



**CAPITAL STRUCTURE AND FINANCIAL PERFORMANCE OF NON-FINANCIAL FIRMS LISTED AT THE NAIROBI SECURITIES EXCHANGE, KENYA**

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**Abstract**

The decisions regarding capital structure play an integral part in firms' financing mechanisms. This is because company's' decisions concerning the use of various forms of financing often lead to varied capital structure choices, potentially have different effect on the firm's financial performance. This has led to a plethora of empirical investigations to ascertain whether capital structure choices have a positive, negative or no effect on financial performance. This study aimed at probing the link between capital structure and financial performance of 43 non financial firms listed at the Nairobi Securities Exchange. The study focused on firms listed at the Nairobi Securities Exchange (NSE). This study adopted Pecking order theory, Trade-Off theory and Agency theory as the principal anchoring theories. The study adopted panel descriptive design. The findings confirmed a positive and significant linkage between capital structure and financial performance. The study recommended that future studies should consider cross-sectional dataset as well as different indicators of the variables to replicate analogous studies.

**Key Words:** *Capital Structure, Financial performance, Debt ratio, market to Book Ratio*

## **Background of the Study**

Among the listed firms, some firms have reported better financial compared to others (NSE, 2020). It is therefore important to empirically investigate whether the variation in the financial performance is attributed to capital structure among the quoted firms. Notably, financial performance remains to be the key parameter that determines the existence of numerous firms in the corporate world that is characterized by pronounced competition and turbulent times especially in the wake of COVID-19 pandemic and lack of adequate finances to support diverse businesses across the globe (Nguyen & Nguyen, 2020). Furthermore, profit and wealth maximization still remain as the pivotal goals of all the firms in the corporate world and financial performance is a key pillar in achievement of these goals.

The nexus between the capital structure and financial performance has been the subject of significant debate, both empirically and theoretically over the last four decades. The controversy regarding capital structure and financial performance continues to be debated within the sphere of finance literature since the landmark significant work of Miller and Modigliani (1958). Based on the Miller and Modigliani (1958) suggestion, the firms' value is separate from its capital structure. The corporate decisions regarding firms' capital structure or financing occupies an integral place in firm's management. This is due firm's decisions concerning the use of diverse forms of financing often lead to varying capital structure, which may have different impact on the firm's financial performance. (Mulyana, Zuraida & Saputra, 2018). This makes financing related decisions to be one of the key issues in corporate decisions. Therefore, the specific capital structure by companies may have diverse effects on the financial performance of firms. Nevertheless, there are distinct perspectives on the empirical works on capital structure, some of which confirm earlier theories such as Modigliani and Miller (1958). Moreover, empirical investigations similarly focus on the pecking order and agency costs theories, which suggest that firms should establish a judicious balance of their capital structure in order to generate an optimal structure that can improve their FP (Awais, 2015).

## **Capital Structure**

Capital structure is an amalgamation of a variety of sources through which the firm finances its operations (Kasaur, 2014). The mix of equity and debt represent firm's

CS (Negasa, 2016). The overall cost of capital can be minimized by cautiously combining the debt and equity capital as well as enhancing the firm value (Mursalim & Kusuma, 2018). The percentage of debt to equity is a strategic in corporate world. The firm's capital structure is said to be optimum when the shares market value is potentially augmented. The absence of the debt capital in the capital structure makes the stockholders' return to be equivalent to the firm's overall returns (Frank & Goyal, 2019). The use of debt affects the return and risk of the stockholders; it is capable of increasing the return on equity funds, but it often escalates risk at the same time. When stockholders' return is overly maximized with given level of risk, shares value is enhanced and the firm's CS is said to be optimum (Goh, 2018). Despite of the critical nature of capital, the empirical investigations have very little to say about the optimal level of debt financing.

### **Financial Performance**

Financial performance is a gauge of how an organization employs its existing assets to get revenue in the course of its mundane operations (Haron, 2016). Financial performance outlines the roadmap that offers a mechanism for future oriented decisions concerning management control, acquisitions of diverse assets, business developments (Zunckel, 2019). It shows what has been attained by the executive in pecuniary terms over a specified period of time and can be employed in making valuable comparisons of analogous firms within the sector. As pointed out by Dai (2017), financial performance provides a mechanism for the assessment of corporate related actions in clear pecuniary terms. It demonstrates how well an investor is at the tail end of an accounting period in comparison to the beginning and this can be achieved by applying various financial ratios obtained using information on share prices or from the financial statements. The principal goal of the firm is wealth maximization of the stockholders and consequently measurement of FP aids in evaluating how richer the shareholder is due to the investment decisions for specified timeframe (Frank & Goyal, 2019).

### **Firms Listed at Nairobi Securities Exchange**

The firms quoted at the NSE are gradually scaling up debt financing in their capital structure as they source for extra capital to support their corporate actions. Evidence from the CMA suggests that a total of 2.3 billion was raised by the firms listed

between 2005 and 2017 via rights issue (Mireku, 2014). Large listed firms unlike their smaller counterparts often raise more debt and equity capital (Mudany, Letting & Gituro, 2020).

### **Statement of the Problem**

Among the listed firms at the NSE, some firms such as Safaricom, EABL among others are reporting superior performance in comparison to other firms (e.g. Eveready E.A, KQ, Mumias Sugar etc.). Based on the financial statements of the last five years (2016-2020), some companies such as Eaagards, Kapchorua tea ltd, Williamson tea ltd, Limuru tea ltd, Eveready E.A ltd, Express Kenya ltd, Sameer East Africa ltd, Uchumi Supermarkets, East Africa Cables ltd and Trascentury have continuously reported an average decline in profit after tax by approximately 21.5% (NSE, 2020). It is therefore important to probe whether the variation in financial performance among the quoted firms is attributed to the capital structure, that is debt or equity finance. Several firms listed at the NSE have embraced enormous use of debt capital in comparison to equity capital in their capital configuration with anticipation of enhancing their financial performance. Debt capital gives firms a chance to improve its financial performance by enhancing productive asset acquisition (Mudany *et al.*, 2015).

Furthermore, multiple empirical inquiries have been undertaken globally/locally on the link between capital structure and financial performance. There is lack of convergence in the empirical findings since some studies have reported positive relationship for example: Nguyen and Nguyen (2020); Shen (2017) neutral Zunckel and Nyide (2019) and negative Swagatika and Ajaya (2018); Sharon and Celani (2019). The mixed findings which have been reported is attributed to the choice of econometric models applied, selection of the indicators used to proxy the variables, contextual variations among others. The review of prior empirical investigations in the local context has produced conflicting and mixed findings, which justifies the need for further investigation. Consistent with the problem statement, this study intends to significantly contribute to the extant literature by addressing the following question: what is the relationship among CS, corporate liquidity, firm size and FP of the firms listed at the NSE?

## **Research Objective**

To assess the relationship between capital structure and financial performance of non-financial firms listed at the Nairobi Securities Exchange.

## **Research Hypotheses**

**H<sub>01</sub>:** There is no significant effect of capital structure and financial performance of non-financial firms listed at the Nairobi Securities Exchange, Kenya.

## **LITERATURE REVIEW**

### **Theoretical Literature**

#### **Pecking Order Theory**

Pecking order theory (POT) is traced to the classical works of Myers and Majluf (1984). On the basis of the POT, there is no pre-specified most favorable capital structure but in its place, companies demonstrate dissimilar preferences for utilizing internally generated funds or retained earnings over externally sourced capital. Pecking order theory remains to be among the most influential theories of firm debt position and is contrary to the organization's idea of possessing distinct amalgamation of debt and equity finance, which potentially reduces the firms overall costs of funds (Teece, 2019). The theory postulates that every company should adhere to a well-defined order of precedence with regard to sources of finances so as to curtail asymmetry (information) related costs; first opting for retained earnings, followed by debt capital and eventually equity capital as the last financing option. Pecking order theory give credence retained earnings to be utilized first in financing long term investments and once it is finished unavailable, then debt capital is issued; and when debt capital is inadequate or unavailable, equity capital is finally issued (Shen, 2017). The theory suggests that, as companies become increasingly profitable, the less likely that they will seek outside funds because they would have adequate inner funds to support their capital projects (Nguyen & Nguyen, 2020).

This theory is relevant in theorizing the connection between capital structure, corporate liquidity, firm size and performance of the firms. Firm size is inversely related to the debt capital as the information asymmetries are weightier for big firms than for small-sized companies. The bigger firms are more complex in their capital structure and agency costs; therefore, it is difficult for the larger firms to generate external equity. Twairesh (2014) opines that in contrast with smaller firms, the big

firms have to release more information. Consequently, the pecking order theory is emphasized by size and there will be an inverse connection between debt and size. Nonetheless, the common investors are more concerned about bigger firms than they are about smaller ones. For this reason, large firms have no difficulties in accessing funds.

### **Trade-Off Theory**

Trade-off theory was propounded by Myers (1984). The theory postulates that the most favorable CS exists for each company, and is largely ascertained by harmonizing the benefits and cost of debt and equity capital. Consequently, a company chooses on the proportion of equity capital and debt capital to integrate in their CS by balancing on the merits and demerits of each source of financing. Incidentally, debt capital leads to advantages such as tax cushion via enhanced debt levels in the CS which can lead to agency bankruptcy costs (Goh, 2018). Agency costs stems from deviation of interest among the varied stakeholders as well as information asymmetry (Al-Thuneibat, 2018).

This theory is relevant in delineating the connection between CS and FP. Organizations with more tangible assets are characterized by pronounced debt ratios whereas companies with extra non-tangible assets should rely on equity finance since they are susceptible to value plummeting in the event of corporate liquidation (Haron, 2016). On the basis of this theory, organizations' should appraise numerous costs/benefits of every debt capacity and ascertain most favorable debt structure that takes into account the benefits as well as additional costs. This confirms why companies are partially financed by debt and also partly financed by equity in their CS.

### **Agency Theory**

Agency theory was fronted by Jensen and Meckling (1976) and is hinged on the contractual connection that exists amongst the stockholders as the principal and the firm's agent (represented by the executive). Generally, an agency connection arises when a single or multiple individuals, known as the principals, contract single or numerous persons, referred to as agents, to undertake out certain services and subsequently give them mandate to make informed decision on their behalf. Jarallah, Saleh and Salim (2018) suggest that, ideal capital structure can is achieved by scaling down agency expense which originates from the contradictory administrative

wellbeing alongside those of debenture holders and owners of the company. Notably, the managerial ownership in the context of the firm should be enhanced to bring into line executive interests with the interests of the stockholders or utilize debt to curtail the prevalent opportunistic behavior of managers by scaling down the unutilized cash related resources. Jensen (1986) confirmed the agency dilemma, which is associated with idle cash resources. Dang *et al.* (2019) argued that the challenge associated with unutilized cash can be managed by enhancing executive ownership in the organization or by raising usage of debt in the firm's CS, therefore reducing available cash in the hands of managers. As a result, companies which increasingly seeks debt capital offer managers limited discretionary power on how to utilize free cash flows in comparison to those financed by equity, and consequently, related finance becomes a control mechanism, where financiers and the owners of the firm become the principals under corporate governance structure (Akomeah, Bentil & Musah, 2018).

Generally, debt capital obliges managers in corporate world to be prohibited by the public related capital. When the shareholders have adverse opinion regarding management's aptitude, they will need high interest payment on the quantity given to the organization or they will institute restraining debt clauses to curtail management extent of freedom (Awais *et al.*, 2016). The outstanding debt capital limits management's capacity to reduce the company's value via incompetent dealings. Furthermore, enterprises with increased debt levels offer numerous advantages in that organizations characterized with heightened debt levels can quickly react very to growth of unfavorable FP compared to organizations with reduced debt level (Mireku *et al.*, 2014). The choice to have high debt levels during usual firm activities seem to inspire the organization to take action financially and operationally in post difficulty, thus aiding to shun prolonged periods of hardship without a response. The presence of debt capital in the CS aids in protecting the value of company (Akingunola, Olawale, & Olaniyan, 2017).

## **Empirical Literature**

### **Capital Structure and Financial Performance**

Rahman *et al.* (2019) probed the influence of the CS and FP of listed companies in Bangladesh. The study utilized a sample of 55 observations using cross-sectional dataset of 11 selected listed firms listed from 2014 to 2018. On the basis of Hausman

test, fixed-effect panel data regression model was applied to ascertain the association between the explanatory variables (debt to equity ratio, equity ratio and debt ratio) and the outcome variable (ROE). The findings revealed that the equity ratio and debt ratio had a significant positive effect on profitability. In contrast, equity ratio showed positive linkage with the FP, but the debt to equity ratio had inverse impact on FP. Nonetheless, the study relied heavily on accounting based measures of financial performance which is prone to managerial manipulation.

Using regression analysis as the main estimation method, Putri and Rahyuda (2020) investigated the effect of CS on profitability. The explanatory variable, CS was operationalized using debt to equity ratio whereas sales growth was used as an indicator for FP. The sample comprised of yearly financial statements of 52 Indonesian listed firms, and the data applied was from 2014 to 2019. The outcome validated that the CS had a negative impact on FP. However, the study was bivariate and largely disregarded other control variables such as the moderators and mediators.

Nassir (2016) investigated the impact of CS on industrial firms' FP among the Turkish firms. Annual financial statements of 137 companies in the industrial industry quoted at the Istanbul Stock Exchange were used for the analysis for the period of 2006 to 2013. To operationalize these variables, equity ratio represented capital structure while ROA was utilized to measure financial performance. Regression model was employed to probe the causal relationship between CS and FP. The findings confirmed that the link between CS and FP was negative. However, the study was conducted in a developed market which has unique institutional and cultural settings and findings therefore may not be applicable in a developing market like Kenya.

### **Conceptual Framework**

The conceptual model demonstrates the relationship between the study variables. Capital structure was modeled as the predictor variable whereas financial performance was conceptualized as the outcome variable.





## **METHODOLOGY**

### **Research Design**

Research design is a plan or roadmap for carrying out a research with sufficient control over any intrusion of the outcome validity by any parameters (Kothari, 2014). This study applied longitudinal design which depicts the association between variables over time. Integrating time series and cross-sectional aspects is vital on three grounds. First, capital structure and financial performance may vary over time hence it is necessary to employ panel methodology since the time series dimension offers wealth of information ignored in cross-sectional investigations. Secondly, longitudinal studies enhance the sample size and degree of freedom which is vital when a relatively large number of explanatory variables are employed. Finally, panel data addresses endogeneity of the predictor variables.

### **Target Population and Sampling**

The target population entailed 43 non-financial firms quoted at the NSE. These firms form the unit of analysis and this is where the target population is drawn. To undertake this study, a census survey was carried out owing to small population size. There were 43 non-financial firms quoted at the NSE listing as at 31<sup>st</sup>December, 2020.

### **Data Collection**

This study applied secondary data, which was sourced from the end of year financial reports of each firm listed at the NSE. The key reason why secondary data was used is the fact that it is cheaper and easy to collect than primary data. The longitudinal data gathered covered a period of five years (2016-2020). The data collected related to capital structure and financial performance. The data was gathered from reports of the relevant firms, which was accessed from both Nairobi Securities Exchange and CMA websites and their physical library facilities.

### **Empirical Model**

For purposes of estimation, an empirical model was applied as specified below;

$$FP_{it} = \beta_0 + \beta_1 CS_{it} + \epsilon_{it} \dots \dots \dots (1)$$

Where: **FP** = financial performance; **CS** = capital structure;  $it$  = is the cross sectional unit where  $i = 1 \dots N$ ,  $t$  is the time period where  $t = 1 \dots T$ ;  $\beta_0$  = regression constant;  $\beta_1$  = regression coefficient;  $\epsilon$ : error term.

## EMPIRICAL FINDINGS AND DISCUSSIONS

### Descriptive Statistics

To visualize the longitudinal data employed in this study, descriptive statistics was undertaken and it was aimed at making the statistical presentations to be more straightforward and meaningful in the interpretations. The descriptive statistics computed include: the mean, standard deviation, minimum and maximum values of each variable employed in the study.

#### Panel Descriptive Statistics

Variable	N	M	SD	Min	Max
<b>DR</b>	215	1.06	0.74	0.03	4.78
<b>FP</b>	215	1.59	1.26	0.00	5.62

Source: Empirical Findings (2021)

As indicated in Table 4.1, the average (mean) score of debt ratio between the period 2016 to 2020 period for the 43 quoted firms at NSE was 1.06 which is moderately low implying that the organizations did not fund their corporate assets using debt capital. Nevertheless, the disparity in debt ratio was comparatively stable with a standard deviation of 0.74 which confirmed a minimal variation in debt ratio. The highest and the lowest values of debt ratio during the period were 0.030 and 4.78 correspondingly signifying a modest range.

The average score for the financial performance, represented by price to book value ratio was 1.587 with a standard deviation of 1.26. This suggests that there was a considerable disparity among the listed firms in terms of performance. Furthermore, the financial performance assumed the uppermost and the lowermost values of 0.00 and 5.62 respectively. This confirms substantial variation in terms of price to book value ratio among the firms listed at the NSE.

### Correlation Analysis Results

The empirical investigation utilized correlation analysis to offer a vivid understanding of the nexus capital structure and financial performance. The outcome guided on the

strength of the nexus between the paired study variables in a single value of Pearson product-moment coefficient (r), which varies normally from a positive unit (1) to a negative unit (-1) .

### Correlations Analysis Results

VARIABLE	DR	FP
Capital Structure	1	
Financial Performance	0.540*	1

Correlation is significant at 0.05 significance level

Source: Empirical Findings (2021)

The correlation outcome suggest that capital structure was moderately and significantly correlated with financial performance ( $r = 0.54$ ,  $p < 0.05$ ).

### Hypothesis Testing and Discussion

#### Capital Structure and Financial Performance

*H<sub>01</sub>: Capital structure does not significantly influence financial performance of non-financial firms listed at the Nairobi Securities Exchange.*

#### Capital structure and Financial Performance

##### Estimation Model: Fixed Effect (Within) Regression

FP		$\beta$	SE	t	p	(95% Confidence Interval)	
Constant		1.26	0.13	9.76	0.00	1.005	1.52
DR		0.31	0.11	2.73	0.01	0.855	0.53
R <sup>2</sup>	Within	0.04					
	Between	0.46					
	Overall	0.29					
Observation per group:	min	5					
	avg	5					
	max	5					
F (1, 171)		7.45					
Prob > F		0.00					
Number of Observations		215					
Number of Groups		43					
Corr (u <sub>i</sub> , Xb)		0.47					

Source: Research Findings (2021)

Table 4.10 demonstrates the outcome of the nexus between the capital structure and financial performance while employing fixed effect estimation model. The findings confirmed that debt ratio was a significant positive predictor of financial performance

( $\beta = 0.31$ ,  $t = 2.73$ ,  $p = < 0.05$ ). This suggests that for every additional unit increase in debt ratio, financial performance improves by 0.309 units, *ceteris paribus*.

The findings of the current study are expressively validate the results obtained by Rahman et al. (2019) who established that equity ratio and capital structure had a significant positive effect on profitability. Dissimilar outcomes are documented by Putri and Rahyuda (2020) investigated the effect of capital structure on profitability and found that capital structure had a noteworthy negative effect on profitability. Contrasting findings are also reported by Nassir (2016) who investigated the influence of capital structure on industrial financial performance among the Turkish listed firms and confirmed negative and significant linkage.

### **Conclusion**

The primary objective of this study was to assess the relationship between capital structure and financial performance of non-financial listed firms Kenya. the study concluded that capital structure significantly and in a positive manner affects financial performance of listed non-financial firms in Kenya. This implies that the overall performance of any listed firm largely depends on the capital structure choices made by the firm.

### **Areas for Further Research**

The current research focused on non-financial listed firms in Kenya and a similar study can be replicate on other private companies. Future inquiries should consider utilizing other measures such as equity ratio to operationalize capital structure and accounting based measures such as return on assets to measure financial performance. In addition, future inquiries can apply cross-sectional data and different sectors of the economy so as to ascertain whether similar findings can be established.

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