# DETERMINANTS OF CAPITAL STRUCTURE FOR REAL ESTATE FIRMS IN NAIROBI COUNTY

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**112287**

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**Strathmore University Business School**

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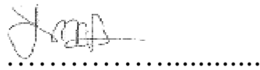
# DECLARATION

I declare that this proposal is my original work and has not been presented to any other university for award of a degree. Any work done by other people has been duly acknowledged. To the best of my knowledge and belief, the proposal contains no material previously published or written by another person.

Yussuf Mohamud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10, October 2021

**APPROVAL**

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………….............

28th Feb 2022

## DEDICATION

I wish to dedicate this work to my family and friends for their encouragement and above all to the almighty God for his care throughout my study.

## ACKNOWLEDGEMENT

First, am grateful to God Almighty for the strength and wisdom He granted me to finish this research project. I am also greatly indebted to my Supervisor, Mr. John Waweru Kamau, for patience and the professional guidance he gave me throughout the writing of the research project. I am equally thankful to all my lecturers for their contributions in making this project to be successful.

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# CHAPTER ONE
# INTRODUCTION

## 1.1 Background information

Real estate is one of the oldest industries in the world having existed from ancient times. Land and building ownership have been source of prestige to the owners (Roosevelt 2019). The sector both provide basic needs and returns at the same time. According to Riddiough (2004) real estate is highly capital intensive and requires considerable investments.

The real estate in Kenya has recently been booming with Nairobi contributing the largest share because of being the regional hub, more housing units were upcoming due to the high demand for housing. This saw many real estate firms venturing into the business with vibrant private sector and increased appetite from foreign companies playing the biggest role. Cyton Investment (one of the real estate firms in Nairobi) shows that the real estate market has grown significantly over the past the past two decade. Tomlison (2007) indicate that African cities are experiencing some of fastest urbanization in the world. Mungai (2017) further suggest that demand for different types of real estate is increasing in Kenya with young, employed population who are willing to own homes driving the demand.

The financing methods for the entire industry has been varying. A report by UN-HABITAT (2009) states that the main problem facing real estate especially is inability to adequately finance urban shelter in the middle of ever-increasing demand. Financing option still poses a great problem for developers in Kenya due to slow economic growth, instability and strict measures imposed by most financial institutions (Mungai 2017). This is increased by the fact that interest rate had unfavorable consequence on funding real estate since funding a real estate project is always a long term. This made providers of funds to compel high interest rate. The Kenyan real estate sector has been dominated by private developers and institutional investors who buy either shares or fully own and operate the firm.

According to Omondi (1996) capital structure comprises of the decision of whether to finance a firm with either equity or long-term debt. Financials issues is the immediate reasons why businesses fail or have little progress in the developing countries. Despite some sectors like real

estate having positive impact by contributing to the nation's GDP and overall economic development and also having a positive impact on the social stability by enabling households to acquire asset according to international finance corporation (IFC) they still fail. This setback made developing nations to lag behind. This also contribute to firms to look for a favorable way of funding their projects. According to Ngugi and Afande (2015) majority of real estate firms (80%) in Kenya had capital structure of 100% equity while the remaining 20% had a balanced capital structure between equity and debt with the main factors influencing this capital structure being the firm asset structure, growth rate of the firm, the operating risk, profitability of the firm, the age of the firm being the big drivers while taxation had the least impact.

The choice of whether make use of equity or debt is one of the dilemmas facing the real estate firms within Nairobi. Wrong mixture of capital will not only affect the performance of the firm but also the survival of the firm. Yabs (2015) state that financing and investment are two major decisions in a firm, how organization is financed is important to both managers and funds providers. The decision is important in the sense that it will maximize organization's returns and ability to compete favorably with other firms in the sector (Abor & Biekpe 2005). Capital structure has been a big issue since the time of Modigliani and Miller. According to Auerbach (1985), Taggart (1977), Marsh (1982) and Opler and Titman (1994) optimal capital structure is endless assignment. This indicate that a firm need to constantly review it capital composition.

The determinants of this financing choices have been varying across the real estate firms located in Nairobi with some firms using the size to instill confidence in potential investors and financial institutions. Kodongo, Mokoteli and Maina (2015) argue that the firm size is one of the drivers of capital structures. Some of the most common criteria used to evaluate the size of a firm is the number of employees, the total net assets, sales and investment levels (Kushnir 2010). A different study undertaken by Gharaibeh (2015) and (Otieno 2016) on the impact of certain measures on firms from developing nations capital structure indicated that the growth opportunity, liquidity, profitability, firms age and tangibility have a significant influence on the choice of capital structure of a firm. This was in line with Tongkong (2012) and Sadam (2014). This are some of drivers that contribute the kind of capital structure that is developed by the

firms. Gharaibeh (2015) further argues that ownership and dividend policy have insignificant relationship with capital structure.

The scarce resources have also enabled some of the firms also to go for other forms of financing. Firms with no huge capital or lack external financing to develop the property opt to go for off-plan sales since it reduces the cost of development Kimaru (2018). Developers using this form of financing mainly face difficulty in raising the target amount and penalties due to delay in completion of the project because of the inability to have enough funds. According to Mwathi and Karanja (2017) some of the firms with enough assets and other factors that will reduce the cost of funds will opt to go for debt financing especially mortgage financing. The study further state that equity and venture capital are the least used method of financing.

Due to the changing environment and need to maximize the market value. Firms will change also with the environment. This study will provide the up-to-date drivers of real estate capital structure in one of the biggest cities in the African continent and come up with accurate reliable conclusion.

## 1.2 Problem statement

Most developing nations, Kenyan being one of them tend to rely on studies done in developed nations. Gathongo and Ragui (2014) note that different countries have different institutional arrangement in reference to the tax and bankruptcy code, the role played by the banking sector, the culture of the people and level of economic development vary from one nation to the other. A study done in a developed country may not accurately reflect on what is happening on a developing country. Knowledge about capital structure is derived from data collected and analyzed in developed economies (Booth et.2002). To properly understand how developing nations capital structure behaves its necessary to examine the determinant of their financing and capital structure decisions. The financing decisions involve wide range of policy issues. At the macro level they have implication for capital market development, interest rate and security price

determination and regulation. At micro level such decisions affect capital structure, corporate governance and company development (Green, Murinde & Suppakitjarak 2002).

It is significant to carry out a study specifically customized to the Kenyan real estate environment and enable us to know the various factors that affect its capital structure. Due to inadequate skills and financials constraints the real estate firms might not be able to conduct a periodic study on whether their capital structure is in line in what is reported in developed nations or totally different. It is significant for the firms to know what their main determinants of capital structure is so that they can adopt a perfect capital structure that will maximize its value. Bill (2011) state that in a competitive and complicated industry with ever changing operating environment, capital structure will always have a huge impact in the future of the firm. The problem of financial mix is very vital and is documented to be an immediate reason for companies failing to start or progress (Muturi & Gathire, 2015).

Different studies had also different conclusion on determinants of capital structure. Studies done by Gathongo and Ragui (2014), Mori and Beretta (2008) indicate that profitable firms rely on their profitability instead of going for debt financing while Salawu and Agboola (2008), Myers (2001) and Roden and Lewellen (1995) contradict the previous studies stating that profitable firm opt to go for debt financing. This inconsistencies in these studies motivate the author to carry a study that will investigate these variables.

### 1.3.1 General objective

To assess determinant the capital structure decisions of real estate firms in Nairobi.

### 1.3.2 Specific objective

I. To evaluate the effect of profitability on capital structure of real estate firms in Nairobi.
II. To establish the influence growth opportunities on the capital structure decision of real estate firms in Nairobi.
III. To investigate the effect of size of a firm on capital structure of real estate firms in Nairobi.
IV. To evaluate whether firm’s asset tangibility influence capital structure in real estate firms in Nairobi.

## 1.4 Research question

I. What is the effect of profitability on capital structure of real estate firm in Nairobi?

II. Do growth opportunities influence the capital structure decision of real estate firms in Nairobi?

III. What is the influence firm size on capital structure of real estate firms in Nairobi?

IV. What is the relationship between firm's asset tangibility and capital structure of real estate firms in Nairobi?

## 1.5 Significance of the study

### 1.51 Foreign investors

The research will be useful to foreign investors who are willing to undertake real estate investment in Kenya by giving them clear picture of the real estate market in terms of what determines the capital structure.

### 1.5.2 Policymakers

The research could be used by the government regulatory bodies to set guidelines for real estate firms. This will enable the government to formulate policies that will contribute to the development of real estate.

### 1.5.3 Scholars and researchers

The research shall contribute immensely to the existing knowledge where future scholars can expand and explore their knowledge on determinant of capital structure real estate firms in Nairobi.

### 1.5.4 Financial institutions

This study will be of great significance to the financial institutions and other providers of capital to a line their plan and services offered to real estate sector with the study in order to get competitive advantage.

### 1.5.5 Investment advisors

The study will be of great importance to investment advisors who will use this to guide their client to make informed decision before committing their funds in the real estate sector.

## 1.6 Scope of the study

The study will be focused on real estate firms located within Nairobi County. Both private and publicly listed firms will be part of the study

# CHAPTER TWO

# LITERATURE REVIEW

## 2.1 Introduction

In this chapter the theoretical review, empirical review, research gap and conceptual frame is looked in depth.

## 2.2 Theoretical review

The study uses the capital structure theories. These theories are the pecking order theory and the trade-off theory.

### 2.21 The pecking order theory

The theory was first suggested by Donaldson in 1961 and later modified by Stewart Myers and Nicolas Majluf in1984.This theory postulates that the cost of financing increases with asymmetric information available (Myers et al.1984). The theory assumes that firms will give the first preferences to internal financing followed by debt financing and external financing as the last resort. This is in line with the researcher`s area of study because it categorizes the financing option into levels. According to Berkline and Zelgalve (2012) the reason why there are levels of financing option is because of information asymmetry, since managers have more crucial information about the performance and future prospect of a firm, they are unlikely to issue external shares when the firm share prices are undervalued but issue when the shares are overvalued.

According to Serrasquiro and Caetano (2015) sample of SME firms located in the interior region of Portugal shows that most profitable SME firms resort less to debt which corroborates the forecast of pecking order theory. According to a study done to Vietnam real estate companies in determining the capital structure the result shows that pecking order is the most appropriate and should be applied for listed real estate firms in Vietnam (Hoang, Viet & Anh 2021). This study can also be relevant outside Vietnam since real estate display similar characteristics, firms can use it to adjust their capital structure can raise their own competitiveness and continue to develop business. Chen and Chen (2011) argue that firms prefer to use their earning to finance business activities and use less debt capital however they also insist that large firms may take advantage of the tax deductibility.

The study will utilize the theory because firms have preference when it comes to methods of financing their project. Chiriac and Offileanu (2015) suggest that financing is influenced by the "level of accessibility" of resources available in the financial market and the financing policy of the firm. Internal financing is readily available to the firm despite the financial strength while debt financing might require the firm to convince the lenders by clearly showing their ability to honor the obligation. External financing especially issuing of shares comes when the shareholders are indifferent of the dilution of ownership. Internal financing can fund business opportunities and alleviate capital shortages but may also cause excessive investment especially in firms with managerial overconfidence (He, Chen & Hu. 2019)

**2.22 The trade-off theory**

The tradeoff theory is traced back to Kraus and Lichtenberger. The theory states that the firm chooses how much equity or debt finance to include in their structure by analyzing the cost and the benefit. According to the theory there is an advantage of partly financing the activities of a firm partly on debt and partly on equity and some of the debt financing advantage being tax benefit since they are allowable expense (Kraus & litchtenberger,1973). The trade-off theory is relevant to this study because it focuses on optimizing the value of firm which is the main goal of shareholders. Managers in a firm will adopt a portfolio that increase the value of the firm by first coming with the optimal debt equity ratio that has the maximum value. According to Khoa and Thai (2021) many companies choose an optimal debt level based on the trade-off between interest and debt. There is empirical evidence that real estate companies listed in the Vietnamese stock market might change their leverage toward a target capital structure determined by influential factors in long term perspective (Khoa & Thai, 2021)

The theory also appreciates some of the advantages of debt financing which most firms are likely to take advantage of. According to Kraus and Lichtenberger (1973) as a firm increase it debt the tax benefit also increases. Berkline and Zelgalve (2012) argue that accurately estimating financing method will minimize the cost of capital, maximize the company value and fulfil the shareholders expectation. The dynamic version of trade-off theory explicitly accounts for adjustments of behavior of the leverage ratio where adjustment take place when the of deviation from the target exceeds the cost of adjustment toward the target (Fischer et al.1989).

The study adopted the trade-off theory because as firms look for a way to finance their project, they will also analyze the effect of the financing option on the overall performance of the firm. Shareholders and managers will ensure that they choose the option that unanimously benefit the interest of both parties as well as those of other stake holders. According to Njoroge, Aduda and Mugo (2018) the demand for houses has been tremendously increasing. In Kenya huge amount of funds is required to develop, market and maintain value of the property. To have a large market share firms ensure that they are liquid enough to meet their operating cost. Most firms may borrow at some point in the organization life cycle but ensure that they borrow in a way that maximize their value. The theory may justify firms mix debt and equity not only finance their project but also increase their value.

## 2.3 Empirical review

### 2.31 Relationship between profitability and firm capital structure

A study done by Rahayu and Saifi (2019) investigating the relationship between profitability and capital structure concludes that profitability has a negative significant influence on capital structure, indicating that profitability is a determining factor upon the corporate capital structure. The study also implies that improvement in profitability in the forms of return on investment and net profit margin triggers decrease in the proportion of debt within the capital structure. The study employed quantitative research using general structural component analysis as analysis tool.

According to Gathongo and Ragui (2014) profitable firms with access to retained earning can rely on it as opposed to outside sources a concept in which Salawu and Agboola (2008) completely disagree with, arguing that profitable firms are likely to apply the debt financing. Myers (2001) contended that highly profitable corporation could have a high level of debt and less danger of bankruptcy and financial distress concluding that profitability is has a positive relationship with firm leverage. A different study done by Roden and Lewellen (1995) where they examined 48 companies in the United States covering between 1981 to1990 have concluded that profitability is positively related to debt. Mori and Beretta (2008) in a study to find out determinant of capital structure in unites states real estate firms indicated that profitable firms are less levered.

According to Addae, Nyarko-Baasi and Hughes (2013) the relationship between profitability and capital structure in Ghana listed firms showed that there is ether positive, negative or neutral relationship between profitability and capital structure.it also showed that there is no conclusive evidence of what the optimal capital structure should be. Tongkong (2012) while undertaking a study in Thai listed property developers concluded that profitability has a negative relationship with leverage. This agrees with Harisson, Panasian and Seiler (2011) who also indicated similar finding. Tongkong (2012) further adds that profitable firms tend to have less debt. Lin, Jiang and Chen (2014) also found out that profitable firms rely more on internal accumulation.

### 2.32 Relationship between tangibility of firm asset and firm capital structure

According to research undertaken by Harc (2015) in Croatia looking into relationship between capital structure and asset tangibility stated small and medium sized firms in Croatia use their asset as collateral to attract long term financing. The result also concluded that tangible assets have positive impact on the long-term financing of Croatian firms. The data used for this study was derived from the annual reports provided by the firms and Pearson correlation coefficient was applied using a population of 50 firms for a period of 5 years, between 2005 and 2010.

The firm asset structure has significant influence in determining its capital structure. Hovakimian et. (2004) suggest that the degree which firm’s asset are tangible should result in the having greater liquidation value. Firms with significant tangible asset also have higher financial leverage since they borrow at lower interest rate Gathongo and Ragui (2014). They further added that firms use their heavy tangible asset to pledge as collaterals, greatly reducing the cost of adverse selection and moral hazard. This will ease access to fund leading to higher outside financing. This is in line with Omondi (1996) who suggested that tangible asset is used to secure debt capital enabling firms with adequate tangible asset to secure debt capital. Titman and Wessel (1988) argue that a firm may give debt finance easily and convince people easily if the firm own more tangible assets. According to Nguyen et al (2012) tangible assets are more valuable than intangible assets, the more tangible assets firms have the more ability to acquire credit.

### 2.33 Relationship between firm size and firm capital structure

A study done by Chikolwa and Bwembya (2019) that investigated the determinants of capital structure in 34 Australian listed property trusts from the period 2003 to 2008 found out that firm size is positively related to leverage. The study used panel data methodology.

Morris and Cristanzani (2009) explained that bigger firms have less demanding access to capital market and they can get financing at more ideal cost. This implies that large firms can rely on other source of finances such retained earning making borrowing as one of the many options. Cortez and Susanto (2012) suggest that creditors prefer to lend to larger firms because reliability and constant cash flows. Rajan and Zingales (1995) also found that bigger companies tend to be more diversified and have stable cash flow making the percentage of default to be low, because of this large firms are capable of taking more debt and can easily access the financial market at the time of their choice. Smaller firms on the other hand face difficulties when it comes to raising long term finances due to unavailability of enough assets to be used as collateral, less and unstable cash flows and lack adequate managerial skills (Kamau & Muiru, 2014), because of the unreliability of small firms they are charged high rate.

Ezeoha and Botha (2011) further add that small firms are less creditworthy, have low profit and less diversified than the large firms, there is possibility that they easily face financial distress and bankruptcy. According to another study carried out by Kurshev and Strebulaev (2015) firm size has been empirically found to have strong positive relationship with capital structure. Harc (2015) indicated that large firms have been well established in their markets, well diversified and have low chances of failing, therefore the author argued that firm size can be seen as an inverse measure of bankruptcy.

For SMEs Harc (2015) concluded that firm size has a negative relationship with leverage stating that firm size differently affects short-term and long-term leverage. The relationship between firm size and short-term leverage is negative while relationship between firm size and long-term leverage is positive. The study also indicated that most of large Croatian firms prefer to use their retained earnings to finance their activities and this made them to be more profitable than small firms who rely on debt financing.

Byuon (2007) suggested that large firms tend to have more leverage perhaps because they are more transparent and have lower asset volatility, have lower probability of default and lower financial distress while small firms who are likely to go experience cashflow volatility narrowing their chances of accessing debt capital. Small firms have large portion of their asset as intangible reducing the chances of them being used as collateral.

### 2.34 Relationship between growth rate and firm capital structure

According to a study done by Tongkong (2012) investigating significant factors determining the capital structure decisions on listed real estate companies in Thailand comes with one of the conclusions being firm growth opportunities is positively related with a firm leverage. The study had a population of 39 companies during the period between 2002 and 2009. The analysis employed multiple linear panel regression models in examining determinants of capital structure as well as dynamic panel regression model. Additionally, the study also discovered that real estate firms partially adjust to their capital structure toward the target level on by 63%.

According to Heshmati (2001) firms with high growth potential rate will require more external financing and should display high leverage contrary to Al-Sakran (2001) who suggest that higher growth firms will use less debt. Jung et al (1996) further argues that firms with growth opportunities finance their growth with equity rather than debt simply because equity finances reduce the chance of the firm been forced into bankruptcy by its creditors.

According to Al-Najjar and Taylor (2008) asset tangibility, firm size and growth rate opportunities are considered to a joint determinant between ownership and capital structure. In a different study conducted in Nigeria by Akinyomi and Olangunju (2013) revealed that capital structure has a negative relationship with firm size and positive relationship with tangibility of asset, profitability and growth rate. The researcher further recommended similar studies to be carried in many other sectors.

### 2.4 Research gap

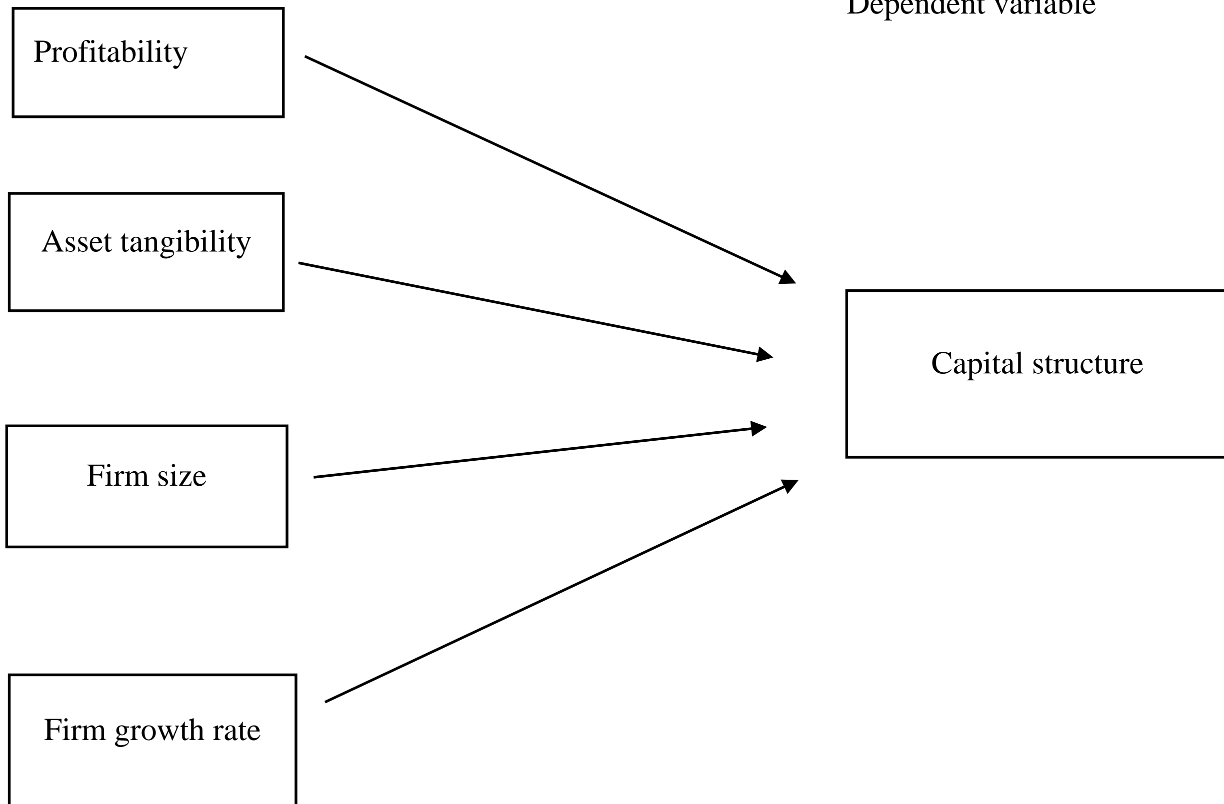
This section outlines the knowledge, contextual and methodological gaps identified by the researcher and intended to fulfil. Several studies were made on the determinant of capital structure on real estate firms with researchers like Gathongo and Ragui (2014) and Mori and Beretta (2008) arguing that profitable firms can rely on their profitability instead of going of debt financing contradicting Salawu and Agboola (2008), Myers (2001) and Roden and Lewellen (1995) who concluded that profitable firms go for debt financing. These researchers argued that profitable firm's ability to face financial distress and bankruptcy is low. The inconsistent findings need to be further explored and explained. They may be brought by the different ways in which variables were measured or the context of their studies.

Most of the studies investigated by the researchers were done in advanced countries. Therefore, the finding might not reflect the actual happening in Kenya which is a developing country. Studies such as Roden and Lewellen (1995), Tongkong (2012) and Harc (2015) were conducted in the United States, Thailand and Croatia respectively. The European, American and Asian firms may display different characteristics compared to Africa. The researcher intends to do a study that truly reflect the real estate in Kenyan environment.

The globe has been constantly evolving with firms appreciating new ways of doing things. The author is of the view that new studies is required to know what is exactly happening in the Kenyan real estate market with the major focus being Nairobi in terms of what determines the capital structure. Other authors like Akinyomi and Olangunju (2013) encouraged further research on the field.

### 2.5 Conceptual framework

The conceptual framework indicates the relationships between the independent variable and dependent variables in determining the capital structure of a real estate firms in Nairobi. Profitability, firm size, asset tangibility and firm growth rate will make the independent variable while capital structure will be the independent variable.




Source Author (2021)

# CHAPTER THREE

# RESEARCH METHODOLOGY

## 3.1 Introduction

The chapter reviews the methodology applied in the process of collecting the data. The chapter precisely examines the research design, the study population, the sampling design, and sampling size that is used. The chapter also elaborate on the data collection technique, method of analysis the data and ethical consideration.

## 3.2 Research design

The research design is a framework in which the author gathers and presents data. A research design can also be termed as an inquiry which provide a certain direction for the course of action in research (Creswell,2008). The objective of the study was what determined of the research design to be used.

The study has applied descriptive design because it will establish the relationship between the variables under study (Mugenda & Mugenda, 2003). Descriptive design is a scientific study done to describe a phenomenon or an object. In this case the study phenomenon is capital structure. This kind of study involves a rigorous research planning and execution often involves answering the research questions. The method was preferred as it permits gathering of data from their natural setting and was most appropriate for the study undertaken. The method has also enabled the researcher to easily compare the collected data with the phenomenon under the study.

## 3.3 Population and sampling

In research population refers to the sum of all units valid for an investigation (Majid, 2018). It is also all units which possess variable characteristics under study and for which finding of the research can be generalized (Satishprakash et al.,2018). According to Cooper and Schindler, 2008 population is the total collection about which a researcher wishes to make some inferences to. For this study the target population is drawn from the members of Kenya Property Developers Association located and fully operated within Nairobi County. The association has a total of 53 developers. 48 of them operate fully within Nairobi.

### 3.3.1 The sampling size

According to Mugenda and Mugenda (2003) quality research must be characterized be easily afforded by the researcher in terms of finances time and human resource. The sample size of the study should not be too large or sample. The sampling technique which provided accurate and reliable data was random sampling. The study used Yamane formula because the sample size is already known by the author.

Yamane formula is given by $n = \frac{N}{1+N(e^2)}$

Where n = the desired sample size

e= the significance level which is 0.05 meaning 95% confidence level

from the population the required sample will be

$$n = \frac{48}{1+48*0.05^2} = 43$$

### 3.4 Data collection technique

The study used questionnaires to collect data. The objective and intention of the study was clearly communicated to the management of the firms and were at liberty to participate. The questionnaire was used for the purpose of the study only and was structured questionnaires which consisted of both open ended and close ended questions. The study applied questionnaire to ensure uniformity in the manner questions are presented. The form of data collection has also enabled the author to collect and easily compare to satisfy the objectives of the study.

### 3.5 Data analysis

The author employed descriptive statistics such as percentages, mean score and standard deviation. Statistical package for social sciences (SPSS) was used to aid in analysis because of its ability to cover wide range the common statistical and graphical data analysis. Computation of frequencies in table, charts bar graphs was used in data presentation.

### 3.6 Research quality

### 3.61 Pilot testing

A pilot study tries to maximize the reliability and validity of the data collected (Mugenda & Mugenda, 2012). The rule of thumb is that at least 10% of the sample should constitute a pilot test Creswell (2003). Using validated questionnaires, a pilot testing was carried out on the instrument using five respondents from five real estate firms (10.87%) of sample that was covered in the actual study. This was done to see how the subject reacted to the questionnaire and whether the items included in the questionnaire were clearly understood by the respondent or whether there was need to include more items in certain areas. From the pilot test the author was able to eliminate ambiguity and modify the questionnaire where necessary.

The quality of a research is also determined by its validity and reliability (Lakonishok & Shapiro 1986). According to Gall and Borg (2003) validity is a criterion used to demonstrate the degree to which deductions drawn in a study provide accurate description or clarification. Bryman and Cramer (2005) state that validity involves the accurateness and connotation of inferences that are grounded on the study outcomes. Validity can either be external or internal. The author intends to increase external validity by applying a sampling strategy that effectively and efficiently capture majority of element under study. For internal validity the author ensured that the data acquired was carefully analyzed to ensure that the content quality provide high standards.

### 3.7 Ethical considerations

The ethical issues that the author intended to maintain throughout the search period is confidentiality of data collected from the various organizations. The information from the organization was solely utilized for academic purpose. The organizations were given the free will to participate in the study. The respondent's anonymity was guaranteed and no information was used against them.

# CHAPTER FOUR

# RESEARCH FINDINGS AND ANALYSIS

## 4.1 Introduction

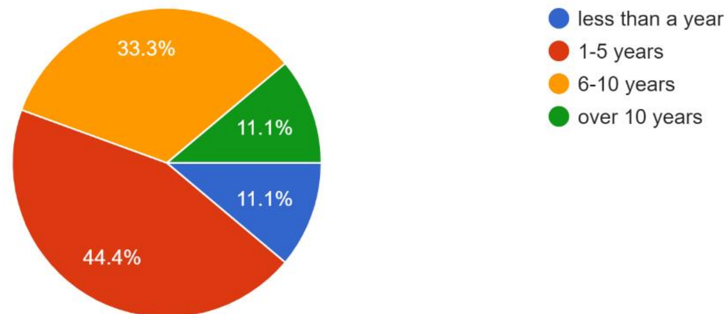
The chapter covers the data analysis presentation and interpretation of the findings. The general objective was to investigate the determinants of capital structure of property companies in Kenya. A total of 41 questionnaires were distributed to the respondents out of which 36 were completed making it 88% response rate. The high response rate could be attributed to follow ups done by the researcher and giving the respondent ample time to complete the questionnaire

### 4.2.1 Major source of financing for Real estate firms in Nairobi

| Sources of funds | Number of respondents | Percentage |
|---|---|---|
| Equity | 6 | 16.7% |
| Debt | 13 | 36.1 |
| Retained earnings | 3 | 8.3% |
| All | 14 | 38.9% |
| **Total** | **36** | **100%** |

The finding indicate that majority of real estate firms combine different types of funds in order to achieve their objective 38.9% of the respondents rely on all types of funds making them flexible and finance their project according to the situation and availability of funds. They are closely followed 13 of the respondents whose major source of funding is equity while equity and retained earnings have 16.7% and 8.3% respectively

### 4.2.2 Number of years firms have been in operation




Source: Author (2022)

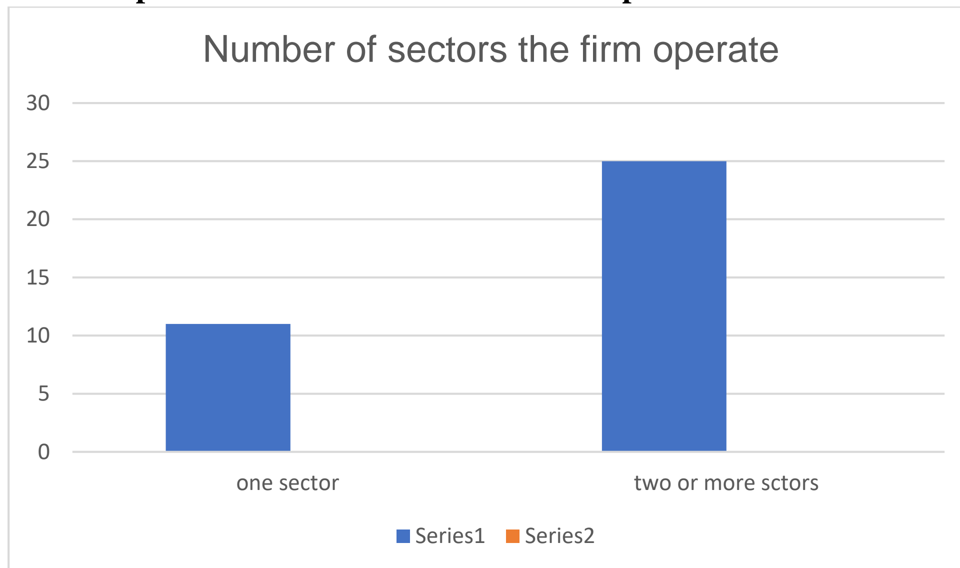
The findings indicate that Majority of the firms (44%) are in operation between 1-5 years, followed closely by firms who are in the business between 6-10 years with 33.3%. This is an indication that the respondents are in operation long enough to understand the operations of the firm. Their responses would be objective.

### 4.2.3 The number of employees the firm have.

| Number of employees | Frequency | Percentage |
|---|---|---|
| 10 or less | 10 | 27.78% |
| 11- 50 | 18 | 50% |
| 50 and above | 8 | 22.22% |
| **Total** | **36** | **100%** |

The study shows that half of the organizations (50%) are medium sized and have employees between 11-50. This shows that are they are growing will require to undertake capital structure decisions.

#### 4.2.4 Graph on number of sectors the firms operate




69.4% of the responses shows that firms operate in more than one sector i.e. residential, commercial or both while 30.6% of the respondent operate in one sector.

#### 4.3.1 Influence of asset tangibility on capital structure

| | N | Mean | Std |
|---|---|---|---|
| extent to which asset tangibility contribute to firm capital structure | 36 | 4.194 | 1.009 |
| The ease of getting funding using the firm assets | 36 | 4.028 | 1.028 |
| Extent in which the firm assets are used as collateral | 36 | 4.417 | 0.736 |
| whether firm takes advantage of its assets to get debt financing | 36 | 4.528 | 0.944 |
| **Overall mean** | 36 | **4.292** | **0.930** |

Source: Author (2022)

The findings indicate that asset tangibility greatly influence the capital structure of the real estate firms located within Nairobi County. The firms use their asset to access funds from their financiers, this is represented by a mean of 4.028 with standard deviation of 1.009 and 25 respondents unanimously agreed that firm assets are vital when looking for external financing. The firm assets are important in being deposited as collateral when securing funding, with a

mean of 4.417. This indicates that assets greatly assist a firm to secure funds. The firm also use its asset to take advantage of debt financing with the highest mean score of 4.528 and second lowest standard deviation of 0.944. majority of the managers of respondent firms agreed that assets give extra advantage to their firms when going for debt financing which is one of the cheapest methods of financing.

Asset tangibility has an overall mean of 4.292 which shows that it is an important factor in influencing capital structure of real estate firms. It is an important determiner of capital structure for firms that operate in the property sector.

### 4.3.2 Influence of firm size on capital structure

| | N | Mean | Std |
|---|---|---|---|
| Whether firm size greatly influences the capital structure of the firm. | 36 | 4.278 | 0.944 |
| Whether the size assist a firm to be stable and liquid | 36 | 4.083 | 0.937 |
| Whether the size assists the firm to borrow at a low cost | 36 | 3.972 | 1.134 |
| whether size of the firm instill confidence in fund providers as it lowers rate of defaults | 36 | 4.222 | 0.866 |
| Overall mean | 36 | **4.139** | **0.972** |

Source: Author (2022)

The study had 36 real estate managers who fully participate. Majority of the respondent (31) agreed that the size of the firm greatly influences the capital structure of the firm, this is represented by a mean of 4.278 with a deviation of 0.944. This is a clear indication that firm size is important driver of real estate capital structure. The respondents also agreed that the size of the firm instill confidence in financiers. Large firms are believed to have low default rate by the lenders. The size assist firm to have easy access to funds. This is represented by a mean of 4.222 which second highest from the table and has lowest standard deviation of 0.866. the respondent also agreed that the size of the firms assist them to be stable and liquid with a mean of 4.083. This implies that the size of the firm is a significant determiner of liquidity. Whether the size of the firm lowers the borrowing cost had the lowest mean of 3.972 and highest standard deviation of 1.134. This is contributed by the facts that lenders consider other factors apart from size.

The overall mean of 4.139 indicate that firm size immensely influences the capital structure of real estate firms in Kenya's capital city.

### 4.3.3 Influence of profitability on capital structure

| | N | Mean | Std |
|---|---|---|---|
| Extent to which the firm rely on their profit | 36 | 3.944 | 1.068 |
| Whether retained earnings and profit are enough to finance the firm projects and future investments | 36 | 3.083 | 1.339 |
| Whether retained earnings and profit have more advantages than all other sources | 36 | 3.306 | 1.305 |
| Whether the use of equity maximizes the weighted average cost of capital | 36 | 3.667 | 1.265 |
| Whether earnings lower the gearing ratio | 36 | 3.778 | 1.017 |
| **Overall mean** | 36 | **3.556** | **1.234** |

Source: Author (2022)

The finding from the table indicate that real estate firms rely on their profit to some extent. This is shown by a mean of 3.994 with standard deviation of 1.068. The firms have also indicated that retained earnings alone might not be enough to finance their projects. This because it is represented by the lowest mean in the entire study and highest standard deviation of 3.083 and 1.339 respectively. The respondents have shown that profit lower the gearing ratio of a firm as shown by the mean of 3.778. They have also indicated that equity maximizes the weight average cost of capital.

Profitability has an overall mean of 3.556. This indicates that profitability is influences capital structure of real estate firms in Nairobi but has less influence compared to the other three variable being investigated by the author.

#### 4.3.4 Influence of firm growth rate on capital structure

| | N | Mean | Std |
|---|---|---|---|
| Whether firm growth rate greatly influences the capital structure of the firm | 36 | 4.083 | 0.937 |
| Whether quick growing firms require external financing | 36 | 4.194 | 0.889 |
| Whether high potential growth assists the firm to borrow at a low cost | 36 | 3.994 | 0.984 |
| Whether high growth opportunities can maximize the capital structure of a firm | 36 | 4.250 | 0.874 |
| **Overall mean** | 36 | **4.118** | **0.920** |

Source: Author (2022)

The findings show that managers and head of real estate firms in Nairobi have agreed that growth rate greatly influences capital structure. This is shown by a mean which of 4.083. The respondents also agreed that growing real estate firms external financing in order to realize their dream of expanding. 27 of the respondents have agreed with it and is represented by a mean of 4.194. High growth potential also greatly influences the capital structure this as indicated by the respondents and with a mean of 4.194, likewise the respondents have also immensely agreed that high growth potential can maximize the capital structure of real estate firms in Nairobi.

The overall mean of 4.118 is a clear indication that firm growth rate greatly influences the capital structure of real estate in Nairobi. Firm growth rate is key determinant of capital structure in Kenya.

# CHAPTER FIVE

# CONCLUSION AND RECOMMENDATION

## 5.1 Introduction

This chapter presents the summary of key findings, conclusion and recommendation of the study. The general objective was to investigate determinants of capital structure for real estate firms in Kenya.

## 5.2 Summary

The key findings of the study entails: majority of real estate in Nairobi have mixed capital structure. Most of the real estate 38.6% of total firms use all kind of available to finance their projects followed closely by debt financing which at 36.1%. This implies that real estate firms use all available funds to start and complete their projects. Another important observation is real estate firms use more than twice debt financing as equity. This is in line with the tradeoff theory which state that there is an advantage of partly financing the activities of a firm partly on debt and partly on equity and some of the debt financing advantage being tax benefit since they are allowable expense.

### 5.2.1 Asset tangibility

The findings show that asset tangibility influence capital structure. Compared to the other three variable being investigated it is the strongest variable that influence capital structure of real estate firms in Nairobi. This is in line with previous studies undertaken by Gathongo and Ragui (2014), Omondi (1996), Titman and Wessel (1988) and Hovakimian et. (2004) who all agreed that asset tangibility influences capital structure. This is because this firms use their asset as collateral and borrow at low interest rate. The authors have also agreed that lenders find this firms attractive and have minimal chance of bankruptcy, similar to what the finding of the study establish. Therefore, there is unanimous agreement between the study and previous studies that asset tangibility is a significant factor that influence capital structure.

### 5.2.2 Firm size

The study shows that firm size significant influences capital structure. It is the second factor that highly influence capital structure after asset tangibility in the study. This is in agreement with studies that were done by Chikolwa and Bwembya (2019), Cortez and Susanto (2012), Rajan and Zingales (1995), Kurshev and Strebulaev (2015) which states that firm size is a determinant of capital structure. The authors further agree big firms install confidence in lenders because they

are more creditworthy, more diversified and have little chances of facing financial distress. Similarly bigger companies tend to have stable cash flow making percentage of default to be very low, this is as a result of large or medium firms being capable of taking more debt and having easy access to financial market.

### 5.2.3 Profitability

The finding from this study show that profitability is a significant influencer of capital structure. Though firms cannot rely on it alone it enables firms to access other sources funds easily. Salawu and Agboola (2008), Myers (2001) and Hughes (2013) agree with the finding of the study that profitability influences capital structure of real estate firms. The authors have also agreed with the study that profitable firms might not rely on retained earnings but use their profit to secure favorable debt since it is attractive to financial institutions. They also agreed that profitability reduces the gearing ratio of the firm.

### 5.2.4 Growth rate

It evident from the study that firm's growth rate is huge determiner of capital structure. Growth rate. Heshmat (2001), Al-Najjar and Taylor (2008) and Tongkong (2012) had a conclusion that is similar to the study. They agreed that because of the quick expansion, firms may rely on external financing in order to achieve their desire. The findings have similarly established high growth rate makes firm attractive and therefore secure both equity and debt finances easily.

The findings further show that the following factors, listed in order of their strength influence the capital structure of real estate firms: Asset tangibility, firm size, growth rate and profitability.

## 5.3 Conclusion

The study aimed at investigating the determinants of capital structure for real estate in Nairobi. Further the study investigated whether Asset tangibility, firm size, growth rate and profitability influenced the capital structure of real estate. Based on the descriptive statics used (especially mean) it is evident that the four factors greatly influence the capital structure. The study is in line with previous studies done by Ngugi and Afande (2015) which also came to a similar conclusion. Despite majority of the firms stating they rely on all sources of funds debt financing play critical role in the real estate in Nairobi. This is in line with Kraus and Lichtenberger (1973) trade off theory. The theory states that managers will opt for debt capital managers will use debt capital not only to finance their projects but also maximize their capital structure since interest from

debt is tax allowable also, the trade-off theory focuses on optimizing the value of firm which is the main goal of shareholders. Managers in a firm will adopt a portfolio that increase the value of the firm by first coming with the optimal debt equity ratio that has the maximum value.

The study will study will help investors particularly those who are new to Kenyan environment by enabling them to be well informed about determinant of capital structure. The study will also enable the government to develop both regulatory and operation guidelines for real estate to encourage rapid development of the sector by deeply looking at what influences their capital structure and coming up with favorable policies. The author is confident that the study will be a baseline for future studies as well as adding knowledge to the existing studies already conducted. Financial institution should also ensure that their policies are in line with the determinants of capital structure in real estate.

### 5.4 Limitation of the study

Like all the other studies, this study too has limitations. The first limitation is that the data is drawn from the members of Kenya Property Developers Association (KPDA). This may lead to result that give one side of the picture because Kenya has many real estate companies that are not under KPDA.

Most real estate firms were affected by covid 19 pandemic. The firms might display restructured capital structure which is meant for short time. This might affect the response of the firm.

### 5.6 Recommendation for further studies

The author recommends further studies to be undertaken in the field that uses another alternative method of analysis like regression to ensure that similar conclusion is reached. The study can use accounting data to establish relationship between capital structure and determining variables.

The author drew the data from only firms under the umbrella of KPDA which may lead to biasness. Further study that includes real estate firms not under the association is recommended.

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# Appendix

**TO BE FILLED BY MANAGERS AND HEAD OF FINANCE**

Dear Respondent: I am undergraduate student from Strathmore University conducting a study on determinants of Capital Structure for Real Estate Firms in Nairobi. It is purely academic and the information obtained shall not be used for any other purpose other than for its intended use and was treated with utmost confidentiality. Your assistance in this research shall be highly appreciated. Thanking you for your co-operation and invaluable contribution(s)

**Section A:**

**Part A: General Information**

**Please tick answers as applicable to you**

1. What is the major source of financing in real estate in Kenya?

Equity ☐ Debt ☐ Retained Earnings ☐ All ☐ other ☐

2. How many sectors do the real estate firm operate in? e.g, Commercial, Residential Property or both

One ☐ Two or more ☐

3 How long was the firm in operation?

less than a year ☐ 1-5 years ☐ 6-10 years ☐ over 10 years ☐

4 How many employees does the firm have?

10 ☐ 11-50 ☐ 50 and above ☐

**Section B**

**GUIDELINES TO THIS SECTION**:

**Please tick the appropriate answer using the following scale.**

1= Strongly Disagree 2= Disagree 3= Not sure 4= Agree 5= Strongly Agree: The following factors affect the choice of financing for your firm.

| | **Asset tangibility** | **5** | **4** | **3** | **2** | **1** |
|---|---|---|---|---|---|---|
| 1 | To what extend does asset tangibility contribute to firm capital structure | | | | | |
| 2 | The ease of getting funding using the firm assets | | | | | |
| 3 | Extended in which the firm assets are used as collateral | | | | | |
| 4 | The firm take advantage of its assets to get debt financing. | | | | | |

| | **Firm size** | **5** | **4** | **3** | **2** | **1** |
|---|---|---|---|---|---|---|
| 1 | Firm size greatly influences the capital structure of the firm. | | | | | |
| 2 | The size assists a firm to be stable and liquid | | | | | |
| 3 | The size assists the firm to borrow at low cost | | | | | |
| 4 | The size of the firm instill confidence in fund providers as it lowers rate of defaults | | | | | |

|  | **Profitability** | **5** | **4** | **3** | **2** | **1** |
|---|---|---|---|---|---|---|
| **1** | to what extended does the firm rely on their profit |  |  |  |  |  |
| 2 | Retained earnings and profit are enough to finance the firm projects and future investments |  |  |  |  |  |
| 3 | Retained earnings and profit have more advantage than all other sources |  |  |  |  |  |
| 4 | With the use of equity, the firm maximizes the weighted average cost of capital |  |  |  |  |  |
| 5 | Retained earnings lowers the gearing ratio |  |  |  |  |  |
|  | **Firm growth rate** | **5** | **4** | **3** | **2** | **1** |
| 1 | Firm growth rate greatly influences the capital structure of the firm. |  |  |  |  |  |
| 2 | Quick growing firms require external financing |  |  |  |  |  |
| 3 | High potential growth assists the firm to borrow at low cost |  |  |  |  |  |
| 4 | High growth opportunities can maximize the capital structure of a firm |  |  |  |  |  |

Suggest any other factor that affect the capital structure decisions

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Suggest other way real estate in which real estate sector in Nairobi is financed

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