RELATIONSHIP BETWEEN CAPITAL STRUCTURE AND FINANCIAL PERFORMANCE OF TOP 100 SMALL AND MEDIUM ENTERPRISES IN NAIROBI COUNTY

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DECLARATION

This research project is my original work and has not been presented to any other institution or university.

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This research project has been submitted for examination with my approval as the university supervisor.

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DEDICATION

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ABBREVIATION

EPS	-	Earnings per Share
LDTA	-	Long-Term Debt to Total Assets Ratio
MFI	-	Micro Finance Institutions
MVBR	-	Market Value of Equity Ratio
ROA	-	Return on Assets
ROE	-	Return on Equity
ROI	-	Return on Investment
SDTA	-	Short-Term Debt to Total Assets Ratio
SMEs	-	Small and Medium Enterprises
SPSS	-	Statistical Package for Social Sciences
TDTA	-	Total Debt to Total Assets Ratio
TDTQ	-	Total Debt to Total Equity Ratio
WACC	-	Weighted Average Cost of Capital

ABSTRACT

Small and Medium Enterprises (SMEs) use different sources of financing. Some of them emerging to be a challenge to the performance of the SME since most SME owners' lack necessary knowledge on which sources of finance enhances financial performance. Despite SMEs using different sources of financing some of them are still not growing and others are collapsing, majority of SME owners do not have ideas on how debts and internal sources of finance influences their financial performance. Therefore, this study aimed at establishing the relationship between capital structure and financial performance of top 100 small and medium enterprises in Nairobi County. Capital structure employed by firms could be a reason influencing their financial performance trends an issue that has not been given serious attention. It is on this basis that the researcher was propelled to investigate the contribution of capital structure on small and medium firms' financial performance. The study targeted 100 SMEs which are registered as companies in Nairobi County. Simple random sampling was applied for choosing the samples size. The sample size selected under proportional allocation was 30. Secondary data was collected from financial records of SMEs. Documentary guide aided in data collection. Descriptive statistics such as mean and standard deviation and inferential statistic such as Pearson correlation and multiple regression model was used in analyzing data. The findings revealed that capital structure had negative relationship on firm financial performance of SMEs in Nairobi County. The study showed that small and medium enterprises in Nairobi County used both debt and equity in their capital structure although debt was predominant. There is evidence that capital structure has a positive significant effect on ROA. From the findings, firm's with more liquid stock is highly likely to meet its financial obligations in the required time and higher liquidity is as a result of proper organization of internal sources and debts. The study affirms that capital structure has a significant effect on financial performance. From the study findings there is enough prove that capital structure enables SMEs to engage in financial investments. The results of study on the relationship between capital structure and performance of SMEs are contradictory which justifies further research.

CHAPTER ONE: INTRODUCTION

1.1 Background to the Study

Capital structure is defined as a mix of a company's long-term debt, specific short-term debt, common equity and preferred equity. The capital structure is how a firm finances its overall operations and growth by using different sources of funds. Debt comes in the form of bond issues or long-term notes payable, while equity is classified as common stock, preferred stock or retained earnings. Short-term debt such as working capital requirements is also considered to be part of the capital structure (Aburub, 2012). Brigham and Houston (2007) referred to Capital structure as the way in which a firm finances its operations which can either, be through debt or equity capital or a combination of both.

According to Myers (2001), there was no universal theory on the debt to equity choice but noted that there were some theories that attempted to explain the capital structure mix. Myers (2001) cited the tradeoff theory which states that firms seek debt levels that balance the tax advantages of additional debt against the costs of possible financial distress. The pecking order theory states that firms will borrow rather than issue equity when internal cash flow is not sufficient to fund capital expenditure. The theory concluded that the amount of debt will reflect the firms' cumulative need for external funds. The free cash flow theory on the other hand stated that dangerously high debt levels would increase firm value despite the threat of finance distress when a firms' operating cash flow significantly exceed its profitable investment opportunities.

Capital structure is a major area of interest for researchers of corporate finance. In recent years the influence of financial crisis on stock markets around the globe has raised renewed concerns on excessive leverage of firms and its impact on their financial performance. Theoretically most models discussing capital structure of firms identify tax savings, bankruptcy costs, transaction costs, adverse selection and agency cost among others as the dominant factors influencing a firm's choice of debt and also its impact on firm performance (Barclay and Smith, 1996). In practice different firms may pursue different goals but the core objective of any firm is to minimize its cost and maximize profits. The creditors and investors in the stock market are concerned specifically in the financing cost of capital. This may be so because debt to equity ratio enables the creditors in knowing the likelihood of default of the excessively leveraged firms. Similarly, investors and traders in the stock market are interested to know the relative impact of debt on a firm's performance. Both investors and traders examine the daily performance of firms listed on stock exchanges and rank firms accordingly. It is on the basis of this ranking and historical prices of stocks that they decide to invest their funds in relatively high performing firms.

Financial performance is a measure of how well a firm can use its' assets from its' primary business to generate revenues. Erasmus (2008) noted that financial performance measures like profitability and liquidity among others provided a valuable tool to stakeholders to evaluate the past financial performance and the current position of a firm. Brigham and Houston (2007) argued that in theory, the Modigliani and Miller

model of capital-structure irrelevance proposition was valid but in practice, bankruptcy, transaction and taxes costs did exist and that these costs were directly proportional to the debt levels in a firm. This conclusion implied a direct relationship between capital structure and financial performance of a firm.

1.1.1 Capital Structure

Capital structure are financing decisions of a firm that have to be made regarding the debt and equity combination i.e. in what proportion debt and equity has to be maintained its how a firm finances its assets through some combination of equity, debt and hybrid securities. These securities are traded in a stock market which is part of the broader market referred to as financial markets (Reily, 1997; Fabozzi, 1995). Investors in the stock market are supposed to act according to rationalism provided by the financial theories. Perspective on how financial markets function is largely based on the notion of rationality of the investors and explanation based on efficient market hypothesis. However, a new dimension based on the notion of behavioral finance provides new models to understand functioning of financial markets and stock exchanges in cases where some participants in the market are not fully rational.

Capital structure refers to a mixture of a variety of long term sources of funds and equity including reserves and surpluses of an enterprise. The historical attempt to building theory of capital structure began with the presentation of a paper by Modigliani & Miller (1958). They revealed the situations under what conditions that the capital structure is relevant or irrelevant to the financial performance of the listed companies. Most of the

decision making process related to the capital structure are deciding factors when determining the capital structure. A number of issues example, cost, various taxes and rate, interest rate have been proposed to explain the variation in financial leverage across firms (Van Horne 1993; Hampton 2008; Titman and Wessels 2008). These issues suggests that depending on attributes that causes the cost of various sources of capital, the firm's select capital structure and benefits related to debt and equity financing.

1.1.2 Financial Performance

This is a measure of how well a firm can use assets from its primary mode of business and generate revenues. This term is also used as a general measure of a firm's overall financial health over a given period of time, and can be used to compare similar firms across the same industry or to compare industries or sectors in aggregation (Bernardin and Russel, 2009). There are many different ways to measure financial performance, but all measures should be taken in aggregation. Line items such as revenue from operations, operating income or cash flow from operations can be used, as well as total unit sales. Furthermore, the analyst or investor may wish to look deeper into financial statements and analyses margin growth rates or any declining debt. Ultimately the universal measure of business performance is profits and the ultimate forms of this measurement are the final accounts of the company. Profits have the advantage that it can be used to measure the effectiveness and efficiency not only of different business functions (marketing, engineering, production) but also compare different businesses or firms.

According to Sunder and Myers (2009), organizational performance encompasses three specific areas of firm outcomes that's includes financial performance (profits, return on assets, return on investment), product market performance (sales, market share) and shareholder's return (total shareholder return, economic value added).

1.1.3 Capital Structure and Financial Performance

The relationship between capital structure and financial performance is one that have received considerable attention in the finance literature. How important is the concentration of control for the company performance or the type of investors exerting that control are questions that authors have tried to answer. Prior studies show that capital structures have a relationship with corporate governance, which is the key issue of state owned enterprises. To study the effects of capital structure or financial performance, will help us know the potential problems in performance and capital structure (Fabozzi, 1995).

The irrelevance of capital structure theory by Modigliani and Miller (1958) argued that in a perfect market situation, there is no link between firm value and its financing mix. The restrictive and unrealistic assumptions of this theory led to subsequent research work suggesting that the firm performance is actually affected by the amount of debt in the capital mix choices available to the firms. Not surprisingly this debate led to contesting views on financial performance and capital structure, and the two main capital structure theories often referred to in the literature are the tradeoff theory and the pecking order

theory of leverage. However, empirical evidence reported is mixed which indicates that theory is not quite simple and straight forward in this regard.

Empirically, studies reporting a negative relationship between firm's performance and capital structure seem to be consistent with the predictions of pecking order theory in contrast to the tradeoff theory. However, this seems to be too simplistic view of the relationship between firm's performance and its capital structure. In practice it is observed that profitable firms tend to retire their debt and maintain leverage close to the lower end, whereas loss making firms are found to have higher debt level and are close to the higher limit of debt ratio. This indicates that profitability may also reflect the growth aspect of firms. Thus in contrast to the static trade off theory, the dynamic trade off theories suggests that firm performance and leverage may be negatively related, implying that trade off theory is ambiguous on profit and debt to equity relation (Frank and Goyal, 2007).

1.1.4 Top 100 Small and Medium Enterprises in Nairobi County

The small and medium enterprises (SMEs) play an important role in the Kenyan Economy. According to the Economic Survey (2006), the sector contributed over 50 percent of new jobs created in the year 2005. Despite their significance, past statistic on capital structure indicate that three out of five businesses fail within the first few months of operation (Kenya National Bureau of Statistic, 2007). According to Amyx (2005), one of the most significant challenges is the negative perception towards SMEs. Potential clients perceive top small and medium businesses as lacking the ability to provide quality

services and are unable to satisfy more than one critical project simultaneously. Often larger companies are selected and given business for their clout in the industry and name recognition alone.

The SME sector has caught the attention of government and other private sector who in a bid to move the country to a middle level economy as envisaged in the development blue print of Vision 2030 are strategizing how to create an enabling environment for this sector with the realization that the sector is a key pillar if the country is to realize its Vision 2030 (Muhoho, 2008). Already the Kenyan government has taken the driver's seat in championing SME sector as key to shaping the Vision 2030 Kenyan dream. "SMEs are central in creating a balance between the needs of rural and other disadvantaged areas, where the majority of the poor live thus increasing competition and contributing to a more equitable distribution of income (Ramachandran, 2008).

Kenya has emphasized micro and small-scale enterprises in its development agenda. This is important since many Kenyans lack formal employment. They therefore depend on informal employment in SMEs. SMEs also create job opportunities, promote national productivity, provide materials and components to other industries, promote rural development, reduce rural-urban migration and supply goods and services to customers at reasonable prices. Micro-Financial Institutions appeared to be not common source of funds for entrepreneurs in Nairobi Central Business District. The variations in sources of funds could be attributed to urban trends in borrowing where banks are readily available as compared Micro-Financial Institutions which are predominantly in rural set-up. There

is also some level of doubts that people have on the authenticity of MFIs. Lack of access to long-term credit for small enterprises thus, forces them to rely on high cost short term finances which in turn hinder their very growth.

1.2. Research Problem

Small and medium enterprises are the major agents of economic growth and employment. In Kenya, over sixty percent of small businesses are estimated to fail each year (Kenya National Bureau of Statistics, 2007). Marsh (1998) observed that the health of the economy as a whole has a strong relationship with the health and nature of SMEs. However, despite government efforts in Kenya to promote SMEs activity, not much progress seems to have been achieved, judging by the performance of the informal sector. When the state of the macro economy is less favorable, by contrast, the opportunities for profitable employment expansion in SMEs are limited. Unfortunately, there is very little information on how the small business sector is structured. Starting and operating a small business includes a possibility of success as well as failure. Because of their small size and the exposure to risks owing to their location, a simple management mistake is likely to lead to sure death of a small enterprise hence no opportunity to learn from its past mistakes.

Capital structure employed by firms could be a reason influencing their financial performance trends an issue that has not been given serious attention. It is on this basis that the researcher was propelled to investigate the contribution of capital structure on small and medium firms' financial performance Berger (2006). On one

hand, costs of designing and enforcing regulatory policies to address the specific challenges of microfinance are substantial; this research was conducted by Odhiambo (2009). On the other hand, complying with supervisory requirements is costly. Barth et al. (2004), have reviewed the implications of supervision on the performance of financial intermediaries.

Studies have been done on capital structure and financial performance. For instance, Abor (2005) also found a positive relationship between total assets and return on equity and that profitable firms in Ghana depended more on debt as a main financing option due to a perceived low financial risk. Brander and Lewis (2006) and Maksimovic (2005) provide the theoretical framework that links capital structure and market structure. Contrary to the profit maximization objective postulated in industrial organization literature, these theories are similar to the corporate finance theory in that they assume that the firm's objective is to maximize the wealth of shareholders. Furthermore, market structure is shown to affect capital structure by influencing the competitive behavior and strategies of firms. Evaluations by Mohammed (2001) that financial and operating performance of newly privatized Egyptian state-owned enterprises and determines whether such performance differs across firms according to their new ownership structure. Study was carried out by Elsayed (2009) on the effect of capital structure on the performance of 64 Egyptian companies during 1997 to 2005. The results suggest that there is a significant negative relationship between ROA and total debt to total assets ratio. Nevertheless, prior researches have difficulty providing evidence on positive relationship between capital structure and financial performance. The interest in the study

has been inspired by the existing knowledge in addition to the current literature, creating further a gap in emerging economies and their unique needs.

A study was done by Wanjeri (2012) on the effect of capital structure on performance of non-financial companies listed in Nairobi Securities Exchange. Similarly, Oyerogba (2012) did a study on perceived relationship between corporate capital structure and firm value in the Kenyan Listed Companies. A study was also done by Gicheha (2012) on the effects of capital structure on the financial performance of Commercial Banks in Kenya. These studies found out that the major factors affecting capital structure of banks were liquidity, size, growth and profitability. In addition the researchers rejected the null hypothesis after conducting the chi test and accepted the alternative hypothesis that there is a relationship between capital structure and financial performance of commercial banks in Kenya.

Capital structure in an organizational performance encompasses specific areas of firm outcomes that's includes financial performance i.e. profits, return on assets, return on investment, product market performance consisting of sales, market share and shareholder's return total shareholder return and economic value added. None of the above studies have critically examined the relevance of capital structure and its effect on financial performance of top 100 small and medium enterprises in Nairobi County. This research work attempts to fill this noticeable gap in literature and bring light on the relationship between capital structure and financial performance of top 100 small and medium enterprises in Nairobi County.

The study therefore seeks to answer the research question: What is the relationship between capital structure and financial performance of top 100 small and medium enterprises in Nairobi County?

1.3 Research Objective

To investigate the relationship between capital structure and financial performance of top 100 small and medium enterprises in Nairobi County.

1.4 Value of the Study

Findings of the study will particularly be useful in providing additional knowledge to existing and future institutions on the relationship between capital structure and financial performance of top 100 small and medium enterprises in Nairobi County and provide information to potential and current scholars on capital structure and financial performance. This will expand their knowledge on capital structure and financial performance in small medium enterprises in Kenya and also identify areas of further study. The study will be a source of reference material for future researchers on other related topic on capital structure; it will also help other academicians who undertake the same topic in their studies.

The findings of this study will help in enlightening the key decision makers in small medium enterprises in Kenya and the government on policies formulation and on capital structure and financial performance of small medium enterprises and how they could

purpose to mitigate the challenges facing it. The study will in addition to the above, be useful to stakeholders, financiers, and investors in formulating and planning areas of intervention and support (Brander and Lewis, 1986).

Finally, the study is important not only to small medium enterprises in Kenya in Kenya but also to other managers in other sectors. It would help them understand the relationship between capital structure and financial performance of small medium enterprises in Kenya; it helps different firms achieve success better than others.

CHAPTER TWO: LITERATURE REVIEW

2.1 Introduction

This chapter is examined the literature relevant to the study. It is followed the empirical framework of the relationship between capital structure and financial performance, incorporate scholarly works and theories.

2.2 Theoretical Review

2.2.1 Capital Structure Theory

Capital structure puts into perspective the way in which a firm finances its operations Brigham (2004). This can either be through debt or equity capital or a combination of both David (1979). Capital structure theory as attributed to Modigliani and Miller concluded that it doesn't matter how a firm finances its' operations and that the value of a firm is independent of its' capital structure making capital structure irrelevant. The study was based on the assumption that there were no brokerage costs, earnings before interest and tax were not affected by the use of debt and that investors could borrow at the same rate as corporations and lastly there was no information asymmetry. Although this statement didn't reject the possible preference of a firm's owner to a certain type of financing over others, it did affect the irrelevance of the value of the firm to the means of financing it given a perfect market (Fischer, Heinkel, and Zechner, 1989). A number of theories were from then onward advanced to explain capital structure notable among which are the pecking order theory and trade off theory which have been often than not a centre of debate.

If the situation were to hold under all circumstances, then it would be best for a firm to increase its debt capital to very high levels. However, as the level of borrowing increases so does the financial risk of the firm. Ordinary shareholders become aware of this increase in risk and will require a greater return to compensate them for it. Thus the cost of equity would start to increase. Similarly, debt providers would also notice the increased financial risk of the firm and require a greater return for additional levels of debt provided to compensate them for the risk. Thus the cost of debt would increase at higher levels of gearing (Brander and Lewis, 1986).

Interest on debt is an allowable expense when determining a company's tax liability and lowers the tax burden. Thus it has an effect of shielding corporate profits which is a benefit to the ordinary shareholder. As the level of debt increases so too does the tax benefits which offsets some of the risk that the ordinary shareholder would require as per MM I. As the increases in the required return by ordinary shareholders is lower than the benefits of debt, the overall cost of capital decreases as the level of borrowing increases. In the absence of bankruptcy costs and financial distress implications MM II promotes high levels of debt financing due to the after tax cost of debt being lower that the cost of equity and its resultant decreasing of the overall cost of capital to the firm. One can conclude that to continue in this manner, the optimal level is at a 100% level of gearing (Jensen and Meckling 2002).

2.2.2 Trade-off Theory

The publications by Modigliani and Miller led to a surge in research where the primary focus was either to prove or disprove the Modigliani and Miller propositions. As MM I is based on a very restrictive set of assumptions, it is only logical that further tests would be conducted to determine if MM I would still hold if these assumptions were to change. The trade-off theory arose due to the relaxation of such assumptions. Kjellman and Hansén (2011) stated that 'the static trade-off model states that value maximizing firms chooses the target debt/equity ratio that maximizes firm value by minimizing the costs of prevailing market imperfections, such as taxes, bankruptcy costs, and agency costs.

MM I state that in a perfect capital market it is irrelevant how a firm chooses to raise finance as the financing decision has no impact on firm value. However, capital markets are imperfect and the existence of bankruptcy costs, taxes and agency costs imply that MM I does not apply in reality. Modigliani and Miller then followed up their article in 1963 and introduced corporate taxes and suggested that to achieve maximum value a firm should have 100% debt. The environment in which a firm operates, taxes, bankruptcy costs, agency costs, asymmetric information as well as non-debt tax credits restricts a firm from using 100% debt, thus the solution provided by MM II seems too extreme in reality (Brander and Lewis, 1986).

According to Myers (2001), in his research on capital structure, he noted that the trade-off theory justifies moderate debt ratios. The purpose of the trade-off theory of capital structure is to explain the strategy a firm uses to finance investments which may be

by equity and sometimes by debt. Tradeoff theory predicts that a weak firm will rely exclusively on a bank for debt capital. That is, for weak firms, bank debt dominates any mix of market and bank debt regardless of the priority structure. This result contradicts the notion that small/young firms avoid public debt because they lack access to such markets or face prohibitive costs in so doing (Hackbarth, Hennessy and Leland, 2007). Within the tradeoff theory, there is a debt "pecking-order" with bank debt being preferred to market debt due to the lower implied bankruptcy costs. When the bank holds all ex post bargaining power, the desired level of debt tax shields can be achieved using only bank debt (Hackbarth *et al.*, 2007).

Further observation by Myers (2001) noted that the firm would borrow up to the point where the marginal value of tax shields on additional debt is offset by the increase in the present value of possible costs of financial distress. According to Modigliani & Miller (1958), the attractiveness of debt decreases with the personal tax on the interest income. A firm experiences financial distress when the firm is unable to cope with the debt holders' obligations. If the firm continues to fail in making payments to the debt holders, the firm can even be insolvent. The theory can be explained by costs of financial distress and agency costs.

In reality, bankruptcy costs can be quite onerous and can be incurred not only when bankruptcy proceedings are in process, but also when the threat of bankruptcy is imminent. Firms that are experiencing bankruptcy issues have high legal and accounting related expenses, costs of debt covenants as well as the potential loss of clients/suppliers,

impaired ability to conduct business. The trade-off theory attempts to incorporate the costs of financial distress into the capital structure decision. According to the trade-off theory, a firm must decide on a target debt ratio which maximizes its value and then slowly move towards that target debt ratio. The optimal capital structure is found when the marginal benefit of each incremental unit of debt thus interest tax shields is equal to marginal cost of each incremental unit of debt thus financial distress costs (Jensen and Meckling, 1976).

2.2.3 Pecking Order Theory

The pecking order theory as developed by Myers (1984) stated that firms prefer internal sources of finance; they adapt their target dividend payout ratios to their investment opportunities although dividends and payout ratios are gradually adjusted to shifts in the extent of valuable investment opportunities. In addition, Myers (1984) stated that in the event that external finance is required, firms are most likely to issue the safest security first that is to say they start with debt then possibly convertible debt then equity comes as last resort. In summary, Myers' argument was such that businesses adhere to a hierarchy of financing sources and prefer internal financing when available. Should external financing be required, debt would be preferred over equity. Pandey (2005) also concurred with Myers' argument when he noted that managers always preferred to use internal finance and would only resort to issuing shares as a last resort. He went on to add that the pecking order theory was able to explain the negative inverse relationship between profitability and debt ratio within an industry however; the theory did not fully explain the capital structure

differences between industries.

A theory by Myers (1995) stated that the equity of a firm will be mispriced by the market when the management of that firm holds more information about the future prospects of the firm and condition of its assets as compared to outside shareholders. According to Myers and Majluf (1984), the market tends to conclude that the shares of an issuing firm are overvalued, which in turn leads to lower proceeds for a share issuing firm. The important fact here is that managers will only issue shares when they are overvalued in order to protect the interests of existing shareholders. Issuing underpriced shares would actually result in the transfer of wealth from old to new shareholders. Since the market is aware of this, an issue of shares by a firm will thus be construed as a signal that the shares are overvalued, or as bad information about an issuing firms‟ quality. The result is that the price of shares tends to fall after a share issue. This can be so severe as to force the managers to pass-up positive NPV projects (Jensen and Meckling, 1976).

Studies by Scherr *et a,* (1993), Holmes *et al* (1991) and Quan (2002) considered the pecking order theory as an appropriate description of Medium Sized Enterprises' financing practices because debt is by far the largest source of financing and that small and medium enterprise managers tend to be owners of the business who do not normally want to dilute their ownership. In addition, they concurred that firms consequently tend to prefer internal financing to external financing of any sort and if they must obtain external funding, they have a preference of debt over equity. They also noted that the order of preference reflected the relative costs of various financing

options. Firms therefore would prefer internal sources of finance as compared to expensive or costly external finance and that firms that are profitable and therefore generate earnings are expected to use less debt than those that do not generate high earnings.

The pecking order theory assumes that management behavior and actions are in the best interests of existing shareholders and any equity issues are due to current equity being overvalued and such value is to be transferred to existing shareholders upon the new issue (Myers, 2001:95). But Myers and Majluf (1984) were unable to prove whether or not managers care if a new stock issue is over-or undervalued which brings the pecking order theory under scrutiny. Also, they make no mention of how management incentives schemes affect the choice between debt and equity issues as mentioned under signaling theory by Ross (2002). Later studies by Frank and Goyal (2003) tested the pecking order theory by analyzing the financing patterns of American firms for the period 1971 to 1998. In their findings Frank and Goyal found little evidence to support the pecking order theory and argued that equity issues are more closely correlated with financing deficits rather than debt.

2.3 Determinants of Financial Performance of SMEs

2.3.1 Size of the Company

Financial performance is positively related with size of company. Arguments were floated by Hardwick (1997) that there is a positive relationship between performance and company size due to operating cost efficiencies through increasing output and

economizing on unit of cost. Large corporate size also enables investors to effectively diversify their assumed risks and respond more quickly to changes in market conditions. Large firms as Bain (1968) and Scherer (1980) argued possess monopoly power which allows them to set prices above the economic costs involved in the production of the products resulting in additional profit for the larger firms. In terms of investment performance, Adams (1996) believes that large companies are able to diversify their investment portfolios and this could reduce their business risks. Observations by Grace and Timme (1992) that large companies generally outperform smaller ones because they manage to utilize economies of scale and have the resources to attract and retain managerial talent.

2.3.2 Liquidity

Liquidity as studies done by Shiu (2004) proves that companies with more liquid assets are likely to perform better as they are able to realize cash at any point of time to meet its obligation and are less exposed to liquidity risks. By not having sufficient cash or liquid assets, companies may be forced to sell investment securities at a substantial loss in order to settle claims promptly. This in effect will affect their financial performance.

According to Adam and Buckle (2003), liquidity measures the ability of managers in companies to fulfill their immediate commitments to policyholders and other creditors without having to increase profit from investment activities and or liquidate financial assets. Therefore, having high liquidity obviates the need for the management of the companies to improve their financial performance

2.3.3 Solvency Margin

Solvency margin of a firm similarly is a determinant of financial performance as it acts as a cushion to absorb the risk of conducting businesses. The capital or surplus is measured as the excess of assets over obligations (Adams & Buckle, 2003). Companies with higher solvency margin are considered to be more financially sound as it has more surpluses to cater for any unexpected losses.

Companies performance may improve as Shiu (2004) observed through a higher solvency margin as better risks are attracted to the more stable investors and this will contribute towards higher returns. The lower the solvency risks of a firm, the better the financial performance expectations.

2.3.4 Interest Rates on Bonds and Fixed Deposits

A major determinant of performance is interest rates. According to D' Arcy (1979), study on insurance companies, high interest rates on bonds and fixed deposits will give rise to high investment earnings and consequently this would enhance the investment performance of insurance companies. Observations by Browne and Hoyt (1995) proved that, as interest earnings are a significant source of revenue for insurers, companies are more likely to perform well and remain solvent when interest earnings are high. Therefore, it is expected that performance is positively related to interest rate levels.

2.4 Empirical Review

A study done by Raheel (2013) on capital structure and financial performance where a total of 83 companies are selected from Pakistan for analysis. Findings of the study suggest that financial performance of firms is significantly affected by their capital structure and their relationship is negative in nature. Moreover capital structure of a firm is negatively related to its market value and also increases its risk level as the share of debt increases in the capital mix. Empirical evidence gives little indication of identifying the casual relationship between capital structure of a firm and its financial performance, However it is generally believed that transactions and bankruptcy costs play a vital role in the choice of debt to equity financing. Debt/Equity ratio is commonly used as a measure of capital structure, while other ratios like (Earning per Share, Price/Earnings Ratio, Operating profit Margin, Return on Asset, Return on equity) are used as proxies for firm performance. These ratios are used to study the relationship between capital structure and firm performance in the context of large private companies in Pakistan.

A study was carried by Mukuria (2012) on the effect of capital structure on the outreach level and default on MFIs in Nairobi that explored how capital structure relates to outreach level and default rate was carried on Nairobi based MFIs. The population comprised 36 MFIs registered by AMFI as at December 2011. Convenient sampling method was employed. From the financial and income statements panel data covering five-year period from 2004 to 2008 was summarized using a secondary data collection form and analyzed using ratios, descriptive statistics and multiple regression analyses. The findings showed that most of the MFIs employed high leverage. The mean total debt

ratio was 76%. Further the results showed that MFIs financed their operations with long term as against short-term debts suggesting a considerable dependence on long-term debts by MFIs for their operations. The MFIs studied were also found to enjoy satisfactory performance recording mean values of 36% and 33% for ROA and ROE respectively. A few MFIs were also found to be doing well while most of them are not as suggested by standard deviation of 1.52 with respect to ROA hence overall mean could be driven by a few MFIs.

A further study was done by Gicheha (2012) on the effects of capital structure on the financial performance of Commercial Banks in Kenya where the financial performance was measured in terms of return on assets and return on equity. The period of study was 2004 to 2009. The population of study consisted of all the 43 commercial banks that are dully registered with Central Bank of Kenya by 2009. Secondary data used was obtained from the Central Bank of Kenya and consisted of consolidated financial statement of commercial banks in the period 2004 - 2009. Data analysis was done by use of regression analysis model with the help of Statistical package for social sciences software. The results found out that the major factors affecting capital structure of banks was liquidity, size, growth and profitability. In addition the researcher rejected the null hypothesis after conducting the chi test and accepted the alternative hypothesis that there is a relationship between capital structure and financial performance of commercial banks in Kenya.

A study on perceived relationship between corporate capital structure and firm value in the Kenyan Listed companies was carried out by Oyerogba, (2012). The study employed

an explanatory research design. The population of the study consisted of 61 companies listed on the NSE. The sample size for this study was made up of 35 listed companies excluding the financial companies, Investment and Insurance companies due to their peculiar nature of capital structure. The study relied on Secondary data sourced from annual audited financial statement of the firms listed on Nairobi Securities Exchange. The study utilized descriptive and regression analysis to determine the relationship between corporate capital structure and firm value of the Kenyan listed companies. The study results were that companies used more debt as a source of financing its assets than equity capital. The regression results indicated that there was a positive relationship between capital structure, size of the firm, liquidity, growth opportunity and firm value. Therefore, the higher the debt to equity ratio, the higher the firm value. The unique contribution of this paper is that it reduces the lack of conclusiveness on the debate about the relationship between corporate capital structure and firms value. The study recommended the listed companies in Kenya to engage strategic investors to shore up their debt capital and also recommended that the equity share holder should be substituted for debt shareholding in future. This would bring about improved firms value.

A study carried out Mwangi (2013) on determinants of financial performance of commercial banks in Kenya revealed that Kenya has experienced slowed economic growth between 2006 and 2012. Under such economic conditions, most industries are expected to register a decline in profitability. The banking industry, however, registered improved performance raising queries on what actually determines the performance of banks in Kenya. This study used secondary data from annual published financial

statements and bank supervision records at the Central Bank of Kenya. Empirical results show that Operational efficiency and financial structure significantly determine performance for commercial banks in Kenya when both local and foreign banks are taken together. The same applies when the regression is run for locally owned banks. However, for foreign banks only operational efficiency is significant. Liquidity was not found to be a significant determinant of financial performance for commercial banks.

A study in India was done by Nadeem (2010) on the impact of capital structure on performance of non-financial listed firms in Pakistan. The researcher employed panel econometric techniques namely pooled ordinary least squares, fixed effects, and random effects methodoligal approach. Empirical results indicate that all measures of capital structure (i.e. total debt ratio, long and short-term debt ratio) are negatively related to return on assets in all regressions. Moreover, total debt ratio and long-term debt ratio are negatively related to market-to-book ratio under the pooled ordinary least squares model, whereas these measures are positively related to market-to-book ratio under the fixed effects model. Short-term debt ratio is positively related to market-to-book ratio in all regressions, however the relationship is found insignificant. A negative relationship between capital structure and performance indicates that agency issues may lead the firms to use higher than appropriate levels of debt in their capital structure. This overleveraging may increase the lenders' influence which in turn limits the managers' ability to manage the operations effectively, hence negatively affecting the firm performance.

Research by Aburub (2012) investigated the impact of capital structure on the firm performance of companies listed in Palestine Stock Exchange, during 2006 to 2010 which 28 companies were selected as samples. In this study, five measures of Return On Equity (ROE), return on assets (ROA), earnings per share (EPS), market value to book value of equity ratio (MVBR) and Tobin Q ratio as the measures of accounting and market of firm performance evaluation and also as dependent variables., and four measures of short-term debt to total assets ratio (SDTA), long-term debt to total assets ratio (LDTA), total debt to total assets ratio (TDTA) and total debt to total equity ratio (TDTQ) as the measures of capital structure and also as the independent variables were selected. Results indicate that the capital structure has a positive effect on firm performance evaluation measures.

2.5 Summary of Literature Review

From the review of literature, it was clear that relationship between capital structure and performance indicates that agency issues may lead the firms to use higher than appropriate levels of debt in their capital structure. This overleveraging may increase the lenders' influence which in turn limits the managers' ability to manage the operations effectively, hence negatively affecting the firm performance. However in the dynamism and turbulence, small businesses are affected more than the large organizations because the response to environmental changes is different in small businesses than in large, which may exit from one business area and have resources and strategic choices not available to small business enterprises.

Capital structure is reached when tax advantage to borrowing (tax shield) is balanced, at the margin, by cost of financial distress as stated by Mwangi, (2013). This is contrasted against the old-fashioned pecking order framework in which the firm prefers internal to external financing and debt to equity if it issues securities. The firm's overall weighted average cost of capital is not influenced by changes in capital structure i.e. capital structure is irrelevant. Their proposition was that in the absence of tax, a company's capital structure would have no impact upon its weighted average cost of capital (WACC).

It was evident that the major factors affecting capital structure of banks was liquidity, size, growth and profitability. The moderating role of ownership identity on the financial performance of commercial banks was insignificant. Thus, it can be concluded that the financial performance of commercial banks in Kenya is driven mainly by board and management decisions, while macroeconomic factors have insignificant contribution. There is a significant relationship between capital structure and performance thereby suggesting that the use of equity financing allows greater flexibility and discretion leading to greater innovative activities than the use of debt.

CHAPTER THREE: RESEARCH METHODOLOGY

3.1 Introduction

This chapter outlines the methods that were adopted by the study in obtaining information on the relationship between capital structure and financial performance of top 100 small and medium enterprises in Nairobi County. The chapter also describes and explains the research instrument that was used in the study. The chapter is thus structured into research design, target population, sample and sampling techniques, data collection and data analysis techniques.

3.2 Research Design

The research design that was used in this study was both cross sectional and descriptive survey method aimed at establishing the relationship between capital structure and financial performance of SME's in Nairobi County. These methods were preferred because it allows for prudent comparison of the research findings. A cross sectional and descriptive survey attempts to describe or define a subject often by creating a profile of a group of problems, people or events through the collection of data and tabulation of the frequencies on research variables or their interaction as indicated.

3.3 Population of Study

The target populations in this study were the 100 SME's who are operating within the Nairobi County. This target group has been chosen, because this is a homogenous group having diverse preferences, yet are operating under similar conditions, who can be identified and who bear similar characteristic capital structure in their marketing

gimmicks. They are also more likely to have tried and experimented with all manner of marketing strategies and plans and would therefore be in a better position of giving valid results. In this study therefore, the SME's were grouped according to the sector that the industry is operating in, more specifically in the following sectors; Manufacturing, Agriculture and other service industry

3.4 Sample

According to Orodho (2002), sample is selecting a given number of subjects from a defined population as representative of that population. Any statements made about the sample should also be true of the population. Mugenda and Mugenda (2003) states that a sample of 30% is considered representative for a population less than 500. The sample size is justified by 30% since it minimized the duplicity and redundancy of the data to be obtained and the size would be large enough to ensure collection of comprehensive data. Therefore, the sample size is 30 respondent from the top small and medium enterprises in Nairobi County.

The study adopted a simple random sampling to select 30 small and medium enterprises in Nairobi County.

3.5 Data Collection

This study used secondary data to solicit information needed in this study. The type of data collected included return on asset, capital structure; size of the company is measured

by natural logarithm of asset, liquidity of SMEs financial statements for a period of 5 years (2009-2013).

The sample SMEs were requested to provide their financial Statements to facilitate extraction of the data to be used in the study. The collected data was captured in excel and Statistical Package for Social Sciences for the purpose of data analysis.

3.6 Data Analysis

A descriptive analysis was employed. Quantitative method of data analysis was used. Data was coded and thereafter analyzed using Statistical Package for Social Sciences (SPSS) program and presented using tables and charts to give a clear picture of the research findings at a glance. Results were presented in tables and charts. Correlation and regression analysis were used to establish the association and effect of independent variables and the dependent variable.

A linear regression model was used in determining the level of influence the independent variables have on dependent variable as shown below:

$$Y = \beta_0 + \beta_1 X_1 + \beta_2 X_2 + \beta_3 X_3 + \varepsilon$$

Where;

Y = Financial Performance, where

Financial performance = Return on Asset (ROA)

X_1= Capital structure is measured by total equity/total assets

X_2= Size of the company is measured by natural logarithm of total asset

X_3= Liquidity is measured using current ratio= current asset/current liability

ε = Error Term

The study used linear regression model equation to test between the independent and dependent variables. The significance of each independent variable was tested with t and f tests at a confidence level of 95%. In this study independent variable are capital structure, size of the company and liquidity.

CHAPTER FOUR: DATA ANALYSIS, RESULTS AND DISCUSSION

4.1 Introduction

This chapter entails presentation, analysis and interpretations of study findings. The main objective of the study was to establish relationship between capital structure and financial performance of top 100 small and medium enterprises in Nairobi County. Data was collected from 30 of the top 100 small and medium enterprises in Nairobi County. The study, solely, adopted the use of secondary data sources. The information on financial performance was captured from SMEs in financial statements, Kenya National Bureau of Statistics (KNBS) offices while data on capital structure was obtained from published books of accounts of the companies 30 companies that were used for the study.

4.2 Response Rate

Data was collected from 30 companies which gave all the information that was required out of the 35 companies that had been targeted. This shows a response rate of 85.7% which according to Mugenda and Mugenda 2003, a response rate of more than 80% is sufficient for research.

4 .3 Descriptive Statistics

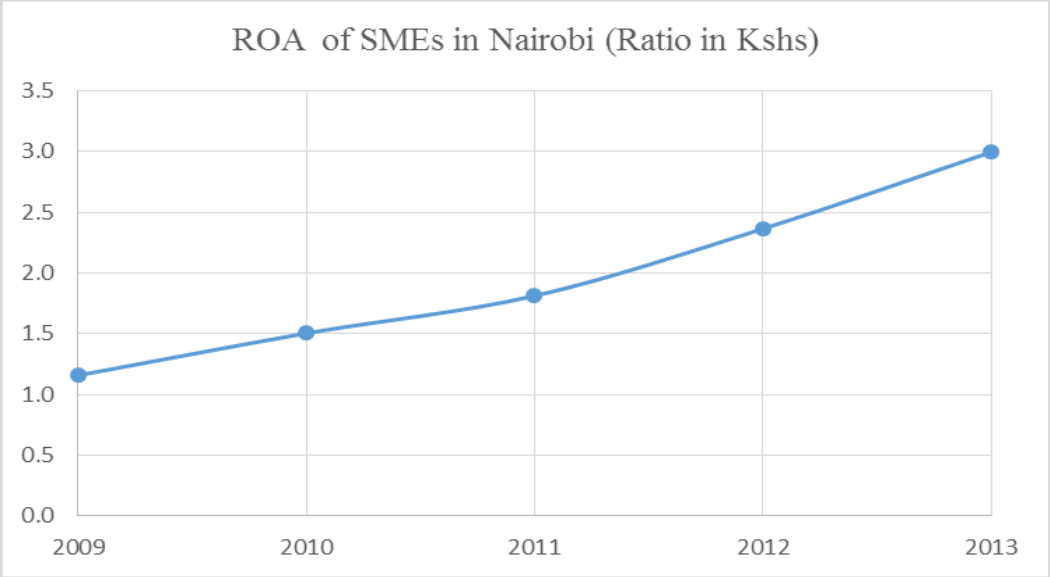
Table 4.1: Descriptive Statistics

Top SMEs Ratio in Kshs	**Lowest**	**Highest**	**Mean**	**Std. Deviation**	**Median**
ROA	0.03	0.47	0.111	0.10295	3.23
Capital structure	0.17	0.63	0.3094	0.08902	3.937
Liquidity	0.66	12.41	2.9611	2.41892	5.599
Firm size	4.55	8.93	7.0896	1.18345	0.783

Source: Researcher (2014)

Findings as shown in Table 4.1 reported that the top 100 SMEs in Nairobi County disclosed profitability at 11.1%. Further, the analysis reported that capital structure was 30.94% debt against internal sources (retained earnings (mean=0.3094). Liquidity was recorded at 2.9611 current asset over current liabilities (mean = 2.9611) with firm size mean of 7.089.

Figure 4.1: ROA of SMEs in Nairobi

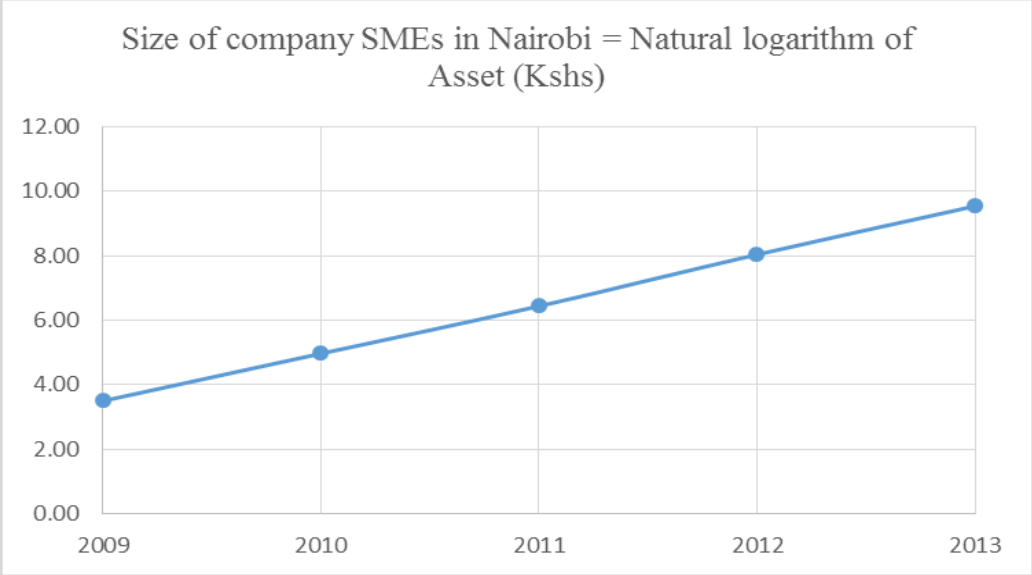


Source: Researcher (2014)

From the findings in table and figure above reveal that the financial performance of top 100 small and medium enterprises in Nairobi County has been on a rise for the past five years. Year 2009 recorded an average ROA of 1.2. This was followed by an increase in subsequent years. The ROA of top 100 small and medium enterprises in Nairobi County has been increasing as seen in year 2010 there was a rise up to 1.5. In year 2011, ROA increased to 1.8 year 2012 had an ROA of 2.4 and year 2013 had an ROA of 3.0

The capital structure of the company has been increasing over the years. There has been an increase over some years while other years resulted to an increase this could be attributed to high debts the companies had been to while the decrease could be due to payments of debts.

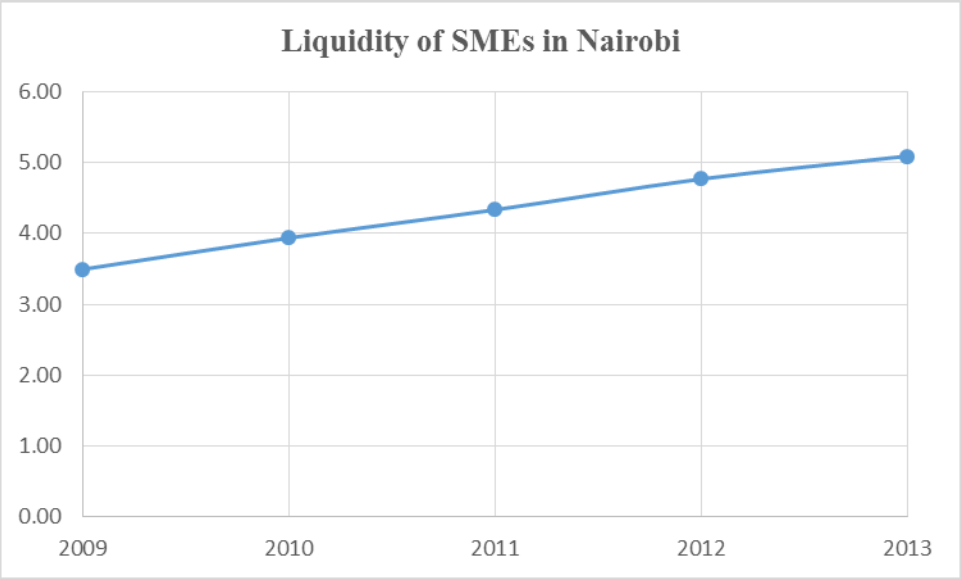
Figure 4.2: Size of company SMEs in Nairobi



Source: Researcher (2014)

The figure and table above shows that the average of the total value of the company size has been increasing over the years. In year 2009 there was an average size of the company as of 3.5. Year 2010 recorded an increase in size to an average size of 4.97. Year 2011 had an average size of 6.43, 2012 had an average size of 8.03 while 2013 had an average size of 9.53. This shows that the size of SMEs has been increasing.

Figure 4.3: Liquidity of SMEs in Nairobi



Source: Researcher (2014)

The findings show that the average liquidity ratio of 30 companies has been increasing over the years in the following way; year 2009=3.5, 2010=3.94, 2011=4.33, 2012=4.77, 2013=5.09.

4.4 Correlation Analysis

The research study wanted to establish the relationship between capital structure on performance of the top 100 small and medium enterprises in Nairobi County. To get performance of the top 100 small and medium enterprises in Nairobi County, Return on asset (ROA) was calculated for the 30 companies whose financial statements were accessed by the researcher. On the other hand, capital structure of the firms was obtained by calculating the total equity of the total assets of the firms.

Table 4.2: Correlation Analysis

	Capital structure	Profitability	Liquidity	Firm size
Capital structure	1			
Profitability	.371	1		
Liquidity	.487	0.504	1	
Firm size	.337	.209	0.036	1

Source: Researcher (2014)

The Pearson correlation test for the variables (capital structure and financial performance) to assess the relationship between the variables is reported in Table above. The relationship between capital structure and firm size indicated a Pearson correlation ratio = (0.337) indicating a significant positive correlation between profitability and firm size of SMEs. The relationship between capital structure and liquidity of listed firms showed a positive and significant correlation as evidenced by Pearson correlation ratio = (0.504) hence the researcher concluded that capital structure was correlated with liquidity. The relationship between capital structure and sales profitability indicated a Pearson correlation ratio = (0.371) hence inferring that capital structure had a significant positive correlation to profitability.

The research findings indicated that there was a weak positive relationship (R= 0.036) between the variables. The study also revealed that 11.0% of capital structure of the firms can be explained by the independent variables. From this study it is evident that at 95% confidence level, the variables produce statistically significant values (high values, $p< 0.1$) hence when the variables are combined, they can be relied on to explain capital structure of the SMEs in Nairobi County. However, when tested individually only

liquidity produces statistically significant values while firm size produces statistically insignificant values.

4.5 Regression Analysis

$Y = \beta_0 + \beta_1 X_1 + \beta_2 X_2 + \beta_3 X_3 + \varepsilon$

Where;

Y = Return on Asset (ROA*)*

X_1= Capital structure is measured by total equity/total assets

X_2= Size of the company is measured by natural logarithm of total asset

X_3= Liquidity is measured using current ratio= current asset/current liability

ε = Error Term

Table 4.3: Model Summary

Model Summary R	**R**	**R Square**	**Adjusted R Square**	**Std. Error of the Estimate**
1	.785	.616	.594	.59347

Predictors: (Constant), Capital structure, Size of the company and Liquidity.

Dependent Variable: Return on Asset

Source: Researcher (2014)

Analysis in Table 4.3 shows that the coefficient of determination,r^2 (the percentage variation in the dependent variable being explained by the changes in the independent variables) R^2 equals 0.616, that is, capital structure, size of the company and liquidity leaving only 38.4 percent unexplained. This portends a very good linear relationship or

dependence of financial performance on capital structure. A coefficient of determination (R-square) value of 0.616 was established.

Table 4.4: Analysis of Variance (ANOVA)

	Sum of Squares	**Df**	**Mean Square**	**F**	**Sig.**
Regression	2431.678	3	1215.839	2.661	.0081a
Residual	19650.235	27	456.982		
Total	22081.913	30			

Predictors: (Constant), Capital structure, Size of the company and Liquidity.
Dependent Variable: Return on Asset
Source: Researcher (2014)

Analysis of Variance was used to test the significance of the regression model as pertains to significance in the differences in means of the dependent and independent variables. The ANOVA test produced an f-value of 2.661 which was significant at 0.05 significance level (p = 0.081). This depicts that the regression model is significant at 95% confidence level; that is, has 0.81% probability of misrepresentation.

Table 4.5:Regression Coefficients

	Unstandardized Coefficients		Standardized Coefficients		
	B	Std. Error	Beta	t	Sig.
(Constant)	16.369	4.542		3.604	.001
Capital structure	-.472	.215	-.316	-2.193	.034
Liquidity	.305	.097	.402	3.145	.002
Firm size	.071	.093	.091	.760	.049

Predictors: (Constant), Capital structure, Size of the company and Liquidity.

Dependent Variable: Return on Asset

Source: Researcher (2014)

The model was used to establish of the relationship between capital structure and financial performance.

$Y = \beta_0 + \beta_1 X_1 + \beta_2 X_2 + \beta_3 X_3 + \varepsilon$

$Y = 16.369 - 0.472\ X_1 + 0.305 X_2 + 0.071 X_3$

Whereby,

Constant = 16.369, shows that if capital structure, size of the company and liquidity are all rated as zero, return on asset would be 16.369

X_1= 0.472, shows that one unit change in capital structure results in 0.472 units decrease in return on asset

x_2= 0.305, shows that one unit change in size of the company results in 0.305 units increase in return on asset

x_3= 0.071, shows that one unit change in liquidity results in 0.071 units increase in return on asset

4.6 Discussion of Findings

The capital structure of the companies was measured by ROA. The findings from the study revealed that liquidity had an inverse relationship on return on assets. liquidity (β=-0.472) indicates that with a 1 percent increase in return on assets led to a 0. 472 percent decrease in liquidity as indicated in the table of co-efficients. This result is consistent with findings by Zeitun and Tian (2007) who also established that capital structure has a significant and negative impact on firm's performance.

From the study it was evident that at 95% confidence level, the debt ratio variable produced statistically significant values (high t-values, $p < 0.05$). From statistical theory, if $p > 0.1$ then the model is said not to be significant. This is concluded that a relationship could not be found among the model variables. From the co-efficients table, findings indicate that the p value for debt ratio was 0.034. 0.034 is found to be less than 0.05. The model was therefore significant at 95 % thus the findings can be accepted.

These findings were consistent with the capital structure irrelevance theory that was first postulated by Modigliani & Miller (1963). These traditional capital structure theories argue that the amount of debt in the capital structure does not affect performance and the value of the firm. Abdul (2012) however, concluded that financial leverage has a significant negative relationship with the firm performance as measured by return on assets (ROA). The findings of this present thesis contradicted the empirical results obtained by Saeedi and Mahmoodi (2011) who concluded that financial leverage is positively related to performance as measured by return on assets.

The result was also found not to be in agreement with Mwangi (2010) study on capital structure on firms listed at the Nairobi Stock Exchange on the relationship between capital structure and financial performance. Strong relationship was found to be between leverage and return on equity, liquidity, and return on investment. However, others find mixed results regarding the impact of capital structure on firm's performance. This can

best be supported by the argument that borrowing introduces varying levels of risk to the company and on the return to shareholders.

The results also corroborate the empirical evidence obtained by Kaumbuthu (2011) who found a negative relationship between financial leverage and ROE. The finding however, contradicts the findings by Javed & Akhtar (2012) who found the relationship between debt to equity ratio and return on equity to be significantly positive. The findings additionally, contradicted the agency theory postulated by Jensen & Meckling (1976) and extended by Elliots (2002). The agency theory postulate that the use of leverage (long-term debt) in the capital structure can be used to mitigate the agency conflict by forcing managers in invest in profitable ventures that benefit the shareholders.

CHAPTER FIVE: SUMMARY, CONCLUSION AND RECOMMENDATIONS

5.1 Introduction

This chapter discusses the summary of the finding in chapter four. Conclusion and recommendations drawn from these findings are discussed in relation to the objectives of the study which was to establish the relationship between capital structure and financial performance of top 100 small and medium enterprises in Nairobi County. This chapter aims at linking and applying the results obtained from the study to solve real life capital structure and financial performance misalignments as described afore in the problem statement. This chapter will also elucidate the policy recommendations that policy makers can implement in order to better align institutions capital raising initiatives with the firms performance.

5.2 Summary of Findings

The research findings indicated that there was a weak positive relationship (R= 0.332) between the variables. The study also revealed that 11.0% of capital structure of the firms listed at the Nairobi securities exchange can be explained by the independent variables. From this study it is evident that at 90% confidence level, the variables produce statistically significant values (high t-values, $p < 0.1$.) hence when the variables are combined hence, they can be relied on to explain capital structure of the top 100 small and medium enterprises in Nairobi County. From the study findings it would be safe to conclude that debt ratio had an inverse relationship with return on assets. Capital structure theory as attributed to Modigliani and Miller concluded that it doesn't matter

how a firm finances its' operations and that the value of a firm is independent of its' capital structure making capital structure irrelevant.

These findings were in line with the findings of Rajan & Zingales (1995) and Wald (1999) who found a significantly negative relationship between profitability and debt/ asset ratios for the USA, UK and Japan. In addition, these findings were similar to the findings of Fama and French (2002), Booth *et al*. (2001) and Wald (1999) whose studies provided empirical evidence supporting this negative relationship between debt levels and a firm's performance or profitability. In addition, Fama and French (1998), for instance argued that the use of excessive debt resulted into agency problems among shareholders and creditors which could result in a negative relationship between leverage and profitability.

Furthermore, Majumdar and Chhibber (1999) in their Indian study found that leverage had a negative effect on performance, while Krishnan and Moyer (1997) connect capital and performance to the country of origin. Gleason *et al*. (2000) also found a negative impact of leverage on the profitability of the firm. Abor (2007) in his scholarly works on debt policy and performance of Medium Sized Enterprises found the effect of short-term debt to be significantly and negatively associated with gross profit margin for both Ghana and South African firms. This indicated that increasing the amount of short-term debt would result in a decrease in the profitability of the firms.

5.3 Conclusion

The study showed that small and medium enterprises in Nairobi County used both debt and equity in their capital structure although debt was predominant. This was largely due to the fact that SMEs perceived debt as a cheaper source of funding and that it lowered the taxes paid since it acted as a tax shield. The debt preference over equity implied that interest was the dominant form of cost of capital among these entities. Access to equity is expensive for SMEs and creates complexity in management of SMEs. It has also been revealed that utilization of different levels of debt and internal sources enables firms to invest more hence more profits.

There is evidence that capital structure has a significant effect on ROA. From the findings, firm's with more liquid stock is highly likely to meet its financial obligations in the required time and higher liquidity is as a result of proper organization of internal sources and debts. Therefore, it is true to state that there is a positive significant relationship between capital structure and liquidity.

The study affirms that capital structure has a significant effect on financial performance. From the study findings there is enough prove that capital structure enables SMEs to engage in financial investments. A high degree of internal sources implies a relative change in growth which results to increased size.

5.4 Recommendations

The study find strong support for the argument that capital structure impacts on liquidity very highly, thus SME owners should be willing to come up with ways to increase the amount of liquid stocks in order to increase financial viability. This way financial performance will improve and growth will be enhanced among the SMEs in the different sectors.

From the study findings, there is an association between capital structure and profitability. Therefore firms should avoid situations where they are highly leveraged since this may lead to bankruptcy if they are unable to make payment on their debt and SME owners should also make good investment decisions in order to increase profitability.

It was considered to be very important when finance directors and managing directors trying to fund the firm's assets to understand the impact of capital structure on their financial performance as well the cost of funds. It was evident from the study and analysis arising thereof. This study established that capital analysis and asset structure analysis was a very important analysis used to boost firm's competitive advantage and consequently profitability. In addition the capital market analyst as well investment analyst should advise the investors as well firms on the optimal capital structure based on capital structure analysis.

5.5 Limitation of the Study

The researcher encountered quite a number of challenges related to the research and most particularly during the process of data collection. Due to inadequate resources, the researcher conducted this research under constraints of finances. In addition Kenya bureau of statistics analysts had to be pushed to assist with data. This was done through many calls to remind them. Others wanted to be paid in order to give data. Other thought that the information they were requested to volunteer was confidential.

Time allocated for the study was insufficient while holding a full time job and studying part time. This was encountered during the collection of material as well as the data to see the success of the study. However the researcher tried to conduct the study within the time frame as specified.

5.6 Suggestions for Further Research

The results of study on the relationship between capital structure and performance of SMEs are contradictory which justifies further research. Further many of the reported studies on the relationship between financial leverage and performance have been conducted in developed countries where capital markets are well-developed. The Kenyan capital market is relatively under developed and therefore the traditional capital structure theories that have their origin in the developed countries needed to be tested in the Kenyan context.

A study should be undertaken to compare the financings decisions of other companies listed on the NSE and those not listed and the effects of these decisions on financial performance. In addition, future studies could be extended to analyse financing decisions and their effect on financial performance across the countries especially those in the East African Community.

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APPENDICES

APPENDIX I: Secondary Data

ROA of SMEs in Nairobi (Ratio in Kshs)					
Firm	**2009**	**2010**	**2011**	**2012**	**2013**
Jungle Nuts Ltd	0.1	0.3	0.2	0.52	0.7
Pentapharm Ltd	0.2	1.6	1.8	2.93	3.94
Kema (E.A.) Ltd	3	3.3	3.9	4.24	5.69
PG Bison (Kenya) Ltd	0.2	0.6	0.7	1.2	1.3
Peak performance	3.5	3.4	4.35	5.98	6.30
Software Technologies	0.1	0.2	0.4	0.8	0.9
Kentons Limited	1.6	1.7	1.9	2.93	3.94
SBO Research	0.3	0.4	0.5	1.6	1.7
Lee Construction	1.1	1.3	2.1	2.3	3.8
Satguru Travels and Tours	3.5	4.4	4.5	4.9	5.3
Dawa Limited	0.3	1.2	1.4	1.6	2.0
Trans Business Machines	1.7	1.8	1.9	2.1	2.5
University of Nairobi Ent. & Services	0.3	0.4	0.5	1.6	1.9
HealthCare Direct (K)	1.1	1.3	2.1	2.3	4.8
Printfast Kenya	2.5	2.7	3.3	4.9	5.3
Gap Marketing	0.3	0.4	0.5	0.6	1.7
Radar Limited	0.6	1.6	1.7	1.9	2.9
Spice World	0.5	0.8	1.3	2.2	2.6
Victoria Furniture's	0.8	0.9	1.7	1.9	2.2
Murang'a Forwarders	1.5	2.4	2.6	2.7	2.9
Investent Q CAPITAL	1.2	1.4	1.6	1.9	2.2
Canon Aluminium Fabricators	1.6	1.7	1.9	2.1	3.3
Kenbro Industries	0.5	0.8	0.9	1.6	1.9
LANTech(Africa)	1.1	1.3	2.1	2.3	2.6
Chemicals & School Supplies	1.2	1.4	1.3	1.9	2.1
Oasis Limited	0.3	0.4	0.6	1.6	3.0
Seasons Restaurants & Hotels	1.7	1.8	1.9	2.9	3.1
Charleston Travel	1.3	2.4	2.5	2.6	3.6
Sheffield Steel Systems	1.1	1.3	2.1	2.3	2.4
Brown's Cheese - Sunpower Products	1.5	1.9	2.1	2.5	3.3
Average	**1.2**	**1.5**	**1.8**	**2.4**	**3.0**

Source: Researcher (2014)

Capital structure of SMEs in Nairobi

Capital structure of SMEs in Nairobi = Total Equity/Total Assets (Ratio in Kshs)					
Firm	**2009**	**2010**	**2011**	**2012**	**2013**
Jungle Nuts Ltd	0.4	0.3	0.4	0.6	0.5
Pentapharm Ltd	0.3	0.4	0.5	0.6	0.9
Kema (E.A.) Ltd	0.1	2.3	0.2	0.3	0.8
PG Bison (Kenya) Ltd	0.5	0.7	0.3	0.5	0.3
Peak performance	0.3	0.4	0.5	0.6	0.7
Software Technologies	0.6	0.6	0.7	0.9	0.8
Kentons Limited	0.5	0.8	0.3	0.2	0.6
SBO Research	0.8	0.9	0.7	0.9	0.2
Lee Construction	0.5	0.4	0.6	0.6	0.9
Satguru Travels and Tours	0.1	0.2	0.6	0.9	0.8
Dawa Limited	0.6	0.7	0.9	0.6	0.5
Trans Business Machines	0.5	0.8	0.9	0.7	0.9
University of Nairobi Ent. & Services	0.5	0.5	0.3	0.5	0.6
HealthCare Direct (K)	0.2	0.4	0.3	0.7	0.6
Printfast Kenya	0.7	0.8	0.9	0.9	0.5
Gap Marketing	0.7	0.8	0.9	0.7	0.8
Radar Limited	0.3	0.4	0.5	0.6	0.6
Spice World	0.3	0.4	0.6	0.6	3.0
Victoria Furniture's	0.5	0.9	0.6	0.5	0.3
Murang'a Forwarders	0.7	0.8	0.9	0.2	0.8
Investent Q CAPITAL	0.3	0.4	0.5	0.6	0.7
Canon Aluminium Fabricators	0.6	0.6	0.7	0.9	0.9
Kenbro Industries	0.5	0.8	0.3	0.2	0.6
LANTech(Africa)	0.8	0.9	0.7	0.9	0.6
Chemicals & School Supplies	0.3	0.4	0.4	0.2	0.6
Oasis Limited	0.5	0.9	0.7	0.9	0.8
Seasons Restaurants & Hotels	0.3	0.4	0.5	0.6	0.7
Charleston Travel	0.6	0.1	0.2	0.3	0.4
Sheffield Steel Systems	0.1	0.2	0.4	0.2	0.6
Brown's Cheese - Sunpower Products	0.2	0.3	0.1	0.1	0.2
Average	0.44	0.62	0.54	0.57	0.71

Source: Researcher (2014)

Size of company SMEs in Nairobi

Size of company SMEs in Nairobi = Natural logarithm of Asset **(Kshs)**					
Firm	**2009**	**2010**	**2011**	**2012**	**2013**
Jungle Nuts Ltd	2	4	6	7	7
Pentapharm Ltd	1	3	4	6	8
Kema (E.A.) Ltd	2	2	3	5	7
PG Bison (Kenya) Ltd	1	1	3	4	6
Peak performance	4	4	5	6	7
Software Technologies	1	1	2	3	4
Kentons Limited	3	3	5	7	9
SBO Research	4	4	5	5	6
Lee Construction	2	5	6	6	7
Satguru Travels and Tours	1	1	2	3	4
Dawa Limited	1	2	3	5	6
Trans Business Machines	3	4	5	6	7
University of Nairobi Ent. & Services	4	6	8	9	12
HealthCare Direct (K)	4	6	8	12	13
Printfast Kenya	5	7	9	11	13
Gap Marketing	2	4	6	8	10
Radar Limited	6	8	12	14	16
Spice World	4	6	8	11	12
Victoria Furniture's	5	7	8	10	13
Murang'a Forwarders	6	7	9	11	12
Investent Q CAPITAL	1	4	5	6	7
Canon Aluminium Fabricators	2	5	6	7	8
Kenbro Industries	1	1	2	4	6
LANTech(Africa)	3	7	9	11	12
Chemicals & School Supplies	8	10	11	13	15
Oasis Limited	11	12	14	15	16
Seasons Restaurants & Hotels	4	5	6	8	10
Charleston Travel	6	8	9	10	11
Sheffield Steel Systems	3	5	5	7	10
Brown's Cheese - Sunpower Products	5	7	9	11	12
Average	3.50	4.97	6.43	8.03	9.53

Source: Researcher (2014)

Liquidity of SMEs in Nairobi

Liquidity of SMEs in Nairobi current ratio= current asset/current liability (Ratio in Kshs)					
Firm	**2009**	**2010**	**2011**	**2012**	**2013**
Jungle Nuts Ltd	2.2	3.4	2.6	2.7	2.3
Pentapharm Ltd	1.1	1.30	2.40	3.60	2.80
Kema (E.A.) Ltd	1.2	4.3	4.4	3.5	4.7
PG Bison (Kenya) Ltd	3.1	3.1	3.3	4.4	4.6
Peak performance	6.4	6.4	6.5	5.6	6.7
Software Technologies	3.1	3.3	3.2	3.4	3.4
Kentons Limited	5.3	4.3	6.5	5.7	6.9
SBO Research	0.4	0.4	1.5	2.5	2.6
Lee Construction	1.2	1.5	1.6	1.6	1.7
Satguru Travels and Tours	0.1	0.1	0.2	0.3	0.4
Dawa Limited	2.1	2.2	2.3	2.5	3.6
Trans Business Machines	3.3	3.4	3.5	4.6	4.7
University of Nairobi Ent. & Services	6.4	6.6	6.8	6.9	7.2
HealthCare Direct (K)	7.4	7.6	6.8	7.2	8,3
Printfast Kenya	7.5	7.7	7.9	8.1	8.3
Gap Marketing	3.2	3.4	4.6	4.8	5.1
Radar Limited	4.6	4.8	4.12	5.14	5.16
Spice World	2.2	2.4	3.6	4.7	3.7
Victoria Furniture's	6.5	7.7	7.8	9.1	9.3
Murang'a Forwarders	4.6	4.7	4.9	5.1	5.2
Investent Q CAPITAL	2.1	2.4	2.5	2.6	2.7
Canon Aluminium Fabricators	4.2	4.5	5.6	5.7	5.8
Kenbro Industries	1.1	1.2	2.3	4.2	5.6
LANTech(Africa)	1.3	2.7	3.9	4.1	4.6
Chemicals & School Supplies	4.8	5.0	5.1	5.3	5.5
Oasis Limited	1.1	1.2	1.4	1.5	1.6
Seasons Restaurants & Hotels	4.4	5.2	6.2	8.1	10
Charleston Travel	6.1	8.1	9.1	10.2	11.1
Sheffield Steel Systems	1.3	2.5	3.5	2.8	4.2
Brown's Cheese - Sunpower Products	6.5	6.7	5.9	7.1	8.2
Average	3.49	3.94	4.33	4.77	5.09

Source: Researcher (2014)

APPENDIX II: 100 SME's Operating the Nairobi County

1. Jungle Nuts Ltd
2. Pentapharm Ltd
3. Kema (E.A.) Ltd
4. PG Bison (Kenya) Ltd
5. Peak performance
6. Software Technologies
7. Kentons Limited
8. SBO Research
9. Lee Construction
10. Satguru Travels and Tours
11. Dawa Limited
12. Trans Business Machines
13. University of Nairobi Ent. & Services
14. HealthCare Direct (K)
15. Printfast Kenya
16. Gap Marketing
17. Radar Limited
18. Spice World
19. Victoria Furniture's
20. Murang'a Forwarders
21. InvesteQ CAPITAL
22. Canon Aluminium Fabricators
23. Kenbro Industries
24. LANTech(Africa)
25. Chemicals & School Supplies
26. Oasis Limited
27. Seasons Restaurants & Hotels
28. Charleston Travel
29. Sheffield Steel Systems
30. Brown's Cheese - Sunpower Products
31. Biselex Kenya
32. Planning Interiors
33. Furniture International
34. Master Power Systems
35. BBC Auto Spares
36. Transport and Lifting Services
37. General Aluminium Fabricators
38. Computer Planet

39. Vajra Drill
40. Avtech Systems
41. Tyremasters Limited
42. Complast Industries
43. Hebatullah Bros
44. OptiWare Communications
45. Ganatra Plant & Equipment
46. Africa Tea Brokers
47. Sai Pharmaceuticals
48. Silverbird Travel Plus
49. Warren Enterprises
50. Pelican Signs
51. Kato bonded travels
52. Homart (Nairobi Garments Enterprises)
53. Chemserve Cleaning Services
54. Gina Din Corporate Communications
55. Madhupaper Kenya
56. Kevian Kenya
57. Biodeal Laboratories
58. Viva Productline
59. Shikara Limited
60. Kinpash Enterprises
61. Faram East Africa
62. The Phoenix
63. Kandia Fresh Produce Suppliers
64. Dharamshi Lakhamshi & Co
65. Union Logistics
66. Creative Edge
67. Njugunas Wines & spirits
68. Marketpower International
69. Waumini Insurance Brokers
70. Stoic Company
71. R & R Plastics
72. East African Elevator Company
73. Alpine Coolers
74. Specialized Aluminium Renovators(SARL)
75. Panesar's Kenya
76. Nationwide Electrical Industries
77. Toolcrafts Limited
78. Circuit Business Systems

79. Sahajanand Enterprises
80. Wines Of the World
81. Airtouch Cooling Systems
82. Hardware and Welding Supplies
83. Limelight Creations
84. Silverlining Travel Agency
85. Axel Engineering and Manufacturing
86. Virgin Tours
87. Skylark Creative Products
88. Eggen Joinex
89. Desbro Engineering
90. Tiger Brands (K)
91. Catalyst Travels
92. Professional Clean Care
93. Premier Industries
94. Chuma Fabricators
95. Prafulchandra & Brothers
96. Parapet Cleaning Services
97. Rongai Workshop & Transport
98. Zaverchand Punja
99. Travelshoppe Company
100. Eurocon Tiles Products