Title: CAPITAL STRUCTURE AND STOCK RETURNS: EVIDENCE FROM THE NAIROBI SECURITIES EXCHANGE.

Author: Nyabicha Edith Masereti

ABSTRACT

Capital structure and stock return are important aspects in financial management. This study examines how debt ratios move in relation with movement in stock prices for listed firms in Kenya. The Fama-Macbeth regression analysis and Bayesian VAR integration approach employed indicates that the two variables are correlated implying that for any stable financial activity to exist in Kenya, attention needs to be paid to the two variables simultaneously since evidence suggests that the two variables will not drift away from each other. A balanced cross-sectional analysis of Kenyan firms over the period from 2000-2010 documents that debt ratios in Kenyan firms are "sticky". Even over 10-year horizons past debt ratio levels explain about 85% of actual debt ratio levels. Second, a larger portion in the variation of the debt ratio can be explained by stock return effects. Specifically, roughly 60% of the 1-year and 50% of the 5-year variation in leverage is captured by return-induced changes in the capital structure. Third, although we observe inertia in the leverage ratios at 5.3%, which suggests that firms do not adjust immediately, they nevertheless seem to follow constant a target debt ratio in the long run. The slow adjustment is consistent with the hypothesis that other considerations such as market timing or pecking order outweigh the costs of deviating from the optimal leverage.