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Effect of Financial Restructuring on the Financial Performance of Firms in Kenya

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Abstract:
Corporate restructuring has become a common phenomenon around the world. It has enabled numerous organisations to respond quickly and more effectively to new opportunities and unexpected pressures so as to re-establish their competitive advantage. One of the critical aspects of corporate restructuring is financial restructuring as it focuses on the reorganization of a firm's assets and liabilities to meet its financing needs. This study will seek to examine the effect of financial restructuring on the financial performance of firms in Kenya. The study will analyze the literature review of various studies conducted in and outside Kenya.
Keywords: Corporate restructuring, Financial restructuring, Equity financing, Debt financing.

1.0 INTRODUCTION

Corporate restructuring has become a common phenomenon around the world. Unprecedented number of companies across the world have reorganised their divisions, restructured their assets, streamlined their operations and spun-off their divisions in a bid to spur company performance. It has enabled numerous organisations to respond quickly and more effectively to new opportunities and unexpected pressures so as to re-establish their competitive advantage. In many cases the desired results cannot be achieved without subjecting the corporate strategy and structure to some transformation. In this context, restructuring no longer becomes an option but a necessity for survival and growth (Rogovsky *et al*., 2005).

Financial restructuring is the reorganizing of a business' assets and liabilities (Nazir & Alam, 2010). It involves re-organisation of capital, buy-back, corporate debt restructuring, acquisitions, mergers, joint ventures and strategic alliances. It therefore involves effecting change in a firm's capital structure to achieve balanced operative results. Financial restructuring is aimed at bringing balance in debts and equity funds, short term and long term financing, to achieve reduction in finance charges, to reduce loss of capital, to increase EPS, to improve market value of shares, to reduce the control of financiers on the management of company etc (Srivastava & Mushtaq, 2011).The first objective of financial restructuring is to take measures that avert the impending insolvency and that ensure the short-term survival of the business. This is the prerequisitefor a sustainable restructuring process. The medium and long-term goal of financial restructuring is re-establishment of a healthy and solid capital structure (Javed & Akhtar, 2012).

The Kenyan business environment has been undergoing drastic changes for some time now. Some of these changes include the accelerated implementation of economic reforms by the government, the liberalization of the economy, discontinuation of price controls, privatization and partial commercialization of the public sector not forgetting increased competition. In this dynamic operating environment, organizations have to constantly adapt their activities and capital structures to reflect the new external realities and hedge inherent financial risks expected (Siro, 2013). This study will therefore seek to examine the effect of financial restructuring on the financial performance of firms in Kenya.

1.2 Objectives of the study

The general objective of the study will be to examine the effect of financial restructuring on the financial performance of firms in Kenya. The study will be guided by the following specific objectives:

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i. To determine the effects of equity financing on the financial performance of firms in Kenya

ii. To establish the effects of long term debt financing on the financial performance of firms in Kenya

iii. To establish the effects of short term debt financing on the financial performance of firms in Kenya

2.0 LITERATURE REVIEW

The study will review past and current studies on the effect of financial restructuring on organizationalfinancial performance.

2.1 Theoretical review

The study will be based on 3 theories namely Resource Based View Theory, Lifecycle Theory and the Static trade-off Theory.

Resource Based View theory asserts that the source of firms' competitive advantage lies in their internal resources, as opposed to their positioning in the external environment. That is, rather than simply evaluating environmental opportunities and threats in conducting business, competitive advantage depends on the unique resources and capabilities that a firm possesses (Barney, 1995). It predicts that certain types of resources owned and controlled by firms have the potential and promise to generate competitive advantage and eventually superior firm performance (Ainuddin *et al*., 2007).

Lifecycle theory contends that a firm grows and eventually matures while moving through the different stages of the corporate lifecycle. It therefore suggests that the unique firm lifecycle characteristics of birth, growth, maturity, and decline affect the financing decisions a firm makes, especially in situations such as financial distress and the threat of bankruptcy (Jensen & Meckling, 1976).

Lastly, the static trade-off theory affirms that firms have optimal capital structures, which they determine by trading off the costs against the benefits of the use of debt and equity. The theory predicts that firms target their capital structures in a way that if the actual leverage ratio deviates from the optimal one, the firm will adapt its financing behaviour in a way that brings the leverage ratio back to the optimal level (Luigi & Visinescu, 2009).

2.2 Conceptual framework

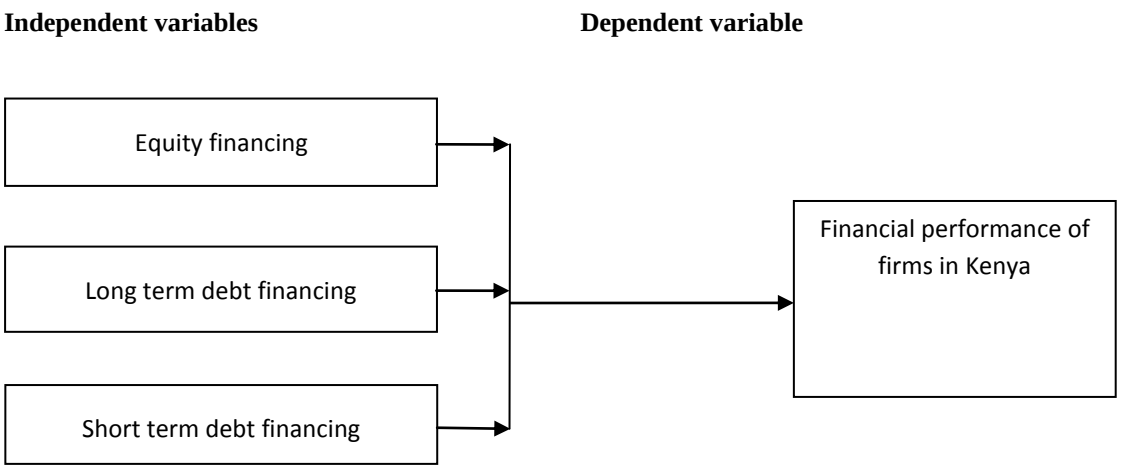

Figure 2.1 Conceptual Framework

The dependent variable in this study will be financial performance of firms in Kenya. The independent variables of the study will include; equity financing, long term debt financing and short term debt financing.

2.3 EMPIRICAL REVIEW

2.3.1 EQUITY FINANCING

Equity financing is money acquired from the small business owners themselves or from other investors. According to Kisgen (2006), equity capital is the mode that enables equity

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holders to exert influence and monitor managerial decisions continuously through the board of directors. It is also likely to result in greater value to equity holders and thereby increasing firm performance. Booth *et al*. (2002) argued that the firm that uses equity finance is able to make its performance better since there is direct control and because all the equity holders are the residual claimants they have to ensure that resources are allocated efficiently to be able to maximize shareholders wealth. Their argument have been supported by Salazar *et al*. (2012) who found that use of equity capital is positively related to the financial performance of firms.

Contrary to the argument of Booth *et al*. (2002) and Salazar *et al*. (2012), Mohamad (2004) did a research on the relationship between capital structure and profitability of listed industrial firms on the main board of the Kuala Lumpur Stock Exchange (KLSE). He used Ordinary Least Squares and Correlation Analysis to analyze the data. His study findings showed that there were significant relationships between market imperfections changes in capital structure on firm's profitability. Further, the study findings showed that equity size was negatively related to a firm's profitability.

Kibet (2009) carried out a study to establish whether there was a relationship between capital structure and profitability of MFIs in Kenya. This study used descriptive statistics. The study found that the capital structure decision is crucial for any business organization. The decision is important because of the need to maximize returns to various organizational constituencies, and also because of the impact such a decision has on an organization's ability to deal with its competitive environment. From the findings the study found that most of MFIs in Kenya were using equity and or donations as their main source finances in Kenya which accounted for by 72.42% and 27.58% in form of debt. The study further found that there exist a positive relationship between equity financing and profitability of MFIs in Kenya.

According to Anthony (2007) when control is to be exerted, the equity holders, as residual claimants, have the right to revise the employment terms of managers. They can successfully adapt by bringing about the desired changes through coordination with firm managers. Such form of coordination is more expensive than coordination through price-based systems. It is also likely to result in greater value to equity holders and thereby increasing firm performance. He further suggested that strategic assets should be financed through equity. A deviation from this relationship can lead to higher organizing costs, which could have far reaching implications in the long run resulting in poor firm performance.

Graham and Harvey (2001) discussed the main costs of equity as; tax costs, adverse selection, premium and floatation costs. These costs have an effect on the performance of firms when aggregated. This view was supported by Javed & Akhtar (2012) who found that use of equity capital is positively related to the performance of family owned businesses in Pakistan.

Kehinde (2012) in his study conducted between 2010 and 2012 examined the relationship that exists between the capital structure mix of the SMEs and the overall performance of the firms over the years in Nigerian. The study made use of questionnaire a survey method for data collection and chi-square a non-parametric method for data analysis. The study revealed that most SMEs have an all equity finance structure and has a less debt finance compared to equity finance. It also revealed that the earning, survival and performance of the SMEs is strongly influenced by their capital structure mix.

2.3.2 Long term debt financing

Long term debt is money that is owed to lenders for a period of more than one year from the date of current balance sheet. The study by Ebaid (2009) found that there was no significant relationship between long term debt and return on assets. Long term debts are most preferable sources of debt financing among well-established corporate institution mostly by virtue of their asset base and collateral is a requirement many deposit taking financial institutions. Report by European Commission (2008) indicates that large financial banks have considerably reduced lending to SMEs thus inhibiting their potential for growth and financial performance.

Pelham (2000) argued that long term debts provided small firms with more competitive advantages when compared with large firms. According to the results it was found out that there is a direct positive and significant relationship between long term loans and financial performance of the small businesses. He reported that long term debt was positively related to the growth/share, /sales effectiveness, and gross profit in small and medium size manufacturing firms.

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Maina and Kondongo (2013) investigated the effect of debt-equity ratio performance of firms listed at the Nairobi Securities exchange. A census of all firms listed at the Nairobi Security Exchange from year 2002-2011 was the sample. The study found a significant negative relationship between debt-equity ratio and all measures of performance. The study further found that that firms listed at NSE used more short-term debts than long term.

Abdul (2012) conducted a similar study to determine the relationship between capital structure decisions and the performance of firms in Pakistan. The study concluded that financial leverage has a significant negative relationship with firm performance as measured by ROA, GM, and Tobin's Q. The relationship between financial leverage and firm performance as measured by the return on equity (ROE) was negative but not statistically significant.

Kar (2012) seeks to answer the question "Does capital and financing structure have any relevance to the performance of microfinance institutions?" from an agency theoretic standpoint. The results of the study confirm the agency theoretic claim that an increase in leverage raises profit-efficiency. It also finds that cost efficiency decreases with decreasing leverage. This showed that leverage have a positive significant impact on firm performance. The study used a panel dataset of 782 MFIs in 92 countries for the period 2000 – 2007. ROA, ROE and operating expenses per dollar lent (OELP) were used as indicators for financial performance while capital-asset ratio, debt-equity ratio, loans asset ratio and PAR30 were used as indicators for capital structure.

In another study, Javed and Akhtar (2012) explored the relationship betweencapital structure and financial performance. They concluded that there is a positiverelationship between financial leverage, financial performance, and growth and size of thecompanies. The study, which focused on the Karachi Stock Exchange in Pakistan, usedcorrelation and regression tests on financial data. The findings of the study are consistent withthe agency theory. This study however isolated the other financing decisions and focused onlyon financial leverage.

Nikolaos (2006) in an attempt to investigate the relationship between debts-to equity ratio and firm's profitability, taking into consideration the level of firms' investment and the degree of market power found that there is negative and statistically significant relationship between debt-to-equity ratio and profit margin. The negative sign indicated that either the cost of borrowed capital is higher than its benefit from investment, or that firms financed by retained profits are more profitable than those financed by borrowed capital. The negative relationship between the financial variable and the profit margin was in line with the results of Baker (1973), Hurdle (1974) and Oustapassidis (1998).

Kaumbuthu (2011) carried out a study to determine the relationship between capital structure and return on equity for industrial and allied sectors in the Nairobi Securities Exchange during the period 2004 to 2008. Capital structure was proxied by debt equity ratio while performance focused on return on equity. The study applied regression analysis and found a negative relationship between debt equity ratio and ROE. The study focused on only one sector of the companies listed in Nairobi Securities Exchange and paid attention to only one aspect of financing decisions. The results of the study, therefore, may not be generalized to the other sectors.

In a study to examine the impact of capital structure on the performance of firms, Adekunle& Sunday (2009) used debt ratio to proxy capital structure while return on asset and return on equity were used as measures of firms' performance. The study used the Ordinary Least Squares method of estimation. The result of the study indicated that debt ratio has a significant negative impact on the firm's financial measures of performance. The study, however, did not consider other financing decisions in the analysis, including the mediating effect of internal cash flow available.

Kiogora (2002) sought to find out whether capital structures of quoted companies were consistent over time and to ascertain whether companies quoted on the Nairobi stock Exchange in the same industry had similar capital structures. He found out that there were differences in capital structure among industry groups: there was a negative relationship between returns of firms quoted on the Nairobi Stock Exchange and their level of leverage and that companies in the Agricultural sector had consistent levels of equity from year to year. Firms within a given sector tended to cluster towards some target Equity/Total Assets ratio implying that an optimal capital structure exists. He also found out that returns increased with increased leverage hence supporting the traditionalists' view of an optimal capital structure.

Akhtar *et al.* (2012) sought to investigate the relationship between financial leverage and the financial performance in their paper titled "Relationship between Financial leverage

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and Financial Performance: Evidence from Fuel & Energy Sector of Pakistan". In their study they employed a sample of 20 listed public limited companies from Fuel and Energy sector listed at Karachi Stock Exchange (KSE). To test the hypothesis, the main variables used in the study consist of a dependent variable which is financial performance of fuel and energy sector while an independent variable financial leverage in fuel and energy sector. Their study showed that financial leverage has got a positive relationship with financial performance. Similar findings were established by Ojo (2012) who empirically examined the effect of financial leverage on corporate performance of some selected companies in Nigeria. The study revealed that leverage significantly affected corporate performance in Nigeria.

2.3.3 Short term debt financing

Short term debt financing have a maturity period of one year or less, they must be repaid quickly within 90 – 120 days. Term loans with short maturities help to meet immediate need for financing without long term commitment (Salazar *et al*., 2012). The cost of servicing short term debt is less taxing on the company. Short term loans usually offer lower interest charges, and most lenders do not charge interest until all credit allowance period is breached. The study by Ebaid (2009) sought to establish the relationship between debt level and financial performance of companies listed on the Egyptian stock exchange. The study found out that there was a negative impact of short term debt on return on assets.

Weinraub and Visscher (1998) in their study on debt financing suggest that aggressive liquidity policy combine the higher levels of normally lower cost short-term debt and less long-term capital. Although capital costs are reduced, this increases the risk of a short-term liquidity. They established that total and short term debt is positively related to firm's profitability, which might be the most important factor in accessing outside financing in countries with weak collateral laws. From their studies they also found out that a negative relation between tangibility and short-term debt and a positive relationship between tangibility and long-term debt exists. These results are consistent with most theories on capital structure that suggest that firms without fixed-assets to use for collateral are unable to access long-term financing. According to Teruel &Solano (2007),short-term debt is positively correlated with firm's growth opportunities. The anecdotal evidence suggests that there is a positive relationship between short term debt financing and financial performance.

Frank & Goyal (2007) observed that profitable firms tend to retire their debt and maintain leverage close to the lower end, whereas loss making firms are found to have higher debt level and are close to the higher limit of debt ratio. This indicates that profitability may also reflect the growth aspect of firms. This suggests that firm performance and leverage may be negatively related. Accordingly, profitable firms are likely to use retained earnings and make less use of debt relative to less profitable firms. It implies firm's performance and debt are expected to be negatively associated.

Magara (2012) did a study on capital structure and its determinants at the Nairobi Securities Exchange. The study sought to find out the major determinants of capital structure. It was established that from the period 2007 to 2011, there was a positive significant relationship between the firm size, tangibility and growth rate and the degree of leverage of the firm. However, the study did not take into consideration macro- economic factors like inflation and interest rates.

Hadlock and James (2002) argued that provided that earning power of firms exceed leverage interest cost of debt, financial leverage will have a positive effect in firms return on equity. They further argued that the extent to which a firm's earnings' power is likely to remain above the breakeven point and the potential speed or flexibility with which it can adjust its debt usage, if its earnings' power falls below average interest costs, should help to determine the level of debt that the firm is willing to commit itself to at a given point in time.

According to Anthony (2007), since debt sales bring additional cash into the firm, this could exacerbate agency problems. Alternatively, if firms use the debt issue proceeds to address the gap between investments needs and internal sources of funding, this would not necessarily lead to an increase in excess cash within the firm. The periodic interest payments on debt would then commit managers to pay out excess free cash flow. Hence, debt issues could reduce agency costs, and have positive effects on firm value and performance.

Silva (2008) on the effect of capital structure on MFIs performance .The objective was to determine the effects of capital structure on MFIs performance in Kristiansand. This study found that total debt and short term debt ratio impacts positively and significantly on ROE while negatively and significantly on ROA. Long term debt ratio had a positively

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and significantly impact ROE but not significantly impact on ROA of MFIs. This shows that if MFIs use long term debt to finance their operations, there may not be a pressure on management of MFI. This further suggests that profitable MFIs depend more on long term debt financing. The study uses a data set which consisted of 290 MFIs from 61 countries.

Mwangi (2010) did a study on the effect of financial structure on the financial performance of firms listed at the Nairobi Stock Exchange. Data was collected using structured questionnaires. The study identified a strong positive relationship between short term debt financing and the firms' return on equity, liquidity, and return on investment. This hypothesis was contrasted by a number of studies, to them the benefit of short term debt financing is less than its negative aspects, and hence argue that firms will always prefer to fund investments by internal sources first before considering external sources of funds (Jensen and Meckling, 1976).

Osuji and Odita (2010) did a study on impact of capital structure on financial performance of Nigerian firms using a sample of thirty non-financial firms listed on the Nigerian Stock Exchange during the seven year period, 2004 – 2010. Panel data for the selected firms were generated and analysed using ordinary least squares (OLS) as a method of estimation. The result showed that a firm's capital structure surrogated by debt ratio had a significantly negative impact on the firm's financial measures, return on asset. Similarly, Mustafa & Osama (2006) investigated the effect of capital structure on the performance of the public Jordanian firms listed in Amman stock market. The study used multiple regression model represented by ordinary least squares (OLS) as a technique to examine what is the effect of capital structure on the performance by applying on 76 firms (53 industrial firms and 23 service corporation) for the period (2001-2006). The results of the study concluded that capital structure associated negatively and statistically with firm performance on the study sample generally. In addition, the study found out that there was no significant difference to the impact of the financial leverage between high financial leverage firms and low financial leverage firms on their performance.

2.4 Summary of literature

Topic, Author and Year	Objective	Findings and Recommendations
Effects of capital structure on financial performance of firms listed at the Nairobi Securities Exchange by Siro, R.O. (2013)	To investigate the effects of capital structure on financial performance of firms listed at the Nairobi Securities Exchange	The study established that there was an inverse relationship between capital structure and financial performance of listed firms in securities exchange in Kenya The study recommended that firms should use shareholders' funds as much as possible before they undertake to borrow, so that they minimize the risks related to borrowing
Effects of Working Capital Management on SME Profitability by Teruel, P. & Solano, P. (2007)	to establish the effects of working capital management on the profitability of a sample of small and medium-sized Spanish firms	The study found out that shortening the cash conversion cycle, inventories days and debtors collection period improves the firm's profitability The study recommended that firms should be conscious of their debtors' credit policy as this affects their performance
Capital structure and financial performance in Kenya: Evidence from firms listed at the Nairobi Securities Exchange by Maina, L. and Mwasa, I. (2014)	To establish the effect of capital structure on financial performance of firms listed at the NSE	The study's key finding was that debt and equity are major determinants of financial performance of firms listed at the NSE It recommended that firms (both highly and lowly geared) should take into cognizance the amount of leverage incurred because it is a major determinant of firms performance

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Effects of working capital management on the performance of non-financial companies listed in the Nairobi Securities Exchange (NSE), Kenya by Mwangi, L.W., Muathe, S.M. and Kosimbei, G. (2014)	To investigate the effect of working capital management on the performance of non-financial companies listed in the Nairobi Securities Exchange (NSE), Kenya	The study findings indicated that an aggressive financing policy had a significant positive effect on return on assets and return on equity while a conservative investing policy was found to affect performance positively The study recommended that managers of listed non-financial companies should adopt an aggressive financing policy and a conservative investing policy should be employed to enhance the performance of non-financial companies listed in the NSE, Kenya
The relationship between capital structure and the firm's profitability of banking industry in Kenya by Yegon, C. *et al*. (2014)	to determine the relationship between capital structure and the firm's profitability of banking industry in Kenya	They found that a significant positive relationship exists between the short term debt and profitability and statistically significant negative relationship between long term debt and profitability The study recommended that the firm must consider using an optimal capital structure. The optimal capital structure includes some debt, but not 100% debt
Does Restructuring Improve Performance? An Industry Analysis Of Nigerian Oil & Gas Sector by Sulaiman, L.A. (2012)	To assess whether restructuring improve the performance of firms by conducting an industry analysis of the oil and gas sector in Nigeria	The study found out that financial restructuring has significant effects on profitability, liquidity and solvency of the firms. The study recommended that restructuring should not be used to keep failing business alive but to increase competitiveness and financial standing and management should also instill discipline upon itself so that the continued existence of the firm is not jeopardized

2.4.1 Conclusion and recommendation

The success of corporate firms in today's dynamic business environment is influencedbyhow well they are able to effectively determine the optimum and appropriate financing mix that is necessary to ensure that the shareholders get good returns. However, based on the empirical review, there are contradicting views regarding the effect of equity and debt financing on firm's financial performance. For instance, Javed & Akhtar (2012), Salzar *et al*. (2012), Antony (2007) found that use of equity capital is positively related to the performance of a firm while Graham and Harvey (2001) pointed out that the main costs of equity are tax costs, adverse selection, premium and floatation costs and thus use of equity finance have an adverse effect on the performance of firms.

Similarly, various studies that have evaluated the effect of debt financing on firm performance have yielded mixed results. For instance, Ebaid (2009) who found that there was no significant relationship between debt and performance; Javed and Akhtar (2012), Peham (2000), Weinraub and Visscher (1998), Mwangi (2010), Magara (2012), Hadlock and James (2002) they established that there is a positive relationship between financial leverage, financial performance, and growth and size of the companies. Maina and Kondongo (2013), Frank & Goyal (2007), Adekunle & Sunday (2009), Abdul (2012), Kaumbuthu (2011) in their studies found a significant negative relationship between debt-equity ratio and all measures of firm performance.

It is therefore evident that there is no clear verdict regarding the relationship between financial restructuring as captured in the various study findings highlighted in the empirical review and performance. This justifies further research.

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Further, many of the reported studies on the relationship between financial restructuring and performance have been conducted in developed countries where capital markets are well-developed. The Kenyan capital market is relatively under developed and therefore the traditional capital structure theories that have their origin in the developed countries need to be tested in the Kenyan context.Further, most of the studies were based on descriptive research design using the panel data model (Siro, 2013; Teruel & Solano, 2007 and Yegon *et al*., 2014). There is need to test the relationship between financial restructuring and firm performance using different models such as the regression and correlation to ascertain whether they would yield similar or contrasting results.

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