



**EFFECTS OF CAPITAL STRUCTURE ON PROFITABILITY OF TRANSPORT
INDUSTRY IN KENYA; CASE STUDY OF KISII COUNTY**

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Abstract

The main objective of the study was to determine the effects of effects of capital structure on profitability in transport industry in Kenya. The specific objectives of the study was to determine the influence of internal equity financing on profitability in transport industry in Kisii County, to determine the influence of debt financing on profitability in transport industry in Kisii County and to identify some of the challenges faced by entrepreneurs when seeking capital in transport industry in Kisii County. The study adopted a survey research design to analyze the effects of capital structure on profitability. The target population of this study shall be all the 389 transport operators whose vehicles are registered by the Kisii County Council in Kisii County. The study shall also employed purposive sampling in the sense that only the Saccos' chair person, secretary and treasurer will be sought from whom the required information will be gathered. This means that the study sought information from 78respondents. Primary data were collected using a personally administered semi-structured questionnaire which will be administered to the Saccos' three officials. The data collected were first tabulated, then analyzed by use of descriptive statistics. The study revealed that most transports are purchased through credit purchase and that, own savings was the major source of internal financing for the purchase of transport. It was also evident that, most transport entrepreneur repay their transport loan within 1-2 years and that these borrowed funds have enabled them to purchase the transport(s) they owned although it is easy to repay borrowed funds from transport's income. The study will also help financiers to know the extent to which transport business entrepreneurs have made use debt financing since they are stakeholders in providing part or whole of capital needed in the business.

Keywords: capital structure, debt financing, equity financing, transport industry

Background of the Study

Investment in transport industry is an opportunity that involves buying of assets which require investing huge capital (Mwangi, Otuya and Kamau, 2014). Bortolotti, Cambini, Rondi And Spiegel (2011) observed that European regulated utilities in transportation industry have accumulated large amounts of debt, a phenomenon which was described by the UK Department of Trade and Industry (DTI) and the HM Treasury (DTI-HM, 2004) as the “dash for debt,” and this raised concerns among policymakers about the financial stability of regulated utilities and their ability to finance future investments. Guzhva and Pagiavlas (2003) noted that that most air transport players do not follow the traditional finance management practice of lowering liabilities during lean times and increasing them during economic upturns, and that, among all airlines, levels of current liabilities are properly adjusted for movements of interest rates. However, this practice seemed not extended to long-terms liabilities. Correia da Silva, Estache and Jarvela (2006) examined the leverage of 121 regulated utilities in 16 less developed countries than the USA from the year 1991 to 2002 and find that leverage varies significantly across sectors, with the highest leverage being observed in transportation The study also found out that leverage steadily increases over time while investment levels fall.

A study by Mwangi *et al.*, (2014) found out that under cost of capital, most shareholders and non shareholders in the transport industry in Kenya have higher preference for owner contributed capital or equity. Nonetheless, the study further indicated that, debt is also used invariably by the respondents and major elements that determine its use are the cost of capital and risk. Nangubo and Gekara’s (2015) study on the factors affecting mergers in the Public Service Road transport in Nairobi County, realized that, low capital position, lack of management and entrepreneurial expertise among various Transport Saccos negatively affects their growth and expansion Transport SACCOs in Kenya.

Thaimuta and Moronge’s (2014) study on the factors affecting the performance of transport paratransit venture in small and medium enterprises in Nairobi County, Kenya, concluded that, management teams with a clean and high quality track record can help the SMEs access finance more easily than those with poor track record management skills, and that policy makers facilitate the private sector to be the engine of economic growth. It was concluded that implementation is done through development strategy to facilitate the Private Sector.

Wanjala (2015) asserted that, despite the government effort on this, matatu Saccos have not been able to grow in terms of profit, Assets and market share. The study also noted that cash Management practices of matatu Sacco were not efficiently done and that Sacco growth was positively related to cash management practices among Transport Saccos in Kimilili Sub-County, Bungoma County, Kenya. Ipaat, Ropand Chepkulei (2014) discovered that the matatu owners perceived that SACCOs had good intentions and that the local authority staff have helped in cutting out costs for the SACCOs to be given to other cartels as they are in charge of parking fees. The study recommended to the SACCO management to ensure that all members of SACCO

are bonded together and the policies are followed fully to maximize profitability and success of the business.

The capital structure is defined as the mix of debt and equity that the firm uses to finance its investments and assets. The capital structure choice that provides the greatest appeal to investors and shareholders, that results in the lowest cost of capital and maximized firm value in the presence of efficient investment strategies is called Optimal Capital Structure (Muzir, 2011). Gill, Biger and Mathur (2011) documented that the relationship between capital structure and profitability cannot be ignored because the improvement in the profitability is necessary for the long-term survivability of the firm.

Saksonova (2006) asserts that, creating optimal capital structure, that is determining the most beneficial proportions of equity and borrowed financing in the capital structure, is one of the main tasks for the process of financial management. The capital structure decision is crucial for business organizations. The capital structure decision is important because of the need to maximize returns of the firms, and because of the impact, such a decision has on the firm's ability to deal with its competitive environment (Gill, Biger and Mathur, 2011).

The relationship between capital structure and profitability is an important one since the amelioration in the profit margins of a firm is extremely essential for its long-term survivability. As the interest payment on debt is tax deductible, the addition of debt to the existing capital funding will improve the profitability of the firm (Erdoğan, 2015). This claim is seconded by Azhagaiah and Gavoury (2011) who stipulated that, if interest was not tax-deductible, firms' owners would be indifferent as to whether to use debt or equity and in situations where interest is tax-deductible, they would maximize the value of their firms by using 100% debt financing.

While firms can choose among many alternative capital structures, including lease financing, warrants, convertible bonds, forward contracts and bond swaps; under the general headlines firms mainly use either debt or equity. The first common source of capital is debt, which surges the risks up associated with the future earnings while at the same time allowing a firm to generate a higher expected rate of return stemming from the tax benefit born from the interest expense; which basically demonstrates a trade-off with the changing levels of the use of debt (Erdoğan, 2015).

Statement of the Problem

In order to start business, one needs capital. This capital can be from owner's equity, borrowed money (debt), or a mix of the two. It has been observed that the manner in which the two forms of capital structure are blended in a business, to some extent, determined the amount of profits realized by the business, hence the need to determine the optimal mix of the two that can maximize profits in the transport industry. Little research has been done in this area. For instance Abor (2005) who studied the effect of capital structure on profitability of listed firms in Ghana. However, the study dwelt on listed firms, none of which ventured in the transport industry. Akoto (2008) investigated the effect of capital structure on bank profitability in Ghana, and this

too did not focus on transport industry. Mohammadzadeh, et al., (2013) who studied the effect of capital structure on the profitability of pharmaceutical companies in Iran, which is an area not related in any way to transport industry. There is no study (known to the researcher), that has been done to establish the effect of capital structure on the profit realized among the entrepreneurs of transport industry. It is for this reason that this study is undertaken so as to ascertain the effects of capital structure on profitability in transport industry in Kisii County.

The Static Trade-off Theory (TOT)

This theory was developed by Modigliani and Miller in 1963. The TOT claims that there are optimal capital structures which can be achieved by trading off the benefits and cost of debt and equity (Chen, 2013), hence firms determine their preferred leverage ratio by calculating the tax advantages, costs of financial distress, mispricing, and incentive effects of debt versus equity (Faulkender and Petersen, 2006). The TOT stresses that, optimal capital structure is reached when tax advantage to borrowing is balanced, at the margin, by cost of financial distress. In a business setting, a micro enterprise's choice of internal equity or external equity depends on which one of the two yields more benefits. If there are more incentives on debt like tax advantage and less cost of financial distress, then a micro enterprise will opt for external equity; but if the incentives on debt are less, then the micro enterprise will opt for internal financing. This theory was found instrumental in the sense that it tries to determine whether firms weigh between internal equity and external equity in terms of their generation of profits before concluding on which to solicit more capital from.

The Market Timing Theory (MTT)

The market timing theory (MTT) was proposed by Baker and Wurgler in 2002. The theory states that firms prefer external equity when the cost of equity is low, and prefer debt financing when the cost of external equity is high (Huang and Ritter, 2004). According to this theory, capital structure is a consequence of managers trying to time equity markets by issuing shares at high market prices and repurchasing them or issuing debt at low market prices (Salminen, 2013), and that the main aim of market timing is to exploit temporary fluctuations in the cost of equity relative to the cost of other forms of capital (Baker and Wugler, 2002). The study further claims that, managers have incentives to time the market if they think it is possible and they care more about ongoing shareholders. The MTT further claims that, there is no optimal capital structure, and for this reason, market timing financing decisions just accumulate over time into capital structure outcome. There are two versions of equity market timing that would be behind these findings. Hence, managers issue equity when they believe that its cost is irrationally low and repurchase the equity when they believe its cost is irrationally high. The MTT is relevant to this study in the sense that it will help in judging whether or not enterprises prefer external equity when the cost of equity is low, and prefer debt financing when the cost of external equity is high.

The Pecking Order Theory

The proponents of Pecking order theory (POT) are Myers and Majluf in 1984 (Salminen, 2013). The POT stresses that firms will initially rely on internally generated funds, and then they will turn to debt if additional funds are needed and finally they will issue equity to cover any remaining (Ahmad, Abdullah and Roslan, 2012). The pecking order theory assumes that there is no target capital structure. For this reason therefore, firms choose capitals according to the following preference order: internal finance, debt, equity (Chen and Chen, 2010). Thus, according to the pecking order hypothesis, firms that are profitable and therefore generate high earnings are expected to use less debt capital than those who do not generate high earnings (Ahmad et al., 2012) since funds used from profits do not dilute ownership. Besides, the funds obtained from debt attract interest which is an extra burden to the firm. According to the Pecking Order theory, there is no optimal debt-equity mix because there are two kinds of equity, retained earnings at the top of the pecking order and the issue of new shares at the bottom (Myers, 1984).

Conceptual Framework

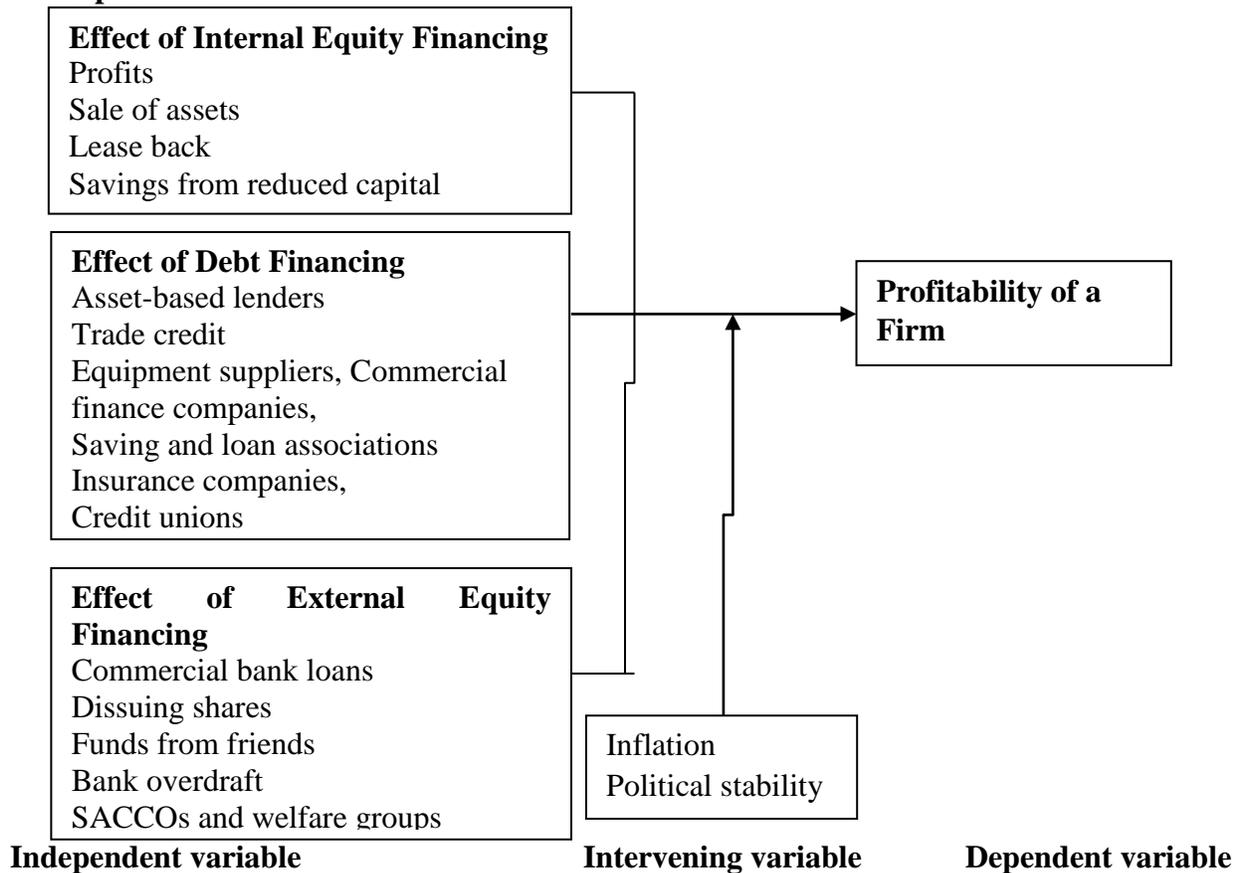


Figure 1: Effect of Capital Structure on Profitability in Transport Industry

Figure 1 above shows the effect of capital structure on profitability in transport industry. The independent variable of the study is internal equity financing, debt financing and the challenges

facing transport industry; while the dependent variables of the study are profitability of transport industry. The study perceives that if debt-financing and internal equity financing are adequately employed in securing a transport; and if the challenges facing transport industry are adequately managed, the transport entrepreneur is likely to realize profits from this business. The intervening variables of the study are political stability and inflation. It is perceived that, even if these are achieved, the business is not likely to realize profit if there is political instability or inflation.

Research Design

The study adopted a survey research design to analyze the effects of capital structure on profitability. This design enabled the researcher to describe and explain and portray characteristics of an event or population as it exists.

Target Population

The target population of this study was all the 389 transport operators whose vehicles are registered by the Kisii County Council in Kisii County. These transport operators are all registered in the 26 Saccos currently recognized by the Kisii County.

Data Collection Instruments

Primary data were collected using a semi-structured questionnaire which was administered to the Saccos' three officials. The questionnaire contained both open ended and closed ended questions. Open ended questions are important when there are too many possible responses to a question, when the researcher does not want to impose response categories to respondents, when the researcher wishes to provide a qualitative dimension to the study (Jackson, 2002).

Data Analysis

The data collected were first tabulated, then analyzed by use of descriptive statistics and inferential statistics. Descriptive statistics involved measures of central tendency and measures of dispersion, and helped in describing the data and determining the respondents' degree of agreement with the various statements under each factor (Ngugi, 2013). The measures of central tendency used were calculation of the weighted means and percentages. The study also used multiple regression analysis and Analysis of Variance (ANOVA) to establish the degree of association between the independent and the dependent variables under study. The results were used to generate a linear regression model of the form:

$$PR = \beta_0 + \beta_1 IEQ + \beta_2 DFN + \beta_3 EXF + \varepsilon$$

Where,

PR-Profitability

IEQ-internal equity financing

DFN-debt equity financing

EXF-external equity financing

$\beta_0, \beta_1, \beta_2$ and β_3 -are the coefficients

ε - is the error term

DATA ANALYSIS AND PRESENTATION

Table 1: Response Rate

The study intended to collect data from 78 respondents. Out of this, only 71 questionnaires were returned to the researcher for analysis. This constituted 91.0% response rate and this was considered enough to analyze and draw conclusion upon.

Number Of Transports	Number of Respondents	Percentage
1-9	6	8.5%
10-19	55	77.5%
20-29	7	9.9%
More than 30	3	4.1%
Total	71	100.0%

From the table 1 it is evident that 8.5% claimed that their SACCOS have between 1-9 registered transports, 77.5% of the respondents observed that they have between 10 and 19 registered transports in their SACCOs, 9.9% of the respondents opined that their SACCOs have between 20 and 29 registered transports while only 4.1% of the respondents have more than 30 registered transports. This implies that majority of the SACCOs have between 10 and 29 registered transports.

Influence of Internal Equity on Profitability of Matatu Industry

The study wanted to unearth the influence of internal equity on profitability of matatu industry. Some sources of internal equity were provided on a five point likert scale and respondents were asked to indicate the level to which they influenced profitability. The findings are presented in table 2.

Table 2: Analysis of the Influence of Internal Equity on Profitability of Matatu

	Most influential 5	Very influential 4	Moderate ly influential 3	Less influential 2	Least influential 1	Σf_i	$\Sigma f_i x_i$	$\frac{\Sigma f_i x_i}{\Sigma f_i}$
Sale of assets	5	7	22	32	5	71	188	2.6
Own savings	2	3	34	21	11	71	177	2.4
Lease back	0	0	5	43	23	71	124	1.7
Savings from reduced capital	0	0	0	43	28	71	114	1.6

The findings of table 2 reveal that sale of assets has “less influential” effect on profitability (weight of 2.65 on a five point likert scale). The findings also revealed that own savings also has “less influential” effect on profitability (weight 2.49). The study further noted that, lease backs were “least influential” effect on profitability of a firm (weight of 1.75 on five point likert scale). Savings from reduced capital influenced capital has the least influence on profitability in matatu business (weight of 1.61 respectively on five point likert scale).

Influence of Internal Equity Financing on Profitability

The first objective of the study was to determine the influence of internal equity financing on profitability in transport industry in Kisii County. In an effort to address this objective, an ANOVA test was run in SPSS version 21. The results are presented in table 3 below:

Table 3: ANOVA Test Statistics for Internal Equity Financing

Internal Equity Financing					
	Sum of Squares	df	Mean Square	F	Sig.
Between Groups	152664.43	65	2348.68	12.534	.003
Within Groups	1124.31	6	187.39		
Total	153788.74	71			

As table 3 reveals, the p-value of the ANOVA was found to be 0.003. Since this value is less than the p-value of 0.05 that was adopted for this study, the study concluded that internal equity financing has a statistically significant influence on the profitability.

Full Repayment of Matatu Loan

The respondents were requested to indicate whether they had finished repaying loans for their matatu. The findings revealed that 57.7% of the respondents had finished repaying their loans while 42.3% of the respondents had not finished repaying their loans. The study sought to know how long those who had finished repaying their loans had taken to do so. The findings realized were as presented in table 4.

Table 4: Analysis of Repayment Periods for Matatu Loans

Duration (Years)	Number of Respondents	Percentage
Within 1 year	3	7.3%
1-2 years	32	78.0%
3-4 years	5	12.2%
More than 4 years	1	2.4%
Total	41	100.0%

Table 4 shows that 7.3% of the respondents repaid their matatu loan within 1 year, 78% of the respondents repaid their loans within 1-2 years, 12.2% of the respondents repaid their loans

within 3-4 years while 2.4% of the respondents repaid their loans for more than 4 years. This shows that majority of the respondents repay their loans within the duration 1-2 years.

Influence of Debt Financing on Profitability in Matatu Industry

The study wanted to know the amount of capital transport owners had used from various sources of debt so as to finance their businesses. The findings revealed that all (100%) of those respondents who had bought their transports on credit used trade credit as the form of debt financing.

Best Mode of Purchase of Matatu Vehicles

Respondents were asked to disclose the best mode of financing their businesses. The study revealed that 77.5% of the respondents preferred cash purchase while only 22.5% of the respondents preferred credit purchase.

Influence of Debt Financing on Profitability in Matatu Industry

The study was interested in determining the influence of debt financing on profitability in the matatu industry. Various sources of debt financing were provided on a five point likert scale and respondents were asked to rate them. The findings were as presented in table 5.

Table 5: Influence of Debt Financing on Profitability in Matatu Industry

	Strongly agree 5	Agree 4	Not sure 3	Disagree 2	Strongly disagree 1	Σf_i	$\Sigma f_i x_i$	$\frac{\Sigma f_i x_i}{\Sigma f_i}$
Borrowed funds enabled me purchase the transport I own	43	17	5	4	2	71	308	4.34
It is not easy to buy transport by own savings	22	35	0	14	0	71	278	3.92
Buying transport on borrowed funds has enabled me realize profits	3	8	11	36	13	71	165	2.32
It is easy to repay borrowed funds from transport's income	5	5	14	29	18	71	163	2.30

As table 5 depicts, the results found out that, the respondents “agreed” that borrowed funds enabled them to purchase the transport(s) they owned (weighed mean 4.34). However, the respondents were “not sure” whether it is not easy to buy transport by own savings (weighted mean 3.93). There was also disagreement with the claim that, buying transport on borrowed funds had enabled me realize profits and that it is easy to repay borrowed funds from transport’s income (weighs of 2.32 and 2.30 respectively).

Influence of Debt Equity Financing on Profitability

The second objective of the study aimed at determining the influence of debt financing on profitability in transport industry in Kisii County. To test this objective, an ANOVA test was run and the results analyzed. The findings are presented in table 5:

Influence of External Equity Financing on Profitability

The third objective of the study was to determine the influence of the influence of debt financing on profitability in transport industry in Kisii County. To test this objective, an ANOVA test was run and the findings are presented in table 6 below:

Table 6: ANOVA Test Statistics for External Equity Financing

External Equity Financing					
	Sum of Squares	df	Mean Square	F	Sig.
Between Groups	90699.71	65	1395.38	7.74	.009
Within Groups	1081.69	6	180.28		
Total	91781.40	71			

The results in table 6 show that the p-value of the ANOVA (0.009) was less than the critical value (0.05), leading to the conclusion that external equity financing has a statistically significant influence on profitability.

Average Annual Profits in Matatu Business

The study wanted to know the average annual profits realized from your transport business since the time one finishes repaying loan. The findings were as presented in table 7.

Table 7: Analysis of Average Annual Profits in Matatu Business

Profit	Number of Respondents	Percentage
Less than sh.50,000	32	45.2%
Between sh.50,001-100,000	25	35.2%
Between sh. 100,001-150,000	5	7.0%
Between sh. 151,000,001-200,000	4	5.6%
Over sh. 200,000	0	0%
Total	0	100.0%

The findings in table 7 revealed that 45.2% of the respondents realized less than sh. 50,000 per annum, 35.2% of the respondents realized between sh. 50,001-100,000 annually, 7% of the respondents got profits of between sh. 101,000-150,000 while only 5.6% of the respondents got profit ranging between sh. 151,000-200,000 per annum. This means that majority of the respondents realized an annual profit of less than sh. 100,000 per annum.

Summary of Findings

The summary and conclusion for this study is based on data that were collected from the respondents and analyzed.

Influence of Internal Equity Financing on Profitability in Matatus Industry

The first objective of the study was to determine the influence of internal equity financing on profitability in transport industry. The study noted that own savings were the most prominent source of finance for transport business. The study went further to reveal that most matatus are purchased through credit purchase. This could be attributed to the high cost of the matatu vans which render it hard for most individuals, especially those making initial entry into the business, to amass enough money to purchase by cash. This makes the businessmen to give a deposit and acquire the van then the balance is offset by the proceeds from the matatu. The research went further to disclose that, own savings was the major source of internal financing for the purchase of transport.

Influence of Debt Financing on Profitability in Transport Industry

The research sought to establish the influence of debt financing on profitability in transport industry. The research noted that majority of the respondents repaid their transport loan within 1-2 years. The respondents also conceded that borrowed funds enabled them to purchase the transport(s) they owned (weighed mean 4.34). This is because most of the businessmen get the vehicles on credit and pays the balance in installments, otherwise majority of them cannot afford buying them by cash.

Influence of External Equity Financing on Profitability in Matatus Industry

The third objective of the study was to determine the influence of external equity financing on profitability in transport industry in Kisii County. The study found out that majority of the respondents felt external sources were costly relative to internal sources. It was also evident from the study that majority of the respondents prefer SACCOs as their major source of external finance. This could be attributed to the low cost of finance from SACCOs and their ease of accessibility compared to other external sources of finance. Besides, the loans don't require collaterals. The finance from SACCOs mainly consisted of the periodic contributions by the members to their SACCOs.

Conclusions

From the findings of this study, it is evident that, that most transports are purchased through credit purchase and that, own savings was the major source of internal financing for the purchase of transport. Secondly, it is evident that, most transport entrepreneur repay their transport loan within 1-2 years and that these borrowed funds have enabled them to purchase the transport(s) they owned although it is easy to repay borrowed funds from transport's income. Thirdly, it is realized from the study that, police bribes, absentee ownership, poor implementation, lack of

political will, lack of proper financial records, lack of strong bank statements, long procedure involved and fear of inability to repay, are the major hindrances to entrepreneurs when seeking external capital. Fourthly, the study depicted that loans from SACCOs and friend are the major sources of finance for the matatu proprietors.

Recommendations

Further studied needs to be done to ascertain factors influencing low profit turnover in the transport industry regardless of the heavy capital investment. A study also needs to be done to establish the various ways in which the challenges cited in the study can be overcome.

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