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Intracompany Loan and Financial Performance of Manufacturing Firms in Rwanda

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Abstract

The manufacturing sector in Rwanda contributes to less than 5 percent of the GDP (UNECA, 2015). The financial performance of manufacturing companies in Rwanda has been declining over the years. This might bedue to low intracompany loans, thus formed the justification of the study. For instance, Cimerwa, the largest cement manufacturing company in the country, made a net loss of Rwf 7.4 million in 2016, Rwf 5.5 million in 2017 and further Rwf 7.1 million in 2018. The reviewed empirical literature had mixed results. Some studies revealed that intracompany loans positively affect financial performance, while other studies showed a negative effect. Based on this background, the study sought to examine the effect of intracompany loan on financial performance of the manufacturing firms in Rwanda. The study was anchored on pecking order theory. The target population was 32 manufacturing firms. . The data was collected from 2015 to 2019. The findings of the study revealed that a positive association existed between intracompany loans and financial performance. Based on the regression analysis, it was found that intracompany loans had a positive and significant effect on return on investment (β=0.956415, p=0.001). The study recommended that intracompany loans need to be increased between a subsidiary and parent company. The terms and conditions of payment of a given loan between a subsidiary and parent company need to be made more friendly and promising than a loan taken from other lenders.

Keywords: *Intracompany loan, ROI, financial performance, manufacturing, Rwanda*

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1.0 INTRODUCTION

1.1 Background of the Study

The manufacturing sector is critical in a country for improving the living standard of people (UNCTAD, 2015). The sustainability of companies is not possible when the companies are performing dismally. Investors inject more investment o companies that are performing well and can increase the returns (Tongli, Tono &Tanasal, 2018). The performance of organization is influenced by investors who inject more capital into the company. This increases efficiency as result of hiring more competent employees. One of the factors influencing the local manufacturing companies' performance is the foreign direct investment (Ekienabor, Aguwamba & Liman, 2016).

Foreign direct investment refers to a phenomenon caused by globalization through integrating local or domestic markets with international markets. It is mainly accomplished through the creation of a conducive business environment to the locals as well as to the foreign investors to enhance rapid economic growth (Omodero & Ogbonnaya, 2018). The lasting interest among various states implies a long-lasting association between direct and indirect investments as it typically directs investors a compelling voice concerning the management of direct investment markets (Antoine, 2015). According to Fernandez, Muhoho and Kahuthia (2019); Belloumi (2014); Ocaya, Ruranga and Kaberuka (2015); Ekienabor, Aguwamba and Liman, (2016); Raisa and Cristian (2015), intracompany loan is a significant measure of foreign direct investment.

Intracompany loan refers to money that has been borrowed by a subsidiary from the parent company (Kambayashi & Kiyota, 2015). The terms and conditions of payment of the given loan is more friendly and promising than a loan taken from other lenders since the companies are related (Ocaya, Ruranga & Kaberuka, 2015). The intracompany loan facilitates easy cash movement to those subsidiary companies that would otherwise experience a financial crisis (Ekienabor, Aguwamba & Liman, 2016). According to Calabrese, Papadavid and Tyson (2017), intracompany loans enable other branches of a company to be financially stable.

Globally, Kambayashi and Kiyota (2015) established that foreign direct investment has helped Japanese firms to sustain foreign market shares and enabled the restructuring of the Japanese economy. Also, Karuranga, Asti, Musonera and Mohiuddin (2014) revealed that foreign direct investment improved the financial performance of Canadian firms positively. Moreover, Raisa and Cristian (2015) reported that short term debt affects profitability negatively

Regionally, Ekienabor, Aguwamba and Liman (2016) revealed a positive relationship existed between foreign direct investment and manufacturing output, exchange rate and interest rate in Nigeria. Also, Ocheni (2018) established that tax incentive significantly influenced the foreign direct investment inflow into African Countries. Besides, Fernandez, Muhoho and Kahuthia (2019) reported that the tax regime is a factor that has a negative effect on the foreign direct investment in Kenya's insurance sector. Moreover, Onyinyechi and Ekwe (2017) noted that foreign direct investments have an insignificant and negative impact on the Nigerian economy and performance companies listed in the Nigerian stock market. Furthermore, Belloumi (2014)

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reported that the relationship between foreign direct investment and economic growth in Tunisia was positive.

In Rwanda, Gakwerere and Bizimana (2016) found that foreign direct investment in the Gasabo district improved the region by introducing capital and technology, promoting competition, enhancing management skills, promoting exportation, and increasing employment opportunities. Besides, Ocaya, Ruranga, Kaberuka (2015) revealed that foreign direct investment improved the financial performance of the manufacturing firms in Rwanda. Rwanda improved its World ranking to 41st in the World in doing business, up from 62th in 2016. In Africa, Rwanda was ranked 2nd in 2017 from 3rd in 2016 and remained number one in the East African Community in doing business (Rwagombwa 2019).

The financial performance of manufacturing in Rwanda is ineffective compared to other sectors (Balinda, 2016). The largest cement manufacturing company in the country, Cimerwa, made a net loss of Rwf 7.4 million in 2016, Rwf 5.5 million in 2017 and Rwf 7.1 million in 2018 (Mukasekuru, 2018). Besides, graphic printing solutions, a subsidiary of the crystal ventures ltd company, was shut down in 2015 due to loss-making (Behuria, 2018). The poor financial performance is worrying, given that the sector is expected to contribute to more than 20% of the total GDP by 2020 (Harelimana, 2017). However, investors are still not more concerned with investing in the manufacturing sector (Gakwerere & Bizimana, 2016). The poor financial performance of the manufacturing firms formed the basis of conducting the study.

1.2 Statement of the problem

The manufacturing sector in Rwanda is struggling compared to other industries such as agriculture, electricity, ICT, financial, wholesale, transportation (Rwagombwa 2019). The average return on investment in percentage since 2015 has fluctuated between 1.05% and 3.92%. In 2015, ROI was 3.92%, 2016 was 3.27%, 2017 was 2.40%, 2018 was 2.35% and in 2019 it went down to 1.05% (Sabiiti, 2019). The decrease in return on the investment shows that most investors are unwilling to venture into the manufacturing sector due to its poor returns. Among the four countries in East Africa (Kenya, Uganda and Tanzania), foreign direct investment has declined in Rwanda while increasing to other East Africa countries. This indicated that the sector is performing poorly; thus, a study needed to be conducted to examine the reasons. The reviewed empirical literature had mixed findings. Some studies revealed that foreign direct investment (intracompany loan) positively affects financial performance, while other studies showed a negative effect. The reviewed studies presented contextual, methodological gaps and conceptual gaps. For instance, Kariuki and Sang (2018) present a contextual gap because the research was conducted on banks while the current was conducted on manufacturing firms. Also, Antoine (2015) presented a contextual gap since commercial banks were the unit of analysis. Wamiori (2019) presented a methodological gap because it used primary data, while the current study used secondary data. Also, Harelimana (2017) used the questionnaire as a data collection instrument, while the current study used a secondary data collection template. Also, Harelimana (2017) presented a conceptual

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gap in assessing risk management, while the current research focused on intracompany loans. This formed the foundation for conducting the recent study.

1.3 Research Objective

The research objective of the study was to examine the effect of intracompany loan on financial performance of manufacturing firms in Rwanda.

1.4 Research Hypothesis

H_0: Intracompany loan has no effect on financial performance of manufacturing firms in Rwanda.

2.0 LITERATURE REVIEW

2.1 Theoretical Review

The study was informed by pecking order theory. The theory emphasizes that organizations prefer to finance internally through retained earnings rather than seeking any external funding (Frank & Goyal, 2003). In case of the external financing, debt financing is more preferred over equity. Equity financing should be used when all the other financing options are exhausted (Chen & Chen, 2011). The theory establishes the importance of utilizing internal funding because there is more information given than the case of equity. Organizations prefer financing from the retained earnings over debt. The equity holders expect their investment to attract a higher return rate, which makes equity more costly than debts (De Jong, Verbeek & Verwijmeren, 2011).

Relying on the internal sources makes the organizations more profitable and also the source of financing is less costly and readily available (Byoun & Rhim, 2005). Manufacturing firms in Rwanda need to use the most efficient financing options to maximize financial performance. Consequently, if the manufacturing firms have to use external funding, then the debt is most appropriate and equity to be used if all the other financing options are exhausted. Financing through equity brings the challenge of information asymmetry between the company and the shareholder that might negatively affect the organization's performance (Tong & Green, 2005).

2.2 Empirical Review

Aziz and Abbas (2019) analysed the effect of debt financing on the performance of firms in the non-financial sector of Pakistan. Secondary data was utilized by the researcher. The results of the survey indicated that debt financing had a negative impact on the performance of firms in the non-financial sector of Pakistan. The study recommended that companies rely more on internal financing because it is a cheap and reliable funding source. Another study was conducted by Antoine (2015) to examine the effect of loan management on performance. The study's findings established that effective management of the loans was positively related to the financial performance of the commercial banks in Rwanda. The study recommended that commercial banks in Rwanda improve the credit department's employees' training to enhance the suitable effective performance of loan management.

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Gakwerere and Bizimana (2016) examined the contribution of foreign direct investment to socio-economic development in Rwanda. A sample of 100 individuals was randomly drawn from the Gasabo district. The documentary technique was used to collect secondary data. Data was processed and analyzed using SPSS as a tool. The findings of the study revealed that foreign direct investment in the Gasabo district improved the region by introducing capital and technology, promoting competition, enhancing management skills, promoting exportation, and increasing employment opportunities. Prempeh and Asare (2016) examined the effect of debt on the manufacturing companies' performance in Ghana. The study revealed that debt has a negative effect on firms' performance.

Mounde (2017) explored the relationship between FDI and performance of firms in Nigeria. The indicators of foreign direct investments included reinvested funds, intracompany loans and foreign equity capital while performance was measured using the return on equity and net income. The data were analysed using descriptive and inferential statistics. The findings revealed that there is a positive relationship between reinvested funds, intracompany loans, foreign equity capital and performance of manufacturing firms. The study recommended that the Government in Nigeria put strategies to encourage foreign direct investment and the manufacturing firms' performance will improve significantly.

Mukasekuru (2018) found that loan capital is positively related to firm performance, as evidenced by the evolution of sales and net profits, financial ratios, and profitability ratios. The study recommended that firms be prompt in repaying loans borrowed to avoid penalties related to late repayment or the repayment running overdue, which affects their reputation and confidence in lending financial institutions. Besides, companies should identify other favourite sources of funding at lower interest rates than commercial banks to empower their development. The study presents a conceptual gap since it examined the effect of loan capital only on performance.

Wamiori (2019) assessed the determinants of financial performance on manufacturing firms in Kenya. The study mainly looked at the effect of access to finance, reinvesting the retained earnings and capital structure on financial performance. The target population was 714 manufacturing firms in Kenya. The simple random sampling procedure was used to select the sample to ensure every firm in the target population was represented. The study adopted a survey design. The study's findings indicated that factors that determine the manufacturing firms' performance in Kenya include access to finance, reinvesting of the retained earnings and capital structure. The study concluded a positive and significant relationship between access to finance, reinvesting of the retained earnings, capital structure and manufacturing firm's financial performance.

Rutto, Odhiambo, Obange and Enock (2019) examined the effect of reinvested funds, intracompany loans, and foreign equity capital on performance. The correlational study design was adopted. Panel data was sourced from secondary sources for twenty of Kenya's trading partners (EAC and COMESA). The study results revealed that reinvested funds and foreign equity capital had a positive effect on performance, while intracompany loans had a negative effect on performance. The study recommended that the Government should formulate policies that

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encourage foreign direct investments inflow that promotes the production of manufactured goods in Kenya for exports.

2.3 Conceptual framework.

A conceptual framework illustrates the relationship, between independent and dependent variables. Figure 1 depicts the conceptual framework that establish the relationship between intracompany loan and performance.

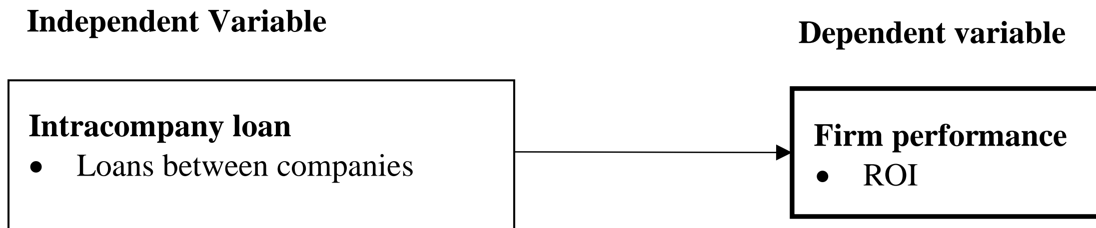

Figure 1: Conceptual Framework

3.0 RESEARCH METHODOLOGY

The study adopted the quantitative research design. There are four main types of quantitative research design, which include descriptive, correlational, explanatory and experimental research (Mohajan, 2018). In this study, the researcher used both descriptive and explanatory research design. The target population was 32 manufacturing firms. The study conducted a census. The data was collected from manufacturing financial statements and the World Bank database. Data was analysed using descriptive and inferential statistics

4.0 RESEARCH FINDINGS AND DISCUSION

The section entailed descriptive statistics, correlation analysis and regression analysis.4.1 Descriptive Statistics

Descriptive statistics are used to describe the basic features of the data in a study. They provide simple summaries about the sample and the measures. The descriptive statistics was presented inform of mean, standard deviation, minimum and maximum as shown in Table 1

Table 1: Descriptive Statistics

Variable	Observation	Mean	Std. Deviation	Minimum	Maximum
ROI (%)	160	2.22401	0.78762	1.05360	3.91960
Intracompany Loan (Rwf)	160	385000000	132000000	104000000	659000000

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Based on the results presented in Table 1, the minimum return on investment between 2015 and 2019 among the manufacturing firms in Rwanda was 1.05360, with a maximum of 3.91960. The mean score of ROI was 2.22401, with a standard deviation of 0.78762. This implied that the return on investment was dismal. A return on investment of below 5% implies that the company performs poorly (Astrella, 2017). These low returns on investments show that most investors are unwilling to venture into the manufacturing sector due to its low returns. The minimum intracompany loan in Rwandan franc between 2015 and 2019 was 104000000, with a maximum of 659000000. The mean score was 385000000, with a standard deviation of 132000000.

4.2 Correlation Analysis

The correlation analysis was done to examine the association between intracompany loan and return on investment (performance). The results of the correlation analysis are presented in Table 2.

Table 2: Correlation Analysis

	ROI	Intra company Loan
ROI	1.0000	
Intracompany Loan	0.5403	1.0000

The results depicted in Table 2 illustrates that a positive association exist between intracompany loan and return on investments. This implies that an intracompany loan is essential in determining financial performance. The correlation coefficient of 0.5403 implies that there is a strong association that exists between intracompany loans and financial performance. Therefore, the intracompany loan is critical in informing the financial performance. These results agree with Antoine's (2015) findings, who established that effective management of the loans is positively related to financial performance. Furthermore, Rutto, Odhiambo, Obange and Enock (2019) revealed that reinvested funds, foreign equity capital and intracompany loans positively affected performance.

4.2 Regression Analysis

The study sought to carry out panel regression analysis to establish the statistically significant relationship between the independent variable intra company loan and dependent variable, performance (return on investment). Table 3 presents the panel regression analysis.

Table 3: Panel Regression Analysis

ROI	Coef.	Std. Err.	t	P>t
Intra company loan	0.956415	0.291619	3.28	0.001
constant	-5.96005	2.497662	-2.39	0.017
R squared=	**0.2919**			

The model was; Y= -5.96005+ 0.956415X

The results presented in Table 3 show that the intracompany loan explained 29.19% of the variations in the return on investment. This was supported by the coefficient of determination, also known as R Square, which was 0.2919 (29.19%). The regression of coefficient shows that intracompany loans were positively and significantly related to return on investment (β=0.956415, p=0.001). This was supported by a calculated t-statistic of 3.28 that is larger than the critical t-statistic of 1.96. The hypothesis to be tested was;

Ho: Intracompany loan has no effect on the financial performance of manufacturing firms in Rwanda. The hypothesis was determined by using the p-value. Based on the results presented in Table 3 the p-value was 0.001. Thus, the null hypothesis was rejected. Therefore, the intracompany loan has an effect on the financial performance of manufacturing firms in Rwanda.

The results concur with the findings of Mounde (2017) who revealed that a positive relationship exist between reinvested funds, intracompany loans, foreign equity capital, and manufacturing firms' performance. Further, Mukasekuru (2018) found that loan capital is positively related to firm performance, as evidenced by the evolution of sales and net profits, financial ratios and profitability ratios. Besides, Antoine (2015) established that effective management of the loans is positively related to Rwanda's commercial banks' financial performance. Besides, Ocaya, Ruranga, Kaberuka (2015) revealed that foreign direct investment improved the manufacturing firms' financial performance in Rwanda. Moreover, Rutto, Odhiambo, Obange and Enock (2019) unveiled that reinvested funds, foreign equity capital and intracompany loans had a positive effect on performance.

5.0 CONCLUSION

The study concluded that a positive association existed between intracompany loans and financial performance (return on investment). Furthermore, it is concluded that a positive and significant relationship existed between intracompany loans and financial performance (return on investment). The intracompany loans entail money borrowed by a subsidiary from the parent company. The intracompany loan is essential and enables a subsidiary company to bounce back to operations during a crisis. The intracompany loan facilitates easy cash movement to those subsidiary companies that would otherwise experience a financial crisis.

6.0 RECCOMENDATION

The study recommended that intracompany loans need to be increased between a subsidiary and parent company. Based on the regression of coefficients, it was established that when intracompany loan increases by one unit, the financial performance, measured in return on investment, will increase by 0.956415 units. The terms and conditions of payment of a given loan between a subsidiary and parent company need to be made more friendly and promising than a loan taken from other lenders. It is also recommended that the intracompany loan to be facilitated and approved faster to those subsidiary companies that would otherwise experience a financial crisis.

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