

Capital Structure Adjustment, Speed of Adjustment and Optimal Target Leverage among Firms Quoted on the Nairobi Stock Exchange

Abstract:

The literature provides conflicting assessments about how firms choose their capital structures, with the trade off, pecking order and market timing hypothesis all receiving some empirical support. The study's objectives were to determine whether firms in Kenya have an optimal target leverage, whether an adjustment towards this target takes place and finally to ascertain the speed of adjustment towards this target leverage. Secondary data was collected from the records maintained at NSE. From these records financial statements for 12 years starting from the year 1999 to 2010, were extracted. Out of the 30 firms targeted, only 23 firms met the criteria of having complete data for at least ten years. Analysis was done using descriptive statistics together with a partial regression model. Estimations from the model established that firms in Kenya do have target capital structure. On average however, a typical firm closes about 5.3% of the gap between the current and the desired leverage within one year. At this rate it takes about 10 years to close half of the gap between a typical firm's current and the desired leverage ratios. The slow adjustment is consistent with the hypothesis that other considerations such as market timing or pecking order outweigh the costs of deviating from the optimal leverage.