The Effect of Debt Financing on the Financial Performance of Selected Private Banks in Ethiopia.

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Abstract

The study examined the effect of debt financing on the financial performance of selected private commercial banks in Ethiopia. Multiple linear regression models were utilized, with return on equity as the dependent variable and short-term debt to total assets, total debt to total assets, total debt to total equity and interest coverage ratio as the independent variables to analyse the effect of debt on banks' performance. The study used an explanatory research design with a quantitative research approach. Secondary data for the sample of 5 private commercial banks were collected from the period (2017-2022) using targeted sampling techniques. Both descriptive and inferential statistics were used with the help of Statistical software E view 10 and the results are presented in tables. Based on the random effect regression model output this study concluded that the short-term debt to total asset ratio has a negative related and statistically insignificant effect on return on equity. The total debt to total asset and interest coverage ratio are positively related and statistically significant to return on equity while total debt to total equity has a negative relationship and is statistically significant with return on equity.

Keywords: short-term debt ratio, total debt ratio, total debt to total equity, interest coverage ratio, bank performance.

1. Introduction

Currently, most commercial banks are involved in an expansion program that requires a very large amount of capital (Muchugia, 2013) commercial banks can raise finance using equity and debts, and the fact that they mobilize deposits, which can act as a source of finance, make their capital structure unique as compared to other business firms (Taani, 2013). Debt financing has become a common occurrence in business globally. It provided a mechanism to “fill the financing gap” of firms that lack the internal resources to finance their investments and operations (Davydov, 2014) Although the factors that determined the choice between debt and equity are well-documented and to a large extent well-established, the effect of different sources of debt on the value and corporate performance was still unclear” (Davydov, 2014, p. 13).

Debt financing is an important component of external financing for companies raising additional capital after incorporation (Baltacı & Ayaydın, 2014). Debt has both advantages and disadvantages for business growth and strategic investments. According to Fama and French (2002), the benefits of debt include interest tax deductions and mitigation of free cash flow problems, while the cost of debt includes potential bankruptcy costs and benefits between shareholders and creditors. Management balances the tax benefits of debt financing for firms with the costs of financial hardship due to the risk of bankruptcy (kraus & Litzenberger, 1973)and agency costs (Jensen & Meckling, 1976).

However, in a dynamic and competitive world, the effect of borrowing on the performance of a commercial bank is so great that it must be reviewed regularly every year. Because, the failure of a single bank can affect not only its shareholders and depositors but also other banks and all other companies (Kumbirai & Webb, 2010). In the event of a business downturn, these firms may struggle to meet repayment

schedules and risk bankruptcy. The situation is especially dangerous when a firm has entered into variable-rate debt arrangements, where a sudden increase in interest rates can lead to serious interest payment problems (Haile et al. , 2014). Factors such as interest rate charged on loan, duration of loan repayment leverage ratio and interest coverage ratio often are known to influence the return on equity of a levered firm (Kirimi, Simiyu, & Dennis, 2017).

In addition, finding the relationship between debt financing and a firm's financial performance has been a topic of long debate globally. While some argue that debt financing harms performance, others argue that it has a positive effect (Jamala & Khatamib, 2023) This study aims to identify the effect of debt financing on the performance of private banks in Ethiopia.

Muchugia (2013) found that the short-term debt ratio has a significantly positive association with the return on equity in commercial banks in Kenya. This result is supported by Pradhan and Khadka (2017). But, Onchong et al., (2016) and Kwadwo et al.,(2016) are contrasted this result in Keyna. Shrestha et al., (2014) found that debt has a significant positive impact on the performance of Nepalese commercial banks. But, Bam et al. (2015), Kajirwa (2015), Obiero (2016), Pradhan and Khadka (2017) observed that the debt ratio harms the firm's performance. Makanga (2015) concluded that the total debt ratio had no significant relationship with return on equity. Pradhan and Khadka (2017), Bist et al., (2014) and Ojha et al., (2014) argued that debt to equity ratio has a negative relationship with the return on equity of commercial banks. This result is contrasted by lambebo (2015) and Modigliani and Miller (1958).

In Ethiopia, there are a few studies about debt financing and firm financial performance. According to lambebo (2015) found that interest coverage ratio and total debt total asset ratio have a positive relationship with banks' performance in Ethiopia. Birru (2016) found that total debt to total asset ratio and debt to equity ratio have statistically significant factors affecting financial performance measured by return on equity selected banks in Ethiopia.

All of the studies listed have assessed the effect of debt financing on a firm's financial performance. Studies are conducted in different directions covering different industries and organizations as well as in different countries. To the knowledge of the researcher disagreement research gap and the lack of studies on the effect of debt financing on the financial performance of private commercial banks in Ethiopia would motivate me to do this study. To fill this gap, the researcher found out the effect of debt financing on the performance of selected private commercial banks in Ethiopia for the period (2017-2022).

2.Review of Relevant Literature

The study was supported by the following theories;

The trade-off theory states that the optimal debt ratio is set by balancing the trade-off between the benefit and cost of debt. According to this theory, the optimal capital structure is achieved when the marginal present value of the tax shield on additional debt is equal to the marginal present value of the financial distress cost on additional debt (Myers S, 1984).

The pecking order theory emphasizes the information asymmetry between the firm insiders and the outside investors suggesting that firms use debt only when internal financing is not available (Myers S. C., 2001). Besides, the agency cost theory predicts the capital structure choice based on the existence of agency

cost. This theory investigates the relationship between the manager of the firm, and the outside equity and debt holders (Jensen & Meckling, 1976).

Short-Term Debt and firms performance

Short-term debt is made up of any debt incurred by a company that is due within the current fiscal year. Most leases are considered long-term debt, but they can sometimes be considered short-term if they are expected to be paid within one year. short-term debt tends to be less expensive, and increasing it with a relatively low-interest rate would lead to an increase in profit levels and therefore performance. Muchugia (2013) found that there was a significant positive relationship between short-term debt financing and profitability. The result is supported by ((lambebo, 2015), (Kipesha & Moshi, 2014), (Onchong et al., 2016)). But, Stephen et al., (2021) and (Karuma et al., (2018) opposed this result. Based on this the following hypothesis was developed.

H01: There is a negative relationship between the short-term debt to total asset ratio and the performance of selected private commercial banks in Ethiopia.

Total debt ratio and firm performance

Total debt is the sum of short-term debt and long-term debt. It measures the amount of total debt a firm used to finance its total assets. It is an indicator of the financial strength of the bank. It provides information about the solvency and the ability of the firm to obtain additional financing for potentially attractive investment opportunities. A ratio greater than 1 indicates that a significant amount part of the debt is financed by assets, or the company has more liabilities than assets. High percentages also show that a business can put itself at risk on its loans if interest rates rise surprise. A ratio less than 1 indicates that more of a company's assets are financed by fair. A high debt ratio usually indicates that a company has been hostile to financing debt capital. This can lead to explosive profits due to additional interest costs (lambebo, 2015) Fama and French (1998) find that debt financing has no positive effect on financial performance because there is no tax advantage of debt due to agency problems after controlling for profits, investment, research and development and dividends. Birru (2016) found that the total debt to total asset ratio has statistically significant factors affecting financial performance measured by return on equity selected banks in Ethiopia. This result is supported by Shibeshi, (2017) and Muchugia (2013). Based on this the following hypothesis was developed.

H02: There is a positive relationship between the total debt to total asset ratio and the performance of selected private commercial banks in Ethiopia.

Debt to equity ratio and firms performance

It shows the amount of debt and equity used to finance the bank's assets. It shows the percentage of the bank's funding coming from creditors and investors. It is a measure of the capital contributed by creditors and the capital contributed by shareholders (Ali & Berhe, 2019). The debt ratio measures the riskiness of a company's financial structure and is calculated by dividing total debt (including long-term debt, short-term debt, and leases) by total equity..The debt-to-equity ratio is a common measure used to assess a firm’s leverage or in other words the extent to which it relies on debt as a source of financing (lambebo, 2015). Birru (2016) found that the total debt-to-equity ratio has statistically significant factors affecting financial performance measured

by return on equity selected banks in Ethiopia. Pradhan and Khadka (2017) found that the debt ratio harms the firm's performance. Based on this the following hypothesis was developed.

H03: There is a negative relationship between the total debt to total equity ratio and the performance of selected private commercial banks in Ethiopia.

Interest Coverage Ratio and firms performance

In a market economy, resources tend to be allocated to activities that provide the best return for the risk borne by the lender. The interest coverage ratio (ICR) is a measure of a company's ability to meet its interests pay. Interest rates act as a market signal of these rates of return, so low-interest rates encourage borrowing and higher debt levels. Kibet (2011) said that interest rate is one of the important macroeconomic variables. Generally speaking, interest is considered the cost of debt incurred over a certain time. From the borrower's perspective, interest is the cost of borrowing (borrowing fees). From the lender's point of view, interest is the fee payable after lending money. According to Karuma et al., (2018), rising interest rates increase the cost of capital. This is affect businesses as well as investors. Based on this the following hypothesis was developed.

H04: There is a positive relationship between the interest coverage ratio and the performance of selected private commercial banks in Ethiopia.

Return on Equity

Return on equity is the amount of net income returned as a percentage of shareholder's equity. Return on equity measures a corporation's profitability by revealing how much profit a company generates with the money shareholders have invested. ROE is an internal performance measure of shareholder value, and it is by far the most popular performance measure (Ali & Berhe, 2019).Return on equity is measured by dividing net income after tax by the book value of owner equity ((Brigham & Houston, 2009).

3. Methodology

3.1 Research Design

This study used an explanatory research design and quantitative approach to establish a cause-and-effect relationship between variables.

3.2 Target Population and Sampling Design

According to Mugenda and Mugenda (1999), a target population is a researcher who wants to generalize the result of the study. Therefore, for this study, the researcher used all private commercial banks as the target population of those engaged in commercial banking activity in Ethiopia as of 30 June 2022, licensed and registered with the national bank of Ethiopia. This study targeted all (28) private commercial banks in Ethiopia for six years covering between 2017 and 2022. For this study, the sample frame includes private banks, which were established before 2017. Private banks established after 2017 are excluded from the study because the study includes six years of data and banks did not meet the required number of annual reports. Therefore, the sample size for this study is selected for five private commercial banks purposively based on their year of establishment and experience.

3.3 Collection Instrument and Type of Date Collected

The researcher used a document review guide to extract and compile the required secondary data for analysis from the financial statements. The secondary data encompassed panel data. The website of each of the banks was also visited to collect the necessary data for the study. A combination of time series with cross-sections enhances the quality and quantity of data to levels that would otherwise be impossible to achieve with only one of the two dimensions (Kothari, 2004). The cross-sectional data consisted of the firms while the time series data was the years between 2017 and 2022 because the data for the periods was current data and easily available.

3.4 Data Analysis

To analyze the collected data, descriptive statistics, correlation matrix, and multiple panel regression data analysis techniques would be employed. In addition, a diagnostic test is employed to check the validity of the model on the bases of the assumption of the classical linear regression model (CLRM). The diagnostic tests that would manage in this study are the Heteroscedasticity test, Auto correction test, and tests for multi-collinearity and normality. The reliability of the data on the model is checked at a 1%, 5%, and 10% level of significance. E-views econometric software version 10 is applied.

4. Results and Discussion

4.1 Descriptive statistics

The descriptive statistics of the dependent variable (return on equity) and independent variables (short-term debt to total assets, total debt to total assets, total debt to equity ratio and interest coverage ratio) of the study period (2017-2022) are shown in Table 1.

Table 1: descriptive statistics variable

	ROE	STDTA	TDTA	TDE	ICR
Mean	0.168967	O.445200	0.878267	7.432933	0.940467
St. Dev	0.077533	0.202895	0.015512	1.136046	0.389921
Minimum	0.015000	0.141000	0.840000	5.243000	0.132000
Maximum	0.336000	0.838000	0.917000	11.00600	1.703000
No.obs	30	30	30	30	30

Source: generated from EViews 10 output

The above Table 1 indicated that the minimum and maximum values of return on equity recorded by the banks were 0.015000 and 0.336000 respectively. The results show that the banks recorded a mean ROE of 0.168967 with a standard deviation of 0.077533 between the year (2017-2022). The positive average ROE indicated that the banks were generally financially stable within that period. The results also show that the minimum, maximum, mean and standard deviation values of short-term debt to total assets, total debt to total assets, total debt to total equity and interest coverage ratio for the banks were (0.141000, 0.840000, 5.243000, 0.132000), (0.838000, 0.917000, 11.00600, 1.703000), (O.445200, 0.878267, 7.432933, 0.940467) and (0.202895, 0.015512, 1.136046, 0.389921) respectively. Generally, each variable ratio indicated most of the bank's asset is financed by debt financing. The result also shows that the sample commercial banks are more capable of meeting their interest obligations from operating earnings and having lesser burdens of interest expenses.

4.2 Correlation analysis

The Correlation analysis of the dependent variable (return on equity) and independent variables (short-term debt to total assets, total debt to total assets, total debt to equity ratio and interest coverage ratio) of the study period (2017-2022).

Table 2: the result of the correlation matrix for dependent and independent variables

	ROE	STDTA	TDTA	TDE	ICR
ROE	1.000000				
SDTA	-0.001828*	1.000000			
TDTA	0.002674*	-0.374102*	1.000000		
TDE	-0.024894*	-0.250598*	0.643981*	1.000000	
ICR	0.661044*	0.321471*	-0.267770*	-0.159851*	1.000000

Source: researcher's own computation 2023

The above table 2 indicated that the value of both the total debt to total asset ratio (0.002674*) and interest coverage ratio (0.661044*) have a positive relationship with the financial performance of sampled private banks in Ethiopia. This implies that the higher total debt to total asset ratio increases return on equity. Similarly, an increase in the interest coverage ratio leads to an increase in return on equity. In contrast, the short-term debt to total asset ratio (-0.001828*) and total debt to total equity ratio (-0.024894*) have a negative relationship with the financial performance of sampled private banks in Ethiopia. It implies that the lower the short-term debt employed, provides a lower return on equity. Likely, the total debt to total equity ratio decreases return on equity also decreases.

4.3 Regression Results Analysis of return on equity and its determinants

The below table 3 indicated the random effect regression test's results and the model can be rewritten as:

$$Yit=-3.85535-0.042714*X1 +4.91921*X2-0.058*X3+ 0.163969*X4$$

Where

Yit = Dependent variable (Financial Performance) of the bank I at time t

X1 it = short-term debt ratio of bank i at time t

X2 it = total Debt ratio of bank I at time t

X3 it = total Debt equity ratio of bank i at time t

X4 it = interest coverage ratio of bank i at time t

Table 3: indicated random effect regression test results

Random effect regression model				
variables	Coefficient	Std. err	t-Statistic	Prob.
C	-3.855350	1.886283	-2.043888	0.0516
STDTA	-0.042714	0.060392	-0.707286	(0.4859****)
TDTA	4.919216	2.372555	2.073383	(0.0486**)
TDE	-0.058020	0.030707	-1.889440	(0.0705***)
ICR	0.163969	0.029800	5.502337	(0.0000*)
		Types of tests used		
R-squared	0.569106	Hausman test		(0.6920****)
Adj R-squared	0.500163	Jarque-Bera test		1.633 (0.441955****)
S.E. of regression	0.054815	Breuasch-Pagan-Godfrey test		(0.5686****)
F-statistic	8.254719	Serial correlation LM test		(0.9454****)
Prob(F-statistic)	(0.000218*)	DW stat		1.879482

Source: researcher's own computation 2023

i. The signs *, ** and ***denote the results are significant at 1%,5% and 10% levels of significance respectively. But, sign **** is insignificance.

ii. The result as shown the above table 3 of the normality, heteroskedasticity,auto-correlation and multi-col linearity test give the same values, the p-value greater than 5% which proves that the null hypothesis is accepted. The study concluded that there is no problem with normality, heteroskedasticity,auto-correlation and multi-col linearity test in the model.

The result of random effect Table 3 indicates the average influence of all the explanatory variables put together can explain the dependent variable up to 56.91% as indicated by the adjusted R-squared and the remaining 43.09% of the variations are affected by other factors outside the model. It also shows that independent variables are the major determinant factors of the performance of private commercial banks in Ethiopia.

The random effect result shows that short-term debt to total asset had an insignificant effect on the financial performance of private banks which was also negative (β = -0.042714, p=0.4859>0.1), The results also show that total debt to total asset had a significant effect on financial performance of commercial banks which was also positive (β =4.919216, p=0.0486**<0.05), the findings also revealed a negative effect and significant between total debt total equity ratio and banks performance (β = -0.058020, p=0.0705***<0.1). Finally, the results further show that interest coverage ratio positively and significantly influenced banks' performance (β =.0312206, p=0.0000*<.01).

4.4 Hypotheses Testing

H01: There is a negative relationship between the short-term debt to total asset ratio and the performance of selected private commercial banks in Ethiopia.

The hypothesis was examined by using panel regression and determined using the p-value. The acceptance/rejection criterion was that, if the p-worth is less than 0.05, we turn down the H01 however if it is more than 0.05, the H01 is not denied. The cause Table 3 show that short-term debt had a negative and insignificant effect on banks' performance (p > 0.05). The null hypothesis was consequently not rejected. This result is supported by (Karuma, Ndamiri, and Oluoch (2018). The results are contrary to those of ((lambebo, 2015), (Kipesha & Moshi, 2014), (Onchong et al. , 2016)).

H02: There is a positive relationship between the total debt to total asset ratio and the performance of selected private commercial banks in Ethiopia.

The results in Table 3 show that the total debt to total asset ratio had a statistically considerable effect on banks' performance (p< 0.05). The null hypothesis was as a result rejected. The research thus took on the alternate hypothesis that the total debt to total asset ratio has a significant effect on the financial performance of sampled commercial financial institutions in Ethiopia. The hypothesis testing results are consistent with the findings of a study by theoretical literature on trade of theory. This result is supported by (Kraus & Litzenberger (1973) Shibeshi (2017), and Shrestha et al. (2014)). But, this result is contrasted by Makanga (2015), Obiero (2016), Bam et al. (2015), and Kajirwa (2015).

H03: There is a negative relationship between the total debt to total equity ratio and the performance of selected private commercial banks in Ethiopia.

Hypothesis was evaluated by panel regression and determined by p-value. The results of the random effects model in Table 3 show that debt to equity ratio has a negative relationship with performance and is statistically significant (p value = . 10% significance. Therefore, the null hypothesis was rejected. Therefore, the study adopted the alternative hypothesis that total debt to total equity has a significant effect on the financial performance of the commercial banks sampled in Ethiopia. Furthermore, this result is supported by the experimental findings of such researchers (Pradhan and Khadka (2017), Birru (2016) and Bist et al., (2014)). However, the results are opposited by Seyoum, (2018).

H04:There is a positive relationship between interest coverage ratio and performance of some private commercial banks in Ethiopia.

The results of the random effect model in Table 3 show that the relationship between interest coverage ratio and performance was positive and statistically significant (p-value = 0.000), even at a 1% significant level. The null hypothesis was consequently rejected. The research hence took on the alternative hypothesis

that the interest coverage ratio has a significant effect financial performance of sampled commercial banks in Ethiopia. this result was supported by (Pradhan and Khadka (2017),lembebo (2015).

5. Conclusion

The study concludes that the results obtained from the random effects regression show an insignificant negative relationship between short-term debt and total assets and the performance of the sampled banks. The study also shows a significant positive relationship between total debt and total assets and bank performance, implying that an increase in debt level tends to be more costly and increases with interest rates. relatively high-interest rates will lead to higher levels of profit, and thus performance. Because interest payments are generally tax-deductible, this reduces cash flow problems and therefore the debt that can increase the value of banks.

According to the leverage ratio (TDE) of commercial banks, there is no optimal capital structure. This high level of debt consists primarily of deposit mobilization. Rising debt-to-equity ratios are a concern, as default risks increase for banks with more volatile earnings and cash flows. Excess debt increases interest payments, earnings volatility and bankruptcy risk. This increases financial risk for shareholders and demands higher returns, which increases the cost of capital and reduces business value. Based on this, private commercial banks use more debt than equity in their capital structure, which has a significant negative impact on the bank's performance.

5.1 Recommendations

The study suggests that managers of private commercial banks should pay attention to deposit mobilization to maximize the company's performance. This deposit is the cheapest source of funding and helps commercial banks to expand their operations and capture a larger market share. In addition, private commercial banks must strive to use these deposits effectively and efficiently to achieve the objectives of the institution.

The study also recommends that Management of private banks should strive to finance the banks operations and expansion with a less costly debt to take advantage of benefits associated with debt finance.

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