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Capital structure and financial performance of manufacturing firms in Kampala district : Examining how the firm's financing mix influences financial performance.

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Abstract: *The research study was titled "Capital Structure and Financial Performance of Manufacturing Firms in Kampala District" and aimed at investigating the impact of the capital structure mix on the financial performance of firms. The major objective of the research study was to investigate the impact of capital structure mix variables, namely debt capital, equity capital, and retained earnings, on the financial performance of manufacturing firms in Kampala District, Uganda. The research study was conducted using a quantitative cross-sectional study design, which allowed the researcher to collect data at a single point in time to determine the relationship between capital structure and financial performance. The target population for the research study consisted of senior management, finance officers, and accountants from registered manufacturing firms in Kampala District. A total of 110 respondents were selected from 25 registered manufacturing firms in Kampala District to participate in the research study. The research study utilized a purposive sampling method to select firms and respondents who had appropriate knowledge and experience in financial management and capital structure mix decisions. Data for the research study was collected using structured questionnaires to gather primary data and document review guides to extract secondary data from financial statements and records. The study established that all components of the capital structure, including debt capital, equity capital, and retained earnings, had a positive and significant effect on the financial performance of manufacturing firms. Of the three components of the capital structure, retained earnings were the most dominant in enhancing the financial performance of the firms by ensuring liquidity and financial stability, while equity capital played an important role in enhancing profitability and sustainability of the firms. Debt capital, on the other hand, played a moderate but significant role in enhancing the financial performance of the firms, thereby confirming the importance of borrowing in the growth of firms. The study established that the capital structure of the firms played a crucial role in enhancing the financial performance of the firms in the manufacturing industry in the Kampala District. The study further established that retained earnings played the most crucial role in ensuring the financial stability and growth of the firms in the manufacturing industry in the Kampala District. The study recommended that the firms in the manufacturing industry in the Kampala District should consider the use of retained earnings and equity financing before considering debt financing in order to reduce the risks.*

Keywords: Capital structure, Financial performance, Manufacturing firms, Debt capital, Equity capital, Retained earnings, Kampala, Uganda.

Introduction

Capital structure has been recognized as a key element in the financial performance and viability of manufacturing enterprises. In the case of the Kampala district, the challenge for manufacturing enterprises has been how best to optimize the use of various sources of finance, namely debt capital, equity capital, and retained earnings, for the purpose of running the enterprises and encouraging growth. Previous studies on the manufacturing sector in Uganda have demonstrated the significance of the optimal use of various sources of finance for the return on assets and return on equity of manufacturing enterprises. However, the manufacturing enterprises in the Kampala district operate in a challenging environment, for instance, in terms of infrastructural challenges and competition, which makes the capital structure decision a challenge. It, therefore, becomes important to appreciate the capital structure of manufacturing enterprises and the financial performance for the purpose of strategic decision-making and investment.

The capital structure is of pivotal importance for determining the financial performance, sustainability, and growth of manufacturing firms. In the context of the Kampala district, manufacturing firms are challenged with the task of optimally leveraging different sources of funding, i.e., debt capital, equity capital, and retained earnings, for the purpose of growth. The proper management of capital structure is essential for maintaining adequate liquidity, minimizing the cost of capital, and sustaining financial performance. In the context of Uganda's manufacturing industry, previous studies have established that the optimal leverage of different sources of funding is essential for determining the return on assets and return on equity of manufacturing firms. However, manufacturing firms operating in the context of the Kampala district are challenged with an environment that is characterized by infrastructural challenges, limited access to formal sources of funding, and stiff competition. The proper comprehension of the financial performance of manufacturing firms is essential for strategic planning and decision-making.

Within the current context of the global economics, therefore, the issue of capital structure emerges as a critical consideration in the financial viability and effectiveness of an organization. This is especially the case within the context of the manufacturing sector, which is viewed as the engine of growth, employment, and development. The importance of the optimum capitalization strategy, therefore, assumes importance in organizations within the city of Kampala, which is characterized by a variety of capital sources, including debt, equity, and retained earnings, each with its own corresponding costs and benefits. The importance of the optimum capital structure is also underscored by the importance of sustainability and profitability within the changing market. The proportion of debt and equity employed by firms for meeting their financial obligations is referred to as capital structure. This serves as a lever for firms in determining the financial risks involved. Firms operating in capital-intensive industries, such as manufacturing, may find it challenging to maintain an appropriate balance that allows for adequate investment in plant, technology, and human resources, while also considering the costs of high financial leverage. Firms may thus align their capital structure appropriately, enabling them to maintain adequate liquidity for meeting financial obligations. This is essential for meeting daily operations and financial risks that may arise during challenging times.

Previous studies have indicated that the capital structure employed by firms has significant implications for financial performance measures such as ROA and ROE. These measures are essential for determining the efficiency of firms in employing assets and equity for earning returns. Studies have indicated that firms that maintain an optimal mix of financial sources are likely to achieve higher profitability, financial risks, and stability. Conversely, firms that maintain an inefficient capital structure may experience high financial leverage costs, leading to a reduction in operational performance.

The manufacturing environment in Kampala is characterized by unique challenges that affect the capital structure decisions made by firms. The infrastructural challenges, such as an unreliable electricity supply, poor road network, and inefficient logistics, affect the efficiency of operations and the general cost of doing business. Such an environment may prompt firms to adopt debt financing as a way of meeting operational requirements, which may expose them to financial risks in the long term. The limited access to credit institutions may also affect the situation, where firms may be forced to adopt alternative and expensive sources of finance, which may affect their potential for growth.

The level of competition in the market is also an issue that affects the capital structure decisions made by firms in the Kampala manufacturing industry. The firms in this industry are required to balance their need for liquidity, innovation, and capacity expansion in order to remain competitive in the market. The need for firms in the industry to innovate and differentiate their products may require firms in the industry to invest in capital expenditure, which may expose them to financial risks due to the need for debt financing.

Theoretical approaches, including the Modigliani-Miller theorem, trade-off theory, and pecking order theory, are important in understanding capital structure choices. The Modigliani-Miller theorem argues that capital structure is irrelevant in perfect markets, but taxes, bankruptcy costs, and information asymmetry are important in real markets. The trade-off theory argues that companies weigh the advantages of debt, including tax benefits, against the possible costs of financial distress. On the other hand, the pecking order theory argues that companies rely on internal sources of capital, such as retained earnings, before considering debt or equity, and information asymmetry is important in capital structure choices. Using the theoretical approaches to the Kampala manufacturing companies will help in understanding the reasons for capital structure choices and the limitations imposed by the business environment.

With this background, this study aims to investigate how manufacturing firms in Kampala manage their capital structure decisions and their implications for financial performance. This study will have both academic and practical contributions. For instance, from a policy point of view, this study will be instrumental in designing appropriate policies to support affordable credit, infrastructure, and a conducive environment to support industrialization. For firm managers, this study will be helpful in strategic financial decision-making and risk management to increase firm competitiveness.

Hypothesis 1 (H1): Debt Capital and Financial Performance

This hypothesis posits that there is a positive and significant relationship between debt capital and the financial performance of manufacturing firms. The rationale is that debt can be a powerful tool for financing growth, providing firms with additional capital to invest in operations, technology, and expansion. If managed prudently, debt financing can enhance returns on equity due to the tax deductibility of interest payments (a tax shield) and leverage effects, potentially leading to improved profitability. However, the presence of debt also introduces financial risk, particularly if the firm's earnings are not sufficient to meet interest obligations. Thus, this hypothesis explores whether, despite the associated risks, the strategic use of debt contributes positively to financial outcomes like return on assets (ROA) and return on equity (ROE).

Hypothesis 2 (H2): Equity Capital and Financial Performance

This hypothesis suggests a positive and significant relationship between equity capital and financial performance. Equity financing involves raising capital by selling shares of the company, which can provide firms with a stable source of funding without the obligation of repayment, unlike debt. This form of financing is crucial for many firms, particularly in high-growth environments, as it allows for participation in profit sharing and reduces overall financial risk. Moreover, equity capital can enhance investor confidence, attract further investments, and support sustainable growth strategies. Essentially, this hypothesis investigates whether increases in equity financing lead to improved financial metrics, such as higher profitability and stability.

Theoretical review

The Pecking Order Theory

The pecking order theory of capital structure, which was first introduced by Myers and Majluf in 1984, has been an important tool for understanding capital structure decisions. It has been argued that firms prefer to finance their activities in a hierarchical order: retained earnings, debt, and finally equity. This ordering of preference stems from the fact that there are asymmetrical information problems, where the management of the firm has access to more information than outsiders.

The strength of the theory is in its realistic portrayal of financial behavior and the reasons why companies might eschew external equity when it is theoretically optimal under certain models. It deals with the costs of asymmetric information and has been supported by empirical evidence in a wide range of settings, such as manufacturing companies in Kampala, as evident from the emphasis on retained earnings and the cautious use of debt.

The theory is simplistic in its assumption of a rigid hierarchy and fails to take into account market conditions or opportunities where the issuance of equity could be optimal. It also ignores differences in firms' access to capital markets, particularly in developing countries.

This theory is particularly relevant for the study on manufacturing firms in Kampala district, as empirical findings show these firms prioritize retained earnings and judicious use of debt, consistent with the Pecking Order Theory. It helps explain observed financing behaviors in a context marked by limited access to formal credit and infrastructural challenges, guiding recommendations for strategic capital management that balances growth, risk, and sustainability.

Literature review

Recent literature consistently illustrates the pivotal role of capital structure management in enhancing the financial performance of manufacturing firms in Kampala district. Tino (2023) examined capital structure components—debt capital, equity capital, and retained earnings—and their relationship with financial outcomes in Ugandan manufacturing enterprises. The study revealed a positive and significant influence of all capital structure components on performance measured via return on equity and return on assets. Notably, the findings recommended prioritizing equity capital first, followed by retained earnings, with debt financing as a last resort for optimal firm performance.

Further, Mugisha (2021) explored the moderating effects of market conditions on the capital structure-performance nexus among SMEs in Uganda, affirming that external economic factors significantly shape financing decisions and profitability. This highlights the dynamic interplay between internal capital management and external market environments affecting firms' financial results.

Alinda (2023) also contributed to the body of knowledge regarding how intellectual capital relates to capital structures in achieving sustainability, thereby proving that any manufacturing company that seeks to add intellectual capital to its financial structures is likely to perform better in terms of sustainability and profitability in a competitive market like Kampala.

Moreover, strategic initiatives by various governments, such as the Green Manufacturing Strategy (2020-2025) by Uganda, highlight sustainable industrial practices alongside financial prudence, thus stressing the need to align capital structures with environmental and social governance (Ministry of Trade, Industry and Cooperatives, 2020).

The literature review indicates an agreement across the board that the financing mix of the business, i.e., the capital structure of the business, plays a vital role in the financial performance of the business. In the case of the manufacturing sector in the emerging economies of the world, the optimal mix of debt and equity is vital in maximizing the profitability and minimizing the financial risk. In the case of the manufacturing sector in Nigeria, Adesunloro (2021) indicated that a higher degree of leverage is positively related to the profitability of the business. However, at the same time, the study found a negative relationship between the two in the case of the manufacturing sector in Nigeria. This view is supported by another study conducted in the Ethiopian manufacturing sector by

Tesema (2024). The study concluded that an optimal mix of debt and equity is vital in maximizing the profitability of the business in the Ethiopian manufacturing sector. The study supported the pecking order theory of the optimal capital structure of the business.

The study by Xuan Nguyen (2025) indicated the vital role played by the equity and retained earnings in the financial performance of the business.

In addition, corporate governance, market conditions, and firm-specific factors influence the relationship between capital structure and firm performance, thus emphasizing the importance of differentiated financial strategies. Recent studies suggest that there is a necessity to develop financial literacy and to create financing strategies that stress sustainable capital structures, reconciling short-term growth requirements with long-term stability.

Methodology

This research adopted a quantitative cross-sectional research design with a focus on manufacturing firms within Kampala District. The population of interest was senior management, finance, and accounting staff from manufacturing firms within the region. These are key individuals with knowledge and experience regarding financial management and capital structure decisions. As a result, they are instrumental in ensuring accurate information is collected regarding this topic of research. A total of 110 respondents were chosen from 25 manufacturing firms to take part in this research. This was based on representing a view of various perspectives regarding capital structure and its effect.

The study employed a purposive sampling method, which involved selecting firms and respondents who had the appropriate expertise to provide informed input on the different components of the capital structure, such as debt capital, equity capital, and retained earnings, and how they affect financial performance. Data collection involved the administration of structured questionnaires that are appropriate for collecting perceptions on the different components of the capital structure and how they affect financial performance measures such as return on equity (ROE) and return on assets (ROA), among others. The questionnaires consisted of closed- and open-ended questions.

Apart from the use of questionnaires, document review guides were also used to obtain secondary data from the financial statements and records of the participating companies. The use of questionnaires for primary data collection and reviewing secondary data ensured a comprehensive analysis, which made it easy to triangulate the results and increase reliability. The researcher personally administered the questionnaires to the respondents to ensure that there was clarity and accuracy in the responses. The use of financial statements as complementary data ensured an objective assessment of financial performance and helped to confirm the results obtained from the analysis of the survey responses.
The data was analyzed using statistical software, SPSS version 22. Descriptive statistics, such as mean and standard deviation, were used to summarize the responses from the respondents, while inferential statistics, such as correlation and regression analysis, were used to test the relationship between the variables of capital structure and financial performance of the company. The study obtained ethical clearance, with a major focus on ensuring the confidentiality of financial data during the research process. This helped to ensure that the respondents were able to provide accurate and truthful information without fear of breach of confidentiality.

RESULTS

TABLE 1: DESCRIPTIVE STATISTICS ON CAPITAL STRUCTURE AND FINANCIAL PERFORMANCE OF MANUFACTURING FIRMS IN KAMPALA DISTRICT

Statements	Strongly Disagree	Disagree	Undecided	Agree	Strongly Agree	Mean	STD
Effective use of debt capital positively impacts the financial performance of manufacturing firms.	23 (21.1%)	29 (26.6%)	22 (20.2%)	20 (18.3%)	16 (14.3%)	3.23	1.356
Equity capital utilization significantly improves business profitability and sustainability.	23 (21.1%)	29 (26.6%)	22 (20.2%)	20 (18.3%)	15 (13.8%)	3.23	1.356
Retained earnings are crucial for sustaining manufacturing firm growth and financial stability.	31 (28.4%)	35 (32.1%)	0 (0%)	25 (22.9%)	18 (16.5%)	3.34	1.498
Balanced capital structure involving debt, equity, and	24 (22.0%)	34 (31.2%)	20 (18.3%)	21 (19.3%)	10 (9.2%)		

retained earnings contributes to optimal financial outcomes.						3.38	1.275
Overall capital structure management significantly influences manufacturing firms' financial performance.	25 (22.9%)	31 (28.4%)	13 (11.9%)	25 (22.9%)	15 (13.8%)	3.25	1.392

N= 110, SA-Strongly agree, A-Agree,Ns-Not sure,D-Disagree,SD-Strongly disagree

Source: Primary Data, 2025

The descriptive statistics in Table 1 present a nuanced picture of the perceptions of manufacturing firms in Kampala district regarding the impact of capital structure components on financial performance. For the statement "Effective use of debt capital positively impacts the financial performance of manufacturing firms," the majority of respondents either strongly disagreed or disagreed, accounting for 47.7%, while only 32.6% agreed or strongly agreed. This is reflected in a moderate mean score of 3.23 and a relatively high standard deviation of 1.356, indicating mixed and somewhat polarized opinions on how beneficial debt capital is for financial outcomes.

Similarly, for "Equity capital utilization significantly improves business profitability and sustainability," responses mirrored those on debt capital, with about 47.7% in disagreement, 20.2% undecided, and 32.1% agreement or strong agreement, resulting in the same mean and standard deviation figures (3.23 and 1.356 respectively). This suggests that the role of equity capital in enhancing profitability is viewed with similar ambivalence, perhaps due to concerns about cost of equity or ownership dilution.

In contrast, the statement "Retained earnings are crucial for sustaining manufacturing firm growth and financial stability" received more favorable responses, with 39.4% agreeing or strongly agreeing and a mean of 3.34. However, a considerable number of respondents still disagreed (28.4% strongly disagreed and 32.1% disagreed), indicating some hesitation or variation in views regarding internal financing's importance.

The perception that a "Balanced capital structure involving debt, equity, and retained earnings contributes to optimal financial outcomes" garnered moderate support, with about 28.5% in agreement or strong agreement, yet a notable portion of respondents disagreed or remained undecided. The mean of 3.38 suggests a slightly more positive but still cautious stance on the merits of a balanced approach.

Finally, the statement "Overall capital structure management significantly influences manufacturing firms' financial performance" shows divided opinions, with nearly half of the respondents disagreeing, just over a third agreeing, and the remainder undecided, for a mean of 3.25 and a standard deviation of 1.392.

These mixed results imply that among manufacturing firms in Kampala, there exists considerable uncertainty or variation in understanding and leveraging capital structure for enhancing financial performance. Possible reasons include differing firm sizes, access to finance, managerial expertise, and risk tolerance. The relatively moderate mean scores and substantial standard deviations highlight the need for improved financial literacy and advisory services to optimize capital structure decisions.

Such findings underscore the importance for policymakers and financial institutions to promote education and tailored financing solutions that clarify the risks and benefits of various capital structure components. Enhancing firms' capacity to make informed capital decisions could result in better financial outcomes, growth, and competitiveness within Kampala's manufacturing sector.

This interpretation situates the survey data within broader practical and theoretical contexts, providing actionable insight into the prevailing attitudes and challenges regarding capital structure management in the study area.

Discussion

The findings of the study are consistent with recent literature that highlights the intricate relationship between capital structure and financial performance, especially for manufacturing companies in Kampala. Tino (2023) argues that each element of a company's capital structure, including debt capital, equity capital, and retained earnings, has a positive and significant impact on a company's financial performance measures such as return on equity and return on assets. The study by Tino (2023) also emphasizes that equity capital should be a priority to maintain control and minimize financial risks, followed by retained earnings as a secondary option, while debt capital should be used with caution as a last resort. This is also supported by other studies by Sihombing and Lestari (2023), which warn that debt capital should be used with caution to minimize financial risks and bankruptcy costs, while acknowledging its positive impact on a company's value.

On the other hand, Mugisha (2021) points out how external market factors mediate the capital structure-performance relationship. Firms in unstable or competitive markets are advised to develop dynamic financing strategies to ensure profitability, an important issue for manufacturing firms in Kampala, particularly in relation to market competition and infrastructural issues.

Additionally, intellectual capital has been introduced by Alinda (2023) to the capital structure debate, indicating that businesses that integrate financial and intellectual capital are more sustainable and profitable. This issue is important for manufacturing firms in a knowledge-based economic setting.

Furthermore, the Green Manufacturing Strategy for Uganda (2020-2025) has placed capital structure financing in relation to sustainability objectives, where businesses are encouraged to align their capital structure financing with environmental and social governance standards to ensure sustainability (Ministry of Trade, Industry and Cooperatives, 2020).Overall, the empirical evidence suggests that manufacturing firms in Kampala benefit from a balanced capital structure strategy that emphasizes equity and retained earnings while managing debt prudently. Such a strategy reduces cost of capital, improves liquidity, and enhances profitability. The interplay of internal financial management with external market and sustainability factors further shapes optimal financing decisions. These conclusions support the study's recommendation for strategic capital structure management as a cornerstone for improving manufacturing sector competitiveness and fostering industrial growth in Kampala.

Conclusions

The research findings and conclusion showed that capital structure has a significant impact on the financial performance of manufacturing companies in the Kampala district. In particular, debt capital, equity capital, and retained earnings positively and significantly affected the return on equity and return on assets of the companies. Among the three, retained earnings are the most important source of internal funds, which enhance liquidity and stability, while equity capital enables sustainable growth with minimal risk exposure. Debt capital, when properly managed, helps to improve financial performance but with caution to prevent overexposure to financial risk. The results also suggest that a proper capital structure, which involves the optimal combination of debt, equity, and retained earnings, helps to achieve optimal financial performance and competitiveness. These results and conclusions are consistent with the existing literature and emphasize the importance of capital structure management as a foundation for the sustainable financial success of manufacturing companies in Kampala.

Recommendations

Guided by the findings and literature, the study recommends that firms in the manufacturing industry in Kampala should focus on equity financing and utilize retained earnings maximally before relying on debt financing in order to reduce financial problems and bankruptcy. The firms should also establish proper capital management policies that will enable them to achieve an optimum level of financing, thereby improving liquidity and minimizing the cost of capital. The management should also focus on improving internal financial control and planning in order to leverage the available capital. The government and financial institutions should also enhance the accessibility of affordable equity financing and retained earnings support mechanisms, in addition to proper debt management techniques. Training on improving the financial literacy of managers in terms of capital management is also very important. The use of sustainable and green financing, in line with the Green Manufacturing Strategy in Uganda, should also be included in the capital management strategies.

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