THE EFFECT OF LENDING INTEREST RATES ON COMPANY PERFORMANCE

(A study of companies quoted on the Nairobi Stock Exchange)

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MU/EMBA/KIM/04/040

A RESEARCH PROJECT SUBMITTED IN PARTIAL FULFILMENT OF THE REQUIREMENTS FOR THE DEGREE OF MASTER OF BUSINESS ADMINISTRATION,

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September, 2005

ABSTRACT

This study sought to examine the impact of lending interest rates on company performance since liberalization of interest rates was effected in Kenya in July 1991. The period following interest rates liberalisation exhibited unprecedented high interest rates and the study sought to answer whether the resulting high lending interest rates impacted negatively on various company performance measures.

The research methodology used entailed a combined methodology involving a qualitative preliminary study coupled with a quantitative approach to the main study using a research design involving construction of 11-year time series financial ratios for each of 12 sample firms quoted on the Nairobi Stock Exchange. Secondary data spanning the period 1993-2003 was collected by way of reference to company annual reports and Nairobi Stock Exchange Handbooks for use in calculating key financial ratios that were used in the analysis. The key financial ratios of return on sales, return on assets, and return on equity; capital investment index and long-term debt ratio computed were used to gauge company performance measures such as profitability, growth in investment, and long-term debt substitution in this period characterised by high lending interest rates and interest rate spreads. The data analysis method used involved correlation analysis making use of the time-series panel data of each sample company to establish the nature of the relationship between lending interest rates and these key company performance measures as well as hypothesis testing in gauging the significance of the relationships established.

The main findings indicated that even though current nominal interest rates are correlated with some of the company performance measures investigated, on the whole, when all the performance measures are taken into account, it was not possible to reject the null hypothesis that the relationship is significantly different from zero. In conclusion, the study found that the interest rate variable does not significantly influence company performance, and this can be because firms may prefer internal to external financing as proposed by the pecking order hypothesis. The study recommends that further studies be undertaken to investigate these other sources of company finance such as internal company borrowing and the factors influencing them.