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Moderating Impact of Foreign Financing, Government Ownership, Firm Liquidity and Size on Leverage - Performance relationship : An Indian Evidence

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Abstract

Research is ambivalent on the impact of leverage on performance. The present study revisits this relationship to discover possible reasons for it by examining the moderating role of firm characteristics such as foreign financing, government ownership, firm liquidity and firm size, which individually are empirically known to be determinants of capital structure and performance.The analysis is based on 17 years financial data of non-financial BSE 500 firms from 2000 to 2016. Leverage was found to have significant negative impact on firm performance, measured by ROA and RONW. However, this relationship was found to be positively moderated by firm characteristics under study. The study also provides insights into the reasons for the moderating impact of these firm characteristics; foreign financing reduces the overall cost of funds, government ownership offers implicit loan guarantee, high liquidity improves debt service capacity and bigger firm size warrants better access to capital markets on better terms.

I. Introduction

CAPITAL STRUCTURE DECISIONS play a vital role in affecting the cash flows, earning per share, share price, risk complexion, flexibility, control, growth and survival of the firm. In addition, the capital structure acts as a signalling device whereby debt is issued to those firms which are less vulnerable to default and display high quality financials. In contrast, well-established capital structure theories such as pecking order theory and market timing theory suggest that firm performance affects the capital structure. This study examines the impact of leverage on firm performance in view of this observed two way causal relationship by using instrumental variable approach. This study adds to the literature by examining the moderating

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has. The negative impact of leverage on performance of firms with government stake was found to be positively moderated by foreign financing and liquidity. As conjectured earlier, liquidity was found to positively and significantly moderate leverage-performance relationship for firms which do not have government stake. Foreign debt positively moderates leverage performance relationship of highly liquid firms. This could possibly be because the high debt service capacity of such firms enables them to take advantage of lower interest rates, improved visibility, global presence and improved investor and customer confidence which eventually leads to improved firm performance. In case of big size firms, moderating influence of liquidity is much stronger than that of foreign financing and government stake on leverage performance relationship.

Thus, leverage as a means of enhancing performance is likely to be more beneficial for large firms. Besides, the findings have yet another important policy implication for capital structure planning. The firms should ensure necessary liquidity/cash flows to take advantage of leverage, for its owners. Foreign financing and government financing could also be considered in the process of capital structure decision making to maximise the wealth of shareholders.

VI. Limitation and Future Scope

Although there could be more number of variables that have a moderating impact on leverage-performance relationship, the present study only analyses 5 of them. Future research could also focus on economy level factors such as GDP growth, economic cycle, or firm specific factors such as imports and exports, group affiliation as moderating variables of leverage-performance relationship. Second, the present study could only show the impact of 2 moderators at once. The future study could also show the moderating role of presence of several moderating factors simultaneously. Third, this study is based on non-financial BSE 500 firms. A more detailed analysis could be undertaken by incorporating more listed firms of India or more listed firms from other countries. Fourth, the study analyses 17 years data from 2000 to 2016. The leverage-performance relationship is dynamic and therefore likely to change with change in data period. So, the future research could increase the time span of study.

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