

CAPITAL STRUCTURE AND CORPORATE PERFORMANCE OF MANUFACTURING COMPANIES LISTED IN NAIROBI SECURITIES EXCHANGE

Wilmot Okello Adera

Department of Commerce and Economic Studies, Jomo Kenyatta University of
Agriculture and Technology, Kenya

Wickliffe Anyango

Department of Commerce and Economic Studies, Jomo Kenyatta University of
Agriculture and Technology, Kenya

Dr. Gladys Rotich

Department of Commerce and Economic Studies, Jomo Kenyatta University of
Agriculture and Technology, Kenya

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ABSTRACT

The study's objective was to assess the effects of capital structure on corporate performance of manufacturing companies listed on the Nairobi Securities Exchange. The researcher adopted explanatory non-experimental research design and the study's population consisted of listed manufacturing companies at the Nairobi Securities Exchange (NSE). The researcher sampled nine listed manufacturing firms. Research findings indicated that there exist a positive and significant correlation between long-term debts, ordinary share capital, preference share capital and reserves and corporate performance of manufacturing firms. The findings showed that a long-term

debts, Ordinary share capital, preference share capital and revenue & capital reserves explains 72.9% of the variation in the corporate performance of manufacturing companies. The researcher concluded that there is a significant and positive relationship between corporate investment and corporate performance of manufacturing firms. Long-term debts, Ordinary share capital, preference share capital and revenue & capital reserves are positively related to corporate performance of manufacturing companies.

Key Words: *capital structure, corporate performance, manufacturing companies, Nairobi Securities Exchange (NSE)*

INTRODUCTION

The financing decisions of companies always involve a wide range of policies some of which have implications for capital market development, interest rate, security price determination which subsequently determine the performance of the company. In different countries, there are different external factors that affects how a firm fairs in the market; this is with respect to regulations of the capital and security markets, tax policies, and the existing market for corporate control (Leon, 2013). Brigham and Houston (2004) referred to capital structure as the way in which a firm finances its operations which can either, be through debt- in form of bond issuing or long term payable notes-or equity capital or a combination of both. Essentially, it is a mixture of a number of long term sources of funding and equity shares with reserves and surpluses of a firm being included. Most of the time, corporate performance is associated with financial performance as a subjective measure of how well companies can employ assets from their primary business to generate revenues for the firm.

The tradeoff theory has it that firms seek to have debt that balances the tax advantages of additional debt against the costs of possible financial distress. Whereas the pecking order theory says that a firm borrows, rather than issue equity, especially when internal cash flow is not sufficient to fund capital expenditures. Thus the amount of debt to be borrowed is reflected by the firm's cumulative need for external funds (Berger & Di Patti, 2006). According to the Agency Theory, problems arise in the relationship between the principal and the agent since interest of the principal and the agent are never exactly the same and as a result, the agent as the

decision-making entity, tends to pursue his own interests in the place of those of the principal. Bankruptcy and other agency costs provide firms with incentives to use less debt hence more equity. Free cash flow theory argues that the cash flow of firms with poor investment opportunities should be at minimum if managers are to be prevented from wasting firm's resources in unprofitable investments.

In the view of the shareholders, financial performance is measurable by how better off the shareholder will be at the end of the financial period compared to the beginning as measured by ratios derived from financial statements. This gives an indication of whether the shareholders objective of maximizing wealth is achieved. For a long time, capital structure has been a major issue in financial economics. According to Berger and Udell (2006) the more efficient a company is, the higher the chances that they will earn higher returns from a given capital structure. High returns gained from firm efficiency cushions companies from portfolio risk making more efficient firms to be in a better position to substitute equity for debt in their capital structure. For most companies, financial structure and capital structure change by a small amount more or less continuously. This is because the reported values of several structural components may be especially fluid from period to period: short term liabilities, long term liabilities, and even retained earnings, for instance.

According to Abdul (2012), increasing the amount of debt in proportion to equity increases the riskiness of a firm. The riskiness in turn may affect the performance of a firm. One of the research gaps that brought about this study is linking performance of manufacturing companies to capital structure since there is variation of companies in terms of their capital structure composition and studies have shown that there is no optimal capital structure composition of equity and debt. Ogebe, Ogebe, and Alewi (2013) conducted in Nigerian which illustrated that the decision to rely on capital structure to change a firms performance is critical for the continued existence on corporations same way with the maximization of returns to shareholders.

San and Heng (2011) in their research focusing on listed construction companies from 2005-2008 showed the existence of relationship between capital structure and corporate performance. Findings of past research suggested that there is a significant impact of capital structure on company performance after controlling for company specific characteristics such as company size, non-duality, leverage and growth. However, no sufficient exploitation study has been done on effect of capital structure on financial performance on listed manufacturing firms in Nairobi security exchange. This study therefore sought to fill in this gap by investigating capital structure on financial performance with specific reference to listed manufacturing firms in Nairobi security exchange.

RESEARCH MATERIALS AND METHODS

The study was carried out at the manufacturing companies that are listed at the NSE. There are nine (9) listed manufacturing companies which were all considered in the study. A census survey method was employed where all the nine companies were studied. The study utilized secondary data which was collected from the CMA reports for the years 2008 – 2013 covering a five year period. Data collected was analyzed through correlation and regression analysis techniques to test the association and effect of the independent variables on corporate performance of the manufacturing firms.

RESEARCH RESULTS

Table 1: Correlation Matrix

		Corporate Performance	Long-term debts	Ordinary share capital	Preference share capital	Revenue and capital reserves
Corporate Performance	Pearson Correlation	1	.716**	.759*	.836**	.873*
	Sig. (2-tailed)		.001	.014	.001	.016
Long-term debts	Pearson Correlation	.716**	1	.737**	.888**	.334**
	Sig. (2-tailed)	.001		.000	.000	.001
Ordinary share capital	Pearson Correlation	.759*	.737**	1	.568**	.293**
	Sig. (2-tailed)	.014	.000		.000	.003
Preference share capital	Pearson Correlation	.836**	.888**	.568**	1	.454**
	Sig. (2-tailed)	.001	.000	.000		.000
Revenue and capital reserves	Pearson Correlation	.873*	.334**	.293**	.454**	1
	Sig. (2-tailed)	.016	.001	.003	.000	

** . Correlation is significant at the 0.01 level (2-tailed).

* . Correlation is significant at the 0.05 level (2-tailed).

According to the findings in table 6, the corporate performance has a strong positive correlation with the capital structure. The association between long-term debts and corporate performance indicated a strong positive correlation of 0.716 and a significance value of 0.001 which is less than 0.025 revealing the significance of the association. This was in line with the findings of the study done by Tharmila and Arulvel (2013) which established that the use of debentures positively affect the financial performance of companies as interest cost incurred on debt financing such as debentures or term loans enjoys a tax shield which indirectly lowers the cost.

The association between ordinary share capital and corporate performance indicated a correlation of 0.759 which is a strong positive correlation significant at the 5% level as indicated by its p-value of 0.014.

The preference share capital and corporate performance had a correlation of 0.636 with a p-value of 0.007 revealing the significance of the association. These were contrary to the findings of a previous study by Abbasali and Esfandir (2012) which revealed a negative effect of the use of preference shares because preference shareholders receive no interest on the accumulated dividends giving firms an incentive to delay paying preference dividends. However, the contrary was the case in this study where preference shares were found to be positively correlated to corporate performance. This difference attributed to the nature of organizations studied as the manufacturing firms may experience different effect due to the type of corporate investment adopted from other firms in other sectors. Further, the difference is believed to be as a result of management and investment designs adopted in the so studied companies.

From the table also, a strong and positive correlation was found between revenue and capital reserves and the corporate performance. This had a correlation coefficient of 0.873 which is the strongest correlation above the other associations and a p-value of 0.016 less than 0.025 the critical value at the 5% level of significance. This was in agreement to the findings of a study done by Velnampy (2013) which revealed a positive influence of reserves on performance of Sri Lanka manufacturing firms.

Table 2: Regression Model Summary

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.748 ^a	.729	.705	1.2631

a. Predictors: (Constant), Long-term debts, Ordinary share capital, preference share capital, Revenue and capital reserves

Findings as illustrated in Table 2 reveal that the coefficient of determination (R²) equals 0.729. This shows that holding other factors constant, the predictor variables in this study (Long-term debts, Ordinary share capital, preference share capital and revenue & capital reserves) explains 72.9% of the variation in the corporate performance. Thus, the variation due to other factors that were not considered in the study is 27.1% implying that the variables used command a significant variation in the corporate performance. The adjusted R Square in the table is 0.705 indicating that had the study included the entire population rather than listed firms, then the study results obtained would change by 29.5%. Therefore, the study results are 70.5% valid as shown by the adjusted R square value.

Table 3: Analysis of Variance (ANOVA)

Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	17.433	1	17.433	4.332	.001 ^a
	Residual	28.169	7	4.024		
	Total	45.602	8			

- a. Predictors: (Constant), Long-term debts, Ordinary share capital, preference share capital, Revenue and capital reserves
- b. Dependent Variable: Corporate Performance

From table 3, the significance value is 0.001 which is less than 0.025 the critical value at the 5% level in a 2-tailed test. This therefore shows that the model is statistically significant in predicting the corporate performance of the manufacturing companies with the use of the variables selected. The F critical at 5% level of significance is 3.23 whereas from the table, the F calculated is 4.332 which is greater than the F critical. Thus, the overall model was significant in presenting the relationship between the variables.

Table 4: Regression Coefficients

Model	Unstandardized Coefficients		Standardized Coefficients Beta	t	Sig.
	B	Std. Error			
(Constant)	.638	.454		1.014	.000
Long-term debts	.692	.016	.421	1.111	.011
Ordinary share capital	1.842	.131	1.106	1.206	.004
Preference share capital	1.009	.773	1.256	1.173	.000
Revenue and capital reserves	1.116	.125	.947	1.119	.000

- a. Dependent Variable: Corporate Performance

The coefficients in table 4 answer the regression equation relating the depended and the independent variables. Testing the significance of the coefficients at 95% confidence level, the table indicates that all the variables had a significance value less than 0.05 thus confirming the significance of the results. Also, from the table, all the variables indicated a positive coefficient indicating a positive relationship between the dependent and independent variables. Based on these coefficients, the regression model therefore becomes;

$$Y = \alpha + \beta_1 X_1 + \beta_2 X_2 + \beta_3 X_3 + \beta_4 X_4$$

Corporate Performance = 0.638 + 0.692Long-term debts + 1.842Ordinary Share capital + 1.009Preference share capital + 1.116 Revenue and capital reserves

Thus, the model indicates that, holding the predictor variables constant, corporate performance of manufacturing companies would have a coefficient of 0.638. From the results, the regression coefficient for long term debts is 0.692. This had a significant value of 0.011 which is less than 0.025 depicting the significance of the relationship between long term debts and corporate performance. Therefore, based on these, there is a positive and significant relationship between a unit long term debts and corporate performance. This shows that, given a unit increase in the long-term debts would result to 0.692 times increase in corporate performance of manufacturing companies.

Findings also show that corporate performance is positive and significantly related to the ordinary share capital. This indicated a regression coefficient of 1.842 which is a positive coefficient and a p-value of 0.004 less than 0.025 showing the significance of the relationship. Based on the coefficient, it is evident that a unit increase in ordinary share capital would result to 1.842 times increase in corporate performance of manufacturing companies listed at the NSE.

From the model also, findings show that, preference share capital has a positive influence on corporate performance of manufacturing companies. This is shown by the regression coefficient of 1.009 with a significance value of 0.000 which is less than 0.025 the critical value at the 5% level of significance. This therefore shows that given a unit increase in preference share capital would result to 1.009 growth in corporate performance of the manufacturing companies. Findings as well show that revenue and capital reserves are positively related to corporate performance. The regression coefficient for this was obtained to be 1.116 with a significant value of 0.000 less than 0.025 indicating a significant effect of revenue and capital reserves on corporate performance of manufacturing firms. Thus, a unit growth in Revenue and capital reserves would result to 1.116 times increase in corporate performance.

These regression results were in line with the results of the studies done by Magara (2010) which established a positive and significant relationship between the firm size, tangibility and growth rate and the degree of leverage of the firm as well as that of Mwangi (2010) which revealed a strong positive relationship between leverage and return on equity, liquidity, and return on investment existed.

Table 5: Significance Test for Relationship between Capital Structure and Corporate Performance

	Value	Degrees of freedom (df)	Asymp. Sig. (2-sided)
Pearson Chi-Square	2.128	8	.000

Table 5 gives the chi-square test results for the test of significance in relationship between capital structure and corporate performance. The table indicates that, the Pearson chi-square value is 2.128 which also significant at 5% level as the asymptotic significance (2-sided) indicate a value of 0.000 which is less than 0.025 the critical value at the 5% level. Thus the results indicate sufficient evidence of the relationship between capital structure and corporate performance of manufacturing companies. The findings are in agreement to the results of Magara (2010), Mwangi (2010) and Ndiwa (2014) in their studies which revealed significant relationship between capital structure and performance of respective organizations considered in their studies.

CONCLUSIONS

The long-term debts of a company are directly related to its corporate performance. The interests and time-span attached to debentures will determine the returns of the company. The long-term debts facilitate capital accumulation overtime creating room for acquisition for more assets. Unlike the shorter-term loans which are not conducive to greater productivity, long-term loans may lead to improvements in productivity and positively influence the quality of capital accumulation without affecting the amount of fixed investment.

As indicated in the results, ordinary share capital is significantly related to the firms' corporate performance. Since the ordinary shares do not have pre-determined dividend amounts, they represent equity ownership in a company which is given much preference in key issues like dividend issuance. Thus, with more ordinary share capital a firm have, the more favorable will be its performance.

Preference shares on the other hand are the firm's stocks with dividends that are paid before ordinary shares stock holders are paid. Although these are given the highest preference when it comes to dividend payment among other benefits in the firms, in the long run these contributes to the increased performance of a firm. This is due to the fact that the shareholders will be willing to offer more shares to the firm for them to benefit from the preferences given to these shares. However, the ordinary shares have the highest contribution to performance as compared to the preference shares in a firm.

Generally, reserves contribute positively to the performance of manufacturing firms. The more reserves are, the higher the capital available for investment which in turn will yield profits thereby increasing the profitability of a firm. Capital reserves, revenue reserves, statutory reserves and realized and unrealized reserves comprise some part of the company assets where the company's ability to create sufficient reserves gives it adequate liquidity during its normal course of operations.

RECOMMENDATIONS

The study recommends that; there is need for the management of manufacturing firms to ensure an optimal capital structure. Ensuring an optimal capital structure and securing the financing sources with the least cost of capital is more important for corporate entities.

The manufacturing firms should have more preference on ordinary shares capital to the preference share capital. With more ordinary share capital then the preference share capital, a firm's liabilities will be less thus making more resources available for investments.

The study also recommends that the management and other stakeholders involved in decision making on corporate investments of the manufacturing firms should be informed through training on corporate investment and financial seminars to educate them on the effects of

different investment types on corporate performance. This would ensure that the key personnel making decision in these firms are well equipped of knowledge and skills on corporate investment thereby giving room for increased performance.

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