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Financing Practices of Micro and Small Enterprises in West Oromia Region, Ethiopia

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Abstract

Ethiopian government has given due emphasis to MSEs though they are facing various constraints. One of the crucial problems is financial constraint for start-up and operational activities. In order to promote MSEs as engines of growth, it is essential to understand the bottlenecks surrounding MSEs' access to finance. The main objective of this study is therefore to examine the barriers confronting Ethiopian MSEs' access to finance. 200 sample MSEs selected from three towns in west Oromia region, Ethiopia are used for this study. The finding indicated that only a small portion of MSEs are able to access finance from Banks and MFIs as a result of lack of collateral, complex Loan procedures, high interest rate charged, difficulty to form group and forced saving required by MFIs. The researchers recommend that banks and MFIs should work on the bottlenecks surrounding loan provision.

Keywords: Access to Finance, Banks, Micro and Small Enterprises, Micro Finance Institutions

1. Introduction

The traditional top-down development approach assumes that development will come by establishing large scale business organizations in every sector. According to this view, investment should be concentrated on large firms including; establishing large mechanized farming in rural areas, creating industrialized urban centres and improving service provision by establishing large service giving companies. Proponents of this view argue that this approach provides economics of scale and agglomeration benefits (Sanyal, 1998).

However, in developing countries like Ethiopia, there are so many limitations as a result of which this approach did not bring the required growth. One of the reasons for the failure among others is that large private firms are criticized for taking the advantages of various types of state protection which made them capital intensive and inefficient. In addition, in underdeveloped countries like Ethiopia, the institutions created to foster such development become the greatest hindrance because of corruption and rigid bureaucracy (Sanyal, 1998)

To initiate broad based development, the bottom up approach was started to be prescribed in the last three decades. This approach advocates the establishment of small scale business that helps to generate employment for large number of poor families who had neither any asset nor source of income. These families will be provided with credit for starting small business. These in turn creates job opportunity for the poor, generate profit, encourage saving and investment at the bottom. As a result nowadays the overwhelming majority of formal businesses globally are Micro and Small Enterprises (MSEs) which account above 83 percent of established business organization especially in sub-Saharan Africa (Sanyal, 1998).

MSEs have been recognized as being great contributors to the Ethiopian economy offering both employment and platform for innovative ideas. Specially, starting from 2004, Ethiopian government has given due attention to the sector and nowadays MSEs form a larger percentage of the businesses that operate in the country as compared to their medium and large counterparts. They are however challenged by many constraints that hinder their performance and consequently their growth. One of the main constraints that have been highlighted over the years is lack of access to finance.

Specifically, to alleviate the financial problems of MSEs, Ethiopian government is supporting the sector by encouraging Micro Finance Institutions (MFIs) to expand to the rural areas, creating favourable environment for banks to expand their branch to regional cities, introducing capital good finance companies. In addition, the government is also trying to give training on how to keep accounting records and financial management, mainly for those found in major urban centres. However, still MSEs operators' main complain is lack of access to finance.

The authors have undertaken a survey research on the topic "Financing Micro and Small Enterprises: Evidence from West Oromia Region" in the academic year 2015/16. The objective is to identify the bottle necks surrounding MSEs in the country and provide appropriate suggestions for solving them. This article is part of the above mentioned study specifically aimed to identify challenges surrounding access to finance of MSEs taking evidence from least developing country Ethiopia. Specifically, the evidence for the study is taken from MSEs in three towns in west Oromia sub region. To achieve the purpose, the remaining part of this paper is structured as follows. Section two explains the research problem, section three reviews related literatures. Section four presents the research design and methodology adopted in the study. Section five presents the result, analysis and discussion and finally section six concludes the paper.

2. Statement of The Problem

Generating business idea is one thing but accessing necessary finance to translate such ideas into reality is another thing. Many new and considerably attractive business ideas have been known to die simply because their originators do not have the necessary capital to operationalize. The availability of finance has been highlighted by many scholars as a major factor in the development, growth and successfulness of MSEs (Ageba & Amaha, 2006). Although finance is not everything, enterprises need finance to invest in new equipment and machinery, reach out to new markets and products, and cope with temporary cash flow shortages as well as to innovate and expand.

The impediments to MSEs' access to finance can arise both from the demand side and supply side. The possible reasons for finance problems among others may be related to the poor management skills of the owner/manager, insufficient capital invested by the owner, an over-reliance on external borrowings (Brooks et al., 1990). The inefficient use of accounting information to support their financial decision-making and the low quality and reliability of financial data are part of the main problems of MSEs. Lack of access to finance and high interest rates charged are partially the result of incomplete or no accounting records, and the inefficient use of accounting information. Poor record keeping and accounting information makes it difficult for financial institutions to evaluate potential risks and returns, making them unwilling to lend to MSEs. As a result, MSEs pay high interest rates or fall back on informal moneylenders, whose loans are costly, and often restrictive. The misuse and inaccuracy of accounting information causes MSEs to inaccurately assess their financial situation and make poor financial decisions which lead them to face high failure rate (Byron & Friedlab, 1976; Mosisa, 2011).

Ethiopian government is doing all its best to support MSEs. Despite its efforts, many research outputs conducted in Ethiopia indicates that access to finance is still the bottleneck for MSEs. For instance, according to a recent survey by Federal MSE Development Agency (2013), shortage of finance (42 percent) was principal challenge followed by lack of working premise (28.3 percent) and lack of access to market (18.1 percent) for MSEs in the regional cites. Studies further showed that the problem is more critical in areas that are very far from the capital city; Addis Ababa (MUD C, 2013).

On the other hand, there are few studies that investigated the status of the problem in west Oromia sub-region including Jimma, Illu Aba Bora and the four Wellega zones. Though some exist, they focus on general problems of MSEs, they are short in depth on many aspects of MSEs, including finance related issues. Therefore, the main purpose of this research is to study problems associated to access to finance in MSEs found in west Oromia sub-region, Ethiopia. This study is different from earlier other studies in the following respect. First, earlier studies focused on general constraints of MSEs, not on the specific financing issue. Investigating an issue focusing on a particular aspect will help to identify the real problem in depth. Second, this study tries to investigate problems related to access to finance both from demand side and supply side as opposed to earlier studies that focused mainly on the demand side problems. Finally, this study concentrates on west Oromia sub-region where there are few studies undertaken. The study contributes to theoretical finance literature by showing the experience in least developed country to the international community. Empirically it will help to identify the specific problems associated to access to finance in the region and give possible way outs to solve the bottlenecks.

3. Literature Review

Over the years, there have been many attempts at defining what constitutes MSE. However, there is no universally accepted definition for these kinds of business enterprises (Ayyagari et al., 2006). In fact it is not possible, because it depends not only on investment level and number of employee but also on technologies and technical complexities of production, degrees of skills demanded from workers and managers, end use of products, economic level of the country in which they operate, law of the land and so on, which varies from country to country. As a result, MSEs are often defined in many countries based on number of employees, total capital, total sales turnover, or total asset. Just like other developed and developing countries, MSEs in Ethiopia are defined on the bases of total capital and number of employees engaged. According to the 2011 revised MSE strategy, MSEs in Ethiopia are defined as shown in table 1 below.

Table 1. Definition of Micro and Small Enterprises (MSEs)

Type of Enterprise	Sector	No. Of Employee	Total Asset
Micro Enterprise	Industry	< 5	< Br.100,000 ($6,000 or €4,500)
	Service	< 5	< Br. 50,000 ($3,000 or €2,200)
Small Enterprise	Industry	6-30	< Br. 1.5 million ($9,000 or €70,000)
	Service	6-30	< Br. 500,000($30,000 or € 23,000)

Source: FMSEDA (2011)

According to the financial growth cycle paradigm proposed by Berger and Udell (1998), financial needs and the financing options available for MSEs change throughout the various phases of a firm's lifecycle. In other words, at different stages of the firm's growth cycle, different financing strategies are required. During the initial stages of MSE development, internal equity financing, as best represented by owner–manager personal savings, is a critical source of funding for MSEs. An entrepreneur usually starts a business by using his own accumulated capital as seed money. The range of capital raising options from theses stretches from the founders of a business tapping their own credit worthiness or resources (savings, home equity, or credit cards) to parents or a trusted business associate stepping up with the needed seed money to launch the company. Subsequently, in later stages, in order to develop and grow MSEs tend to reduce their dependence on these sources and start seeking alternative channels for raising capital. Internally generated profits and venture capital exemplify just two of the other equity options MSEs seek to expand as they grow. Further, families, friends, and close business associates are alternative primary capital sources to launch new business concepts since the beginning of time and will most likely continue to fill this role in the future. This is the main source of finance in Ethiopia and any other developing country (Ageba and Amha, 2006). Generally, this type of capital tends to be for lower birr amounts, geared toward equity as opposed to debt, and provided to closely held and/or family operated businesses.

The next source is external finance. There are two notable variants of external finance: debt financing and equity financing. Debt financing involves the procurement of interest bearing instruments such as loans, overdrafts, letters of credit and accounts receivable etc. They are secured by asset-based collateral and have term structures, that is either short or long term. The equity component of external finance gives the financier the right of ownership in the business and as such may not require collateral since the equity participant will be part of the management of the business (Berger and Udell, 2002).

It is well known that capital structure decisions, in MSEs as in large firms, relate to the use of either equity or debt or both. However, Berger and Udell (1998) believe that in the case of MSEs, this is partly incorrect because information scarcity is more severe in MSEs. Issuing additional equity to satisfy the firm's financial needs would then lead to a dilution in ownership and control. Therefore, in order to keep full ownership and control of their businesses, MSEs owner–managers may prefer to seek debt financing rather than external equity. Two significant differences between debt financing for MSEs and that of large firms have been identified in the literature (Wu et al., 2008). First, unlike managers of large firms who usually have the choice of broader range of debt financing resources, MSEs tend to be more attached to commercial lenders, especially institutional lenders, as a source of short-term debt financing that can be renewed for long-term debt. Second, as information asymmetry problems are more acute in MSEs than in large firms, long-term lending relationships are important for MSEs in order to deal with the resultant agency problems.

Debt capital sources includes: banks, leasing companies, Microfinance Institutions, asset-based lenders, factoring companies. For almost any debt-based need, some type of lender is readily available in the market. These groups, tend to look for a common set of characteristics when extending capital in the form of debt: Security of some sort — an asset or personal guarantee, for example —must be presented and Debt providers tend to look for more stable business environments where a company has been in business for an extended period of time and has a proven track record.

Micro finance institutions have emerged as a growing industry to provide financial services to very poor people. Now at national level, there is recognition that poor people need a variety of financial services, not just credit. Current microfinance institutions have therefore moved towards providing a range of financial services, including credit & savings to poor enterprises and households. Providing access to loan especially to MSEs has been given due attention by the government of Ethiopia at national level. Microfinance has been regarded as the motor for enhancing income to the population at urban and rural areas, especially to the people who are regarded as poor. Even if microfinance institutions are important especially in encouraging MSEs by providing credit without any collateral asset, they are not free of problems. Especially the question of collection performance and default are critical issues (Ageba & Amha, 2006).

Besides, their credit instruments are limited; only two types of loan products - agricultural and micro-business loans- were on offer. Both are based on the principles of group guarantee and group attendance requirements. Agricultural loans are delivered for agricultural input, livestock, bee-keeping, etc. They are usually term loans in which the principal and interest are paid at the end of the loan term. Micro business loans, on the other hand, are loans for petty trading, handicraft and services, or loans for MSEs which are repaid on regular basis (Ageba & Amha, 2006).

Instead of borrowing money and purchase capital asset such as machinery, equipment or even complete production units; it is sometimes possible to acquire them through lease agreement. Lease is an agreement of giving to another party the right to use an asset for a specified period, in exchange for a periodic lease payment. In other words, just like liquid money, productive assets can be borrowed through Leasing. These assets are however contained in the balance sheet of the lessor and not in the balance sheet of the borrowing firm, the lessee. Therefore, leasing essentially represents a form of off-balance sheet financing. This aspect may be important in situations in which a firm prefers to maintain a certain debt-equity ratio or is not in a position to further increase its debentures (Petrson & Fabozi, 2003).

Another most important source of external financing for MSEs is trade credit which involves a delay in the payment for goods or services after they have been delivered or provided as a result of an agreement between the supplier and the firm. Therefore, for the firm, this is a source of finance that appears in the balance sheet under current liabilities, whereas for the supplier it is an investment in accounts receivable. The rationale behind the widespread use of trade credit among MSEs has been argued in the literature. Ellihausen and Wolken (1993) attributed this attitude to both transaction motive and financing motive. The transaction motive suggests the better ability for both the seller and the buyer to predict their cash needs in the short-term. As such, cash management transaction costs can be economized. The financing motive is that MSEs resort to trade credit when alternative sources of finance are unavailable or more expensive. In addition, Fatoki & Odeyemi (2010) argued that trade credit financing is preferred by new and young MSEs when the risk of default is high during the early years of operations. Moreover, in relation to financial motives, firms with easier access to credit market can act as a financial intermediaries and offer funding for firms that face difficulties in accessing external financing (Beck, Demirgüç-Kunt & Maksimovic, 2008). The role of trade credit as a source of raising finance for MSEs is even more important in countries with less developed banking and financial systems where asymmetric information problems are more pronounced.

Trade credit has both an advantages and disadvantages. To start with the advantages, first, as trade credit suppliers have more information on their partners' businesses, trade credit can mitigate the problem of information asymmetry enabling them evaluate and control the credit risk of their buyers. Second, by using trade credit, MSEs can demonstrate their creditworthiness to banks, consequently, banks will be more willing to lend to them on the basis of this signal. However, Wilson and Summer (2002) argued that trade credit can be a costly financing source for MSEs if the buyer delays the payment beyond the specified date in the agreement. Nevertheless, Berger and Udell (2006) believe that in spite off some drawbacks, trade credit remains a crucial financing source for most MSEs, especially the young. They further explained that trade credit has the ability to provide the desired cushion during credit crunches, contractions of monetary policy or other shocks that may make other funding suppliers unwilling to provide financing to MSEs.

Empirical evidence indicates that, financing is one of the crucial elements that determine the development of MSEs. According Bekele and Muchie (2009), while encouraging effort have been made in liberalizing the domestic financial sector; still it is a bottleneck for the rapid growth and development of the sector in Ethiopia. In the study of Bekele and Muchie (2009), 79 percent of MSEs stated that getting credit from formal financial institutions is a key problem. It is obvious that inadequate access to credit limits the expansion of firms, choice of technology, hiring suitable premises and the employment of skilled personnel. This hinders the potential to adequately meet the needs of consumers. Access to credit on favourable terms is essential for initiating new business ventures, fulfilling working capital requirements, as well as for expanding existing businesses. In this regard, the formal financial institutions are reluctant to avail credit facilities to the sector. Formal financial institutions such as commercial banks are reluctant to lend small amounts of money to small businesses because the cost of administering the loan exceeds the benefits accrued from them.

Access to finance is also a problem to MSE in other least developed countries. Thevaruban (2009) examined small scale industries and their financial problems in Sri Lanka. He underscored that MSEs of small scale industries in Sri Lanka find it extremely difficult to get outside credit because the cash inflow and savings of the MSEs in the small scale sector is significantly low. Hence, bank and non bank financial institutions do not emphasise much on credit lending for the development of MSEs in the small scale sector in Sri Lanka.

4. Research Design and Methodology

This study is designed to describe challenges related to access to finance of MSEs. Thus descriptive research design is viewed as an appropriate research design for this study. Generally, the first step in any sampling method is to identify the study population from where the samples would be drawn. However, not only the population of MSEs is too large and their distributions across sectors and zones have been diverse, but also the records showing their lists were not available in very remote districts. Hence, we decided to conduct the study in three major towns in west Oromia including Jimma, Nekemte and Metu towns where relatively well organized data are available. Therefore, the sample size for this study is determined to be 300 MSEs. Once the sample size is decided, stratified sampling technique was applied to take representative samples from each sector. The final sample MSEs were selected using stratified random sampling from each group as follows. First, the list of these MSEs was collected from the respective towns MSE agency. Second, the organizations were stratified based on the five industry grouping and numbered sequentially and finally, the samples were selected using lottery method from each stratum in each city keeping the proportion of the industries the same as the one in the population. However, when the selected MSE is not found around or the owners are not willing to participate, another similar MSE from the same vicinity were replaced.

To achieve the objective of the study, survey method was implemented to collect data using interview schedule. The questions are designed to get the opinion of respondents on issues related to financing practices, challenges of access to finance, and other general demographic data. The interview schedule was prepared considering all the variables to be analyzed and using questionnaires of similar research conducted in earlier studies. Unlike, the limited previous studies and surveys in the Ethiopian MSE sector, the present study included relatively detailed questions related to financial aspects of MSE, thereby generating data that permits an in-depth analysis of many finance related issues.

The interview schedule prepared in English was later translated in to Amharic (local language) so that the respondents easily understand the questions. After refining and translating the questionnaire as mentioned above, the data for the research were gathered by trained enumerators. In this method, the enumerators go to the respondents premises and collect their opinion. This method was selected because of the following reasons. First, in this approach, the enumerator will present the questions orally and respondents can give their opinion without much difficulty. Second, this method allows face to face contact and respondents can ask clarification on any ambiguity in the questionnaire. Third, this method saves time of busy respondents and increases the response rate. Finally, this method requires the researcher to visit the MSEs under study which helps to make informal conversation with other employees for further general information and clarification. Further for triangulation purpose, semi-structured interview was conducted with branch managers of financial institutions operating in the area.

5. Result and Discussion

Even though MSE's have important roles in economic development, poverty alleviation and employment creation, they are critically challenged by certain impeding factors. The following figure 1 depicts the main challenges faced by MSEs in the study areas.

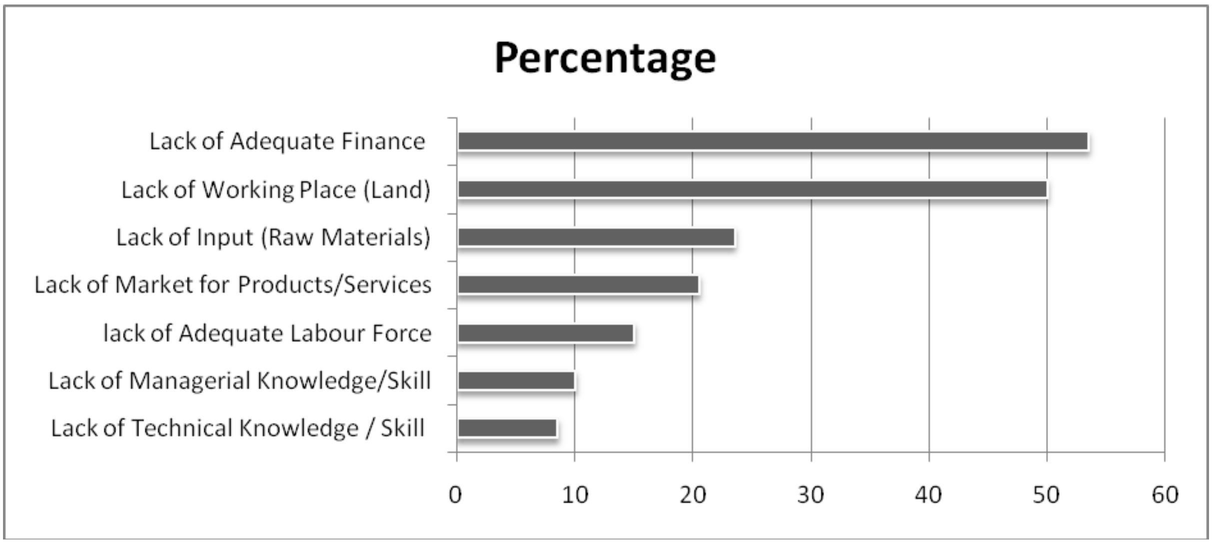

Figure 1. Critical Problems Faced by MSEs

As can be seen from the figure 1, the most critical problems faced by MSEs in the study area are financial problems and lack of working place. Further, some percentage of the respondents have also mentioned that they are facing lack of raw material, lack of market for their product, lack of skilled labour force and lack of management and technical skills. In addition, a significant proportion of respondents complained that frequent power interruption is another problem they are facing. Similar to this result, the survey by Mohammed et al. (2015) and MOUDC (2013) also put lack of adequate finance as the first critical problem of MSEs. Further, about 41 percent of the cottage/handicraft manufacturing establishment in the 2002 CSA survey in Ethiopia indicated lack of capital as the major problem. This implies despite the wide expansion of financial institutions and the increase in number of colleges and universities that teach how to use limited financial resources more efficiently, lack of finance is still a critical problem.

Credit institutions in Ethiopia can be broadly characterized into formal and informal institutions. Formal institutions are licensed and regulated by National bank of Ethiopia or any relevant government agency. These institutions comprise of 18 commercial banks, 35 microfinance institutions, one government owned development banks, various cooperatives and capital lease companies. Informal credit markets refer to those markets which are not licensed and regulated by government authority which include Iqub, moneylenders, traders, friends and relatives. The informal sector is not regulated by any formal institution and the lending conditions are often flexible. Starting a business requires a lot of money. Entrepreneur should have sufficient fund which will serve as seed money to start a business. Various sources of fund are available to entrepreneurs. The following figure 2 summarizes the source of fund used to start MSE in the selected towns.

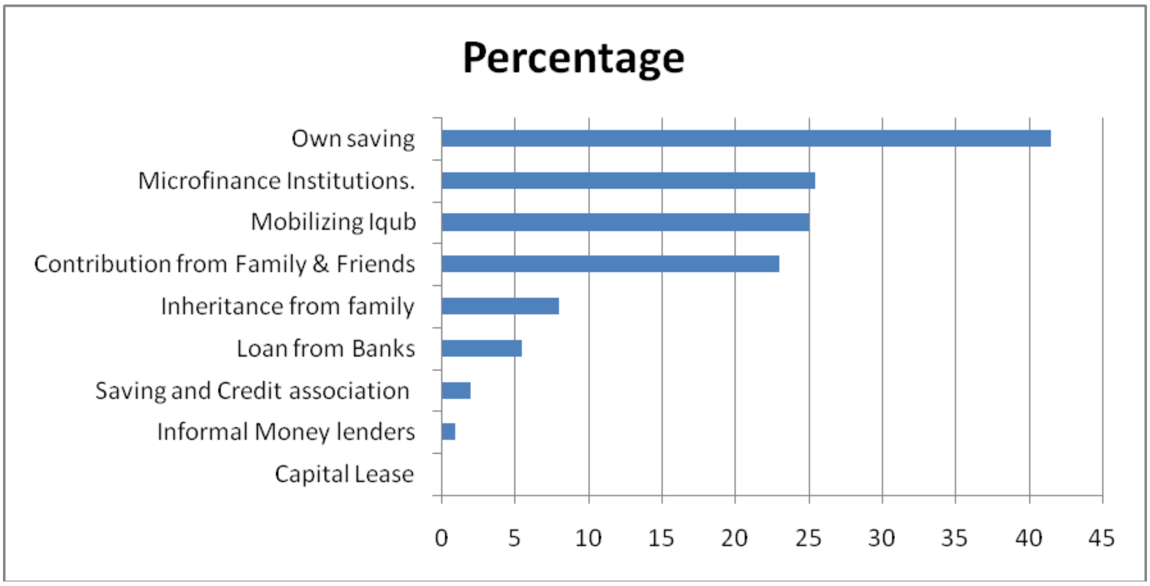

Figure 2. Source of fund for Starting Business

As can be seen from figure 2 above, the main sources of finance for business start-up are from personal savings, credit from MFIs, Mobilizing Iqub and contribution from family and friends. Capital lease and informal money lenders are rarely used for starting a business. Contrary to expectations, the sample MSEs under study rarely resorts to moneylenders as a source of finance. One possible reason is the availability of alternative sources of loans whose terms and conditions are better than that of moneylenders. Another reason might be such informal money Lenders are considered as illegal per the Ethiopian financial regulations and they do not exist. In line with this finding, the 2002 CSA survey at national level also indicated that own saving (37.24 percent), and assistance from friends and relatives (26.93 percent) were the major sources of obtaining initial capital.

This result is similar with the practice in Laos where sources of finance for start-up including; personal savings of business owners, retained earnings and loans from friends and relatives make up the highest share which accounts for about 70 percent of total sources of finance. Only Less than 15 percent of MSEs in Laos obtain seed money from financial institutions (Kyophilavong, 2011). The result of this survey is also similar with the practice in Uganda where the majority of MSEs in the sample use internal financing including own saving. The Theory of Pecking Order (Myers 1984) which states that owners has a preference to choose internal financing before external financing was also proven in this study in the aspects of MSEs using internally generated funds as compared to borrowed funds.

Further respondents were asked whether they have requested credit from Banks and become successful after starting the MSE and the possible reasons if not successful. The following table 1 summarizes the result of the survey.

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Table 2. Credit from Banks

Have you requested Credit from Banks	Jimma	Mettu	Nekemte	Total	%
Yes & Succeeded	13	6	5	24	12.00
Not at all	80	38	22	140	70.00
Yes but not Succeeded	8	19	9	36	18.00
Total	101	63	36	200	100.00
If not, what are the reasons?					
Inadequate collateral	48	45	13	106	53.00
High interest rate charged	7	12	5	24	12.00
Long loan processing time	2	4	2	8	4.00
Business plan & report requirements	3	0	9	12	6.00
Did not want to incur debt	14	8	2	24	12.00
Fear of inability to repay	16	8	1	25	12.50
Because I have sufficient cash	11	2	2	15	7.50

As it can be visible from table 1 above, only 12 percent of MSEs that requested bank credit are successful in securing credit. About 88 percent of the MSEs surveyed either did not requested or requested but unsuccessful in getting credit. Several reasons were mentioned for not requesting credit or being unsuccessful. The major one includes; lack of collateral, fear of inability to pay principal and interest, high interest rate charged by banks and not wanting to take credit for various reasons. Especially lack of collateral can be confirmed when one see the proportion of MSEs that posses fixed asset. Only about one quarter of the firms surveyed have fixed asset of their own that can qualify for collateral where as the remaining majority did not have. Similar to this finding, Lack of fixed asset that can serve as Collateral was found to be a critical problem in the recent survey conducted by Mohammed et al. (2015).

Currently, the only acceptable collateral properties by commercial banks in Ethiopia are buildings under municipalities and vehicles registered by Transport Authority of Ethiopia. Because of the land policy of the current ruling party, land is not a private property and cannot be used as collateral. Hence, bank loan are hard to get as banks require strong collateral ranging from 125 percent to 400 percent of the amount of loan requested. So, any investor who wishes to get bank loan should possess such properties. There is also a problem of under estimation of collaterals by banks. This makes it difficult for those firms which are young and have no asset in place to be used as collateral to get bank credit.

Commercial Banks may change the interest rate based on the directive of the National Bank of Ethiopia. In addition, as per the new Credit Policy, the Bank's customers may be charged various interest rates based on their: loan recovery history, business strength, collateral strength and other similar factors. That is, customers who meet the Bank's performance parameters are charged a lower interest rate, where as the Bank will impose an additional three percent penalty interest rate per annum on non-performing loans. This high interest rate charged discourages MSEs from taking credit.

In addition, the process of securing bank loan is procedural and officious in Ethiopia. Most of the banks have very strict requirement which seeks elaborate details of the various aspects of the borrowing company and about the projects financed. Documents required from customers during loan request includes: Written application that clearly indicates, among others, the amount and purpose of the loan requested, License as appropriate, Financial statements (audited as necessary), A business plan or a project feasibility study (for new projects), Ownership certificate for assets or merchandise offered as collateral, Memorandum and Articles of Association for legally established companies and Management profile. Out of these requirements, Business plan or feasibility study is the major requirements to secure a loan.

From this we can sum up, the commercial banking system could not address the financial needs of MSEs for the very fact that they are not their ultimate target clients. On top of this, the transaction costs and risks involved in serving these businesses are perceived to be too high. Further, even if there are few private banks that are interested in providing financial services to MSEs, they have not developed yet a suitable credit system for micro lending activities and also they do not have trained personnel for this purpose. Cognizant of this Fanta (2012), advice that Policy maker should devise mechanisms that enhance competition in the banking sector and establish a policy framework that encourages them to lend to the MSE sector.

On account of the non suitability of commercial banks, the government of Ethiopia established a legal framework for the establishment and operation of Micro Finance Institutions (MFIs) to provide financial services to poor households. Since Proclamation 40/1996 for licensing and supervision of MFIs came into effect in July 1996, about 35 MFIs have been registered and licensed by the National Bank of Ethiopia (NBE). The majority of the regions now have their own MFIs. Some of the MFIs are totally region-based MFIs, with a specific objective of enhancing the living standard of poor households in their respective regions. Of the MFIs found in Oromia region, only a few are operating in the target research area. For instance, OCSSCO, Harbu and Eshet MFIs are operating in Jimma town; OCSSCO and Wasasa MFIs S.C are operating in Mettu town. Respondents were asked whether they have requested credit from MFIs and the reasons if not successful. The following table 2 presents the survey result.

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Table 3. Credit from MFIs

Have you requested Credit from MFIs	Jimma	Mettu	Nekemte	Total	%
Yes & Succeeded	10	21	17	48	24.00
Not at all	80	27	15	122	61.00
Yes but not Succeeded	11	15	4	30	15.00
Total	101	63	36	200	100.00
The reasons for being unsuccessful?					
Lack of awareness about MFIs service	15	1	7	23	11.50
Business size beyond target of MFIs	10	8	3	21	10.50
Lack of guarantee for taking Loan	17	29	4	50	25.00
Difficulty to form group for taking Loan	38	2	2	42	21.00
Forced Saving by MFIs	6	28	1	35	17.50
High interest rate	17	6	1	24	12.00
No MFIs in my Place	0	1	0	1	0.50

As can be seen from table 2 above, only about one quarter of the MSEs has requested and successful in getting credit from MFIs. MSEs found in Metu and Nekemte town are better in getting credit from MFIs. Theoretically, one may have never received a loan for either of two reasons: never tried to borrow or was rejected. In order to discern between these, MSEs that reported having never received loans from MFIs were asked whether they have ever applied for one, and if not, why? As the results in table 2 above show, more than three fourth of MSEs have requested but unsuccessful or not requested at all. Many of these are what may be considered as discouraged potential borrowers while some are what may be considered as uninformed (i.e. not aware of the facility, or where and how to apply, etc.).

The most frequently mentioned reasons for not getting credit from MFIs include: lack of guarantee or collateral, difficulty to form group which is a requirement for MFI loans, forced saving required. In fact, this time, the forced saving amount required to get credit has reduced from 20% to 5% recently in government affiliated MFIs. Another point that is worth mentioning is that there is a religious dimension to the interest charge issue. Significant number of Muslim respondents mentioned that charging an interest on loans is something that a Muslim should not do. Similar to this finding, the study by Ageba & Amaha (2006) also showed that the main reasons for not using Credit from MFIs includes: respondent not aware of MFI loan facilities (36.4 percent); respondent’s business size beyond the target for MFI credit facilities (23 percent); difficulty to form a group which is a requirement for MFI loans (15.6 percent), and no MFI operates in the area (8.3 percent). In the study by Gobena & Jembere (2016), the main factors that prevent loan from MFIs are forced saving required and the long loan processing time in the MFIs.

The branch managers of MFIs in the three towns added that, there are some hindrances that prevent MSEs from Borrowing from MFIs. First, the interest rate plus service charge is very high in most of the MFIs. Second, the amount of loan extended is very small to start and run a business. Third, the group collateral system creates a problem in loan repayment, Lack of cooperation from city municipalities in loan pay-back follow-up, and finally, since formal

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business plan is not required in most of the firms, the money borrowed can be used for consumption and may not serve the intended purpose.

The above discussions are related to formal way of financing MSEs. In addition to the formal method of financing, other informal financing mechanism are common among MSEs operators. Mobilizing Iqub is one of the informal financing mechanisms. Iqub is an informal type of cooperative society organized by members for the purpose of pooling their savings in accordance with rules established by the group. Members agree to deposit monthly or weekly contributions of a fixed sum with an elected treasurer or, where accessible, in a bank. Lots are drawn weekly or monthly by turns and members in need can purchase the winner's lot by paying a premium. Out of the total respondents, above 85 percent has used Iquib to mobilize capital. The high proportion of MSEs that ever took loans from Iqubs, considering the abundant presence and wide participation by business people in Iqubs is normal culture. Respondents were further asked the reasons for selecting Iqub as a financing mechanism. Increasing cooperation (58 percent), no interest payment (50 percent) involved and local availability (45 percent) are some of the reasons for using Iqub. Similar to this, the survey conducted by Mohammed et al. (2015) confirmed that many MSE operators rely on Iqub to save their money and mobilize finance for starting business.

In addition to Iqub, trade credit is another source of informal finance for MSEs. It refers to loans that suppliers extend to their customers upon product purchase. Firms may receive trade credit either as a substitute for or a complement to bank credit. Respondents were asked whether they have taken any trade credit and the associated reasons. The following table 3 summarize the result of the survey.

Table 4. Trade Credit

Have you taken trade credit from suppliers?	Jimma	Mettu	Nekemte	Total	%
Yes always	18	3	8	29	14.50
Yes sometimes	36	44	20	100	50.00
Not at all	47	16	8	71	35.50
Total	101	63	36	200	100.00
What are your reasons for taking credit?					
Willingness to grant credit by the supplier	34	32	11	77	38.50
Being regular client of the supplier	29	17	14	60	30.00
It is free of interest	18	18	5	41	20.50

From table 3, we can see that the use of trade credit is a common practice in the MSE sector. Trade credit has an attractive feature of not being guaranteed by collateral, which is advantageous for enterprises lacking fixed assets. Majority of the sample MSEs (about 64.5 percent) participated in trade credit at least sometimes. Similar finding was obtained by Ageba & Amha (2006) in which above 80 percent of samples take trade credit from their suppliers. There are at least three reasons to take trade credit by MSEs: (i) Willingness to grant credit by the supplier; (ii) Being regular client of the supplier which means regular buyers may establish reputation, which increases their chance of getting suppliers credit and finally iii) trade credit is free from interest.

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Another recently introduced form of financing by Proclamation No 103/1998 (as amended by Pro. 807/ 2013) was Capital Goods Leasing. This form of financing was introduced for those businesses which have the interest to participate in various investment activities but could not act due to lack of capital. The objective is to create enabling environment for the establishment of alternative source of finance believing that lessors of capital goods can fill existing gap which is not addressed by the existing financial institution. In order to know whether MSEs are aware of the existence of such services, a question about machine lease was raised to respondents. Almost all MSEs under study replied that they have never used Machine lease. The following table 4 summarizes the reason mentioned by the respondents.

Table 5. Lease Financing

Reasons for not using Machine lease	Jimma	Mettu	Nekemte	Total	%
I do not know what it is	91	48	11	150	75.00%
High Interest rate	3	10	8	21	10.50%
It is not locally available	4	24	15	43	21.50%

As one can see from the table 4, the majority of MSEs owners have no awareness about the lease facility provided. From the analysis above, it can be seen that lease finance seems to play an important role in MSEs being able to obtain machinery, vehicles and other equipment if the necessary awareness creation was done and machine lease service is started in the towns under study.

6. Conclusion

One of the most critical problems faced by MSEs under study is lack of adequate finance from formal sources. The major reasons mentioned by MSEs for not taking credit from formal Banks and MFIs include: Lack of collateral, difficulty to form group and forced saving required by MFIs. Further the process of securing loan from banks and MFIs is procedural and officious in Ethiopia. Most of the banks have very strict requirement which seeks elaborate details of the various aspects of the borrowing company and about the project. The procedure of MFIs is also not attractive to debtor as most of them require long loan processing time even to get a very small credit. The high interest rate and service charge by MFIs is also another discouraging factor mentioned by significant number of respondents. In addition, though lease financing was introduced almost 20 years ago. it is not widely known to almost all MSEs under study at least at awareness level.

Instead MSEs in the study area heavily relay on informal sources of finance including Iqub, credit from relatives and trade credit from suppliers. The wide use of Iqub is because it is free of interest and enhances collaboration among MSEs operators. The use of trade credit is also a common practice among MSEs under study. The major reasons mentioned for wide use of trade credit include; willingness of the supplier to grant credit and being free from interest.

In order to effectively utilize credit from formal financial institutions, the researchers recommend that National Bank of Ethiopia should encourage private banks to grant credit to MSEs by formulating appropriate regulations and creating competitive environment. In addition, MFIs should improve their loan provision procedures such as group requirement, high interest rate and penalty. Both Banks and MFIs operating in the study area should think of introducing non interest financial service especially in Jimma town where a significant number of Muslim populations are available. The awareness of finance lease should be created in the study area and the facilities should be made available to MSE operators in the sub region.

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