The Mistaken Identity: Debt Versus Equity: The Kenyan Perspective

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Abstract
Debt has always been perceived as expensive compared to equity, many people, especially businessmen have always assumed that debt is more expensive to equity, however going through literature and theories it is clear that this has been the most mistaken identity, according to pecking order theory, firms would first of all prefer internals funds, followed by debt and lastly followed by equity, thus according to the Myer's Pecking order theory, equity is less preferred than debt and internal funds are preferred more to debt. Thus as per the order of priority, Debt is preferred to equity, and equity according to the theory is more expensive in the long run to debt, the reasons being the tax advantage given to debt holders among others .
Keywords: Pecking order theory, debt, equity

1.0 INTRODUCTION
Debt has always been taken to be expensive as compared to equity, many people, especially business men have always assumed that debt is more expensive to equity, however going through literature and theories it is clear that this has been the most mistaken identity, according to pecking order theory, firms would first prefer internals funds, followed by debt and as a last resort equity, thus according to the Myer's (1984)Pecking order theory, equity is less preferred than debt and internal funds are preferred more to debt. This is the hierarchical order of priority. Debt is better than equity, and equity according to the theory is more expensive in the long run to debt, the reasons being the tax advantage given to debt holders.

1.1 OBJECTIVES OF THE STUDY
To demystify the issue of debt and equity. To find out whether students prefer debt to equity or vice versa. One needs to talk to any Kenyan in the streets or in schools, colleges or universities to know how Kenyans fear debt, whether one is talking to high school teachers, lecturers, farmers or debt is truly feared. The million dollar question is between debt and equity, Which of the two sources of funds is cheaper and preferable to the population sampled.

1.2. MOTIVATION FOR THE PAPER
Most people have always avoided taking money from the bank because they feared the repercussions; however it is hard for an economy develop if their leaders do not take loans from the bank as it is one way of enhancing expenditure which in turn leads to development. The paper tries to compare the Pecking order theory and practically what happens in Kenya. Pecking order theory postulates a scenario where the managers prefer internal funds followed by debt and that equity is only used as a last resort.

2.0 REVIEWED LITERATURE
pecking order theory of Myers (1984) and Myers and Majluf (1984) gives the Hierarchy of financing decisions. Managers Prefer internal resources to external resources. If external resources are to be used, then they Prefer debt to equity. A cause of this choice is Information asymmetry. When a company earns profits, these ideally belong to the shareholders who are the owners of the firm. They however get these profits after all the other claimants have been paid their dues. However in most cases the investors/shareholders do not share all the profits in the name of dividend. As they want to be able to take advantage of positive investments that may come their way in the future periods (firms cycle). In this case they would normally take a part of the profits and the management will retain some of the profits for future use (Frank and Goyal (2007); Manoj Anand (2002).

This retained amount by the management is what is termed as retained earnings. Therefore for there to be retained earnings both the investors and the managers must sacrifice. The investors or the owners of the business have to forego profits for future benefits while the employees (managers) will have to reduce the perks. However if the managers earn their income by percentage of sales and production. The retaining funds will be at their advantage as the retained funds may increase the operations of the firm Baker *et al.* (2004). This will make it more profitable or taking advantage of the large scale productions. Retained earnings are part of the internal funds referred to by the pecking order theory, it also includes savings that have been made by the business or firm in general.

2.1 DOES THIS THEORY WORK IN KENYA

That is the question to be answered in this paper. Myers and Majluf (1984)- Pecking order theory .Myers (1984)- pecking order theory was supported by .Lakshmi- Sunder and Myers (1999) who came up with the model for testing Pecking Order Theory(POT).while Chirinko and Singha (2000) doubted the results. Lemmon and Zender (2002) supported the theory: Modigliani and Miller (1958.1963) introduced the first theory of capital structure. The question therefore is does pecking order theory work? To answer this question, we pick our third and fourth year students in Kenya? It almost comes out that the students do not seem to agree on this theory from the general answers they gave. Of course the comparison is just for exploratory purposes as the pecking order theory is done on firms while the Kenyan study has been done on individuals. These students are however the same ones who in the next one year onwards will be the ones making important decisions in the corporate world in Kenya. The reason we carried this study is to see the differing nature of support or opposing sides of pecking order theory from the preference of debt use and equity use. According to Claudio *et al*, (2006) firms choose debt at the early stages as their first choice, then later on settle on equity or debt is then substituted by internal capital in the maturity stage. Storey (1994) posits that firm's growth is affected by the availability and the cost of funding. Given that funds are not always available in plenty and in surplus, they are usually scarce and therefore it becomes necessary for managers to be cautious on how to use it for their investments. However for managers to use the finances well, they must first secure and get it and how this is done was core of this study. The two main sources of funds to business are debt and equity, by debt is meant borrowing which is money that does not belong to the owner and equity is what is owned by the businessman.

3.0 DATA AND METHODOLOGY

The research conducted a survey of students in universities in Kenya. We also looked at the other studies done in this area and using these studies to arrive at a conclusion regarding debt and equity, the grounding of this study is Pecking order theory.

3.1 APPROACH:

This paper looks at the perception of students with regard to the pertinent issue of preference between debt and equity. It is an exploratory study and used both primary and secondary data. The study looked at pecking order theory and tries to merge it with the results of an oral interview with 600 third year and fourth year students of two universities in Kenya .90 % of the students selected were from business management and business s administration classes. The other 10% were from other faculties. The study was done between September and October 2012.

4.0 DATA ANALYSIS

The study used a sample of students from the three main public universities in Kenya. The universities were in three cities, towns in Kenya .questionnaires were given to a total of 600 students from these universities. The period of the research was between 2012 September to November 2012. The students chosen were third years and fourth years who were the finalists. These students were from Bachelor of BBM (Moi) and BBA of JOOUST) Then a constituent college of Maseno university.

200 students from Nairobi's branch of Moi university campus and 200 students from Moi University main campus and 200 Jaramogi Oginga Odinga University. For diversity we made sure that a 10 % of the sampled population was from outside business field just to know how they polled as regards the debt equity choice. The first thing the study did was to ascertain the knowledge of the terms given that not all students were from the business field. The students were asked whether they understood what debt and equity were, and from the number, 600 or all the students of Eldoret, Nairobi and Bondo students said they understood and knew what debt was. The question regarding equity was as follows:

Table 4.1: percentage and numbers of those non business students who knew what equity meant

	Moi (main campus	Moi (Nairobi campus	Jooust
20	10(50%)		
20		7(35%)	
20			5(25%)

Source. Author (2014)

In Eldoret, 190 knew what equity meant and 10 did not understand the term. In Nairobi 187 knew the terms and 13 did not know the terms. In bondo 185 knew the terms and 15 did not know

For those who did not understand the meaning of equity, the researcher explained what it was.

The other important question for this study was which of the two sources of finance the students would choose if both sources were equally available. In Eldoret, 130 out of 200 preferred equity to debt and 70 preferred debt. In Nairobi 120 felt that equity was preferable to debt and 80 preferred debt. And Jooust 150 preferred equity to debt and only 50 preferred debt. The other question was given one choice only what would they choice between equity and debt and the results were exactly the same as before. We went ahead and asked them why they believed equity was better and debt should not be used.159 from Moi university, Eldoret said they had heard of someone who lost all the properties through auction because of loans they had borrowed from the banks.25 said they knew someone who kept complaining about the loans they had taken.16 of them just felt debt was scary. In Nairobi, 140 knew of people who had been harassed after taking loans by their creditors by auctioning their properties after failing to meet the bargains. 18 had heard complaints from former university students who had taken loans and could not pay as they were not employed. And 32 just didn't feel comfortable with debt. In Bondo 191 had heard of someone's property being auctioned or taken away because of a loan by the creditors.4 knew someone who someone who were being stressed after taking a university loan. And 5 did not feel comfortable with a loan.

4.1 ANALYSIS FROM THE FINDINGS OF THE STUDY.

In Eldoret 65%preferred equity.35% preferred debt and In Nairobi 60%-equity 40%-debt. In Bondo; 70 % preferred equity and 30 prefer debt .In total 66.7% preferred equity. 33.3% preferred debt.

Table 4.2 Debt or equity: what do you prefer?

	Debt	Equity	TOTAL
Eldoret(Moi Uni)	35%	65%	100
Nairobi(Moi UNI	40%	60%	100
Bondo(JOOUST)	30%	70%	100

Source: Author (2014)

As regards the reasons as to why they would prefer equity to debt, the results were as follows: In Moi's main campus: 79.5% had heard of someone being harassed. 12.5% knew someone who had been harassed. And 8% just disliked debt. In Moi University, Nairobi campus .70 % had heard of someone being harassed.9% knew someone who had been harassed. And 16 % just disliked debt. In bondo's JOOUST; 95.5 % had heard of someone being harassed. 2% knew someone who had been harassed. And 2.5 % just disliked debt.

Table 4.3 why do you prefer equity to debt?

	Heard someone	Knew someone	Don't like	TOTAL
Eldoret(Moi Uni)	79.5%	12.5%	8%	100
Nairobi(Moi UNI	70%	9%	16%	100
Bondo(JOOUST)	95.5%	2%	2.5%	100

Source: Author (2014)

The main question therefore is whether there is a problem with the pecking order theory or is the problem with the way students understand some of these concepts or is it with the banking sector rules in Kenya. This is because most of those who did not want to use debt were because of the scare from the banking sector. An emerging issue is that nowadays the debt is secured and is now less abrasive than before. It is clear that most students do prefer equity to debt. One point that comes out clearly is that most of the student's decisions were based on hearsay while a very small percentage could give direct evidence or about the debt being very risky. What will be the impact of this when they get to work and are in positions where they make decisions for companies? However most of them said they would use loans if the other options are not available. We then tied to give the reasons that have contributed to this scenario in Kenya.

1) The cultural aspects where having borrowed property was seen as a weakness.
2) The earlier treatment of loan borrowers was so savage that most people feared the word loans.
3) The banks use very tempting languages to get customers but once they have them they turn onto them roughly.

4) It is also found that most of the students in Kenya believe in hearsay more than experiencing it or witnessing that scenario personally.
5) It also means that we are not prone to risky ventures and thus they prefer non risky businesses.

Since these students are in their final years at the university, we can confidently say that at the business level people still fear taking debts than going for equity. In unreported results the students who preferred debt said that by issuing shares they would lose control of their businesses and therefore they would rather get debt and clear with it .We have programmes which run on our electronic and print media advising people not to take loans and instead save for their expenditure. People depend so much on hearsay than on actual factual actions. This in pecking order is equated to information asymmetry.

5.0 IMPACT OF THIS ON THE ECONOMY

Developed countries did most of their infrastructural activities using borrowed funds. The fear of loans might impact on the countries developments as most of the projects are very expensive and can only be done using debt.

5.1 RECOMMENDATIONS

Based on the finding s of the study, it is suggested that the government should do more to encourage the student to take and utilize loans facilities and the staff at the universities needs to promote the use of loans for development. We should have more successful business men talking to student on the benefits of using loans.

5.2 SUMMARY AND CONCLUSIONS

The student population finds the debt as an unfavorable option compared to equity. The findings differ from pecking order theory and do not support pecking order theory. In Kenya it would appear that the student population do not support pecking order theory and therefore most of the companies may not support POT too because the same students would be the ones working there as executives. It may however be that the people who use loans would not want to get competitors and thus discourage the use to encourage monopoly.

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