CAPITAL STRUCTURE, LIQUIDITY AND FINANCIAL PERFORMANCE OF NON FINANCIAL FIRMS LISTED AT THE NAIROBI SECURITIES EXCHANGE

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Abstract

This paper examines the effect of capital structure on the financial performance of the and nonfinancial firms listed at the Nairobi Securities exchange. It also examines how this relationship is intervened by liquidity. Additionally, it evaluates the existence of equilibrium\disequilibrium relationship among the variables. The study analyzed unbalanced panel data sourced from across 53 nonfinancial firms listed at the Nairobi Securities Exchange covering 2010 to 2017. Total debt to total equity was used for assessing the capital structure of the listed nonfinancial firms. The indicator of liquidity was asset liquidity and was operationalized by the ratio of current assets to current liabilities. Financial performance attribute was operationalized by Tobin's Q. Analysis of data was done using descriptive statistics, multiple and simple regression analyses. The study showed that leverage positively and significantly affected the financial performance of the listed nonfinancial firms. Furthermore, liquidity has a positive intervening effect on capital structure and financial performance relationship. The conclusion from the study is that companies should strive to raise their liquidity as long as it does not cause instability to the firm. This is due to the finding that liquidity has a statistically significant positive effect on the financial performance of the NSE listed nonfinancial firms. The study further concludes that company managers should strive to enhance an optimum balance of current assets and current liabilities in firms because they help in enhancing a firm's capability in meeting its current obligations. Furthermore, because it has a significant positive effect on the financial performance of the NSE listed nonfinancial firms statistically.

Key Words: *Financial performance, Tobin's Q, Capital structure, Liquidity, Multiple regression analysis*

1.1   Introduction

Capital structure is an intensely controversial issue in finance (Myers, 2001). According to the

Modigliani and Miller (1958) theorem, a firm's level of debt or equity is inconsequential

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economically. This is due to corporate tax shield resulting from debt financing and an increase in the cost of equity. An increase in the cost of equity leads to an increased cost of capital. In their research, Modigliani and Miller evaluated two firms with varying capital structures, one having debt in its capital structure while the other firm's capital structure constituted no debt. The authors concluded that a company's financial performance is not influenced by the financial decisions taken by firms and hence the market value. Ideally, Modigliani and Miller (1958) speculate that the forecasted cash flow is divided adequately between the firm's investors as per capital structure while this share-out does not affect company value.

This dimension has however been opposed through several studies which argue that debt levels have non-neutral effects on a firm's behaviour. Kosimbei *et al.,* (2014), argued that corporate failure among Kenyan companies has often had a connection with the behaviour of financing in firms. A dilemma exists on the possibility of firms attaining an optimal capital structure, both short-term and long-term. Capital structure and its optimal influence on financial performance is also a matter under consideration. According to Harris (2017), higher firm performance is realized at higher levels of debt. Increased leverage leads to tax exclusion on interest paid on debt. This influences directly firm profitability hence financial performance. Simerly and Li (2000) on the contrary opine about the debt presence in the firm enables the firm to face increased bankruptcy risk due to interest repayments which cause decreased financial performance.

Nonfinancial firms face liquidity problems in meeting their short-term financial obligations. This is because of the diversity of business activities in which nonfinancial firms are involved that exposes them to high levels of illiquidity. Illiquidity is more manifest in larger firms than in small ones because of increased short-term financial obligations associated with large firms (Muigai&Muriithi, 2017).   According to Frieder and Subrahmanyam (2005), the low liquidity levels can be attributed to increased cash outflows in the form of debt repayments A firm with high liquidity levels can deal with contingencies that are unexpected Large firms deal with liquidity challenges by holding onto liquid assets and increasing the amount of current assets in their books of account (Liargovas &Skanda lis, 2008). Firms that have the best firm financing

tend to have a good working capital that helps promote firm liquidity and therefore increased financial performance. This improved financial performance is attributable to reduced cost as a result of defaults from short-term debt. Alfi and Safarzadeh (2016) opine that decreased liquidity levels reduce the financial performance of nonfinancial firms.

Bhunia (2010) makes an argument that liquidity of assets raises financiers' liquidation costs. Consequently, leverage and liquidity have a relationship. Shleifer and Vishny (1992) make the argument that the positive leverage and asset liquidity relationship emanates from managers who have control over expected costs of liquidation and distress. However, the marginal effect liquidity of assets on the costs expected as a result of distress reduces if there is reduced distress probability. Thus, regardless of liquidity of assets, reduction of leverage will not be done by managers if there is low distress. This, therefore, causes reduced expected costs of distress. The asset liquidity and leverage relationship grow insignificant and weak in such circumstances. Therefore, this implies that there is a weaker (stronger) asset liquidity and leverage relationship for companies with a lower (higher) probability of defaulting on their debts.

Firm liquidity is a vital determinant of companies' financial performance. Firms that hold highly liquid assets can avoid high costs associated with liquidation that ultimately affect financial performance. Furthermore, companies that hold to highly liquid assets can avoid costly defaults to debt holders when repayments of those debts become due. According to Bhunia (2010), liquidity is a firm's ability to meet its obligations in the short term. These obligations can be in the form of short-term liabilities. Therefore, liquidity has a vital part to play in a business entity or company's successful functioning. Mwangi and Iraya (2014) further stated that liquidity is the term used to make the description of how easily the conversion of assets to cash takes place. It is crucial to have liquid assets during emergency periods because its challenging to convert them to cash. Insufficient liquidity can cause money to be tied up in difficult to cash out of systems that are even challenging to assess actual cash value. In times of emergency, big financial institutions shut down cash accessibility making it difficult to make purchases of essentials such as food, gasoline, and other emergency supplies.

Almajali *et al.,* (2012) opine that firm liquidity affects the financial performance of firms. Liquidity is vital for the existence of a firm. Principally liquidity's effects on the reduction of financial costs or growth have a change dynamism that is sales related, as well as its company risk level influence. Liquidity's decisive significance implies that it is vital for firm development. The importance of liquidity to firm performance can cause a conclusion to be made that it decides of a firm's profitability level. Liquidity is very essential to firms in that insufficient liquidity makes a business fail to meet its payment obligations. This indicates that businesses might face challenges in terms of satisfying urgent obligations financially. This can, in turn, affect the profitability and operations of a company.

1.2   Research Problem

Nonfinancial firms in Kenya have faced liquidity problems making it difficult for them to meet their current financial obligations (Muigai & Muriithi, 2017). Existing empirical studies mainly focus on the immediate impact of capital structure on financial performance with few studies examining the intervening effect of liquidity. Moreover, there have been differences in the operationalization of firm financial performance between accounting profitability measures including return on sales (ROS), return on equity (ROE) and return on assets(ROA) or stock market-based measures such as market return and Tobin's Q. Majority of the studies have made use of accounting profitability measures when studying on the financial performance of listed firms ignoring the stock-based measures such as market return and Tobin's Q, that comprehensively evaluates firm financial performance (Hoskisson e*t al.,* 1999; Hult *et al.,* 2008; Combs *et al.,* 2005).

Despite this clear, causal relationship between financing, liquidity and financial performance on companies that are listed, firms with high liquidity such as Kenya Airways, Home Africa, ARM cement and Transcentury have had big losses owing debts more than their net worth. These firms that have relied much on debt financing tend to be more liquid. This is to enable them to pay their debt obligations. This causes these firms to have increased default risk which leads to decreased financial performance. The default risk increases due to the need to make interest repayments and the need to meet their current obligations. Consequently, firm managers are

unable to decipher the contribution that capital structure has on the financial performance of NSE listed firms companies (Kamuti & Omwenga, 2017). The inability of firm managers to make decisions on capital structure can be linked to difficulties in determining exactly the optimal capital structure for their firms that can help increase financial performance (Noreen, 2013). The intervening role of liquidity in the capital structure and financial performance relationship of the nonfinancial firms that are listed also adds to the challenge that firms managers grapple within seeking to improve the financial performance of the nonfinancial firms that are listed. This study intends to answer the question: what is the intervening role of liquidity on the relationship between capital structure and financial performance of the NSE listed nonfinancial firms?

1.3 Research Objective

To determine the intervening effect of liquidity on the capital structure and the financial performance relationship of Nairobi Securities Exchange listed nonfinancial firms.

2.1   Literature Review

Saeedi and Mahmoodi (2011) using regression analysis studied the relationship between capital structure and firm financial performance of firms listed in Iran. The study used four performance indicators i.e. dependent variables (including ROA, EPS, ROE, and Tobin's Q) and three capital structure measures as independent variables. These independent variables are total debt ratios, short and long-term debt. The findings reveal that firm financial performance as computed using Tobin's Q and EPS exhibit a significant positive relationship with capital structure while a negative relationship exists between capital structure and ROA. However, no significant relationship exists between ROE and capital structure. The study used four independent variables. Furthermore, the study did not include the intervening effect of liquidity.

Anthony and Chinaemerem (2012) using panel data analysis and ordinary least squares (OLS) as a method of estimation examined the impact of capital structure on the financial performance of Nigerian firms using a sample of thirty (30) non-financial firms listed on the Nigerian Stock Exchange during the seven years, 2004-2010. The result showed that a firm's capital structure

surrogated by debt ratio has a significant negative impact on the firm's financial performance measures (Return on Asset, ROA, and Return on Equity, ROE). The conclusion of this study indicates consistency with prior empirical studies and provides evidence in support of agency cost theory. The study used Return on Asset, ROA, and Return on Equity, ROE). The current study will use Tobin's Q. The study did not include the intervening effect of liquidity.

Frieder and Subrahmanyam (2005) using multiple regression analysis conducted a study that sought to determine how debt financing affected financial performance among the Ghanaian listed firms. The authors sought to test the validity of the agency hypothesis of capital structure as propounded by Jensen and Meckling (1976) on the Ghanaian capital markets. Leverage was represented by the total debt to total capital ratio, while the current ratio was used as a proxy for liquidity. The authors found a significant and negative relationship between the study variables. They attributed the low liquidity levels to increased cash outflows in form of debt repayments. The findings were in support of the agency conflict hypothesis that provides for increased financial risk as a result of debt financing. This results in an increase in the financial burden (through loan interest payments) to the firm and hence low levels of free cash flows. The study focused on debt financing only to the exclusion of equity financing. The study also did not consider the intervening effect of liquidity.

2.2   Conceptual Framework and Hypotheses

Based on the theoretical and literature review, the following conceptual model guided the study as presented in Figure 1. The figure shows that the relationship could be influenced by the capital structure and intervened by liquidity as shown by the arrow representation.

Figure 1: Conceptual Model and Hypotheses
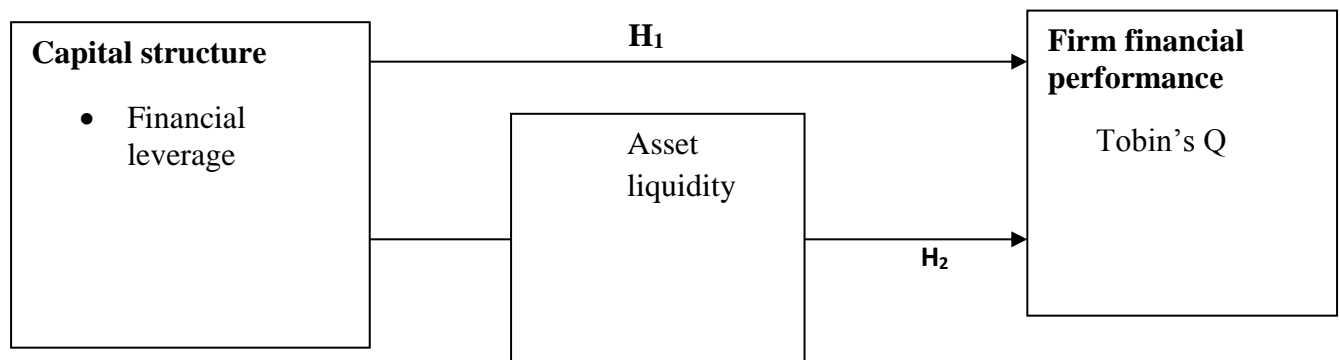
Based on the research objectives the study developed the following null-hypothesis;

H₁: There is no relationship between capital structure and financial performance of nonfinancial firms listed at the NSE.

H₂: The relationship between capital structure and financial performance of nonfinancial firms listed at the NSE is not intervened by liquidity.

3.1   Methodology

Quantitative secondary data on the study variables was obtained from the NSE website (NSE, 2019). Data on capital structure was determined by obtaining debt and equity employed by the listed nonfinancial companies in their various operations. The book values of total equity and total assets were employed to determine the listed nonfinancial firms' financial performance. Liquidity is determined by asset liquidity and temporary investment. Asset liquidity indicator is operationalized by current assets to current liabilities based on (Jorion, 2001).

Secondary data on capital structure and financial performance was used because it gives reliable results as compared to primary data. Secondary data was mainly a seven-year (2010-2017) annual historical data on the listed nonfinancial firms' financial performance. A census survey was conducted since the size of the population is small. There are a total of fifty three (53) non-financial firms on the NSE listing as of 31st December 2017. Analysis of data was done through the use of descriptives. Regression was also done to establish the magnitude and nature of the relationships between the study variables and to test the hypothesized relationships. Pearson's correlation analysis was done to ascertain the degree of linear relationship among the variables.

To determine the capital structure and financial performance relationship (objective i),

hypothesis (**H₁**) the following model was used;

$$Y=\beta_0+\beta_1 X_1 +\varepsilon...3.1$$

Y=Firm financial Performance,

B₀=intercept, X₁=CS, β_1, β_2, β_3, β_4= coefficients, ε= Error term

Where Y and CS are vectors for firm financial performance and capital structure respectively.

To test the intervening effect of liquidity on the capital structure and financial performance relationship (objective ii), the second hypothesis (**H2**) was tested using the process advocated by Baron and Kenny (1986). The second hypothesis (**H₂**) was done by the following model;

Stepwise Regression Analysis

Firm financial performance = f (CS, asset liquidity)

$$Y = \beta_0 + \beta_1 X_1 + \beta_2 X_2 + \varepsilon$$

Y= Financial performance, β_0= intercept, X1= CS, X_2= Asset liquidity, β_1, β_2= coefficients, ε= Error

Where Y and CS are vectors for financial performance and capital structure respectively.

4.1   Diagnostic Tests

Correlation analysis was done to decide whether the variables had a linear relationship. The null hypothesis for the test was that there is no linear relationship. The test statistic for a linear relationship between the predictor variable and firm financial performance (explanatory variable) are shown in Table 1 below.

Table1: Test for Linearity

Reference Variable: Firm Performance	Coefficient of Correlation	P-Value
Capital structure	0.506	0.000
Liquidity(asset liquidity)	0.521	0.000

From table 1 capital structure indicates a coefficient of correlation of 0.506 and liquidity shows a coefficient of 0.521. The values exceed 0.5000 meaning a correlation that is positive exists. The respective coefficient of correlation p-value is 0.000 which is lower than 0.05. Thus capital structure has a significant positive correlation with financial performance at five percent level of significance. Therefore the predictor variables and the explanatory variable move in the direction which suggests a linear relationship. This positive correlation indicates that the signage coefficient of the predictor variables in the simple regression model is positive.

To test the level of multicollinearity, VIF was used.VIF of less than 10 indicates tolerable levels of multicollinearity (Robinson & Schumacker, 2009). Multicollinearity test finds applications

only in multivariate regressions, VIF statistics are the only ones reported because the regressions have independent variables that are more than one.

Table 2: Multicollinearity Test

Variables	VIF
Capital structure	1.280
Financial Performance	1.712
Liquidity(Asset liquidity)	1.470

Table 2 above shows that the VIF for all models are between the acceptable ranges of 1.280 to 1.712. This indicates multicollinearity was not exhibited by the variables. Therefore regression analysis could be carried out.

4.2   Analysis and Discussion of Findings

4.2.1   Descriptive Statistics

In order to visualize the dataset, descriptive statistics were generated as shown in table 3.

Table 3: Descriptive Statistics

	N	Minimum	Maximum	Mean	Std. Deviation
FP	367	.00	5.62	1.3511	1.19312
ASSETLQ	367	.00	2.99	.9835	.79082
CS	367	.01	4.79	1.7916	.83616
Valid N (listwise)	367				

The results presented in Table 3 above show descriptive statistics for secondary data for 7 years from 2010 to 2017. Table 1 gives the descriptive for the main research study variables. The table shows that the average Tobin's Q is1.3511.This indicates that on average, NSE listed companies fairly have an impressive financial performance. Tobin's Q mean of 1.3511 suggests that the firm's market values are more than the firms' book values. The market price to book value ratio is more than one, the market value of these companies is expected to increase in the future because the future earnings are taken into account using the current price. For Capital structure

the average is 1.7916, meaning that most NSE listed non-financial companies have a large debt amount compared to equity.

4.2.2: Pearson Moment Correlations between Financial Performance and Capital Structure

The strength and direction of the variables' relationship was investigated. This was done using correlation coefficient. This was significant to assess whether any relationship exists between the variables before proceeding with further analyses. The study employed the following classification: strong if 0.7 and above; moderate if 0.4 but less than 0.7 and weak if 0 and less than 0.4.

Apart from analyzing the direction and strength of the relationship, correlation analysis was also used to find out the existence of multicollinearity. Multicollinearity exists if independent variables are highly correlated. (r=or greater than 0.75).Multicollinearity reduces the importance of predictors, making it difficult to assess the individual importance of a predictor. Multicollinearity may lead to poor regression modeling (Dancey & Reid, 2011). The results in table 4 below show that there is no multicollinearity since all the predictor coefficient results are below 0.75.

Table 4: Pearson Moment Correlations

		FP	ASSETLQ	CS
FP	Pearson Correlation	1	.518**	.556**
	Sig. (2-tailed)		.000	.000
	N	367	367	367
ASSETLQ	Pearson Correlation	.518**	1	.343**
	Sig. (2-tailed)	.000		.000
	N	367	367	367
CS	Pearson Correlation	.556**	.343**	1

	Sig. (2-tailed)	.000	.000	
	N	367	367	367

As shown in table 4 above a fairly strong positive correlation exists between financial performance and capital structure(r=0.556).Financial performance and capital structure relationship moved in the same direction as hypothesized in the study. Furthermore the correlation between financial performance and liquidity (asset liquidity) is fairly strong but positive(r=0.518). The relationship between financial performance and capital structure, liquidity (asset liquidity), moved in the same direction as hypothesized in the study.

4.2.3: Regression of Capital Structure and Financial Performance

The study resorted to determine the effect of capital structure and financial performance of the NSE listed nonfinancial firms and it employed panel data design. Panel data was used in establishing financial performance which was measured by Tobin's Q. Debt/equity ratio was used to measure capital structure. The study sought to identify the effect of capital structure on financial performance. The following hypothesis was developed:

H$_1$: Capital structure has no effect on the financial performance of nonfinancial firms listed on the NSE.

Maximum Likelihood regression Model was employed in data analysis. Test statistic regression results with the dependent variable and the independent variable are reported in Table 5 below:

Table 5: Panel data results for Capital Structure and Financial Performance

Model Summary

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.567^a	.321	.319	.98432

a. Predictors: (Constant), CS

ANOVA

Model	Sum of Squares	df	Mean Square	F	Sig.

1	Regression	167.231	1	167.231	172.602	.000[b]
	Residual	353.643	365	.969		
	Total	520.874	366			

a. Dependent Variable: FP

Coefficients

Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.
		B	Std. Error	Beta		
1	(Constant)	.589	.077		7.602	.000
	CS	.715	.054	.567	13.138	.000

a. Dependent Variable: FP

b. Predictors: (Constant), CS

The coefficients of the model are shown in table 3 above. The study results show that capital structure is a significant predictor because the p-value is 0.000. This is lesser than 0.05(level of significance). Furthermore, the results indicate R^2 of 0.321 which implies that capital structure explains 32.1% of the variability in financial performance. The null hypothesis has been rejected giving the implication that capital structure has an effect that is significant on the financial performance of nonfinancial firms listed at the NSE as shown below:

$Q_{it=}-0.589+0.715CS_{it}$

Where:

Q= Financial Performance

CS= Capital Structure

4.2.4   Capital structure, Liquidity and Financial Performance

This study sought to ascertain the effect of liquidity on the relationship between capital structure and financial performance of the listed nonfinancial firms on the NSE. The corresponding hypothesis is:

Hypothesis 2: Liquidity has no effect on the relationship between capital structure and financial performance of nonfinancial firms listed at the Nairobi Securities Exchange.

The study employed secondary panel data in determining the results under this hypothesis. Secondary data was obtained from financial statements.

Asset liquidity was measured using current assets and current liabilities. In testing for mediation, first, the relationship between the dependent variable (financial performance) and the independent variable (capital structure) was carried out ignoring the intervening variable liquidity (asset liquidity). This was step 1 and is similar to the regressions performed under hypothesis 1 section 5.2. The model should indicate significance, where $p = <0.05$.

Next in the regression analysis is done between capital structure (independent variable) and liquidity (asset liquidity) ignoring financial performance (the dependent variable). Capital structure and liquidity (asset liquidity) relationship should be significant ($p = <0.05$) if one is to move to step 3.

Under step 3, regression analysis is done with financial performance as the dependent variable and both capital structure and liquidity (asset liquidity) as the independent variables. Regression results for step 1 are the same as shown in table 3 earlier: Results from step 1 shown in Table 3 indicate the p-value of 0.000 and is therefore significant. The regression model is specified as $Q_{it=}-0.589+0.715CS_{it.}$This necessitates moving to step 2 the results of which are depicted in Table 6 below.

Table 6: Panel data results of Liquidity (asset liquidity) as the Dependent variable and Capital structure as the Independent variable

Model Summary

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.351[a]	.124	.121	.90094

a. Predictors: (Constant), CS

ANOVA

Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	41.748	1	41.748	51.433	.000[b]
	Residual	296.269	365	.812		
	Total	338.017	366			

a. Dependent Variable: ASSETLQ
b. Predictors: (Constant), CS

Coefficients

Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.
		B	Std. Error	Beta		
1	(Constant)	.676	.071		9.532	.000
	CS	.357	.050	.351	7.172	.000

a. Dependent Variable: ASSETLQ

Results in the table above indicate that capital structure is a significant predictor of asset liquidity as shown by sig=<0.05. Table 4(a) above shows an R squared of 0.124 which implies 12.4% variations in asset liquidity are explained by capital structure. The regression model for the relationship between capital structure and asset liquidity ignoring financial performance is given below:

$Q_{it} = 0.676 + 0.357CS_{it}$

Since the relationship between capital structure and asset liquidity is significant (as depicted by sig=0.00) we can now move to step 3; where financial performance is the dependent variable, while capital structure and asset liquidity are the predictor variables. The results for step 3 are displayed in table 7 below:

Table 7: Panel Data Results of Financial Performance as the Dependent variable while Liquidity (asset liquidity) and Capital Structure are the Independent Variables.

Model Summary

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate

| 1 | .661[a] | .437 | .434 | .89726 |

a. Predictors: (Constant), ASSETLQ, CS

ANOVA[a]

Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	227.828	2	113.914	141.496	.000[b]
	Residual	293.046	364	.805		
	Total	520.874	366			

a. Dependent Variable: FP
b. Predictors: (Constant), ASSETLQ, CS

Coefficients[a]

Model		Unstandardized Coefficients		Standardized Coefficients		
		B	Std. Error	Beta	t	Sig.
1	(Constant)	.283	.079		3.588	.000
	CS	.554	.053	.439	10.444	.000
	ASSETLQ	.452	.052	.364	8.676	.000

a. Dependent Variable: FP

The findings in Table 7 above indicate that financial performance is significantly predicted by asset liquidity (p=0.000 which is<0.05). Capital structure also significantly predicts financial performance. This is depicted by (p=0.000 which is <0.05). From the regression results above, Adjusted R squared changed from 0.124 to 0.437 showing a significant increase in the relationship between capital structure and financial performance of the listed nonfinancial firms on the NSE.

This change is attributed to the intervening variable effect. The conclusion is drawn from the findings, therefore, is that asset liquidity has a positive statistically significant intervening effect on the relationship between capital structure and financial performance. The null sub-hypothesis that asset liquidity has no intervening effect on the relationship between capital structure and financial performance of nonfinancial firms listed on the Nairobi Securities Exchange is therefore rejected. The resultant regression model is as shown below.

$$Q_{it} = .283 + 0.452 \text{ASSETLQ}_{it} + 0.554 \text{CS}_{it}$$

5.1   Discussion

These findings are supported by Akenga (2015) who posits that liquidity plays a major role in influencing the profitability of the firms listed at the NSE. Akenga(2015) further argues that liquidity needs to be emphasized in the financial department of firms by ensuring that firms have adequate amounts required for meeting their obligations, as and when they fall due maximizing their ROA.

The study also shows that highly leveraged nonfinancial firms tend to have high liquidity. This is to prevent money from becoming tied up in systems that are difficult to cash out of and even more difficult to assess for actual cash value. During times of emergency, large financial institutions shut down, making it difficult for people to access the cash they need to buy essentials like food, gasoline and other emergency supplies. These study findings are in agreement with Frieder and Subrahmanyam (2005) who conducted a study that sought to determine how leverage influenced liquidity levels of firms listed in the Toronto stocks exchange, Canada. They sought to test the validity of the agency hypothesis of capital structure as propounded by Jensen and Meckling (1976) on the Canadian capital markets. Leverage was represented by the total debt to total capital ratio, while the current ratio was used as a proxy for liquidity (asset liquidity). The study found a significant and negative relationship between the study variables. The differences in the study findings are due to low liquidity levels caused by increased cash outflows in form of debt repayments. The firms in the Canadian capital markets held unto highly illiquid assets thereby they were unable to meet their current obligations.

Consistent with these findings, Ogundipe *et al.,* (2012) in their study to assess the effect of debt structure on liquidity levels of the Nigerian listed firms over the period 2002-2010, found a significant positive relationship between long term debt and liquidity. On the other hand, a significant inverse relationship between short-term debt and liquidity ratios was observed. This finding agrees with the signaling effect theory of debt structure postulated by Ross (1977) which opines that higher levels of long-term debt signify higher quality to the investors who respond by

investing in the firm; effectively raising the cash flow levels. The results of this study reveal that liquidity is positive and significantly associated with financial performance. This is attributed to liquidity providing the necessary cash to firms to be able to meet their precautionary, transaction and speculative needs effectively. This helps increase firms' financial performance. The similarity in the study findings indicates that the study contexts are similar in that the firms under study are based in developing countries that share almost similar economic risks.

5.2   Conclusions

Based on the findings of the study, capital structure is vital to the firm financial performance of the nonfinancial firms listed at the Nairobi Securities Exchange. Best firm financing choices help firms to enhance their liquidity thereby improving their financial performance. Firms should strive to increase their leverage since it has a statistically significant positive effect on the financial performance of the nonfinancial firms listed on the NSE. Similarly, firms should increase their liquidity which; according to the findings in this study if increased leads to increased financial performance. This study has found no evidence supporting the tradeoff theory.

5.3   Recommendations

The study, therefore, recommends that firm managers, other practitioners and investors should focus on the need to make the right capital structure decisions that involve increased debt levels that will help increase firm financial performance. The positive capital structure indicates that a firm is utilizing more debt than equity in its financing decisions. The implication of this is to achieve growth and improved financial performance, firms should be highly leveraged. Firm managers should also seek to enhance asset liquidity to help increase liquidity in firms. Regulators, policymakers, investors and other practitioners should emphasize the right capital structure choices and high levels of liquidity in firms to maintain, if not improve firm high firm performance.

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