

# **LONG TERM DEBTS AND FINANCIAL PERFORMANCE OF MANUFACTURING FIRMS LISTED AT NAIROBI SECURITIES EXCHANGE, KENYA**

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**International Academic Journal of Economics and Finance (IAJEF) | ISSN 2518-2366**

**Received:** 25<sup>th</sup> September 2023

**Published:** 4<sup>th</sup> October 2023

Full Length Research

**Available Online at:** [https://iajournals.org/articles/iajef\\_v3\\_i10\\_267\\_278.pdf](https://iajournals.org/articles/iajef_v3_i10_267_278.pdf)

**Citation:** Mwiti, M. E., Gitagia, F. (2023). Long term debts and financial performance of manufacturing firms listed at Nairobi Securities Exchange, Kenya. *International Academic Journal of Economics and Finance*, 3(10), 267-278.

## **ABSTRACT**

The manufacturing sector plays a pivotal role in the economies of developing nations inclusive of Kenya. This sector contributed \$7.99 billion in output translating to an increase in GDP by 4.33% in the year 2021. However, the sector showed a decline in performance as indicated by declining trends in return on assets. Empirical evidence show that manufacturing sector have been unable to raise their own finances to boost their operations, and significantly rely on credit, an aspect that is suspected to affect performance. The study sought to determine the effect of long term debts on financial performance of manufacturing firms listed at Nairobi Securities Exchange. The main theory that anchored the study was pecking order theory. The target population was the 9 manufacturing firms listed in the Nairobi securities Exchange. A census of all the manufacturing firms listed in the Nairobi Securities Exchange was done. The study used secondary data from financial reports as published in the NSE handbook and Kenya

National Bureau of Statistics for the period between 2017-2021. Panel regressions analysis and Pearson's product moment correlation analysis were used for inferential analysis while means and standard deviations were used for purposes of descriptive analysis. Feasible Generalized Least Square (FGLS) regression results indicated that long term debt ( $p=0.044, <0.05$ ) had a statistically significant positive effect on financial performance. Correlation analysis indicated that long term debt had a weak positive correlation with financial performance. The study concludes that firms with high long term liabilities relative to total assets and low current ratio show increased return on assets. The study recommends that, companies increase levels of debt to an optimal level (both long-term) and reduce interest rate coverage.

**Key words:** Financial Performance, Long term debt

## **INTRODUCTION**

### **Background of the study**

After formation, many companies end up requiring additional funding over and above what is provided by the shareholders as capital. Given this case, such entities are pushed to credit from external sources. Taking this move has both positive as well as negative impacts on the growth of a firm. When it comes to the positive impacts, the use of credit to finance a business helps in relieving it from interest paid on taxes, and also helps in ensuring that there is sufficient flow of cash. On the other hand, the negative impact of the use of credit in financing a business is that it may push the organization to insolvency, and will subsequently reduce shareholders' wealth (Yasmin, & Wepukhulu, 2019). When the Long term debt of an organization is in such a manner that has a higher rate of debt, the implication of this is that there will be fall in the return on shareholder's equity. This happens when an entity in subject experiences a significant drop in income leading to more debt.

Mulwa (2018) in his study done in Egypt showed that long term debts had a negative effect on the return on assets. This research further conducted an investigation to determine the effect of the choice of Long term debt on the performance in organizations. The capital structure, in this regard, comprised of elements such as long term debts, and total debts, with performance based on the metrics of ROE and the GPM. The results of this study indicated that the Long term debt had no effect on the performance of a firm.

Muiruri, & Wepukhulu (2018) in their study conducted in Kenya provided a clear background outlining that the economy of the nation has been dominated by agricultural practices, with minimal industrial or manufacturing activity and this has been the trend since independence. In the less dominant manufacturing sector, it was noted that there are at least 2300 firms. This study further conducted an inquiry on the relationship between the Long term debt and financial performance of firms that were listed in Nairobi Stocks Exchange between 2007 and 2012. The results indicated a negative relationship between debt equity ratio and ROE.

The current study seeks to investigate the effects of long term debt on the financial performance among manufacturing firms listed in Nairobi Stocks Exchange between 2017 and 2021. The purpose of this study is to determine if long term debts among firms can increase the returns by a firm thus improving its financial performance.

## **Credit Financing**

Credit financing is whereby an organization advances for a flexible loan from a financial institution and this comprises of a specific amount of money that can be accessed as per the needs of the company advancing for the credit to be repaid either immediately or at an agreed period of time. In taking this amount from the creditor, the organization borrowing is always charged a defined interest rate. The charges are placed to the borrower at a point when the credit is advanced. When servicing the loan amount, the expectation is that the borrower will have to pay the principal and the interest charged.

Consequently, it should be noted that credit financing is important for any business as most entities often do not have sufficient financial resources to run their day to day activities. In order to ensure that there is no service interruption, business owners often opt for credit financing to boost their financing base. Without credit financing, chances are that most business organizations may have closed their operations long time ago. Therefore, the importance of credit financing is that it helps in the survival of business organizations.

When advancing for credit financing, business organizations can either opt for short term debt or long term debt. Short term debt is one which is supposed to be repaid within one year, while long term debt is that which is to be repaid in more than one year. Moreover, short term debts often carry a higher interest rate compared to the long term debts, and this is because they are perceived to carry a higher risk by the lenders. In this study, long term debt will be measured by bank loans and debentures.

## **Financial performance of manufacturing firms**

Yasmin, & Wepukhulu (2019) defined financial performance as the measurement of the strategy, policies and operations of firms in monetary terms. The results, in this regard, are often quantified or measured based on financial ratios such as ROE and ROA. For the case of a manufacturing firm, which has an integrated Long term debt that comprises of credit financing and equity financing, the financial performance is measured on the metrics of profitability, repayment capacity, financial efficiency, among other elements. The financial performance of a firm is an important indicator from which the investors can make their investment decisions from. In addition, this indicator can also be used in providing a comparison of the performance among firms within a given segment or sector to include in manufacturing.

The importance of the financial performance of an organization is that it helps in increasing the market value of the entity in subject and this is in addition to leading to the growth of the industry and the overall economic prosperity. This is the reason why there has been growing *literature on corporate finance over years. Organizations provide a mechanism for the transfer* of risks and the channeling of the financial resources at their disposal in a manner that supports the activities of a business (Ambroise, Prim-Allaz, & Teyssier, 2018). It is through the financial decisions by the management that the financial structures are developed. One of the critical elements in running an organization is the financing choices since it is from this that the optimal capital structures are developed. Long term debt has for last decades posed serious challenge to scholars in the area of finance thereby posing an increased remarkable attention as to which is the most appropriate and optimal capital structure. Businesses are strongly advised by recent researchers to assess the Marginal benefit of either debt to equity financing to the marginal cost of either mode of financing and where possible to determine the optimal levels of Long term debt that would spur growth in their businesses.

**Table 1: Trend in Performance of Manufacturing Firms listed in NSE over five-year period**

YEAR	2017	2018	2019	2020	2021
ROE	0.06	0.136	0.036	0.087	0.02
ROA	0.053	0.128	0.04	0.09	0.04

Source (CMA)

From the data above, performance of manufacturing firms has been declining year after the other with the highest growth on return on assets of 12.8% being recorded in the year 2018 and the lowest of 4% being recorded in 2021. Likewise, return on equity experienced a similar pattern with the highest of 13.6% being recorded in 2018 and he lowest of 2% being of record in the year 2021.

## **Statement of the problem**

The manufacturing sector plays a critical role in economic development. Recent statistics indicate that the manufacturing sector accounts for at least 7.2% of the GDP of the nation. Despite this significant contribution, the sector has experienced fluctuations over years in its financial performance. Most of the manufacturing firms that are listed at the Nairobi Securities Exchange have been unable to select the most appropriate credit financing, and this has a negative effect on

their financial performance. This claim can be justified by the fact that there has been a decline in the ROA, which is an important measure of performance.

Some studies (Afolabi, Olabisi, Kajola, & Asaoulu, 2019) have focused more on covered leverage in general terms and not specifically on the financial leverage and this have led to conceptual gaps. In addition, there are also studies on financial performance that have focused on different firms rather than those in the manufacturing sector and thus bringing contextual gaps.

Attempts to unlock the financing dilemma have seen various studies which have provided contradictory finding. Some studies (Fatihudin, 2018) indicate that leverage does not have a statistical significance on financial performance, while others (Yusuf, & Surjaatmadja, 2018) indicate that there is significant relationship. To fill this gap, the current research shall carry out further empirical analyses in order to come up with conclusions which may help in construction of optimal credit financing.

In the current era that gives relative importance to the concept of credit financing, many empirical studies have been conducted in developing nations such as Palacín-Sánchez, Canto-Cuevas, & Di-Pietro, (2019). This gives a clear indication that the findings in these previous researches cannot be generalized to an emerging nation such as Kenya.

### **Objectives of the study**

The objective of the study was to determine the effects of long-term debts on the financial performance of manufacturing firms listed in Nairobi Securities Exchange, Kenya.

### **Hypothesis**

**H0<sub>1</sub>** Long term debt does not have a significant effect on financial performance of manufacturing firms listed in Nairobi Securities Exchange.

## **LITERATURE REVIEW**

### **Theoretical Review**

#### **Pecking Order Theory**

The pecking order theory has its proponents as Myers and Majiluf (1984). Based on the stipulations by these theorists, an organization prefers internal funding than external funding. In case an organization is in need of funding, it will prefer advancing for debts, with equity being the last resort. It should be noted that organizations operate in such a manner that they embrace information asymmetry whereby they do not a pre-set or optimum Long term Liabilities ratio. Traditional tactics are often used by the management of firms whereby prefer using debts to pay dividends to the shareholders. This theory acknowledges that a firm follows a systematic order that is favorable as far as the utilization of capital to fund their business is concerned. With information asymmetry between the investors and the firm at play, preference is given by the firm on short term debts over

long term debts, retained earnings over debt, and debt over equity. The Pecking Order Theory explains the reason why firms are in debts. This theory will be relevant to the study at hand as it can be mapped to the first and second objectives of this research which focus on both the long term debts.

### **Empirical Literature review**

#### **Long term debt and financial performance**

Research by Rajamani (2021) focused on investigating the effects of Long term debt on financial performance of Indian SMEs. A total of 30 companies were considered in this study, whereby these entities were tested with data collected from them for a period of 10 years between 2001 and 2011. The finding to this study was that there existed a significant positive correlation between the total assets of a company and its long term debts. Therefore, there was a positive effect between Long term debt and financial performance. This study ignored other credit sources and the focus was in a different context which cannot be generalized in Kenya. To address this gap the current study included short-term debt and interest rate coverage and considered manufacturing sector in Kenya. According to Kakiya & Misango (2019) whose study focused on Listed Manufacturing firms with one of the aims being to investigate the effects of long term debts on financial performance, it was revealed that there exists a negative relationship between long term debt and financial performance. This study provided a conflicting finding to that by Kenn-Ndubuisi, & Nweke (2019) who indicated that long term loans advanced by firms helped in enhancing their productivity. However, the study ignored other elements which form credit finance. To address the gap, the current study included both short term and long term debt.

### **RESEARCH METHODOLOGY**

This research applied correlational research design. The reason for the utilization of this research approach is that it is suitable in studying associations that exists among the study variables and can also be used as an important linearity test. In addition, descriptive statistics was used whereby there was application of linear regression model to determine the relative strength between the independent variables and dependent variables. The target population refers to a specific group that is relevant in a given study. There are a total of 9 companies listed in the manufacturing and allied segment as per the recent reports from the NSE. Given this small number, this study applied a census approach in arriving at the number of companies to be considered for the research. The period under consideration was between 2017 and 2021. This study adopted a census sampling technique because of relatively small number of target respondents in the target region. All the manufacturing and allied companies listed in NSE formed the sample for the study. This study mainly utilized secondary data collected from published financial statements of the manufacturing firms between 2017 and 2021. The data that was used in this study was available in the respective organizational websites, NSE and Capital Market Authorities website. The collected data was analyzed using quantitative techniques. The results were then presented in the form of figures, tables, and charts. Quantitative data collected was then analyzed using SPSS version 22.

Regression model was used in determining the relative degree of association among variables. The regression model adopted will be as follows.

$$Y_{it} = \alpha + \beta_1 LTD_{it} + \epsilon_{it}$$

Where:

Y=financial performance

$\alpha$  = the Y intercept.

$LTD_{it}$  = long term debts of firm  $i$  at time  $t$

$\beta_1$  = the coefficient of long term debt while  $\varepsilon$  is error term.

To ensure non violation the study carried out the tests for normality, linearity, autocorrelation, Heteroskedasticity and Panel Unit root test as supported by fadhili *et al.* (2011).

## **Research Findings and Discussion**

### ***Descriptive Analysis***

Results in Table 2 show the summary of the descriptive statistics of long term debt.

**Table 2: Descriptive Statistics**

	Long term debt
Mean	0.889917
Median	0.766120
Maximum	15.23839
Minimum	-93.60150
Std. Dev.	5.778509
Skewness	-12.76850
Kurtosis	203.7340
Jarque-Bera	614194.0
Probability	0.000000
Sum	320.3701
Sum Sq. Dev.	11987.43
Observations	360

*Source: Research Data, 2021*

Table 2 indicates that on average companies had more long term debt relative to the Total assets. This is shown by average of long debt ratio of 0.889917. This points out to a trend in companies applying more long term debt in financing the Total assets. The standard deviation of long term debt ratio was 0.6661 indicating a higher variability in the long term liabilities among the listed companies considered in the period of study. The maximum and minimum of the long term liabilities was 15.23839 and -93.60150 while the negative in the minimum indicating that more companies were geared.

## **Diagnostic Test Results**

### **Normality Test**

Since multiple regressions was used as a principle data analysis method, the assumption of normality of data was necessary. Normality of data can be tested using Kolmogorov-Smirnov tests, Shapiro Wilk test, Kurtosis and Skewness, Quantile-Quantile plots (Q-Q plots), Jarque-Bera test and histograms (Saunders *et al.*, 2009). In this study, Jarque-Bera test was used as a test of normality since the data set contained more than 2000 observations as advocated for by Field (2005).

**Table 3: Normality test results**

<b>Variable</b>	<b>Jarque-Bera test</b>	<b>P-value</b>
Long Term debt	3.70389	0.156931
Financial Performance	1.55628,	0.459259

*Source: Research Data, 2021*

The results in the table 3 above indicate that the residuals for the variables were normally distributed. Where the p-value is very small, usually less than or equal to a threshold value previously preferred called the significance level, it suggests that the observed data is inconsistent with the assumption that the null hypothesis is true (Brooks, 2008). The significance level for the study was 0.05 and all the p-values were found to be higher than the level of significance. Similarly, for all the variables of Jarque-Bera test statistics were greater than the level of significance of 0.05 hence the data was found to be normal and therefore fit for panel multiple regressions.

### **Stationarity Test**

Since the data used in the study was panel, it was necessary to assume that the mean and variance of data over time was constant. Failure of the assumption would lead to spurious regression and the results would be rendered unreliable (Bhargava, 1986; Aczel, 2009).

**Table 4: Stationarity Test results**

<b>Variable</b>	<b>ADF Statistics</b>	<b>Prob.*</b>	<b>1%</b>	<b>5%</b>	<b>10%</b>
Long term debt	3.1608	0.0097	-2.5708	-1.9416	-1.6162
Financial Performance	-11.0054	0.0000	-2.5708	-1.9416	-1.6162

*Source: Research Data, 2021*

From the test result, the ADF statistics for Long Term debt and interest rate coverage were found to be more than the critical values at 1%, 5% and 10%, and Financial Performance were found to be less than the respective levels of significance. Woolridge (2002) postulates that where ADF statistic is more than the critical values, the null hypothesis that the data has a unit root should be rejected and the data deemed to be stationery. This implies that Long term debt was found to be stationery and Financial Performance was found to be non-stationery and therefore unfit for regression. To resolve this, the variables found to have unit roots were differenced and equations run using the differenced variable as supported by Dansey and Reidy (2004).

### **Heteroskedasticity Test**

In order to ensure that the error term among different values of financing structure have constant variances, it was necessary to carry out Heteroskedasticity test. In order to carry the test, Breusch-Pagan (1980) test was applied and the table below indicates the test results.



**Table 5: Heteroskedasticity Test Results**

Test	Statistic	d.f.	Prob.
Breusch-Pagan LM	3968.072	780	0.0000
Pesaran scaled LM	79.70440		0.0000
Bias-corrected scaled LM	77.20440		0.0000
Pesaran CD	22.27754		0.0000

*Source: Research Data, 2021*

The Null hypothesis for Breusch-Pagan test is Homoscedasticity while alternative is Heteroskedasticity. Where the P value is less than critical level of significance at 0.05, then the null hypothesis should be accepted and resulting residuals are homoskedastic (Poi and Wiggins, 2001). The table above shows the test statistic value, test of degree-of-freedom, and the associated p-value. In this case, the value of the test statistic, 3968.072 is well into the upper tail of a  $\chi^2_{780}$ , therefore, the null hypothesis of constant variance at conventional significance levels of 5% was rejected and therefore heteroskedastic. Heteroskedastic data implies that error term among different values of credit financing does not have constant variances and as such, OLS estimator would bring inefficient predictions and cannot be utilized for hypothesis testing (Dansey & Reidy, 2004). To remedy this, the study employed the FGLS estimation technique as applied by Mwangi *et al.*, (2014).

**Autocorrelation Test**

Autocorrelation test was necessary to ensure that error terms between periods were not correlated. Existence of autocorrelation causes error terms to be biased and inefficient hence wrong inferences (Wooldridge, 2003; Baltagi, 2005). To test for autocorrelation, the study applied Wald Test where Null Hypothesis was no autocorrelation, that is, no serial relation in residual of model while alternative is serial correlation (Doornik, Bond and Arellano, 2006). The results of the test were as shown below.

**Table 6: Autocorrelation Test Results**

Wald Test:

Equation: Untitled

Test Statistic	Value	df	Probability
F-statistic	15197.41	(4, 316)	0.0000
Chi-square	60789.65	4	0.0000

*Source: Research Data, 2021*

Table 6 above indicates single linear restriction so that F-statistic and Chi-square statistic are identical. In determining whether to accept or reject the hypothesis, a comparison is made of the p-value of F-statistic and level of significance which in this case is 5% (Miller & Startz, 2018.) A p-value lesser than the level of significance signifies autocorrelation and therefore the null hypothesis is rejected (Blumberg Cooper & Schindler, 2008). Therefore, the study found serial correlation and therefore first order autocorrelation. To solve this FGLS estimation technique was applied as employed by Mwangi *et al.*, (2014).

### Test for Random or fixed Effect

In order to determine the appropriate model to use for estimation, the study estimated both the fixed effects model and random effects model. Then Hausman specification test was carried out to establish the appropriate model to be used for the study (Full results in appendix IV). Table 7 indicates the summary of test result.

**Table 7: Summary of Hausman Test**

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	1.800508	0.216563	8.314022	0.000
Long term debt	0.007781	0.036736	-0.211818	0.832
Weighted Statistics				
R-squared	0.210865	Mean dependent var		1.400905
Adjusted R-squared	0.201974	S.D. dependent var		3.952838
S.E. of regression	3.531162	Sum squared resid		4426.532
F-statistic	23.71496	Durbin-Watson stat		1.041013
Prob(F-statistic)	0.0000			

Source: Research Data, 2021

The null hypothesis under Hausman is that random effect model was appropriate for the data at conventional significance level of 0.05 (Hausman, 1978). Data was ran using Feasible Generalised Least Squares and the resulting p -value was 0.0000 which led to rejection of the null hypothesis that random effect was appropriate for the data and therefore fixed effect model was preferred.

### Regression Analysis

The diagnostics test carried out indicated that Long term debt was found to be stationery and therefore ran at their levels. First differentiation made the non-stationary variables stationary as advocated for by Dansey and Reidy (2004)

Using Financial Performance as the dependent variable, the study considered a set of hypotheses pertaining to the relationship between Long term debt and Financial Performance. Financial Performance as measured by ROA was regressed against Long term Liabilities ratio

**Table 8: FGLS Regression Results (Dependent variable: ROA)**

Variable	Coefficient	Std. Error	t-Statistic	P> t	Low	High
C	1.5468	0.438	3.5285	0.001	0.684	2.409
Long term debt	0.0070	0.003	2.5940	0.044	-0.03	0.016
Effects Specification						

### Cross-section fixed (dummy variables)

Weighted Statistics			
R-squared	0.269356	Mean dependent var	2.002270
Adjusted R-squared	0.169933	S.D. dependent var	3.660233

S.E. of regression	3.341509	Sum squared resid	3528.355
F-statistic	2.709195	Durbin-Watson stat	1.086187
Prob(F-statistic)	0.000000		

Unweighted Statistics

R-squared	0.247680	Mean dependent var	1.470390
Sum squared resid	4264.107	Durbin-Watson stat	1.102935

*Source: Research Data, 2018*

From the above regression results the following regression equation was generated

**Financial Performance=1.5468+0.007LTD+ ε.....3.2**

Where:

CS=Long term debt Decision

ε= Error term

**1.5468**= Y- intercept or constant term

**0.007**= an estimate of the expected percentage increase in Financial Performance corresponding to a one percentage increase in Long term debt.

The results in table 8 indicate an R squared of 0.2694. This implies that the Long term debt had low explanatory power on Financial Performance. The F statistic value was 2.7092 with a p-value of 0.0000 which is less than 0.05. This indicates that, long term debts had significant effect on Financial Performance of manufacturing firms listed at Nairobi Securities Exchange, Kenya.

**Effects of Long term debt on Financial Performance**

The first hypothesis of the study sought to test the statistical significance of the relationship between Long term debt and Financial Performance of manufacturing firms listed in the NSE. The regression results presented in Table 4.9 indicate that the p- value of Long term debt was at (p=0.044, <0.05) indicating a statistically significant relationship between Long term debt and Financial Performance of manufacturing firms listed at the NSE. The findings of the current study were consistent with Pecking order theory. Theory was founded by Durand David (1959). According to this approach, the market value of equity shares is based on the earning available for equity Shareholders after the payment of interest on debt if it is included in the Long term debt (Pandey, 2010). In line with this theory,Eysimkele, & Koori (2019) contend that, as the proportion of cheaper source of funds (debt) increases, overall cost of capital declines which consequently increases the market value of the firm. Hence, the optimum Long term debt exists when the firm employs 100% debt or maximum debt in the Long term debt (Durand, 1959; Klein, O'Brien & Peters, 2002). From the above results, use of debt in the Long term debt significantly increases the value of the firm as indicated by 0.7%.

**Summary, Conclusions and Recommendations**

**Summary**

The study sought to determine the effect of Long term debt on Financial Performance of manufacturing firms listed at NSE. Long term debt was proxied by long term liabilities ratio while the Financial Performance was represented by ROA. To understand the contribution of long term debt to the Financial Performance, Pecking order theory was utilized to hypothesize the effect of

long term debt. The findings of correlation analysis document that Long term debt had a weak and positive correlation with Financial Performance of manufacturing firms listed in Nairobi Securities exchange. Using the FGLS estimation technique, the study established a significant positive relationship between increased used of debt and Financial Performance. Pecking order theory to Long term debt supported the findings of the study.

### **Conclusion**

The study documents an increased trend in use of debt as opposed to equity. The study therefore concludes that there is an elaborate financial institutions available fund for firms to borrow. In addition to this long term debt was found to have a positive significant relationship with Financial Performance. Therefore, the study concludes that when a firm increases long term debt in its credit financing ROA increases. This has been supported by various literatures for example pecking order theory.

### **Recommendations**

From the above conclusions, the study makes the following recommendations. Firstly, long term debt was found to have a significant positive effect on ROA, therefore the study recommends that manufacturing firms increase long term debt to enhance the firm performance. This may include term loans, bonds and mortgage loans among other sources.

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