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EFFECT OF FREE CASH FLOW ON TOTAL DEBT OF FIRMS QUOTED ON NAIROBI SECURITIES EXCHANGE, KENYA

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Abstract: **A positive cash flow situation gives a business more liquidity, which enables it to continue operating and generate greater revenue. Total debt describes how a corporation finances its assets through a combination of equity and debt, where the debt's structure might include both short- and long-term debt. The research investigated the effect of free cash flow on total debt of companies listed on Nairobi Securities Exchange. The study was anchored on free cash flow theory and trade off theory. The study applied descriptive research design and secondary data was obtained from the firms from 2007-2011. Panel regression analysis was applied and fixed effect model was used. The result showed a positive and significant relationship between free cash flow and total debt of firms. The study recommends that firm management should manage and maintain appropriate level of cash flow in order not to increase total debt of companies, which can lead to decrease in performance.**

Keywords: **Free Cash Flow, Free Cash Flow Theory, Total Debt, Trade off Theory.**

1. INTRODUCTION

Considering that it is an essential option that may have a bearing on the worth of the company, the choice of capital structure is among the most important choices for businesses in the corporate finance industry. In overall, total debt is an accumulation of societal and outside resources utilized to fund the day-to-day activities of a certain business or firm (Bannerman & Fu, 2019). The option of debt in securities (internal or external), has been primarily highlighted in the both the theoretical and the empirical examination of the capitalization of businesses.

Total debt are defined as the borrowing of money from a single lender to start an organization and repaying it with interests over a predefined length of time. Total loans is the process of obtaining borrowing from various banks, businesses, or financial organizations to finance a company's activities. Before the debt's maturity duration, an interest expenditure is made, and the loan principal is repaid at a later date (Wambua, 2019). The choice on the debt structure and the debt's relationship to capital (total loan) must be made. It describes how a corporation finances its assets through a combination of equity and debt, where the debt's structure might include both short- and long-term debt (Sila, 2018).

Free cash flow is defined as the net cash the company receives from operations after deducting costs associated with development, which are then incorporated into expenses related to research and development before expenditures on investments for novel initiatives are subtracted. The cash flows that are accessible to, respectively, every of the company's owners and its shareholders are referred to as free cash flow to the company (Wanjiku, 2019). A business's cash flow is a key element that improves its ability to function. In accordance with Adelegan (2013), commercial enterprises ought to create a proper cash flow composition and utilize it with the goal to optimize investors' assets because cash flows are important to the functioning and success of a business. According to Ikechukwu, Nwakaego, and Celestine (2015), a business's cash flows are the "pool of money the company devotes to its fixed-asset stocks, receivables for accounts, and tradable securities," which result in profit for the company. A strong financial position management versus inadequately managed cash flows can be distinguished by an organization's capacity to identify a suitable form of funding for its activities (Adelegan, 2013).

Goals for organizations with a common significant typically go hand in alongside and share a connection to one another, such as cash flow as well as business viability. According to Nobanee and Abraham (2017), a positive cash flow situation gives a business more liquidity, which enables it to continue operating and generate greater revenue. Wisely reinvesting these earnings also contributes to the business's expansion. A continuous cash flow favorable position will enable better profit rates and consequently more money for investments. These goals are influenced by the firm's operational orientation, the type of its activities, the length of its existence, as well as the world surrounding it, including factors like competition, governmental regulations, consumers, and employees, among others. Profits reflect projected cash flow.

Derivatives, debt, equity, and five other related financial products are supported for trading and clearing settlement by Nairobi financial Exchange. Its responsibility is to list companies on the securities exchange, which makes it possible for different investors to trade stocks. As a result, it keeps the exchange of securities healthy. Companies can now engage local involvement in their equities through the Nairobi Securities Exchange, offering Kenyans the opportunity to acquire shares. Additionally, businesses might raise additional funds necessary for growth and development. A new issuer produces a prospectus to raise money, which contains all necessary information about the business and future prospects as well as the issue price. The Nairobi Securities Exchange also increases foreign capital influx. They could also be helpful resources for privatization plans (Oginda, 2017)

To reduce distortions, companies on the Nairobi Securities Exchange have moved their attention to broadening. The majority of traders have been managed to making use of the data that is at their disposal to participate in valuable initiatives and investments because of Kenya's effective industry. Companies that are publicly traded are concentrating on controlling the elements of working capital with the goal to reduce operating costs. Companies that are publicly traded in Kenya have been controlling the operational the investment's cash flow element to get rid of any surplus cash flows that could be misused by managers for poor investment prospects (Sila, 2018).

There are numerous studies that compare the relationship between free cash flows and company operations, both locally and globally. According to Chung, Firth, and Kim (2015), organizations with high free cash flow run the risk of using abuse of earnings to undermine the value of their businesses. This is because managers may be encouraged to do so by the agency costs of free cash flow. Also discussed was the fact that there was an upward correlation among disposable income and free cash flow and a negative correlation with operating results.

The impact of free cash flow on the earnings of luxury hotels in Kenya was explored in an investigation by Muthusi (2014), who found that it provided a positive and substantial effects on the earnings of Kenyan hotels. According to Sila (2018), profits of publicly traded businesses at the Kenyan NSE is impacted by free cash flows. According to the study, free cash flows had a significantly detrimental impact on stated non-financial enterprises' profits. These studies did not examine free cash flows effect on total debts of quoted firms on Kenya's NSE.

2. THEORETICAL REVIEW

Free Cash Flow Theory

Jensen's (1986) free cash flow theory suggests that executives desire to keep a substantial cash rate in order to increase the amount of total assets under their ownership. Additionally, executives made an effort to assert their leadership roles in the company's funding as well as investment choices. According to Jensen (1986), businesses that generate extra funds that is needed for funding initiatives with positive outcomes experience worse agency issues since the free cash flow worsens the disparity in value between shareholders and management. According to Jensen's free cash flow hypothesis, businesses with large amounts of free cash flow can also be anticipated to start making value-declining acquisitions and investment.

According to the free cash flow theory, firms that have free cash flows will see greater anomalous profits after announcing an asset repurchase strategy instead of companies which do not. Jensen (1986) made the case that managers are typically reluctant to distribute free cash flow to the investors since pursuing so could result in a decrease in the company's assets within their management while maintaining their financial position because paying dividends is not their primary individual objective. Ferreira and Vilela (2004) claim that supervisors of companies with surplus cash flow are under compulsion to distribute the surplus to shareholders rather than investing again the money in less lucrative ventures. Excessive investments problems may be impacted by these measures.

Huseyin (2011) suggests that managers have an incentive to accumulate cash, leading to increased firm assets under their discretionary control. This allows them to contribute to capital markets' comprehensive information on investment projects without external finance. However, this may lead to negative investments that negatively affect shareholder wealth. Managers of firms with poor investment opportunities may hold more cash to ensure financial accessibility for growth projects, even if they have negative net present value (NPV). This could destroy shareholder value and negatively impact the organization's market-to-book ratio and investment program (Al-Najjar & Belghitar, 2015).

Trade-Off Theory

Myers (1984) suggested this view. According to the theory, the best CS is obtained by considering the advantages and disadvantages of lending. Consequently, the governing body of the company is in charge of determining the debt to equity ratio to be included in the CS by weighing the benefits and costs associated with each. Although large amounts of debt in the capital structure can lead to bankruptcy and agency costs, debt capital has advantages including tax exemptions. Agency costs are a product of asymmetry of information as well as the various corporate partners' conflicting interests (Jensen & Meckling, 1976).

The trade-off argument has, however, drawn criticism from numerous academics. Luigi and Sorin (2009) claim that as soon as taxation on corporations was included to the trade-off theory, it provided debt perks because it was a tax barrier, meaning that it provided full debt financing, after discussions over the MM relevance hypothesis. Businesses with real estate that provide substantial returns will borrow more money than organizations with hazardous assets that generate low returns (Sheikh & Wang, 2011).

Considering some of the shares to be offered could be mispriced and entail negative choice expenses, the conclusion of this hypothesis is that certain of the enterprises may wind up pursuing initiatives which are without favorable current values. Capital structure is crucial in asymmetrical information because the type of loans a corporation chooses can lower the expenses associated with choosing adversely (Kemsley & Nissim, 2002).

Empirical Review

The impact of free cash flow on the profitability of companies published in Germany's automotive industry was examined by Ali, Ormal, and Ahmad (2018). The study used a study that is descriptive to examine the impact. However, just five companies were relatively discovered for the intent of the research from the overall sample accessible, as well as particularly the secondary data utilized in the research was gathered from the reviewed yearly observations and accounting records of the companies provided within the automotive industry. In addition, the populace for the research was made up of dominant major companies, as well as a simple random sampling method was implemented, giving every company throughout the automotive industry a fair chance of participating in the research. As a result, the regression findings showed a favorable correlation between featured companies' earnings and free cash flows. Nevertheless, evaluating the proxies (Leverage, Current Asset, Firm Size, Capital Liquidity, Sales Growth, and FCF) shows that leverage has an inverse, minor impact on performance (ROA).

Mamaro and Legotlo (2020) looked into how loans affected the revenue and earnings of retail companies quoted on the Johannesburg Stock Exchange from 2010 to 2019. The available literature presents disparate results regarding the funding strategy for businesses in retail. Return on equity serves as a revenue determine as well as is a dependent factor in the fixed-effect analysis employing the earnings proportions. Lagged return on equity, long-term debt to total asset, and total debt to total asset are employed as independent variables, while size as well as increase in sales are utilized as control factors. Lagged return on equity, total debt to total asset, and sales growth have significant statistically implications for return on equity at a threshold of 1 percent, while long-term debt to total assets while size of the company have negative effects on company performance with statistical effects of 1 percent and 5 percent, accordingly.

In their study of the profitability of Diversified Holding businesses listed on the Colombo Stock Exchange, Rajapaksha and Weerawickrama (2020) looked at the impact of free cash flow. Nineteen (19) businesses that are classified as Diversified Holdings on the CSE made up the populace as of June 2019. A random selection of 17 companies quoted on the CSE was chosen using the purposeful sampling approach (panel data). From the companies' audit accounting records as well as yearly accounts, which were obtained from CSE for a time frame of five years (2014 – 2019), secondary data was collected. Given that the data were quantifiable in nature, analysis of the data was carried out utilizing a regression model. The financial success of Sri Lanka's mentioned diversified investment firms is significantly influenced by free cash flows. It is clear from the evaluation's conclusions that the firm's profit is significantly influenced by free cash flows, firm size, and the Lag value of ROCE.

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3. RESEARCH METHODOLOGY

The study chose to adopt a descriptive study design which sought to examine the effect of a select set of firm-level factors on financial leverage of firms that have been listed in the Nairobi Securities Exchange (NSE). To achieve this purpose the study undertook a quantitative approach. A quantitative approach was deemed apt in this study since the data that was used was quantitative. Data used related to firms that are listed in the NSE for the period of five years (2007-2011).

The study chose to use secondary data from the semi-annual as well as the annual financial statements of the firms listed on the NSE for a period of 5 years

This stage had comprised of three steps which are; data preparation, data analysis and reporting. The Ms-Excel and STATA were used to clean, explore and analyze that data. Data was analyzed using panel regression methods. This is because neither cross sectional data or time series data analysis could not give out the best result because of the combined variation in both the firms and time.

Panel data is used to increase data observations and therefore very helpful in looking at change dynamics. The data was initially analyzed using pooled ordinary least squares (OLS) regression model. In this study a fixed effect model was used. The fixed effect model as an analysis tool allows for the heterogeneity among the subjects by allowing the subjects individually to have its own value for the intercept but assume that the coefficients of the slope are constant across the firms.

Regression model is expressed as follows

$Y_{it} = \alpha + \beta X_{it} + \varepsilon_{it}$

Where

$\varepsilon\varepsilon_{it}$ = error term

Y_{it} = Total Debt for i^{th} firm in t^{th} year.

X_{it} = Free Cash Flow

β = Vector of Coefficients free cash flow

4. RESEARCH FINDINGS AND DISCUSSIONS

Fixed Effect Panel Regression on Total Debt

Group variable: Company				Number of groups =	52	
R-sq:	within = 0.1848			Obs per group: min =	2	
	between = 0.3324			avg =	10.0	
	overall = 0.3040			max =	10	
				F(9,459) =	11.56	
corr(u_i, Xb) = 0.2667				Prob > F =	0.0000	
Total debt	Coef.	Std. Err.	t	P>t	[95% Conf.	Interval]
Free cash flow	0.1055668	0.0410973	2.57	0.011	0.0248046	0.1863291
_cons	0.8147678	0.1621965	5.02	0.000	0.4960281	1.133508
sigma_u	0.17825974					
sigma_e	0.07262303					
rho	0.85765148	(fraction of variance due to u_i)				
F test that all u_i=0:	F(51, 459) = 21.24			Prob > F = 0.0000		

The table above demonstrates the fixed effects regression for total debt. From the table, the overall r-squares is 30.4% which means overall 30.4% of the variations in total debt is explained as shown by free cash flow. The within r-squared is 18.48% which means that 18.48% of the variations within the variables were explained by the model. The between r-squared is 33.24% which means that 33.24% of the variations between the variables were explained as shown by model. It is observed that free cash flow was significantly as well as positively related with the total debt. This meant that a point increase in the Total debt, free cash flow increase by 0.1056.

Free cash flow was found to be having a significant relationship that was positive with total debt. This means that a higher levels of free cash flow would result in the increased use of the total debt. This is expected because the firm has funds to pay off the debts as they became due. The results are consistent with the tradeoff theory which suggested a relationship that was positive between free cash flow and total debt. The reason for this relationship is that firms with large amounts of free cash flows are most likely exposed to lesser risk and therefore able to borrow. This is contrary to pecking order theory that suggested a relationship that was negative between free cash flow and leverage. This theory suggested that firms would use these free cash flows as sources of funds to finance their activities instead of borrowing. However, this is not the case in this study as the firms borrow and use these cash flows to repay the debts. The results are supports Rajapaksha and Weerawickrama (2020) that found a significant relationship.

5. CONCLUSION, RECOMMENDATIONS AND SUGGESTIONS FOR FURTHER STUDIES

The study found that free cash flow was positively and significantly related to total debt supporting trade off theory. The study recommends that firm management should manage and maintain appropriate level of cash flow in order not to increase total debt of companies and to continue to improve shareholders wealth. Companies should not rely much on free cash flow, as an increase in free cash flow increases total debt which affects the financial performance of firms and increases bankruptcy vulnerabilities. The authorities should improve operations in company that improves the income statement.

Further studies can be carried out on; free cash flow and equity of firms listed on NSE, Kenya, and the effect of total debt on the financial performance of companies, free cash flow on total debt of banking institutions, Saccos or insurance firms.

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