EFFECT OF EQUITY FINANCING ON THE FINANCIAL PERFORMANCE OF MANUFACTURING FIRMS LISTED IN NAIROBI SECURITIES EXCHANGE

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ABSTRACT

Manufacturing sector plays a key role in economic development of Kenya. Data published by the Kenya National Bureau of Statistics shows that manufacturing sector's contribution to gross domestic product stood at 7.6 percent in 2021. However, the manufacturing sector has experienced fluctuations in its financial performance over the years. In 2020 it contributed 7.9 percent down from 8.4 percent, (2019), 8.7 percent in 2018 and 9.3 percent (2017) therefore the study sought to assess effect of retained earnings on the financial performance of manufacturing firms listed in Nairobi securities exchange. The study was anchored on the pecking order theory. The study used descriptive research design to explore its set objectives. The units of observation were manufacturing firms listed in Nairobi Securities Exchange. The study sampling frame was seven (7) manufacturing firms listed in Nairobi Securities Exchange. Since the target population of the study is small the study adopted census to incorporate all the seven (7) manufacturing firms listed in Nairobi Securities Exchange. The study collected secondary data relating to short term debt, long term debt and retained earnings and ROA of manufacturing firms listed in Nairobi Securities Exchange. Panel regressions analysis and Pearson's product moment correlation analysis was used for inferential analysis and standard deviations was used for purposes of descriptive analysis. The analyzed data were presented in form of tables and pie charts and bar graphs. From the findings the study concluded that equity financing has a statistical effect on the financial performance of manufacturing firms listed in Nairobi Securities Exchange.

Key words: Capital Structure, Equity Financing, Financial Performance, Manufacturing Firms.

INTRODUCTION

A flourishing manufacturing sector is an important driver for sustainable job creation and economic growth in any country because of its links with other sectors. Furthermore, given its labor-intensive nature, the manufacturing sector may be more effective as a source of employment creation compared to other sectors in any given economy, (Aashish, Mehta, & Changyong, 2018). Globally manufacturing is the anchor pillar of various economies. The performance of manufacturing firms in China plays a significant role in the overall health of the Chinese economy. Manufacturing is a key sector in China's economy, accounting for a large share of GDP, employment, and exports. Therefore, the performance of manufacturing firms can have a ripple effect throughout the economy (Baral, 2017).

In USA manufacturing firms play a critical role in the in creating jobs, driving innovation and increasing productivity. The presence of a strong manufacturing sector can lead to increased economic growth, as it generates a positive multiplier effect throughout the economy (Masood, 2018).

In the Sub-Saharan African region, manufacturing accounts for only about 13 per cent of gross domestic product (GDP) (Abata, & Migiro, 2019). Manufacturing firms play a significant role in the economy of Nigeria by creating jobs, driving economic growth, and generating revenue through exports. Manufacturing firms also create jobs for a large number of Nigerians, particularly in rural areas where unemployment is high. This has helped to reduce poverty and improve the standard of living for many people. Additionally, by producing goods and services, manufacturing firms help to generate revenue through exports, which has helped to improve the country's balance of trade and contribute to the overall health of the economy (Ajibola, Wisdom and Qudus, 2018)

The Government of Kenya considers manufacturing as one of the economic pillars for creating employment and wealth and due to this reason, the Government has sought to increase the share of the manufacturing sector from the current 9.2% to 15% in the Medium-Term Expenditure Framework (MTEF 2018– 2020) and 20% as per the vision 2030, (Manda, 2018). In terms of the output, productivity and the performance of the manufacturing sector is subdued as indicated by its contribution to GDP, value addition, growth and employment which were 7.50%, 6.03%, 3.20% and 12.1% respectively, (Libanio & Moro, 2018). Despite immense contribution of the Kenyan manufacturing sector to the economic development, several firms use debt to leverage on their capital in order to enhance profit levels

Capital structure refers to the combination of debt and equity that a manufacturing firm uses to finance its operations and growth. The optimal capital structure for a manufacturing firm will depend on a variety of factors, including the firm's industry, growth prospects, and risk tolerance (Morris & Fessehaie, 2017). A well-structured capital structure can help to lower a firm's cost of capital and increase its return on equity, but it's crucial to balance the benefits and risks of using debt. It's important for manufacturing firms to continually evaluate and adjust their capital structure as circumstances change (Arulvel & Ajanthan, 2018). Capital structure is the most significant decision in a company not only on the maximization of shareholders wealth, but also the decision determines the ability of the company to sustain a competitive edge (Chandrapala & Knapkova, 2018).

There is various type of capital structure manufacturing firm can adopt. One of the capital structure that manufacturing firms can adopt is equity financing. From a manufacturing perspective, equity as a source of capital refers to the funds that a manufacturing firm raises by issuing shares of its stock to investors. When a manufacturing firm issues new shares of stock, it is essentially selling ownership in the company to the investors who purchase the shares. These investors become shareholders and have a claim on a portion of the company's profits and assets, based on the number of shares they own (Mutuva & Njuguna, 2019). Equity can be a valuable source of capital for manufacturing firms because it can help them to finance growth and expansion without taking on additional debt. Equity also allows manufacturing firms to bring in outside investors who can provide fresh perspectives, resources, and expertise, which can help to improve the company's operations and strategic decision-making (Arimi, 2012).

Financial performance is the ability to work profitably, competently, and successfully, to withstand environmental threats while capitalizing on current opportunities, and to develop, (Almajali, 2017). Financial performance measures, profitability, and liquidity, as well as providing partners with a significant tool to assess a firm's recorded and current financial position (Siro, 2018). A company's financial performance can be measured using metrics such as profitability, dividend growth, sales turnover, asset base, and capital employed, among others, (Liargovas & Skandalis, 2019). In this study the financial performance of the firm will be measured by return on assets.

The manufacturing sector plays a key role in the overall development of the economy. Currently, manufacturing accounts for about 7.2 per cent of the country's GDP. However, the manufacturing sector has experienced fluctuations in its financial performance over the years. Majority of manufacturing firms listed in Nairobi Securities Exchange have not been able to appropriately choose the right mix of capital structure, this has negatively affected their financial performance. For example in 2016 Mumias Sugar record Ksh 6.3 billion in pretax losses which led to its closure for nearly three months in 2017 the company still recorded a loss of 6.8 billion, in 2018 the company further recorded a loss of Ksh15.1 billion.

One of the factors that was attributed to this low financial performance was poor financing mode. In 2018 the company recorded a loss of Ksh 166.8 million. ARM cement had huge debts in its capital structure and it reported huge losses hence finding itself in serious debt crises owing creditors more than its net worth (Juma, 2016). In 2016 ARM recorded a loss of Ksh 6.3 billion while in 2017 the company recorded a loss of ksh 6.9 billion, (Kenya Association of Manufacturers Priority Report, 2018). Such poor financial performance among manufacturing firms necessitates empirical studies to determine the effects of equity financing and the financial performance of manufacturing firms

LITERATURE REVIEW

Theoretical Review

The study was anchored on Pecking Order Theory by Myers and Majluf. Pecking Order Theory states that firms prefer to use internal funds to finance their investments before turning to debt or equity financing. According to the theory, firms have a hierarchy of financing sources, with the most preferred source being retained earnings, followed by debt, and finally equity (Saad, 2015). The theory suggests that firms will choose the cheapest source of funding first, and will only turn to more expensive sources of funding as the cheaper sources become exhausted. The theory also suggests that firms with poor profitability or high levels of uncertainty will have a greater preference for debt financing, while firms with good profitability and low levels of uncertainty will have a greater preference for equity financing. (Afrasiabishani, Ahmadinia & Hesami, 2012).

Pecking order theory is relevant to this study as it contends that firms first opt to employ internal sources like reserves & retain earnings to finance a project instead of arranging new debt, or prefer debt to issuance of new shares. Directors won't issue new undervalued shares, in the event that they are acting for shareholders. Managers will issue new equity shares with the expectation of getting offset by NPV of development opportunity or new venture opportunity. According to the Pecking Order Theory, retained earnings are considered safest as they have no adverse selection problems and hence a cheap source of finance. Therefore, the theory helps in explaining the effect of retained earnings on the financial performance of manufacturing firms listed in Nairobi Securities Exchange.

Empirical Review

Nyeadi, Banyen, and Mbawuni (2015) investigated equity financing of manufacturing firms listed in Ghana: Empirical Evidence Using a Dynamic System. The sole drive of the study was to empirically investigate the elements affecting the equity financing decisions of manufacturing firms listed in Ghana. 28 firms listed on the Ghana Stock Exchange were utilized for a time period of 8years, spanning from 2007-2014. The study espoused a vibrant panel scheme of overall Methods of Moments in testing the hypotheses. The outcomes from the empirical estimation revealed that listed firms in Ghana utilize more equity than debt and they prefer utilizing short-term debt rather than long-term debt in financing their activities. The study also finds a significant affirmative association amid tangibility of firms, liquidity, managerial ownership, firm size and long-term debt ratio.

Githinji (2017) conducted a study on the effects of equity financing and financial performance of manufacturing firms in Embu County, Kenya. The definite intention of the study was to determine the effects of equity capital, retained earnings and debt capital on financial performance of manufacturing firms. To conduct the survey the researcher used the causal research design. All the 95 registered SMEs operating as manufacturing and agricultural firms in Embu County as at 31st December 2016 formed the target population. A sample of 29 (30%) was selected from the target population by use of stratified random sampling techniques. To enhance collection of primary data questionnaires were administered by use drop and pick up later technique to the sampled respondents. For a detailed examination of quantitative data Statistical Package for Social Sciences (SPSS version 20) data software was applied. The study findings established that equity capital has a significant effect on financial performance of the firms.

Gathara, Kilika and Maingi, (2019) conducted a study on the effect of equity on financial performance of selected companies listed in the Nairobi securities exchange, Kenya. Causal or explanatory research design was employed in the study due to the nature of the problem and available. Quantitative data was used. Multivariate tests using panel data model examined the effects of the independent variable on company’s financial performance. Data was collected from 30 selected companies for the period 2007-2015. The study found out that equity had significant positive effect on financial performance of selected companies listed at NSE, Kenya.

Raude, Wesonga & Wawire, (2015) conducted a study on the equity financing strategy and the performance of small and medium enterprises in Kenya. To achieve desired results, this study employed a descriptive survey research design that employed a questionnaire with dichotomous questions to collect data from the respondents and made interviews with top management of the respective enterprises. The study found evidence of strong correlation between equity financing strategy and the performance of SMEs.

Conceptual Framework

RESEARCH DESIGN

The study used descriptive research design to explore its set objectives. The unit of observation were manufacturing firms listed in Nairobi Securities Exchange. The choice of manufacturing firms listed in Nairobi Securities Exchange is because majority of their financial statement are made public and hence it is easier to access them. They also have well defined capital structure. The study sampling frame was 7 manufacturing firms listed in Nairobi Securities Exchange. Since the target population of the study is small the study adopted census to incorporate all the 7 manufacturing firms listed in Nairobi Securities Exchange. The study collected secondary data relating to short term debt, long term debt retained earnings and financial performance of manufacturing firms listed in Nairobi Securities Exchange. Secondary data entails information gathered from already existing sources (Mugenda & Mugenda, 2012). This set of data was acquired from published annual reports size (Annual Audited Reports, 2017-2021) of 9 manufacturing firms listed in Nairobi Securities Exchange. The study was limited to a time scope of 5 years starting 2017 to the year 2021. The time scope is considered adequate since it is possible to monitor cost of capital trends within this period and evaluate how they affect financial performance of manufacturing firms listed in Nairobi. The financial statements from which the data was extracted include the income statement, statement of financial position, cash flow statements and notes to the accounts. After the necessary authorization the researcher collected data from both the NSE and individual companies. The study used panel data regression analysis model. Panel data utilizes observations that carry both cross-sectional. (Baltagi, 2011). Correlation and regression analysis was used in the study to identify the role of firm size in the relationship between cost of capital determinants and financial performance of manufacturing firms listed in Nairobi Securities Exchange. Descriptive statistics and inferential statistical techniques were used to analyze the data. This was done with the aid of a computer programme – Stata package for windows was used. All inferential statistics was tested at $\propto = 0.05$ significance level.

$\mathbf{Y} = \beta_0 + \beta_1 \mathbf{X_1} + \varepsilon$ ………………………………. Model 1.

Where,

Y = Financial Performance

X_1 = Equity Financing

Research Analysis and Findings

This chapter indicates the descriptive analysis of the study variables which are presented in cross tabulation in order to show trends in the study variables

Descriptive Analysis

Descriptive Statistics										
	N	Mn	Max	Sum	Mean	Std. Deviation	Skewness		Kurtosis	
		Statistic	Statistic	Statistic	Statistic	Statistic	Statistic	Std. Error	Statistic	Std. Error
Equity	35	547895500.00000	1335311383000.00000	1571247868687.00020	44892796248.2000050	224663729479.26535000	5.905	.398	34.913	.778
Return on Assets	35	359216000.00000	79878634000.00000	340945617832.00000	9741303366.6285700	16741988744.27158400	2.658	.398	8.331	.778

The findings indicated that manufacturing firms listed in NSE relied on equity financing as a source of financing. This is shown by a mean of 44,892,796,248. This points out to a trend in companies applying more of equity. The finding agrees with a study conducted by Nyeadi, Banyen, and Mbawuni (2015) who found that the listed firms in Ghana utilize more equity than debt. The study also finds a significant affirmative association amid tangibility of firms, liquidity, managerial ownership, firm size and long-term debt ratio. The study also conquers with the findings of Githinji (2017) who found that equity capital has a significant effect on financial performance of the firms. Another study by Gathara, Kilika and Maingi, (2019) who found that equity had significant positive effect on financial performance of selected companies listed at NSE, Kenya. With equity financing, there is no loan to repay. The business does not have to make a monthly loan payment which can be particularly important if the business does not initially generate a profit. This in turn, gives the firm the freedom to channel more money into the growing business. The standard deviation of equity was 224,663,729,479 indicating a higher variability in equity among listed manufacturing companies considered in the period of study. The maximum and minimum of equity was 1,335,311,383,000 and 547,895,500 this indicate that all the manufacturing firms listed in NSE depended on equity as their source of capital.

The findings indicated that manufacturing firms listed in NSE had a mean Return on Assets of 9,741,303,367indicating that all manufacturing firms listed in NSE retained made profit between the year 2016 and 2020. The findings agree with a study of Choudhry (2018) who found that the ROA figure gives investors an idea of how effective the company is in converting the money it invests into net income. The higher the ROA number, the better, because the company is able to earn more money with a smaller investment. Put simply, a higher ROA means more asset efficiency. Another study by Gup (2016) which reported that the average return on equity in modern firms is 11 percent to 33 percent, according to the Bank for International Settlements, (BIS) reports over some 20 years. There is a direct relationship between the return on assets, which measures how efficiently the firm is run, and the return on assets which measures how well the owners are doing on their investment, (Goel, 2015). The standard deviation was 16,741,988,744 indicating a higher level of variability of Return on Assets among manufacturing firms listed in NSE. This can be attributed to the fact that sole purpose of a company's assets is to generate income and revenue for the company. Hence, the return on assets ratio helps the management and the investor understand how well a company can convert its assets investments into profits. ROA can also be considered as a return on investment as, for most companies, their assets are their biggest investments. The return in such cases is often measured as profits. Higher the company's ROA, the better the utilization of a company's assets.

Correlation Analysis

The study sought to establish the nature of the relationship between equity financing and the financial performance of manufacturing firms listed in Nairobi Securities Exchange.

Correlation Matrix

		Financial Performance
Equity Financing	Pearson Correlation	.242**
	Sig. (2-tailed)	.001
	N	35

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

The findings indicated that r=0.651 and p=0.004. The p value was less than the significant level of 0.01 meaning that there was strong positive statistically significant relationship between equity financing and financial performance of manufacturing firms listed in Nairobi Securities Exchange. The findings are in line with those of Gathara, Kilika and Maingi, (2019) who found that equity had significant positive effect on financial performance of selected companies listed at NSE, Kenya. Another study by Raude, Wesonga & Wawire, (2015) also found strong evidence of strong correlation between equity financing strategy and the performance of SMEs.

Regression Coefficients

Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.
		B	Std. Error	Beta		
1	(Constant)	2168153587.606	3255495882.061		.666	.511
	Equity Financing	.004	.011	.053	.346	.002

From the findings the value of financial performance of manufacturing firms listed in Nairobi securities exchange without the influence of the predictor variables is 2168153587.606. This explains that, at any given time, financial performance of manufacturing firms listed in NSE will be 2168153587.606 holding other factors constant at 0. The results also illustrate that a unit increase in equity would result to .004 times increase in financial performance of manufacturing firms listed in NSE, a unit increase in retained earnings would result to 0.050 times increase in financial performance of manufacturing firms listed in NSE.

The study sought to test the fourth hypothesis that stated that equity financing has no statistical effect on the financial performance of manufacturing firms listed in Nairobi Securities Exchange. From the findings the p-value was 0.004 which was less than 0.01 significant level. Therefore, based on the rule of significance, the study rejects the fourth null hypothesis and concluded that equity financing has no statistical effect on the financial performance of manufacturing firms listed in Nairobi Securities Exchange. The findings are in line with Maingi, Kilika and Gathara, (2017) which found that equity had significant positive effect on financial performance of selected companies listed at NSE, Kenya. The study also showed a significant positive relationship between financial performance and growth opportunities and equity ratio. It can be concluded that firms which invest resources towards increasing growth in asset base show greater improvement in financial performance. Equity financing are important especially as far as raising capital for growth, expansions or acquisitions is concerned.

CONCLUSIONS AND RECOMMENDATIONS

Conclusions

From the findings the study concluded that equity financing has no statistical effect on the financial performance of manufacturing firms listed in Nairobi Securities Exchange. Majority of manufacturing firms listed in NSE prefer equity financing because it allows companies to raise capital without taking on debt. This can be particularly advantageous for companies that are just starting out or that have limited assets, as they may not be able to qualify for traditional bank loans. Equity financing can also be a good option for companies that are looking to fund long-term growth initiatives, such as research and development or new product launches. Equity financing also allows companies to bring on investors who can provide valuable expertise and connections. This can be particularly important for startups, which often lack the experience and resources needed to navigate complex industries. By bringing on experienced investors, companies can tap into their knowledge and networks to help grow their business.

Recommendations

The study recommended that manufacturing firms should raise more capital through equity financing this is because it provides them with the capital they need without the burden of debt. Unlike debt financing, equity financing does not require the company to make regular interest or principal payments. Instead, investors provide capital in exchange for a share of ownership in the company. This can be particularly advantageous for manufacturing firms, which often have high capital expenditures and long-term investments. By using equity financing, manufacturing firms can fund these investments without taking on the additional burden of debt payments.

Another reason why equity financing is recommended for manufacturing firms is that it provides them with access to valuable resources and expertise. When manufacturing firms raise capital through equity financing, they bring on investors who have a vested interest in the success of the company. These investors can provide more than just capital; they can also offer valuable insights, connections, and guidance

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