Effect of Financial Leverage on Firm’s Market Value Creation in Bangladesh: A Comparison between MNCs and Domestic Firms

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ABSTRACT

This article contends that a firm’s performance is affected by various factors and capital structure is one of the factors among them. The basic objective of the research is to analyze and compare the impact of financial leverage on firms’ Market to Book Value (MV/BV) and Tobin’s Q ratio of DSE-listed MNCs & domestic firms of Bangladesh over a 20-year period (1996-2015). Explained variables are Market to Book Value (MV/BV) and Tobin’s Q ratio. Explanatory variables of the interest are indicators of six financial leverage ratios. MV/BV is negatively related with leverage ratios of both types of companies. Domestic companies’ MV/BV decreases by 0.016 times for 1% increase of debt ratio while MNCs’ MV/BV decreases by 0.048 times for 1% increase of debt-equity ratio and vice-versa. With debt-equity ratio, domestic companies’ Tobin’s Q is positively related while that of MNCs is negatively related.

KEYWORDS

Book, Capital, Debt, Equity, Leverage, Market, Structure, Value

INTRODUCTION

An appropriate financial structure is a critical decision for any business organization and this decision is very important not just because of its need to maximize shareholder’s wealth or increase the market value of companies but also because of the impact such decision has on the company’s ability to deal with the competitive environment through satisfactory financial performance. The prime objective of this decision is to keep the cost of finance at the minimum with maximum utilization of funds, in order to maximize profit. Capital structure is very important decision for firms as it can maximize returns to their various stakeholders. The global financial crisis that has hit the world economy during year 2007-08 has brought the most significant economic recession. Giant corporations like Lehman Brothers, Merrill Lynch, AIG, HBOS, Royal Bank of Scotland, Bradford & Bingley, Fortis, Hypo Real Estate, Alliance & Leicester etc. went bankrupt during this period and a significant reason behind the bankruptcy was excessive use of debt capital or borrowing. Over the years borrowed capital has gained importance the level of its usage has increased. In Kenya, Aaccording to Mayer (1988), debt financing by corporate firms is about 90% of external financing. The study of Githaiga and Kabiru (2015) revealed that short term loan and long-term loans had negative impact on financial performance of SMEs of Kenya. Yazdanfar and Öhman (2015) found that debt ratios, short-term debt and long-term debt, negatively affect firm performance in terms of profitability of Swedish firms. To gain advantages of tax shield and higher earnings per share many companies raise too much debt capital which is detrimental to their good performance and survival. Excessive use of debt capital leads to financial distress and excessive use of equity capital leads to poor financial performance and low company value.

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LITERATURE REVIEW

Modigliani and Miller (1958) were the first ones to landmark the topic of capital structure and they argued that capital structure was irrelevant in determining the firm’s value. Lubatkin and Chatterjee (1994) have proved that there exists a relationship between capital structure and firm value. Rajan and Zingales (1995) as well as Fama and French also (1998) found that there was negative relationship between debt and financial achievement. Champion (1999) found positive association between leverage and firm performance. Booth et al., (2001) in their study found that in the developing countries, the profitability of a firm has a consistently negative relationship with financial leverage. Siddiqui and Rahman (2002) in their study attempted to present a comparison of capital structures between MNCs and local blue chip companies enlisted with the DSE. The results indicated that the capital structures of the firms depend on the industry within which they operate. Islam and Islam (2003) had studied on the linkage between capital structure and profitability of North Bengal Paper Mills Limited. The unfavorable debt-equity ratio had adversely affected the profitability of the mill measured in terms of ROCE and ROI. Uddin, Hossain and Abdullah (2004) had undertaken a research on capital structure of DSE listed companies. The aim of their study was to analyze the effect of DAR (Debt to Asset Ratio) on risk and return of shareholders’ stock. They found that DAR had insignificant positive correlation with the average stock returns. Zeitun and Tian (2007) as well as Abor (2007) indicated that firm performance is negatively related to capital structure.

Chowdhury and Chowdhury (2010) conducted research study to analyze the impact of capital structure on the value of Bangladeshi firms. A strong positively correlated association between stock price and leverage ratio was evident. According to Apergis and Sorros (2010), firms with few growth options are large and have more long-term debt in their capital structure. Research work of Islam, Rahman and Khan (2011) revealed that, profitability and risk played significant role in explaining the capital structure of cement industry in Bangladesh. Lima (2011) had conducted a research work on the determinants of capital structure of pharmaceutical companies in Bangladesh. Important observation of this study was that pecking order theory helps describe the capital pattern of the pharmaceutical companies. Sayeed (2011) found that agency costs are negatively affecting the total debt ratios of Bangladeshi companies. Tax rate is having positive impact only for long term debt and non-debt tax shields are negatively impacting on total debt ratio. Antwi, Mills and Zhao (2012) in their study sought to provide evidence on the impact of capital structure on a firm’s value of Ghana. The result of the study revealed that in an emerging economy like Ghana, equity capital as a component of capital structure was relevant to the value of a firm. Maxwell and Emeni (2012) in their study revealed that in an emerging economy like Nigeria, using more of long-term debt than equity capital in financing their operations was resulted in a positive firm value. Salteh et al., (2012) in their study investigated the impact of capital structure on Tehran Stock Exchange–listed firms’ performance. The results indicated that firm performance, which is measured by ROE, MBVR (Market to Book Value ratio) & Tobin’s Q is significantly and positively associated with capital structure. Moghadas, Pouraghajian and Bazugir (2013) in their paper indicated that there was a meaningful relationship between capital structure and firm value of Iran. Muscettola (2013) in his work revealed a significantly positive relationship between borrowed capital and probability of default. Barakat (2014) in his study aimed to investigate the effect of financial structure, financial leverage and profitability on industrial company’s value. He concluded that there is statistically significant direct relationship between two independent variables: return on equity and capital structure and the dependent variable represented by stock market price. Hasan, Ahsan, Rahaman & Alam (2014) in their study investigated the influence of capital structure on firm’s performance. They found that EPS is significantly positively related to short term debt while significantly negatively related to long term debt. Rouf (2015) showed that Debt Ratio and Debt Equity Ratio are negatively and significant relationship with return on asset and return on sales of non-financial firms of Bangladesh.
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