

The Effect of Equity Financing on Financial Efficacy of Listed Manufacturing Companies in Kenya

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Abstract: The objective of the study was to establish the effect of equity financing on financial efficacy of listed manufacturing companies in Kenya listed in Nairobi securities exchange over a period of seven (7) years (2011 – 2017). The study was based on Modigliani and Miller Proposition I and II, the trade-off theory, pecking order theory and the agency theory. The research adopted a descriptive research design. The target population for the study were staff members of the listed manufacturing firms in Kenya. The target constituted respondents from, accounting department, finance department, Auditing and Assurance Department and Monitoring and Evaluation Department of listed manufacturing firms in Nairobi securities exchange in Kenya. A sample of 106 respondents were selected by use of stratified random sampling. Data was collected through a structured questionnaire. Both descriptive and inferential statistics were used to analyze the data. Data presentation was done by the use of charts and tables for ease of understanding and interpretation. Pilot study was conducted by the researcher taking some questionnaires to the listed manufacturing firms head offices in Kenya. The study used Cronbach (Alpha – α) model to test the internal consistency with the alpha coefficient of above 0.7 being considered reliable. To establish the validity of the research instrument the research pursued the opinions of experts in the survey of study especially the researcher's supervisors. Quantitative and qualitative data that were collected using questionnaires and the questionnaires were inspected for errors and gaps before issuing to the respondents. The findings revealed that equity financing positively and significantly influenced financial efficacy among the listed manufacturing firms.

Key words: Equity Financing, Financial Efficacy, Manufacturing Companies

I. Introduction

Equity financing has become a critical source of capital for companies worldwide, particularly for manufacturing firms that require significant investment to expand operations, adopt modern technologies, and remain competitive in dynamic markets. Equity financing refers to the process through which firms raise funds by issuing shares to investors, thereby increasing ownership capital without incurring debt obligations (Myers, 2001). Unlike debt financing, equity does not require mandatory interest payments, but it dilutes ownership and may subject firms to increased shareholder scrutiny (Modigliani & Miller, 1958). In developing economies such as Kenya, equity financing has been increasingly utilized by listed companies to support long-term growth and enhance financial efficacy (Were & Wambua, 2018).

The manufacturing sector in Kenya plays a pivotal role in economic development, contributing approximately 7–10% of the country's Gross Domestic Product (GDP) and providing employment to millions of people (Kenya National Bureau of Statistics [KNBS], 2023). However, the sector faces persistent challenges such as high production costs, stiff competition from imports, limited access to affordable credit, and fluctuating demand (World Bank, 2020). For listed manufacturing firms, access to sustainable financing is essential for maintaining operational stability, undertaking research and development, and diversifying product offerings. While traditional debt financing is often constrained by high interest rates and stringent collateral requirements in Kenya, equity financing provides an alternative avenue for raising long-term capital (Ngugi, Amanja, & Maana, 2019).

Globally, empirical evidence suggests that equity financing can influence financial performance and efficacy through improved liquidity, enhanced solvency, and reduced financial distress risk (Harris & Raviv, 1991). In developed economies, equity capital has facilitated technological innovation, improved governance structures, and strengthened corporate sustainability (Demirgüç-Kunt & Levine, 2008). In Kenya, however, equity financing is underutilized, with only a few manufacturing firms actively engaging in share issuance through the Nairobi Securities Exchange (NSE) (NSE, 2022). This has raised concerns about the sector's ability to leverage equity financing for improved financial outcomes.

Financial efficacy, which refers to the capacity of a firm to effectively mobilize, allocate, and utilize financial resources to achieve sustainable growth, is a key determinant of business success (Gitman & Zutter, 2015). For listed manufacturing companies, equity financing is expected to improve financial efficacy by lowering reliance on debt, reducing default risks, and increasing investment capacity (Abor, 2005). However, concerns have been raised regarding ownership dilution, shareholder activism, and the volatility of stock market performance, which may undermine the expected benefits of equity financing (Brealey, Myers, & Allen, 2011).

Statement of the Problem

Most manufacturing firms in Kenya are facing financial challenges (Jennifer et al, 2017). Consequently, according to 2017 Kenya manufacturers Association Annual Report and Financial statements of most manufacturing firms in Kenya, the directors indicated that "Due to the challenging performance in the period under review, the Directors do not recommend payment of dividends".

Giving a clear indication that the company financial efficacy was at stake due to financial leverage (debt to equity ratios) (Banafa et al, 2015).

Despite the theoretical appeal of financial leverage, researchers in capital structure have not found the optimal capital structure of firms and various studies have been made in different countries to examine the relationship between financial leverage and firm's financial efficacy. However, the results documented are contradictory and mixed (Shibanda et al, 2015)

According to Were, (2016), most manufacturing firms have reported low dividend pay out to shareholders, low profits, difficulty in debt repayments and low return on equity. The overall production growth in 2015 is slower than the economy, however. In 2015, manufacturing rose 5.6%. This means that the export share in GDP has declined over time. As a result, Kenya is experiencing premature de-industrialization in the sense of still largely underdeveloped manufacturing and industry. At a point much lower than in many Asia Kenya seems to have peaked. (KNBS, 2016).

Margaritis et al, (2010) proved also that total debt ratio correlated positively and significantly with financial efficacy of Indian firms. Even though, they identified that total debt ratio has a positive impact on firms' financial efficacy, they could not split the total debt ratio into short- and long-term debt, to identify the effect of long-term debt on firm's financial efficacy. This research seeks to fill this gap on firm's financial efficacy, specifically the consequence of extended debt on financial efficacy.

In the light of above studies, there is little empirical studies in Kenya concerning the relationship of financial leverage and financial efficacy in the context of listed Manufacturing firms in Kenya, which motivated the researcher to put her own contribution on the relationship of financial leverage and financial efficacy of listed manufacturing firms in Kenya.

Theoretical Framework

The research explored four hypotheses, Modigliani Miller's theory of irrelevance with respect to capital structure and commercial theory, which analyses the varying risks and advantages of alternative leverage plans. The principle of pecking order does not originate from an ideal capital structure but rather states the objective fact that businesses have a distinct tendency to use internal financing (like profits from retained or surplus liquid capital) over external funding.

Modigliani and Miller Proposition I and II.

The theorem of the irrelevance of the capital structure, according to Modigliani and Miller (1958), does not have an effect on the valuation of the business in capital structure decisions. The MM proposal I 'pie model,' since the valuation of the company remains the same no matter which capital structure a company chooses.

The principle of capital structure irrelevance, Modigliani and Miller (1958), is only meant to be ideal capital markets. Their original hypothesis was updated to MM II by reducing the 0-tax presumption that leveraged businesses are more prized as unlevered corporations, because interest is a tax-free expense, but because share-holders are at greater risk due to defaults, the cost of equity rises due to high debt. The studying's hypothesis is important in promoting MM II, Dasgupta and Sengupta (2003) since it provides an insight into the gap between companies with high leverage and unlevered. Levered firms get tax advantage, thus helping finance managers to make right financial leverage decisions.

The trade-off theory

The theory of trade-off claims that the optimum leverage of an enterprise is determined by the expense and profit of borrowing and that the company's assets and investments are kept continuously (Myers, 1984; Kraus and Litzenberger 1973). The leverage exchange theory suggests that leveraging within the capital system would profit before an optimum framework of capital is achieved. The principle accepts that debt interest (tax benefit) is tax free. This decreases tax responsibility and thus increases the tax defence. A substantial share of the company's debt makes investors very risky. This adds to a high portfolio or dividend premium for buyers. The principle assumes a corporation has optimal capital framework founded on the compensation between the expense and advantages of debt utilization. This hypothesis does not demonstrate that leverage is compatible in many countries and have diverging taxation regimes by using debt financing (Popescu, 2009).

The optimum debt ratio of the company is determined by the trade-off between bankruptcy losses and the tax benefit from borrowing and is reached at an instance where the marginal current value of the surcharge of debt is equivalent to a rise in the current worth of cost of financial hardship. Thus, firms should restructure their capital structure up to optimal point in order to attain benefits of leverage.

Empirical Literature

Omukaga (2017), evaluated the financial success of enterprises and services providers on the Nairobi Stock Exchange in Kenya by controlling the capital structure. In order to define the independent variable, the researcher used descriptive research style. The influence of the independent variable on dependent variables was defined by explanatory analysis. Only the secondary data collected from the reported accounts of commercial and service companies on the Nairobi Stock Exchange is analysed for the study purposes. The research then represented a five-year census sample (from 2012-2016).

The study's research formula consists of the separate equity ratio and the following ratios: return on equity, profits before tax and after-tax benefit and earnings per share. In order to provide descriptive and inferential statistics, data obtained for the study was analysed using the Social Science Statistics Package (SPSS). Tables and figures revealed the results. There have been relevant recommendations and findings. The degree of relationship among independent and dependent variables used in the study was defined by regression analysis. The research analysed the capital structure elements used by businesses. The analysis found that the principal components of corporate financial leverage include debt and equity. Other components are equity capital, share premium, income-reserve, and reserves of capital and retained profits. The analysis concludes that the Debt-to-Equity ratio is strongly correlated to Return on Equities and both Pre- and After-Tax Earnings with the impact of capital structure on profitability. With respect to its effect on the share performance of businesses, the analysis revealed that there is a poor association between the debt equity ratio and profits per share. The analysis showed that the composition of capital consists of two essential elements: debt and equity.

Stephen (2012) states that capital equity reflects compensation on the company's value to lenders following deduction of liabilities. Equity may be kept in the form of common stocks (share capital), preference shares, surplus, withheld earnings and reserves in financial statements.

II. Research Methodology

Descriptive survey design was used to collect data for this study. Descriptive survey design is a technique for studying populations by surveys for study and exploration, according to Oso and Onen. This was a suitable design, since data about the financial leverage and financial performance of listed manufacturing undertakings in Kenya could be generalized for a part of the population. Due to its relative cost efficiency and the potential to consider the whole population of the survey, the research methodology was used. The research also explored the causal link between variables to describe the association between two or more quantitative variables. In a period of seven years between 2011 and 2017, the quantitative data concerning financial performance metrics and financial leverage for manufacturers listed in the Nairobi Stock Exchange has been obtained in accordance with the debt levels of the same firms in time.

The study was conducted in only listed manufacturing companies in NSE. There are nine (9) companies listed on the Nairobi Stock Exchange. All the nine listed companies were considered for study. The study interviewed only financial managers, accounting officers, auditing and assurance officers, monitoring and evaluation officers of these listed manufacturing companies in Kenya because financial managers have an in depth knowledge on Financial efficacy of the company, they advise on the sources of funds companies can resort to, monitor the risks associated with leveraging, advise which projects the company should invest, prepare the financial statements of the company etc thus they are the most suitable respondents to answer questions pertaining equity financing and efficacy of listed manufacturing businesses in Kenya.

III. Results and Discussion

Descriptive Statistics of Equity Financing on Financial Efficacy

Table 4.1 Equity financing

n=82	Mean	Std. Dev	Skewness	Kurtosis
Finance mangers should have a clear understanding of the level of equity the firm is using to finance its operations.	3.71	0.909	0.116	-1.034
Finance managers should have a clear understanding of the total ordinary share capital the firm uses.	4.11	0.903	-1.047	1.548
Preferred share capital constitutes equity financing for the firm.	3.82	0.944	-0.884	0.784
The allotment of shares should be done by the finance managers.	3.8	0.935	-0.617	0.472
Equity financing should be in line with the objectives of the firm.	3.82	0.772	-0.166	-0.387
A firm with greater equity to debt ratio is likely to attain greater financial efficacy.	4.13	0.843	-0.769	0.056
Equity financing of the firm should be assessed and evaluated well by finance managers	4.06	0.759	-0.103	-1.241
Equity financing includes other sources of finance like income from sale of assets of the firm, income from leasing etc.	3.43	1.474	-0.517	-1.113
Ordinary share capital is an important driving force of equity finance	3.43	1.238	-0.309	-0.895
Equity financing decisions have been collected into one list and have been allocated to a specific job title	3.74	0.872	0.185	-1.085

Finance Managers have been trained to determine and evaluate the optimal level of equity finance of the firm	4.07	0.913	-0.945	1.214
Equity financing method planning is the important process which responds to capital requirements of the firm	3.27	0.917	-0.368	-0.026
Equity financing plans should be updated on a quarterly basis	3.34	1.045	-0.265	-0.353
Equity financing decisions should be implemented and monitored regularly by finance managers to ensure good financial efficacy of the firm.	3.18	1.044	-0.378	-0.135
Equity	3.708	0.395	0.107	-0.128

Source: Field Data

The finance managers have a clear understanding of the level of equity the firm is using to finance its operations (mean = 3.71, SD = 0.909). Particularly, preferred share capital constitutes equity financing for the firm (mean = 3.82, SD = 0.944). Besides, financial managers are aware of the total ordinary share capital the firm uses (mean = 4.11, SD = 0.903). Moreover, they assess and evaluate the equity financing by the firms (mean = 4.06, SD = 0.759). As well, the allotment of shares is done by the finance managers (mean = 3.8, SD = 0.935). Further, equity financing is in line with the objectives of the firm (mean = 3.82, SD = 0.772). Moreover, firms with greater equity to debt ratio is likely to attain greater financial efficacy (mean = 4.13, SD = 0.843).

However, it has not been fully established if equity financing included other sources of finance like income from sale of assets of the firm, income from leasing (mean = 3.43, SD = 1.474). Also, there is uncertainty as to whether ordinary share capital is an important driving force of equity finance (mean = 3.43, SD = 1.238). In the same way, there is doubt if equity financing method planning is the important process which responds capital requirements of the firm (mean = 3.27, SD = 0.917).

In addition, it is undefined whether equity financing plans should be updated on a quarterly basis (mean = 3.34, SD = 1.045). Similarly, there is uncertainty as to whether equity financing decisions should be implemented and monitored regularly by finance managers to ensure good finance efficacy of the firm (mean = 3.18, SD = 1.044). Finally, finance managers have been trained to determine and evaluate the optimal level of equity finance of the firm (mean = 4.07, SD = 0.913).

Overall, the findings on equity financing summed up to a mean of 3.708 and standard deviation of 0.395. The findings suggest that there are notable gaps regarding equity financing by manufacturing firms listed in NSE. Some of these gaps include uncertainty on other sources of equity financing, role of ordinary share capital in driving equity financing and the monitoring and implementation of equity financing decisions. Not unless such gaps are addressed, manufacturing firms are less likely to benefit optimally from equity financing.

Inferential Statistics of Equity Financing on Financial Efficacy

The objective of the study was to establish the effects of Equity financing on financial efficacy of listed manufacturing companies in Kenya.

Table 4.2 Effect of Equity Financing on Financial Efficacy

	Unstandardized Coefficients		Standardized Coefficients		
	B	Std. Error	Beta	t	Sig.
(Constant)	1.673	0.236		7.078	0.000
Equity Financing	0.614	0.072	0.656	8.520	0.000
Summary Statistics					
R	0.656				
R Square	0.431				
Adjusted R Square	0.425				
ANOVA (F-stat)	72.585				
ANOVA (p value)	0.000				
a Dependent Variable: Financial efficacy					

Source; Field Data (2020).

The regression results in Table 4.2 show that equity financing has a positive and significant effect on financial efficacy of listed manufacturing companies in Kenya. The unstandardized coefficient ($B = 0.614$, $p = 0.000$) indicates that a one-unit increase in equity financing leads to a 0.614 increase in financial efficacy, holding other factors constant. The standardized coefficient (Beta = 0.656) further confirms that equity financing is a strong predictor of financial efficacy. The model's R value (0.656) shows a strong positive correlation between equity financing and financial efficacy. The R Square (0.431) implies that 43.1% of the variation in financial efficacy can be explained by equity financing, while the adjusted R Square (0.425) accounts for model efficiency, suggesting the model is a good fit. The ANOVA results ($F = 72.585$, $p = 0.000$) confirm that the regression model is statistically significant, meaning equity financing reliably predicts financial efficacy. Overall, these findings suggest that increasing equity financing enhances the financial efficacy of listed manufacturing firms, making it an important financing strategy.

IV. Conclusion

The results on equity financing indicated that finance managers should have a clear understanding of the level of equity the firm is using to finance its operations. Also, there was confirmation that finance managers should have a clear understanding of the total ordinary share capital the firm uses. Moreover, preferred share capital constitutes equity financing for the firm. Further, the allotment of shares should be done by the finance managers. As well, equity financing is in line with the objectives of the firm. Moreover, firms with greater equity to debt ratio is likely to attain greater financial efficacy. Additionally, equity financing of the firm should be assessed and evaluated well by finance managers.

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