

**ASSESSMENT OF CAPITAL STRUCTURE ON PROFITABILITY AND
PERFORMANCE OF FINANCIAL FIRMS: A CASE OF NAIROBI SECURITIES
EXCHANGE**

LEON TED ODHIAMBO

REG NO. BCOM/2013/50809

**A RESEARCH PROJECT SUBMITTED IN PARTIAL FULFILLMENT OF THE
REQUIREMENTS FOR THE AWARD OF DEGREE OF BACHELOR OF COMMERCE
OF MOUNT KENYA UNIVERSITY**

DECEMBER 2015

ABSTRACT

Capital structure is the mix of a company's long term debt, specific short term debt, common equity and preferred equity; that is, how a firm finances its overall operations and growth using different sources of funding. This is composed of equity and debt financing. This research sought to assess capital structure on profitability and performance of financial firms listed at Nairobi Securities Exchange during the period 2010-2014. The success of financial institutions in Kenya's dynamic business environment depend on their ability to effectively determine the optimum and appropriate capital mix that is necessary to ensure that the shareholders get returns. It is worth noting that financial institutions depend on their ability to identify, assess, monitor and manage risks in a sound manner; thus, financial firms must have effective ways of determining the appropriate amount of capital that is necessary to absorb unexpected losses arising from their market, credit and operational risk exposures. The sector has recorded double-digit growth in profits for most of the past decade, when the economic growth has averaged at about five per cent. Factors such as amount of debt, the risks associated with indebtedness, interest rates and debt equity combination could affect the financial performance of firms. This research investigated the effect of capital structure on financial performance in relation to these factors. In respect of the above objectives of the study, data was collected by a review of documents, annual reports of the companies and the Nairobi Securities Exchange reports. Data collected was analysed using Statistical Packages for Social Sciences (SPSS) which gave descriptive analysis. The data was then be summarised and presented using tables. The results show that the mean values of gearing ratio and debt to total funds were 10.1506% and 86.02% respectively. The mean value of debt/equity ratio suggests that debt is 10.1506 times higher than equity capital. The debt/equity ratio is normally safe up to 2. It shows the fact that listed financial institutions in Kenya depend more on debt rather than equity capital. The mean value of debt to total funds ratio indicates 86.02% of the total capital of listed banks in Kenya is made up of debt. This has re-emphasized the fact that banks are highly levered institutions. An increase in the level of debt finance increases the interest payments thus resulting in a decline in profitability. Arising from this observation it can be concluded that capital structure choice among listed financial firms support the pecking order theory that firms prefer raising capital, first from retained earnings, second from debt, and third from issuing new equity. The study noted that

banks generally play a crucial role in the economic development of every country. One critical decision banks face is the gearing ratio choice. Among others, this choice is necessary for the profit determination of firms. What this means is that banks that are able to make their financing decisions prudently would have a competitive advantage in the industry and make superior profits. However, it is essential to recognize that this decision can only be wisely taken if banks know how debt policy influences their profitability.