sufficiently available | 50 | 32 | 3 | 7 | 8 |
| Trade credit is an important financial approach for SMEs | 50 | 27 | 6 | 0 | 17 |
| My SME has a higher dependence on the trade credit because of manifold constraints to traditional capital market | 41 | 34 | 11 | 6 | 8 |
| My SMErelieson trade credit as certain investment to improve value and profitability | 37 | 27 | 16 | 15 | 5 |

From the findings the researcher established that the respondents agreed that throughtrade credit, suppliers reduced the transaction costs associated with liquidation of lending exchange (65%). On the other hand majority of the respondents agreed that SME relied on trade credit to promote growth (74%), SMEs also financed their SMEs through trade credit when other types of financeswere not sufficiently available (82%) and trade credit was an important financial approachfor SMEs (77%). In addition, the respondents agreed that their

SMEhad higher dependencies on the trade credit because of manifold constraints to traditional capital market (75%) and that SMEreliedon trade credit as certain investment to improve value and profitability (64%).

These findings concur withMianand Smith (2015)who revealed that trade credit allowed delayed payment for its products instead of cash payment.According to Lee and Stowe (1993) enabled firms to sells goods or services and simultaneously extend credit forthe purchase to the customer. The results are also in harmony with Mian and Smith (2015) who argue that through trade credit firms are able to obtain funds when facing financial challenges. In addition, Demigurc-Kunt andMaksimovic (2017) argue that trade credit is an important channel by whichfirms can access capital indirectly, through suppliers,because of the difficulty in accessing financial markets.Nadiri (2015) also concurs that trade credit can boost sales byalleviating informational asymmetry between suppliers and buyers in terms of productquality.The respondents observed that SMEs received trade credit to boost their business. This improves growth of SMEs. This finally boosts jobs and boost the country’s GDP, they face a myriad of challenges that always hamper their growth. Overall, the respondents noted that trade credit helped many SMEs boosttheir incomes.

**4.2 Microcredit and Growth of SMEs**

The study also sought to establish the respondents’ views in regard to microcredit by SMEs in Kapsabet Town. The means and standard deviations were computed for all the responses and the findings are presented in table 4.

**Table 4:** Effect of Microcredit onSMEs in Kapsabet town

| | S A | A | N | D | SD |
|---|---|---|---|---|---|
| **Statements** | **%** | **%** | **%** | **%** | **%** |
| My business sometimes receive short term loans for using as working capital | 39 | 24 | 13 | 16 | 8 |
| Credit from microfinance institutions favors businesses without sufficient assets to use as collateral | 30 | 21 | 15 | 15 | 20 |
| MFIs contribute to the increase of entrepreneurs who start new venture | 40 | 43 | 3 | 0 | 14 |
| SMEs increase their productivity through getting funds from MFIs that leads to enterprises growth | 39 | 34 | 8 | 3 | 16 |
| Borrowing from microfinance institutions help low-income operators to enhance the growth of their enterprises | 30 | 35 | 8 | 8 | 5 |
| Microfinance is a source of financial services for SMEs which have difficulties meeting strict preconditions of access to bank credit | 36 | 33 | 3 | 10 | 8 |

The findings demonstrated that the respondents agreed that their businesses sometimes received short term loans for use as working capital (63%), that credit from microfinance institutions favored businesses without sufficient assets to use as collateral(51%) and that MFIs contributed to the increase of entrepreneurs who started new SMEs venture (83%). Majority of the respondents also agreed that SMEs increased their productivity through getting funds from MFIs that led to SMEs’ growth (73%)and that borrowing from MFIs helped low-income operators to enhance the growth of their enterprises (65%). Moreover, majority of the respondents agreed that MFIs were a source of financial services for SMEs which had difficulties meeting strict preconditions of access to bank loans (69%).

Generally, these findings have been supported by previous studies. For instance, Mwangi (2011) noted that the strength of MFIs was that they served the rural areas at low costs as they delivered flexible financial services from them. Derbile (2003) concurred that the success of microcredit has been achieved in alleviating poverty in by enabling SMEs create job opportunities and economic empowerment.Mayoux (2017) noted that microcredit programmes promoted economic independence and provided SMEs with access to networks and markets to necessitate wider experience.In regard to the benefits of obtaining finance from a microfinance institution to support SMEs in Kapsabet Town, the respondents revealed that microcredit credit significantly improved growth of SMEs.

**4.3Growth of SMEs in Kapsabet Town**

The researcher sought to establish the respondents’ perceptions regarding growthofSMEs. The findings in terms of means and standard deviations are shown in table5.

**Table 5:** GrowthofSMEs

| | SA | A | N | D | SD |
|---|---|---|---|---|---|
| **Indicators of growth** | **%** | **%** | **%** | **%** | **%** |
| Sales volume in my SME keeps on increasing in the same proportion of resource input | 40 | 20 | 17 | 13 | 10 |
| My SME market share is relatively higher compared to others | 42 | 21 | 15 | 8 | 14 |
| I control a large market based on profit margin of mySME | 26 | 33 | 13 | 12 | 16 |
| There is rapid gaining of profit share in mySME as attested by increase in branch networks and number of staff | 30 | 34 | 16 | 6 | 14 |

| | | | | | |
|---|---|---|---|---|---|
| There is commitment by my SME to invest in other ventures | 27 | 25 | 15 | 10 | 10 |
| Diversification of services and products is the main factor which leads to market growth | 20 | 37 | 15 | 17 | 11 |

The findings demonstrated that majority of the respondents concurred that sales volume in their SME kept on increasing in the same proportion of resource input(60%), that their market share was relatively higher (63%) and that they controlled a sizeable market share based on profit margin of theirSMEs(59%). The respondents further agreed that there was rapid gaining of profit share in theirSME as attested by increase in branch networks and number of staff (64%), that there was commitment by SMEs to invest in other ventures(52%) and that diversification of services and products was the main factor which lead to market growth (57%).

The results concur with Mashenene (2014) who observed that increase in a firm's size was the best measure of a firm's growth realized over a long period of time. Fjose (2010) further concurred that a firm's size was determined by profitable supply of capital, labor and appropriate management and opportunities for investments. Moreover,Caruabna (2017) agreed that market share growth was a portion of customer base that kept on increasing in the same proportion of resource input and was used to define a firm's increase in volume of sales, employment levels, and profitability and total assets as a measure of growth of SMEs.Moreover, Langat (2013) concurred that SMEs growth indicators included the number of business enterprises, number of business activities, increase in market for the production, increase in employment absorption rate, overall economic growth and increased rate of investment in real estate by SMEs entrepreneurs.

### 4.4 Correlation Analysis

The study sought to establish the underlying relationships betweendebt financing and growthofSMEs in Kapsabet town and the extent to which the independent variables influenced the dependent variable. Correlation analysis was used to accomplish this purpose. The composite scores for debt financing were correlated with the growth of SMEs. The results are presented in table 6.

**Table 6:**Pearson's Correlation analysis for significant relationship between debt financing and growth of SMEs

| **Variables** | SMEs' growth | Trade credit | Microcredit |
|---|---|---|---|
| SMEs' growth | **1** | | |
| Trade credit | 0.311** | **1** | |
| Microcredit | 0.317** | 0.566* | **1** |

** σ=0.01 (Correlation is significant at 0.01 level (2-tailed)

* σ=0.05 (Correlation is significant at 0.05 level (2-tailed)

The correlation table presents the relationship between the dimensions of trade credit measured by trade credit, microcredit, bank loans and borrowing against growth of SMEs.The results show that all the dimensions related positively as discussed in the subsections.

#### 4.4.1 Relationship between Trade credit and Growth of SMEs

Pearson correlation coefficient was used to determine the degree of relationship betweentrade credits and growth of SMEs in Kapsabet town. The results revealed a positive relationship ($r=0.311$, $p=0.001$) between trade credit and growth of SMEs in Kapsabet town. Moreover, the relationship was statistically significant at $p<0.05$ level of significance. Therefore, the researcher observed that trade credit significantly determined growth of SMEs in Kapsabet town. Hence, the first hypothesis $\mathbf{H_{01}}$ which stated that there was no statistically significant relationship between trade creditandgrowth of SMEs in Kapsabet town was rejected, thus accepting that trade credit significantly determined growth of SMEs in Kapsabet town. It can be noticed that the research hypothesis, in general, is supported by data. This was due to most banks' culture in Kapsabet town to urge SMEs to take up loans to improve the growth of SMEs.

#### 4.4.2 Relationship between Microcredit and Growth of SMEs

The second objective was to establish the effect of micro-credit on growth of SMEs in Kapsabet town. The researcher used Pearson correlation coefficient to establish the relationship between microcredit and growthof SMEs and to test the hypothesis that there was no statistically significant effect of microcredit on growth of SMEs in Kapsabet town. The findings are presented in table 6. Pearson correlation coefficient was used to determine the degree of relationship between microcredit and growth of SMEs. The study established that there was a positive relationship ($r=0.317$;$p=0.007$) between microcredit and the SMEs' growth. The relationship was statistically significant at $p<0.05$ level of significance. Therefore, the null hypothesis ($\mathbf{H_{02}}$) that there was no statistically significant effect of microcredit on growth of SMEs in Kapsabet town was rejected. Therefore, the researcher concluded that the growth of SMEs in Kapsabet Town depended on microcredit.

**4.6 Regression Analysis**

The researcher attempted to fit a regression model for this study to establish the relationship between the independent variables and the dependent variable. Multiple regression analysis was performed and the results presented in table 7.

**Table 7:** Model Summary

| Model | R | R Square | Adjusted R Square | Std. Error of the Estimate |
|---|---|---|---|---|
| 1 | 0.809[a] | 0.654 | 0.0313 | 0.0101 |

a. Predictors: (Constant), Borrowing, Microcredit, Bank loans, Trade credit

The model summary indicated the presence of a positive multiple correlation (R=0.809) between the independent variables and the dependent variable. Further, the R squared value of 0.654 indicated that the independent variables accounted for 65.4% of the total variance in the growth of SMEs. Therefore, the researcher observed that the independent variables influenced the dependent variable. The model coefficient values from the regression analysis are presented in table 7.

**Table 7:** Coefficients[a]

| Model | | Unstandardized Coefficients | | Standardized Coefficients | T | Sig. |
|---|---|---|---|---|---|---|
| | | B | Std. Error | Beta | | |
| | (Constant) | 1.745 | 0.763 | | 3.237 | 0.000 |
| | Trade credit | 0.311 | 0.145 | 0.041 | 0.332 | 0.001 |
| 1 | Microcredit | 0. 317 | 0.111 | 0.311 | 2.128 | 0.002 |
| | Bank loans | 0.219 | 0.128 | 0.097 | 0.749 | 0.002 |
| | Borrowing | 0.119 | 0.102 | 0.179 | 1.359 | 0.125 |

a. Dependent Variable: Growth of SMEs

From the model coefficients table, the following mathematical model was fitted

$Y = 1.745 + 0.311X_1 + 0.317X_2$.From the derived regression model, with all the other factors remaining constant, growth of SMEs in Kapsabet Town had a constant value of 1.745. It is also evident that the *B* value of 0.311 supported by a probability value of 0.001 indicated how much variation in growthof SMEs could be explained by trade credit. In this case, holding other factors constant,31.1% of growth of SMEs in Kapsabet Town could be explained by trade credit. Also the *B* value of 0.317supported by a probability value of 0.011 indicated how much variation in growth could be explained by the independent variable, microcredit. In this case, 31.7% of growth of SMEs in Kapsabet Town could be explained by microcredit.

## V. Conclusions and Recommendations

**5.1 Conclusions**

The purpose of this study was to investigate the effect of debt financing on the growth of small and medium enterprises in Kapsabet town, Nandi County. Based on the study findings, the study concludes that debt financing impacted on the growth of SMEs in Kapsabet town. SME relied on trade credit to promote growth their SMEs. There was a positive relationship between trade credit and growth of SMEs in Kapsabet town. This implies that 31.1% of growth of SMEs in Kapsabet Town could be explained by trade credit. The study established that there was a positive relationship between microcredit and SMEs' growth.In general, the study concludes that trade credit and microcredit accounted for the variance in the growth of SMEs in Kapsabet Town.

**5.2 Recommendations**

The main object of the study was to examine the effect of debt financing on the growth of SMEs in Kapsabet Town. The study has established that debt financing positively affected SMEs' growth rate. Based on the findings and conclusions drawn from the study, several recommendations are made for policy makers, practice and theory. The studyrecommends that SMEs should establish good credit history with the lending institutions sothat they can easily access funding.The government should relax rules regarding absorption of Uwezo Fund, Youth Enterprise Development Fund, SME development fund and Kenya Industrial Estateto attract SMEs to borrow from these funds. This will boost their growth and expansion of SMEs in Kapsabet town. SMEs should also increase their capital base byploughing back profit earned so as to enhance their collateral security for easier acquisition of debt financing.

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IOSR Journal of Business and Management (IOSR-JBM) is UGC approved Journal with Sl. No. 4481, Journal no. 46879.

Irene Jepkorir." Effects of Debt Financing on the Growth of Small and Medium Enterprises in Kapsabet Town, Nandi County". IOSR Journal of Business and Management (IOSR-JBM), Vol. 21, No. 10, 2019, pp. -.01-13