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THE EFFECT OF DEBT TO EQUITY ON FINANCIAL PERFORMANCE OF MICROFINANCE INSTITUTIONS IN KENYA

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Abstract

A debate on capital structure has existed for a very long time. This paper is basically a conceptual review in design and, intends to analyze the capital structure framework with a particular bias on the effect of debt to equity on financial performance of microfinance institutions in Kenya. The main obligation of firms is maximize profits and wealth for their shareholders. Internal shareholders equity is the first line of consideration by firms intending to invest followed by debt then seeking fresh equity. This has been squarely outlined by the Pecking order theory alongside other empirical studies mentioned by various authors cited by this paper. The findings of this paper reveal that there exists a significant relationship between debt-to-equity and financial performance. A recommendation for further studies on the subject based on the dynamics of the industry was made at the last.

Keywords: Financial Leverage, Wealth Maximization, Capital Structure, Debt to equity, Return on Equity, Trade-off theory

INTRODUCTION

Firms have five objectives as to why they exist; profit maximization, wealth maximization, social responsibility, business ethics and growth. Out of these objectives, wealth maximization stands out strong since it aims at increasing the value of these firms and ensuring their long term survival. This therefore means that firm managers have a task of staying focused and strategic in their capital budgeting decisions because such decisions may either lead them to wrongly invest institutional capital leading to bankruptcy or efficiently invest institutional capital leading to increased wealth for their shareholders. Financing of such institutions is a matter of financial leveraging in which the decision makers have to decide as to whether to go for external debt as compared to seeking fresh equity from the shareholders. Most firms opt for a mix of debt and equity as in their financing decisions, Nassar S. (2016).

Finance managers are hired by shareholders to run their firms and earn them attractive proceeds in form of dividends. This agency relationship is pegged on the fact that the managers who are otherwise referred to as agents create more wealth for their shareholders who are otherwise referred to as principals. In order for these managers to maximize the value of firms, they need to be conscious of various the factors that can adversely affect the capital structure of their firms. Firms are going concerns by nature and for them to remain foreseeable, they must come up with an optimal investment decisions particularly on the mode of financing. This will always bring up the question on whether to go for internal funding, commonly referred to as equity or seek external funding which is otherwise referred to as debt. The optimization of capital structure of firms, recognizing various financial sources and financing sources are of particular significance, Zahra et al (2013).

Firms that are highly levered fall into the risk of running into financial distress or ultimate bankruptcy. Financial leverage can be long-term, medium-term or short-term depending on the period of loan repayment. Financial leverage is reached at, through a contractual agreement between the lender of debt and the borrower who is under an obligation to pay the loan alongside the predetermined interest within a fixed period of time. Loans are normally taken up for investment purposes where funds are sacrificed with expectation for future uncertain values from those investments Anas and Mahmoud (2013). Financial leverage is one of the most important leverages in the capital structure of a firm as it outlines the use of debt to acquire a firm's investments instead of equity. The degree of financial leverage (DFL) is described as the percentage of changes in net profit relative to changes in operating income (OI), Blazenko (1996).

Financial performance is a yardstick against which the success of institutions are measured. The value of these firms is measured by Return on Equity (ROE), Return on Assets

(ROA), Earnings Per Share (EPS) and Earnings Before Interest, Tax, Depreciation and Amortization (EBITDA). The financial indicators used include; dividend yield, price earnings ratio, growth in sales, market capitalization among others Barbosa and Louri (2005). Micro-finance institutions include these indicators in their annual financial reports which they present to their shareholders. This seminar paper endeavors to find out the effect of financial leverage as measured using debt to equity ratio on the financial performance of micro-finance institutions in Kenya.

From the background information given above, it clearly comes out that finance managers have a bigger role to play when it comes to making investment decisions. As agents, they must strive to keep the agency relation with their principals (shareholders) alive by maximizing the institutional wealth as well as profits. Financial leverage studies have been conducted world over by many authors with the aim of trying to solve the emerging issues in the field of finance; Zahra et al, (2013) made a study on financial leverage and firm value on companies listed in Tehran stock exchange, Aries V, (2015) made a study on the influence of financial leverage and its size on the earnings management in Indonesian firms, Bosire J, (2017) did a study on financial leverage as an antecedent to financial distress on companies listed in the Nairobi Securities Exchange, Kenya.

Throughout the world, performance of microfinance institutions has been one of the areas that has caught the attention of many researchers in the field of finance. This is because micro-finance institutions are meant to advance 'small' funds to their customers who in many cases are low income earners, Central bank of Kenya report, (2018). This therefore means that there is much need to try and understand the financial performance of microfinance institutions in Kenya as most of the Kenyan population (64.4%) are low income earners, Kenya National Bureau of Statistics (2015) who look up to microfinance institutions as their main source of debt.

A study by B. Githinji (2009), indicated that funding is one of the major challenge facing Micro-finance Institutions in Kenya thus the need to boost their portfolios for them to be able to operate with minimal financial distress. The Central Bank of Kenya's Bank supervision annual report (2018) cites inadequate capital and weak liquidity buffers as one of the key challenges facing Micro-finance institutions in Kenya. It is therefore against this backdrop that this paper seeks to understand more on the role of financial leverage as measured using debt to equity ratio on the financial performance of Micro-Finance Institutions in Kenya. More precisely, the paper intends to find answers to the research question bellow;

To what extent does Debt-to-equity ratio affect the financial performance of micro- finance institutions in Kenya?

Debt-to-equity ratio is mostly the first line of consideration that that most firms look at when it comes to making of investment decisions. For this reason, this paper has narrowed the independent variable (financial leverage) elements to that debt to equity.

THE REVIEW

Theoretical Part

Pecking Order Theory

This paper considered the Pecking Order Theory as the lead theory that analyses financial leverage as well as capital structure of firms in details. The Pecking Order theory was developed in 1984 by Myers. The theory asserts that firms prefer internal funding as compared to external funding. Edim, Atseye and Eke, (2014) outlines the different types of financing sources which are valued differently; internal financing which comprise of equity and retained earnings, debt from lenders and new equity from issue of new stocks. According to the pecking order theory, different costs of finances are associated with different sources, Abor (2005). If the capital comes from internal financing like the use of retained earnings from the earlier years, the pecking order means that there are no costs of acquiring new capital.

Firms do not have predetermined or optimum debt to equity ratio due to information asymmetry. This results to firms adopting a conservative approach when it comes to return on equity and debt financing in the maximization of financial performance. Most investors are risk averse, and this makes most firms to opt for internal financing as compared to seeking external debt as a source of financing. New investors and creditors require higher rate of return since they do not know everything about the company and therefore have less understanding for how financial performance may be, Abor (2005). Much emphasis of the pecking order theory is given to internal financing and seeking and that of seeking new equity from the owners of the firm (shareholders). The other is that of debt with an associated interest cost is a better alternative of financing than equity financing, Myers (1984). This theory therefore explains the fact that most firms are risk averse and would opt to go for internal funding as a form of financial leverage for fear of running into insolvency or ultimate bankruptcy. This therefore means that the fact that debt is easier and cheaper to obtain, it requires careful decisions to avoid running into insolvency.

Other theory: Trade-Off Theory

Trade-off theory provides explanations on the factors that determine the choice of a firm's choice financial leverage. This theory is based on the findings of Modigliani and Miller theory of 1958 and states that debt and equity is determined by taxes and cost of financial

distress. Interest has benefits since it is tax deductible. It is further pointed out by Wolfgang and Roger (2003) that trade-off theory of capital structure suggests that a firm's target leverage is driven by three competing forces; taxes, cost of financial distress (bankruptcy costs) and agency conflicts. Apparently, adding debt to a firm's capital structure lowers its (corporate) tax liability and increases the after tax cash flow available to the provider of capital resulting to a positive relationship between corporate tax shield and value of a firm. This theory therefore provides explanations on the importance of managing the debt to equity ratio with a view to increase the value of firms.

Practical Part

Johan and Victor (2015) conducted a study on debt versus equity in a low interest environment in Sweden. This was a longitudinal study on 19 Swedish companies during 1998 until 2014 aimed at testing the effect of external factor(s) (interest rate) on debt to equity ratio. The research utilized a simple linear regression analysis to come up with results and conclusions. The outcome of this study indicated that the tested firms decrease their debt to equity ratios when the cost of debt is lower. The study also showed that debt becomes cheaper relative to cost of equity making the result more noteworthy. These findings are in tandem with the trade-off theory which takes more variables into account when determining financial distress.

Debt to equity ratio is used to measure the use of debt to total shareholders' equity of the company, Ang (1997). Adenugba, Ige and Kesinro (2016) carried out a study on financial leverage and firm value on Nigerian firms listed at the Nigerian Stock Exchange (NSE) to establish the relationship between these variables. The study sampled 5 firms for a period of six years using the Ordinary Least Square (OLS) statistical technique to analyze the data and test the hypothesis. This study revealed that there exists a significant relationship between financial leverage and firms' value and that financial leverage is a better source of finance than equity to firms when there is need to finance long-term projects. The study further recommended that financial leverage be optimized by firms to aid maximization of firms' value.

A study by Yegon, C. et al (2014) on the effect of financial risk management on firms' profitability through panel data econometrics of selected Micro-Finance institutions in Kenya used descriptive data to illustrate the relationship between debt and firm profitability. In their work, they found out that debt has a positive effect on profitability as financial leverage. They further stated that extremely low level of debt and lower value of financial liabilities inferior to own equity makes companies not risky in terms of financial solvency. In this regard, firms are more advantageous if they use medium and long term loans to finance their investments thus

additional profit. They study further advises that using debt should be made with caution in order to limit the financial independence of firms and reduce additional debt in time of crisis. The study recommends that debt risk assessment be done on the basis of the leverage coefficients so as to predict behavior analysis for estimating future results which must be taken into account in the decision making process.

Oyerogba (2016), conducted a study to find out the relationship between corporate capital structure and firm value on the Kenyan Listed companies. The study utilized an explanatory research design with a population of 35 listed companies with a focus on secondary data. The results of this study showed that companies that use more debt as a source of financing its assets than equity. The study utilized descriptive regression analysis to determine the relationship between corporate capital and firm value of the Kenyan listed companies. The regression results showed that there was a positive relation between capital structure and firm value. The study further recommended that listed companies should engage strategic investors to shore up their debt capital and that equity capital should be substituted for debt shareholding. The relationship between financial leverage and financial performance can be illustrated through a conceptual model as below;

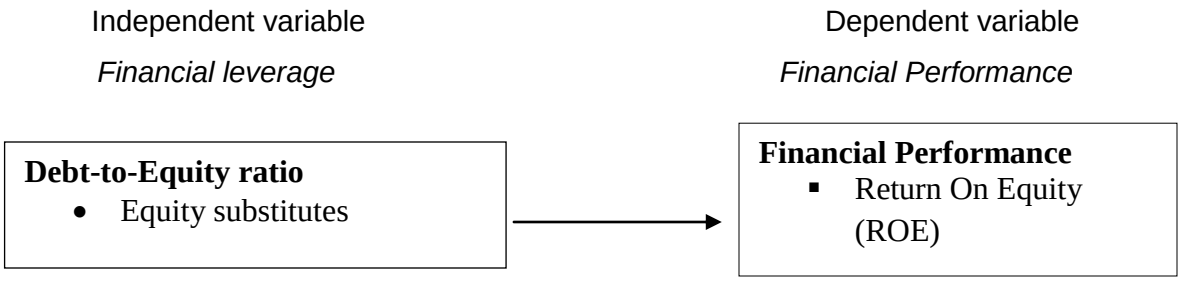

Figure 1 Conceptualization

Source: Authors (2023)

Financial leverage element of debt-to-equity is the Independent Variable and is employed by firms to explain the variation or changes in the financial performance of firms (Dependent variable). The application or use of this element will determine the level of financial performance of the firms. The dependent (Debt-to-equity ratio) variable attempts to depict the likely outcome on the application or use of the independent variable (ROE). It is expected that the standard of firms' financial performance will be affected by the use and application of the independent variable.

The debt to equity ratio is referred to as the ratio that exists between the value of debt borrowed Vis a Vis the value of total equity owned by the firm. The mathematical computation is a follows;

$$\text{Debt-to-equity ratio} = \frac{\text{Total Debt}}{\text{Total Equity}}$$

The expected optimal ratio should be 0.5 or less for the capital decision to be considered viable.

CONCLUSION AND RECOMMENDATIONS

In summary, this paper establishes that there exists a significant relationship between financial leverage when using debt-to-equity as an independent variable in relation to financial performance as the dependent variable. High level of debt shows that the composition of debt (both long-term and short term), is greater if compared to total capital itself hence it will have an impact on the greater burden on the company who are creditors. Therefore, it is prudent for firms to adopt sound financial leverage practices and portfolio management in order to achieve their objective of wealth maximization as depicted through prompt debt repayment and maintenance of a good loan asset quality. This reconciles with a study by Yegon, C. et al (2014) which concludes that debt can be very risky to an entity and its shareholders but the method of financing becomes advantageous simply because they are able to hold assets that are more important than equity value, thus increasing their economic power. This places Micro-finance institutions on a pedestal to achieve a sustainable growth and development by deepening financial intermediation as well as maximizing shareholders' wealth. Sound financial leverage practices enables Micro-finance institutions to hold a balance in their liquidity ratio thus ability to remain going concerns. The theoretical expositions and practices highlighted by various experts and authorities on the basic financial leverage principles provides a pertinent guide for this research.

Financial leverage is a critical area in the field of finance. However, it remains a huge puzzle to both the academicians and practitioners in trying to understand the underlying challenges that come with such capital budgeting decisions since various factors need to be taken into consideration. These factors can be circumstantial, political social or economic. It is therefore necessary for financial managers, shareholders and all stakeholders to take into cognizant all the prudential measures when handling financial leverage matters since such decisions critically influences the performance and ultimate sustainability of their firms. It is also

important to note the need for firms to hire competent financial analyst and strategic planners to enable these institutions to remain economically progressive.

This paper therefore recommends that further studies be done in the area of finance, particularly on the correlation between financial leverage by use of the debt to equity ratio variable in relation to the financial performance of firms since this area meets continuous dynamics caused by fluctuations in the economy and other emerging issues in the field of finance. It is also recommended that other elements of financial leverage; debt to asset, debt to capital and debt to earnings before interest, tax, depreciation and amortization be considered so as to have a more insightful revelation on the relationship between financial leverage and financial performance of Micro-Finance institutions in Kenya.

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