

**THE EFFECT OF WORKING CAPITAL MANAGEMENT ON THE  
PROFITABILITY OF THE HOTEL INDUSTRY IN KENYA; A STUDY  
OF THE FIVE STAR HOTELS IN NAIROBI.**

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## DECLARATION

I declare that this research project is my original work, and has not been presented for a degree or any other award in any other university.

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## **DEDICATION**

This research project is dedicated my Husband Nathan, children Sam and Abby, my parents, my mother in law, and my brothers and sisters.

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## **ABSTRACT**

Working capital management involves the management of the most liquid resources of the firm which includes cash and cash equivalents, Inventories and trade and other receivables. Most firms do not hold the correct amount of working capital and this has been a major obstacle to their overall profitability. The study examined the effect of working capital management on profitability of the five star hotels in Nairobi. A sample of four five star hotel in Nairobi out of the targeted population of seven were used, the period under study was between the year 2009 to 2013. Multiple Regression analysis model was used to determine the effect of independent variables on the dependent variable. Correlation coefficient was used to investigate how the independent variables inter-relate with the dependent variable. Analysis of Variance (ANOVA) was performed to determine the impact of independent variables on the dependent variable in the multiple regression analysis. The study established that there exist a highly significant negative relationship between the time it takes for firms to collect its cash from their customers or Days Sales Outstanding and profitability, and also there is a strong positive relationship between days payables outstanding and profitability. The relationship between the Cash Conversion Cycle, Days Inventory outstanding and profitability was found to be statistically insignificant. The findings imply that more profitable firms take shortest time to collect receivables from their customers, and wait longer to pay their bills by withholding their payment to suppliers so as to take advantage of the cash available for their working capital needs, it also makes economic sense in that, the longer a firm delays its payment to its creditors the higher the working capital levels it reserves and uses it in order to increase profitability. The study recommends that managers should focus on collecting receivables as quickly as possible and lag payment of creditors as long as it does not strain their relationship, so as to maximize the profitability of their firms.

## **ABBREVIATIONS**

AHIF: African Hotel investment Forum

ASE: Athens Stock Market Exchange

CCC: Cash Conversion Cycle

DIO: Days inventory outstanding

DPO: Days payables outstanding

DSO: Days sales outstanding

JIT: Just- in- time

KHRA: Kenya Hotel and Restaurant Authority

NSE: Nairobi Securities Exchange

ROA: Return on Assets

SPSS: Statistical Package for Social Sciences

WCM: Working Capital Management

# **CHAPTER ONE**

## **INTRODUCTION**

### **1.1 Background of the Study**

In financial affairs of every firm, working capital management is a very important factor, and it has a direct positive effect on profitability. Proper optimization of working capital balance means minimizing the working capital requirement and realizing maximum possible revenues (Ganesan, 2007). If a firm minimizes its investment in current assets, the resulting funds can be invested in value creating profitable projects, so it can increase the firm's growth opportunities and shareholders return. The ability of financial managers to effectively and efficiently manage their receivables, inventories, and payables has a significant impact on the success of the business and on profitability as well (Agha, 2014).

Most firms have a large amount of cash invested in working capital, as well as substantial amounts of short-term payables as a source of financing. It can be expected that the way in which working capital is managed will have a significant impact on the profitability of firms. Accordingly, for many firms working capital management (WCM) is a very important component of their financial management. Firms may have an optimal level of working capital that maximizes their value. On the one hand, large inventory and a generous trade credit policy may lead to higher sales. Larger inventory reduces the risk of a stock-out. Trade credit may stimulate sales because it allows customers to assess product quality before paying (Long, Malitz & Ravid, 1993).

A well designed and implemented working capital management practices is expected to contribute positively to the creation of a firm's value through profit generation. When

managing any kind of business, financial manager should always ensure the firm is able to meet their financial obligations as they fall due, as this instills a sense of confidence to the investors and thus wins their loyalty. On the contrary, a poor liquidity status could lead to inability of firms meeting their financial obligations. Proper working capital management is thus a crucial instrument, and it is only when a firm is profitable that it will see the light of market growth, market share and progress through product and industry life cycles.

### **1.1.1 Working Capital Management**

Working capital sometimes called gross working capital refers to current assets used in operations (Brigham & Ehrhardt, 2005). Working capital management (WCM) is the management of short-term financing requirements of a firm, and involves finding the optimal levels for cash, marketable securities, accounts receivable, and inventory and then financing that working capital for the least cost (Brigham & Houston, 2007). Optimization of working capital balance means minimizing the working capital requirement and realizing maximum possible revenues (Ganesan, 2007).

The financial executive probably devotes more time to working capital management than any other activity, this is because current assets by their nature are changing daily and managerial decisions have to be made. Unlike long term decisions there can be no deferral of action, short term decisions on working capital determines if the firm gets to the long term (Block & Hirt, 2009).

There are two concepts of working capital, which are net and gross working capital. Gross working capital refers to the firm's investment in current assets, which refers to those assets which can be converted into cash within an accounting year and includes; short term securities, accounts receivable, and inventories. Net working capital refers to the difference

between current assets and current liabilities. Current liabilities are those claims of outsiders, which are expected to mature within an accounting year they includes creditors, and outstanding expenses. The two concepts of working capital gross and net are not exclusive rather they have equal significance from the management point of view (Pandey, 2005).

The consideration of level of investment should avoid either excessive or in adequate investments in current assets. Excessive investment should be avoided as it impairs the firm's profitability. On the other hand, inadequate amount of working capital may expose the firm to insolvency. Whenever a need for working capital arises due to increasing level of business activity, financing arrangement should be sought quickly. Similarly if surplus funds arise they should be invested in short term securities (Pandey, 2008).

### **1.1.2 Profitability**

Profitability is a widely used financial measure of performance and is the ultimate goal of every business entity. All the strategies designed and activities performed thereof are meant to realize this grand objective, this does not mean that they have no other goals, since the business could also have additional social and economic goals. However, the intention of this study is related to the first objective, profitability.

To measure the profitability, there are a variety of ratios used of which Return on Asset, Return on Equity and Net profit Margin are the major ones (Ongore & Kusa 2013). Profitability, in this reference may be defined as the return earned on the total assets of the company. Profit is determined by matching revenue against cost associated with it and without profit business will not survive in the long run (Salauddin, 2001). Profitability is measured with income and expenses, income is money generated from the activities of the firm. However, money coming into the firm from activities such as borrowing does not create

income but is simply a cash transaction between the firm and the lender to generate cash for operating the business. Although one year of losses may not permanently harm the business, consecutive years of losses or net income insufficient to cover the expenditure may jeopardize the viability of the business (Block & Hirt 2009).

### **1.1.3 Working Capital Management and Profitability**

Working Capital management is important because of its effects on the firm's profitability, risk and consequently its value (Smith, 1980). Efficient working capital management practices involves planning and controlling current assets and liabilities so as to eliminate the risk of inability to meet short term obligations as they fall due and avoid excessive investment in these assets ( Eljelly, 2004). The term profitability refers to the ability of a firm to yield a financial gain. There is a strong linear relationship between profitability of the firm and its working capital efficiency (Agha, 2014).

Keeping high levels of current assets gives a firm a better liquidity position. With high level of current assets, a firm is able to meet its obligations on time and the operations of the firm are smooth. But, high levels of current asset come at a cost, namely, profitability. The amount blocked in the current assets has an opportunity cost. As the amount of current assets increase, the cost associated with it also increases and the profitability of the firm decreases (Vijayalakshmi & Bansal, 2013). An optimal working capital management is expected to contribute positively to the creation of firm value (Howorth & Weshead, 2003).

Mathuva, (quoted in Deloof, 2003), indicated that the way working capital is managed can have significant impact on both liquidity and profitability of the firm, for example decisions that tend to maximize profitability tend to minimize the chances of adequate liquidity. Conversely, focusing almost entirely on liquidity will tend to reduce the potential profitability

of the firm. A firm can have large sales with generous credit policy which extend the cash conversion cycle, in this case the cash conversion cycle may result in higher profitability, however the traditional view of the relationship between the cash conversion cycle and corporate profitability is that *ceteris paribus* a longer cash conversion cycle hurts the profitability of the firm.

A firm can be very profitable, but if this is not translated into cash from operations within the same operating cycle, the firm would need to borrow to support its continued working capital needs. Thus, the twin objectives of profitability and liquidity must be synchronized and one should not impinge on the other for long. Investments in current assets are inevitable to ensure delivery of goods or services to the ultimate customers and a proper management of same should give the desired impact on either profitability or liquidity. If resources are blocked at the different stage of the supply chain, this will prolong the cash operating cycle. Although this might increase profitability (due to increase sales), it may also adversely affect the profitability if the costs tied up in working capital exceed the benefits of holding more inventory and/or granting more trade credit to customers (Padachi, 2006).

A firm is required to maintain a balance between liquidity and profitability while conducting its day to day operations. Liquidity is a precondition to ensure that firms are able to meet its short-term obligations and its continued flow can be guaranteed from a profitable venture (Padachi, 2006). The importance of cash as an indicator of continuing financial health should not be surprising in view of its crucial role within the business. This requires that business must be run both efficiently and profitably. In the process, an asset-liability mismatch may occur which may increase firm's profitability in the short run but at a risk of its insolvency, (Pandey, 2008).

About 60 percent of a typical Finance manager's time is devoted to working capital management (Brigham & Houston, 2007). One reason for this is that current assets are short-lived investments that are continually being converted into other types (Rao, 1989). With regard to current liabilities, the company is responsible for paying these obligations on a timely basis. Taken together, decisions on the level of different working capital components become frequent, repetitive, and time consuming (Raheman & Nasr, 2007).

#### **1.1.4 The Hotel Industry in Kenya**

A hotel is an establishment providing for reward accommodation, food and drinks for travelers and temporary residents, and sometimes other facilities for the transaction of business meetings, conferences, recreation and entertainment. In that sense hotels are essential to economies and societies (Medlik & Ingram, 2000).

The hotel industry play a vital role to the Kenyan economy, in that the industry support the tourism sector which currently is the second foreign exchange earner after agriculture. Tourism is accepted as an economic boon and a valuable asset to the national economy, the United Nations World Tourism Organization confirms that between 70% to 75% of international tourists' expenditure goes to hotel services on annual basis (Akpabio, 2007), affirming the strategic importance of the sector. Tourism represents a cheaper alternative for diversification of sectors of the economy, considering the country's competitive advantage in terms of environmental attraction suitable for nature tourism (Akama, 2000), which has consequently has contributed to the growth of the hotel industry over the years.

The regulation, rating and licensing of Hotels in Kenya is done by the Kenya Hotel and Restaurants Authority (KHRA) established under the Hotels and Restaurants Act, Cap 494 of



the Kenyan laws, the hotels in Kenya are rated from one to five star. According to the African Hotel investment Forum (AHIF) held in Nairobi in September 2013, it revealed that the Kenyan hotel industry is facing an acute deficit of 10,000 classified beds, a situation, it is feared, is denying the country an opportunity to benefit from increasing numbers of international tourist arrivals. By end of 2012, according to the Vision 2030 Medium Term Plan, bed capacity ought to have been increased to 65,000 beds in classified hotels from the estimated figure of 55,000 classified beds. According to the Kenya Tourist Board (KTB) Managing Director Muriithi Ndegwa the country's bed capacity in categorized hotels is still below the envisioned target (Waithatu, 2013).

The hotel industry in Kenya is seasonal in nature and hence the effect of seasonality can be a great challenge when it comes to the management of working capital, basically because of the difficulty faced in attracting large pools of permanent funds through the use of equity capital, in this case suppliers are likely to provide the short term financing. There should be sufficient planning and efficient management of the working capital to ensure that excess funds generated during the peak season are optimally invested as this will prevent the closure of the business, enhance profitability which will at the same time ensure that value of the firm is maximized. The current demand for standard hotel bed shows that there is great potential for growth in the hotel industry in Kenya and working capital management cannot therefore be underestimated.

## **1.2 Research Problem**

Working Capital is considered as the lifeblood and nerve centre of any business (Khan & Jain, 2005). Weak financial management and particularly poor working capital management and inadequate long-term financing are a primary cause of failure among businesses (Berryman, 1983; Dunn & Cheatham, 1993). Besides, to be operationally efficient, every

organization requires necessary amount of working capital irrespective of their size, or nature of business operation, whether profit oriented or not (Eljelly, 2004).

Working capital management is of particular importance to businesses with limited access to the long-term capital markets, these firms tend to rely more heavily on owner financing, trade credit and short-term bank loans to finance their needed investment in cash, accounts receivable and inventory (Chittenden et al, 1998). A number of studies on the relationship between working capital and profitability have been done, Deloof (2003), did a study on the effect of working capital management on Belgian firm's profitability. Lazaridis & Tryfonidis (2006) investigated the relationship between profitability and working capital management in Athens Stock market Exchange (ASE). In Kenya similar studies have been carried out for example Mathuva (2010), conducted a study on working capital management on corporate profitability of the listed firms in the Nairobi Securities Exchange (NSE), a similar was conducted by Waithaka (2010), but on Agricultural Companies listed at the NSE. Mathai (2010) did a study on the relationship between working capital management and profitability of retail supermarket chains in Kenya. Kweri (2011) conducted a study on the relationship between working capital management and profitability of the manufacturing firms listed on the NSE. Runyora (2012) also did a study on the impact of working capital management on the profitability of the oil industry in Kenya. Given that there is no specific research studies exclusively on the impact of working capital management on profitability of the hotel industry in Kenya the study seeks to bridge this gap.

Keeping this in view and the wider recognition of the potential contribution of the hotel industry to the Kenyan economy which is a developing country, the study is a great attempt to measure and analyze the trend of working capital management in the hotel industry. The

study will seek to fill the gap by studying the relationship between working capital management and the profitability of the five star hotels in Kenya. The Question that the study seeks to answer is: what is the effect of working capital management on the profitability of the five star hotels in Kenya?

### **1.3 Research Objective**

The research sought to establish the relationship between working capital management and the profitability of five star hotels in Kenya.

### **1.4 Value of the study**

The findings of the study will be of great importance to;

#### **The Five Star Hotels in Kenya**

This study will focus on the effect of working capital management on firm's profitability and shed more light to how managers affect firm's profitability by managing working capital efficiently. The recommendations and findings of this study will help the five star hotels understand the effects of working capital management on profitability so as to enhance their growth and success.

#### **Policy Makers**

It is envisioned in the economic pillar of Vision 2030 that the economy will grow by 10% by the year 2030. The tourism industry which encompasses the hotel industry being the second economic contributor from agriculture stands to benefit. The study findings will recommend to the policy makers who will in turn propose to government interventions on how to spur growth in five star hotels and see more hotels in the three and four star transient to the next level of four and five star.

#### **The Academia**

This study will contribute to the body of knowledge by identifying how working capital management affect firm's profitability and how managers can use working capital strategies

to increase the firm's market value. The researchers and the academician will find this study useful for further discussion and research.

### **Financial Institutions and Development Partners**

The study will assist financial institutions and development partners to understand the status of the working capital management practices of the five stars hotels in Kenya and the interventions that need to be taken up to achieve the increased performance and hence returns for their funding.

## **CHAPTER TWO**

### **LITERATURE REVIEW**

#### **2.1 Introduction**

This chapter is organized into four parts. The first part focuses on the theoretical review. The second part is on the determinants of profitability. The third part reviews the empirical studies by scholars and finally the conclusion.

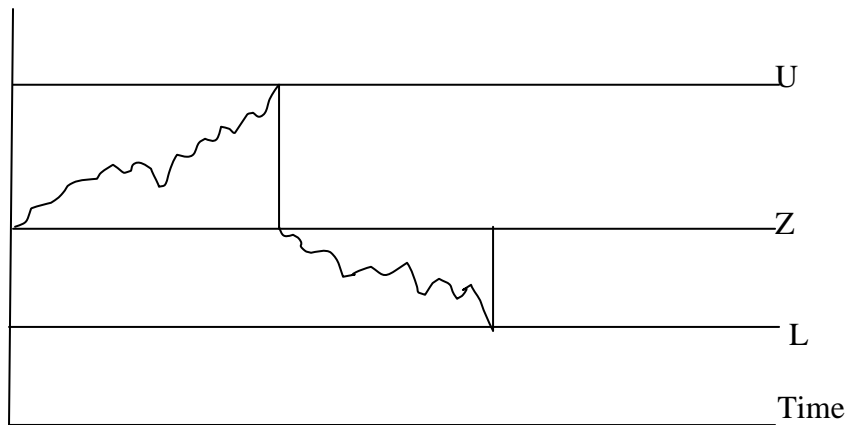
#### **2.2. Theoretical review**

There are several theories of working capital, some of which include:

##### **2.2.1 The Miller- Orr Model**

Merton Miller and Daniel Orr developed a cash balance model to deal with cash inflows and outflows that fluctuate randomly from day to day. The model assumes that the distribution of daily net cash flows is normally distributed. On each day the net cash flow could be the expected value or some higher or lower value. The model operates in terms of upper (U) and lower (L) control limits and target cash balance (Z). The firm allows its cash balance to wander randomly within the lower and upper limits. As long as the cash balance is between upper and lower limit, the firm makes no transaction. When the cash balance reaches upper limit, the firm buys  $U-Z$  units of marketable securities. This action will decrease the cash balance to Z. In the same way, when cash balances fall to Lower limit, the firm should sell  $Z-L$  securities and increase the cash balance to Z. As a consequence, trading costs per period depend on the expected number of transactions in marketable securities during the period. Similarly, the opportunity costs of holding cash are a function of the expected cash balance per period (Hillier et al 2010).

Figure 1



Source: Hillier et al (2010)

The Formula in determining the desired cash level is as follows

$$Z^* = \sqrt[3]{\frac{3F\sigma^2}{4K+L}}$$

$$\text{Upper Limit} = 3Z^* - 2L$$

$$\text{Average cash balance} = \frac{4Z^* - L}{3}$$

Where  $Z^*$  = Desired cash Level

F = Fixed Transaction cost of buying and selling marketable securities

$\sigma^2$  = Variance of daily cash flows

K = Daily Interest rate on marketable securities

L = Minimum cash balance

## 2.2.2 Economic Order Quantity Model

According to Pandey (2010), this classical inventory management model that calculates an optimum order size by balancing the costs of holding inventory against the costs of ordering fresh supplies. This optimum order size is the basis of a minimum cost procurement policy. The economic order quantity model assumes that, for the period under consideration (usually one year), costs and demand are constant and known with certainty. It is also called a deterministic model because it makes these steady-state assumptions. It makes no allowance for the existence of buffer inventory. Economic Order Quantity (EOQ) aims at setting up the ordering and carrying cost at minimal level.

Total annual cost = Annual holding cost + Annual ordering cost

$$TC = Q/2(H) + S/Q (F)$$

Where: Q = order quantity in units

H = holding cost per unit per year

S = annual demand in units per year

F = ordering cost per order

TC = Total cost

Putting holding costs equal to ordering costs and rearranging gives:

$$Q = \frac{2XSXF}{H}$$

Q is now the economic order quantity, i.e. the order quantity which minimises the sum of holding costs and ordering costs.

### **2.2.3 Keynesian Theory of Money**

Keynes (1956) discussed that the level of cash and marketable securities held by firm is determined by the motive of holding them. The speculative motive is the need to hold cash to be able to take advantage of bargain purchase and favorable exchange rate fluctuations. For most firms, reserve borrowing ability and marketable securities can be used to satisfy speculative motive. The precautionary motive is the need for safety supply to act as financial reserve. However there is no need of holding such substantial amount of money given that the money market instruments are quite liquid. Cash is also needed for transaction motive. Firms will have the need to have cash so as to settle bills. The disbursement of cash includes; payment of salaries trade debts, taxes and dividends.

### 2.2.4 Baumol Model

The Baumol Model of cash management provides a formal approach for determining a firm's optimum cash balance under certainty. Cash management is considered similar to inventory management. Firms attempt to minimize the cost of holding cash and the cost of converting marketable securities into cash. The model makes the assumption that the firm is able to forecast its cash needs with certainty; the firm's cash payments occur uniformly over a period of time; the opportunity cost of holding cash is known and it does not change over time; and the firm will incur the same transaction cost whenever it converts securities to cash (Baumol 1952).

The firm incurs a holding cost known as opportunity cost for keeping the cash balance. The opportunity cost is the return forgone on the marketable securities. If the opportunity cost is  $k$ , then the firm's holding cost for maintaining an average cash balance ( $C$ ) is calculated as follows; Holding cost =  $K(C/2)$ .

The firm incurs a transaction cost whenever it converts its marketable securities to cash. Total number of transactions during the year will be the total funds requirement,  $T$ , divided by the cash balance,  $C$ . The assumption is that the cost per transaction is constant. If the cost per transaction is  $F$ , the total transaction cost will be;

Transaction cost =  $F(T/C)$

The total Cost = Opportunity Cost + Trading Cost

$$= K(C/2) + F(T/C)$$

#### Optimum levels of cash balance

As the demand for cash ' $C$ ' increases, the holding cost will also increase and the transaction cost will reduce because of decline in the number of transactions. Hence it can be said that there is a relationship between holding cost and transaction cost. The optimum cash balance  $C^*$  is obtained when total cost is minimum and the formula is;



$$C^* = \sqrt{2FT/K}$$

Where  $C^*$  is the optimum cash balance

T is the total cash needed during the year

K is the opportunity cost of holding cash balances and

F is the transaction cost

### **2.2.5 Just-in-Time**

The idea under this model is that inventories are acquired and inserted in production at the exact times they are needed. The Just-in-time (JIT) management philosophy thus focuses on pulling inventory through the production process on an “as-needed” basis, rather than pushing inventory through the process on an “as-produced” basis. This requires a very accurate production and inventory information system, highly efficient purchasing, very reliable suppliers, and an efficient inventory-handling system. Although raw-materials inventory and in-transit inventory can never be reduced to zero, the notion of “just in time” is one of extremely tight control so as to cut back on inventories. The goal of a JIT system, however, is not only to reduce inventories but also to continuously improve productivity, product quality, and manufacturing flexibility (Wachowicz & Van Horne, 2008).

## **2.3 Determinants of profitability in the Hotel Industry**

According Brigham & Houston (2007), Working capital consists of four main components: cash, marketable securities, inventory, and accounts receivable. These components should be managed efficiently so as to increase a firm’s profitability.

### **2.3.1 Inventory**

Inventories, which can includes: supplies, raw materials, work in process, and finished goods, are an essential part of virtually all business operations. Optimal inventory levels depend on

sales, so sales must be forecasted before target inventories can be established (Brigham & Houston, 2007). Excessive inventory can place a heavy burden on the cash resources of a business. Insufficient inventory can result in lost sales and delays for customers. Large inventory levels also reduce the risk of stock out (Pandey, 2010). Because of the large size of inventories maintained by firms, a considerable amount of fund is required to be committed to them. It is therefore, absolutely imperative to manage inventories efficiently and effectively by adopting appropriate working capital management policy in order to avoid unnecessary investments. An undertaking neglecting appropriate working capital management policy of inventories will be jeopardizing its long-run profitability and the firm may fail ultimately (Ochieng, 2007).

### **2.3.2 Accounts Receivable**

The credit policy of the firm affects the working capital by influencing the level of accounts receivable. Liberal credit policy can be detrimental as it can lead to difficulties in debt collection. This may lead to tying of huge funds and increased bad debts. The business firm should follow a rationalized credit policy to avoid tying of funds unnecessarily. Cash flow can be significantly enhanced if the amounts owing to a business are collected faster. Slow payment has a crippling effect on business; in particular on small businesses who can least afford it (Block & Hirt, 2009). Longer credit terms may increase turnover, but will also increase the risk of bad debts. In order to operate its trade receivables policy, a company needs to set up a credit analysis system, a credit control system and a trade receivables collection system (Gitman, 2008).

### **2.3.3 Cash**

Cash is the most liquid current asset. It is of vital importance to the daily operations of business. While the proportion of assets held in the form of cash is very small, its efficient

management is crucial to the solvency of the business. Therefore, planning cash and controlling its use are very important tasks. Firm's requires holding an optimal cash balance since excessive cash means foregone interest income and inadequate cash means difficulty in implementing operating activities of an enterprise. Inadequate cash will also mean that the firm cannot meet its short term maturing financial obligations as and when they fall due. Any idle cash held by a firm should be converted into an earning form so that it can generate interest income. This is achieved though buying or investing in short term marketable securities or investing the idle cash in short term lending. (Pandey,2005). Cash is often called a "nonearning asset." .Thus, the goal of the cash manager is to minimize the amount of cash the firm must hold for use in conducting its normal business activities, yet, at the same time, to have sufficient cash to take trade discounts, to maintain its credit rating, and to meet unexpected cash needs (Brigham & Houston 2007).

### **2.3.4 Accounts Payable**

Creditors are a vital part of effective cash management and should be managed carefully to enhance the cash position. Purchasing initiates cash outflow and an overzealous purchasing function can create liquidity problems. Delaying payment of accounts payable to suppliers allows a firm to access the quality of bought products and can be inexpensive and flexible source of financing. On the other hand delaying of such payables can be expensive if a firm is offered a discount for the early payment (Blocks & Hirts, 2009).

### **2.4 Empirical Studies**

Extensive research works on working capital management have been done in public and private sectors and both locally and internationally. Shin & Soenen (1998), investigate the relation between a measure of the cash conversion cycle and corporate profitability for listed American firms for the period 1975-1994. The study indicated that the way working capital

was managed had a significant impact on both profitability and liquidity. The relationship between the length of Net Trading Cycle, corporate profitability and risk adjusted stock return was examined using correlation and regression analysis, by industry and capital intensity. They found a strong negative relationship between lengths of the firm's net trading Cycle and its profitability. The results indicated that managers can create value for their shareholders by reducing the cash conversion cycle to a reasonable minimum.

Deloof (2003) carried out a study on the effect of working capital management on the profitability by sampling 1009 most important Belgium firms spread from 1992-1996, by means of a regression analysis, proved that enterprises with a long cash conversion cycles and long inventory, accounts receivables, and current liabilities cycles obtained lower rates of return measured through the operational profit in respect of enterprises with shorter cycles. Similar findings were observed by (Lazaridis & Tryfonidis 2006) the study investigated the relationship between working capital management and firms' profitability for 131 listed companies in the Athens Stock Exchange for the period 2001-2004, they suggested that that managers can create profits for their companies by handling correctly the cash conversion cycle and keeping each different component (accounts receivables, accounts payables, inventory) to an optimum level.

The study by (Padachi 2006), used return on total assets as a measure of profitability the relationship between working capital management and corporate profitability was investigated for a sample of 58 small Mauritian manufacturing firms using panel data analysis for the period 1998 – 2003. The regression result of the study indicates that high investment in inventories and receivables is associated with lower profitability. The study by, (Raheman & Nasr 2007), evaluated Working Capital Management and Profitability Case of

Pakistani firms. A sample consists of 94 Pakistani firms listed on Karachi Stock Exchange for the duration of 1999 – 2004. The outcome showed that there were strong negative relationship between working capital variables and profitability.

Garcia & Martinez (2007) did a study about working capital management and profitability relationships in Small and Medium size firms (SME). For this purpose, they collected a panel of 8872 Spanish corporations for the period from 1996 to 2002. Using panel data analysis with both random effect and fix effect models, they revealed a negative relationship between return on asset and cash conversion cycle, They argued that small and medium-size firms also can increase their profitability by shortening cash conversion cycle.

Samiloglo & Demirgunes (2008) conducted a study to examine the relationship between working capital management and profitability. Applying multiple regression analyses over a sample of manufacturing firms listed in Istanbul stock exchange for the period of 1998-2007, they found that the accounts receivable cycle, the inventory conversion period have negative impact on profitability, which means the shorter cycle of these variables cause increasing in profitability.

Garcia et al (2011), did a study on the impact of working capital management upon Companies' Profitability. This study was based on a sample of 2,974 non - financial companies listed in 11 European Stock Exchanges for a period of 12 years: 1998 - 2009. The results found a significant negative relationship between Receivables collection period, Inventory conversion period, Payables deferral period, Cash Conversion Cycle and profitability. The study suggested that companies can improve their profitability by reducing the time span during which working capital is tied up within the company.

Mansoori & Muhammad (2012) did a study to investigate the relationship between working capital management on firm's profitability among firms listed on Singapore stock market exchange for the period 2004-2011. The finding from a sample of 92 firms indicated that cash conversion cycle negatively associated to the Return on Assets (ROA). The results demonstrate that firm's profitability is increased by decreasing in receivable conversion period and inventory conversion period. The negative relationship between payable conversion period and profitability might stem from the fact that more lengthening of payable deferral period would damage firm's reputation, and consequently decrease profitability.

Mathuva (2010), carried out a survey on the working capital management components on the corporate profitability among Kenyan firms listed at the Nairobi Securities Exchange (NSE). The findings from a sample of 30 listed firms indicated that firm's can increase profitability by reducing the number of days accounts receivable as well as increasing inventory to a reasonable level and taking longer to pay their creditors as far as they do not strain their relationship. By careful reduction of the CCC to its minimum, the profitability of the firm is expected to increase.

Kiplimo (2010), carried out a study on the relationship between working capital and profitability of the state owned commercial enterprises in Kenya. The findings from a sample of 23 firms for a period of 2005 to 2009 revealed that firms operating on shorter cash conversion cycle reported better returns. The firms with lower current to total assets ratios earned relatively better returns because they kept idle resources at optimum levels. Firms yielded better returns if they cautiously follow aggressive working capital management on profitability in large firms in Kenya.

## **2.5 Summary of the Literature Review**

The theoretical and empirical literature reveal that working capital is of great concern to all firms, and that efficient management of the working capital components that is cash, accounts receivable, inventories marketable securities and current liabilities will lead to improved financial performance. Managers should therefore aim at reducing the cash conversion cycle as far as it does not affect the business operations. Inventory should be maintained at optimal level in order to meet the customer demands. Very high inventory level on the other hand would lead to tying up of funds which would otherwise be utilized in viable venture. The firm should take longer to settle its accounts payable without straining the relationship with suppliers. Firms should also strive to collect the accounts receivable within the shortest time possible so as to utilize the funding to generate more sales.

Generally the results of previous studies document that, the way the various components of working capital are managed have a direct effect on the profitability. Given the seasonality of the hotel industry in Kenya there is need for effective management of the working capital management to maximize profitability in the industry. This study therefore is a modest attempt to close the knowledge gap by analyzing the effect of working capital management on profitability in the local setting of the five star hotels in Kenya.

## **CHAPTER THREE**

### **RESEARCH METHODOLOGY**

#### **3.1 Introduction**

This Chapter contains the methodology that was used to conduct the research. It described the research design, the population, sample, data collection and data analysis.

#### **3.2 Research Design**

The study used a descriptive design. A descriptive research is a process of collecting data in order to answer questions concerning the current status of the subjects in the study. The research often involves collecting information through data review. This type of research best describes the way things are (Mugenda & Mugenda, 2003).

#### **3.3 Population and Sample of the Study**

According to Cooper & Schindler (2003), a population is the subject such as a person, organization, customer database or amount of quantitative data on which measurement is being taken. The population of the study was the five star hotels in Kenya, as per the Hotels and Restaurants classification regulation, issued on 13<sup>th</sup> June 2003, Kenya Gazette notice No. 3976 (see Appendix II). The study targeted the five star hotels in Nairobi. According to the classification, there are seven five star hotels in Kenya which are all based in Nairobi.

#### **3.4 Data Collection**

The study employed the use of secondary data. The data was obtained from the audited statements of comprehensive income and statements of financial position for a period of 5 years from 2009 to 2013, from the respective five star hotels. Data was collected for each variable for each year under review, using a data collection sheet (see Appendix I). The specific data that was collected was the net profit and sales revenue so as to determine the net profit margin which is the dependent variable. Data for the analysis of the independent variable were: Cost of sales and inventory to determine the average number of days the firm



holds its inventory. Cost of Sales and Accounts payable to determine the average number of days the firm takes to pay its suppliers. Sales and Accounts receivable to determine the average number of days that the firm takes to collect its payments from its customers.

### **3.5 Data Analysis and Presentation**

In order to analyze the effect of working capital management on the profitability of the five star hotels, net profit margin as a measure of profitability was used as the dependent variable, which was derived as follows;

$$\text{Net profit Margin (NPM)} = (\text{Net profit}/\text{Total Sales}) * 100$$

With regards to the independent variables, working capital management was measured by using the number of days' accounts receivable, number of days of inventory and number of days accounts payable. In this respect, number of days sales outstanding (DSO) is calculated as  $[\text{accounts receivable}/\text{sales}] \times 365$ . This variable represents the average number of days that the firm takes to collect payments from its customers.

The number of days of inventory outstanding (DIO) is calculated as  $[\text{inventories}/\text{cost of sales}] \times 365$ . This variable reflects the average number of days of stock held by the firm. Longer storage times represent a greater investment in inventory for a particular level of operations.

The number of days payables outstanding (DPO) reflects the average time it takes firms to pay their suppliers and is calculated as  $[\text{accounts payable}/\text{Cost of sales}] \times 365$ . The higher the value, the longer firms take to settle their payment commitments to their suppliers.

Considering these three periods jointly, we will estimate the cash conversion cycle (CCC). This variable is calculated as;  $CCC = \text{Days inventory outstanding (DIO)} + \text{Days Sales outstanding (DSO)} - \text{Days payables outstanding (DPO)}$ .

**Control Variable;**

The Company Size (LOS): The companies which have more sales naturally are more Profitable. So the company size variable was used to control the effect of this. The company size is: *natural logarithm* of sale.

The study used regression model. The model was as follows;

$$Y_i = \alpha_0 + \beta_1 CCC_i + \beta_2 DIO_i + \beta_3 DSO_i + \beta_4 DPO_i + \beta_5 LOS_i + e_t$$

Where:

$Y_i$  = Profitability of firm

$\alpha_0$  = Estimated value of Y when all the other variables are Zero

$\beta_1, \beta_2, \beta_3, \beta_4, \& \beta_5$  = are the regression co-efficient

$CCC_i$  = Cash conversion cycle of firm i

$DIO_i$  = Days inventory outstanding of firm i

$DSO_i$  = Days sales outstanding of firm i

$DPO_i$  = Days payables outstanding of firm i

$LOS_i$  = The size of the firm i

$e_t$  = Error term

Coefficient of determination ( $R^2$ ) test was used to analyze how well the line of goodness of fit represents the data. Appropriate statistical tools such as Microsoft excel and statistical package for Social Sciences (SPSS) were used for analyzing the descriptive and other statistical measures.

## CHAPTER FOUR

### DATA ANALYSIS, RESULTS AND DISCUSSION

#### 4.1 Introduction

This chapter presents data analysis, interpretation and discussion of the research findings.

Descriptive and regression analysis has been utilized to analyze the findings in this study.

#### 4.2 Data Presentation

##### 4.2.1 Descriptive Data Presentation

**Table 4.1: Summary of Variables Statistics**

	NPM	DIO	DSO	DPO	CCC	LOS
Mean	.2355	49.0500	73.5500	57.2500	64.4000	14.5000
N	20	20	20	20	20	20
Std. Deviation	.07432	14.85181	21.08747	14.70723	41.45435	.82717

The above table gives the descriptive statistics of the collected variables. On average the Net profit margin is 23.55. %, inventory takes on average 49.05 days to be converted into sales. The credit period granted to customers ranged at an average of 73.55, the creditors are paid in 57.25 days on average, the overall average cash conversion cycle ranges at 64.4 days. The table also shows that on average firm has a turnover of 14.5 as measured by the natural logarithm of its total sales. All variables share a common sample size of four firms for a period of five years.

**Table 4. 2: Correlation between Variables**

Correlations							
Pearson Correlation	NPM	Year	DIO	DSO	DPO	CCC	LOS
NPM	1	-.276	-.922**	-.989**	.939**	-.981**	-.353
Year		1	.212	.263	-.187	.244	.088
DIO			1	.204	-.314	.253	.418
DSO				1	-.256	.281	.297
DPO					1	-.374	-.305
CCC						1	.342
LOS							1

\*\* . Correlation is significant at the 0.01 level (2-tailed).

There is a negative relationship between the DIO, DSO, CCC and the NPM while there is a positive relationship between DPO and the NPM.

#### 4.2.2 Regression Analysis

To establish the effect of working capital management on profitability of five star hotels in Kenya a multiple regression analysis was conducted. The regression model used was as follows;

$$\begin{aligned} \text{NPM} = & \alpha_0 + \beta_1 \text{ Cash Conversion Cycle} + \beta_2 \text{ Days Inventory Outstanding} \\ & + \beta_3 \text{ Days Sales Outstanding} + \beta_4 \text{ Days Payables Outstanding} \\ & + \beta_5 \text{ Size of the firm} + e_t \end{aligned}$$

Through regression analysis the results of correlation, coefficient of determination and analysis of variance (ANOVA) were also attained. Correlation sought to show the nature of relationship between dependent and independent variables while coefficient of determination showed the strength of the relationship.

**Table 4.3: Coefficient of Determination**

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.994 <sup>a</sup>	.988	.984	.00941

a. Predictors: (Constant), LOS, DSO, DIO, DPO, CCC  
 From table above, the adjusted R<sup>2</sup> (coefficient of determination) is 98.8% meaning 98.8% of the variation in the dependent variable is explained by the model.

**Table 4.4: ANOVA Table**

Model	Sum of Squares	Df	Mean Square	F	Sig.
1 Regression	.104	5	.021	234.217	.000 <sup>b</sup>
Residual	.001	14	.000		
Total	.105	19			

a. Dependent Variable: NPM  
 b. Predictors: (Constant), LOS, DSO, DIO, DPO, CCC

ANOVA was conducted to determine the differences in the means of the dependent and independent variable thus show whether a relationship exist between the two, from the ANOVA table above, degrees of freedom of (5,14) the F test value is 234.217 which is statistically significant at 5% level of significance. This indicates that at least one of the independent variables has significant effect on the dependent variable.

**Table 4. 5: Regression Table**

Model	Unstandardized Coefficients		Standardized Coefficients	t	Sig.
	B	Std. Error	Beta		
Intercept	.636	.068		9.280	.000
DIO	-7.454E-005	.001	-.015	-.126	.902
DSO	-.003	.001	-.740	-4.229	.001
DPO	0.002	.001	-.314	-2.352	.034
CCC	-.001	.001	-.533	-1.770	.098
LOS	-.004	.003	-.040	-1.225	.241

a. Dependent Variable: NPM

According the regression analysis table, the DSO, DPO and the intercept with the coefficients -0.003, 0.002 and 0.636 respectively shows significance according to their p-values (0.001, 0.034 and 0.001) less than 0.05 and are significantly affecting the NPM.

From the results the following regression model can be derived;

$$\text{NPM} = 0.636 - 0.003 \text{ DSO} + 0.002 \text{ DPO}$$

It is therefore clear that for every 0.003 unit decrease in the days sales outstanding the Net profit margin increase by 1 unit, this is consistent with the study carried out by Deloof (2003), Reheman and Nasr (2007), Shin and Soenen (1998) and Garcia- teruel and Martinez-Salano (2007). The results suggest that firms can improve their profitability by reducing the number of days accounts receivables are outstanding.

On the other hand for every 0.002 unit increase in days accounts payables outstanding the net profit Margin increases by 1 units. The positive relationship can be explained by the fact that more profitable firms wait longer to pay their bills, so as to take advantage of the cash available for their working capital need, the findings are in line with study carried out by Mathuva (2010), but contradicts the findings by Lazaridis & Tryfonidis (2006), who found that lower gross profit is associated with increase in the number of days accounts payables are outstanding. Days inventory outstanding affects the net profit margin minimally at -7.454E-0.05 and p value of 0.902, also the cash conversion cycle is at -0.001 and p value of 0.098 and hence the two are not statistically significant.

## **CHAPTER FIVE**

### **SUMMARY, CONCLUSIONS AND RECOMMENDATIONS**

#### **5.1 Introduction**

The purpose of the study was to analyze the effects of working capital management on profitability of the hotel industry in Kenya and focused on the five star hotels in Nairobi .This chapter is therefore a summary of the findings from the analysis of data, conclusions and recommendations based on the findings of the research study. The chapter also provides suggestions for further research in the field of working capital management and the limitations of the study.

#### **5.2 Summary of the Findings**

The study established that there is negative relationship between the Net profit Margin and the days sales outstanding a decrease by 0.003 in days sales outstanding will result to a unit increase in profitability, this is consistent with the study carried out by Deloof (2003), Reheman and Nasr (2007),Shin and Soenen (1998) and Garcia- teruel and Martinez- Salano (2007) this can be explained as the less time it takes for customers to pay their bills the more cash is available to replenish inventory hence the higher the sales realized leading to higher profitability, firms should collect receivables as soon as possible because it's better to receive inflows sooner than later and invest the money in different profitable ventures/areas. Managers can improve profitability by reducing the credit period granted to their customers

The findings also established that there is a positive relationship between the Net profit margin and the days payables outstanding, an increase of days payables outstanding by 0.002 units will result to an increase in net profit by one unit. This finding is in line with working capital management rule that firms should strive to lag their payments to creditors as much as

possible taking care not to spoil their relationship with them. Further this relationship can be explained that, more profitable firms wait longer to pay their bills by withholding their payment to suppliers so as to take advantage of the cash available for their working capital needs. It also makes economic sense in that, the longer a firm delays its payment to its creditors the higher the working capital levels it reserves and uses it in order to increase profitability. The findings are consistent with study carried by Lazaridis & Tryfonidis (2006), but contrary to studies by Deloof (2003) and Raheman and Nasr (2007). Although the days inventory outstanding and the cash conversion cycle were found to have a negative relationship to the net profit margin, the results are not statistically significant.

### **5.3 Conclusion**

The study shows that the profitability five star hotels highly depend upon effective working capital management. Net profit margin is negatively related to the days sales are outstanding, the inventory conversion period and the cash conversion cycle, and positively related to the days payables outstanding payables. The negative relationship between accounts receivables and firms' profitability suggests that less profitable firms will pursue a decrease of their accounts receivables in an attempt to reduce their cash gap in the cash conversion cycle. On the other hand they should delay the payment of creditors as long as they maintain a good relationship. Likewise the negative relationship between number of days in inventory and corporate profitability suggests that in the case of a sudden drop in sales accompanied with a mismanagement of inventory will lead to tying up excess capital at the expense of profitable operations.



## **5.4 Recommendations**

The management of the five star hotels can create value for their shareholders by reducing the number of days accounts receivable, taking long to pay their creditors as far as it does not strain their relationship maintaining the inventories at an optimal level to avoid stock outs as well as ensuring idle inventories are not held. Firms are capable of gaining sustainable competitive advantage by means of effective and efficient utilization of the resources through a careful reduction of the cash conversion cycle to its minimum. In doing so the profitability of the firm is expected to increase.

## **5.5 Limitations of the Study**

Most of the five star hotels in Kenya are privately owned and hence do not publicly avail their financial statements due to their nature of their operation. This made the data collection tedious and time consuming, due to this out of the population of seven hotels data was only obtained for four of them.

## **5.6 Recommendations for Further Research**

This research concludes that there is a pressing need for further empirical studies to be undertaken on the same topic on an industry wise analysis to better the performance of the hotel industry and to identify the specific problems they face in the management of their working capital, there is need to extend the sample size and the period of study as well.

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## APPEDINCES

### APPENDIX I

	<b>Data Collection Sheet</b>					
	<b>Name of the Hotel</b>					
Year	Sales Revenue Kshs. '000'	Cost of Sales Kshs. '000'	Net Profit Before Tax Kshs. '000'	Inventory Kshs. '000'	Accounts Receivable Kshs. '000'	Accounts Payable Kshs. '000'
2013						
2012						
2011						
2010						
2009						

## APPENDIX II

<b>LIST OF THE FIVE STAR TOWN HOTELS IN NAIROBI</b>			
	<b>Name of the Hotel</b>	<b>Postal Address</b>	<b>Number of Beds</b>
1	Intercontinental Hotel	P.O Box 30353-00200, Nairobi	770
2	Grand Regency Hotel/ Laico	P.O Box 57549-Nairobi	388
3	Hilton Hotel	P.O Box 30624-00100 Nairobi	353
4	Norfolk Hotel	P.O Box 40064 Nairobi	334
5	Serena Hotel	P.O Box 46302 Nairobi	283
6	New Stanely	P.O Box 30680 Nairobi	434
7	Safari Park Hotel	P.O Box 30680 Nairobi	285