

**CAPITAL STRUCTURE CHOICE: VIEWS AND PRACTICES OF FINANCIAL
MANAGERS OF COMPANIES LISTED AT THE NAIROBI STOCK
EXCHANGE**

By

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**A MANAGEMENT RESEARCH PROJECT SUBMITTED IN PARTIAL
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DECLARATION

This Management Research Project is my original work and has not been presented for a degree in any other university.


Signed..........

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

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DEDICATION

To my father and mother Daniel and Naomie; who gave almost all they had for the sake of my education.

To my sisters and my fiancé for their love, encouragement, patience and dedication to my well being during the whole period of my studies.

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I am also grateful to all my colleagues for their valuable suggestions and contributions throughout my study period. To all of you I say thank you for the teamwork and may God bless you.

Many thanks to the respondents who participated in the study. Most sincere thanks goes to my sister Dorcas Kayo for buying me a superb Toshiba laptop with which I was able to type my work with leisure.

I am incredibly thankful to God who gave me strength, good health and a sound mind throughout my study period.

ABSTRACT

This paper reports the findings of a survey of companies listed at the Nairobi Stock Exchange to learn about the managerial opinions and practices with respect to long term financing decisions. Frequency tables, mean score tabulations, and percentages to represent the response rate and information on the variables under study were the tests applied with the use of the Microsoft Excel program.

Primary data was collected using structured questionnaires that were completed by the respondents. The questionnaires comprised both open and closed ended questions and was administered through the drop and pick later method. For firms located in towns away from Nairobi, the questionnaires were dispatched by way of electronic mail to the financial manager or the officer most familiar with financing procedures to answer the questions.

The financial managers in this study were found to be more likely to follow a financing hierarchy than adhere to target capital structures. If confronted with new growth opportunities which would force them to deviate from the target capital structure or the financing hierarchies, most firms would go for the growth opportunity. The message conveyed by the managers of the firms is that they are likely to be much more flexible with capital decisions than with either dividend policy decisions or with the investment decisions.

Still a lot needs to be done in the area of capital structure of companies in Kenya, specifically to establish the nature of capital structure of companies not quoted at the Nairobi Stock Exchange.

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CHAPTER ONE

INTRODUCTION

1.1 Background

The issues concerning the long-term financing decisions of firms and their impact on the capital structure have been an enigma to corporation finance researchers. A three prong-attack by academicians has made numerous inroads into these crucial areas of interest. The first and foremost attack is by theoreticians like Modigliani and Miller (1958), Litner (1963), Ross (1985), and Myers (1977), to name a few. These scholars, among others, attempt to present theoretical models of, arguments for, and explanations of long-term financing and capital structure decisions of corporations. The second of the three-prong attack is represented by the empirical studies by Barton (1989), Masulis (1980), Kim (1986), Baskin (1989), Titman and Wessels (1988), Friend and Larry (1988), Peterson and Gary (1983) and McCabe (1979) which investigate the financial behavior of firms to test the validity of the theoretical postulates. As in other areas of finance, the third step of the learning ladder is represented by sample surveys aimed at ascertaining the views and practices of financial managers and thereby create a linkage between theory, empirical evidence, and practice. However, unlike the well developed survey literature in certain areas, like capital budgeting for example, there is relative scarcity of such studies in long-term financing and capital structure decisions of firms. The present study is an attempt to fill this void in the literature. This paper reports the findings of a survey of a sample of Kenyan firms listed at the NSE about their views and practices with respect to long term financing.

In addition to the scarcity of studies which attempt to find out managers' views and actions with respect to long-term financing decisions, at least three other factors provide impetus for the study. First, there is the "neutral mutation" argument forwarded by Miller (1977). If in fact such reasoning is a valid description of a managerial decision making process, surveys will have a better chance of discovering this phenomenon than empirical studies. Secondly, as Titman and Wessels (1988) aptly point out, empirical testing of

theoretical provisions suffers from a number of problems. First and foremost among them is the selection of meaningful surrogates from a large number of available accounting proxies to measure economic attributes encompassing the theoretical framework. Given this general drawback of empirical work in corporation finance, the coverage of related topics in text books can be further enhanced by observing the corporate practices. Thirdly, the model developed by Fischer, Heinkel, and Zechner (1989) and their tests suggest that corporate capital structure decisions are dynamic in nature rather than static. The reasoning embedded in their arguments point to wide variation of corporate managers' behavior.

1.1.1 The concept of capital structure

Capital structure refers to the way in which a corporation finances its assets through some combination of equity, debt, or hybrid securities. A firm's capital structure is then the composition or 'structure' of its liabilities. Assuming perfect and complete capital markets, costless and symmetric information, value-maximizing decision makers, and no taxes, Modigliani and Miller (1958) show that capital structure choices are irrelevant to the firm's investment decisions, its overall cost of capital, and its value. In this simplified Modigliani and Miller world, there will not be any systematic variation in capital structure across firms.

1.1.2 Debt tax shields

When tax laws permit the deductibility of interest expenses, firms can increase their net cash flows by financing with debt rather than equity (Modigliani and Miller, 1963). Borrowing lowers the real after-tax cost of capital and raises the value of the firm. Total value is maximized when the firm is entirely debt financed. This is completely independent of the particular firm, its strategy or industry. There are two problems with this theory. First, we rarely observe firms entirely financed with debt. Secondly, debt has existed long before the advent of the corporate income tax. A number of theories have attempted to find an optimal capital structure that is not 100% debt. The main thrust of the arguments in these theories is that the tax benefits of debt are offset by a variety of costs that are due to capital market imperfections (Miller, 1977).

1.1.3 Agency theory and debt

Significant agency costs arise from the fundamental conflict of interest between stockholders and bondholders. Stockholders are mainly concerned about the upper part of the probability distribution of possible performance outcomes-over and above the amount required to repay debt. Bondholders on the other hand receive only the specified payment in the debt contract and nothing of the cash flows above that payment. Therefore, they are concerned with only the lower end of the probability distribution of outcomes. Riskier projects therefore reduce the expected pay-offs to bondholders. This can lead to what is called the 'asset substitution problem' in the finance literature (Myers, 1977).

1.1.4 Free cash flow, debt, and bankruptcy

Agency theory (Jensen and Meckling, 1976) suggests that managers have an incentive to over-expand the size and scope of the firm to satisfy their own ends at the expense of the shareholders. A larger firm may have more career and promotion opportunities, more status, and less risk of bankruptcy, especially if it is diversified. Jensen (1986) has argued that there can be 'agency benefits' to debt if it reduces the scope of managerial discretion. Higher debt increases the probability of bankruptcy. This, in turn, increases the risks to the managers of losing their jobs and/or damaging their reputation. If the firm defaults and faces bankruptcy, there is a change of control over the underlying assets of the firm from the stockholders and managers to the bondholders. This change of control is usually costly. The direct costs are the legal fees, delays and bargaining costs involved in the bankruptcy proceeding itself. Indirect bankruptcy costs may be more important for managers. Titman (1988) argues that the value of a durable good (which requires service, maintenance or updating) falls, as the likelihood of liquidation increases. The customers recognize that they may be 'left holding the bag' and take that risk into account and reduce demand. Firms selling these kinds of products face higher bankruptcy costs. The managers personally bear a substantial portion of these bankruptcy costs (Titman, 1988). Faced with the burden of potential bankruptcy from increased debt, managers are less likely to take on unprofitable investments that they otherwise would. The 'free cash flow' (Jensen, 1976) or the residual cash flow after all positive net present value investment needs have been met, will be used to pay off the lenders rather than to expand the manager's empire. If the incumbent management team is unwilling to increase debt, then

another team has an incentive to take over the firm and restructure it. The types of firms that are most likely candidates for using debt to discipline managers would be firms whose cash flows exceed their growth opportunities. Thus the agency related problems between managers and stockholders will result in a negative relationship between leverage and growth opportunities, in just the same way as the agency issues between stockholders and bondholders.

1.2 Statement of the problem

A number of theories have been proposed to explain the variation in debt ratios across firms. These theories suggest that the firms select capital structures depending on attributes that determine the various costs and benefits associated with debt and equity financing.

Kamere (1987) reveals that the stability of future cash flows, the level of interest rates, the firm's asset structure, the firm's tax advantage of debt and the maturity of debt are all important factors in deciding a firm's capital structure. Apart from Kamere's findings, other factors have been highlighted in different studies to be important determinants of capital structure.

Aggrawal and Baliga (1987) for example, in a study of Latin American firm's capital structures found that while size did not seem to be significant, both country and industry were significant determinants of capital structure. Ravindra (1997) in a study of New York Stock Exchange firms obtained results which suggested that financial managers are more likely to follow a financing hierarchy than adhere to target capital structures. The study also presented evidence that risk and return characteristics of projects to be financed are deemed as the two most important determinants of long term financing decisions. This study used the Nairobi Stock Exchange companies to test if they share views of companies listed in a developed economy.

1.3 Objective

The objective of the study is to find out factors that motivate management of NSE firms in choosing their capital structure.

1.4 Importance of the study

1.4.1 Academicians

Academicians and researchers will use the research as an addition to their wealth of knowledge and constitute a firm foundation for further research in the area of study. This study will help them understand why financial managers display a much greater flexibility with capital structure decisions than with either dividend policy decisions or investment decisions.

1.4.2 Business consultants

Business consultants who may be interested in gaining knowledge on why capital decisions matter will also need the findings of this research in advising their clients. This study will also help them understand the factors considered by financial managers and advise them accordingly.

1.4.3 Corporate managers

The fundamental objective of financial management decision making is the maximization of shareholders' wealth by way of maximizing the market value of company's shares. Managers will therefore find the results of this study useful in guiding them towards making financing decisions that are in line with this fundamental objective. Management will appreciate the resultant effect of using debt in financing projects and move towards a capital structure that is optimal.

CHAPTER TWO

LITERATURE REVIEW

2.1 Introduction

A firm's choice on whether to finance itself debt/debt equivalent sources of finance or equity is what the capital structure decision is all about. Each of the two sources has merits and demerit.

Debt on one hand, because of the tax deductibility of interest payments is a much cheaper form of capital (Taggart, 1980). On the other hand, interest payments on debt are fixed irrespective of the firm's present financial strength. This is coupled with the risk of loans being recalled at short notice makes debt risky. The danger of bankruptcy and liquidation of assets when a firm is unable to service its debts may increase at high levels of debt making debt even more risky.

The use of equity poses no bankruptcy or liquidation risk but on the other hand, the costs of issuing new equity are generally higher than those of acquiring debt. Floatation costs and a higher required rate of return both contribute in making the issuing of equity a prohibition for smaller concerns (Archer and Faeber 1966).

Studies in capital structure have tried to address this issue together with their respective implications and their results are inconclusive. Whereas there is evidence from the traditional school that an optimal capital structure exists, there is also evidence (e.g. MM 1958) that no such a thing as an optimal capital structure exists.

The proponents of the optimal capital structure view are said in financial literature to belong to the traditional school and they hold that the value of the firm could be maximized by minimizing the cost of capital through careful use a debt. In 1958, Modigliani and Miller developed a new financial theory, which cast doubt on this view. They came up with three propositions, which changed the hitherto unchallenged belief on capital structure.

The controversy surrounding the choice of debt and equity into the capital structure has boiled to what Myers (1984) called "the capital structure puzzle" which he identified as

“tougher than the dividend puzzle”. Studies in capital structure have tried to address this issue and their results have turned out to be inconclusive. Whereas traditionalists give some evidence on existence of an optimal capital structure, Modigliani and Miller (1958) disputed this and gave further evidence that no such things as an optimal capital structure exist.

The remaining part of this section will give details of the developments of capital structure studies. MM view (1958), MM view (1963), Miller (1997), Agency costs, signaling theory of capital structure, trade-off theory of capital structure and pecking order theory of capital structure are extensively covered. Empirical studies are also covered at the end of this section.

2.2 Different Perspectives of Capital Structure

Various models have been proposed in finance literature to guide between the choice of debt and equity. These models are based on the benefits and costs associated with each source of finance. The greatest assumption that underlies each theory is that the decision maker has a need to have a need to minimize costs and maximize shareholders wealth.

2.2.1 The Traditional View

This theory holds that there exists an optimal level of leverage. The implication is that minimizing the cost of capital when the optimal level of debt capital is employed maximizes the value of the firm Brealy and Myers (1988). It is based on the argument that at low levels of debt, increased leverage does not increase the cost of debt finance and hence the replacement of an expensive source of capital (equity) with a cheaper source (debt) translates into increase in the value of the firm. It is this benefit that creates borrowing incentives to firms. However, borrowing will continue up to a certain level and beyond that level, let us call it the turning point; the cost of debt begins to rise. It is at this turning point that the firm’s value is at maximum and is considered to be the optimal capital structure.

Brealy and Myers (1988) observe that this argument holds because investors who hold debt are informed of the increased risk at ‘moderate’ debt levels and will continue

demanding the same return on debt. They argue that it is only at “excessive” debt levels that they demand a higher return.

Alexander (1963) better explains the fact that debt funds are cheaper than equity funds carries the clear implication that the cost of debt plus the increased cost of equity together on weighted basis will be less than the cost of equity, which existed on equity before debt financing. In other words the weighted average costs of capital will decrease with the use of debt.

The validity of the traditional view is questioned on the ground that the market value of the firm depends upon its net operating income and risk attached to it. The form of financing does not change net operating income nor the risk attached to it but simply the way in which the income is distributed between equity holders and debt holders (Brealey and Myers, 1984).

Modigliani and Miller (1958), criticize the traditional view on the ground that the assumption that the cost of equity remains unaffected by leverage up to some reasonable limit does not provide sufficient justification for such an assumption. They do not accept the contention that moderate amounts of debt in ‘sound’ firms do not really add very much to the ‘riskiness’ of the share.

However, the traditional view represents a logical appeal and should be appreciated for prompting the kind of vigorous analysis that MM subjected capital structure choice to. According to Omondi (1996), the notions of traditional view have been subjected to more abstract reasoning and analysis and some contemporary ways of looking at capital structure for example signaling theory (Ross,1977) and the Agency theory (Jensen, 1976).

Pandey (1999) asserts that the argument of traditional theorists that an optimum level structure exists can be supported on two counts: the tax deductibility of interest charges and Market imperfections. Therefore, there is no doubt that traditional theorists are important contributors on the debate about financing choices.

2.2.2 Modigliani and Miller (1958) MM without Corporate Taxes

Modigliani and Miller challenged the traditional theory of capital structure by developing a new theory. They did their work with certain assumptions, which include: existence of homogeneous risk class, homogeneous expectations, efficient capital market, risk-less debt and zero growth. They concluded that the capital structure of a firm is irrelevant to its value in a world without corporate taxes. The market value of a firm is determined solely by the magnitude and risk of the cash flow generated by the capital assets. The debt equity ratio merely indicates how the stream of future cash flows will be divided among the debt holders and shareholders.

This argument was based on the arbitrage process, which refers to the buying and selling of identical assets at different prices when one is over valued (Omondi,1996). The demand will continue to rise for the under valued asset in order to sell to the over valued firm, The law of demand and supply will set in to restore the prices at equilibrium. MM's first proposition therefore holds that the value of the levered firm equals the value of the unlevered firm:

$$V_L = V_U$$

Where, V_L = value of the levered firm

V_U = value of the unlevered firm

This implies that a firm's capital structure is irrelevant and that Weighted Average Cost of Capital (WACC) is the same no matter what mix of debt and equity is used. Hence a firm should use any source of financing provided it is convenient.

In their second proposition, they argued that the cost of equity capital is an increasing function of leverage. It is based on the argument that when debt is introduced, it increases the risk of the firm; this will compel the equity holders to demand a risk premium to compensate them for additional risk. Hence, the cost of equity to a levered firm is the sum of the cost of equity to unlevered firm and a risk premium. This implies that the cost

of equity rises as the firm increases its use of debt financing. The risk of equity depends on the risk of firm operations and on the degree of financial leverage.

2.2.3 Modigliani and Miller (1963) MM with corporate taxes

This was an improvement of the MM's previous work. The assumption of zero tax rate was seen as a serious limiting factor, and hence the need to come up with a model that incorporates taxes. Modigliani and Miller (1963), argued that the value of a firm will increase with leverage because interest in debt is tax deductible expense, hence there exist an extra benefit to the levered firm. The value of the levered firm will be the sum of the value of unlevered firm and the gain from the leverage.

$$V_L = V_U + t_d$$

Where, V_L = value of the levered firm

V_u = value of the unlevered firm

t_d = tax saving

This implies that the firms should use only 100 percent debt financing to take advantage of the tax savings. In practice, for many reasons, no firm deliberately follows a policy of one hundred percent debt financing.

The underlying rationale for the M&M argument is that the value of the firm is determined solely by the non current assets section of the balance sheet i.e. by what is usually referred to as the company's investment policy. The economic substance of the firm is unaffected whether the liability side of the firm's balance sheet is sliced into more or less debt. To increase the value of the firm, it must invest in additional projects with positive net present values.

Schwartz and Aronson (1996), argue that various classes of firms have developed some typical financial structures that are optimal for their operational risks and assets structures. This is especially in a market where sources of funds may be somewhat segregated. Miller (1977) introduced a model that incorporated both personal and corporate taxes. He

concluded that when personal taxes are introduced, the income available to investors is reduced when dividends are paid; this has the impact of reducing the value of the firm. However, Miller at a later date proposed that both corporate and personal taxes do not adequately explain the use of debt.

2.3 Modern Theories of capital structure

Modern theories have been advanced to try and explain the factors that affect capital structure. Not satisfied with the reason given as to why firms use debt, researchers embarked on research to justify the wide use of debt in the real world. A number of theories have been advanced as useful in corporate usage of debt. These theories identify other factors apart from the tax advantage of debt that explain a firm's capital structure. Some of these theories and factors are discussed below.

2.3.1 Business risk (Profitability of financial distress) and capital structure

Business risk is the first of two determinants of the costs of financial distress, according to Myers (1984). If one multiplies the costs of bankruptcy (which differ from industry to industry) by the probability of financial distress (not just bankruptcy, because indirect costs can be incurred even if a firm recovers), one obtains the expected financial distress. Financial distress has been defined as the disruption of normal operation and financial conditions caused by impending insolvency (Emery, 1998). Companies should then balance this cost against the tax benefits of debt in this static approach to obtaining the optimum leverage ratio.

The variability of cash flows is at the heart of business risk. The greater the fluctuations in a company's cash flows, the greater the chance it will be unable to meet its obligation in any given period. Firms with steadier cash flow will be able to support higher debt levels than riskier firms, all other factors being equal. An important point to note is that shareholders bear the costs of adjusting the firm's levels of risk every time risky debt is issued. This is so because the market demands a premium to buy the bonds of risky firms; on average, that premium covers expected bankruptcy costs.

Financial distress costs will affect both the cost of debt and the cost of equity. If a firm becomes bankrupt, financial distress costs will fall mostly on the bondholders since equity holders can lose nothing more than their original investment of equity investors will have largely disappeared. Financial leverage increases the profitability of financial distress and hence the cost of debt increases.

On the basis of his study, Altman (1984) found out that bankruptcy costs often exceed 20% of the firm value. He further observed that costs of financial distress are peculiar to leveraged firms only and they can be high especially as the level of debt rises. Contrary, Emery (1998) observed that any company with fixed costs becomes financially distressed when its cash flows are insufficient to cover its capital structure. Therefore even unleveraged firms can face financial distress. Haugen and Seubet (1978) in their study concluded that bankruptcy costs are not sufficient to influence capital structure.

2.3.2 Agency costs and Capital structure

Agency problems result when members of one group of stakeholders (such as managers) place their own interest before the interests of the group they represent (such as the stakeholders). How well the company controls the losses associated with the agency problems (either through incentive plans, monitoring, or covenants) can have a dramatic impact on its capital structure and value.

Bondholders are protected by some covenants against the possibility of managers trying to take advantage of them. Accord to Jensen (1976) these covenants hamper the corporation's legitimate operations to some extent. He further puts it that the cost of efficiency plus those incurred by monitoring the covenants are what are referred to as agency costs. Agency costs increases the cost of debt and at the same time reduces the value of equity as noted by Musili (2005).

Kamcre (1987) noted that agency problems may bring about an optimal ratio of debt and equity financing when agency costs related to debt and equity financing are considered. Costs associated with protective covenants are substantial and rise with the amount of

debt financing. Shareholders incur monitoring costs to ensure manager's actions are based on maximizing the value of the firm. Jensen and Meckling (1976) noted that with increasing costs associated with higher levels of debt and equity, an optimal combination of debt and equity might exist that minimizes total agency costs.

2.3.3 Signaling Theory and Capital structure

Ross (1978) introduced signaling theory to finance in which he suggested that managers can use capital structure as well as dividends to give some signals about the firm's future prospectus. More specifically, outsiders may interpret increasing the amount of debt in the firm's capital structure as a sign of confidence in a firm's future.

Kamere (1987) notes that signaling is closely related to agency problem in that the use of a firm's capital structure to convey information to the market about a firm's profitability is made possible by failure on the part of principals to control actions of management fully. Harris and Raviv (1990) contend that in general, managers do not always behave in the best interest of investors. Debt according to them serves this purpose by offering creditors the option to force the firm into liquidation and it also generates information about these aspects.

Therefore, the expectation is that a debt equity ratio should be balanced between the demands of the firm and the speculations of the investors and the general public about the firm's prospects.

2.3.4 The Trade off Theory of Capital Structure

Myers (1984) noted that the theories of capital structure do not seem to explain the actual financing behavior. He therefore ushered two ways of thinking which he identified as static trade off framework and pecking order framework. In Trade off theory of capital structure. Myers (1984) draws extensively from his work related to MM papers in which the firms' tradeoff the benefits of debt financing (favorable corporate tax treatment) against higher interest rates and bankruptcy costs. "A firm's optimal debt ratio is determined by a trade off of the costs and benefits of borrowing, holding the firm's assets and investment plan constant" This implies that an optimal capital structure is a result of

balancing the value of interest rate tax shields against various costs of bankruptcy or financial distress.

The trade off theory contrasted MM (1963) by implying that, in real world, firms rarely use 100 percent debt. The primary reason is that firms limit their use of debt to reduce the probability of financial distress (bankruptcy) and also that interest rate on debt becomes prohibitively high at high debt levels (Musili, 2005).

2.3.5 The Pecking Order Theory of Capital Structure

The pecking order model, argues that adverse selection issues in raising funds by different methods dominate other considerations in the tradeoff model such that a hierarchy of funds results. Firms will use internal funds first, then debt and only when such options are exhausted will they resort to using new equity finance.

Under the pecking order model developed by Myers and Majiluf (1984), there is a strict ordering or hierarchy of sources of finance. These results from adverse selection issues that arise when the firm has more information about its value than providers of funds. These adverse selection issues are absent when retained earnings are used as the marginal source of funds and are greater for equity than debt finance. Providers of finance therefore require a risk premium that is greater for equity than debt finance. The result is that firms will have a preference for internal sources of funds followed by debt and then, when such sources are exhausted, equity finance will be used. An implication of the pecking order approach is that firms do not have a target level leverage and their actual level of debt essentially responds to the difference between investment and retained earnings. The pecking order model implies that leverage is decreasing in company cash flow or profitability and increasing in investment, *ceteris paribus*. The availability of internal funds, through cash flow or current profitability, implies that firms have less need make recourse to external debt, implying a lower debt ratio. Moreover, for a given level of cash flow the amount of debt will increase in the investment being undertaken by the firm. The important observation is that both of these predictions are in contrast to those described above for the tradeoff model. However, in a refined (i.e. non-static)

pecking order model capital structure decisions are influenced by future as well current financing costs. In this context, firms may wish to maintain a capacity for additional debt with larger expected investment implying lower current indebtedness. This implies the importance of controlling for investment opportunities. A consideration of the relation between debt and growth opportunities is also of interest in its own right. A case for expecting a positive relation (particularly when the debt ratio is measured at book values) could be expected, especially under the pecking order model. As growth opportunities increase the demand for funds, this may mean that for given availability of internal funds, additional external funds are required including additional debt.

2.4. Major Determinants of Capital Structure Choice

There are various attributes that different theories of capital structure suggest may affect the firm's capital structure decision. These attributes according to Titman and Wessels (1988) are denoted as non-debt tax shields, asset structure, growth, uniqueness, industry classification, size, earnings volatility, and profitability. This study will explore each determinant and identify other determinants that have been established in recent studies.

2.4.1 Asset structure (Tangible versus Intangible Assets)

One of the biggest determinants of the cost of financial distress is the tangibility of a company's underlying assets. Tangible assets such as plants and property retain their value even in bankruptcy, so capital intensive firms can support higher levels debt at lower costs because there is little threat to bondholders that the assets they claim to be worthless. Many companies maintain a lot of their value in technology and human capital, assets that may only have value as part of going concern. These firms stand to lose more from going bankrupt and an efficient bond market will recognize that. They will pay a higher cost for debt and typically support lower leverage ratios than similar firms with more tangible assets. Myers (1984) asserts that firms holding valuable intangible assets tend to borrow less than firms holding mostly tangible assets. Long and Malitz (1983) found a significant positive relationship between the rate of capital expenditure (in fixed plant and equipment) and the level of borrowing. In Kenya the view that firms with tangible assets borrow more is supported by both Kamere (1987) and

Omondi (1996). This means that firms in Kenya prefer debt issues that equity issues that are supportive of the pecking order hypothesis.

2.4.2 Growth

As observed by Titman and Wessels (1988) equity controlled firms have tendency to invest sub optimally to expropriate wealth from the firm's bondholders. The cost associated with this agency relationship is likely to be higher for firms in growing industries which have more flexibility in their choice of future investments. Therefore, expected future growth should be negatively related to long-term debt levels. Myers (1977) however noted that this agency problem is instigated if the firms issue short term rather than long-term debt.

In support of this, Long and Malitz (1983) found a significant negative relationship between rates of investment in advertising and research and development (R&D) and the level of borrowing. Advertising and Research and Development act as proxies for growth.

Kamere (1987) has initiated similar views. The prediction of growth on capital structure is in contrast with the pecking order theory prediction. This is because the high growth firms are particularly subject to adverse selection problem and according to the pecking order theory they should be indicative of more debt issues. Using growth as proxy for pecking order theory prediction then, it would be appropriate to conclude that firms in Kenya do not follow the pecking order philosophy in their financing choices. However, this would be termed too shallow for making such a major conclusion.

2.4.3 Size

The cost of issuing debt and equity is much more with small firms than large ones as noted by Musili (2005). This suggests that small firms may be more leveraged than large firms and may prefer to borrow short term rather than issue long-term debt because of the lower fixed costs associated with this alternative (Titman and Wessels, 1988). This may be supportive of pecking order prediction since small firms are faced with adverse selection problem.

In Kenya, Kamere (1987) found out that long-term debt and the value of total assets (size) are positively correlated. This suggests that the use of debt financing may be higher among large firms than among smaller ones. This is inconsistent with the pecking order theory prediction.

2.4.4 Profitability

Brigham and Gapenski (1990) observed that firms with very high rates of return on investments use relatively little debt. The practical reason is that highly profitable firms do not need to do much debt financing since their high rates of return enable them to do their financing with retained earnings. This behavior is consistent with pecking order theory prediction.

Myers (1977) cites evidence from Brealey and Myers (1984) that suggests that firms prefer raising capital, first from retained earnings second from debt and third from issuing new equity. These can be the costs discussed in Myers and Majiluf that arise because profitability of a firm, and hence the amount of earnings available to be retained should be an important determinant of current capital structure.

Contrary, Omondi (1996) found out that Kenyan firms tend to borrow more when their profits are high. He gives an explanation for this, that high profits serve as an incentive to the firm to invest more and this is what may warrant borrowing for expansion of business. Omondi's finding on profitability would be indicative that firms in Kenya do not follow the pecking order theory of capital structure in their financing choices. However, Odinga (2003) found a significant negative relationship between leverage and profitability. He argued that profitable firms financed most of their investment opportunities from retained earnings and borrowed less to avoid contractual obligations to pay. Equity is more secure in the sense that investors do not demand the required rate of return.

2.4.5 Asymmetric Information

Another key assumption inherent to the validity of MM proposition I is the homogeneity of expectations. This means that all market participants (managers as well as other stakeholders) are assumed to have equal information about the future states of nature, and to interpret the same way. This is not, however, always an innocuous assumption. New

security issues illustrate this point. Myers and Majluf (1984) also assumed that a potential purchaser of securities has less information about the prospects of the firm than management and that management is more likely to issue securities when the market price of the firms traded securities is higher than management's assessment of their value. Sophisticated investors revise their estimate of the value of the firm if management announces a new security issue; further more, the larger the potential disparity in information, the greater the revision in expectations and the larger the negative price reaction to the announcement of a new issue.

2.4.6 Corporate Control

Capital structure has been shown to have an important impact on the market for corporate control. The debt versus equity decision has an impact on the eventual distribution of voting rights in these contests, as well as an influence on the expected payoffs to the target would be buyer.

2.5 Empirical studies

2.5.1 International Context

From the international point of view there is no longer consistency in capital structures. RutterFord (1985) provides evidence that Japanese firms depend heavily on debt whereas U.K and U.S firms tend to have more equity. The reasons given is that in Japan there is a closer relationship between banks and their client firms and this may have an effect of reducing costs of issuing debt than in U.S and U.K.

Booth et al (2001) analyzed the capital structure choices of firms in ten developing countries and concluded that their capital structure decisions are affected by the same variables as developed countries. The countries studied were India, Pakistan, Thailand, Malaysia, Turkey, Zimbabwe, Mexico, Brazil, Jordan and Korea.

Ravindra (1997) in a study of New York Stock Exchange firms obtained results which suggested that financial managers are more likely to follow a financing hierarchy than adhere to target capital structures. The study also presented evidence that risk and return

characteristics of projects to be financed are deemed as the two most important determinants of long term financing decisions.

2.5.2 Kenyan Context

A number of capital structure related studies have been done in Kenya. Kamere (1987) performed an opinion survey to find out from the auditors and financial managers what factors they consider to be important in their capital structure decisions. Most notable in his findings as significant factors that influence capital structure decisions include the stability cash flows, the level of interest rates, the firm's asset structure, tax shield and the maturity of debt.

Omondi (1996), extended on the work of Kamere, though restricted his analysis on to public listed companies. Using correlation coefficient and data for the period 1987-1994, he analyzed the relationship between leverage and the variables. His results revealed a significant positive relationship between leverage and profitability. Interest charges also tested positive, though the coefficient was very low.

Odinga (2003) built on Omondi's work. He studied the major determinants of capital structure variations of listed companies. He regressed asset tangibility, profitability, growth opportunities, business risk, non-debt tax shield and firm's size against leverage. Only profitability and non-debt shield tested significant, profitability being negatively related with leverage. His findings on profitability contradicted Omondi's findings. Unlike Odinga (2003), Omondi (1996) found a significant relationship.

The limitation in Odinga's study is that it only explains the existing capital structures without giving an insight of the capital structure issues from a practical point of view. This study borrows heavily from the previous studies in terms of study design and methodology, except for the industrial orientation.

The corporate tax rate has not been investigated as a factor that influences the capital structure though it is central to the various theories of capital structure. There is need to

establish the association that exists between tax rate and leverage. This study focused on the association of various proxies of corporate tax rate and leverage. Using data from NSE the capital structure was analyzed with respect to the changing corporate tax rate over the years.

In summary, this study will be carried out with the aim of examining the factors that motivate management of NSE firms in choosing their capital structure. This literature gives a new direction of study in that a similar study was done by Ravindra (1997) for firms listed at the New York Stock Exchange (NYSE) and hence will establish what is experienced by companies in a developing economy.

CHAPTER THREE

RESEARCH METHODOLOGY

3.1 Introduction

This chapter discusses the methodology used in gathering the data, analyzing the data and reporting the results. The researcher aimed at explaining the methods and tools used to collect and analyze data to get proper and maximum information related to the subject under study.

3.2 Research design

This research was carried out as a survey to study the financing policy of management of companies listed at the Nairobi Stock Exchange while making capital structure decisions and to determine their effectiveness based on empirical evidence.

3.3 Population

The population will consist of the 54 companies listed at the Nairobi Stock Exchange (NSE) as at 2008. These firms were preferred because they represent agriculture, commercial and services, finance and investment and industrial and allied sectors. Hence these firms experience different capital requirements. The study being a survey implies that data will be collected from all 50 companies excluding the 4 suspended companies namely: Hutchings Biemer Limited, Uchumi Supermarkets Limited, B.O.C Kenya Limited and Carbacid Investments Limited.

3.4 Data collection

Primary data was collected using structured questionnaires that were completed by the respondents. The questionnaires comprised both open and closed ended questions and was administered through the drop and pick later method. For firms located in towns away from Nairobi, the questionnaire was dispatched by way of electronic mail to the financial manager or the officer most familiar with financing procedures to answer the questions.

3.6 Data analysis method

The study is a descriptive survey aimed at identifying the factors that motivate management of firms listed at the NSE in choosing their capital structure. According to Cooper and Schindler (1998), such a study concerned with finding out what, where and how a phenomenon is a descriptive study and as such, descriptive statistics was used to analyze the data.

Once data had been collected, the questionnaires were edited for accuracy, uniformity, consistency and completeness. The responses were rated on a likert scale and the data was then analyzed by use of frequency tables, mean score tabulations, and percentages to represent the response rate and information on the variables under study. These tools were selected because of their clarity, preciseness, ease of understanding and interpretation.

CHAPTER FOUR

DATA ANALYSIS

4.1 Introduction

In accordance to the objectives set out in 1.3, the conclusions were arrived at as set out below. A total of 50 companies as listed in appendix 1 (excluding the 4 suspended companies) as at 2008 were used which were deemed sufficient to support the conclusions and interpretations arrived at in this chapter. 23 out of 50 companies responded to the questionnaire representing 46 % response rate.

4.2.1 Trade off versus pecking order theory

The first question of this inquiry was stated as follows:

In raising new funds, your firm:

- a) Seeks to maintain a target capital structure by using approximately constant proportions of several types of long-term capital simultaneously.
- b) Follows a hierarchy in which the most advantageous source of funds is exhausted before other sources are used.

The responses are presented in table one below.

Table 1

	Frequency	Percent
Target capital structure	11	48
Hierarchy which is most advantageous	12	52
Total	23	100

Twelve respondents (52 percent) indicated that they prefer to follow a financing hierarchy while the remaining 11 respondents (48 percent) indicated that they seek to maintain a target capital structure. This is near one to one preference for the financing hierarchy comparable to the 65.5 percent to 34.5 percent preference for the financing hierarchy in the Ravindra study for New York Stock Exchange (NYSE) firms.

4.2.2 Determination of cost of equity capital

The respondents were asked if they estimate the cost of equity capital. For the firms that do estimate, the methods used are analyzed in table 2 below.

Table 2

Choice by order of priority	Frequency	Percent
a) Using Capital Asset Pricing Model (CAPM, the beta approach)	2	9
b) Using CAPM but including some extra risk factors	8	35
c) By regulatory decisions	2	9
d) Using whatever our investors tell us they require	1	4
e) Using average historical returns on common stock	5	22
f) Does not estimate cost of equity capital	5	22

78.3 percent of the respondents indicated that they do estimate the cost of equity capital. 35 percent of the respondents indicated that they use CAPM but including some extra risk factors in determining the cost of equity capital while using what he investors require obtained the least implying reluctance of firms relying on investors requirements. In support for this is the fact that firms are owned by very many investors who may have different views.

4.2.3 Preference rankings of long term sources of funds.

The respondents that reported following a financing hierarchy in 4.2.1 were asked to rank 6 sources of long-term financing. Their responses are reported in table 3. For each type of financing, this table shows the percentage of responses within each rank as well the mean ranking.

As indicated, 81.8%of the respondents ranked retained earnings as their first choice while 50% ranked straight preferred stock as their last choice. The respective mean rankings for the sources of funds were 5.9 and 2.1. Similarly, straight debt dominates convertible debt with mean ranks of 4.4 and 3.6 respectively.

The respondents' preference for retained earnings over externally generated equity is very clear, as is the preference for the straight debt over convertible debt. Hence the survey results summarized in Table 3 strongly support the primary postulates of the pecking order hypothesis. The rankings of the six forms of financing are identical to those of Ravindra's (1997) study.

Percentage of responses within each rank

Table 3: Percentage of Responses within Each Rank

Sources by Order of Preference	First	Second	Third	Fourth	Fifth	Sixth	Not Ranked	Mean*
a. Retained earnings	81.8	14.3	0.0	0.0	12.5	0.0	0.0	5.9
b. Straight debt	18.2	57.1	0.0	0.0	25.0	0.0	0.0	4.4
c. Convertible debt	0.0	7.1	60.0	28.6	0.0	0.0	20.0	3.6
d. External common equity	0.0	7.1	20.0	42.9	12.5	25.0	20.0	2.9
e. Straight preferred stock	0.0	0.0	10.0	14.3	37.5	50.0	20.0	2.1
f. Convertible preferred stock	0.0	14.3	10.0	14.3	12.5	25.0	4.0	2.0

*Means were computed by assigning values of 6 through to 1 for rankings from 1 through 6 respectively and by multiplying each value by the percent of responses within each rank. The unranked sources are assigned 0 values.

4.2.4 Financing planning principles

The NSE firms were asked to evaluate the relative importance of 8 financial planning principles. Their responses are summarized in table 4. By using the percentage responses under each relative rank, a mean importance value was calculated for each of the eight considerations.

Six out of eight principles above have mean ranks of 1.9 or higher. In contrast, the means of the eight guidelines does not vary much as shown in Table 4. It is worth noting that among the planning principles; firms are more concerned about maximizing security prices, ensuring long-term survivability and maintaining financial flexibility than minimizing the probability of being acquired. In Ravindra’s study, the objective of minimizing the probability of being acquired was viewed to be as relatively unimportant even at the peak of corporate acquisition activity.

Table 4: Percentage of Responses within Each Rank

Planning Principle by Order of Importance	Unimportant 1	2	3	4	Important 5	Mean *
1.Maintaining financial flexibility	5.3	0.0	0.0	4.3	35.8	2.0
2.Ensuring long-term survivability	5.3	0.0	4.7	19.1	20.8	2.0
3.Maximizing security prices	0.0	20.0	14.0	19.1	9.4	2.1
4.Maintaining a predictable source of funds	15.8	13.3	14.0	14.9	9.4	1.9
5.Maintaining Financial independence	10.5	6.7	18.6	14.9	9.4	1.9
6.Maintaining high debt rating	42.1	20.0	14.0	8.5	1.9	1.7
7.Maintaining comparability with other firms in the industry	10.5	20.0	23.3	10.6	5.7	1.9
8.Minimizing the probability of being acquired	10.5	20.0	11.6	8.5	7.5	1.6

*Means were calculated by assigning values of 1 through 5 for rankings from “unimportant” to “important” respectively, and by multiplying each value by the fraction of responses within each rank. A value of 0 is assigned when a factor is not ranked.

4.2.5 Managerial choices when confronted with an attractive new growth opportunity

Since the capital structure decisions are made in constantly changing product as well as capital markets, the reactions of financial managers to dynamic changes in their decision making environment are worth studying. One example of an effect of such a change in the environment which managers face is a possibility of pursuing an investment with an

attractive growth potential, yet embracing the opportunity might mean deviating from the target capital structure or a desired financing hierarchy. Table 5 presents the responses to such an inquiry.

Table 5

Response of Firms %		
Course of Action	Firms which seek to maintain a Target Capital Structure in Raising New Funds	Firms which seek to Follow a Financing Hierarchy in Raising New Funds
1.Deviate from the target capital structure or financing hierarchy	58.3	33.3
2.Forgo the growth opportunity	0.0	0.0
3.Sell other assets	0.0	16.7
4.Cut the dividend	41.7	50.0

58.3 % of the respondents that maintain a target capital structure would deviate from the target capital structure when confronted with an attractive new growth opportunity as compared to 33.3% for firms that follow a financing hierarchy. On the other hand 50% of the firms that follow a hierarchy would rather cut their dividend compared to 41.7% for firms that maintain a target capital structure. Only 16.7% of the respondents would sell other assets. The responses clearly indicate that managers perceive a much greater degree of flexibility with the capital structure decisions. These responses are similar to those of Ravindra's study.

4.2.6 Relative importance of capital structure inputs

The financial managers of the NSE firms were asked to rank 10 capital structure model inputs on a scale of 1 (unimportant) to 5 (important). The survey findings are summarized in table 6 employing the same procedure that that was used in preparing table 4.

Table 6

Percentage of Responses Within Each Rank						
Inputs/Assumptions by order of importance	Unimportant 1	2	3	4	Important 5	Mean*
1. Projected cash flow from asset to be financed	5.0	3.4	0.0	8.6	30.0	2.0
2. Risk of asset to be financed	5.0	3.4	6.3	10.3	20.0	1.7
3. Restrictive covenants on securities	5.0	3.4	9.5	12.1	14.0	1.6
4. Avoiding dilution of common shareholders' claims	0.0	10.3	17.5	12.1	2.0	1.3
5. Corporate tax rate	5.0	6.9	15.9	12.1	4.0	1.3
6. Voting control	0.0	17.2	3.2	20.7	6.0	1.6
7. Depreciation and other non-debt tax shields	5.0	13.8	14.3	10.3	4.0	1.4
8. Correcting mispricing of outstanding securities	10.0	10.3	14.3	10.3	4.0	1.3
9. Personal tax rates of debt and equity holders	30.0	17.2	15.9	1.7	0.0	1.2
10. Bankruptcy costs	35.0	13.8	3.2	1.7	16.0	1.6

Means were calculated by assigning values of 1 through 5 for rankings from “unimportant” to “important,” respectively, and by multiplying each value by the fraction of responses within each rank. A value of 0 is assigned when a factor is not ranked.

The tabulated mean scores clearly show that the two most important capital structure considerations, according to the respondents, are the two primary characteristics of the investment to be financed. With mean scores of 2.0 and 1.7, the projected cash flow and the risk of the investment to be financed top the list of the 10 capital structure input. Thus, the findings strongly suggest that corporate financing decisions and investment decisions cannot be segregated and that investment characteristics are very influential in financial decisions of firms. In this regard, these findings echo the sentiments expressed by Ravindra.

Restrictive covenants on securities, voting control and bankruptcy costs were the next most important factors governing financing decisions all having a mean score of 1.6. Of the remaining inputs, personal tax rates of debt and equity holders, correcting mispricing of outstanding securities, avoiding dilution of common shareholders' claims and corporate tax rate are reported to be relatively unimportant. To a large extent, the results exhibited in Table 6 are similar to those reported by Ravindra.

4.2.7 Debt ratio respondents' views

The final inquiry in the present survey sought respondents' degree of agreement with five statements concerning the debt ratio of firms. The survey responses are included in table 7. The computational procedure adopted for preparing previous tables was also adopted hereto compute the mean scores.

The highest ranked debt ratio determining factor was found to be the “past profits,” with a mean score of 3.4. On the other hand, the respondents were found to be closer disagreeing with the statement that debt ratio of their firms depend on “past dividend payout,” with a mean score of 2.7.

Table 7

Percentage of Responses Within Each Rank						
Statement	Disagree 1	2	3	4	Agree 5	Mean*
1.Past profits	18.2	0.0	10.0	11.4	50.0	3.4
2.Average debt ratio in your industry	18.2	18.2	16.7	25.7	17.9	3.0
3.Past growth	18.2	18.2	20.0	25.7	14.3	2.9
4.Degree of diversification achieved by your firm	36.4	63.6	23.3	8.6	7.1	3.0
5.Past dividend payout	9.1	0.0	30.0	28.6	10.7	2.7

*Means will be calculated by assigning values of 1 through 5 for ranking from “disagree” to “agree,” respectively, and by multiplying each value by the fraction of responses within each rank. A value 0 is assigned when a statement is not ranked.

4.3 Summary

This study examines survey evidence on managerial views and practices with respect to long-term financing decisions. The primary results emerging from the survey are summarized in chapter 5.

CHAPTER FIVE

5.1 CONCLUSIONS AND RECOMMENDATIONS

This paper has examined the capital structure decisions of firms. The two main candidate models which have attempted to resolve the 'capital structure puzzle' have been the tradeoff and pecking order theories. Each relaxes conditions under which the Modigliani and Miller (1958) theorem was derived. The tradeoff theory views companies setting a level of debt where the marginal benefit of debt, in the form of tax deductibility of interest payments and possible mitigation of agency costs, exactly offsets the marginal cost of debt in the form of bankruptcy costs. The pecking order theory instead views these considerations as of secondary importance being dominated by adverse selection issues arising from the fact that managers have greater information about the value of the firm than outside providers of funds. The resulting premium that such suppliers of finance demand is especially strong where equity finance is concerned such that firms have a strict ranking of preferred source of funds: internal funds, followed by debt and then equity.

The financial managers in this study were found to be more likely to follow a financing hierarchy than adhere to target capital structures. As regards capital structure theories, the results of the study support the pecking order model developed by Myers and Majiluf (1984). If confronted with new growth opportunities which would force them to deviate from the target capital structure or the financing hierarchies, most firms would go for the growth opportunity. The message conveyed by the managers of the firms is that they are likely to be much more flexible with capital decisions than with either dividend policy decisions or with the investment decisions.

Personal tax rates of debt and equity holders, correcting mispricing of outstanding securities, avoiding dilution of common shareholders' claims and corporate tax rate are reported to be relatively unimportant when determining the financing mix. Financial managers seem to be more concerned with projected cash flow from asset to be financed.

5.2 Limitations of the study

In spite of taking the normal precautionary steps to increase the responses such as assurance of anonymity and confidentiality of individual responses, the response rate was low and the strength of the findings could adversely be affected by the non-response bias.

5.3 Suggestions for further research

To improve on this study it is suggested that:

A test for the signaling theory of capital structure among companies quoted at the Nairobi Stock Exchange.

Still a lot needs to be done in the area of capital structure of companies in Kenya, specifically to establish the nature of capital structure of companies not quoted at the Nairobi Stock Exchange.

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6.0 APPENDICES

6.1 Appendix: List of Companies listed at the Nairobi Stock Exchange (NSE)

Agriculture

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

Commercial and Services

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

Finance and Investment

1. Barclays Bank of Kenya Ltd.
2. CFC Stanbic Bank Ltd.
3. Housing Finance Company of Kenya Ltd.
4. Centum Investment Ltd.
5. Kenya Commercial Bank Ltd.
6. National Bank of Kenya Ltd.
7. Pan Africa Insurance Holdings Co. Ltd

8. Diamond Trust Bank of Kenya Ltd.
9. Jubilee Insurance Co. Ltd
10. Standard Chartered Bank Ltd.
11. NIC Bank Ltd.
12. Equity Bank Ltd.
13. The Co-operative Bank of Kenya Ltd.

Industrial and Allied

1. Athi River Mining Ltd.
2. BOC Kenya Ltd. (suspended)
3. British American Tobacco Kenya Ltd.
4. Carbacid Investments Ltd. (suspended)
5. Olympia Capital Holdings Ltd.
6. E.A. Cables Ltd.
7. E.A. Breweries Ltd.
8. Sameer Africa Ltd.
9. Kenya Oil Ltd.
10. Mumias Sugar Company Ltd.
11. Unga Group Ltd.
12. Bamburi Cement Ltd.
13. Crown berger (K) Ltd.
14. E.A Portland Cement Co. Ltd.
15. Kenya Power & Lighting Co. Ltd.
16. Total Kenya Ltd.
17. Eveready East Africa Ltd.
18. Kengen Ltd.

Alternative Investments Market

1. A.Baumann & Co.Ltd Ord 5.00
2. Eaagads Ltd Ord 1.25
3. Williamson Tea Kenya Ltd Ord 5.00
4. Kenya Orchards Ltd Ord 5.00
5. City Trust Ltd Ord 5.00
6. Express Ltd Ord 5.00
7. Kapchorua Tea Co. Ltd Ord Ord 5.00
8. Limuru Tea Co. Ltd Ord 20.00

5.2 Appendix 2: Letter of introduction

University of Nairobi
Faculty of Commerce
Department of Finance and
Accounting
P.O.Box 30197-00100
Nairobi

TO WHOM IT MAY CONCERN

Dear Respondent,

RE: REQUEST FOR RESEARCH DATA

I am a Postgraduate student at the University of Nairobi, Faculty of Commerce. In partial fulfillment of the requirements for the award of the degree in Master of Business Administration, I am conducting a study titled; **“CAPITAL STRUCTURE CHOICE: VIEWS AND PRACTICES OF FINANCIAL MANAGERS OF COMPANIES LISTED AT THE NAIROBI STOCK EXCHANGE”**

For the purpose of enhancing my research work, I wish to collect data through the questionnaire method. I would highly appreciate if you would kindly assist in filling this questionnaire.

This information is purely for the purpose of my project work and all information provided will be treated with strict confidentiality.

Thanking you in advance.

Yours faithfully,

Ndung'u Amos
D61/70087/2007
MBA student

Mr. Luther Otieno
Supervisor

5.3 Appendix 3: QUESTIONNAIRE

Introduction

This is an academic research that seeks to determine the financing policy within Kenyan companies. It will facilitate understanding as to why firms have different proportions of long-term financing and how they finance new viable projects. Thus, the information obtained will be treated confidentially and cannot be used to affect any of your roles in the company.

Part 1: Company Background

1. What is the name of your company?

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2. In raising new funds, your firm (Tick one)

a) Seeks to maintain a target capital structure by using approximately constant proportions of several types of long-term capital'

b) Follows a hierarchy in which the most advantageous source of funds is exhausted before other sources are used.

3. Does your firm estimate the cost of equity capital?

Yes

No

4. If yes tick from the choices given below how you determine your firm's cost of equity capital.

a) Using Capital Asset Pricing Model (CAPM, the beta approach)

b) Using CAPM but including some extra risk factors

c) By regulatory decisions

d) Using whatever our investors tell us they require

e) Using average historical returns on common stock

5. Rank the following sources of long-term funds in order of preference for financing new investments

	1 st	2 nd	3 rd	4 th	5 th
a. Retained earnings	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
b. Straight debt	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
c. Convertible debt	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
d. External common equity	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
e. Straight preferred stock	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
f. Convertible preferred stock	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>

6 Indicate the relative importance of the following considerations in governing your firm's financing decisions (Most important = 6, unimportant = 1)

	1	2	3	4	5	6
a. Maintaining financial flexibility	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
b. Ensuring long-term survivability	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
c. Maximizing security prices	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
d. Maintaining a predictable source of funds	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
e. Maintaining Financial independence	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
f. Maintaining high debt rating	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
g. Maintaining comparability with other firms in the industry	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>

h. Minimizing the probability of being acquired

7. Given an attractive new growth opportunity that could not be taken without departing from your target capital structure or financing hierarchy, cutting the dividend, or selling off other assets, what action is your firm likely to take? (Tick one)

a. Deviate from the target capital structure or financing hierarchy

b. Forgo the growth opportunity

c. Sell other assets

d. Cut the dividend

8. Indicate the Relative Importance of the Following Factors in Governing Your Firm's Financing Decisions (Most important = 5, unimportant = 1)

	1	2	3	4	5
a. Projected cash flow from asset to be financed	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
b. Risk of asset to be financed	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
c. Restrictive covenants on securities	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
d. Avoiding dilution of common shareholders' claims	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
e. Corporate tax rate	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
f. Voting control	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
g. Depreciation and other non-debt tax shields	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>

h. Correcting mispricing of outstanding securities

i. Personal tax rates of debt and equity holders

j. Bankruptcy costs

9. In your opinion, the Debt Ratio of Your Firm Depends on (Agree = 5, Disagree = 1)

	1	2	3	4	5
a. Past profits	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>

b. Average debt ratio in your industry	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
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c. Past growth	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
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d. Degree of diversification achieved by your firm	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
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e. Past dividend payout	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
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10. What other factors do you consider while making long-term financing decisions?

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