Debt/Equity Ratio and Expected Common Stock Returns: Empirical Evidence from the Nairobi Stock Exchange

Abstract:

The main objective of the study was to establish the relationship between the Debt-equity ratio and the expected common stock returns while controlling for beta and size of the firm. Similar studies have been carried out in developed markets (Bhandari, 1988) that have a confirmed that a statistically significant positive relationship exists between the debt-equity ratio and the expected common stock returns. The dependent variable in the study was the expected common stock returns while the independent variables were the firm size, beta the risk measure and the debt-equity ratio. The main objective was to determine whether the debt-equity ratio is positive. Secondary data comprising of stock prices, dividends, financial statements of the listed companies and the Nairobi stock exchange monthly 20 share index was obtained from Nairobi Stock exchange and analyzed using linear multiple regression for a period of 10 years, 1998 to 2007. The results were inconclusive therefore there was no relationship that was found to exist between the expected common stock returns and the debt-equity ratio in the Kenyan market. In the Kenyan capital market, the debt-equity ratio of a firm is probably not a major factor to consider when making investment decisions on common stock securities. The government could consider various incentives in order to encourage firms to make use of debt financing in their operations.