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Effects of Capital Structure Decisions on the Financial Performance of Hotel Industry in Kisii County, Kenya

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Abstract:
The purpose of the study was to examine the effects of capital structure decisions on the financial performance of hotels in Kisii County. The objectives of the study were to identify the effects of debt financing decisions, equity financing decisions and retained earning decisions affect the financial performance of the hotel industry in Kisii County. A survey study design was adopted. The total target population was 180. Stratified random sampling method was used to get the sample size, 30% of the targeted population. hotels and respondents, respectively. The sample size 54 respondents were used and it comprised The collected data was analyzed using descriptive statistics, percentages and five point likert scale was used for in depth analysis. The analyzed data was then presented using tables and figures. The study findings observed that the mix of long term and short term debt was most popular. Then finally, the common stock ranked third in that order. The study recommended that the hotel and lodging operators and entrepreneurs should consider internal financing during initial and final stages of operations and prefer debt as a second alternative in financing on-going operations. The study also recommended that the government through the tourism board and other donor agencies should consider providing incentives to small and medium enterprises by reducing lending interest rates and increase repayment window period.

1. Background of the Study

According to Fischer *et al.* (1999) capital structure decision is the optimal combining of the financing options available to a business. A business' capital structure include: common equity, preferred stock, and other debts. Business enterprises usually utilizes debt funds for their short term requirements, and also opt for long term options such as debentures, preferred stocks, and common equity when making any major expansion or purchase of long term assets. Such long term capital, options include profits retained by the business as reserves for any impending purchase or expansion. A profit making business finds it easier to raise money by offering common equity, and preferred stocks. Unlike it, a startup may have little choice but to opt for debt route. Interest rates applicable on debt depend upon prevailing market conditions and the risk associated with the business (Welch, 2004).

According to Fama and French (2001) preference in management style may affect what type of capital structure business owners choose. A business firm's capital structure may also depend upon the enterprise's current growth stage. Companies in the initial growth stages may tend to take on more debt in order to facilitate growth. However, many times firms may grow too rapidly, which causes their growth to be unstable. Firms that are more stable usually require less debt, due to more stable revenue streams. Market conditions are a significant factor in making capital structure decisions. In a stagnant market, investors may be less likely to invest capital; therefore, interest rates may be significantly higher. Therefore, companies may tend to avoid a high debt ratio during a struggling market.

Excluding debt, business risk is the basic risk of the company's operations. The greater the business risk, the lower the optimal debt ratio. A utility company generally has more stability in earnings. The company has less risk in its business given its stable revenue stream. However, a retail apparel company has the potential for a bit more variability in its earnings. **Financial flexibility** is essentially the firm's ability to raise capital in bad times. It should come as no surprise that companies typically have no problem raising capital when sales are growing and earnings are strong. Firms that are in the growth stage of their cycle typically finance that growth through debt, borrowing money to grow faster. The conflict that arises with this method is that the revenues of growth firms are typically unstable and unproven (Fama and French, 2001). Operating structure involved in making capital structure decisions. The factor of profitability also plays an important role in capital structure decisions. The firms which get high rates of return on investment do not use high debt but they use relatively little debt (Rajan and Zingales, 1995). High rates of return on investment make them able to do financing with internally generated funds (Strebulaev, 2007).

In Kenya, international hotel chains are opening their branches to reap the market rewards from this competitive industry. Firms with a high demand for additional capital may resort to a greater variety of sources of funding than firms with lesser needs. For firms

possessing a high-level of no-lien fixed assets, debt is the preferred choice to fund positive Net Present Value projects when internal funding is insufficient internal and inadequate non-collateralized fixed assets are less averse to ceding control and resort to external equity from new investors (Hogan and Hutson, 2005). This may be especially true for firms engaged in a high level of intangible activity relative to their turnover (Berggren et al 2000).

1.1. Statement of the Problem

The decline in world tourism has grossly affected hotel sales and posed a challenge to hotel operators because Kenyan hotels largely depend on the international tourism market (Oketch et.al, 2010). Further Kamau (2008) states that the tourism sectors under which hotels are found in Kenya has been facing numerous challenges which have posed a threat to their existence. These challenges include competition, technological changes economic challenge including inadequate financing. However most of the research work has been carried out in developed economies and very little is known about the capital structure of firms in developing economies particularly in the Hotel industry in Kisii County. This research may unearth some information as to whether conclusions from theoretical and empirical research carried out in developing economies are valid for developed countries too or a different set of factors. Influence capital structure decisions in developing countries, particularly the hotel industry.

Conclusion from research on capital structure are portable across countries in general, are inadequate on addressing the issue of capital structure Rajan Zingales (1995) studied the G.7 countries the conclusion from their studies indicate common features in the capital structure of firms in different countries, but that further research is necessary to determine the effects of the financing decisions in particular institutional settings or countries particularly the hotel industry.

Studies on strategic plan practices (Kamau 2008) and strategic competitive advantage (Mibei 2007). These researches have been done away from Kisii County and in areas of management. Most researches on hotel industry have been conducted at Nairobi and Mombasa cities. These inadequacies in the hotel industry seek for this study on capital structure decisions on capital performance of the hotel industry.

1.2. Objectives of the Study

1.2.1. General Objective

The general objective of this study was to determine the effects of capital structure decisions on the financial performance of the Hotel Industry in Kisii County, Kenya.

1.2.2. Specific Objectives

i. To identify the effects of debt financing on the financial performance of Hotel Industry in Kisii County, Kenya.
ii. To identify the effects of equity financing on the financial performance of Hotel Industry in Kisii County, Kenya.
iii. To establish the extent to which retained earnings affect the financial performance of the Hotel industry in Kisii County – Kenya.

1.3. Research Questions

i. To what extent do debt financing influence the financial performance of the Hotel industry in Kisii County, Kenya?
ii. To what extent do equity financing influence the financial performance of Hotel industry in Kisii County, Kenya?
iii. To what extent do retained earnings affect the financial performance of hotel industry in Kisii County, Kenya?

2. Empirical Literature Review

According to DeAngelo and Masulis (1990), corporate finance is an area of finance dealing with the financial decisions corporations make and the tools and analysis used to make these decisions. The primary goal of corporate finance is to maximize corporate value while reducing the firm's financial risks. Although it is in principle different from managerial finance which studies the financial decisions of all firms, rather than corporations alone, the main concepts in the study of corporate finance are applicable to the financial problems of all kinds of firms. The discipline can be divided into long-term and short-term decisions and techniques. Michael and Mark (2004) added that capital investment decisions are long-term choices about which projects receive investment, whether to finance that investment with equity or debt, and when or whether to pay dividends to shareholders. Management must allocate limited resources between competing opportunities in a process known as capital budgeting. Making this capital allocation decision requires estimating the value of each opportunity or project: a function of the size, timing and predictability of future cash flows.

Harris and Raviv (1991) observed that achieving the goals of corporate finance requires that any corporate investment be financed appropriately. The sources of financing will, generically, comprise some combination of debt and equity. Financing a project through debt results in a liability that must be serviced-and hence there are cash flow implications regardless of the project's success. Equity financing is less risky in the sense of cash flow commitments, but results in a dilution of ownership and earnings. The cost of equity is also typically higher than the cost of debt and so equity financing may result in an increased hurdle rate which may offset any reduction in cash flow risk.

In general, management must decide whether to invest in additional projects, reinvest in existing operations, or return free cash as dividends to shareholders. The dividend is calculated mainly on the basis of the company's inappropriate profit and its business prospects for the coming year. If there are no NPV positive opportunities, i.e. where returns exceed the hurdle rate, then management must return excess cash to investors. These free cash flows comprise cash remaining after all business expenses have been met.

Management must also decide on the form of the distribution, generally as cash dividends or via a share buyback. There are various considerations: where shareholders pay tax on dividends, companies may elect to retain earnings, or to perform a stock buyback, in both cases increasing the value of shares outstanding; some companies will pay dividends from stock rather than in cash (Gilson, 1997).

Capital structure is a mix of a company's long-term debt, specific short-term debt, common equity and preferred equity. Firms that rely heavily on debt for financing operations pose greater investment risks. Factors that affect a company's capital structure include business risk, taxation, financial flexibility, management style, growth rate and market conditions. Business risk is the basic risk of a firm's operations without factoring in debt. Greater business risk should be countered by a lower debt ratio in a firm's capital structure. Applicable tax laws and regulations may also play an important role in capital structure decisions. Since debt payments are tax deductible, if a company's tax rate is high, it may make sense to use debt as a means of financing. The lower a firm's debt ratio, the more flexibility the company has during difficult economic periods. Financial flexibility is a company's ability to raise capital during slow-growth periods (Faccio and Masulis, 2005).

2.1. Research Design

A survey research design was used as it allowed obtaining the same kind of data from a large group of people in a standard and systematic way (Sekevan and Rodgers 2011) using this design, patterns of data from the hotels and restaurants will be investigated and generalized to a large population. The study was descriptive in nature whereby the characteristics of various variables to be studied were described and any correlation determined.

2.2. Target Population

The target population of the study included the established hotels and lodging firms operating in Kisii County. A pre-survey identified a total of 72 hotels and lodgings.

The target population was 180 respondents. The population consisted of hotel managers, hotel accountants, the hotel owners and the hotel financial managers where applicable. These are the people with full knowledge concerning
the hotel capital structure.

Category	Population	Percentage
Owners	50	28
Managers	74	41
Accountants	30	17
Finance managers	26	14
Total	180	100

Table 1: Target population

2.3. Sampling Design

Stratified sampling was used to select the hotels for each category for the study. Kothari (2012) notes that stratified sampling is used when a population from which a sample is to be drawn does not constitute a homogeneous group. This method also involved dividing the population into a series of relevant strata which implies that the sample is likely to be more representatives (Saunders et.al, 2009).A total of twenty two large hotels and restaurants that are well established were surveyed and the related data was analyzed.

2.4. Sample Size

The researcher used a sample size of 30% of each category of the target population as recommended by Mugenda and Mugenda (2003) who recommends a sample size of between 10% and 30% of the target population for the research.

A total of 22 hotels were sampled from the total target population of 72 hotels in
Kisii County. A sample size of 54 respondents was used.

No	Category	Target population	Sample
1	Owners/shareholders	50	15
2	General managers	74	22
3	Accountants	30	9
4	Finance managers	26	8
	Grand total	180	54

Table 2: Sample size Determination

2.5. Data Collection Procedures

The study adopted a multiple data collection technique in order to achieve a higher response rate. Data collection tools were administered by the researcher targeting primary data sources that were deemed to be important to the study.

Primary data was collected by use of closed and open ended self administered questionnaires. According to Sekeran (2009), a questionnaire is a pre-formulated written set question to which respondents record their answers usually within closely defined alternatives. The questions were administered using a drop and pick later approach so that the respondents could have ample time.

The researcher drafted a letter of introduction that helped to conduct the study. The university also issued the authority letter which assisted in getting permission to collect data.

3. Data Analysis

Data analysis was done to test research questions and data that were obtained from the respondents through questionnaires and interviews. Data was edited and categorized before analyzing it and interpreting it.
Frequency distributions were obtained for all personal data and classified variables under the data. The frequencies for the number of respondents in each department number of males and females employees education levels and length of stay in the hotel. Inferential statistics was used to analyze, the relationship between variables. Likert scale was also used for in-depth analysis.

3.1. Debt Capital Structure Decisions

3.1.1. Influence of Debt Capital Structure Decisions on the Growth of the Hotel Industry

The study sought to determine the extent to which respondent rate the significance of debt capital structure decisions on the growth of the hotel industry in Kisii County.

Rate	Frequency	Percentage
Most significant	10	18.5
More Significant	29	53.7
Moderately Significant	8	14.8
Less significant	5	9.3
Not significant	2	3.7
Total	**54**	**100**

Table 3: Influence of debt capital structure decisions on the growth of the hotel industry

As shown in Table 3 in the findings, most of the respondents as shown by 53.7% indicated that it was more significant this is because capital structure relates to growth of wealth maximization through external financing, 18.5% of the respondents indicated that to be most significant, 14.8 % of the respondents indicated moderately significant, 9.3% said it was less significant whereas 3.7% of the respondents indicated to be not significant. This is an indication that the debt capital structure decisions on the growth of the hotel industry in Kisii County are significantly influenced. Bank credit was most preferred for ongoing operations followed by retained earnings and share capital respectively. Future financing of the firm in hotel and lodging sector favoured use of internal sources followed by use of debt which support pecking order theory. These findings concurred with Hall et al (2004) who agreed that age of a business is significantly as well as positively related to long term debt but negatively related to short term debt

3.2. Retained Earnings and Growth of Hotel Firms

3.2.1. Statements on Appraising Retained Earnings in Relation to Growth of Hospitality Firms

The study sought to determine the respondent's level of agreement with the statements below relating to appraising retained earnings in relation to growth of hospitality firms.

Category	Strongly Agree	Agree	Undecided	Disagree	Strongly Disagree	Total	Percentage (%)
Retained earnings are used to pay regularly other expenses	20	13	10	7	4	54	
Percentage (%)	37.0	24.1	18.5	13.0	7.4		100
The retained earnings from the previous years accumulate over time	22	14	9	6	3	54	
Percentage (%)	40.7	25.9	16.7	11.1	5.6		100
Level of retained earnings affect the performance of the hotel industry	24	15	8	5	2	54	
Percentage (%)	**44.4**	**27.8**	**14.8**	**9.3**	**3.7**		**100**

Table 4: Statements on appraising retained earnings in relation to growth of hospitality firms

From the research findings the study established that majority of the respondents strongly agreed that Level of retained earnings affect the performance of the hotel industry as shown by 44.4%, followed by respondents who also strongly agreed that the retained earnings from the previous year's accumulate over time as shown by 40.7%, and finally that retained earnings are used to pay regularly other expenses as shown by 37.0%, the above findings concurs with the findings by (Frielinghaus et al. 2005) according to Frielinghaus et al. determining bank credits entails retained earnings and trade credits as the main sources of financing for publicly traded Indonesian firms. Retained earnings are internal sources used in a higher percentage especially for small hotel businesses. However, both equity and debt sources may be used proportionately depending on the profitability of the hotel.

3.3. Equity Capital Structure Decisions

3.3.1. Assessment of Equity Capital Structure Decisions on an Organization

The study sought to determine the respondent's level of agreement with the statements relating to assessing equity capital structure decisions on an organization.

Category	Strongly Agree	Agree	Undecided	Disagree	Strongly Disagree	Total	Percentage (%)
Financial flexibility is the ability of an hotel to raise capital during slow-growth periods	16	28	7	2	1	54	
Percentage (%)	**29.6**	**51.9**	**13.0**	**3.7**	**1.9**		**100**
The mix of an organization consists of equity as sources of capital	14	25	8	5	2	54	
Percentage (%)	**25.9**	**46.3**	**14.8**	**9.3**	**3.7**		**100**
Organization to maintain certain optimal mix of financing	15	26	6	4	3	54	
Percentage (%)	**27.8**	**48.1**	**11.1**	**7.4**	**5.6**		**100**
Is it profitable to use debt financing	12	21	10	7	4	54	
Percentage (%)	**22.2**	**38.9**	**18.5**	**13.0**	**7.4**		**100**
Sources of capital include equity only	10	24	9	6	5	54	
Percentage (%)	**18.5**	**44.4**	**16.7**	**11.1**	**9.3**		**100**
Is equity the least expensive source of capital	11	23	10	8	2	54	
Percentage (%)	**20.4**	**42.6**	**18.5**	**14.8**	**3.7**		**100**

Table 5: Assessment of equity capital structure decisions on an organization

From the research findings the study established that majority of the respondents agreed that Financial flexibility is the ability of an hotel to raise capital during slow-growth periods as shown by 51.9%, Organization to maintain certain optimal mix of financing as shown by 48.1%, The mix of an organization consists of equity as sources of capital as shown by 46.3% also that the sources of capital include equity only as shown by 44.4%, Is equity the least expensive source of capital as shown by 42.6% and finally that it is profitable to use debt financing as shown by 38.9%, the above findings concurs with the findings by (Hovakimian et al. 2004) according to Hovakimian et al. Several works show a positive relationship between firm size and leverage. Their results suggest that smaller firms are more likely to use equity finance while larger firms are more likely to use debt rather than stock. Small enterprises have greater problems with credit than larger firms. Their results showed that the success rate for large firms applying for bank loans was higher than that of small firms.

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