International Journal of Economics, Commerce and Management
United Kingdom ISSN 2348 0386 Vol. 13, Issue 10, Oct 2025

https://ijecm.co.uk/

PRIVATE EQUITY INVESTMENTS, FIRM LIQUIDITY AND FINANCIAL PERFORMANCE: EVIDENCE FROM INVESTEE FIRMS IN KENYA

Ronald Ongoma Musundi
PhD Candidate, Department of Finance and Accounting,
Faculty of Business and Management Science, University of Nairobi, Kenya
ronmusundi@gmail.com

Herick Ondigo
Senior Lecturer, Department of Finance and Accounting,
Faculty of Business and Management Science, University of Nairobi, Kenya
hondigo@uonbi.ac.ke

Josiah Aduda
Professor, Department of Finance and Accounting,
Faculty of Business and Management Science, University of Nairobi, Kenya
jaduda@uonbi.ac.ke

Abstract

Private equity investment has emerged as a pivotal financing mechanism for firms in emerging markets, providing not only capital but also strategic and operational support. However, the extent to which PE investments enhance firm performance may depend on the internal financial health of the investee firms—particularly their liquidity position. This study investigates the moderating effect of firm liquidity on the relationship between private equity investments and financial performance among investee firms in Kenya. Using panel data from 144 PE-backed firms spanning 2006 to 2021 and applying a fixed effects regression model, the study disaggregates PE into venture capital, growth capital, and buyout capital while measuring financial performance using return on assets. Firm liquidity is measured using the current ratio.

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The findings reveal that all three forms of private equity have a positive and significant impact on financial performance, and that this relationship is significantly moderated by the firm's liquidity level. Specifically, firms with stronger liquidity profiles benefit more from PE funding in terms of enhanced financial performance, suggesting that internal cash flow buffers complement the strategic advantages of external capital. The study contributes to the growing literature on contextual factors that shape PE effectiveness in Africa and offers practical insights for investors, fund managers, and policymakers on the importance of liquidity management in maximizing the value of private equity financing.

Keywords: Private equity, firm liquidity, financial performance, venture capital, growth capital, buyout capital, Return on Assets

INTRODUCTION

Private equity (PE) has gained prominence as a financing strategy that combines capital infusion with governance and operational support to improve firm performance, particularly in emerging markets (Bernstein et al., 2017; Ashhari, 2012). In Kenya, PE investors have increasingly targeted firms across retail, manufacturing, and healthcare sectors with expectations of generating value through professionalization, growth scaling, and strategic realignment (Karanja, 2018; Babarinde, 2012). These interventions are typically implemented through venture capital, growth capital, or buyout models, each tailored to the stage and needs of the investee firm.

While the capital and managerial expertise provided by PE are known to enhance financial performance, the internal liquidity position of a firm may influence the extent to which these benefits materialize. Liquidity—defined as a firm's ability to meet short-term obligations—is crucial for maintaining operational stability and facilitating the execution of growth strategies post-investment (Almajali, Alamro & Al-Soub, 2012). Firms with higher liquidity can allocate PE capital toward innovation, expansion, and performance improvement, whereas illiquid firms may redirect funds to meet basic obligations, undermining intended strategic outcomes.

Despite the growing empirical focus on PE and performance, limited attention has been paid to how firm liquidity interacts with PE funding in shaping financial outcomes, particularly in African settings. Existing studies either focus on the direct effects of PE (Karugu, 2018; Ahiadorme, 2016) or assess liquidity as an isolated performance driver (Dioha, Mohammed & Okpanachi, 2018), without examining its moderating role. Given the contextual differences in financing structures and working capital constraints among Kenyan firms, there is need for

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empirical inquiry into how liquidity conditions influence the effectiveness of private equity in enhancing firm-level financial performance.

Research Problem

Although private equity financing is widely regarded as a catalyst for improved financial performance, its success is often contingent on firm-specific characteristics that shape how such capital is utilized (Battistin et al., 2017; Ashhari, 2012). In the Kenyan context, PE-backed firms exhibit mixed performance trajectories, with some recording significant profitability gains while others fail to achieve anticipated growth. A possible explanation for this inconsistency lies in variations in liquidity, which may affect how efficiently firms absorb and apply PE capital (Almajali et al., 2012; Awan & Amin, 2014).

Specifically, firms with strong liquidity buffers are likely to deploy PE funding toward innovation, asset expansion, and market penetration—key avenues for long-term performance improvement. In contrast, firms with weak liquidity positions may use PE injections to resolve immediate financial distress or cover operational shortfalls, thereby diluting the long-term strategic value of the investment (Dioha et al., 2018; Bonn, 2015). This implies that liquidity may not merely influence performance directly but also moderate the impact of external equity investments.

Despite this theoretical plausibility, empirical studies in Kenya have yet to explore the interactive effect of firm liquidity and private equity investments on financial performance. Most existing studies either analyze liquidity and PE independently or focus on other moderators such as firm size, age, or firm liquidity (Mutende et al., 2017; Karugu, 2018). This gap in literature creates uncertainty for PE fund managers, policymakers, and firm executives seeking to optimize financial outcomes. The current study therefore investigates how firm liquidity moderates the relationship between private equity investments and financial performance among investee firms in Kenya.

LITERATURE REVIEW

Theoretical Foundation

Private equity investment and its performance outcomes can be well understood through the lens of Agency Theory, as proposed by Jensen and Meckling (1976). The theory posits that conflicts often arise between owners (principals) and managers (agents), especially in firms with dispersed ownership. Private equity addresses agency problems by aligning the interests of capital providers and firm management through equity ownership, active monitoring, and performance-based incentives (Mutende et al., 2017). In Kenyan firms, where separation of

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ownership and control is prevalent, PE investors often influence governance and decision-making to mitigate managerial inefficiencies and drive performance. This theory is critical to understanding how the structural features of PE contribute to financial improvements in investee firms.

In addition to agency concerns, the Trade-Off Theory offers a complementary explanation for the financial outcomes of firms engaging with private equity. Originally advanced by Kraus and Litzenberger (1973), the trade-off theory suggests that firms balance the benefits of debt (such as tax shields) against the risks of financial distress. PE capital, typically in the form of equity, alters the firm's capital structure by reducing reliance on debt and improving liquidity positions (Almajali et al., 2012). This theory is especially relevant when considering firm liquidity as a moderating factor. Investee firms with low liquidity may face higher marginal costs of debt, making equity investments more valuable in preserving solvency and funding long-term growth.

From a broader financial system perspective, Financial Intermediation Theory explains the role of private equity as a specialized form of intermediation that goes beyond capital provision. PE firms bridge the gap between surplus and deficit units by not only channeling funds but also providing strategic oversight, risk-sharing mechanisms, and technical expertise to enhance firm value (Karanja, 2018). This contrasts traditional banks, which primarily offer debt without managerial input. In Kenya's evolving capital markets, PE firms serve as critical intermediaries, particularly in sectors with limited access to conventional financing, thereby influencing firm-level liquidity management and financial outcomes.

Lastly, the Resource-Based View (RBV) of the firm also informs the conceptual foundation of this study. This theory, as articulated by Barney (1991), emphasizes that firm performance stems from the possession and deployment of valuable, rare, inimitable, and non-substitutable (VRIN) resources. PE firms often bring such strategic resources—including financial capital, technical know-how, and managerial expertise—that investee firms lack (Muriithi et al., 2016). When these resources complement a firm's internal liquidity strength, the result is improved efficiency and enhanced competitiveness. Thus, the RBV supports the idea that the interaction between external investments and internal capabilities—such as liquidity—drives superior financial performance.

Empirical Review

Mutende et al. (2017) investigated the effect of private equity investments on the financial performance of selected firms in Kenya. Using a descriptive research design and regression analysis, the study found that firms receiving private equity financing demonstrated

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significant improvement in return on assets (ROA) and return on equity (ROE). The study concluded that private equity plays a catalytic role in enhancing firm performance through managerial input, capital injection, and governance reforms. However, the study did not explicitly account for internal financial characteristics such as liquidity, leaving a moderating gap that the current study addresses.

Maina and Muturi (2016) assessed the impact of capital structure, including equity financing, on the financial performance of listed firms in the Nairobi Securities Exchange. Their panel regression analysis revealed a strong positive relationship between equity financing and ROE, implying that firms with higher equity components in their capital structures tend to perform better. The study acknowledged the potential influence of firm-specific variables, including liquidity, but did not incorporate them in the model, pointing to a conceptual gap that the present study fills by introducing firm liquidity as a moderating factor.

Muriithi et al. (2016) focused on the determinants of financial performance among microfinance institutions in Kenya. Through panel data analysis, the study found that institutional factors such as operational efficiency, capital structure, and liquidity ratios significantly influenced firm performance. Specifically, high liquidity was associated with better returns and financial resilience. While the study did not examine private equity specifically, its findings underscore the role of liquidity in moderating financial outcomes, thereby justifying its inclusion in the current model.

Almajali et al. (2012) conducted a study on Jordanian insurance firms to determine the impact of financial factors on performance. The study utilized multivariate regression analysis and discovered that liquidity, leverage, and asset turnover were significant predictors of firm profitability. Firms with higher liquidity ratios were better able to meet their obligations and invest in growth, enhancing their ROA. These findings provide cross-country support for the moderating role of liquidity in the link between external capital (such as PE) and firm performance, reinforcing the theoretical framework adopted in this study.

RESEARCH METHODOLOGY

This study adopted a descriptive research design to examine the moderating effect of firm liquidity on the relationship between private equity investments and financial performance of investee firms in Kenya. The study was anchored on positivist philosophy, emphasizing empirical measurement and statistical testing to establish causal inferences. The target population comprised 152 firms that received private equity funding between 2006 and 2021. This period was chosen as it provided comprehensive data for robust regression analysis. Complete data was available for 144 firms, forming an unbalanced panel dataset spanning a 16-year period.

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Secondary data was obtained from private equity fund reports, investee firms' audited financial statements, and industry publications. The independent variable, private equity investments, was operationalized in three categories: venture capital, growth capital, and buyout capital (KPMG, 2021; Deloitte, 2018). The moderating variable, liquidity, was measured as the ratio of current assets to current liabilities in each of the investee firms in Kenya, consistent with prior studies (Ramadhan, 2014; Hu & Loh, 2018). The dependent variable, financial performance, was measured using Return on Assets (ROA), a widely used profitability indicator in similar empirical studies (Karugu, 2018; Wang & Clift, 2009).

Panel regression models were employed to analyze the data, with interaction terms introduced to test the moderating effect of firm liquidity on the relationship between each PE category and financial performance. Diagnostic tests were conducted to ensure robustness of the model, including tests for multicollinearity, stationarity, heteroskedasticity, autocorrelation, and normality. The Hausman specification test was applied to determine the choice between fixed effects and random effects models. The statistical significance of the moderating effect was assessed through the interaction coefficients, with results interpreted at the 1%, 5%, and 10% significance levels. All analyses were performed using Stata statistical software version 16.

FINDINGS AND DISCUSSION

Baron and Kenny's (1986) framework for testing moderation is a widely used methodological approach in empirical research. The process involves a systematic three-step procedure aimed at establishing whether a moderating variable alters the strength or direction of the relationship between an independent variable and a dependent variable. In Step 1, the model assesses the direct relationship between the independent and dependent variables; this relationship must be statistically significant to proceed. Step 2 introduces the moderator variable into the model alongside the predictor and the criterion variables. A statistically significant model at this stage suggests that the moderator and the predictor have a joint influence on the outcome variable.

In Step 3, the interaction term, computed as the product of the centered predictor and the centered moderator, is introduced into the regression model. This interaction term is critical in determining the presence of a moderating effect. A statistically significant interaction term implies that the moderator significantly influences the strength or direction of the relationship between the predictor and the outcome variable. The Baron and Kenny approach assumes that there is a significant baseline relationship between the independent and dependent variables, which provides the foundation for testing whether this relationship is contingent upon the presence of a moderator.

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In step 1 (Model 1), regression analysis estimated the relationship between financial performance and each of the private equity investments indicators. The regression analysis in Table 1 reveals positive and significant coefficients for each private equity investment indicator on financial performance, indicating a favorable impact on financial outcomes.

Table 1: Private Equity Investments Indicators and Financial Performance

ROA	Coef.	Std. Err.	P>t
Venture capital	0.047226*	0.02338	0.015
Growth capital	0.409957*	0.04779	0.000
Buyout capital	0.08728*	0.026956	0.003
_cons	-4.71495*	0.35955	0.000
Model Summary			
R-squared	0.1768		
F(3,2292)	164.07		
Prob > F	0.0000		
Observations	2,448		
ID	153		

In Step 2 (Model 2), the association among the criterion, moderator, and predictor variables (private equity investments indicators, measured by venture capital, growth capital and buy out investment) was assessed using the panel regression analysis Hausman test as a guide. A statistically significant regression model is required. To determine whether firm liquidity moderates the relationship between financial performance and venture capital, financial performance was regressed on venture capital and firm liquidity. Table 2 presents the results of regressing financial performance on venture capital and firm liquidity. The negative and significant coefficient for firm liquidity suggests that it independently influences financial performance, and the Hausman test indicates a statistically significant regression model.

Table 2: Venture Capital, Firm liquidity and Financial Performance

ROA	Coef.	Std. Err.	P>t
Venture Capital	-0.23637	0.100692	0.019
Firm liquidity	-0.04019	0.01905	0.035
_cons	1.520954	1.095277	0.165
R-squared	0.044		
F(2,2293)	5.10		
Prob > F	0.0062		

Note: * p<0.05

In step 3, Model 3, financial performance was regressed on firm liquidity, private equity investments indicators, and interaction term created by multiplying the centered private equity

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investments indicators (independent variable) and centered moderator (firm liquidity). The interaction term should be statistically significant if there is a moderating influence.

The relationship between venture capital (independent variable), firm liquidity (moderator), the interaction term (VC*FL), and financial performance (dependent variable) was estimated using Fixed-effects regression.

Table 3: Interaction Term for Venture Capital and Firm Liquidity

ROA	Coef.	Std. Err.	P>t
Venture Capital	-0.5092	0.098488	0.000
Firm liquidity	4.174479	0.298375	0.000
FC*FL	-0.42362	0.029934	0.000
_cons	4.368207	1.069667	0.000
R-squared	0.0844		
F(3,2292) =	70.45		
Prob > F	0.0000		

Note: * p<0.05

The coefficients in Table 3 demonstrate that the interaction term is statistically significant (p = 0.000), indicating a moderating influence of firm liquidity. The negative coefficient for the interaction term suggests that, in the presence of firm liquidity, the impact of venture capital on financial performance is attenuated.

The findings from Tables 1 to 3 reject the null hypothesis H_{01}, providing evidence that firm liquidity moderates the relationship between private equity investments, particularly venture capital, and the financial performance of investee firms in Kenya. The results highlight the nuanced role of firm liquidity in influencing how private equity investments impact the financial outcomes of investee firms.

To determine whether firm liquidity moderates the relationship between financial performance and growth capital, financial performance was regressed on growth capital and firm liquidity.

Table 4: Growth Capital, Firm Liquidity and Financial Performance

ROA	Coef.	Std. Err.	P>t
Growth Capital	0.494298	0.022062	0.000
Firm liquidity	-0.10015	0.01747	0.000
_cons	-5.87892	0.215615	0.000
R-squared	0.1813		
F(2,2293)	253.84		
Prob > F	0.0000		

Note: * p<0.05

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In Table 4, which explores the moderating effect of firm liquidity on the relationship between financial performance and growth capital, the regression coefficients indicate significant associations. Growth capital has a positive coefficient on financial performance, suggesting a favorable impact on the latter. Firm liquidity, with a negative coefficient, independently influences financial performance negatively. The statistically significant model (p = 0.000) confirms the relevance of these variables in explaining variations in financial performance. The R-squared value of 0.1813 indicates that approximately 18.13% of the variability in financial performance is explained by growth capital and firm liquidity.

The relationship between growth capital (independent variable), firm liquidity (moderator), the interaction term (GC*FL), and financial performance (dependent variable) was estimated using the Fixed-effects regression. The results are as shown in the Table 5.

Table 5: Interaction Term for Growth Capital and Firm Liquidity

ROA	Coef.	Std. Err.	P>t
Growth Capitals	0.341742	0.023125	0.000
Firm liquidity	4.033672	0.264478	0.000
FL*GC	-0.44161	0.028198	0.000
_cons	-4.4689	0.223876	0.000
R-squared	0.2604		
F(3,2292)	269.01		
Prob > F	0.0000		

Note: * p<0.05

Table 5 presents the results for the interaction term when estimating the moderating effect of firm liquidity on the relationship between growth capital and financial performance. The coefficients show that the interaction term FLGC is statistically significant (p=0.000), indicating that firm liquidity significantly moderates the association between growth capital and financial performance. The negative coefficient for FLGC (-0.44161) suggests that the positive impact of growth capital on financial performance is diminished in the presence of higher firm liquidity.

To determine whether firm liquidity moderates the relationship between financial performance and buy out investment, financial performance was regressed on buyout investment and firm liquidity.

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Table 6: Buy Out Investment, Firm Liquidity and Financial Performance

ROA	Coef.	Std. Err.	P>t
Buyout Capital	0.53383	0.023769	0.000
Firm liquidity	-0.11085	0.01754	0.000
_cons	-6.11408	0.225562	0.000
R-squared	0.1520		
F(2,2293)	233.40		
Prob > F	0.0000		

Note: * p<0.05

The results show that both buyout capital and firm liquidity exhibit statistically significant coefficients (p=0.000). This implies that both buyout investment and firm liquidity independently influence financial performance significantly. The F-statistic for the model is highly significant (p=0.000), indicating that the overall model is statistically significant.

The relationship between buy out investment (independent variable), firm liquidity (moderator), the interaction term (FL*GC), and financial performance (dependent variable) was estimated using Fixed-effects regression. The results are as shown in Table 7.

Table 7: Interaction Term for Buyout Investment and Firm Liquidity

ROA	Coef.	Std. Err.	P>t
Buyout Capital	0.473044	0.023448	0.000
Firm liquidity	2.094991	0.172792	0.000
FL*BC	-0.23982	0.018696	0.000
_cons	-5.57445	0.221947	0.000
R-squared	0.2368		
F(3,2292)	237.02		
Prob > F	0.0000		

Note: * p<0.05

The results are as shown in Table 7. The interaction term FLBC is also statistically significant (p=0.000), signifying that firm liquidity significantly moderates the relationship between buyout investment and financial performance. The negative coefficient for FLBC (-0.23982) suggests that the positive impact of buyout investment on financial performance is weakened in the presence of higher firm liquidity.

H_{01} investigated the moderating effect of firm liquidity on the relationship between private equity investments and financial performance of investee firms in Kenya. Each of the private equity investments indicators was analyzed separately. This study indicates that firm liquidity has a moderation influence on the link between private equity investments indicators and the financial performance of investee firms in Kenya since all the private equity investments

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indicators fulfilled all of the above Baron and Kenny's (1986) steps for testing the moderating influence as indicated in Tables 1 to 7. So, the research rejected H_{01}.

CONCLUSIONS

The results of this study affirm that private equity investments exert a statistically significant effect on the financial performance of investee firms in Kenya. However, this relationship is not uniform and appears to be conditioned by firm-specific financial characteristics—most notably, liquidity. The study confirms that firm liquidity plays a moderating role, altering the direction and strength of the relationship between private equity funding and financial performance. This moderating effect was evidenced across all three private equity investment categories—venture capital, growth capital, and buyout capital—each of which demonstrated statistically significant interaction effects with liquidity.

The nature of this moderation reveals a counterintuitive insight: while liquidity is traditionally viewed as a positive attribute, excess liquidity may dilute the performance benefits derived from private equity capital. The negative sign of the interaction coefficients suggests that the marginal gains from private equity diminish when investee firms already possess high liquidity. This may occur due to inefficient capital deployment or a reduction in pressure to optimize operational decisions when cash reserves are abundant. Consequently, this finding challenges the assumption that higher liquidity invariably enhances firm outcomes and highlights the need for optimal capital structuring post-investment.

These findings collectively challenge practitioners and fund managers to think beyond capital injection and consider firm-level characteristics when deploying private equity. It is not just the volume of investment that matters but the context within which the firm operates. Therefore, the strategic alignment between the financial structure of investee firms and the nature of private equity support is critical in realizing sustained performance improvements. The study contributes to the evolving understanding of how firm liquidity can either enhance or suppress the value-adding potential of private equity in emerging markets such as Kenya.

RECOMMENDATIONS

Based on the empirical evidence that firm liquidity significantly moderates the relationship between private equity investments and financial performance, fund managers and private equity investors are advised to incorporate liquidity profiling as a critical component of due diligence. Investment strategies should not only assess growth potential but also the current liquidity position of prospective investee firms. For firms with high liquidity, investors should consider mechanisms that promote disciplined capital allocation, such as milestone-based

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disbursements or performance-linked tranches, to reduce the risk of inefficiencies or complacency in resource utilization.

For the managers of investee firms, the findings underscore the need for proactive liquidity management post-investment. Firms must align capital inflows from private equity with operational efficiency strategies to avoid liquidity-driven underperformance. This includes investing in areas that directly enhance return on assets, such as innovation, market expansion, or operational restructuring. Overcapitalization without strategic deployment may erode the expected performance benefits of private equity, especially under venture capital and growth capital scenarios.

From a policy standpoint, regulators and development-focused private equity networks in Kenya should design guidelines that encourage both capital access and financial discipline. This may involve the development of sector-wide benchmarks on liquidity thresholds for optimal investment absorption or the integration of liquidity-based risk profiling tools into investment readiness assessments. By promoting a balance between financial inflows and firm-level absorptive capacity, such policies can enhance the overall impact of private equity in driving sustainable firm-level growth within Kenya's investment ecosystem.

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