The relationship between capital structure and Value of firms listed at Nairobi stock exchange

Abstract:

Corporate finance literature suggests that the capital structure decision has played a pivotal role over the years in driving the establishment and growth of firms. There is also a body of evidence that financial markets take a keen interest in firm value, especially for those listed on the Stock Exchange. There is no empirical evidence that there is a causal relationship between capital structure and the firm’s value despite the importance of the two concepts. This study uses debt/equity ratio as the proxy for capital structure and a selected few financial ratios to represent the attributes of firms value (profitability ratio, dividend payout ratio, asset and operating efficiency, growth rate, liquidity and business risks) in investigating the relationship between the two in the Kenyan context. The data obtained from the published annual financial reports and the authorized Nairobi stock Exchange Data vendors from January 2005 to December 31, 2010 was analyzed using a cross sectional regression and time series analyses. The study also used correlation analyses to describe the degree to which one variable linearly relate to another in this study. Findings show that the value of the firm is highly correlated with dividend per share. Dividend per share and the value of the firm are positively correlated. From this we can understand that price of stock in these four sectors mostly depends on dividend per share. Findings show that when the dividend per share increases, price for particular share tends to increase. Findings also show that value of the firm as measured by share price and sales growth is inversely related. The study found that price and share capital are negatively correlated. It can be inferred from the analysis that none of the variables are perfectly correlated or inversely correlated. Each and every variable has some relationship with each other. When there is sales growth in a company the future earning expectation increase and market price of share also increase in association with that expectation. From the analysis, the relationship is negative: the logic behind this may be the fact that at the time of growth companies generally retain most of their profit for future and usually don’t declare dividend; as the dividend amount is reduced the price may fall. In association with it the other thing may be true: to support the sales growth the companies need to borrow from outside, this increases the financial expenditure as well as the burden to the firm and affect the market price. From the nature of these findings it is fairly concluded that there is a causal relationship between the capital structure and the value of the firm as all factors that influences capital structure choice indicates varying relationships with the value of the firm. Fluctuating levels of debts in the capital structures affects the value of the firm proportionately. The results however are inconclusive but they lay foundation for potential future research and useful recommendations for policy direction and management of these firms. Interesting insights are drawn from using some of the limitations identified in the literature to try and explain why the results are the way they are.