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Formal Financing and Financial Performance of Youth-Based Small and Medium Enterprises: Evidence from Bungoma County, Kenya

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Abstract- Youth unemployment remains a critical challenge in Kenya, with youth-based Small and Medium Enterprises (SMEs) offering potential solutions for economic empowerment. This study examines the influence of formal financing on the financial performance of youth-based SMEs in Bungoma County, Kenya. Using a descriptive survey design, data were collected from 231 youth entrepreneurs through structured questionnaires. Correlation and regression analyses revealed a strong positive relationship ($r = 0.735$, $p < 0.001$) between formal financing and financial performance, with formal financing explaining 54% of performance variance ($R^2 = 0.540$). The regression coefficient ($\beta = 0.620$, $p < 0.001$) indicates that increased formal financing access significantly improves youth SME performance. However, barriers including high interest rates and stringent collateral requirements limit access. The study recommends policy interventions to improve formal financing accessibility for young entrepreneurs.

Indexed Terms- Formal Financing, Youth Entrepreneurship, SME Performance, Financial Inclusion

I. INTRODUCTION

Kenya faces significant youth unemployment, with 38.9% of young people aged 15-34 being unemployed (KNBS, 2019). Small and Medium Enterprises (SMEs), particularly youth-owned ventures, contribute 33.8% to Kenya's GDP and provide 80% of employment (Onsomu et al., 2022). Despite their economic importance, youth-based SMEs struggle with limited access to adequate financing, constraining growth and sustainability.

Formal financing through banks, microfinance institutions, and SACCOs represents structured financial support that can enhance SME performance (Beck & Demirgüç-Kunt, 2019). However, young entrepreneurs face barriers including lack of collateral, limited credit history, and stringent lending requirements (Nguyen & Cahn, 2021).

Bungoma County, with youth constituting 32% of its 1,759,499 population, presents a unique context for examining youth entrepreneurship (NCPD, 2017). The county has 765 registered youth-based SMEs across various sectors, yet many remain undercapitalized (CGBLD, 2024). This study establishes the influence of formal financing on youth-based SME financial performance in Bungoma County, providing evidence for policy interventions and financial sector development.

II. LITERATURE REVIEW

2.1 Theoretical Foundation

The Pecking Order Theory (Myers, 1984) explains that firms prefer internal financing over external financing due to information asymmetries. For youth SMEs, this theory explains initial reliance on personal funds before seeking formal financing as businesses grow. The Financial Intermediation Theory (Gurley & Shaw, 1960) posits that financial institutions bridge gaps between savers and borrowers, facilitating efficient capital allocation essential for youth enterprise development.

2.2 Empirical Evidence

Recent studies demonstrate positive relationships between formal financing and SME performance. Kyengo et al. (2023) found that bank loan financing significantly improved SME financial performance in

Mombasa County, Kenya. Similarly, Okonkwo (2024) established that formal financing had significant positive effects on small business performance in Nigeria.

Manyanga et al. (2023) studied debt financing effects on SME performance in Zimbabwe, finding that formal debt financing positively influenced financial performance in emerging markets. In Kenya, Makau and Wanjiru (2023) revealed that bank credit had the most significant effect on SME financial performance in Thika Town.

However, barriers limit youth access to formal financing. Ali et al. (2022) highlighted that financial literacy significantly affects SME access to formal finance, while Fatoki (2020) identified stringent collateral requirements and high interest rates as major constraints in South Africa.

2.3 Research Gap and Hypothesis

Limited studies focus specifically on youth-owned SMEs in rural contexts like Bungoma County. This study addresses this gap by examining formal financing effects on youth SME performance in a semi-urban setting.

Hypothesis: There is a statistically significant positive relationship between formal financing and financial performance of youth-based SMEs in Bungoma County.

III. RESEARCH METHODOLOGY

3.1 Research Design

This study adopted a descriptive survey design to examine relationships between formal financing and youth SME performance without manipulating variables (Mugenda & Mugenda, 2019).

3.2 Population and Sampling

The target population comprised 765 registered youth-based SMEs in Bungoma County (CGBLD, 2024). Using Yamane's (1967) formula with 95% confidence level and 5% precision:

$$n = N / (1 + N(e)^2) = 765 / (1 + 765(0.05)^2) = 263$$

Stratified random sampling ensured representation across business categories including retail, services, and manufacturing.

3.3 Data Collection and Analysis

Primary data were collected using structured questionnaires with 5-point Likert scales. Data analysis employed SPSS version 27 for descriptive statistics, Pearson correlation, and simple linear regression analysis.

3.4 Reliability and Validity

A pilot study with 27 respondents achieved Cronbach's Alpha of 0.701 for formal financing constructs, indicating acceptable reliability. Content validity was ensured through expert review.

IV. RESULTS AND DISCUSSION

4.1 Response Rate and Demographics

Of 263 questionnaires distributed, 231 were returned (87.8% response rate). Demographics showed 58.9% male, 41.1% female respondents. The majority (38.1%) were aged 26-30 years, with 55.4% holding diplomas. Most businesses (42.4%) operated for 2-5 years.

4.2 Descriptive Analysis

Table 1 presents formal financing descriptive statistics:

Table 1: Formal Financing Descriptive Statistics

Results indicate positive perceptions of formal financing (Mean = 3.82) but concerns about collateral requirements and interest rates.

Indicator	Mean	Std. Dev
Access to bank/SACCO loans	4.03	1.147
Favorable loan processing procedures	4.02	1.174
Credit availability affects growth	3.97	1.149
Formal financing improves sustainability	3.85	1.200
Excessive collateral requirements	3.80	1.196
Overall Mean	3.82	1.209

4.3 Correlation Analysis

Pearson correlation revealed a strong positive relationship between formal financing and financial performance ($r = 0.735$, $p < 0.001$), indicating that 54% of performance variation relates to formal financing factors.

4.4 Regression Analysis

Table 2 presents regression results:

Table 2: Regression Analysis Results

Model Summary	Value
R	0.735
R Square	0.540
Adjusted R Square	0.533
F-statistic	268.12***

Regression Equation: Financial Performance = 9.694 + 0.620 × Formal Financing

The coefficient ($\beta = 0.620$, $t = 10.684$, $p < 0.001$) indicates that each unit increase in formal financing improves financial performance by 0.620 units.

4.5 Discussion

Findings support both Pecking Order and Financial Intermediation theories, demonstrating formal financing's critical role in youth SME success. Results align with Kyengo et al. (2023) and Okonkwo (2024), extending evidence to rural Kenyan contexts. The strong explanatory power (54%) suggests substantial policy implications for youth entrepreneurship development.

Identified barriers (collateral requirements, interest rates) reflect systemic financial sector challenges requiring targeted interventions to improve youth access to formal credit.

CONCLUSION

This study provides compelling evidence that formal financing significantly and positively influences youth-based SME financial performance in Bungoma County. The strong correlation ($r = 0.735$) and substantial explanatory power ($R^2 = 0.540$) demonstrate formal financing as a critical success determinant for young entrepreneurs.

Findings support theoretical predictions about external financing importance for business growth and validate the role of financial institutions as vital intermediaries. However, persistent barriers limit youth access, highlighting needs for policy interventions and financial sector reforms.

The study contributes to SME financing literature by providing youth-focused evidence from a rural Kenyan context, offering theoretical and practical implications for stakeholders involved in youth entrepreneurship development.

RECOMMENDATIONS

1. Government should collaborate with financial institutions to develop youth-friendly lending policies with reduced collateral requirements and competitive interest rates. Credit guarantee schemes could reduce lending risks while improving youth access.
2. Banks and SACCOs should design specialized products for youth entrepreneurs featuring simplified procedures, flexible terms, and integrated business development services.
3. Young entrepreneurs should prioritize financial literacy improvement and business formalization to enhance formal financing eligibility and management capabilities.
4. Longitudinal studies should examine long-term formal financing effects on youth SME sustainability. Comparative research across counties would provide broader insights into regional variations and policy effectiveness.

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