The Effects of Relationship Banking and Entrepreneurial Orientation on Financial Performance of Manufacturing Firms in Kenya

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Abstract
The purpose of the study was to determine if relationship banking, and entrepreneurial orientation (EO) affect the financial performance of manufacturing firms in Kenya. The study adopted a cross-sectional research design with the population being 620 manufacturing SMEs involved in relationship banking with commercial banks in Kenya. Stratified random sampling was employed to pick a sample of 138 manufacturing SMEs with the respondents being the owner/ managers of the sampled SMEs. A semi structured questionnaire was used for data collection. The data was analyzed regression analysis with the moderating effects of EO being tested using the moderated multiple regression. The study revealed that EO moderates the relationship between relationship banking and financial performance of manufacturing SMEs in Kenya. The study concluded that relationship banking and financial performance have a positive relationship and that EO moderates this relationship. By forging strategic links with the banks, manufacturing SMEs would be able to access funding which is key to their growth and survival.

Keywords: Relationship Banking, Entrepreneurial orientation, Financial Performance

INTRODUCTION

Despite the acknowledged importance of SMEs, they operate under an environment of harsh credit constraints due to perceived higher credit risk and the resulting unwillingness of financial providers to offer credit (Beck, Demirgu & Maksimovic, 2004). In Africa, SME financing is plagued by the 'missing middle' phenomena where they are seen as being too big to benefit from micro financing and too small to benefit from bank financing (Hsieh & Olken, 2014). As a result of this "missing middle" situation, SMEs face barriers to growth, informality and a significant lack of financing preventing entrepreneurship and scalability (Yago, 2007). Lack of access to long-term credit for SMEs forces them to rely on high cost short term finance (Goh, 2011). Mainstream banks have in the past shunned availing credit to the SME sector on the account of their opaqueness, a situation that leads to information asymmetry. This state of affairs leads to

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adverse selection, information opacity, and moral hazard. Adverse selection happens when where a high firm of high quality may not obtain credit because the financial institution is not able to discern its quality (Levin, 2001). Because of information opacity of SMEs, financiers have difficulties detecting entrepreneurs' behavior, resulting in the moral hazard. The related "costly state verification" problem further increases the perceived risk of SME investing.

One of the avenues available for banks to overcome information asymmetry among SMEs is relationship banking. Boot (2000) describes relationship banking as the provision of financial services by a bank on the basis of long-term investment in obtaining firm-specific information through multiple interactions with diverse financial services. The underlying concept of this approach has to do with developing more comprehensive working relationships with each client, assessing his or her individual situation and making suggestions for various services offered by the bank to help improve the financial well-being of the customer. This is in total contrast with transactional banking whose relationship with the customer is perceived to be at arm's length as they focus mainly on specific transactions rather than information intensive relationship with the customer (Boot, 2000). Relationship banking has four components that is, relationship lending, relationship monitoring, bundle of products and risk sharing (Nam, 2004).Relationship banking is unique and distinct from other modes of enterprise financing hence can lead to competitive advantage of the firm.

Statement of the Problem

Relationship banking has been heralded as being capable of helping SMEs access bank financing thereby boosting their financial and overall firm performance. In Kenya relationship lending has taken root with Kiama (2012) reporting that the majority of SMEs in relationship banking in Kenya are in the manufacturing sector. However Calice, Chando and Sekioua (2012) found evidence that though bank – firm relationships have enhanced credit supply to SMEs, many such SMEs still posted dismal financial performance and stagnation. Thus in spite of the financial support availed to the sector, manufacturing SMEs have not performed financially well and are affected by challenges of product quality and inability to venture into the export markets (Kedogo, 2013). This view is reinforced by Kiama (2012) who reported that while there was strong relationship banking ties with manufacturing SMEs in Kenya, such relationships were not beneficial to the manufacturing SMEs and had no effect on their profitability. The dearth of entrepreneurial orientation among Kenyan SMEs has been well documented in literature. Okatch (2012) reported that manufacturing SMEs in Kenya's motor vehicle assembly sector did not exhibit high levels of innovation , proactivity and risk taking hence they lose out to foreign competitors. This demonstrates that manufacturing SMEs in Kenya have failed to infuse EO well as a strategic tool for growth. The inability to infuse EO makes Kenyan SMEs extremely vulnerable in the face of international competition.

Local scholars like Marwa (2008) researched on the effect of relationship lending on Kenyan banks and reported that it enhanced bank performance. Also Kiama (2012) studied the effect of relationship lending on credit availability argued that such banking relationships have no effect on credit availability to manufacturing SMEs thereby exposing them to failure. Additionally, Wambua & Mugambi (2013) studied the effect of multiple banking relationships on performance of SMEs and reported that diversity of relationship banking is correlated positively to financial performance of SMEs in Kenya. Research has shown that EO is extremely influential in determining the performance of firms globally. In spite of this realization limited attention has been paid to the moderating role of EO on the relationship between relationship banking and financial performance amongst manufacturing SMEs in Kenya by Kenyan scholars and researchers. This study filled in on this existing knowledge gap.

LITERATURE REVIEW

Resource dependency theory focuses on the firm's ability to establish relationships to access resources (Van Witteloostuijn & Boone, 2006). Resource dependency theory assumes that the organization makes active choices to achieve objectives. According to this theory, firms are not able to build all resources internally and therefore depend on exchanges with other organizations in their environment to obtain access to scarce resources (Sirmon, Hitt & Ireland, 2007). For organizations to survive or prosper, resources must be obtained from external sources (Barringer & Harrison, 2000).

Small and medium enterprises in Kenya face a shortage of capital (Nabintu, 2013). Relationship banking is therefore is one avenue of an organization to access external funds in line with the resource dependency theory (Boot, 2000). Based on this theory it could be argued that a firm may enter relationship banking to fill a perceived resource need to enable them exploit opportunities. Following this rationale it is argued in this research that manufacturing SMEs that face resource constraints are likely to use relationship banking as a strategy for accessing or acquiring resources.

The effect of relationship banking on firm performance is well documented in literature. Amhed and Uchinda (2005) empirically tested the effect of relationship banking on beneficiaries in Japan and reported that firms involved in relationship banking could see their performance rise. This view is consistent with Monferrà & Sampagnaro (2011) who conducted a study on the role of lending relationships during the 2007 – 2009 and found out that such firms enjoyed a better and permanent access to finance during the period of the crisis. Proponents of relationship banking posit that it is capable of availing funds to SMEs, prevent business failure (Nam, 2004) and thus ease fluctuations in the availability of credit. The funds accessed by the firm can be used to fund entrepreneurial ventures hence improving financial performance. The importance of credit to SMEs have been of interest to many scholars such as Perry (1995), Kljelly (2004) and Amrhein & Katz (1999).

Some studies however dispute the effect of relationship banking on the firm performance. While attrition of SMEs has in the past been attributed to lack of credit among other reasons, the availing of credit is not a panacea for the ills affecting them. This is because beyond credit, SMEs are still affected by other challenges such as business planning, marketing effectiveness and entrepreneurial capability. Kljelly (2004) posits that if not handled properly credit may ruin an organization because it can saddle the organization with the burden of high intrest payments and penalties as a result of inability to pay debts in time. Two studies i.e Berger and Udell (1995) and Berger and Udell (1994) gave two contradictory findings on interest rates in a relationship banking arrangement. Berger and Udell (1994) and Elsas and Krahnen (1998) found that there was no significant decrease in interest rates for SMEs who are in a relationship banking arrangement. The Berger and Udell (1995) study however provided evidence that if SMEs in relationship banking are offered lines of credit, there would be a significant drop in interest payments that they make when the loans become due for repayment. Further Ferri *et al* (2000) argued that the benefits of reduced cost of credit may not accrue to borrowers because as lenders accumulate information concerning the borrowers, they may be able to apply unfair credit terms.

Some studies have pointed out that the relationship banking concept may not find wide spread application to SMEs owing to the unprofitability of some segments (Leverin & Liljander, 2006). This is because for banks, customers' profitability may be segment specific. Zeithaml, Rust and Lemon (2001 posit that banking in all client segments does not give the same returns. Thus relationship banking is mostly targeted at groups who are deemed to be profitable from the banks perspective (Carson *et al*., 2004). Reinartz and Kumar (2002) posit that the bank-firm relationships may be untenable owing to the fact that not all long-term customers are profitable while not all short term clients are unprofitable. This is consistent with Anderson and Mittal (2000) whose study reported that not all firms are likely to benefit from relationship banking because profitability is a function of many factors such as maintenance cost of the customers and the revenue they bring.

It is not a guarantee that relationship banking will make a difference in the performance of an SME. Madill, Feeney, Riding and Haines (2002) argued that there is a strong correlation between the account managers management of the bank – client relationship. The implications for this is that the overall outcome in this relationship is dependent on the account manager. Ferri, Kang and Kim **(**2000) posit that relationship banking could result in misallocation due to the soft-budget constraint problem. This occurs because borrowers can renegotiate the cost of credit with the bank hence they have little incentive to boost their efforts. (Bolton and Scharfstein, 1996).

Switching costs is considered one of the disadvantages of relationship banking. Jones, Michael, David and Sharon (2000), describes switching barriers as those issues that makes it problematic for customers to change bank service providers. Pezzetti (2004) demonstrated that firms participating in relationship banking face high switching costs. This is because the firms will find it hard to change bankers because the substitution of the main bank is a time consuming and resource consuming process. Tesfom and Birch (2009) examined the correlation between switching costs and age groups and found out that that attitudes towards switching barriers and costs differ amongst the different age. The implications are that switching costs increase with age and as such will be high for relationship banking. Some studies have demonstrated that banks need SMEs more than SMEs need the banks. Vegholm (2011) study on the effect of relationship banking on the bank's image showed that banks view relationship banking as being critical for its image though this also depends on the effectiveness of its relationship personnel. The image boost becomes critical for banks especially if they are able to be seen to be meeting the demands of their clients. This is consistent with Lam and Burton (2006) who posited that SMEs expect banks to be useful to them in as far as their needs are concerned.

Entrepreneurial Orientation

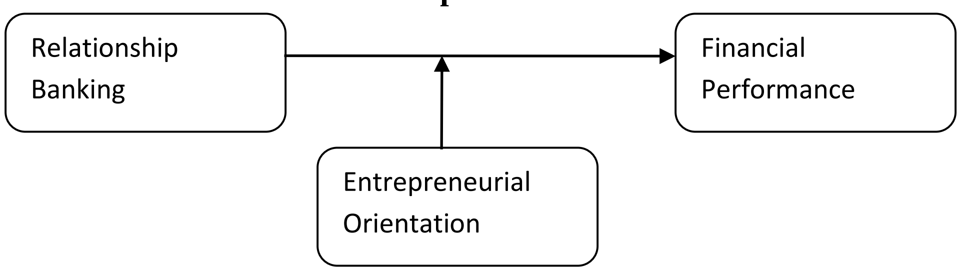
The role of EO has been well articulated in entrepreneurship literature. EO refers to the extent to which a firm is entrepreneurial (Davidson & Wiklund, 2001). Entrepreneurial firms pursues entrepreneurial activities by adapting structure, management, and processes accordingly in order to gain the required agility, speed, creativity and drive to act profitably upon specific opportunities. Miller (1983) developed a framework of EO that has three constructs that is, innovation, risk taking and proactivity. Later other constructs were added that is, competitive aggressiveness and autonomy (Lumpkin & Dess, 1996). Miller (1983) treated EO as a unidimenstional construct while others such as Kreiser, Louis & Weaver (2002) argued that each construct of EO ought to be taken as separate constructs.

Entrepreneurial orientation (EO) is crucial for the performance of SMEs. Studies such as Brown, Davidsson, & Wiklund (2001) and Stevenson & Jarillo, (1990) were able to demonstrate the link between the performance of a firm and the entrepreneurial orientation of the owners. Mullins and Forlani (2005) study also did underpin the superiority of EO in explaining firm performance. That EO contributes to the performance of an enterprise is not in doubt. According to Wiklund (1999) EO has implications for SME performance because aspects of EO such as 'risk-taking, innovativeness and proactiveness keep small firms ahead of competitors. This view is consistent with Lyon, Lumpkin and Dess (1996) who reported that EO is a necessary antecedent to entrepreneurial actions that are essential for survival and growth of firms. In a nutshell, it means that EO, is what translates plans into reality. This is also consistent with Amit and Zott (2001) who argued that having critical resources only is not sufficient to contribute to superior financial performance of the organization. It matters a lot how or what the said resources are deployed for.By acting entrepreneurially firms would utile the bundle of products to fund innovations thereby improving profitability. Some studies however have found out that EO may be deficient in predicting SME performance because it lacks reference to opportunity identification which is key to sme growth (Stevenson, 1983).

Slater and Narver, (2000) posits that firms ought to develop propensity to act as this will enable them to act on the opportunities available to them. Individuals who are high on Entrepneurail orientation are also risk takers and innovative and proactive (Matsuno, Mentzer, and Ozsomer, 2002). This is also related to self efficacy which is the belief in self, i.e. self-efficacy affects an individuals' assessment as to whether he/ she is capable of actually starting a business. This trait had been noted earlier on by Shapero (1981) who posited that those keen on starting a business ought to be able to visualize themselves in that role. While some individuals are low on self efficacy, it can be improved through education and exposure to business and customer contacts (Gompers et al, 2003). Leicht et al. (2004) also researched to the relationship of education and propensity to act among women in Germany and reported that propensity as been increasing with an increase in education.

There is little consensus on what constitutes suitable moderators though Miller & Toulouse (1986) recommended that a variable is a moderator if the relationship between two variables differs on a given attribute. Previous studies by Anderson and Mittal (2000) and Dass and Massa (2006) showed that the effect of relationship banking on the financial performance can be positive or negative depending on the entrepreneurial attributes of the proprietor. On this basis therefore, EO is taken as a moderator – see figure 1 below.

FIGURE 1
Conceptual Model



METHODOLOGY

The target population of this study were 620 the owner managers of SMEs involved in relationship banking with banks in Nairobi, Kenya. The 620 owner managers were listed as being involved in relationship banking with the top five commercial banks in Nairobi's industrial area with the sampling frame being provided by the relationship managers of the respective banks. The study employed stratified random sampling to identify a sample of 138 respondents. This sample size was calculated using a sample size formula (equation 1), at 95% confidence interval. The basis of stratification was the sector in which they operate. The identified strata were cloth manufacturing, chemicals, food processing, Construction and Electronics. Primary data was collected using a structured questionnaire which contained both open and close ended questions with the close ended questions being in a 5 point Likert scale. The questionnaires were self administered and thus data was collected on the basis of 'drop and pick' method. Data on the dependent variable was collected on a data capture form attached to questionnaire where respondents were asked to indicate average growth in financial performance indicators for the past 3 years.

RESULTS AND FINDINGS

A total of 138 questionnaires were distributed to the respondents out of which 131 questionnaires were successfully filled and returned. This represents a response rate of 91%. The response rate at 91% is comparable to similar studies in the domain of relationship banking such as Agarwal, et al. (2009) whose study on the determinants of relationship banking reported a response rate of 80%.

Regression analysis was employed in this study to test the conceptual relationships between the variables under study. The study also conducted a correlation test. Correlation is often used to explore the relationship among a group of variables (Pallant, 2010), in turn helping in testing for multicollinearity. The results presented in table 1 show that the correlation between relationship banking and financial performance (FP) is positive with R being 0.575 with a p value of 0.000, implying that there is positive correlation between the two variables

TABLE 1
Correlation Analysis

		FP	RB
Financial Performance	Pearson Correlation	1	
relationship banking	Pearson Correlation	.575**	1

*** Correlation significant at the 5% level*

The next step, exploratory factor analysis (EFA), was conducted to uncover the underlying factor structure (Tabachnick & Fidell, 2013). As part of EFA the pattern matrix, communalities and factor analysis using principal components analysis (PCA) were determined. The KMO test shows the fitness of data for factor analysis. The results shown in Table 2 show that the KMO = 0.829 which was significant (p= 0.00). This score is greater than the recommended threshold of 0.5 by Hair et al. (1998) who recommended that a KMO score 0.5 is an indicator of sample adequacy. The bartlet Test of Sphericity was significant at p= 0.000 showing that the sample data was factorable. A total of 21 items were subjected to factor analysis. Items with factor loadings less than 0.6 were dropped. The remaining items were thus subjected to regression analysis.

TABLE 2

KMO and Bartlett's Test

KMO and Bartlett's Test		
Kaiser-Meyer-Olkin Measure of Sampling Adequacy.		0.829
Bartlett's Test of Sphericity	Approx. Chi-Square	1.23E+03
	Df	190
	Sig.	0.00

Regression analysis was conducted by setting relationship banking as the independent variable while financial performance was set as the dependent variable. The resultant model showed a good fit with the R^2 being significant ($p>0.05$) as shown in table 3. Further table 4 shows that the model was significant with F being significant ($P>0.05$). The regression coefficients were significant Ho was rejected and the study concluded that relationship banking has significant effects on the performance of SMES in Kenya. Fitting the coefficients to the OLS equation resulted in the model shown below:

Y = 11.155 + 0.258 x.

TABLE 3

Model Fitness

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	0.575	0.331	0.325	3.53736

TABLE 4

Anova

Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	797.052	1	797.052	63.698	0.00
	Residual	1614.16	129	12.513		
	Total	2411.21	130			

TABLE 5

Relationship between Relationship Banking and Financial Performance

	Unstandardized Coefficients		Standardized Coefficients		
	B	Std Error	Beta	t	sig
(Constant)	11.155	1.099		10.15	0.00
RB	0.258	0.032	0.575	7.981	0.00

A moderated multiple regression (MMR) was done to determine if EO moderates the relationship between relationship banking and financial performance. Table 7 how the model summary for both relationship banking and financial performance. The coefficients for all variables for Model 1 and Model 2 are presented in table 7. As shown in table 6, the results for model 1, R=0.460, R^2=0.212 and F= 17.22, p=0.000. This shows the 21.2% variation in financial performance is explained by relationship banking.

TABLE 6
Model Summary for Entrepreneurial Orientation

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate	Change Statistics					Durbin-Watson
					R Square Change	F Change	df1	df2	Sig. F Change	
1	.460[a]	0.212	0.2	3.50473	0.212	17.224	2	128	0	
2	.489[b]	0.239	0.221	3.45711	0.027	4.551	1	127	0.035	1.832

In model 2 of the same table,the interaction term (Banking*entrepre) is introduced. The results of model 2 shows that the change in R^2= 0.020, F= 3.354. This shows that the moderating variable explains only 2% of the variation in financial performance. The p value (p = 0.035) is less than the level of significance (0.05) hence the change is significant.

TABLE 7
Moderating Coefficients for Relationship Lending

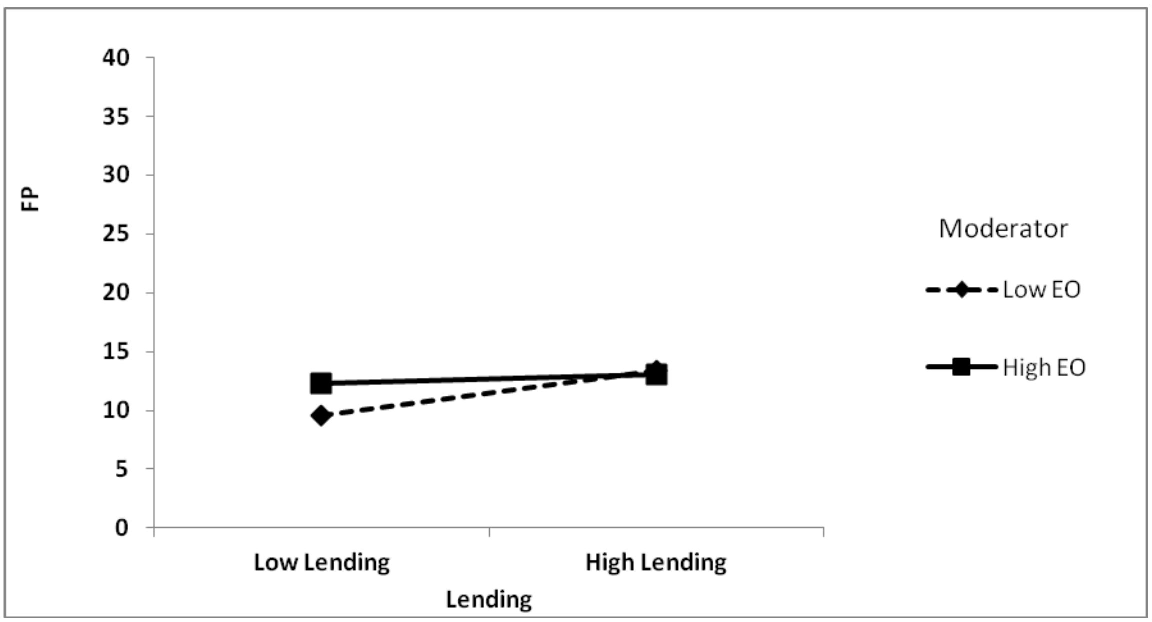
Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.
		B	Std. Error	Beta		
1	(Constant)	12.068	1.946		6.202	0.00
	Relationship Banking	0.185	0.032	0.452	5.715	0.00
	Entrepreneurial orientation	0.156	0.075	0.164	2.071	0.04
2	(Constant)	4.274	4.127		1.036	0.302
	Relationship Banking	0.46	0.133	1.128	3.457	0.001
	Entrepreneurial orientation	0.534	0.192	0.561	2.779	0.006
	BANKING.ENTREPRE	-0.014	0.006	-0.756	-2.133	0.035

a. Dependent Variable: FINANCIAL PERFORMANCE After RELATIONSHIP BANKING

The conclusion is that the EO has a moderating effect on the relationship between relationship banking and financial performance. Other studies that have supported the moderating effects of EO on firm performance include Nelson and Coulthard (2005) who found that beyond EO having a direct effect on SME performance, its moderating effect is also significant. Another study by Wiklund and Shepherd (2005) reported systematic empirical evidence to support the effect of EO on the relationship between lending and firm performance. Other Studies by Shimizu and Hitt (2004) and Kroeger (2007) also did found evidence to support significant moderating effects of EO on firm performance

FIGURE 2

Moderated Multiple regression for Relationship Banking



Discussion

The core finding of this study is that relationship banking positively affects the financial performance of manufacturing SMEs in Kenya. By forging links with the banks, strategic SMEs would be able to access funding is key to SME growth and survival. This study makes a contribution to the field of strategic entrepreneurship. Ireland et al (2003) identified resources and networks as part of the domains of strategic entrepreneurship. This study has been able to show that the bank – SME relationship enables the SME to access credit.

Relationship banking is offered in a package which includes credit, monitoring and risk sharing all of which have positive consequence on financial performance. Relationship banking not only avails credit to the firm but also provides the supportive environment for enterprises to thrive. While entrepreneurs are good in spotting opportunities in the market, financing is needed to enable them exploit them which usually has positive consequences on profitability and other indicators of financial performance. This view is consistent with Shane (2003) who argued that acquisition of financial resources is key in enabling SMEs exploit the opportunities in the environment. Without access to financing, organizational plans and strategies would not be successful. Pelham (2000) argued that with credit from the banks could be used to acquire the necessary fixed and capital assets and investment in product development which not only increase the customer base but also sales turnover and profitability. Manufacturing SMEs in Kenya would gain a lot by forging relationship banking arrangements with the banks as this would help unlock financial resources that can be applied to enhance the competitiveness of the farm hence leading to increased sales turnover and profitability hence financial performance. Relationship banking is essentially one of the networks that firms forge with various stakeholders. This fits well into strategic entrepreneurship where networks were identified by Hitt etal (2001) as one of the domains of strategic entrepreneurship. Thus relationship banking would help SMEs attain their strategic goals.

The study found out that EO moderates the relationship between relationship banking and financial performance of manufacturing SMEs in Kenya. While relationship banking enables the firm access credit, EO puts the firm in a good position to outcompete its rivals. Entrepreneurial orientation enables firms to monitor market changes and respond rapidly, thus seizing emerging opportunities. The modern business environment is considered to be highly dynamic, the life cycles of products and business models are shortened, the future profit streams from existing operations are uncertain, and businesses need to constantly monitor the environment for new opportunities. In such circumstances, adopting an entrepreneurially oriented posture may be beneficial for a firm. Thus, in the context of relationship banking, EO enables the firm to utilize borrowed funds entrepreneurially. Manufacturing SMEs in Kenya operate in a rapidly competitive environment and as such they would cope with the competition by acting entrepreneurially. This will also enable them create a market niche for themselves thus, forcing multinational firms to revise their entry strategies

Overally, the study has demonstrated the positive association between relationship banking and the financial performance of manufacturing SMEs in Kenya. It has also shown that entrepreneurial orientation enhances that relationship. Since many manufacturing SMEs in Kenya face financing constraints due to their information opacity, certainly they can adopt this model as it can help improve their financial performance. This study also fills the knowledge gaps identified at the literature review stage where it was revealed that limited attention has been paid to the moderating role of entrepreneurial orientation on the relationship between relationship banking and financial performance of SMEs in Kenya.

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Appendix 1: Test of Normality for Relationship Banking

		Statistic	Standard Error
Financial Performance	Skewness	-.272	.212
	Kurtosis	-.568	.420

Appendix 2: Factor Analysis

Factor label	**Component Matrix**	
		Factor Loadings
18	The financier has improved the financial position of the firm	0.775
23	Because of relationship with the bank, we get bank guarantees	0.754
26	The bank has contributed to the financial competence in the firm	0.743
27	The relationship with this financier has improved the profitability of the firm	0.742
37	This financier has transferred knowledge on product development to our firm	0.736
30	In tough times it is vital to have backing from this financier.	0.732
25	The cost of debt as been decreasing as the length of relationship increases.	0.721

34	The financier has had high demands with regard to the equity to debt level of the firms.	0.704
36	The financier has been of great importance for the development of new products.	0.7
33	The financier has demanded that we use budgets, marketing plans and	0.699
24	Because of the relationship with the bank the cost of credit has come down for our firm	0.696
21	Because of relationship with the bank, we have had extended credit limits	0.676
37	This financier has given our firm knowledge that has led to new customers	0.665
35	The financier has had tough demands as regard to the sale developments of the firms	0.63
22	Because of our relationship with the bank, we are charged low interest on loans.	0.588
29	The financier has been a source of moral support.	0.584
18	Relationship banking has had a positive impact on the firm's.	0.402
31	This financier has connected our firm with other financiers.	0.321
32	The financier has had demands with regard to the composition of the board of directors and/or accountants	0.301
19	Excess time is spent meeting with and providing information to the bank	0.101*
20	Our company feels tied to it's current bank	0.038*

Extraction Method: Principal Component Analysis.