

MICROFINANCE MARKET COVERAGE AND RETURN ON ASSET

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ABSTRACT

The objective of the study was to assess the influence of market coverage on return on asset in the microfinance industry in Kenya. The population of the study consisted of microfinance institutions with physical banking halls and registered with the Association of Microfinance Institutions in Kenya. We used descriptive cross-sectional survey design and collected data through semi-structured questionnaire. Data on return on asset were collected from annual industry performance reports prepared by the Microfinance Rating Africa and the Association of Microfinance Institutions in Kenya. We subjected our data through reliability and validity tests. We tested our hypothesis through regression analysis. The results of our study demonstrate that market coverage has strong statistical significant influence on return on asset in the Microfinance industry. In addition, the results demonstrate that distribution capability of the firm has a significant positive influence on return on asset. We conclude that wider market coverage increases customer's access to microfinance services which in turn, leads to higher profitability.

Key words: Microfinance outreach, Return on Asset, Microfinance

Introduction

Access to financial services is a major bottleneck to low income earners and small enterprises considered high risk customers by conventional commercial banks in Sub-Saharan Africa. For a long time, low income earners lacked access to banking services and relied on informal lending sources to access financial resources. Yunus (1996) reports documented experiences of the negative perceptions banks held pertaining to doing business with poor people. However, based on counter experiences suggesting the possibility of profitable credit services tailor made to suit the needs of poor people, the practice of microfinance developed. Microfinance emerged in the 1970s as a means for promoting financial inclusion of the market segments that were unable to access financial services from banks. However, over time, the industry has attracted financial service providers with more commercial motivation and profit maximization objectives (Lahkar, Pingali & Sadhu, 2012). Although microfinance institutions continue to provide solutions to poor people's needs by enhancing financial inclusion through savings and credit products at affordable cost, there has been a major shift from social objective to market based financial solutions (Rauf & Mahmood, 2009). This involves developing credit recovery strategies that minimize default. Unlike the banks that for many years use collateral or other forms of tangible securities to safeguard against loan default, majority of the microfinance institutions use innovative social network strategies such as group lending to encourage loan repayment rates.

Microfinance has taken different forms leading to a variety of outcomes and varying levels of success rates in several countries (Shahinpoor, 2009). In the African context, microfinance institutions (MFIs) consist of diverse and geographically dispersed financial intermediaries that offer a wide range of savings and credit services to individuals, micro and small enterprise clients (Lafourcade et al., 2005). Microfinance covers the design and delivery of a wide range of financial services to low income groups at affordable cost (Khandakar & Rahman, 2006). The industry comprises formal and semi-formal institutions such as banks offering micro-credit, wholesale microfinance institutions, deposit-taking microfinance (DTM) institutions and retail microfinance institutions. Ahmed (2005) describes microfinance institutions as organizations that are engaged in the provision of a variety of financial services to the poor, based on market driven and commercial approaches. Microfinance institutions are found in over 85 countries in the world with the highest concentration in Latin America and East Asia (Lapenu & Zeller, 2001). The emergence of microfinance institutions was necessitated by the failure by commercial banks to develop financial products targeting the poor and the withdrawal of banking services from rural areas by multinational banks. The multinational banks perceived rural and low-income residential urban areas as non profitable due to the high transactions costs involved, high risk of loan default, weak contractual engagement and the unpredictable income flows upon which poor people are dependent (Mutua & Oyugi, 2006). Hence, multinational banks left a void in the financial services through the closure of branches in the rural areas in the early 2000 (Katwalo & Muhanji, 2014). In Kenya for example, the gap created by the neglect of poor people led to the introduction of microfinance institutions such as Kenya Women Finance Trust (KWFT), K-Rep Bank, Faulu Africa as well as microfinance services by some of the Kenyan owned commercial banks.

Microfinance institutions in the current times pursue both social and commercial objectives by alleviating poverty using market driven and sustainable micro-lending strategies. Therefore, the success of microfinance institutions is gauged by the extent of their outreach. Outreach is associated with the number of people served by the microfinance institution and the range of loan size accessed by borrowers. Countries leading in outreach of microfinance services to customers are located in the East and are specifically found in Indonesia, Bangladesh, Thailand, Viet Nam, Sri Lanka and India. In addition to the vast Asia, there is high outreach of microfinance in more than 25 percent of the countries based in Latin America. These countries include Colombia, Ecuador, Bolivia, Mexico, Uruguay and Honduras. In Africa, microfinance services are dynamic and active in East Africa and South Africa.

Although the practice of microfinance has been in existence since 1970s, it took a turning point in the 1980s following Grameen Bank's evidence which linked commercial approaches to profitability of microfinance. This development shifted the modelling of microfinance from thrift to business. In Kenya, microfinance institutions exist in different forms. Omino et al. (2005) found that microfinance institutions in Kenya operate under many legal forms such as companies limited by shares or guarantees, nongovernmental organizations, cooperatives, associations or community based organizations. Furthermore, microfinance institutions even of the same legal status differ by scope of outreach, level of sophistication, target market, size as well as organizational attributes. Governance of microfinance institution is an emerging concern in many countries. Consequently, in some countries such as Kenya, regulation of the microfinance industry is gaining foothold with the introduction of law and policies to streamline operations of institutions. The Government of Kenya signed into law the Microfinance Act in 2006. The Act creates a legal framework for supervision and regulation of deposit taking microfinance institutions in Kenya. Even though operations of deposit taking microfinance institutions closely resemble those of commercial banks, majority are constrained by inadequate capital resources and cannot provide full range of services offered by banks.

Microfinance industry play an important role in the economy by stimulating investment and job creation through increased access to financial capital. Microfinance institutions serve more than 1.5 million Kenyan borrowers with an estimated loan book value of 1.4 billion dollars every year. However, the microfinance institutions operate in a competitive financial sector where success depends on organizational ability to match resources and capabilities with marketing opportunities in the external environment. Outreach is an important capability for improving organizational performance in competitive markets. Studies examining geographic outreach and performance argue that superior performance emerges from market coverage, market dominance and the spread of risks across spatially diverse located branches (Delios & Beamish, 1999). Kimondo, Kihoro and Njogu (2012) concluded that market outreach ultimately influenced sustainability of micro-finance institutions. Insightful results have been reported in Ethiopia by Kereta (2007) who established a trade-off between market outreach and sustainability of microfinance institutions. While theoretically convincing arguments associating market outreach and performance relationship have been advanced in literature, there is little empirical evidence to support the claim. Therefore, the current study is an attempt to empirically test whether outreach has a significant influence on performance of microfinance institutions. In the current study, outreach is operationally defined as the number of functional branches operated by a microfinance institution to serve its customers spread across different locations in the market. On the other hand, performance was measured by observing the return on asset as reported by each of the microfinance institution.

Literature Review

The current study draws its support from the dynamic capabilities theory which is an extension of the resource-based view of the firm. The resource based view argues that a firm uses its constellation of tangible and intangible resources to build competitive advantage. However, the resource based view does not explain how resources are developed and deployed to achieve competitive advantage in the market. The dynamic capabilities theory addresses this limitation by suggesting that since marketplaces are dynamic, inter-firm performance variance is explained by organizational capabilities for acquiring and deploying resources in ways that match the firm's marketing environment (Makadok, 2001). Teece et al. (1997) explain that capabilities are dynamic when they facilitate implementation of new strategies that reflect changing market conditions. Marketing capabilities are developed through continuous application of marketing knowledge and skills by employees to solve marketing problems (Vorhies, Harker & Rao, 1999). This argument is further supported by the work of Zollo and Winter (2002) who suggest that deliberate investment in organizational learning may facilitate the creation and modification of dynamic capabilities. Even though Winter (2003) argues that dynamic capabilities involve long-term commitment to specialized resources; it is important to note that in the long-run, other firms can acquire resources which may eclipse capabilities of rival firms. Hence, competitive advantage is more useful for sustainable performance when the capabilities of the firm are valuable, rare, inimitable and non-substitutable.

The resource based literature explains that factors both internal and external to the firm govern the optimal growth path chosen by the organization. Market outreach is a reflection of the distribution capabilities of the firm. Yaron (1999) avers that outreach is the ability of a microfinance institution to provide financial services to a large number of clients who are not served by the commercial banks. According to Meyer (2002) outreach refers to the number of customers accessing microfinance services, but who were initially deprived of access to formal financial services. Schreiner (2002) proposes measurement for outreach by assessing the extent to which a microfinance institution has reached people who were initially cut-off from accessing financial services. However, this method of assessing the extent of outreach considers only one dimension. Outreach has two dimensions comprising breadth and depth. While breadth relates to the number of clients served and the volume of services offered by a microfinance institution, depth refers to the socio-economic level of clients reached. Therefore, performance of a microfinance institution can be improved by deepening the depth and extending the breadth of outreach. Outreach of microfinance services in Africa varies from one firm to another depending on the region, wherein East Africa enjoys outreach dominance of 45% in the continent (Lafourcade et al., 2005).

Growth is one of the key goals of business firms including microfinance institutions. While several firms pursue either product oriented or market based growth paths, the latter involves developing new markets by selling existing micro-finance products in new geographic markets. Geographic expansion leads to discovery and exploitation of profit generating opportunities (Delios & Beamish, 1999). Porter (1980) maintained that firms with a large market size earn high profits because they reap benefits associated with economies of scale. Yaron (1999) argues that outreach is the means through which a microfinance institution

generates internal resources necessary for sustaining the provision of financial services over a long period of time. Consequently, outreach indirectly contributes to sustainability of a microfinance institution.

Buzzell (2004) contends that market outreach leads to higher performance due to economies of scale and market power obtained through increased number of customers. In addition, a large market share due to outreach may signal brand quality in the minds of buyers and accelerate acceptance of products offered by a micro-finance institution. Increased brand acceptance is likely to translate into sales and consequently increases both revenue and profitability of the microfinance institution. On his part, Morduch (2005) reinforce the argument linking outreach with microfinance institution's long term performance. In the long-term, the microfinance institution is capable of spreading costs among increased number of customers hence, more efficient operations and higher return on asset. Whereas market outreach can create competitive advantage to the firm, critiques argue that geographic market expansion involves acquisition of new assets which may be counterproductive as it adds to the costs of operating the business. Furthermore, Sheth and Sisodia (2002) caution that market outreach may only contribute to performance, up to a certain size beyond which the firm loses scale advantages and experiences diminishing returns. Some researchers have advanced arguments in favour of a U-shaped relationship between outreach and performance (Dobrev & Carroll, 2003). However the consensus in literature is that market coverage is positively, although not necessarily linearly related to performance (Geringer, Beamish and da Costa, 1989; Tallman & Li, 1996). The enormity of arguments presented in literature suggests that market coverage could be associated with performance. Nevertheless, to rule out the possibility of doubt on the relationship between market coverage and performance, we test the following hypotheses.

H1: Distribution capability is positively linked to performance of microfinance institutions

H2: Market outreach is positively associated with return on asset in the microfinance industry

Research Methodology

The study was guided by the positivism philosophy premised on the deductive approach. Positivism philosophy assumes objective observation and measurement of phenomena under investigation. Deductive reasoning assumes universality of theory and works back to test it in a particular research context. Deductive logic aims at testing hypotheses and patterns of relationships drawn from theory using empirical data. The study was guided by theory and it aimed at testing the relationship between market coverage and performance. Market coverage was operationalized as number of active branches operated by microfinance institution whereas performance of the microfinance institution was measured through return on asset and proxy indicators. Descriptive cross-sectional survey design was adopted in the collection and analysis of data. The descriptive design was chosen because the study aimed at describing the relationship between outreach and performance. The cross-section research design was selected because the survey was concerned with collecting data from the units of observation at one point in time for purposes of hypotheses testing.

The target population comprised microfinance institutions in Kenya that were members of the Association of Microfinance Institutions (AMFI) in Kenya. Out of the 55 MFIs; 5 were commercial banks offering microfinance services; 5 wholesale microfinance lenders; 16 deposit taking micro-finance (DTM) institutions; and 29 retail microfinance lenders. The microfinance institutions were spread out in several parts of the country, but with higher concentrations in Nairobi, Mombasa cities and parts of Western and Rift Valley regions. Data were obtained from both secondary and primary sources. Secondary data were extracted from annual reports published by AMFI and Micro-finance Rating Africa. Secondary data were used to measure return on asset (ROA) and the number of branches operated by each of the microfinance institution.

Primary data were collected using semi-structured questionnaire. The questionnaire was pretested and revised before actual collection of data. Reliability of the data collection instrument was tested through internal consistency technique by computing Cronbach's alpha coefficient. Alpha coefficient of 0.7 and above was considered indicator of acceptable reliability. The final questionnaire was administered by trained research assistants through a drop and pick later method. Research assistants booked appointment with respondent organizations at least two days before the visit to pick the completed questionnaire. The questionnaire was administered to the Chief Executive Officer, Human Resources Manager and Marketing Manager. In smaller microfinance institutions with leaner top management especially where positions of human resources manager as well as marketing managers were not part of the organization structure, the questionnaire was administered to the chief executive officer or their equivalent. Aggregated individual scores for each microfinance institution were used to reduce common source bias. Data obtained were cleaned by checking for questionnaire completeness, recording accuracy and removing outliers. Out of the questionnaires circulated to 55 microfinance institutions, complete and useable data were obtained from 53 MFIs leading to a response rate of 96.4%. Data were analyzed using descriptive statistics and regression analysis. Descriptive statistics comprising mean scores and standard deviation were used to summarize the distribution of microfinance institutions and to measure distribution capabilities as perceived by respective MFIs. We used simple regression analysis to test our hypotheses. We tested our models using the ordinary least squares (OLS) estimators. The data was analyzed using SPSS (Version 20). We used the beta coefficients to assess the direction and strength of the relationship between the explanatory and the explained variables. We assessed goodness-of-fit of the regression models using coefficient of determination (R²). The findings of the study are presented in the section below.

Findings

1. Level of Outreach by Microfinance Institutions

Microfinance institutions have both social and financial objectives. Level of outreach was used as an indicator of social performance among microfinance institutions. While outreach is measured in many dimensions including depth, breadth, length and scope (Kereta, 2007), in the current study, outreach was measured using the number of branches operated by the microfinance institution. Relevant results are shown in Table 1.

Table 1: number of branches operated by microfinance institutions

Number of Branches	Frequency	Percent (%)
Less than 10	31	58.5
10 – 19	9	17.0
20 – 29	6	11.3
30 and Above	7	13.2
Total	53	100.0

The results in Table 1 show that more than half (59%) of the microfinance institutions in Kenya had less than 10 branches. Seventeen percent of the firms operated in branches ranging between 10 and 19. The results further indicate that 24.5% of the MFIs offer their services in at least 20 branches across the country. The findings connote low levels of outreach by majority of the microfinance institutions. Low level of outreach is an indicator of weak social performance in the microfinance industry. On the other hand, low levels of outreach signify intense competition in the industry. However, the results demonstrate that a quarter (25%) of the firms had relatively good outreach and as a consequence, good social performance.

2. Distribution Capability

Distribution provides the channel through which products and services are delivered to customers. Ineffective distribution network can weaken a firm's marketing efforts irrespective of the success of complimentary marketing strategies. In other words, organizations have no choice, but to ensure that they strengthen their distribution capability. Microfinance services can be distributed by reaching out to customers through physical outlets, field visits by sales force and internet enabled services such as online banking and mobile money transfer. The distribution capability of microfinance institutions was measured using 3 question items that covered physical and electronic distribution. A 5-point rating scale was used to compute the mean scores and standard deviations. The results of the distribution of mean scores and standard deviations are presented in Table 2.

Table 2: mean scores and standard deviations of distribution capability

Distribution Capability Items	N	Mean	Std. Deviation
Partnership with money transfer service providers	53	4.00	1.074
Size of sales force	53	3.42	1.232
Distribution of branch network	53	3.28	1.231
Overall Mean Score and Std. Dev.		3.57	1.179

Table 2 shows that item 1 had the highest score (Mean = 4.0, SD = 1.074). This implies that partnering with money transfer service providers was largely practiced in the microfinance industry. It can be construed from the results that mobile money transfer was a popular service distribution channel in the microfinance industry. Developments in the mobile telephone industry such as mobile money transfer (*Mpesa*) and micro-banking aided by mobile telephone have increased the scope of distribution for services besides offering convenience to both upstream and downstream users.

With regard to increased scope, mobile money transfer enables microfinance institutions to channel loans to clients in different parts of the country including locations without physical branch of a microfinance institution. In addition, mobile money transfer service empowers borrowers to amortize their loans without the trouble of physically travelling to the premises of a microfinance institution. Mobile money transfer service provides convenience to customers through multiple solutions such as making deposits, withdrawals, payments and receipt of cash at convenient locations and time. As for upstream users such as microfinance institutions, mobile money transfer reduces the cost of maintaining a large branch network and lessening service access costs by customers.

Question item 2 sought to assess the size of a firm’s sales force relative to that of competitors. A mean score of 3.42 and a standard deviation of 1.23 were obtained, suggesting that majority of the microfinance institutions employed small sales force. This implies that majority of the firms were constrained by insufficient sales people to push their products to the market. The third question item sought to measure the distribution of branch network. A mean score of 3.28 and a standard deviation of 1.23 were obtained indicating that majority of the firms had modest branch distribution. Provision of microfinance services in a few branches may reduce overhead and variable costs, but it may stifle outreach efforts and negatively affect performance.

3. Service Distribution Capability and Performance

The influence of microfinance service distribution capability on performance was tested through linear regression analysis. Diagnostic tests were undertaken prior to regression analysis. The tests assessed whether the linear regression assumptions comprising normality, linearity, autocorrelation, and homoscedasticity were met. Following positive results of the diagnostic tests, we proceeded to test the influence of service distribution capability on performance. The results of the linear regression analysis are contained in Table 3.

Table 3: regression results for the relationship between service distribution capability and performance

Model		Unstandardized		Standardized	t	Sig.	R	R ²	F
		Coefficients		Coefficients					
		B	Std. Error	Beta					
1	(Constant)	2.352	.272		8.638	.000			
	Distribution Capability	.339	.074	.541	4.599	.000	.541	.293	21.155

a. Dependent Variable: Organizational non-financial performance

The results in Table 3 indicate statistically significant and positive relationship between service distribution capability and performance of microfinance institution ($t = 4.599$, Std. Beta = .541, $R^2 = .293$, $p\text{-value} < 0.05$). The results imply that service distribution capability accounted for 29.3% of the variation in performance of microfinance institution. The F-statics of 21.155 demonstrate significance of the regression model fitting the relationship between service distribution capability and performance. The beta coefficient (Std. Beta = .541) suggest that for every 1% change in service distribution capability, there is a corresponding 0.541% change in the performance of microfinance institution.

4. Microfinance Outreach and Return on Asset (ROA)

Simple linear regression analysis was performed to determine the relationship between microfinance outreach and return on asset. The number of branches operated by microfinance institution was used as the proxy indicator of outreach breadth. Return on asset was treated as the indicator for finance performance. Table 4 displays results of the regression analysis.

Table 4: regression results for the relationship between outreach and return on asset

Model		R Square	Adjusted R Square	Unstandardized Coefficients		Standardized	t	Sig.	F
				B	Std. Error	Coefficients			
						Beta			
1	(Constant)			.324	.138		2.341	.027	
	Number of branches	.780	.772	.038	.004	.883	9.794	.000	95.928

a. Dependent Variable: Return on Asset

The results obtained express statistically significant and positive association between microfinance outreach and return on asset (ROA) ($t = 9.794$, Std. Beta = .883, $R^2 = .780$, $p\text{-value} \leq 0.05$). The F-statistics of 95.928 exhibit a robust model fitting the relationship between outreach and ROA. The beta coefficient (Std. Beta = .883) signify high financial returns springing from the deployment of assets through enhanced microfinance outreach. For every 1% increase in the number of branches (outreach breadth), there is a matching 0.883% increase in return on asset.

Discussion

Microfinance outreach is rooted in the provision of tailor-made financial services to a large section of customers who were initially locked out of access to credit services by the commercial banks. The breadth of outreach is indicated by the number of active borrowers. Through descriptive results, we revealed that majority of microfinance institutions in Kenya have low levels of outreach owing to few number of branches they operate and concentrated within specific major towns. The results suggest that more than half of the microfinance institutions lack the critical mass of customers and consequently, they experience weak social performance. The low outreach level is a pointer to the intensity of competition in Kenya's financial industry where large commercial banks enjoy market dominance. While commercial banks enjoy the privilege of mobilizing funds through deposits by customers, majority of microfinance institutions are not deposit takers and only rely on credit provision to generate interest income. Therefore, commercial banks have comparative advantage over microfinance institutions due to their ability to utilize deposits for expanding outreach by opening more branches in their chosen market segments. Nonetheless, based on our descriptive evidence, microfinance institutions in Kenya appear to counter the problem of low outreach by partnering with money transfer service providers to reach out to more customers including in regions where they lack physical presence. Money transfer service providers including mobile telephone companies provide alternative efficient and convenient channel for enhancing microfinance outreach. Despite weak physical presence of microfinance institutions, the significant positive relationship between distribution capability and performance imply that majority of the microfinance institutions could be experiencing moderate to low performance. Conversely, higher branch network increases access to microfinance services by customers leading to better financial performance.

Extant literature associates outreach with financial sustainability of microfinance institutions. The findings of the current study empirically reveal the strong positive relationship between microfinance outreach and ROA. The results mean that increased number of customers served by microfinance institution leads to positive financial performance. Our findings are consistent with previous studies that have reported empirical evidence positively inking breadth of outreach with profitability measures (Abinet, 2015; Kimando, Kihoro & Njogu, 2012; Delios & Beamish, 1999). However, our findings contradict results by Ganka (2010) who established a negative association between microfinance outreach and financial performance on the basis of inefficiencies arising from increased number of branches. In addition, our findings do not agree with Kereta (2007) who established a trade-off between microfinance outreach and performance. Researchers (Hulme & Mosely, 1996; Kereta, 2007) who suggest an inverse relationship between outreach and performance of microfinance institution, maintain that outreach increases transaction costs. Hence, the high costs of transaction cuts down the profit margins realized by microfinance institutions. While it is true that outreach may contribute to increased cost of operation, this may not necessarily have negative effect on performance. As the number of customers increases, the costs are spread out leading to economies of scale.

Economies of scale create downward pressure on overall costs leading to positive financial performance. Meyer (2002) observes complimentary relationship between outreach and financial performance due to economies of scale as an immediate outcome of breadth of outreach. Furthermore, as outreach is extended more assets are acquired and deployed to generate financial returns. Therefore, we hold the view that microfinance outreach is positively related to performance. The inverse relationship argued by other scholars could be due to failure on the part of management to effectively deploy resources and manage costs. In addition, failure by the firm to match market needs could negatively affect performance of microfinance institution irrespective of its size. Our results support the view by Shahinpoor (2009) who argue that microfinance institutions serve poor people who often lack the capacity to access financial services from commercial banks. Therefore, firms targeting poor people thrive on a push business model that focuses on reaching out to customers. Outreach enables microfinance institutions to serve their clients better by building closer relations, lowering borrower screening costs and cutting down on loan default rates. Microfinance institutions with wider outreach serve their customers at convenient locations where they do not need to travel long distances to access services.

Conclusion

Outreach and financial performance are complimentary in nature in the microfinance industry. Whereas, increased outreach positively influences financial performance, microfinance institutions use financial gains to expand their outreach in the market. Therefore, outreach is both an antecedent and a consequence of financial performance. Although a microfinance institution may lack the capacity to open more branches, the availability of money transfer services provides alternative efficient and smart strategy for increasing outreach in the competitive financial industry. The strong relationship between microfinance outreach and performance connotes the important role played by marketing in financial performance outcomes. Therefore, we conclude that return on asset (ROA) is a function of the number of customers served. However, this relationship holds on condition that customers with active loan balances do not default. Further, we anticipate stronger link between outreach and financial performance where the frequency of borrowing by customers increases over time.

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