The Impact of Debt Financing on Financial Performance: Evidence from Retail Firms Listed on the JSE

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Abstract: Objectives: The study investigates the impact of debt financing on financial performance of retail firms listed on the Johannesburg Stock Exchange for a period 2010–2019. The extant literature shows contradicting findings on the financing structure for retail firms. The fixed effects was applied using the financial performance ratios, return on equity is used as the profitability measure and is the dependent variable, whereas lagged return on equity, long term debt to total asset, total debt to total asset are used as independent variables, while size, sales growth are used as control variables. The lagged return on equity, total debt to total asset and growth in sales strongly influence financial performance of return on equity with high statistically significance of 1% level, whereas long-term debt to total asset and firm size negatively influence financial performance with a statistically significance of 1% and 5%, respectively. The study will retail managers with decision-making when financing their assets to increase profit. The study contributes to the literature and inform all stakeholders in the retail sector to make a profitable form of financing and the results are limited to South Africa retail firms.

Keywords: retail sector; firm size; corporate finance

JEL Classification: G320

1. Introduction

The firm's structure is commonly financed with the combination of debt and equity, identified as the most important financial decision because it has significant impact on the firm's financial performance. Debt financing is the main external financing used by companies (Baltaci & Ayaydian, 2014). The major increase in external financing over a longer period of years shows the economic expansion of firms. Debt financing has both advantages and disadvantages on the growth of the firms/companies and strategy (Irby et al., 2010). According to the capital structure theory, capital structure refers to the way an organization funds its resources. A firm can be financed by 100% equity or debt finance (Murugesu, 2013).

1.1. Research Objectives

Although many empirical studies have been conducted on the impact of debt financing on financial performance, there is a huge research gap to explore. Thus, this study investigates the impact of debt financing of retail firms in South Africa on firm performance over a period of ten (10) years from 2010 to 2019, and the factors influencing debt financing on firm performance in South Africa. The study objectives are twofold:

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- To determine the impact of debt financing on firm's financial performance.
- To determine the extent of debt financing on firm's financial performance.

1.2. Research Questions

- How does debt-financing affect companies' financial performance?
- To what extent does debt affect companies' financial performance?

1.3. Problem Statement

A profitable form of financing: debt or equity, is essential. The choice of the capital structure has been a central question in the corporate finance literature for the past 50 years. While determinants of the choice between debt and equity are well documented and established, the effects of various debt sources on firm value and performance remain unclear. Apima et al., (2016) confirms that there is no universal theory on the debt to equity choice.

Several studies such as Shah and Hijazi (2004), Shah and Khan (2007), and Ilyas (2008) have been conducted on capital structure in Pakistan. These studies have focused on identifying the determinants of capital structure for non-financial firms in Pakistan; however, they have not investigated how the capital structure affects the firm's financial performance. Since a firm has a choice of using debt or equity for financing its assets, there is a need to explore how the company's financing mix influences its financial performance.

This research study can inform retail managers about the impact of debt financing on firms' performance. It will help them when selecting an appropriate structure to improve financial performance. Furthermore, the study could be used to inform the investor's decision by considering the influence of debt financing in South African listed firms.

2. Literature Review

The financial structure is typically the combination of both debt and equity financing; however, the study focuses on the impact of debt financing on the performance of retail companies listed on the Johannesburg Securities Exchange (JSE) (Tauseef et al., 2015). It is reported that successful choice of capital financing may affect the business or organisation positively or negatively (Kajananthan, 2012). Debt, resources borrowed with expectations of repayment (Kajirwa, 2015), is an alternative mode for raising additional funds to meet the day-to-day needs of a given organization.

Kajirwa (2015) examined the effects of debt financing on firm performance for a period of five (5) years using eleven commercial banks listed in Kenya. The study showed that debt financing does not influence the financial performance of commercial banks. Nwude et al., (2016) found that debt financing has negative and significant impact on the performance of Nigerian quoted firms.

Most empirical studies such as Margaritis and Psillaki (2010), Nimalathasan and Valeriu (2010) and Kajirwa (2015) found that there is empirical relationship between debt financing on the financial performance. However, some academic researchers such as Iorpev and Kwanum (2010), Nwude et al., (2016) found the negative significant relationship between debt financing on financial performance.

Velnamby and Nimalathasan (2010) examined the impact of the firm size on profitability of branches of Bank of Ceylon (BOC) and Commercial Bank of Ceylon Ltd (CBC) from 1997 to 2006. They showed a positive correlation between firm size and profitability but there was no relationship between firm size and profitability in BOC.

Sadeghian et al., (2012) investigated the relationship between capital structure and firm performance of Tehran Stock Exchange Companies for a period 2006–2011. The study employed three financial performance measures: gross profit margin, return on assets, return on equity as dependent variables and long-term debt, short-term debt, and total debt ratio as three independent variables. The study revealed a positive significant relationship between return on asset, return on equity with total asset ratio and short-term debt but insignificant relationship with long term debt and gross profit margin.

Ebaid (2009) found that the capital structure choice, in common terms, has no impact on the financial performance of listed firms from 1997 to 2005 in Egypt, a country regarded as one of the rising economies in Africa. Using three accounting-based estimations of money related execution: return on asset, return on equity, and gross profit margins, the empirical tests revealed that capital structure, especially short-term obligations and total debt, has a negative impact on financial performance, which is measured by ROA. Conversely, capital structure that includes short-term obligation, long-term obligation, and total debt has no significant influence on financial performance, which is measured by ROE and gross profit margins.

Iorpev and Kwanum (2012) examined the impact of capital structure on the performance of manufacturing companies in Nigeria. The annual financial statements of 15 manufacturing companies listed on the Nigerian Stock Exchange were used for this study from 2005 to 2009. Multiple regression analysis was applied on performance indicators such as return on asset and profit margin as well as short-term debt to total assets, long-term debt to total assets and total debt to equity as capital structure variables. The results show that there is a negative and insignificant relationship between short-term debt to total assets and long-term debt to total assets, and ROA and profit margin, while total debt to equity is positively related with ROA and negatively related with profit margin. Short-term debt to total assets is while total long-term debt to total assets is significant using profit margin. The findings show statistically that capital structure is not a major determinant of firm performance.

2.1. Theoretical Framework

Modigliani and Miller (1958) disregarded theory that states that debt or equity financing does not influence the company's performance. Nevertheless, based on the propositions imposed, increase or decrease in financial leverage does not affect the financial performance based on this theory. However, the theory imposed by Modigliani and Miller (1963) stated that the cost of capital affects the capital structure decision whether to use debt or equity financing by not taking in account tax, which provides taxbenefits to a company. The main implications of this theory are unrealistic assumptions, which attracted too much attention.

2.1.1. Agency Theory

The agency cost theory involves the separation of ownership and control where managers of the company always act on behalf of the owners or shareholders. The main problem arises because of the conflicting interest on whether to finance the company with equity or debt. The bondholders

commonly raise the cost of debt financing for the company's operation (Nguyen, 2013). It is commonly explaining the company's instalment financing.

At last, the "agency theory" hides within the foundation of much of the theoretical discussion. Agency concerns are ordinarily included within the trade-off framework. Each theory, in any case, has attempted to clarify the reasons behind the choice between debt financing and other form of financing. The result proved that financial structure does not influence financial performance, which may be due to high financing cost exposing firms to bankruptcy cost.

2.1.2. Trade-off Theory

Nguyen (2013:6) characterises the trade-off hypothesis as the choice of financing between debt and equity utilised by considering cost and benefits. However, debt financing is recommended as the most appropriate financing as opposed to equity financing owing to tax benefits on interest cost. The most objective of this theory is to expand the shareholders' esteem. The trade-off theory proposes that a company should not utilize excessive debt (Mayers, 1984). The most benefits of the trade-off theory encompass a well-defined optimal level of debt financing.

2.1.3. Pecking Order Theory

Companies prefer internal source of financing debt and finally the external financing. The pecking order theory by Myers and Majluf (1984) is driven by the desire to enhance financial performance. The theory prefers debt financing over equity financing. However, the pecking order theory does not have a well-defined optimal level. Based on the pecking order theory, in the presence of information asymmetry, a firm prefers internal finance and external funding such as long-term debt or equity if internal funds are exhausted (Chen & Chen, 2011). However, Myers and Majluf (1984) found no relationship between debt and financial performance, inconsistent with findings of Magoro and Abeywardhan, (2017) who indicated that most successful firms depend on their internal finance.

Table 1. Comparable empirical studies

Comparable studies	Model, sample size and country	Key findings
Onaolapo et al., (2015)	$Lit = \beta 0 + \beta 1PROF + \beta 2SIZ + \beta 3TANG + \beta 4NDTS + \beta 5STDP + \beta 6DIV + eit$ sample consists of 245 – firm year observations for 35 firms over the 2006-2012 periods in Nigeria.	Results reveal that the three leverages ratios (Total Leverage Ratio, Long-Term Leverage Ratio and Short-Term Leverage Ratio) are negatively and significantly related with profitability. Firm size and asset tangibility are, however, positively and significantly related with leverage proxies
Githaiga and Kabiru, (2015)	$yi = \beta 1 + \beta 1x1 + \beta 2x2 + \varepsilon$ The study sampled SMEs' fina 2011 to 2013.	Findings revealed that long- and short-term loans reduce financial performance of SMEs
Murugesu (2013)	$ROE = .125 + -.015\beta + .224\beta + -.491\beta$ Sampled 11 hotel companies listed in the Colombo Stock Exchange in Sri-Lanka	The finding revealed that there is no relationship between long-term debt to profitability and a negative relationship between debt on profitability
Magoro and Abeywardhan (2017)	$ROA_{i,t} = \beta_0 + \beta_1 STD_{i,t} + \beta_2 LTD_{i,t} + \beta_3 Size_{i,t} + \beta_4 Age_{i,t} + \mu_{i,t}$ $ROS_{i,t} = \beta_0 + \beta_1 STD_{i,t} + \beta_2 LTD_{i,t} + \beta_3 Size_{i,t} + \beta_4 Age_{i,t} + \mu_{i,t}$ The study sampled 25 South African wholesale and retail sector companies to examine the impact of debt capital on the financial performance of companies over the period 2011–2015.	The study confirms that debt capital, in terms of short- and long-term debts, has negative impact on the financial performance of wholesale and retail sector companies of South Africa
Harelimana (2017)	$LA\,it = \beta 0 + \beta 1DR\,it + \beta 2\,DTE\,it + pit$ $LD\,it = \beta 0 + \beta 1DR\,it + \beta 2\,DTE\,it + pit$ $ROE\,it = \beta 0 + \beta 1DR\,it + \beta 2\,DTE\,it + pit$ $ROA\,it = \beta 0 + \beta 1DR\,it + \beta 2\,DTE\,it + pit$ $SGR\,it = \beta 0 + \beta 1DR\,it + \beta 2\,DTE\,it + pit$ $IGR\,it = \beta 0 + \beta 1DR\,it + \beta 2\,DTE\,it + pit$ The study sampled I&M Bank and Bank of Kigali within a period of six years from 2010 in Rwanda.	Profitability increases more with the control variables: DR and DE for Bank of Kigali, than I&M Bank, and the liquidity shows that I &M Bank is positively sensible with debt level than Bank of Kigali. Therefore, the debt level will positively affect the firm's financial performance

3. Research Methodology

The post positivism philosophy was adopted for this study since the existing theory and empirical study are being tested. This topic is based on a deductive approach in which theory-testing technique must be used. To find data, we analyzed Thomson Reuters data stream.

The study conducted the longitudinal research design and employed secondary data. The data were collected from Iress of Retail firms listed on the JSE. The quantitative research approach was followed and analyzed using E-Views 10. This study applied the quantitative research to determine the impact of debt financing on the financial performance of retail firms in South Africa. The scientific approach used is positivist because the study is informed by the quantitative research in nature. This approach of research paradigm combines both deductive and quantitative measurement of secondary data. The study used descriptive statistical analysis, correlation matrix, panel data, and ordinary least square (OLS) applied through regression analysis.

3.1. Population

The population consist twenty-six (26) retail firms listed on the JSE from 2010 to 2019.

3.2. Sampling

The JSE companies were selected based on the availability and accessibility of data for the period 2010–2019. The convenience sampling was used owing to accessibility and availability of data. Only seventeen retail firms listed on the JSE were selected from the Iress data source based on the availability of data within the study period. It was difficult to use the entire population during this study owing to several reasons such as non-availability of complete data set of some firms and closure of operations.

3.3. Econometric Model

The main aim of the study was to examine the impact of debt financing on financial performance. It involves four independent variables (lagged return on equity, long term to total asset, total debt to total assets, growth in sales and firm size).

3.4. Model of Specification

The approach of Nguyen (2013) will be adopted; its panel regression equation is stated as follows:

$$Y_{i,t} = \alpha_i + \beta X_{i,t} + \varepsilon_{i,t} \quad (1)$$

where the subscripts i and t represent the cross-sectional and time series dimension of the data, respectively, while α and β denote constant and regression coefficients, respectively. As $Y_{i,t}$ represents the dependent variable, $X_{i,t}$ represents the set of exogenous variables of firm I time t, and e measures the error term. The specific panel regression equation used for the study is as follows:

$$ROE_{i,t} = \alpha = \beta_1 LROE_{i,t} + \beta_2 LTDA_{i,t} + \beta_3 TDA_{i,t} + \beta_4 GRS_{i,t} + \beta_5 SZ_{i,t} + \varepsilon_{i,t}$$

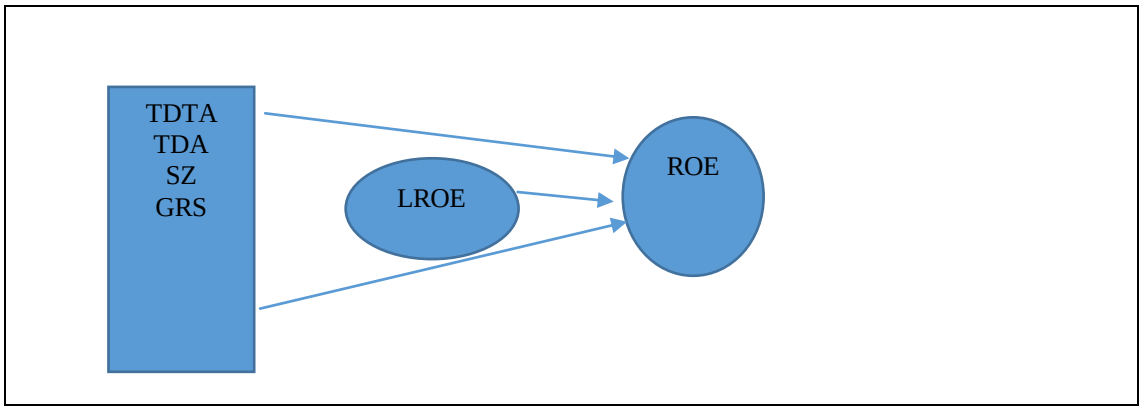

Figure 1. How Independent Variable Influences Dependent Variable
Source: Authors' compilation

Table 2. Variable and Measurement

Variables	Measurement	Abbreviation
Return on Equity	**Net income/Total Equity**	**ROE**
Lagged Return on Equity	Previous return on equity	LROE
Long-term debt to total asset	Long-term debt/total assets	LDTA
Total debt to total assets	Total debt/Total asset	TDTA
Firm size	Logarithm of Total asset	TA

Source: Authors' compilation

4. Analysis of Results

Table 3 Descriptive Statistics Results

	ROE	LROE	LTDA	TDA	SZ	GRS
Mean	**0.2782**	**0.2913**	**0.0993**	**0.5173**	**6.7123**	**0.0897**
Median	0.2750	0.2793	0.0624	0.5446	6.8243	0.0874
Maximum	0.9300	0.9300	0.4411	0.8809	7.8128	0.8381
Minimum	-0.2703	-0.2703	0.0000	0.0936	5.4628	-0.8171
Std. Dev.	0.1762	0.1793	0.0933	0.2355	0.6419	0.1513
Observations	170	170	170	170	170	170

Source: Eviews

The standard deviation and mean are being used to obtain the relationship and direction of variables above. The results showed that all variables have positive mean: ROE 28%, LROE 29%, LTDA 10%, TDA 52%, and SZ 671% 9%. The 52% TDA of retail firms listed on the JSE heavily financed their assets with debt; most of the firms do not use long-term debts to finance assets. Moreover, all standard deviation values are below the mean values; they reflect a small coefficient of variation. The range of variation between maximum and minimum is also reasonable.

Table 4 Correlation Results

Correlation	**ROE**	**LROE**	**LTDA**	**TDA**	**SZ**	**GRS**
ROE	1.0000					
LROE	0.8730	1.0000				
LTDA	-0.1803	-0.1101	1.0000			
TDA	0.2814	0.2817	0.1598	1.0000		
SZ	0.4108	0.4730	0.4774	0.3696	1.0000	
GRS	0.2697	0.1742	0.2163	-0.0485	0.2579	1.0000

Source: Eviews

Table 5 represents the correlation between all the variables included in the study. Based on the correlation matrix, there is a negative relationship between long-term debt to total asset. Conversely, there is a positive relation of previous return on equity, total debt to total asset, firm size, and growth in sales. ROE is positive, but the correlation is quite small. There is a high and positive correlation between the total debt to total equity and LROE (0.8730). Firm growth positively correlates with ROA and ROE.

4.1. Diagnostic Test

It is important to perform normality test before considering the regression analysis. The normality test ensures that the data is distributed normally. However, Data were found not normally distributed and thus the outliers were removed to normalize data since the number of observations is greater than 100 (Gujarati, 2009).

Table 5. Hausman Test Results

17 retail firms on No:	Cross section Chi-square statistics	Decision

observation 120		
52.352686		
Hypothesis testing	H_0: Random effect is appropriate H_1: Fixed effect model is appropriate	Fixed effect model

*; ** and *** indicates significance at 10%, 5% and 1%, respectively.

Source: Author's Regression Results

The Hausman test shows that the fixed effect model is appropriate; therefore, the panel regression result is based on the fixed effect model. This test shows a chi-square of 52.34 and p-value of 0.0000; as a result, the null hypothesis is rejected and so the random effect model is inappropriate.

Table 6. Fixed Effect Regression Results

Dependent variable: ROE	Fixed effect model	Pooled effect robust	Random effect model robust	GLM robust
LROE	0.4619***	0.7681***	0.7681***	0.7681***
	(7.8800)	(17.307)	(19.414)	(17.307)
TDA	0.3270***	0.0574**	0.0574**	0.0574**
	(2.720)	(1.9789)	(2.2198)	(1.9789)
GRS	0.1846***	0.1863***	0.1863***	0.1863***
	(4.5336)	(4.2725)	(4.7925)	(4.2725)
LTDA	-0.3875***	-0.3120***	-0.3120***	-0.3120***
	(-3.2661)	(-3.6704)	(-4.1171)	(-3.6704)
SZ	-0.1029**	0.0138	0.0138	0.0138
	(-0.0006)	(-0.1958)	(0.9794)	(0.9794)
_cons	0.6876	0.2974	-0.0538	-0.0538
	(2.436)	(0.9794)	(-0.7424)	(-0.6619)
N	170	170	170	170
R-squared	0.8548	0.7976	0.7976	
Durbin Watson (DW)	2.3234	2.3019	2.3019	
F-stat	41.504	129.26	129.26	
Prob> F-stats	0.000	0.0000	0.000	
Hausman Test	0.0000			
Prob> chi2	52.3526			
t statistics in parentheses				
*** p < 0.10**	" ** p < 0.05"	"*** p < 0.01"		

Source: Eviews

The results from Table 7 above show a negative correlation between ROE and TDA, with high statistically significance (with 1% level of significance) and a positive correlation between ROE and three independent variables LROE, TDA, and GRS. However, LROE, TDA, and GRS appear to have high statistical significance (with 1% level of significance), while SZ negatively influences ROE with a statistical significance of 5%. The coefficient of determinants (R2) of the significant correlation between ROE and LROE is 0.46, which indicates that a 46% change in ROE is influenced by LROE; it also means that 44% of the variation will be attributable to factors not included in the study. TDA and GRS influence the ROE by 33% and 18%, respectively, which indicates that a change in ROE is caused by TDA and GRS. The table shows a negative but high statistically significant correlation between long-term debt to total assets ratio LDTA, firm size SZ and ROE. This implies that long-term

debt to total asset LTDA decreases as ROE increases by -39%. Firm size (SZ) also has a negative correlation with return on equity by -10% with statistical significance of 5% level. The R squared is 85%, which shows that the overall data included in the model is greater than 50%.

Table 7. Expected Research Hypothesis and Results

Independent variables	Expected hypothesis	Actual results	Level of significant
LROE	**+**	**+**	**1% (fail to reject the null)**
TDA	+	+	1% fail to reject the null)
LTDA	+	-	1% (reject the null)
GRS	+	+	1% (fail reject the null)
SZ	+	-	5% (reject the null)

Source: Authors' Compilation

The above table shows the research hypothesis. LROE and TDA were consistent with the economic theory, whereas LTDA and SZ are inconsistent with the economic theory since the actual results show the negative relationship.

Table 8. Possible Justification of the Results

Variables	Possible reason
Long-term debt to Total Asset (LTDA)	**The possible reason for negative relationship could be the fact that most retail firms use internal financing or equity financing.**
Firm Size (SZ)	The possible reason for negative relationship could be the fact that most established firms do not seek debt financing; hence, debt financing decreases financial performance.

Source: Authors' Compilation

The findings suggest that size and long-term debt to asset negatively influence the financial performance of retail firms, which is consistent with the trade-off theory, and inconsistent with the pecking order theory. The possible reason could be that most established retail firms prefer internal source of financing such as equity over debt. The lagged return on equity (LROE), total debt to asset (TDA), and growth in sales (GRS) influence the financial performance of retail firms listed on the JSE.

The findings of the study corroborate the trade-off theory, which states that the lagged return on equity (LROE), total debt to asset (TDA), and growth in sales (GRS) increase the financial performance of retail firms in South Africa by 45%, 33%, 18%, respectively. The results imply that most retail firms in South Africa rely on internal source of financing rather than long-term debt, because it is cost-effective, whereas long-term debt requires an obligation to make repayment. Further, retail firms in South Africa avoid using long-term debt to finance their operation because repaying it is costly compared to short-term financing and internal financing.

5. Further Research

The current study is limited to retail firms listed on the JSE in South Africa; therefore, it cannot be generalized to other countries. Future studies should be conducted in other sectors of the economy. Modigliani and Miller (1958) proposed that performance does not depend on the form of financing of the business; contrary to our study, future studies can consider this proposition to yield different outcomes. The study recommends that retail firm managers should be careful when considering options of financing and should preferably use internal source of financing. There is a need to improve

capital market development in the JSE. The recommendation will to improve the study period preferably from 15 years onwards and all other important sectors of the economy to be included.

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