

## EFFECT OF DEBT FINANCING ON FINANCIAL PERFORMANCE OF SELECTED MANUFACTURING FIRMS IN NIGERIA

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### ABSTRACT

*This study examined the effect of debt financing on financial performance of selected manufacturing firms in Nigeria. Specifically, the study analyzed the impact of total debt, debt ratio, and interest expenses on profit after tax of selected quoted firms in Nigeria. The study covered five (5) manufacturing firms randomly selected from all listed manufacturing companies in Nigeria. The scope of this study by years will span through a period of five (5) years, covering 2012 to 2016, data used in the study were sourced from the annual reports of firms sampled for the study. The study employed panel-based modeling, in which profit after tax was used to measure profitability, while debt finance was proxied by total debt, debt ratio and interest expenses. The study made use of estimation techniques including pooled OLS estimation, fixed effect estimation, random effect estimation, followed by post estimation test including restricted f-test, and Hausman test. Findings revealed that total debt exerts insignificant positive impact on profit after tax, with coefficient estimate of .0477349 ( $p=0.590 > 0.05$ ), while debt ratio exerts significant negative impact on profit after tax, with coefficient estimate of -2421.905 ( $p=0.003 < 0.05$ ), results also revealed that interest expenses exerts insignificant negative impact on profit after tax, with coefficient estimate of -58.03436 ( $p=0.469 > 0.05$ ). The study recommends that manufacturing firms in the country should ensure to organize their financing options, manufacturing firms should avoid debt overhand and manufacturing firms in the country should ensure that they opt in for debt finance only when it is necessary as the last resort, to position them for better operational efficiency.*

**Keywords:** Debt, Finance, Financial Performance, Debt Finance, Firms, Nigeria

### Introduction

Issue surrounding how debt finance influence performance of organizations has continued to trigger unending debate amount scholars around the world in their quest to reach a consensus on how the financial structure of a company determines its level of performance (Siyabola, Olaoye and Olurin, 2015). Finance is a crucial discourse in the operation of any business, as this describes the foundation upon which the survival,

expansion and growth of company is hinged. The finance structure of an organization often time is determined upon the source from where funds is being raised to sustaining uninterrupted functioning/operation of the firms. According to Abu-Rub (2012), the capital structure of an organization is what determines whether the organization will keep existing or not. A firm could increase or decrease its leverage by either issuing more debt to buy back stock or

issuing stock to pay debt, thus submitting that objective management of capital structure is a prerequisite for maximization of shareholders wealth and minimization of firms' cost of capital (Chechet, and Olayiwola, 2014)

Debt finance entails mechanisms through which an entity is financed using borrowed funds usually through selling bonds, bills, or notes to individuals and/or institutions, in which they will be entitled to both the principal and interest accrued at a specified maturity date (Hassan, Faisal, and Muhammad, 2016). In this modern corporate era, every corporation tries to survive the tough market competition. Capital structure decision making has become one of the most difficult tasks for firmmanagements as it plays a vital role for any business organization which aims at maximizing returns. Notably, there are two major sources of funding available to firms, namely: internal and external sources. The internal sources refer to the funds generated from within an enterprise which is mostly retained earnings from previous business activities, while funds sourced not from within the earnings of firms' past activities are termed external financing. The external funding might be through increasing the number of co-owners of a business or outright borrowing in form of loan. Issuance of equity is also a source of funding through external sources by increasing the number of owners. These owners are entitled to dividends when surplus is declared and also exercise a greater decision control over the firm because they bear the larger share of risk. On the other hand, however, outright borrowing makes the business entity a creditor to its lenders (Chechet and Olayiwola, 2014).

As pointed out by Pandey (2010), corporate financing involves significant managerial decision-making because it influences the shareholder's returns, risks and the firms' share of the market. Pandey (2010) also pointed out that in making capital structure decisions corporate

managers are expected to seek answers to the following questions: how should the investment project be financed?; does the way in which the investment projects are financed matter?; how does financing affect the shareholders' risk, return and value?; does there exist an optimum financing mix in terms of the maximum value to the firm's shareholders?; can the optimum financing mix be determined in practice for a company?; and what factors in practice should a company consider in designing its financing policy?. Debt finance is believed by most business owners and/or management to be detrimental to the growth and expansion process of an organization due to the relatively high cost of raising funds through debt.

As pointed out by (Siyanbola et al, 2015) most firms in Nigeria prefer to run their businesses raising funds from other sources apart from debt. They relayed that listed companies always prefer to use share capital option of finance rather than long term borrowing that may pose problematic interest burden on the business profit at the end of maturity. In clear term, firms now consider borrowing as 'dead weight' that can affect their performance. On empirical ground debt finance had been acclaimed to be useful in boosting business coverage and expansion and growth. (Margrates and Psillaki 2010; Abu-Rub, 2012; Gill, Biger and Mathur, 2011). Previous studies focused on the impact of capital structure on the performance of firms in the country (Oke and Afolabi, 2011; Chechet and Olayiwola, 2014; Osuji and Odita (2012); Uremadu and Efobi, 2012; Babalola 2014; Akinyomi, 2013) without specifically looking into the impact of debt financing on the profitability of manufacturing companies in the country, thus, this study set to fill this gap by analyzing the impact of debt financing on performance of manufacturing companies in Nigeria. Specifically, this study examined the:

- (i) impact of total debt on profit after tax of selected quoted firms in Nigeria
- (ii) effect of debt ratio on profit after tax of selected quoted firms in Nigeria and
- (iii) influence of interest expenses on profit after tax of selected quoted firms in Nigeria

#### The Debt Financing Concept

Debt financing is the main element of external financing for companies, companies and business organizations raising extra funds after creation (Baltacı and Ayaydin 2014). There has been a major increase in external financing over the years, particularly evident during the periods of economic expansion of companies (Mizruchi and Stearns 1994). Majority of companies looking for external financing options use debt financing rather than equity financing (Goswami and Shrikhande 2001). Debt financing has both an advantage and a disadvantage on the growth of companies and for their strategic investments (O'Brien and David 2010). According to Fama and French (2002), the benefits of debt financing include the tax deductibility of interest and the reduction of free cash flow problems, while the costs of debt financing include potential bankruptcy costs and agency conflicts between stockholders and debt holders. Therefore, in making debt financing decisions, managers try to create a balance between the corporate tax advantages of debt financing and the costs of financial distress that arise from bankruptcy risks (Baltacı and Ayaydin 2014). It is believed with no doubt that debt financing matters in the discourse of firms profitability, value and overall performance (Huyghebaert, and Lijian 2014)

The factors that influence debt-financing choice remain indefinite despite much theoretical literature and the reassurance of decades of empirical tests (Frank and Goyal 2009: 1). A number of studies, like Jõeveer (2013); De Jong, Kabir and

Nguyen (2008); Kayo and Kimura (2011) and Frank and Goyal (2009), categorised the factors that influence debt financing into company characteristics or specific factors, macroeconomic factors. Company specific factors are those factors which are distinct to each individual company, while macroeconomic factors are economic factors of the country which have a common effect to all the companies within the country.

While company specific factors have remained the main focus of debt financing studies (Kayo and Kimura 2011), from the second proposition of Modigliani and Miller (1963) to the current studies, like Jõeveer (2013); Majumdar (2012); Frank and Goyal (2009); Antoniou, Guney and Paudyal (2008) and Deesomsak, Paudyal and Pescetto (2004). The company specific factors influencing debt financing from the above studies, include company profitability, company size and growth, nature of assets, non-debt tax shields, liquidity and probability of bankruptcy. Other company factors, like company tax rates, business risk, access to capital markets, the finance manager's gender and the composition of the board of directors, are also considered to have influence on debt financing (Jõeveer 2013; Antoniou, Guney and Paudyal 2008). Profitable companies are believed to face reduced expected costs of financial distress and find interest-tax benefits more important (Frank and Goyal 2009). Therefore, the tax benefit and the bankruptcy costs' perspective predict that profitable companies should use more debt. On the other hand, Deesomsak, Paudyal and Pescetto (2004) argued that they expect an inverse relation between profitability and debt financing levels since the pecking-order theory suggests that managers prefer to finance investments internally because of the informational asymmetry between managers and outside investors. Thus, profitable companies could prefer not to raise external funds in order to avoid potential dilution of ownership and

additional external monitoring. The theory of debt financing and profitability, therefore, predicts both a positive relationship, which supports the trade-off theory, and a negative relationship which supports the pecking order theory (Kayo and Kimura 2011).

The company size is also a very important factor that influences a company's debt financing decision (Kayo and Kimura 2011: 360). The trade-off theory suggests a positive relation between company size and debt financing level, since larger companies have been revealed to have lower bankruptcy risk and relatively lower bankruptcy cost (Deesomsak, Paudyal and Pescetto 2004). Generally, theoretical studies suggest that company growth opportunities are negatively related with debt-financing levels (Huang and Song 2006). Growth increases costs of financial distress, reduces free cash-flow problems, which the company managers tend to protect, hence, making worse debt financing related agency problems (Frank and Goyal 2009). According to the authors, growing companies put a lot of emphasis on investments that benefits the shareholders; hence, the trade-off theory predicts that growth reduces the debt financing level. Nevertheless, growth opportunities can also compare positively with leverage, in line with the pecking order presumption (Kayo and Kimura 2011). According to Frank and Goyal (2009), the pecking order theory implies that companies with more investments, holding profitability constant, should accumulate more debt over time. Thus, growth opportunities and debt financing are positively related under the pecking order theory.

Macroeconomic factors are regional or national economic factors which externally influence the company's financial strategies, including debt financing decisions. Financial management literature recognizes the important role that macroeconomic factors play in the determination of capital structure decisions

of firms (Lemma and Negash 2013). Recent and past literature identifies the gross domestic product (GDP), inflation rate, interest rate, financial institutions' activities and industry median as the common macroeconomic factors which have an influence on the debt-financing decisions of companies (Mokhova and Zinecker 2014; Baltacı and Ayaydın 2014; Lemma and Negash 2013; Jõeveer 2013; Kayo and Kimura 2011; Frank & Goyal 2009; Deesomsak, Paudyal & Pescetto 2004). It is believed that a country's economic development level reflects the wealth disparity between them, and, hence, access to finance including debt financing (Lemma & Negash 2013). During expansions, stock prices go up, expected bankruptcy costs go down, taxable income goes up, and cash increases, which leads to more debt financing within companies (Frank and Goyal 2009). Inflation is considered one of the main indicators of a country's stability and increase in the inflation rate causes uncertainty in economic conditions (Baltacı and Ayaydın 2014). The authors argued that this uncertainty causes inability of companies to repay their debt. Gungoraydinoglu and Öztekin (2011) also argued that higher inflation decreases the benefits of debt financing because of higher bankruptcy costs of debt imposed on companies. In addition, Drobetz, Gounopoulos, Merikas and Schröder (2013) argued that, in periods with higher inflation rates, companies use currently weak currencies to repay debt and, in turn, lower their debt-financing levels. It is, therefore, expected that inflation rates should be negatively related to companies' debt financing levels. On the other hand, Jõeveer (2013) maintained that the expected inflation is predicted to be positively related to debt financing due to higher real value of tax deductions on debt.

In the presence of other variables such as taxation and bankruptcy costs, changes in interest rates can influence debt financing levels within a company, since companies

are more likely to use debt when the cost of borrowing is low (Deesomsak, Paudyal and Pescetto 2004). They argued that, under this hypothesis, the level of interest rates is expected to be negatively related to debt-financing levels. Deesomsak, Paudyal and Pescetto (2004) further noted that interest rates also incorporate inflation expectations and, therefore, companies could be expected to change from equity to debt financing when interest rates are increasing. In this case, the level of interest rates is expected to be positively related to leverage. As aforementioned, the interest rates in Kenya showed an increasing trend over the five-year period-2007 to 2011, and it will be important to determine its effect on debt financing within public companies

**Methodology**

Secondary data were sourced from Audited Annual Reports of selected manufacturing firms spanning five (5) years between 2012 – 2016. Data obtained were analysed with the aids of descriptive

statistics to determine the growth rate of variables under study (i.e. Profit after tax, Debt ratio and Interest expenses. Inferential statistical tools of panel data analysis, specifically panel-based methods of estimation including pooled OLS panel analysis, fixed effect panel analysis, random effect panel analysis, followed by post-estimation test such as restricted f-test, and Hausman test were employed to determine the effect of Debt financing on the performance indices of selected manufacturing firms.

**Model Specification**

This study made use of a single equation modeling, in which financial performance measured in terms of profit after tax was made a function of total debt (TOD), Debt ratio (DR), and Interest expenses. For simplicity the model of the study is presented in linear form below:

$$PAT_{it} = \alpha_0 + \alpha_1TOD_{it} + \alpha_2DR_{it} + \alpha_3INTEXP_{it} + \mu_i$$

Where:

- PAT = Profit after tax
- TOD = Total debt
- DR = Debt ratio
- INTEXP = Interest expenses
- U = Error Term

**Results and Discussion**

*Correlation Analysis*

Table 4.1: Correlation Matrix

	PAT	TOD	DR	INTEXP
PAT	1.0000			
TOD	0.9619	1.0000		
DR	-0.3471	-0.2429	1.0000	
INTEXP	0.9097	0.9716	-0.2503	1.0000

Sources: Author's Computation, (2018)

Table 4.1 showed the correlation between variables used in the study. From the table it can be observed that there is positive correlation between pairs of variables including PAT and TOD, PAT and INTEXP, TOD and INTEXP with

correlation value of 0.9619, 0.9097, 0.9716, while the correlation between pairs such as PAT and DR, TOD and DR, DR and INTEXP is negative with specific correlation statistics of -0.3471, -0.2429, and -0.2503 respectively.

Pooled OLS Estimation

Table 4.2: Pooled OLS Parameter Estimates

Series: PAT TOD DR INTEXP

Variable	Coefficient	Standard Error	T-Test Values	Probability
C	958.4861	2668.535	0.36	0.723
TOD	.5695856	.0829865	6.86	0.000
DR	-2122.074	824.1473	-2.57	0.018
INTEXP	-299.0355	127.7829	-2.34	0.029

R-square=0.9515

Adjusted R-square=0.9446

F-statistics=137.42

Prob(F-stat)=0.0000

Pooled OLS regression estimation as shown in Table 4.2 revealed that total debt exerts significant positive impact on profit after tax, with coefficient estimate of .5695856 ( $p=0.000 < 0.05$ ), debt ratio exerts significant negative impact of profit after tax, with coefficient estimate of -2122.074 ( $p=0.018 < 0.05$ ), and interest

expenses exerts significant negative impact on profit after tax, with coefficient estimate of -299.0355 ( $p=0.029 < 0.05$ ). R-square statistics reported in table 4.3 revealed that about 95% of the systematic variation in profit after tax can be explained by total debt, debt ratio and interest expenses.

Fixed Effect Panel Analysis

Table 4.3 Fixed Effects Estimates (cross sectional and period specific)

CROSS-SECTIONAL SPECIFIC EFFECT			TIME SPECIFIC EFFECT		
Variables	Coefficients	Prob	Variables	Coefficients	Prob
C	30942.99	0.000	C	2390.465	0.483
TOD	.0477349	0.590	TOD	.5212382	0.000
DR	-2421.905	0.003	DR	-1974.61	0.034
INTEXP	-58.03436	0.469	INTEXP	-213.2921	0.194
<b>Effects</b>			<b>Effects</b>		
PZ CUSSON	-26020.56	0.000	2013	-2986.552	0.377
UNILEVER	-16249.28	0.000	2014	-371.7034	0.913
NIG BREWERIES	32065.58	0.000	2015	-3624.224	0.304
7UP	-18820.25	0.000	2016	-5069.37	0.197
R-square=0.9919			R-square=0.9588		
Adjusted R-square=0.9885			Adjusted R-square=0.9418		
F-statistics=296.62			F-statistics= 56.47		
Prob(F-stat)=0.0000			Prob(F-stat)=0.0000		

Sources: Author's Computation, (2018)

Table 4.3 showed that when heterogeneity effect across sampled state is incorporated into intercept term, total debt exerts insignificant positive impact on profit after tax, with coefficient estimate of .0477349 ( $p=0.590 > 0.05$ ), debt ratio exerts significant negative impact on profit after

tax, with coefficient estimate of -2421.905 ( $p=0.003 < 0.05$ ), interest expenses exerts insignificant negative impact on profit after tax, with coefficient estimate of -58.03436 ( $p=0.469 > 0.05$ ). Reported R-square value for cross sectional specific fixed effect estimation

stood at 0.9919, which connote that about 99% of the systematic variation in profit after tax can be explained by total debt, debt ratio and interest expenses.

Estimation result presented in table 4.3 also showed that when heterogeneity effect over time covered in the study is incorporated into intercept term, total debt exerts significant positive impact on profit after tax, with coefficient estimate of .5212382 ( $p=0.000 < 0.05$ ), debt ratio exerts significant negative impact on profit

*Random Effect Analysis*

*Table 4.4 Random Effect Estimation*

*Series: PAT TOD DR INTEXP*

Variable	Coefficient	Standard Error	Z-Test Values	Probability
C	10408.36	4996.217	2.08	0.037
TOD	.3546411	.1009904	3.51	0.000
DR	-3044.141	1102.93	-2.76	0.006
INTEXP	-158.499	118.5814	-1.34	0.181

R-square=0.9338

Wald chi2(5)= 34.47

Prob> chi2 =0.0000

Table 4.4 revealed that when heterogeneity effect across states sampled in the study over time is incorporated into the error term, total debt exerts significant positive impact on profit after tax, with coefficient estimate of .3546411 ( $p=0.000 < 0.05$ ), debt ratio exerts significant negative impact on profit after tax, with coefficient estimate of -3044.141 ( $p=0.006 < 0.05$ ), and

after tax, with coefficient estimate of -1974.61 ( $p=0.034 < 0.05$ ), interest expenses exerts insignificant negative impact on profit after tax, with coefficient estimate of -213.2921 ( $p=0.194 > 0.05$ ). Reported R-square value for cross sectional specific fixed effect estimation stood at 0.9588, which connote that about 96% of the systematic variation in profit after tax can be explained by total debt, debt ratio and interest expenses.

the impact of interest expenses on profit after tax is negative and significant, with coefficient estimate of -158.499 ( $p=0.181 > 0.05$ ). R-square statistics reported in Table 4.5 stood at about 0.9338 which connotes that about 93% of the systematic variation in profit after tax can be explained by total debt, debt ratio and interest expenses.

*Post Estimation Test*

*Table 4.5 Restricted F Test of Heterogeneity (Cross-Sectional and Time Specific)*

	F-statistics	Probability
<b>Cross sectional</b>	21.12	0.0000
<b>Time specific</b>	0.75	0.5743

*Source: Author's Computation, (2018)*

Table 4.5 revealed the results of the heterogeneity test conducted with respects to both cross-sectional and period specific effect. The f-statistics values of 21.12 and 0.75 with probability values of 0.0000, and 0.5743 for cross sectional and period specific effect respectively. Hence the table revealed that there is enough evidence to reject the null hypothesis that all differential intercept corresponding to

the cross-sectional specific units are equal to zero, but otherwise for the period specific intercepts. Therefore, it can be concluded that there is only cross-sectional heterogeneity/uniqueness effect among the sampled states. Thus, pooled OLS estimator restriction is not valid as cross-sectional heterogeneity effect is too significant to be ignored.

*Hausman Test*

*Table 4.6 Hausman Test*

Null hypothesis	Chi-square stat	Probability
Difference in coefficient not systematic	6.37	0.0415

*Source: Author's Computation, (2018)*

Table 4.6 revealed a chi-square value of 6.37 alongside a probability value of 0.0415. The result showed that there is enough evidence to reject the null hypothesis that differences in coefficients of fixed effect estimator and random effect estimation is not systematic. It stands that the most consistent and efficient estimation is the fixed effect cross sectional specific estimation.

From the foregoing, estimation results presented for cross sectional specific effect is the most consistent and efficient estimation amidst all estimation conducted in the study. from the estimation it was discovered that total debt exerts insignificant positive impact on profit after tax, with coefficient estimate of .0477349 ( $p=0.590 > 0.05$ ), debt ratio exerts significant negative impact on profit after tax, with coefficient estimate of -2421.905 ( $p=0.003 < 0.05$ ), interest expenses exerts insignificant negative impact on profit after tax, with coefficient estimate of -58.03436 ( $p=0.469 > 0.05$ ). Reported R-square value for cross sectional specific fixed effect estimation stood at 0.9919, which connote that about 99% of the systematic variation in profit after tax can be explained by total debt, debt ratio and interest expenses. The study established that though debt finance has

the tendency to positively the profitability of manufacturing firms in Nigeria, it impact becomes significantly negative when the ratio relative to equity becomes higher.

**Conclusion and Recommendation**

Based on the result of the study, it was concluded that debt finance has notable impact on the profitability of manufacturing firms in Nigeria, especially when analyzed in the context of debt ratio. Hence to sustain improve level of profitability among manufacturing firms, debt finance should be well managed and organized. The study thus recommended the need for firmsto organize their financing options in such a way that it will not be over debt oriented as the expense of other sources of finance, avoid debt overhand, as this might significantly dampen their prospect for growth, expansion as well as going concern, and opt in for debt finance only when it is necessary as the last resort, to position them for better operational efficiency

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