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Effect of Financial Leverage on Financial Performance of Non - Financial Firms Listed at the Nairobi Securities Exchange, Kenya

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Abstract

Financial leverage, commonly expressed through the debt-equity ratio, plays an essential role in determining a firm's capital structure and has significant implications on its overall performance, especially in developing economies characterized by relatively underdeveloped economies. A firm's financial performance depicts its capacity to utilize the available resources effectively and efficiently to generate resources and sustain long-term growth. While the scholars in the field have explored the correlation between financial leverage and financial performance, empirical findings remain inconclusive, with the studies reporting mixed findings. The study conducted a census on 32 non-financial listed firms, leading to 160 firm-year observations from 2019 to 2023. The study relied predominantly on secondary data gathered from the published financial reports and statements from the selected firms within the period. The study also employed descriptive statistics in the data analysis to provide valuable insights into understanding the data collected. Similarly, it utilized the inferential statistics methodology to examine the proposed relationship. After the analysis, the paper established that the financial leverage had a positive relationship but a statistically insignificant effect on financial performance, indicating that leverage alone cannot significantly explain the variations in the firm's performance during the period between 2019 and 2023. Based on the overall R squared figure; 4.22% of the variance in ROE of non-financial firms quoted at the NSE is explained by D/E ratio (coef. = 0.106, p = 0.410).

Keywords: *Financial Leverage, Financial performance, Nairobi Securities Exchange.*

1. INTRODUCTION

A firm's capital structure decisions are essential to its profitability because they decide the appropriate mix of debt and equity used to fund the organization's operations. When companies utilize debt to fund their operations and investments prudently, they are more probable to be profitable (Ogolla, 2021). While debt may provide additional resources for expansion and impose financial discipline on managers, excessive use of debt may increase interest obligations, financial distress, and lead to bankruptcy risk. Therefore, firms with excessive debt exposure may experience declining financial performance.

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Firms listed on the NSE are steadily enlarging debt financing in their capital structures as they seek more resources to support their corporate initiatives. In Kenya, seven firms have been delisted from the NSE due to corporate governance challenges and financial performance since the year 2008 (Chirchir, Kalui and Tari ,2024). Recently, the non-financial firm's financial performance has declined, and this has raised a key apprehension for the regulators. The emphasis on reviving the firms has shifted to how they might be financially reorganized to attain optimal financial performance (Kajirwa & Martin, 2019).

Recently, the non-financial firm's financial performance has declined, and this has raised a key apprehension for the regulators. The emphasis on reviving the firms has shifted to how they might be financially reorganized in order to attain optimal financial performance (Kajirwa & Martin, 2019). Numerous research works have explored the association amongst leverage and financial performance. Some of these studies imply that there is a beneficial effect that financial leverage has on financial performance, (Dalci, 2018; Muturi, 2019) while others suggest that too much debt can negatively impact a company's financial health (Osagie & Enadeghe, 2022) (Kithandi & Kithandi, 2020). A majority of the studies reviewed were carried out in economies which are not comparable to developing economies (Dsouza, Kathavarayan, Mathias, Bhatia, & AlKhawaja 2025; Ahmed, Rahman, Rehman, Imran, and Dunay 2024). As a result, research comparing financial leverage and performance in developing and developed markets is still lacking.

Decisions on financing are complex and differ between companies. The performance of the company will suffer if funding is made with the incorrect mix of debt and equity. Adding more debt might increase the risk for shareholders, though if the conditions are favorable, it might significantly boost their profits(Aziz & Abbas, 2019) .For firms listed at the NSE, sound financial decisions are expected to protect shareholder wealth, sustain dividend payments and maintain confidence in the wider market while corporate governance is expected to ensure that financing choices are made prudently and in the interest of shareholders .However ,there are listed non-financial firms which have failed to meet these expectations.

According to Kajirwa and Martin (2019), there has been an emphasis on optimal financial restructuring in an effort to revive the companies and the restructure leads to optimal financial

performance. As companies grow and their operating costs rise, more funding is required (Afey & Warui, 2019). How much debt or how much equity to utilize is a puzzle for managers According to the CMA, number of listed non-financial firms experiencing difficulties in their finances and being under statutory or delisted supervision is on the rise (Mbaabu, Musau & Muturi,2022). As per the CMAs reports with regards to firms' NSE delisting, majority of firms which are delisted are from non-financial organizations, with key issues being those firms' performance. During the 2022 financial year cycle, nearly 50% of firms listed on the NSE did not distribute dividends, indicating subdued returns for investors on the exchange. Most of the quoted non-financial firms have been facing financial problems which necessitate the need for research.

Aderemi (2024) investigated how leverage affected the financial performance of consumer products firms listed on the Nigerian Exchange Group during the period 2015-2022. Panel regression analysis was utilized in the study, which concentrated on a sample of eleven businesses. The short-term debt ratio, long-term debt ratio, and interest coverage ratio were used to evaluate leverage, while ROE was used to gauge financial performance. The findings established that whereas short-term debt and interest coverage ratio were favorably correlated but not statistically significant, long-term debt had a favorable and substantial effect on financial performance. Overall, the study found that leverage had a beneficial impact on financial performance

Nyambane, Kinyariro, and Gesage (2024) sought to establish a connection between financial performance and financial leverage in agricultural firms that are listed on the NSE. Using a correlational research approach, the study took into account the financial performance of all seven listed agricultural companies using ROE. The findings demonstrated that financial performance was not significantly impacted by leverage.

Ahmed, Rahman, Rehman, Imran, and Dunay (2024) investigated 78 publicly traded companies on the Dhaka Stock Exchange between 2017 and 2021 to see how capital structure and corporate performance related to each other. The debt-to-equity ratio, short-term leverage ratio, long-term leverage ratio, and total debt ratio were used to quantify capital structure using panel data analysis, and ROA, ROE, and EPS were used to evaluate financial performance. Overall, the results showed that the total debt ratio, long-term debt, and short-term debt all significantly lowered ROA.

Contrastingly, the long-term debt ratio had a negative but negligible impact on ROE, whereas the short-term debt-to-total-asset ratio and the overall debt ratio exhibited a substantial positive correlation with ROE.

2. METHODOLOGY

This study adopted descriptive research design of quantitative nature. The study also employed descriptive statistics in the data analysis to provide valuable insights into understanding the data collected. Similarly, it utilized the inferential statistics methodology to examine the proposed relationship. The research design aided in establishing causal relationships between Financial Leverage and Financial Performance. The target population comprised nine sectors which included: agricultural sector, manufacturing and allied, commercial and services sector, investment, automobiles, construction and allied sector, telecommunications and technology, energy, and petroleum, REIT. The data was obtained from NSE's financial report publications of various non-financial organizations.

Model Specification

$FP= \beta_0+ \beta_1 DER_{it} +\mathcal{E}_{it}$

Where

β_0=Constant

εit=Error term

β_1=Beta

FP=Financial Performance.

3. RESULTS

Based on table one, Debt equity ratio has a mean of 0.0002211 and a standard deviation of 0. 9986. According to the findings, nearly all the non-financial firms have a debt equity ratio of 0. 0002. On average, the firms show a very low return on equity (1.06%), with a wide dispersion (high standard deviation). Mean = 0.0106. On average, the firms had a low return on equity, indicating relatively modest profitability among non-financial firms on the NSE. Some firms are significantly unprofitable (up to -170.87% ROE), while others are highly profitable (up to 273.44%). The mean ROE is slightly positive, implying low average profitability among NSE-listed firms. The broad

range indicates that while some firms are very profitable, others have experienced substantial losses. The high variability suggests inconsistent performance across firms.

Table 1: Descriptive Statistics

Variable	Obs	Mean	Std. Dev.	Min	Max
ROE	160	0.0106	0.9722	-1.7087	2.7344
DERATIO	160	0.0002	0.9986	-2.7344	2.7344

3.1 Correlation Analysis

This section outlines the results of correlation analysis of the research variables. It was undertaken through use of the Pearson's product moment correlation. The table below demonstrates detailed information on correlation analysis carried out.

Table 2: Correlation Analysis

	DERATIO	ROE
DERATIO	1.000	
ROE	0.2055	1.000
	0.0091	

3.2 Financial Leverage and Financial Performance

The table above depicts the association amongst the response variable Financial Performance, operationalized by ROE and the Predictor Variable which is Financial Leverage, and indicator DERATIO. From the above table, DERATIO and ROE were positively correlated and the relationship was weak (r=0.2055). This means that when DERATIO increases the return on equity also increases.

3.3 Relationship between Financial Leverage and Financial Performance

The goal of the research was determining the relationship between financial leverage and financial performance. The indicator of financial leverage was D/E ratio. Financial performance was operationalized by ROE.

Table 3: Fixed-Effects Regression Results (Dependent Variable: ROE)

Statistic	**Value**
Number0of0observations	160
Number0of0groups (Company)	32
Observations per group (min/avg/max)	5 / 5 / 5
Within R^2	.005
Between R^2	.067
Overall R^2	.042
Correlation (u_i, Xb)	0.125
F (1, 127)	0.68
Prob > *F*	.410

Predictor	B	SE	*T*	*P*	95% CI
DERATIO	0.106	0.128	0.83	.410	–0.148, 0.359
Constant	0.011	0.052	0.20	.840	–0.093, 0.114

sigma_u | .76085126

sigma_e | .66176544

rho | .56931414 (fraction of variance due to u_i)

F test that all u_i=0: F (31, 127) = 6.51 Prob > F = 0.0000

An increase of one unit in the debt-to-equity ratio corresponded to a 0.106 rise in ROE. To assess this relationship, the study utilized a fixed-effects regression model, drawing on panel data covering 32 firms across a five-year period. The analysis indicated that while DERATIO exhibited a positive effect on ROE (coef. = 0.106, p = 0.410), the correlation is statistically insignificant. This implies that shifts in financial leverage did not have a meaningful implication on firm performance during the study horizon. Furthermore, the overall regression model was not significant (F = 0.68, p = 0.4098).

The overall R squared was 4.22% of the variance in ROE of non-financial firms quoted at the NSE is explained by D/E ratio. However, the significant F-test for fixed effects (F = 6.51, p = 0.0000) confirms that unobserved firm-specific characteristics significantly affect ROE, justifying the use of fixed effects. Additionally, approximately 57% of the variance in ROE is attributed to between-company differences (rho = 0.569), emphasizing the relevance of controlling for individual firm heterogeneity.

4. DISCUSSION

The research found a positive and statistically insignificant relationship between the debt-to-equity ratio and ROE The research concluded that financial leverage does not have a significant effect on financial performance.

The outcome of the research aligns with the study of (Lyimo & Walter, 2023) which revealed a positive insignificant association amongst leverage and profitability**.** (Olaoye & Adesina, 2022) on the other hand the findings contradict with that of (Zhao & Zhai, 2023) which found a negative association between Corporate leverage and performance. This led to the conclusion that no significant association exists between financial leverage and financial performance in the sampled firms.

The finding implies that variations in the level of financial leverage were not associated with corresponding changes in financial performance within the firms included in the study. Therefore, firms with higher levels of debt did not necessarily perform better or worse than those with lower levels of debt. This Study also suggests that simply increasing debt is not sufficient to improve financial performance. While financial leverage can provide access to additional capital for expansion and investment, its benefits depend on how effectively the borrowed funds are utilized. If debt finances projects that do not generate adequate returns, its impact on financial performance may be negligible.

The study is important to the regulators like the Capital Markets Authority in the formulation of policies about the level of debt to control debt levels and to help in the attainment of financial stability of the companies. This can lead to a favorable environment for investors and stakeholders

and help them to make informed decisions for their business operations. The findings may also assist the companies when seeking additional funds from outside investors. The findings of the research may also be instrumental to the government in the formulation of policies in establishing how firms can get extra finances to fund their initiatives. Additionally, the results of the study can be used by executives and investors to guide their decision making on the use of liabilities to support investment initiatives and business operations investments.

Overall, the finding underscores the importance of viewing financial leverage as one of several factors that influence financial performance rather than as an independent driver of profitability. Managers should therefore focus not only on determining appropriate debt levels but also on ensuring that borrowed funds are invested in projects that generate sufficient returns and contribute to sustainable financial performance.

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