



**RELATIONSHIP BETWEEN CAPITAL RESTRUCTURING AND FINANCIAL PERFORMANCE OF LISTED FIRMS IN KENYA**

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**ABSTRACT**

*The study sought to determine the relationship between capital restructuring and financial performance of listed firms in Kenya. The study used a descriptive research design. Data was collected for a 10-year period between 2010 and 2019. The data was collected from financial statements of listed firms and annual reports from Nairobi Securities Exchange. The study was based on panel data based on forty-eight firms listed within the period. Descriptive and inferential statistics were used to analyze the data. Multiple regression and correlation analysis were used as inferential statistics. From the findings, debt to capitalization ratio showed a positive effect on ROA of listed firms between 2010 and 2019. The study found that firm size affected ROA of listed firms negatively. From the regression analysis, debt to capitalization ratio showed a significant effect on financial performance as measured by ROA. From the correlation analysis, debt to capitalization ratio showed a significant and positive relationship with ROA. The study concluded that capital restructuring has a positive relationship with financial performance of firms listed in Kenya. Firm size has a controlling negative relationship with financial performance of listed firms in Kenya. The study recommended that listed firms undertake continuous capital restructuring in order to enhance their financial performance. Similar studies in non-listed firms and with a different period was recommended for further research*

**Key words:** Asset; Capital; Restructuring; Capitalization; Debt; Equity; Financial Performance; Firm Size

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## INTRODUCTION

In the current global environment, firms have faced challenges from the dynamic external environment for sustainable growth and improved financial performance as a long-term goal (Kratochvilova, 2011). As countries grow economically, firms are increasingly needed to check on their capital structure and reduce the incidence of having high debt situation while at the same time ensuring a balance between debt and equity for maximization of profitability and shareholders' value (Robbins & Coulter, 2016). Firms restructure their capital due to an increase in the competition and changes in technology calling for redesigning of business process (Gowing, Kraft & Quick, 2018). Robbins and Coulter (2016) posits that where a firm faces a risk of bankruptcy, it is forced to restructure for financial sustainability.

Nairobi Securities Exchange has seen sixty-seven firms listed by the end of 2019, an increase from the 61 companies listed in 2014 (NSE, 2015). Despite more firms being listed at the NSE, the firms have faced turbulence in the recent past. Listed firms have been faced by the challenges of economic changes relating to increased level of competition and requirement of minimum capital required for the firms. This has forced listed firms to undergo capital restructuring in order to enhance their capital base and hence meet the conditions for listing. In this turbulent environment, listed firms have to constantly change their capital structure to hedge inherent financial risks expected (Kiarie, 2014). The NSE has seen listed firms go into financial depression due to huge losses and failure to adapt to the changing environment. This has created the need for capital restructuring with the Nairobi Securities Exchange. This study sought to establish whether the restructuring done by listed firms had a relationship with their financial performance.

Capital structure is a major factor influencing financial performance of a firm. Hence capital restructuring is a feasible strategy that can be adopted by a firm in its effort to enhance

performance. Capital restructuring enhances firm value, profitability and share value of a firm in a competitive and turbulent environment. According to Roberts (2017), capital restructuring brings in balance in debts and equity funds which in turn influence a firm's financial performance.

In Kenya, listed firms have been experiencing issues related to financial performance (NSE, 2018). For example, Mumias Sugar has been making huge losses which have crippled the sugar manufacturing firm. Other firms experiencing like Uchumi supermarket have also been experiencing financial performance issues. Listed firms have been making changes in their capital structure in an effort to improve their financial performance (Odula, 2015). Improved financial performance is expected to increase confidence in the shareholders and increase investment returns through increased share prices. The improved performance would also increase a firm's financial capacity to get more assets and increase employee base and remuneration.

The concepts of restructuring and financial performance have been empirically compared and related. Globally, Norazlan (2018) examined capital restructuring and its effect on performance of firms listed in Malaysia; Oloyede and Sulaiman (2013) studied financial restructuring and performance of Nigerian firms; Gupta (2017) did an impact study on corporate debt restructuring and financial performance of Indian firms. Local studies have been done on the topic of study. Osoro (2014) studied financial restructuring and financial performance of commercial banks; Kithinji (2017) studied organization restructuring and financial performance in Kenya; while Riany et al (2012) did an impact study on restructuring and performance of Kenyan mobile service providers. Despite the studies focusing on restructuring and financial performance, no local study focused on capital restructuring and financial performance of listed firms within the period of study (2010 and 2019). What is the relationship between capital

restructuring and financial performance of firms listed at the NSE?

### **Capital Restructuring**

Capital restructuring is defined as the changing of the firm's capital structure based on the changing business environment and with the aim of funding the growth of a firm (Koh, Dai & Chang, 2012). Gilson (2010), define capital restructuring as the reorganization of a firm's capital structure in order to enhance the financial performance of a firm based on the profitability objective. Capital restructuring is the change in the equity-debt mix when restructuring a firm (Casco, 2012). Lal, Pitt and Beloucif (2013) note that capital restructuring becomes necessary where a firm seeks to expand operations, increase assets base, gain market share, modify their debt level and alter the ownership structure. Casco (2012) supports capital restructuring when a firm seeks to maximize profitability or when responding to changing environmental conditions, attempted firm takeover or bankruptcy. Further, capital restructuring replicates the targeted efforts of financial management to maximize shareholder wealth. Nazir and Alam (2010) posits that prospective investors find a firm that restructures its capital to be more appealing due to improved performance metrics.

Capital restructuring is measured through the changing capital structure relating to leverage buyouts, recapitalization and swapping debt with equity (Rogovsky, et al, 2015). According to Javed and Akhtar (2012) measuring capital restructuring in a firm is measured in terms of increase in equity through issue of new shares, changes in the debt policy and the amount of equity replaced with debt. On the other hand, Bowman et al. (2016) indicated that capital restructuring in a firm is measured through the changes in debt to capital ratio over the years. In this study, the change in debt to capitalization ratio was used to measure the capital restructuring.

### **Financial Performance**

Financial performance is revenue generation through utilization of firm assets (Adams & Mehran, 2015). Financial performance relates to evaluating the financial aspect of a firm in form of financial records based on the financial efficiency of a firm (Amalendu, Somnath & Gautam, 2011). Financial performance is the monetary measurement of the outcomes of a firm (Kwaning, Awuah & Mahama, 2015). Rogovsky (2015) notes that financial performance is defined as the measurement of a firm's financial outcomes for a specified period of time in comparison to other firms within a sector. Financial performance, according to me, is the measurement of a firm's output measured in terms of money.

The financial performance is based on a specified period of time, mainly years (Omran & Pointon, 2014). For the financial performance measures to be effective, they need support from the non-financial measures of firm performance (Kaplan & Norton, 2010). Mario (2014) notes that a firm measures financial standing in an attempt to meet long term financial objectives and enhance the periodic financial outcomes of a firm. This is supported by Roberts (2017) who asserts that measurement of financial performance requires activity-based inputs supporting firm's long-term objectives.

Chen and Wong (2014) measured financial performance in term of profitability. This is supported by Ceylan, Emre and Asl (2018) who contends that profitability is the best measurement of a firm's financial performance. He recommended ratios like return on assets (ROA) and return on equity (ROE). Oladipupo and Okafor (2013) measured performance in terms of ROE, ROA, ROI and ROIC. Omran and Pointon (2014), recommended the use of ratios like Tobin Q, marketing, accounting, and economic value added (EVA) to measure firm financial performance. From the different researchers, financial performance is measured through various measures that include Tobin Q, EVA, ROA, ROE, ROI and ROIC. This study measured financial performance in terms of ROA.

### **Capital Restructuring and Financial performance**

Capital restructuring has been found to enable a firm to handle financial performance related issues (Bowman et al., 2016). They contended that capital restructuring influences the value of a firm in terms of billions. Roberts (2017) posits that capital restructuring brings a capital structure balance in terms of equity and debt funding which leads to reduction in finance costs and loss of capital while at the same time improving firm performance through increased profits and revenue. In effecting change in capital structure to achieve balanced operative results, capital restructuring reduces financial costs and improve financial ratios over time (Adams & Mehran, 2015). This show that capital restructuring has a direct relationship with financial performance.

Empirically, capital structure has shown mixed results in its relationship with financial performance. Oloyede and Sulaiman (2013) shows capital restructuring to have had a significant impact on firm profitability. Kwaning, Churchill and Opoku (2014); Ongwae and Moronge (2016); and Osoro (2014) in their empirical studies established positive relationship between capital restructuring and financial performance. Norazlan (2018) showed a significant relationship between capital restructuring and firm performance which was negative. Inoue et al (2010) found no relationship between capital restructuring and firm financial performance.

In Malaysia, Norazlan (2018) studied restructuring of listed firms in Bursa stock exchange and how it related to the firm's financial performance between 1990 and 2012. The research was based return on assets and equity of forty-seven firms that announced debt restructuring. Panel regression and descriptive analysis was done. Capital restructuring showed significant negative relationship with financial performance. This was shown by a significant regression coefficient between capital restructuring and financial ratios. The study was done listed firms that shows similarity to the current study. However, the study was done in the

Bursa stock exchange while the current study was done in the Nairobi Securities Exchange.

In Japan, Inoue et al. (2010) studied post financial performance of commercial banks. It was based on the pre- and post-restructuring financial performance between 1990 and 2005. Eighty-nine banks were sampled. Descriptive research design was used. Panel data regression model was used to establish the relationship between variables. The findings showed no change in financial ratios after restructuring in the first three years. However, the ratio improved three years after capital restructuring.

In Nigeria, Oloyede and Sulaiman (2013) did a comparative analysis on financial performance before and after restructuring of listed firms. Financial and real sectors were targeted by the researcher. Ten banks were sampled and selected randomly. Data were collected from published financial reports of listed firms between 2000 and 2011. Descriptive and t testing was used in data analysis. It was found that capital restructuring significantly impacted on firm's financial performance in real sector but insignificant in financial sector. The study used t-testing while the current study used F-testing to test the significance of the model. The study was done for a 12-year period while the current study was done for a 10-year period.

In India, Gupta (2017) researched on debt restructuring and financial performance. Six firms that had restructured their debt in India were used in the study. Gupta examined ten ratios of financial performance three years before and after the restructuring. Data was collected from audited financial statements of individual firms. Descriptive statistics and t-testing were used for data analysis. Firm's debt restructuring did not change the financial ratios of the selected firms within the first 3 years after which they improved. The study focused on firms that restructured their debt while the current study focused on firms that restructured both debt and equity. T-testing was

used for significance while the current study will use F-test.

In Ghana, Kwaning, Churchill and Opoku (2014) assessed financial restructuring of banks and their influence on their financial performance. African development bank was used as the case. Primary and secondary data were collected. Interview schedules were used in primary data collection from the management. Secondary data was collected using a data sheet. Descriptive and correlation analysis was done to establish the relationship between variables. Capital restructuring influenced financial performance. Profitability ratios improved with capital restructuring. This study was done in the banking sector while the current study was done on listed firms. The study used both primary and secondary data while the current study used secondary data only.

In the commercial banking sector, Ongwae and Moronge (2016) did a research on restructuring and performance between 2011 and 2014. Forty-four banks were involved in the study. The research involved 462 employees from the head office selected through random sampling. Data were collected through self-administered questionnaires. Descriptive analysis was done. The findings showed that capital restructuring improved financial performance of the banks. The improvement, however, was felt two years after restructuring was done. This study focused on banks and used primary data. However, the current study will use all listed firms and secondary data. The study was also done for a 5-year period while the current study focuses on a 10-year period between 2010 and 2019.

Osoro (2014) studied financial restructuring and financial performance of eleven commercial banks from 2008 to 2013. Listed banks within the six-year period were involved in the research. Data were collected from published annual reports of the banks from the NSE. The study used a quantitative research design. Data was analyzed through descriptive statistics and multiple regression. T-test

was done to show the significance of the model. The results showed that financial restructuring positively influenced financial ratios of commercial banks.

Using positivism philosophy, Kithinji (2017) studied restructuring and financial performance of commercial banks that restructured between 2002 and 2014. The study used both descriptive and causal research designs. Forty-four commercial banks were targeted for the study. Data were collected from published individual bank financial statements using collection schedule. Descriptive and inferential statistics were used in analysis. Restructuring was found to affect the financial ratios where they improved after the restructuring. This research was done only for the banks while the current study will include all listed firms. The study focused on a 12-year period while the current study was done on a 10-year period.

In commercial banks, Kithinji (2019) studied bank restructuring and financial performance. The research targeted forty-four banks from 2012 to 2014. The study involved 39 banks that had published financial reports for the period of study. Secondary data were collected for the study. The research involved descriptive statistics and multiple regression analysis. Findings showed that capital restructuring was done by the banks. Findings further showed that capital restructuring positively influenced financial performance. This study focused only on commercial banks and assumed other firms listed at the NSE. The study focused on a 12-year period while the current study was done on a 10-year period.

For mobile service providers, Riany et. al (2012) reviewed restructuring and performance. The research was based on causal design. Four mobile service providers were targeted for the study. Ninety-six employees were sampled through stratified random sampling. The research was based both secondary and primary data. Questionnaires collected primary data from the employees. Data collection sheet was used to gather secondary data. The data was from annual reports. The research

used descriptive statistics for analysis. The findings showed that capital restructuring led to increased profitability and firm value of mobile service providers. This study was done on mobile service providers with the current study focusing on listed firms. Both primary and secondary data was used while the current study was based purely on secondary data. Causal design was used while the current study was based on descriptive and cross-sectional design.

### **Theoretical framework**

This section reviewed the theoretical basis of the study. This study was based on trade-off, transaction cost, contingency and institutional theories. In 1973, trade off theory was postulated by Kraus and Litzenberger. Trade off theory posits that a firm that uses debt other than equity financing faces costs of financial distress despite it benefiting from benefits of taxation. The theory also states that increase in debt financing leads to marginal increase in costs and reduction in benefits. When the benefits decrease and cost increase marginally, a firm requires replacing debt with equity to get a balance between the two for maximization of benefits and minimization of the cost of debt financing.

Trade-off theory further argues that tax benefits trade off against the cost of debt. It states that firm management seek to optimally select the level of debt by balancing taxation benefits and the cost of debt finance (Brealey et al, 2012). Berk (2017) adds that capital structure balance calls for maintenance of a balance between taxation benefits and costs of debt by a firm. However, Danso and Adomako (2014) states that the assumptions of this theory are theoretical and do not hold in reality. This makes the theory weak in the explanation of the capital structure of a firm.

For this study, high interest rate levels will be paid by listed firms with high debt levels. The firms may get bankrupt if they fail to pay the interest on the debt. This calls for an optimal balance of the capital structure through trading off of debt with which would lead to the maximization of the benefits and

minimization of debt related costs which may lead to firm getting bankrupt. This in turn would in turn influence the financial performance of the listed firms. This shows that this theory is relevant for the study.

Contingency theory was applied in financial by Reid and Smith (2010) from the sociological theory of 1978. Contingency theory postulates that firm capital and organizational structure defines the level of firm performance. The theory states that contingent factors define the organizational structure and design of a firm (Cadez & Guilding, 2018). This theory works under the assumption that the structure of a firm is adopted based on the firm capability, need and objectives/goals with the technology in existence playing a key role (Islam & Hu, 2012). This means that the capital structure should be a fit for the IT systems which ensures smooth operations of a firm for improved financial performance.

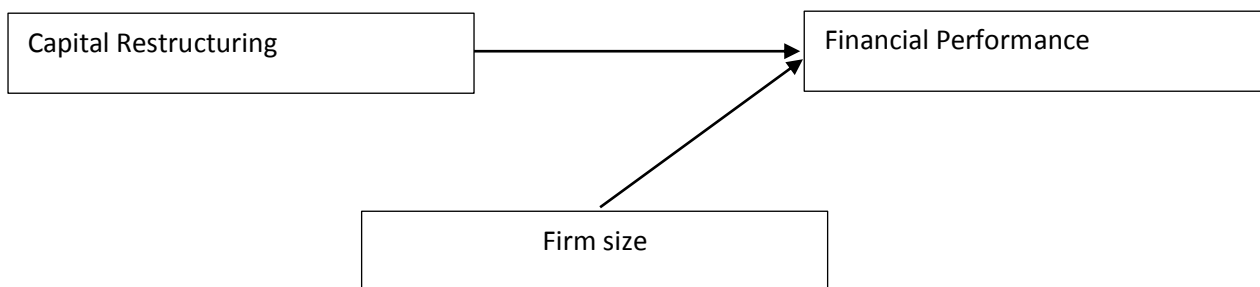
Another assumption fundamental to this theory is that an organizational structure cannot be applicable to every organization (Islam & Hu, 2012). This calls for firms to adjust the structure based on environmental and firm characteristics. The organizational structure changes with the changes in the environment to avoid cases of deteriorating financial performance and make a fit with the environmental fluctuations (Sisaye, 2016). Javed and Jahanzeb (2012) criticized this theory based on the assumption that the capital structure should fit the IT structure for improved performance.

For this study this theory explains the reason listed firms restructure their capital. This theory supports the assertion that restructuring seeks to improve the financial standing of a firm. The theory will guide the reader into understanding the reason for capital restructuring among the listed firms. In this case, firms seek to enhance their financial performance through restructuring their capital to deal with changes in environmental conditions.

The institutional theory was developed by Scott in 2004. This theory states that firms are social

structures that make them to imitate other firms in form of norms. This in turn reduce adversity across firms (Scott, 2004). Based on the theory, firms find themselves adopting other firm's standards hence increasing the legitimacy of the firms. In this theory, firms are restructured in an attempt to meet their profitability and shareholder value maximization as the key objectives of the firms (Bealing, Riordann & Rordan 2011). Where listed firms face under capitalization, they may be forced to inject capital. If the firms are underfunded, external financing may be sought (Chege & Kimencu, 2018).

Toma, Dubrow and Hartley (2015) criticizes this theory based on the fact that it assumes the fact that shareholders seek to maximize their earnings and are not interested in the norms and beliefs of the firm. Firms listed in Kenya restructure their capital structure to enhance shareholder and improve firm performance. Financial performance is enhanced as capital; restructuring increases efficiency of the firms. This shows that this theory is relevant for this study.



**Independent Variable**

**Control Variable**

**Dependent Variable**

**Figure 1: Conceptual Framework**

**Table 1: Operationalization Framework**

| Variable Type | Variable              | Indicators                              | Measurement   |
|---------------|-----------------------|---|---|
| Dependent     | Financial performance | Return on assets                        | Net profit before Tax/Total Assets  |
| Independent   | Capital restructuring | changes in debt to capitalization ratio | (debt to capitalization ratio in the current year - debt to capitalization ratio in previous year)/ debt to capitalization ratio in the previous year<br>$(DR_1 - DR_0)/DR_0$ |
| Control       | Firm size             | Total assets                            | log of total assets   |

**METHODOLOGY**

Descriptive design was adopted in this research. The design enabled the researcher describe how the variables of the study (capital restructuring and financial performance) related to each other hence provided guidance in undertaking the research. All firms in Kenya listed at the NSE were targeted. According to NSE (2019), forty-eight (48) firms were listed at the NSE which formed the sampling frame

of this research. Firms not listed within the period of study were excluded.

The Forty-eight firms listed at the NSE between 2010 and 2019 were involved in the study. All the forty-eight firms were involved. This ensured that the researcher had sufficient data points for analysis. Unbalanced panel data was used for the 48 firms for the 10-year period. This gave a total of 480 data points. In this study, secondary data



collected from annual financial reports of listed firms was used. The study involved firms listed between 2010 and 2019 at the NSE. Financial ratios were calculated from the data in order to address the research objective. Both cross-sectional and time series data was used in this study. This shows that this study was based on panel data.

Diagnostic tests were done to show the relevance of the analysis model to the data. In this research, the diagnostic tests involved the test for multicollinearity through variance Inflation Factor, normality through Shapiro–Wilk test, heteroscedasticity through Breusch Pagan Test and autocorrelation through Durbin Watson statistics.

Data analysis relates to data extraction, compilation and modelling with the objective of getting relevant information (Brians, 2011). Data was analysed using multiple regression, correlation and descriptive analysis. The correlation analysis used Pearson’s correlation coefficient. The factors were calculated on an annual basis. Average data per firm was used in analysis. The analysis was done by the use of STATA 13. The study used panel data regression model that took the form of:

$$Y_{it} = \alpha + \beta_1 X_{1it} + \beta_2 X_{2it} + \epsilon$$

Where:  $Y_{it}$  was financial performance of as measured by ROA of firm,  $i$  at time  $t$ ;  $\alpha$  is constant

term;  $\beta_1, \beta_2$  were regression coefficients;  $X_1$  was capital restructuring as measured by the change in debt to capitalization ratio of firm,  $i$  at time  $t$ ;  $X_2$  was firm size as measured by log of total assets of firm,  $i$  at time  $t$ ;  $\mu$  = error term.

## RESULTS AND DISCUSSIONS

From table 2, return on assets as a measure of financial performance showed a mean of 15.48% for the listed firms between 2010 and 2019. The minimum ROA for the period between 2010 and 2019 was 4.85%. For the period, the firms showed a maximum ROA of 32.09%. Financial performance across the listed firms between 2010 and 2019 showed a standard deviation of 6.05% showing low variation. For the period between 2010 and 2019, change in debt to capitalization ratio (capital restructuring) showed a mean of 195.29% for the listed firms. Standard deviation for the listed firms across the firms was 127.0%. This shows that debt to capitalization ratio for the listed firms varied greatly between 2010 and 2019. The firms showed a minimum ratio of 5.16% with a maximum of 415.57%. Firm size as measured by log of assets was used as the control variable. Firm size of listed firms showed an average of 16.89 between 2010 and 2019. The standard deviation was 2.41 for the period. The firms showed a minimum of 12.24 and a maximum of 20.62 between 2010 and 2019.

**Table 2: Descriptive statistics**

| Variable | Obs | Mean     | Std. Dev. | Min      | Max      |
|----------|-----|----------|-----------|----------|----------|
| ROA      | 480 | 15.48197 | 6.053321  | 4.8519   | 32.0892  |
| X1       | 480 | 195.2945 | 127.0217  | 5.156    | 415.5736 |
| X2       | 480 | 16.89228 | 2.409154  | 12.23921 | 20.624   |

Multi-collinearity of the data used in the research was tested. From the findings, the VIF values were close to 1 with the tolerance values (1/VIF) close to 95%. This showed that variance of the study variables had been inflated at a very low extent. On normality of the data using Shapiro-Wilk test, the variables displayed a p-value which was less than the critical 0.05 value. Hence, we reject the null hypothesis that data is normally distributed and

assume the alternative hypothesis. This shows that the data for the variables is not normally distributed.

On heteroscedasticity test, the p-value is more than 0.05. Hence, we cannot reject the null hypothesis that there is constant variance in our data. Hence, the data used in analysis has low levels of heteroscedasticity which is not a problem. On the autocorrelation test based on Durbin Watson test

for the data from listed firms between 2010 and 2019. The data displayed a Durbin Watson statistic of 1.707. The value is close to 2 which shows that there is low autocorrelation across the data. Thus, it can be determined that were independent due to the fact that residuals were autonomous and there was no autocorrelation.

From the findings, the regression model showed that capital restructuring caused more than 50% change in ROA of Kenyan listed firms between 2010 and 2019. Changes in debt to capitalization ratio and firm size had a significant combined impact on ROA of listed firms in Kenya between 2010 and 2019. From the regression, capital restructuring was found to have an effect on financial performance of listed firms as measured by ROA. The findings concur with those of Oloyede and Sulaiman (2013); and Kwaning, Churchill and Opoku (2014) who found that capital restructuring significantly impacted on firm's financial performance.

The findings from the correlation analysis showed that capital restructuring had a positive effect on financial performance (ROA) significant at the 95% confidence level. The findings differ with those of Norazlan (2018) who found that capital restructuring showed significant negative relationship with financial performance. Inoue et al. (2010) showed no relationship between capital restructuring and financial performance.

Firm size showed an effect on the financial performance of the listed firms. The findings concur with that of Babalola (2013) who found that firm size has an effect on financial performance. The study found that increase in firm size in terms of assets would decrease ROA of listed firms. From the correlation analysis, firm size showed a significant negative relationship with financial performance (ROA). The findings differ with those of Abdulkadir (2016) who established that firm size and firm financial performance relates positively. Niresh and Velnampy (2014) found that firm size had no relationship on the financial performance.

## CONCLUSIONS AND RECOMMENDATIONS

From the findings the study concluded that;

- Capital restructuring has a significant effect on financial performance of listed firms in Kenya
- Capital restructuring significantly and positively relates with the financial performance of listed firms in Kenya.
- Firm size has a controlling effect on the relationship between capital restructuring and financial performance of listed firms in Kenya.
- Firm size has a negative controlling effect on the relationship between capital restructuring and financial performance of listed firms in Kenya.

Limitations of the Study were;

- The study was based on 10-year study period of 2010 to 2019. This means that the findings may differ where the analysis is done based on a different period like 5 years.
- The study was limited by the inability of the researcher to assess the credibility of the data from the published reports. This is despite the data having been sought from financial reports and the Nairobi Securities Exchange.
- The study was also limited to the capital restructuring in listed firms which may give different results if done on other firms.

From the findings the study recommended that:

- Listed firms regularly restructured their capital in order to improve their financial ratios. The firms listed firms should ensure that they have an optimal balance between debt and equity to ensure an effective capital structure for improved performance.
- Listed firms put relevant controls on the use of capital and other forms of equity regardless of the statutory requirements so that the financial performance of the firm is not jeopardized.
- Nairobi Securities Exchange recommends capital restructuring to the listed firms to improve their financial performance.

- Capital Market Authority give individual firms the freedom to identify the best strategies to use in restructuring their capital
- A study on capital restructuring and financial performance of non-listed firms
- A study on other factors influencing financial performance of listed firms other than capital restructuring
- A study based on a different period like 5 years

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