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The Strategic JOURNAL of Business & Change MANAGEMENT
ISSN: 2312-9492 www.strategicjournals.com

Vol. 5, Iss. 4, pp 2124 - 2132, November 29, 2018. www.strategicjournals.com, ©Strategic Journals

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Accepted: November 27, 2018

ABSTRACT

Kenya's real estate market is well diversified in terms of income, geography and types. In terms of income, there is a clear segmentation of high, medium and low incomes. Real estate companies in Kenya have not adopted a pecking order hierarchy of financing. The main objective of the research was to establish the influence of the hierarchy on real estate performance in Nairobi County. The specific objectives of the study was to evaluate the influence of internal funds on performance of real estate industry in Nairobi County, to determine the influence of debt on performance of real estate industry in Nairobi County and to assess the effects of new equity on performance of real estate industry in Nairobi county. The study applied a descriptive research design and the target population was 69 companies. The study found that internal funds don't have significant effect on performance of real estate industry in Nairobi County since the p-value of the t-test for this variable was 0.719. Debt does not have a significant effect on performance of real estate industry in Nairobi County as evidenced by the p-value of the t-statistic for the variable financial services were 0. 253. New equity has a significant effect on performance of real estate industry in Nairobi County as evidenced by the p-value 0.000 of the t-statistic which was below 0.05. The study concluded that real estate firms have not embraced pecking order hierarchy as an alternative method of financing which affects their performance. The study concluded that real estate firms in Kenya have low retention ratio which makes it difficult for them to grow their businesses. The study recommended that real estate firms in Kenya should encourage the investors in the company to forego their dividends so as to increase the retention ratio. Real estate companies should also increase their dividends as their profits increase to increase investor motivation and prevent potentials from leaving the company. To increase use of equity and venture capital as a source of financing requires real estate firms to sell their ideas to people who have money to invest.

Key Words: *Pecking Order, Debt, New Equity, Internal Funds*

CITATION: Kilonzi, F., Ibrahim, T., & Kanai, C. (2018) Influence of pecking order hierarchy on performance of real estate sector in Nairobi County, Kenya. *The Strategic Journal of Business & Change Management,* 5(4), 2124 - 2132.

INTRODUCTION

In corporate financing, the pecking model hypothesizes that financing cost increases with unbalanced data. Financing originates from three sources, funding internally, debts and new equities (Bhaird, 2013). Organizations organize their financing sources, first favouring inward financing, and after that obligation, finally raising value "if all else fails". Thus, inner financing is utilized first; when that is drained, at that point obligation is issued; and when it is never again sensible to issue any more debt obligations, value is issued. This hypothesis keeps up that organizations stick to a chain of importance of financing sources and lean toward inner financing when accessible, and obligation is favored over value if outer financing is required. Therefore, the type of obligation a firm picks can go about as a flag of its requirement for external financing (Chakraborty, 2010).

Hierarchical order theory explains the inverse relationship between profitability and debt indices: companies prefer internal financing. They adapt their target dividend payment ratios to their investment opportunities, while trying to avoid sudden changes in dividends. rigid dividend policies, the most unpredictable fluctuations in profits and investment opportunities means that internally generated cash flow is sometimes more than the cost of capital and sometimes less (Vanacker & Manigart, 2010).

Haron & Ibrahim (2012) found that large companies that have access to capital markets do not follow hierarchy when they choose the type of security to offer. They concluded that equity is not the least desirable source of funding, as the theory of hierarchical order suggests. Gharaibeh (2015) has illustrated that societies in the Chinese economy do not follow the old theory of hierarchical order, but in fact follow the modified theory of the hierarchical order, which proposes that companies use retained profits, equity and therefore debt term.

Statement of the Problem

The pecking order theory provides a hierarchical order of how firms should finance their operations. According to Gharaibeh (2015), a company should start with internal financing, if external finance is required, firms should issue debt first and equity as a last resort. Moreover, the pecking order seems to explain why profitable firms have low debt ratios. This happens not because they have low target debt ratios, but because they do not need to obtain external financing.

Studies on pecking order theory have not been conclusive. While Vanacker and Manigart (2010) argues that firms should finance their operations by use of internal funds before going to debt, Modigliani & Miller (1961) argues that debt financing is cheaper and therefore firms should constitute debt capital in their structure. These studies are opposing thereby leaving researchers in a dilemma.

Kayo and Limura (2010) conducted a study on the existence of Real Estate Investment Trusts (REITS) by institutional investors in the Nairobi Securities Exchange. Wahome *et al.* (2015) conducted a study to establish the effects of mortgage financing on the performance of companies. Tarus *et al.* (2014) studied the effect of capital structure on performance in the financial perspectives of commercial companies and services listed on the NSE. These studies have failed to explain the influence of pecking order hierarchy on performance of real estate sector. This study therefore aims to determine the influence of pecking order hierarchy on performance of real estate sector in Nairobi County**,** Kenya.

Objectives

The study sought to investigate the influence of pecking order hierarchy on performance of real estate sector in Nairobi County. The specific objectives were:-

- To evaluate the influence of internal funds on performance of real estate industry in Nairobi county
- To determine the influence of debt on performance of real estate industry in Nairobi county
- To assess the effects of new equity on performance of real estate industry in Nairobi county

Hypotheses

- H_{01} Internal funds do not have significant effect on performance of real estate industry in Nairobi County
- H_{02} Debt does not have a significant effect on performance of real estate industry in Nairobi County
- H_{03} New equity does not have a significant effect on performance of real estate industry in Nairobi County

LITERATURE REVIEW

The study reviewed key theories as well as empirical literature as documented hereunder.

Theoretical Review

The study was anchored on 3 theories which are highlighted here under.

Pecking Order Theory- The flagship order theory was first suggested by Donaldson (1961) and modified by Stewart and Myers in 1984. It establishes that companies prioritize their sources of funding (from internal equity financing) to compliance with the cost of financing, preferring to increase equity as a means of financing of last resort (Myers & Majluf, 1984). The pecking order theory begins with asymmetric information, as managers in the real estate industry know better the prospects, risks and value of their company than external investors. Asymmetric information affects the choice between internal and external financing in the real estate industry and the issuance of debt or capital (Yabs, 2014).

Trade-off Theory-the classic version of the hypothesis dates back to Kraus and Litzenberger (1973) who considered a balance between the costs of tandem bankruptcy and the benefits of tax savings in debt. Often, agency costs are also included in the budget. This theory is often established as a theory of competition with respect to the hierarchical theory of the structure of capital. San and Heng (2011) provide a review of the literature. The tradeoff theory assumes that there are benefits to leverage within a capital structure up until the optimal capital structure is reached. The theory recognizes the tax benefit from interest payments. Studies suggest, however, that most companies have less leverage than this theory would suggest is optimal.

Modigliani and Miller Theorem-Modigliani and Miller (1958) proposed that there isn't any existence of an optimal capital structure, hence the firm's capital structure is not relevant or has no influence on the firm's value. However, Modigliani and Miller (1963) amended their earlier model on capital structure irrelevance theory. The amendment according to Watson and Head (2010) was done in relation to the existence of corporate tax and the tax deductibility of interest payment which they acknowledged. Based on this assertion, firms could replace equity with debt. However, Brigham & Gapenski (1996) disagreed with the MM model since it does not hold in practice because of the existence of bankruptcy costs which was increase as a result of tradeoff between equity and debt.

EMPIRICAL REVIEW

Kamau (2011) conducted a study on the factors influencing investment in real estate in Nairobi. The research project used by the study was a descriptive research focused on all the authorized real estate companies located in Nairobi. The researcher used questionnaires to collect data and analyze those using SPSS. The results of the study indicated that all real estate investment companies are working to reduce the housing deficit in the city of Nairobi, which currently stands at 410 units per day, the study also concluded that although the deregulation of this sector is a necessary condition for The reactivation of a healthy real estate investment sector, deregulation cannot in itself guarantee that a complete range of housing for real estate investments is provided.

The San and Heng (2011) sought to assess the effects of real estate financing on the financial performance of listed commercial banks in Kenya. The main result of the study was that mortgage financing had a strong negative effect on the financial performance of commercial banks in Kenya, a huge growth in the recent past to be ranked as the fourth most important contribution to the economy Furthermore, the liquidity and cost of operations had a strong impact on the financial results of commercial banks. The study concludes that land finance affects the money performance of business banks in Kenya.

Newing (2011) conducted a study on the relationship between debt financing and the market value of about 272 Chinese real estate companies, all from the Shanghai Stock Exchange and the Shenzhen Stock Exchange between 2002 and 2007. We conducted an empirical study, the empirical results show that the list Debt / debt ratio of the real estate financing of our country relatively large percentage of total assets, on average 55%. And in general, improving the overall debt financing rate can improve the company's market value. As a result of further studies, we believe that long-term debt and commercial credit financing have a positive correlation with the market value of the company, however, the short-term debt and the market value of the company have had a negative correlation.

San and Heng (2011) studied the factors affecting real estate private equity fund performance through the lens of three factors: own effects, rival effects and market effects. The findings and implications from the above analysis was be examined and opined upon. This field is particularly interesting because relatively little research has been done on the real estate private equity landscape, given the limited data that is publically available. The majority of research has been focused on public real estate equities, as it composes a larger portion of the overall economy and is accessible to both professional and retail investors.

Tongkong (2012) studied a disappearing effect in the positive relationship between financial development through capital financing and real estate development. They show that this relationship is positive and significant for 1960-89, but is not statistically different from zero for 1990-2004. They find evidence that this loss effect is associated with the incidence of financial crises. His study showed a positive impact of capital financing on the growth of real estate development.

METHODOLOGY

The research design adopted was a descriptive survey design. This ensured collections and descriptive analysis of data from the population of study. The population of this study was 69 Real estate companies who had been members of Kenya Property Developers Association (KPDA) from the year 2012 to the year 2015. A census study was used. The study sample consisted of real estate companies in Nairobi County, registered by the Kenyan Property Developers' Association (KPDA). This meant that a census was used to include the 69 real estate companies. Conducting a census leads to a sufficient number of respondents to have a high degree of statistical confidence in the results of the survey (Gharaibeh, 2015). Data collection through the census method offers the opportunity for the researcher to have an in-depth study of a problem study of a problem. The researcher collected a lot of knowledge through this method. This method was also applicable for units that presented heterogeneity or differences.

Secondary data was utilized in this study. This means that all the study variables utilized quantitative data. Data for real estate development was secondary data which was sourced from the real estate company’s published financial reports. This included internal funds, debt and new equity in the span of five years (2012- 2017). Data for the independent variables was gathered from the banks’ annual report. To compile the data, a secondary data collection template was used.

RESULTS AND FINDINGS

The section presents results and makes interpretations of the same besides a discussion.

Descriptive Analysis

Internal funds had a higher mean of (M=0. 5310, SD=0.18771). This shows that internal funds have significant effect on performance of real estate firms in Kenya. The findings disagrees with Oztekin and Flannery (2012) who conducted a study to establish the sources of financing real estate in Kenya and argued that mortgage financing is the most used source of financing, with equity and venture capital being the least source of financing used. The findings conjointly indicated that there's a considerably positive relationship between mortgage finance and assets development.

Debt had a higher mean of (M=0. 4622, SD=0. 29636). This shows that debt has significance effect on performance of real estate firms in Kenya. The study findings agrees with Newing (2011) who conducted an empirical study and argued that the list Debt / debt ratio of the real estate financing of a country relatively large percentage of total assets, on average 55%. And in general, improving the overall debt financing rate can improve the company's market value. As a result of further studies, we believe that long-term debt and commercial credit financing have a positive correlation with the market value of the company, however, the short-term debt and the market value of the company have had a negative correlation.

Debt had a higher mean of (M=0.5622, SD=0.21278). This shows that debt has significance effect on performance of real estate firms in Kenya. The study findings agree with Aduda (2011) who conducted a study on the effects of flight and found a fundamental relationship between equity financing and real estate development. He found that due to the fact that standard models do not allow a non-monotonous relationship between financial development and the real estate sector.

Inferential Analysis

The section presents results and findings on Pearson’s Correlation Analysis and Multiple Regression Analysis. In view of correlation analysis, there was a negative relationship between internal funds and performance of real estate firms in Kenya. The relationship is significant ($r = -0.181, p<0.01$) thus internal funds has no effect on performance of real estate sector. There was a positive but weak relationship between debt and performance of real estate sector. The relationship was significant at ($r = 0.089$, $p> 0.05$), thus debt has influence on performance of real estate sector. There was a strong positive relationship between new equity and performance of real estate sector. The relationship was significant at ($r = 0.501$, $p>0.05$), thus new equity greatly influenced performance of real estate sector. The correlation coefficients are significant with p-values only re-organization was found to have a p-value of more than 0.05.

Discussion

The p-value of the t-test for this variable is 0.719. Since the p-value 0.719 is above 0.05, the null hypothesis is accepted. Hence, the study finds that the study finds that internal funds don't have significant effect on performance of real estate industry in Nairobi County. The study findings disagree with Kamau (2011) who conducted a study on the factors influencing investment in real estate in Nairobi. He argued that real estate investment companies are working to reduce the housing deficit in the city of Nairobi, which currently stands at 410 units per day, the study also concluded that although the deregulation of this sector is a necessary condition for The reactivation of a healthy real estate investment sector, deregulation cannot in itself guarantee that a complete range of housing for real estate investments is provided.

The p-value of the t-statistic for the variable financial services is 0. 253. Since the p-value 0. 253 are above than 0.05, the null hypothesis is accepted and the alternative hypothesis rejected. This means that debt has influence on performance of real estate sector. The study findings disagrees with Newing (2011) who conducted an empirical study and argued that the list Debt / debt ratio of the real estate financing of a country relatively large percentage of total assets, on average 55%. And in general, improving the overall debt financing rate can improve the company's market value. As a result of further studies, we believe that long-term debt and commercial credit financing have a positive correlation with the market value of the company, however, the short-term debt and the market value of the company have had a negative correlation. The study findings agree with Sekaran (2011) who argued that debt financing causes the company to invest first in the case of pure capital financing. Furthermore, the incentive to anticipate investment decisions increases with the amount of the debt.

The p-value 0.000 of the t-statistic is below 0.05 implying that the null hypothesis H_{03} is rejected and alternative hypothesis is accepted. Hence, new equity has a significant effect on performance of real estate industry in Nairobi County. The study findings agree with Tongkong (2012) who studied a disappearing effect in the positive relationship between financial development through capital financing and real estate development. They show that this relationship is positive and significant for 1960-89, but is not statistically different from zero for 1990-2004. They find evidence that this loss effect is associated with the incidence of financial crises. His study showed a positive impact of capital financing on the growth of real estate development.

CONCLUSIONS

From the findings, the study concluded that real estate firms had not embraced pecking order hierarchy as an alternative method of financing which affects their performance. According to the findings, real estate firms had not been using internal sources of financing since they had not been registering huge profits. Real estate firms in Kenya had low retention ratio which made it difficult for them to grow their businesses. Investors in real estate firms were not willing to forego dividends which hampered growth.

The findings showed that real estate firms had been using debts as way of financing their operations. Real estate firms in Kenya mostly used short term debts to finance their operations. Real estate firms needed to use internal funds before using debt. The short-term debt and the market value of the real estate firms have a negative correlation to the performance. Majority of real estate firms in Kenya had a higher percentages of debt ratio as compared to assets which makes it difficult for investors to invest in real estate companies.

The findings showed a positive relationship between new equity and performance of real estate firms in

Kenya. Real estate firms needed to use internal funds, debt before using equity. It was evident that real estate firms had been using new equity to finance their operations without following pecking order hierarchy. Real estate firms had been using proportion of equity from the balance sheet to finance their operations. Real estate firms had low equity ratio which was good for return on assets.

POLICY RECOMMENDATIONS

Management of Real estate firms in Kenya should come up with policies to implement pecking order hierarchy to finance their operations. Real estate firms in Kenya should increase their products in the market which should lead to increased profits. Real estate companies should seek investors who will enable them to increase retention ratio. Real estate firms in Kenya should encourage the investors in the company to forego their dividends so as to increase the retention ratio. Financial institutions should adopt policies that finances real estate firms that follow pecking order hierarchy.

Managers of real estate companies should come up with policies aimed at increasing more products with embedded long-term financing. The study also recommends that owners of real investment companies should forgo some of their property rights over potential investors to invest. Like when an investor puts his money into an investment, there is hard work on his part to generate more profits which then increases his dividends. Real estate companies should adopt policies that increase their dividends as their profits increase to increase investor motivation and prevent potentials from leaving the company.

The government should come up with policies aimed at increasing investment in the real estate industry. The investors in real estate industry should also be encouraged to use equity financing since it is cheap in the long run because there is no interest charge. To increase use of equity and venture capital as a source of financing requires real estate firms to sell their ideas to people who have money to invest. Careful planning can help convince potential investors that the real estate firms are competent and that there is a high potential in growth in the future.

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