Determinants of Cost of Capital: Kenyan context

George Onyiego Kengere[1], Manasseh Njagi[1], Patricia Luvuno Chonga[1], Charles Guandaru Kamau[2]

[1]Postgraduate Student, Department of Business Administration, Technical University of Mombasa.

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

Abstract: *The purpose of this paper was to look at the determinants of the cost of capital for a firm. The study conducted a literature review with the goal of identifying the factors that influence the cost of capital for a firm. The research showed that profitability, liquidity, tax, growth, size, and age of the company are among the major determinants that influence the cost of capital for a firm. Further the research showed a positive correlation between the cost of capital and profitability, liquidity, growth, size, and age of the company. The capital arrangement of a firm is determined on account of the pecking order theory and trade-off theory while bearing in mind the cost elements associated with it. In Kenya, economic stability and political stability are the primary determinants that determine the cost of capital for a firm. This determining factor influences the availability and cost of credit offered by financial institutions in Kenya.*

Keywords: Capital Arrangement, Cost of Capital, Profitability, Liquidity, Leverage.

1. Introduction

The cost of capital is a critical aspect of any business's financial management as it determines the minimum return that a company must earn on its investments to satisfy its investors. In Kenya, several factors determine the cost of capital for businesses. Extensive research has been done to identify the determinants of capital costs. The two major sources of capital for a firm are either debt or equity financing. The source of capital adopted by the firm will ultimately be motivated by shareholder interest in profit maximization. We define the cost of capital as the amount of money that a firm pays after earning profit, to its shareholders, bondholders, or lenders.

Equity financing is usually provided by the shareholders of the firm or entity, and debt financing is usually provided by bondholders or lenders. For this reason, determinants of the cost of capital are largely influenced by the financing model adopted by a company. Many researchers have identified profitability, liquidity, growth, size, and age of the company among the major determinants that influence the cost of capital. According to Mittal and JHA (2020), "capital structure" refers to the incorporation of all accessible sources, and this incorporation is dependent upon firm, industry, and country-specific characteristics, where company and industry aspects both serve as macro environmental factors for the

organization. The capital arrangement adopted by a firm is determined by the capital costs associated with it.

2. Literature Review

According to Saif-Alyousfi et al. (2020), there are a number of factors influencing the cost of capital. These factors include profitability, growth, tax shield, liquidity, and unpredictability in cashflow, all of which have a negative weighty effect on the cost of capital. Equally important, additional factors include collateral, non-debt tax, and earnings unpredictability, which have a positive consequence on the cost of capital. Further, their study identified firm size, firm age, the inflation rate, and the interest rate as important determining factor of the present value of debt. Another study by Khan, Bashir, and Islam, (2021) suggested that earnings unpredictability, growth, and bank size show positive consequences and noteworthy relationships with book leverage. Further, the study suggests that profitability and tangibility of assets have a negative consequence on the book's leverage. The empirical findings of the study suggest that the evaluative variables of profitability, earnings unpredictability, tangibility of assets, growth, and bank size have material consequences on the capital structure decisions of Saudi commercial banks. In conclusion, the determinants of capital structure for Saudi banks are similar to those of non-financial entities but are unique in nature.

According to a 2019 study by Almanaseer, an array of factors, such as financial leverage, age, size, risk, growth, and tax, affect the capital structure of a bank.The capital arrangement of the bank influences its steadiness and its capacity to effectively provide adequate liquidity and credit, it is crucial for the banking sector to support economic growth in any nation and to make it easier for money to be transferred between units that are in deficit and those that are in surplus.The findings of the study show that there is a positive consequence linking financial leverage and age, growth, risk, size, and tax. This implies that older and larger financial institutions that have an increased growth rate will require financial support for their expansion operations and, if their internal resources are insufficient, will borrow money from outside sources. For this reason, banks must consider their solvency and liquidity, which necessitates the use of appropriate methodologies to establish the appropriate capital level and its appropriateness.

In another study conducted by Rahayu et al. (2020), The capital arrangement of an organization is determined by forms of profitability such as return on investment (ROI), return on equity (ROE), and net profit margins. The study further suggests that profitability is a determining factor in the capital structure of a firm. Profitability has a negative consequence on the capital structure of a firm. We also agree with the study that a decline in the fraction of debt within the capital structure of a firm is a result of increased profitability as measured by return on investment, return on equity, and net profit margin. According to Muhammad et al. (2019), A number of factors, such as firm size, profitability, and tangibility, influence the capital structure of a firm. According to their study, a case reference on banks in Bangladesh, there is a negative relationship between the capital structure and the profitability, size, and tangibility of a bank. The study suggested that firms with large banks with greater profitability and tangibility have less need for debt financing, but the opposite is actually true.

According to Flor and Petersen (2021), A number of factors, such as profitability, market-to-book, and the industry median average, influence the capital structure of an organization. Other factors include sales and tangibility. The study further suggests that the determinants

of the cost of capital are interdependent. We could not agree more that the main determinant of profitability is market-to-book and industry median averages, sales, and tangibility.

Accounting profit adjustments that reflect the opportunity cost of capital has been the focus of discussion for some time as per Alfred Marshall's principles. Cost of capital also have some degree of influence on financial performance (Kasidi et al, 2022). According to Ghani et al. (2022), an array of factors influences the capital arrangement of a firm. These factors include profitability, tangibility of assets, size, and the non-debt tax shield among others. Other factors include inflation and the debt-to-equity ratio. An entity has to do a trade-off theory analysis on the optimal capital arrangement that they intend to adopt. This, in essence, will also be determined by other factors affecting capital costs, such as profitability, tangibility, size, non-debt tax, inflation, and debt-to-equity ratio.

According to Cankaya and Bylo (2019), Many factors influence the capital arrangement of a firm. These factors, which include total debt to equity and short-term debt to equity ratios, profitability, liquidity, and taxes, influence the capital cost of a firm. The study focused mainly on emerging and transitional economies. In tandem with the pecking-order theory, a firm has to choose debt capital first before equity capital in that order. According to Juliasari et al. (2020), an array of factors influences the capital structure of a firm. These factors include asset structure, profitability, and company size. These variables have a positive consequence on the capital arrangement of a firm, and by extension, they influence the cost of capital for that firm. We could not agree more on this study.

According to Abeid et al (2020), The factors that influence the capital arrangement of a company include size, profitability, and investment opportunity. Further study indicates that the tangibility of assets is a factor, however not significant, that also affects the capital structure of a firm. Investment opportunities will open a window to explore various sources of capital that an entity can draw from, bearing in mind the cost elements of each thereof. The size of the company, i.e., the net worth of the company, and profitability levels will influence the capital arrangement and hence the cost implications of the capital arrangement adopted. According to Soekarno and Benyamin. (2023), A number of factors influence the capital structure of a firm, including profitability, liquidity, tangibility, and growth. The study suggests that the variables profitability, liquidity, tangibility, and growth have a positive and constructive impact on the leverage ratio of a firm.

Higher levels of cash dividend payouts increase a firm's likelihood of surviving since it leads to lower cost of debt. Dividend payouts have a signaling effect to the market and can effectively lead to cost-reduction (Mukhongo et al., 2022). According to Oudgou (2020), A number of factors, including growth rate, asset tangibility, profitability, size, taxes, and industry sector, affect an organization's capital arrangement. According to the study, profitability has an influence on the total debt of a firm. Profitable firms prefer to use resources generated by their assets. This ploughed-back profit is less costly. The study also underscores the benefits of debt financing for a firm; the interest paid on debt is tax deductible. According to the assumptions of the study, size, economic profitability, and risk are negatively associated with the total debt ratio. On the other hand, profitability and industry sector are positively related to the debt ratio. The findings of this study can be presented in the following diagram (Fig. 1)

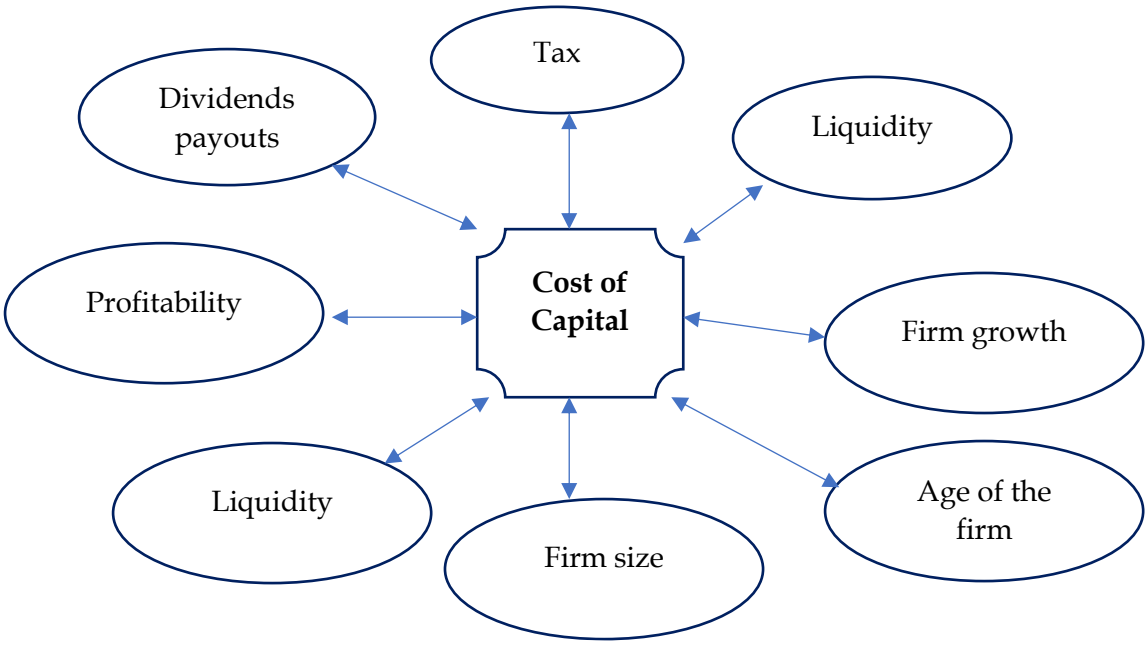

Figure 1: Determinants of Cost of Capital

3. Conclusion

The research paper explored the determinants of the cost of capital in a firm. The capital arrangement of a firm is determined on account of the pecking order theory and trade-off theory while bearing in mind the cost elements associated with it. Many researchers have identified profitability, liquidity, growth, size, age, and tangibility of the assets of the company among the major determinants that influence the cost of capital of a firm. The study identified significant interdependence among the variables therein that impact the cost of capital.

Firms that are highly profitable adopt self-financing models where profits are ploughed back into the company, while firms that are less profitable prefer debt financing models. Equity financing is usually the last resort for most firms because of its expensive nature.

One of the primary determinants of the cost of capital in Kenya is the country's political and economic stability. Political stability is crucial as it assures investors that their investments are secure, and their returns are not subject to disruption due to political upheavals. Economic stability, on the other hand, provides a predictable environment for businesses to operate in, reducing the risk of investment. Another determinant of the cost of capital in Kenya is the level of inflation. Inflation rates affect capital costs by increasing the risk of investment. Higher inflation rates lead to an increase in the cost of borrowing, which in turn increases the cost of capital for businesses.

The availability and cost of credit are also significant determinants of the cost of capital in Kenya. The cost of borrowing in Kenya is high due to the high-risk nature of the lending environment. Banks and other financial institutions charge high interest rates to compensate for the risk of default. This, in turn, increases the cost of capital for businesses. The level of competition in the market also affects the cost of capital in Kenya. Businesses that operate in

highly competitive markets have to offer higher returns to investors to encourage them to invest in their company. This, in turn, increases the cost of capital for companies operating in such markets.

Finally, the level of regulation in the financial sector in Kenya also affects the cost of capital. Tight regulations increase the cost of compliance for businesses, which in turn increases their cost of capital. In conclusion, the cost of capital in Kenya is determined by a combination of factors, including political and economic stability, inflation rates, availability and cost of credit, level of competition in the market, and the level of regulation in the financial sector. Businesses that understand these factors can make informed decisions on how to manage their cost of capital and maximize their returns on investment.

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