EFFECT OF DEVELOPMENT FINANCE LENDING ON FINANCIAL PERFORMANCE OF SMALL AND MEDIUM ENTERPRISES IN SRI LANKA

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Abstract

The purpose of this study is to identify the relationship between development finance lending on the financial performance of SMEs and determine what components of development finance credit have the most impact on the growth of SMEs. The study was adopted with a target sample of 120 registered SMEs within the ABC Bank PLC, Sri Lanka. Secondary data was collected for the study using internal documents from the SME section in ABC Bank PLC and annual reports. SME financial performance has been considered as the dependent variable, whereas development finance credit amount, development finance loan period, initial credit amount, and collateral requirement have been considered as independent variables. Data was analysed using descriptive statistics, correction and multiple regression approach. Findings revealed that development finance credit positively influences the financial performance of SMEs through the amount of credit provided, the initial credit amount, the collateral requirement, and the loan period granted by the bank, which affects the financial performance negatively based on the analysis. The study also found that all SMEs borrow credit to increase their financial performance. The study concludes that return improved with each consecutive loan, showing that microfinance facilities enhance the financial performance of SMEs in Sri Lanka with the evidence from ABC Bank PLC. The regression results propose that development finance credit gives more to the financial performance of SMEs and thus higher return.

Keywords: Small and Medium Enterprises, Development Finance, Financial Performance, Micro Finance Institutions.

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Introduction

The Government of Sri Lanka identifies SMEs as the backbone of the economy, as it reports for more than 75% of the total number of organizations, provides 45% of the employment and contributes 52% of the GDP (Chen & Mitra, 2022). SMEs encourage broad-based equitable development and deliver more opportunities for women and youth to contribute to the country's economic advancement. (Ministry of Industry and Commerce,n.d). This study is fixed by four main theories, which are the Pecking Order Model, Microfinance Credit Theory, Credit Access Theory and Theory of Financial Intermediation and other relevant theoretical literature which displays the effect of Development Finance lending on financial performance (Stiglitz & Weiss, 1981; Jaffee & Russell, 1996).

Researchers have found numerous findings on the effect of development finance lending on the financial performance of SMEs, and they have provided substantial, remarkable theories explaining the connection between them. Quaye, Nil, & Obli (2011) studied the effect of microfinance institutions on the growth of small and medium-scale enterprises (SMEs), a case study of selected SMEs in the Kumasi Metropolis. This study shows that most SMEs are at their Micro stages since they employ fewer than six people and the sector is hugely controlled by the commerce sub-sector. The research also suggests that MFIs have positively impacted the growth of SMEs. Koech and Betty (2011) did a study to determine the financial constraints that hinder the growth of SMEs in Kenya. The researcher adapted the case study approach and affected SMEs in the Kamukunji District. The study recommended that business financiers through loans believe in reducing collateral requirements to facilitate SMEs easy access to loans.

Wakaba (2013) studied the impact of microfinance credit on the financial performance of SMEs in Kiambu County, Kenya. The study was done by applying a survey design. Out of the 2,061 SMEs licensed, the study arbitrarily sampled 60 SMEs. The study found a direct relationship between access to credit and the financial performance of the firms. The study also concludes that the companies' advantage from loans from microfinance institutions is that the SMEs seek financial support from the MFIs due to interest rates, easy loan repayment, and the amount offered.

Madole (2013) conducted the study in Tanzania and shows that credit attained from NMB Bank in Morogoro, SMEs have been clever to improve businesses in terms of improved business profit, increased staff, improved sales turnover, increased business diversification, increased business capital and assets as well as decrease of poverty amongst customers surveyed. Owusu & Ismail (2018) examined the numerous financing options for SMEs in Ghana, a random sample of 10 formal and informal finance sources and 50 SMEs in 6 chosen small and medium businesses in Kumasi, Accra, and Tamale. Idowu Salami (2011) organized a study on the effect of Microfinance on Small and Medium Enterprises (SMEs) in Ghana.

Skrabic & Novokmet (2018) conducted a study in Europe to identify determinants of Bank Profitability in Croatia with a cross-sectional survey of 4500. Koech & Betty's (2011) study focuses on the financial constraints that hinder the growth of SMEs in Kenya. The researcher modified the case study approach aimed at SMEs in Kamukunji District, according to Wachira (2013), investigated the factors that influence the use of microcredit among the SMEs based in the Mutindwa market of Buru Buru estate. Makena and Kubaison (2014) conducted a study to recognize the disputes encountered by SMEs in retrieving finance in Kiambu Town.

A cross-sectional survey was conducted in the Ho Municipality of the Volta Region of Ghana by Ahiawodzi & Adade (2012) using both survey and econometric methods on the effect of approach to

lending on the financial performance of Small and Medium Scale Enterprises (SMEs). Another study was conducted by Ugoani (2012) to calculate the connection between financial performance and microcredit of SMEs in Ghana. Muthoka & James (2012) examined the link between microcredit and the financial sustainability of SMEs, though continually highlighted by contributors and experts in seminars and conferences, is a debatable area of empirical research. A study done by Madole (2013) on the impact of microfinance credit on the performance of SMEs in Tanzania shows that credit obtained from NMB Bank in Morogoro and Wekhoba (2012) also highlighted many factors affecting microfinance credit availability in Kenya. Then, Wakaba (2013) studied the impact of microfinance credit on the financial performance of SMEs in Kiambu, Kenya. The study was done by applying a survey design. Out of the 2,061 SMEs licensed, the study arbitrarily sampled 60 SMEs. The study found a direct relationship between access to credit and the financial performance of the firms. The study also concludes that the companies' advantage from loans from microfinance institutions is that the SMEs seek financial support from the MFIs due to interest rates, easy loan repayment, and the amount offered. This study helped SMEs better understand the effects of development finance credit on the performance of SMEs in Sri Lanka and exposed areas of improvement in Development Finance Lending in Sri Lanka.

Several research studies have been done in developed countries, developing countries and least-developed countries focusing on the effect of microfinance credit on the financial performance of SMEs. However, only a few studies have been done in developing countries on the effect of microfinance credit on the financial performance of SMEs. There is a dearth of studies using a quantitative approach to the effect of development finance credit on the financial performance of SMEs in Sri Lanka. Therefore, researchers chose this research topic to find answers by using the portfolio of ABC Bank PLC. This study is thus pitched to answer the research question: What is the relationship between Development Finance Lending and the Financial Performance of SMEs in ABC Bank PLC, Sri Lanka? With the below objectives:

- To identify the relationship between Development Finance Lending on the Financial Performance of SMEs in ABC Bank PLC, Sri Lanka.

- To identify what components of Development Finance Credit, have the most impact on the growth of SMEs in ABC Bank PLC, Sri Lanka.

Research Methodology

The study used deductive and quantitative research approaches. Conceptual framework (figure 1) and variable operationalization (table 1) were developed based on the existing literature.

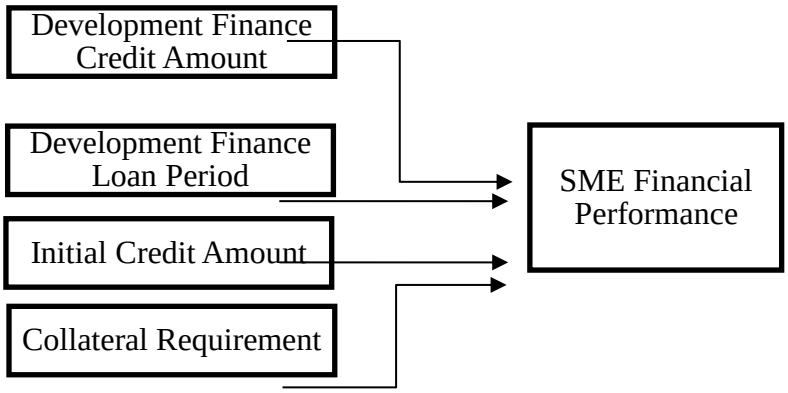

Figure 1: Conceptual Framework
Source -created based on Kibet, Dennis, Kenneth, & Gedion, 2015

Four independent variables affect the SMEs' financial performance: development finance credit amount, development finance loan period, initial credit amount and collateral requirement. The below hypotheses were developed.

H_1: There is a significant relationship between development finance credit amount and the financial performance of SMEs.
H2: There is a significant relationship between the development finance loan period and the financial performance of SMEs.

H3: There is a significant relationship between the initial credit amount and the financial performance of SMEs

H_4: There is a significant relationship between the collateral requirement and the financial performance of SMEs

Table 1: Operationalization

Variable Type	Variable	Indicator	Author/Source
Dependent Variable	SME Financial Performance	• Accounting-based performance indicator – Revenue	(Kibet, Dennis, Kenneth, & Gedion , 2015)
Independent Variable	Development Finance Credit Amount	• Lending amount offered	(Kibet, Dennis, Kenneth, & Gedion , 2015) and ABC loan portfolio)
Independent Variable	Development Finance Loan Period	• Loan period requested by the customer. • The loan period can be offered as per the loan scheme.	(Kibet, Dennis, Kenneth, & Gedion , 2015) and ABC loan portfolio
Independent Variable	Initial Credit Amount	• The maximum loan amount can be offered	(Kibet, Dennis, Kenneth, & Gedion , 2015) and

		initially. • Maximum loan installment	ABC loan portfolio
Independent Variable	Collateral Requirement	• Value of the collateral	(Kibet, Dennis, Kenneth, & Gedion , 2015) and ABC loan portfolio

Source – Authors Compiled using literature.

The target population for this study is Small and Medium Enterprises customers of ABC Bank PLC, Sri Lanka, as of 30th April 2022. Population of over 51,000 SMEs as of 30th April 2022. A sample describes a small group from the available population (Mugenda & Mugenda, 2003).

Secondary data was collected for the study using internal documents from the SME section in ABC Bank PLC and annual reports. The study was adopted with a target sample of 120 registered SMEs (Every 40 borrowers from one loan category) within the ABC Bank, and the highest loan-obtained customers were selected. Using the type of secondary data for the years 2021,2022., the research continued to achieve the objectives of the research.

The study used a multiple regression model of the equation to determine the connection between access to Development Finance credit and the financial performance of SMEs.

$$\mathbf{Y = \alpha - 0.071 + 0.005\ (X1) - 0.085\ (X2) + 1.499\ (X3) + e}$$

Where,

Y	=	SMEs Financial Performance measured using the Revenue
X1	=	Loan Period
X2	=	Initial Credit Amount
X3	=	Collateral Requirement
α and β	=	Constants
e	=	Error term

A multiple regression model was used for the data analysis part. The data collected was entirely quantitative and was examined using a regression model. This study used a multiple regression equation. The dependent variable is the financial performance of SMEs in ABC Bank PLC Sri Lanka, which is measured using the return of SMEs. The independent variables are the Development Finance Credit amount, DF loan period, Initial Credit amount, and collateral, which are determined by checking the loan book records from the ABC PLC portfolio.

The subsequent professional and ethical considerations shall be observed throughout the research.

- Respect for anonymity and confidentiality of borrower's data.
- The reports that are created shall be objective and unbiased.
- All resources offered for this study shall be used for the specific intended purpose.
- The time frame of the project shall always be followed unless otherwise stated.

Results and Discussion

Data was collected for 120 Development Finance beneficiaries in the ABC Bank PLC. However, only

113 borrowers were taken to the research as some of the borrowers' details were not completed in the loan portfolio. These borrowers were identified by filtering highest to lowest based on the loan amount irrespective of the district or other factors. The study is purely based on quantitative data, and data has been processed through SPSS statistical software.

The dependent and independent variables are inside the -3, +3 range for skewness, according to the data in Table 2. This indicates that the skewness is in order. Those variables' kurtosis values are between the -10 and +10 range and are also in order. As per the data in Table 2, half of the dependent and independent variables are within the accepted values, and variable-wise skewness and kurtosis have been explained for further explanation.

Table 2: Summary of Statistics for Skewness and Kurtosis

Statistics					
	DF Credit Amount	Loan Period	Initial Credit Amount	Collateral Requirement	Revenue
Skewness	2.579	-.782	2.555	2.579	2.558
Std. Error of Skewness	.226	.226	.226	.226	.226
Kurtosis	8.957	-1.301	9.292	8.957	8.908
Std. Error of Kurtosis	.449	.449	.449	.449	.449

Source – Data Analysis Results. (2022).

The researcher used ANOVA tables to determine the data set's reliability in SMEs, Evidence from ABC Bank PLC, Sri Lanka (table 3). Analysis of variance shows the connection between the two variables. This section demonstrates the p-value ("sig" for "significance") of the predictor's effect on the criterion variable. P-values less than .05 are usually believed to be statistically significant. In that case, the researcher examined the relationship between Development Finance Lending and Financial Performance. From the ANOVA results, the probability value of 0.000 was acquired, and it implied that the regression model was statically significant in planning the relationship between Development Finance Credit and the performance of SMEs: Evidence from ABC Bank PLC, Sri Lanka.

Table 3: Results of ANOVA

ANOVA[a]						
Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	21249.868	3	7083.289	10964.375	.000[b]
	Residual	71.063	110	.646		
	Total	21320.931	113			

a. Dependent Variable: Revenue

b. Predictors: (Constant), Collateral Requirement, Loan Period, Initial Credit Amount

Source – Data Analysis results (2022).

Correlation analysis was used to determine the relationship between dependent and independent variables for SMEs. The dependent variable Revenue and independent variables, Development Finance

Credit amount, Loan Period, Initial Credit amount, and Collateral requirement have a positive association, which is moderate because Pearson correlation values are larger than 0.2 and less than 1. For these kinds of data, we generally consider correlations above 0.4 to be relatively strong; correlations between 0.2 and 0.4 are moderate, and those below 0.2 are considered weak.

According to Table 4, the correlation between SMEs revenue and loan period was considered weak at the 0.01 level, with a Pearson coefficient of +.162. The correlation between SMEs revenue and the initial credit amount was statistically significant at the 0.01 level with a Pearson coefficient of +.960. It shows a positive and robust connection between SMEs revenue and the initial credit amount in SMSs. It also revealed that when comparing correlation values, SMEs revenue and Collateral requirements were statistically significant at the 0.01 level with a Pearson coefficient of +.998. It also shows a positive and robust connection between SMEs revenue and the collateral requirement in SMSs.

Furthermore, SMEs Revenue and Development Finance Credit amount was significant at the 0.01 level with a Pearson coefficient of +.998. It shows a positive and strong association between the Development Finance Credit amount and the revenue in SMSs. According to the above findings, SME revenue was slightly more positively associated with the collateral requirement and Development Finance credit amount than other variables (loan period, initial credit amount).

Table 4: Correlations analysis of Dependent and Independent variables in SMEs

Correlations (n=114)

		DF Credit Amount	Loan Period	Initial Credit Amount	Collateral Requirement	Revenue
DF Credit Amount	Pearson Correlation	1				
	Sig.					
Loan Period	Pearson Correlation	.162	1			
	Sig.	.084				
Initial Credit Amount	Pearson Correlation	.963**	.120			
	Sig.	.000	.205			
Collateral Requirement	Pearson Correlation	1.000**	.162	.963**	1	
	Sig.	.000	.084	.000		
Revenue	Pearson Correlation	.998**	.164	.960**	.998**	1
	Sig.	.000	.081	.000	.000	

**. Correlation is significant at the 0.01 level (2-tailed).

Source – Data Analysis Results (2022).

Before proceeding with the regression analysis, a multicollinearity diagnostic test is required to determine the independent variables (DF credit amount, loan period, initial credit amount, collateral requirement) correlated with each other. The multicollinearity test is conducted in two steps: using an intercorrelation matrix for the IVs and comparing tolerance values variance inflation factor (VIF).

Table 5: Tolerance Values and VIF values in SMEs

		Unstandardized Coefficients		Standardized Coefficients			Collinearity Statistics	
	Model	B	Std. Error	Beta	t	Sig.	Tolerance	VIF
1	(Constant)	.071	.233		.304	.762		
	Loan Period	.005	.025	.001	.191	.849	.955	1.047
	Initial Credit Amount	-.085	.070	-.025	-1.20	.232	.071	7.081
	Collateral Requirement	1.499	.030	1.022	49.1	.000	.070	7.255

Source – Data Analysis Results (2022).

The researchers conducted a multiple regression analysis to determine The Effect of Development Finance Lending on the Financial Performance of SMEs: Evidence from ABC Bank PLC, Sri Lanka. Multiple regressions are a statistical technique that allows us to predict a score of one variable based on their scores on several other variables. The primary purpose of multiple regressions is to learn more about the relationship between several independent or predictor variables and a dependent or criterion variable. Table 6 demonstrates the summary of the model for a data set with the R-squared value and the computed Durbin-Watson value.

Table 6: Model Summary for data set in SMEs

Model Summary[b]					
Model	R	R Square	Adjusted R Square	Std. Error of the Estimate	Durbin-Watson
1	.998[a]	.997	.997	.80375	2.093
a. Predictors: (Constant), Collateral Requirement, Loan Period, Initial Credit Amount					
b. Dependent Variable: Revenue					

Source- Data Analysis Results (2022).

According to Table 6, the R square value is 0.997 with a statistical significance of $P < .05$. It suggested that 99.7% of the variants in SMEs Financial Performance (dependent variable) were predicted from loan period, initial credit amount and collateral requirement (independent variables). The Durbin-Watson statistic was 2.093 and was in the range of +1 to +3, indicating that the observations were independent. Analysis of variance displays the connection between the two variables. This segment shows the p-value of the predictor's effect on the criterion variable. P-values less than .05 are usually considered "statistically significant". Thus, the researcher observed the relationship between the Development Finance lending and the financial performance of SMEs. From the ANOVA outcomes in Table 7, the probability value of 0.0000 was found, implying that the regression model was statically significant in forecasting the association between Development Finance lending and the Financial Performance of SMEs: Evidence from ABC Bank PLC Sri Lanka.

Table 7: ANOVA a table for data set in SMEs

ANOVA[a]						
	Model	Sum of Squares	df	Mean Square	F	Sig.
1	Regression	21249.868	3	7083.289	10964.375	.000[b]
	Residual	71.063	110	.646		
	Total	21320.931	113			

a. Dependent Variable: Revenue

b. Predictors: (Constant), Collateral Requirement, Loan Period, Initial Credit Amount

Source – Data Analysis Results (2022).

The unstandardized coefficients for the loan period, initial credit amount and collateral requirement are 0.005, -0.085 and 1.499, respectively, as shown in the above results in Table 8.

Table 8: Unstandardized & Standardized Coefficients

		Unstandardized Coefficients		Standardized Coefficients		
Model		B	Std. Error	Beta	t	Sig.
1	(Constant)	.071	208877.456		-.311	.756
	Loan Period	.005	24662.45	.002	.354	.724
	Initial Credit Amount	-.085	.039	-.002	-.126	.900
	Collateral Requirement	1.499	.030	1.022	49.177	.000

Source – Data Analysis Results (2022).

From the results of the data analysis of data collected through secondary data sources from a sample of 113 borrowers, the following conclusion is made of the hypothesis Table 9).

Table 9: Hypothesis Acceptance/Rejection

Hypothesis	Correlation	Significance	Accept/Reject
H_1: There is a significant relationship between the Development Finance Credit amount and the Financial Performance of SMEs in ABC PLC, Sri Lanka.	.998	.000	Accept
H2: There is a significant relationship between the DF Loan Period and the Financial Performance of SMEs in ABC PLC, Sri Lanka.	.164	.081	Reject
H3: There is a significant relationship between the Initial Credit amount and the Financial Performance of SMEs in ABC PLC, Sri Lanka.	.960	.000	Accept
H_4: There is a significant relationship between the Collateral Requirement and the Financial Performance of SMEs in ABC PLC, Sri Lanka.	.998	.000	Accept

Source – Data Analysis Results (2022).

As per the data analysis, hypotheses H1, H3 and H4 are accepted, and H2 was rejected because the loan

period does not significantly impact the financial performance of SMEs. Hence, the credit amount, initial credit amount and collateral requirement are highlighted as the variables of development finance that significantly impact the financial performance of SMEs. Therefore, the first question addressed through this research has been answered as the relationship between the development of financial credit and the financial performance of SMEs is established as intended. The development finance credit can positively influence the financial performance of SMEs through the amount of credit provided, the initial credit amount approved by the bank and the collateral requirement of the bank. However, the loan period granted by the bank affects the financial performance negatively based on the analysis.

Moreover, the second question regarding the variables that have the most impact on financial performance was also answered through the study. There, it was identified that the credit amount and the collateral requirement are the components of development credit that have the highest impact on the financial performance of SMEs. The initial credit amount followed these. The impact of the loan period on the financial performance of SMEs is minimal. Hence, the components that have the highest impact on the financial performance of SMEs are the credit amount, collateral requirement, and the initial credit amount.

This is approved by Cheston & Kuhn (2001). In any nation, there are underserved businesses and families, fluctuating from the ultra-poor who may not be economically active to small rising businesses that deliver employment in their societies. The research found that there was a strong positive association between credit and the financial performance of SMEs. This is similar to Schrieder & Heidhues et al. (1995), who specified that retrieving credit is a vital factor in enhancing the growth of SMEs. The study also recognized that the businesses benefit from loans from microfinance organizations; the SMEs pursue financial support from the MFIs. The loan settlement period, as per the conditions of the MFIs, is typically short, and the SMEs face challenges as loan beneficiaries from the SMEs. This concurs with the findings of Navajas et al. (2000) that the key objective of microcredit is to advance the welfare of the poor because of improved access to small loans not presented by recognized financial institutions. Aliou Zeller (2001) also argues that inadequate access to credit by the poor just below or just above the poverty line may have negative consequences for SMEs and overall welfare.

Conclusion and Recommendations

In Sri Lanka, SMEs comprise more than 75% of enterprises and account for more than 20% of exports, 45% of employment, and 52% of GDP (Chen & Mitra, 2022). The purpose of this study was to establish the effect of Development Finance lending on the financial performance of SMEs using sample data from Sri Lanka. The study was adopted with a target sample of 120 registered SMEs within the ABC Bank PLC, Sri Lanka. To accomplish the planned objective of the study, the highest loan-obtained customers were selected.

Secondary data was collected for the study using internal documents from the SME section in ABC Bank PLC and annual reports. Data was analyzed using descriptive statistics and a multiple regression approach, and the research discovered the following findings from the analysis. The study found that all SMEs borrow to increase their financial performance. MFIs provide financial services to economically poor citizens who, hence, experience financial rejection because they do not have ready access to mainstream, commercial financial services. It is concerned with establishing financial services for poor individuals using means that are just, fair, and supportable. For instance, they accept social collateral rather than financial collateral, access to higher loans if repayment performance is positive, unforced ways to access finance without much paperwork, and easy and short dealings. Many Sri

Lankan residents develop their livelihood from the SMEs.

Still, despite the significance of this segment, experience shows that the provision and supply of credit services to the segment by formal financial organizations such as commercial banks and MFIs has been lower expectations. As SMEs grow, they need cash to finance development in fixed assets and improve working capital. SMEs thus need long-term credit in continuously enhancing amounts. SMEs need funds to obtain raw materials and operate activities to support production. The study found that all SMEs borrow investment capital and use it to determine for which they borrow; most do not have other financing bases.

The study concludes that return improved with each consecutive loan, showing that microfinance facilities enhance the financial performance of SMEs in Sri Lanka, Evidence from ABC Bank PLC. The regression results propose that development finance credit gives more to the financial performance of SMEs and thus higher return. The government needs to set up strategies to enhance the development of finance credit to SMEs. These strategies should be in line with both the possessors of SMEs and financial institutions to prevent hindrances to prospective and creditworthy customers who are pursuing the increase of or start-up of a business. This will create a window for the development and growth of the economy as a result of more job chances and an increased flow of money movement in the market. Financial institutions should guarantee that they provoke the owners of SMEs on the best financial management systems. This will help the owners of SMEs to account for loans lent. Lending institutions should also instruct borrowers on how to appraise their projects for viability to make sure that they make smart decisions when investing in projects.

The study suggests that MFIs partner with the county governments and other stakeholders to create recognition of the accessibility and the process of accessing development finance loans. The study advises that the central bank should set policies and procedures to avoid barriers that prevent potential owners and managers of SMEs from accessing credit services. Financial institutions should also deliver advisory services to individual owners when advancing credit. They should lower lending rates while enhancing service delivery and training people on risk and financial management. The government should also legalize financial institutions to ensure that the owners and managers of SMEs get permission to use information in order to make the right investment judgments. The findings of this study cannot be generalized to all the SMEs in Sri Lanka. The study suggests that further research could be conducted on SMEs nationally to investigate the effects of development finance credit on the financial performance of SMEs to find out whether there are shared aims or unique factors. Future research should also focus on the various aspects of development financing on the performance of SMEs. For the SMEs sector to grow, small businesses need to link with the rest of the economy. Further research should be done to determine the best way of linking small and medium businesses with large companies in the economy.

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