

# **Effect of Stakeholder Power on Capital Structure among Firms Listed In Nairobi Securities Exchange**

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## **Abstract**

*The financial management should ensure that the firm's capital structure maintains a healthy mix of debt and equity financing, taking into account the specific conditions of the business. While borrowing money makes financial sense, a company should avoid becoming unduly reliant on it because it raises its risk. Despite substantial research on the subject, little attention has been paid to the likely effect of stakeholder power on capital structure. In trying to solve this problem, the study sought to establish the effect of stakeholder power on capital structure. The specific objectives were to determine: the effect of government power, investor power, and creditor power on capital structure. The study concluded that firm size, government power, creditor power, and investor power had a positive and significant effect on capital structure and that, increase in these variables significantly increased debt ratio. On the other hand firm age and growth opportunities had a negative and significant relationship on capital structure. Meaning an increase in these variables significantly reduced debt ratio. The study made several recommendations, including that management develop a model that takes into account the interests of the different stakeholders under this study, company BODs ensure that CEO dominance is reduced as it affects borrowing, and capital market authority remove barriers that prevent firms from borrowing.*

**Key words:** *government power, creditor power, investor power, and capital structure.*

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## **I. Introduction**

The tradeoff theory, for example, claims that corporations pursue debt levels that balance the tax benefits of greater debt with the risks of possible financial distress. According to the static trade-off hypothesis, the timing of loan issuance is critical for achieving zero leverage in the cross-section of enterprises (Haddad and Lotfaliei, 2019). When internal cash flow is insufficient to cover capital expenditures, the pecking order hypothesis states that the corporation will borrow rather than issue shares. The free cash flow theory states that when a company's operating cash flow greatly exceeds its lucrative investment prospects, despite the risk of financial crisis, its value will rise. The existence of information asymmetry in emerging economies' financial markets may limit access to foreign sources of funding. As a result, free cash flow may be a more cost-effective source of capital. This advantage may offset, cancel out, or even outweigh the agency costs incurred as a result of excess free cash flow (Nguyen and Nguyen, 2018).

According to Yapa (2017), the capital structure or financial leverage decision should be defined in terms of how the debt and equity mix in a company's capital structure affects its market value. The debt-to-equity ratio of a company can have a big impact on its value and cost of capital. In some industries, the relationship between cost of capital, cost of equity capital, company value, and other financial factors supports the Traditional view, whereas in others, it supports the Modigliani and Miller view (Kaur and Khullar, 2019). More debt capital is used in the capital structure to maximize shareholder value because interest paid is tax deductible and lowers the debt's effective cost.

Equity is the money invested by shareholders and presents long-term financing since it does not obligate to an effective repayment, though the firm may choose to distribute funds to the owners in the form of cash dividends as there is no legal requirement to do so. This is the associated return expected by the shareholders for the sustained risk, which is dependable on the firm's profitability. However, if this return does not meet the shareholders expectations the company will not be necessarily in a situation of bankruptcy. Equity value has a bigger impact on earnings per share than debt equity ratio, according to Lucky et al. (2017). Earnings belong to the owners and can be given to them as cash dividends or reinvested in the business. Owners anticipate earnings to be invested in projects that will increase the firm's worth and thus the value of their shares if management ploughs profits back into the company. There is no uniform theory of debt equity choice, according to Myers (2001), and no reason to assume one.

In terms of both economic uptrend and downtrend, equity financing, which has a higher risk tolerance, has a more beneficial impact than debt financing. Because debt investors receive a predetermined return, equity holders are not required to share their gains with debt holders. They also have certain rights, such as the ability to elect the board of directors, who will function as an agent to monitor the performance of the firm's managers (Zhang et.al, 2017).

Debt, on the other hand, refers to the money invested in businesses by creditors, and it implies an obligation and an effective payment, which is usually linked to an interest rate and a maturity date. Debt financing has become a widespread occurrence in the corporate world around the world, according to Onchong'a, Muturi, and Atambo (2016). It provides a platform for commercial firms to fill funding gaps caused by a lack of internal resources to fund their investment and operating activities. Before commencing on debt financing for investment, managers must assess the level of liquidity, liquidity drift, and interest rates (Mtunya, Ngare and Nkansah-Gyekye, 2018).

Creditors expect the amount of interest and principal, as well as specified legal commitments, to be paid back as pledged if a company decides to finance its activities with debt; failing to do so may result in legal action by creditors. Failure to pay can also lead to financial distress, which is when a company makes decisions under duress in order to meet its legal responsibilities to its creditors. Financial distress is negatively influenced by leverage (Masdupi, Tasman and Davista 2018, July). These decisions may not be in the best interests of the owners of the firm. According to Feng et al. (2007), there are three main reasons why companies borrow money. One, it generates funds. Second, interest payments are tax deductible, so the debt tax shield adds value to the firm. Finally, the mandatory interest payment on debt reduces the agency cost of managerial proclivity to waste money on bad investments. On the negative side, debt can expose a company to bankruptcy costs, and leverage can cause managers to avoid profitable investments in order to minimize wealth transfer to bond holders.

The more money a company borrows, the more it is committed to repaying in interest and principal, whether it is profitable or not. As these commitments grow, so does the risk to the common shareholder, who receives a dividend only after all other financial obligations have been met (Mcmenamain, 2005).

### **Objectives**

1. Investigate the effect of government power on capital structure
2. Establish the effect of creditor power on capital structure
3. Determine the effect of investor power on capital structure

### **Hypothesis**

**H<sub>01</sub>**: government power has no significant effect on capital structure

**H<sub>02</sub>**: creditor power has no significant effect on capital structure

**H<sub>03</sub>**: investor power has no significant effect on capital structure

### **Empirical review**

#### **Government power and capital structure**

The growing popularization of stakeholder theory among management scholars has offered a useful framework for understanding the multiple and interdependent roles of government and business in an increasingly challenging political and regulatory environment. Despite this trend, attention to the role and responsibility of government to protect citizen rights has been limited. Governments serve four roles in the business government society nexus namely; framework, business partner, interfering and advocate.

Stakeholder theory has granted government cursory attention and role in its view of business society relations. Indeed, government is typically seen as either a non-stakeholder in the background or merely one among many stakeholders, with no consideration for its unique roles and place in the business government society nexus Dahan et al. (2015). According to Graham, leary and Roberts (2014) aggregate corporate leverage

and the leverage of the regulated sector have remained quite stable over time. In contrast, leverage of unregulated firms has increased significantly, approaching the level of indebtedness of regulated firms.

Firms appear to have increased their propensity to use debt financing over the century. Changes in the economic environment plausibly increased firms' willingness to issue, or investors' willingness to hold, corporate debt. These include increased corporate tax rates, reductions in aggregate uncertainty, growth in financial intermediation, and a large reduction in government borrowing. Finally, their study found a negative association between government borrowing and corporate debt issuance with the supply of competing securities, such as Treasury debt, affecting aggregate leverage by shifting the demand curve for corporate debt. Jin (2021) corporate tax can result in lower debt usage, and this relationship is dependent on the size and profitability of the organization, with large firms experiencing more sensitive substitution effects and extremely profitable firms experiencing complementary rather than substitution effects and Panda and Nanda (2020) the effective tax rate has a substantial impact on debt levels.

### **Creditor power and capital structure**

Creditor is an individual or institution that lends money. In corporations, this forms the company financial leverage. According to Cortez, and Susanto, (2012) when creditors are faced by the problem of being unable to monitor the firm's behavior carefully, they would demand higher yield to compensate for such risk and firms face a higher contraction costs in the public market. This is why larger firms that are presented with a lower degree of asymmetric information, face lower risk and prefer to issue corporate bonds instead. On the other hand, smaller firms who face a higher degree of information asymmetry and have more growth options in their investment opportunity, are more likely to borrow from banks and creditors because they mitigate adverse selection problems.

According to Ishari and Abeyrathna (2016) a company financing from the debt capital has a legal binding to pay interest on the debt at the predetermined rate and this liability cannot be eliminated until the withdrawal of the debt capital. Increasing use of debt in the capital structure also increases financial risk and bankruptcy cost to the shareholders. Therefore within these two conflicting legal bindings, the management of the company has to pay more attention on the maximization of shareholders' wealth because the survival of the company and its managements is dependent on the satisfaction of the shareholders. Thus the management of the company should consider how financing of required funds affect the shareholder risk, return and value of the firm. Roberts and Sufi (2009) demonstrate that incentive conflicts between companies and their creditors have a significant impact on corporate debt policy following debt covenant violations, when creditors exercise their acceleration and termination powers to raise interest rates and decrease credit availability, net debt issuance activity drops sharply and persistently. When the borrower's alternative sources of finance are expensive, creditor activities have the greatest impact on debt policy.

According to oino (2013) firms seek target leverage. The dependence of a firm's leverage level of firm characteristics has usually been interpreted in favour of either the trade-off theory or the pecking order theory. Profitability is negatively associated with leverage which is consistent with the prediction of Myers' pecking order hypothesis rather than the trade-off theory. Also, large firms appear to be highly leveraged, which supports the agency theory in that as firms grow in size, owners become devoid of control and hence will prefer debt so that managers can be committed to interest payment obligations. El Ghouli, Guedhami, Kwok and Zheng (2021) found that Strong creditor protection helps less leveraged businesses, but it hurts highly leveraged businesses by raising negative responses from consumers, competitors, and staff. Creditor rights have a greater negative impact on high-leverage costs in nations with developed debt markets and banking systems, but are largely inconsequential in countries with developed stock markets and low information asymmetry and Singh, Jادیyappa, and Sisodia(2021)found that strengthening creditors' rights had a negative impact on debt ratio and debt heterogeneity, but a good impact on long-term debt maturity structure.

### **Investor power and capital structure**

Investor is any person or other entity, such as a firm or mutual fund who commits capital with the expectation of receiving financial returns. Investors utilize investments in order to grow their money and/or provide an income during retirement, such as with an annuity.

The current scenario of corporate firm's objective is to maximize the shareholder esteem. Wealth of shareholders is inferred mostly from stock price changes over a period and dividends paid. To accomplish this, the firm ought to view point of its impact on the value of the firm. There exist numerous components which affect the firm value and shareholder wealth. In such variables capital structure is one. The firm needs to raise finance to invest in projects and the future cash flows of the projects will enhance the firm's value and hence enhance the shareholder wealth. Karismawati and Suarjaya(2020)dividends have a minor positive effect on capital structure and Susilawati and Suryaningsih (2020) found thatthe debt-to-equity ratio has no impact on stock prices since most investors are more interested in the company's ability to finance with debt than the amount of debt.

This involves a capital structure decision because it has to decide the amount of finance to be raised as well as the source from which it is to be raised (Venugopal and Reddy, 2016). Jozwiak (2015) dividend payout ratio is a negative function of profitability and leverage. Vatavu (2015) the most profitable manufacturing companies were those maintaining a high proportion of equity in their capital mix, avoiding borrowed funds. Shareholders' equity has a positive impact on performance indicators, while total debt and short-term debt have negative relationships with ROA and ROE. Acheampong, Agalega and Shibu (2014) the study established a negative and significant relationship between leverage and stock return when the overall industrial data is used. However at the individual firm level the relationship was not stable.

Chen, and Malaquias (2018) the behavior of prioritizing shareholders of exclusive funds is particularly strong during a period when the market volatility is high. Companies owning a large proportion of fixed assets register lower earnings. Data provided information that companies barely use debt with long maturities. Moreover, sometimes they operate without long-term debt over a few years. Therefore, the decision of accessing borrowed funds for their growth opportunities would be an exceptional one. Margaritis and Psillaki (2010) more debt in the capital structure is often correlated with more concentrated ownership, but there is little evidence that ownership type influences leverage decisions.

## II. Methodology

The panel and explanatory research designs were used in this study. The target population included 67 firms that were listed on the Nairobi Securities Exchange between 2008 and 2020. The study's inclusion and exclusion criteria focused on levered firms that were in operation between 2008 and 2020. Because they did not meet the criteria, 27 firms were dropped. As a result, the final sample surveyed was a balanced panel of 40 firms over a 13-year period. As a result, there were 520 firm-year observations for firms listed on the NSE. The study relied on secondary data. The detailed information on government power, investor power, creditor power, capital structure, and control variables was gathered from published company reports, planning documents, and audited financial statements of the sample firms listed on the Nairobi stock exchange. The debt ratio was used to assess capital structure (Daher, 2017), (Salim and Yadav, 2012), and (Vatavu, 2015). The debt ratio is defined as book debt divided by total assets, where book debt is the sum of short and long term debt. This study used the Degryse, de Goeij, and Kappert (2012), Chao, Hu, Munir, and Li (2017), Ernst, Richter, and Riedel (2014), and Zirculis, and Sarapovas (2017) effective tax rate to calculate corporate and personal tax payments. Creditor power was measured in this study using net debt issuance, which was defined as the difference between book debt at year t and book debt at year t-1 scaled by total assets (Daher, 2017). (Lu and Abeysekera, 2014). The study calculated investor power by dividing the change in share price over the year plus dividends by the beginning-of-the-year price (Takacs Haynes, Campbell, & Hitt, 2017).

## III. Results

### Fixed effects regression results

**Table 1 Direct Variables and Capital Structure**

Oneway (individual) effect Within Model				
Balanced Panel: n = 13, T = 40, N = 520				
Residuals:				
Min.	1st Qu.	Median	3rd Qu.	Max.
-0.5480755	-0.0978432	0.0064606	0.1122679	0.6220480
Coefficients:				
Estimate	Std. Error	t-value	Pr(> t )	
fsize	1.9820e-02	9.2255e-03	2.1484	0.032 *
fage	-9.4045e-04	2.2220e-04	-4.2325	0.000 ***
grth	-1.6143e-02	3.7060e-03	-4.3560	0.000 ***
gp	2.4284e-01	4.7089e-02	5.1571	0.000 ***
cp	3.4255e-01	1.8087e-02	18.9393	0.000 ***
ip	5.4280e-02	9.3333e-03	5.8157	0.000 ***
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Signif. codes: 0 '***' 0.001 '**' 0.01 '*' 0.05 '.' 0.1 ' ' 1				
Total Sum of Squares: 41.387				
Residual Sum of Squares: 13.037				
R-Squared: 0.68499				
Adj. R-Squared: 0.67236				
F-statistic: 135.632 on 8 and 499 DF, p-value: < 2.22e-16				

**Hausman Test:** chisq = 26.095, df = 8, p-value = 0.001012

The study objective here was to investigate the effect of government power, creditor power, and investor power on capital structure. Table 1 presents the fixed effects regression model results on the effect of firm size, firm age, growth opportunities, government power, creditor power and investor power on capital structure. The results showed that the overall model is significant ( $p < 0.05$ ) indicating that the model has an effect on capital structure. Also from the table results the study concluded that firm size, firm age, growth opportunities, government power, creditor power, and investor power can explain 68.499% variation in capital structure. The results indicated that firm size had a positive and significant effect on capital structure ( $\beta = 0.01982$ ,  $p = 0.032$ ), this means that a unit change in firm size causes 0.0198 increase in debt ratio and the p-value was less than 0.05 showing that firm size significantly affects debt ratio, firm age had a negative and significant effect on capital structure ( $\beta = -0.00094045$ ,  $p = 0.000$ ), meaning that a unit change in firm age causes a reduction of 0.00094045 in debt ratio and the p-value was less than 0.05 indicating that firm age significantly affects debt ratio, growth opportunities showed a negative and significant effect on capital structure ( $\beta = -0.016143$ ,  $p = 0.000$ ) meaning that a unit change in growth opportunities decreases debt ratio by 0.016143 and the p-value was less than 0.05 reporting that growth opportunities significantly affects debt ratio.

Government power had a positive and significant effect on capital structure ( $\beta = 0.24284$ ,  $p = 0.000$ ) indicating that a unit change in government power leads to 0.24284 increase in debt ratio and the p-value was less than 0.05 showing that government power significantly affects debt ratio. This disagrees with Jin (2021) which found that corporate tax can result in lower debt usage, and this relationship is dependent on the size and profitability of the organization, with large firms experiencing more sensitive substitution effects and extremely profitable firms experiencing complementary rather than substitution effects and Panda and Nanda (2020) found that the effective tax rate has a substantial impact on debt levels.

Creditor power had a positive and significant effect on capital structure ( $\beta = 0.34255$ ,  $p = 0.000$ ) showing that a unit change in creditor power increases debt by 0.34255 and the p-value was less than 0.05 indicating that creditor power significantly affects debt ratio. This agrees with the findings of El Ghouli, Guedhami, Kwok and Zheng (2021) which found that Strong creditor protection helps less leveraged businesses, but it hurts highly leveraged businesses by raising negative responses from consumers, competitors, and staff. Creditor rights have a greater negative impact on high-leverage costs in nations with developed debt markets and banking systems, but are largely inconsequential in countries with developed stock markets and low information asymmetry but inconsistent with the findings of Singh, Jadyappa, and Sisodia (2021) which found that strengthening creditors' rights had a negative impact on debt ratio and debt heterogeneity, but a good impact on long-term debt maturity structure.

Investor power had a positive and significant effect on capital structure ( $\beta = 0.05428$ ,  $p = 0.000$ ) meaning that a unit change in investor power increases debt by 0.05428 and the p-value was less than 0.05 indicating that investor power significantly affects capital structure. This is consistent with Karismawati and Suarjaya (2020) findings, that dividends have a minor positive effect on capital structure and inconsistent with Susilawati and Suryaningsih (2020) which found that the debt-to-equity ratio has no impact on stock prices since most investors are more interested in the company's ability to finance with debt than the amount of debt.

#### **H<sub>01</sub>: government power has no significant effect on capital structure**

Table 1 results indicated that government power had a positive and significant effect on capital structure ( $\beta = 0.24$ ,  $p = 0.000$ ) showing that a unit change in government power increases debt ratio by firms listed at Nairobi securities exchange by 0.24. The p-value is less than 0.05 indicating that the null hypothesis that government power has no significant effect on capital structure was rejected and conclude that government power has significant effect on capital structure. This means that an increase in effective tax rate increases debt ratio, hence, firms use more debt to finance their investments when taxes are high. This is consistent with Overesch and Voeller (2010) findings that, an increase in the debt tax advantage is likely to have a considerable favorable influence on a company's financial leverage. Smaller firms' capital structures react more strongly to changes in the debt tax benefit, and not only corporation taxes are important for corporate financial planning, but variations in capital income tax rates at the shareholder level also result in significant capital structure changes.

#### **H<sub>02</sub>: creditor power has no significant effect on capital structure**

Table 1 showed that creditor power had a positive and significant effect on capital structure ( $\beta = 0.34$ ,  $p = 0.000$ ) reporting that a unit change in creditor power increases debt ratio by 0.34 of firms listed in Nairobi securities exchange. The p-value is less than 0.05 indicating that the null hypothesis that creditor power has no effect on capital structure was rejected and conclude that creditor power has significant effect on capital structure. This means that with high creditor power firms tend to finance their investments using debt than

equity. This is in agreement with Roberts and Sufi (2009) findings that incentive conflicts between companies and their creditors have a significant impact on corporate debt policy following debt covenant violations, when creditors exercise their acceleration and termination powers to raise interest rates and decrease credit availability, net debt issuance activity drops sharply and persistently. When the borrower's alternative sources of finance are expensive, creditor activities have the greatest impact on debt policy.

### **H<sub>03</sub>: investor power has no significant effect on capital structure**

Table 1 showed that investor power had a positive and significant effect on capital structure ( $\beta=0.054$ ,  $p=0.000$ ) reporting that a unit change in investor power increases debt ratio by 0.054. The p-value is less than 0.05 indicating that the null hypothesis that investor power has no significant effect on capital structure was rejected and conclude that investor power has significant effect on capital structure. This indicates that firms use more of debt financing than equity financing when the investor power is high. This is consistent with Margaritis and Psillaki (2010) findings that more debt in the capital structure is often correlated with more concentrated ownership, but there is little evidence that ownership type influences leverage decisions.

## **IV. Conclusions**

The study sought to investigate the effect of control variables and stakeholder power proxies on capital structure. The study findings on the stakeholder power proxies found that government power had a direct effect on the capital structure. A high government power significantly increases the debt ratio, meaning that firms listed on the Nairobi securities exchange use more debt than equity when the government power is relatively high. When the government increases taxes, it leads to an effective tax rate within the firm; therefore, firms react by borrowing more and issuing less equity. This means that, with increased taxes, firms listed on the Nairobi securities exchange tend to use more debt than equity in their capital structure in financing real investment.

The study found that creditor power had a direct effect on the capital structure. A high creditor power increases the debt ratio, meaning that firms listed on the Nairobi securities exchange use more debt than equity to finance real investment when the creditor power is considerably high. Firms listed on the Nairobi securities exchange use more debt every year compared to equity in funding their assets when there are insufficient funds within the firm. This affirms the pecking order theory that firms use retained earnings to finance investments, and in the event that there is a deficit, the firm will go for debt, with equity being the last resort.

The study also found that investor power had a direct effect on the capital structure. A high level of investor power increased the debt ratio, which means that firms listed on the Nairobi Securities Exchange use more debt than equity to fund investment projects. This is also in line with the arguments of pecking order theory and static trade off theory. Firms that declare dividends to their shareholders every year encourage borrowing to finance their assets rather than issuing equity, meaning that firms described as having high shareholder returns use more debt than equity.

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