A SURVEY OF FACTORS INFLUENCING LONG TERM DEBT DECISIONS BY COMPANIES QUOTED AT THE NAIROBI STOCK EXCHANGE

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DECLARATION

I, the undersigned declare that this is my original work and has not been submitted to any other college, institution or university other than University of Nairobi for academic credit;

Sign: .................................................. Date: ..............................................

KAMAU MUGENDE
D61/8873/2005

Supervisor

This project has been presented for examination with my approval as the university supervisor;

Sign: .................................................. Date: ..............................................

Mr. J. Barasa
ACKNOWLEDGEMENT

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Finally and most importantly, I wish to thank my God and the Lord of the Universe for bringing me this far.
DEDICATION

This thesis is dedicated to my dear and loving wife; Anne Kamau and my two beautiful daughters; Bayu and Chichi for their love, support, patience, encouragement and understanding that gave me the will and determination to complete my postgraduate studies.
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<tr>
<td>AIG</td>
<td>American investment group</td>
</tr>
<tr>
<td>CDSC</td>
<td>Central Depository System Corporation</td>
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<tr>
<td>ETS</td>
<td>Electronic Trading System</td>
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<tr>
<td>GDP</td>
<td>Growth domestic Product</td>
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<tr>
<td>LAN</td>
<td>Local Area Network</td>
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<tr>
<td>NASI</td>
<td>Nairobi Stock Exchange All Share Index</td>
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<td>NSE</td>
<td>NAIROBI STOCK EXCHANGE</td>
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<td>WAN</td>
<td>Wide Area Network</td>
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ABSTRACT

Long term financing is very important to a business. It is normally used as a facilitator for the acquisition of assets of a business that include equipment, land, machinery, buildings and other major assets that may include mergers and acquisitions; however there are factors influencing long term debt financing in the organizations and thus the main purpose of the study was to investigate the factors affecting long term debt decisions for Kenyan firms quoted at NSE.

The study used descriptive research design. The population of interest was 47 companies quoted at the Nairobi Stock Exchange and the response rate was 38 companies. The primary data was collected by use of questionnaires which were circulated to the companies through drop and pick method. Liner regression method was used to analyze collected data. Data was also analyzed through the help of Statistical Package for Social Science (SPSS) Version 17.

The study established that majority of the companies used long term debt for financing. Factors such as, firm’s size, and corporate tax affected the borrowing decision of an organization and borrowing position of the company. Interest rate was also a very important determinant of long term debt financing decisions since it carried with it the threat of liquidation. The result shows that interest rates had a major impact on the debt financing decisions as also indicated by the literature review By way of recommendation, the personnel involved in selection of debt as a source of capital finance should ensure its done in line with the costs and benefits associated with its use (debt). Managers should also consider conditions in the stock and bonds market before deciding the long term debt to take however the organization should try to effectively and efficiently utilize the available funds. There is also need for government to reduce the level of personal income tax and company income tax further to encourage firms to plough back their profits into profitable investment opportunities. Government should therefore pursue sectoral allocation of credit in favour of firms. This will also enable firms to take advantage of the tax benefit from debt financing.
CHAPTER ONE

INTRODUCTION

1.1 Background to the Study

Long term financing is normally used as a facilitator for the acquisition of assets of a business that include equipment, land, machinery, buildings and other major assets that may include mergers and acquisitions. The repayment of such long term loan spreads over a long period of time. Long term debt financing is usually used in large capital equipment purchase, fixed assets, large scale equipment purchase, and in the expansion of a company’s facilities (Brealey and Myers, 2003).

Financial management is largely concerned with financing, dividend and investment decisions of the firm with some overall goal in mind (Arditti and Haim, 1997). Firm financing has mainly emphasized the choice of debt versus (internal or external) equity. Although the idea of debt as a homogeneous source of funds is a powerful theoretical construct and a useful first step, one must go beyond the leverage decision and investigate other dimensions of the debt choice. In particular, the nature of debt and its incentive properties can differ according, for instance, to its maturity (long and short) and to the provider (Banks or markets) (Brealey and Myers, 2003).

Achieving the goals of corporate finance requires that any corporate investment be financed appropriately. As both hurdle rate and cash flows (and hence the riskiness of the firm) will be affected, the financing mix can impact the valuation of a firm. Management must therefore identify the "optimal mix" of financing the capital structure that results in maximum value of the firm (Forsberg, 2004).

One of the objectives within the financing decision is to match the maturity of liabilities with the life expectancy of assets. This allows liabilities to be self-liquidating. If the maturity of liabilities is less than the life expectancy of assets, then you face refinancing risk since you have to raise new capital to pay off liabilities. If the maturity of liabilities is longer than the life expectancy of
assets, then there will be plenty of assets around to pay off debts. However, these surplus assets may not earn enough to increase the market value of the firm (Boateng, 2004).

According to Tien Pao, Pikas and Lee (2003), firms avoid external financing while they have internal financing available and avoid new equity financing while they can engage in new debt financing at reasonably low interest rates. Firms are assumed to trade-off the tax benefits of debt with the bankruptcy costs of debt when making their decisions. One last theory about this decision is the Market timing hypothesis which states that firms look for the cheaper type of financing regardless of their current levels of internal resources, debt and equity (Tien Pao, Pikas and Lee, 2003).

The financial decision influences the capital structure of a firm which eventually impacts on the shareholder’s wealth. Capital is crucial in any firm since it finances long-term assets (mainly property, plant, and equipment) and the net working capital. In most cases there is a gap between the cash that companies need to invest and the cash that they generate internally. This gap is the financial deficit. To make up the deficit, companies must either sell new equity or borrow (Brealey and Myers, 2003).

When making corporate financing decisions, one needs to consider many factors. One must think about the type of Organization and its objectives, Organization’s affairs in the short and long term, and the potential implications of the decisions to the employees and stockholders. Looking at the situation from several different angles better equips the analyst to make good financing decisions.

1.1.1 The Nairobi Stock Exchange

The Nairobi Stock Exchange (NSE) is the principal stock exchange of Kenya. Nairobi Stock Exchange is Africa’s fourth largest stock exchange in terms of trading volumes, and fifth in terms of market capitalization as a percentage of GDP. The Exchange works in cooperation with the Uganda Securities Exchange and the Dar es Salaam Stock Exchange, including the crosslisting of various equities. Trading is done through the Electronic Trading System (ETS) which was commissioned in 2006. In 2008, the Nairobi Stock Exchange All Share Index (NASI) was
introduced as an alternative index. Its measure is an overall indicator of market performance. The Index incorporates all the traded shares of the day. Its attention is therefore on the overall market capitalization rather than the price movements of select counters.

There is however a third Index; the AIG 27 Index that compares price movements of 27 companies identified as relatively stable. The rational behind the index compares to that of the NSE 20-Share Index. But whereas the AIG is primarily defined by the AIG company (a financial service company and part of the AIG Group), the 20-share Index is from the NSE itself (www.nse.co.ke).

NSE is fully owned by nineteen licensed stockbrokers. The NSE is currently increasingly experiencing volatility as NSE 20-Share Index fell below the 3,000 psychological mark, lowering the total value of shareholders’ wealth (market capitalization) to Sh740.877 billion, from Sh1.3 trillion in June 2008. The market capitalization grew to KSh 1.3 trillion by the end of June after the listing of the Safaricom shares (NSE, 2007). NSE’s has three core stakeholders; the investors, the listed companies, and the members/brokers. The most important stakeholders in any exchange are the investors (Ngugi, 2003). In case of Kenya, the number of investors remains very small, though in the recent years substantial number of investors has been attracted to the market.

The gross number of investors in all listed companies is approximately 1.5 million based on CDS accounts that had been opened as at April, 2008 (CDS Preliminary Report, 2008). NSE has 55 listed companies on Equities board and 2 securities on preference shares board. It also has 9 listed Corporate Bonds and 65 listed Treasury bonds on the fixed income securities board (NSE Weekly Market Statistics, 2008). The NSE has 19 active trading members (brokers) and one dormant member. There are 11 directors on the board of the NSE. 5 of board members are elected from the brokers, 2 are elected to represent listed companies, 2 to represent institutional interests, 1 to represent the public interest, managing director of the NSE and the legal officer/company secretary (Ngugi and Njiru, 2005).

In the recent past NSE has undergone some major development on the trading and the settlement front. These developments entail establishment of a modern fully automated custody and
settlement services which are being provided by the Central Depository System Corporation (CDSC). CDSC became operational in 2004 after decades of manual clearing and settlement system. The shareholders of the CDSC are brokers and some financial institutions.

There was a successful implementation of the automated trading system (ATS) in September 2006 on a local area network (LAN) at the trading floor. The system has facilitated efficient trading by reducing the time it takes to execute a trade. The integration of the ATS, CDS and brokers’ back office systems improved service delivery to investors. To begin with ATS operated on a Local Area Network (LAN) but after a success testing and implementation phase the ATS now runs on a Wide Area Network (WAN) for members to trade from their offices. On the 17th December 2007, number of the trading hours increased to 6 hours (9.00 hrs-15.00hrs) (NSE Trading Rules, 2008).

Global financial services industry is being driven by new strong forces. These forces are causing exchanges like NSE to re-examine their business structures in order to remain competitive. Globalization of the markets, advances in technology, competitive pricing pressures and government deregulation are all contributing to the allure of demutualization (Mensah, 2005). In the recent past NSE has gone through some very turbulent times. Three stockbrokers have gone under in a span of three two years due to poor corporate governance. This bad image has led to low investor confidence. This has threatened to negate some huge gains made by automation of both trading and settlement systems.

1.2 Statement of the Problem

There are many sources of debt financing; these can be divided into two categories which are the private and the public sources. The private sources includes banks, consumers, credit unions, friends and relatives, trade credit, commercial finance companies, insurance companies, leasing companies and also factor companies. The public sources of the debt financing include the loan programs which is state and federal government provided in order to provide all the business (Bathala et al, 1994).
Chirinko and Singha (2000), argue that the regression of debt financing on financial deficit is unable to identify the order in which funds from various sources are used. Furthermore, the approach cannot properly address situations in which firms have to issue high percentage of equity, for example, due to limited debt capacity. An emerging area in finance theory is right-financing whereby investment banks and corporations can enhance investment return and company value over time by determining the right investment objectives, policy framework, institutional structure, source of financing (debt or equity) and expenditure framework within a given economy and under given market conditions.

Some of the previous studies consider maturing debt in their analyses. Shyam- Sunder and Myers (1999) include current maturity long-term debt in their financing deficit measure. Frank and Goyal (2003) also consider current maturity long-term debt but argue for its exclusion from financing deficit.

Locally, Muriithi, 2003 did a study on comparisons of interest rates between short and long term financial debt securities but failed to address the factors influencing long term debt financing. Unlike these studies, however, the current study will go deeper and investigate the factors that influence long term debt financing decisions.

To fill the above gap, this study therefore seeks to assess the factors that are taken into consideration when making long term debt financing decisions. Specifically, the study intends to determine the impact of interest rates, shareholders composition and tax shelter benefit on long term debt financing decisions. No such study in the specified time frame has been done previously.

1.3 Objectives of the study

The main objective of the study is to investigate factors affecting long term debt decisions for Kenyan firms quoted at NSE.
1.4 Significance of the Study

The study will act as a guide to company executives as it will bring out empirical evidence of what influences corporate debt decisions. Additionally, policy makers will gain insight on how their decisions impacts on long term debt financing.

Banks and financial institutions are in the business of lending money to firms and individuals. The study will help banking institutions in checking their interest rates to ensure they facilitate growth in economic activities of the country. They will also understand what drives borrowing decisions for firms quoted at the NSE.

It will provide a solid and rich foundation for future researchers determined to explore further in this field. The study will further create linkages and contribute to the body of knowledge as to what influences long term debt decisions from a Kenyan perspective.
CHAPTER TWO

LITERATURE REVIEW

2.1 Introduction

This chapter is divided into three parts. The first part reviews the theories related to this study while the second part covers the empirical studies in relation to the effects of interest rates, tax shelter benefits and firm size on long term debt decisions. Finally, the third chapter draws a conclusion based on the reviews and also provides a knowledge gap.

2.2 Theoretical Review

2.2.1 The Pecking Order Theory

The pecking order theory of capital structure is among the most influential theories of corporate leverage. Originally developed by Myers-Majluf (1984), it considers the role of information asymmetries (with regard to presently held assets and investment opportunities) between firms and capital markets. According to Myers (1984) firms use internal funds that are less costly than external funds. When outside funds are necessary, firms prefer debt to equity because of lower information costs associated with debt issues, while equity is rarely issued. Later, these ideas were refined into testable predictions and confirmed by Vogt (1994) who finds that internal funds have an important influence in firm’s investment decisions; pecking order behavior is most pronounced in firms that have low long-run dividend payout policies.

2.2.1.1 Adverse Selection

The most common motivation for the pecking order is adverse selection developed by Myers and Majluf (1984) and Myers (1984). The key idea is that the owner-manager of the firm knows the true value of the firm’s assets and growth opportunities. Outside investors can only guess these values. If the manager offers to sell equity, then the outside investor must ask why the manager is willing to do so. In many cases the manager of an overvalued firm will be happy to sell equity, while the manager of an undervalued firm will not.
The subsequent theoretical literature has considered many versions of adverse selection problems. Generally, the results are not as elegant as the standard pecking order suggests. For example, the adverse selection model of Myers and Majluf (1984) assumes one-sided asymmetric information in which a firm selects securities for cash. However, if information asymmetry is two-sided (Eckbo et al. 1990), there are several possible equilibria leading to the firm’s preference for stock, or a combination of stock and cash over pure cash. Thus, in mergers with two-sided information asymmetry, firms sometimes actually prefer stock transactions over cash transactions. Dybvig and Zender (1991) show that properly designed managerial compensation contracts (with compensation tied to the value of the firm) could solve adverse selection problems. However, in practice, one rarely observes managerial compensation contracts that are linked to firm value; they are mostly tied to equity value. Viswanath (1993) considers a world with more than one period and he finds that the results depend on how the first- and the second-period uncertainties are related. Ravid and Spiegel (1997) consider adverse selection with no assets in place to start with. This results in entrepreneur and the investor splitting the proceeds. In their setting, as in the examples discussed above, firms will use riskless debt before turning to equity financing.

Eckbo and Masulis (1992) and Eckbo and Norli (2004) extend the basic adverse selection model to allow for current shareholder participation in equity issue and underwriter quality certification. Adverse selection would be less severe if current shareholders were allowed to participate in the equity issue. In their model, firms that expect a high proportion of their current shareholder to take-up new issues face low adverse selection and prefer to issue uninsured rights. Firms with expectations of low current shareholder take-up prefer to issue equity using firm commitment underwritten offerings.

Firms with expectations of intermediate current shareholder take-up issue equity using standby rights. This implies what might be termed a pecking order of equity floatation method choices. Halov and Heider (2005) argue that the standard pecking order is a special case of adverse selection. When there is adverse selection about firm value, firms prefer to issue debt over outside equity and standard pecking order models apply. However, when there is asymmetric
information about risk, adverse selection arguments for debt apply and firms prefer to issue external equity over debt. Thus, adverse selection can lead to a preference for external debt or external equity depending on whether asymmetric information problems concern value or risk.

2.2.2 The Signaling Theory

The concept of signaling was first studied in the context of job and product markets by Akerlof and Arrow and was developed into signal equilibrium theory by Spence (1973), which says a good firm can distinguish itself from a bad firm by sending a credible signal about its quality to capital markets. The signal will be credible only if the bad firm is unable to mimic the good firm by sending the same signal. If the cost of the signal is higher for the bad type than that of the good type firm, the bad type may not find it worthwhile to mimic, and so the signal could be credible. Ross (1977) shows how debt could be used as a costly signal to separate the good from the bad firms. Under the asymmetric information between management and investors, signals from firms are crucial to obtain financial resources. Ross assumes that managers (the insiders) know the true distribution of firm returns, but investors do not. Signaling of higher debt by managers then suggests an optimistic future and high quality firms would use more debt while low quality firms have lower debt levels. In this way, a good firm can separate itself by attracting scrutiny while the bad firm will not mimic because the bad firm will not want to be discovered.

Two types of signaling inside information have been suggested: one is the costly signaling equilibrium discussed by Spence (1973) and Talmor (1981), the other is the costless signaling equilibrium as proposed by Bhattacharya and Heinkel (1982). A signal is costly if the production of the signal consumes resource or if the signal is associated with a loss in welfare generated by deviations from allocation or distribution of claims in perfect markets. The signaling paradigm is multivariate for financial instruments. Poitevin (1989) demonstrates that debt could be used as a signal to differentiate the potential competition of new entrant firms. Low cost entrants signal this fact by issuing debt while the incumbent or high cost entrants issue only equity; Harris and Raviv (1985) argue that calling firm’s convertibles can be a kind of signal and Bhattacharya and Dittmar (1991) show stock repurchase is another kind of signal to represent firm value.
2.2.3 The Trade-Off Theory

The term trade-off theory is used by different authors to describe a family of related theories. In all of these theories, a decision maker running a firm evaluates the various costs and benefits of alternative leverage plans. Often it is assumed that an interior solution is obtained so that marginal costs and marginal benefits are balanced. The original version of the trade-off theory grew out of the debate over the Modigliani-Miller theorem. When corporate income tax was added to the original irrelevance proposition (Modigliani and Miller, 1963), this created a benefit for debt in that it served to shield earnings from taxes. Since the firm’s objective function is linear, and there is no offsetting cost of debt, this implied 100% debt financing.

To avoid this extreme prediction, an offsetting cost of debt is needed. The obvious candidate is bankruptcy. Kraus and Litzenberger (1973) provide a classic statement of the theory that optimal leverage reflects a trade-off between the tax benefits of debt and the deadweight costs of bankruptcy. According to Myers (1984), a firm that follows the trade-off theory sets a target debt-to-value ratio and then gradually moves towards the target. The target is determined by balancing debt tax shields against costs of bankruptcy.

Several aspects of Myers’ definition merit discussion. First, the target is not directly observable. It may be imputed from evidence, but that depends on adding a structure. Different papers add that structure in different ways. Second, the tax code is much more complex than that assumed by the theory. Depending on which features of the tax code are included, different conclusions regarding the target can be reached. Graham (2003) provides a useful review of the literature on tax effects.

Third, bankruptcy costs must be deadweight costs rather than transfers from one claimant to another. The nature of these costs is important too. Are these fixed costs? Do they increase with the size of the bankruptcy? Are the costs one-time costs like a lawyer’s fees, or are they permanent costs like the cost of a damaged reputation? Haugen and Senbet (1978) provide a useful discussion of bankruptcy costs. Fourth, transactions costs must take a specific form for the analysis to work. For the adjustment to be gradual rather than abrupt, the marginal cost of
adjusting must increase when the adjustment is larger. This assumed form of adjustment cost is rather surprising since one expects to see large fixed costs and perhaps roughly constant marginal costs. This implies a very different adjustment path. Leary and Roberts (2005a) describe the implications of alternative adjustment cost assumptions.

2.2.4 Contracting Costs Hypotheses
Although his research does not delineate debt into specific maturities, the ideas of Myers (1977) tend to indicate that firms should use more long-term debt. According to Myers, future investment opportunities represent options whose value depends upon exercising them at the optimum time. While the market recognizes the value of these growth opportunities, their value is not reflected on the book values of the balance sheet. With more growth opportunities, the conflict between lenders and owners increases. Accordingly, the owners of a firm can reduce these conflicts by reducing the amount of debt in the capital structure, shortening the maturity of the debt, or both.

In a related sense firm assets can be roughly divided into two groups: Those that are heavily dependent upon further investment by the firm and those that are largely unrelated to additional firm investment. The distinction must be considered rather generally, as the values of nearly all assets are dependent upon further investment by the firm. However, Myers argues that variable costs can be considered discretionary investments—including labor, marketing and research and development costs. On the other hand, physical plant expenditures (“assets in place”) have costs associated with them that can be considered non-discretionary (interest expense, for example). Accordingly, firms with greater future discretionary investment or growth opportunities should use less debt, as found by Barclay and Smith (1995). On the other hand, firms with more assets in place should use more debt.

An additional argument related to growth opportunities involves debt maturity. Given the conflict between owners and lenders, numerous considerations may have to be made to insure optimal investment decisions. Myers (1977) suggests numerous methods for solving this conflict including rewriting and renegotiating debt contracts. However, these methods may produce contracts that are difficult to enforce or costly to construct. Therefore, one relatively efficient
solution for firms with significant growth opportunities is to reduce the maturity of their debt. Accordingly, one would expect firms with more assets in place to not only have more debt, but more long-term debt as well. Furthermore, recent research by Wald (1999) provides empirical evidence of a positive relationship between assets-in-place (property, plant and equipment) and the use of long-term debt for a wide variety of domestic and international firms.

The problem of moral hazard is also related to the contracting costs. As previously mentioned, Myers (1977) argues that debt can create agency problems between owners and lenders, leading to more costly contracting. An increase in debt causes shareholders to invest suboptimally, thereby leaving any downside risk to the lenders. As discussed by Wald (1999), the amount of physical assets in place such as plant and equipment may show creditors that these assets are being gainfully employed. Because lodging firms usually have a majority of their capital invested in fixed assets, it follows that the direct relationship between the use of debt and the amount of physical assets employed should operate for lodging firms.

Another consideration may be firm size. Debt issues have a significant fixed cost component that may not be afforded by smaller firms. Barclay and Smith (1995) found evidence to support this assumption. Smaller firms that cannot afford the out-of-pocket costs associated with long-term debt issues prefer private short-term debt. This preference is confirmed by Wald (1999), who found a positive relationship between firm size and long-term debt for both U.S. and international firms. Moreover, larger firms have a more diluted ownership structure, encouraging the use of debt as the potential for personal bankruptcy losses decreases.

2.2.5 Tax Hypotheses

DeAngelo and Marsulis (1980) argue that firms with greater non-debt tax shields issue less debt. MacKie-Mason (1990) found a negative relationship between the amount of depreciation taken by a firm and the use of debt. Moreover, given the fixed-asset intensive nature of the industry, non-debt tax shields may be significant in determining the capital structure of hotel firms.

The previous discussion reveals that firms with a significant amount of physical assets will issue more long-term debt because of moral hazard effects. On the other hand, a significant amount of
depreciation attached to physical assets should be negatively correlated with debt. As shown by Wald (1999), both physical plant and depreciation must be included in a statistical analysis to segregate their effects. Wald found a positive relationship between long-term debt and physical assets and a negative relationship between long-term debt and depreciation tax shields.

2.3 Empirical Review

The financial literature has examined debt as a factor that influences firm performance as well as the other way around. For example, Supanvanij (2006) uses a measure of profitability (the ratio of operating income to total assets) as an agent affecting the use of long-term debt by Asian firms. He finds a negative relationship between profitability and long-term debt for all Asian firms, although it is only modestly significant. However, a significant negative relationship is found for Japanese firms alone. Thus, highly profitable Japanese firms use less debt.

On the other hand, Abor (2005) examines the relationship between debt and return on equity for firms in Ghana using a number of debt measures as independent variables in regression models. His findings are interesting in that he finds a negative relationship between long-term debt and return on equity (ROE), but a positive relationship between short-term debt and ROE. Thus, firms that use more long-term debt have a lower ROE. Ruland and Zhou (2005) examine the relationship between debt, diversification and firm value. Although their focus is on diversification, they assess how long-term debt affects a firm’s ‘‘excess value’’. Excess value is defined as a firm’s market value above and beyond the average for its industry. Their results indicate a significantly negative relationship between long-term debt and excess market value. This result is similar to Abor (2005) in that long-term debt appears to reduce shareholder value.

2.3.1 Interest rates effects on long term debt decisions

Debt financing is one component of the capital structure, the other being equity. Interest rate is a very important determinant of long-term debt financing decisions because it carries with it the threat of liquidation. A study done in the United Kingdom by Ooi (2000) using the quantitative research design involving 50 companies using a regression model did indicate that interest rate is significant determinant of the bank debt ratio of property companies. This is consistent with
the findings of Eriotis, Vasilio and Ventoura-Neokosmidi (2007) who researched on the determinants of interest rates using a multivariate model and concluded that there is a negative relation between the debt ratio of the firms and their growth, their quick ratio and their interest rates. Size appears to maintain a positive relation and according to the dummy variable there is a differentiation in the capital structure among the firms with a debt ratio greater than 50 per cent and those with a debt ratio lower than 50 percent.

These findings are not restricted to the developed economies only. A survey conducted on 91 companies in Sri Lanka using a multivariate model to test the determinants of corporate financing by Sisira and Colombage (2007) did indicate corporate financing decisions seem to be influenced mostly by interest and tax considerations, while lesser weight is accorded to financial flexibility in determining the amount of funds to be raised externally through debt contracts. The evidence largely supports the propositions of the pecking order model, but also confirms some predictions found in static trade-off theory.

However not all studies have supported this view point. Gama, Gulamhussen and Esperança, (2003) disputed earlier studies because corporate debt policy has previously been studied in the context of both large and small firms in developed countries, but comparatively less developed countries have received much less attention in the literature. They used the pooled time series cross-section regression estimates for 995 firms over a four year period to investigate determinants of debt financing in the context of the developing world and suggested that variables such as taxes, bankruptcy costs, size, collateral, age and growth opportunities affect the capital structure decisions of small firms. The study did not find evidence of interest rates being influential in financing decisions. Additionally it is the debt capacity that is a major determinant of financial decisions and never interest rates (Woodruff, 2007). Creditors can also use the estimated debt capacity when deciding the terms (including the interest rate) of extending credit. Investors can shy away from companies with very little or no unused debt capacity to reduce their portfolio risk. This thus suggests that firms can borrow so as to appeal to investors. This is consistent with the signaling theory where it is postulated that borrowing is an important strategic tool available to a company in order to communicate its quality to investors.
Casey, Sumner and Packer (2006) used a crossectional model to investigate the influence of interest rates on debt financing using a sample of 80 companies in the UK and reported that the potentiality of interest rates to influence debt decisions is minimal. The study which used a qualitative research design did find out that investors do appear to be attracted to specific debt characteristics capital structure and is influenced by market factors. The debt levels appear to be directly influenced by the price-to-book ratio and are inversely related to the percentage of institutional ownership and price-to-cash flow. Interest rates do not appear to significantly influence debt while the type of REIT (mortgage, retail, etc.) does appear to influence the level of debt.

Interest rates do not appear to have impact on the hi-tech business referred to as the ‘new economy. Platt (2006) used the quantitative research design by incorporation a regression model to investigate the effects of interest rates hike for hi-tech firms and reported that their reaction to these interest rates hikes can be described as sluggish at best. At least one cause of this reduced sensitivity is that the firms responsible for the 1999 economic expansion respond differently to monetary pressure than the Federal Reserve expected. High technology businesses face unique conditions that will alter their incentives regarding interest rates. Due to their cost structure and their use of venture capital financing, the output of these firms is less sensitive to interest rate changes. Moreover, these firms will take longer to exhibit this response than traditional firms do. However, these conditions do not create perfect inelasticity.

Unlike in traditional industries, interest rates do not have any impact on developed products. Brick and Palmon (2006) researched on the impact of interest rates on products developed in the hi-tech industries using a regression model. The findings did point out that once a technology firm has developed the information needed for a product; it has already made the largest portion of its expenditures. Reproducing this information to sell it costs a mere pittance in comparison. This lopsided cost structure reduces the impact an interest rate change will have on an operating venture.
2.3.2 Tax shelter benefits and distress costs influence long term debt decisions

Graham and Tucker (2005) aver that tax incentives vary among the firms, almost entirely due to current or prospective tax losses. Results are inevitably mixed, given that firms with losses or non-debt tax shields may have different propensities to borrow even ignoring taxes. Their research used the US Statistics of Income balance sheet data on all corporations, to compare the debt policies of firms of different sizes. Given the progressive rise in the corporate tax schedule, small firms face very different tax rates than larger firms. The results suggest that taxes have had a strong and statistically significant effect on debt levels. In particular, the difference in corporate tax rates currently faced by the largest vs. the smallest firms is forecast to induce larger firms to finance an additional 8% of their assets with debt, compared with smaller firms.

Dav and Leatham (2001) used a survey design by incorporating a time series model to determine whether tax rate was important in the usage of interest rate swaps in corporate debt financing decisions. The empirical results show that the firms with higher effective tax rates reduce their optimal debt ratio range when they use interest rate swaps. It was also found that the swap users may enlarge the influence of firm size on corporate dynamic debt policy, though it was not clear that it helped reduce or increase the optimal debt ratio range. No effect of swaps usage on the optimal debt ratio range was found related to bankruptcy costs and the volatility of income. The findings imply that the use of swaps can help firms stick to an initial high debt ratio and make more use of the large tax benefits of debts on debt financing decisions. This is also consistent with the findings of Grey and Laffer (1989) who suggested that companies who want to buy out other companies are likely to use debt financing. Tax arbitrage is feasible when corporations are carrying assets at historical cost. With undervalued assets in a positive inflation environment, it can be seen that in some cases the actual sum of the parts of the company is greater than the whole (i.e., the current market value). The corporate raider recognizes this disparity and raises the money necessary to take over the company. This larger amount paid for the company values the corporation's capital more realistically. The takeover agent then sells off components of the company at their value and realizes a capital gain. A substantial one-time capital gains tax (at a lower rate than the corporate tax rate) is levied, and the company is now free to use all of its cash flow to service the debt. The previous earnings stream that was once tapped for dividends is
freed to pay interest. To the corporation, the increased interest payments are tax free, the previously paid dividends were not. So the effective tax rate on the company has been substantially reduced.

Desai and Dharmapala (2005) used a multivariate model to investigate the relationship between corporate tax avoidance, debt financing and shareholder interests. The research which used a quantitative design reported that unexplained differences between income reported to capital markets and to tax authorities are used to proxy for tax avoidance activity. These “book-tax” gaps are shown to be larger when firms are alleged to be involved in tax shelters. Ordinary least squares estimates indicate that the average effect of tax avoidance on firm value is not significantly different from zero, but is positive for well-governed firms as predicted by an agency perspective on corporate tax avoidance. An exogenous change in tax regulations that affected the ability of some firms to avoid taxes is used to construct instruments for tax avoidance activity. The estimates yield larger overall effects and reinforce the basic result that higher quality firm governance leads to a larger effect of tax avoidance on firm value. The results are robust to a wide variety of tests for alternative explanations. Taken together, the results suggest that the simple view of corporate tax avoidance as a transfer of resources from the state to shareholders is incomplete given the agency problems characterizing shareholder-manager relations and is thus inappropriate in explaining corporate financing decisions.

Fazzari, Hubbard and Petersen (2005) reported that firms choose finance from a mix of debt, internal funds and equity. The implication for tax policy is clear. The marginal tax of return on new project matters for investments not the firm’s average tax burden from its investments in place. For firms that face imperfect external markets for finance however, it is not sufficient to focus on the cost of funds determined in the securities market. Specifically if the cost of finance differs substantially from external finance, their investments depend on cash flow. For these firms, the amounts devoted to tax matters for investments, possibly with the incentives efforts of marginal tax rates.

Desai and Dharmapala (2006) used a time series model to investigate the proliferation of corporate tax shelters in recent American history and reported that Corporations may be
motivated to pursue debt financing because the attendant tax shelters benefits the shareholders. Initial explorations of these shelters suggest that a purely tax-driven motivation for these activities is not sufficient to account for many of their features. Second, the magnitude of corporate tax rates is sufficiently high relative to levels of ownership concentration that it is reasonable to characterize the state as the largest claimant on pretax corporate cash flows. Such a transaction merely diverts resources from the state to shareholders. For there to be a meaningful intersection of taxation and corporate governance, it must be the case that ownership and management are separated and that the incomplete nature of contracting and monitoring creates the scope for managerial opportunism.

2.3.3 Effect of Firm size on long term decisions
Empirically, the relationship between debt maturity and firms’ characteristics is not observed in all studies. For example, Barclay and Smith (1995a) show that long term debt is likely to be used by larger firms, those that are regulated and those with high credit quality but less by those with growth opportunities. Stohs and Mauer (1995) show that debt maturity rises with a firm’s size, and decreases with level of risk. They find, however, mixed support for an inverse relationship between debt maturity and growth opportunities. Guedes and Opler (1996) analyse the maturity of new debt issues to find that size, bond ratings and lack of growth opportunities are important determinants of a firm’s propensity to borrow long-term. Their results do not support the signalling and taxation hypotheses.

According to the trade-off theory there should be a positive relationship between firm size and debt ratio, because larger firms are better diversified and have a lower probability of experiencing financial distress. Lower bankruptcy costs allow large firms take advantage of leverage (Antoniou et al., 2002). On the contrary, the pecking order theory implies a negative relationship between firm size and debt ratio, since information asymmetrical is less severe issue in big firms. Thus, big firms' cost of capital should be less than that of small firms (Zou and Xiao, 2006). Empirical studies generally found a positive relationship between the two variables, and hence support for the trade-off theory (Dalbor and Upneja, 2002;
The analysis of the priority structure of corporate debt is not well researched. The only study that addressed this issue directly is Barclay and Smith (1995b). They show that, in general, consistent with the agency theory, the priority structure of corporate debt is dependent on firms’ growth opportunities and regulation dummy. However, for ordinary and subordinated debt, regulation dummy is not significant. Similarly, taxation explains capitalized leases and preferred stocks but does not explain firm’s use of secured and subordinated debt. Most previous studies have, however, analyzed the determinants of each component of debt priority individually.

For example, a large number of studies show that leasing propensity is associated with tax-related factors (Graham, Lemmon and Schallheim, 1998), firm’s debt capacity (Marston and Harris (1988); firm’s size (Sharpe and Nguyen, 1995), in firms with assets that make good collateral (Finucane (1988), in firms with high growth opportunities and those that are not regulated (Barclay and Smith (1995b), in firms with high proportion of insider ownership (Mehran and Taggart (1996) and in certain industries (Finucane (1988). These results are consistent with the tax effects, debt substitutability and agency costs. However, other studies show that taxation does not explain firms’ leasing decision (Mehran and Taggart (1996)).

2.4 Conclusion

Debt issues pay for the largest proportion of new investments, particularly for large firms. Equity has a relatively small role. This initial pattern seems consistent with a pecking order view of capital structure. Over time, however, firms systematically replace the new debt with equity funds. Relative to large firms, small firms rely more on issuing new equity to replace debt, while medium-sized firms tend to use internal cash flow. This seems inconsistent with the pecking order theory of capital structure, because smaller firms are often said to confront higher information costs in selling their shares.
CHAPTER THREE

RESEARCH METHODOLOGY

3.1 Introduction
This chapter outlines the methods and procedures used in this research. The chapter covered the research design used, the population of interest, the sampling methodology, the sample size, data collection methods, the analysis and presentation of the results.

3.2 Research Design
Research design is the plan and structure of investigation so developed as to obtain answers to research questions. The plan is the overall scheme or program of the research (Robson, 2002). According to Cooper & Schinder (2003), there are many definitions of research design but no one definition impacts the full range of important aspects. The research design used for the study was descriptive research design. Gay (1983) defines descriptive research as a process of collecting data to test hypothesis or to answer questions concerning the current study. Hypothesis are made but not yet tested or questions are asked but not yet answered. The researcher has to collect data to answer questions to research questions in order to provide recommendations.

Furthermore, descriptive research determines and reports the way things are. It portrays the facts as it really is; if another researcher goes to the field now, he or she will find the situation as described (Mugenda & Mugenda, 2003). These writers claim the descriptive research design is one of the best methods for conducting research in human contexts because of portraying accurate current facts through data collection for testing hypothesis or answering questions to conclude the study (Robinson 2002, Chandran 2004). The study questions for this study were answered through the description of the current status of long term debt financing decisions in companies listed at the NSE.

3.3 Population

3.3.1 Population

“A population is an entire group of individuals, events or objects having common characteristics that conform to a given specification.” (Mugenda & Mugenda, 2003: 9). According to Saunders
(2003) the population is the full set of cases from which a sample is taken. The population of interest was 47 companies quoted at the Nairobi Stock Exchange. The target population included all the quoted companies at the NSE.

3.3.2 Study Sample

“Sampling is the process of selecting a number of individuals for a study in such a way that the individual selected represents the large group from which they are selected.” (Mugenda & Mugenda, 2003: 260). Sampling procedure may be defined as a systematic process of individuals for a study to represent the larger group from which they are selected (Cooper and Schindler, 2003; Robson, 2002).

This study employed a census method as the sampling technique that involved the entire population of the 47 companies. According to Cooper & Schindler (2007) a census is feasible when the population is small and necessary when the elements are quite different from each other. When the population is small and variable, any sample we draw may not be representative of the population from which it is drawn.

3.3.3 Sample Size

According to Chandran (2003) a sample is a small proportion of an entire population; a selection from the population. The entire population of 47 companies quoted at the NSE was taken and thus no need for sampling.

3.4 Data Collection

Data collection is gathering empirical evidence in order to gain new insights about a situation and answer questions that prompt undertaking of the research (Flick, 1998). Primary and secondary data are the types of data collected. Primary data is defined as first hand information received from a respondent. Data that has been already collected and process is secondary data (Chandran, 2003). According to Chandran (2003), questionnaire is a series of written questions on a topic about which the respondents’ opinions are sought. Questionnaires provide a high degree of data standardization and adoption of generalized information amongst any population. They are useful in a descriptive study where there is need to quickly and easily get information
from people in a non-threatening way. In this study, questionnaires were circulated to the companies through drop and pick method.

The secondary data was collected from the NSE. The NSE maintains annual financial statements of all listed companies. Since these financial statements comply with the International Financial Reporting Standards, then they were deemed to provide an accurate and true position of the firm’s operations in any given year. Data relating to interest rates, tax rate, and debt ratio was derived from these financial statements. The same financial statements provided the debt / equity (D/E) ratio for each of the sampled companies annually for the entire research period.

3.5 Data Analysis

The whole process which starts immediately after data collection and ends at the point of interpretation and processing data is data analysis (Cooper & Schindler, 2003). Chandran (2004), defines statistics as a discipline that provides the tools of analysis in research and one which refers to facts, information or data and to a system of data collection and analysis.

Factor analysis, a statistical method used to describe variability among observed variables in terms of a potentially lower number of unobserved variables, was utilized in this study. The information gained about the interdependencies between observed variables can be used later to reduce the set of variables in a dataset. In this study, data was analyzed through the help of Statistical Package for Social Science (SPSS) Version 17 and the data was presented in tables and graphs.
CHAPTER FOUR

DATA ANALYSIS AND INTERPRETATION

4.1 Introduction
This chapter entails the findings of the study based on the data collected from the field. The analysis focused on factors influencing long term debt decisions by companies quoted at the Nairobi stock exchange. A sample size of 47 companies quoted at the Nairobi Stock Exchange was used and 38 of them successfully responded. The data was analyzed using Statistical Package for social sciences (SPSS) and the information was presented in form of pie charts, bar graphs and tables.

4.2 Response rate
This section sought to show the actual number of respondents who responded in the study against the targeted sample size. The findings are shown in table 4.1 below.

Table 4.1 Response rate

<table>
<thead>
<tr>
<th></th>
<th>Frequency</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Non-respondents</td>
<td>9</td>
<td>19.1</td>
</tr>
<tr>
<td>Actual response</td>
<td>38</td>
<td>80.8</td>
</tr>
<tr>
<td>Target Population</td>
<td>47</td>
<td>100</td>
</tr>
</tbody>
</table>

The study targeted 47 companies quoted at the Nairobi Stock Exchange who were a representation of 100% of the total sample size. However, the study managed to successfully collect data from 38 respondents who represented 80.8% of the total sample size. This sample size was reliable to meet the objectives of the study. Only 19.1% of the respondents did not respond.

4.3 Demographic Information
In order to capture the general information of the respondents under study issues such position in the company and duration worked at the organization were addressed in the first section of the
questionnaire. This was important because it enhanced reliability and gave the basic understanding of the respondents.

4.3.1 Position in the company

The study sought to show the position of the respondents in the company. Figure 4.1 shows the findings of the study.

**Figure 4.1 Position in the company**

The study established that majority (45%) of the respondents indicated that they were finance managers, 32% said that they were chief accountants, 18% indicated that there were accountants while 5% said that there were finance directors.

4.3.2 Duration worked in the company

This section of the study sought to show the duration the respondents had worked in the company. Figure 4.2 shows the findings.

**Figure 4.2 Duration worked in the company**
Majority of the respondents indicated that they had worked in the company for 6-10 years and were represented by 58%, 26% indicated that they had worked in the organization for duration of 0-5 years while 16% said that they had worked in the organization for over 10 years.

4.4 Type of debt finance used

This section of the study sought to show the extent which the company agreed with the following statements, extent which the company preferred the following sources of financing and extent to which they preferred debt financing to be paid.

4.4.1 Extent to which the company agrees with the following statements

This section of the study sought to show the extent to which the company agrees with the following statements and table 4.2 shows the findings.

Table 4.2 Extent to which the company agrees with the following statements

<table>
<thead>
<tr>
<th></th>
<th>Strongly Disagree</th>
<th>Disagree</th>
<th>Undecided</th>
<th>Agree</th>
<th>Strongly Agree</th>
</tr>
</thead>
<tbody>
<tr>
<td>This company uses long term debt for financing</td>
<td>2 5.2</td>
<td>4 10.5</td>
<td>6 15.7</td>
<td>21 55.2</td>
<td>5 13.1</td>
</tr>
<tr>
<td>This company is under regulation</td>
<td>2 5.2</td>
<td>3 7.8</td>
<td>5 13.1</td>
<td>25 65.7</td>
<td>3 7.8</td>
</tr>
<tr>
<td>The company determines the financing decisions</td>
<td>1 2.6</td>
<td>2 5.2</td>
<td>2 5.2</td>
<td>30 78.9</td>
<td>3 7.8</td>
</tr>
</tbody>
</table>

From the table, majority (55.2%) of the respondents agreed while 15.7% were undecided whether the company used long term debt for financing. On the other hand, 65.7% agreed while 13.1% were undecided whether that the company was under regulation. Further 78.9% of the respondents agreed that the company size determined the financing decisions; this was concurred by 7.8% who strongly agreed.

4.4.2 Extent to which the company prefers the following sources of financing

The study sought to show the extent to which the company prefers the following sources of financing. Table 4.3 shows the findings.
Table 4.3 Extent to which the company prefers the following sources of financing

<table>
<thead>
<tr>
<th>Source of Financing</th>
<th>Very low extent</th>
<th>Low extent</th>
<th>Moderate extent</th>
<th>High extent</th>
<th>Very high extent</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bonds</td>
<td>10 F 26.3 %</td>
<td>14 F 36.8 %</td>
<td>2 F 5.2 %</td>
<td>5 F 13.5 %</td>
<td>7 F 18.4 %</td>
</tr>
<tr>
<td>Commercial papers</td>
<td>3 F 7.8 %</td>
<td>12 F 31.5 %</td>
<td>20 F 52.6 %</td>
<td>1 F 2.6 %</td>
<td>2 F 5.2 %</td>
</tr>
<tr>
<td>Money market loan from financial institutions</td>
<td>3 F 7.8 %</td>
<td>2 F 5.2 %</td>
<td>3 F 7.8 %</td>
<td>25 F 65.7 %</td>
<td>5 F 13.5 %</td>
</tr>
<tr>
<td>Offshore loans from international financial institutions</td>
<td>2 F 5.2 %</td>
<td>15 F 65.7 %</td>
<td>8 F 21.0 %</td>
<td>7 F 18.4 %</td>
<td>6 F 15.7 %</td>
</tr>
<tr>
<td>Syndicated loans</td>
<td>1 F 2.6 %</td>
<td>25 F 65.7 %</td>
<td>5 F 13.5 %</td>
<td>4 F 10.5 %</td>
<td>3 F 7.8 %</td>
</tr>
<tr>
<td>New issue of shares</td>
<td>2 F 5.2 %</td>
<td>15 F 39.4 %</td>
<td>9 F 23.6 %</td>
<td>6 F 15.7 %</td>
<td>6 F 15.7 %</td>
</tr>
</tbody>
</table>

Most of the respondents (36.8%) indicated to a low extent that the company preferred bonds as a source of financing; this was concurred by 26.3% who indicated that the company used bonds to a very low extent. On the other hand 52.6% indicated to a moderate extent the use of commercial papers in the company while 31.5% indicated the use of the papers to a low extent. In addition 39.4% of the respondents revealed that the company used offshore loans from international financial institutions to a low extent while twenty one percent indicated to a moderate extent. The respondents indicated to a low extent that the company preferred syndicated loans and this was represented by 65.7% while 13.5% indicated that the loans were preferred to a moderate extent. The respondents further indicated that the company preferred new issue of shares to a low extent, this was represented by 39.4% while 23.6% indicated that the company preferred to a moderate extent.

4.4.3 Extent to which the company prefers debt financing to pay the following

The study sought to show the extent to which the company preferred debt financing to pay the following. Table 4.4 shows the results of the findings.
### Table 4.4 Extent to which the company prefers debt financing to pay the following

<table>
<thead>
<tr>
<th></th>
<th>Very low</th>
<th></th>
<th>Low</th>
<th></th>
<th>Moderate</th>
<th></th>
<th>High</th>
<th></th>
<th>Very high</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>F</td>
<td>%</td>
<td>F</td>
<td>%</td>
<td>F</td>
<td>%</td>
<td>F</td>
<td>%</td>
<td>F</td>
<td>%</td>
</tr>
<tr>
<td>Acquiring new assets</td>
<td>1</td>
<td>2.6</td>
<td>2</td>
<td>5.2</td>
<td>3</td>
<td>7.8</td>
<td>17</td>
<td>44.7</td>
<td>15</td>
<td>39.4</td>
</tr>
<tr>
<td>Expansion of existing assets</td>
<td>10</td>
<td>26.3</td>
<td>20</td>
<td>52.6</td>
<td>4</td>
<td>10.5</td>
<td>2</td>
<td>5.2</td>
<td>2</td>
<td>5.2</td>
</tr>
<tr>
<td>Payment to suppliers</td>
<td>5</td>
<td>13.5</td>
<td>25</td>
<td>65.7</td>
<td>3</td>
<td>7.8</td>
<td>2</td>
<td>5.2</td>
<td>3</td>
<td>7.8</td>
</tr>
</tbody>
</table>

From the table, most (44.7%) of the respondents indicated to a high extent that they preferred debt financing for acquiring new assets, this was concurred by 39.4% who indicated that they preferred to a very high extent. On the other hand 52.6% indicated to a low extent that the company preferred debt financing for expansion of existing assets while 26.3% indicated to a very low extent. Further 65.7% of the respondents indicated to a low extent that debt financing was preferred for payment to suppliers while this was concurred by 13.5% who indicated to a very low extent.

### 4.5 Impact of interest rates on long term debt decisions

The study sought to show how interest rate affects the company borrowing decisions, and the extent to which the following factors affect their decision to use long term financing.

#### 4.5.1 Interest rates on borrowing decisions

This section of the study sought to show the respondents views on how interest rates affect borrowing decisions. Figure 4.3 shows the findings.
The study shows that all the respondents (100%) were in agreement that interest rates affects their company’s decisions.

4.5.2 Extent to which the following factors affect their decisions to use long term financing

The study sought to show the extent to which the following factors affect their decisions to use long term financing. Table 4.5 shows the findings.

Table 4.5 Extent to which the following factors affect their decisions to use long term financing

<table>
<thead>
<tr>
<th>Factor</th>
<th>Very low</th>
<th>Low</th>
<th>Moderate</th>
<th>High</th>
<th>Very high</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>F</td>
<td>%</td>
<td>F</td>
<td>%</td>
<td>F</td>
</tr>
<tr>
<td>Interest rates</td>
<td>3</td>
<td>7.8</td>
<td>2</td>
<td>5.2</td>
<td>8</td>
</tr>
<tr>
<td>Shareholders composition</td>
<td>10</td>
<td>26.3</td>
<td>15</td>
<td>39.4</td>
<td>8</td>
</tr>
<tr>
<td>Tax shelter benefit</td>
<td>4</td>
<td>10.5</td>
<td>6</td>
<td>15.7</td>
<td>9</td>
</tr>
<tr>
<td>Availability of projects</td>
<td>2</td>
<td>5.2</td>
<td>3</td>
<td>7.8</td>
<td>6</td>
</tr>
<tr>
<td>Future cash flows</td>
<td>3</td>
<td>7.8</td>
<td>4</td>
<td>10.5</td>
<td>10</td>
</tr>
<tr>
<td>Distress costs</td>
<td>5</td>
<td>13.1</td>
<td>12</td>
<td>31.5</td>
<td>16</td>
</tr>
</tbody>
</table>

Majority (52.6%) of the respondents indicated to a high extent that interest rates affect their decisions to use long term financing; this was concurred by 21% who indicated to a moderate extent. In addition 39.4% indicated that shareholders composition affected their decisions to use
long term financing to a low extent while 26.3% indicated that their decisions were affected to a very low extent. Most (36.8%) of the respondents indicated that tax shelter benefit affected their decisions to use long term financing to a high extent while 23.6% indicated that it affected decisions to a moderate extent. On the other hand 34.2% indicated that future cash flows affected their decisions to use long term financing to a high extent while 26.3 indicated that they their decisions were affected to a moderate extent. Distress costs affected decisions for long term financing to a moderate extent and this was represented by 42.1% and concurred by 31.5% who indicated that their decisions were affected to a low extent.

**4.6 Firm size and its effect on the long term debt decisions**

This section of the study sought to show whether the firm size influences long term debt decisions, order of preferences for the following finances and whether the debts in the company are secured, unsecured or subordinate.

**4.6.1 Influence of firm size on long term debt decisions**

The study sought to show whether the firm size influenced long term debt decisions. Figure 4.4 shows the findings.

**Figure 4.4 Influence of firm size on long term debt decisions**

Majority (66%) of the respondents indicated that the firm’s size influenced the company’s long term debt decisions while 34% indicated that the size did not influence debt decisions.
4.6.2 Order of preference for the following debt finances

This section of the study sought to show the respondents order of preference for the following debt finances. Table 4.6 shows the results of the findings.

Table 4.6 Order of preference for the following debt finances

<table>
<thead>
<tr>
<th></th>
<th>Lowest</th>
<th>Low</th>
<th>Moderate</th>
<th>High</th>
<th>Highly</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>F</td>
<td>%</td>
<td>F</td>
<td>%</td>
<td>F</td>
</tr>
<tr>
<td>Bank loans</td>
<td>6</td>
<td>15.7</td>
<td>11</td>
<td>28.9</td>
<td>16</td>
</tr>
<tr>
<td>Overdraft</td>
<td>1</td>
<td>2.6</td>
<td>3</td>
<td>7.8</td>
<td>10</td>
</tr>
<tr>
<td>Long term loans</td>
<td>3</td>
<td>7.8</td>
<td>4</td>
<td>10.5</td>
<td>12</td>
</tr>
<tr>
<td>Intergroup loans</td>
<td>12</td>
<td>31.5</td>
<td>15</td>
<td>39.4</td>
<td>5</td>
</tr>
</tbody>
</table>

The study established that most (42.1%) of the respondents indicated to a moderate extent bank loans in their order of preference while 28.9% indicate to a low extent as their preference. Overdrafts were rated by 52.6% to a high extent by respondents as their order of preference while 26.3% rated to a moderate extent as their order of preference. On the other hand 36.8% rated to a high extent the long term loans while 31.5 % indicated to a moderate extent. Intergroup loans were indicated to a low extent by 39.4% of the respondents as their order of preference while 31.5% indicated to a lowest extent in their order of preference.
4.6.3 Debts

This section of the study sought to show whether the debts of the company were secured, unsecured or subordinate. Figure 4.5 shows the findings.

**Figure 4.5 Nature of the Company’s Debts**

![Pie chart showing the nature of the company's debts. 66% are secured, 24% are unsecured, and 11% are subordinate.]

The study established that majority (66%) of the respondents indicated that their debts were secured, 24% indicated that their debts were unsecured while 11% indicated that their debts were subordinate.

4.7 Extent of tax benefits effects on long term debt decisions

The study sought to show whether the corporate tax rate influences the company’s borrowing position and the reasons to this.

4.7.1 Whether corporate tax rate influences the borrowing position

This section of the study sought to show the respondents views on corporate tax rate on borrowing position. Figure 4.6 shows the findings of the study.
Figure 4.6 whether corporate tax rate influences the borrowing position

The study established that majority (74%) of the respondents indicated that corporate tax influenced their borrowing position while 26% indicated that the corporate tax rate did not affect their borrowing.

Majority of the respondents indicated that corporate tax influenced borrowing position because larger firms finance an additional 8% of their assets with debt, compared with smaller firms, thus taxes have a strong and statistically effect on debt levels.

4.8 Factor analysis

4.8.1 Factor analysis on preference of sources of financing

Table 4.7: Total Variance Explained

<table>
<thead>
<tr>
<th>Component</th>
<th>Initial Eigen values</th>
<th>Rotation Sums of Squared Loadings</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Total</td>
<td>% of Variance</td>
</tr>
<tr>
<td>1</td>
<td>2.848</td>
<td>47.469</td>
</tr>
<tr>
<td>2</td>
<td>1.182</td>
<td>19.692</td>
</tr>
<tr>
<td>3</td>
<td>0.932</td>
<td>15.532</td>
</tr>
<tr>
<td>4</td>
<td>0.550</td>
<td>9.161</td>
</tr>
<tr>
<td>5</td>
<td>0.372</td>
<td>6.198</td>
</tr>
<tr>
<td>6</td>
<td>0.117</td>
<td>1.947</td>
</tr>
</tbody>
</table>

Extraction Method: Principal Component Analysis.

From the variance table above the variables that are contributing to the explanation of variances among the six variables are two. The first factor or factor one has a cumulative total of 47.5%
hence an indicator that the level of contribution is very high compared to the other factors. It also means that explaining the variables for each factor will be easier because of the high percentage of the two factors hence the need to use the Scree Plot does not arise.

Table 4.8 Rotated Component Matrix of preference of sources of finance

<table>
<thead>
<tr>
<th>Source of Finance</th>
<th>Component 1</th>
<th>Component 2</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bonds</td>
<td>.721</td>
<td>.015</td>
</tr>
<tr>
<td>Commercial Paper</td>
<td>.830</td>
<td>.129</td>
</tr>
<tr>
<td>Money Market Loan from Financial institution</td>
<td>.747</td>
<td>.089</td>
</tr>
<tr>
<td>Offshore Loan From international Financial institution</td>
<td>.852</td>
<td>-.302</td>
</tr>
<tr>
<td>Syndicated Loan</td>
<td>.496</td>
<td>-.667</td>
</tr>
<tr>
<td>New Issue of Shares</td>
<td>.305</td>
<td>.797</td>
</tr>
</tbody>
</table>


Factor one which can be called external source of finance includes the following variables; bonds, commercial paper Loan from financial institutions local and international and syndicate loans. Factor two which is internal sources has only one variable that is issuing new shares.

4.8.2 Factor analysis on use of debt financing

Table 4.9: Total Variance Explained

<table>
<thead>
<tr>
<th>Component</th>
<th>Initial Eigen values</th>
<th>Rotation Sums of Squared Loadings</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Total</td>
<td>% of Variance</td>
</tr>
<tr>
<td>1</td>
<td>1.235</td>
<td>41.179</td>
</tr>
<tr>
<td>2</td>
<td>1.113</td>
<td>37.101</td>
</tr>
<tr>
<td>3</td>
<td>.652</td>
<td>21.720</td>
</tr>
</tbody>
</table>

Extraction Method: Principal Component Analysis.

Out of the three variables two factors were derived. The two factors have a combined contribution of 78.2% which shows that there is a significant difference between the three variables. From the Scree plot it will also be seen that there is minimal difference between the two variables. The difference between the two and the third variable is also very high as can be seen in the Eigen values.
The Scree plot above shows that the slope between the first two variables is not very steep as compared to the third. Hence this is an indication that two factors can be chosen easily from amongst the three. Further differences are shown below in the rotated matrix.

**Table 4.10: Rotated Component Matrix on use of debt financing**

<table>
<thead>
<tr>
<th>Component</th>
<th>1</th>
<th>2</th>
</tr>
</thead>
<tbody>
<tr>
<td>Acquiring new Assets</td>
<td>.040</td>
<td>.912</td>
</tr>
<tr>
<td>expansion of Existing Assets</td>
<td>-.741</td>
<td>.441</td>
</tr>
<tr>
<td>Payment to Suppliers</td>
<td>.822</td>
<td>.312</td>
</tr>
</tbody>
</table>


As was stated earlier there are two factors derived, the first one payment to suppliers which has a contribution of 82.2%. The second factor, assets, has two variables; acquisition of new assets at 91.2% and expansion of existing assets at 44.1%. Therefore it can be concluded that debt financing will likely be used to acquire new assets and pay suppliers. Other sources of finance are preferred to expand existing assets these may be seen in the fact that it is the only variable with a negative sign in the whole matrix.
4.8.3 Factor analysis on factors affecting decision on use of long term financing

Table 4.11: Total Variance Explained

<table>
<thead>
<tr>
<th>Component</th>
<th>Initial Eigen values</th>
<th>Rotation Sums of Squared Loadings</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Total</td>
<td>% of Variance</td>
</tr>
<tr>
<td>1</td>
<td>1.948</td>
<td>32.470</td>
</tr>
<tr>
<td>2</td>
<td>1.494</td>
<td>24.894</td>
</tr>
<tr>
<td>3</td>
<td>1.079</td>
<td>17.981</td>
</tr>
<tr>
<td>4</td>
<td>.835</td>
<td>13.913</td>
</tr>
<tr>
<td>5</td>
<td>.422</td>
<td>7.035</td>
</tr>
<tr>
<td>6</td>
<td>.222</td>
<td>3.707</td>
</tr>
</tbody>
</table>

Extraction Method: Principal Component Analysis.

From table above it can be seen that there are three factors that have an Eigen value that is greater than one, but due to the fact that more than three will lead to a distortion of the explanation and hence only two factors are chosen. The two factors have a contribution of 57.4% which is a very high contribution to the explanation of the variances. The Eigen value is also very high for the two factors at 1.95 and 1.49. also as will be seen in the Scree plot in the appendix there are three factors that can be chosen but in the rotation matrix of three factors some of the variables will be repeated in more than one factor which will not give a clear outcome.

Table 4.12: Rotated Component Matrix

<table>
<thead>
<tr>
<th>Component</th>
<th>1</th>
<th>2</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest Rate</td>
<td>.865</td>
<td>.107</td>
</tr>
<tr>
<td>Shareholders Composition</td>
<td>.932</td>
<td>-.022</td>
</tr>
<tr>
<td>Tax Shelter Benefit</td>
<td>.351</td>
<td>.626</td>
</tr>
<tr>
<td>Availability of Projects</td>
<td>-.011</td>
<td>.805</td>
</tr>
<tr>
<td>Future Cash Flows</td>
<td>-.117</td>
<td>.705</td>
</tr>
<tr>
<td>Distress Costs</td>
<td>-.066</td>
<td>-.366</td>
</tr>
</tbody>
</table>


Factor one, which can be seen as sources of capital has two variables Interest rate which can be seen as debt and shareholder composition or ordinary shares and preference shares (and one can go further to elaborate on the type of preference shares). Factor two, can be seen to be income because one tax shelter increases income, and two availability of projects increases cash flow which is a source of finance. Distress costs is the only factor that is not contributing because it becomes null as the other variables lead
to cash and not cost. Interest rate contributes 86.5% and shareholder composition contributes 93.2% to factor one while tax shelter contributes 62.6%, availability of project 80.5% and future cash flows 70.5% to factor two.

### 4.8.4 Factor analysis on order of preference for debt financing.

#### Table 4.13: Total Variance Explained

<table>
<thead>
<tr>
<th>Component</th>
<th>Initial Eigen values</th>
<th>Rotation Sums of Squared Loadings</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Total</td>
<td>% of Variance</td>
</tr>
<tr>
<td>1</td>
<td>1.361</td>
<td>34.030</td>
</tr>
<tr>
<td>2</td>
<td>1.313</td>
<td>32.830</td>
</tr>
<tr>
<td>3</td>
<td>.764</td>
<td>19.103</td>
</tr>
<tr>
<td>4</td>
<td>.561</td>
<td>14.037</td>
</tr>
</tbody>
</table>

Extraction Method: Principal Component Analysis.

From the table above there are only two factors out of the four components have an Eigen value greater than one so only two components are chosen. The two components chosen contribute 66.86% of cumulative percent. Factor one contributes 34% while factor two contributes 32.83% (Eigen Values % of variance).

#### Table 4.14: Rotated Component Matrix

<table>
<thead>
<tr>
<th>Component</th>
<th>1</th>
<th>2</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bank Loan</td>
<td>.419</td>
<td>.692</td>
</tr>
<tr>
<td>Overdraft</td>
<td>-.234</td>
<td>.840</td>
</tr>
<tr>
<td>Long Term Loans</td>
<td>.701</td>
<td>.236</td>
</tr>
<tr>
<td>Intergroup Loan</td>
<td>.788</td>
<td>-.299</td>
</tr>
</tbody>
</table>


From the rotated component matrix, factor one (bank) has two factors, one bank loan at 69.2% and two overdraft which is given by a bank account holders at 84%. Factor two (other sources plus bank) also has two factors, long term loans from any financial institution at 70.1% and intergroup loans from any form of group (example merry go round) or the bank at 78.8%.
### 4.8.5 Factor analysis on position of company about source of finance

#### Table 4.15: Total Variance Explained

<table>
<thead>
<tr>
<th>Component</th>
<th>Initial Eigen values</th>
<th>Rotation Sums of Squared Loadings</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Total</td>
<td>% of Variance</td>
</tr>
<tr>
<td>1</td>
<td>2.334</td>
<td>77.784</td>
</tr>
<tr>
<td>2</td>
<td>.464</td>
<td>15.450</td>
</tr>
<tr>
<td>3</td>
<td>.203</td>
<td>6.766</td>
</tr>
</tbody>
</table>

Extraction Method: Principal Component Analysis.

The total variance table above shows that there are two factors derived. Derivation is not done through the Eigen values that are greater than one because this gives only one factor. The two factors have a combined contribution of 93.23% which is a very high contribution. Factor one alone contributes 77.78% cumulative total. The two factors will be used to explain the variance among the three variables.
The Scree above shows that only one factor is above the elbow hence it agrees with the Eigen values. If only one factor is derived then there will be no analysis carried out since one factor cannot be compared to itself. So the Scree plot is also ignored in order for a more in depth analysis to be done.

Table 4.16: Rotated Component Matrix

<table>
<thead>
<tr>
<th>Component</th>
<th>1</th>
<th>2</th>
</tr>
</thead>
<tbody>
<tr>
<td>Does The Company use Long term Debt?</td>
<td>.935</td>
<td>.240</td>
</tr>
<tr>
<td>Is the Company Under Regulation</td>
<td>.314</td>
<td>.943</td>
</tr>
<tr>
<td>Does Company Size Determine the Financing?</td>
<td>.801</td>
<td>.486</td>
</tr>
</tbody>
</table>


From the rotated matrix the variables are assigned a factor depending on their contribution to each factor. Each variable is allocated where it contributes the highest. Factor one is size in terms of the debt and the company itself whose contributions are 93.5% and 80.1% respectively. Factor two is regulation at 94.3% which is the only factor.

4.9 Summary of analysis

The data that was collected was analyzed using spss that is factor analysis. Here the data was given codes for easy interpretation and analysis (Appendix VI). After coding the data was fed into the system to carry out the factor analysis (Appendix VII). The analysis was able to group the different sets or variables into two or more factors which are explained above. Not all factors derived were applied due to difficulties in interpretation, for example factor analysis on the decision affecting use of long term finance which had three factors initially and they could not be interpreted and hence the number of factors had to be restricted to two. Another analysis was the Scree plot which was not always applied because it always seemed to agree with the Eigen value which was ignored in the example above. For the same reason not all Scree plots are explained above because it would have been a repetition of the Eigen values.
CHAPTER FIVE

SUMMARY, CONCLUSION AND RECOMMENDATIONS

5.1 Introduction

This chapter provides a summary of the findings of the research, the conclusion and the recommendations of the study which sought to investigate factors affecting long term debt decisions for Kenyan firms quoted at NSE.

5.2 Summary

The following are the major findings of the study;

5.2.1 Type of Debt Finance Used

The study first sought to find out the type of debt finance used by the organization. Majority of the respondents agreed that the company had used long term debt for financing. The respondents also agreed that the companies were under regulation and that the companies’ size determined the financing decisions. The study also sought to determine the extent to which the companies preferred various sources of financing. Majority of the respondents indicated that their companies preferred bonds and syndicated loans as a source of financing to a low extent. Further, most of the respondents revealed that their companies preferred offshore loans from international financial institutions and issuing of new shares as a source of financing to a small extent. On the other hand, majority of the respondents indicated that their companies preferred money market loan from financial institutions as a source of financing to great extent. However, majority of the respondents indicated that their companies were moderate on the extent to which they preferred Commercial papers as a source of financing for their organizations. Moreover, the study sought to find out the extent to which the company preferred debt financing to acquire new assets, expand existing assets and payment to suppliers. Majority of the respondents revealed that their companies preferred debt financing to acquire new assets. However, the respondents indicated that their companies considered debt financing for expansion of existing assets and for payment to suppliers to a low extent.
5.2.2 Impact of interest rates on long term debt decisions

The study further sought to determine the impact of interest rates on long term debt decisions. All the respondents were in agreement that interest rate affect the borrowing decision of an organization. Interest rate is a very important determinant of long term debt financing decisions because it carries with it the threat of liquidation. On the factors affecting the decision to use long term financing; majority of the respondents indicated that availability of projects, interest rates and future cash flows affected the companies’ decisions to use long term financing to a high extent. Moreover, tax shelter benefits was also found to be a factor affecting the organizations decisions to use long term financing to a high extent. Taxes have been found to have a strong and statistically significant effect on debt levels. On the other hand, it was revealed that shareholders composition affected the organizations’ decisions to use long term financing to a low extent. However, it was found out that distress costs affected decisions for long term financing to a moderate extent.

5.2.3 Firm Size and Its Effect on the Long Term Debt Decisions.

The firm’s size influences the company’s long term debt decisions; this was revealed by majority of the respondents. Further, the study sought to establish the order of preference for the various debt finances. Majority of the respondents indicated that their company highly preferred long term loans and overdraft as their debt finances. However, majority revealed that their organizations preferred intergroup loans while on the other hand most of the respondents indicated that their companies preferred bank loans as debt finances to a low extent. On overall, it was found out that organizations highly preferred overdraft and long term loans then followed by bank loans and intergroup loans in that order. Moreover, majority of the respondents indicated that their companies’ debts were secured. A number of the respondents though indicated that their companies’ debts were unsecured while for others the debts were subordinate.

5.2.4 Extent of tax benefits effects on long term debt decisions

The study also sought to determine the extent of tax benefits effects on long term debt decisions. Majority of the respondents indicated that corporate tax influenced their companies’ borrowing position. The respondents further revealed that corporate tax influenced borrowing position
because larger firms financed an additional 8% of their assets with debt, compared with smaller firms, thus the reason taxes had a strong and statistically effect on debt levels

5.3 Conclusions

The main purpose of the study is to investigate factors affecting long term debt decisions for Kenyan firms quoted at NSE. The following are the conclusions of the study based on the findings.

Majority of the companies used long term debt for financing. The study established that companies’ size determines the financing decisions. Majority of the company’s preferred money market loan from financial institutions as a source of financing; however a number of the company’s preferred bonds, syndicated loans, offshore loans from international financial institutions and issuing of new shares as a source of financing but to a low extent. The companies highly preferred debt financing to acquire new assets. However, the companies also considered debt financing for expansion of existing assets and for payment of suppliers though to a low extent.

The study established that interest rate affect the borrowing decision of an organization. Interest rate is a very important determinant of long term debt financing decisions because it carries with it the threat of liquidation. Factors such as availability of projects, interest rates, future cash flows and Tax shelter benefits affect the companies’ decisions to use long term financing to a high extent. Taxes have been found to have a strong and statistically significant effect on debt levels. It was also revealed that shareholders composition affected the organizations’ decisions to use long term financing though to a very low extent.

The firm’s size influences the company’s long term debt decisions. Majority of the companies highly preferred long term loans and overdraft as their debt finances. Intergroup loans and bank loans were also preferred as debt finances though to a low extent. In general, overdraft and long term were preferred most by the organization as debt finances. Majority of the companies’ debts were secured. A few of the companies’ debts were however unsecured while others were subordinate. The researcher would also like to conclude that corporate tax influences the
companies borrowing position. Corporate tax influenced borrowing position because larger firms financed an additional 8% of their assets with debt, compared with smaller firms, thus the taxes have a strong and statistically effect on debt levels and on long term debt decisions.

5.4 Recommendations
The following recommendations were made based on findings and conclusions of the research study.

Selection of debt as a source of capital finance should be done in line with the costs and benefits associated with its use (debt). Costs such as interest charges, bankruptcy costs and agency costs should be weighed against the tax benefits of debt. The initial phase to assess the impact of using debt on firms’ returns should start by comparing expected ROA to the estimated cost of debt. If the return on assets is higher than the before-tax interest on debt (interest rate), managers can then go on to assess any other costs presented as a result of using debt. The reason for not using debt when the before-tax interest on debt is higher than the return on assets is that the use of debt would lead to a decrease in value/profitability (negative leverage) of a firm if sales decline. This can lead to bankruptcy because the firm will not be able to repay its debts.

Managers should also consider conditions in the stock and bonds market. For example, during the recent credit crunch, the junk bond market dried up and there was simply no market at a “reasonable interest rate” for any new long term bonds rated below BBB. Therefore low rated companies in need of capital were forced to go to stock market or to the short-term debt market regardless of their target capital structure. When the conditions eased, however, these companies sold bonds to get their capital structures on target. However, the organization should effectively and efficiently utilize the available funds

There is also the need for government to reduce the level of personal income tax and company income tax further to encourage firms to plough back their profits into profitable investment opportunities. The prevailing interest rate on debt is on the high side, apart from the fact that firms are often discriminated against in lending, the lending rate is also discouraging firms from seeking debt financing. Government should therefore pursue sectoral allocation of credit in
favour of firms and especially manufacturing firms. This enables firms to take advantage of the tax benefit from debt financing.

5.5 Suggestions for further studies

The current research was focused mainly listed companies at the NSE which have a strong financial base. If a study would be done on Medium enterprises we would see the relationship between debt and value in both the small–sized and big firms have some difference and thus we would make a clear decision as to what factors influence debt decisions in Kenya. This would ensure that comprehensive findings are found that would aid in policy makers in decision making.
REFERENCES


APPENDICES

Appendix I: Check List

The aim of this research is to undertake a survey of the factors influencing long term debt decisions by companies quoted at the Nairobi Stock Exchange. The results of the study will show the characteristics of companies which use long term debt financing in Kenya.

Company’s name:

<table>
<thead>
<tr>
<th></th>
<th>2005</th>
<th>2006</th>
<th>2007</th>
<th>2008</th>
<th>2009</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total Assets</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Equity capital</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Debt Capital-Loans</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>-Bonds</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>-CPs</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>-Accruals</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Interest rate</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Taxation rate</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Debt/equity ratio</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Institutional share holders</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Retail shareholders</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
Appendix II: Letter of Introduction

Kamau Mugenda
University of Nairobi
P. O. Box 19662-00100
Nairobi, Kenya
Date: 30\textsuperscript{th} September 2010

Dear Respondent,

\textbf{RE: RESEARCH STUDY}

I am a student at the University of Nairobi, pursuing a Masters of Business Administration (MBA) degree in Finance.

In partial fulfillment for the award of the Masters in Business Administration degree, I am presently carrying out a survey of factors influencing Long Term Debt Decisions by companies quoted at the Nairobi Stock Exchange. I would be grateful if you could spare some time to respond to the questions attached herein. I would personally pick the completed questionnaire from your office.

Please be assured that the response from this survey will be treated with utmost confidentiality and be used for academic purposes only.

Thanking you in advance for taking your time to participate in this study

Yours Sincerely

Kamau Mugenda
Appendix III: Questionnaire

SECTION I: General Information

1. Kindly indicate your position in the company.

   Finance Director □  Finance Manager □
   Chief Accountant □
   Other (Specify) □

2. How long have you worked in this company?

   0-5 years □
   6-10 years □
   Over 10 years □

SECTION II: Type of Debt Finance used

3. To what extent does your company prefer the following sources of financing? Tick as applicable.

<table>
<thead>
<tr>
<th>Source of Financing</th>
<th>Very Low extent</th>
<th>Low extent</th>
<th>Moderate extent</th>
<th>High extent</th>
<th>Very high extent</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bonds</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Commercial Papers</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Money Market loan from local financial institutions</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Offshore loans from International financial institutions</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Syndicated loans</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>New Issue of shares</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Others(Specify)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

4. Please state the extent to which you prefer debt financing to pay for the following. Kindly indicate by ticking appropriately.

<table>
<thead>
<tr>
<th>Source of Financing</th>
<th>Very Low</th>
<th>Low</th>
<th>Moderate</th>
<th>High</th>
<th>Very high</th>
</tr>
</thead>
<tbody>
<tr>
<td>Acquiring new assets</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Expansion of existing assets</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Payment to suppliers</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Other (specify)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
SECTION III: Impact of Interest Rates on Long Term Debt Decisions

5. Does interest rate affect your borrowing decisions?
   - [ ] Yes  - [ ] No

6. Please indicate the extent to which the following factors affect your decision to use Long Term Financing? Kindly indicate by ticking appropriately.

<table>
<thead>
<tr>
<th>Factor</th>
<th>Very Low</th>
<th>Low</th>
<th>Moderate</th>
<th>High</th>
<th>Very high</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest Rates</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Shareholders composition</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Tax shelter benefit</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Availability of projects</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Future Cash flows</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Distress costs</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

SECTION IV: Firm size and its effect on the Long Term Debt Decisions

7. Does firm size influence your long term debt decisions?
   - [ ] Yes  - [ ] No

8. Indicate the order of preference for the following debt finances, where 1 = lowest, 2 = low, 3 = moderate, 4 = high and 5 = highly

<table>
<thead>
<tr>
<th>Debt Finances</th>
<th>1</th>
<th>2</th>
<th>3</th>
<th>4</th>
<th>5</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bank Loans</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Overdraft</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Long term loans</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Intergroup loans</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

9. Are your debts?
   - [ ] Secured  - [ ] Unsecured  - [ ] Subordinate

10. To what extent do you agree with the following statements about your company? Where

   1 = strongly disagree, 2 = Disagree, 3 = undecided 4 = Agree and 5 = strongly agree

<table>
<thead>
<tr>
<th>Statement</th>
<th>1</th>
<th>2</th>
<th>3</th>
<th>4</th>
<th>5</th>
</tr>
</thead>
<tbody>
<tr>
<td>This company uses long term debt for financing</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>This company is under regulation</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>The company size determines the financing decisions</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
SECTION V: Extent of Tax Shelter Benefits’ on Long Term Debt Decisions

11. Does the corporate tax rate influence your borrowing position?
   □ Yes  □ No

12. If yes please explain how?

THE END

Thank very much you for your participation
APPENDIX V: Companies quoted at the Nairobi Stock Exchange

MAIN INVESTMENT MARKET SEGMENT (MIMS)

Agriculture

1. Rea Vipingo Ltd.
2. Sasini Tea & Coffee Ltd.
3. Kakuzi Ltd.

Commercial and Services

1. Access Kenya Group
2. Marshalls E.A. Ltd.
3. Car & General Ltd.
4. Hutchings Biemer Ltd. (Suspended)
5. Kenya Airways Ltd.
6. CMC Holdings Ltd.
7. Uchumi Supermarkets Ltd. (Suspended)
8. Nation Media Group Ltd.
9. TPS (Serena) Ltd.
10. ScanGroup Ltd.
11. Standard Group Ltd.
12. Safaricom Ltd.

Finance and Investment

1. Barclays Bank of Kenya Ltd.
2. CFC Stanbic Bank Ltd.
3. Housing Finance Ltd.
4. Centum Investment Ltd.
5. Kenya Commercial Bank Ltd.
7. Pan Africa Insurance Holdings Co. Ltd
10. Standard Chartered Bank Ltd.
11. NIC Bank Ltd.
12. Equity Bank Ltd.
13. Olympia Capital Holdings Ltd
15. Kenya Re-Insurance Ltd.

**Industrial and Allied**

1. Athi River Mining Ltd.
2. BOC Kenya Ltd.
4. Carbacid Investments Ltd.
5. E.A. Cables Ltd.
6. E.A. Breweries Ltd.
7. Sameer Africa Ltd.
8. KenolKobil Limited
9. Mumias Sugar Company Ltd.
10. Unga Group Ltd.
11. Bamburi Cement Ltd.
12. Crown berger (K) Ltd.
13. E.A Portland Cement Co. Ltd.
15. Total Kenya Ltd.
16. Eveready East Africa Ltd.
17. Kengen Ltd.
APPENDIX VI: FACTOR ANALYSIS

Factor Analysis

<table>
<thead>
<tr>
<th>Component</th>
<th>Initial Eigen values</th>
<th>Rotation Sums of Squared Loadings</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Total</td>
<td>% of Variance</td>
</tr>
<tr>
<td>1</td>
<td>2.848</td>
<td>47.469</td>
</tr>
<tr>
<td>2</td>
<td>1.182</td>
<td>19.692</td>
</tr>
<tr>
<td>3</td>
<td>.932</td>
<td>15.532</td>
</tr>
<tr>
<td>4</td>
<td>.550</td>
<td>9.161</td>
</tr>
<tr>
<td>5</td>
<td>.372</td>
<td>6.198</td>
</tr>
<tr>
<td>6</td>
<td>.117</td>
<td>1.947</td>
</tr>
</tbody>
</table>

Extraction Method: Principal Component Analysis.

<table>
<thead>
<tr>
<th>Component</th>
<th>Component</th>
<th>1</th>
<th>2</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bonds</td>
<td></td>
<td>.721</td>
<td>.015</td>
</tr>
<tr>
<td>Commercial Paper</td>
<td></td>
<td>.830</td>
<td>.129</td>
</tr>
<tr>
<td>Money Market Loan from Financial institution</td>
<td></td>
<td>.747</td>
<td>.089</td>
</tr>
<tr>
<td>Offshore Loan From international Financial institution</td>
<td></td>
<td>.852</td>
<td>-.302</td>
</tr>
<tr>
<td>Syndicated Loan</td>
<td></td>
<td>.496</td>
<td>-.667</td>
</tr>
<tr>
<td>New Issue of Shares</td>
<td></td>
<td>.305</td>
<td>.797</td>
</tr>
</tbody>
</table>

Extraction Method: Principal Component Analysis.
Rotation Method: Varimax with Kaiser Normalization.

a. Rotation converged in 3 iterations.
Component Transformation Matrix

<table>
<thead>
<tr>
<th>Component</th>
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</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>.995</td>
<td>-.096</td>
</tr>
<tr>
<td>2</td>
<td>.096</td>
<td>.995</td>
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</table>

Extraction Method: Principal Component Analysis.
Rotation Method: Varimax with Kaiser Normalization.

Total Variance Explained

<table>
<thead>
<tr>
<th>Component</th>
<th>Initial Eigen values</th>
<th>Rotation Sums of Squared Loadings</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Total</td>
<td>% of Variance</td>
</tr>
<tr>
<td>1</td>
<td>1.235</td>
<td>41.179</td>
</tr>
<tr>
<td>2</td>
<td>1.113</td>
<td>37.101</td>
</tr>
<tr>
<td>3</td>
<td>.652</td>
<td>21.720</td>
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</table>

Extraction Method: Principal Component Analysis.
rotated Component Matrix

<table>
<thead>
<tr>
<th></th>
<th>Component</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>1</td>
</tr>
<tr>
<td>Acquiring new Assets</td>
<td>.040</td>
</tr>
<tr>
<td>expansion of Existing Assets</td>
<td>-.741</td>
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<tr>
<td>Payment to Suppliers</td>
<td>.822</td>
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Extraction Method: Principal Component Analysis.
Rotation Method: Varimax with Kaiser Normalization.

a. Rotation converged in 3 iterations.

Component Transformation Matrix

<table>
<thead>
<tr>
<th>Component</th>
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<th>2</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>-.958</td>
<td>.288</td>
</tr>
<tr>
<td>2</td>
<td>.288</td>
<td>.958</td>
</tr>
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</table>

Extraction Method: Principal Component Analysis.
Rotation Method: Varimax with Kaiser Normalization.
### Total Variance Explained

<table>
<thead>
<tr>
<th>Component</th>
<th>Initial Eigen values</th>
<th>Rotation Sums of Squared Loadings</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Total</td>
<td>% of Variance</td>
</tr>
<tr>
<td>1</td>
<td>1.948</td>
<td>32.470</td>
</tr>
<tr>
<td>2</td>
<td>1.494</td>
<td>24.894</td>
</tr>
<tr>
<td>3</td>
<td>1.079</td>
<td>17.981</td>
</tr>
<tr>
<td>4</td>
<td>.835</td>
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<td>5</td>
<td>.422</td>
<td>7.035</td>
</tr>
<tr>
<td>6</td>
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Extraction Method: Principal Component Analysis.

### Rotated Component Matrix

<table>
<thead>
<tr>
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<th>Component 2</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest Rate</td>
<td>.865</td>
<td>.107</td>
</tr>
<tr>
<td>Shareholders Composition</td>
<td>.932</td>
<td>-.022</td>
</tr>
<tr>
<td>Tax Shelter Benefit</td>
<td>.351</td>
<td>.626</td>
</tr>
<tr>
<td>Availability of Projects</td>
<td>-.011</td>
<td>.805</td>
</tr>
<tr>
<td>Future Cash Flows</td>
<td>-.117</td>
<td>.705</td>
</tr>
<tr>
<td>Distress Costs</td>
<td>-.066</td>
<td>-.366</td>
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</table>

Extraction Method: Principal Component Analysis.
Rotation Method: Varimax with Kaiser Normalization.
a. Rotation converged in 3 iterations.

### Total Variance Explained

<table>
<thead>
<tr>
<th>Component</th>
<th>Initial Eigen values</th>
<th>Rotation Sums of Squared Loadings</th>
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<tbody>
<tr>
<td></td>
<td>Total</td>
<td>% of Variance</td>
</tr>
<tr>
<td>1</td>
<td>1.361</td>
<td>34.030</td>
</tr>
<tr>
<td>2</td>
<td>1.313</td>
<td>32.830</td>
</tr>
<tr>
<td>3</td>
<td>.764</td>
<td>19.103</td>
</tr>
<tr>
<td>4</td>
<td>.561</td>
<td>14.037</td>
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</table>
### Total Variance Explained

<table>
<thead>
<tr>
<th>Component</th>
<th>Initial Eigen values</th>
<th>Rotation Sums of Squared Loadings</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
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<td>1.361</td>
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<td>1.313</td>
<td>32.830</td>
</tr>
<tr>
<td>3</td>
<td>.764</td>
<td>19.103</td>
</tr>
<tr>
<td>4</td>
<td>.561</td>
<td>14.037</td>
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</table>

Extraction Method: Principal Component Analysis.

### Rotated Component Matrix

<table>
<thead>
<tr>
<th>Component</th>
<th>1</th>
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</thead>
<tbody>
<tr>
<td>Bank Loan</td>
<td>.419</td>
<td>.692</td>
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<tr>
<td>Overdraft</td>
<td>-.234</td>
<td>.840</td>
</tr>
<tr>
<td>Long Term Loans</td>
<td>.701</td>
<td>.236</td>
</tr>
<tr>
<td>Intergroup Loan</td>
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<td>-.299</td>
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</table>

Extraction Method: Principal Component Analysis.
Rotation Method: Varimax with Kaiser Normalization.

a. Rotation converged in 3 iterations.

### Total Variance Explained

<table>
<thead>
<tr>
<th>Component</th>
<th>Initial Eigen values</th>
<th>Rotation Sums of Squared Loadings</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Total</td>
<td>% of Variance</td>
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<tr>
<td>1</td>
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Extraction Method: Principal Component Analysis.
Rotated Component Matrix

<table>
<thead>
<tr>
<th></th>
<th>Component 1</th>
<th>Component 2</th>
</tr>
</thead>
<tbody>
<tr>
<td>Does The Company use Long term Debt?</td>
<td>.935</td>
<td>.240</td>
</tr>
<tr>
<td>Is the Company Under Regulation</td>
<td>.314</td>
<td>.943</td>
</tr>
<tr>
<td>Does Company Size Determine the Financing?</td>
<td>.801</td>
<td>.486</td>
</tr>
</tbody>
</table>

Extraction Method: Principal Component Analysis.
Rotation Method: Varimax with Kaiser Normalization.
a. Rotation converged in 3 iterations.