

**A SURVEY OF SOURCES OF FINANCE FOR BUILDING CONSTRUCTION
FIRMS IN KENYA**

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**A RESEARCH PROJECT SUBMITTED IN PARTIAL FULFILMENT FOR THE
AWARD OF MASTER OF BUSINESS ADMINISTRATION OF THE UNIVERSITY
OF NAIROBI**

NOVEMBER 2008

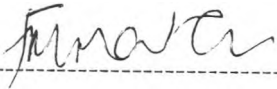
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DECLARATION

I hereby declare that this is my original work and has not been presented to any other university as a proposal for research.



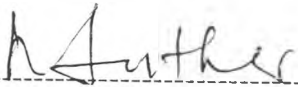
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This project has been submitted for examination with my approval as a university supervisor.



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DEDICATION

This project is dedicated to those who believe in the future.

ACKNOWLEDGEMENT

I would like to thank all those that helped me to ensure the success of this project. This included the several employees of various building construction firms' proprietors in Kenya that took time out of their busy schedule to respond to my questionnaire.

I would also like to thank my supervisor for the useful comments that he gave to me in carrying the research.

TABLE OF CONTENTS

DECLARATION.....	I
DEDICATION.....	II
ACKNOWLEDGEMENT.....	III
TABLE OF CONTENTS.....	IV
ABSTRACT.....	VIII
LIST OF TABLES.....	IX
LIST OF FIGURES.....	X
LIST OF ACRONYMS.....	XI
CHAPTER ONE.....	1
1.0 INTRODUCTION.....	1
1.1 Background of the Study.....	1
1.1.1 Review of the Construction Industry.....	2
1.2 Statement of the Problem.....	3
1.3 Objectives of the Study.....	4
1.4 Significance of the Study.....	5
CHAPTER TWO.....	6
2.0 LITERATURE REVIEW.....	6
2.1 Introduction.....	6
2.2 Capital Structure Policy.....	6
2.3 Sources of Finance.....	8
2.4 Sources of finance for Building Construction Firms.....	9
2.5 Short-term/Operating sources of capital.....	11

2.5.1 Trade Credit.....	11
2.5.2 Short-term Loan.....	12
2.5.3 Commercial Paper.....	13
2.5.4 Informal Finance.....	13
2.6 Long-term Sources of Finance.....	14
2.6.1 Common Shares.....	14
2.6.2 Preference Shares.....	16
2.6.3 Retained Earnings.....	17
2.6.4 Long-term Loan.....	18
2.6.5 Venture Capital.....	19
CHAPTER THREE.....	21
3.0 RESEARCH METHODOLOGY.....	21
3.1 Research Design.....	21
3.2 Population.....	21
3.3 Sampling.....	21
3.4 Strategies for Determining Sample Size.....	22
3.5 Data Collection.....	22
3.6 Data Analysis.....	23
CHAPTER FOUR.....	24
4.0 DATA ANALYSIS AND FINDINGS.....	24
4.1 Introduction.....	24
4.2 Year of starting the business.....	24
4.3 category of the firm.....	25
4.5 Type of business organization.....	25
4.6 Source of initial capital.....	26
4.7 Sufficiency of capital.....	27

4.8 Problems in raising capital.....	28
4.9 Reasons for problems in raising capital.....	28
4.10: Enough equipment.....	29
4.11 Finance of construction equipment.....	29
4.12 Source purchased of equipment.....	30
4.13 Intention of increasing capital	31
4.14 Composition of capital.....	31
4.15 Publishing financial statements	32
4.16 Risks associated with business operations.....	33
4.17: Overall financial performance	34
4.18: Average turnover for the last three years.....	34
4.19 Growth and profitability affected by capital issues	35
4.20 Invitation to external auditors.....	36
4.21: Finance the acquisition of security bonds.....	37
4.22 Requirement of depositing security bonds and cash flow position	37
4.23 Technology and financial position.....	38
4.24 Sources of finance for day to day activities.....	38
4.25 Source of capital affecting the level of profitability	39
4.26 Source of finances.....	39
CHAPTER FIVE	41
5.0 SUMMARY AND RECOMMENDATION.....	41
5.1 Introductions	41
5.2 Summary of the Findings	41
5.3 Conclusions	42
5.4 Policy Recommendation.....	43
5.5 Recommendations for Further study	43
REFERENCES	44

APPENDIX 1	49
APPENDIX II	50
APPENDIX III.....	51

ABSTRACT

Financing decisions is an important managerial task. Business managers must consider sources of financing available and their relative costs as well the financial risk. Tangible assets, such as fixed assets can support a higher debt level as compared to intangible assets, such as growth opportunities. The tax trade-off models predict that profitable companies will employ more debt since they are more likely to have a higher tax burden and low bankruptcy risk. This study therefore sought to find out the sources of finance for building construction firms in Kenya.

The objective of the study was to establish the various ways in which building construction firms finance their operations. The study used both quantitative and qualitative analysis for its research methodology. The total population of interest comprised of 1799 firms according to the Ministry of Roads and Public Works, 2006. A sample size of 34 firms was included in the study. Primary data was collected by questionnaire method.

The result of the study showed that that for the construction firms involved in the survey, most of them reported that they faced hurdles in raising finance and these hurdles emanated from the high interest and the smallness in size of the firm. This is the reason why most of them did not have adequate equipment. The firms therefore did have intention of increasing their capital and this was mainly through bank loans. The firms involved in the study published their accounts annually while a few did not publish their accounts at all. Fewer still engaged external auditors to verify their books of accounts.

Earnings were considered a great risk while funding was ranked a moderate risk by most of the participants in the survey. For most firms involved in the study they considered equity to be least expensive and bank loans as being the most expensive. The companies involved in the survey also listed the main challenges they faced including competition and funding,

LIST OF TABLES

Table 1: Year of commencement of business.....	24
Table 2: Category of the firm	25
Table 3: Source of capital	27
Table 4: Whether capital is sufficient.....	27
Table 5: Reasons for challenges in raising capital.....	28
Table 6: Presence of enough equipment.....	29
Table 7: Source purchased of equipment.....	30
Table 8: Intention of increasing capital	31
Table 9: Methods of raising of capital.....	31
Table 10: Composition of capital	32
Table 11: Risks associated with business operations	34
Table 12: Overall financial performance	34
Table 13: Growth and profitability affected by capital issues.....	35
Table 14: Extent of effect	36
Table 15: Invitation to external auditors.....	36
Table 16: Whether depositing bonds affect cash flow position.....	37
Table 17: Covering for the shortfall	38
Table 18: Technology effect on financial position.....	38
Table 19: Source of capital affecting the level of profitability.....	39
Table 20: Rank of sources of finance	40

LIST OF FIGURES

Figure 1: Type of business organization.....	26
Figure 2: Problems in raising capital.....	28
Figure 3: Acquisition of construction equipment.....	30
Figure 4: Frequency of publishing financial statements.....	33
Figure 5: Average turnover for the last three years.....	35
Figure 6: Finance the acquisition of security bonds.....	37
Figure 7: Sources of finance for day to day activities.....	39

LIST OF ACRONYMS

CP – Commercial Paper

GDP – Gross Domestic Product

AGM – Annual General Meeting

IPO – Initial Public Offer

EVA – Economic Value Added

CAPM – Capital Asset Pricing Model

UN – United Nations

SSPS – Statistical Package for Social Sciences

CBK – Central Bank of Kenya

MOR&PW – Ministry of Roads and Public Works

CHAPTER ONE

1.0 INTRODUCTION

1.1 Background of the Study

The literature of corporate finance has seen some significant progress since the seminal works of Modigliani and Miller (1958; 1963). Theoretical advancement particularly on capital structure model has shed some light on the financing behaviour of firms. Many researchers have tested the validity of the modern theory of finance in various sectors of the economy. No business venture can operate without the consideration of financial issues which comprises of investment and financing decisions.

In 1958, Modigliani/Miller laid an important foundation for a positive theory of financial structure by developing the implications of market equilibrium for optimal debt policy. They demonstrated that given the firm's investment policy and with no taxes or contracting costs, the firm's choice of financing policy does not affect the value of the firm. The capital structure irrelevance proposition shows that the firm's choice of financing policy cannot affect the value of the firm so long as it does not affect the probability distribution of the total cashflows of the firm.

Zingales (2000) argues that corporate finance means financing a firm – not simply an asset, not an individual, but that unique combination of assets and individuals that constitutes a firm. It is the study of how firms are financed. Financing an entity deals with the planning for, acquiring and using funds so as to maximize the value of the organization. It reflects how funds are generated and allocated to the most efficient users.

Financing decisions will help a firm determine long term asset mix, capital mix, profit allocation and short-term asset mix decisions. The interaction of these decisions will have an impact on the competitiveness of a firm; its ability to attract more capital and this in turn determines its long-term survival. Studies carried by Marris and Elayan (1990) and Allen (1995) indicated that the nature of the assets owned by an organization has a significant impact on its capital structure. Firms have a corporate personality but from the outside they are assumed to have an impersonal appearance. However, on the inside, the personalities of the owners and managers have a strong impact on firm behaviour. Struggles over control of the firm are frequent for one obvious reason: with control comes access to the firm's

earnings. As a result, maintaining control can preoccupy management or owners whenever capital structure decisions especially between debt and equity are being made.

1.1.1 Review of the Construction Industry

Construction contracting firms in both building and civil engineering sub-sectors require various types of efficiently managed assets in a different mix to successfully and profitably carry out their primary operation. In a complex and highly competitive industry as the construction industry, with ever changing operating environment, the asset portfolio of any contracting firm determines how far they can go, what they can handle and what share of the market they can get (Kehinde and Mosaku, 2006). The construction industry is vital in the development and maintenance of physical infrastructure of any economy. It provides the infrastructure that supports other sectors of the economy.

In developing countries the construction industry may account for anywhere between 1.8 – 11% of the GDP (Lopes, 1998) depending on the performance of the economy. This contribution could be much higher if the hidden economy, of which construction usually boasts a substantial proportion through its backward and forward linkages, is taken into account (Chen 1998; Flemming 1998). Thus, construction plays an important role that goes beyond its share of national economy output in the development strategy of any country or region. In Kenya, the construction industry contributes about 4.0% of the GDP (Economic Survey, 2006,) and provides direct employment to 78,200 people. In the year 2005, this sector expanded by 7.2% (Kenyafacts 2006). Building construction is usually involved in nature of works which mostly have contracts. In Kenya, the cost of finance has been very high. Interest rates on borrowed funds have since the early 1990s been in excess of 20%. It is only recently that the rate has fallen below the said margin (20%). Firms have to decide on how to finance their operations.

Poor economic performance in Kenya characterized the last decade where the growth rate was very low. However, the economy has witnessed an upward growth in Real GDP from a low of 0.6% in 2002 to 6.1% in 2006 (Economic Survey, 2007). Yavas *et al* (2004) argues that many small and medium sized enterprises lack capital and that house-building contractors are particularly dependent on commercial financing. Access to finance on competitive and realistic terms is key to their viability and growth. Large firms have ready

access both to debt and equity markets, but small firms have nowhere else to go but banks. Firms must be well financed for their continued stay in business. It is in the midst of this scenario that a cheap and reliable source of finance stands to enhance the performance of firms in the building construction industry. After deciding on the financing mix, the managers of the firm must still determine how best to physically acquire the needed funds.

Lopes (1998) observed that according to the UN system of national accounts convention, construction is the only sector of the economy that appears twice in national accounts statistics: first as one of the sectors that compounds GDP by industry origin; and secondly as a component of a country's gross capital formation.

1.2 Statement of the Problem

Egan's (1998) report on rethinking construction expressed grave concern on the low and unreliable rate of profitability of the construction industry, which was difficult to sustain healthy development. The industry also invests too little in capital, research, development and training. Construction is intensely competitive especially in the building sector, where there are no major economic and technological barriers to entry (Chiang *et al.*, 2001; Chiang and Tang, 2002), where there is not much value added by contractors (Ball *et al.*, 2000) and where contractors have relied on developers' interim payments for much of the construction finance.

Chan *et al.* (2005) posits that most contractors in Hong Kong are suffering from business reduction and profitability deterioration. Some are struggling very hard to retain their financial performance. This necessitates the need to review the macro-economic situation in the construction market. Chiang *et al.* (2001) points out that building contractors in Hong Kong compete intensely on cost reduction rather than technology improvement and this leads to poor construction safety and product quality. These local contractors are unable to compete with international firms from the developed countries and China.

(Chiang *et al.*, 2002) argues that the high failure rates and low performance of contracting firms in the industry is precipitated by the apparent low level of investment in fixed assets, which could serve as collateral for loans during times of distress. Locally, in January 2007, one of the largest construction firms operating in Kenya and Uganda, Mugoya Construction

and Civil Engineering Limited was placed under receivership by their creditors (*Sunday Nation* July 29, 2007). This clearly shows the sector is not immune to financial problems.

Sources of finance for building construction firms are a relatively under-explored area in the finance literature. Currently we do not have a clear understanding on what factors affect their corporate financing behaviour. Many researchers have carried out researches on capital structures of firms in various sectors. There is little knowledge on sources of finance for building construction firms. Given their unique product market environment; building construction companies operate on contracts, projects which have durations, operate in cyclical and volatile environments and have non-standard products. Property assets are known to be indivisible and highly localized in nature. This provides an illiquid market for their products. Therefore, there are strong grounds justifying a separate study of sources of finance from building construction firms.

Locally prior study on sources of finance of firms mainly focused on different sectors. Ng'ang'a (1999) focused on the use of commercial paper as a source of finance for Kenyan companies. Lesiew (1998) examined sources of finance for Eldoret based pharmaceutical outlets. Otieno (1988) examined sources of finance for jua kali businesses based in Nairobi. Mwirichia (1983) focused on the way local authorities are financed in Kenya.

Since the construction sector is an important aspect of any economy, the researcher is of the opinion that a study on sources of finance will contribute to literature on finance. The ensuing literature considers the sources of finance on business firms of which construction companies are among them. A better access to finance is believed to benefit particularly the construction industry, as this would help contractors upgrade their technology and managerial capacity.

1.3 Objectives of the Study

- (i) The study sought to establish the various ways in which building construction firms finance their operations.

1.4 Significance of the Study

The proposed study will be important to different stakeholders

1. The finding of this study will be of significant to the providers of capital and credit after it is determined which mode of financing is preferred most by building construction firms.
2. The findings will determine the most preferred sources of financing for building construction firms.
3. The study will help to determine if there are alternative forms of financing other than the traditional ones in the financing of business.

CHAPTER TWO

2.0 LITERATURE REVIEW

2.1 Introduction

The finance literature through the early 1950s consisted in large part of ad hoc theories and institutional detail, but with little systematic analysis. In the 1950s, fundamental changes in finance began to occur. The analytical methods and techniques traditional to economics began to be applied to problems in finance, and the resulting transformation has been significant. This evolution was accompanied by a change in the focus of the literature from normative questions such as “what should investment, financing or dividend policies be”?) or “what are the effects of alternative investment, financing, or dividend policies on the value of the firm”?) (Smith Jr., 1989).

The theory and validity of modern finance has been tested in various sectors of the economy, such as manufacturing firms (Long and Malitz 1985, Titman and Wessels, 1988), electric-utility companies (Miller and Modigliani 1966), nonprofit hospitals (Wedig *et al* 1988) and agricultural firms (Jens and Langemeir 1996). One main conclusion is that industrial classification is an important determinant of capital structure (Ooi 1999). The source of the finance is equally an important factor. Williamson (1988), argues that existing literature has focused largely on property financing at individual project level. While it is possible to view a corporation as a series of separately financed projects, such approach ignores the interaction and synergistic effects of the projects at the firm level. At the corporate level, the whole account may equate the sum of the parts.

2.2 Capital Structure Policy

While Modigliani/Miller (1958) permanently changed the role of economic analysis in discussions of capital structure, their work provides no explanations on corporate financing policies observed in practice. However the Modigliani/Miller irrelevance proposition does tell that if the choice of corporate financing policy does affect the current value of the firm, it must do so in three ways: the choice of the financing policy must change either the tax liabilities of the firm or the firm’s claim-holders, change agency costs, or change the firm’s incentives with respect to its choices of future investment policy. Among the aspects of the theory of finance in relation to capital structure that affects the way a firm is financed are;

Taxes - the question is how the optimal debt-equity ratio is to be set. Modigliani and Miller (1963) argues that since the corporate profits tax allows the deduction of interest payments in calculating taxable income, the more debt in the capital structure, the lower the corporate tax liability, the higher after-tax cash flows, and the greater the market value of the firm. Miller (1977) argues that the tax advantage of the debt is exaggerated by considering the corporate profits tax in isolation from personal income taxes. That corporate tax advantage is offset by personal tax on investors/owner.

Bankruptcy costs - Increases in leverage increases the probability of bankruptcy and thus increase in bankruptcy costs. Kraus/Litznberger (1973) argues that the corporate tax shield is offset by the expected increase in bankruptcy costs. Bankruptcy costs can take two forms, direct and indirect. Direct bankruptcy costs are the actual costs involved in the winding of the firm. Indirect bankruptcy costs are specific contracting costs which arise because the firm's investment policy and resource allocation decisions and are not fixed. They include lost sales, lost profits, costs associated with the restrictions on the firm's borrowing and key employees jumping ship to other firms. Some of these costs arise because the bankruptcy trustee is an agent and thus has limited incentives to make value-maximizing investment or financing decisions.

Agency costs - Smith Jr. (1989) defines agency relationship as a contract in which one or more persons {the principal(s)} engage another person (the agent) to perform some service on their behalf which involves delegating some decision making authority. Conflict of interest exists among common stockholders, bondholders and managers because corporate decisions that increase the welfare of one of these groups often reduce the welfare of the others. Jensen/Meckling (1976) argues that determining the optimal quantities of debt versus equity is too narrow. More generally the problem involves determining the optimal ownership structure of the firm including the relative debt held by managers and outsiders as well as the details of short-term, the allocation of voting rights, preferred stock and warrants. At its most general level it involves the capital structure problem involves the joint determination of the entire set of contracts among stockholders, bondholders, and managers as well as other agents in the nexus of the contracts, including customers, employees lessors, insurers.

2.3 Sources of Finance

Financing decisions form part of a manager's responsibility. Finance managers must consider sources of financing available and their relative costs as well the financial risk. Myers' (1977) argues that tangible assets, such as fixed assets can support a higher debt level as compared to intangible assets, such as growth opportunities. The tax trade-off models predict that profitable companies will employ more debt since they are more likely to have a higher tax burden and low bankruptcy risk. On the other hand, the pecking order theory of finance proposed by Myers (1984) prescribes a negative relationship between debt and profitability on the basis that successful companies do not need to depend so much on external funding. They can instead, rely on their internal reserves accumulated from past profits.

Ooi (1999) notes that firms are more likely to use debt when the cost of borrowing is low. Conversely when interest rates are high, companies would be inclined to use equity financing. Higher interest rates also increase the probability of financial distress which can lead to bankruptcy.

Firms have three general sources of funds available; these include internally generated cash, Short-term external funds and long-term external funds. Shapiro (2002) argues that the percentage of external finance fluctuates with the business cycle. When profits are high, firms rely less on external finance and that industry's sources of external finance differ from one country to another.

Rajan and Zingales (1998) argues that in the modern capitalist economy, the financial institutions have the important task of collaborating and 'picking the winner' in a decentralized way. Capital markets make a contribution to growth by reallocating capital to the highest value use while limiting risks of loss through moral hazard, adverse selection or transaction costs.

The defining feature of debt is the ability of creditors to exercise control. Specifically, a debt is a contract in which a borrower gets some funds from the lender, and promises to make a pre-specified stream of future payments to the lender. In addition, the borrower typically promises not to violate a range of covenants (Smith and Warner 1997), such as maintaining the value of assets inside the firm. If the borrower violates any covenant and especially if he defaults on payment, the lender gets certain rights, such as the ability to repossess some of the

firm's assets (collateral), this may lead to some sort of financial distress or the opportunity to throw the firm into bankruptcy. Financial distress has costs, which include legal and administrative costs of a liquidation or reorganization (Ross *et al* 1990). Titman and Wessels (1988), Rajan and Zingales (1995) argues that debt financing is most common for firms with tangible assets. An essential feature of debt, then, is that a failure by the borrower to adhere to the contract triggers the transfer of some control rights from him to the lender. (Sheiffer and Vishny, 1997).

2.4 Sources of finance for Building Construction Firms

Building contractors usually supervise the execution and repair of construction project i.e all activities associated with the erection and repair of immobile facilities. Firms in the construction industry, like any other sector of the economy must source for funds to carry out their activities from the cheapest source.

Hendrikson (1989) argues that construction firms undertake projects which take long periods of time to complete. Investment in a constructed facility represents a cost in the short term that returns benefits only in the long term use of the facility. This is from the perspective of the owner of the facility. Thus costs occur much earlier than the benefits and owners of facilities must obtain the capital resource to finance the cost of construction. Kangari (1988) advised that the construction companies must always be aware of the possibility of business failure. Those contractors who react promptly to economic conditions by implementing appropriate strategic policies should be able to avoid failure.

Cheah and Garvin (2004) argues that in the construction industry, conventional contractual elements such as surety bonds and insurance policies are closely related to financing of firms. A strong balance sheet is one of the primary necessities to continually secure surety (bid) and performance bonds for ongoing projects. Pitt and Collins (2006) argues that bid costs are really the antithesis of competition. They create entry barriers for new competitors.

Raftery *et al*, (1998) posits that contractors have relied on developer's interim payments for much of the construction finance. That they need to become more financially independent to compete internationally.

Property development and investment are capital intensive. In addition to the high cost development, capital requirements is a formidable economic barrier to entry to the construction market. The pledge of tangible property and land assets as collateral reduces both agency and bankruptcy costs. Physical assets that are tangible and non-specific can easily be liquidated should a firm fail. Ooi (1999b) finds that, in examining the collateral role of assets, the ratio of property assets to total assets is a statistically significant of capital structure of property companies in the UK.

Najjar and Love (2001) in their study of the global construction market conclude that small domestic firms simply do not have the resources to operate effectively in the global market.

Raftery *et al* (1998) considered that in the long term technology transfer via joint ventures with developed countries might “leapfrog the gap” in order to minimize the increasing “inferiority” of these domestic contractors of low technology.

Chiang *et al* (2002) argues that local contractors (in Hong Kong) whenever possible, raise finances preferably from their reserves, rather than bank loans and debt issues. The equity market is the last resort. Firms that engage in construction projects will usually find there is a lag between the execution of work and time a payment is realized. They therefore have to use their own funds before the owner of the facility under construction pays. A project cannot proceed without adequate financing and the cost of providing adequate financing can be quite large. Finance is also of concern to other parties involved in the construction like the suppliers of materials and equipment.

The way a firm acquires its finances is of significance to all business entities and stakeholders. The globalization and liberalization of the world economies has presented challenges and opportunities for Kenyan firms to source for finance. Construction firms in Kenya are unique in that, none of them is publicly quoted. In practice, listed companies face more stringent reporting and also monitored closely by market analysts (Ooi, 2000). The Kenya government statistics indicate that in September 2006, consumption of cement surpassed production. This has pushed up the prices of cement which is a major input in the construction industry (*Daily Nation* January 9, 2007).

Finance managers must have the ability to spot trends in world economies. They must also be able to adapt to change. Economic wants should be fulfilled for positive growth of an economy. When funds are misallocated, the growth of the economy will be slowed and this

misallocation of funds may work to the detriment of the society. A better access to finance is believed to benefit particularly the construction industry, as this would help contractors upgrade their technology and managerial capacity. A link between finance and technology, managerial development will establish the role of finance in the formation of their sustainable competitive advantage (Chiang *et al*, 2002).

A firm which plans to undertake a large capital project may use its retained earnings, seek equity partners in the project, issue bonds, offer new stocks in financial markets or seek borrowed funds. There is therefore need to look for the cheapest and most convenient source of finance. Firms in various sectors of the economy will compete for the available funds. Therefore the profitability of a sector, its growth rate will determine or influence how lenders make decisions on giving credit (Brigham and Houston, 1998).

Chiang *et al* (2002) posits that contractors generally incur much higher costs of equities because of their higher business and bankruptcy risk perceived by the market. He argues that the banking sector is cautious in lending to construction firms than firms in any other industry. They see that the construction industry carries a very high business and bankruptcy risk, even when the contractors have assets, amount receivables or even their firm's shares to pledge. Empirical results from their studies shows that profitability, cost of equity and capital structure are interrelated.

2.5 Short-term/Operating sources of capital

Funds available for a period of one year or less are called short-term finance (Brigham and Houston, 1998). Two most significant sources of short-term finance are trade credit and bank borrowing. Others include commercial paper and informal sources of finance.

2.5.1 Trade Credit.

Trade credit refers to the credit that a customer gets from supplier of goods in the normal course of business. A buyer does not have to pay cash immediately for supply of goods. The deferral of payment is a short-term financing called trade credit.

Because suppliers are generally more liberal in the extension of credit than are financial institutions, trade credit is an important source of funds for small and medium sized companies in particular (van Horne *et al*, 1978). According to Petersen and Rajan (1998), this leads to development of strong and competitive trading firms as well as financial intermediation process in a country.

Trade credit is mostly an informal arrangement and relies on the establishment of mutual confidence between the seller and the buyer. Trade credit has costs and these costs will have to borne either by the supplier or buyer. The supplier risks not being paid by the buyer while the buyer loses any cash discounts that are available. Credit terms usually accompany the arrangement and conditions under which the supplier sells on credit to the buyer. Trade credit has the following advantages

Readily available – unlike other sources, it is relatively easy to obtain especially from suppliers. It does not require much negotiation once trust between the parties involved has been established. It is suitable for small firms unable to obtain funds from capital markets or financial institutions. Flexibility – Trade credit grows with a firm’s sales. If a firm’s purchase of goods and services increase, its trade credit will expand. On the other hand if business contracts, the trade credit will decline. Informal – Trade credit is an informal and spontaneous source of finance. It does not require lengthy negotiations and formal agreement. There are no restrictive covenants imposed as it is done in long-term debt.

Trade credit is not absolutely cost free, its shortcomings include the buyer might be buying the goods at a higher cost than it is normal, the suppliers by extending credit incur costs in the form of opportunity costs of funds invested in accounts receivable and the buyer foregoes cash discount that could be available

A firm should compare the opportunity cost of trade credit with the costs of other sources of credit while making its financing decisions.

2.5.2 Short-term Loan

Banks are main institutional sources of operating capital. A bank considers a firm’s sales and production plans in determining its working capital requirements (Brigham and Houston, 1998). The bank will determine the limit to which it can lend a firm. Such a firm may be required to deposit some form of security.

Bank finance can be in the form of bank overdraft where a firm will overdraw its account. This amount is payable on demand and attracts interest. This seems flexible from the

borrower's point of view. Kehinde and Mosaku (2006) notes that using short-term funds to finance long-term investments can negatively impact on the working capital of firms.

Cash credit takes the form of where a borrower is advanced cash up to the credit limit. These are sanctioned against the security of current assets. Funds loaned under this arrangement are payable on demand.

Securities required include mortgage where there is transfer of a legal or equitable interest in a specific immovable property for the payment of debt. Lien where the lender has the right to retain property belonging to the borrower until the loan is repaid or pledge where the borrower is required to transfer the physical possession of the property offered as a security to the bank to obtain credit.

2.5.3 Commercial Paper.

Commercial paper (CP) is an important source of short-term finance. The duration is usually less than 365 days. This is also known as a form of unsecured promissory note issued to raise short-term funds. In the USA, its duration runs between 1-270 days and it is only financially sound and highest rated companies that are able to issue commercial paper. The interest rate on CP is determined by the market but is slightly below the prime rate.

Commercial paper financing is handy and comes during period of credit squeeze. However, it is issued by financially sound companies. A company facing temporary liquidity problems may not be able to raise funds by issuing new paper. Commercial paper cannot be redeemed until maturity.

In the USA in 1996, there was \$720 billion of commercial paper outstanding against \$960 billion for bank loans (Brigham and Houston, 1998). The size of commercial paper in that country in 1987 was \$ 350 billion (Shapiro 2002) clearly showing its importance and growth over that period. In Kenya, commercial paper is a recent phenomenon having been issued first in the 1990s and few companies have issued the paper so far.

2.5.4 Informal Finance

Informal finance can be described as that part of the economy in which financial activities, which are not officially regulated or monitored, take place. The principal reason for the

emergence of an informal financial market is the unwillingness of the formal financial sector to lend to some relatively risky category of borrowers. Interest rates in formal financial sector tend to be higher than in formal financial sector (Aleem 1990). It is argued that lenders sometimes borrow from the formal market to lend at even higher interest rates. The relatively higher costs of funds is attributed to; large costs of monitoring and administering informal contracts, higher risks and costs of delinquency

Informal lenders use personal, social and business relationship to pre-select clients in geographically limited areas.

2.6 Long-term Sources of Finance

Long-term markets are sometimes called capital markets and consist of securities having maturities of greater than one year. The most common corporate securities are bonds, common stock, preferred stock and convertible securities.

There are various factors that determine the type of long-term financing that a company will choose. These include; the competitiveness of the environment within which the company operates, the state of the financial markets in terms of information availability in that particular market, the attitude of the company's management towards risk and the existing capital structures of the company. If the existing proportion of debt is high then the company is unlikely to get more debt.

Long term Funds can be classified in terms of debt, whether they are Internally or externally generated and their maturity i.e short term, funds repayable within one year Medium term 1-10 years and long term funds in excess of 10 years, like mortgages, common share capital, retained earnings and preference shares.

2.6.1 Common Shares

The theory behind the use of common stock lies within the financing decisions which determine its financial risk. Financial risk encompasses both risk of possibility of insolvency and the variability of earnings available to common shareholders. As a firm increases the proportion of debt, lease commitment and preferred stock in its capital structure, fixed

charges increase and there is greater probability that the firm will be unable to meet these charges, even if all other business factors remain unchanged.

As the firm continues to lever itself, the risk of cash insolvency, which may lead to bankruptcy increases. Financial risk encompasses volatility of earnings available to shareholders and probability of insolvency.

Common stock represents the ownership of the company since the holders of common shares are the legal owners of the company. The shareholders are entitled to dividend for the investment they have made in the purchase of the shares. Being the owners of the company the shareholders bear the risk of ownership and are entitled to dividends and residual claim for the assets of the company in the event of the company being liquidated

Ordinary Shares have a claim on income – they are entitled to dividends if the company makes a profit and the dividend is declared by the directors. Retained earnings form part of the equity and will lead to value of shares increasing

They have a claim on assets – In the case of liquidation, ordinary shares have a residual claim on the company's assets i.e out of the realized value of the assets, the first claimants could be the debt holders followed by the preference shareholders. Whatever remains will be distributed to the common stockholders in proportion of the number of shares that exists.

The shareholders have a right of control – the common stockholders have a right to elect the directors and make other major decisions such as appointment of the company's auditors, company lawyers. Such decisions are made during the AGM.

There is a limited liability of shareholders – though the ordinary shareholders are the true owners of the company, their liability is limited to the amount of investment in shares.

Finally they have pre-emptive rights – the pre-emptive right entitles a shareholder of the company to maintain a proportionate share of the ownership of the company.

A company raises funds through common shares in the following ways. Private placement/equity – it is common where a company is not listed. Private companies who would want to raise funds but have not gone public mainly use this method. The Co-operative bank of Kenya has been selling shares to the co-operative movement privately.

It can also use public issue – common where companies where shares are issued to the general public for the first time through an IPO.

To a company it becomes advantageous to use common stock equity because they are not redeemable i.e they form part of the permanent capital of the company, they increase the borrowing capacity of the company because most lenders are interested with the proportion of capital contributed by owners since this will act as their margin of safety, and the payment of dividend is at the discretion of management. This implies that payment of dividend does not increase the financial risk of the company.

However there are shortcomings in the use of common stock equity. This can be due to cost, share issues are quite costly (floatation costs). In the recent second share offer of Mumias Sugar Company, floatation costs were estimated to be Kshs. 230.66 million out of the anticipated gross proceeds of Kshs. 4.554 billion. This clearly shows that 5.1% of the proceeds were to be consumed in expenses (Mumias Share Offer: Information Memorandum) There is the risk of uncertainty regarding dividends and capital gains. Consequently shareholders will demand a higher rate of return.

There can be earning dilution where the issue of new ordinary shares dilutes the existing shareholders and loss or reduction in control. This occurs where there is issuance of new shares may dilute the ownership and control of the existing shareholders.

2.6.2 Preference Shares

They are considered to be hybrid securities since they have characteristics of both debt and equity. Preferred stocks are the least used of all long-term corporate securities. The major reason is that the dividend is not tax deductible. Block *et al* (1992) argues that the most corporations that issue preferred stock do so to achieve a balance in their capital structure. It is a means of expanding the capital base of the firm without diluting the common stock ownership or incurring contractual debt obligation.

They are similar to ordinary shares since; non-payment of dividends does not lead to financial distress of the company. These dividends must be paid before ordinary share dividend and that dividends are not deductible expenses for tax purposes. It is taken as a distribution of earnings.

Preference shareholders are similar to debt holders since; they have a fixed dividend rate, the preference shareholders do not share in the residual earnings of the company and that normally they do not normally have voting rights

Preference Shares have characteristics that include claim on income – Preference shareholders are superior to ordinary shareholders in that they have a claim over income. Also have a superior claim over the company's asset incase of a liquidation.

They have a fixed dividend – Preference shareholders have a fixed dividend rate. They are therefore referred to as fixed income securities. However, the payment of their dividend is not a legal obligation.

They have voting rights – preference shareholders normally do not have any voting rights but may be entitled to conditional or contingent voting rights and can either be convertible or nonconvertible with shareholders being allowed to convert their shares either fully or partially at a specified price and at a specified time period.

2.6.3 Retained Earnings

Retained earnings refer to internal financing which also includes cash flow from depreciation Block *et al* (1992). The amount of retained earnings depends on corporate profits made in addition to the firm's dividend policy. The pecking order theory brings out the preference by firms for internal financing in favour of external financing (Myers, 1984). The order starts from safer debt, riskier debt and finally equity. Kehinde and Mosaku (2006) in their study finds that construction firms do not always reinvest their profits in fixed assets (especially those that would enhance their present and future operations) that have considerable effect on their assets structure. That they divert the funds to other types of businesses that are not usually construction related and such investments are regarded as belonging to a different entity. This situation may create a scenario where banks and other financing houses become reluctant in extending medium or long term loan facilities to construction firms, as there may not be sufficient collateral against which such loans can be secured. They are left in most cases, with the option of financing their present operations and possibility for future expansion (growth) through overdrafts that have high interest rates, which may further impact on their profitability.

In theory, corporate directors should ask, “How can the best use of the funds be made?” The rate of return for the benefit of stockholder must be compared to what stockholders could earn if the funds were paid out as dividends. This is known as the marginal principle of retained earnings. Each potential project to be financed by internal funds must provide a higher rate of return than a shareholder can provide for himself. This is money retained by the company from profitable operation. These funds are therefore available for investment in the company (Brigham and Houston 1998).

2.6.4 Long-term Loan

Long-term debt is an important form of long-term financing. This is financing with an initial maturity of more than one year. It can be obtained with a term loan which is negotiated from a financial institution or through a sale of bonds which are marketable debt sold to a number of institutional and individual lenders.

Gitman (1997) argues that long term debt provides financial leverage and is a desirable component of capital structure because it tends to lower the weighted average cost of capital. This is primarily because of tax deductibility of interest, which causes the explicit cost of long-term debt to be low. Long-term debt agreements, whether resulting from a term loan or a bond issue normally include certain restricted covenants. Restrictive covenants are contractual clauses that place certain operating and financial constraints on the borrower. Because the lender is providing funds for a long period, it seeks to protect itself.

Restrictive covenants, coupled with standard debt provisions, allow the lender to monitor and control the borrower’s activities to protect itself against the agency problem created by the relationship between the owners and lenders. Chiang *et al* (2002) stated that contractor’s access to bank loans (usually long-term) is limited due to lack of assets to pledge as collateral and they rely on interim payments for much of their financing. The pledge of tangible assets as collateral reduces both agency and bankruptcy costs (Jensen and Meckling, 1976). Due to the conflict of interest between debt providers and shareholders, lenders may demand security and collateral valued to serve as a major determinant of debt finance available to firms (Williamson, 1988).

Bonds are secured debentures while debentures themselves are not secured. Bonds are long term fixed obligation debt security that are issued by organizations, municipal councils and governments for sell to individuals and institutions. They represent claims on the income and

asset of the issuing company, unlike common stock the return on debt does not depend on the level of profit made by the issuing entity hence the individual investor in bonds does not face the uncertainty associated with profits. However, bond holders face the risk of default.

Based on maturity period we have two types of bonds. Those of maturity period of one year and less are bills while those of maturity period of more than one year are called bonds

Bonds generally have interest rates are fixed and known and payment of interest is legally binding to the issuing entity and also the interest on bonds is tax deductible

They have a maturity – bonds are issued for a specific period of time where the time period is referred to as the maturity period indicating the time when the par value of the bond will be redeemed.

Finally they have a redemption period – Bonds are redeemable on maturity and the redemption can be accomplished either through a sinking fund or buy back provision. A sinking fund refers to funds set a side periodically for retirement of bonds at maturity. The fund is usually under the control of a trustee.

Business use bond financing because the interest charged is usually tax deductible; the repayment of capital is deferred or amortized over the period of the loan and there is no loss in control to financiers unless there is default.

The use of bond financing comes at a cost as is a fixed interest charged that is a legal obligation to the company. There is a higher risk as interest and capital repayments have to be met on due date. The issuance of bonds is usually associated with restrictions or covenants such as dividend restrictions and maintenance of financial ratios. Finally, issuance of bonds increases the gearing ratio and as a result decreases the borrowing capacity of the company.

2.6.5 Venture Capital

Venture capital can be thought as financing for privately held companies, generally in the form of equity and/ or long-term convertible debt. It becomes available from banks or similar financial institutions and the public debt or equity market is either in appropriate or unavailable. Venture capital has been used to finance emerging growth, privately held businesses. Such investments differ from investments in publicly held companies in that they are generally for newer companies with little operating history and for smaller companies in

CHAPTER THREE

3.0 RESEARCH METHODOLOGY

3.1 Research Design

This chapter outlines the methodology, which was used in carrying out the study. Aspects to be covered include research design, population and sampling design, data collection methods and data analysis methods. The study adopted a descriptive survey of building construction firms in Kenya. This study was concerned with the sources of finance for building construction firms.

Anderson and Poole (2001) argues that it is difficult to generalize about research designs because of wide variety of types of research. One subdivision is according to whether the approach is predominantly quantitative or qualitative. Quantitative research is typified by experimental studies in science-based disciplines where findings are usually expressed in numerical form. Qualitative research on the other hand is used in disciplines or parts of disciplines that utilize such methods as case studies, questionnaires surveys, personal interviews and participant observation.

3.2 Population

The population of interest was building construction firms registered with the Ministry of Roads and Public Works in the July 2006 Edition. The Population comprised of 1799 firms.

3.3 Sampling

Sampling is the process of selecting a number of individuals for the study in such a way that the selected individuals represent the large group from which they are selected. This ensures a representative sample. (Anderson and Poole, 2001). According to Israel (1992) one of the most frequently asked question is on the determination on the sample size. He argues that the answer to this question is influenced by several factors including the purpose of the study, population size, the risk of selecting a "bad" sample, and the allowable sampling error. In addition to the purpose of the study and population size, three criteria usually determine the appropriate sample size: level of precision, level of confidence or risk, and the degree of variability in the attributes being measured (Miaoulis and Michener, 1976). The degree of variability refers to the distribution of attributes in the population. The more the

heterogeneous a population, the larger the sample size required to obtain a given level of precision. A proportion of 50% indicates a greater level of variability than either 20% or 80%. Because a proportion of .5 indicates maximum variability in a population, it is often used in determining a more conservative size.

3.4 Strategies for Determining Sample Size

There are several approaches to determining the sample size. These include using a census for a small population, imitating a sample size of similar studies, using published tables, and applying formulas to calculate a sample size. The use of a census is applicable where the population is less than 200.

The Population of this study comprises of 1799 firms which are categorized A – H depending on the value of work which they can undertake. Since there are eight categories in the list, a survey of big private (unquoted) building construction firms will be considered because they are likely to be more reliable than small size firms. Small firms could be dormant and have poor record keeping practices. The sample size comprised of 34 firms selected among those registered in categories A – D. The study used simple random sampling from the list that is arranged in an alphabetical order.

The Ministry of Roads and Public Works' list of contractors was revised in 2005 where all contractors were to re-register a fresh and the list updated annually. The latest edition is the July 2006 Edition. Contractors are listed alphabetically with an indication of the category. This study will utilize the category section.

3.5 Data Collection

This study utilized primary data through use of a questionnaire which has open and closed ended questions. Since none of the firms under study is a public company, the researcher chose purposefully. The respondents comprised of executive/managing directors or chief financial officers of these firms.

The researcher used the drop – and – pick method of administering the questionnaire. The use of questionnaire was preferred for this study because it was the typical method through which descriptive data are collected (Gay 1981). The suitability of using questionnaires was also outlined by (Gay 1981) to include large coverage of population with little time, personnel and

cost, anonymity of the respondents may help to be honesty in their responses avoids bias due to characteristic of interview and allows the respondents enough time to answer questions to avoid hasty responses.

3.6 Data Analysis

Anderson and Poole (2001) postulates that once data has been collected, the researcher must be able to interpret the data reliably. The process can involve summarizing the data to a temporary manageable length to categorize, identify themes, analyze and assess. It is from this point that the researcher will look for meaning within the data and often relate findings to previous studies to see if these support existing research.

Data for this study was analyzed using descriptive statistics, such as frequencies, percentages and measures of central tendency, with the application of the statistical package for social sciences (SPSS) software. Descriptive statistics were used to describe the basic features of the data in the study; they provided simple summaries about the sample and the measures. The data was then presented in tables, cross tabulation charts and graphs. Inferences were also drawn from the results obtained.

CHAPTER FOUR

4.0 DATA ANALYSIS AND FINDINGS

4.1 Introduction

This chapter gives a detailed analysis of the data collected and presents the findings. The data has been analyzed and presented in form of frequency tables, percentages, means and standard deviations.

4.2 Year of starting the business

This section was dedicated in finding out the year the construction companies involved in the study started their operations. The results are tabulated below.

Table 1: Year of commencement of business

Year	Frequency	Percent
1980-1985	3	8.8
1986-1990	5	14.7
1991-1995	6	17.7
1996-2000	7	20.6
2001- current	13	38.2
Total	34	100.00

The above table shows that most of the companies involved in the study started their operations after the beginning of the 21st century. This comprised of 38.2% of the total population. On the other hand those who started their business between years 1996 to 2000 comprised of 20.59, those started from 1991 to 1995 comprised of 17.7%. Between the years 1986 to 1990, 14.7% of the companies involved in the survey commenced their operations while 8.8% commence their operations between years 1980 to 1995.

4.3 category of the firm

This section was devoted in finding out the category of the firms according to the classification by the Ministry of Roads and Public Works involved in the survey.

Table 2: Category of the firm

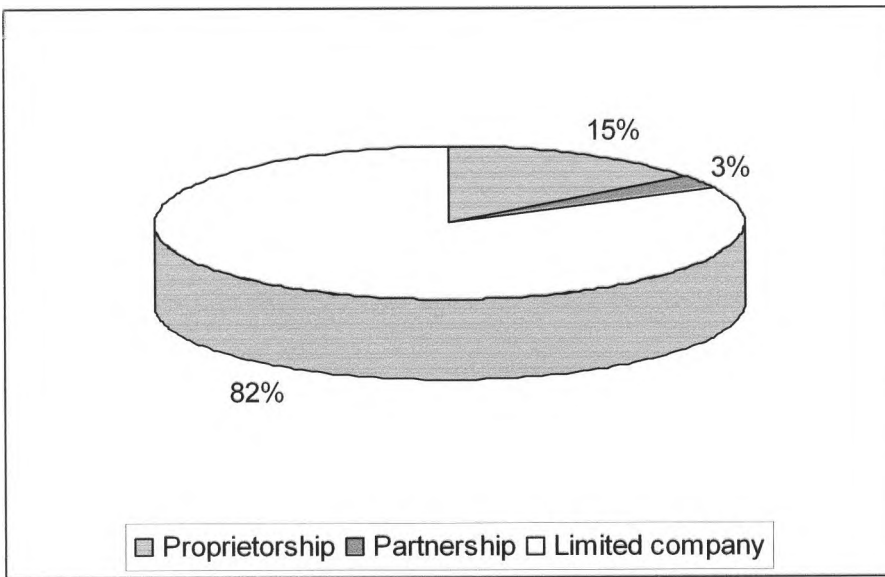
	Frequency	Percent
A	9	26.5
B	14	41.2
C	7	20.5
D	4	11.8
Total	34	100.0

The above table shows that 41.2% were in category B, 26.5% were in category A, 20.5% were in category C. On the other hand those in category D comprised of 11.8% of the total companies involved in the survey. Given that those in class A and B are the ones awarded huge contracts, the study achieved its objective by selecting big construction firms.

4.5 Type of business organization

There are different forms of businesses. Business people select the form that is most suitable to them. They actually consider the advantages of each as well as its shortcomings. Generally there are three types of business organizations: sole proprietorship, partnership and limited liability companies.

Figure 1: Type of business organization



Source

The above chart shows that most of the businesses involved in the study were limited liability companies comprising of 82%. On the other hand 15% of the businesses involved in the study were sole proprietorships while only 3% were partnership business.

The respondents also mentioned the overriding decision in entering the type of business organization. Those in sole proprietorship business mentioned the easy management and faster decision making. For those in partnership they mentioned better decision making since partners had to be consulted in making decisions. The participants mentioned that in limited liability companies there were various advantages including separate legal personality from its members, better management, perpetual succession and growth prospects being high. The other major advantage was that the company had a wide capital base and was in a better form to seek further capital.

4.6 Source of initial capital

Capital is a very important factor in formation of a business. An entrepreneur's access to it determines if his or her business idea is brought into reality. The amount of capital available would also determine the size of the business to be created. The table below shows the initial source of capital for the businesses involved in the survey.

Table 3: Source of capital

Source	Frequency	Percent
Own savings	15	44.1
Inheritance	1	2.9
Bank loan	18	52.9
Total	34	100.0

The table above shows that majority of the businesses involved in the study obtained their initial capital from banks. This comprised of 52.9% of the total population while 44.1% obtained their initial investment from their own savings. Only 2.9% of the businesses involved in the study obtained their initial capital in form of inheritance.

4.7 Sufficiency of capital

Capital is sufficient if it enables a company to start off with the necessary assets and other business resources. To continue being sufficient capital must enable a company to carry out diversification or even the purchase of major equipment and property for the business. The table below shows whether businesses involved in the survey had sufficient capital.

Table 4: Whether capital is sufficient

Response rate	Frequency	Percent
Yes	10	29.4
No	24	70.6
Total	34	100.0

It can be seen from table 4 above that majority of the respondents said that capital was not sufficient for their operations while 29.4% said that capital was sufficient for their operations.

The reason for insufficiency of capital include: the need to expand business by increasing the number of outlets, purchase of major equipment, research and development and the need to acquire large contracts.

4.8 Problems in raising capital

Small businesses often face major hurdles in trying to raise capital. This is generally because financial institutions consider them more risky and are therefore stringent in advancing loans to them. The figure below shows whether the companies involved in the survey faced problems in raising capital.

Figure 2: Problems in raising capital.

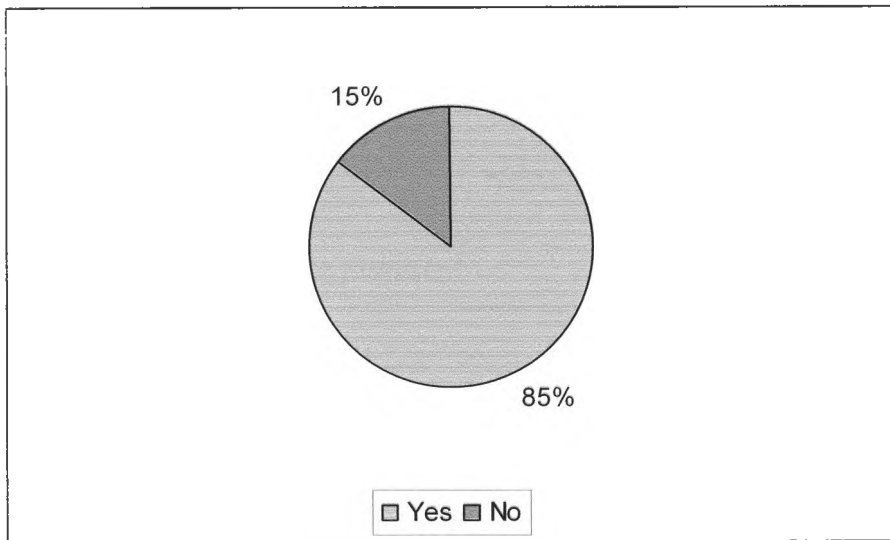


Figure 2 shows that most of the business involved in the survey comprising of 85% indicated that they encountered problems in raising capital while the remaining population of 15% pointed out they did not face challenges in raising capital.

4.9 Reasons for problems in raising capital

There are various reasons why businesses face problems in raising capital. These are as shown below.

Table 5: Reasons for challenges in raising capital

Reason	Frequency	Percent
Lack of security	8	25.0
High interest rates	16	50.0
Smallness in size of the firm	8	25.0
Total	32	100.0

The high interest rates was a major challenge to 50% of construction companies involved in the study, 25% mentioned that the smallness in size of the firm was the reason for not getting capital while another 25% mentioned the lack of security as a reason for not getting capital.

4.10: Enough equipment

For construction companies possession of the right equipment will determine the type of contract they can be awarded. Equipment therefore forms an important aspect of construction business. The table below shows whether the firms in the study had enough equipment for their operation.

Table 6: Presence of enough equipment

Response rate	Frequency	Percent
Yes	15	44.1
No	19	55.9
Total	34	100.0

The above table shows that 55.9% of the businesses involved in the study did not have adequate equipment while 44.1% did have adequate equipment.

4.11 Finance of construction equipment

There are various way of acquiring construction equipment. The main objective in obtaining such equipment is minimizing cost and ensuring convenience in payments. The figure below shows the ways in which firms involved in the survey acquired their assets.

Figure 3: Acquisition of construction equipment



Half of the companies involved in the survey did purchased outrightly purchased their assets, while 29.4% acquired their assets through leasing and 20.6% acquired their assets through hiring.

4.12 Source purchased of equipment

The source of purchased equipment will determine the overall cost to the business. If equipment is purchased straight from the manufacturer the cost is likely to be lower compared with purchase from a middle man. However, the manufacturer may be located very far from the construction company and therefore suppliers will suffice.

Table 7: Source purchased of equipment

Source	Frequency	Percent
Manufacturer	13	38.2
Supplier	21	61.8
Total	34	100.0

Table 7 shows that 61.8% of construction companies purchased their equipment from suppliers while 38.2% purchased it from the manufacturer.

4.13 Intention of increasing capital

As a business expands so is the need to increase capital. The following table illustrates whether the firms involved in the survey had the intention of increasing their capital.

Table 8: Intention of increasing capital

Response Rate	Frequency	Percent
Yes	29	85.3
No	5	14.7
Total	34	100.0

It can be seen that majority of the businesses involved in the survey comprising of 85.3% had the intention of increasing capital while only 14.7% did not have the intention of increasing their capital. The ways of raising capital are as shown in table 9 below.

Table 9: Methods of raising of capital

Method	Frequency	Percent
Floating new shares	7	24.1
Bank loan	22	78.9
Total	29	85.3

For most companies they considered raising of capital through a bank loan and that constituted 78.1% while 24.1% considered raising of capital through a bank loan.

4.14 Composition of capital

In a business it is important to strike a balance between debt and equity. A good capital mix will enable a company take advantage of the benefits of various sources of finance optimally. The following table illustrates the current composition of capital for the companies involved in the study.

Table 10: Composition of capital

Composition	Equity		Debt	
	Frequency	Percent	Frequency	Percent
0-25%	2	5.9	21	61.8
25-50%	4	11.8	12	35.3
50-75%	10	29.4	1	2.9
75-100%	18	52.9	0	0
Total	34	100.0	34	100.0

For 52.9% of the companies involved equity comprised of 75-100% while for 61.8% debt comprised of 0-25%. Those whose equity composition ranged from 50-75% comprised of 29.4% while those with debt composition of 25-50% comprised of 35.3% of the total population. The percentage of companies with equity composition of 25-50% was 11.8% while those with debt composition of 50-75% comprised of 2.9%.

4.15 Publishing financial statements

Financial statements are used to gauge a company's performance. For public quoted companies it is a requirement that the companies publish these financial statements for shareholders to know the financial position of the company as a certain date. For smaller companies like those involved in the study publishing financial statements is more of their own accord than by obligation. The following figure shows the frequency with which financial statements are published by the companies involved in the study.

Figure 4: Frequency of publishing financial statements

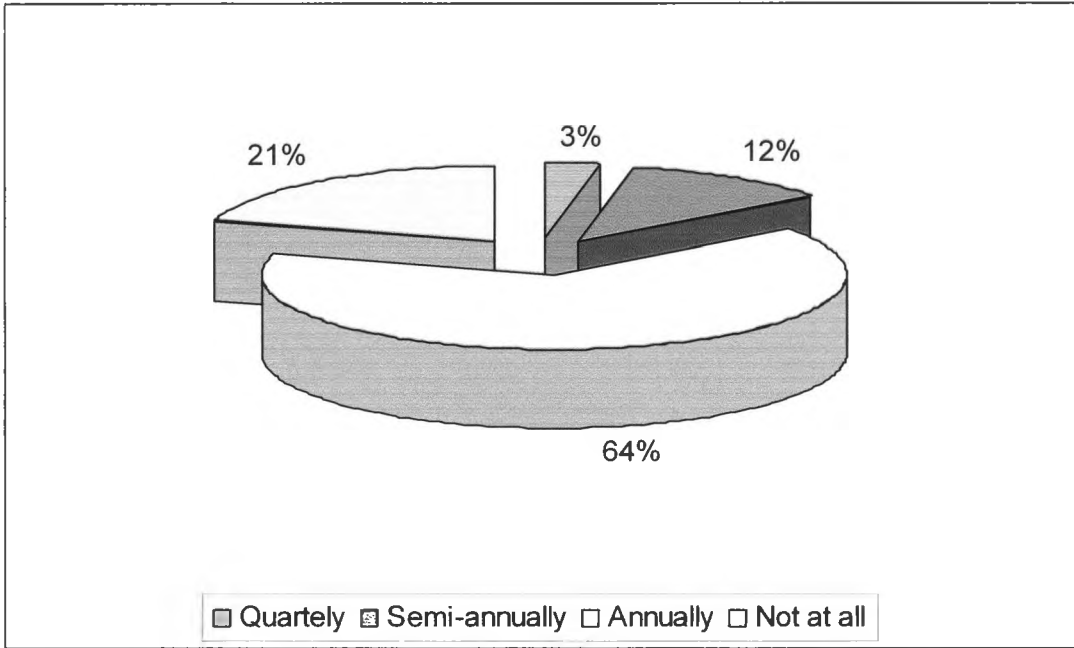


Figure 4 shows that 64% of the companies involved in the study published their accounts annually, 21% did not publish their accounts at all, 12% published their accounts semi annually while only 3% published their accounts quarterly.

4.16 Risks associated with business operations

Financial risks emanate from adverse movements in economic variables that affect a firm's activities. These adverse movements can reduce income, expected profits, reported value of foreign assets, and increased in value of foreign liabilities. Risk management, from a wider perspective, is identifying, evaluation, and controlling risks. The following table shows the risks for the businesses involved in the survey and their extent.

Table 11: Risks associated with business operations

Risk	Greatest risk		Great risk		Moderate risk		Least risk		No risk at all	
	Freq	%	Freq	%	Freq	%	Freq	%	Freq	%
Capital base	5	14.7	8	23.5	13	38.2	3	8.8	5	14.7
Clients	4	11.8	17	50.0	13	38.2	0	0	0	0
Funding	7	20.6	7	20.6	19	55.9	0	0	1	2.9
Earnings	1	2.9	23	67.6	5	14.7	4	11.8	1	2.9
Reputation	5	14.7	10	29.4	15	44.1	0	0	4	11.8

Table 11 shows the risks that affect the constructions firms. For 38.2% of the businesses involved in the study, capital base was a moderate risk while for 50% of the population, clients posed as a great risk. Funding was a moderate risk for 55.9% of the constructions firms involved in the study while for 67.6% of the population earnings posed as great risk and for 44.1% of the population reputation posed a moderate risk.

4.17: Overall financial performance

This section was devoted to finding out the overall financial performance of the firms involved in the study.

Table 12: Overall financial performance

Performance	Frequency	Percent
Good	24	70.6
Fair	10	29.4
Total	34	100.0

Table 12 shows that 70.6% of the respondents rated their overall financial performance of their companies as being good while 29.4% rated their performance as being fair.

4.18: Average turnover for the last three years

Turnover is a very useful indicator of the financial position of a company. The following graph indicates the average turnover for the last three years of the construction firms involved in the survey.

Figure 5: Average turnover for the last three years

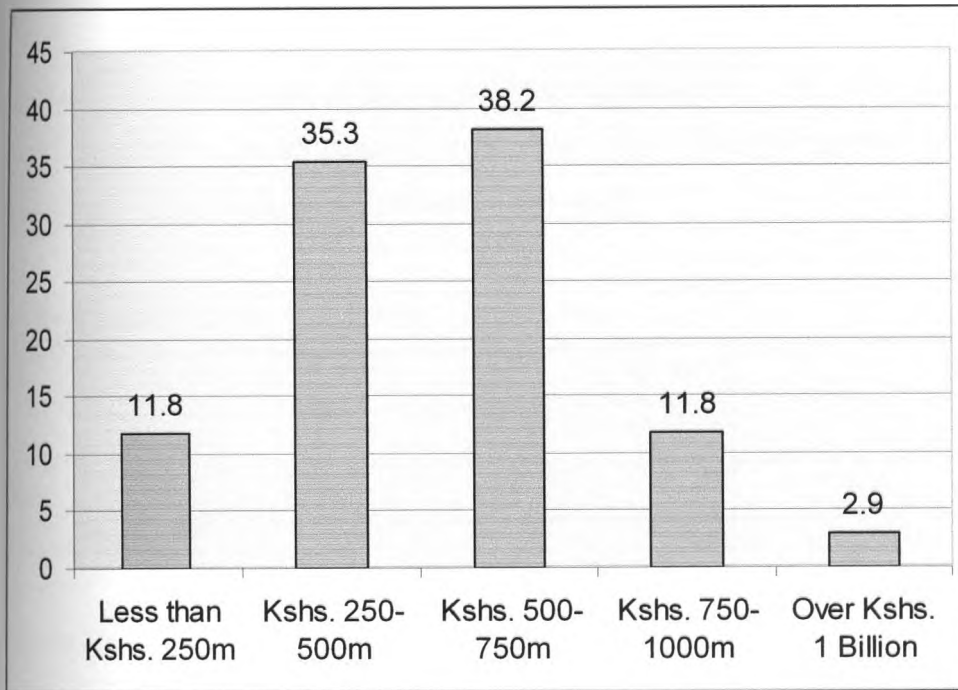


Figure 5 above shows that 38.2% of the firms involved in the study had an annual average turnover of Kshs. 500 to 750 million, 35.3% had an average turnover of Kshs. 250 to 500 million, and 11.8% had turnover of less than Kshs. 250 million per year. It can also be seen that another 11.8% of the construction companies involved in the study had an annual average profits of Kshs 750 million while only 2.9% had an annual average turnover of over Kshs 1 billion.

4.19 Growth and profitability affected by capital issues

Capital issues necessarily affect profitability as well as costs of the company. This section is devoted in finding if the firms involved in the study had their profitability and growth affected by capital issues.

Table 13: Growth and profitability affected by capital issues

Response rate	Frequency	Percent
Yes	27	79.4
No	7	20.6
Total	34	100.0

The above table shows that majority of the firms involved in the survey comprising of 79.4% agreed that capital issues had affected their growth and profitability while 20.6% reported that capital issues did not affect their growth and profitability. The following table below illustrates the extent to which such effect is reported to affect the growth and profitability of the construction companies involved in the study.

Table 14: Extent of effect

Extent	Frequency	Percent
Great	10	37.0
Moderate	9	33.3
Low extent	8	29.6
Total	27	100.0

Table 14 shows that out of those who reported that capital issues affected growth and profitability of the company, 37% reported that the effect was great, 33.3% reported that the effect was moderate while on the other hand 29.6% reported that the effect was to a low extent.

2.0 Invitation to external auditors

Auditing of books of accounts enables their users to have confidence as the auditors ensure their completeness and their accuracy. For publicly quoted companies this is a mandatory requirement but for the companies involved in the survey this is not obligatory.

Table 15: Invitation to external auditors

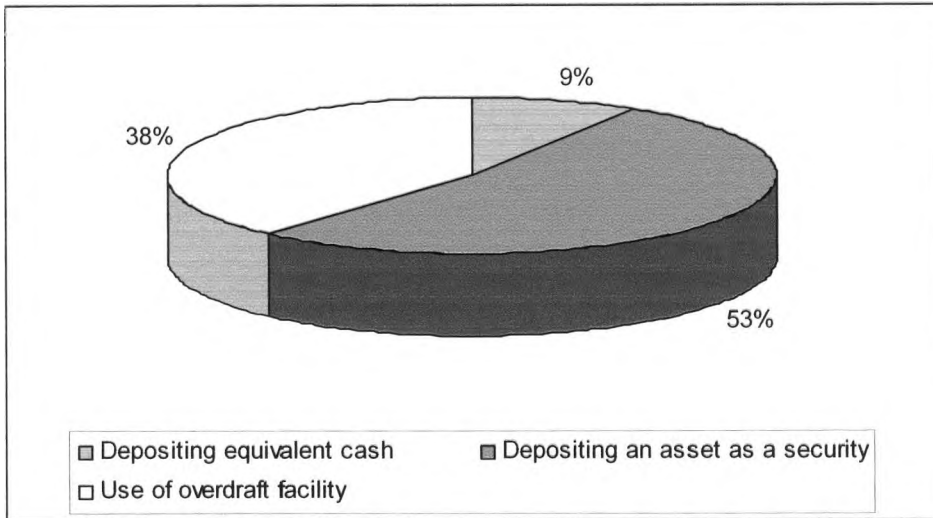
Response Rate	Frequency	Percent
Yes	18	52.9
No	16	47.1
Total	34	100.0

Just over half the construction companies involved in the survey comprising of 52.9% invited external auditors to audit their accounts while 47.1% did not see the necessity of external auditors.

4.21: Finance the acquisition of security bonds

Proper financing of security bonds enables a company to save on costs by choosing the least expensive method. The figure below shows the financing methods used by construction firms involved in the study.

Figure 6: Finance the acquisition of security bonds



The above figure shows that 53% of the companies involved in the study financed their assets by depositing an asset as a security, 38% used an overdraft facility while 9% deposited the equivalent cash.

4.22 Requirement of depositing security bonds and cash flow position

The section was devoted in finding out whether the firms in the study had their cash flow position affected by depositing of security bonds.

Table 16: Whether depositing bonds affect cash flow position

Response rate	Frequency	Percent
Yes	15	44.1
No	19	55.9
Total	34	100.0

Table 16 above shows that 55.9% of the firms involved in the survey were not affected by the requirement of depositing security bonds while 44.1% had this requirement affect their cash flow position. Table 17 below shows the ways in which these firms covered the shortfall.

Table 17: Covering for the shortfall

Method	Frequency	Percent
Borrowing from bank	4	23.5
Use of savings/reserves	13	76.5
Total	17	50.0

Most of the firms involved in the study comprising of 76.5% used savings and or reserves to cover this shortfall while 23.5% borrowed money from the bank to cover the short fall.

4.23 Technology and financial position

For most companies technology affects their operations. This can lead to reduction of costs if such companies acquire the latest technological innovations that are more efficient, effective and economical. The table below shows whether the firms involved in the survey have their financial position affected by technological changes.

Table 18: Technology effect on financial position

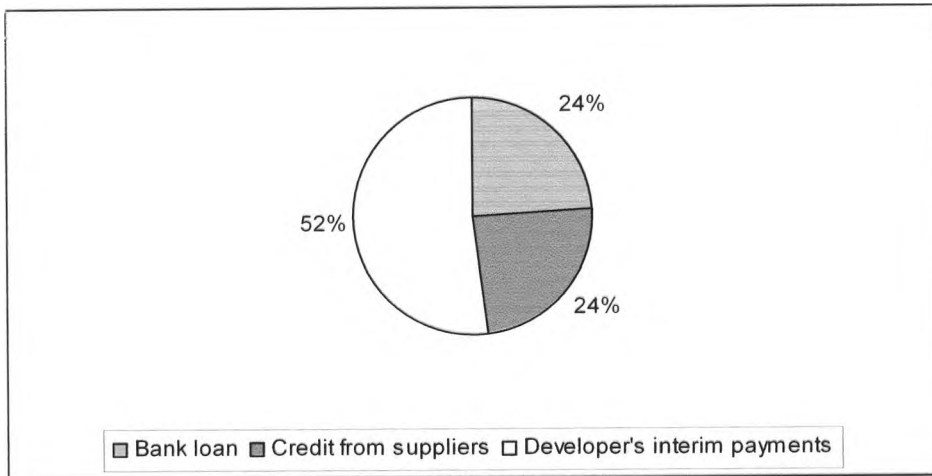
Response rate	Frequency	Percent
Yes	26	76.5
No	8	23.5
Total	34	100.0

Table 18 shows that 76.5% reported that technology affected their financial position while 23.5% reported that technology did not affect their financial position.

4.24 Sources of finance for day to day activities

This part was devoted for finding out which source of finance sustained the firm's day to day operations. The results are as shown below.

Figure 7: Sources of finance for day to day activities



It can be seen from the above figure that 52% of the firms used developer's interim payments to finance day to day activities, 24% used credit from suppliers and another 24% used bank loans to sustain day to day activities.

4.25 Source of capital affecting the level of profitability

This section sought to find out whether source of capital affected the level of profitability.

Table 19: Source of capital affecting the level of profitability

Response rate	Frequency	Percent
Yes	32	94.1
No	2	5.9
Total	34	100.0

For most firms involved in the survey, comprising of 94.1% agreed that source of capital affected their level of profitability while only 5.9% said that source of capital did not affect their level of profitability.

4.26 Source of finances

There are various source of finance and each differs according to their costliness. The firms involved in the survey ranked various sources of finance according to their cost as shown in the table below.

Table 20: Rank of sources of finance

Source	Not expensive		Least expensive		Moderate		Expensive		Most expensive	
	Freq	%	Freq	%	Freq	%	Freq	%	Freq	%
Equity	8	23.5	20	58.8	5	14.7	0	0	1	2.9
Bank overdraft	0	0	3	8.8	9	26.5	18	52.9	4	11.8
Credit from suppliers	1	2.9	1	2.9	25	73.5	6	17.6	1	2.9
Bank loan	1	2.9	0	0	0	0	16	47.1	17	50.0

For most firms involved in the study comprising of 58.8% they considered equity to be least expensive, 52.9% considered bank overdraft to be expensive, 73.5% considered credit from suppliers as being moderately expensive while 50% considered bank loan as being the most expensive.

The companies involved in the survey also listed the main challenges they faced including competition and funding, completing projects within specified duration, coordinating with other partners and employees, diversification and expansion. Other challenges they faced includes, highway robbery, technological changes, maintaining profitability and growth, management of capital, managing employees and terrain landscape.

CHAPTER FIVE

5.0 SUMMARY AND RECOMMENDATION

5.1 Introductions

This chapter provides a summary of the findings, conclusions and recommendations into the sources of finance for building construction firms in Kenya.

5.2 Summary of the Findings

The objective of the study was to establish the various ways in which building construction firms finance their operations. The findings indicate most of the firms involved in the study were limited liability companies. The major source of initial capital for most businesses involved in the study was their own savings and bank loans.

The findings also indicate that most of the businesses involved in the survey were limited liability companies comprising few were partnership business. The major source of start up capital was in owner's savings and bank loans. Majority of the respondents said that capital was not sufficient for their operations. The reason for insufficiency of capital include: the need to expand business by increasing the number of outlets, purchase of major equipment, research and development and the need to acquire large contracts.

For the construction firms involved in the survey, most of them reported that they faced hurdles in raising finance and these hurdles emanated from the high interest and the smallness in size of the firm. This is the reason why most of them did not have adequate equipment. The firms therefore did have intention of increasing their capital and this was mainly through bank loans. The firms involved in the study published their accounts annually while a few did not publish their accounts at all. Fewer still engaged external auditors to verify their books of accounts.

Earnings were considered a great risk while funding was ranked a moderate risk by most of the participants in the survey. For most firms involved in the study they considered equity to be least expensive and bank loans as being the most expensive. The companies involved in the survey also listed the main challenges they faced including competition and funding,

completing projects within specified duration, coordinating with other partners and employees, diversification and expansion.

5.3 Conclusions

Financing decisions are very important for all businesses. This is irrespective of the industry the firms belong to. For construction companies identifying a source of finance forms an important part of a manager's responsibility. Since such firms can be awarded projects that may require sophisticated equipment then it necessarily becomes imperative to identify sources of finance that can come to assist in the acquisition of such equipment. The managers of such firms must consider sources of financing available and their relative costs as well the financial risk.

Debt plays a crucial role in the survival of a business. However for financial institutions to grant small businesses credit, there are a number of factors they have to look at. Small businesses usually do not get loan facilities from financial institutions because such businesses are usually perceived to be risky. Usually financial institutions do a credit selection and analysis to determine whether small businesses should get loans. The problem usually arises when these small businesses do not have adequate collateral to base their loans on.

The only way construction companies can be get financing for their projects is to keep good business records, have a sound capital base and have increasing revenue collection. It is important to have a good financial control. It is important for small business owners to know that income does not mean cash flow. In this case they should manage credit policies closely to assure a positive cash flow. A good way to overcome financial problems is through good bookkeeping. Once financial institutions see a good management of business funds then they would be willing to partner with small business owners to ensure their growth.

The decision to identify the cheapest source of financing is dependent on very many factors. Debt has the interest rates which even though it is tax deductible it eats into the company's profits. Savings from the business may be too minimal for huge expansion plans and so is the

owner's savings. Going public may be sound good but there are various costs to be able to offer shares to the public. This notwithstanding the numerous legal requirements for publicly quoted companies. The best decision is an optimal mix of debt and equity to ensure that a business enjoys the various advantages from each source of finance.

5.4 Policy Recommendation

There are a number of recommendations that can be made to building construction companies. Effective management of finance at the disposal of the company is a very important step in taking control of the businesses finances. Planning well would dramatically improve the chances of getting loans from financial institutions. It is also important to have to keep accounting records and have auditors to audit them to ensure their accuracy and completeness. Good management of cash would mean avoiding under capitalization as well as avoiding unnecessary acquisitions of fixed assets. With such planning the business can be able to increase its sales volume as well as its market share. When a financial institution sees a business whose revenue has been growing steadily then it would be easy to advance loans to them.

5.5 Recommendations for Further study

This study concentrated mainly on sources of finance for building construction firms in Kenya. Future researchers should consider expanding the study to other industries such as telecommunication companies.

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APPENDIX 1

VALUE OF WORK THAT BUILDING CONTRACTORS CAN UNDERTAKE

CATEGORY	VALUE OF WORK (KSHS.)
A	Unlimited
B	Up to 250 Million
C	Up to 150 Million
D	Up to 100 Million
E	Up to 50 Million
F	Up to 20 Million
G	Up to 10 Million
H	Up to 5 Million

Source. Ministry of Roads and Public Works, Nairobi Kenya

APPENDIX II

LETTER

Fredrick Matara Matoke
P.O. Box 18255-00100
NAIROBI

Dear Respondent,

REQUEST TO FILL THE QUESTIONNAIRE FOR RESEARCH PURPOSE

This is to request you to kindly fill the attached questionnaire for research purpose.

The research focuses on sources of finance for building construction firms/companies in Kenya. The information sought from you will be treated with utmost confidence, and results of this study will be available for your use/reference.

Thank you,

Yours sincerely,



Fredrick Matara Matoke

APPENDIX III

QUESTIONNAIRE

Please answer freely the questions below. The information provided will be treated with the highest degree of confidence. When the questionnaire is completed, it should be submitted to the researcher.

1. Name of organization -----

2. What position do you hold in the firm (optional)-----

3. When did your firm start business? -----

4. In what category is your firm registered in the MOR&PW list of building contractors? A [] B [] C [] D []

5. What type of business organization is your firm? Tick where appropriate.
Proprietorship [] Partnership [] Limited Company []
Other (specify) -----

6. Why did you decide to adopt the above form -----

7. Where did you get starting capital from?
Own savings [] Inheritance [] Bank loan []
Other (specify) -----

8. Do you feel your capital is sufficient for your operations?
Yes [] No []
If not what are the reasons
i) -----
ii) -----
iii) -----
iv) -----

9. Do you face any problem(s) when raising capital?

Yes No

If yes, which one of the following

Lack of security High interest rates Smallness in size of firm

Lack of goodwill Other (specify) -----

10. Do you feel that you have enough equipment for your operations?

Yes No

11. How do you finance the acquisition of construction equipment?

Outright purchase Hiring Leasing

Other (specify) -----

12. Where do you buy the equipment from

Manufacturer Supplier Another contractor

Other (specify) -----

13. Do you have any intention of increasing your capital?

Yes No

If yes, how

Floating new shares Bank loan Preference shares

Other (specify) -----

14. What is your current composition of your organization's capital?

Equity. 0 - 25% 25 - 50% 50 - 75% 75 - 100%

Debt. 0 - 25% 25 - 50% 50 - 75% 75 - 100%

Other -----%

15. How often do you publish your financial statements?

Quarterly Semi-annually Annually Not at all

16. What are the major risks associated with your business operations? Please tick in order of importance

Greatest risk 5, Great risk 4, Moderate risk 3, Least risk 2, No risk at all 1

	5	4	3	2	1
Capital base					
Clients					
Funding					
Earnings					
Reputation					

17. How do you rate the overall financial performance of your firm?

Good Fair Poor

18. What has been your average annual turnover in the last three years in Kshs.

Less than Kshs. 250m Kshs. 250m – 500m Kshs. 500 – 750m

Kshs. 750m – 1000m Over Kshs. 1 Billion

19. Has the growth and profitability of your firm been affected by capital issues?

Yes No

If yes, to what extent?

Very great Great Moderate Low extent Very low extent

20. Does your firm invite external auditors to audit your books of accounts?

Yes No

21. How do you finance the acquisition of security bonds (bid and performance bonds)?

Depositing equivalent cash Depositing an asset as security

Use of overdraft facility Other (specify) -----

22. Does the requirement of depositing security bonds with clients affect your cash flow position?

Yes No

If yes how do you cover for this shortfall?

By borrowing from bank [] Use of saving/reserves []

Invite new equity capital []

23. Does the level of technology affect your financial performance?

Yes [] No []

24. Which of the following sources of finance sustains your firm's financial operations on day-to-day basis?

Bank loans [] Credit from suppliers [] Developer's interim payments []

Savings [] Other (specify) -----

25. Does the source of capital affect the level of profitability of your firm?

Yes [] No []

26. How do you rank the following sources of finance in order of expensiveness

Most expensive 5, Expensive 4, Moderate 3, Least expensive 2, Not expensive at all 1

	5	4	3	2	1
Equity/own capital					
Bank overdraft					
Credit from suppliers					
Bank loan					

27 List down the main challenges that you encounter in your business -----

