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-RESEARCH ARTICLE-

CAPITAL STRUCTURE AND PROFITABILITY OF FOOD PRODUCER COMPANIES IN SOUTH AFRICA

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─Abstract─

This study examined the consumer products sector over eleven years (2011–2021), focusing on ten food production firms listed on the Johannesburg Stock Exchange, selected from a total of eleven companies. Financial data extracted from these firms' statements were analysed using the random effects model. The findings revealed that non-current liabilities (coefficient = 6.785681, p = 0.029801) and retained earnings (coefficient = 3.556491, p = 0.001701) had a positive and significant effect on return on equity. Additionally, equity capital was found to negatively influence firm performance, while retained earnings, current liabilities, and non-current liabilities contributed positively to profitability. The study concluded that retained earnings and liabilities are crucial sources of financing that enhance profitability in South African food production firms. It recommends that firms avoid relying heavily on equity capital unless measures are taken to offset its negative impact.

Keywords: Capital Structure, Profitability, South African Food Producer Companies

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INTRODUCTION

The capital structure is composed of equity capital, current liabilities, non-current liabilities, and retained earnings (earned surplus). For food production companies, access to sufficient financial resources is essential for sustaining operational activities, and such resources must be deployed effectively to avoid adverse consequences. Typically, the financial instruments utilised to support various enterprises include equity capital, retained earnings, and both current and non-current liabilities. The selection of appropriate financing options has the potential to enhance a firm's profitability; however, improper use of these sources may expose the company to financial setbacks. Employing a combination of funding sources to meet operational needs can assist in reducing the overall cost of capital, improving net returns, and ultimately strengthening profitability (Myers, 2003). Although reliance on a single source of finance might temporarily increase profitability, an overdependence on non-current liabilities, such as long-term borrowings, could introduce significant financial risks. Similarly, an excessive focus on equity financing may elevate the cost of capital, undermining financial efficiency (Muigai, 2016).

Although relying on a single form of capital may temporarily enhance a company's profitability, such an approach can become unsustainable, particularly when dependent solely on non-current liabilities. Exclusive use of borrowed funds exposes firms to considerable financial risks, while excessive dependence on equity capital may substantially increase the cost of financing (Baxter, 1967). Therefore, it is imperative for corporate finance managers to adopt an optimal combination of capital sources to fund operations and maximise profitability (Damodaran, 2014). Firms that maintain adequate profit reserves are generally in a stronger position to allocate additional funds towards strategic initiatives that promote growth and operational efficiency compared to companies with limited financial resources (Pistor, 2013).

Furthermore, the scarcity of long-term financing options has led to a situation where much of the overall debt burden is borne by small enterprises globally (Karadag, 2015). Non-current liabilities represent a prevalent external financing mechanism employed by medium-sized firms across different regions (Katti & Phani, 2016). Such liabilities serve as critical instruments for bridging funding gaps, particularly when internal cash flows are insufficient to sustain operations (Padachi et al., 2012). Profitability reflects the extent to which an organisation effectively utilises its financial resources to generate income. It constitutes a fundamental objective that every enterprise strives to achieve. Assessing profitability also enables comparisons among firms, providing valuable insights into relative performance (Narkunienė & Ulbinaitė, 2018). Profitability is commonly assessed through various indicators such as turnover growth, enhanced asset utilisation, revenue expansion, strong liquidity positions, and improvements in share value. Conversely, low profitability is often associated with excessive expenditures,

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weak profit margins, poor liquidity, sustained operational difficulties, and a lack of notable innovations (Narkunienė & Ulbinaitė, 2018). Among the numerous profitability measures, return on equity remains one of the most widely adopted indicators, having been utilised extensively by scholars to evaluate corporate profitability across different global contexts (Ameer & Othman, 2012).

Debate continues among academics regarding the most effective capital structure for enhancing firm profitability (Abor, 2005). In addition, growing attention has been given in recent literature to the identification of optimal capital structures that can maximise both value and profitability specifically within South African food production firms (Olarewaju & Msomi, 2021). These companies require adequate and strategic investment to advance their growth and profitability potential. Nevertheless, limited attention has been paid to determining the most effective combination of funding sources to finance their operations. Previous studies and existing literature have explored a range of potential capital sources deemed to be effective; however, some of these options remain underexplored in the context of food production, signalling a need for further scholarly inquiry (Fafchamps, 2003; Makhaye, 2021). Traditionally, analyses have focused predominantly on indicators such as financial leverage, capital inflows through equity and debt, and debt financing when assessing profitability.

In contrast, this study adopts a broader conceptualisation of capital structure by examining the impact of equity capital, retained earnings, current liabilities, and non-current liabilities on the profitability of listed food production firms in South Africa. This approach helps to address a significant gap in the literature, as most prior research has concentrated on other sectors such as agriculture, energy, banking and finance, small and medium enterprises (SMEs), higher education, healthcare, and manufacturing, leaving the food production sector relatively under-researched. Furthermore, a review of related studies revealed that few have simultaneously incorporated explanatory variables such as retained earnings, current liabilities, non-current liabilities, and equity capital within a unified analytical framework. Another notable limitation in existing research is the exclusion of the time period from 2011 to 2021, which this study uniquely covers. Therefore, this research responds to these gaps by focusing specifically on listed food production firms, considering equity capital, current and non-current liabilities, along with retained earnings, to examine their influence on profitability over an extended period. By employing robust data forecasting techniques and methodological approaches, this study aims to produce more accurate and reliable findings that contribute to strengthening the research objectives and enhancing understanding in this domain.

The central objective of this study is to examine the influence of capital structure on the profitability of food production companies listed in South Africa. In particular, the research seeks to investigate the following:

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1. To assess the effect of equity capital on the profitability of publicly listed food production companies in South Africa.
2. To evaluate the influence of short-term liabilities on the profitability of publicly listed food production firms in South Africa.
3. To analyse the impact of long-term liabilities on the profitability of publicly listed food production companies in South Africa.
4. To examine the relationship between retained earnings and the profitability of publicly listed food production firms in South Africa.
5. To investigate the effect of retained earnings on the profitability of publicly traded food production companies in South Africa.

LITERATURE REVIEW

Corporate financing involves the utilisation of equity and debt capital to support a firm's operational activities. The fundamental purpose of such financing is to mobilise a balanced mix of funds necessary for sustaining and expanding businesses (Shames & Scherr, 2020). This process entails the strategic combination of various financial sources, including retained earnings, equity capital, short-term and long-term liabilities, and earned surplus, to facilitate a company's operations (Nyakundi, 2003). The financing structure adopted by companies represents a critical component of broader corporate financial decisions, particularly those relating to capital investments in organised enterprises (Mayer, 1990).

Earned surplus represents an essential form of internal financing, reflecting the portion of profits allocated for reinvestment into the business (Bender, 2013). It signifies the earnings retained within the firm to finance its activities, and it is recognised as one of the primary sources of internal capital, often referred to as reserved profits (Calabrese, 2012). As noted by Rascolean and Rakos (2015) Rascolean and Rakos (2015), earned surplus constitutes internally generated financial streams, typically classified under non-current liabilities for company operations. Furthermore, Chung et al. (2005) regard earned surplus as the most significant internal funding mechanism available to a firm. Equity capital, likewise, plays a crucial role in determining corporate profitability. It consists of funds raised through the issuance of various equity instruments to existing or potential investors (Lerner & Leamon, 2023). This form of capital includes resources obtained via the sale of ordinary and preference shares, as well as other external equity channels (Myers, 2003). Equity capital represents the aggregate value of funds accumulated through public or private offerings of shares and other forms of ownership stakes (Myers, 2000).

Evaluating the influence of current liabilities on firm profitability is equally essential. Current liabilities refer to obligations that must be repaid to creditors within a fiscal year (Arnold et al., 2020). Short-term borrowing enables firms to meet immediate

financial obligations without resorting to long-term debt instruments (Nyakundi, 2003). Furthermore, such short-term liabilities typically carry lower interest rates, as creditors often impose minimal interest costs when repayment schedules are honoured (Bratton, 2006). Non-current liabilities, on the other hand, are long-term debt instruments obliging firms to make periodic repayments of principal and interest (Mustafina et al., 2020). Notably, interest on debentures is tax-deductible because corporate taxes are levied on profits after deducting interest payments (Lawlor, 1978). Tax savings thus refer to reductions in corporate tax liabilities through allowable deductions such as interest expenses (Poterba et al., 1987). Additionally, preference shares represent a form of equity that guarantees fixed dividend payments to holders and takes precedence over ordinary shares concerning profit distribution (Mtshali, 2016). As Gebhardt (2012) and (Michaelson, 1952) further emphasise, non-current liabilities, including debentures, are critical financing instruments requiring regular interest and principal payments, with the added benefit of tax-deductible interest, contributing to overall corporate tax savings (Poterba et al., 1987).

Profitability reflects the extent to which a company effectively utilises its resources in daily operations to generate income (Davila et al., 2012). It serves as a critical indicator of a firm's financial health over a defined accounting period (Kristýna, 2018). As an essential measure of organisational success, profitability must be evaluated accurately using recognised and appropriate criteria (Fan et al., 2012). Fundamentally, profitability signifies a company's capacity to achieve its financial and operational objectives (Bandono & Nugroho, 2023). Through profitability analysis, organisations can assess their financial condition and overall performance (Carton & Hofer, 2006). One of the common measures of profitability is return on equity, calculated by dividing the net income, after deducting taxes and interest, by shareholders' equity. The theoretical foundation of this research is based on Tirole's Theory of Corporate Finance (Tirole, 2006), one of the fundamental theories addressing the relationship between financing strategies and corporate profitability. According to this theory, corporate finance involves acquiring funds from diverse sources to support a firm's operations (Tirole, 2006). Tirole argues that excessive reliance on debt financing can significantly increase a firm's liabilities and expose it to recurring debt obligations, which must be consistently serviced. Therefore, it is crucial for corporate managers to adopt prudent financing decisions that align with the overarching goal of enhancing profitability (Tirole, 2006). The theory further emphasises that firms should carefully evaluate their financing approaches to ensure that capital is not raised solely through cash flows, while also managing liabilities and assets efficiently to avoid any misalignment (Tirole, 2006).

Moreover, the theory focuses on achieving optimal outcomes through appropriate financing strategies and effective allocation of assets (Jensen, 2010). It suggests that attaining higher profitability requires the strategic use of financial resources. Hence, efficient capital mobilisation and sound investment decisions are vital for achieving a

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firm's objectives of profitability and sustainability (Abeywardhana & Magoro, 2017). The core principle of this theory advocates for the selection of an appropriate mix of funding sources to improve profitability, which corresponds with the focus of this study. A trend was observed among listed companies in Sri Lanka, where current liabilities exert a detrimental effect on profitability, whereas non-current liabilities have a favourable impact. Based on these results, the study recommended that retail and wholesale firms in South Africa should adopt more efficient use of equity capital and retained earnings to mitigate potential conflicts of interest between managers and investors and reduce dependence on external lenders. In the Sri Lankan context, it was suggested that owners and managers of retail businesses should consider reducing reliance on current liabilities, given their negative impact on profitability, and instead increase the use of non-current liabilities, which have demonstrated a positive contribution to profitability.

These four hull hypotheses guide this research:

1. Equity capital does not impact the profits of listed food producer companies in SA.
2. Current liabilities do not impact the profits of listed food producer companies in SA.
3. Non-current liabilities have no impact on the profits of listed food producer companies in SA, and
4. Earned surplus does not impact the profits of listed food producer companies in SA.

METHODS

The research utilised secondary data derived from the annual financial statements and reports of food production companies listed on the JSE in South Africa. The use of this data source is justified, as it is publicly accessible and facilitates the analysis of the research variables without the need for primary data collection (White et al., 2002). The study population consisted of twenty food production firms listed on the JSE.

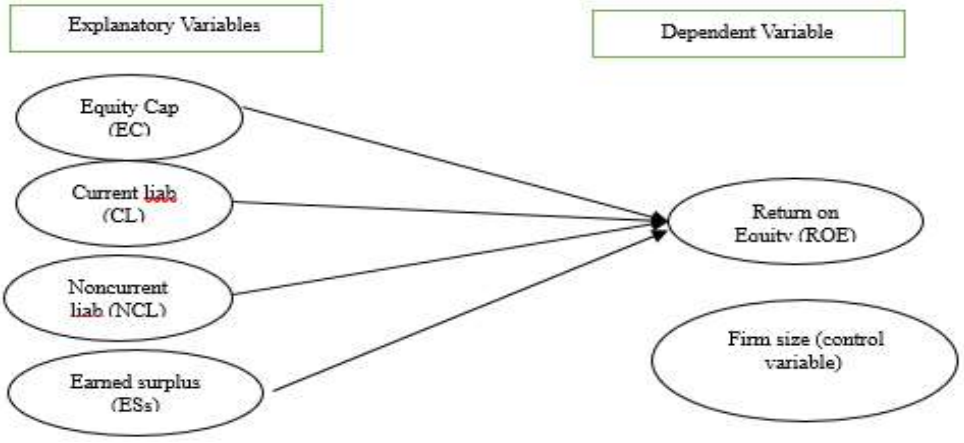

Figure 1: Conceptual Model

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The model outlined above identifies the independent variables of current liabilities, equity capital, non-current liabilities, and earned surplus as proxies for company financing methods. The dependent variable, return on equity (ROE), serves as a measure of profitability, while firm size is incorporated as a control variable. This research adopts the approach of Olowe (2008), who examined the effect of capital structure on the profitability of selected publicly listed companies in Nigeria. Here is the model:

$$ROE_{i,t} = f(NL_{i,t}, NCL_{i,t}, DE_{i,t}, FS_{i,t},) \ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots (1)$$

The modified equation is provided below:

$$ROE_{i,t} = f(EC_{i,t}, CL_{i,t}, NCL_{i,t},, ES_{i,t}, FS_{i,t},) \ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots (2)$$

Where:

$ROE_{I,t}$ = Return on equity of the mentioned companies I in year t;
$CL_{i,t}$ = Ratio of current liabilities to the total assets of the mentioned companies i in year t;
$NCL_{i,t}$ = Ratio of non-current liabilities to the total assets of the companies cited I in year t as a control variable;
$EC_{i,t}$ = Ratio of current liabilities to the total assets of the companies cited i in year t;
$RE_{i,t}$) = Ratio of current liabilities to the total assets of the companies cited i in year t;
$FS_{i,t}$ = Companies; size i in year t;

RESULTS

The results of the pooled ordinary least squares (POLS) analysis are presented in Table 1 above. The R-squared value reveals that the combined influence of current liabilities (CL), equity capital (EC), non-current liabilities (NCL), earned surplus (ESs), debt-equity ratio (DE), and firm size (FS) explains 0.8061041 (81%) of the variance in return on equity (ROE).

Table 1: Pooled Ordinary Least Square Estimation Result SERIES: ROE, EC, CL, NCL, ES, DE, FS

Variables	Coefficient	Std. Error	T-Statistic	Probability
Constant	-1.770772	4.450522	-0.39790	0.69154
EC	-1.862621	7.209481	-0.25842	0.79661
NL	5.086621	3.617142	1.40604	0.00070
NCL	6.785681	3.123804	2.17203	0.03212
DE	3.9920913	3.556493	1.12201	0.00431
FS	-0.735664	0.263371	-2.79304	0.00624

R-Squared Adjusted: 0.8061041
R-Squared: 0.7948091
Significance Level: 5%

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The remaining 19% is attributed to additional variables captured within the error term. The adjusted R-squared value of 0.7948091 for ROE indicates that the inclusion of various control variables, influenced by the stochastic component of the model, accounts for approximately 80% of the variance in enterprise profitability. This suggests that the examined variables collectively exert a significant influence on firm profitability. The coefficient for EC is negative (-1.862621) and statistically insignificant ($p = 0.79661 > 0.05$), indicating that this variable has a detrimental yet non-significant effect on ROE. Conversely, the beta coefficient for CL is positive (5.086621) and statistically significant ($p = 0.00071 < 0.05$), demonstrating a positively significant impact on ROE. Similarly, NCL exhibits a positive beta coefficient (6.785681) and is statistically significant ($p = 0.0321 < 0.05$), reflecting its positive influence on ROE. Additionally, the coefficient for ESs is positive (3.992091) and statistically significant ($p = 0.00431 < 0.05$), signifying its favourable effect on ROE.

Table 2 presents the R-squared statistic, which reveals that the independent variables collectively explain approximately 81% ($R^2 = 0.8061$) of the variation in Return on Equity (ROE), while the remaining 19% is attributed to factors represented by the error term. The coefficient for equity capital is negative (-1.8626) and statistically significant ($p = 0.0056 < 0.05$), indicating a significant negative effect on ROE. In contrast, current liabilities exhibit a positive coefficient (5.0866) and are statistically significant ($p = 0.0024 < 0.05$), suggesting a significant positive influence on ROE. Similarly, non-current liabilities have a positive coefficient (6.7857) and are statistically significant ($p = 0.0407 < 0.05$), confirming their positive impact on ROE.

Table 2: Fixed Effect Estimation Outcome (Cross-Sectional Period-Specific) Series: ROE, EC, CL, NCL, ES, DE, FS.

Variables	Coefficient	Std. Error	T-Statistic	Probability
Constant	-1.770773	4.658711	-0.38012	0.70472
EC	-1.862621	7.546734	-0.24684	0.00561
NL	5.086621	3.786341	1.34300	0.00241
NCL	6.785681	3.269920	2.07501	0.04071
DE	3.992091	3.722853	1.07203	0.00631
FS	-0.735662	0.275692	-2.66802	0.00903

R-Squared: 0.8061041
Significance Level: 5%

Table 3 provides the findings from the random effects model. The R-squared value reveals explanatory variables that account for 0.8061041(81%) of the variation in ROE, with the remaining 19 percent described by other information included in the error term. The adjusted R-squared value of 0.775163 indicates after adjusting for various influencing factors, earned surplus (ES), current liabilities (CL), equity capital (EC), non-current liabilities (NCL), the debt-equity ratio (DE), and firm size (FS) contribute

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to 78% rise in profitability. This suggests that the variables in this study have had a notable global impact on corporate profitability.

Table 3: Random Effect Estimation Outcome (Cross-Sectional Period-Specific) Series: ROE, EC, CL, NCL, ES, DE, FS.

Variables	Coefficient	Std. Error	T-Statistic	Probability
Constant	-1.770772	4.450524	-0.39791	0.69073
EC	-1.862621	7.209480	-0.25840	0.79611
NL	5.086621	3.617142	1.40603	0.05161
NCL	6.785681	3.123803	2.17204	0.02981
DE	3.992091	3.556491	1.12202	0.00171
FS	-0.735664	0.263374	-2.79301	0.00522

R-Squared	0.8061041
Adjusted R-Squared	0.7751632
F-Stat	26.053070
P (F-Stat)	0.0000000
Durbin-Watson	1.9292783
Post Data Analysis Tests	
P-Value	0.0003451
Lagrange Multiplier Test	1.000
P-Value	5.5001
Hausman Test	0.0191
Chi-Square Stat	
P-Value	0.0000
Ward Test for Hetero	1.0001
Chi-Square	
P-Value	0.00031
Wooldridge Test	
T-Statistical	7.863561
P-Value	2.51201

Significance Level: 5%

The F-statistics is 26.05307, reflect a probability value of 0.000000, substantiating that the model possesses statistical validity and does not exhibit a noteworthy linear correlation between the explanatory variables and the ROE. The model, data analysis techniques and probability values are sufficient and reliable in explaining ROE results. The coefficient for equity capital (EC) is negative (-1.862621) and statistically insignificant (p = 0.79611), revealing this factor has little to no effect on ROE. However, current liabilities (CL) have a positive coefficient (5.086621) and are statistically significant (p = 0.05161), indicating a beneficial impact on ROE. Non-current liabilities (NCL) also show a positive (6.785681) and statistically significant (p = 0.02981) effect, supporting a positive influence on ROE. Earned surplus (ES) has a positive coefficient (3.992091) and is statistically significant (p = 0.00171), reflecting a favorable impact

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on ROE. The Durbin-Watson statistic of 2 suggests no autocorrelation in the error terms and variables.

Post-estimation analysis reveals that the F-tests comparing the POLS and fixed effects models result in a value of 0.0003451 with a probability of 1.000, supporting the null hypothesis that the POLS model is inadequate for South African listed food producer companies (LFPCs) in favor of the fixed effects model. The Lagrange multiplier test comparing POLS and random effects produces a value of 5.5001 with a probability of 0.0191, rejecting the null hypothesis and validating the random effects model as a better alternative. Further verification through the Hausman test comparing fixed and random effects models results in a chi-square statistic of 0.000 and a probability of 1.0001, exceeding the 0.05 threshold, which supports the random effects model as the most appropriate method. Additional post-estimation assessments, including the Ward test (chi-square value of 0.00031 and probability of 1.0001), confirm no heteroscedasticity. In contrast, the Wooldridge t-statistic of 7.863561 with a probability of 2.51201 indicates no autocorrelation.

DISCUSSION

The analysis identified a negative relationship between equity capital and corporate profitability. Specifically, a one-unit increase in equity capital is associated with a 186% decline in profitability. This finding suggests that publicly listed food production firms in South Africa should minimise their reliance on equity capital for operational financing to avoid potential reductions in profitability. This insight may explain why, as evidenced by the descriptive statistics, only 1% of the total assets of these companies are financed through equity. Accordingly, any further increase in equity-based financing is likely to diminish profitability. Thus, the null hypothesis of no significant link between equity capital and profitability is rejected. Current liabilities positively impact profitability, with a unit rise linked to a 508% increase. These results align with Mashal et al. (2021), who found a positive relation between current liabilities and profitability.

In addition, the analysis establishes that non-current liabilities have a positive and statistically significant effect on profitability among publicly listed food production companies in South Africa. Specifically, an increase in non-current liabilities enhances profitability by approximately 679%. This result aligns with the conclusions of Mashal et al. (2021), who also reported the beneficial role of non-current liabilities in improving organisational profitability. Finally, the study confirms that retained earnings contribute positively to profitability. The findings suggest that a unit increase in retained earnings leads to a 356% improvement in profitability, underscoring the role of retained earnings as a critical internal financing mechanism. These results corroborate the findings of Bassey and Tapang (2012), who affirmed that retained earnings significantly

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and positively influence profitability, serving as a reliable and accessible source of internal capital to support future revenue growth.

CONCLUSION

The study reveals that earned surplus, current liabilities, and non-current liabilities positively influence the profitability of South African food production companies. In contrast, equity capital has a negative impact. This finding is significant, as companies' inability to raise additional equity may compel them to adjust their leverage ratios, potentially elevating financial risk. The results suggest that financing operations through equity issuance adversely affects profitability. The F-statistics confirm the statistical significance of the research variables, the appropriateness of the analytical models, and the importance of probability values in explaining ROE outcomes. Supplementary tests, such as the Wooldridge and Durbin-Watson tests, found no evidence of autocorrelation, while the Ramsey RESET test validated the model's suitability. The study highlights that earned surplus, current liabilities, and non-current liabilities are essential for financing profitable enterprises. In light of these findings, it is recommended that the South African government develop new industrial strategies or revive existing ones to rejuvenate defunct local companies, particularly those in the food production sector, rather than imposing annual corporate tax increases. Additionally, companies should avoid relying on equity capital to fund operations unless corrective measures are taken to mitigate the adverse effects of non-current liabilities on profitability. The research contributes to the existing body of knowledge by identifying retained profits, current liabilities, and non-current liabilities as viable capital sources for enhancing the profitability of South African food production companies. The research utilises data from 2011 to 2021, suggesting that future studies could extend this analysis to other African countries, incorporating comparable variables and expanding the timeframe to include data up to 2023.

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