



INFLUENCE OF CAPITAL STRUCTURE ON FINANCIAL PERFORMANCE OF LICENSED MICROFINANCE BANKS IN KENYA

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ABSTRACT

Capital structure is deemed to have an impact on a firm's performance against the position held by Modigliani and Miller in their seminal work of 1958 when they stated that capital structure is irrelevant in investment decisions. The study was guided by the following specific objectives: To determine the effect of debt capital, equity capital and retained earnings on financial performance of licensed microfinance banks in Kenya. This study utilized descriptive research design. Empirical research method was used. It used panel data of five years due to the advantage that it had. It helped to study the behavior of each licensed microfinance bank over time and across space. In this study, the population consisted of all the licensed microfinance bank registered by the Central Bank of Kenya. According to the central bank of Kenya, there were 13 licensed microfinance banks in Kenya. The results revealed that the firm utilized trade credits to finance our microfinance banks. Further the findings indicated that, the licensed microfinance banks considered the use of asset based lenders to ensure consistency in capital flow. Similarly, the findings also indicated that the firm considered the financing through commercial finance companies as a means of raising their capital. The study recommended that the licensed microfinance banks should utilize trade credits to finance their microfinance banks. Also, the licensed microfinance banks to consider the use of asset based lenders to ensure consistency in capital flow. Overall the study revealed through statistical analysis that while equity has highest influence on profitability, retaining profits has a moderate influence while debt financing has least influence. This means MFBs should take debt financing with caution but should always encourage equity financing and retainance of profits when they intend to inject more capital into their business. Applying the findings could be of benefit to managers and shareholders of MFBs as well as to researchers and students interested in this area of study.

Key Words: Debt Capital, Equity Capital, Retained Earnings, Financial Performance

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INTRODUCTION

The concept of capital structure has been one of the most puzzling issues in corporate finance literature which has attracted much attention from the financial scholars for many years. According to Alexandru, Genu and Romanescu (2008) capital structure is the manner in which a firm funds its investments by the use of a mixture of debt and equity. Capital structure choice has been and will continue to be a very vital management decision of firms. Hence the managers need to pay much attention on the optimal capital structure failure to which, firms may not be able to economically use the available resources. The financial performance of any firm is directly influenced by the capital structure decisions thus making it a vital managerial decision. This section provides the break down in the context of global, regional and local perspectives to the area of study.

The MFI industry encompasses thousands of entities worldwide and has become the main context for policy discussion and research on microfinance (Diamond & Raghuram., 2011) especially with regard to providing growth opportunities. In Sri Lanka, growth opportunities for firms is positively linked to their financial leverage (Ebaid , 2016), which corroborates Mand, Sharma and Mathur (2012) and Goldstein, Nengjiu and Hayne (2009) .Capital structure including debt ratio of firms listed in Iran Securities market is a matter of importance too when it comes to growth (Goldstein Nengjiu and Hayne, 2009).

In Nigeria, firm size is a factor vital their financial performance. Big firms are likely to perform better though asset tangibility in most listed firms leads to lower Return on Assets (ROA) contrary to theoretical expectations (Olayinka, 2011) which means companies with higher asset tangibility ratio have lower financial performance ratio (ROA and ROE). Ooi (2014) posits a that higher asset base has positive influence on financial performance (ROA) of manufacturing firms in Nigeria. In Ghana there is positive but weak correlation of firm liquidity and

financial performance of the banks listed in Ghana Stock Exchange Abor (2015).

In Kenyan listed firmss profitability is weakly but positively linked to retained earnings, while there is weak negative relationship between retained earnings with growth opportunities and company size (Wanjama, 2015). Ongore (2011) argues that debt and retained earnings are significant in predicting financial performance in commercial banks. According to Kalui (2017) non-debt tax shields, information asymmetries, and local capital market's infrastructure are relevant to firms financing behavior within the cotext of the pecking order theory. According to him, the deficit in internal financing can be used to identify the financing gap in internal finances that may trigger to use debt. Kenya still faces major challenges with efficiently and effectively delivering microfinance services in the country. The issues that need attention include maintaining status quo, the government regulation of all MFIs and voluntarily closing of the microfinance gap in the supply of microfinance services (Matu , 2018).

Financial performance of commercial banks can be measured through variety of ratios of which Return on Asset, Return on Equity and Net Interest Margin are the major ones (Murthy, 2014). Return on Equity (ROE) is a financial ratio that refers to how much profit a company earned compared to the total amount of shareholder equity invested or found on the balance sheet. ROE is what the shareholders look in return for their investment. A business that has a high return on equity is more likely to be one that is capable of generating cash internally.

Thus, the higher the ROE the better the company is in terms of profit generation. It is further explained by Khrawish (2011) that ROE is the ratio of Net Income after Taxes divided by Total Equity Capital. It represents the rate of return earned on the funds invested in the bank by its stockholders. ROE reflects how effectively a bank management is using shareholders' funds. Thus, it can be deduced from the above statement that the better the ROE the

more effective the management in utilizing the shareholders capital. Return on Asset, (ROA) is also another major ratio that indicates the profitability of a bank. It is a ratio of Income to its total asset (Khrawish, 2011).

It measures the ability of the bank management to generate income by utilizing company assets at their disposal. In other words, it shows how efficiently the resources of the company are used to generate the income. It further indicates the efficiency of the management of a company in generating net income from all the resources of the institution (Khrawish, 2011). Wen (2010) state that a higher ROA shows that the company is more efficient in using its resources. Net Interest Margin is a measure of the difference between the interest income generated by banks and the amount of interest paid out to their lenders (for example, deposits), relative to the amount of their assets. It is usually expressed as a percentage of what the financial institution earns on loans in a specific time period and other assets minus the interest paid on borrowed funds divided by the average amount of the assets on which it earned income in that time period (the average earning assets).

Key providers of microfinance services fall under three broad categories: formal, semi-formal and informal banks. The level of formality is defined by the degree of regulation and supervision. Under the formal category are commercial banks, non-bank financial banks, building societies and post office savings Bank. The semi-formal category includes savings and credit co-operatives (SACCOs) and microfinance entities, while accumulating and rotating savings and credit associations (ROSCAs) and money-lenders (shylocks) dominate the informal category. Microfinance entities offering financial services and products to low income households are over one hundred. They include; trusts, companies, non-governmental organizations (NGOs), societies and co-operative societies. The informal microfinance practitioners account for less than 20% of Kenya's microfinance business. Microfinance entities offering financial services and

products to low income households are over one hundred. They include; trusts, companies, non-governmental organizations (NGOs), societies and co-operative societies. The informal microfinance practitioners account for less than 20% of Kenya's microfinance business. As at December 2017, there were thirteen licensed Microfinance Banks, eleven had nationwide microfinance bank licenses while two had community microfinance bank licenses. In 2017, CBK approved the conversion of U & I Microfinance Bank from community microfinance bank to nationwide microfinance bank.

Statement of the Problem

Microfinance banks (MFBs) have risen to the forefront as invaluable lending financial institutions in the national development process, thereby playing a crucial financial intermediation role in many economies the world over. However, capital constraints have hindered the expansion of microfinance programmes which means microfinance organizations have had various degrees of sustainability. Indicatively, a Central bank report shows that Kenya's Microfinance banks registered a modest decline in growth in the year 2017 with a modest 7 percent reduction in total assets from Ksh.72.5 billion in December 2016 to Ksh.67.6 billion in December 2017. This was contrary to the trend observed in year 2016 and 2015 where total assets grew by 5 percent and 22 percent respectively. Furthermore, while lending remained the most significant activity undertaken by the MFBs, customer deposits declined by 3 percent from Ksh.40.2 billion in December 2016 to Ksh.38.9 billion in December 2017. During the year under review, customer deposits accounted for 57 percent of the microfinance banks total funding sources compared to 55 percent in 2016 meaning there was a marginal increase. Borrowing as a source of funding decreased marginally accounting to 20 percent compared to 23 percent in 2016 (CBK, 2018). Understanding MFB's capital structure is important since an optimal capital structure is a requisite for the optimal performance and subsequent sustainability of MFBs. A firm's capital

structure is a mix of debt and equity which a firm deems appropriate to enhance its operations. The question of how best a firm should finance itself is critical. Studies on the impact of capital structure on a firm's performance have been few and in most cases in developed economies. There is a missing link on how debt capital, equity capital, and retained earnings affect the financial performance of licensed MFBs in Kenya. It is in this vacuum that this study was carried out in Kenya, a developing economy. It was an examination into the capital structure of licensed MFBs in Kenya and an exploration on how changes in capital structure could affect their financial performance. The best mix of debt and equity should ensure solvency and self-sufficiency (Bogan, 2012) of MFBs, a key issue and a puzzle that this research addressed.

Research Objectives

The general objective of this study was to establish the influence of capital structure on financial performance of licensed microfinance banks in Kenya. specific objective were:-

- To determine the effect of debt capital on financial performance of licensed microfinancebanks in Kenya.
- To assess the effect of equity capital on financial performance of licensed microfinance banks in Kenya.
- To assess the effect of retained earnings on financial performance of licensed microfinance banks in Kenya.

Research Hypothesis

H₀₁: Debt capital has no significant influence on financial performance of licensed microfinance banks in Kenya

H₀₂: Equity capital has no significant influence on financial performance of licensed microfinance banks in Kenya

H₀₃: Retained earnings has no significant influence on financial performance of licensed microfinance banks in Kenya

LITERATURE REVIEW

Theoretical Review

Franco Modigliani and Merton Miller Theorem

In 1958, the two financial researchers developed Modigliani and Miller contributed widely to capital structure by Proposition I Theorem that showed that under certain restrictive assumptions the value of the firm is unaffected by the debt. Later they developed Proposition II that relaxed the assumptions under Proposition I and further considered corporate taxes. In 1977 Miller advanced the two propositions and developed a model that recognized personal taxes.

Proposition I also known as net operating income, they argued that the capital structure is irrelevant in determining the value of the firm. Capital structure decisions do not affect the value of the firm since firm value is independent of its leverage there is no advantage of using debt since there are no corporate taxes, the weighted average cost of capital of a levered firm and unlevered firm is independent of the capital structure, the cost of equity increases as the gearing increases and the cost of debt remain unchanged as level of gearing increases hence irrelevance of capital structure decision on the value of the firm. Under restrictive assumptions of a perfect market, tax free economy, no transaction costs and homogeneous expectation of investors, capital structure is irrelevant in determining the firm value.

According to Modigliani and Miller if the assumptions do not hold, the arbitrage process shall take place where investors take advantage of the market imperfections and opt to sell the shares in the overvalued firms and buy the shares in the undervalued firms resulting to arbitrage gain realized. They supported their argument that capital structure is irrelevant in determining the value of the firm by applying the arbitrage process to two companies identical in every As investors take advantage of arbitrage opportunities, the market will reach equilibrium when the prices of overvalued shares fall and the undervalued shares rise (Wokabi & Aloy, 2015).

The Trade-Off Theory

The term trade-off theory is used by different authors to describe a family of related theories. In all of these theories, a decision maker running a firm evaluates the various costs and benefits of alternative leverage plans. Often it is assumed that an interior solution is obtained so that marginal costs and marginal benefits are balanced. The original version of the trade-off theory grew out of the debate over the Modigliani- Miller theorem.

When corporate income tax was added to the original irrelevance, this created a benefit for debt in that it served to shield earnings from taxes. Since the firm's objective function is linear, and there is no offsetting cost of debt, this implied 100% debt financing. There are several aspects of Myers' definition of the trade-off merit discussion, (Myers, 2010). First, the target is not directly observable. It may be imputed from evidence, but that depends on adding a structure. Different papers add that structure in different ways. Second, the tax code is much more complex than that assumed by the theory. Depending on which features of the tax code are included, different conclusions regarding the target can be reached. Graham (2001) provides a useful review of the literature on the tax effects.

Static Trade-off Theory

Theories suggest that there is an optimal capital structure that maximizes the value of the firm in balancing the costs and benefits of an additional unit of debt, are characterized as models of tradeoff (Ghazouani, 2013)

The static trade-off theory affirms that firms have optimal capital structures, which they determine by trading off the costs against the benefits of the use of debt and equity. One of the benefits of the use of debt is the advantage of a debt tax shield. One of the disadvantages of debt is the cost of potential financial distress, especially when the firm relies on too much debt. Already, this leads to a trade-off between the tax benefit and the disadvantage of higher risk of financial distress. But there are more cost and benefits involved with the use of debt and equity.

One other major cost factor consists of agency costs. Agency costs are internal costs incurred from asymmetric information or conflicts of interest between principals and agents in an organization.

In a corporation, the principals would be the shareholders and the agents would be the managers. The shareholders want the managers to run the company in a way that maximizes shareholder value. The managers, on the other hand, may want to run the company in a way that maximizes the managers' own personal power or wealth, even if it lowers the market value of the company. These divergent interests can result in agency costs. There are three common types of agency costs: monitoring, bonding, and residual loss. (Wilkinson, , 2013).

The Dynamic Trade-off Theory

Constructing models that recognize the role of time requires specifying a number of aspects that are typically ignored in a single-period model. Of particular importance are the roles of expectations and adjustment costs. In a dynamic model, the correct financing decision typically depends on the financing margin that the firm anticipates in the next period. Some firms expect to pay out funds in the next period, while others expect to raise funds. If funds are to be raised, they may take the form of debt or equity.

Dynamic trade-off models can also be used to consider the option values embedded in deferring leverage decisions to the next period. Goldstein et al. (2013) observe that a firm with low leverage today has the subsequent option to increase leverage. Under their assumptions, the option to increase leverage in the future serves to reduce the otherwise optimal level of leverage today.

If firms optimally finance only periodically because of transaction costs, then the debt ratios of most firms will deviate from the optimum most of the time. In the model, the firm's leverage responds less to short-run equity fluctuations and more to long-run value changes. Certain ideas are fairly general in dynamic models (Popescu & Visinescu,

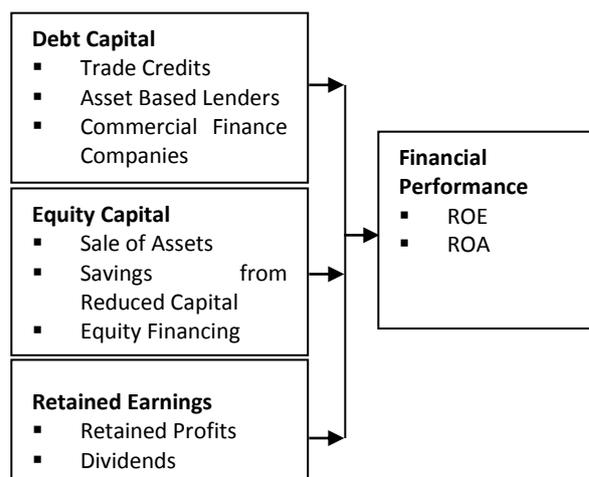
2009). The optimal financial choice today depends on what is expected to be optimal in the next period. In the next period, it may be optimal to raise funds or to pay them out. If raising new funds, it might be optimal to raise them in the form of debt or in the form of equity. In each case, what is expected to be optimal in the next period will help to pin down the relevant comparison for the firm in the current period.

The Pecking Order Theory

Pecking order theory is a theory related to capital structure. It was initially suggested by Donaldson. Myers and Majluf (1984) modified the theory and made it popular. According to this theory, managers follow a hierarchy to choose sources of finance (Barclay & Smith, 2017). The hierarchy gives first preference to internal financing. If internal financing is not enough, then managers would have to shift to external sources. They will issue debt to generate funds. After a point when it is no longer practical to issue more debt, equity is issued as a last option (Borad, 2018)

In Myers and Majluf model outside investors rationally discount the firm's stock price when managers issue equity instead of riskless debt. To avoid this discount, managers avoid equity whenever possible. The Myers and Majluf model predicts that managers will follow a pecking order, using up internal funds first, then using up risky debt, and finally resorting to equity. In the absence of investment opportunities, firms retain profits and build up financial slack to avoid having to raise external finance in the future. The pecking order theory regards the market-to-book ratio as a measure of investment opportunities. With this interpretation in mind, Fama and French (2014) note that a contemporaneous relationship between the market-to-book ratio and capital structure is difficult to reconcile with the static pecking order model. Iteration of the static version also suggests that periods of high investment opportunities will tend to push leverage higher toward a debt capacity.

Conceptual Framework



Independent Variables **Dependent Variable**

Figure 1: Conceptual Framework

Source: Author (2019)

Empirical Review

Globally, Alti (2013) conducted a research to establish the impact capital structure would have on the financial performance of firms listed in the Tehran Stock Exchange. The study used a sample of 400 listed firms in the Tehran Stock Exchange from 12 industrial groups for the period 2006 to 2010. They measured financial performance of the listed firms using return on ROE and ROA. Their study revealed that there was a positive and significant correlation between asset tangibility, firm size, and growth opportunities with the measures of financial performance. Firm size revealed a positive and significant correlation with ROE and ROA hence financial performance. Equally, the study showed that asset tangibility a significant and statistically positive relation with financial performance as measured by ROE and ROA. Finally, the results indicated positive and significant correlation between growth opportunities and financial performance measured by ROA and ROE.

Pouraghajan and Malekian (2012) conducted a research to establish the impact capital structure would have on the financial performance of firms listed in the Tehran Stock Exchange. The study used a sample of 400 listed firms in the Tehran Stock Exchange from 12 industrial groups for the period 2006 to 2010. They measured financial

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Kamau (2014) sought to establish the impact internal factors would have on the profitability of private hospitals in Kenya, using Karen Hospital as the study used a case study. The study targeted the finance staff and the departmental heads to fill the questionnaires. The study used stratified random sampling technique in collecting primary data through a semi-structured questionnaire. The study found a positive correlation of asset tangibility, firm size and volume of capital on profitability of private hospitals and while leverage showed a negative correlation. The results of the study deduced that asset tangibility, leverage, firm size and capital volume affect profitability of private hospitals in Kenya.

Chinaemerem and Anthony (2012) conducted a study to determine the effects of capital structure on the financial performance of Nigerian companies sampling using 30 non-financial companies listed on the Nigerian Stock Exchange between 2004 and 2010. The study used asset tangibility as one of the independent variables while financial performance (ROA & ROE). The results showed a negative and significant correlation between company's asset tangibility and ROA against theoretical expectations. They concluded that companies that have higher asset tangibility ratio would have lower financial performance ratio (ROA and ROE). On the other hand, asset tangibility showed a positive but not significant correlation with ROE. The study concluded that the sampled companies failed to use

their tangible assets component in the total asset prudently to influence on their financial performance.

Babalola (2013) did a study to determine the effect of firm size on the financial performance of manufacturing firms listed in the Nigerian Stock Exchange. The study analyzed secondary panel data from the firms sampled between the year 2000 and 2009. In the study ROA was used to measure financial performance, while firm size was measured using both total sales and total assets. From the study, it was deduced that firm size, both measured using total sales and total assets, revealed a positive correlation on financial performance (ROA) of manufacturing firms in Nigeria. This showed that firm size is a very vital factor in establishing the financial performance of firms in Nigeria and therefore big firms are likely to perform better financially.

Boadi, Antwi and Lartey (2013) did a study to establish the correlation between the firm liquidity and the financial performance of banks listed on the Ghana Stock Exchange for the period 2005 to 2010. They collected and analyzed data of 7 from the 9 listed banks. They did the analysis of relevant documents as the main procedure of their research for the collection of secondary data for the study. They measured firm liquidity as the ratio of current assets and current liabilities while financial performance used ROE and ROE ratios as the proxies for its measurement. In data analysis the study used time series analysis to establish the trend between firm liquidity and financial performance. The results revealed a positive but weak correlation of firm liquidity and financial performance of the banks listed in Ghana Stock Exchange.

METHODOLOGY

The study used descriptive survey research design. According to Orodho (2012) descriptive survey research design can generate accurate information for large number of people over a wide area using a small sample. In this study, the population consisted of all the licensed microfinance banks

registered by the Central Bank of Kenya in Kenya. According to the central bank of Kenya, there were 13 licensed microfinance banks in Kenya. In this study, the population considered the licensed microfinance banks which were in existence for the period of 2013 to 2017. This study employed closed-ended questionnaire, which was also referred to as structured questionnaire to gather data for this study's independent variables. The researcher used multiple regression models to establish if the relationship between the independent variables and the dependent variables were statistically significant. The multiple regression models was assumed to hold under the equation;

$$Y = \beta_0 + \beta_1 X_1 + \beta_2 X_2 + \beta_3 X_3 + \epsilon$$

Where;

Y Represents Financial Performance of licensed microfinance banks in Kenya.

β_0 represents the regression model Constant

X_1 represents Debt Capital

X_2 represents Equity Capital

X_3 represents Retained Earnings

ϵ represents the estimated error of the regression model

$\beta_{1, \dots}$ are the coefficients of the variables determined by the model

FINDINGS

Debt Capital and Financial Performance

The first objective of the study was to determine the effect of debt capital on financial performance of licensed microfinance banks in Kenya. A five point Likert scale was used to rate responses of this variable and it ranged from; 1 = strongly disagree to 5 = strongly agree and was analysed on the basis of the percentages, mean score and standard deviation. The closer the score on each item was to 5, the more the agreement concerning the statement. A score of not sure (3) would indicate uncertainty while scores significantly below 3 would showed disagreement regarding the statement posed. The findings are presented in Table 1.

Table 1: Debt Capital and Financial Performance

Statement	SA %	A %	N %	D %	SD %	Mean	Std. Dev.
The firm utilizes trade credits to finance our microfinance banks	20	48	25	5	2	3.16	0.629
The firm considers the use of asset based lenders to ensure consistency in capital flow	16	54	14	12	4	3.42	0.676
The firm considers the financing through commercial finance companies as a means of raising our capital	23	43	14	11	9	3.45	0.574
The firm considers obligations payable within a year like overdraft facilities as one of the ways of raising capital	14	54	16	11	5	2.81	0.535
The firm considers debt capital as it offers us a potential to increase the volume of our operations	28	35	25	9	1	3.06	0.846
Our firm considers debt capital as it carries benefits like tax savings since in many jurisdictions, interest on debt is an allowable deduction	27	57	10	4	2	3.33	0.738
Aggregate Score						3.445	0.754

The results in Table 1 suggested that the majority (68%) of firms utilized trade credits to finance our microfinance banks whereby 48% agreed and 20% strongly agreed. Majority (70%, where 54% agreed and 16% strongly agreed with a mean of 3.16 and a standard deviation of 0.629) of firm considered the use of asset based lenders to ensure consistency in capital flow. The findings also revealed that most

(66%, where 43% agreed and 23% strongly agreed, with a mean of 3.42 and a standard deviation of 0.676) firm agreed with the view that there was financing through commercial finance companies as a means of raising their capital. The study also revealed that majority (68%, in which 54% agreed and 14% strongly agreed with a mean of 3.45 and a standard deviation of 0.574) of firms considers obligations payable within a year like overdraft

facilities as one of the ways of raising capital. The findings further revealed that majority (63% in which 35% agreed and 28% strongly agreed with a mean of 2.8 and a standard deviation of 0.535) of firms consider debt capital as it offers them a potential to increase the volume of their operations. The findings also indicated that majority firm considers debt capital as it carries benefits like tax savings since in many jurisdictions, interest on debt is an allowable deduction whereby cumulatively 84% (57% agreed and 27% strongly with a mean of a mean of 3.33 and a standard deviation of 0.738). This findings especially that of the firm carrying debt capital is consistent with those of Maigua & Mouni (2016) who found that businesses however use debt because it offers them potential to increase the volume of their operations and increase the average ROE and ROA through tax savings since in many jurisdictions, interest on debt is an allowable deduction. The use

of debt will have this effect only if the rate of return on the investment or assets is greater than the rate of return on the debt.

Equity Capital and Financial Performance

The second objective of the study was to determine the effect of equity capital on financial performance of licensed microfinance banks in Kenya. A five point Likert scale was used to rate responses of this variable and it ranged from; 1 = strongly disagree to 5 = strongly agree and was analysed on the basis of the percentages, mean and standard deviation. The closer the mean score on each item was to 5, the more the agreement concerning the statement. A score around 2.5 would indicate uncertainty while scores significantly below 2.5 would suggest disagreement regarding the statement posed. The findings are presented in Table 2.

Table 2: Equity Capital and Financial Performance

Statement	SA %	A %	N %	D %	SD %	Mean	Std. Dev
The firm sometimes raise capital through sale of assets in order to reduce dilution of ownership	33	29	20	11	7	2.68	0.714
The firm considers the savings from reduced capital when raising capital	40	20	14	20	6	3.41	0.663
Our microfinance bank utilizes internal and external equity financing to raise more capital	31	49	17	1	0	4.04	0.831
Our microfinance bank includes both short term and long term sources of equity financing	42	31	18	7	2	3.8	0.648
Our shareholders are better off at the end of a period than at the beginning when we use equity capital	21	50	15	8	6	3.31	0.612
Aggregate Score						3.36	0.761

Looking at the results in Table 2, revealed that majority of firm sometimes raise capital through sale of assets in order to reduce dilution of ownership whereby accumulatively 62% (29% agree and 33% strongly agree, Mean = 2.68 and standard deviation of 0.714). Similarly, there was uncertainty that majority (60% of which 40 strongly agreed and 20% agreed, mean = 3.41 and SD 0.663) of firm considers the savings from reduced capital when raising capital. The findings also shows that majority (80% of which 49% agreed and 31% strongly

agreed, mean = 4.04 and SD = 0.831) of the licensed microfinance banks our MFB utilizes internal and external equity financing to raise more capital. The findings revealed that the licensed microfinance considers both short term and long term sources of external financing (in which 73% cumulatively agreed with 31% agreeing and 42% strongly agreeing with a mean of 3.8 and a standard deviation of 0.648). Other findings indicate that shareholders are better off at the end of a period than at the beginning when firms use equity

capital (with 71% cumulatively agreeing of which 50% agreed and 21% strongly agreed, mean = 3.31, SD, 0.612). The aggregate (mean = 3.36) suggest that overall, there was some slight agreement with the statements indicating that equity capital ranking was not strongly emphasized by the licensed microfinance institution. Thus, the study was consistent with Kipsha and Moshi (2014) whom found that while debt is negatively related with profitability but equity is directly related with profitability.

Retained Earnings and Financial Performance

The third objective of the study was to determine the effect of retained earnings on financial

Table 3: Retained Earnings and Financial Performance

Statement	SA %	A %	N %	D %	SD %	Mean	Std. Dev
The firm considers the use of retained profits to ensure consistence in the financial performance	33	51	10	4	2	3.23	0.58
The firm considers the use of dividends before distribution to be used as a source of capital	35	26	17	15	7	2.68	0.814
We maintain our firm's value through the use of retained earnings	31	49	17	1	0	4.24	0.731
Our firm uses retained earnings as a sources of finance for new projects in emerging markets	27	37	22	10	4	3.67	0.728
Aggregate Score						3.45	0.764

Looking at the results in Table 3, it was evident that most licensed microfinance banks considers the use of retained profits to ensure consistence in the financial performance as supported by 84% of those who cumulatively agreed, 51% agreed and 33 strongly agreed, Mean = 3.93, SD, 0.58). There data revealed most firms agreed that licensed microfinance banks consider the use of dividends before distribution to be used as a source of capital where cummulatively 61% agreed (26% agreed and 35% strongly agreed, with a mean = of 2.68 and SD of 0.814). The findings also indicate that the licensed microfinance banks maintain their firm's value through the use of retained earnings (Mean = 4.24). The respondents also were in agreement that the licensed microfinance banks uses retained earnings as a sources of finance for new projects in

performance of licensed microfinance banks in Kenya. A five point Likert scale was used to rate responses of this variable and it ranged from; 1 = strongly disagree to 5 = strongly agree and was analysed on the basis of the percentges, mean score and standard deviation. The closer the mean score on each item was to 5, the more the agreement concerning the statement. A score around 2.5 would indicate uncertainty while scores significantly below 2.5 would suggest disagreement regarding the statement posed. The findings are presented in Table 3.

emerging markets(Mean = 3.67). The aggregate mean of 3.45 suggested that overall, there was some slight agreement with the statements indicating that retained earnings ranking was not strongly emphasized by the licensed microfinance banks. The findings disagree with the findings of Akingunola (2011) whom revealed that a great number of small scale enterprises in Nigeria used internal sources of finance, mainly personal savings and retained earnings in the financing of capital equipment.

Trend Analysis of Return on Equity (ROE)

The study established the trends of annual ROE over the study period. The results are presented in Figure 2.

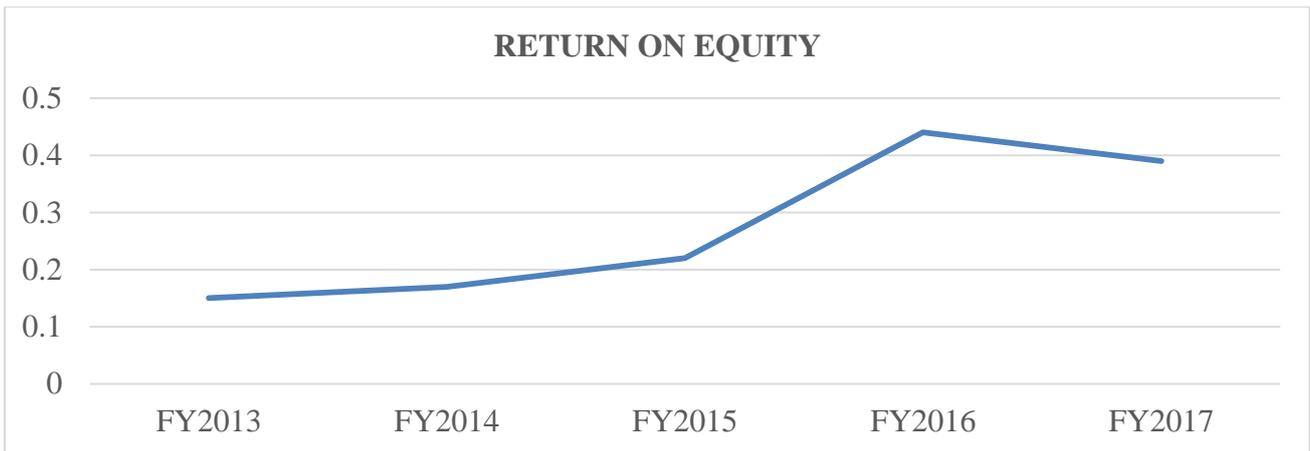


Figure 2: Trend Analysis Return on Equity

The study findings in Figure 2 indicated that the mean ROE recorded annually for the licensed microfinance banks had increasing trends from the first year of 2013 up to the fourth year 2016 which also recorded the highest ROE of 0.44. The ROE then decreased up to a figure of 0.39 which was the lowest average in the study period. These findings were consistent with the Central Bank of Kenya (2018) the microfinance banks registered a modest decline in growth in 2017 with a 7 percent decline in total assets from Ksh.72.5 billion in December

2016 to Ksh.67.6 billion in December 2017. ROE reflected how effectively a firm management is using shareholders' funds. Thus, it can be deduced from the above statement that the better the ROE the more effective the management in utilizing the shareholders capital.

Trend Analysis of Return on Equity (ROA)

The study established the trends of annual ROA over the study period. The results are presented in Figure 3.

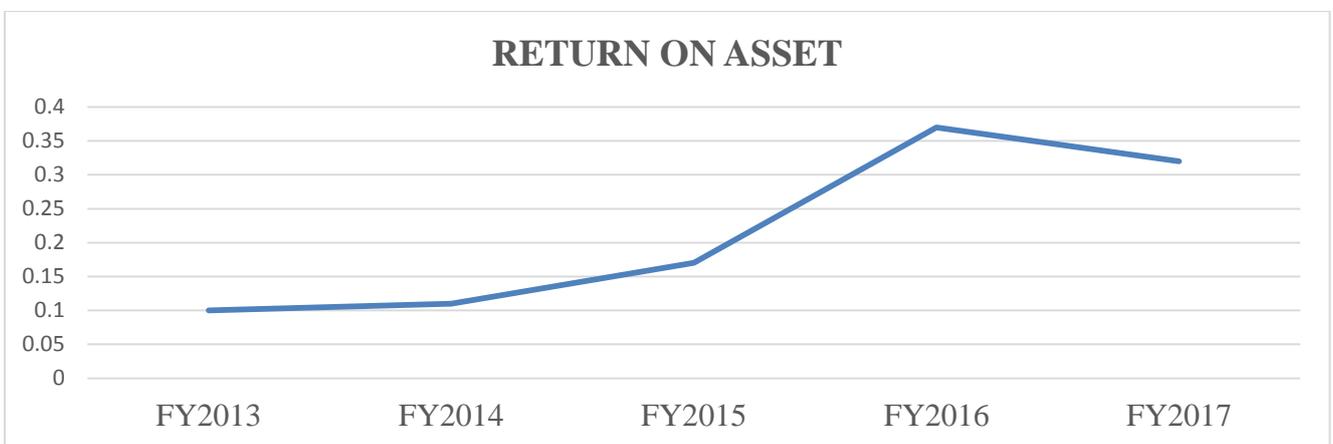


Figure 3: Trend Analysis Return on Asset

The study findings in Figure 3 indicated that the mean ROA recorded annually for the licensed microfinance banks had increasing trends in 2016 with a mean of 0.37 to the year 2017 which also recorded lower ROA during the study period with a mean of 0.32.

Correlation Analysis

This study focused on the influence of capital structure on financial performance of licensed microfinance banks in Kenya. In particular, the capital structures studied include debt capital, equity capital and retained earnings. Correlating each of the said forms of capital structure with financial performance enabled the researcher to

determine the relationships between each independent variable and the dependent variable of the study. Further, a multiple regression analysis was done to assess the relationship between capital structure and financial performance of licensed microfinance banks in Kenya.

Relationship between Debt Capital and Financial Performance

This section outlines the results of correlation analysis between Debt Capital and Financial Performance of Licensed Microfinance Banks (Table 4). The findings were interpreted and discussed accordingly.

Table 4: Correlation between Debt Capital and Financial Performance

		Financial Performance
Debt Capital	Pearson Correlation	.204
	Sig. (2-tailed)	.071
	N	31

*. Correlation is significant at the 0.05 level (2-tailed).

The study results revealed a weak, positive and statistically insignificant ($r=0.204$; $p>0.05$) relationship between debt capital and financial performance of licensed microfinance banks. The analysis implied that the inclusion of debt capital on the capital structure does not influence the financial performance of licensed microfinance banks according to this study. This findings are consistent with those of Muchiri, Muturi and Ngumi (2016) whom stated that, a firm which is highly

indebted, whether by short or long term, is likely to suffer distress and dilute the return hence poor financial performance.

Relationship between Equity Capital and Financial Performance

This section outlines the results of correlation analysis between equity capital and financial performance of Licensed Microfinance Banks (Table 5). The findings were interpreted and discussed accordingly.

Table 5: Correlation between Equity Capital and Financial Performance

		Financial Performance
Equity Capital	Pearson Correlation	.601**
	Sig. (2-tailed)	.000
	N	31

*. Correlation is significant at the 0.05 level (2-tailed).

The study results indicated a strong, positive and statistically significant ($r=0.601$; $p<0.05$) relationship between equity capital and financial performance. The analysis implied that the incorporation of equity capital in the licensed microfinance capital structure significantly influences the financial performance. This findings are consistent with those of Kipsha and Moshi (2014) whom examined capital structure and profitability of the Nigerian listed firms from the agency cost theory

perspective and found that debt is negatively related with profitability but equity is directly related with profitability.

Relationship between Retained Earnings and Financial Performance

This section outlines the results of correlation analysis between retained earnings and financial performance of licensed microfinance banks (Table 6). The findings were interpreted and discussed accordingly.

Table 6: Correlation between Retained Earnings and Financial Performance

		Financial Performance
Retained Earnings	Pearson Correlation	.586**
	Sig. (2-tailed)	.000
	N	31

*. Correlation is significant at the 0.05 level (2-tailed).

The findings of the study revealed a moderate, positive and statistically significant ($r=0.586$; $p<0.05$) relationship between retained earnings and financial performance of licensed microfinance banks. The analysis implied that the incorporation of retained earnings in the capital structure significantly influences the financial performance of the licensed microfinance banks in Kenya according to this study. The results were consistent with those of Hermelo and Vassolo (2010) whom held

that retained earnings are used as sources to finance new projects in emerging enterprises where capital markets are not well.

Relationship between Capital Structure and Financial Performance of Licensed Microfinance Banks

This study assessed how capital structure influenced the financial performance of licensed microfinance banks in Kenya.

Table 7: Model Summary

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.747 ^a	.558	.541	.39938

a. Predictors: (Constant), Debt Capital, Equity Capital, Retained Earnings

Table 8: ANOVA

Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	15.114	3	5.038	11.37	.000 ^b
	Residual	11.963	27	.443		
	Total	27.077	30			

a. Dependent Variable: Financial Performance

b. Predictors: (Constant), Debt Capital, Equity Capital, Retained Earnings

Table 9: Results of Regression Analysis

Model		Coefficients ^a				
		Unstandardized Coefficients		Standardized Coefficients	t	Sig.
		B	Std. Error	Beta		
1	(Constant)	-.584	.501		-1.167	.247
	Debt Capital	-.073	.085	-.074	-.861	.392
	Equity Capital	.628	.110	.511	5.721	.000
	Retained Earnings	.537	.094	.454	5.687	.000

a. Dependent Variable: Financial Performance

The outcomes of the regression analysis were interpreted using the following regression function: $Y = \beta_0 + \beta_1X_1 + \beta_2X_2 + \beta_3X_3 + \hat{e}$ where Y , X_1 , X_2 , and X_3 represented Financial Performance of licensed microfinance banks, Debt Capital, Equity Capital, and Retained Earnings respectively. The regression results were therefore interpreted as follows:

$$Y = -0.584 - 0.073X_1 + 0.628X_2 + 0.537X_3 + e$$

Hypothesis Testing

The first hypothesis was tested under the null hypothesis;

H₀₁: Debt capital has no significant influence on financial performance of licensed microfinance banks in Kenya

From the beta values, it was evident that there was no significant relationship ($t = -0.861$; $p > 0.05$) between debt capital and financial performance of licensed microfinance banks in Kenya. Therefore, the study **accepts** the null hypothesis and adopts the view that debt capital does not significantly influence financial performance of licensed microfinance banks in Kenya.

The second hypothesis was tested under the null hypothesis;

H₀₂: Equity capital has no significant influence on financial performance of licensed microfinance banks in Kenya

The beta value from the multiple regression results indicate that there was a significant relationship between the two variables ($t = 5.721$; $p < 0.05$). Consequently, the study **rejects** the null hypothesis and this implies that equity capital has a significant influence on financial performance of licensed microfinance banks in Kenya.

The third hypothesis was tested under the null hypothesis;

H₀₃: Retained earnings has no significant influence on financial performance of licensed microfinance banks in Kenya

Looking at the results, it is evident that there was significant association between Retained earnings and financial performance of MFBS ($t = 5.687$; $p < 0.05$). This meant that the study **rejects** the null hypothesis and this implied that retained earnings as a source of capital has a significant influence on financial performance of licensed microfinance banks in Kenya.

CONCLUSIONS

In respect to the first objective which sought to determine the effect of debt capital on financial performance of licensed microfinance banks in Kenya, the study concludes that MFBS utilizes trade credits, asset based borrowing, commercial finance companies and overdraft facilities as sources of debt financing for their operations. The study concludes that MFBS have a wide array of sources from which they they can get laon capital. MFBS considers debt capital as it offers them a potential to increase the volume of their operations. Moreover, the microfinance banks consider debt capital as it carries benefits like tax savings where interest on debt is an allowable deduction during tax obligations. Managers and shareholders of MFBS should consider debt financing with caution in order to maintain profitability of their firms.

Concerning the second objective which sought to assess the effect of equity capital on financial performance of licensed microfinance banks in Kenya, the study concludes that the licensed microfinance banks consider raising capital through sale of assets in order to reduce dilution of

ownership. They also consider the savings from reduced capital due to reduction of shareholders equity. MFBS also consider internal and external equity financing to raise more capital. The study further concludes that licensed microfinance banks' equity providers earn returns inform of dividends from the profits generated by the firms. Other findings indicated that shareholders are better off at the end of a period than at the beginning when they use equity capital. The study concludes that MFBS have a wide range of alternatives that they could use for raising equity capital. The study results indicated a strong, positive and statistically significant ($r = 0.601$; $p < 0.05$) relationship between equity capital and financial performance. This means that MFBS should always consider raising equity from shareholders before borrowing .

Finally, the study concluded that in respect to the third objective which sought to assess the effect of retained earnings on financial performance of licensed microfinance banks in Kenya, most licensed microfinance banks consider the use of retained profits to ensure consistence in their financial performance. The study concludes that the licensed microfinance banks maintain their firm's value through the use of retained earnings. In addition, licensed microfinance banks consider the use of dividends before distribution as a source of capital. All the licensed microfinance banks use retained earnings as a sources of finance for new projects in emerging markets. Retaining profits have a moderate influence on profitability.

Overall, equity has highest influence on profitability followed by retained profits while debts has least desirable effect on profitability.

RECOMMENDATIONS

The following recommendations are drawn with regard to the study findings;

In respect to the first objective which sought to determine the effect of debt capital on financial performance of licensed microfinance banks in Kenya, the study recommends that the licensed

microfinance banks should utilize debt financing with caution. The available debt financing includes trade credits, asset based borrowing and through use of commercial finance companies. The other channel available to licensed microfinance banks should be obligations payable within a year like overdraft facilities. Aim of debt capital to MFBs should be to increase the volume of their operations. Microfinance banks should consider debt capital which carries with it benefits such as tax savings whereby interest on the debt is an allowable tax deduction.

Concerning the second objective which sought to assess the effect of equity capital on financial performance of licensed microfinance banks in Kenya, the study recommends the licensed microfinance banks to consider Equity capital as the best option of increasing profitability of MFBs. The profit available for financing should be considered first before collecting equity from shareholders. The licensed microfinance banks should raise capital through sale of assets in order to reduce dilution of ownership. Similarly, the licensed microfinance banks should consider the savings from reduced capital as an approach of raising capital. Microfinance banks should ensure that shareholders earn dividends in order to motivate them to contribute more equi. The findings further conclude that the licensed microfinance banks

should consider internal and external equity financing to raise capital.

Finally, in respect to the third objective which sought to assess the effect of retained earnings on financial performance of licensed microfinance banks in Kenya. the study recommends that most licensed microfinance banks should consider the use of retained profits to ensure consistence in the financial performance which has a moderate influence on profitability. Besides, the licensed microfinance banks should also considers the use of dividends before distribution as a source of capital. The study further recommends that the licensed microfinance banks should maintain their firm's value through the use of retained earnings. All the licensed microfinance banks should embrace retained earnings as a sources of finance for new projects in emerging markets.

Suggestions for Further Study

This study focused on influence of capital structure on financial performance of licensed microfinance banks. This study recommends that more research be conducted to find out on the effect of preference share capital on the financial performance of licensed microfinance banks and other sectors that would improve economic development. It is also proposes a study on existing finance companies and their contributions to current capital structure of MFBs in Kenya.

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