

Effects of Cost of Capital on Firm Performance in Kenya

Scolar Nyamori Ochoki

Postgraduate Student, Department of Business Administration, Technical University of Mombasa.

Hermans Ochieng Oloo

Postgraduate Student, Department of Business Administration, Technical University of Mombasa.

Peter Mwadime Mwabaka

Postgraduate Student, Department of Business Administration, Technical University of Mombasa.

Charles Guandaru Kamau

Senior Lecturer, Department of Accounting and Finance, Technical University of Mombasa.

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Abstract:

This paper discusses the importance of the cost of capital and its impact on the performance of firms in Kenya. The cost of capital is affected by various factors such as interest rates, inflation, market conditions, and government policies. Financial managers use discounting cash flow techniques to evaluate capital investments, which requires the estimation of the project's cash flows and the discount rate. The article also explores the concept of capital structure and its significance in determining the cost of capital. Managers need to manage the capital structure effectively to optimize shareholder wealth and minimize the company's cost of capital. The article highlights the importance of balancing the mix of financing sources between debt and equity. High costs of capital can limit a firm's access to financing, while low costs of capital can improve a firm's investment and growth opportunities. This article concludes that the cost of capital is an essential factor that affects the performance of firms in Kenya. It impacts investment decisions, financial structure, and competitiveness in the market. Researchers suggest that managers should balance the use of debt and equity financing in an optimum manner to maximize shareholder wealth. However, the research suggests that high costs of capital can discourage firms from investing in new projects, reducing growth and profitability. Firms need to evaluate their cost of capital and consider strategies to lower it, such as improving creditworthiness or exploring alternative financing options.

Keywords: Cost of Capital, Capital Structure, Financial Performance

1. Introduction

The cost of capital is an important factor that affects the performance of firms in Kenya. The cost of capital refers to the total cost that a company incurs when raising funds from various sources such as debt, equity, or other financing options. In Kenya, the cost of capital can be affected by various factors such as interest rates, inflation, market conditions, and government policies. The cost of capital has a significant impact on a firm's performance, as it affects the company's ability to raise funds for investment, expansion, and other activities. High costs of capital can limit a firm's access to financing, which can impact its growth potential and profitability. Conversely, low costs of capital can improve a firm's access to financing, which can lead to increased investment and growth opportunities.

Financial managers use discounting cash flow techniques to evaluate capital investments. The discounting technique requires two inputs: the estimates of the project's cash flows and the discount rate. The opportunity cost of capital for a project is its discount rate. A firm's cost of capital will be the aggregate, or average, needed rate of return on the whole of the investment projects because a firm will have numerous projects. The needed rate of return on each investment project can be determined using the firm's cost of capital as a benchmark. The cost of capital for the company can then be changed either upwards or downwards to reflect the varying riskiness of the investment projects. A company might get the cost of capital from different places. The cost of capital from each source of capital varies due to the variances in risk and the contractual arrangements between the investors and the company. Component or specific cost of capital are terms used to describe the cost of capital from each source. The overall or average cost of capital is the total cost of all capital sources (Pandey, I M;, 2015).

Cost of capital goes hand in hand with capital structure. Capital structure is the mix of both short and long-term debt used by the business, combined with equity financing. Debt consists of any outstanding bond issues and other payables with a payment duration of one year or more. Equity consists of the retained earnings of a business together with the common and preferred shares of stock held as part of the company assets. Capital structure and its significance on the performance of businesses has been highly debated among finance researchers and scholars. Its importance arises from the fact that capital structure represents the relationship between management, debtholders and shareholders and their financing costs. It is from the capital structure that the cost of capital of a firm is derived. Managers should manage the capital structure to ensure that the mix of finance sources is done in a manner that optimizes shareholder's wealth and minimizes the companies cost of capital (Uremadu & Onyekachi, 2019).

2. Theoretical review of literature.

Many studies have been conducted to ascertain the impact of financial sources, their cost impacts, as well as the various variants of capital structure, on a company's worth or on its potential future earnings. Ibrahim et al. (2021) claim that the M&M theory, trade-off theory,

pecking order theory, agency cost theory, and conventional theory are the most pertinent theories to investigate the capital structure and cost of capital.

The relationship between financial leverage (capital structure), the cost of capital, and corporate value was originally investigated in a study by Modigliani and Miller. The purpose of this research was to prove that the market value of the company is unaffected by its capital structure and by changes in financial leverage. The study by Modigliani and Miller, which focused on American businesses, provided proof that capital structure has no positive impact on the cost of capital and has no bearing on a company's value or investment choices. Yet, it was discovered that the capital structure has an impact on financing choices that have an impact on a firm's value.

Miller and Modigliani theory illustrate that, a firm's value is unaffected by its capital structure under key assumptions that Capital market is perfect, there is free information to both insiders and outsiders, there are no transaction costs, bankruptcy cost and businesses are not taxed. In this theory equity and debt mix is irrelevant hence internal and external financing options can be substituted perfectly. The Modigliani and Miller theory opined that a firm's value should not be dependent on its capital structure but rather its performance should depend on the return on its investments and the risks of its operations.

Trade-off theory: This theory illustrates that there exists an optimal capital structure, it explains that firms target the optimal capital structure in the mix of their financing options. The theory suggests that debt capital gives rise to challenges of tax benefits and bankruptcy costs. Therefore, firms need to have a balance between equity and debt financing. This theory recommends that firms which have high growth potential should minimize the use of debt as they are likely to lose value in financial distress. Trade off theory identifies the existence of safe firms and risky firms. It defines safe firms to be firms which have more tangible assets and high taxable income to shield them from high debt ratios and risky firms to be firms with more intangible assets whose value will disappear in case of liquidation. Trade off theory suggests that risky firms should use more equity finance.

Pecking order theory: Pecking Order Theory argues that managers will act on the best interest of the existing shareholders. It identifies the existence of asymmetric information where one party has more information than other interested parties causing an imbalance in transactional power. According to this theory there is a preference in the order of choosing the source of capital financing. It argues that a firm will prefer exhausting the use of retained earnings before seeking finance outside the firm. It also states that a firm will prefer debt with lower risks before going to equity as a last resort. This is in agreement with the pecking order theory, considering private debt will need more detailed company information than public debt. When a firm goes for equity financing the equity investors will interpret the move that

managers of the firm consider it to be overvalued and hence place low value on the issuance of new equity.

Agency cost theory: This theory opines that firm manager (agents) conduct business on behalf of shareholders (principals). Agency costs arise due to the control activities of management. Shareholders expect management to accommodate their interest and maximize the shareholders wealth. However there arises a conflict of interest between shareholders, debtholders and management which give rise to agency costs. Agency costs are costs to justify that management acts in accordance with the contractual agreement of the firm management with the shareholders.

Traditional theory: This theory illustrates that there is an optimal capital structure. According to this theory, the firms value increases as it moves towards the optimum debt level, then it remains constant and then the value starts decreasing as the firm exceeds the optimum debt level. The traditional theory indicates that wealth is not only created through investments with a positive yield return on investment but using an optimal mix of debt and equity is equally significant.

3. Literature Review

Nwude & Anyalechi (2018) evaluated the impact of capital structure on organizational performance using a sample of 10 commercial banks in Nigeria selected between the years 2000 and 2013. The study found that the use of debt financing significantly and negatively influenced the Nigerian commercial banks' return on assets. On the other hand, the debt-to-equity ratio had a negative and negligible impact on the return on assets, whereas equity financing had a favorable and negligible impact. The results of the study's evaluation of a second model revealed that the influence of debt financing on return on equity is favorable and negligible, the impact of equity financing is negative and insignificant, and the impact of the debt-to-equity ratio is positive and significant. In conclusion, Nwude's study suggested that, up to the optimum capital structure, the degree of debt financing greatly influenced the effect that capital structures had on the organizational performance of commercial banks in Nigeria. High equity-to-debt ratios have a tendency to hurt the performance of the chosen banks under consideration. In order to improve the performance of banks in terms of return on equity, the study also recommended that the management of commercial banks make sure that the proper ratio of equity and debt financing is attained. It is important to involve current owners in the process of obtaining additional capital financing.

Omwanza (2018) carried out research on the effect of cost of capital on financial performance, focusing on the cost of capital and financial performance of commercial banks trading on the Nairobi Securities Exchange (NSE), using cost of debt and return on assets (ROA) as measures. At a 95% level of confidence, the results demonstrated a strong relationship among the various variables. The report recommended against the use of debt financing since it risked financial performance and encouraged using equity financing offered by the NSE instead.

Uremadu and Onyekachi (2019) focused on companies in the consumer products industry as they studied the effect of capital structure on corporate performance in Nigeria. According to the study, the ratio of long-term debt to total assets had a negative and negligible effect on asset returns. Based on the total debt-to-equity ratio, the return on assets was negatively and insignificantly impacted. The ratio of total debt to equity capital also had a detrimental but minor effect on returns on assets. According to the study, the capital structure, as measured by the long-term debt to total assets ratio and the total debt to equity capital ratio, had no bearing on a corporate firm's performance. As a result, business activities should be financed by retained earnings, with debt financing serving as a last resort. This is in accordance with the theory of the pecking order.

Ibrahim and Badara (2020) conducted a study on the empirical estimation of the moderating effect of the cost of capital on equity financing and the value of listed industrial goods corporations in Nigeria. The results showed a strong positive correlation between equity funding and the valuation of Nigerian listed industrial goods companies. According to the study, the cost of capital and equity financing were the main factors behind listed industrial product businesses' rising stock values. The study also advised managers to focus on investment costs and utilize more stock rather than debt when financing, as doing so sustainably increases the firm's worth.

While evaluating a firm's performance based on return on assets, Sakr and Bedear (2019) observed that the capital structure had a negative effect. But when return on equity is used as a proxy for business performance, capital structure has a favorable effect. Nonetheless, the study indicated that issues surrounding capital finance choices are contentious, necessitating more research – particularly in economies that are transitioning or developing, like Egypt. The study recommended further investigation into the effects of ownership structure, either independently or in conjunction with capital structure, as well as other control elements, such as firm size and growth prospects, that have an impact on both capital structure and business performance.

In a developing economy such as Jordan's, Alrjoub and Ahmad (2017) conducted research on the moderating impact of cost of capital on inventory types and firm value as a proxy for business performance. According to the study, the cost of capital influences the relationship between inventory management and company performance. Different kinds of inventory were affected differently by the cost of capital. The study further stated that because inventory has a substantial impact on firm performance and may incur costs if it is not managed optimally, businesses should take the impact of cost of capital into account when making decisions on inventory control. According to Chasha et al. (2022), the majority of the research that was examined clearly indicates that working capital management and performance are strongly correlated. Besides that, the cost of business financing, as well as its accessibility and availability, is a crucial component that stimulates sustainable value creation (Kamau, 2021). In another study conducted by Nina et al. (2020) capital structure has a negative and

significant effect on the company's financial performance. The findings of this study were in line with the agency theory on increase in debt leading to increase in agency costs through the increase of interest rate of debt from creditors.

Abdulkareem and Ahmed, (2020) suggested that leverage and cost of capital make very important variables investors consider when deciding whether to invest in pharmaceutical companies.

According to a study by Ganiyu et al. (2019), a firm's capital structure can affect its performance in both good and bad ways. According to the study, whether debt is utilized to resolve conflicts of interest between shareholders and managers, between debt holders and shareholders, as well as between shareholders and debt holders, depends on the structure of the company and its financial situation. According to the findings of this study, the use of debt may cause majority shareholders to constantly monitor company operations to ensure that they are successful in reducing debt and maximizing shareholder wealth.

4. Conclusion

The research on how capital structure affects a firm's performance has yielded a variety of contradictory findings. While some researchers discovered a favorable and significant link between finance decisions and performance, others found a negative and minor impact. Several factors, such as the sort of variables a study focused on, the sample size, the industry of the companies under evaluation, the time period covered by the study, the nation where the study was conducted, and the study methodology employed, could be to blame for this. Many researchers agree that cost of capital has an effect on the value and performance of a firm. They recommend the use of retained earnings before going to external financing in financing investments with positive returns. These researchers further suggest that managers should balance the use of debt and equity financing in an optimum manner to maximize the shareholders wealth.

One way in which the cost of capital affects firm performance in Kenya is through its impact on investment decisions. High costs of capital can discourage firms from investing in new projects or expanding their operations, as the expected returns may not be sufficient to justify the cost of capital. This can lead to reduced growth and profitability for the firm. In addition, the cost of capital can also impact a firm's financial structure and capital allocation decisions. Firms that face high costs of capital may opt for more debt financing to lower their overall cost of capital, but this can increase their financial risk and reduce their creditworthiness. Conversely, firms that have low costs of capital may prefer equity financing, which can dilute ownership but provide greater flexibility in terms of capital structure and growth opportunities.

Moreover, the cost of capital can also affect a firm's competitiveness in the market. Firms that have lower costs of capital may have a competitive advantage over their peers, as they can offer more attractive financing options and potentially lower prices to customers. This can lead to increased market share and profitability. Overall, the cost of capital is a crucial factor

that affects the performance of firms in Kenya. It can impact a firm's investment decisions, financial structure, and competitiveness in the market. Therefore, firms need to carefully evaluate their cost of capital and consider strategies to lower it, such as improving their creditworthiness, negotiating better terms with lenders, or exploring alternative financing options.

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