

Impact of Financial Leverage on Financial Performance: Special Reference to John Keells Holdings plc in Sri Lanka

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Abstract- A general concept prevails that the financial leverage is helpful to enhance the financial performance of the companies. For measuring the impact of financial leverage on the financial health of the companies, it is essential to know whether a positive relationship exists between financial leverage and financial performance or not? So, this study is intended to test the hypothesis and to measure a relationship between the financial leverage and the financial performance of the John Keells Holdings plc in Sri Lanka during the periods of 2006-2012. The findings of the study show a negative relationship between the financial leverage and the financial performance of the John Keells Holdings plc. But the financial leverage has a significant impact on the financial performance of the John Keells Holdings plc in Sri Lanka.

Keywords— Financial Leverage, Financial Performance.

I. INTRODUCTION

This study attempt to analyze the Impact of financial leverage on the financial performance of the John Keells Holdings plc in Sri Lanka (During the periods 2006-2012). Financial Leverage can be defined as the degree to which a company uses fixed-income securities such as debt and preferred equity. With a high degree of financial leverage come high interest payments. As a result, the bottom-line earnings per share is negatively affected by interest payments. As interest payments increase as a result of increased financial leverage, EPS is driven lower. As mentioned previously, financial risk is the risk to the stockholders that is caused by an increase in debt and preferred equities in a company's capital structure. As a company increases debt and preferred equities, interest payments increase, reducing EPS. As a result, risk to stockholder return is increased. A company should keep its optimal capital structure in mind when making financing decisions to ensure any increase in debt and preferred equity increase the value of the company. Strength of financial position of an organization is called financial performance. Financial analysis is the process of identifying the financial strength & weakness of the firm by properly establishing relationship between the item of the balance sheet and the profit & loss account. In financial analysis a ratio is used as a key measure for evaluating the financial position & performance of a firm. In this study Net profit, Return on

capital employed and the return on equity are used to measure the financial performance of John Keells Holdings plc in Sri Lanka (During the periods 2006-2012)

II. BACKGROUND OF THE COMPANY

John Keells Holdings plc (JKH) is the largest listed company on the Colombo Stock Exchange, with a business interests primarily in Transportation, Leisure, Property, Consumer Foods & Retail, Financial services and Information technology among others. Started in early 1870 s as a produce and exchange broking business by two Englishmen, Edwin and George John, the Group has been known to constantly re-align, re-position and re-invent itself in pursuing growth sectors of the time. JKH was incorporated as a public limited liability company in 1979 and obtained a listing on the Colombo Stock Exchange in 1985. Having issued Global Depository Receipts (GDRs) which were listed on the Luxemburg Stock Exchange, JKH became the first Sri Lankan company to be listed overseas. The Group's investment philosophy is based on a positive outlook, bold approach, commitment to delivery and flexibility to change. JKH is also committed to maintaining integrity, ethical dealings, sustainable development and greater social responsibility in a multi-stakeholder context. JKH is a full member of the World Economic Forum and a participant of the United Nations Global Compact Initiative. The holding company of the group – John Keells Holdings plc is based at 130, Glennie Street, Colombo 02 and the group has significant operations and business across Sri Lanka, India and Maldives.

III. OBJECTIVES OF THE STUDY

This study attempt to achieve the following objectives;

- To find out interrelationship between Financial leverage and financial performance of the John Keells Holdings plc in Sri Lanka.
- To find out the impact of Financial leverage on the Financial performance of the John Keells Holding plc in Sri Lanka.

IV. LITERATURE REVIEW

Experimental evidence is much more reliable as naturalistic observations are vulnerable to researcher bias. In this context, According to the Smith (2002), Leverage can be explained as the use of borrowed money to make an investment and return on that investment. It is more risky for a company to have a high ratio of financial leverage.

The stock leverage can be defined as the ratio of total liabilities to total assets. It can be seen as alternative for the residual claim of equity holders. However, the stock leverage may not be a healthy indicator in terms of identifying the firms default risk in near future (Rajan; Zingales, 1995). The earnings are independently and identically distributed, so the multi period earnings and leverage relationship is examined by Barnea, Haugen, and Talmo (1987). In their point of view adequate earnings causes brings losses for tax benefits as Raymar (1991) find that the leverage increases with the ration of operating earnings to value. According to Barnea, Haugen, and Talmo (1987), the leverage to risk relationship is dependent upon the economy-wide pricing variables while Raymar(1991) comes across the result that optimal leverage generally decreases with business risk. The diminished future debt usage implies smaller terminal firm value (Haugen; Senbet,1998). They further elaborate that the default acts as deterrent to leverage in their model, and default occurs primarily ue to a depressed value of the firm, Sensitivity of firm's earnings is paramount in the determination of the debt optimum. Thus, stable (low sensitivity of firm's earnings) firm with high earnings risk may be highly levered. If earnings processes are heterogeneous (wither as reflected by sensitivity of firm's earnings or in a general sense). Simple earnings variability measures would not adequately capture the relation between a firm's business risk and its use of debt. The free cash flow indicators identified in literature are observed as low levels of financial leverage, inadequate valuable investment opportunities; considerable and sustainable cash flows; and high level of diversification (Jenson, 1986). While in view of Gibbs (1993) no relationship exists with investment opportunity and initial financial leverage. Management has incentives to minimize the liquidation risks of the companies. Moreover, the management may option to avoid the corrective action of the capital market by financing unprofitable projects internally with retained earnings. This too has the effect of reducing leverage. Thus we can infer that such action of management may reduce the risk if the firm by reducing leverage and so the returns as result. The author further explains that with decreasing board power, the management may tend to be stable and in a position to resist takeover. Decreasing values of leverage and investment opportunity are expected to increase likelihood of the capital structure reforms due to take over threat. The ultimate findings of the author reveal that the degree of operating leverage (Mandelker,G.N;and S.G.Rhee, 1984) also determines the capital structure mix, as firm then exposed to industry influence at some scale and those having higher degree of operating leverage may have less debt percentage and vice versa. In an empirical study (Hatfield, Cheng, Davidson, 1994) of high debt and low debt firms belonging from the same industry, the results shown that in opposition of the perception of market decision of granting finances by comparing firm's leverage ratio with the industry average has been proved to reverse case. Ferri; Jones (1979) has observed

the relationship between leverage and size of the firm as it is a general perception that the likelihood of larger

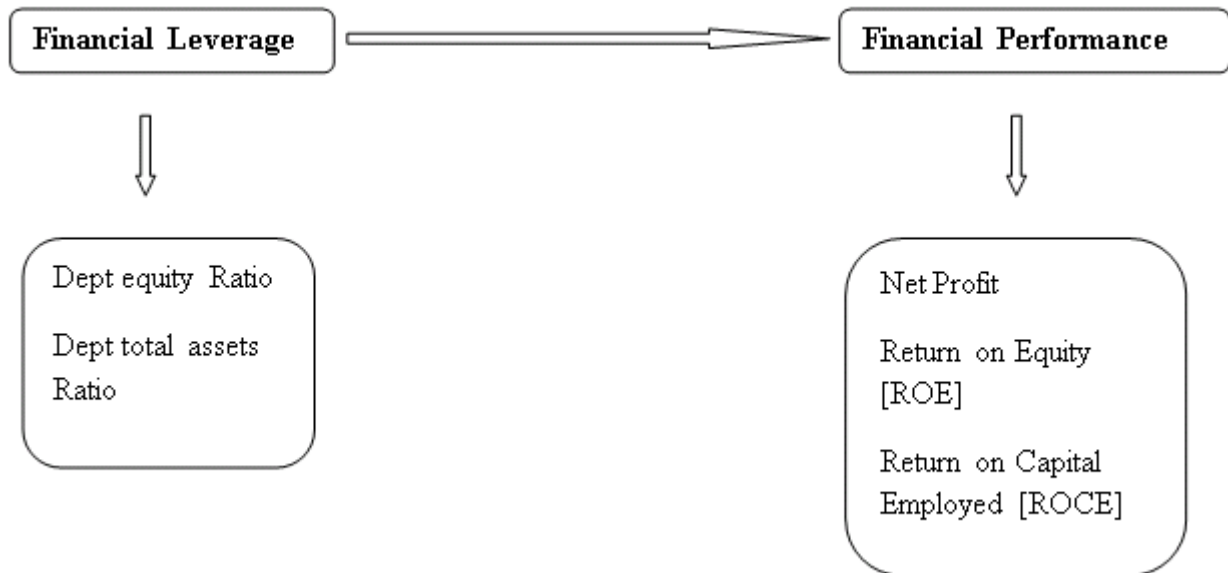
Firms to be diversified is more, as they can access to the capital market easily, may benefit from the higher credit ratings for issue of debt, and lower interest rates on external financing. It reveals' that leverage may enhance the profit after tax due to lower interest rates and ultimately the higher earnings may result in the highest EPS or dividend payout ratios which may increase the firm's performance. Even if the marginal earnings as the result of lower interest rates and tax shields are retained for the company's growth, it may maximize the company's value in long term and may lead towards the achievement of wealth maximization objective for which the real owners invest. So the author found the relationship between the size of the firm and leverage class. Modigliani and Miller (1958) support this verdict , that financial leverage and firm value have insignificant relationship while it exists only when those operate in taxable environment call for tax payments affecting capital structure. J. Fred Weston (1989) comments on MM's propositions which state that equilibrium in a perfect capital market requires that the market value of a firm not be changed by its financing decisions and the required return on equity will raise (linearly) with financial leverage. There is an inverse relationship among profitability change and leverage change in short run provided with the fixed dividends and investments where the dominant mode of external financing is debt. It has been observed that large firms are inclined to issue less equity. With the increase in firm size, the negative effect of profitability on leverage should be stronger but if the smaller firms are provide with investment opportunities, it may diminish correlation of profitability & leverage by larger equity issuance (Rajan; Zingales, 1995). Harris and Raviv (1991) provided that there are corresponding leverage ratios commonly accepted by the firm in a given industry whereas leverage ratios vary across industries. When the firms increase their leverage, shareholders' bid for common shares with low market value and less dividend than the value at liquidation and fixed dividend offered on preferred stock. Thus, the net effect on the firm is to increase its fixed obligations. In researcher's opinion it may lead to the greater creditors' influence and the representation in the board of directors of the company which may lead the management to take risky projects for the company to maximize the returns as returns are the function of proportionate risks. Moreover as the common shareholder have a vote per share, so the voting rights of equity holders may decline who intent to participate in the offer (Pinegar; Lease,1986).

According to Masulis'(1983) and DeAngelo and Masulis'(1980) assumption that a firm may question and optimal level of debt that it could have may increase or diminish its value and may move push towards industry average. Firms efforts to work out optimal capital structure (DeAngelo and Masulis, 1980) is determined by various agency costs bankruptcy or tax gain on losses from leverage usage, compensating for other tax shield instruments of depletion, depreciation, amortization and investments tax credits. Another research conducted by Hamada (1972), found the relationship of equity cost and leverage of firms across industries. More variations were observed for the firms using leverage than that performing unlevered capital structure. A study by Hall and Leonard Weiss (1967) explained the

presence of significant relationship of greter equity /dept ration with profitability, but also an influence of reducing risk, resulting in an increased profitability is observed. According to Louis, Cheng and Davidson (1994) the market response to the dept announcements may be affected by growth rate of firm. The firm with high growth rate may absorb the increased financial leverage as it may have ability to pay incremental interest expense and vice versa.

V. CONCEPTUALISATION

The research design choice of this study is analytical, which focuses on the financial leverage on financial performance of the John Keells Holdings plc in Sri Lanka (During the periods 2006-2012). In this study financial performance assumed as dependent variables its depend on the financial leverage of the firm. Based on that conceptual frame work is prepared by the researcher.



Based on the above conceptual frame work the operationalization variables could be shown below.

Conceptual Frame Work

Concept	Variable	Indicator	Measurement
Leverage	Financial Leverage	Dept equity ratio	$\frac{\text{Dept}}{\text{Equity}} \times 100$
		Dept total assets ratio	$\frac{\text{Dept}}{\text{Total Assets}} \times 100$
Financial Performance	Net profit	Net profit based on sales	$\frac{\text{Net profit}}{\text{Sales}} \times 100$
	ROE	Profit based on Equity	$\frac{\text{Profit after tax}}{\text{Share Holders Capital}} \times 100$
	ROCE	Profit based on investment	$\frac{\text{Profit before interest and tax}}{\text{Capital employed}} \times 100$

This operationalization frame work also describes the indicators selected for testing on each variable and what are the decided measurement for each indicator.

VI. HYPOTHESIS OF THIS STUDY

This research has also some hypotheses relating to the financial leveraging on firm performance of the organization. This research also conducted based on the centralized hypotheses. The prescribed hypotheses formed for this particular research are as follows.

H1: There is a significant positive relationship between Financial leverage and financial performance of John Keells Holdings plc Sri Lanka.

H2: The financial leverage has a significant impact on financial performance of John Keells Holdings plc Sri Lanka.

VII. METHODOLOGY

Data Collection and Data analysis method

This research to be conducted is a quantitative research study among different variables. The core data for the research will be collected by using the relevant annual reports (2006 -2012) of the John Keells Holdings plc in Sri Lanka and it would help in gaining authentic results.

VIII. FINDINGS AND DISCUSSION

Correlation analysis

For the purpose of identifying the pattern of relationship between Financial leverage and firm performance, correlation analysis has been used.

Table: 2 Correlation Output

		Financial Performance	Financial Leverage
Financial_Performance	Pearson Correlation	1	-.789*
	Sig. (2-tailed)		.035
	N	7	7
Financial_Leverage	Pearson Correlation	-.789*	1
	Sig. (2-tailed)	.035	
	N	7	7

*. Correlation is significant at the 0.05 level (2-tailed).

According to the correlation output (Table : 2), which is indicate there is strong negative relationship (-.789) between the financial performance and financial leverage, at 0.05 significant level. This reveals financial leverage negatively correlate with financial performance of the John Keells Holdings plc during the period of 2006-2012. So the **H1** is rejected by the researcher.

Regression analysis

Regression analysis is used to predict the value of one variable on the basis of other variables. In this study the researcher has analyzed the impact of financial leverage on the firm financial performance.

Table: 3 Model Summary

Model Summary

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
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1	.789 ^a	.623	.548	1.03340
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a. Predictors: (Constant), Financial_Leverage

Table: 4 ANOVA Test in the Regression analysis

ANOVA^b

Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	8.829	1	8.829	8.267	.035 ^a
	Residual	5.340	5	1.068		
	Total	14.169	6			

a. Predictors: (Constant), Financial_Leverage

b. Dependent Variable: Financial_Performance

Table: 5 Coefficient in the Regression analysis.

Coefficients^a

Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.
		B	Std. Error	Beta		
1	(Constant)	17.780	1.660		10.711	.000
	Financial_Leverage	-.199	.069	-.789	-2.875	.035

a. Dependent Variable: Financial_Performance

Based on the model summary (Table: 3) the Adjusted R square is 0.548 it means that 54.8% of the firm's financial performance influenced by the financial leverage The remaining 45.2% is influenced by other factors which are not describe here, because this is beyond the scope of study. From the ANOVA test (Table :4) the significant level is at 0.035 which is less than the significant level 5% so researcher

concluded that the 54.8% of the impact is significant. So the H2 is accepted.

From the coefficient test (Table: 5) the regression equation could be derived in the following manner $Y = 17.780 - 0.199X$ The b value is -0.199, this reveals that Financial leverage and financial performance tends to move in opposite direction.

Hypotheses testing

Hypotheses	Results	Tools
H1: There is a significant positive relationship between Financial leverage and financial performance of John Keells Holdings plc Sri Lanka.	Rejected	Correlation Analysis.
H2: The financial leverage has a significant impact on financial performance of John Keells Holdings plc Sri Lanka.	Accepted	Regression Analysis

IX. CONCLUSION

The findings of the study by saying that the financial leverage has got a negative relationship with financial performance of John Keells Holdings plc Sri Lanka during the periods 2006 - 2012. But financial leverage has significant impact on financial performance. Similarly the findings support the work of Higgins (1972) and McCabe (1979) who suggested that debt has a negative influence o the amount of dividend paid. This is because firms with higher fixed charges pay lower dividends in order to avoid the costs of external finance. This study also closer to Pakistani researchers that is,

Nishat (1992) who had checked the relationship of leverage with stock returns and return volatility. He was in the view that the leverage at industry level has been historically high in Pakistan and he checked the relationship of leverage and returns. His findings were that there is negatively and significant relationship between return and volatility change. In most cases, highly levered industries had a stronger negative relationship between return and volatility change than the less levered industries. The employment of debt in the capital structure of the companies may make a negative impact on the performance. The John Keells Holdings plc in Sri Lanka is requested to minimize the debt capital in their

capital structure in order to maximize their financial performance in future.

X. RECOMMENDATION FOR FUTURE RESEARCHERS

This research has been done in only one company. So Future researchers to be carried out by analyzing individual company's performance and making a comparison with the whole industry by using the industry performance as bench marks. Further recommended to study about How the firm's stock value is influenced by using the different levels of leverage and how companies lying in such sector or the industry players can achieve the sustainable growth by implying the leverage concept.

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