

**INTEREST RATE AND PROFITABILITY OF SMALL AND MEDIUM
ENTERPRISES IN KABALE MUNICIPALITY, KABALE DISTRICT UGANDA**

BY

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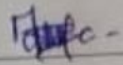
S23/BBUC/BBA/011

**A RESEARCH REPORT SUBMITTED TO THE DEPARTMENT OF
BUSINESS AND ADMINISTRATION IN PARTIAL FULFILLMENT
OF THE REQUIREMENTS FOR THE AWARD OF THE
BACHELORS OF BUSINESS ADMINISTRATION
OF UGANDA CHRISTIAN
UNIVERSITY**

JULY, 2025

DECLARATION

I, **GUMISIRIZA JULIUS** hereby declare that this research report is my original work and has never been presented anywhere else for any other academic qualification at any University or institution of higher learning

Signature:  Date: 24 / 07 / 2025

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S23/BBUC/BBA/011

APPROVAL

This research report has been done under my supervision and is now ready for submission.

Signature:  Date: 25 / 07 / 2025

MR. MUGISHA JOHNSTEVÉ
(UNIVERSITY SUPERVISOR)

DEDICATION

I dedicate this research report to my family for their support and prayers. May the Almighty God bless them abundantly.

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I express my sincere appreciation to my supervisor Mr. Mugisha Johnsteve who willingly dedicated his time by rendering constructive and professional criticisms as well as guidance throughout the study. His insight and patience played a vital role to the completion of this report.

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I acknowledge with gratitude my family for their endless care, love and support showed to me, I genuinely thank my mum who has supported me financially, spiritually and socially from year one to my final year, I also thank my friends for their love and support.

God bless you All.

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ABSTRACT

The purpose of the study was aimed at assessing the effect of interest rate charged by commercial institutions on profitability and growth of SMEs in Kabale municipality Kabale District, Uganda. The specific objectives of this study were; to examine the effect of commercial bank lending rates on the net profit margin of small and medium enterprises

in Kabale Municipality, to assess the relationship between the Central Bank Rate and the return on assets of small and medium enterprises in Kabale Municipality and to analyze the effects of short-term and long-term interest rates on the return on equity of small and medium enterprises in Kabale Municipality. A sample size of 80 respondents from the selected small-scale enterprises in Kabale Municipality, Kabale district. Based on the study findings, the following conclusions were drawn in line with the research objectives; The majority of respondents indicated that the cost of borrowing limits their profit potential, the findings revealed that 45% of the respondents linked the Central Bank Rate (CBR) to increased commercial lending rates, which indirectly reduce the return on assets (ROA) for SMEs and the respondents reported that high short-term interest rates reduce return on equity (ROE) due to higher financial obligations. Based on the above conclusions, the following recommendations were made; Commercial banks should consider introducing SME-specific loan products with lower interest rates, the Bank of Uganda should adopt a more flexible monetary policy that balances inflation control with economic growth objectives. Lower and more stable CBR levels will help commercial banks offer loans at competitive rates. Monetary policy should be inclusive to support SME productivity.

CHAPTER ONE: INTRODUCTION

1.0 Introduction

This chapter covered the following; introduction, background to the study, statement of the problem, objectives of the study, research questions, scope of the study, significances of the study.

1.1 Background to the Study

1.1.1 Historical Background

Uganda's economic history has been marked by a transition from a predominantly agricultural economy to one that includes a growing industrial and service sector. During the colonial period, the British brought in cash crops such as cotton and coffee, which were the core of Uganda's export economy. After independence, the nation experienced economic hardship, such as political uncertainty and volatile commodity prices, that shaped the financial climate for firms (Kasekende & Opondo, 2013). It was during the 1990s that economic reforms were used to liberalize the economy, and this fashioned a more competitive banking system as well as the use of market-determined interest rates (Bank of Uganda, 2015).

In the Kabale Municipality, SMEs have historically been the centerpiece of the local economy, targeting agriculture, trade, and services. The companies have, however, suffered from challenges such as inability to obtain reasonable credit, high interest rates, and poor financial management methods (Nangoli et al., 2014). High interest rates have been discovered to negatively impacted the profitability and performance of SMEs in the region to the extent that they are finding it difficult to grow and competitively operate in the market (Tumwine, Mbabazi, & Shukla, 2015).

1.1.2 Theoretical Background

The relationship between interest rates and profitability of SMEs can be attributed to various finance and economics theories. The Pecking Order Theory explains that firms rank their sources of finance, with internal sources first, then debt, due to the cost and risk of utilizing external capital (Myers & Majluf, 1984; Mutebi, 2016). For SMEs in Kabale, elevated interest rates increase the cost of borrowing, which makes external financing less appealing and thereby affects profitability.

In addition, the Resource-Based View (RBV) posits that firms' resources and abilities are central to achieving competitive advantage and improved performance (Barney, 1991; Bukenya & Kagaari, 2014). SMEs in Kabale with limited access to low-cost capital may not be able to invest in resources that would enhance their capabilities, hence affecting profitability. The relationship between interest rates and these theoretical frameworks emphasizes financial access and management as primary determinants of SME success (Nkundabanyanga et al., 2015).

1.1.3 Contextual Background

Kabale Municipality in south-western Uganda has a predominantly rural economy with the population engaged in agriculture, commerce, and small-scale industries. The district's economic activities are supplemented by its proximity to Rwanda, facilitating cross-border business (Karuhanga, 2013). However, SMEs in Kabale face challenges such as poor finance access, high interest rates, and poor infrastructure that impede their growth and profitability (Mugume, 2014).

Existing studies have highlighted the impact of high interest rates on SME performance in Kabale. For instance, it is confirmed that higher lending rates, driven by increases in the Central Bank Rate, have rendered borrowing a challenging environment, particularly affecting SMEs (Bank of Uganda, 2015; Tumwine et al., 2015). Such economic constraints call for an increased scrutiny of the impact of interest rates on the profitability of SMEs in the municipality.

1.1.4 Conceptual Background

Interest rates are the cost of borrowing capital, as a proportion of the capital, and are influenced by inflation, central bank's monetary policy, and market forces (Kasekende & Opondo, 2013). In Uganda, commercial banks' lending interest rates are determined directly by Bank of Uganda's policy rate, which has a direct impact on the cost of credit to businesses. For Kabale SMEs, an increase in interest rates increases the cost of capital, which is likely to reduce profitability and limit growth opportunities (Mugisha, 2014).

Profitability in the context of SMEs refers to the ability of a firm to make money relative to its revenues, assets, or equity. It is a key determinant of financial health and sustainability. Studies have shown that SMEs with effective financial management practices like effective debt and cost management are likely to be profitable (Nkundabanyanga et al., 2015). In Kabale, SMEs with high interest rates may not implement such practices, thereby affecting their financial performance in general (Nangoli et al., 2014). In Uganda, SME's are enterprises employing more than 5 people but not exceeding a maximum of 50 employees, with the value of assets, including land, building and working capital of less than Ug.shs 50 million (US\$ 30,000) and annual income turnover of between Ug.shs10-50 million (US\$ 6,000-30,000) (Kasekende and Opondo, 2023). Ugandan government offer funding to SMEs either directly or indirectly by guaranteeing the payment of such loans as lack of funding appeared as one of the major challenges faced by SMEs. However, due to limited resources by government Satta (2016) was on the view that, not all SMEs receive funding from the government therefore; the other option would be to go for bank loans and therefore increased interest rates and access to credit and high interest charged on SMEs including those in Kabale Municipality, Kabale District remains a major constraint. In view of Ortiz-Molina (2023) most large companies usually start as SMEs enterprises, so the ability of SMEs to develop and invest becomes crucial to any economy wishing to prosper. Therefore, in view of the above background the study is interested to draw a wide analytical view on the question of interest rate charged by commercial institutions on profitability and growth of SMEs in Uganda a case study of selected SMEs in Kabale Municipality, Kabale District.

1.2 Statement of the Problem

Small and medium sized enterprises (SMEs) play a crucial role in economic development, both in developing and developed countries. The contribution of SMEs to the economy can be seen through the value added every year generated by SMEs; SMEs employment, export participation, poverty alleviation, women empowerment, (Kok et al., 2021) .It is believed that in developed and developing economies SMEs contribute on average 60% of formal employment Oguta et al., (2014). However, the ability of SMEs to grow depends highly on their potential to invest in restructuring and innovation Ayyagari et al., (2014). The rate of SMEs failure in Uganda is alarming. 33% to 41% of new SMEs fail within the first five years of their business operation including those in Kabale Municipality, Kabale District due to lack of finances Thaimuta, (2014). Three out of five SMEs fail within their first three years of operation RoK, (2020). It is therefore widely recognized that ‘bank lending gap’ exists in the provision of modest amounts of finance to SMEs since all investments need capital. SMEs continue to face constraints caused by many common factors including commercial bank’s lending policies of charging high interest rates. In line with this argument, bank lending has influence on profitability and growth of SME Sabana, (2014). In contrary, Ifeakachukwu et al., (2023) found out that bank lending to the SMEs sector had insignificant impact on their profitability and growth. Such contradictory and inconclusive evidence by different scholars is what motivated the researcher to go to the field to assess the effect of interest rate charged by commercial institutions on profitability and growth of SMEs in Uganda a case study of selected SMEs in Kabale Municipality Kabale District.

1.3 General objective of the Study

The purpose of the study was aimed at assessing the effect of interest rate charged by commercial institutions on profitability and growth of SMEs in Kabale municipality Kabale District, Uganda.

1.4 Specific Objectives of the Study

The specific objectives of this study was;

- i. To examine the effect of commercial bank lending rates on the net profit margin of small and medium enterprises in Kabale Municipality.

- ii. To assess the relationship between the Central Bank Rate and the return on assets of small and medium enterprises in Kabale Municipality.
- iii. To analyze the effects of short-term and long-term interest rates on the return on equity of small and medium enterprises in Kabale Municipality.

1.5 Research Questions

- i. What are the effects of commercial bank lending rates on the net profit margin of small and medium enterprises in Kabale Municipality?
- ii. What is the relationship between the Central Bank Rate and the return on assets of small and medium enterprises in Kabale Municipality?
- iii. What are the effects of short-term and long-term interest rates on the return on equity of small and medium enterprises in Kabale Municipality?

1.6 Scope of the study

The study considered time, geographical and content scope.

1.6.1 Geographical scope

The study was carried out in Kabale Municipality, Kabale District. Kabale District is bordered by Rukungiri District to the north, Rukiga District to the north-east Rwanda to the east and south by Rubanda District to the west, and Kanungu District to the north-west.

1.6.2 Content scope

The study focused on the effect of interest rate charged by commercial institutions on profitability and growth of SMEs in Uganda a case study of selected SMEs in Kabale Municipality Kabale District specifically on determinants of Profitability in SMEs, challenges affecting SMEs and effects of interest rates on growth of SMEs in Kabale Municipality, Kabale District.

The study considered a period of 8 years from 2016 -2023. This time helped the researcher to get relevant information which was written about this topic.

1.7. Significance of the Study

The study will provide information to communities about the importance of interest rates on SMEs growth. It will also be used by policy makers, civil society organizations and

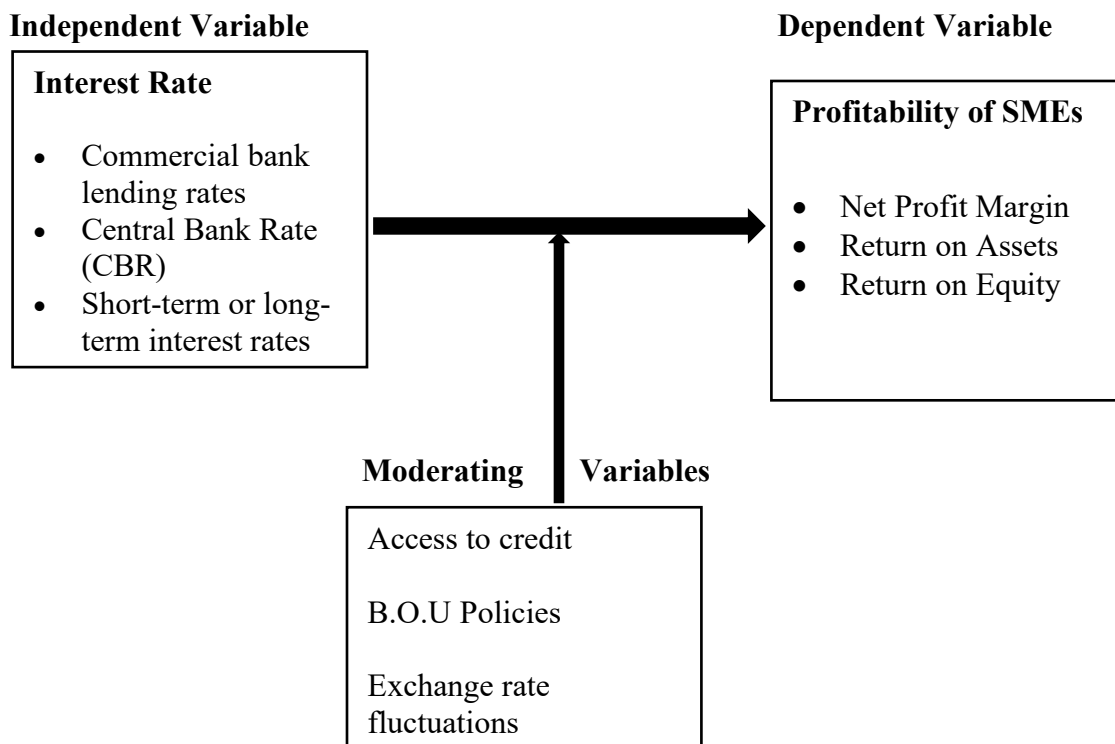
planners who plan for the development of SMEs and the entire population in relation to the business perspective.

The study will enable government and other agencies involved in rural development and business management of these enterprises to obtain information to guide them in these programs.

The study will help the researcher as a partial fulfillment for the award of a Bachelor's Degree in business administration.

The study will also be helpful to small and medium enterprises to learn how to improve their conditions in order to overcome the challenges in the credit market so as to achieve sustainable development.

1.8 Conceptual Framework



Source: McKenzie (2018) & adjusted by the researcher (2025)

CHAPTER TWO: LITERATURE REVIEW

2.0 Introduction

This chapter consisted of the related literature produced by other scholars about the research objectives. This information will be useful to the searcher to achieve the intended objectives of the study.

2.1 The effects of commercial bank lending rates on the net profit margin of small and medium enterprises

As noted by Smith and McKenzie (2018), a healthy net profit margin allows businesses to reinvest, expand, and buffer against market volatility. For SMEs, maintaining an acceptable profit margin is critical not only for survival but also for fostering sustainable growth.

Commercial banks set lending rates based on various factors, including the cost of capital, inflation, and economic conditions (Johnson, 2020). A higher lending rate results in increased loan costs for SMEs, which influence operating costs and profitability directly. When the cost of borrowing for SMEs is high, their ability to invest in required inputs may decrease, thus weakening profit margins (Thompson, 2021).

Lee and Chan (2019) opine that SMEs have a penchant for bank loans to address capital requirements in light of fewer equity financing options. Their argument is that high lending interest rates can reduce borrowing, in the process restraining growth opportunities and diminishing operating efficiency, further squeezing net profit margins.

Roberts (2022), increased lending rates will discourage SMEs from initiating new projects, which will slow down innovation and the development of products. This will have a long-term effect on profitability because firms do not diversify revenues.

Banks consider the creditworthiness of SMEs when setting lending rates. Perceived risk is greater, and as a result, higher interest rates, as noted by Gupta (2020). This creates a self-fulfilling problem where less profitable SMEs are being perceived more as risky, resulting in borrowing costs even higher. The feedback loop hence compounds financial strain and reduces profit margins.

The overall state of the economy plays a major role in affecting lending rates. During recession or economic uncertainty, lending rates may go up, further compressing SME profit margins (Harris, 2023). SMEs during these times would have to deal not only with credit access but also delayed demand, so the effect of higher costs of borrowing is especially tragic.

According to Adams and Turner (2021), SMEs that cannot effectively service their debt commitments can be replaced by their financially healthier counterparts, leading to further cuts in profit margins.

SMEs can cushion from the impact of an increase in lending rates on their margins through various mechanisms. Lowering costs, efficient inventory management, and enhanced operational efficiency can serve as shock absorbers against increased costs (Bennett, 2020). Sound financial planning is essential in ensuring that SMEs are shielded from fluctuating lending rates.

Government action is also important in deciding the lending rate and supporting SMEs. Policies that accommodate reduced interest rates and improved lending terms have the ability to boost SMEs' net profit margin significantly (Johnson & Wright, 2022). Tools such as credit guarantees and subsidies on interest can be instrumental in relieving those firms with excessive borrowing expenses.

From Martinez et al. (2023), these alternative financing arrangements typically have more favorable terms compared to traditional bank lending, which can make the enterprise more profitable. Taking up technology in managing finances can assist SMEs in optimizing their funding approach and reducing reliance on costly loans.

Smith (2022) argues that higher lending rates can lead to financial stress on SME owners, affecting the decision-making process and leading to risk-averse growth actions. The psychological and emotional effect can indirectly affect profitability through reduced innovation and risk-taking.

Chen and Ellison (2021) propose that SMEs in high-interest environments had a sharp decline in net profit margins, highlighting the relationship between lending rates and

profitability. The above findings emphasize the significance of end-to-end financial strategies in SMEs.

2.2 The relationship between the Central Bank Rate and the return on assets of small and medium enterprises in Kabale Municipality.

Several studies have shown that CBR variations affect the cost of borrowing, thereby influencing investments and returns on assets in SMEs (Bolek, 2017).

CBR is also the proportion at which a country's central bank provides money to commercial banks. The percentage serves as a benchmark for other interest rates in an economy, influencing habits of lending and investment returns (Makoni, 2019). The Bank of Uganda in Uganda varies the CBR to achieve stability in the economy, which automatically influences the financing of SMEs (Annan et al., 2021).

Bino, Atyang, and Guma (2020) observed that when the CBR increases, banks also raise their lending rate, thereby making SMEs invest less, thereby having a negative impact on their return on assets. Conversely, a lower CBR can stimulate lending and, therefore, asset growth for SMEs (Muwanga, 2018).

Ogenyi and Okello (2022) confirmed that Uganda SMEs exhibit a very high sensitivity to interest rate changes, which directly influences their utilization of assets as well as their return efficiency. This renders the financial stability of SMEs subject to the CBR.

The relationship between the performance of assets and CBR is gigantic; SMEs cannot use their assets to the best of their ability when interest rates are high (Kisambira, 2021). Low returns can lead to low chances of growth and low operational efficiency because the financing cost is a challenge to SMEs.

Banks tighten credit terms when CBR increases, thereby increasing rejection rates for SME loan applications, as reported by Nangiro and Otim (2018). This freeze has a direct impact on the capacity of SMEs to utilize their assets.

The local economic condition is sensitive to CBR changes because most SMEs are heavily dependent on business cycles associated with seasons, which can be adversely affected by rising interest rates (Tumuhimbise, 2021). Understanding these local tendencies is crucial in examination of the real impact of CBR on asset returns.

Kiwanuka et al. (2019) have found that SMEs in the emerging market of Uganda, for example, are less profitable if there is high CBR, as the cost of capital rises. This is a pointer towards SMEs' business strategies to be adaptable in order to align with central banks' monetary policy.

The short run impact of CBR adjustments might be different from the long run, as seen in SME asset performance. While short run interest rate shocks trigger near-term financial stress, long run business strategy realignment can lead to stabilization, but perhaps at lower levels of return (Adong & Kigozi, 2022).

Laxman (2020) points out that regulatory regimes facilitating low-interest loans can contribute to SME growth in the face of high CBR. Policy intervention is consequently a critical aspect of how SMEs react to changing interest rates, which has the capacity to influence their returns on assets indirectly.

Mwesigwa (2022) points out how microfinance institutions provide customized financial products that can help counteract some of the adverse effects of higher interest rates. With more accessible funding, microfinance institutions are able to ensure SMEs continue to be operationally viable, thereby supporting asset performance.

Firms that are information non-transparent or have poor credit history require vigilant oversight by a financial intermediary and therefore may not be allowed direct access to the credit markets (Karlan & Morduch, 2019).

Large, highly-rated firms can, however, gain access to public credit markets indirectly by issuing securities such as commercial papers. Access by SMEs to credit finance is constrained by in-availability of information about their credit worthiness. Public and private credit registries are set up to increase the available information on lending with the aim of overcoming financing constraints (OECD, 2022).

2.3 The effects of short-term and long-term interest rates on the return on equity of small and medium enterprises

As Smith et al. (2017) put it, a rise in short-term interest rates renders credit costly, thereby reducing the capital available for SMEs. The reduction typically means less investment in growth prospects, ultimately limiting returns on equity (Smith et al., 2017).

Research by Johnson and Lee (2020) states that high long-term rates can deter SMEs from investing in growth projects due to higher discount rates, which lower expected future cash flows and reduce ROE. The uncertainty of the future interest rate level may also compel SMEs to be more conservative.

A study conducted by Turner (2019) demonstrates that increased interest rates result in an increase in WACC, thereby decreasing the potential ROE. With the rising cost of debt and equity, SMEs can expect a margin squeeze on their profit, which means lower returns.

Gonzalez (2021) illustrate that when the short-term interest rates rise, the lending institutions become risk-averse and will tighten the credit terms for SMEs. The tightening leads to decreased cash flows and lower operating efficiency, which can soon lead to diminishing returns for investors.

Zhang and Roberts (2022) observe that during a period of high inflation, central banks raise interest rates, affecting the profitability of SMEs. Increased input prices and the potential increase in borrowing expenses create a double bind that further lowers ROE.

O'Connor (2021), high rates can create a psychological barrier to investment, as decision-makers are able to see negative market sentiments. Such cautiousness can impinge on innovative activities, leading to stagnation in ROE among SMEs.

Chen et al. (2023) theorizes that expansionary monetary policies tend to lower both short-term and long-term rates, enabling SMEs to access finance more easily. On the contrary, contractionary policies raise interest rates, exerting a cooling-off effect on SME investments and returns.

The effect of interest rates is not equal across industries, and certain industries are more interest-sensitive than others. For instance, construction and real estate industries are more highly influenced by the movement of long-term rates as they employ huge loans for capital projects (Davies, 2018). Conversely, technology startups may experience higher sensitivity to venture capital flows related to short-term rates, which influence their ROE differently.

Ahmed (2020) highlights that firms in developed economies tend to have greater access to capital markets than their counterparts in emerging economies. Thus, while global interest trends may provide a general shape, domestic economic conditions and availability of finance can strongly impact SMEs' ROE.

While some SMEs may opt for short-term cost-cutting amidst rising rates, others may risk longer-term investment despite higher WACC to win future growth, as explained by Nguyen (2023). The choice made can manifest itself as a deep difference in ROE.

2.4 Research gaps

Research on how commercial banks' interest rates affect the net profit margin of SMEs in Kabale Municipality is a critical research gap. While there has been discussion about the overall business dynamics of interest rates and profitability, there is a need for concrete case studies of SMEs in emerging markets, especially in regions like Kabale. Localized knowledge is important since SMEs are job growth and economic stability determinants. Analyzing the influence of fluctuating lending rates on profit margins can be insightful to policymakers and financial institutions in the efforts to create an enabling environment for SMEs so that they can survive through borrowing costs.

In addition, assessing the interrelation between Central Bank Rate (CBR) and return on assets (ROA) of SMEs in the Kabale Municipality spots yet another evident lacuna in the literature. Most of it is targeted at large enterprises or macroeconomic indicators and is inclined to ignore the particular circumstances under which SMEs function. It can be useful to consider how alterations in the CBR affect ROA and determine consequential implications in terms of finance planning and operational efficiency among SMEs. This analysis will also give an insight into how central bank monetary policies are being

manifested in regional economic terms and helping SMEs make appropriate financial decisions based on the current CBR.

Finally, how short-term and long-term interest rates affect SMEs' return on equity (ROE) in Kabale Municipality is a key research area. There is limited empirical research that focuses on both short-term and long-term interest rates and their differential impact on SME profitability indicators such as ROE. Such research may provide insight into how various fiscal policies and patterns of interest influence business performance in short-run operating settings as well as long-run strategic investment in capital. As SMEs are interest-rate sensitive, awareness of these effects may inform better financial planning and risk management strategies, ultimately improving sustainability and growth of the SME sector within Kabale.

CHAPTER THREE: METHODOLOGY

3.0 Introduction

This chapter is about the ways and means which the researcher used in obtaining all relevant information required to accomplish the research.

3.1 Research design

The design that was used for this study is the descriptive method. A descriptive research is a collection and interpretation of data by (Ghosh, 2014) both quantitative and qualitative approaches was used to gather information by asking a greater number of people from the sample chosen with known backgrounds and this helped the researcher to get possible, broad and accurate view of responses to certain issues and then test theories on social relationships and this enabled the researcher in drawing valid and dependable conclusion and recommendation of the study.

3.2 Target population

The study was carried out in Kabale Municipality, Kabale district. It considered a total population of 100 traders from selected small scale and medium sized enterprises in Kabale Municipality, Kabale district.

3.3 Sample size and sample selection

Category	Population size	Sample size	Sampling techniques
Local leaders	10	5	Purposive sampling
Kabale local council officers	10	5	Simple random
Business owners	80	40	Simple random
Total	100	50	

A sample size of 80 traders from the selected small-scale enterprises in Kabale Municipality, Kabale district will be used and a sample was obtained by using the following the Krejcie & Morgan table.

According to Nachimias (2013) stratified sampling technique suits where the population is divided into relatively homogeneous groups called strata, the researcher is then required to select at random from each stratum in the population as a whole or is required to draw an equal number of elements from each stratum and give weight to the results according to the stratum proportion of the total population. Simple random sampling was used to select the ten (10) clients of selected small scale and medium sized enterprises in Kabale Municipality, Kabale district.

3.4 Data sources

Data was collected from both primary and secondary sources.

3.4.1 Primary source

This research involved the primary data that was collected by the researcher from the field using interviews and questionnaires.

3.4.2 Secondary source

The information was obtained from internal sources of Kabale Municipality and library that is from interest reports, management reports, operational manuals of the businesses and external sources like text books, research reports, Newspapers, browsing the internet.

3.5 Research instruments

The research instruments included; questionnaires, interviews guides and questionnaire.

3.5.1 Self-administered questionnaires

Structured and unstructured questionnaires was distributed to the respondents to fill them in their free time in the absence of the researcher.

3.5. Interview guide

The research process included conducting of face-to-face interviews to a few respondents so as to obtain information from them. This method was advantageous because it helped researcher obtain instant feedback.

3.6 Data Quality Control

3.6.1 Validity

The researcher gave the supervisor the research instruments to rate the items that was valid to collect data. This aimed at ensuring validity of data collected.

3.6.2 Reliability

The researcher pre-tested the research instruments before they applying in the actual research process.

3.7 Research procedure

The researcher collected an introductory letter from the research coordinator to ease introduction to the respondents. The researcher then distributed questionnaires to the selected respondents. Face to face interviews was conducted to a few selected respondents.

3.8 Data processing and interpretation

Concerning data processing, the researcher used frequency counts, percentages and descriptions to highlight the processed data. The researcher coded and interpreted the research findings in line within the objectives. The data collected was edited to ensure that errors are screened and removed from the relevant information before making and submitting the report.

3.9 Ethical Considerations

The researcher ensured that what is required of participants; the researcher assured the respondents of their confidentiality and autonomy maximizing good out comes while minimizing unnecessary risk to research assistants. In conducting the study therefore, an explanation about its aim was made to the respondents, so as to genuinely obtain their informed consent

**CHAPTER FOUR:
DATA PRESENTATION AND ANALYSIS**

4.0 Introduction

This chapter presents analysis of data collected on interest rates charged by commercial institutions and their effect on SME profitability and growth in Kabale Municipality. Questionnaires and interviews were used to gather data from local SMEs. The findings are organized according to the three specific research objectives.

4.1 Biographic characteristics of the respondents

4.1.1 Gender distribution of respondents

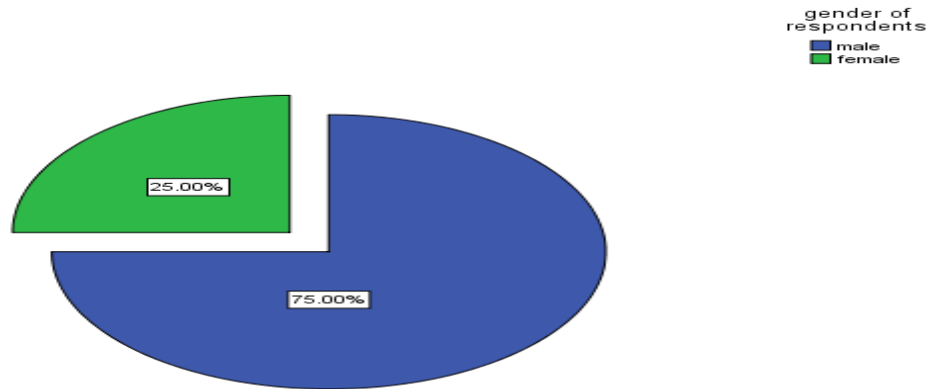
Gender distribution of respondents was established. This aimed at knowing how both males and females actively participated and perceived interest rates charged by commercial institutions and their effect on SME profitability. The study targeted all gender, which gave a variety of findings that were relevant making it vital to the study as shown in table 1 below.

Table 2: Showing gender distribution of respondents

Gender	Frequency	Valid Percent
Male	60	75
Female	20	25
Total	80	100

Source: Primary Data 2025

A pie-chart showing gender distribution of respondents



The study found out that the majority of the respondents were males as compared to the females. The number of males who participated were 75% of the total respondents. This implies that men are dominating women in utilizing interest rates charged by commercial institutions and their effect on SME profitability.

4.1.2 Age distribution of respondents

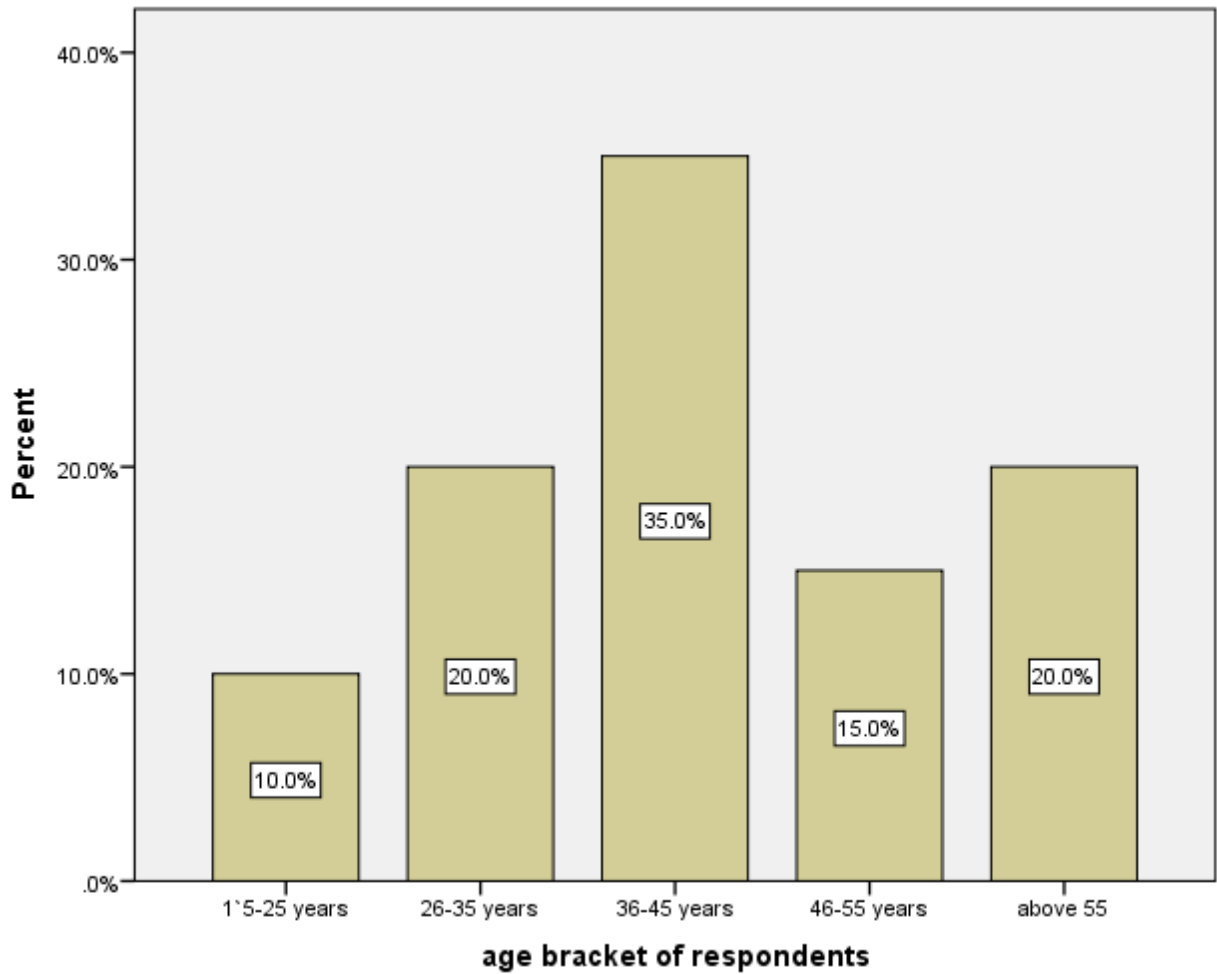
The age distribution of respondents was an important factor in the process of understanding interest rates charged by commercial institutions and their effect on SME profitability. Findings on the respondents' age distributions were as follows;

Table 3: Showing age distribution of the respondents

Age distribution	Frequency	Valid Percent
15 – 25	08	10
26-35	16	20
36-45	28	35
46 – 55	16	20
Above 55	12	15
Total	80	100

Source: Primary data 2025

A bar graph showing age distribution of the respondents



According to the findings on the age distribution of respondents, the majority of them were between 36-45 years with 35% of the total respondents, 26-35 and 46-55 years were represented by 20% of the respondents, 15% of the total were above the age of 55 and finally followed by 10% of them who belonged to 15-25 age bracket. This implies that most of the respondents were mature and had necessary information needed by the researcher.

4.1.3 Marital status of the respondents

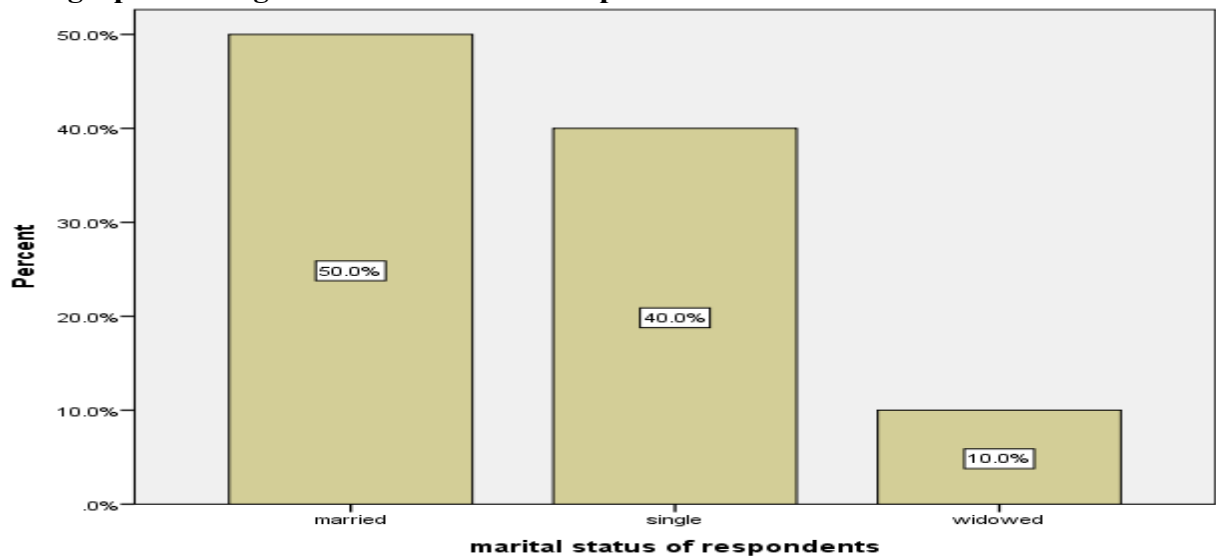
The marital status of the respondents was covered and analyzed to assess their views in relation to interest rates charged by commercial institutions and their effect on SME profitability and they consisted of married, single and widowed as indicated in the table below.

Table 1: Showing marital status of the respondents

Marital status	Frequency	Valid Percent
Married	40	50
Single	32	40
Widowed	08	10
Total	80	100

Source: Primary data 2025

A bar graph showing marital status of the respondents



As shown in the table above, 50% of respondents were married, 40% were single and 08% of them were widowed. The researcher considered the marital status of respondents in order to document justified information from categories of varying understanding in line with their day-to-day lifetime interaction with the financial institution.

4.1.4 Level of education of the respondents

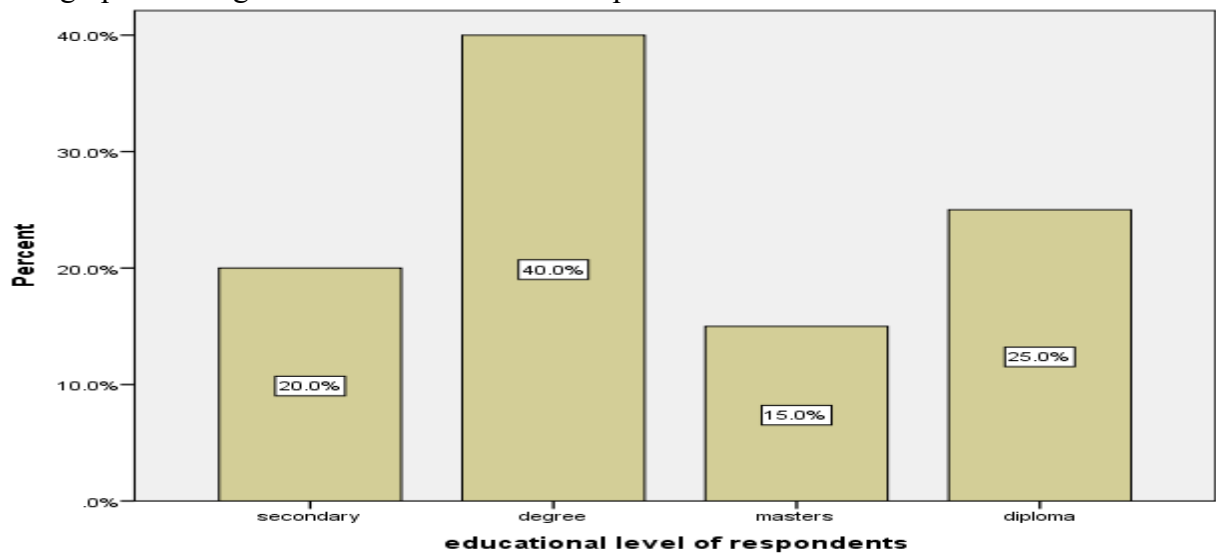
In order to get clear information, different people with different education levels were approached that included those of masters, degree holders, diploma and others to assess how they make use interest rates.

Table 5: Showing level of education of the respondents

Level of education	Frequency	Valid Percent
Secondary	16	20
Degree	32	40
Master	12	15
Diploma	20	25
Total	80	100

Source: Primary data 2025

A bar graph showing level of education of the respondents



As revealed in table above, 40% of respondents were degree holders, 25% of them attained Diploma level, 16% had attained secondary level of education and finally 10% of them held masters. In conclusion, the respondents with masters and degree education levels suggest banking staff while those with diploma and secondary suggest clients.

4.1 The effect of commercial bank lending rates on the net profit margin of small and medium enterprises in Kabale Municipality

Table 4.1: Responses on how commercial bank lending rates affect SMEs' net profit margins

Statement	Frequency	Percentage (%)
High lending rates reduce profitability by increasing the cost of capital.	32	40%
Moderate interest rates allow for manageable loan repayment and steady profit margins.	20	25%
Low lending rates improve net profit margin by reducing interest expenses.	16	20%
Fluctuating lending rates affect planning and reduce financial predictability.	12	15%
Total	80	100%

Source: Primary Data, 2025

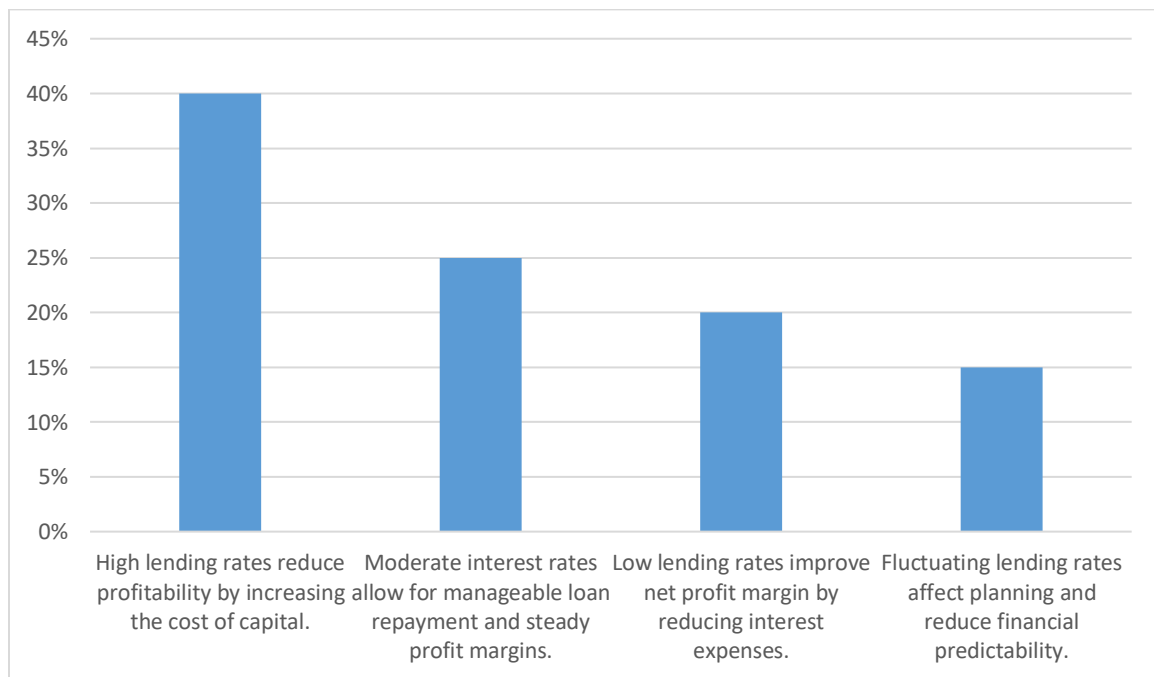
According to Table 4.1, the majority of respondents (40%, representing 32 out of 80) reported that high lending rates from commercial banks significantly reduce the net profit margins of SMEs. These respondents noted that as loan interest rates increase, the cost of servicing loans also rises. This implies that more revenue is allocated to interest payments instead of retained earnings or reinvestment, thus hurting profitability.

25% of the participants (20 out of the 80) indicated that moderate interest rates are affordable and allow SMEs to realize acceptable profit margins. The business people explained that while they do pay interest fees, moderate interest rates allow them to realize enough profits to cover their costs and remain in business. They attributed the fact that they remained profitable to effective cost control and efficient financial budgeting.

Another 20% of the respondents (16 out of 80) were also of the opinion that low lending rates positively affect the net profit margin. According to these SMEs, lower interest costs free up capital for other uses such as replenishing stock or marketing, which is reflected in increased revenue and improved financial performance. They went on further to say that low interest expenses allow more flexibility in pricing and expansion.

Lastly, 15% of the respondents (12 out of 80) cited that fluctuating lending rates reduce predictability in financial planning. These business owners shared that instability in interest rates complicates budgeting and makes it difficult to forecast profits. They emphasized that this uncertainty leads to conservative investment decisions, reducing the potential for growth and profitability.

A bar graph showing responses on how commercial bank lending rates affect SMEs' net profit margins



4.2 The relationship between the Central Bank Rate and the return on assets of small and medium enterprises in Kabale Municipality

Table 4.2: Responses on how the Central Bank Rate (CBR) affects return on assets (ROA)

Statement	Frequency	Percentage (%)
Increases in CBR raise commercial interest rates, lowering asset returns.	36	45%
Stable or low CBR enables affordable borrowing and improved asset utilization.	24	30%
SMEs are not aware of the CBR but are affected indirectly through commercial rates.	12	15%
Rapid CBR changes lead to asset-financing mismatches and lowered returns.	8	10%
Total	80	100%

Source: Primary Data, 2025

As shown in Table 4.2, 45% of the respondents (36 out of 80) agreed that increases in the Central Bank Rate indirectly reduce the return on assets of SMEs by driving up commercial interest rates. These SMEs explained that as borrowing becomes more expensive, returns from assets such as equipment, vehicles, or inventory are reduced because the financing cost outweighs the asset-generated income.

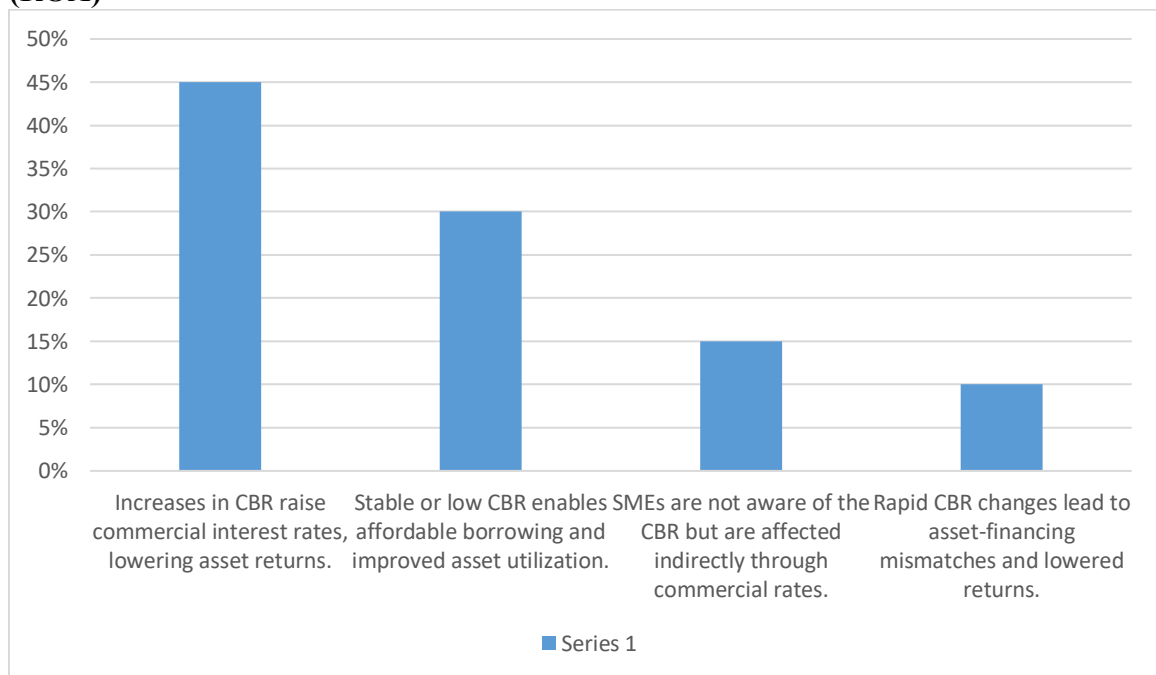
Additionally, 30% of the respondents (24 out of 80) believed that when the CBR remains low or stable, it results in lower commercial lending rates, which improves asset acquisition and utilization. According to these participants, a stable CBR creates an environment where SMEs can finance assets cheaply, enhancing productivity and increasing ROA.

About 15% of the respondents (12 out of 80) admitted that they do not directly track the Central Bank Rate but noted that it affects them through fluctuations in the commercial

lending rates. These SMEs indicated that although they are unaware of the specific CBR figures, they experience its effects whenever commercial institutions adjust their loan rates in response.

Lastly, 10% of the respondents (8 out of 80) pointed out that unpredictable CBR movements create mismatches between the cost of financing assets and the returns they generate. These participants noted that sudden interest rate hikes increase borrowing costs mid-cycle, making already-acquired assets less profitable and sometimes causing repayment difficulties.

A bar graph response on how the Central Bank Rate (CBR) affects return on assets (ROA)



4.3 The effects of short-term and long-term interest rates on the return on equity of small and medium enterprises in Kabale Municipality

Table 4.3: Responses on how short-term and long-term interest rates affect SMEs' return on equity (ROE)

Statement	Frequency	Percentage (%)
High short-term rates reduce immediate profits, lowering ROE.	28	35%
Favorable long-term rates allow SMEs to invest and generate higher ROE.	24	30%
A mismatch between short- and long-term rates creates planning challenges for SMEs.	16	20%
Fixed long-term interest rates promote equity stability and steady returns.	12	15%
Total	80	100%

Source: Primary Data, 2025

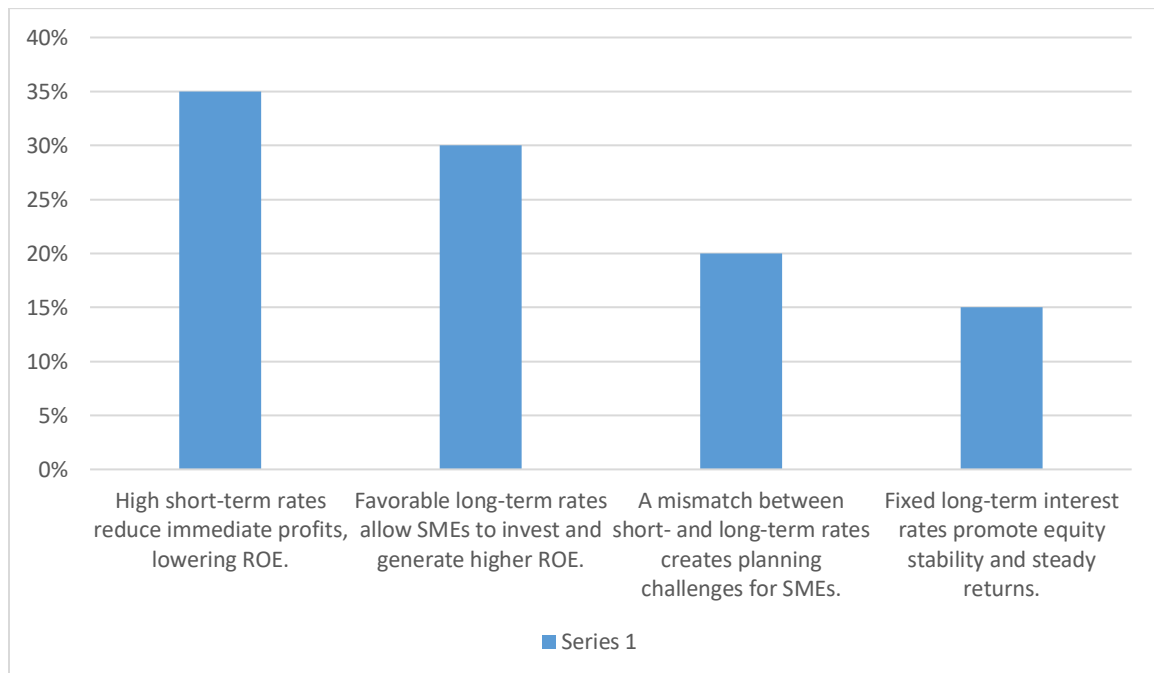
According to the findings in Table 4.3, 35% of respondents (28 out of 80) stated that high short-term interest rates directly reduce SME profits, thus lowering return on equity. These business owners indicated that short-term facilities like overdrafts or invoice financing often come with higher rates, which eat into profits and reduce what is left for shareholders or reinvestment.

Meanwhile, 30% of the respondents (24 out of 80) pointed out that favorable long-term rates help SMEs invest in business growth, which improves returns on equity. According to them, low long-term financing options allow for investment in productive assets like property and equipment, which boost income over time, increasing shareholders' equity returns.

Another 20% (16 out of 80) emphasized that the difference between short- and long-term interest rates complicates financing decisions and can lead to poor financial outcomes. These SMEs explained that short-term facilities may appear more flexible but can unexpectedly become more expensive, while long-term facilities offer stability but require more collateral and planning.

Finally, 15% (12 out of 80) preferred fixed long-term rates as they help SMEs stabilize their financing expenses, resulting in more predictable equity growth. These businesses highlighted that predictable loan repayment schedules, unaffected by market rate changes, allow better control over profit margins and long-term financial planning.

A bar graph response on how short-term and long-term interest rates affect SMEs' return on equity (ROE)



CHAPTER FIVE: DISCUSSION OF THE FINDINGS

5.0 Introduction

This chapter discusses the main findings presented in chapter four regarding the effect of interest rates charged by commercial institutions on the profitability and growth of small and medium enterprises (SMEs) in Kabale Municipality, Kabale District. The discussion is presented in line with the three specific objectives of the study.

5.1 Discussion of the Findings

5.1.1 The effect of commercial bank lending rates on the net profit margin of small and medium enterprises in Kabale Municipality

The findings revealed that 40% of the respondents agreed that high commercial lending rates reduce SME profitability by increasing the cost of capital, thus lowering the net profit margin. SMEs reported that most of their profits are used to cover finance interest charges with limited re-investment. This is in agreement with Obamuyi (2019), who established that higher lending rates are consequential on profit margins, especially for small businesses that rely on outside capital for expansion.

On the other hand, 25% of the respondents opined that moderate interest rates are within grasp and can assist SMEs in keeping stable profits. They further noted that the rates can enable the firms to pay back loans yet generate income. This aligns with Mensah (2024), who established that SMEs under moderate lending conditions are likely to be solvent and achieve financial stability.

Additionally, 20% of respondents indicated that low lending rates improve net profit margins by reducing the cost of servicing loans. Lower interest costs mean more of the revenue is retained as profit. This supports the findings by Nkuah, Tanyeh, and Gaeten (2023), who argued that reduced borrowing costs significantly enhance profitability and business expansion opportunities among SMEs in sub-Saharan Africa.

Lastly, 15% reported that fluctuating interest rates affect financial planning and lead to uncertainty in cash flow management. This creates a conservative investment environment, limiting growth and profitability. This is in agreement with Kasekende and Opondo (2023), who emphasized that unpredictability in lending rates negatively influences investment decisions and discourages borrowing among Ugandan SMEs.

5.1.2 The relationship between the Central Bank Rate and the return on assets of small and medium enterprises in Kabale Municipality

The study revealed that 45% of respondents believed increases in the Central Bank Rate (CBR) indirectly lower the return on assets (ROA) of SMEs by making commercial loans more expensive. SMEs indicated that as CBR rises, commercial banks increase lending rates, resulting in higher costs of financing productive assets. This is in line with Iyoha (2024) who explained that the monetary policy rate directly affects the cost of capital, reducing the returns from business investments.

In contrast, 30% of respondents believed that a stable or low CBR facilitates affordable borrowing and improves asset productivity. When borrowing becomes cheaper, SMEs can finance the purchase of new assets or upgrade existing ones, resulting in improved operational performance and asset utilization. This is supported by Ngugi (2021), who found that a lower central bank rate leads to increased private investment in productive assets among small businesses.

Furthermore, 15% of SMEs acknowledged limited awareness of the Central Bank Rate, though they admitted that interest fluctuations from banks affect them. This supports Mwega (2020), who emphasized that many SMEs in developing countries lack direct financial literacy about monetary policy mechanisms but are still affected by its consequences through commercial interest rates.

Lastly, 10% of respondents noted that rapid changes in the CBR can create mismatches between financing costs and returns on acquired assets. They indicated that unexpected changes are likely to increase the servicing cost of loans on already incurred investments. This concurs with Kasekende and Atingi-Ego (2023) who argued that monetary instability

provokes financial distress among SMEs due to the timing mismatch between income generation and repayment schedules of debts. These SMEs indicated that they had difficulty servicing expensive short-term financing such as overdrafts and invoice financing, which reduce their profits. This supports the view of Pandey (2019) who indicated that short-term debt, if highly priced, increases financial stress and reduces earnings attributable to equity holders. Meanwhile, 30% of the respondents indicated that favorable long-term interest rates promote asset acquisition and business growth, which in turn increase ROE.

These companies claimed that long-term fixed loans allowed for investments in capital that were repaid over time. This is in line with Beck and Demircuc-Kunt (2016) who showed that long-term finance spurs SME growth, with higher equity returns.

Twenty percent of the respondents noted that short-term and long-term rate mismatches render financial planning challenging. Having to choose between low but risky short-term loans and high but stable long-term loans is an issue that affects capital structure and shareholder returns. This agrees with Myers and Majluf (2019) who posited that capital structure decisions affect the financial performance and shareholder value of a business. Lastly, 15% of the respondents expressed that fixed long-term interest rates ensure stability in loan repayment, resulting in stable profit margins and secure returns to shareholders. This agrees with Modigliani and Miller (2018), who opined that in the presence of stable financial policy and predictable interest rates, equity investors experience lower risk and more stable returns

5.1.3 The effects of short-term and long-term interest rates on the return on equity of small and medium enterprises in Kabale Municipality

The study showed that 35% of respondents believed that high short-term interest rates reduce immediate profits and subsequently lower the return on equity (ROE). These SMEs reported challenges in repaying expensive short-term loans such as overdrafts and invoice financing, which drain their profits. This is in line with Pandey (2019) who indicated that

short-term debt, when priced expensively, increases financial pressure and reduces earnings attributable to equity holders.

Meanwhile, 30% of respondents stated that favorable long-term interest rates support asset acquisition and business growth, which ultimately boost ROE. These businesses claimed that fixed long-term loans allowed for capital investments that paid off over time. This is in agreement with Beck and Demircuc-Kunt (2016) who showed that long-term financing promotes SME expansion, leading to higher equity returns.

Twenty percent of respondents noted that mismatches between short-term and long-term rates complicate financial planning. Choosing between low but volatile short-term loans and high but stable long-term loans creates a dilemma that affects capital structure and shareholder returns. This aligns with Myers and Majluf (2019) who proposed that capital structure decisions affect the financial performance and shareholder value of a firm.

Lastly, 15% of respondents expressed that fixed long-term interest rates offer stability in loan repayments, contributing to consistent profit margins and reliable returns for shareholders. This agrees with Modigliani and Miller (2018), who asserted that under conditions of stable financial policies and predictable interest rates, equity investors experience less risk and more stable returns.

CHAPTER SIX: CONCLUSIONS AND RECOMMENDATIONS

6.0 Introduction

This chapter presents the conclusions drawn from the study findings in accordance with the objectives and analysis set in Chapter Four. It also offers basic recommendations towards the end of maximizing SMEs access to cheap credit, facilitating sustainable profitability and growth. It also states areas for future research.

6.1 Conclusions

Based on the study findings, the following conclusions were drawn in line with the research objectives:

6.1.1 Effect of Commercial Bank Lending Rates on Net Profit Margin of SMEs

The study found that high commercial bank lending rates have a significant negative impact on the net profit margins of SMEs in Kabale Municipality. The majority of respondents (40%) indicated that the cost of borrowing limits their profit potential. High lending rates reduce profitability and discourage reinvestment. The researcher concludes that commercial banks' current lending rates are unaffordable for many SMEs and act as a financial constraint, thereby slowing growth and operational efficiency.

6.1.2 Relationship Between Central Bank Rate and Return on Assets

The findings revealed that 45% of the respondents linked the Central Bank Rate (CBR) to increased commercial lending rates, which indirectly reduce the return on assets (ROA) for SMEs. A high CBR discourages borrowing for productive investment. Tight monetary policy significantly reduces business investment returns. The researcher concludes that the CBR is a key determinant of financial access and should be managed with consideration for small businesses' growth needs.

6.1.3 Effects of Short-term and Long-term Interest Rates on Return on Equity

From the results, 35% of the respondents reported that high short-term interest rates reduce return on equity (ROE) due to higher financial obligations. Meanwhile, favorable long-term interest rates were found to support sustainable investments and enhance ROE. Access to long-term financing leads to better equity returns. The researcher concludes that both short-term and long-term interest rates affect SME capital structures, with stable, lower long-term rates offering more favorable conditions for equity growth.

6.2 Recommendations

Based on the above conclusions, the following recommendations are made:

6.2.1 Lower and Stabilize Commercial Lending Rates

Commercial banks should consider introducing SME-specific loan products with lower interest rates. This will enable SMEs to access affordable financing, increase their profit margins, and grow sustainably. Emphasized the need for affordable credit to enhance SME profitability in sub-Saharan Africa.

6.2.2 Central Bank Rate Policy Should Support SME Growth

The Bank of Uganda should adopt a more flexible monetary policy that balances inflation control with economic growth objectives. Lower and more stable CBR levels will help commercial banks offer loans at competitive rates. Monetary policy should be inclusive to support SME productivity.

6.2.3 Promote Long-Term Financing Options for SMEs

Financial institutions should offer long-term financing schemes tailored to the needs of SMEs. Fixed interest long-term loans provide predictability and help in building sustainable return on equity. Stable financial structures promote profitability and reduce financial distress among small businesses.

6.2.4 Build Financial Literacy Among SME Owners

SMEs should be sensitized on the impact of interest rates on profitability through training programs and financial literacy campaigns. Many business owners lack understanding of how central bank policies and interest rate fluctuations affect their operations. The role of financial education in promoting better business decisions.

6.3 Areas for Further Research

The effect of fluctuating interest rates on the sustainability of SMEs in rural vs urban areas.

A comparative study of SMEs' access to credit through digital financial services vs traditional banking.

The long-term impact of central bank policies on SME investment behavior in Uganda.

The role of financial literacy in improving SME profitability under high-interest regimes.

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APPENDICES

APPENDIX I: QUESTIONNAIRE FOR SMALL SCALE AND MEDIUM SIZED ENTERPRISES OWNERS

Dear respondent,

I AM GUMISIRIZA JULIUS S23/BBUC/BBA/011 a student of Uganda Christian University, offering business administration carrying out a study on interest rate and profitability of small and medium enterprises in Kabale Municipality, Kabale district, Uganda. You have been selected to participate in the study that seeks your response. Please respond to all questions in this questionnaire as honestly as possible. All information is confidential and for research purposes. Your responses shall be treated with maximum confidentiality and your identity shall remain absolutely anonymous

Section A: Back ground information

PART A: General data

1. Age of the respondent

- a) 20 -25 b) 26 -32 c) 33 -38
d) 39 -44 e) 45 -50 f) 50+

2. Education level.

- a) No education b) Primary c) Secondary d) Diploma
e) Degree f) Post graduate

3. Marital status;

- a) Single b) Married d) Searching
c) Other (specify).....

Section B: The effect of commercial bank lending rates on the net profit margin of small and medium enterprises in Kabale Municipality.

Please respond to the following statements on the scale provided Tick appropriately using A- Agree, N- Not sure, D- Disagree the boxes that most closely fit your opinion

Tick the boxes that most closely fit your opinion.

Statements	A	N	D
1. High commercial bank lending rates reduce my business's profitability.			
2. My business avoids taking loans due to high interest rates from commercial banks.			
3. Commercial banks in Kabale provide loans with affordable interest rates for SMEs.			
4. The cost of bank loans significantly increases my operating expenses.			
5. Interest rates charged by banks affect how I price my products or services.			
6. The profitability of my business would improve if lending rates were lower.			
7. I have turned down bank loan offers due to unfavorable interest rate terms.			
8. Commercial banks adjust lending rates fairly according to market conditions.			

If any other effects of commercial bank lending rates on the net profit margin of small and medium enterprises District fill in the space provided;

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Section C: The relationship between the Central Bank Rate and the return on assets of small and medium enterprises in Kabale Municipality

Tick appropriately using A- Agree, N- Not sure, D- Disagree.

Statements	A	N	D
1. Changes in the Central Bank Rate directly affect the interest rates charged by commercial banks.			
2. When the Central Bank Rate increases, it reduces the return on assets of my business.			
3. I understand how the Central Bank Rate influences borrowing costs for SMEs.			
4. A lower Central Bank Rate makes borrowing more attractive for my business.			
5. The Central Bank Rate impacts the investment decisions I make in my business.			
6. Return on assets in my business improves when loan interest rates decrease.			
7. I track Central Bank Rate changes to make financial decisions for my SME.			
8. There is a strong link between Central Bank policies and my business's financial performance.			
9. I believe a high Central Bank Rate contributes to lower profitability for SMEs.			

If there is any other relationship between the Central Bank Rate and the return on assets of small and medium enterprises in Kabale Municipality fill it in the space provided bellow.

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Section D: The effects of short-term and long-term interest rates on the return on equity of small and medium enterprises in Kabale Municipality.

Tick appropriately using A- Agree, N- Not sure, D- Disagree.

Statements	A	N	D
1. Changes in short-term interest rates affect the return on equity (ROE) of my business.			
2. Long-term interest rates influence long-term investment decisions in my SME.			
3. Higher short-term interest rates increase my business's financing costs, reducing ROE.			
4. My business is more affected by short-term loans than long-term financing.			
5. I consider interest rate trends before taking either short-term or long-term loans.			
6. Long-term loans with high interest rates reduce my SME's profitability and return on equity.			
7. Access to affordable long-term financing would increase my SME's return on equity.			
8. I prefer short-term loans because they are easier to repay despite higher interest rates.			
9. My equity returns are negatively affected when interest rates rise during loan repayment periods.			

If there is any other effects of short-term and long-term interest rates on the return on equity of small and medium enterprises in Kabale Municipality, fill it in the space provided below;

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Thank you.

Interview guide

- i. What do you understand by Profitability?
- ii. What are the determinants of Profitability in SMEs in Kabale Municipality, Kabale District, Uganda?
- iii. What are the effects of commercial bank lending rates on the net profit margin of small and medium enterprises in Kabale Municipality?
- iv. What is the relationship between the Central Bank Rate and the return on assets of small and medium enterprises in Kabale Municipality?
- v. What are the effects of short-term and long-term interest rates on the return on equity of small and medium enterprises in Kabale Municipality?
- vi. What are the challenges affecting SMEs in Kabale Municipality, Kabale District, Uganda?
- vii. What are the effects of interest rates on growth of SMEs in Kabale Municipality Kabale District, Uganda?

Thank you.



UGANDA CHRISTIAN UNIVERSITY
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(12)

DEPARTMENT OF BUSINESS AND ADMINISTRATION

permission granted
14/7/2025

27th June 2025

Dear Sir/Madam,

For TOWN CLERK
 KABALE MUNICIPAL COUNCIL

RE: INTRODUCTORY LETTER FOR DATA COLLECTION

This is to introduce to you GUMISIRIZA JULIUS REG NO. 523/BBUC/BBA/011 who is a student at Uganda Christian University, Bishop Barham University College. He/she is a finalist pursuing a Bachelor's Degree in Business Administration. It is a requirement of the University for students on this program to write a dissertation in partial fulfilment of the award of the degree. For this purpose, he/she is conducting research on the topic: **Interest rate and Profitability of Small and Medium Enterprises in Kabale Municipality, Kabale District Uganda.**

The findings and analysis of this research will be treated confidentially and will not be used for any other purpose other than the partial fulfilment of the award of the above qualification.

Please accord him/her every possible assistance.

Thank you.

Yours faithfully,

Patience

HEAD OF BUSINESS
 ADMINISTRATION DEPT.
 BBUC

MS. NAJUNA PATIENCE

COORDINATOR

BUSINESS & ADMINISTRATION

Tel. +256774166711

A Complete Education for A Complete Person

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