CAPITAL STRUCTURE CHOICE: A SURVEY OF INDUSTRIAL FIRMS IN KENYA.

BY:

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DECLARATION

This research project is my original work and has not been presented elsewhere for any other assessment or award.

Signed.......................... Date..........................
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Supervisor's approval

This research project has been presented for examination with my approval as the course instructor.

Signed.......................... Date..........................
Mr Josphat Lishenga
DEDICATION

To my wife Eunice, and our daughter, Faith, for your understanding, support and encouragement during the entire period of study.

To my parents, Mr. Julius Musili Ngui and Mrs. Rhoda Musili for your moral and material support that made my academic dream come true.

To Brothers and sisters, you always urged me to move on. May God Bless you all.

To the Almighty, through whom all things are possible.
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ABSTRACT

If it is difficult for a firm to measure impact on the value of the firm under different levels of leverage, it should not be surprising that managers are not very concerned about maintaining an exact capital structure.

The judgment required to make sound financing decisions implies that managers balance the need to avoid dilution against (for example) the need to grow and maintain financial flexibility. This study sought to find out the factors that motivate management of industrial firms in Kenya in choosing their capital structure.

The findings revealed that managers do avoid issuing under-valued securities by financing first with internal equity and then with external claims that are least likely to be mis-priced. Internal equity is the most preferred source, external equity is the least and straight and convertible debts are in the middle.

The pecking order theory seems more predictive of how financing decisions are made in practice. More descriptive still, however, are the conventional financial planning principles.
CHAPTER ONE.

1.0 INTRODUCTION

1.1 Background

Industrial firms are the cutting edge of development. No country has ever been known to register a sustained increase in output without strengthening her industrial sector. Industrial firms, whether publicly or privately owned expand the range of possibilities for individuals and communities and are therefore the backbone of any nation's economy. They constitute the basis of any development agenda such as industrialization hence the need to lay their base on sound financial principles cannot be over emphasized.

The decision of whether to finance an enterprise with long term debt or equity sources of finance is what the capital structure decision is all about. Capital structuring and in particular locating the optimal capital structure, has for a long time been the focus of attention as many academic and financial institutions probe into this area. The trade off theory says that firms have optimal debt equity ratios which they determine by trading off the benefits of debt with the costs (Scott 1976), Modigliani and Miller (1963), observe that in traditional trade off models the chief benefits of debt is the tax advantage of interest deductibility.

Academically, the capital structure problem is appealing because it is fairly open-ended and subject to controversies and criticisms. Practically there is a great interest, especially in the area of corporate and project finance, as there is a lot of interest in firms knowing how to improve their capital structure. (Sagala 2003).

The major breakthrough in capital structuring came with Modigliani and Miller (MM) propositions in 1958. This has lead to a considerable amount of literature both on theoretical and practical approaches on how to determine and locate the optimal capital structure.
Overall, the approaches range from being purely subjective to all analytical with the former comprising of qualitative descriptions of roughly where the optimal structure falls and the latter providing comprehensive graphs of the weighted average cost of capital, which depict the location of the optimum.

Modigliani and Miller in their first study in 1958 provided empirical evidence in support of their hypothesis that capital structure is invariant to the cost of capital. This led to the conclusion that there is no optimal capital structure and that use of debt in the capital structure only changes the way the net income is shared between the providers of capital. On the other hand, the traditionalists believe that the cost of capital can be reduced by judicious mix of debt and equity. This implies that the cost of capital first declines then increases with the leverage suggesting that there is a minimum, which represents the optimal level of gearing.

In a latter study, Modigliani and Miller (1963) corrected their earlier proposition by introducing taxes into their model. They claim that the value of the firm increases when debt is introduced into the capital structure because of the tax shield arising due to interest charge deductibility when determining taxable income.

DeAngelo and Masulis (1980) extended Miller's analysis and used alternative tax shields and investments tax credits to demonstrate that an interior capital structure may exist for individual firms when it is assumed that firms with huge alternative tax shields issue little debt and firms with little alternative tax shield depend on debt financing to shield their income. Capital structure therefore, still remains a puzzle.
1.2 Definition of Terms

1.2.1 Capital structure:
Generally, the term capital structure represents the proportionate relationship between the different forms of long-term financing. These include: long-term debt, preferred stock and the shareholders equity. Kochhar (1997) defines capital structure as mixture of financial liabilities (Debt and Equity) that is used to finance the operations of a firm.

1.2.2 Financial structure
The term financial structure refers to the manner in which the assets of a company are financed. It includes the entire capital and liability side of the balance sheet. Therefore capital structure forms part of the financial structure.

1.2.3 Cost of capital
Cost of capital may be defined as the average cost, which is used as an acceptable criterion to be applied to investment projects. For an investment project to be accepted, it must earn a minimum rate of return equal to the cost of capital. Therefore, the cost of capital represents a standard for allocating the firm’s funds in the most optimum manner.

1.2.4 Leverage
Leverage refers to the employment of debt in the capital structure. A firm is said to be levered if it uses debt in its Capital Structure. The opposite is true for an unlevered firm.

1.2.5 Equity
Judith (1999) defines equity as the contribution that shareholders make to a company’s operation. In other words, it is the contribution of the owners of a company towards its operation. Equity plus debt is equal to the capital structure of a firm.
1.26 Optimal Capital Structure

Ross, et al., (2002) defines an optimal capital structure as one that yields the lowest possible overall cost of capital and at the same time maximises the value of the firm.

1.3 Statement of the Problem

In recent years, a number of theories have been proposed to explain the variation in debt ratios across firms. The theories suggest that firms select capital structures depending on attributes that determine the various costs and benefits associated with debt and equity financing.

Kamere (1987) reveals that the stability of future cash flows, the level of interest rates, the firm’s asset structure, the firm’s tax advantage of debt and the maturity of debt are all important factors in deciding a firm’s capital structure. Apart from Kamere’s findings, other factors have been highlighted in different studies to be important determinants of capital structure.

Aggarwal and Baliga (1987) for example, in a study of Latin American firm’s capital structures found that while size did not seem to be significant, both country and industry were significant determinants of capital structure.

Another notable study was done by Ferri and Jones (1979). They tested hypotheses that industrial class, firm size, variability of future income and operating leverage were significant determinants of capital structure.

Marsh (1982) studied 748 issues of equity and debt by U.K. companies between 1959 and 1970 to see how companies select between financing instruments and found that firms are
heavily influenced by market conditions and the past history of security prices in choosing between debt and equity. The study also presented evidence that the choice seemed to be made as if certain debt levels were borne in mind.

Jalilvand and Harris (1984) in a study of U.S. corporations obtained results which suggested that financial decisions are interdependent and firm size, interest rate conditions and stock price levels affect speeds of adjustments to capital structure, suggesting that they do influence it.

This project uses a survey to document manager’s perceptions regarding capital structure theories and to more precisely investigate what factors motivate management of industrial firms in choosing their capital structure.

1.4 Objective of the Study

The objective of the study is to find out the factors that motivate management of industrial firms in choosing their capital structure.

1.5 Importance of the Study

The findings of this study will be of benefit to the following:

i) Corporate managers

The fundamental objective of financial management decision-making is the maximization of shareholders wealth by way of maximizing the market value of company’s shares. Managers will therefore find the results of this study useful in guiding them towards making financing decisions that are in line with this fundamental objective. Management will appreciate the resultant effect of using debt in financing projects and move towards a capital structure that is optimal.
ii) **Investors**

Most investors in the capital market want to beat the market by buying under valued securities and selling them later when the market has correctly priced them or selling over valued securities and buying them later when the price is down hence making abnormal profits. This can only happen if the investors move fast to act on signals sent by the corporations and not received by other market participants. The current research will provide evidence on whether Kenyan firms abide by any of the capital structure theories on choosing their capital structures. This is deemed vital for investors will realize better returns if capital structure is optimal for cost of capital will be reduced leading to increased value of the company.

iii) **Business consultants.**

Business advisors who may be interested in gaining knowledge on why capital decisions matter will also need the findings of this research in advising their clients.

iv) **Academics**

Academics and researchers will also use the research as an addition to their wealth of knowledge and constitute a firm foundation for further research in the area of study.
2.0 CHAPTER TWO: LITERATURE REVIEW

2.1 Introduction

A firm's choice on whether to finance itself with debt/debt equivalent sources of finance or equity is what the capital structure decision is all about. Each of the two sources of financing has merits and demerits.

Debt on one hand, because of the tax deductibility of interest payments is a much cheaper form of capital (Taggart, 1980). On the other hand, interest payments on debt are fixed irrespective of the firm's present financial strength. This coupled with the risk of loans being recalled at short notice makes debt risky. The danger of bankruptcy and liquidation of assets when a firm is unable to service its debt may increase at high levels of debt making debt even more risky.

The use of equity poses no bankruptcy or liquidation risk on one hand but on the other, the costs of issuing new equity are generally higher than those of acquiring debt. Floatation costs and a higher required rate of return both contribute in making the issuing of equity a prohibition for smaller concerns (Archer and Faebre 1966).

Studies in capital structure have tried to address this issue together with their respective implications and their results are inconclusive. Whereas there is evidence from the traditional school that an optimal capital structure exists, there is also evidence (e.g. MM 1958) that no such a thing as an optimal capital structure exists.

The proponents of the optimal capital structure view are said in financial literature to belong to the traditional school and they hold that the value of the firm could be maximized by minimizing the cost of capital through careful use of debt. In 1958, Modigliani and Miller
developed a new financial theory, which cast doubt on this view. They came up with three propositions, which changed the hitherto unchallenged belief on capital structure.

Determination of an appropriate long-term source of finance is what the capital structure decisions are all about. This task according to Brealy and Myers (1988) is difficult for management and in their words. "... We cannot say that debt is better. Debt may be better than equity in some cases, worse in others". The difficulty of the task lies in the fact that shareholders expect management to issue a financing combination that attempts to maximize a firm's overall market value. This is usually done in an environment full of many conditional ties, which exert influence on this important decision. Kamere (1987) notes these conditions as of the individual firm, the suppliers of funds, and economic, social and legal.

The capital budgeting projects of firms can be financed by retained earnings, by using new equity capital or by borrowing. Use of retained earnings is cheaper but done at the expense of paying out dividends to shareholders. The shareholders would only forego present income if better investment opportunities exist. (Pandey, 1999).

The use of new equity has no financial distress and liquidation costs but floatation costs pose a danger. Apchep and Faeber (1966) holds the view that floatation costs, and a higher required rate of return both contribute in making the issuing of new equity a prohibition for smaller concerns.

Debt may seem favorable because of tax deductibility of interest payments, which makes it a cheaper form of capital. But on the other hand, interest payments on debt are a fixed cost of the business, which makes debt more risky.

The controversy surrounding the choice of debt and equity into the capital structure has boiled to what Myers (1984) called "the capital structure puzzle" which he identified as
"tougher than the dividend puzzle". Studies in capital structure have tried to address this issue and their results have turned out to be inconclusive. Whereas traditionalists give some evidence on existence of an optimal capital structure, Modiglian – Miller (1958) disputed this and gave further evidence that no such things as an optimal capital structure exist.

The remaining part of this section is divided into five subsections, which details the developments of capital structure studies. Subsection two covers the relevance of capital structure into which the traditional view, M-M view (1958), M-M view (1963) and Miller (1997) are extensively documented. Subsection three looks at the subsequent developments where financial distress, Agency costs and signaling theory of capital structure are covered. The trade-off theory of capital structure and the pecking order theory of capital structure are extensively covered in subsection four. Some major determinants of capital structure choice are done in subsection five.

2.2 The relevance of the capital structure choice

The debate on whether the capital structure choice is relevant constitutes a bulk of capital structure studies. This controversial debate was sparked off by M-M (1958) when they disputed the traditional view, which held ‘the hitherto unchallenged belief on capital structure.

2.2.1 The Traditional View

The traditional views according to Kamere (1987) are the views of finance theorists before 1958. This view is founded on the assertion that an optimal capital structure exists and that the value of a firm can be maximized and the cost of capital minimized through careful use of debt. According to this view, the value of the firm can be increased or the cost of capital be
reduced by a judicious mix of debt and equity capital (Pandey, 1999). This implies that the cost of capital decreases within reasonable limit of debt and then increases with leverage. Thus, an optimum capital structure exists and it occurs when the cost of capital is minimum or the value of the firm is maximum. Alexander (1963) better explains, the fact that debt funds are cheaper than equity funds carries the clear implication that the cost of debt, plus the increased cost of equity, together on a weighted basis, will be less than the cost of equity which existed on equity before debt financing. In other words, the weighted average costs of capital will decrease with the use of debt.

The validity of traditional view is questioned on the ground that the market value of the firm depends upon its net operating income and risk attached to it. The form of financing does not change net operating income nor the risk attached to it but simply the way in which the income is distributed between equity-holders and debt-holders. (Brealey and Myers, 1988).

Modigliani and Miller (1958) criticize the traditional view on the ground that the assumption that the cost of equity remains unaffected by leverage up to some reasonable limit does not provide sufficient justification for such an assumption. They do not accept the contention that moderate amounts of debt in ‘sound’ firms do not really add very much to the ‘riskness’ of the share.

However, the traditional view represents a logical appeal and should be appreciated for prompting the kind of rigorous analysis that MM subjected capital structure question to. According to Omondi (1996) the notions of traditional view have been subjected to more abstract reasoning and analysis and some contemporary ways of looking at capital structure for example the signaling theory (Ross, 1977) and the Agency theory (Jensen, 1976).
Pandey (1999) asserts that the argument of traditional theorists that an optimum capital structure exists can be supported on two counts: the tax deductibility of interest charges and market imperfections. Therefore, there is no doubt that traditional theorists are important contributors on the debate about financing choices.

2.2.2 The Modiglian – Miller View (1958)

In 1958 Modiglian-Miller challenged the traditional view and termed it as incorrect through their article entitled “The cost of capital corporation finance and the theory of investment”. On the basis of the assumptions that there exists a perfect capital markets, homogenous risk classes, full pay out of earnings, MM (1958) concluded that the capital structure of a firm is irrelevant to its value in a world without taxes. Arbitrage, they argued would ensure that an individual’s exposure to risk would not change because home-made leverage was as good as corporate leverage (Ibid 2000). Arbitrage refers to the buying and selling of identical assets at different prices (Omondi, 1996).

According to MM, if two companies differ only in the way they were financed and in their total market values, then investors would sell their stock of the over-valued firm and buy those of the under-valued firm. This process persists until the two firm’s value equalizes. Durand (1959) reacted to MM’s irrelevance theory and questioned the applicability of arbitrage process and the assumption of riskless world.

2.2.3 The Modigliani-Miller View (1963)

In connection to their original propositions, MM recognized that the value of a firm was dependent on the after tax net cashflows. On this new line of thinking, they concluded that leverage will increase a firm’s value because interest on debt is a tax deductible expense, and hence, more of a leveraged firm’s operating income flows to investors.
In their first propositions, $VL = Vu + TD$ where $VL$ represents the value of the levered firms, $Vu$ the unlevered firm and $TD$ the tax savings. This means that the value of the levered firm equals the value of an unlevered firm in the same risk class plus the gain from leverage which is the value of the tax savings defined by the corporate tax rate times the amount of debt that the firm uses.

Their second proposition stated that the cost of equity to a levered firm is equal to the cost of equity to an unlevered firm in the same risk class plus a financial risk premium which depends on the difference between the costs of equity and debt to an unlevered firm, then amount of leverage and the corporate tax rate. This in equation form is expressed as:

$$KSL = KSU + (KSU - KD) (1 - T) (D/S)$$

where $Ksl$ is the cost of equity to the levered firm $KSU$ is the cost of equity to the unlevered firm, $KD$ is the interest rate on the firm’s debt, $T$ is the corporate tax rate, $D$ is the market value of the firm’s debt and $S$ represents the market value of the firm’s common stock.

The MM (1963) view reduced the difference in the perceived effects of leverage between the differential view and MM’s original propositions. They however warned against maximizing of debt in the capital structure as other sources of finance like retained earnings may be cheaper when personal income taxes are put into consideration. The increasing costs of debt financing and the limitations imposed by lenders may check the amount of debt that a firm can carry. From this view, it is appropriate to conclude that the choice between debt and equity is clearly of some relevance.
2.2.4 The Miller Model-1977

Miller (1977) on the basis that MM studies ignored personal taxes introduced a model designed to show how leverage affects firm's values when both personal and corporate taxes are taken into consideration. Miller concluded that with both corporate and personal taxes capital structure decisions by the firm are irrelevant, that is, alterations of the capital structure have no effect on the firm's valuation. His model suggests that in market equilibrium, corporate tax advantages are cancelled out by the effect of personal taxes (Van Horne, 1997).

Taggert (1980) extended Millers views to conditions of incomplete capital markets and special costs associated with corporate debt. Its conclusion was that miller's findings could be upheld to the extent that the tax savings from corporate debt is seen as less valuable than was previously supposed and all equity capital structures are seen as perfectly rational for at least some firms.

Much of the theories of capital structure owe a lot to contributions of Modigliani and Miller. More fundamental is their path finding article in 1958, which acted as a spring board for all the studies that followed.

2.3 Subsequent Developments

These developments have centred much on Stiglitz's (1969) work by delineating the major limitations of MM's model based on the assumptions of MM. These studies have particularly attempted to understand the magnitude and implications of market imperfections, for optimal capital structure in the real world. Kraus and Litzenbergere (1977) observe that the market imperfections are central on the effects of leverage on firms' market value.
2.3.1 Financial Distress and Capital Structure

Financial distress has been defined as the disruption of normal operating and financial conditions caused by impending insolvency. (Emery 1998). Brealey and Myers (1988) observe that financial distress occurs when promises to creditors are broken or honoured with difficulty. They further observe that sometimes financial distress leads to bankruptcy and at other times, it means that the firm only ‘skates on thin ice’. Ross and Westerfield (1988) hold an identical view and further recognize direct and indirect costs of financial distress.

Direct costs of financial distress include legal and administrative costs of liquidation or reorganization. While the indirect costs of financial distress are: loss of sales due to weakened assurance of delivery, inability to take an otherwise profitable investment opportunity, the cost of reorganizing a firm that should be liquidated, loss of financial flexibility and costs from conflicts among claimants.

Financial distress costs will affect both the cost of debt and the cost of equity. If a firm becomes bankrupt, financial distress costs will fall mostly on the bondholders, since equity holders can lose nothing more than their original investment, and in financial distress, the original investment of equity investors will have largely disappeared (Ibid2000). Financial leverage increases the probability of financial distress and hence the cost of debt capital increases.

On the basis of his study, Altman (1984) found out that bankruptcy costs often exceed 20% of firm value. He further observed that costs of financial distress are peculiar to leveraged firms only and they can be high especially as the level of debt rises. Contrary, Emery (1998)
observes that any company with fixed costs becomes financially distressed when its cash inflows are insufficient to cover its capital structure. Therefore, even unleveraged firms can face financial distress. Haugen and Senbet (1978) in their study concluded that bankruptcy costs are not sufficient to influence capital structure.

2.3.2 Agency Costs and the Capital Structure

Bondholders are protected by some covenants against the possibility of managers trying to take advantage of them. According to Jensen (1976) these covenants hamper the corporation’s legitimate operations to some extent. He further puts it that the costs of lost efficiency plus those incurred by monitoring the covenants are what is referred to as agency costs. Agency costs increases the costs of debt and at the same time reduce the value of equity.

Kamere (1987) noted that agency problems may bring about an optimal ratio of debt and equity financing when agency costs related to debt and equity financing are considered. Costs associated with protective covenants are substantial and rise with the amount of debt financing. Shareholders incur monitoring costs to ensure manager’s actions are based on maximizing the value of the firm. Jensen and Meckling (1976) noted that with increasing costs associated with higher levels of debt and equity, an optimal combination of debt and equity may exist that minimizes total agency costs.

2.3.3 Signaling Theory and Capital Structure

Ross (1978) introduced signaling theory to finance in which he suggested that managers can use capital structure as well as dividends to give some signals about the firm’s future
prospects. More specifically, increasing the amount of debt in the firm’s capital structure may be interpreted by outsiders as a sign of confidence in a firm’s future.

Kamere (1987) notes that signaling theory is closely related to agency problem in that the use of a firm’s capital structure to convey information to the market about a firm’s profitability is made possible by failure on the part of principals to control actions of management fully.

With a similar view, Harris and Raviv (1990) contend that in general, managers do not always behave in the best interests of their investors. Debt according to them serves this purpose by offering creditors the option to force the firm into liquidation and it also generates information that can be used by investors to evaluate major operating decisions including liquidation. This suggests that if investors are uncertain about the quality of management and the efficacy of business strategy, they can use debt to generate information about these aspects.

Therefore, the expectation is that a debt equity ratio should be balanced between the demands of the firm and the speculations of the investors and the general public about the firm’s prospects.

2.4 Explaining the Financing Choice

"The theories of capital structure don’t seem to explain actual financing behavior, and it seems presumptuous to advice firms on optimal capital structure when we are so far from explaining actual decisions”. (Myers, 1984). It is in this light Myer ushered in two ways of thinking into which he identified as the static trade off framework and pecking order framework.
2.4.1 The Trade off Theory of Capital Structure

Myers (1984), drawing extensively from the work related to MM papers came up with the "trade off theory", in which firms' trade off the benefits of debt financing (favorable corporate tax treatment) against higher interest rates and bankruptcy costs. "A firms optimal debt ratio is determined by a trade off of the costs and benefits of borrowing, holding the firm's assets and investment plans constant" (Ibid). This implies that an optimal capital structure is a result of balancing the value of interest tax shields against various costs of bankruptcy or financial distress.

The trade off theory contrasted MM (1963) by implying that, in real world, firms rarely use 100 percent debt. The primary reason is that firms limit their use of debt to reduce the probability of financial distress (bankruptcy) and also that interest rate on debt becomes prohibitively high at high debt levels.

Brearlay, Smith and Watts (1995) tested the trade off theory by examining the association between companies market to book ratios and their use of financial leverage. They reasoned that companies with high market to book ratios have more growth options (and therefore more likely to lose in financial distress) than companies with low market-to-book ratios. The trade-off theory predicts the high market-to-book ratio companies will use less leverage to avoid these distress costs and this is exactly what they found.

With identical results were Alderson and Betker (1996). They examined the capital choices of companies emerging from bankruptcy and found that those with high liquidation costs used less debt than those with low liquidation costs. The high liquidation cost companies
used methods of debt financing that prescribed their financial flexibility so that they could more easily avoid distress in the future.

The trade-off theory has had a lot of empirical support (Emery, 1898). On the other hand, Myers asserts that none of the evidence noted so far justifies discarding the trade-off theory as its "foolish not to be skeptical". He goes on to say that the theory may sound right to financial economists but business people will give it lip service. He concludes that the theory is a weak guide to average behaviors and it's not of much help in understanding any given firm's decisions. In this case, the trade-off theory is no more than an open invitation to develop an organizational theory which leaves the pecking order theory as the contender in the race to explain capital structure. (Stern and Chew, 1998).

2.4.2 The Pecking Order Theory of Capital Structure

The pecking order theory of capital structure is among the most influential theories of corporate leverage and has of recent taken the center stage among the finance theorists. This theory is from Myers (1984) and Myers and Majluf (1984). However Myers (1984) noted that the pecking order hypothesis is "hardly new". He gave Donaldson's 1961 study of the financing practices of a sample of large corporations as an example. Donaldson had observed that "management strongly favored internal generation as a source of new funds even to the exclusion of external funds except for occasional unavoidable 'bulges' in the need for funds. These bulges were not generally met by cutting dividends. Reducing the customary cash dividend payment was unthinkable to most management except as a defensive measure in a
period of extreme financial distress. Given that external finance was needed, managers rarely thought of issuing stocks. (pg 67)"

Contrary to trade off theory, Myers (1984) observed that due to asymmetric information, firms based their financing activity on a pecking order. He identified the theory that:

1. Firms prefer internal finance

2. They adopt their target dividend payout ratios to their investment opportunities, although dividends are sticky and target payout ratios are only gradually adjusted to shifts in the extent of valuable investment opportunities.

3. Sticky dividend policies, plus unpredictable fluctuations in profitability and investment opportunities, mean that internally generated cash flows may be more or less than investment outlays. If it is less, the firm first draws down its cash balance or marketable securities portfolio.

4. If external finance is required, firms issue the safest security first. That is, they start with debt, then possibly hybrid securities such as convertible bonds, and then perhaps equity is a last resort.

The pecking order theory is explained by the information assumedly between insiders (management) and outsiders (investors). This means that managers know more about their firms than outside investors. This is indicated by the fact that stock prices react to firm announcements of earnings, major capital expenditures, exchange offers, stock repurchases etc. The market simply learns from managers actions because the managers are believed to have better or earlier information. (Myers, 1998).

Because managers know more about their firms than outside investors do, they are reluctant to issue stock when they believe their shares are undervalued and are therefore likely to issue
when their shares are fairly priced. Investors on the other hand interpret the decision to issue as bad news, and firms can only issue at a discount. This creates an adverse selection problem in which firms prefer internal to external finance and when outside funds are necessary, firms prefer debt to equity because of lower information costs associated with debt issues and therefore equity is rarely issued. This establishes the pecking order.

Majluf and Myers (1984) notes that an equity issue becomes feasible in the pecking order only when leverage is already high enough to make additional debt materially expensive e.g. threat of financial distress costs.

2.5 Major Determinants of Capital Structure Choice

There are various attributes that different theories of capital structure suggest may affect the firm’s debt-equity choice. These attributes according to Titman and Wessels (1988) are denoted as asset structure, non-debt tax shields, growth, uniqueness, industry classification, size, earnings volatility, and profitability. This study is limited to the major attributes as given by Kamere (1987).

2.5.1 Asset Structure

Most capital structure theories argue that the type of assets owned by a firm have a major influence in its capital structure choice. Myers (1984) asserts that firms holding valuable intangible assets tend to borrow less than firms holding mostly tangible assets. Long and Malitz (1983) found a significant positive relationship between the rate of capital expenditure (in fixed plant and equipment) and the level of borrowing. Myers and Majluf (1984) assert that firms may find it advantageous to sell secured debt. They demonstrate that there are
costs associated with issuing securities about which the firm’s managers have better information than outside shareholders. Issuing debt secured by property with known values avoids these costs. For this reason, firms with assets that can be used as collateral may be expected to issue more debt to take advantage of this opportunity.

Tendency of managers to consume more than the optimal level of perquisites may produce the opposite relation between collateralizable capital and debt levels. (Titman and Wessels, 1988). Grossman (1982) found that higher debt level diminishes this tendency because of the increased threat of bankruptcy. For this reason, firms especially with less collateralizable assets may choose higher debt levels to limit their manager’s consumption of perquisites.

Work by Galai and Masulis (1976), Jensen and Meckling (1976) and Myers (1977) suggest that stockholders of leveraged firms have an incentive to invest suboptimally to expropriate wealth from the firm’s bondholders. This incentive may induce a positive relation between debt ratios and the capacity of firms to collateralize their debt. If the debt can be collateralized the borrower is restricted to use the funds for a specified project. Since no such guarantee can be used for projects that cannot be collateralised, creditors may require more favourable terms, which in turn may lead such firms to use equity rather than debt financing.

In Kenya the view that firms with tangible assets borrow more is supported by both Kamere (1987) and Omondi (1996). This means that firms in Kenya prefer debt issues than equity issues which are supportive of the pecking order hypothesis.

2.5.2 Growth

As observed by Titman and Halt (1988) equity controlled firms have a tendency to invest suboptimally to expropriate wealth from the firm’s bond holders. The cost associated with this
agency relationship is likely to be higher for firms in growing industries which have more flexibility in their choice of future investments. Therefore, expected future growth should be negatively related to long-term debt levels. Myers (1977) however noted that this agency problem is instigated if the firms issue short term rather than long term debt.

In support of this, Long and Malitz (1983) found a significant negative relationship between rates of investment in advertising and research and development (R&D) and the level of borrowing. Advertising and RD acts as proxies for growth.

Kamere (1987) has indicated similar views. The prediction of growth on capital structure is in contrast with the pecking order theory prediction. This is because the high growth firms are particularly subject to adverse selection problem and according to the pecking order theory they should be indicative of more debt issues. Using growth as proxy for pecking order theory prediction then, it would be appropriate to conclude that firms in Kenya do not follow the pecking order philosophy in their financing choices. However, this would be termed too shallow for making such a major conclusion.

2.5.3 Size

There is a relationship between size and the level of leverage (Titman and Wessels, 1988). Chua and McConnel (1982) provide evidence that suggests that direct bankruptcy costs appear to constitute a larger proportion of a firm’s value as that value decreases. It is also the case that relatively large firms tend to be more diversified and less prone to bankruptcy. This indicates that large firms should be more highly leveraged.
The cost of issuing debt and equity is much more with small firms than large ones. This suggests that small firms may be more leveraged than large firms and may prefer to borrow short term rather than issue long-term debt because of the lower fixed costs associated with this alternative. (Titman and Wessels, 1988). This may be supportive of pecking order prediction since small firms are faced with severe adverse selection problem.

In Kenya, Kamere (1987) found out that long-term debt and the value of total assets (size) are positively correlated. This suggests that the use of debt financing may be higher among large firms than among smaller ones. This is inconsistent with the pecking order theory prediction.

2.5.4 Profitability

Brigham and Gapenski (1990) observed that firms with very high rates of return on investments use relatively little debt. The practical reason is that highly profitable firms do not need to do much debt financing since their high rates of return enable them to do their financing with retained earnings. This behavior is consistent with the pecking order theory prediction.

Myers (1977) cites evidence from Donaldson (1961) and Brealey and Myers (1984) that suggests that firms prefer raising capital, first from retained earnings second from debt and third from issuing new equity. He suggests that this behavior may be due to the costs of issuing new equity. These can be the costs discussed in Myers and Majluf that arise because
profitability of a firm, and hence the amount of earnings available to be retained should be an important determinant of current capital structure.

Contrary, Omondi (1996) found out that Kenyan firms tend to borrow more when their profits are high. He gives an explanation for this, that high profits serve as an incentive to the firm to invest more and this is what may warrant borrowing for expansion of business. Omondi’s finding on profitability would be indicative that firms in Kenya do not follow the pecking order theory of capital structure in their financing choices.
CHAPTER THREE: RESEARCH METHODOLOGY

3.0 POPULATION

The population of study comprised all industrial firms listed under the Kenya association of manufacturers.

3.1 SAMPLE AND SAMPLING TECHNIQUE

A list of 50 industrial firms was obtained by way of stratified random sampling from a population of 475 firms listed under the Kenya association of Manufacturers. Since the population is heterogeneous but consisting of a number of homogenous sub-populations, the industrial firms were classified according to the nature of their activities. A sample of 50 firms was then drawn from the population using the formula:

\[
\frac{X}{N} \times NI
\]

Where \(X\) = sample size = 50

\(N\) = total population = 475

\(NI\) = population per strata

Thus
<table>
<thead>
<tr>
<th>CATEGORY</th>
<th>PPS</th>
<th>SPS</th>
</tr>
</thead>
<tbody>
<tr>
<td>1) food and beverages</td>
<td>104</td>
<td>11</td>
</tr>
<tr>
<td>2) chemical and allied</td>
<td>53</td>
<td>6</td>
</tr>
<tr>
<td>3) building and construction</td>
<td>14</td>
<td>2</td>
</tr>
<tr>
<td>4) leather and footwear</td>
<td>7</td>
<td>1</td>
</tr>
<tr>
<td>5) metal and allied</td>
<td>17</td>
<td>1</td>
</tr>
<tr>
<td>6) fast moving consumer products</td>
<td>30</td>
<td>3</td>
</tr>
<tr>
<td>7) motor vehicle and accessories</td>
<td>15</td>
<td>1</td>
</tr>
<tr>
<td>8) paper and board</td>
<td>47</td>
<td>5</td>
</tr>
<tr>
<td>9) pharmaceuticals and medical equipment</td>
<td>16</td>
<td>1</td>
</tr>
<tr>
<td>10) plastic and rubber</td>
<td>41</td>
<td>4</td>
</tr>
<tr>
<td>11) services</td>
<td>19</td>
<td>2</td>
</tr>
<tr>
<td>12) textiles and apparels</td>
<td>72</td>
<td>8</td>
</tr>
<tr>
<td>13) timber, wood and furniture</td>
<td>13</td>
<td>2</td>
</tr>
<tr>
<td>14) Energy, electrical and electronics</td>
<td>27</td>
<td>3</td>
</tr>
<tr>
<td>TOTAL</td>
<td>475</td>
<td>50</td>
</tr>
</tbody>
</table>

Where PPS and SPS denotes population per strata and Sample per strata respectively.

3.2 DATA COLLECTION METHOD.

Primary data was collected using a structured questionnaire that was completed by the respondents. The questionnaire comprised both open and closed ended questions and was administered through the drop and pick later method.

For firms located in towns away from Nairobi, the questionnaire was dispatched by way of electronic mail to the chief finance officer or the officer most familiar with financing procedures to answer the questions.
3.3 DATA ANALYSIS

The study is a descriptive survey aimed at identifying the factors that motivate management of industrial firms in choosing their capital structure. According to Cooper and Schindler (1998), such a study concerned with finding out what, where and how of a phenomenon is a descriptive study and as such, descriptive statistics was used to analyze the data.

Once data had been collected, the questionnaires were edited for accuracy, uniformity, consistency and completeness. The responses were rated on a 4-point likert scale and the data was then analyzed by use of frequency tables, mean score tabulations, and percentages to represent the response rate and information on the variables under study. These tools were selected because of their clarity, preciseness, ease of understanding and interpretation.
CHAPTER FOUR

FINDINGS

INTRODUCTION

The objective of this study was to find out the factors that motivate management of industrial firms in choosing their capital structure. To realize this objective, a survey of the industrial firms was conducted by way of a questionnaire. Of the 50 sampled industrial firms, 33 responded, a reasonably high response rate of 66 percent. Three questionnaires were rejected for clerical errors and inappropriate responses, an indication that Capital structure theories still remain unclear to some industrial firms. The findings revealed the following.

Table 4.2.1:

<table>
<thead>
<tr>
<th>EXTENT</th>
<th>FREQUENCY</th>
<th>PERCENT</th>
</tr>
</thead>
<tbody>
<tr>
<td>More than 80% of the time</td>
<td>14</td>
<td>46.7</td>
</tr>
<tr>
<td>Between 50 to 80% of the time</td>
<td>12</td>
<td>40</td>
</tr>
<tr>
<td>Less than 50% of the time</td>
<td>4</td>
<td>13.3</td>
</tr>
<tr>
<td><strong>TOTAL</strong></td>
<td><strong>30</strong></td>
<td><strong>100</strong></td>
</tr>
</tbody>
</table>

Almost half of the managers (46.7%) indicated that their securities were correctly priced more than 80% of the time, another 40% indicated fair pricing between 50 to 80% of the time and 13.3% said their securities were correctly priced less than 50% of the time. A clear
indication that many managers disagree with the notion of efficient markets at least part of the time.

These findings can be presented in a chart as below;

Chart 4.2.1

4.2.2 Determination of cost of equity capital.

73.3 percent (22/30) of the survey respondents indicated that they do estimate the cost of equity capital. Given below is a summary of their responses regarding the method they use in determining their firm’s equity capital?
Table 4.2.2: **Determination of cost of equity capital.**

<table>
<thead>
<tr>
<th>Choice by order of priority</th>
<th>Frequency</th>
<th>Percent</th>
</tr>
</thead>
<tbody>
<tr>
<td>a) Using capital asset pricing model, the beta approach)</td>
<td>11</td>
<td>36.7</td>
</tr>
<tr>
<td>b) Using CAPM but including some extra risk factors</td>
<td>8</td>
<td>26.7</td>
</tr>
<tr>
<td>c) By regulatory decisions</td>
<td>4</td>
<td>13.3</td>
</tr>
<tr>
<td>d) using whatever our investors tell us they require</td>
<td>4</td>
<td>13.3</td>
</tr>
<tr>
<td>e) using average historical returns on common stock</td>
<td>3</td>
<td>10</td>
</tr>
<tr>
<td><strong>TOTAL</strong></td>
<td><strong>30</strong></td>
<td><strong>100</strong></td>
</tr>
</tbody>
</table>

36.7% of the respondents indicated that they use CAPM (the beta approach) in determining the cost of equity capital while historical return on common stock obtained the least percentage of 10% implying the reluctance of firms relying on the past in order to predict the future. In support for this is the fact that businesses operate in uncertain environments hence past success may not necessarily guarantee future success.

These findings are presented in a chart below,
4.2.3 Static trade off versus pecking order theory and other models.

66.7 percent (20/30) of the survey respondents indicated a preference for the financing hierarchy. Rankings of six sources of long term funds by respondents who expressed this preference are summarized below. For each source, the percentage of responses within each rank, the percentage of respondents who did not rank the source and the mean of the rankings are given in table 4.3. Higher means imply higher preferences.
Table 4.2.3

Preference rankings of long term sources of funds.

Percentage of responses within each rank

<table>
<thead>
<tr>
<th>Sources by order of preference</th>
<th>First</th>
<th>Second</th>
<th>Third</th>
<th>Fourth</th>
<th>Fifth</th>
<th>Sixth</th>
<th>Not ranked</th>
<th>Mean*</th>
</tr>
</thead>
<tbody>
<tr>
<td>1) internal equity (retained earnings)</td>
<td>56.7</td>
<td>16.7</td>
<td>10</td>
<td>6.7</td>
<td>3.3</td>
<td>6.7</td>
<td>4.97</td>
<td></td>
</tr>
<tr>
<td>2) straight debt</td>
<td>13.3</td>
<td>53.3</td>
<td>10</td>
<td>10</td>
<td>6.7</td>
<td>3.3</td>
<td>3.3</td>
<td>4.33</td>
</tr>
<tr>
<td>3) convertible debt</td>
<td>0.0</td>
<td>6.7</td>
<td>43.3</td>
<td>30</td>
<td>10</td>
<td>3.3</td>
<td>6.7</td>
<td>3.20</td>
</tr>
<tr>
<td>4) external common equity</td>
<td>0.0</td>
<td>6.7</td>
<td>23.3</td>
<td>20</td>
<td>3.3</td>
<td>40</td>
<td>6.7</td>
<td>2.33</td>
</tr>
<tr>
<td>5) straight preferred stock</td>
<td>0.0</td>
<td>3.3</td>
<td>16.7</td>
<td>13.3</td>
<td>36.7</td>
<td>16.7</td>
<td>13.3</td>
<td>2.13</td>
</tr>
<tr>
<td>6) convertible preferred stock</td>
<td>0.0</td>
<td>3.3</td>
<td>6.7</td>
<td>13.3</td>
<td>33.3</td>
<td>33.3</td>
<td>10</td>
<td>1.83</td>
</tr>
</tbody>
</table>
* Means are calculated by assigning scores of 6 through 1 for rankings from 1 to 6 respectively and then multiplying each score by the fraction of responses within each rank. A score of 0 is assigned when a source is not ranked.

As indicated, 56.7% of the respondents ranked internal equity as their first choice while 40% ranked external equity as their last choice. The respective mean rankings for the equity alternatives were 4.97 and 2.33. Similarly, straight debt dominates convertible debt with mean ranks of 4.33 and 3.20 respectively.

For debt and common equity therefore, the pattern depicted conforms to the Myers and Majluf predictions that managers who follow a financing hierarchy prefer internal equity, then straight debt, then convertible debt, and finally new common stock.

If managers move to the target capital structure by following a hierarchy, these two concepts need not be mutually exclusive. However, the process envisioned by Myers and the responses above seem to imply that managers do not even seek the target capital structure as the process is dynamic rather than static.
Table 4.2.4 Relative importance of capital structure guidelines and/or assumptions in making financing decisions.

<table>
<thead>
<tr>
<th>Guidelines or assumptions by order of importance</th>
<th>VU</th>
<th>MU</th>
<th>SU</th>
<th>NU</th>
<th>NR</th>
<th>M*</th>
</tr>
</thead>
<tbody>
<tr>
<td>Projected cash flow from assets to be financed</td>
<td>73.3</td>
<td>16.7</td>
<td>10</td>
<td>3.53</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Avoiding dilution of common share holders claims</td>
<td>66.7</td>
<td>20</td>
<td>6.7</td>
<td>3.3</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Risk of asset to be financed</td>
<td>33.3</td>
<td>40</td>
<td>13.3</td>
<td>6.7</td>
<td>6.7</td>
<td>2.87</td>
</tr>
<tr>
<td>Restrictive covenants on senior securities</td>
<td>26.7</td>
<td>33.3</td>
<td>30</td>
<td>10</td>
<td>0.0</td>
<td>2.77</td>
</tr>
<tr>
<td>Avoiding mis-pricing of securities to be issued</td>
<td>36.7</td>
<td>23.3</td>
<td>10</td>
<td>20</td>
<td>10</td>
<td>2.57</td>
</tr>
<tr>
<td>Corporate tax rate</td>
<td>23.3</td>
<td>40</td>
<td>16.7</td>
<td>6.7</td>
<td>13.3</td>
<td>2.52</td>
</tr>
<tr>
<td>Voting control</td>
<td>13.3</td>
<td>43.3</td>
<td>23.3</td>
<td>16.7</td>
<td>3.3</td>
<td>2.47</td>
</tr>
<tr>
<td>Depreciation and other non-debt tax shields</td>
<td>10</td>
<td>23.3</td>
<td>40</td>
<td>26.7</td>
<td>0.0</td>
<td>2.17</td>
</tr>
<tr>
<td>Correcting mis-pricing of outstanding securities</td>
<td>6.7</td>
<td>20</td>
<td>50</td>
<td>10</td>
<td>13.3</td>
<td>1.97</td>
</tr>
<tr>
<td>Personal tax rates of debt and equity holders</td>
<td>6.7</td>
<td>10</td>
<td>33.3</td>
<td>50</td>
<td>0.0</td>
<td>1.74</td>
</tr>
<tr>
<td>Bankruptcy costs</td>
<td>3.3</td>
<td>6.7</td>
<td>16.7</td>
<td>73.3</td>
<td>0.0</td>
<td>1.40</td>
</tr>
</tbody>
</table>

Where VU, MU, SU, NU, NR, M* denote; Very useful, moderately useful, slightly useful, Not useful, Not ranked, and Mean respectively.

* Means are calculated by assigning scores of 4 through 1 for rankings from 'very useful' to 'not useful' respectively and then multiplying each score by the fraction of responses within each rank. A score of 0 is assigned when a factor is not ranked.

The percentages are based on 30 responses.

Manager's relative disinclination towards capital structure theory in general is further reflected in their rankings of seven financial planning principles summarized in table 4.2.5 below.
Table 4.2.5
Relative importance of various financial planning principles in governing financing decisions.

<table>
<thead>
<tr>
<th>Planning principle by order of importance</th>
<th>Very important</th>
<th>Moderately important</th>
<th>Slightly important</th>
<th>Not important</th>
<th>Not ranked</th>
<th>Mean*</th>
</tr>
</thead>
<tbody>
<tr>
<td>Ensuring long term</td>
<td>76.7</td>
<td>16.7</td>
<td>6.7</td>
<td>0.0</td>
<td>0.0</td>
<td>3.70</td>
</tr>
<tr>
<td>Survivability</td>
<td>70</td>
<td>23.3</td>
<td>6.7</td>
<td>0.0</td>
<td>0.0</td>
<td>3.63</td>
</tr>
<tr>
<td>Maintaining financial</td>
<td>56.7</td>
<td>23.3</td>
<td>3.3</td>
<td>3.3</td>
<td>13.3</td>
<td>3.08</td>
</tr>
<tr>
<td>Flexibility</td>
<td>43.3</td>
<td>26.7</td>
<td>20</td>
<td>3.3</td>
<td>6.7</td>
<td>2.97</td>
</tr>
<tr>
<td>Maintaining predictable source of funds</td>
<td>36.7</td>
<td>40</td>
<td>20</td>
<td>3.3</td>
<td>0.0</td>
<td>3.10</td>
</tr>
<tr>
<td>Maximizing security prices</td>
<td>13.3</td>
<td>43.3</td>
<td>26.7</td>
<td>16.7</td>
<td>0.0</td>
<td>2.53</td>
</tr>
<tr>
<td>Maintaining a high debt</td>
<td>10</td>
<td>60</td>
<td>16.7</td>
<td>10</td>
<td></td>
<td>1.80</td>
</tr>
</tbody>
</table>

* Means are calculated by assigning scores of 4 through 1 for rankings from ‘very important’ to ‘not important’ respectively and then multiplying each score by the fraction of responses within each rank. A score of 0 is assigned when a principle is not ranked.

Five of the seven principles above have mean ranks of 2.97 or higher. In contrast, only two of the eleven guidelines in table 4.2.4 had mean ranks that high. Financial planning principles therefore dominate specific capital structure models in governing financing decisions for the firms in the sample. This finding is underscored by the observation from table 4.2.5 that, maximizing security prices also has a lower mean rank (3.08) than three of the other financial planning principles.

It is also worth noting that among the planning principles, firms are more concerned about ensuring long-term survival than maintaining financial flexibility. Given these findings and
the absence of a strong relationship between manager’s perceptions of market efficiency and the importance attached to information factors/guidelines in table 4.2.4, it is evident that projected cash flow, risk of the assets to be financed and avoiding dilution of common shareholder’s claims are the factors more closely associated with financial planning principles than with information related capital structure theories.

**4.2.6 Financial variables that help determine a firm’s level of leverage.**

<table>
<thead>
<tr>
<th>FACTOR</th>
<th>VI</th>
<th>MI</th>
<th>SI</th>
<th>NI</th>
<th>MEAN</th>
</tr>
</thead>
<tbody>
<tr>
<td>Firm’s asset base</td>
<td>73.3</td>
<td>16.7</td>
<td>10</td>
<td></td>
<td>3.63</td>
</tr>
<tr>
<td>Firm’s perceived growth</td>
<td>66.7</td>
<td>26.7</td>
<td>6.7</td>
<td></td>
<td>3.60</td>
</tr>
<tr>
<td>Size of the firm</td>
<td>60</td>
<td>33.3</td>
<td>3.3</td>
<td>3.3</td>
<td>3.50</td>
</tr>
<tr>
<td>Firm’s profitability</td>
<td>50</td>
<td>46.7</td>
<td>3.3</td>
<td></td>
<td>3.47</td>
</tr>
<tr>
<td>Earnings volatility</td>
<td>33.3</td>
<td>40</td>
<td>26.7</td>
<td></td>
<td>3.07</td>
</tr>
</tbody>
</table>

Where VI, MI, SI, and NI denote very important, moderately important, slightly important and not important respectively.

- Means are calculated by assigning scores of 4 through 1 for rankings from ‘very important’ to ‘not important’ respectively and then multiplying each score by the fraction of responses within each rank. A score of 0 is assigned when a principle is not ranked.

From the above findings, it is evident that the type of assets owned by a firm has a major influence in its capital structure choice. Myers (1984) asserts that firms holding valuable intangible assets tend to borrow less than firms holding mostly tangible assets. Long and
Malitz (1983) found a significant positive relationship between the rate of capital expenditure (in fixed plant and equipment) and the level of borrowing.

Worth noting also is the revelation that a firm’s profitability may not be as core a factor in determining a firm’s capital structure as a firm’s size, growth and asset base are. Brigham and Gapenski (1990) observed that firms with very high rates of return on investments use relatively little debt. The practical reason is that highly profitable firms do not need to do much debt financing since their high rates of return enable them to do their financing with retained earnings.
CHAPTER FIVE

5.0 CONCLUSION AND RECOMMENDATIONS.

Industrial firms in this sample are more likely to follow a financing hierarchy than to maintain a target debt to equity ratio. Further, models based on corporate and / or personal taxes, bankruptcy and other leverage related costs are not as useful in determining the financing mix as are the models that suggest that new financing reveals aspects of the firm’s marginal asset performance.

In addition, the importance managers attach to specific capital structure theories is not related to managerial perceptions of market efficiency. Thus, most managers do not overtly signal firm value through capital structure adjustments.

In general, financial planning principles are more important in governing the financing decisions of the firm than are specific capital structure theories.

Moreover, the judgement required to make sound financing decisions implies that managers balance the need to avoid dilution of common share holder’s claims against (for example) the need to grow and maintain financial flexibility. Hence multiple factors bear on the financing choice and several financing alternatives may be considered simultaneously.

Perhaps, such complexities explain why managers are guided more by planning principles than by the implied precision of theoretical models.
5.1 LIMITATIONS OF THE STUDY.

1. A significant percentage of the companies (34%) did not respond implying their reluctance to release company information.

2. The fact that three questionnaires were rejected owing to inappropriate responses could be an indication that capital structure theories still remain unclear among some managers.

5.2 SUGGESTION FOR FURTHER RESEARCH

Findings of this research reveal that majority of the factors influencing capital structure choice are internal to the organization. A similar research can therefore be done to investigate whether the macro-environment (Economic, social, cultural, political and technological factors) within which businesses operate have a role to play in capital structure choice.
5.3 REFERENCES


Alexander, B. The Effects of Capital Structure of the Cost of Capital, Prentice – Hall, Inc. 1963


Kamau, B. K., The Magnitude and causes of Corporate Failures in Kenya, Unpublished MBA project University of Nairobi, 1985


Myers, S. "The Search for Optimal Capital Structure", Midland Corporate Finance Journal, 1984, 6 – 16


Odinga G O. Determinants of capital structure of companies listed at Nairobi Stock exchange, University of Nairobi, Unpublished MBA project [2003]


Sagala G. The relationship between cost of capital and leverage for companies quoted at the Nairobi Stock exchange, Unpublished MBA project [2003]


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5.4 APPENDICES

5.4.1 LETTER OF INTRODUCTION

UNIVERSITY OF NAIROBI
FACULTY OF COMMERCE
DEPARTMENT OF
ACCOUNTING
P.O. BOX 30197
NAIROBI

TO WHOM IT MAY CONCERN

Dear Respondent

RE: REQUEST FOR RESEARCH DATA

I am a Postgraduate student at the University of Nairobi, Faculty of Commerce. In partial fulfillment of the requirements for the award of the degree in Master of Business Administration, I am conducting a study entitled, "CAPITAL STRUCTURE CHOICE: A SURVEY OF INDUSTRIAL FIRMS IN KENYA"

For the purpose of enhancing my research work, I wish to collect data through the questionnaire method. I would highly appreciate if you would kindly assist in filling this questionnaire.

This information is purely for the purpose of my project work and all information provided will be treated with strict confidentiality.

Thanking you in advance.

Yours faithfully

Musili, Kioko
D61/7124/2002
MBA II Student

Mr. J Lishenga
Supervisor
5.4.2 QUESTIONNAIRE TO BE FILLED BY THE RESPONDENT

PART I: COMPANY BACKGROUND

(Please help answer the following questions)

1. What is the name of your company?

2. State the nature of product(s) dealt in by your company

3. About what percentage expenditure does your firm spent in research and development in a year?

4. Would you consider your securities to be correctly or incorrectly priced?

5. If you consider your securities to be correctly priced in 4 above, to what extent would you consider them to be correctly priced over time,
   - More than 80% of the time [ ]
   - Between 50 to 80% of the time [ ]
   - Less than 50% of the time [ ]

6. In raising new funds, your firm (Tick one).
   a) Seeks to maintain a target capital structure by using approximately constant proportions of several types of long term capital.
b) Follows a hierarchy in which the most advantageous source of funds is exhausted before other sources are used.

7. Does your firm estimate the cost of equity capital?
   Yes [ ] No [ ]

8. If yes tick from the choices given below how you determine your firm's cost of equity capital.
   Choices
   a) Using capital Asset Pricing Model (CAPM, the beta approach) [ ]
   b) Using CAPM but including some extra risk factors [ ]
   c) By regulatory decisions [ ]
   d) Using whatever our investors tell us they require [ ]
   e) Using average historical returns on common stock [ ]

**PART II: INFORMATION ON CAPITAL STRUCTURE CHOICE**

Please answer the following questions as they relate to decisions you make in raising new long-term funds.

1. a) Rank the following sources of long term funds in order of preference for financing new investments (1 = first choice, 6 = last choice)
   a) Straight debt [ ]
   b) Internal equity (retained earnings) [ ]
   c) Straight preferred stock [ ]
   d) Convertible debt [ ]
   e) External common equity [ ]
   f) Convertible preferred stock [ ]

2. Tick on the scale provided the extent to which you find the following factors/guidelines useful in making financing decisions.
   Scale: Very useful=4, Moderately useful = 3 , Slightly useful = 2, Not useful = 1
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<td>Avoiding mis-pricings of securities to be issued</td>
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<tr>
<td>ii) Corporate tax rate</td>
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<td>iii) Risk of asset to be financed</td>
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<td>iv) Restrictive covenants on senior Securities</td>
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<td>v) Projected cash flow from asset to be financed</td>
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<td>vi) Voting control</td>
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<td>vii) Avoiding dilution of common shareholders claims</td>
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<td>viii) Depreciation and other non-debt tax shields</td>
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<td>ix) Personal tax rates of debt and equity holders</td>
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<td>x) Bankruptcy costs</td>
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<td>xi) Correcting mispricings of outstanding securities</td>
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3. Please indicate how important the following financial planning principles would be to you in making financing decisions for the firm.

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<td>a) Maintaining financial flexibility</td>
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<td>b) Maximizing security prices</td>
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<td>c) Ensuring long term survivability</td>
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<td>d) Maintaining comparability with other firms in the industry</td>
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<tr>
<td>e) Maintaining a high debt rating</td>
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<tr>
<td>f) Maintaining a predictable source of funds</td>
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<tr>
<td>g) Maintaining financial independence</td>
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4. Please rate the following factors according to their importance in choosing capital structure by the firm.

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<td>ii) Earnings volatility</td>
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<td>iii) Size of the firm</td>
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<td>iv) Asset base of the firm</td>
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THANK YOU FOR YOUR ASSISTANCE
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<td><a href="mailto:contact@nairobi.beiersdorff.com">contact@nairobi.beiersdorff.com</a></td>
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<tr>
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<td>020 612117</td>
<td><a href="mailto:info@cooper.co.ke">info@cooper.co.ke</a></td>
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<td><a href="mailto:desbro@desbro.org">desbro@desbro.org</a></td>
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<td><a href="mailto:alum@wamco.com">alum@wamco.com</a></td>
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<td><a href="mailto:echemical@frankhealth.co.ke">echemical@frankhealth.co.ke</a></td>
<td>P. O. Box 83249 Mombasa</td>
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<td>020-511148</td>
<td><a href="mailto:elys@africanonline.co.ke">elys@africanonline.co.ke</a></td>
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<td><a href="mailto:info@kelchemicals.com">info@kelchemicals.com</a></td>
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<td>AAM Resources</td>
<td>Certified Public Accountants &amp; Management Co.</td>
<td>020 3742075</td>
<td>020 3742075</td>
<td><a href="mailto:aam@amresources.com">aam@amresources.com</a></td>
<td>P. O. Box 456901 - 00100 Nairobi</td>
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<td>Livingstone Registrars (Dell)</td>
<td>Customs and International Trade Consultancy</td>
<td>020 4442209</td>
<td>020 4442209</td>
<td><a href="mailto:nsk@livingstone.com">nsk@livingstone.com</a></td>
<td>P. O. Box 456901 - 00100 Nairobi</td>
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<td>Ngasi Consulting Engineers</td>
<td>Structural &amp; Civil Engineering - design of buildings</td>
<td>020 3742075</td>
<td>020 3742075</td>
<td><a href="mailto:nsk@livingstone.com">nsk@livingstone.com</a></td>
<td>P. O. Box 456901 - 00100 Nairobi</td>
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