THE EFFECT OF FINANCIAL LEVERAGE ON THE FINANCIAL PERFORMANCE OF QUOTED INDUSTRIAL GOODS FIRMS IN NIGERIA.

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ABSTRACT

This study sought to ascertain whether variations in financial leverage significantly affect financial performance of quoted industrial goods firms in Nigeria. The specific objectives of the study are: i. to determine the effects of debt-to-equity ratio on stock returns of quoted industrial goods firms in Nigeria. ii. to assess the effect of long-term debt ratio on stock returns of quoted industrial goods firms in Nigeria. In line with the above objectives, the following null hypotheses were formulated. Ho1: There is no significant effect of debt-to-equity ratio on financial performance proxy by stock returns of quoted industrial goods firms in Nigeria. Ho2: There is no significant effect of long term debt ratio on financial performance proxy by stock returns of quoted industrial goods firms in Nigeria. The study analyzed data from financial statement of 14 (fourteen) quoted industrial goods firms in Nigeria covering the period 2010-2022. The following findings were made: i. The is a significant but negative relationship between debt-to- equity ratio and cash value added of quoted industrial goods firms in Nigeria at 5% level of significance. ii. The is a significant but negative relationship between long-term debt ratio and cash value added of industrial goods firms in Nigeria at 5% level of significance. The following recommendations were made: i. In an attempt to reverse the negative relationship between debt –to- equity ratio and cash value added, firms need to look more closely at the company's ability to pay its debts obligations by managing the use of assets and cash flows to reduce the firms risk of loss from not paying a liability on time.. ii. In order to reverse the negative relationship between Long term debt ratio and cash value added, industrial goods firms should employ financing mix that can improve their earning per share, market capitalization and enhance the value of the firm for the benefit of the shareholders.

Key Terms: Financial leverage, Financial performance, Debt/Equity ratio, Stock returns.

INTRODUCTION

Financing decision plays a significant role in sustaining the profitability and growth of firms. The primary objective of every rational investor, be it an institutional investor or individual investor, is to maximize expected returns on their investments within an acceptable level of risk. Thus, they prefer to invest their funds in shares of companies with increasing prices that will eventually boost their

wealth in the stock market. Most investors prefer persistent increase in the value of their shares in the stock market in order to earn more return on their investments and maximize their wealth. Financial leverage is a measure of how much a firm uses equity and debt to finance its assets. As debt increases, financial leverage increases. (Will, 2021).

Financial leverage is the degree to which Companies employ debt in their capital structure. Increase in the use of debt in a firm's capital structure increases the risk of financial distress and probability of bankruptcy which may arise as a result of default. There are certain benefits and costs associated with usage of debt financing. Companies can take advantage of tax shields benefits of debt by employing debt in their capital structure. Interest on debt is tax deductible and the use of debt in a firm's capital structure, unlike equity, does not lead to dilution of ownership. However, they are certain costs associated with debt financing vis-à-vis fixed interest payments, cost of financial distress and bankruptcy costs arising from inability of Companies to meet up with their debt obligations as at when due. Companies are therefore, expected to trade-off the benefits of debts against its costs in order to improve financial performance (Abubakar & Garba 2019).

The effect of financial leverage on firm performance has been a controversial issue in corporate finance literature since the seminal work of Modigliani and Miller in 1958 which asserted irrelevance of debt-to- equity ratio for firm value. However, since they considered the assumptions of perfect markets, with no taxes, absence of transaction and bankruptcy costs, the theory about the debt irrelevance became unrealistic. Later, Modigliani and Miller (1963) relaxed a no-tax assumption and developed a theory about tax benefits of debt. That paper gave rise to a serious academic discussion on the theory of financial leverage (Adam, 2021; Will, 2021).

Technically, financial leverage represents the percentage change in earning after tax (EAT) divided by percentage change in earnings before interest and tax (EBIT. A firm can be either highly geared (having more debt than equity in its capital structure) or lowly geared (having more equity than debt in its capital structure). Companies with higher leverage are mostly inclined to improve their performance. However, higher leverage usually leads to higher agency costs because of the diverging interests between shareholders and debt holders. Thus, leverage may negatively affect performance. Furthermore, having debt in a firm's capital structure is beneficial to a firm; this is because a firm with debt in its capital structure enjoys tax savings as interest is paid before tax is deducted from the firm's income. Financial experts also state that financial leverage is a financial tool that is widely used to improve a firm's rate of return and its performance. (Ogbodo, Amahalu & Abiahu, 2017; Adam, 2021).).

However, financial leverage irrespective, of its benefit to a firm, also creates financial risk such as

risk to the company; if a highly geared firm is unable to make sufficient EBIT, such firm might go into liquidation as it may not be able to meet its interest obligations and also finance other expenses of the firm. The capital structure choice is a noteworthy managerial decision which impacts the risk and return of the shareholders. Financial leverage can be seen as the application money borrowed. It is concerned with using money generated on a fixed cost with a view to enhancing the shareholder's return. (Amahalu & Obi, 2020).

Financial leverage is the extent to which fixed income securities (debt) are used in a firm's capital structure. There is therefore a need to continually ascertain whether variations in capital structure or leverage are significantly associated with variations in stock returns. Companies should apply the best financing sources to arrive at the optimal capital structure so that they can make suitable financing decision that would enable them achieve positive returns. In order to take timely decision, accurate information and proper analysis of the sector is necessary. It is therefore on this basis, that this study sought to investigate the relationship between financial leverage and financial performance of quoted industrial goods firms in Nigeria.

Objectives of the Study

The main objective of the study was to ascertain the effect of financial leverage on financial performance of quoted industrial goods firms in Nigeria. The specific objectives include:

i.   To determine the effects of debt-to-equity ratio on stock returns of quoted industrial goods firms in Nigeria.

ii.   To assess the effect of long-term debt ratio on stock returns of quoted industrial goods firms in Nigeria.

Research Hypotheses

Ho1: There is no significant effect of debt-to-equity ratio on stock returns of quoted industrial goods firms in Nigeria.

Ho2: There is no significant effect long term debt ratio on stock returns of quoted industrial goods firms in Nigeria.

Conceptual framework.

Financial Leverage

Financial leverage is the use of borrowed money (debt) to finance the purchase of assets with the expectation that the income or capital gain from the new asset will exceed the cost of borrowing Leverage is an investment strategy of using borrowed money, specifically, the use of various financial instruments or borrowed capital to increase the potential return of an investment. Leverage can also refer to the amount of debt a firm uses to finance assets. Leverage results from using

borrowed capital as a funding source when investing to expand the firm's asset base and generate returns on risk capital (James, 2021).

Financial leverage which is also known as leverage or trading on equity refers to the use of debt to acquire additional assets. Financial leverage; is the use of debt to buy more assets. Leverage is employed to increase the return on equity. However, an excessive amount of financial leverage increases the risk of failure, since it becomes more difficult to repay debt (Will, 2021; Kenton, 2021).

Debt-to-Equity Ratio

The debt-to-equity ratio is a financial ratio indicating the relative proportion of shareholders' equity and debt used to finance a company's assets (Manglik, 2020). The debt to equity ratio is a leverage ratio that calculates the weight of total debt and financial liabilities against total shareholders' equity (Rohit, 2020). The debt to equity ratio is a financial liquidity ratio that compares a company's total debt to total equity. The debt to equity ratio shows the percentage of company financing that comes from creditors and investors. A higher debt to equity ratio indicates that more creditor financing (bank loans) is used than investor financing (shareholders). And vice versa.

Financial Performance

Financial performance is a subjective measure of how well a firm can use assets from its primary mode of business and generate revenues. It is also used as a general measure of a firm's overall financial health over a given period (Eshna, 2021). Financial performance is a complete evaluation of a company's overall standing in categories such as assets, liabilities, equity, expenses, revenue, and overall profitability. It is measured through various business-related formulas that allow users to calculate exact details regarding a company's potential effectiveness (Verma, 2021). Financial performance refers to the degree to which financial objectives have been accomplished. It is the process of measuring the results of a firm's policies and operations in monetary terms. It is used to measure a firm's overall financial health over a given period of time and can also be used to compare similar firms across the same industry or to compare industries or sectors in aggregation (Kenton, 2021). There are many stakeholders in a company, including trade creditors, bondholders, investors, employees, and management. Each group has its own interest in tracking the financial performance of a company. The financial performance identifies how well a company generates revenues and manages its assets, liabilities, and the financial interests of its stake-holders and stockholders (Will, 2021). There are many ways to measure financial performance, but all measures should be taken in aggregate. Line items, such as revenue from operations, operating income, or cash flow from operations can be used, as well as total unit sales. Furthermore, the analyst or investor may wish to

look deeper into financial statements and seek out margin growth rates or any declining debt (Scott, 2021).

Theoretical Framework

Perking Order Theory

This theory which this study is anchored on was propounded by Stewart C. Myers in (1984). It states that companies prioritize their sources of financing according to the law of least effort or least resistance, preferring to risk equity as a financing means of last resort. Hence, internal funds are used first and when it is depleted, debt is issued and when it is not sensible to issue any more debt, equity is used. The theory maintains that companies adhere to hierarchy of financial sources and should prefer internal financing when equity is available and debt is preferred over equity if external financing is required (Oye 2014). The Perking Order Theory is based on the fact that managers have more information about their companies then investors. The disparity of information is known as asymmetric information. Because of this disparity, managers will issue debt when they are positive about their firm's future prospect and will issue equity when they are not sure. A commitment to pay fix amount of interest and principal to debt holders means that the company expects steady cash flow. On the other hand, equity issue would mean that the current stock returns are overvalued.

Empirical Review

Hasan, Ahsan, Rahaman and Alam (2014) studied the influence of capital structure on performance of 36 Bangladeshi firms listed on the Dhaka Stock Exchange from the period 2007 to 2012. The study which excludes financial services firms owing to their different capital structures and operations uses four performance measures; earnings per share (EPS), return on equity (ROE), return on assets (ROA) and Tobin's Q as measures of firm performance and three capital structure ratios; short-term debt, long-term debt and total debt as independent variables. Using panel data regression method, the authors find that whereas EPS is significantly positively related to short-term debt, same is also significantly negatively related to long-term debt. The results also reveal a significant negative influence of capital structure on ROA. However, the results did not provide evidence of a significant influence of capital structure on firm performance as measured by ROE and Tobin's Q. Thus, the study concludes that capital structure has negative impact on firm performance, a finding that is consistent with the pecking order hypothesis. The findings from the above empirical studies are inconclusive.

Adesina, Nwidobie and Adesina (2015) examine the impact of post-consolidation capital structure on the financial performance of 10 Nigerian banks for the period 2005 through 2012. The study which employed profit before tax as a dependent variable, equity and debt as independent variables

and Ordinary Least Squares as a regression technique shows that capital structure has a significant positive relationship with the profitability of Nigerian quoted banks. The authors suggest among others the use of debt and equity capital in financing Nigerian banks to improve earnings.

Taiwo & Adewale (2015), "examined the optimum level of capital structure through which a firm can increase its financial performance using annual data of ten firms spanning a five year period. The results in, Pesaran & Shine unit root test shows that all the variables where non stationary at level. The study hypothesized negative relationship between capital structure and operational firm performance. However, the results from Panel Least Square (PLS) confirmed that asset turn over, size, firm's age and firm's asset tangibility are positively related to firm's performance. Findings provide evidence of a negative and significant relationship between asset tangibility are positively and ROA as a measure of performance in the model. The implication of this is that sampled firms were not able to utilize the fixed asset composition of their total assets judiciously to impact positively on their firm's performance. Hence, the study recommends that assets tangibility should be a driven factor to capital structure because firm's with more tangible assets are less likely to be financially constrained."

Onyenwe & Glory (2017), in their study on effect of financial leverage on firm's performance of Nigerian banks, studied thirteen deposit-money banks listed on the Nigerian Stock Exchange over the period of ten years from 2006 to 2015. Findings from the empirical study revealed that financial leverage had positive effect on the profitability and efficiency of the firms, while there was no significant effect of financial leverage on the liquidity, size and market capitalization value of the firm; the overall finding indicated that financial leverage has effects on the financial performance of the selected firms, with focus on the profitability of the firms.

Contrary to several other empirical studies that found positive relationships between financial leverage and firm performance, (Hamouri, Al-Rdaydeh, & Ghazalat, 2018) examined the effect of financial leverage on firm growth using empirical evidence from listed firms in Amman stock exchange. The aim of the study was to determine how the firm's growth factors were affected by the financial leverage, especially in emerging markets like Jordan. Findings from the research indicated that there was an irrelevant relationship between financial leverage and the growth of assets.

Iqbal & Usman, 2018 investigated the relationship between financial leverage and the performance of Textile Composite Companies of Pakistan. Findings from the empirical analysis indicated that there was a negative and significant relationship between financial leverage on return on equity, while there was a positive and significant relationship between financial leverage and return on assets. Kenn, Juliet, & Onyema (2019), studied the effect of financial leverage on the profit growth

of 80 quoted non-financial firms in Nigeria Stock Exchange over the period of 2000 to 2018. The empirical findings reported a positive relationship between total debt to capital ratio, debt to asset ratio and long-term debt to capital ratios whereas a negative relationship between the debt to equity ratio and the cost of debt was reported.

Rafiuddin and Rafiqul (2020), examined firm level characteristics and firm performance (or profitability) of service sector firms listed in the Australian Stock Exchange (ASX), using a panel regression approach on data collected over an eleven-year period (2009–2019), the effect of capital structure and leverage was examined. Four measures of firm performance were used: return on assets, return on equity, operating margin ratio and return on capital employed. The analysis of data revealed a significant association between return on equity and leverage levels.

Nurhinkmawaty and Isnurhadi (2020) conducted a study on the effect of debt ratio (leverage) and return on equity on stock return with dividend policy as intervening variables in subsectors property and real estate on Bei. They investigated the effect of debt to equity ratio and return on equity on stock returns with dividend policy as an intervening variable on the property and real estate companies in Indonesia. Data was collected for eighteen property and real estate companies in Indonesia from the Indonesia Stock Exchange over the period of 2014-2018. Multiple linear regression model was applied using SPSS and the Sobel test. The analysis results found that Debt to Equity Ratio (DER), Return on Equity (ROE), and Dividend Payout Ratio (DPR) have a positive and significant effect on stock returns, both partially and jointly. Furthermore, the result of Sobel test revealed Dividend Payout ratio (DPR) can mediate the relationship of Debt to Equity Ratio (DER) and Return on Equity (ROE) on stock returns. The study concluded that Debt to Equity Ratio (DER) and Return on Equity (ROE) have direct and indirect effects on Stock Return in 18 Indonesia's property and real estate companies.

Senan, Ahmad, Anagreh, Tabash and Al-Homaidi, (2021) investigated the determinants of financial performance, firm liquidity and leverage ratio on the Bombay Stock Exchange. The study focused on balanced panel data for 1,333 Indian companies collected over a 12-year period from 2007 to 2018. The study used both static models (pooled, fixed and random effects) and the Generalized Moment Method (GMM). It is revealed that the current ratio and the quick ratio have a significant impact on the financial leverage of Indian listed firms.

Research Design

Ex-post facto research design was used for this study. Purposive sampling technique was adopted to select the sample size of fourteen (14) quoted industrial goods firms that were continuously listed by Nigerian Exchange Group Limited during the period of January 2010 to December, 2022 and whose

financial statements and reports are available and have been consistently submitted to the Nigerian Exchange Group Limited for the period of study.

Population of the study and Sample Size

The population of the study consisted of all the thirteen quoted industrial goods firms in Nigerian Exchange Group Limited.

The sample size consisted of fourteen (14) quoted industrial goods firms in the Nigeria Exchange Group Limited from January 2010 – December, 2022.

Dependent variable

Stock Returns = $(P_1 - P_0) / P_0$

Where P_0 = Original price of stock

P_1 = Current price of stock

Independent variables

i.   Debt-to-equity ratio = Total Liabilities / Total shareholders' equity

ii. Long-term debt ratio = Long-term debts / Common Stock + Preference Stock.

Model specification.

The mathematical and regression models used for this study are stated as follows:

Financial Performance = f(Financial Leverage)

Financial performance = f(DER,STDR, LTDR, LQD, FSIZ)

Therefore; Stock Returns = f(DER,STDR, LTDR, LQD, FSIZ)

$SRE = \beta_0 + \beta_1 DER + \beta_2 STDR + \beta_3 LTDR + \beta_4 LQD + \beta_5 FSIZ + et$

$SRE_{it} = \beta_0 + \beta_1 DER_{it} + \beta_2 STDR_{it} + \beta_3 LTDR_{it} + \beta_4 LQD_{it} + \beta_5 FSIZ_{it} + et_{it}$

where;

SRE_{it} = Stock Returns of firm i in period it

β_0 = constant term

$\beta_1 - \beta_5$ = Regression coefficients of the independent and control variables.

DER_{it}

$STDR_{it}$

$LTDR_{it}$

LQD_{it}

$FSIZ_{it}$

et_{it} = Error Term of firm i in period t

i = individual firms (1,2,3,4…….,14)

t = time periods (2010, 2011, 2012 …….2022)

CVA_{it} = Cash Value Added of firm i in period t

DER_{it} = Debt - to - Equity Ratio of firm i in period t

$STDR_{it}$ = Short- Term Debt Ratio of firm i in period t

$LTDR_{it}$ = Long-Term Debt Ratio of firm i in period t

Data Presentation and Analysis

Descriptive Statistics of Study Variables

	CVA	DER	STDR	LTDR
Mean	0.124615	1.849231	4.183077	7.133077
Median	0.120000	0.950000	4.560000	7.050000
Maximum	0.160000	5.870000	6.580000	15.150000
Minimum	0.100000	0.110000	1.460000	3.270000
Std. Dev.	0.018081	1.772265	1.521153	3.284259
Skewness	0.416760	1.276022	-0.211286	1.026545
Kurtosis	2.017370	3.164987	2.056191	3.779024
Jarque-Bera	0.899338	3.542582	0.579227	2.611945
Probability	0.637839	0.170113	0.748553	0.270909
Sum	1.620000	24.04000	54.38000	92.73000
Sum sq. Dev	0.003923	37.69109	27.76688	129.4363
Observations	182	182	182	182

Source: E-Views 10.0 output file, 2023

Interpretation

This study considered descriptive statistics (mean, standard deviation, minimum and maximum) for the panels for 182 firm-year observations (that is, 14 firms x 13 years). The above table depicts CVA of an average of 0.1246 with a minimum of 0.1000, a maximum of 0.16000, and a standard deviation of 0.0181. DER was on the average of 1.8492 with a standard deviation of 1.7722, a minimum of 0.1100, and a maximum of 5.870. On average, STDR stood at 4.1830, the minimum STDR stood at 1.4600 while the maximum STDR stood at 6.5800 of the firms under study. Similarly, on LTDR the results showed that on average the mean value is approximately 7.133077, with a standard deviation of 3.2842.

Pearson Correlation Matrix

	CVA	DER	STDR	LTDR
CVA	1.0000			

DER	0.2953	1.0000		
STDR	-0.1687	0.3888	1.0000	
LTDR	-0.2870	0.2545	0.5822	1.0000

Source: E-views 10.0 output, 2023

The Pearson correlation resultant output shows that there is a positive relationship between CVA and

DER (0.2953). On the other hand, CVA negatively correlates with STDR (-0.1687) and

LTDR (-0.2870).

Test of Multicollinearity

Variance Inflation Factors			
Date: 10/06/2023 Time: 13:47			
Sample: 2010 – 2022			
Included observations: 13			
	Coefficient	Uncentered	Centered
Variable	Variance	VIF	VIF
C	0.000247	9.729711	NA
DER	1.03E-05	2.571326	1.179794
STDR	1.98E-05	15.34314	1.669122
LTDR	3.86E-06	9.256172	1.514863

Source: E-Views10.0 output file, 2023

Multicollinearity exists in a model if the Centered VIF is greater than 10 ((Mishra & Alok, 2011).

The above table shows that the variance inflation factors (VIF) for the study variables are less than

10 respectively as revealed by the values of the Centered VIF. This is an indication of the non-

existence of multicollinearity among the variables in the model.

Test of Hypotheses

Ho1: There is no significant relationship between the debt-to-equity ratio and cash

value -added of quoted Industrial goods firms in Nigeria.

Ho2: There is no significant relationship between long-term debt ratio and cash

value- added quoted industrial goods firms in Nigeria.

Panel Least Square Regression Analysis testing the relationship between DER, STDR, LTDR, and CVA.

Dependent variable		
Method: Panel Least Squares		
Date: 10/06/2023. Time: 3:15pm		
Sample: 2010-2022		

Periods included: 13				
Cross-sections included:14				
Total panel observations: 182				
Variable	Coefficient	Std Error	t-statistic	Prob
C	0.149043	0.035704	4.174370	0.0000
DER	-0.240209	0.089194	-2.693097	0.0078
STDR	0.124954	0.026321	4.747238	0.0000
LTDR	-0.169621	0.063447	-2.673418	0.0082
R-squared	0.509148	Mean dependent var		0.136459
Adjusted R-square	0.477551	S.D. dependent var		0.125188
S.E. of regression	0.125659	Akaike info criterion		-1.288751
Sum squared resid	2.810670	Schewarz criterion		-1.218333
Log –likelihood	121.2763	Hannan Quinn criteria		-1.260204
F-statistic	13.47815	Durbin –watson state		1.593007
Prob (F-statistic)	0.000000			

Source: E – views 10.0 output file, 2023

Discussion of Findings

The above table proves that the functional relationship between the dependent and independent variables is:

CVA = 0.149043 - 0.240209 DER + 0.124954 STDR - 0.169621 LTDR.

The implication of the regression model is that a unit increase in DER and LTDR will cause CVA to reduce by 24% and 17% respectively, while a unit increase in STDR will exert a 12% increase in CVA. The beta coefficient of the variables shows that; β_1 is -0.240209; β_2 = 0.124954; β_3 = -0.169621. The slope coefficients indicate that X_1 = 0.0078< 0.05; X_2 = 0.0000< 0.05; X_3 = 0.0082<0.05. This implies that DER and LTDR are negatively and significantly correlated with the CVA of quoted industrial goods firms in Nigeria. On the other hand, a positive and significant relationship exists between STDR and CVA. As evident in table 4.2.1, the adjusted R^2 is 0.477551. This means that approximately 48% of the variations in the sampled firms' CVA can be explained jointly by DER, STDR, and LTDR. The overall regression result with a P-Value = 0.000000 evidenced that DER, STDR, and LTDR exhibit a significant relationship with CVA.

Decision

The regression result with P-value = 0.000000 provides a basis for accepting the alternative hypotheses, which states that Debt-to-Equity Ratio, Short-term Debt Ratio, and Long-term Debt Ratio have a significant relationship with cash value-added of quoted industrial goods firms in Nigeria at 5% level of significance.

Summary of Findings

Based on the analysis of the study, the following findings were made;

i.   There is a significant but negative relationship between debt-to- equity ratio and cash value added of quoted industrial goods firms in Nigeria at 5% level of significance.

ii. There is a significant but negative relationship between long-term debt ratio and cash value added of industrial goods firms in Nigeria at 5% level of significance.

Conclusion

The study assessed the relationship between financial leverage and financial performance of quoted industrial goods firms in Nigeria Exchange Group Limited for period of thirteen years from 2010-2022. The independent variable (financial leverage) was proxied by Debt-to-Equity Ratio, and Long-Term Debt Ratio. While the dependent variable (financial performance) was proxied by Cash Value Added. The study obtained data from the annual reports and account and publications of fourteen (14) industrial goods firms that operated from 2010-2022. With the aid of E-view 10.0, inferential statistics using Pearson Correlation Coefficient, multicollinearity test and Panel Least Square regression analysis were used.

The study revealed that Debt –to- Equity Ratio and Long Term Debt Ratio have a negative significant relationship with cash value Added of quoted industrial goods firms in Nigeria at 5% level of significance.

Recommendations

Based on the findings of the study, the following recommendations were made.

i.   In an attempt to reverse the negative relationship between debt –to- equity ratio and cash value added, firms need to look more closely at the company's ability to pay its debts obligations by managing the use of assets and cash flows to reduce the firms risk of loss from not paying a liability on time.

ii. In order to reverse the negative relationship between Long term debt ratio and cash value added, industrial goods firms should employ financing mix that can improve their earing per share, market capitalization and enhance the value of the firm for the benefit of the shareholders.

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